EUROPEAN CENTRAL BANK
EUROSYSTEM

Occasional Paper Series

Ad van Riet

Safeguarding the euro as a currency beyond the state

No 173 / May 2016

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Abstract

This paper reviews the debate on the longer-term requirements for safeguarding the euro as a currency beyond the state that is anchored through collective governance instead of a central government. The strengthening of EU economic and financial governance in the wake of the euro area crisis goes a long way towards creating the minimum conditions for a more perfect EMU. At the same time, the current principle of nation states coordinating their sovereignty to 'do whatever is required' to stabilise the euro area as a whole rather than sharing their sovereignty in common institutions to achieve this common objective has its limitations. Challenges in this context relate inter alia to the effectiveness of market discipline and reinforced economic policy surveillance, the requirement of a truly single financial system, the demand for eurobonds and a euro area fiscal capacity, and the transnational democracy that should legitimate EMU decision-making based on common values. To safeguard the euro as a currency beyond the state, euro area countries should consider pooling their national sovereignty over a wider range of EMU-related policy areas, as necessary to achieve more effective risk control and more efficient risk sharing.

JEL codes: E4, E6, F15, F33

Key words: national sovereignty, collective governance, euro area stability

Executive summary

Following the euro area crisis, commentators have expressed a continuum of views on the future of the single currency. Some suggest abolishing the euro, letting member countries return to their national currencies and make a new start. Others propose pooling the functions that are necessary for a more perfect monetary union, drawing on the lessons from the crisis. Yet another group argues in favour of making a quantum leap to a single currency embedded in supranational political institutions.

As the crisis pressure has subsided, many governments seem to be satisfied for the time being with an incomplete Economic and Monetary Union (EMU) that allows them to largely preserve their sovereignty in economic and fiscal matters. This paper reviews the ongoing debate and addresses the question of whether the status quo of nation states coordinating their sovereignty rather than sharing their sovereignty is sufficient to safeguard the euro as a currency beyond the state.

Since the Treaty of Rome of 1957 – which laid the foundations for the European Economic Community – the process of economic and monetary integration has served as a means of advancing towards the political objective of an 'ever closer union'. The launch of the euro in 1999 was regarded as an intermediate goal on this road. Long before the Maastricht Treaty of 1992, that defined the architecture of EMU, the question arose of how much political integration a sustainable monetary union required. Does a single currency for Europe also need a federal state behind it, since the power to issue money is traditionally an attribute of sovereignty? Or alternatively, can it develop purely out of market principles because it facilitates commerce and minimises the costs of trade in the internal market? Or should one consider the single currency as unifying a single sovereign and a single market?

The euro was created as a currency without a state: the founding members decided to confer their monetary policy sovereignty to the European Central Bank (ECB) with an independent mandate to maintain price stability for the euro area as a whole while retaining their sovereign powers for all non-monetary policies (other than in the field of competition law where more centralisation was required for the proper functioning of the internal market). To a large extent they also kept national control over financial regulation and prudential supervision. Further political integration, although seriously debated at the time, was relegated to the future. Accordingly, the euro became a *denationalised* currency, grounded in the society of its member states, as well as a *depoliticised* currency, with its internal and external stability to be maintained by the independent ECB.

This unique constellation left the long-term political vision of the eurozone unclear. The rejection of the Treaty establishing a Constitution for Europe, in spring 2005, implied that the ultimate goal of building a sort of federal state moved out of sight. The Lisbon Treaty that was adopted in its place in 2007 instead sees the European Union (EU) institutions and the eurozone countries as the joint sovereign behind the euro. This perspective has turned it into a currency beyond the state, whereby statehood remains national but sovereignty is shared in areas of vital importance for

the proper functioning of EMU. But the key question to be answered remains: what is the right balance of economic, monetary and political integration for the eurozone?

During the first 10 years of EMU all member countries appeared to enjoy favourable economic developments and higher prosperity. But as the structural transformation of some economies was slow, this episode also saw increasing macroeconomic imbalances, a build-up of fiscal vulnerabilities and growing systemic financial risks in several participating countries. The global financial crisis of 2008 exposed these weaknesses, leading to a crisis of confidence in the euro. Looking back, the euro area crisis revealed three main fault lines in the design of EMU:

1. The EU economic governance framework that relies on a monitoring of fiscal stability and structural reform programmes, country-specific recommendations and peer pressure to support compliance with the common rules of behaviour was hardly effective in preventing and correcting diverging macroeconomic policies, in an environment of unexpectedly weak market discipline.

2. A European Banking Union to supervise the rapidly growing cross-border banks according to a single set of rules, provide unified retail deposit insurance, and if necessary, resolve troubled banks at the supranational level was badly missing. The same was also true of a common macroprudential policy framework.

3. There were no common fiscal tools to adress cyclical disturbances at the euro area level, assist member countries in dealing with large asymmetric economic shocks, or to support them in managing and resolving a sovereign debt crisis in a situation where their participation in the euro was irrevocable and the Maastricht Treaty excluded a bail-out.

Recognising that they have a common responsibility for the proper functioning of EMU, European leaders and institutions have taken many vital steps to put in place an enhanced EU economic and financial governance framework. This integration has resulted, in particular, in a reinforced surveillance of national macroeconomic, fiscal and financial policies, a permanent common fiscal backstop, the main pillars of a European Banking Union and the initiative of a Capital Markets Union. Separately, the Eurosystem expressed a strong commitment to stand guard against the ‘tail risk’ of a break-up of the euro arising in national sovereign bond markets, acting within its monetary policy mandate and subject to strict conditions.

These comprehensive policy actions demonstrated the willingness of European leaders and institutions to ‘do whatever is required’ to ensure the (financial) stability of the euro area as a whole. Their strong commitment confirmed that the euro has been transformed from a currency without a state (whereby the EU institutions and all member countries are individually responsible for its integrity and stability) into a currency beyond the state (for which all policy actors assume a joint responsibility). The result is a ‘more perfect EMU’, based on collective governance.

Several observers have argued that the architecture of EMU must be developed further in order to secure the stability of the euro as a currency beyond the state. This reflects a belief that the current principle of nation states coordinating rather

than sharing their sovereignty has its limitations. To guarantee the future integrity and stability of EMU at least seven challenges will need to be addressed:

1. EMU is vulnerable to non-compliance with the common rules of behaviour by one or more of its members. Managing this risk demands stronger market-led incentives, complemented by central steering and intervention powers if needed to align national economic policies with euro area requirements.

2. EMU requires a single financial system. A healthy, integrated financial sector is essential for market-based risk sharing, an effective monetary transmission and for financial stability in the whole euro area. Completion of the Capital Markets Union and the European Banking Union should therefore be a high priority.

3. EMU lacks a single sovereign asset that functions as the cornerstone of a stable and truly single euro area financial system and that supports financial integration. Eurobonds are only foreseen after full fiscal integration. The proposed transitional solution of 'synthetic' eurobonds created out of a portfolio of national government bonds requires flanking measures to control moral hazard.

4. EMU would benefit from a common fiscal capacity with the mandate to stabilise the euro area economy and offer a conditional central insurance for countries hit by large asymmetric shocks.This would make it easier both to ensure an adequate euro area policy mix and to avoid undue economic divergences.

5. Conflicting national interests might complicate the effective operation of the European Stabilisation Mechanism (ESM). This common fiscal backstop for troubled sovereigns and systemic banks could operate more credibly with the required speed if it was anchored in the EU Treaties and could be activated by a central fiscal authority that is able to generate sufficient stabilisation funds.

6. The credibilty of the no bail-out rule of the Maastricht Treaty has been impaired. To restore it one could investigate introducing formal sovereign debt reprofiling and restructuring mechanisms, which are to be activated before access to ESM facilities is granted. This would signal that as a rule private creditors will be asked to complement official assistance to a government facing a fiscal crisis.

7. Collective euro area decisions must respond to shared beliefs that support the euro. The political commitment to 'do whatever is required' to maintain the (financial) stability of the euro area as a whole could serve as a new common value that legitimises deeper political integration based on transnational democratic principles, in particular for decisions related to EMU matters.

These seven challenges suggest that continued coordination of national sovereignty in a number of key policy areas is likely to constrain the efficiency and effectiveness of crisis prevention, management and resolution in EMU. To safeguard the euro as a currency beyond the state, euro area countries should consider a further pooling of national sovereignty so as to achieve a more adequate level of risk control and risk sharing, subject to democratic legitimacy of the common euro area institutions.

1 Introduction

The euro area has advanced a long way as a monetary union. … But we have not yet advanced far enough to put all questions about our future to bed. We need to remove those lingering doubts that resurface whenever a shock hits. And to do so we have to accelerate both our economic and institutional convergence.
Draghi (2015)

The euro is regarded as one of the most positive achievements of the "ever closer union among the peoples of Europe" foreseen in the Treaty of Rome that was signed in 1957, almost 60 years ago.[1] The single currency was launched on 1 January 1999 and membership of the Economic and Monetary Union (EMU) increased from 11 Member States of the European Union (EU) at its birth to 19 at the start of 2015. Although there were a few episodes of moderate tensions, during the first 10 years the euro was perceived as "a resounding success" (European Commission, 2008, p.3). All member countries appeared to enjoy trade expansion, output growth, employment creation and higher prosperity, albeit less than some observers had initially expected (European Central Bank, 2008). However, as the structural transformation of some economies was slow, macroeconomic imbalances, fiscal vulnerabilities and systemic financial risks were meanwhile growing (see also the early analysis in Posen (ed.), 2005).

Following the bankruptcy of Lehman Brothers in September 2008, the subsequent years saw the successive unfolding of a financial crisis, an economic crisis and a sovereign debt crisis which undermined public confidence and threatened the very existence of the euro (Mongelli and van Riet, 2013). This triple crisis acted as a wake-up call and a catalyst for change (Mongelli, 2013). European leaders repeatedly showed their political commitment to "do whatever is required" to sustain financial stability for the euro area as a whole. In addition, the ECB President committed to "do whatever it takes to preserve the euro", within the Eurosystem's mandate. While many reforms of EU governance were undertaken and market volatility has since abated, European leaders still have to address the question of how to safeguard the euro in the longer term.

Several observers argue that the euro now stands at a crossroads of two alternative choices: to go back to the beginning or to jump ahead. Some suggest abolishing the euro to allow member countries to return to their currencies and make a new start on a more durable, democratic basis (Heisbourg, 2013). Others argue that the triple crisis has shown the fault lines in the initial institutional design of EMU, pointing out that the euro was created as a 'fair weather' currency without a central government behind it to enforce sound national policies and combat a major euro area crisis (see for example the essays in Baldwin and Giavazzi (eds.), 2015).

[1] According to the Standard Eurobarometer 84 Survey of Autumn 2015, for Europeans the most positive results of the EU are "peace among the Member States of the EU" and "the free movement of people, goods and services within the EU". Having "the euro" takes the third position in the survey.

Many leading economists propose to fix the shortcomings of the eurozone and take further steps in the direction of a “normal monetary union” in which sharing of more sovereignty is paired with sharing of more risks via both private and public channels (Baldwin and Giavazzi (eds.), 2016). To restore confidence in the single currency, Bergsten and Kirkegaard (2012) urge its political leaders to complete the euro’s half-built house “as far as possible as soon as possible”. This requires a firm political commitment to substantially deepen euro area integration and transfer national sovereignty in key policy areas to the supranational level. De Grauwe (2016) and McNamara (2015) stress in this regard that the euro will only survive by embedding it in more robust European political institutions.

As this quantum leap in the long-term process of creating the 'ever closer union' initiated by the Treaty of Rome has repeatedly run into political resistance and the alternative of breaking up the euro would be very costly, many commentators instead favour pragmatic intermediate solutions. They suggest reducing the level of ambition regarding euro area political integration and focusing on making EMU work in an environment where national sovereignty in particular over economic and fiscal policies remains predominant. After all, European populations are heterogeneous and have different preferences, a fact which raises the costs of integration with every integration step (Spolaore, 2013).

For example, den Butter and Segers (2014) suggest that policy-makers could look for welfare-enhancing ways to deepen economic coordination within EMU as a “middle road” between nationalism and federalism. Trichet (2013) proposes a “federation by exception”, whereby countries running astray with their economic and fiscal policies would be called to order by the use of federal intervention powers, but only in exceptional circumstances. Draghi (2013, 2015) supports pooling the set of functions that are necessary for a “more perfect union”. He advocates a “quantum leap in institutional integration” with the euro area countries taking further steps in sharing their sovereignty within common institutions, while strengthening democratic accountability in this domain.

Given the absence of a European 'demos', Rodrik (2015) suggests that it may be better to ask how much economic integration is compatible with democracy as it is constituted right now and to selectively give politicians more policy space again. Pisani-Ferry (2015) believes that the euro area should combine more integration or centralisation in some policy fields with more margins for manoeuvre in other fields. Given the fundamental barrier to giving up sovereignty, Mody (2013) wants to make national economic governance frameworks more robust. This could be done by agreeing a set of voluntary compacts between member countries that create time, space and pressure for the evolution of mutual solidarity.

Taken together, there is a continuum of views about the future of the eurozone, ranging from advocates to sceptics of further political integration (Mongelli, 2013). Most politicians appear to favour intermediate approaches that for the time being preserve the predominant role of the nation state. This preference notwithstanding, the debate continues on what type and how much of their sovereignty member countries should transfer to the central level in order to make EMU sustainable.

This paper reviews this discussion, focusing on the requirements for safeguarding the euro as a "currency beyond the state" (Hoeksma and Schoenmaker, 2011) that is anchored by collective governance instead of a central government. The question it poses is whether the half-way measures taken on the path of deeper euro area integration – staying within the boundaries of the 2007 Lisbon Treaty while also introducing new intergovernmental agreements to ensure national control and veto rights – are sufficient to secure the longer-term stability of the single currency.

After reviewing the EU economic and financial governance reforms decided since the start of the euro area crisis, the paper concludes that European leaders and institutions have gone a long way in putting in place the minimum conditions for a more perfect EMU. At the same time, however, the current principle of nation states coordinating their sovereignty through common agreements to stabilise the euro area rather than sharing their sovereignty in common institutions with a democratic mandate to safeguard the single currency has its limitations.

Following the ongoing debate, the status quo of collective governance of the euro points to at least seven challenges that remain to be addressed for a sustainable EMU. These relate to the effectiveness of market discipline and reinforced economic policy surveillance, the completion of the Capital Markets Union and the European Banking Union, the need for a single sovereign benchmark asset, the demand for a euro area fiscal capacity, the efficiency of the common fiscal backstop, the credibility of the no bail-out rule for governments in distress, and the transnational democracy that should legitimate euro area decision-making based on common values. These seven challenges suggest that to safeguard the euro as a currency beyond the state, euro area countries should consider a further pooling of national sovereignty – especially for functions that are essential for a proper functioning of EMU – so as to achieve more effective risk control and more efficient risk sharing, subject to democratic legitimacy of the common euro area institutions.

The paper is organised as follows: Section 2 recalls how the Maastricht Treaty of 1992 provided for the establishment of the euro as a currency without a state and how the Lisbon Treaty effectively turned the euro into a currency beyond the state. Section 3 discusses the three main fault lines in the institutional design of EMU, as exposed by the triple crisis that hit the eurozone. Section 4 provides an overview of the main measures taken to strengthen the architecture of EMU, which together demonstrated that European leaders and institutions assumed a joint responsibility for the stability of the euro area as a whole. Section 5 reviews seven main policy challenges arising from member countries continuing to coordinate their sovereign actions rather than deciding to share their sovereign powers for a sustainable EMU. Section 6 concludes that European policy-makers will need to address these seven challenges in order to safeguard the euro's future as a currency beyond the state.

2 The euro: from currency without a state to currency beyond the state

Historically, the attempt to introduce a monetary union often involved “the force of arms" (see De Grauwe, 2016, p.ix). The creation of the euro was instead driven by the process of European political integration, based on the idea that economic and monetary integration could be used as the means of achieving that objective (see Issing, 2008). Concrete steps toward a political union could in this view be relegated to the future.

On the one hand, the decision to establish an Economic and Monetary Union was regarded as an intermediate step in the political project of forming the 'ever closer union' that was initiated with the Treaty of Rome, signed in 1957. The new single currency thereby served both as the ‘peacemaker’ that sealed the permanent reconciliation between Germany and France, and as the ‘pacemaker’ towards a political union.

On the other hand, this political decision reflected economic motives, in particular the view that the benefits of a single market could only be fully exploited with a single currency (European Commission, 1990). The globalisation of product and capital markets had also increasingly undermined the national policy autonomy of EU countries. The adoption of the euro offered them the prospect of regaining the ability to influence economic and financial developments, albeit within a common policy framework.

The process of building a monetary union based on the principle of an open market economy with free competition was further guided by the criteria of an optimum currency area, following a theory pioneered by Mundell (1961) and McKinnon (1963) (see for example the discussion by De Grauwe, 2016). This theory also offered a new perspective on the role of the state in the evolution of money: it saw a common currency as a supranational public good governed by a common central bank that with appropriate ‘market-preserving’ political arrangements at the union level did not necessarily require a full-blown federal state in order to survive (McKinnon, 1997; van Riet, 2016) – although Kenen (1969) stated that there should be a treasury opposite the central bank to ensure an appropriate policy mix for the currency area.

2.1 The origins and functions of money

Looking at history, the creation of money has traditionally been viewed as an act of national sovereignty, corresponding to a Westphalian world of “one country, one currency” (Otero-Iglesias, 2015, p.354). National currencies developed in line with the main attributes of a country's sovereignty, notably the state's coercive power, fiscal authority, administrative capacity and its related ability to issue money. These sovereign powers enabled the nation state to collect taxes from its citizens to be paid

with the currency denoted as sole legal tender, as well as to earn seigniorage from its money issuance privilege. Both sources of revenue could be used for financing public goods and services, including expenses for public administration, protecting citizens and securing the state's territory. However, an opportunistic ruler could also abuse these monetary privileges for personal advantage, notably by debasing coins or imposing an inflation tax. The sovereign power to issue money thus also became a convenient way of financing the ruler's own expenses.

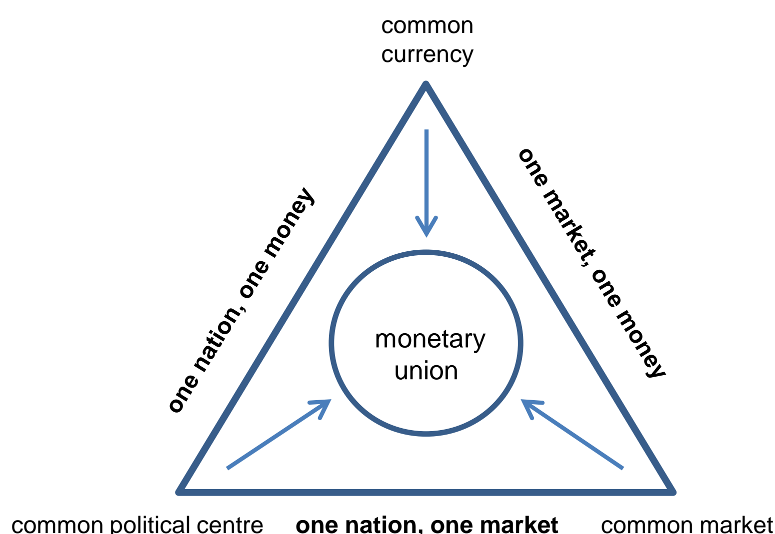
As discussed by Goodhart (1998), many scholars in history have instead argued that the evolution of money was driven by the development of market economies, closely associated with the desire of economic agents to reduce their transaction costs and facilitate commerce and trade. These writers stressed the intrinsic value of money in lubricating the economy. A currency arose in their view to serve the market needs of commerce rather than to meet the special interests of the nation state. On normative grounds, they advocated a denationalised currency to protect it from political abuse, i.e. they focused on the benefits of having 'one market, one currency'.

A third, unifying school of thought argues that money played an important historical role in aligning the political, commercial and financial interests of three groups crucial to the creation of a viable nation state: the ruler, merchants and financiers (Calomiris and Haber, 2014). As tax revenues were volatile or uncertain, the ruler was always in need of cash to wage war and expand the empire. Apart from borrowing abroad, the solution was to grant a national bank funded by a group of financiers the privilege to issue money and to give merchants special concessions to exploit lucrative trade routes. The national bank provided money-financed loans to the ruler and created the financial instruments necessary for merchants to engage in international trade. This monetary and financial system guaranteed by the sovereign's signature played a vital role in financing the activities of the nation state and in fostering commerce and trade, thus combining 'one nation, one market, one currency' (see Chart 1).

The currency of successful monetary unions comprising several states was normally fully aligned with a common political centre, i.e. the common currency for a group of states closely connected by a common market was created and supported by a supranational or federal political authority, governed by a representative democracy. Their leaders recognised that for the common currency to be sustainable the market dynamics had to be embedded in a set of political, social and cultural institutions at the supranational or federal level that facilitated economic adjustment and secured the stability of the monetary and financial system. Given its sovereign attributes, the common political centre had the power to balance the mix of fiscal, financial and monetary policies at the level of the monetary union, impose unified rules for the common market and regulate the whole financial system. Moreover, it had the fiscal authority to issue its own debt instruments, impose union-wide taxes and spend on common public goods and regional subsidies. McNamara (2015) calls this set-up an "embedded currency area" (see Chart 1).[2]

[2] The need to embed a monetary union in a complete political union and the fragility of a monetary union without budgetary integration and political unification are also addressed by De Grauwe (2016).

Chart 1
Three features of an embedded monetary union



An embedded monetary union also implied that central government debt securities denominated in the common currency functioned as the ‘risk free’ benchmark asset. The market's perception of the central political authority as a safe creditor mainly reflected its attributes of sovereignty. These signalled to investors that – apart from raising union-wide taxes, repressing financial markets or using its coercive power to acquire the necessary budgetary resources – it could always issue more money to repay its nominal debt obligations, at least if it was prepared to avoid a default that would be damaging for the domestic economy. Given these sovereign privileges, (only) the central government had the ‘deep pockets’ that were needed in turbulent times to borrow on a large scale in order to wage war, absorb large asymmetric shocks within the currency area, guarantee the lender of last resort operations of the common central bank and credibly safeguard the stability of the common currency.

An evident risk was that the supranational or federal authority could also abuse its sovereign powers to interfere in financial markets and create inflation or devalue the currency for purely political benefits (McKinnon, 1997). However, these dangers could in principle be addressed by transferring the control over the money supply and the regulation of financial markets from the political centre to a common central bank with an independent mandate to stabilise the value of the common currency and to guarantee the overall stability of the financial system.

As part of a fiscal union agreement, the central political authority could also make automatic transfer payments to sub-central states facing less fortunate economic times and organise a redistribution of taxes between them in order to equalise living standards; and it could also guarantee or mutualise their outstanding public debt. To counter the risk of free-riding, the union's contract could exclude involvement of the participating states in central political decision-making or restrict their budgetary autonomy. When subsidiary governments considered both of these two alternative

constraints on their sovereignty unacceptable, for example in view of the deviating preferences of their citizens, another option was that they retained full responsibility and control over their own budget but without enjoying the benefits of redistributive transfers and common guarantees for their public debt. In this case it was basically left to market forces to promote a dynamic economy and sustainable public finances in the participating states (see also Enderlein, 2009).

2.2 The euro as a currency without a state

The discussion about the origins and functions of money came back in the run-up to EMU (see James, 2012, Chapter 1). A key question was whether the euro needed a European government behind it, or whether it should develop from market principles through a private sector process of minimising the costs of transactions in the EU internal market (Goodhart, 1998; Issing, 2008; and Otero-Iglesias, 2015).

The influential report by the European Commission (1990, pp.13, 23), aptly called "one market, one money", emphasised the net economic benefits of moving to a single currency and stated that the case for centralised powers over budgetary policy was less evident than that for monetary policy. Still, given the increased economic interdependence between Member States a more intensified coordination of fiscal policies and mutual surveillance was warranted, especially in relation to the overall monetary-budgetary policy mix for the single currency area.

The Maastricht Treaty of 1992 established the euro as the sole legal tender of the European monetary union, as successor to the national legacy currencies. While this was seen as an important step in the long-term process of political unification, the economic focus was on "drawing together the national economies via the market mechanism" (Issing, 2008, p.309), resulting in "one market, one currency" (Otero-Iglesias, 2015, p.355). By irrevocably fixing their bilateral exchange rates the first participating Member States transferred their monetary policy authority with effect from 1 January 1999 to the supranational level, placing it in the hands of the ECB.

While the founding members of the euro were willing to give up their control over monetary policy, they were not ready to surrender sovereign powers in economic, budgetary and financial policies. They only accepted that EU restrictions on national competition law were necessary for a proper functioning of the internal market and that the conduct of their economic policies (including public finances) was a matter of common concern and therefore required coordination witin the Council of Ministers. The choice of keeping non-monetary policies largely in their own hands could be explained by the diversity of national preferences, political priorities and legal traditions characterising a group of still rather heterogeneous economies that had entered on a path of increasing economic and institutional convergence. Moreover, it reflected the principle of subsidiarity, i.e. a belief that for the time being these core policies could best be exercised at the national level. Accordingly, the euro became a "currency without a state" (Padoa-Schioppa, 2004; Issing, 2006), a *denationalised* currency grounded in the "society of states" (Trichet, 2013, p.474). Hence, the

participating countries engaged in the unprecedented experiment of constructing a viable monetary union for "one market, but many polities" (Rodrik, 2015, p.67).

With a view to establishing a superior supranational monetary order, the ECB was given an independent mandate to ensure price stability for the euro area as a whole. Without prejudice to this primary objective, it was also asked to support the general economic policies in the Union. The European Parliament was given a key role in holding the ECB to account. This was perceived as the safest way to keep monetary policy out of the hands of politicians, as a precondition for a stable currency. In this sense, the euro also became a *depoliticised* currency. This represented the triad of 'one market, one currency and one central bank' (van Riet, 2016).

For the promise of a stable euro made to citizens to be credible, however, it must comprise price stability as well as financial stability for the whole monetary union. The realisation of this promise demands sound public and private finances in each and every participating country in addition to appropriate regulation and supervision of the financial sector. As pointed out by Richter (2013), the ECB as a monetary policy institution could hardly be expected to assume on its own the responsibility for securing this dual stability in its function as lender of last resort (see also Linzert and Smets, 2015). The main reason is that the 'non-standard' stabilisation measures that become necessary in a crisis have major implications for both resource allocation and income distribution, and therefore require a political decision. Monetary policy and financial policy actions may also conflict at times. The true challenge for Europe therefore was (and still is) to find the right balance between economic, monetary and political integration, in the triangle between 'one market, one currency and many member states' (see Issing, 2006).

2.3 The euro as a currency beyond the state

The incomplete architecture of EMU left the question unanswered of how far and how quickly political integration would evolve. Spolaore (2013, p.136) mentions in this regard that the long-term vision of the integration process was left ambiguous, because Europe could be regarded as a "federation to be completed" or as a "post-federation". Correspondingly, was the euro "a currency without a state *yet*, or … a currency without a state *ever*?"

According to Hoeksma and Schoenmaker (2011), after the Treaty establishing a Constitution for Europe had been rejected in the French and Dutch referendums in spring 2005, the earlier expectation of many observers that the EU would eventually develop into a sort of federal state could no longer be maintained. The subsequent Lisbon Treaty, signed in 2007, conceived of the EU as a democratic polity of states and citizens in which sovereignty is shared and resources are pooled to achieve common objectives. Hoeksma and Schoenmaker (2011) argue that this perspective confirmed the EU institutions and the euro area countries as the *joint sovereign* behind the euro, which should therefore be regarded – at least for the time being – as a "currency beyond the state", i.e. a currency beyond the traditional Westphalian concept of the sovereign nation state.

As a consequence, the ‘deep pockets’ necessary to ensure the stability of the single currency and the integrity of EMU are still to be found at the national level, requiring an effective coordination mechanism to pool these budgetary resources, while controlling the moral hazard that plagues any collective insurance mechanism. To facilitate this process, the Lisbon Treaty (Article 136) gave the Member States participating in the euro the possibility to conclude specific arrangements within the EU legal framework to ensure the proper functioning of EMU. Moreover, it gave the European Council the status of an EU institution with a permanent President, who was so far also elected to be President of the Euro Summit of the Heads of State or Government of the euro area countries. In addition, the informal Eurogroup of the Ministers of Finance and Economics of the euro area countries gained legal recognition.

Among others, Habermas (2011) and Crum (2013) describe this political solution to the “governance trilemma” of the eurozone as “executive federalism”. This specific model of collective governance combines member countries' participation in EMU with continued national policy autonomy and a delegation of specific common tasks to technocratic EU institutions, subject to independent legal checks by the European Court of Justice and still comparatively weak democratic control by the European Parliament (even though the Lisbon Treaty has extended its powers). Because the democratic legitimacy and accountability of collective political decisions for the euro area remain largely vested at the national level, this raises the question of how to organise a sufficiently encompassing common democracy that is evolving beyond the euro area nation states, in particular for decisions on EMU matters (see the discussion by Bastasin, 2015; Mersch, 2015; Rodrik, 2015; and Hoeksma, 2016).

3 Three fault lines in the design of EMU: does the euro need a state after all?

EU countries that adopted the euro extended the benefits of the internal market by being able to expand their trade with other participants and allocate capital to the most profitable projects in the eurozone without having to consider distorting intra-area exchange rate fluctuations. Moreover, their access to a wide pool of savings denominated in the euro allowed for a diversification of funding and a more efficient market-based absorption of national shocks. This monetary unification combined with trade and financial integration was expected to promote further sustainable convergence.

At the same time, member countries became more vulnerable to shifts in market sentiment related to home-grown economic and financial imbalances or shocks from abroad. Their growing interdependencies in trade and finance also implied that contagion effects could spread quickly and have systemic implications, especially in the face of high private and public sector debt levels. This greater exposure to trade shocks, market turbulence and systemic risk called for prudent national policies to make economies *ex ante* more flexible and resilient; it required the steady pursuit of sound public finances, continuous structural reforms and sufficiently alert financial supervision in the common interest of the euro area.

The importance of observing the rules of the single currency area were clear to every member country. However, market discipline turned out to be weaker than expected and euro area policy coordination to promote effective risk control was too weak and too narrowly defined. Given these misaligned incentives, many governments looked for ways to promote short-term national interests and to avoid the political costs of stability and reform-oriented policies. They mostly ignored the dangers from growing macroeconomic and financial imbalances, until the financial crisis of 2008 exposed these weaknesses.

Affected by the fall-out from the triple crisis, governments discovered that their own room for manoeuvre to respond had become “uncomfortably narrow” (Crafts, 2014, p.713). Consequently, they came to consider euro membership as a “strait-jacket” (Bastasin, 2015, p.144). The absence of public risk sharing mechanisms at the supranational level to support large national adjustments pushed some of them to (re)introduce (hidden) protectionist measures and (soft) capital outflow controls (van Riet, 2016). Since this undermined the internal cohesion and stability of EMU, the EU institutions including the ECB *ex post* came under strong pressure from member countries to establish the necessary mechanisms to support them in a time of crisis, as also anticipated by McKinnon (1995, p.474).

3.1 The growing imbalances inside the eurozone

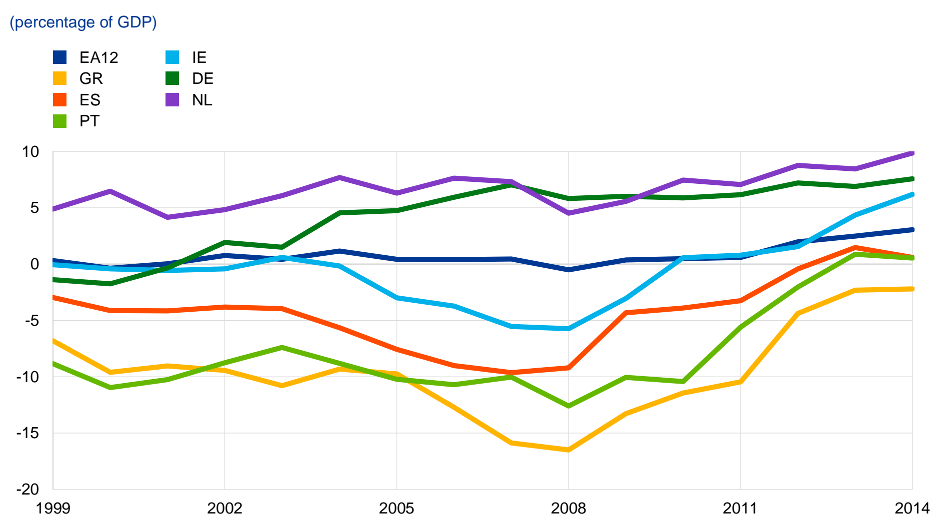
The triple crisis in the eurozone was triggered by the global financial crisis which revealed how fragile the single currency's initial stability was. Many participating countries were reluctant to face the economic consequences of opening up their markets and adopting the euro, which increased foreign competition at a time when the globalisation of trade and finance was gathering pace, further increasing the pressure on them to adjust to the new environment. Without being able to use the old instruments of monetary and exchange rate policies to soften the impact on their economies, national politicians resorted to 'opportunistic strategies' as a substitute for undertaking structural reforms (see Bastasin, 2015).

Over the first 10 years of the euro's existence, several member countries allowed profound macroeconomic, fiscal and financial imbalances to accumulate, as reflected in their rising current account deficits (see among others Lane, 2013; De Rougemont and Winkler, 2014; Baldwin and Giavazzi (eds.), 2015; and de Haan et al., 2016). Their experience contrasted with steadily growing current account surpluses in a number of other member countries where private savings exceeded investments (see Chart 2). Under these circumstances, the convergence of real GDP per capita between the first 12 euro area participants has stagnated over the past 15 years (European Central Bank, 2015).

Chart 2

Current account of the balance of payments of euro area countries, 1999-2014

(percentage of GDP)



Source: European Commission.
Note: EA12 comprises the 12 countries that adopted the euro in 1999 and 2001.

Why were these growing imbalances not detected and corrected in a timely manner? A plausible answer is that several euro area countries used to high interest rates enjoyed much more favourable financing conditions after entering EMU. Their downward convergence of long-term interest rates was one of the conditions for joining the eurozone. However, it continued in the following years (see Chart 5 on p.26), favoured by the unified short-term interest rates set by the single monetary policy and above all by the easy access to private credit from investors in other

eurozone countries. The ample supply of foreign capital pushed interest rates persistently below inflation and fuelled a credit-driven domestic demand and real estate boom (see Chart 3 on p.20). Overly optimistic growth expectations masked the underlying structural weaknesses in these economies characterised by many supply rigidities, poor competitiveness, spendthrift governments and undercapitalised banks. Moreover, the massive private capital inflows that the external deficit countries steadily required were to a large extent misallocated, as they mostly funded public and private debt rather than direct equity investments or ended up in low-productivity, non-tradable sectors.

By contrast, financial institutions based in Germany and in other relatively 'safe' countries could always draw on low-cost savings at home. After the introduction of the single currency the supply of funds grew even larger because these countries (notably Germany and France) became a prime destination for foreign investors from outside the euro area looking for attractive debt securities (see Chen et al., 2013). The banking sector and institutional investors in turn intermediated this abundant capital, eager to invest their cheap resources in higher-yielding assets across the whole eurozone (focusing on cross-border interbank loans and debt issued by governments and financial institutions) without having to worry about exchange rate risk. Their 'search for yield' reflected lower investment returns at home and was a major driving factor behind the narrowing of long-term bond spreads and the booming economies of the external deficit countries. These investors apparently expected that their massive lending to public and private borrowers elsewhere in the eurozone was safe; any bank in trouble would always be rescued by its home sovereign, while an over-indebted euro area government would definitely be bailed out as was in fact signalled by the assumption in EU prudential legislation that sovereign claims were risk free and could be held without limit (see van Riet, 2015).

As long as this financial bonanza translated into high returns for capital-exporting investors and significant growth benefits in capital-importing countries there was no apparent reason for market participants to doubt the sustainability of these trends. As a result, market discipline was weak in the first 10 years of EMU and euro area countries enjoying cheap credit became subject to moral hazard. Their incentives to abide by the EU rules for economic policy coordination, sound public finances and prudent financial supervision were misaligned with the political and economic realities of their participation in EMU.

As Sims (1999) predicted, the low cost of borrowing for all public creditors created incentives for fiscal free-riding at the expense of eurozone partners. The common budget rules and the supranational monitoring were too weak to prevent countries from using the unsustainable growth benefits of maintaining a bias towards fiscal expansion in order to hide their structural weaknesses. One could argue that this recourse to (asymmetric) fiscal flexibility was a rational response of the national authorities that had lost control over their monetary and exchange rate policies as (imperfect) adjustment tools for their rigid economies (see Posen (ed.), 2005). But in reality, many eurozone countries had de facto given up their autonomy over these monetary instruments already in the course of the 1980-90s, deliberately 'tying their hands' when they opened up their capital markets and gave their respective National

Central Banks an independent monetary policy mandate to establish price stability through the pursuit of a ‘hard currency’ strategy (see Eijffinger and De Haan, 2000). Hence, countries with an excessive budget deficit and high government debt had to demonstrate their creditworthiness through sound and sustainable fiscal policies well before they adopted the euro, since this was a prerequisite for achieving low inflation and a stable national currency and for getting access to competitive capital markets at acceptable interest rates.

Apart from fiscal policy, the incentives for free-riding also applied to the conduct of other non-monetary policies where effective supranational constraints on national policies were missing, such as those related to the regulation of labour markets and banking (Chari and Kehoe, 2008). In addition, there were few if any EU policies that could have motivated governments to enhance the institutional capacity of the state, even though some Member States adopting the euro lacked an efficient and effective public administration to enforce contracts, implement legislation, impose taxation, and fight rent-seeking and corruption (Masuch et al., 2016; Papaioannou, 2016). According to Fernández-Villaverde et al. (2013), the easier financing conditions that the capital-importing countries experienced with the adoption of the euro had political economy implications, as this windfall relaxed constraints that should have forced them to prioritise economic and institutional reforms. Moreover, it weakened the resolve of their prudential supervisors to counter the emerging credit bubbles. The domestic supervisors of financial investors from the capital exporting countries for their part insufficiently recognised the liquidity and credit risks associated with the rapid growth of cross-border debt exposures. Under these circumstances, the market-based channels for correcting relative price increases and a loss of competitiveness were hardly operational (Ruscher, 2015). Current account adjustment processes were also slower for EU countries participating in EMU than for those in floating or fixed exchange rate regimes (Herrmann and Jochem, 2013).

The steadily increasing current account deficits of several euro area countries were financed by intra-euro area private capital flows and translated into rapidly rising net external (debt) liabilities. The corresponding private capital exports of the current account surplus countries led to a steady accumulation of net external assets in the form of portfolio debt and other (mostly cross-border banking) claims vis-á-vis the euro area debtor countries (see Chen et al., 2013). Moreover, the countries with high external debt generally had less efficient bankruptcy regimes, lower creditor protection standards and weaker judicial enforcement regimes than the ‘safe haven’ nations (Papaioannou, 2016). This set the stage for sudden private capital outflows in a balance of payments crisis. As noted by Bolton and Jeanne (2011), the global expansion of trade and growing integration of financial markets had positive welfare implications. But the growing cross-border interdependencies in the financial system – especially where these were based on debt rather than equity – also carried risks for financial stability, as became apparent for the whole eurozone.

3.2 Three fault lines in the architecture of EMU

Looking at the EU institutional factors in more detail, the euro area crisis exposed three main fault lines in the design of EMU – closely related to the efficiency and effectiveness of crisis prevention, crisis management and crisis resolution – signalling that the founding members may not have foreseen or understood all the economic and political implications of creating the euro as a currency without a state (see also Sapir, 2011; Bastasin, 2015; and De Grauwe, 2016). This notwithstanding, the three faults lines described below closely correspond to three concerns that have shaped the debate on European monetary integration over the past 50 years but were not properly addressed, namely the need for greater economic convergence, supranational banking regulation and official financial support for weakened member countries. As such, they represent long-standing themes instead of new challenges associated with the euro area crisis (see Mourlon-Druol, 2014).

The **first fault line** of EMU was the lack of an effective supranational surveillance and enforcement mechanism for economic and fiscal policies. As market discipline was unexpectedly weak, the centre should have been able to call those member countries to order that flouted the common rules of behaviour and allowed their economies to stray from the path of sustainable convergence.

Although the Maastricht Treaty spoke of an Economic and Monetary Union, the economic axis was missing (Delors, 2013; Trichet, 2013). The economic policies of Member States were coordinated in the Council of Ministers but the country-specific policy guidelines were to a large extent ignored. Since these EU recommendations were too soft to force a change in national policies, there was neither an effective means of preventing or correcting macroeconomic imbalances, nor a determined effort to create a true economic union (De Streel, 2013).

The steady capital movements, above all in the form of debt, flowing from ‘safe haven’ to ‘catching-up’ countries as investors searched for higher yields fuelled an asymmetric credit-driven financial cycle within the eurozone (see Chart 3 panel a, and de Haan et al., 2016). This in turn translated into diverging trends in domestic demand (Chart 3 panel b), asset prices, inflation, wages and competitiveness, and hence a growing gap in current account positions (see also Landmann, 2011; Lane, 2013; De Rougemont and Winkler, 2014; European Central Bank, 2015).

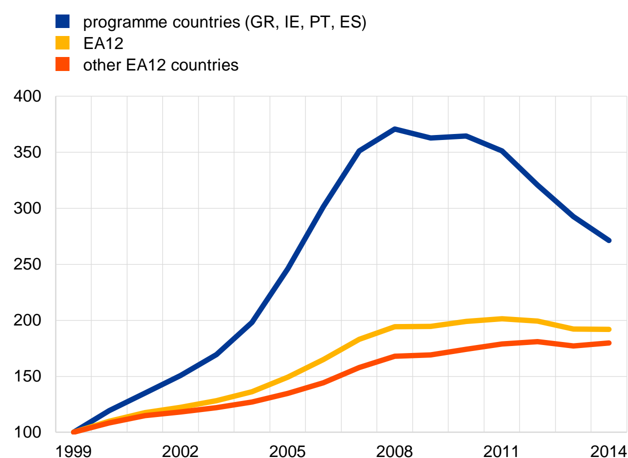
Since euro area countries had given up control over the exchange rate, a persistent loss of competiveness could only be corrected through adjustments in relative prices (i.e. an internal devaluation) or in non-price factors. This assumed a high degree of economic and institutional flexibility. By contrast, in most of the affected countries prices and costs were downward rigid and the structural reforms needed to address supply rigidities slow in being implemented (Ruscher, 2015), also because in some cases the administrative capacity of the state to realise the necessary institutional changes was weak (see Masuch et al., 2016; Papaioannou, 2016). Output and employment in the end had to bear the brunt of this adjustment, also because there were no union-wide facilities that could offer assistance (other than EU structural and cohesion funds that however required co-financing of projects and an effective public administration to execute them).

Chart 3

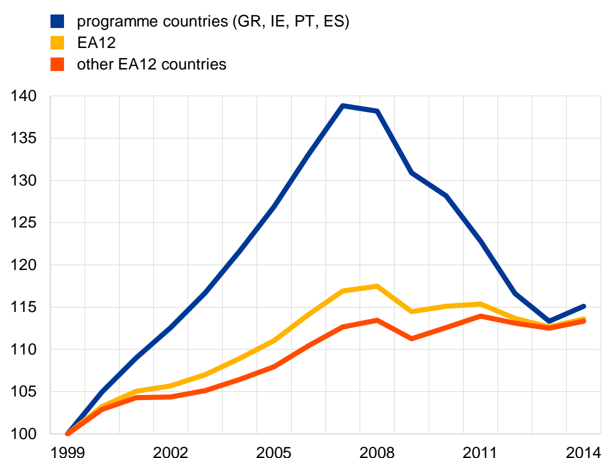
Asymmetric cycles within the euro area

(1999=100)

a) Credit to the private sector, 1999-2014



b) Domestic demand, 1999-2014



Sources: European Central Bank and European Commission.
Notes: EA12 comprises the 12 countries that adopted the euro in 1999 and 2001. Programme countries are those EA12 countries that received EU/IMF financial assistance in 2010-2012, namely Greece, Ireland, Portugal and Spain.

Only with regard to fiscal policies did the Maastricht Treaty go further, placing an obligation on Member States to avoid excessive deficits. For eurozone countries this could ultimately lead to financial sanctions in the case of repeated non-compliance with EU Council recommendations to keep the budget deficit below the reference value of 3% of GDP and government debt on a sufficiently declining path towards the reference value of 60% of GDP. This was specified in more detail by the Stability and Growth Pact (SGP) of 1997 that defined common procedures for preventing and correcting excessive deficits and specified a budget that was close to balance or in surplus as a medium-term objective.[3]

The credibility of EU fiscal governance suffered a blow when in 2003 Germany and France – supported by the Council of Ministers – resisted implementng the steps recommended by the European Commission that were necessary to correct their excessive deficits. The subsequent overhaul of the SGP in 2005 introduced more elements of flexibility to take mitigating country-specific circumstances into account. This extra leniency further undermined the political incentives to preserve sound and sustainable public finances.

Only very few euro area countries ever achieved the medium-term objective of a close to balanced budget or a surplus position, which would have been a sound starting point to let automatic fiscal stabilisers work freely to accommodate cyclical shocks (see Chart 4 and Koester et al., 2012). The correction of excessive budget deficits was slow and the upward impact on government debt not reversed because peer pressure was weak and enforcement by imposing financial sanctions was avoided. According to De Streel (2013), this showed the limits of sanctions on non-

[3] See Heipertz and Verdun (2010) for theoretical explanations of the political origins of the SGP and its relation to the process of European integration.

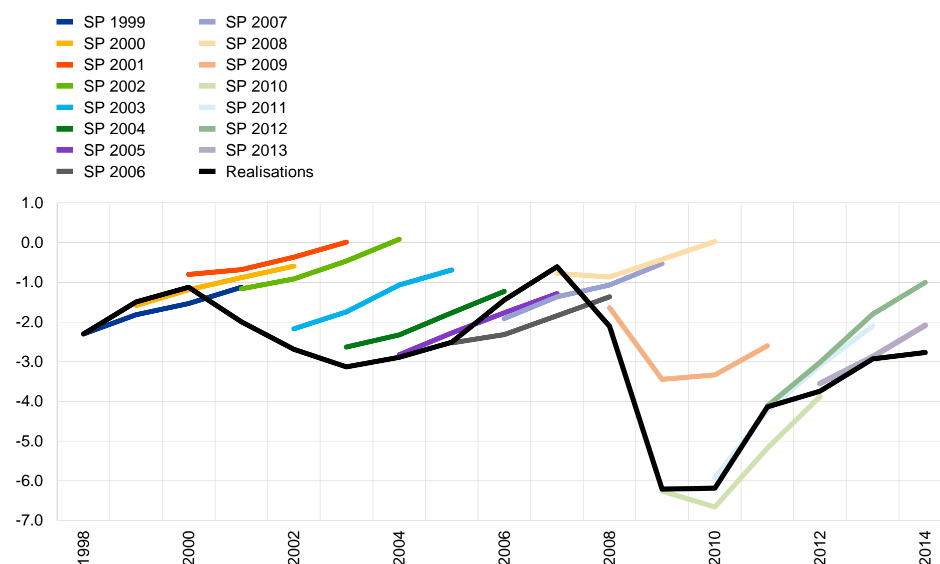
compliant countries being decided by political institutions rather than an independent court. At the start of the global financial crisis many euro area countries thus faced a relatively high level of public debt relative to GDP, which then jumped to even higher levels due to the costs of bank rescues, the deep economic recession and the coordinated fiscal stimulus measures (see van Riet (ed.), 2010).

When the euro area crisis broke out, countries with an excessive private and/or public debt, weak productivity growth, low competitiveness, large and persistent current account deficits and a poor administrative capacity to address these and other macroeconomic imbalances proved to be particularly vulnerable to market volatility. The increasing liquidity and credit risk premia translated into rapidly rising sovereign bond yields, first for Greece but it was soon followed by Ireland, Portugal, Spain, Italy and later Cyprus (see Chart 5 on p.26). They suddenly saw large net private sector payment outflows, as a result of which their highly leveraged banks had great difficulty accessing short-term funds in the interbank market and turned to the Eurosystem for loans. Recourse to the ample supply of central bank liquidity to the euro area banking system – which is provided in a decentralised manner via the National Central Banks – was indeed the largest in the vulnerable member countries. By contrast, the credit institutions in the safer countries that enjoyed net payment inflows were awash with funds and placed these on a deposit with the ECB.

Chart 4

Euro area average budget balance: annual plans versus realisations, 1998-2014

(weighted average of euro area countries, percentage of GDP)



Source: European Commission, Eurostat and Koester et al. (2012).
Note: coloured lines are averages of the budget balance plans in the annual national stability programs (SP) of euro area countries, the black line shows the annual realisations for the euro area average budget balance.

The growing recourse of banks to Eurosystem refinancing and its uneven distribution across euro area countries manifested itself in a rise in net liabilities (or claims) of the National Central Banks of current account deficit (or surplus) countries vis-à-vis the ECB in the so-called TARGET2 system through which cross-border payments are settled using central bank money. Through this in itself normal feature of the

decentralised execution of the single monetary policy the Eurosystem effectively substituted for the private financing of current account deficits. In addition, private capital flows into the crisis-affected countries were replaced by substantial official sector assistance. Both reflected the eruption of underling tensions that had built up inside EMU (see Cour-Thimann, 2013; Lane, 2013).

Looking back, Delors (2013, p.176) – former President of the European Commission and Chairman of the Committee that advised the European Council in 1989 on the concrete steps that should lead to EMU – admits to having underestimated at that time “that a single market with a single currency could exacerbate, to such a point, the divergences between Member States”.

To repair the first fault line, a reinforced EU economic governance was warranted in order to restart the process of sustainable convergence of euro area economies, the success of which is a precondition for deeper economic integration and the political acceptance of new risk sharing mechanisms. This necessary risk reduction process can be accelerated through a more symmetric rebalancing process within the euro area whereby creditor countries also carry part of the adjustment burden and thereby facilitate the ongoing reforms of debtor countries aimed at reducing their excessive net external liabilities (see Cœuré, 2016). The main task for the creditor countries would be to promote the growth capacity of their non-tradables sector, while debtor countries should focus on improving the performance of their tradables industry.

The **second design flaw** was to leave the organisation of banking supervision and resolution in EMU as well as the responsibility for financial stability in national hands. National policy-makers closely guarded their prerogative of supervising domestic credit institutions because banks were the main source of finance for the economy, including for the government. This showed a preference for maintaining domestic control over an important tool of private and public debt management as well as for the promotion of national financial interests.

One of the first drafts of the report of the Committee for the study of EMU (1989), chaired by Delors, envisaged giving a macroprudential role to the European System of Central Banks (ESCB), i.e. it would be assigned with the task to oversee the functioning of financial markets in Europe in order to ensure a balanced development of the financial system and its safety. To play this macroprudential role, the ESCB would also have to exercise the function of banking supervision and should at least take part in establishing general regulations in this field (see van den Berg, 2005, p.278). The final text of the Delors report restricted the ESCB's role to participating in the coordination of banking supervision policies of the (national) supervisory authorities (see Committee for the study of EMU, 1989, p.26).

The draft Statute of the ESCB/ECB, prepared by the Committee of Central Bank Governors in 1990, gave it the task to participate as necessary in the formulation, coordination and execution of prudential supervision policies and the stability of the financial system. However, the opponents of giving a supervisory task to the ESCB stressed the possible conflict of interest with the single monetary policy, that it lacked the corresponding democratic accountability, and the creation of moral hazard when financial institutions could in effect count on stability guarantees.

The Maastricht Treaty therefore in the end only provided the ESCB with the task to contribute to the smooth conduct of the policies pursued by the competent (national) authorities specifically relating to the prudential supervision of credit institutions and the stability of the financial system. At the same time, the text included the option that in future it might be asked to perform specific prudential supervisory tasks for banks and other financial institutions except insurance undertakings. This could occur for example when cross-border mergers and acquisitions, rising systemic risks and financial support to the banking sector made this necessary (see van den Berg, 2005, pp.279-287; as well as James, 2012, pp.291-292 and 302). A supranational approach to the conduct of prudential policy was thus relegated to the future.

This political preference ignored the constraints implied by the financial trilemma, which states that deeper financial integration and preserving financial stability are incompatible with financial policies based at the national level (Schoenmaker, 2011; Sapir, 2011). The lack of coordinated or centralised macroprudential policies for managing intra-area capital flows and preventing regional credit booms that the single monetary policy could not address but that could turn into a systemic risk for financial stability, became evident during the financial crisis.

After adopting the euro, reflecting a form of 'financial nationalism' and 'regulatory capture', many governments (as before) protected national banking champions against foreign take-overs and gave them regulatory competitive advantages so as to strengthen their position in the single financial market in return for priority access to bank savings for resident borrowers (as argued by Véron, 2013). The banking sector furthermore enjoyed relatively cheap market funding thanks to the implicit government guarantee on their growing liabilities. These benefits supported the incentives for banks to expand through domestic acquisitions and build up large and risky cross-border exposures in their securities business as part of their strategies to become international market players.

The partial nature of financial integration in retail banking meant that banks, on the one hand, could accumulate short-term and debt-based foreign interbank liabilities, while on the other hand, they were allowed to concentrate their assets with domestic real estate borrowers rather than diversifying the associated risks (Draghi, 2014a). This mismatch made bank balance sheets vulnerable to asymmetric shocks and contagion effects from abroad, as well as to a growing share of non-performing loans at home. Following national rulebooks for banking sector oversight, the competent authorities applied the EU banking directive with local discretion, bending regulatory standards, tolerating rising leverage and exercising forbearance in dealing with non-performing loans.

At the time of the financial crisis, it became clear that Europe had an overstretched banking sector which was, moreover, highly concentrated and highly leveraged (as reported by the Advisory Scientific Committee of the European Systemic Risk Board, 2014). A swift resolution was prevented because governments decided to prop up rather than restructure domestic banks and national supervisors adopted a rather lenient attitude towards banks 'gambling for resurrection' that were trying to hide the extent of their leverage and non-performing loans in stress tests (see Legrain, 2014; Posen and Véron, 2014).

Keeping supervisory policies in national hands in a deeply, if not fully, integrated financial market relied on a close coordination between euro area countries in dealing with international banks. However, the existing coordination mechanisms proved sub-optimal during the financial crisis when large cross-border banks had to be broken up or restructured at short notice in order to stabilise the financial system – a complicated task which would have demanded a common financial resolution authority to overcome the conflicting national interests. Absent a European bank resolution framework governments first individually and then collectively decided to keep the troubled banks in their jurisdiction afloat, without sufficiently forcing them to redress their over-leveraged balance sheets.

Several euro area countries nevertheless lacked the fiscal space to undertake substantial bank rescue operations. Those with an over-indebted private sector and excessive external liabilities were heavily exposed to a large number of unviable savings banks, whereas in other, overbanked countries the size of the banking sector far exceeded national GDP. These characteristics fuelled a vicious feedback loop between troubled banks holding a large amount of sovereign debt on their balance sheets and vulnerable governments with limited fiscal room for manoeuvre to (once again) socialise their rescue. The increase in sovereign bond yields of the affected countries went hand-in-hand with a rise in bank borrowing and lending rates, which caused a fragmentation in euro area financial markets across national lines of creditworthiness.

To break the ‘doom loop’ between credit institutions and their sovereign, at least the systemic and cross-border banks established in the eurozone had to be subjected to a supranational regime for supervision, recovery, resolution and deposit insurance, i.e. a fully-fledged banking union was required. In addition, it was vital to design an effective framework for macroprudential policies at the European level.

The **third fault line** was the absence of a common budgetary authority to stabilise the euro area economy and offer a fiscal insurance to member countries hit by large asymmetric economic shocks.[4] Two other missing key elements were an adequate fiscal backstop at the EMU level to assist governments facing serious liquidity stress and a statutory mechanism that could have allowed insolvent sovereigns to organise an orderly debt restructuring as an ‘ultimum remedium’. Thus, EMU had no common fiscal tools to adress cyclical disturbances at the euro area level, counter the growing economic disparities between member countries and to backstop and/or resolve a national fiscal crisis, whereas a country's participation in the euro was irrevocable and the Maastricht Treaty excluded a bail-out operation by the official sector.

Discussing the theory of optimum currency areas, Kenen (1969, pp.45-46) pointed to the advantages of a federal budget for stabilising a monetary union, financing common public goods and for redistribution purposes. He stated that the domain of monetary and fiscal policies should be the same so as to establish an 'optimum' policy mix that maintains both internal and external balance. Too much reliance on

4 Asymmetric shocks may originate in one member country or may be the result of common euro area shocks having a significantly different impact across member countries (see Ruscher, 2015).

one of these two instruments could have severe consequences for particular sectors of the economy. An important function of a large central budget was also to offset regional differences and to combat local recessions that the single monetary policy was unable to deal with.

Lamfalussy reviewed the arguments in the context of the Committee for the study of EMU (1989, pp.91-125) and concluded that the coordination of national fiscal policies was a vital element of a European monetary union. Otherwise, the EMU fiscal stance would just be the accidental outcome of the aggregation of national budgetary decisions. A union-wide fiscal policy should therefore be put in place, which should be allowed to gradually emerge during the transition to EMU and become fully operational once it was completed. Without it, the common monetary policy would be the only available macroeconomic tool at the union level, which he saw as "an unappealing prospect".

Analysing the costs and benefits of EMU, the European Commission (1990) argued that the coordination of national fiscal policies and mutual surveillance was sufficient to establish an appropriate overall monetary-fiscal policy mix and that the case for a central budget for the euro area was not very strong. After all, participation in EMU was expected to reduce the incidence of country-specific shocks and Member States would still have the fiscal autonomy to respond to them, assisted by EU structural funds. As noted by Vallée (2014), this confident view contrasted with a number of official reports published in the 1970s but was taken over in the Maastricht Treaty. As became clear during the euro area crisis, the fiscal policy apparatus of EMU was largely incapable of dealing with non-standard economic shocks. The burden to deal with them was in effect put on the shoulders of the ECB, which had to take recourse to non-standard monetary instruments.

As early as the transition to EMU, prospective euro area countries participating in the exchange rate mechanism of the European Monetary System (EMS) had adopted a 'hard currency' strategy – some with more success than other members – which limited their national room for policy manoeuvre. After adopting the single currency they finally surrendered their monetary and exchange rate autonomy and had to find other, more fundamental ways to address asymmetric economic shocks, market volatility and fiscal duress. Their options in a severe crisis were limited to finding national solutions. The Maastricht Treaty explicitly forbids the ECB to directly finance governments through loans and by printing money and it prohibits measures not based on prudential considerations that would give governments privileged access to funds from financial institutions. The European Union or its Member States also cannot be liable for or assume the public sector commitments of a particular Member State. A facility for balance of payments assistance only existed for EU countries outside the eurozone. Otherwise, the Treaty only offered the option of granting conditional EU financial assistance to countries affected by natural disasters or exceptional occurrences beyond their control.

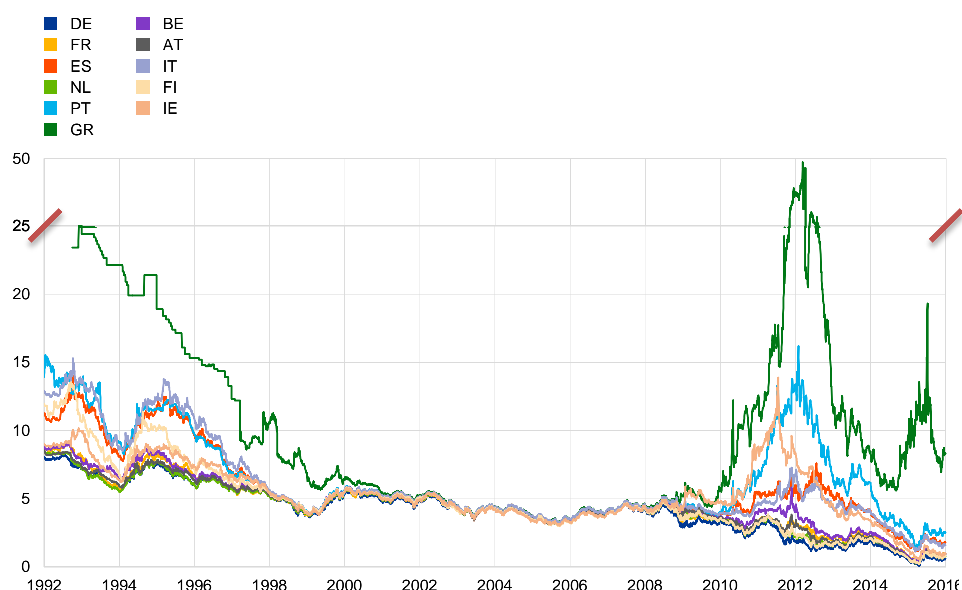
While the single monetary policy was successful in maintaining price stability at the eurozone level, the stability of EMU was undermined by rather complacent national policies. As discussed above, these were characterised by a slow pace of structural reforms, an accommodating fiscal stance, lenient supervision of the financial industry

and a permissive attitude toward a credit-driven boom in overheating economies which was largely financed by abundant capital flowing in from eurozone members with a surplus of savings.

As it turned out after 2008, the EMU architecture only provided for a 'fair weather' euro which was not sustainable under stormy conditions. Kopf (2011) observed that many eurozone countries had heavily financed themselves abroad in the first 10 years of EMU and thereby became vulnerable to a 'sudden stop' in capital inflows (see Calvo, 1998, for the mechanics). As soon as a government faced massive capital outflows leading to soaring interest rates and funding stress (see Chart 5) it could get trapped in the 'bad equilibrium' of self-fulfilling default expectations (see Calvo, 1988).[5] While euro area countries could of course use their sovereign power to increase taxes, this was only an illiquid longer-term asset, of little use in a liquidity crisis when foreign investors (who anyhow are not subject to domestic taxes) refuse to roll over their debt (Gros, 2012). Moreover, this option could also aggravate debt sustainability in view of the distortive effects of higher taxes for potential growth and competitiveness.

Chart 5
Government bond yields of the euro area countries, 1992-2015

(daily data in percentages)



Sources: Datastream and ECB.
Notes: Ten-year government bond yields. The yields for Cyprus, Estonia, Luxembourg, Malta and Slovenia are excluded owing to infrequent or a lack of observations. Last date included: 31 December 2015.

As popularised by De Grauwe (2012), the single currency was thus characterised by a "systemic fragility", since all member countries exposed to foreign debt could be vulnerable to a sudden reversal of capital inflows or affected by contagion. Without a central budgetary authority that might support them in times of need, without the

[5] The uncontrollable default under EMU conditions compares with the earlier partial default due to inflation during EMS crises, when participating countries still had their monetary autonomy and tended to devalue their currency in order to escape market tensions (see Gros, 2012).

option to ask partner countries or the European Union for a bail-out, and without access to the common central bank, vulnerable euro area governments were at the mercy of markets the moment a large adverse shock hit them. To regain market confidence and convince foreign investors that the 'good equilibrium' was a plausible outcome, they had no alternative but to implement a credible economic adjustment programme. Together with the fiscal consolidation measures undertaken by most other member countries seeking to curb the rise of their own public debt this resulted in a collective austerity drive without countervailing budgetary action at the euro area level.

Empirical evidence showed that during the crisis the spreads of government bond yields of crisis-hit countries relative to Germany (as depicted in Chart 5) rose to levels well beyond those that could be justified by diverging national fundamentals (see Di Cesare et al., 2012; and Battistini et al., 2014). This suggested a possible explanatory role for common or systemic factors, such as contagion effects and the perceived risk of a break-up of the euro, which could be addressed only by the euro area political leaders and EU institutions acting together.

Taken together, EMU would have benefited from the key elements of a fiscal union, notably a euro area budget to address large common macroeconomic shocks and a central insurance scheme to deal with major country-specific cyclical disturbances. Furthermore, Thygesen (2013, p.30) – academic member of the Delors Committee for the study of EMU – observed that it would have been better "to design a crisis mechanism for the situation when, despite all good intentions and rules, a country falls into severe difficulties and loses access to international financial markets". For solvent governments confronted with a 'sudden stop' in private funding one could argue that a "sudden backstop" of official funding was required, subject to policy conditions (Richter et al., 2013, p.8). As a last resort for insolvent governments a procedure for first removing the unsustainable part of sovereign debt was advisable. At the same time, offering debt relief required taking care of moral hazard concerns, preventing contagion of other vulnerable euro area countries and controlling the risks to bank balance sheets and financial stability (Bénassy-Quéré et al., 2016).

4 Towards a more perfect EMU: enhanced eurozone governance

To regain confidence, European leaders cooperated in order to remedy the three main design flaws in the architecture of the eurozone and to enhance the existing and create the new institutions necessary for a 'more perfect EMU'. Among the key objectives was to promote the correction of national economic and financial imbalances, prevent the build-up of excessive public and/or private debt, promote competitiveness and economic dynamism and, in the event that a balance of payments, banking and/or sovereign debt crisis still occurred, to have adequate crisis management and resolution tools at hand.

The intention of the many comprehensive policy measures that were announced was to demonstrate a credible joint commitment to preserving the (financial) stability of the euro area as a whole, which was a strong common interest and emerged as a new objective of all policy-makers (Cisotta, 2015; and Schimmelfennig, 2015). This joint political response to the euro area crisis showed that "like-minded people and their governments can introduce, manage and safeguard a single currency without having to merge into one overarching federal state" (Mersch, 2015).

4.1 The political commitment to do whatever is required

As the sovereign debt crisis intensified, the leaders of euro area countries and the EU institutions repeatedly stressed their political commitment – stated for the first time in December 2010 – to "do whatever is required" to safeguard the (financial) stability of the euro area as a whole (see the collection of relevant quotes from official statements by the Heads of State or Government of the Euro Area and the EU institutions).[6] This new, explicitly formulated common objective created high expectations of enhanced solidarity and deeper political integration.

[6] This collective commitment to preserve financial stability followed similar pledges after the collapse of Lehman Brothers by the European G8 members on 4 October 2008: "We jointly commit to ensure the soundness of our banking and financial system and will take all the necessary measures to achieve this objective". Similarly, the G20 leaders declared at the Washington DC summit on 15 November 2008 to "take whatever further actions are necessary to stabilize the financial system" and at their London summit on 2 April 2009 "to do whatever is necessary" to bring the world economy out of recession and prevent a recurrence of the crisis.

The political commitment to safeguard the (financial) stability of the euro area as a whole

Quotes from official statements by the Heads of State or Government of the Euro Area and the EU institutions issued during the sovereign debt crisis

Brussels, 11 February 2010: Euro area Member States will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole.

Brussels, 25 March 2010: Euro area Member States reaffirm their willingness to take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole, as decided the 11th of February.

Brussels, 7 May 2010: In the current crisis, we reaffirm our commitment to ensure the stability, unity and integrity of the euro area. All the institutions of the euro area (Council, Commission, ECB) as well as all euro area Member States agree to use the full range of means available to ensure the stability of the euro area.

Brussels, 29 October 2010 (European Council): Heads of State or Government agree on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole.

Brussels, 17 December 2010: The Heads of State or Government of the euro area and the EU institutions have made it clear … that they stand ready to do whatever is required to ensure the stability of the euro area as a whole. The euro is and will remain a central part of European integration.

Brussels, 4 February 2011: Following their December 2010 Statement, and reiterating their readiness to do whatever is required to ensure the stability of the euro area as a whole …

Brussels, 21 July 2011: We reaffirm our commitment to the euro and to do whatever is needed to ensure the financial stability of the euro area as a whole and its Member States.

Brussels, 26 October 2011: … today we agree on a comprehensive set of additional measures reflecting our strong determination to do whatever is required to overcome the present difficulties and take the necessary steps for the completion of our economic and monetary union. … All tools available [of the EFSF] will be used in an effective way to ensure financial stability in the euro area.

Brussels, 9 December 2011: Today we agreed to move towards a stronger economic union. This implies action in two directions: a new fiscal compact and strengthened economic policy coordination; the development of our stabilisation tools to face short term challenges.

Brussels, 29 June 2012: We affirm our strong commitment to do what is necessary to ensure the financial stability of the euro area ….

Brussels, 7 July 2015: We met tonight to discuss the serious situation in Greece. We noted that the euro area authorities stand ready to do whatever is necessary to ensure the financial stability of the euro area as a whole.

Market participants had been in doubt as to whether the euro area governments would be ready to provide as much concessional financial assistance in an act of solidarity to troubled partner countries as necessary and these, in exchange, would accept to implement a strict three-year economic adjustment programme supervised jointly by the EU (European Commission and ECB) and the International Monetary Fund (IMF). They feared in particular that a sovereign default of Greece would hurt private creditors, could be repeated by other governments under stress and might even lead to a break-up of the euro. Their first reaction to this heightened uncertainty was to dump the government bonds of Greece and of other vulnerable member countries and to repatriate their funds and/or to shift them towards 'safe havens'.[7]

Most fundamentally, this market reaction reflected a lack of trust in the capacity of euro area policy-makers to organise an effective common response to an attack on the single currency that was targeted at its weakest members. Market participants were regularly disappointed by the political deals that were concluded in order to address the evolving euro area crisis (usually under the leadership of Germany and France). The successive comprehensive packages that were announced after long debates were often perceived as offering only short-term relief and as ‘too little, too late’ to provide for a final solution.

The political choice of euro area leaders in spring 2010 in favour of funding the Greek government's excessive debt instead of writing it off, suggested to markets that its fiscal distress was treated as if it was a temporary liquidity problem and that money from European taxpayers was used to avoid bailing in private investors. This initial response to the Greek crisis was motivated by the heavy exposure of many European banks to Greek public and private sector debt. This meant that there were incalculable risks associated with a restructuring of Greek sovereign debt, not just for the Greek economy but for all weakened banks and vulnerable countries throughout EMU, and hence for the economic and financial stability of the euro area as a whole.

According to Legrain (2014), this choice of the European authorities transformed a country-specific issue, which was by itself manageable, into a eurozone concern of growing proportions. But as explained by Bastasin (2015), Cisotta (2015) and Hinarejos (2015), the Maastricht Treaty’s ban on bailing out Member States could only be overcome by the supporting countries stressing their overriding concern for the stability of the euro area as a whole. To this effect, the Member States added an explicit endorsement to the Lisbon Treaty (Article 136(3)) that allowed euro area countries to establish a financial assistance mechanism on a permanent basis. This was felt to be necessary to prevent the admissibility of legal complaints against the chosen strategy of giving official financial assistance on a temporary and voluntary basis under strict policy conditions. Moreover, after the three-year EU/IMF adjustment programme, the Greek government was expected to be able to return to the capital market for its funding needs. This seemed a credible prospect, if it consolidated its public finances and reformed its economy and if in turn private investors responded positively.

[7] At the same time, many domestic financial institutions stepped in to purchase more securities issued by their own government.

Continued market uncertainty about the sustainability of public debt in Greece and other vulnerable countries turned into severe market tensions following the Deauville agreement between France and Germany of October 2010. The leaders of these two countries indicated that in future a euro area country in need of official financial assistance was always expected to arrange an adequate participation of private creditors – even when it was fundamentally solvent and only needed temporary financial support from its partners to overcome short-term funding difficulties. After this burden sharing was endorsed at the euro area level, this new credit risk of an automatic private sector involvement – even though it was intended to apply only from 2013 onwards – translated for all debt-ridden countries into capital flight and soaring sovereign bond yields. The market rout only subsided when the political decision to bail in the private sector was later restricted to the exceptional case of a country with an unsustainable public debt, in line with established IMF procedures. Greece was judged to be such a 'unique case' when euro area leaders accepted that it would restructure its sovereign debt held by private creditors in March 2012 in conjunction with a second EU/IMF adjustment programme.

During the renewed Greek sovereign debt crisis from February to July 2015, when even the option of a temporary 'Grexit' was put on the negotiating table, the euro area authorities reiterated their political commitment to preserving the integrity and stability of the euro area. The third 'loans for reforms' agreement that was finally reached with Greece after months of difficult negotiations was clear evidence that "Europe will ultimately pull together, even to try to help its weakest link".[8]

As discussed below, the willingness of European leaders and institutions to act together was demonstrated by a major overhaul of the EU economic and financial governance framework. This reform included a stronger surveillance of national macroeconomic, fiscal and financial policies, the creation of a permanent common stabilisation mechanism operating under joint (but not several) guarantees of the participating countries, the main pillars of a European Banking Union, and the initiative of a Capital Markets Union. Moreover, the Eurogroup Ministers committed to take all the necessary measures to further improve their economies' resilience. They also declared to make full use of all the instruments available to preserve the integrity and stability of the euro area and to take decisive steps to further strengthen EMU.[9] Separately, the ECB President committed in July 2012 to "do whatever it takes to preserve the euro" within the Eurosystem's mandate.[10]

This collective governance shows that the character of the euro has changed from a currency without a state (whereby the EU institutions and all member countries are individually responsible for its integrity and stability subject to weak coordination mechanisms and a strict application of the no bail-out rule) into a currency beyond

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8 See "Euro economy, markets should recover on Greek deal", interview with Nouriel Roubini, Reuters, Business News, 13 July 2015.

9 See the Europgroup statement issued on 27 June 2015 in Brussels.

10 See the remarks made by Mario Draghi at the Global Investment Forum in London on 26 July 2012. Otereo-Iglesias (2015, p.359) argues that in effect a legitimate sovereign saved the euro, as his words were endorsed by the German Chancellor, Angela Merkel, "representing the full weight of the German taxpayer".

the state (for which all policy actors assume a collective responsibility and pool their resources if and when necessary). The comprehensive policy actions that were taken under the pressure of the evolving triple crisis provide evidence of a strong joint political commitment from the participating countries and the EU institutions to respectively coordinate their sovereignty and use their mandates in the common interest of safeguarding the integrity and stability of the euro area. Arguably, when unavoidable in episodes of severe market volatility, this also involved a de facto mutualisation of economic risks, albeit subject to strict conditions (Vallée, 2014).

4.2 Stronger crisis prevention

As regards new preventive instruments, one initial response to the financial crisis was to strengthen prudential supervision of systemic risks, securities markets and financial institutions. As of 2011, the European Systemic Risk Board (ESRB) is in charge of macroprudential oversight of the EU financial system and it may give warnings or recommendations to national authorities. Also as of 2011, three new European Supervisory Authorities (ESAs) have the task of coordinating more effectively national microprudential policies in the areas of banking (EBA), occupational pensions (EIOPA) and securities markets (ESMA) respectively.

Responding to the structural weaknesses exposed by the crisis, the European Commission and the Member States launched in March 2010 the Europe 2020 strategy to create the conditions for the EU to become a "smart, sustainable and inclusive economy" over the next decade. The aim was to deal both with the short-term crisis challenges and the longer-term structural reform needs. A set of EU and national policy targets should deliver high levels of employment, productivity and social cohesion. As a key element of the strategy, the European Semester has offered since the start of 2011 a new umbrella under which the Council of Ministers undertakes an annual review of the medium-term macroeconomic, fiscal and structural policy plans of the EU, the euro area and the Member States within a coordinated and consistent framework, leading to ex ante guidance and possible policy recommendations. To improve the quality of economic policy coordination the euro area countries as well as Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania further signed the Euro Plus Pact in March 2011. These EU countries committed to take concrete actions with the common objective to improve their competitiveness and convergence. The results would be monitored politically by their Heads of State and Government on a yearly basis. Furthermore, Eurostat has been given extended powers to ensure the quality and integrity of all statistical data relevant for macroeconomic and budgetary surveillance at the EU level.

A new EU surveillance framework to prevent and correct harmful and excessive macroeconomic imbalances entered into force in December 2011 (see Kamps et al., 2014). The so-called Macroeconomic Imbalance Procedure (MIP) seeks to address a range of economic and financial vulnerabilities in Member States, as would for example show up in high private debt, deteriorating price and cost competitiveness and rising unemployment. The annual examination of a country's position by the European Commission is based on a scoreboard of 'early warning' indicators and

may be followed up by an in-depth review. The conclusions may lead to specific monitoring and an intensified dialogue with the national authorities if an imbalance is identified. But if the imbalance is judged to be excessive, this could trigger – only for euro area countries – an excessive imbalance procedure and an enforcement of corrective policy measures, including through financial sanctions if the (planned or implemented) corrective actions were deemed insufficient. The assessment takes account of the severity of macroeconomic imbalances and their potential to generate negative spillover effects to other participating countries that could pose risks to the smooth functioning of EMU. Member countries with a large and persistent current account deficit may in this regard be recommended to correct them as a matter of urgency, especially when their situation raises concerns about the sustainability of net external debt. Countries with repeatedly very large current account surpluses clearly do not face such concerns. This makes it unlikely that they would ever face an excessive imbalance procedure and potential sanctions calling for a reduction of their current account surplus. These countries are nevertheless expected to identify and implement policy measures that raise potential growth and domestic demand.

To improve the effectiveness of EU budgetary surveillance, the Stability and Growth Pact has been reinforced in December 2011, in particular for euro area countries (see Koester et al., 2012). This included inter alia the introduction of an expenditure growth rule, a renewed focus on a steady decline of high government debt towards the 60% of GDP reference value and new financial sanctions for euro area members to address non-compliance. Moreover, a new EU directive was adopted which sets requirements for national budgetary frameworks. A new EU regulation strengthened, from May 2013, the budgetary surveillance mechanisms in the euro area even further. They gave new powers to the European Commission to assess the draft budgetary plans of euro area countries and request a revision, if necessary, as well as to secure the timely and durable correction of a country's excessive deficit. To foster national ownership, compliance with EU fiscal rules also had to be monitored by an independent body, such as a National Fiscal Council.

As a further new legal instrument to promote sustainable public finances, economic policy coordination and eurozone governance, the Treaty on Stability, Coordination and Governance in EMU (TSCG) entered into force on 1 January 2013 for the 16 Member States which had completed ratification and on 1 April 2014 for all the 25 signatory parties (comprising all Member States except Croatia, the Czech Republic, and the United Kingdom). As part of the Fiscal Compact that is enshrined in this intergovernmental treaty, countries had to introduce in their national legislation a structural balanced budget rule and an automatic mechanism to correct deviations (see Koester et al., 2012). Moreover, the TSCG enhanced the excessive deficit procedure, in particular by introducing more automatic steps when a euro area country breaches the Maastricht Treaty's deficit ceiling of 3% of GDP. The TSCG also gives the government debt reduction rule of the reinforced SGP the status of primary law and requires the more timely and comprehensive ex ante reporting of public debt issuance plans at the European level. The latter should lead to a better coordination of national public debt management strategies.

The TSCG also calls for stronger economic policy coordination to promote growth and foster the smooth functioning of EMU through enhanced convergence and competitiveness. To make this operational, all major economic policy reforms planned by a country should be discussed ex ante and – where appropriate – coordinated among all Member States bound by this provision. A ‘Compact for Growth, Jobs and Competitiveness’ with indicative targets was agreed in June 2012 to complement this aspect of the TSCG. This initiative led to political discussions on the potential usefulness of offering financial incentives to Member States that signed up to country-specific growth and job-enhancing policies as laid down in mutually agreed 'cash for reform' contracts. However, a positive conclusion on this suggestion could not be reached.

Faced with the need to break the vicious financial nexus between banks and their sovereign, euro area leaders furthermore took the historical decision in June 2012 to move towards a European Banking Union, which is also open for other EU countries wishing to join. With the establishment of the Single Supervisory Mechanism (SSM), which became operational in November 2014, the ECB assumed full responsibility for supervising all the 123 significant banks in the eurozone (after a comprehensive health-check of their balance sheets) representing about 85% of total banking assets in the euro area. In addition, it received ultimate intervention powers for the nearly 3200 less significant banks (at the consolidated level) which remain under national supervisory control, subject to a new single rulebook.

The European Banking Union also enlarges the options for medium-size banks to lend to households and firms abroad, which in turn supports private risk sharing in bank credit markets across EMU, once these banks have tackled their crisis legacy of non-performing domestic loans. Given its independent supervisory powers, the ECB is able to address excessive risk-taking by individual banks and to take account of the related cross-border externalities. Moreover, it has been entrusted with new macroprudential tasks and tools. These enable the ECB to impose stricter (but not weaker) measures on banks than those imposed by the newly established national macroprudential authorities, if it sees a need to counter financial imbalances (see Angeloni, 2014). An interinstitutional agreement with the European Parliament and a memorandum of understanding with the EU Council ensures that the ECB in its role as the responsible supervisor for the banking sector is subject to democratic accountability.

Finally, the European Commission (2015b) put forward an action plan to build a Capital Markets Union, i.e. a genuine single market for capital based on uniform financial legislation that should unlock non-bank funding sources, support more allocation of savings across the union in the form of equity rather than debt and contribute to stronger growth in Europe. A further benefit is the greater scope for private risk sharing in the single capital market, associated with the union-wide diversification of investors' corporate bond and equity portfolios, the creation of comparable corporate insolvency regimes and the establishment of equivalent creditor protection and legal standards (see also European Central Bank, 2016).

4.3 Stronger crisis management and resolution

Following the outbreak of the sovereign debt crisis in early 2010, several euro area countries faced liquidity stress or lost market access. Given the evidence of financial contagion to other vulnerable members, there were growing risks for the economic and financial stability of the euro area as a whole. To improve crisis management and resolution, European leaders committed substantial financial resources to create new common fiscal backstops as a 'firewall' against the spreading of sovereign default concerns, subject to a strict adjustment programme to be undertaken by the receiving country. After an initial bilateral loan facility for Greece, these instruments comprised the temporary European Financial Stability Facility (EFSF) and European Financial Stability Mechanism (EFSM) and later the permanent European Stability Mechanism (ESM). They were complemented by the financing facilities of the International Monetary Fund (IMF). New EU legal provisions in force since May 2013 gave a firmer legal basis to more intrusive policy surveillance of euro area countries in financial distress or receiving financial assistance, as initially this oversight was being practised on an ad hoc basis by the 'troika' of European Commission, ECB and IMF.

The Treaty establishing the European Stability Mechanism – an intergovernmental agreement between the euro area countries – was signed in February 2012.[11] The ESM instruments available to member countries facing financing difficulties (if they have ratified the TSCG and implemented the Fiscal Compact) are credit lines (either on a precautionary basis or under enhanced policy conditions), market support facilities (for access to primary or secondary government bond markets), loans to assist with bank recapitalisation (subject to financial sector conditionality) and loans in case market access was lost altogether (then involving the IMF where possible and with full conditionality). Although the effective financial resources available to the ESM are subject to a ceiling of EUR 500 bn, they offer troubled countries protection from undue market pressure and help to ring-fence them against cross-border contagion to the rest of the eurozone.

Euro area countries that do not just face a lack of liquidity but are virtually insolvent, as shown by an examination of their public debt sustainability, require a permanent remedy before being able to draw on the ESM: in line with IMF procedures they are expected to negotiate a debt restructuring with their private creditors, in order to remove the debt overhang. Although there is at present no EU statutory framework for dealing with a sovereign's insolvency, all euro area countries are including the same type of collective action clauses (CACs) in central government bond contracts issued from January 2013. This feature should facilitate an orderly sovereign default procedure for exceptional cases in the future.

[11] On 27 November 2012, the European Court of Justice judged that the tasks and functions of the ESM were compatible with the provisions of the EU Treaties, in particular the no bail-out clause, provided that three conditions were met: 1) the financial assistance for a distressed eurozone country served to safeguard financial stability in the euro area as a whole, 2) the beneficiary state would have to meet strict policy conditions, and 3) it remained fully responsible for its own commitments with regard to its creditors. See Case C-370/12, Thomas Pringle v. Government of Ireland. For a discussion from a constitutional perspective see Hinarejos (2015).

The Eurosystem for its part initiated in May 2010 a series of limited and initially sterilised interventions into impaired national government bond markets under its Securities Market Programme, so as to restore a homogeneous transmission of monetary policy across the eurozone. This temporary facility was replaced in mid-2012 by the strong commitment of the Eurosystem to activate unlimited Outright Monetary Transactions (OMT) in national sovereign bond markets affected by a currency redenomination risk, if this was required for monetary policy reasons and the countries concerned had accepted the strict conditions of an EFSF or ESM adjustment programme.[12] [13]

Moving on to the banking sector, the EU Bank Recovery and Resolution Directive provides the competent national authorities with common powers and instruments to pre-empt banking crises, intervene early in troubled banks and resolve them in an orderly way in the event of failure. The provisions for restructuring distressed banks and sharing the burden entered into force in January 2016. They require the national resolution authorities to first write down the claims of shareholders and then convert the claims of unsecured creditors and, if needed, eligible bank deposits into equity, before granting access to the national bank resolution fund (that must be built up over 10 years through bank levies).

Among some other liabilities, deposits covered by retail deposit guarantees are excluded from such bail-in operations. A recast EU directive on Deposit Guarantee Schemes provides for the harmonisation of national deposit insurance schemes – fully protecting retail bank deposits up to EUR 100,000 – and ensures that these are pre-funded by the banking sector with a targeted level of 0.8% of the amount of the covered deposits of its members (i.e. about EUR 55 bn for the EU as a whole) to be reached over a ten-year period until mid-2024.

The priority given to a bail-in of the private sector over a bail-out by the public sector should give market actors a stronger incentive to closely watch the risk exposure of the banks in which they invest. Subject to the EU's state aid rules, in exceptional circumstances, the government could still inject temporary capital into solvent banks that cannot access sufficient private funds. Also in emergency situations, when financial stability is in danger, the government is allowed to use taxpayer funds for capital injections.[14]

Governments without the necessary fiscal capacity could borrow from the ESM to recapitalise troubled banks, in line with existing procedures (as applied in the case of Spain in 2012 and of Cyprus in 2013). Alternatively, the ESM instrument for direct bank recapitalisation may be activated to return the systemic bank in question to

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[12] On 16 June 2015, the European Court of Justice judged that the OMT programme was compatible with the provisions of the EU Treaties, in particular that it falls within the scope of the ECB's mandate and includes sufficient safeguards to avoid monetary financing. See Case C-62/14, Gauweiler and Others.

[13] De Nederlandsche Bank received in 2012 a guarantee from the Dutch government for the crisis-related exposure to the extraordinary financial risks that it assumed under these non-standard monetary policy measures taken by the Eurosystem. This allowed De Nederlandsche Bank to maintain lower risk buffers and hence to make higher annual profit payments to the Dutch government than otherwise.

[14] For the period until 2016, the state aid rules updated by the European Commission in August 2013 created a harmonised EU framework for bank rescue operations financed by Member States.

viability. As a precondition, from November 2014 to December 2015, at least 8% of the bank's liabilities had to be bailed in first, while since January 2016 all the burden-sharing arrangements that then became operational must first have proved to be insufficient. The ESM funds earmarked for direct bank recapitalisation are limited to EUR 60 bn.

As an integral part of the European Banking Union, a Single Resolution Board was established as the Single Resolution Authority for significant and cross-border banks in the participating Member States. The decisions on whether and how to use its resolution powers are taken upon a proposal from the ECB (in its capacity as the responsible authority of the Single Supervisory Mechanism) that such a bank is on the brink of failing and based on a resolution scheme adopted by the European Commission. Since January 2016, the Single Resolution Board can draw upon a Single Resolution Fund (SRF) with a targeted level of EUR 55 bn financed by risk-based contributions from the banking industry. An intergovernmental agreement arranged that the bank payments into the national resolution funds are progressively transferred to national compartments of the SRF which are to be merged over an eight-year period starting with 40% in 2016 and 20% in 2017 and continuously increasing by equal amounts over the subsequent six years until the SRF is fully mutualised. During the build-up phase, when the SRF may not yet be sufficiently funded by the banking sector, governments stand ready to make bridge financing available as a last resort, either from national resources (an individual credit line backed by bank levies) or from the ESM. The intention is to develop a common backstop for the SRF that is ultimately funded by the banking sector and therefore fiscally neutral over time. As a result, the costs of bank failures paid by the SRF will in the end always be borne by the banking industry and not by taxpayers.

4.4 Explanations for the survival of the euro

Altogether, European leaders and EU institutions have taken many vital steps to address the three main design flaws of EMU. Their response to the triple crisis constituted the most far-reaching set of institutional enhancements since the single currency was launched. As a result, during the many episodes of financial market volatility the affected euro area members could count on substantial stability support from their partners, including an ECB commitment to a potential monetary policy intervention. Alongside, the European authorities put in place stronger, albeit more complex rule-based frameworks for both banks and governments to reduce the risk of new imbalances and prevent future euro area crises.

Given this revamped EMU architecture, one could reasonably argue that the euro is viable as a currency beyond the state and that it has successfully countered the widespread belief that a monetary union always needs a nation state in order to survive (Mersch, 2015). This view assumes of course that the European institutions will operate in a fully effective manner and the enhanced common rules of behaviour are strictly implemented and rigorously enforced to balance greater solidarity with stronger compliance.

Looking back, Ioannou et al. (2015) ask the fundamental question what exactly motivated European leaders during the euro area crisis to take these steps towards a deeper and more integrated EMU. Reviewing a range of academic studies based on different but complementary theoretical approaches to explain this outcome, they conclude that the economic interdependies between the participating countries were so strong and the costs of a break-up of the euro so high that "no one wanted EMU to fail, including the general public" (Ioannou et al., 2015, p.172).

Combining the various theoretical analyses, this strong and widely shared desire suggested that the introduction of the euro created its own dynamics in a crisis that challenged the existing EU institutions. The emerging macroeconomic imbalances, the uncontrolled financial booms and the rising sovereign default risk after the bust showed that the existing EU tools to enforce sound national policies, coordinate a sustainable rebalancing between member countries and preserve financial stability for the euro area as a whole were deficient, not applied, or simply missing. This pointed to serious functional shortcomings in the set-up of EMU, reflecting that the area-wide policy mix was determined by one centralised monetary policy and many decentralised fiscal policies and prudential frameworks. The collective political solutions that were adopted to address the three main design flaws of EMU that were discussed above, responded to pressure from business, financial and elite interests to preserve the euro and tried to reconcile eurosceptic voices and legal constraints with a generally supportive public opinion. This ensured that the new EMU architecture emerging from the tense negotiations between the elected representatives of the Member States also rested in national political legitimacy.

Following the analysis by Schimmelfennig (2015), the common political objective of preserving the euro in a crisis situation of negative interdependence was essential to overcome the divergent preferences of the relatively 'safe' creditor countries and the more 'vulnerable' debtor countries; this focused the minds of all the negotiators in a process of 'hard bargaining' so as to arrive at cooperative solutions to stabilise the euro. During the tough negotiations about how best to address the euro area crisis the creditor countries mostly favoured stronger supranational surveillance, tighter supervision of systemic banks and stricter enforcement of sound national policies, anchored in EU law, in order to more effectively limit the risk of macroeconomic and fiscal imbalances and renewed bank rescues. At the same time, they preferred to keep political control over new euro area stabilisation mechanisms that entailed a significant pooling of national budgetary resources. By contrast, the debtor countries were generally more hesitant to submit themselves to a reinforced EU governance and risk control framework. They moreover looked for crisis protection by introducing supranational risk sharing mechanisms in EU legislation rather than in the form of intergovernmental treaties.

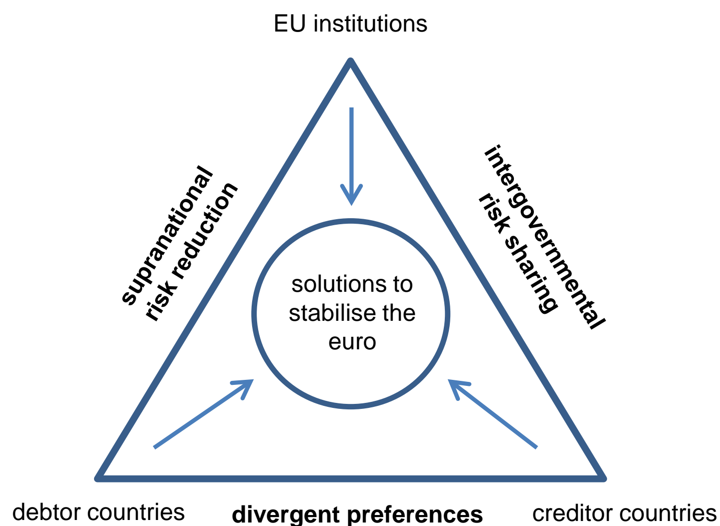
The EMU institutional enhancements resulting from these negotiations combined risk reduction and risk sharing agreements, which were laid down respectively (broadly at least) in EU legislation within the boundaries of the Lisbon Treaty and in separate intergovernmental treaties with the (explicit or implicit) intention to integrate these later into the EU Treaties. According to Schimmelfennig (2015), the exact design of the new common institutions and the terms of stabilisation in the end reflected the

relative bargaining powers of the two groups of euro area countries, whereby in most cases the creditor countries prevailed.

The bargaining process, however, also involved the EU institutions (see Chart 6). Bastasin (2015) observes that national thinking prevailed during the crisis, leading to a fight between the ECB – asking for a 'quantum leap' in economic governance and a euro area stability mechanism with sufficient resources and a strong mandate – and governments of creditor and debtor countries alike reluctant to take sufficiently determined measures to address the underlying problems. Legrain (2014) argues that European leaders failed to live up to their political commitment to stabilise the euro area because the measures taken under exceptional uncertainty fuelled market panic instead of containing it, leading to the near-collapse of the euro. He criticises them for allowing the triple crisis – which could have united Europe – to become a divisive force, inter alia, due to their battles over how to share the burden of losses. As a consequence, the ECB was forced to 'buy time' for politicians to develop effective crisis solutions that were agreeable to all (Eijffinger and Hoogduin, 2012). During the euro area crisis, the President of the European Council, Van Rompuy, often played a vital role in finally aligning the conflicting views. While important progress was achieved in designing a more crisis-prone euro area governance framework, the interest in addressing the longer-run challenges to EMU waned, however, as as soon as the market pressures abated.

Chart 6

Collective governance to stabilise the euro



Source: Based on an extension of the analysis by Schimmelfennig (2015).

5 Coordinating versus sharing national sovereignty for euro area stability

Several observers have expressed doubts as to whether the post-crisis 'executive federalism' of reinforced EU institutions and new intergovernmental arrangements will be sufficiently strong to secure the integrity and stability of EMU in the longer term. Moreover, national economic sovereignty remains the cornerstone of the new EMU architecture. Bastasin (2015) attributes this result to policy-makers' continued accountability to national democratic systems, their unwillingness to see the euro as a new political dimension and the weakly legitimated supranational governance of the eurozone this led to. The crisis experience suggests to him that the institutional design and regulatory framework of the current 'post crisis EMU' (see the overview on p.43) must be further enhanced in order to successfully govern the euro as a currency beyond the state (see also Deutsche Bundesbank, 2015; Villeroy de Galhau, 2016; and the collection of essays in Baldwin and Giavazzi (eds.), 2016).

The new status quo of collective governance demands mutually consistent and coherent national policies as well as complementary measures at the eurozone level to ensure EMU-friendly outcomes (cf. Buti, 2014; Draghi, 2014b; Pisani-Ferry, 2015). However, in a number of key areas the common mechanisms for crisis prevention, management and resolution are still to be completed. EU institutions have few tools, if any, to correct the policies of sovereign Member States that – despite the common rules to which they subscribed when adopting the euro – are unwilling or unable to internalise the policy requirements of moving towards a more optimum currency area. Adequate euro area mechanisms for realising a more sustainable symmetric rebalancing between member economies and securing a policy mix attuned to the needs of the euro area as a whole are missing. The degree of risk sharing taking place through private and public channels for cushioning large asymmetric shocks and addressing a sovereign liquidity or solvency crisis also leaves a few things to be desired. Moreover, there remains a wide gap to bridge between the political accountability of eurozone decision-makers and national democratic legitimacy.

5.1 Visions of a deep and genuine EMU

Acknowledging these challenges, European leaders and institutions also considered how to further enhance the EMU's design and how to make it politically sustainable – a question already put forward by many observers in the past, for example, by Dyson and Featherstone (1999, p.796). The European Commission (2012) presented them with an ambitious blueprint for a ‘deep and genuine EMU’ that according to a specific time plan would subject all major economic and fiscal policy choices of its member countries to increasingly closer coordination, endorsement and surveillance at the eurozone level. This integration would be accompanied by commensurate progress towards a political union. The European Parliament also made a contribution in this direction.

The four Presidents of the EU (i.e. those of the European Council, European Commission, Eurogroup and European Central Bank) offered their own vision of a ‘genuine EMU’ and put forward a roadmap (see Van Rompuy, 2012). Their reports proposed to extend the monetary union with integrated frameworks for financial, budgetary and economic policies that are subject to democratic control and accountability at the level where the decisions are taken. This should lead in three stages to a financial market union, a central fiscal capacity to facilitate adjustment to country-specific shocks and systematic coordination of major economic reforms to address structural rigidities. The four Presidents further noted that the joint exercise of sovereignty for common policies and mutual solidarity also called for ensuring the necessary democratic legitimacy and accountability of EMU decision-making.

Reflecting on these contributions, the European Council agreed in December 2012 on a roadmap for the completion of EMU, focused on achieving deeper integration and reinforced solidarity for the euro area countries, building on the EU's institutional and legal framework. However, European leaders could not reach a agreement on the substantial transfer of national sovereignty implied by the proposals, other than what was necessary to put in place the main pillars of a European Banking Union. This also precluded any form of mutualisation of national government debt into eurobonds in view of the implied moral hazard that would affect the participating countries as long as no fiscal union existed to discipline their fiscal behaviour.

A new impetus came with a further study by the five Presidents of the EU – this time also in association with the President of the European Parliament (Juncker, 2015). Their report described EMU as a house under construction that had to be stabilised quickly when the storm hit. To reinforce its foundations the five Presidents proposed three stages for further euro area integration. For Stage 1 (to run from 1 July 2015 to 30 June 2017) the report called upon European leaders to take immediate action on four fronts:

1. to complete the financial market union, comprising a full banking union, a well-functioning capital markets union under a single supervisor and a reinforced macroprudential oversight of all financial players;

2. to initiate a stronger coordination of economic policies focused on increasing competitiveness, output growth, employment, social inclusion and convergence while ensuring an effective economic rebalancing between member countries;

3. to achieve and maintain sound fiscal policies, as a condition for sustainable public debt and regaining fiscal space for cushioning national economic shocks while also ensuring an appropriate euro area average fiscal stance; and

4. to strengthen euro area democratic legitimacy and accountability by giving a key role to the European Parliament in the European Semester with a more direct involvement of national parliaments, as well as to reinforce euro area institutions by giving a central steer to the Eurogroup, moving towards a unified external representation of EMU and integrating most of the intergovernmental agreements concluded since the crisis in the framework of the EU Treaties.

A European Commission White Paper should then outline in spring 2017 the more far-reaching steps and legal measures needed to complete the architecture of EMU in Stage 2 (due to start on 1 July 2017). This stage would involve inter alia:

1. a sharing of sovereignty over economic policies of common concern, formalised by a more binding convergence process to a set of commonly agreed high-level benchmarks that, once reached, would allow for
2. the introduction of a fiscal stabilisation function at the euro area level operating with pooled resources and projects to cushion large macroeconomic shocks hitting member countries and to make EMU overall more resilient;
3. a further institutional strengthening of EMU by setting up a euro area treasury for collective fiscal policy decisions subject to euro area democratic legitimacy and accountability, and by integrating the ESM Treaty into the EU Treaties

Once Stage 2 was completed, the final stage would see a 'deep, genuine and fair EMU' (to be reached at the latest by 2025).

Further to the Five Presidents' Report, the European Council confirmed in December 2015 its commitment to work towards completing EMU.The European Commission (2015c) has in the meantime put forward concrete steps for Stage 1 of the process to deepen EMU.

5.2 Governance of the euro as a currency beyond the state

The political preference for collective governance and the principle of nation states *coordinating their sovereignty* to safeguard the euro as a currency beyond the state faces a number of challenges. Going forward, more effective common mechanisms for risk reduction and control are warranted, i.e. a reinforcement of national policy discipline associated with the free functioning of open and competitive markets. These market-led incentives may have to be complemented at times by a central enforcement of the common rules of behaviour, entailing "full coordination" rather than "full integration" of national economic policies (see Villeroy de Galhau, 2016). Such a better risk management system probably first needs to show tangible results before substantial additional risk sharing via euro area public sector channels can realistically be envisioned (Cœuré, 2016).

A viable governance model for a 'sustainable EMU' implies further steps of euro area integration and capacity building covering the main elements of the Five Presidents' Report and a few other key features to round it off (see the overview on p.43). This process would lead to an extension and deepening of collective decision-making (rather than a political centralisation of decisions) with member countries increasingly *sharing their sovereignty* in euro area institutions in all macroeconomic, fiscal and financial policy areas of relevance for a well-functioning monetary union

Economic and financial governance in the post-crisis EMU and in a sustainable EMU

	Coordinating sovereignty (Post-crisis EMU)	Sharing sovereignty (Sustainable EMU)
Governance of national policies		
1. Risk control		
a. Private		
Market-based discipline	Partial internal market	Complete internal market
b. Public		
Sustainable economic policies	Surveillance of common rules	Ability to enforce common rules
Financial sector supervision	National authorities, SSM, ESAs	Single financial supervisor(s)
Macroprudential supervision	National authorities, ESRB, ECB	Single financial supervisor
2. Risk sharing		
a. Private		
Market-based channels	Partial internal market	Complete internal market
Private sector bankruptcy	National bankrupty regimes	Common bankruptcy regime
b. Public		
Asymmetric economic shocks	National shock absorption	National + central shock absorption
Sovereign liquidity crisis	ESM facilities, OMT	ESM facilities (backed up by EMU treasury) combined with debt reprofiling, OMT
Sovereign solvency crisis	ESM loans, CACs for debt restructuring	ESM loans (backed up by EMU treasury) combined with debt restructuring
3. Democratic legitimacy	National parliaments	National parliaments
Governance of EU/EMU policies		
1. Risk control		
a. Private		
Policing of internal market	European Commission,European Court of Justice	European Commission, European Court of Justice
b. Public		
Sustainable economic policy	Coordination in European Semester	Central economic policy
Financial sector supervision	SSM, ESAs	Single financial supervisor(s)
Macroprudential supervision	ESRB, ECB	Single financial supervisor
2. Risk sharing		
a. Private		
Systemic financial crisis	Private sector bail-in	Private sector bail-in
b. Public		
Symmetric economic shocks	ECB monetary policy, coordinated or aggregated fiscal stance	ECB monetary policy, euro area fiscal stance
Safe + liquid sovereign asset	National sovereign bonds	Synthetic eurobonds
Systemic financial crisis	SRF(no common backstop), direct recap. of banks by ESM, harmonised deposit insurance schemes	EMU treasury behind SRF and direct recap. by ESM, European Deposit Insurance Scheme
3. Democratic legitimacy	European Parliament, national parliaments	European Parliament with a euro area chamber

Genschel and Jachtenfuchs (2016) observe in this respect that the more European integration advances, the more it involves the core powers of Member States, going further than the coordination of sovereign national policies in line with common rules and procedures. For euro area countries with a shared interest in the performance of the single currency this implies giving up direct control over ever more attributes of a sovereign nation state beyond their earlier loss of sovereignty over the imposition of

barriers in the internal market, the conduct of monetary policy and more recently the prudential supervision of banks.

Further euro area integration would increasingly constrain their autonomy over the national fiscal policy stance, their authority over local economic structures and their remaining competence to regulate the domestic financial sector. These sovereign powers give member countries control over vital instruments for providing security of jobs, income and savings to their citizens, as they may be exploited by policy-makers to stabilise the business cycle, protect living standards and provide insurance against financial losses, in accordance with national preferences and political choices. As the economies of the euro area countries are becoming increasingly interconnected and interdependent, these national sovereign powers are ever more difficult to maintain and would at least have to be shared in common institutions.

To make this path politically feasible at all European leaders will first need to agree on a shared vision of the direction in which the euro area and its institutions should evolve, taking account of their citizens' views (Pisani-Ferry, 2015). A shared vision would be a precondition for each of them to internalise the significant constraints on their sovereign policies that unavoidably arise from participating in a monetary union. This in turn makes political action necessary to remove the apparent 'democratic deficit' for economic and financial policy decisions taken at the EMU level. As the Four Presidents' Report formulated it: "Closer EMU integration will require a stronger democratic basis and broad support from citizens. For this reason, it is essential that already the process towards realising this vision is based on wide consultation and participation. Integration and legitimacy have to advance in parallel" (Van Rompuy, 2012, vision report, p.3). Naturally, new transnational democratic arrangements would have to be laid down in the EU Treaties. The national constitutions of the member countries would have to be amended accordingly. This also presupposes the existence of common values among euro area citizens and a sense of common purpose leading to national ownership of euro area policies, discipline and solidarity (see also Habermas, 2011; Crum, 2013; and Rodrik, 2015).

5.3 Securing the sustainability of EMU

The main challenges for collectively managing the euro as a currency beyond the state – whereby statehood remains national but sovereignty is shared in areas of vital importance for the proper functioning of EMU – can be elaborated in at least seven points. As it will take considerable political courage and leadership to address these challenges, the discussion below also identifies some possibilities for taking smaller steps ahead to secure the sustainability of EMU.

First of all, it is important to preserve the market-based incentives for economic adjustment and national policy discipline and to complement these with effective central intervention powers (see also van Riet, 2016). Markets play an important role in guiding economic agents in efficiently allocating resources and adjusting to a changing environment. This is especially true for EMU, where volatile intra-area

exchange rates do not distort cross-border comparisons and internal adjustment processes.

The proper working of the market mechanism in managing opportunities and risks across the eurozone is however hampered by internal market barriers, nominal rigidities, financial frictions and impaired private sector balance sheets. Many banks moreover are exposed to high public debt. This constrains potential output growth and fuels economic divergences between member countries (see Ruscher, 2015). Governments therefore have the task to promote open and competitive markets and flexible economies, while the European Commission and the European Court of Justice police the application of internal market legislation. Moreover, full compliance with the reinforced EU economic governance framework together with strict macro and microprudential supervision of the financial sector should promote both private sector and public sector deleveraging and restore sound and resilient balance sheets.

Countries participating in an international treaty naturally assume that all signatories will fully adhere to the agreed rules of behaviour. The Lisbon Treaty in this respect expects Member States to fulfil their duty of 'sincere cooperation' and to faithfully implement European decisions as well as to respect the constraints imposed on those policies that – in line with the subsidiarity principle – are (still) more effectively pursued at the national level. At the same time, this assumption makes EU countries vulnerable to non-compliance with common rules, misaligned national interests or even opportunistic behaviour by one or more of their partners (see Richter, 2013).

The Member States that adopted the euro – a decision associated with very high exit costs – therefore have a strong mutual interest in ensuring that all members pursue stability and growth-oriented economic policies. To meet their valid concerns, the Five Presidents' Report made the suggestion to strengthen both national ownership and mutual control. All member countries could introduce National Competitiveness Authorities with an independent mandate to assess the implementation of economic and institutional reforms and developments in labour costs relative to trade partners. They would coordinate their opinions in a euro area system. A similar euro area framework is being developed to coordinate the existing independent National Fiscal Councils in an advisory European Fiscal Board (see European Commission, 2015c).

To counter the risk of free-riding by individual Member States, European authorities should also strengthen market-led incentives. This can be achieved by completing the EU internal market, restricting the preferential treatment of national sovereign bonds in EU financial legislation and restoring the credibility of the no bail-out rule of the Maastricht Treaty (see Wyplosz, 2013; Wendorff and Mahle, 2015; Feld et al., 2016; and point six below).

Looking further ahead, as markets may not always give the right signals, national authorities may also have to give stronger political steering and intervention tools to European institutions, empowering them if needed to align the fiscal and structural policies of individual euro area countries with EMU requirements (see Trichet, 2013). This ability to enforce compliance is important, both to ensure further economic and institutional convergence and to facilitate a sustainable rebalancing between euro

area economies that consistently involves all member countries. The Five Presidents' Report assigns in this respect a central steering role to the Eurogroup and a euro area treasury.

Such a more forceful intervention may under circumstances constrain national economic sovereignty. The corresponding decisions and actions must therefore be subject to a commensurate supranational democratic legitimacy and accountability. Central political institutions that impose EMU-related decisions must in the end reflect the views of their constituency, so as to gain the trust of euro area citizens they need for their effective implementation (see Rodrik, 2015; and below under point seven).

Second, an effective monetary union requires a single diversified financial system that provides opportunities for market-based risk sharing across national borders, facilitates the transmission of monetary policy and secures overall financial stability. Completion of the Capital Markets Union and the European Banking Union should therefore be a high priority on the political agenda. Securing an encompassing and effective EU system of macroprudential oversight also deserves attention.

A deeply integrated capital market is characterised by a single set of rules and offers participants equal access to financial instruments and services as well as equal treatment of their financial activities (Constâncio, 2016). Completing the internal market in this area demands single supervision and harmonised corporate law, bankruptcy legislation, creditor protection, capital taxation, legal enforcement and other financial legislation. Such a level playing field could increase foreign direct investment and enhance the corporate sector's financing opportunities in integrated securities markets and hence for market-based risk sharing (see European Central Bank, 2016).

EMU is however still characterised mostly by bank-based rather than market-based corporate financing and banks are also the basic source of credit for consumers. A sound, safe and integrated euro area banking system is therefore essential for cross-border private risk sharing in bank credit markets, a smooth transmission of monetary policy and for financial stability throughout the eurozone (Linzert and Smets, 2015). The short-term political focus has been on breaking the pernicious feedback loop between fragile systemic banks and their vulnerable governments in a crisis, an issue to which the steps towards a European Banking Union offered a partial solution. As pointed out by Schoenmaker (2015), the long-term objective should be to adequately deal with the intensification of cross-border banking in an integrated euro area financial market. The greater opportunities for private risk sharing in an area-wide market for bank credit must be balanced by truly European supervision, recovery, resolution and depositor protection to address the attendant risks for financial stability.

A similar argument could be applied with equal force to the growth of non-banking financial services, where national regulation and supervision still largely prevail, subject to EU directives. A comprehensive macro and microprudential framework needs to go beyond banking and cover the whole financial system (cf. Constâncio, 2016).

As noted by many observers, European leaders have so far put in place only half a European Banking Union (for example Posen and Véron, 2014). Although this is a major political achievement, there are still several national elements in European banking supervision, recovery, resolution and deposit insurance which prevent a level playing field for banks operating across national borders (see also European Central Bank, 2016). The ECB's preventive interventions in its new function as the responsible supervisor for the banking sector are bound by EU prudential legislation, which in some areas gives local regulators leeway to apply national options and discretionary measures. EU banking law also accepts large exposures to public debt and largely exempts it from risk-based capital and liquidity requirements, making it necessary for the ECB to call on some banks to contain the attendant risks. In addition, national bank regulations affect the scope of the ECB's supervisory actions, although there is a formal mediation procedure to settle differences of views with national competent authorities in how to implement the single rulebook.

Moreover, the risk remains of a re-emergence of vicious national feedback loops when vulnerable sovereigns may still have to rescue weak systemic banks, notably when in a crisis situation the limits of a private sector bail-in are reached. The Single Resolution Authority that will deal with troubled banks leaves some autonomy with the national authorities. Schoenmaker (2015) observes that there is no governance mechanism to resolve disputes between the different crisis-management agencies at the national and supranational levels. The financial capacity of the Single Resolution Fund (SRF) to act as a lender of last resort for distressed banks is restricted to just EUR 55 bn and will only be reached after a transition period of eight years. Although it could borrow in the market to increase its firepower, the SRF would need a credit guarantee from the participating countries to make this at all feasible. As an interim solution Eurogroup and ECOFIN Ministers agreed in December 2013 to make bridge financing available as a last resort. However, the European Council conclusion of December 2012 to give the SRF access to an ultimate fiscal backstop at the euro area level, for example in the form of a temporary credit line from the ESM (whereby any public sector assistance for resolving a failing bank would be recouped through ex post levies on the whole banking industry), still has to be implemented.

Following the recommendations of the Five Presidents' Report for Stage 1 of further euro area integration, the European Commission presented in November 2015 a proposal to establish in three stages a European Deposit Insurance Scheme (EDIS), accompanied by a series of measures to reduce risks in the banking sector. The first step of the EDIS foresees introducing a three-year re-insurance of national deposit guarantee schemes before moving on to co-insurance in 2020 and full insurance in 2024. The EDIS is a key element towards completing the European Banking Union. Moving from many harmonised national deposit guarantee systems to a common deposit insurance scheme that also includes a European Deposit Insurance Fund is warranted, in order to further secure the safety of retail bank deposits, reduce the nexus between banks and their sovereigns and reinforce financial stability. The EU Council has started the process of determining its position on the proposed EDIS. Some Member States have expressed their reservations. As an alternative, euro area countries may decide to retain control over the central use of their national

deposit insurance funds by concluding a time-bound intergovernmental agreement rather than signing up to EU legislation in this field.

The main resistance to completing the European Banking Union appears to be related to the crisis legacy burdening a number of banks that still face high risks from non-performing loans and a heavy exposure to their own high-debt governments. This makes a mutualisation of national bank resolution funds and deposit insurance funds an unattractive proposition for participating countries with a relatively healthy banking industry as well as a sound fiscal position. Further progress might only be envisaged once the risk of future bank failures in the eurozone has been reduced to a low level and is more equally distributed. To reach such a level playing field all banks must complete the process of building up strong capital and liquidity buffers and cleaning up their balance sheets under (final) supervisory responsibility of the ECB. This could also entail changes in the prudential treatment of banks' exposure to sovereign debt.

Third, EMU requires a single sovereign benchmark asset that can function as the cornerstone of a stable and truly single euro area financial system and support financial integration (see International Monetary Fund, 2012; Castro and Mencía, 2014). Giovannini (2013) explains that a pooling of national sovereign risk is needed in order to create a deep and liquid euro area government bond market and a single reference asset with which a full integration of the financial system can be achieved. From this point of view, the introduction of eurobonds is an essential component of a genuine Capital and Financial Markets Union.

A monetary union with free capital mobility and an individual member's ‘safe haven’ bonds functioning as a nominal anchor for the whole financial system will always see international investors searching for yield and buying the most risky government debt in quiet times, while scrambling for safety and moving into the most ‘risk free’ and ‘liquid’ sovereign bonds in crisis times. The sharp reversal of capital flows triggered by such shifts in market sentiment could once again trigger financial fragmentation and might destabilise the eurozone. A partial consolidation of national government debt issuance in a relatively 'safe' euro area sovereign bond reduces the permanent risk of disruptive capital movements and financial fragmentation related to suddenly shifting market views about the sustainability of national public debt.

An integrated financial system is a precondition for realising an even transmission of the single monetary policy throughout the eurozone. A ‘safe’ eurobond serves as an attractive form of collateral for secured interbank lending and may be pledged by commercial banks wishing to draw on the ECB's refinancing facilities. Such a ‘safe’ instrument would also be very suitable as the preferred monetary policy tool for the Eurosystem to undertake non-standard open market operations in government

bonds.[15] Moreover, a 'safe' euro area sovereign bond is an effective tool to break the diabolic feedback loop between national governments being exposed to systemic banks and weak banks being dependent on rescues by their own sovereign.

Previous political discussions have clarified that the introduction of eurobonds can only be envisioned at the end of a longer-term process of fiscal integration, whereby member countries transfer sufficient fiscal sovereignty to the euro area level.[16] As long as there is no euro area fiscal authority issuing its own 'safe haven' eurobonds, national governments will need to find an alternative answer to the market demand for an essential common public good. Some scholars have argued that the creation of 'synthetic' eurobonds might be a workable transitional solution. Brunnermeier et al. (2011) propose to construct two separate tranches of 'synthetic' eurobonds out of a maximised and diversified portfolio of national government bonds, one 'safe' senior instrument that is free of sovereign default risk and one 'risky' junior instrument that would absorb any public debt restructurings affecting the underlying portfolio. The bank-sovereign nexus would be broken if banks would only hold the senior tranche. Moreover, a flight to safety by investors would concentrate on portfolio shifts from the junior to the senior eurobonds, thereby mitigating the impact on national government bond markets and the attendant risk of financial fragmentation within the euro area capital market. An important policy advantage is also that 'synthetic' eurobonds would avoid a formal debt mutualisation since national governments bonds would continue to be issued and each country therefore remains responsible for its own solvency.

To make their proposal operational, Brunnermeier et al. (2011) favour the solution whereby the euro area countries mandate a European Public Debt Agency to issue 'synthetic' eurobonds, if necessary with a credit enhancement to secure a superior level of safety for the senior tranche or to attract sufficient demand from investors for the risky junior tranche. Corsetti et al. (2015) see scope for a market-based private sector initiative to create 'synthetic' eurobonds. The feasibility of their idea depends in particular on a regulatory intervention by the ECB, which is assumed to qualify the 'safe' eurobonds as representing risk-free, high-quality liquid assets for the purpose of bank capital and liquidity requirements. Moreover, the authors expect the ECB to use only the senior tranche for its open market interventions in sovereign bonds and to favour them as good collateral in its refinancing operations.

The introduction of such a 'synthetic' euro area sovereign instrument should be accompanied by measures that counter the moral hazard on the part of national governments. The liquidity and credit risks on all their outstanding bonds will most likely decline, which reduces average debt service costs (see De Grauwe, 2016). The marginal interest rate on their new bond issues will depend on the prevailing

[15] The ECB's large-scale purchase programme of public sector securities, which was activated in March 2015 to address the risk of inflation remaining low for too long, foresees only a limited sharing of possible losses on this portfolio at the level of the Eurosystem, because a large part is being purchased by the National Central Banks at their own risk. The main motivation for this specific agreement is to preserve monetary dominance vis-à-vis the 19 euro area governments (Praet, 2015); it prevents to a large extent the mutualisation of sovereign credit risks, which otherwise could be interpreted as introducing a fiscal transfer union by the back door.

[16] For a survey of the costs and benefits of various eurobond proposals, see Claessens et al. (2012).

market conditions, which will be determined to a large extent by the demand from the European Public Debt Agency or the issuing private sector body, as they constantly need to roll over a considerable part of the portfolio of national government bonds on which the 'synthetic' eurobonds are built. To maintain the right incentives for national fiscal prudence, a country's participation in 'synthetic' eurobonds could be made conditional on its continued observance of the Stability and Growth Pact and the Macroeconomic Imbalance Procedure, as proposed by de Haan et al. (2016). Another precondition could be a collective decision (associated with an international agreement) to gradually limit and carefully phase out the preferential EU regulatory treatment of national government bonds, which would also be facilitated by their lower liquidity and credit risks in the presence of 'synthetic' eurobonds.

Fourth, EMU could benefit from a euro area treasury that has the mandate and fiscal policy tools to provide common public goods[17] as well as to stabilise the euro area economy on behalf of the member countries and that is vested in European democratic legitimacy and accountability. Given the monetary policy stance determined by the ECB, the macroprudential policies coordinated by the ESRB and the ECB, and the aggregate of national fiscal policies, one of its tasks would be to establish an adequate policy mix for the euro area as a whole which moreover is compatible with global requirements (cf. Buti, 2014; Draghi, 2014b; Juncker, 2015).

The national pursuit of stability-oriented fiscal policies, however appropriate, may sometimes contribute to an aggregate budgetary stance that is less desirable from a euro area perspective. Several studies conclude that a euro area fiscal capacity could offer a useful counterbalance and make EMU more adaptive to symmetric economic shocks (for example, European Commission, 2012). Assuming that national fiscal policies reflect compliance with (binding) common budgetary rules, i.e. the obligation to avoid an excessive deficit and to observe a structural balanced budget, the euro area treasury would at least require an adequate budget and fiscal instruments of its own in order to amend the aggregate budgetary stance.

However, to make a real difference a sufficiently large common budget would be needed and that in turn would assume a much higher level of political integration. For the time being, euro area fiscal stabilisation will therefore need to come from the national budgets (see Bénassy-Quéré et al., 2016). To cater for this purpose, the Stability and Growth Pact includes since December 2011 a provision that allows for amending the pace of fiscal consolidation for all Member States in case of a severe economic downturn in the euro area (or in the European Union) as a whole, as long as this does not endanger their fiscal sustainability in the medium term.

As progress is made with more common decision-making on budgetary matters, a euro area fiscal stabilisation mechanism could assist member countries in dealing with the asymmetric impact of common shocks and with large localised shocks that

[17] The EU budget already provides for public goods that are better taken care of at the European level. For instance, the European Fund for Strategic Investments that was launched in mid-2015 jointly by the European Commission and the European Investment Bank can be regarded as financing common public goods. Following deeper political integration additional common public goods of specific interest to euro area countries may be identified (see the discussion by Bénassy-Quéré et al., 2016).

otherwise could lead to a rapid accumulation of macroeconomic imbalances – clearly without entering into fine-tuning business cycles or preventing structural adjustment. Although market-driven adjustment, automatic fiscal stabilisers and discretionary national policies should remain the first and main lines of defense (Ruscher, 2015), the risk from major country-specific demand shocks could be partially shared through temporary collective budgetary means. A central fiscal capacity for cushioning asymmetric demand shocks would give euro area governments more budgetary leeway to fight them while maintaining their fiscal sustainability.[18]

The distinction between temporary demand shocks and permanent supply shocks is in practice not always easy to make. One could therefore consider to let the central stabilisation fund complement the EU structural and cohesion funds for co-financing the costs of projects that euro area countries initiate to adjust their economies to major supply changes. This would bring into practice the earlier suggestion to offer financial incentives to Member States that undertake structural reforms and/or public investments to raise potential growth and employment ('cash for reform' contracts).

There are various ways to construct a euro area fiscal stabilisation mechanism for the specific purpose of absorbing large macroeconomic shocks at the national level. Most proposals are centred around a common unemployment (re)insurance scheme because the necessary data are more easily available, in contrast to a system based on output gap estimates which moreover are subject to revisions. Unemployment benefits can also be fine-tuned in a particular way so as to avoid moral hazard (see the ideas put forward by Andor et al., 2014; and the remarks by Bénassy-Quéré et al., 2016). The likelihood of a country having to draw on this central (re)insurance should be about the same over time for all participants, i.e. they must have reduced already their exposure to asymmetric economic shocks by lowering public and private debt levels and increased their resilience by implementing structural reforms. A particular condition to be met is more harmonised labour market structures. As indicated in the Five Presidents' Report, automatic entitlements to a euro area fiscal stabilisation fund must be conditional on sustainable economic and institutional convergence in line with high-level standards defined in EU legislation. Monitoring how local public authorities deploy the fiscal transfers from the centre also appears advisable.

A final question is whether future public risk sharing arrangements should go as far as providing horizontal or vertical fiscal redistribution mechanisms from 'rich' to 'poor' member countries in order to reduce structural income per capita disparities and establish similar living standards over time. This is a political choice which strongly depends on the member countries' willingness to accept a common destiny and the attendant full transfer of sovereign decision-making powers to the political centre.

[18] For high-debt countries this is an advantage over getting more budgetary space through a more lenient interpretation by the European Commission (2015a) of the flexibility available under the SGP when it assesses a country's compliance with fiscal policy obligations. As alternative to more SGP flexibility Bénassy-Quéré et al. (2016) prefer to make national fiscal policies more stabilising by allowing them to allocate incremental spending on public investment and unemployment to a separate national adjustment account that balances over the business cycle.

Fifth, regarding the crisis management tools of the EFSF/ESM, the political limits of pooling stability support for partner countries facing liquidity stress became clearly visible during the sovereign debt crisis. Euro area leaders acted only with reluctance and after lengthy ad hoc meetings under intense pressure from volatile markets. As foreseen by Sims (1999, 2012), fiscal coordination to establish a strong floor under the euro was challenging in crisis conditions.

While governments were in the end willing to assume a common responsibility for euro area stability, creditor and debtor countries had conflicting interests as regards the maximum capacity of the common fiscal backstops, the concessional nature of the financial assistance and the strictness of the associated policy conditions (Otero-Iglesias, 2015; and Schimmelfennig, 2015). A complex intergovernmental decision-making procedure repeatedly delayed urgent crisis measures. This constellation put pressure on the ECB to 'buy time' by stepping up its monetary policy interventions, which in turn created a risk that beneficiary governments might waste this window of opportunity (Eijffinger and Hoogduin, 2012).

The funds available for the ESM are subject to a ceiling and only guaranteed by pro-rata burden sharing among the participating countries. This makes its borrowing and lending capacity vulnerable to member countries whose credit rating is downgraded and to distressed members requiring financial assistance stepping out. The amount that governments have committed for the ESM – although very substantial – may be insufficient to address serious liquidity problems in the largest member countries or to recapitalise several systemic banks that are 'too big to fail'. Moreover, the Single Resolution Fund for banks may also require temporary access to an ultimate fiscal backstop at the euro area level (see above under point two).

At present, the ESM is able to address a possible lack of rescue funds by calling in the substantial remaining capital committed by the participating countries[19] to secure its own borrowing in the capital market. The ESM uses its financial capacity to assist a distressed member, subject to a strict adjustment programme and the consent of the other countries to commit their tax resources. The political decisions on whether to activate the ESM facilities, how much and what type of financial support to give, the appropriate repayment schedule, the applicable interest rate and the appropriate policy conditions, require intense and sometimes protracted negotiations. Although there is an emergency procedure, the necessary decisions could probably be more credibly achieved with the required speed by anchoring the ESM in the EU Treaties, as suggested by the Five Presidents' Report. Only EU decision-making rules provide full efficiency and legitimacy, as they rest on qualified majority voting instead of burdensome unanimity requirements (see European Commission, 2012).

Following further fiscal integration, (the successor of) the ESM could instead draw on the 'deep pockets' of a euro area treasury and its own ability to collect taxes and issue debt. For such a future common risk sharing arrangement to gain political

[19] The ESM has in total EUR 700 bn of authorised capital of which EUR 80 bn was paid in by the participating countries.

acceptance it is important to first put in place credible risk reduction and risk control measures (in line with points one and two above).

Sixth, the conditional financial assistance that the official sector granted to euro area countries hit by the crisis fuelled market expectations that in future cases eurozone taxpayers will again step in to rescue distressed member countries (Wyplosz, 2013). To restore the credibilty of the no bail-out rule and thereby the market incentives for fiscal discipline the suggestion has been made (for example Deutsche Bundesbank, 2015) to introduce contractual arrangements that ensure a proper burden sharing with investors in national sovereign bonds and/or a statutory default mechanism to resolve cases when government debt can no longer be regarded as sustainable. A well-defined orderly involvement of the private sector in solving a fiscal emergency should underscore that the fiscal backstop facilities of the ESM (and thus also the potential activation of government bond market interventions by the Eurosystem under the OMT) are meant to be temporary and assume an engagement of the country's creditors.

For crisis management purposes, Wendorff and Mahle (2015) propose to include a clause in sovereign bond contracts that automatically triggers a maturity extension when a country facing temporary liquidity stress has been granted ESM financial assistance. The government's need to access the capital market to refinance its debt would thereby be delayed until after the three-year ESM programme, without triggering a disruptive 'credit event'. This 'buys time' for the country concerned to regain market confidence and it limits the necessary involvement of the ESM.

For crisis resolution purposes, one could reflect on a statutory procedure to arrange an orderly sovereign default as an ‘ultimum remedium’, in connection with granting an ESM loan, once it has been established that a participating country is (nearly) insolvent, i.e. its government debt is unsustainable, it cannot realistically commit more future taxes for debt service payments and it is unlikely to grow out of its debt (see Feld et al., 2016; and Fuest et al., 2016).[20] Assuming a gradual introduction over time to prevent market disruption, a sovereign insolvency procedure in combination with official assistance could allow for removing a government debt overhang as an alternative or complement to the activation of collective action clauses (CACs) that are being included in new central government bond contracts since January 2013 but that are prone to holdouts on the part of minority creditors.

The advantage of well-designed sovereign illiquidity and insolvency procedures is that they establish a more timely and efficient process of arranging ESM financial support in conjunction with debt relief from the creditors of the troubled government. Such pre-announded solutions for a potential sovereign debt crisis would ensure an appropriate contribution from the country's private creditors at the same time when official sector assistance is granted, notably through an extension of debt maturities, a suspension of debt coupon payments and/or a debt restructuring that reduces the principal. A more realistic prospect of an orderly sovereign debt reprofiling and/or

[20] This option should be distinguished from academic proposals to use public debt restructuring as a tool for removing the crisis-related legacy of high public debt with the aim to restore euro area countries' room for fiscal policy manoeuvre (see for example Wyplosz, 2013; and Corsetti et al., 2015).

restructuring should be expected to increase the credit risk premium and the cost of public sector borrowing. These new legal provisions should be expected to make investors more cautious when placing their money in government bonds because they would know that eurozone countries with market access difficulties associated with an excessive public debt would as a rule receive official sector assistance only in combination with a debt reprofiling and/or a debt restructuring. This enhanced market discipline would also reduce the implicit subsidy that private creditors enjoy when they may count on the official sector to step in with loans and/or market access support for a troubled eurozone country.[21]

One barrier to introducing such special debt operations is the preferential treatment of national government debt in EU prudential legislation, which in effect tells financial institutions that their investments in sovereign bonds issued by the Member States can be considered as 'safe' without limits to their exposure (see also van Riet, 2015). This may reflect above all that financial markets require a 'safe' asset that increases in value in turbulent times. Historically, before the start of EMU, national sovereign bonds have performed the role of 'safe haven' instrument. Many European banks and institutional investors therefore still hold large amounts of national government bonds on their books and they would be hit hard by an (unexpected) sovereign debt restructuring, with negative ramifications for the financial sector and the economy at large. The contagion effects to other vulnerable countries would further fragment the euro area capital market. To resolve a fiscal solvency crisis at the lowest cost to the economy concerned and also at the lowest risk to financial stability in the euro area as a whole, the risks associated with an unavoidable public debt restructuring must first be reduced. For this purpose it is advisable to carefully limit and gradually phase out the preferential treatment of government bonds in EU financial legislation (as part of an international agreement) and, in addition, to introduce 'synthetic' eurobonds of which the senior tranche can play the stabilising role of 'safe harbour' asset (as already mentioned above under point three; see also Brunnermeier et al., 2011; Corsetti et al., 2015; Deutsche Bundesbank, 2015; and Feld et al., 2016).

Another barrier is the concern that a statutory insolvency procedure might create moral hazard among opportunistic governments, which could be attracted by debt-financed public spending and the option to ask for default protection whenever their debt obligations became insurmountable – especially when the sovereign bonds are to a large extent held by non-residents and hence the impact of a debt restructuring would be felt less among domestic creditors. To address this moral hazard concern, the reinforced EU fiscal surveillance framework against excessive public debt must be strictly implemented and rigorously enforced (see above under point one).

Finally, the governance of the eurozone requires stronger democratic accountability. At the moment, collective euro area decisions are still to a large extent vested in

[21] The IMF applies the principle that exceptional access to its lending facilities requires public debt to be sustainable with a high probability. For cases when the probability of a return to sustainable public debt is not high, the IMF may ask the country concerned to implement a debt reprofiling (i.e. an extension of maturities falling due during the support program) and/or to get additional financing from other official sources before it grants large-scale loans. When government debt is clearly unsustainable, exceptional access to IMF funds is conditional on a debt restructuring to remove the debt overhang and restore public debt sustainability with a high probability.

national legitimacy and may respond to national interests rather than shared beliefs that support the euro. The EU Treaties recognise the national identities of Member States and their sovereignty as regards economic and fiscal policies. EU countries have nevertheless shared their sovereignty in several policy areas of common interest without losing their statehood. They could decide together to continue on this path with the aim to ensure the proper functioning of EMU, including by integrating intergovernmental agreements that were set up during the euro area crisis into the EU legislative framework (see Mersch, 2015). EMU related political decisions could in this context be debated in a new euro area chamber of the European Parliament, alongside a stronger involvement of the national parliaments.

A precondition for the sustainability of EMU to become “self-enforcing” is however the existence of common values and preferences among euro area citizens, such as an embedded stability culture (Richter, 2013, p.147). These shared beliefs should motivate voters to select political representatives (both at the national and European level) that will preserve the integrity and stability of the euro and to send them home if they act contrary to this common objective.

Cisotta (2015, p.283) argues that the concept of safeguarding the financial stability of the euro area as a whole has emerged as a value and as an objective of both the national and the EU legal orders. As a “coherence factor” it is a guiding principle for the policy actions of national and EU bodies and institutions and can serve as the cornerstone for the evolving EU legislation, in particular that related to EMU matters. This new common value accordingly legitimises a further sharing of sovereignty and deepening of political integration based on transnational democratic principles.

As observed by Hoeksma (2016), the Lisbon Treaty entitles EU citizens to participate both in their national democracies and in the common democracy of the European Union. For the euro to survive as a currency beyond the state, the Member States must be willing to share their sovereignty over a wider range of key policy areas as well as to empower their citizens to take part in this evolving common democracy for a common market with a common currency. This would recognise that according to surveys two-thirds of euro area respondents support EMU and the euro.[22]

[22] See the Standard Eurobarometer 84 Survey of Autumn 2015.

6 Conclusions

This paper reviewed the debate on the requirements for safeguarding the euro as a currency beyond the state that is anchored through collective governance instead of a central government. Looking back, the euro area crisis was a crisis of confidence in the ability and willingness of individual governments to secure the credibility of their “sovereign signature” in economic and financial policies (Trichet, 2013, p.476). To preserve this confidence, governments should have assumed full responsibility since the start of EMU, firstly, for securing fiscal sustainability and competitiveness and, secondly, for closely supervising private sector credit growth and the expansion of cross-border lending by systemic banks. In addition, more effective common tools for crisis prevention and new common instruments for crisis management and crisis resolution proved to be necessary.

Recognising that they have a common responsibility for financial stability in the euro area as a whole, European leaders and institutions first addressed the euro area crisis by putting in place a reinforced EU economic and financial governance framework. This key element of the new architecture for the eurozone should be more successful than its predecessor in aligning national economic and financial policies with EMU requirements, provided that the enhanced common rules are strictly implemented and rigorously enforced. The political leaders also established the main pillars of a European Banking Union and are following an action plan to build a Capital Markets Union. The objective is to break the nexus between banks and governments at the national level, counter financial fragmentation, provide greater opportunities for private risk sharing and secure overall financial stability.

Moreover, Eurogroup Ministers provided for a common fiscal backstop that may be activated if member countries or systemic banks nevertheless run into trouble. They also firmly expressed their intention to improve the resilience of their economies and take decisive steps to further strengthen EMU. The Eurosystem for its part made a strong commitment to stand guard against the 'tail risk' of a break-up of the euro arising in national sovereign bond markets, acting within its monetary policy mandate and subject to strict conditions. Taken together, these comprehensive policy actions and strong commitments show that the euro has in fact become a currency beyond the state and that its stability is anchored in and preserved by collective governance.

European leaders and institutions have taken these vital steps to improve crisis prevention, management and resolution in EMU and thereby to put in place the foundations for a more perfect monetary union. As many observers have noticed, however, they represent only half-way measures of euro area political integration. Governments have deliberately stayed within the boundaries of the Lisbon Treaty and where necessary introduced new intergovernmental treaties to ensure national control and veto rights. However, the current principle of nation states coordinating their sovereignty through common agreements to ‘do whatever is required’ for euro area stability rather than sharing their sovereignty in common institutions with a democratic mandate to safeguard the single currency has its limitations.

The analysis in the Five Presidents' Report and the academic debate point to at least seven challenges facing the status quo of collective governance and the ability of policy-makers to secure the sustainability of EMU. As discussed in this paper, these concern the effectiveness of market discipline and reinforced surveillance of national economic policies, the completion of the Capital Markets Union and the European Banking Union, the need for a single sovereign benchmark asset, the demand for a euro area fiscal capacity, the efficiency of the common fiscal backstop, the credibility of the no bail-out rule for governments in distress, and the transnational democracy that should legitimate euro area decision-making.

European leaders could address these seven challenges by targeting further political integration at the objective of safeguarding the euro as a currency beyond the state. Advancing on this path would recognise that a denationalised single currency also demands a credible political commitment from all participating Member States to ‘do whatever is required’ for euro area stability. Ownership of this commitment entails promoting sustainable economic and institutional convergence, reducing exposure to stability risks, enlarging the capacity to absorb risks, and creating credible risk sharing mechanisms. This in turn requires euro area countries to pool their national sovereignty over a wider range of EMU-related policy areas by entrusting common institutions with a democratic mandate to act in the common interest of their citizens.

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Acknowledgements
This paper builds on a study on *The Future of the Euro at 15* which was presented at the Conference 'In Search of European Political Union', University of Utrecht (Netherlands), 19-21 June 2014. An earlier version of this paper was presented at the Annual Meeting 2015 of the European Public Choice Society, University of Groningen (Netherlands), 7-10 April 2015 and at the NIAS Workshop on 'European Union Decision-Making and Challenges to Economic and Financial Governance', Wassenaar (Netherlands), 8-9 December 2015. The helpful comments and suggestions from the discussants, Fabian Ambtenbrink, Jacob de Haan and Eelke de Jong, as well as from the colleagues Stefan Huemer, Demos Ioannou, William Lelieveldt, Francesco Mongelli, Gilles Noblet and Bernhard Winkler, are gratefully acknowledged.

Ad van Riet
European Central Bank; email: ad.van_riet@ecb.europa.eu

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Postal address 60640 Frankfurt am Main, Germany
Telephone +49 69 1344 0
Website www.ecb.europa.eu

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ISSN 1725-6534 (online)
ISBN 978-92-899-2336-1
DOI 10.2866/517793
EU catalogue No QB-AQ-16-006-EN-N