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EUROPEAN INTEGRATION

Completing Europe’s Economic and Monetary Union

Reform options under discussion

September 2015

- **The crisis and its aftermath have shown that the European Economic and Monetary Union (EMU) is in serious need of reform.** The euro area does not have sufficient mechanisms to respond to GDP shocks, while member states lack the fiscal flexibility to assume their stabilisation function.

- **The Five Presidents’ Report presents extensive proposals to complete the EMU.** Alongside deepening the Single Market in general, it proposes numerous institutional amendments and the creation of a Fiscal Union in the long term. In the first stage, running until June 2017, existing instruments will be used, after which a White Paper will define the next steps in detail.

- **A long-term stabilisation of the EMU will require the completion of the Banking and Capital Markets Union as well as closer economic policy coordination and a significant deepening of the Fiscal Union.** Alongside the creation of new institutions and common policy instruments, an increased provision of public goods by the EMU should be considered. This must go hand in hand with a strengthening of the democratic decision-making processes.

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The EMU – a successful model with constructional flaws

The debate about the future of the euro and the EMU is not new, but one which has flared up recently as a result of the current developments related to managing the crisis. The Five Presidents' Report puts forward an ambitious package of measures to complete the EMU. France and Germany, above all, have prominently expressed their views on this report in the media. The German Council of Economic Experts has also joined in the debate with a special report (2015).

The academic and political debate on the EMU goes back further. The economic basis was laid by the works of Robert Mundell (1961) and Peter B. Kenen (1969) on optimum currency areas. The main conclusion of these works is that countries in an optimum currency area are characterised by a high factor mobility of labour and capital due to a strongly convergent economic policy framework. These conditions are necessary in order to compensate for the loss of flexibility provided by exchange rate adjustments and national monetary policy. To put it simply, a monetary union needs a strong economic, fiscal and political union in order to be successful. These elements are not (yet) present in the euro area.

As revealed by a study of the ECB (2015b), there has not been real convergence among the first twelve countries in the euro area. To the contrary, during the crisis the countries even appeared to be drifting apart. The euro has not fulfilled its promise of convergence towards a common high standard of living due to its constructional flaws. This makes remedying these flaws in a targeted and effective manner all the more important before further problems arise.

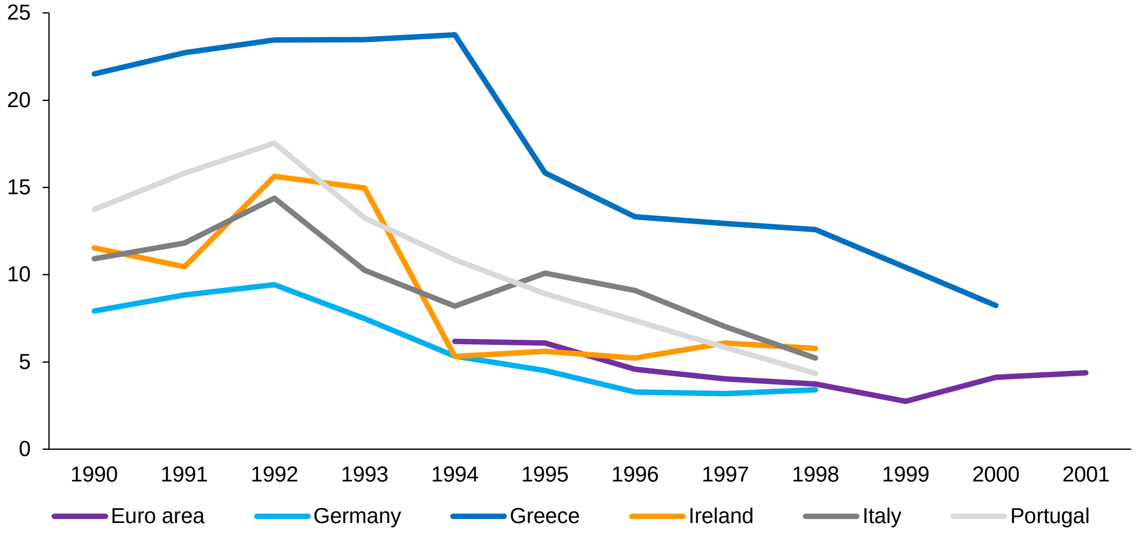
A look back at the history of the EMU

An exchange rate union was established back in the 1970s (Werner Report 1970) with a fixed range within which the currencies of the EU member states could fluctuate. This system was then abandoned in the wake of the oil crisis to enable the member states to respond to shocks by adjusting their exchange rates. In 1977, the MacDougall Report (European Commission 1977) concluded that around five to seven percent of the EU's GDP would need to be budgeted to balance out these kinds of shocks. The Delors Report (1989) abandoned the concept of a fiscal union in favour of other mechanisms to ensure the stability of the EMU. The Maastricht criteria on upper limits for new debt and overall debt were designed to provide member states with sufficient leeway at the national level for discretionary and automatic stabilisers to take effect.

The year 1990 saw the start of the implementation of the EMU with preparations for cross-border payments, the creation of the European System of Central Banks and numerous other measures. On 1 January 1999, the euro was introduced as book money in eleven countries (Greece joined in 2001) and was given out in notes and coins three years later. This was the (temporary) completion of the EMU for the twelve participating EU member states. To the present day seven other countries have joined, bringing the total number of EU member states in the euro area up to 19.

Alongside simplifications in cross-border payments for consumers and companies, the common currency area also unified interest rates. In 1990, the daily interest rates of the first eleven euro countries still fluctuated between 15 and 8 percent; in 1998, one year before the introduction of the euro, they hovered between 6 and 3 percent. In 2001, with the inclusion of Greece in the euro area, the interest rate was just over 4 percent. The conditions on which countries could issue government bonds also converged. The spreads in comparison to German government bonds fell from an average of 250 basis points in 1990 to 25 basis points in 2001. Irrespective of the country-specific risk, the financing costs of the public budgets were de facto on a uniform level.

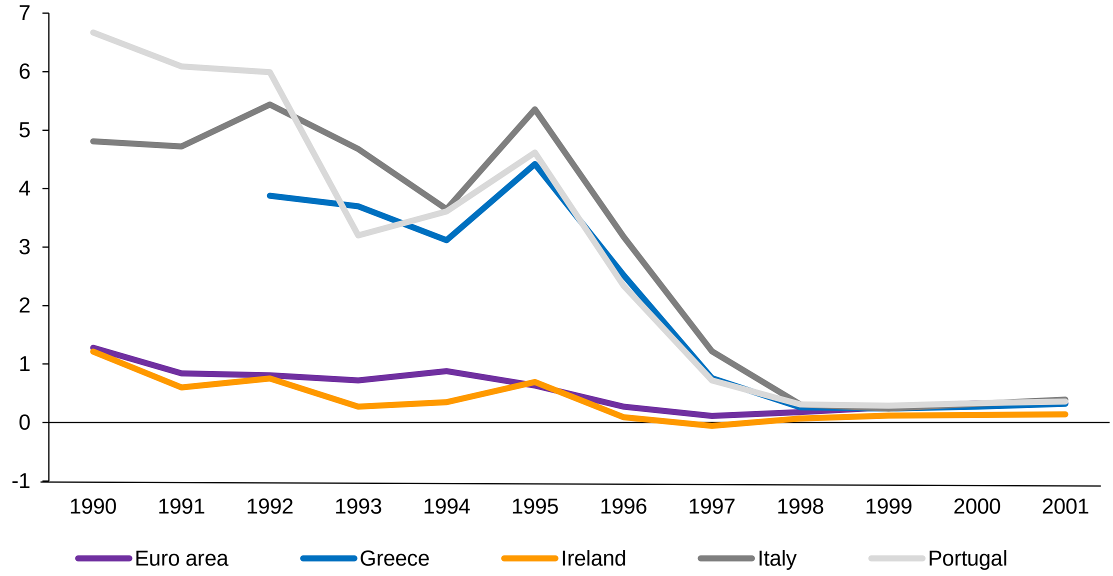
Daily interest rates in the Euro area, in percent



Source: Eurostat

BDI

Spreads compared to German government bonds, in percent



Source: Eurostat

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The constructional flaws of the euro area and the consequences

The harmonisation of these values was interpreted as an indication of the increased degree of convergence between the euro countries. However, the convergence of the nominal factors had little to do with real convergence. Despite the Maastricht criteria and other tools, there are still huge differences between the individual euro countries. The Stability and Growth Pact designed to ensure balanced budgets throughout the economic cycle and national fiscal flexibility in times of crisis was only respected in part and was also politically weakened. The consequences of this became evident in the crisis and are well known.

Those countries that have been hardest hit by the crisis had virtually no fiscal flexibility to counteract the economic developments. Rising public debt was putting increasing pressure on budgets and further restricting this flexibility. Automatic stabilisers only had a limited impact because labour and capital were not very mobile. The IMF (2013) estimates that, within the euro area, only around 40 percent of GDP shocks is smoothed by federal stabilisers and risk sharing at the federal level (around 30 percent by credit markets and 10 percent by capital markets). There are no real federal fiscal stabilisers. In comparison, in the US a shock in one state is cushioned to 80 percent through federal risk-sharing. Around 45 percent is attributed to the federally integrated capital markets, 20 percent the credit markets and 15 percent the federal tax and transfer system. Greater convergence and an improved institutional framework could therefore significantly increase the stability and resilience to crises in the euro area.

Differences between the EMU and the United States

The EMU is often compared to the United States. However, there are fundamental differences between the two currency areas. Even though the US states are largely autonomous in their economic policy, numerous factors are controlled by the federal government in Washington, D.C. The tax and transfer system, in particular, has an automatically stabilising effect. If one state is hit by a shock to per capita gross state product, tax payments decrease and transfers increase due to higher unemployment benefit payments. Alongside these fiscal components on a federal level, the mobility of labour and capital is significantly higher in the US. If there are downward economic trends and increasing unemployment in one state, employees in the US are more likely to get a job in a different state than they are in Europe. Several factors are favourable to the mobility of labour in the US. Among other things, having the same language and a federal social and pension system makes changing jobs easier within the US. The mobility of capital is also facilitated by the uniform legal framework. On the one hand, much more money is invested in the capital market, and on the other, these investments are usually not just limited to one state. A crisis that includes a write-off of capital does not just affect the population of the affected state but also others.

With its efforts to complete the Single Market, the EU is working to increase the mobility of labour and capital. The free movement of workers is, however, still heavily restricted by the differing social security and pension insurance systems. The free movement of capital is held back by the diverging legal frameworks. There is still a strong home bias in both jobs and capital investments. This low level of mobility is hugely restricting convergence in the member states, and a look at the developments of the last few years shows that the rate of convergence has not increased during this period. It is therefore all the more important to make the EMU a top priority issue. The Five Presidents' Report under the leadership of the European Commission (2015c) has put this issue on the table.

The current debate and the Five Presidents' Report

The background to the report

The June 2015 report is a distillation of numerous previous contributions on the EMU after the crisis. Significant academic input was provided by the Brussels think tank Bruegel (2011, 2012, 2013 and 2015a) and the report of the Tommaso Padoa-Schioppa Group of Notre Europe (2012). These contributions were picked up on a political level in several communications. The Van Rompuy Report (European Council 2012) was the start of a whole series of papers on the future of the euro. The European Commission (2012) has taken this debate further with its blueprint for a deeper and genuine EMU and for a convergence and competitiveness instrument.

In view of the many reports prior to this one, criticism was voiced from many sides that the European Commission President Jean-Claude Juncker had simply presented yet another paper and postponed operational steps for the years to come. However, some important tools have already been implemented. The European Semester, the Six-Pack and the Two-Pack all strengthen economic policy coordination and carefully monitor macroeconomic imbalances. The Country-Specific Recommendations identify useful structural reforms that can make a major contribution to convergence in the euro countries, but the bulk of these reform proposals have not been implemented. Only 18 percent of these recommendations have been fully implemented in the past, while 43 percent have not been addressed at all.

The proposals to complete the EMU

The Five Presidents’ Report proposes a two-stage implementation process with measures for economic, financial and fiscal union and for political union. Stage 1, which runs until June 2017, comprises reforms that build on existing instruments and can be implemented within the current legal framework. Stage 2, which runs until 2025 at the latest, encompasses all reforms that will require amendments to existing treaties and complete the EMU. Stage 1 includes, for example, the Banking Union and the Capital Markets Union that are already in the works. Streamlining the European Semester is also included in the first stage of the plan. The Commission will publish a White Paper by spring 2017 to present the second stage in more detail. This will come after the UK referendum on staying in the EU and probably before the elections in France (May 2017) and Germany (September 2017).

Economic, Financial, Fiscal and Political Union

The key proposals of the report are:

Economic Union

- **A new boost to convergence, jobs and growth**
  - Creation of a euro area system of Competitiveness Authorities
  - Strengthened implementation of the Macroeconomic Imbalance Procedure
  - Greater focus on employment and social performance
  - Stronger coordination of economic policies within a revamped European Semester
- **Stage 2**: formalise and make more binding the convergence process

Financial Union

- **Launch the Capital Markets Union**
- **Reinforce the European Systemic Risk Board (ESRB)**
- **Complete the Banking Union**
  - Setting up a bridge financing mechanism for the Single Resolution Fund (SRF)

- Implementing concrete steps towards the common backstop to the SRF
- Agreeing on a common Deposit Insurance Scheme
- Improving the effectiveness of the instrument for direct bank recapitalisation in the European Security Mechanism (ESM)

Fiscal Union

- **A new advisory European Fiscal Board**
  - The board would provide a public and independent assessment at European level of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal governance framework. Its advice should feed into the decisions taken by the Commission in the context of the European Semester.
- **Stage 2:** set up a macroeconomic stabilisation function for the euro area
  - Convergence towards similarly resilient national economic structures would be a condition to access this mechanism

Political Union: democratic accountability, legitimacy and institutional strengthening

- **Revamp the European Semester**
  - Reorganise the Semester in two consecutive stages, with the first stage devoted to the euro area as a whole, before the discussion of country-specific issues in the second stage.
  - Strengthen parliamentary control as part of the European Semester
  - Plenary debate at the European Parliament on the Annual Growth Survey both before and after it is issued by the Commission, followed by a plenary debate on the Country-Specific Recommendations
  - More systematic interactions between Commissioners and national parliaments both on the Country-Specific Recommendations and on national budgets
  - More systematic consultation and involvement by governments of national parliaments and social partners before the annual submission of National Reform and Stability Programmes
- **Increase the level of cooperation between the European Parliament and national parliaments**
- **Reinforce the steer of the Eurogroup**
- **Take steps towards a consolidated external representation of the euro area**
- **Integrate into the framework of EU law the Treaty on Stability, Coordination and Governance; the relevant parts of the Euro Plus Pact; and the inter-governmental Agreement on the Single Resolution Fund**
- **Phase 2:** democratic accountability, legitimacy and institutional strengthening
  - Integrate the European Stability Mechanism (ESM) into the EU legal framework
  - Set up a euro area treasury

An assessment of the current reform proposals and other ideas

Many of the proposed reforms do not tackle the problems of the euro area directly, but can have a positive impact on the EMU in indirect ways. Many of the reforms might create a divide between EU member states that use the euro and those that do not. While most of the proposals point in the right direction, they will require a great deal more concerted political commitment, particularly in Stage 2.

Economic Union

Creation of a euro area system of Competitiveness Authorities
Belgium and the Netherlands already have national competition authorities. It would be advisable to evaluate these institutions before implementing the concept throughout the euro area. Numerous aspects of competitiveness are already monitored under the European Semester. Expanding monitoring to include wage trends in relation to productivity is not a bad idea in itself. However, in view of the very different mechanisms of wage-setting in the different member states, the question arises as to what scope for action a national competitiveness authority could be assigned. The Five Presidents' Report expressly states that the aim of the Competitiveness Authorities is not to harmonise practices and institutions in charge of wage formation. If the competence of these authorities is restricted to giving opinions, then this monitoring process could also be included in the European Semester without creating a separate institution. This proposal must in any case be made more concrete before it can be assessed conclusively. Clarity and consensus must be reached in advance concerning tasks, objectives and forms of consultation. This institutional concept cannot be supported before a solid basis for decision-making has been established.

Strengthened implementation of the Macroeconomic Imbalance Procedure
This proposal deserves full support. Implementation needs to be speeded up and the threshold values could also be stepped up and made more symmetrical. Common economic policy coordination (European Semester, Six Pack and Two-Pack) and the Country-Specific Recommendations are not taken seriously enough overall. Only 18 percent of these recommendations have been implemented in full, while 43 percent have not been addressed at all. A first step to take here should be to increase discipline among member states. It could, for example, be made binding for national parliaments to address the Country-Specific Recommendations. This reform should be implemented with high priority in view of the major macroeconomic role this procedure has in preventing economic and financial crises and in strengthening convergence.

Greater focus on employment and social performance
Combating unemployment and promoting education and training are not issues that are specific to the euro area. A greater integration of the labour markets towards a Single Market is in the interests of the whole EU. This item therefore belongs on the overall European agenda. A point one should view critically is the possible interpretation of the report's rather vague wording as a call for EU-wide minimum wages. This measure will not serve its purpose as long as there is insufficient convergence among the member states.

Stronger coordination of economic policies within a revamped European Semester
As with the strengthening of the Macroeconomic Imbalance Procedure, this proposal should be supported. The recommendations must be formulated with more clarity to enable a clear documentation and review of their implementation. The Commission's recommendations should be more aligned to the requirements of a stable EMU and guided by the convergence target for per capita income. A multi-annual approach is also a good idea as some recommendations take more than one year to implement. Structuring the European Semester into two stages – first reviewing the euro area as a whole, followed by a concluding analysis at the member state level – is primarily a technical issue but one that does make sense. Further details on the functioning of these instruments will be given in a report to be presented by the European Commission on 14 October 2015.

Stage 2: **formalising and making more binding the convergence process**
Convergence is not a genuine euro area issue either and affects the whole of the EU. It is nonetheless important that stronger convergence is regarded as a necessary condition for Stage 2. Integration must involve setting a

minimum level of real convergence and economic policy coordination, and foster the achievement of this target. The Commission should present a report discussing the main policy instruments. The Five Presidents' Report is correct in stating explicitly that convergence towards similarly resilient economies should be a condition for further measures such as a fiscal capacity. This brings us back to the Country-Specific Recommendations for structural reforms, which largely correspond to the proposals of the OECD and the IMF. In very general terms, the report recommends further harmonisation in some areas and common standards in others. It specifically mentions a common corporate tax base and a "flexicurity" concept for the labour markets. Making these reform efforts more binding would be welcomed, but would also signify a reduction of national sovereignty.

Financial Union

Completing the Banking Union

Groundwork preparations for creating a European Banking Union – with single bank supervision, a single banking system and single deposit insurance – are in full swing. The Banking Union will contribute significantly to stabilising the financial markets, which is of central importance to industry. The further proposals in this area are not yet developed with enough precision in the Five Presidents' Report to be assessed conclusively. But the basic concept of completing the Banking Union is appropriate and very important. Concrete steps for a common backstop to the Single Resolution Fund are purposeful and will support the stability of the euro area. It will, however, be a politically delicate procedure given the necessary synchronisation of liability and governance that this will involve. A fundamental reform of the European deposit guarantee schemes is a necessary step in safeguarding the functioning of the EMU. Setting up common deposit insurance on the path to completing the Banking Union could help to better cushion shocks in the banking and financial system and alleviate monetary policy and bank supervision of para-fiscal tasks. But this is a long-term task. In the short to medium term, preference should be given to gradually developing the financial basis for national deposit guarantee schemes. Before installing any new instruments, those already in place should first be reviewed to determine whether convergence in the financial markets is sufficient to justify the next step towards integration. Deutsche Bank Research (2015) proposes three medium-term options for this point: first, bilateral lending between the national schemes; second, a common fiscal backstop; and third, access to the European Stability Mechanism (ESM). Each of these three options harbour both advantages and disadvantages as well as different degrees of moral hazard. The next proposal in the Five Presidents' Report to improve the effectiveness of the ESM's direct bank recapitalisation instrument is difficult to evaluate given the insufficient degree of clarity. With restrictive eligibility criteria, this could increase confidence in the financial market and lead to greater stability.

Launching the Capital Markets Union

The Green Paper on Building a Capital Markets Union (European Commission 2015a) makes important contributions in showing how capital market financing may be strengthened in order to supplement financing by banks. Compared to the United States, European businesses are much less oriented on capital market financing. The Capital Markets Union will open up a range of opportunities. In addition to diversifying the sources of financing available to businesses, a more deeply integrated capital market would also be better able to absorb national shocks. The individual measures (simplification of prospectus requirements; a revived EU market for high quality securitisation; improved availability of credit information on SMEs; harmonisation of the legal framework for private placements; greater harmonisation of accounting and auditing practices, and of insolvency and company law) would all support the deepening and integration of the capital markets. An effective EU-wide capital market will necessarily require supervision and regulation on a European level. In this context, it will be important to avoid inconsistencies with other areas (e.g. bank supervision) and national regulations, and unnecessary over-regulation. The current debate on shadow banks gives cause for concern that hedge transactions that are commonplace in industry to minimise risks would also be covered by regulations intended for financial companies. The implementing provisions must be kept in proportion and "gold-plating" should be avoided under all circumstances. The Capital Markets Union is an undertaking that will bring mainly long-term benefits as presented in the Bruegel analysis (2015b). Given the still deeply divergent national legal frameworks in the individual EMU states for the mortgage industry, business valuation, corporate governance and corporate financing, the shock absorption capacity of the Capital Markets Union in the euro area and the EU will remain below the US level for decades to come. It is therefore all the more important to develop other mechanisms.

Reinforcing the European Systematic Risk Board (ESRB)

The report is mostly very vague on this point. In principle, there are no objections to strengthening macro-prudential supervision. The ESRB can presently only make recommendations and request justification when these are not complied with. The use of this "act-or-explain" mechanism should be stepped up and a suitable implementation framework put into place for macro-prudential instruments. The EU legal framework should also be amended to create the conditions necessary to increase the range of policy instruments available.

Fiscal Union

Reviewing the Six-Pack and the Two-Pack

The budgetary regulations of the Six-Pack and the Two-Pack could definitely be improved in terms of clarity and simplification. The complex drafting of these regulations creates loopholes and enables deviations to be covered up. A report to be published on 14 October 2015 will present the functioning of these financial policy instruments and set out the road map going forward.

A new advisory European Fiscal Board

The proposals on this point are still largely vague and propose an advisory board to coordinate the national fiscal councils. Before creating a further instrument, the existing institutions should first be reviewed to determine to what extent they already assume this monitoring role. There are no objection to strengthened coordination, but it should not result in an increase in the complexity of macroeconomic governance.

Stage 2: setting up a macroeconomic stabilisation function for the euro area

This is one of the most politically and economically controversial proposals of the Five Presidents' Report. It is therefore not without reason that the report proposes an expert group to analyse this task in more depth. Most other monetary unions have fiscal capacities. In the United States, the federal tax and transfer system cushions around 15 percent of an income shock in one state, contributing considerably towards macroeconomic stability. The United States has the added advantage that it is economically more deeply integrated with higher labour and capital mobility.

The report rightly points out that a fiscal capacity is a long-term measure and a culmination of a process of convergence. The EMU would need a kind of *ex ante* qualifying procedure – similar to the Maastricht criteria – to prevent permanent transfers between countries or transfers in one direction only. Access to this mechanism must be tightly linked to compliance with the fiscal policy framework (European Semester, Six-Pack, Two-Pack) to prevent moral hazard.

The expert group would have to analyse a whole range of further questions. This would, first of all, involve looking into the volume of the fiscal capacity. A realistic figure here, according to the current academic debate, seems to be between one and two percent of euro area GDP. Second, the financing needs to be clarified. Possible options would be regular payments as with the EU budget, the diversion of tax revenues, surcharges on national taxes, separate taxes or a credit authorisation. From a fiscal policy perspective, corporate and income taxes and, above all, value added tax (VAT) would be suitable for surcharges – whether direct or indirect – at the national level. The total volume of tax revenues in the euro area is sufficient for stabilisation in principle, but the revenue distribution should be changed and the EU should be allotted a defined – and indirect – share of the revenue of one of the type of taxes named above. "Indirect" means that the EU does not receive any legislative competence itself but that all decisions are made by the national parliaments. VAT appears to be the most suitable option. This is a general tax on consumption and as such is much less volatile than taxes on earnings, so would provide a reliable revenue base even during a crisis. Commonly issued eurobonds are also an option that is brought up repeatedly in discussions.

The third main unresolved point is the type of stabilisation. The spectrum ranges from fully automatic stabilisation to a rule-based but discretionary approach to fully discretionary management capabilities. There are many other aspects (governance, indicators, etc.) that make this proposal of the Five Presidents' Report a very thorny undertaking. However, having a fiscal capacity to act as a federal stabilisation function against shocks will be unavoidable in the long run. On account of the heterogeneity of the national economies in the euro area, it will have to be heavily rule-based but also discretionary. The role of automatic stabilisation should be maintained at the national budget level. A fiscal capacity will need to be based on a set of rules without gaps and on rigorous qualification criteria in order to avoid moral hazard and incentive problems. The financing through – indirect – shares of national taxes seems useful, and a credit authorisation will be necessary in the case of a symmetric shock that affects the whole euro area. To avoid increasing the tax burden on production factors, taxes should not be increased. This would require corresponding complementary tax relief at the national level, which is not particularly likely in the current political environment. Any form of credit authorisation would have to be integrated into the EU's general policies for managing government debt and to take care not to overstep legal and political bounds.

Political Union

Revamping the European Semester
Strengthening parliamentary oversight as part of the European Semester seems to be a promising approach. It also seems necessary to involve national parliaments and social partners more, particularly in the Country-Specific Recommendations. To improve the proportion of recommendations that actually get implemented, it would be advisable to increase transparency and make it binding for national parliaments to address these recommendations. The same argument can be made about the national reform programmes that are set up by governments without obligatory participation of other partners. Formalising the involvement of national social partners should also be reviewed as a way of broadening the basis of the European Semester. The frequency of consultations has increased significantly recently, which is a welcome development.

Stepping up the involvement of the Eurogroup in the European Semester is feasible and does make sense although it also harbours the danger of driving a wedge between the euro countries and the other member states. Consolidating the external representation of the euro area on international committees would be good but will probably not be possible as other countries would then have to give up their seats. Obtaining an additional seat for the euro area in international institutions is not a realistic option. The representation of EMU interests is currently coordinated in advance by the Eurogroup. The integration of the Treaty on Stability, Coordination and Governance, the relevant sections of the Euro Plus Pact and the intergovernmental agreement on the Single Resolution Fund within the EU legal framework is a far-reaching and necessary step that could conceivably be implemented in Stage 2 from 2017.

Stage 2: Democratic accountability, legitimacy and institutional strengthening
The integration of the ESM within the EU legal framework is an advisable and necessary step in the long term. In view of the current application of this mechanism in Greece, discussion on this point should be postponed until after an evaluation has taken place. Setting up a euro area treasury represents a further step towards integration and the transfer of fiscal competences. This proposal is part of the Fiscal Union measures, but is one that requires extensive democratic legitimation. A euro area treasury is a far-reaching and fundamental decision, but a further convergence of the economic structures will be needed as justification for a deeper union in democratic, economic and political terms.

Further reform proposals for the euro area

Alongside the proposals included in the Five Presidents' Report, debates on the future of the EMU also cover numerous other aspects. Not all instruments are directly related to the euro area, but affect the whole EU to a greater or lesser extent. The other measures most frequently debated are European unemployment insurance, eurobonds in various forms and the financial transaction tax.

European unemployment insurance

As with a fiscal capacity, the concept of EU unemployment insurance is designed to have a stabilising function. Member states with a weak economy and increasing unemployment rates would receive more transfers than the contributions they pay into the system. Countries in a good economic position would temporarily pay more than they receive. GDP shocks would thus be absorbed and cycles less pronounced. Even though these considerations are correct in principle, they still harbour numerous problems. This type of insurance would trigger significant negative incentives and moral hazards. If transfers are paid for out of a common fund, member states would have less incentive to implement labour market reforms. Alongside cyclical reasons, there are also structural reasons for unemployment. An appropriate design could reduce negative incentives but not eliminate them. Former EU Social Affairs Commissioner Lazlo Andor's proposal from June 2014, for example, suggested that European unemployment benefit should be paid for a period of six months at 40 percent of the previous reference wage. After that period, recipients would be reverted back to the national system. Another problem with this approach is that unemployment is a lagging indicator of economic development. The stabilisation function would then be (too) late and could have a pro-cyclical effect. It is also unclear what the redistribution effects would be and whether it would result in transfers in one direction only. Furthermore, the financing, duration and amount of unemployment benefit and the eligibility criteria of the national insurance systems are very heterogeneous and would additionally complicate communitisation. In view of these problems, it would therefore seem more advisable to set up a fiscal capacity for discretionary stabilisation and leave the automatic stabilisation function on a national level.

Eurobonds and a European debt agency

Different proposals have been advanced regarding commonly issued bonds. In its Green Paper on the feasibility for introducing Stability Bonds (2011), the European Commission outlined various possible forms and their consequences for the euro area. The core idea of this instrument is to cut financing costs by improving the credit rating on the one hand and reducing the dependence of individual member states on the financial markets on the other. The various forms differ in particular in the proportion of individual sovereign debt that is commonly issued and in the type of guarantee.

Another concept is a new financing instrument, the European Safe Bonds (ESBies) (Brunnermeier et al. 2015). A European debt agency would buy a fixed proportion of government bonds (limited to 60 percent of national GDP) and issue two securities at the same time, 70 percent as a senior security and 30 percent as a junior security. This would make two bonds available with different risk-return profiles. The advantage of this solution is that it would provide a highly liquid and secure investment vehicle for the financial markets that is no longer tied to a national issuer. The market for bonds issued by EU institutions (EU, EIB, etc.) is too small to serve this purpose. This concept has the added benefit that it is unlikely to require any changes to the legal framework. However, disadvantages exist in the form of the negative incentives it would trigger. Other unresolved issues (purchase of ESBies by the ECB, legal form of the debt agency, etc.) would additionally complicate implementation. The option should nonetheless be given more thought.

Financial transaction tax

The financial transaction tax is only indirectly related to the EMU. It does, however, come up in the debate on the financing of a fiscal capacity or of various resolution funds. The introduction of a financial transaction tax in a moderately integrated capital market such as the euro area would create considerable obstacles. Although the tax would be targeted at the financial economy, it would primarily affect businesses in the real economy and private savers. Conservative estimates put the total tax burden of this tax on German businesses at between €2.4 billion and €3.7 billion per year. The majority of this cost would result from the use of derivatives by businesses to hedge operations against fluctuations in exchange rates, commodity prices and interest rates.

Company pension schemes would also be affected by this tax as a significant proportion of employee pension entitlements is invested in securities that would be subject to the tax. In view of these problems, there are alternative and better sources of financing for the euro area facilities in question.

Conclusion and outlook

The completion of the EMU will require courageous reforms and a wealth of measures that cannot be considered in isolation. The Five Presidents' Report goes in the right direction and presents important concepts to make the euro area architecture more resistant to crises. Some of these steps can be implemented in the short term, while others will first require further convergence to take place within the EMU. The crisis that started in 2008 clearly showed that the loss of exchange rates, on the one hand, and the lack of a common financial market supervision, on the other, have led to a major destabilisation of the EMU. Progress has been made on supervision as part of the Banking Union. Progress is now needed on convergence among the EMU member states and on implementation of the stabilisation instruments. The European Semester has proven to be an effective tool for diagnosing macroeconomic imbalances. The implementation of the ensuing economic policy recommendations is the responsibility of the member states, some of whom show very little commitment in this respect.

In the short term, priority needs to be given to consolidating budgets in order to give fiscal policy room for manoeuvre in bad times. At the same time, coordination must take place across the euro area to ensure the right fiscal momentum throughout the EMU. In the long term, this stabilisation function can be assumed by a fiscal capacity if this is linked to compliance with clear-cut rules. These could be developed out of the European Semester and can then, in a next step, be streamlined, structured more symmetrically and stepped up in certain areas. Concerning the Country-Specific Recommendations, a mechanism needs to be developed that makes the national implementation of these reforms more binding. The proposed structural reforms can promote growth as well as stability in the EMU. Binding resolutions of the parliaments and consultations with the social partners on this point seem promising.

Stability on the financial and capital markets needs to be substantiated by the further implementation of the Banking Union and the launch of the Capital Markets Union. Confidence in the markets can be increased with a deposit guarantee system based on mutual reinsurance in the short term that can then be further integrated following convergence among the member states. The Capital Markets Union can also help make the EMU more resistant to crises. With all instruments care needs to be taken that there are no inconsistencies with the existing objectives. Financial market regulation and monitoring rules need to be implemented in moderation to avoid needlessly restraining the real economy and hampering the creation of jobs and prosperity. The restructuring of macroeconomic governance by the European Semester needs to be turned into a transparent and effective instrument and not lead to an even greater degree of complexity.

Despite all its setbacks, the EMU is still a successful model. As with all institutions, it needs to be reconsidered from time to time and further developed. There is currently a unique window of opportunity for this to take place because of the favourable economic environment with low interest rates, low oil prices and a low euro exchange rate. If clever reforms are implemented now, it will mean that in the future crises will be much better cushioned and losses in prosperity, such as those following the crisis in 2008, could be avoided. In the long term, the EMU has the potential and the declared objective to be a uniquely successful project that enjoys the backing of all EU member states.

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