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A BIG LEAP FORWARD: INSTITUTIONS AND POLICIES FOR A VIABLE EURO AREA

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"Reform of the euro, financial and budgetary perspectives of the European Union"

Economic and Monetary Union (EMU) reform is critical for a viable Euro area but is taking place against a backdrop of political constraints. As a contribution to this on-going discussion, this paper situates the reform debate in the context of the main lessons from the Euro crisis and the current economic and political cycle, and discusses the different elements of the reform agenda. The focus is on the main critical reform and institutional issues which remain as stumbling blocks.

1. Exiting the crisis: the politics and economics of EMU

1.1. What have we learned? Taking stock of the crisis

The euro area crisis was in many ways an accident waiting to happen. It took an (admittedly major) external shock to trigger the unwinding of imbalances accumulated in the first decade of the euro, reveal the vulnerabilities of the euro area and expose its design faults. The crisis prompted action to safeguard the common currency and remedy its weaknesses. Today, at a time when reform efforts are well under way but very much incomplete, it is useful to situate the on-going debate about the next steps necessary for a viable euro area in the lessons of the crisis itself and in the context of the initiatives already initiated. This helps understand the urgency of completing the reform effort as well as the obstacles it is facing.

The crisis originated in excessive US subprime mortgage lending whose consequences on the market for asset-backed securities contaminated the European banking system before triggering a severe recession in the Euratlantic economy; this then spread to the rest of the world as international financial markets responded by tightening credit globally. It found a fertile ground in Europe not only because of the exposure of its banking sector to toxic US banking products, but also because of a combination of domestic fiscal imbalances, real estate bubbles, and competitiveness losses. European banks proved vulnerable due to their exposure to domestic and cross-border credit risk, as well as insufficient capital and liquidity.

The true nature of the crisis was however for a long time misread in Europe. As the trigger of the acute phase of the euro area crisis was the Greek fiscal derailment, fiscal issues took precedence over the crisis' banking sector origins, whose liabilities ended up on public balance sheets as governments bailed

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out the banks or guaranteed deposits. This guided the post-2009 policy response: it focused initially almost exclusively on fiscal retrenchment, while its systemic nature and the weaknesses of an incomplete European banking union took time to be addressed. Whereas the US stress tests of May 2009 restored confidence in the banking system, paving the way for the ensuing recovery, forbearance prevailed in Europe at least until mid-2012 (when Spain launched its bank recapitalisation programme and banking union took centre stage on the policy agenda) and in fact for much longer.

The overall policy response exhibited all the flaws of the existing EU institutional and political architecture. Key decisions were taken under duress, with significant lags compared with market and economic reality; they were typically reactive rather than proactive, prone to reversal, and too costly for both borrowers and lenders alike. Major mistakes were made, both economically and politically; it was an expensive and dangerous trial-and-error process. Ultimately however, the will to save the common currency prevailed.

1.2. Fixing the bicycle while riding it: main reform initiatives during the crisis

The policy response during the crisis moved gradually from fire-fighting to reforming the euro area. A reform agenda was already sketched out in the October 2010 Task Force report on the economic governance in the EU and its follow-up 2012 report[1]. As the initial reading of the roots of the crisis was focused on a failure of fiscal discipline, it was on the fiscal front that most subsequent initiatives focused, starting with the main thrust of the "Six Pack" set of legislative measures in 2011[2]. It was followed in 2012 by the "Fiscal Compact"[3] , with provisions related to fiscal discipline (notably the preventive arm of the Stability and Growth Pact) and rules and procedures for coordination and governance, and in 2013 by the "Two Pack" directives[4], aimed at reinforcing economic coordination and budgetary surveillance. Collectively, this series of policy and legislative initiatives, adopted as a direct response to the Euro area crisis, significantly strengthened the fiscal framework, while also attempting through macroprudential supervision and the Macroeconomic Imbalance Procedure to detect non-primarily fiscal imbalances potentially leading to a banking crisis or a collapse in competitiveness. The focus however was clearly on revamping fiscal rules; more attention was paid to debt dynamics, with more flexibility during a crisis as regards deficit limits. The new rules also increased the complexity and arguably the opacity of the surveillance process.

Most importantly, reforms of the crisis prevention framework were complemented by the creation of a permanent financial "backstop" to assist countries in danger of losing market access. The European Stability Mechanism replaced as of 2012 the idiosyncratic temporary support mechanisms created during the crisis. Its creation represented a significant addition, both to the European institutional landscape and to the policy toolbox. It has since become central to the current debate about the future of the euro area, with different views on its evolution, role and responsibilities.

Addressing the fragility of the banking system came next, in light of the "doom loop" transmitting the crisis from banks to sovereigns and back. Banking union was the forgotten element in the creation of a common currency, whose critical importance was demonstrated during the crisis. It was introduced in June 2012 with a Euro Summit statement whose first sentence read "we affirm that it is imperative to break the vicious circle between banks and sovereigns"[5]. In 2014, supervisory authority and the power to grant or withdraw banking licenses were transferred from national authorities to the Supervisory Board of the Single Supervisory Mechanism (SSM), a new structure within the European Central Bank (ECB). In 2015, the EU created the Single Resolution Board, a new Brussels-based entity which, together with national resolution authorities, constitutes the Single Resolution Mechanism. A Single Resolution Fund (SRF) financed by contributions from banks is being built up to support resolution procedures within the framework of the EU-wide Bank Recovery and Resolution Directive (BRRD). It was agreed at the Euro Summit in December 2018 that the SRF will be further backstopped by European Stability Mechanism (ESM) credit lines.[6] In addition to the European Council decisions, the European Central Bank has proved to be the most important actor in resolving the crisis. In response to the freeze of the interbank market, it quickly extended liquidity to the banking system and further provided it on increasingly flexible terms, effectively rewriting the rules to accommodate a fast-evolving situation. Its "Securities Markets Programme" of bond purchases from crisis countries since 2010 leveraged European Council decisions at a critical time, and was followed by the "Outright Monetary Transactions" programme of open-ended purchases in secondary sovereign debt markets, contingent on strict conditionality. The ECB was admittedly late in embarking on an unconventional monetary stimulus (which started in 2015 only), but its actions and words have been instrumental in defusing the crisis. They have also been the focus of intense criticism in a number of countries.

1.3. Out of the woods? Economic situation, prospects and risks today

Following a severe and comparatively protracted economic recession and a near-existentialist crisis, the euro area has seen a remarkable turnaround. By early 2013, the common currency no longer faced imminent danger, and the currency redenomination risk which haunted the currency union for about five years was tackled in 2015 when a Euro Summit decided against Greece leaving. By early 2019 the EU as a whole was in its seventh year of economic expansion, with no economy contracting in 2018. Unemployment is at the lowest rate in the last twenty years, and it has declined significantly (though still remaining high) even in the crisis-hit euro area countries. Nevertheless, the policy debate on what is necessary for a viable euro area is today taking place in an economic environment whose outlook is characterised by increasing risks.[7] The recovery has been long but also weak and is now petering out, with the slowdown in the second half of 2018 being more pronounced than expected. Economic activity is expected to slow down further in the next few years, against a backdrop of increasing EU-specific as well as global economic and policy downside risks, not least from the Brexit process. Legacy crisis problems continue to weigh heavily. Despite its efforts, the ECB has not succeeded in bringing core inflation back to 2% and it is approaching self-imposed limits to the use of non-conventional policy instruments. Fiscal space is more limited than in 2008: for the euro area, debt levels are today almost 20 percentage points of GDP higher than at the beginning of the crisis, and are particularly high in a number of countries. This implies higher risks in a new downturn or in a sudden stop situation. Core-periphery divergences have narrowed down unevenly, feeding populist narratives and potentially prompting a backlash which could become a full-blown crisis. In short, it is questionable whether despite the efforts made, the EU as a whole and the euro area in particular are prepared today to handle the next crisis.

2. Outlining a reform agenda

2.1. From Mars or from Venus? The different starting points

The difficulty in pushing forwards with euro-area reform can be traced to two contrasting models for the EMU, which reflect national preferences that were openly expressed in decision-making during the crisis. In a stylized fashion, the first starts from the premise that crises mostly result from inadequate domestic policies. To correct them, it puts emphasis on stronger enforcement of EU fiscal rules to rein in debt and deficits, more market discipline, and an end to the risk-free status for sovereign debt. Regarding macro imbalances, its focus is on shoring up the competitiveness of lagging countries with high external deficits through structural reforms. This view is associated with reluctance to accept transfers, be they the result of an explicit budgetary mechanism or of risk-sharing mechanisms such as common deposit insurance for banks.

The contrasting view puts much more emphasis on systemic fault lines such as a lack of aggregate stabilisation and a vulnerability to destabilising capital flows. As far as solutions are concerned, it advocates the creation of a euro-wide fiscal capacity for stabilisation purposes, a distribution of fiscal efforts across countries to achieve an appropriate aggregate fiscal stance, and risk-sharing mechanisms. A corollary is the need for a euro-area Treasury. Fiscal difficulties during crises are perceived mainly as liquidity problems which could be solved through financial assistance. According to this view, macroeconomic adjustment should be symmetric in order to help weak countries and avoid the deflationary bias resulting from deficit ceilings. And as far as banking union is concerned, this view advocates common deposit insurance in order to ensure financial stability and private risk sharing.

The fault line between these two policy views is a philosophical and academic one as well as a geographical one. In philosophical terms, it has been described as discipline vs. flexibility. In academic terms, it is the distinction often stylized as rules vs. discretion in economic policy-making. In geographical terms, it has been painted as a German/French or alternatively a north/

side divide. This divide is caricatured as the European north focusing on responsibility while the south on solidarity. More accurately, the first camp emphasizes risk-reduction while the latter risk-sharing.

The prospect of transforming the EU into a "transfer union" has haunted the European north and prompted fear of any risk-sharing. In practice however, both risk-reduction and risk-sharing are to be pursued simultaneously: risk sharing without effective risk reduction increases moral hazard and ultimately risk. Similarly, in the absence of appropriate risk-sharing arrangements, risk reduction in the financial area can result in market instability and higher effective risk. The debate will not be settled any time soon. Academics from France and Germany have emphasized that both approaches are more complement than substitute and have proposed a compromise to "reconcile risk-sharing with market discipline".[8] Finding common ground in a practical way is therefore essential for both economic and political reasons, but discussions haven't made much progress towards reaching this end.

2.2. About windows of opportunity: The politics of EMU reform

The handling of the euro area crisis has taught us that the solutions which prevail tend to be found at the intersection of what is economically desirable and politically feasible. Timing, sequencing, personalities all play a critical role; and policy choices on the table as well as decisions reached ultimately reflect the political constraints and realities in EU countries. Hence the vibrant academic debate on the most effective policy tools required to complete the EMU is necessary, but by no means sufficient. Catching the political momentum and forging alliances and agreements which can support reform is equally if not more important.

In this context, the last few years have been characterised by an attempt to fashion together a "grand bargain"; a compromise between the "risk-sharing" and "risk-reduction" approach which to become politically feasible would even extend beyond the policy parameters of EMU reform and include other EU policy areas such as security and defence. Political developments however in the main countries driving such a "grand bargain", France and Germany, as well as the position of EU actors such as the so-called "New Hanseatic League" of fiscally conservative northern European states as well as populist positions in certain EU member states have complicated this outcome. The result and political balance emerging from the upcoming European Parliament elections will be critical for such as prospect.

2.3. Agenda setting: The proposals as set out by the institutions

A comprehensive policy agenda for EMU reform was laid out in the 2015 Five Presidents report[9] with its politically-driven two-stage approach for an economic, financial, fiscal, and political union, and the follow-up reflection paper and related communications by the Commission[10]. It is a comprehensive agenda which gives policy-makers different options; it represents a good starting point for the policy debate though it cannot represent the end-point.

This ensuing debate has crystallized around a limited number of specific but also difficult to resolve policy issues which are believed to represent the core in any attempt to reform the EMU. The main ones are:

- increasing the resilience and stability of the banking system through common deposit insurance (the discussion on the European Deposit Insurance Scheme - EDIS);
- creating appropriate common budgetary instruments such as a macroeconomic stabilisation function to better deal with country-specific shocks;
- creating a related central fiscal capacity that would equip the euro area with a proper fiscal policy;
- reducing risk at the level of the euro area with a joint financial instrument (the European Safe Asset);
- whether or how unsustainable sovereign debt in the Euro area should be restructured;
- reforming/streamlining fiscal rules beyond the changes already undertaken during the crisis years.

3. The critical policy elements of EMU reform

The individual policy issues above fall under the broad policy areas of banking union and fiscal union. Together with changes in Euro area governance, they represent the areas which will determine whether the crisis will have been used as an opportunity to repair the design faults of the common currency by overhauling policies and institutions.

3.1. The state of Banking Union

Nearly seven years later since the 2012 Euro Summit statement on the need to break "the vicious circle between banks and sovereigns", an impressive package of reforms has been implemented. There are, however, three reasons to be concerned that the "vicious circle" or "doom loop" at the core of the euro crisis of 2010-2012 has not been really broken.

1. The persistence of a strong home bias in the composition of bank assets in vulnerable countries. At end-2018, the share of sovereign bonds held by domestic banks exceeded pre-crisis levels in Greece, Ireland, Italy and Portugal (but not in Spain). Disproportionate holdings of bonds issued by the national sovereign result in an important channel of contagion from sovereign insolvency, or the threat thereof, to bank fragility, credit constraints and economic contraction[11].

2. A resolution framework that is single in name only. Whereas supervisory authority and the effective supervision of the major banks largely rest with the ECB, the Single Resolution Board has a more confederal structure

that combines a "design" role of the SRB with the implementation role of the national resolution authorities. Early experience, especially in Italy, has shown that national governments and authorities often remain first in line to address banking troubles and provide financial support. Furthermore, regulators remain suspicious of possible cross-country transfers arising from the failure of a national entity within a cross-national group. For this reason, they tend to rely on ring-fencing to limit the potential mutualisation of resources.

3. Lingering disagreement on deposit insurance. The European Deposit Insurance Scheme (EDIS) proposed in 2015 by the European Commission was meant to ensure an equal protection of all deposits and a partial mutualisation of the corresponding risk. Despite proposals aiming at limiting potential transfers, it has been caught by the risk reduction/risk sharing debate and remains a remote perspective (it was not even mentioned by name in the December 2018 Euro summit statement). This is despite the fact that the Five Presidents report clarified that EDIS would be privately funded through ex-ante risk-based fees paid by participating banks[12].

Because of the strength of indirect linkages between banks and sovereigns, even a full banking union that would have severed any direct link between them would not have eliminated the doom loop entirely. The persistence of direct channels further adds to the problem, whose significance was highlighted by the co-movements of sovereign and bank default risks on the occasion of the end-2018 dispute between the Italian government and the European Commission. The problem with the doom loop is that it may come back with full force as long as the national sovereign risks being perceived as the last-resort guarantor of bank liabilities and as long as the national banks risk being perceived as the last-resort purchaser of government securities. What matters is not whether the average risk is covered; it is instead who bears the marginal risk. Though significant, measures adopted so far have been insufficient to severe this link. Further reforms are needed to cut the doom loop for good. In ascending order of difficulty what is required is first, a more integrated structure that gives the SRB responsibility for the execution of bank resolution schemes; second, an integrated deposit insurance scheme that combines an incentive-compatible financing structure with the uniform protection of all depositors (this involves resolving the legacy of the large stock of non-performing loans in a number of countries); third, the gradual phasing-in of concentration charges which give incentives to bank asset diversification; fourth, introduction of a euro-area safe asset that provides banks with a channel for asset diversification (see also below on the safe asset)[13]. Ultimately, a stable currency area cannot rely on segmented credit markets. Banks are risk aggregators. As long as they aggregate risk along national lines, their fate tends to be correlated to that of their sovereign. The best way to eliminate this vulnerability would be to create integrated pan-European banks whose balance sheet structure provides an endogenous diversification of risk. This move, however, continues being resisted.

3.2. Fiscal union: core and peripheral issues

"Fiscal union" is often regarded as an essential requirement of a well-functioning currency area. This concept however encompasses several distinct components that differ in nature, aim and ambition. Five key proposals can be distinguished:

a. *A macroeconomic stabilisation function*

The idea of a euro-area counter-cyclical instrument improving the cushioning of large asymmetric macro shocks (and not meant as a crisis budgetary instrument) has been discussed since very first blueprints for Economic and Monetary Union. The essential rationale for it is that in a currency union where the exchange rate cannot anymore serve to cushion country-specific shocks, and where national fiscal policies have limited scope to provide such a cushion, there is a need for a stabilisation scheme that absorbs part of the larger shocks that cannot be coped with through national stabilisation.
Policy tools discussed in this respect are: a European Investment Protection Scheme which would preserve priority investment from spending cuts in the event of a downturn; a "rainy day fund" through which participating countries could accumulate funds on a regular basis and disburse them to cushion a large shock; and a European unemployment insurance (EUI) or reinsurance scheme to help national economies better weather the crisis.
A scheme that would add to the EMU system a cross-country insurance dimension and help cushion asymmetric shocks, while avoiding one-way fiscal transfers, involves careful design in order to minimize moral hazard and the distortion of incentives. Various variants have been explored, from direct pay-outs to reinsurance of national schemes, with the latter receiving most support. None fully avoid moral hazard, and while important, none can be expected to provide powerful stabilisation.[14]
The intellectual arguments underpinning the political objections raised to a stabilisation scheme do not dispute its potential stability benefits; instead they argue that these can be better achieved through stronger financial market risk sharing (once the banking union is complete) and a more effective use of fiscal stabilizers (building higher fiscal buffers).[15]
In recent policy discussions, attention has focused on an investment protection scheme or an unemployment insurance or reinsurance scheme. Both options were considered in the French-German proposal tabled on the occasion of the Meseberg meeting of June 2018.[16] However, the very principle of a macroeconomic stabilisation function has been opposed by the 'New Hanseatic League' led by The Netherlands and did not make its way to the Euro Summit decisions of December 2018.

b. *A central fiscal capacity*

Whereas stabilisation is generally considered in response to country-specific (or asymmetric) shocks, a separate issue is whether there is a need for an aggregate fiscal capacity that would make it possible to conduct a common policy at euro-area level without having recourse to coordination among participating countries. The case for it stems from the reconsideration of the role of fiscal policy in a low interest rate environment that limits the scope for monetary action. However, a common euro-area budget would need to be rooted in a yet-inexistent legal and institutional framework. The proposal in the Five Presidents report on a euro-area Treasury is carefully worded and embedded in the cluster of suggestions aimed at enhancing democratic accountability and legitimacy, rather than under the purely fiscal measures where there are more political objections. Following a proposal initiated by France and agreed with Germany, the Euro summit took a first step in the direction of a Euro area budget in late 2018, without mentioning the stabilization function.[17] While an important step, it remains timid and tentative; it is furthermore unlikely that it would be scaled up to represent a significant addition to the Multiannual Financial framework. Furthermore blueprints for a fiscal capacity under discussion are a far cry from proposals in the direction of a federalist EMU involving joint revenue-generating mechanisms through a Europe-wide tax administration system.

c. A European Safe Asset

The initial push for a common safe asset came in 2010 from the Delpla-Weizsäcker proposal for Eurobonds[18] and the ensuing flurry of variants – from Eurobills to ESBies and E-bonds. In its initial form, the common asset would have resulted from a joint and several guarantee on the 'blue debt' (below 60% of GDP), the counterpart of it would have been a juniorisation of the remainder or 'red debt' (above 60%). The differences between the various schemes which have since been proposed relate to critical features such as partial or common issuance, whether based on mutualisation of risks or entail no joint liabilities, involve pooling of sovereign bonds or "tranching" of national issuances.[19] The different proposals share a common goal: an asset which would be attractive to global and domestic investors as an alternative to national sovereign bonds, thereby allowing euro-area governments to finance themselves at reasonable cost, and in the process achieve the integration of European bond markets. To perform this role, such an asset would need a transparent structure with different maturity profiles, carrying comparatively the lowest possible credit and liquidity risk, while avoiding contagion. It would also need to be large enough to ensure it becomes a reference for collateral and liquidity both in the Euro area as well as for global demand. Through offering a vehicle for balance sheet diversification, a common safe asset could also complement concentration charges on oversized bank portfolios of (domestic) sovereign bonds and help address the "doom loop" between banks and sovereigns - a key destabilizing element in the euro area sovereign debt crisis.[20] Policy discussions have moved away from the initial proposal for Eurobonds, which has been rejected by Germany and would anyhow require a level of centralised control over national budgets that no country is willing to accept. The alternative of relying on sovereign bond-backed securities (SBBS – the creation of common assets through the tranching and pooling of national issuances, but no mutualisation) is regarded with scepticism by policymakers and market participants. Though far from consensual, the only version that commands some support is the Eurobill – an asset issued by a common institution such as the ESM, including as a counterpart to direct loans to euro-area sovereigns.

d. *Restructuring unsustainable sovereign debt at national level*

The constitution of the euro was based on an ambiguity regarding the meaning of the "no bail-out clause": whereas some, especially in Germany, regarded it as implying automatic restructuring of unsustainable public debt (and, in its strictest form, the prohibition of conditional financial assistance), the letter of the Treaty only ruled out taking responsibility for a member state's debt. Therefore, the sovereign debt crisis that erupted in 2010 prompted wide-ranging soul-searching on the treatment of excessive public debt. Though repeatedly discussed, the issue has not yet been settled.
The euro area initially refused to address this issue at the beginning of the crisis, until the sudden turnaround with the ill-designed Deauville decision in late 2010 and eventually the 2012-3 Greek debt restructuring, the only instance to-date of an actual "write-down" of sovereign debt in a euro area county. However, the legacy of high and still rising debt levels is increasingly a matter of concern. In light especially of particularly high and unsustainable debt-to-GDP ratios in countries such as Greece and Italy, the discussion of whether debt restructuring should become a viable policy option in a more general sense, if all else fails, has taken on new significance.
The issue of a sovereign debt restructuring mechanism is a related one. In this area also, the argument for more market discipline and a return to the "no bailout rule" of the EU Treaty is pitted against fears of contagion that argue in favour of providing liquidity assistance, even in cases where solvency is not guaranteed. To euro area leaders, the Greek debt restructuring exercise was supposed to be a "one-off" event. But the pendulum seems to have decidedly swung: the idea of "orderly sovereign-debt restructuring" in cases where solvency cannot be restored through conditional crisis lending is gaining ground. In its most nuanced version, this does not imply automatic debt haircuts or maturity extensions when a country is forced into an ESM programme. It suggests debt restructuring as a last-resort option, with the ESM following IMF rules in this regard. In addition, it makes proposals for such restructuring to become less disruptive economically and financially; these include the concentration charges and the safe asset discussed earlier, as well as a euro area deposit insurance. It is an approach which tries to stay faithful to the "no bailout" clause in the Treaty while providing a framework to make it operational.[21]

e. *Simplification of fiscal rules*

The reforms during the crisis sought to amend and strengthen the SGP framework; yet their accumulation has made it too complex and ineffective. The criticism that the rules and their interpretation produced too little debt reduction in the first decade of the euro and too much fiscal austerity during the crisis continues to resonate today. The SGP reforms were aimed at creating a more robust framework for assessing countries' fiscal positions and adjustment paths. But they rely on unobservable variables such as the structural deficit and forecasts of potential output growth; hence both the European Commission and Member States resort to creative interpretations in order to enforce a complex and error-prone set of rules avoid without unnecessarily sanctioning countries.[22]

The simplification of fiscal rules is probably the most mature reform area. Proposals vary, but the reform direction is shared both by proponents of a rules-based approach to fiscal monitoring as well as by those who put more focus on discretion. The core of most proposals is to replace the current system with a simpler rule focused on limiting the annual growth rate of expenditures. They differ on whether it would be "anchored" on a balanced budget rule or (as most suggest) on a medium-term debt target such as the 60% debt to GDP ratio in the SGP, or another to be defined in a discretionary way.[23]

4. Governance reform

The management of the sovereign debt crisis was clearly not the euro area's finest moment. While the decision-making process used may have worked for defusing the crisis, in the longer term it undermines the legitimacy of the European project. In this context, governance reform involves both reformulating the role of key European institutions in the common currency area, as well as addressing issues of democratic legitimacy.
The core issue concerns the EU ambition and desire for a common destiny and initiatives to support it. There is a broader EU discussion of whether, given political realities and divergent national priorities, the Union will move ahead with "coalitions of the willing" emerging to work together in different policy areas, ranging from the economy to security and defence. Within this broader discussion, a number of practical proposals for institutional reforms in the euro area have been advanced.

4.1. The future role of the ESM

The one most advanced is the establishment of a European Monetary Fund within the EU's legal framework, built on the structure of the ESM. The ESM has indeed evolved since it was set up and is in the process of becoming, together with the ECB, central to the new EMU architecture. Once strictly limited to providing finance, it has equipped itself with the capabilities needed to be designing the financial aspects of support programmes, as well as monitoring former programme countries and undertaking debt sustainability analyses (for example the validation of the debt sustainability necessary for the ECB to use tools such as the OMT programme).[24] In these roles it has emerged as the backbone of a fully-fledged financial institution and an alternative to the European Commission.

There are two practical ways in which the ESM will evolve and come closer to resembling a European Monetary Fund. The first is to act as a financial backstop for the SRF in the form of a revolving credit line, so that the latter has adequate resources to restructure failing credit institutions and more generally withstand a financial crisis. The second relates to fiscal risk-sharing and providing a limited fiscal capacity for the euro area through shorter-term loans with lighter conditionality than under regular programmes.
The idea is to assist stabilisation and thereby avoid a situation where a full ESM programme is required. The main elements of this backstop were endorsed by the Council in December 2018 while the Council also made a move in the second direction by endorsing a "Term sheet on the European Stability Mechanism reform".[25] This represents an improvement on existing rules; the stringent ex-ante eligibility conditions attached however may limit its usefulness in practice.[26]
An additional direction for ESM reform is in the context of debt restructuring. The ESM has effectively been given the mandate to manage an eventual sovereign debt restructuring framework and become a moderator between states and private creditors. The announced intention to change by 2022 the collective action clauses (CACs) framework and include this commitment in the ESM Treaty is a clear movement in the direction of making "orderly debt restructuring" part of the new EMU architecture.
The practical discussion on how the ESM will evolve and what additional tools it will be given takes place against the background of an institutional power struggle between the European Commission and the European Council. During the crisis, the initial creation of the EFSF and subsequently of the ESM showed that member states intended to keep financial support under their control. But as the ESM evolves into a future EMF, key euro-area member states might in fact use the necessary broadening of its scope to rebalance responsibilities. There are indeed three major differences between governance by the Commission and by the ESM: membership, as the former includes all EU members, and the latter only those taking part of the euro; balance as each country appoints one Commissioner whereas votes are weighted within the ESM; and distance, as the Commission is formally independent from the member states whereas the ESM is an intergovernmental institution.[27]

4.2. Institutional balance and accountability

The role of the Eurogroup in helping manage the crisis cannot be overemphasized. Because of this indisputably pivotal role in euro area decision-making, it has attracted widespread criticism about its lack of transparency and legitimacy.[28] The criticism has focused on its informal character and lack of democratic accountability, given the gravity and nature of its decisions. As we move beyond the crisis, this needs to be addressed. Publishing the minutes of the meetings, more formal hearings of the Eurogroup President at the Parliament or electing a full-time President may help. Fundamentally however, the issue is about resolving the conflict of interest expressed at the Eurogroup between creditor and debtor countries. The former

require "house cleaning" from debtors, with debts repaid through higher taxes and lower expenditures; the latter want a more balanced adjustment and more risk-sharing instruments. Reconciling the two goes beyond simple institutional changes at the Eurogroup.
The supranational European institution which played the most central role in keeping the single currency together is the European Central Bank. The "whatever it takes" stance taken by Mario Draghi in 2012 is widely credited as representing the watershed in overcoming the worst of the crisis. While the statement itself proved to have enormous impact, the ECB had from the start of the crisis regarded itself as endowed with the mission of preserving the integrity of the euro area – an implicit mandate as important perhaps as the stated mandate of preserving price stability.
Its gradually evolving initiatives since the beginning of the crisis involved secondary market sovereign debt purchases, long-term refinancing operations to provide liquidity to the European banking system, and targeted refinancing to unclog policy transmission channels. And following the 2012 statement, the introduction of the OMT scheme indicated that, in the name of tackling the redenomination risk, it could get closer to fulfilling a de facto function of lender of last resort. These moves were often met with considerable opposition from both within and outside the institution, and claims that it was operating beyond its mandate.
As Europe integrates further economically and socially, its institutions have not adapted sufficiently. Rather than following through with what should be a "quantum leap in institutional integration",[29] Europe hesitates and dithers. This is because economic integration is accompanied by political divergence. And yet, the new geopolitics it is facing demand exactly the opposite.

5. Concluding remarks

Is the mission accomplished? Following the crisis, much has been done, but the euro area is still fragile. Financially, it is less so than in 2011, but the Italian episode has shown that the doom loop is still there, with the redenomination risk not fully eliminated. Economically, the current slowdown illustrates how quickly the outlook can deteriorate. There is not much monetary and fiscal ammunition left to ward off the next recession, and the asymmetry between successful and struggling countries remains blatant. Finally, while the political risk was second-order in mid-crisis, it now has center stage, with both northern and southern populism now developed - the one thing they have in common is a distaste for Europe.
What is required at this juncture is an agreement on a minimal agenda that would not deliver an ideal EMU but would deliver a viable EMU. Its key ingredients could be to:

- Focus on structural reform and competitiveness. There seems to be agreement to use the EU budget to this end; combined with clever financial engineering (re: the Juncker plan) it can help in a much better way

- Finish the last mile in Banking union. Euro area countries have invested too much to backtrack. The priority agenda includes EDIS, concentration charges and a truly integrated resolution mechanism. Looking beyond, what is at stake is whether we agree on building an integrated banking market, as part of CMU.
- Harvest the low-hanging fruits in fiscal reform. These include a reform of the SGP that lengthens the leash for member states, and as a quid pro quo more individual responsibility in the case debt proves unsustainable (but no procedural or arithmetic automaticity). Stabilisation and a fiscal capacity are desirable, but not indispensable in the short term.
- Safeguard the institutions. Fully develop the new role of the ESM while avoiding a turf war between with the Commission. In this context, one solution could be that the Commissioner becomes the chair of the Eurogroup, but with fiscal surveillance delegated to a fiscal council.

This minimal agenda should not stop us from pursuing all the elements discussed above for a fully functioning EMU. A safe asset, a stabilization tool and a central fiscal capacity for example continue to be necessary in this respect. But few of these reforms are technical; almost all incorporate a view on the general future EMU direction, on which there is no consensus. Further political integration represents both a limit and a prerequisite to full EMU reform. In the current political and economic environment, it is critical to at least proceed with what is absolutely necessary; for the rest, it is important to paint the bigger picture, lay out the political choices and the policy options that follow, and prepare the ground for decisions at a later stage.

[1] "Strengthening Economic Governance in the EU – Report of the Task Force to the European Council" (https://www.consilium.europa.eu/media/27405/117236.pdf) and "Towards a Genuine Economic and Monetary Union" (https://www.consilium.europa.eu/media/23818/134069.pdf).

[2] See https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119888.pdf

[3] The text can be found in http://europa.eu/rapid/press-release_DOC-12-2_en.htm

[4] See http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp147_en.pdf

[5] See https://www.consilium.europa.eu/media/21400/20120629-euro-area-summit-statement-en.pdf

[6] See https://www.consilium.europa.eu/media/37268/tor-backstop_041218_final_clean.pdf.

[7] See ec.europa.eu/info/sites/info/files/economy-finance/ip096_en.pdf

[8] Bénassy-Quéré et al. (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", a report by French and German economists, CEPR Policy Insights No 91, January. The report can be found in https://cepr.org/active/publications/policy_insights/viewpi.php?pino=91

[9] "Completing Europe's Economic and Monetary Union" (the Five Presidents Report). The report can be found in ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf

[10] "Reflection paper on the Deepening of EMU" (https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf). The policy package proposed by the European Commission for completing EMU can be found in: https://ec.europa.eu/info/publications/economy-finance/completing-europes-economic-and-monetary-union-policy-package_en

[11] See http://bruegel.org/publications/datasets/sovereign-bond-holdings/.

[12] The European Commission produced in 2016 an "Effects Analysis" of the introduction of an European Deposit Insurance Scheme (EDIS). The non-paper can be found here: https://ec.europa.eu/info/sites/info/files/161011-edis-effect-analysis_en.pdf.

[13] These proposals are taken from Bénassy-Quéré et al. (2018), ibid.

[14] See for example Koester, G. and Sondermann, D. (2018), "A euro area macroeconomic stabilisation function: assessing options in view of their redistribution and stabilisation properties", European Central Bank Occasional Paper series, No. 216; CEPS (2017), "Feasibility and Added Value of a European Unemployment Benefits Scheme", Report commissioned by the European Commission.

[15] See Heijdra, M. et al. (2018), "A more stable EMU does not require a central fiscal capacity". This article (by economists working for the Dutch government) can be found in: https://voxeu.org/article/more-stable-emu-does-not-require-central-fiscal-capacity.

[16] See https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806

[17] The December 2018 Euro Summit statement mandates the Eurogroup to work on "a budgetary instrument for convergence and competitiveness for the euro area". It is a watered-down version of the June 2018 "French German roadmap for the Euro Area": https://www.economie.gouv.fr/files/files/PDF/2018/Finances-Euro_Area_Roadmap-EN.pdf.

[18] Delpla, J., and von Weizsäcker , J. (2010), "The Blue Bond Proposal", Bruegel Policy Brief.

[19] Different schemes are discussed in Monti, M. (2010), "A new strategy for the single market", Report to the European Commission, pp. 61- 65 (E-bonds); Philippon, T. and Hellwig, C. (2011), "Eurobills, not Eurobonds", VoxEU.org,; Claessens, S. et. al. (2012) "Making sense of Eurobond proposals", VoxEU.org; Brunnermeier, M. et al. (2016), "ESBies: Safety in the Tranches", ESRB Working Paper No. 21, September. European Commission (2011), "Green paper on the feasibility of introducing stability bonds", COM(2011) 818, provides an overview: http://www.europarl.europa.eu/meetdocs/2009_2014/documents/com/com_com(2011)0818_/com_com(2011)0818_en.pdf

[20] The argument is made in Bénassy-Quéré et al. (2018), ibid.

[21] The "orderly debt restructuring" argument is made in Bénassy-Quéré, A. et al. (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No 91. It has been endorsed in part by the France-German roadmap for Euro area reform. Two critical opinion pieces are De Grauwe, P. and Y. Ji (2018), "Financial engineering will not stabilise an unstable euro area"; and Tabellini, G. (2018), "Risk sharing and market discipline: Finding the right mix", both in VoxEU.org.

[22] This argument is made inter alia in Wieser, T. (2018), "Fiscal rules and the role of the Commission", VoxEU.org.

[23] Feld, L., et al. (2018), "Refocusing the European fiscal framework", propose an expenditure rule within the "rules-based approach". Other alternatives are in Darvas, Z., Martin, P. and Ragot, X., "The economic case for an expenditure rule in Europe"; and Beetsma, R. (2018), "Reforming the EU fiscal framework: A proposal by the European Fiscal Board", all in VoxEU.org.

[24] This argument for the necessity that ESM and ECB work seamlessly in the EMU to defuse crisis is developed in Claeys, G. (2018), "Make euro-area sovereign bonds safe again", VoxEu.org.

[25] See https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf

[26] See Claeys, G. and Collin, A. (2018) "Does the Eurogroup's reform of the ESM toolkit represent real progress?", VoxEu.org.

[27] For the ESM's own view, see "A European Monetary Fund: for what purpose?": https://www.esm.europa.eu/speeches-and-presentations/european-monetary-fund-what-purpose-speech-klaus-regling.

[28] See, inter alia, the case opened by the European Ombudsman in 2016 (Transparency of the Eurogroup - https://www.ombudsman.europa.eu/en/case/en/48285); the EP resolution on the review of the economic governance framework: stocktaking and challenges (2014/2145(INI)); and the Transparency International project on European Economic Governance (https://transparency.eu/project/euro/).

[29] Draghi, M. (2015), Speech at SZ Finance Day 2015, Frankfurt am Main, 16 March.