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EUROPEAN POLICY ANALYSIS

The euro is fragile; that's OK

Charles Wyplosz*

Summary

The Economic and Monetary Union (EMU) was adopted through compromises between governments with widely different views. Many things have gone wrong, but the euro has survived despite its imperfect construction, and it will probably survive in the future as well. The reasons are that it provides a stable exchange rate among its members and leaving the euro would be so disruptive that no government would even contemplate the idea.

What the EMU needs is (i) decentralized fiscal discipline based on sound economic principles and legal obligations, (ii) a central bank that acts as a lender of last resort to governments, and (iii) complete banking union, which makes it possible for the central bank to act as the lender of last resort to financial institutions.

The first and second requirements are essential for the survival of the euro. The third is desirable and includes a bank resolution authority and a macro-prudential authority. Further integrating capital markets in the union and introducing eurobonds would further help the monetary union become even more efficient.

* Charles Wyplosz is Emeritus Professor of International Economics at the Graduate Institute, Geneva.

The opinions expressed in the publication are those of the author.

1. Introduction[1]

We knew from the start that the European Monetary Union (EMU) would face many challenges. Europe was not an optimal monetary union and is still not (Bayoumi and Eichengreen, 2017). Its institutions were adopted through compromises among governments that held widely different views, and many of these views were not based on best practice and up-to-date theories. The go-ahead decision had been pushed through to an uniformed public by policymakers who vastly oversold the creation of the common currency as the beginning of a golden age (European Commission, 1990). Many things could go wrong, and several did. And yet, the euro has survived. Today, it is still a highly imperfect construction, but my bet is that the euro will survive.

> "[...] leaving the euro area is bound to be so disruptive that no government is likely to ever contemplate leaving the EMU."

There are two reasons for this conclusion. The first is positive and is the key initial driver for the EMU (Baldwin and Wyplosz, 2017): a deeply integrated trading market requires stable exchange rates among its members. At the same time, financial market integration either leads to significant exchange rate volatility or imposes very tight limits on central bank autonomy; this is Mundell's celebrated trilemma (Mundell, 1960). A monetary union with a unique central bank is a sound logical way to respond to the trilemma. The second reason why the euro will survive is that leaving the euro area is bound to be so disruptive that no government is likely to ever contemplate leaving the EMU. Indeed, a new currency must replace the previous one overnight but preparations, unavoidably long and impossible to hide, stand to trigger massive financial outflows apt to destroy the banking system and plunge the economy into depression.

These concerns should not let us forget that no other group of independent countries has ever achieved such a degree of trade and financial integration, which is why the EMU remains a unique case.[2] Of course, a number of EU member countries have not joined the EMU, but the existence of a large core of countries that did so provides the required exchange rate stabilizing effect. All other EU central banks manage their exchange rates with regard to the euro one way or another.

So, here we are, stuck with an imperfect construction. The EMU was not perfectly set up when it started but it has changed and will continue to do so, although very slowly and not always in the right direction. Actually, there is a surplus of proposals on how to take the EMU a few steps further, some of which are under consideration. Given the existing limitations of the EMU, this is not surprising and could be helpful. However, reforms are often difficult to adopt and implement, particularly when they must be accepted by many countries, each with its own history and political traditions. In addition, some of the proposals are not well grounded in robust principles. Policymakers must therefore sort out the proposals, which is not an easy task, and decide on which ones to enact, taking into consideration relevance, urgency, and political feasibility.

In this paper, I examine a number of proposals, separating them into three categories:

- reforms that are essential to the long-term survival of the euro;
- reforms that would improve the functioning of the monetary union but are not crucial at this stage;
- reforms that are not needed and are sometimes even potentially harmful.

2. Survival needs

2.1 ECB as lender of last resort

No matter what they say, central banks are lenders of last resort to both their governments and their systemic financial institutions. For a long time, they had a policy of denying this ex ante for fear of

[1] I am grateful to Harry Flam and Alexandra Leonhard for numerous suggestions.
[2] There exist a few other monetary unions but they are of a different nature. The Caribbean countries are small islands. The two African monetary unions are a leftover of colonial times supported by France.

creating a moral hazard. After a few major crises, this commitment is now obvious, even if it still is clouded in some ambiguity. This is the case for the ECB as well, which bailed out governments during the 2010–12 debt crisis ("whatever it takes"). Yet, it took more than two years for the ECB to take that step. Eichengreen and Wyplosz (2016) argue that the crisis probably would not have spread had the ECB intervened in its early phase. Ambiguity can be very costly.

Lending in last resort to banks is taken up in Section 3 below; here, I look at the case of public debts. Lending is always risky, and this applies to lending to governments. The founders of the Maastricht Treaty were concerned that it could open up the possibility for fiscally undisciplined governments to use this avenue to obtain income transfers from disciplined governments. Two articles of the Treaty on the Functioning of the EU (TFEU) were designed to avoid such a gaming of the monetary union. Article 123(1) explicitly prohibits the ECB from lending to governments, and Article 125(1) rules out support for a member state's indebtedness by other members.

The spirit of these articles is not controversial but, as always, details matter. Article 125(1), unofficially dubbed the "no-bailout clause", has been circumvented during the debt crisis by interpreting it as forbidding member states from assuming the debt obligations of another state, not preventing support. When it was later asked to evaluate the "bailouts" to Greece, Ireland, and Portugal, the Court of Justice of the European Union (CJEU) stated that "Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy".[3] As we know, legal texts always can be reinterpreted if the political will is there.

Article 123(1) is even more fragile, and rightly so. It forbids the ECB from directly financing member governments either by transferring money to their accounts or by buying public debts on the primary market, that is, when they are issued. The Article, however, allows the ECB to purchase public bonds on the secondary market, acquiring them from banks or other financial institutions. Indeed, like many other central banks, the ECB routinely purchases public bonds for its standard open market operations. Ex post, however, the distinction is very thin. When the ECB lets it be known that it will purchase some amounts of public bonds on the secondary market, banks and financial institutions merely act as intermediaries. They buy bonds on the primary market, knowing that they will sell them to the central bank on the secondary market. In fact, this is what happened in 2020 and 2021 during the COVID-19 crisis.

Even though secondary market purchases are similar to primary market purchases, they are not equivalent. First, the detour via the second market is not innocuous. If the financial institutions grow concerned about a country's indebtedness, they require higher interest rates to hold the bonds, even for a brief period. They may even desist from primary purchases. Second, there are limits on what the ECB can achieve on the secondary markets in normal times. It has established rules about its purchases of public bonds that are considered risky by rating agencies. Thus, since the debt crisis, the ECB does not purchase Greek bonds (with the exception of its Pandemic Exceptional Purchase Programme).

> "The 2012 'whatever it takes' decision was effectively a promise to lend in last resort."

The 2012 "whatever it takes" decision was effectively a promise to lend in last resort. The ECB committed to buying unlimited amounts of public debts ("and believe me, it will be enough") through the newly created Outright Monetary Transactions (OMT) programme. This reassured the financial markets. They stopped speculating on some national debts and the crisis was soon over, without the ECB having to carry out any purchase under OMT. Here again, the CJEU backed this

[3] Court of Justice of the European Union, Judgement of 27 November 2012, https://curia.europa.eu/juris/document/document_print.jsf?doclang=EN&text=&pageIndex=0&part=1&mode=lst&docid=130381&occ=first&dir=&cid=332500.

intervention when it was asked to formulate an opinion. Afterwards, when the ECB followed other central banks in its quantitative easing (QE) policy (which it calls "asset purchase programmes"), it was correctly presented as monetary policy under another guise, which the CJEU again approved. Finally, during the COVID-19 pandemic, as part of its Pandemic Emergency Purchase Programme, the ECB even departed from its previous rule of purchasing public debts in proportion to member countries' shareholdings, explicitly supporting some countries under indebtedness stress. No doubt the CJEU will confirm the legality of these actions as well.

Thus, legal arguments do not prevent the ECB from lending in last resort to member states. It has done so, with great effectiveness, and will continue to do so when needed. In each case, however, some governments will be opposed, which could again slow these interventions even though they are a matter of urgency. Yet, the issue remains taboo, with unwelcome consequences. When the need arises, the ECB needs to reach an informal agreement with member governments, which can take time when delays usually make matters worse. Ambiguity is implicitly used to contain moral hazard. A superior arrangement would be to agree ex ante on a formal framework, which could offer guarantees to fiscally disciplined governments and impose obligations on rescued governments. The arrangement would specify who would bear the losses that may follow the ECB interventions, with a view to preventing or limiting transfers across member countries. Unfortunately, the issue is currently considered as taboo, which means that there can be no discussions about such an agreement. This weakens the monetary union. It is not completely reassuring that the obstacle has been circumvented previously.

2.2 The Stability and Growth Pact

Since the creation of the euro, the area's overall public debt has risen from an average of 60 percent of GDP to about 100 percent. On the eve of the debt crisis, in 2009, the ratio already stood at 80 percent. These numbers strongly suggest that the Stability and Growth Pact had already failed long before the debt and pandemic crises. The pact has been suspended since 2020 and is currently expected to remain so until the end of 2022. This further suggests that its strictures can be implemented only in fair weather, where it is not effective, and that it cannot face occasional storms.

> "[...] the Stability and Growth Pact had already failed long before the debt and pandemic crises."

The Stability and Growth Pact has been a sore ever since it was mooted (Eichengreen and Wyplosz, 1998). It underwent two revisions, in 2005 and 2011–12, designed to deal with its weaknesses, mostly its rigidity and arbitrary objectives (a deficit less than 3 percent of GDP and a debt target of 60 percent of GDP). These revisions have added layers of rules and criteria, turning the pact into a complex web of dos and don'ts, which have failed to make it more effective. This diagnostic is widely accepted but disagreements about what to do about it are deep.

The pact faces the familiar trade-off between rules and discretion. In addition, it must deal with deep differences among countries, in terms of both legacy and opinion, which feed fears or hopes of inter-country income transfers. As already mentioned, there are fiscally disciplined countries, roughly the North, and undisciplined countries, roughly the South. This suggest that some countries have designed their own rules, explicit or implicit, which are reasonably effective, while others have not got to grips with the need to prevent public debts from rising. Yet, membership of the monetary union requires fiscal discipline in each and every country because indiscipline creates negative externalities.

Wrong concepts survive forever

The 3 percent deficit and 60 percent debt rules are, finally, acknowledged as completely arbitrary by their enforcers (Deroose et al., 2018). Unfortunately, there still is much confusion about how to define fiscal discipline. Economic theory offers an alternative concept: debt sustainability. The problem is that the sustainability condition, technically referred to as the transversality condition, involves the debt level in infinite time, which cannot be implemented. Any practical rule, therefore, must be ad hoc, which creates a huge space for interpretation, hence the proliferation of proposals.

Still, the debt sustainability condition can be used to rule out some proposals. For example, the pact's annual deficit is clearly fraught. A few years with large deficits does not violate the debt sustainability condition if they are followed by a string of years with surpluses. Even permanent deficits, if small enough, are possible when the growth-adjusted interest rate ($r - g$) is negative. Requiring, as the Stability and Growth Pact does, that deficits in excess of 3 percent be promptly reduced forces adjustment over a short period, while it can be spread over the longer run. As the debt crisis made clear, such emergency adjustments can have unnecessarily dramatic adverse effects on growth and unemployment.

The 2005 reform of the pact recognized that emergency correction stands to lead to procyclical fiscal policies in the midst of recession. The solution was to emphasize cyclically adjusted budget measures under the newly created preventive arm. While it failed to recognize that deficit adjustment must be a long-run concept, the solution also relied on the famously imprecise cyclical adjustment. The 2011–12 reform sought to respond to this challenge by multiplying indicators and by allowing for a more judgmental approach. Complexity increased and politicization deepened.

> "The drift in reforms illustrates how sticking with a demonstrably wrong concept leads to 'refinements' that make the situation worse [...]."

A currently popular proposal targeting public spending is bound to make things worse. However, fiscal discipline concerns the deficits, not just the spending side. This is why the proposed spending rules typically involve provisions regarding tax revenues. For example, permanent tax increases are counted as a reduction in spending. This is a deeply misleading use of budgetary accounting. In addition, in order to not be pro-cyclical, the rule involves cyclical adjustments. In effect, the proposed spending rule is the cyclically adjusted budget rule made worse because it suggests that public spending is the key instrument, irrespective of whether current spending is too low or too large to be efficient and adapted to needs. The drift in reforms illustrates how sticking with a demonstrably wrong concept leads to "refinements" that make the situation worse by adding complexity, arbitrariness, and opaqueness to the previous complex, arbitrary, and opaque rule.

Conflict with national fiscal authorities

A rule is only as good as its enforcement. The procedures of the Stability and Growth Pact rest on instructions sent by the Commission and the Council to member governments, backed by the threat of fines against recalcitrant countries.[4] Fines are simply impossible to impose, as argued long ago in Eichengreen and Wyplosz (1998). Indeed, despite repeated violations over more than two decades, no fine has ever been imposed. This is not surprising. Final decisions on fines require the approbation by the Council, which is a political institution where colleagues deal with each other on many issues, fiscal discipline being just one of them.

To make matters worse, a fundamental characteristic of European democracies is that spending and taxing decisions must be approved by parliaments. "Instructions from Brussels" clash with this national prerogative. To be sure, there are many areas in which EU member countries have formally given up national autonomy, monetary policy being one of them, but fiscal policy remains a national prerogative. The treaties are thus inconsistent. The predictable consequence is that political considerations dominate. National parliaments insist on retaining the last word.

In the end, therefore, the Stability and Growth Pact cannot be enforced. This makes the pact fatally weak. Of course, this conclusion is well understood but the political appetite for tackling this aspect has been nonexistent so far.

Outline of a properly functioning discipline framework[5]

The natural solution is to decentralize the task of fiscal discipline to the national level, following

[4] The decision process is more complicated, but details can safely be omitted.
[5] This section draws on Wyplosz (2015, 2020).

procedures validated at the European level. The corresponding rules would be part of the national legal system, possibly at the constitutional level. This would solve most weaknesses of the existing pact. However, while it would break the treaty's inconsistency, it would leave the risk that one or more governments may not abide by their own national legal requirements.

> "The natural solution is to decentralize the task of fiscal discipline to the national level […]."

Each country would adopt its own discipline procedure, backed by legal obligations. The Commission, following consultations with the European Fiscal Board, would issue minimum requirements, based on state-of-the-art existing procedures. These requirements should include the following:

A proper definition of fiscal discipline. Debt as a ratio of GDP at a sufficiently long horizon corresponds to the transversality condition for sustainability. A short horizon represents an inefficient constraint that often results in pro-cyclical fiscal policies. Complex rules (like the Stability and Growth Pact) and ambiguous measures (like cyclically adjusted measures of deficits or spending) open the door to measurement errors and arbitrariness.

One verifiable target and one directly observable instrument directly related to the definition of discipline. The logical target is a debt path for the debt ratio and the corresponding instrument is a path for the budget balance. The Commission's reliance on more than one target and more than one instrument opens up the possibility of inconsistency and avoidance.

An independent monitor. A well-staffed office with unlimited access to information determines in real time whether the government decisions and their implementation are compatible with the objective and the announced target and instrument. This office must be independent of the government, like the Congressional Budget Office in the US or the CPB Bureau for Economic Policy Analysis in the Netherlands. Another example is the Treasury in New Zealand, which is independent from the political authorities.

An enforcement mechanism. Such a mechanism must fit national political institutions. The aim is for the independent monitoring office to require that deviations from the announced target and instrument be promptly corrected, unless the office determines that special conditions justify the deviations. The key here is that the government must be legally compelled to hold to its commitments.

A European-level oversight mechanism. Because of the risk that some governments may sometimes be able to circumvent their own legal obligations, the national monitoring offices must be backed by European-level oversight. Given that fiscal authority remains national, the procedure should focus on domestic violations of domestic legal obligations. It remains likely that, in the end, no government can be forced to comply, but the hurdle should be high enough to deter most attempts.

Importantly, there should not be one model applied to all countries. Traditions, institutions and starting positions differ markedly from country to country so the framework must differ. The 60% debt target of the Stability and Growth Pact is an example of the perils of uniformity; the German debt brake is an example of a framework that is adapted to institutions.

3. Necessary but not urgently needed reforms

The Banking Union, adopted in 2012, goes a long way to plugging a hole of the monetary union. Since the creation of the euro, banks have remained mostly national even though the adoption of the single currency was intended to foster a pan-European banking system. The main reason is that the responsibilities for banking regulation and supervision remained in national hands. As a result, a truly European bank would have to navigate through a complex web of different rules. Yet, the Banking Union remains incomplete.

3.1 A bank resolution authority

The creation of a single bank supervision authority – the Single Supervisory Mechanism (SSM) –

represents a crucial step toward limiting the odds of banking crises in a financially integrated eurozone. This authority is now housed in the ECB, where it benefits from the central bank's independence and ability to draw high-quality staff. The mild environment of low interest rates and abundant liquidity that has prevailed since 2014 may give the impression that the monetary union is now safe. Yet, no matter how effective supervision is, it cannot be expected to completely avoid occasional bank crises.

"A surprising outcome of the SSM so far is that bank integration has not increased and has quite possibly decreased."

A surprising outcome of the SSM so far is that bank integration has not increased and has quite possibly decreased. Most bank mergers have occurred within national borders, leading to more concentration at the national level (Duijm and Schoenmaker, 2018). There are many plausible reasons, the main one being that national authorities exploit numerous loopholes in the existing agreements to deter entry by foreign banks. A key question concerns what happens when a bank fails.

In that case, the authorities must intervene to protect at least some categories of depositors. If the authorities are purely national, depositors may feel, rightly or wrongly, that they stand to be better protected if their assets are in a national bank. The absence of a national resolution authority, therefore, may deter progress in banking integration in the monetary union. A full banking union requires a single supervisor but also a single resolution authority. This is well understood and led to the creation of the Single Resolution Board (SRB) in 2014. However, the Board is not single. It operates alongside national resolution authorities to form the Single Resolution Mechanism (SRM). Officially, the SRB is meant to organize bank resolutions, but the actual interventions are meant to remain in the hands of national resolution authorities.

The SRM, therefore, is a fragile construction in the face of powerful national interests. The SRB stands to be less well informed of the detailed situations of failing banks and its recommendations are not binding on the national resolution authorities. The experience so far, based on a limited number of cases of mostly small banks, suggests that, indeed, the banking union is not complete (Philippon and Salord, 2017). The spectre of messy and ultimately expensive resolutions in the midst of a large-scale banking crisis remains present (Dewatripont et al., 2021). The stalemate is clearly related to the influence of private interests in some member countries.

3.2 A macro-prudential authority

A similar issue concerns macro-prudential policies. This is an additional instrument to preserve financial stability, much less blunt than the interest rate. It operates by varying prudential regulations to limit specific credit growth and risk taking without raising interest rates, thus avoiding wide financial market and macroeconomic effects.

The authority to implement macro-prudential policies remains at the national level (Constâncio, 2019). As Single Supervisor, the ECB carries out stress tests, which provide important information on the need to take action. Yet, it can only make recommendations. The rationale is that the evolution of housing prices, a key target of macro-prudential policies, and mortgage lending tend to differ from country to county. However, although banking systems remain predominantly national, capital mobility stands to stunt disparate macro-prudential measures taken at the national level. Macro-prudential policies are subject to an important inaction bias, which is potentially dangerous (Draghi, 2019).

4. Useful needs

Two recurrent projects would certainly help to make the monetary union more coherent and to deliver some of its promises, even though they are not essential to its survival.

4.1 Capital markets

In contrast to banks, European capital markets have become more integrated, partly because they are shielded from the exchange rate risk. Yet, the monetary union has not reaped all the potential gains from increasing returns and risk diversification. The truth is that its capital markets remain not commensurate with Europe's economic size. Table 1 shows that in 2015 the financial centres of New York and London were far bigger than those of the Eurozone. The London Stock Exchange is suffering now from Brexit but European exchanges remain far from being a match for their US counterparts. Importantly, cross-border investments remain limited.

Table 1. Stock Exchange Capitalization (US$ trillion)

	2015	2020
NY Stock Exchange	19.22	26.23
NASDAQ	6.83	19.02
Euronext	3.21	5.44
Deutsche Börse	1.76	n.a.
London Stock Exchange	6.18	4.05

Source: World Atlas

The small size of European exchanges is the mirror image of the dominant role played by banks in financing corporate needs. Reasons often mentioned to explain this peculiarity include the lack of unified bankruptcy legislation to protect investors as well as a lack of transparency, taxation, and access by SMEs.

Following the 2015 report by the five presidents[6] (European Commission, 2015), which called for changes in national regulations that would provide incentives for market financing, the European Commission launched a Capital Markets Union (CMU) initiative. It was followed by a new 2021 Action Plan. The general view (see, e.g., the IMF Report by Bhatia et al., 2019) is that this effort has not delivered on its promises. According to Acharya and Steffen (2017), a real CMU will not occur until the bond markets are fully integrated, which is the issue considered next.

4.2 Eurobonds

Although European public debts are large by international comparison, there is no European bond market, only a collection of relatively small national markets for national bonds. There are no "European bonds", and each government's debt has idiosyncratic characteristics, including risk factors.

This is not optimal, it is often argued. A deep market for safe securities is a necessary condition for the development of financial markets. The largest national bond market, for the German Federal Bund, is one tenth the size of the US market for US Treasuries. The euro is a long way behind in competition with the US dollar as a major currency for financial transactions. Were eurobonds to replace national public debt instruments, the situation would be radically different.

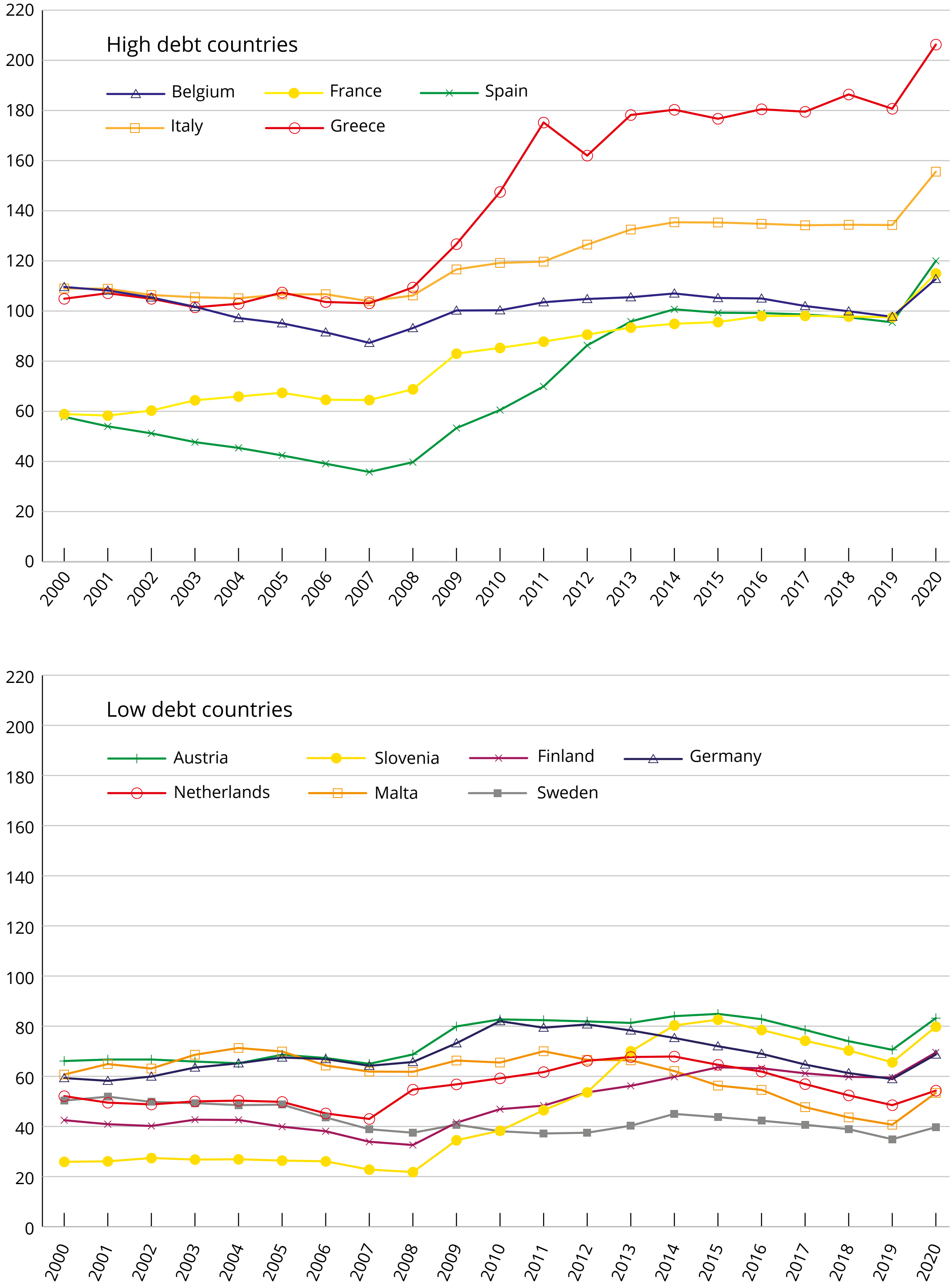
> "Had eurobonds been in existence at the time, Greece would not have undergone a massive recession and the Greek situation would not have spread to other countries."

Another consideration is risk pooling. When a country faces an adverse shock, the riskiness of its public bonds rises, which can lead to instability. If, instead, all national debts were eurobonds, jointly issued and guaranteed by all euro-area member governments, a purely national shock would have a limited impact on the corresponding national debt. The episode of the public debt crisis in 2010–11 is an illustration of this observation. Had eurobonds been in existence at the time, Greece would not have undergone a massive recession and the Greek situation would not have spread to other countries. The crisis, instead, led to deep hardship in many countries and even raised the possibility of a breakdown of the euro area.

These are powerful arguments. Yet, they must be confronted with the moral hazard counterargument that risk pooling via eurobonds is likely to weaken fiscal discipline in high public debt countries. It matters that, over the last two decades before the pandemic, some countries have managed to keep their public debts under control, even during the double-dip recession following the global financial crisis, while others have let their public debts rise (Figure 1). The countries with increasing debts were taking advantage of the fact that interest rates had remained about the same throughout the euro area, thus shutting off the market discipline channel.

[6] The presidents of the European Commission, ECB, European Council, Council of Finance Ministers, and European Parliament.

Figure 1. Debts as a share of GDP (%)



Source: Eurostat

The debt crisis saw a massive rise in interest rates in the high-debt countries. The low-debt countries obviously think that there is something amiss in these countries' budgetary processes.

Plainly, the low-debt countries are unwilling to assume responsibility for other countries' debts and see eurobonds not just as a way to force their hands but also as an incentive to let debts grow since interest rates will not reflect each country's riskiness.[7] The failure of the Stability and Growth Pact to rein in the deficit bias among the high-debt countries is sometimes seen as an argument to rely on market discipline to provide adequate incentives. Unfortunately, market discipline has a poor track record. Interest rates often rise too late and too far, prompting a sudden crisis, which was precisely what happened in 2010. The correct alternative to market discipline is to replace the Stability and Growth Pact with a better arrangement, as discussed in Section 2.2.

5. Wrongly perceived needs

Finally, other proposals presented below are not really needed. They may be helpful, but they are not necessary for the smooth functioning of the euro area and are too politically controversial at this stage to justify their adoption. They raise the familiar debate about whether Europe should evolve to become a federal state, starting with the euro area, which already operates a common currency, the quintessential federal instrument. One can be an enthusiastic pro-European and yet worry about destabilizing a fragile construction with an excess of enthusiasm. This is a political call, of course. This section focuses on the economic merits of the proposals, taking the view that if the economic justification is weak, then controversial political views should be tempered. Of course, it can be argued that Europe, including the adoption of the EU, has been created through political will, which should trump purely economic reasoning.

5.1 Fiscal policy: a real European budget

The closest example of a vast monetary union is the case of the United States, which achieved that goal more than a century after it became independent. By that time, it already had a significant, albeit small by current standards, federal budget. The EU has proceeded in the opposite order, which has led many to conclude that the monetary union will fail (Jonung and Drea, 2009).

> "The case for a European budget is weak."

The case for a European budget is weak. One argument in its favour is that profoundly integrated national economies stand to benefit from increasing returns in some areas where public funds play a dominant role. Research and innovation is a clear example, along with defence, higher education, and infrastructures – but not the Common Agricultural Policy, which absorbs a significant share of the EU budget. Another argument is that risk pooling would help individual countries as they deal with idiosyncratic shocks all the while when they have lost the ability to use their own exchange rates, the traditional shock absorbers. For instance, a European-level unemployment benefit system could top up national systems.

But there are powerful counterarguments. There already exist instruments to exploit returns to scale through the existing EU budget and through explicit agreements. In addition, public borrowing is not the only way of absorbing shocks; private borrowing has an important role to play as well. Completing the Banking Union and the Capital Markets Union stands to enhance the ability to face idiosyncratic shocks. Finally, most governments are unwilling to transfer budgetary powers to the EU for obvious political reasons. This opposition is strong among the low-debt countries, which fear the moral hazard issue discussed in Section 4.2. A more substantial federal budget than the existing

[7] Soon after the COVID-19 pandemic hit, it was agreed to create a temporary common European budget with the explicit aim of making it possible for the poorer or more indebted governments to protect their citizens and firms through large-scale fiscal policy interventions. The NextGenerationEU programme will distribute €750 billion over a five-year period, to be financed through borrowing by the Commission. It comes in the footsteps of the €100 billion Support to mitigate Unemployment Risks in an Emergency (SURE) programme financed by the Commission out of its own budget. Both programmes are explicitly exceptional and temporary. Yet, they create a precedent and may eventually represent a historical evolution.

Commission budget is therefore not necessary from an economic viewpoint and is highly divisive from a political angle, at least as long the euro area has not established an effective fiscal discipline mechanism.

Yet, an important step has been taken in the wake of the pandemic crisis with the €750 billion recovery programme. Financed by the Commission's borrowing and intended to last some five years, the resources of NextGeneration EU, as it is called, are being distributed partly as loans and partly as grants. Both the grants and the loans explicitly favour countries with large public debts. Thus, NextGeneration EU effectively issues eurobonds to transfer funds from some countries to others. As such it is innovative.

Can it be the beginning of a European Treasury? In principle, it is an exceptional undertaking designed to deal with a unique event, the pandemic. Exceptional initiatives may become permanent, though, but we will not know whether this will be the case for many years. In addition, the amounts to be disbursed have been hotly debated by governments and the European Parliament, leaving the Commission with limited ability to make decisions. Furthermore, the financing of the borrowing has not yet been decided and is bound to become highly controversial. Finally, the amounts may nearly double the very limited Commission's resources, but they are modest, less than 1 percent of EU GDP spread over five years.

5.2 Fiscal policy coordination

If a substantial common budget is currently unreachable, some argue that, at least, we should create a mechanism to coordinate national fiscal policies to achieve a desirable fiscal stance at the euro-area level. The argument is well known from the policy coordination literature: externalities tilt national decisions away from the best stance for the euro area as a whole.[8] In addition, coordination between the common monetary policy and national fiscal policies is only possible if there exists a concerted euro-area fiscal policy. The argument is obviously correct, although only under specific assumptions. The question is whether the effect is large enough to warrant imposing constraints on national authorities. Unfortunately, there does not seem to exist any recent attempt at measuring what would be gained. The older literature takes a dim view of the prospects for policy coordination (Cooper, 1985). At this stage, fiscal policy coordination is an interesting idea without empirical support.

> "At this stage, fiscal policy coordination is an interesting idea without empirical support."

5.3 Identifying macroeconomic imbalances

The EU adopted a Macroeconomic Imbalances Procedure (MIP) in 2011. The procedure is to have the Commission identify current account imbalances in addition to budget imbalances as part of its macroeconomic monitoring procedure. The rationale is that euro-area member countries cannot correct persistent current account surpluses or deficits through an exchange rate adjustment. The current account of the euro area being roughly balanced, presumably because the euro remains close to its equilibrium level, translates into continuing surpluses in some countries (usually in the North) and deficits in others (in the South). These imbalances prosper and last through direct and indirect capital flows from the North to the South made easier by the common currency. Over time, flows turn into stocks and the net positive or negative asset position grows until a crisis occurs, as it did in 2010. Thus the MIP can be seen as a response to the lack of exchange rate adjustments. The track record of the MIP is poor. Bénassy-Quéré and Wolff (2020) note that the procedure imparts a contractionary bias, is internally inconsistent, and is not well integrated with country-level procedures. They suggest streamlining the indicators, with a clearer link to economic analyses, and improving the Commission's role.

However, the reasons for these imbalances are poorly identified. The MIP rests on a large set of indicators, most of which cannot be properly seen as exogenous. For example, policy prescriptions that call for improving external competitiveness are not precise enough to deliver the desired effects. Gros (2012) and Wyplosz (2013) argue that the external imbalances – and their apparent "cause",

[8] The argument is spelled out in Deroose and Langedijk (2002).

competitiveness changes – are largely driven by public and private saving or dissaving. Budget imbalances are already subject to the Stability and Growth Pact while unsustainable bank credit expansion, which may lead to endless dissaving, can be dealt with through the macro-prudential instrument. Macroeconomic imbalances call for a better fiscal discipline framework and for the use of macro-prudential policies, not for another layer of suggestions and constraints from the Commission through the MIP. In addition, the MIP aims at affecting variables like the evolution of labour costs that are not only deeply embedded in domestic policies and politics but also not really controlled by governments. The MIP simply cannot deliver on its objectives.

6. Conclusions

The euro remains fragile more than twenty years after its creation. This widely shared view was clearly anticipated when the Swedish Ministry of Finance concluded in 2002 that "a monetary policy formulated for a group of countries will inevitably be a less sharp policy instrument than a monetary policy formulated specially for one particular country" (Swedish Ministry of Finance, 2002; p. 2). The challenge has always been to make the euro area function under difficult economic and political conditions. The hope was that, over time, the experience would reveal the usefulness of the currency area, which in turn would lead to better institutional arrangements and to a decline of disagreements.

The key economic aim of the common currency was to eliminate the currency crises that plagued the functioning of the Single Market (Wyplosz, 1997). This is mission accomplished. Yet, it has not been a smooth ride. The limitations of the arrangement, largely foreseen by a large academic literature, have gradually surfaced, leading to political tensions (as in 2003–04 in the wake of the large German budget deficits that followed unification) and economic upheaval (the 2010 debt crisis). In each case, reforms followed. Unfortunately, most of these reforms were superficial. Mostly focusing on bureaucratic mechanisms rather than on precise diagnoses, they have not delivered the institutional changes that would reduce the euro's fragility.[9]

The widely accepted recognition of this fragility has led to a slew of reform proposals by policymakers and academics. Regrettably, many of them lack solid analyses of the fundamental causes of the fragility or, when they do, they fail to abstract from non-economic principles. This is understandable. The euro is largely a political construction subject to political objectives that are not shared by each and every member country. As a result, first-best policies are deemed unreachable. The reform proposals all lie in the second-best world, which means that the authors look for the best policy under explicit or, much more often, implicit political constraints. Policymakers then argue in favour of reforms that match their national or political preferences. The result is that the reform process is driven by negotiations about arbitrary second-best proposals. The diplomatic outcome is the adoption of third-best (or worse) reforms that eventually fail to solve the problem at hand.

> "Progress is not linear and the process is frustrating and far too slow, but the euro is less fragile than it was at the start."

Thanks to successful, if incomplete, reforms like the banking union and the Single Supervisor, some progress has been achieved. Progress is not linear and the process is frustrating and far too slow, but the euro is less fragile than it was at the start. This paper suggests which priorities should guide the reform effort.

Even so, the euro area remains a quite imperfect arrangement. Existential threats emerged during the sovereign debt crisis because the deeply fraught policy responses could not be accommodated by sturdy institutions. Once the ECB shifted to underpin public debts, as it should have done from the start, the threat quietly vanished. More threats may emerge from unexpected shocks and the probability of the euro eventually succumbing to ill-conceived policy responses is not nil. But it is very, very low.

9 For a tongue-in-cheek analysis of the response to the debt crisis, see Eichengreen and Wyplosz (2016).

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