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EUROPEAN POLICY ANALYSIS

A Monetary Union for All EU Members

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Summary

A majority of Swedish voters are still reluctant to join the euro area. For this to change, the monetary union would have to be more successful in bringing economic prosperity. This, in turn, would require taking some steps forward as well as backward. A forward step would be to complete the banking union and a backward step would be to phase out the fiscal transfers.

It is important for the monetary union to be able to deal with financial crises, and through reforms undertaken, the union has much better crisis management today than in 2008. However, the interconnection between national banking sectors and Member States' public finances poses a risk for both the banking sector and public finances. The European Central Bank has created fiscal space in countries with weak public finances by buying sovereign debt. But this creates implicit liabilities for other member countries, which makes adopting the euro a less attractive option for Sweden.

The current fiscal rules would benefit from both simplification and flexibility. However, since allowing treaty changes has its own risks, it seems safer to build on the existing framework for the fiscal rules. Finding ways to enforce fiscal discipline would help Member States create their own fiscal space, which ultimately is what is needed for structural reform as well as effective crisis management.

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

1. Introduction

When Sweden held a referendum on whether to adopt the euro in 2003, about 56 percent voted no. According to opinion polls, except for a short period during 2009, there has been a consistent majority against adoption of the euro ever since (see Figure 1). In 2012 and 2013, about 80 percent of respondents said that they would vote no if another referendum were held. That share had decreased in the latest opinion poll from November 2021 but was still a quite significant majority of 63.5 percent.

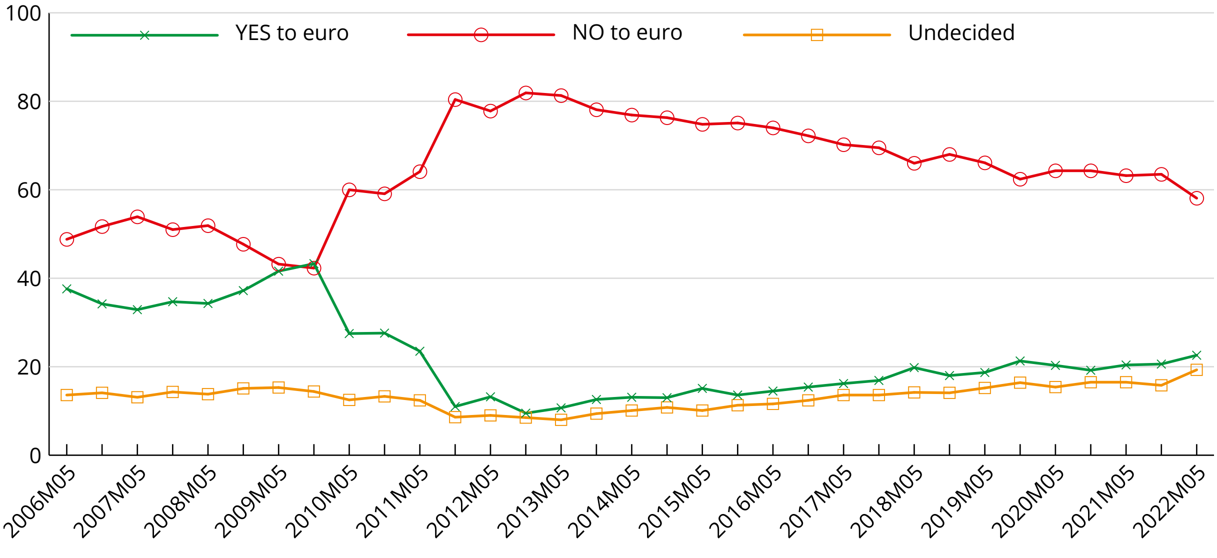
The decrease in voters' support for adoption of the euro coincides in time with the euro crisis. It is reasonable to assume that the difficulties faced by the euro area during that period and the subsequent slow economic recovery have had a negative effect on sentiments regarding euro membership. Rightly or wrongly, a majority of voters think that it would be better to stay outside.

Still, some of the current euro members joined after the outset of the euro crisis and some EU members are set to join in the years to come. Evidently, euro membership has remained attractive for several EU countries. The new members since 2010 are the three Baltic states: Estonia in 2011, Latvia in 2014, and Lithuania in 2015. Most likely, their reasons for joining the euro area were different from what might be reasons for a country such as Sweden to join. They were all severely hit by the global financial crisis and, being very small, struggled to maintain their exchange rate pegs in the face of massive capital outflows (Staehr, 2015).

For the monetary union to survive in the long run, it needs to offer something more than being preferrable to extreme volatility, which arguably was the case for the Baltic states. It may be instructive to ask what it would take to make euro adoption attractive to voters in Sweden – voters who may think that the economy works reasonably well being on the outside. In the absence of a domestic crisis leading to widespread doubts about the ability of domestic institutions to manage the economy, euro membership would have to bring some apparent advantages in terms of how well the economy performs.

Most importantly, the monetary union needs to be able to deal with financial crises in an efficient way. That was certainly not the case when it was hit by the global financial crisis in 2008. But, as I will argue in this paper, subsequent reform has created a much better basis for crisis management. There are still some gaps to be filled, in particular regarding the interconnection between national banking sectors and the Member States' public finances. On the whole, however, the monetary union is significantly better equipped to deal with financial crises today than it was in 2008.

Figure 1. Opinions regarding adoption of the euro in Sweden, share of respondents (percent)



Source: Statistics Sweden
Note: The question asked was the following: "If there were a referendum today about substituting the Swedish krona as currency, would you vote yes or no to adopting the euro as currency in Sweden?"

Another central task is to manage aggregate demand for macroeconomic stabilization. In normal times, symmetric shocks are mainly dealt with by countercyclical monetary policy. However, in a low-interest environment, where monetary policy is constrained by the effective lower bound, macroeconomic stabilization mainly falls on fiscal policy, as would also be the case when members are hit by asymmetric shocks. In order to rely on fiscal policy for macroeconomic stabilization, Member States need to have sufficient fiscal space to use fiscal stimuli in a downturn. With current levels of public indebtedness, it is questionable whether such fiscal space can be assured. By buying public debt, the European Central Bank (ECB) can prevent the rise of interest rate differentials across members, but in the long run it cannot prevent the general interest rate level from rising. Creating a central fiscal capacity could potentially solve the lack of fiscal space for some members. But allowing fiscal transfers on a permanent basis would almost certainly be considered anathema in a country such as Sweden and perhaps also in some of the current euro members, thus creating risks of disintegration. Continuing with the kinds of fiscal rules that are part of the Stability and Growth Pact (SGP) may thus be the only viable option, even if some of the actual rules are outdated and have become irrelevant.

In my view, it may be necessary to take steps forward as well as backward in order to ensure the long-run survival of the monetary union. Forward steps are particularly needed in the area of banking union, while backward steps may be needed in the area of fiscal transfers. In the following sections, I will describe how I view the underlying problems that led to the euro crisis, what measures I consider crucial for resolving that crisis, in what way the efforts to create a banking union can make the monetary union more stable, and the scope for reform regarding fiscal rules. In the final section, I draw some conclusions about the prospects of creating a stable monetary union.

2. An outsider's perspective on the euro crisis

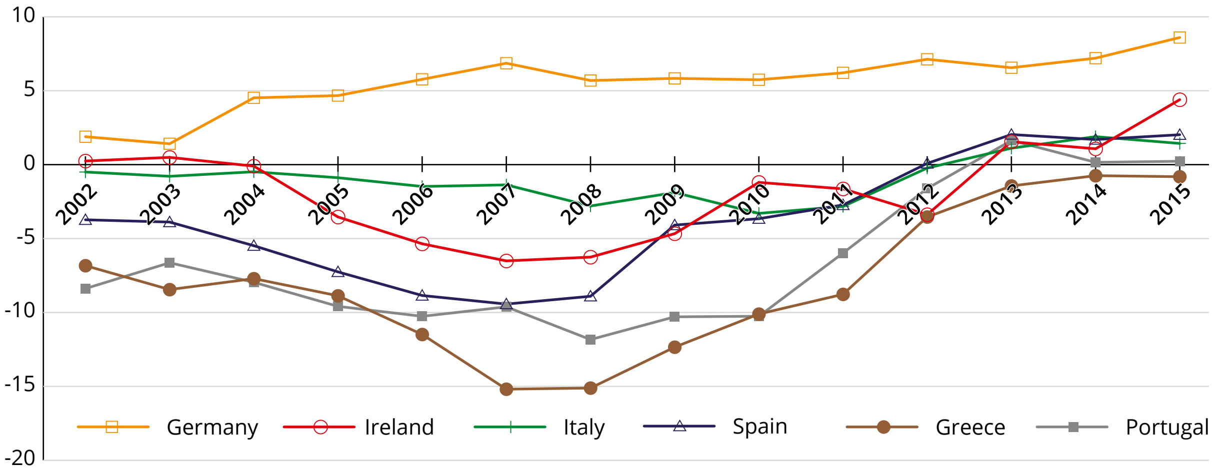
In order to have a view on what a stable monetary union would look like, one needs to go back to the euro crisis when it seemed uncertain whether the euro would survive. What caused the euro crisis? Why did it unfold the way it did? And why has it been so difficult for several euro countries to recover from it?

A way to study economic crises is to analyse what the underlying weaknesses were, what triggered the crisis, and what reinforcing feedback effects made an initial shock unfold into a full-blown crisis.

2.1 Underlying weaknesses

The underlying weaknesses in the euro area leading up to the euro crisis are well understood by now but were perhaps not so well understood at the time. It was clear that there were macroeconomic imbalances in the sense that several of what would become crisis countries had significant deficits in their current accounts while other euro countries had significant surpluses (see Figure 2). The deficit

Figure 2. Current account, percent of GDP



Source: Eurostat

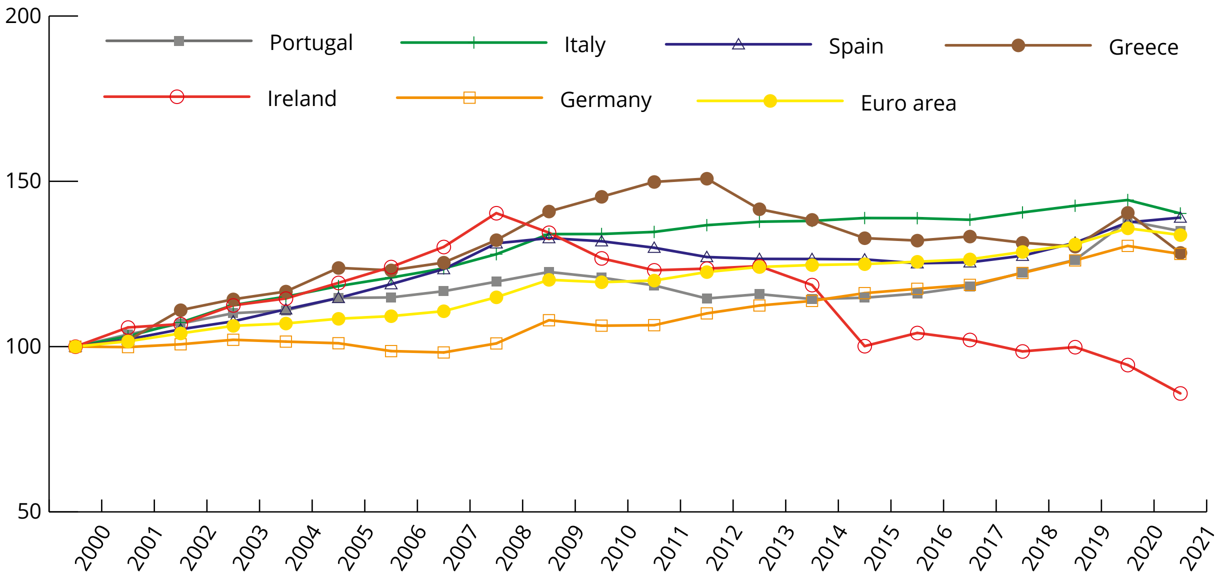
countries were largely found in Southern Europe while the surplus countries were largely found in Northern Europe. Germany and France were running current account surpluses while Greece, Portugal, and Spain together with Ireland were running corresponding deficits. Imbalances in the current account reflect capital flows, so it was clear that capital was being exported from the north to the south. Since the Southern European countries were relatively capital scarce and thereby had potentially large investment opportunities, while the Northern European countries were relatively capital abundant, a situation where capital moved from the north to the south seemed to be a reasonable state of affairs. It would simply constitute a reallocation of capital within Europe that would potentially benefit all – Southern Europe would become more productive and Northern European investors would receive a higher return on their investments than otherwise.

However, what was going on in reality does not match up with this benign story. The inflow of capital to countries such as Greece, Portugal, Spain, and Ireland did not seem to lead to increased productivity to the extent that one might have expected. Capital inflows seem to have been channelled into real estate, construction, and wholesale trade, essentially non-traded sectors with less scope for productivity growth than traded ones. They did however seem to contribute to price and wage growth. Booming non-traded sectors pushed up wages in the whole economy, making traded sectors less competitive. That high wage growth led these countries to successively lose international competitiveness is suggested by their above-average increase in labour costs per hour worked (see Figure 3).

One possible explanation for why capital inflows did not lead to the productivity-enhancing investments that were expected is that the domestic financial markets and political institutions simply were not adapted to allocate capital to its most productive use. If financial markets are shallow and political interference in which sectors and firms are given access to credit is pervasive, a credit boom may exacerbate credit misallocation and affect productivity negatively (Brunnermeier and Reis, 2019).

Another underlying weakness in the run-up to the euro crisis was the lack of fiscal discipline that prevailed in spite of the strict rules of the SGP. An important factor in this context was the compression of risk premia that the creation of the monetary union brought. As shown in Figure 4, as soon as the monetary union was created, the governments of countries such as Greece, Portugal, and Italy could borrow at essentially the same cost as Germany.

Figure 3. Nominal unit labour costs based on hours worked, index (2000 = 100)



Source: Eurostat

With such favourable borrowing conditions, it is understandable that governments with pressing spending needs would want to fund part of those needs by debt. That Germany and France breached the SGP rules early on also made deviation from the rules less costly. But the outcome was that several countries already had relatively weak public finances when the crisis hit.

2.2 Trigger

What triggered the euro crisis is to some extent up for debate. Obviously, at some level the global financial crisis was the negative shock that eventually led to a debt crisis in parts of Europe. But the trajectory from being affected by the global financial crisis to a situation where the spreads on government debt in the crisis countries started to rise as shown in Figure 4 is debated.

One view is that the Greek crisis was the important event from which the larger crisis followed. The discovery of a much bigger hole in Greek public finances than anyone had thought in connection with a shift of government in the autumn of 2009 meant that suddenly there was a real possibility of a sovereign default within the euro area. It brought to the fore the issue of whether the no-bailout rule in the SGP was credible or not. The complete compression of spreads on government debt prior to the global financial crisis suggests that it was not considered credible by investors then. But when the Greek crisis hit, it was initially unclear whether there would be a bailout or not.

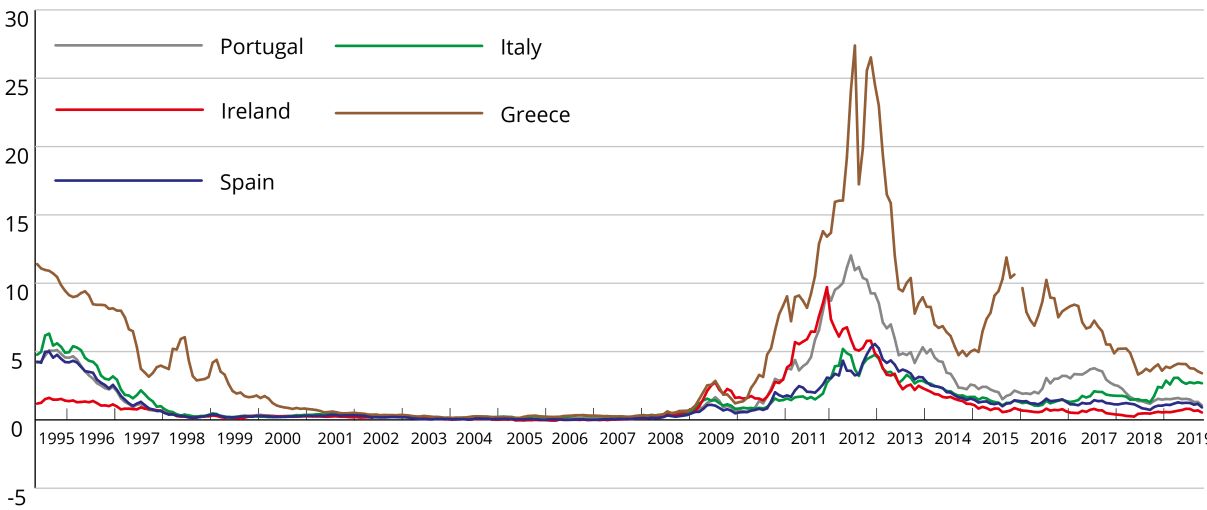
In the end, there was a bailout, but there was also a default in the sense that private investors had to take a loss on Greek debt. Neither the bailout nor the restructuring of the Greek debt was organized in a particularly swift and efficient manner, which meant that uncertainties arising in connection with the Greek debt crisis lingered for quite some time.

But there is another story about what triggered the euro crisis. On 19 October 2010, Angela Merkel and Nicolas Sarkozy met in Deauville and discussed the future of the monetary union while strolling along the beach. It turned out that they had agreed that any sovereign bailout from the European Stability Mechanism (ESM), which was going to be created as a permanent source of financial assistance for euro-area members, would require that losses be imposed on private creditors. The argument can be made that the explicit decision by these European leaders to impose losses on private creditors led potential investors to flee from sovereign debt markets of euro countries with weak public finances. According to the graph in Figure 4, it was not really until the autumn of 2010 that government spreads of the crisis countries started to rise in a dramatic way.

2.3 Reinforcing feedback effects

The most obvious reinforcing feedback effect in the case of the euro crisis was the so-called "doom loop" between sovereigns and their banks, sometimes also referred to as the "sovereign-bank nexus". When sovereign debt increases, more often than not this

Figure 4. Spreads on 10-year government bonds against Germany, percentage points



Source: ECB

debt has a tendency to end up on the balance sheets of domestic banks. Taken together with the fact that failing systemically important banks tend to be bailed out by their governments, it means that the financial positions of the governments and the banking sectors become dependent on one another. If public finances are weakened and risk premia increase on government debt, the value of the debt held on banks' balance sheets declines and the financial positions of the banks deteriorate. But since the banks constitute a potential liability for the government, deteriorating financial positions of banks put further upward pressure on risk premia on government debt. This makes borrowing more costly for the sovereign and further reduces the value of government debt held on the balance sheets of the banks, thus creating a vicious circle of deteriorating financial positions. This type of dynamic was clearly on display at the height of the euro crisis, when not only the governments of the crisis countries but also the banks operating in those countries saw their borrowing become more costly (Farhi and Tirole, 2017).

> "Thus the euro crisis can be considered to have essentially ended in 2012, even though some of the affected countries have not yet recovered completely."

It is clear from Figure 4 that the spreads on government debt of the crisis countries started to come down in 2012 and that, apart from a temporary increase in the spread on Greek debt in connection with the Syriza government taking office in 2015, these spreads have remained fairly low. Thus the euro crisis can be considered to have essentially ended in 2012, even though some of the affected countries have not yet recovered completely.

Many things that were potentially important in resolving the crisis happened in 2012. For instance, the ESM was established then. But the most important factor seems to have been actions undertaken by the ECB. The ECB had done things previously to contain the crisis, such as launching the Securities Markets Programme (SMP), under which the ECB could buy sovereign debt in the secondary market. But it was not really until Mario Draghi became the ECB president that ECB interventions were perceived as sufficiently forceful to make a difference. In July 2012, Mario Draghi gave a speech in London with the now famous line that the ECB was ready to do "whatever it takes to preserve the euro", with the off-the-cuff addition "Believe me, it will be enough".[1] It was later backed up by the introduction of a programme called Outright Monetary Transactions (OMT), which would allow the ECB to purchase sovereign debt in unlimited amounts provided that the Member State in question had asked for and been granted a conditional emergency loan from the ESM. So far, this programme has never been activated but it may nevertheless be an important backstop that prevents speculators from pushing up yields on debt issued by financially weak Member States.

3. Banking Union

A development viewed by many as crucial for preserving the euro is the creation of a banking union. This view is related to the idea that there is a financial trilemma in the sense of it being impossible to achieve financial stability and financial integration while at the same time pursuing autonomous financial policies (Schoenmaker, 2011). Any two of these three potential objectives can be achieved, but not all three at the same time. For an economic union, it is reasonable to give up on pursuing national financial policies in order to maintain integrated financial markets at the same time as avoiding financial crises.

As of today, important elements of a European banking union have been put into place. There is common banking supervision taking place at the Single Supervisory Mechanism (SSM) in Frankfurt. There is a common recovery and resolution framework and a common authority for handling resolution cases (the Single Resolution Board, SRB). What is missing is a common deposit insurance scheme, although there has been some streamlining of Member States' national deposit insurance schemes.

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[1] Reporting about the speech and the remark can, for instance, be found on Politico's European webpage; see www.politico.eu/article/ecb-will-do-whatever-it-takes-to-save-the-euro/.

Building the banking union has been a slow process and it is still unclear if and when it will be completed. An important reason why it is difficult to complete the project is that the starting positions of the Member States are so different. In discussions about the completion of the banking union, references are often made to the concepts of *risk sharing* and *risk reduction*. Risk sharing involves insurance mechanisms such as a common deposit insurance scheme, emergency lending by the EMS, and possible capital injections into failing banks paid for by the Single Resolution Fund (SRF). Risk reduction can be thought of as processes that reduce risks in national financial sectors, involving the cleaning up of banks' balance sheets by getting rid of nonperforming loans and increasing the levels of loss-absorbing capital. The need for such processes appears to be quite different across euro members if the aim is to reach similar risk levels in the end.

But an argument can be made that it is difficult to reduce risks without having the insurance provided by risk-sharing instruments in place. If one subscribes to the view that countries with sound fundamentals can be drawn into a crisis simply by self-fulfilling speculation, there are good reasons to push for the immediate introduction of strong risk-sharing mechanisms. Whether this is in fact a correct description of how financial markets work is up for debate. Clearly, there were speculative elements affecting funding costs for sovereigns and financial institutions during the euro crisis. However, it would be a stretch to claim that the borrowers targeted by such speculative trades had completely sound fundamentals. Moreover, one needs to factor in that any form of insurance is likely to bring moral hazard, leading to more risky behaviour on the part of insured parties. From that perspective, it is understandable that euro members with stronger fundamentals are hesitant to enter into mutual insurance mechanisms that they risk having to pay for.

Still, over time one would expect common bank supervision to even out differences across countries regarding the financial strength and riskiness of financial institutions. At that point, the resistance to introducing further risk-sharing mechanisms may fade away. However, so far there has not been any substantial reform regarding the mechanisms that may give rise to a doom loop between banks and their sovereign. Sovereign debt is treated as risk-free assets, and risk weights on sovereign debt are set to zero in risk-weighted capital adequacy requirements. Every attempt to introduce the possibility of applying positive risk weights or concentration limits on sovereign debt has so far been rejected. This means that nothing has been done to weaken the reinforcing feedback effect that can potentially amplify a financial crisis in the euro area. There seems to be something of a catch-22 situation: some members – typically the ones with relatively strong public finances – require measures to force diversification of banks' sovereign exposures to accept more risk-sharing instruments, such as a common deposition insurance. Other members – typically the ones with relatively weak public finances – require more risk-sharing instruments in order to accept measures that force diversification of banks' sovereign exposures. Solving this dilemma is important to enable the completion of the banking union.

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As long as the ECB can ensure low borrowing rates for euro area governments through its implementation of monetary policy, the risk of releasing another downward spiral of the financial positions of banks and their sovereigns is low. The ECB has managed to establish that bringing down interest rate spreads between member countries is part of its mandate on the basis that such spreads impact negatively on the monetary policy transmission mechanism. But if the general interest rate level increases because of rising inflation in the euro area, the financial positions of highly indebted countries such as Italy, Portugal, and Spain may appear too weak for potential investors to offer funding costs similar to those offered to euro-area members with lower debt ratios. In such a case, removing increases in risk premia leading to increased interest rate spreads within the euro area would be difficult for the ECB to justify on monetary policy grounds. Affected members might ask for emergency loans from the ESM, thereby qualifying for the hitherto never used OMT programme, which could be used to compress interest rate spreads. But the appetite of countries such as Italy, Portugal, and Spain for applying for such emergency lending, which would involve conditionality, is likely to be poor. Thus, without a solution to the catch-22 situation regarding trading more risk sharing for limits to the banks' sovereign exposure, there is a risk that the downward spiral due to the doom loop between banks and sovereigns will re-emerge.

4. Fiscal integration versus reformed fiscal rules

Many economists argue that a stable monetary union requires significantly more risk sharing than what is implicit in the creation of the banking union (e.g. Bénassy-Quéré et al., 2018; Doménech et al., 2018). Some argue that ultimately what is needed is a fiscal union, where common debt is issued to finance fiscal spending decided on by a central fiscal authority. Moving towards a fiscal union, which implies transfers between Member States, may indeed be the most obvious way to try to ensure the long-run survival of the monetary union. The analysis of optimum currency areas suggests that a mechanism for fiscal transfers is important to deal with asymmetric shocks (Mundell, 1961).

However, giving up national sovereignty regarding fiscal matters is not a small thing. It is hard to imagine that voters would be willing to transfer power over fiscal policy to the supranational level given the current institutional set up of the EU. Of course, it has to some extent already happened with NextGenerationEU – the jointly funded package to support recovery from the shock connected with the COVID-19 pandemic that was agreed on in the summer of 2020. But there are different opinions as to whether the decision to finance grants with debt issued at EU level is truly a "Hamiltonian moment" that sets the EU on a trajectory towards fiscal integration or whether it is simply a one-off motivated by exceptional circumstances.[2] The fact that there have been lengthy negotiations about the conditions for Member States to access the funds and there is a detailed framework for determining whether the conditions for further disbursements are met shows how sensitive fiscal transfers are within the union. In some of the Member States – perhaps most notably the "frugal" ones whose governments have been consistently against risk sharing and fiscal transfers – a majority of the voters can be expected to be against fiscal integration. Pushing hard for fiscal integration in spite of this risks unleashing anti-EU sentiments and perhaps even processes that will ultimately lead to disintegration.

> "However, giving up national sovereignty regarding fiscal matters is not a small thing."

Without fiscal integration and a jointly financed central fiscal capacity, asymmetric shocks and symmetric shocks when monetary policy is at its effective lower bound have to be dealt with using national fiscal policy. There are two possible hurdles for doing that in an efficient way. One is that the fiscal rules in the SGP may prevent Member States from adopting sufficiently large fiscal stimulus packages to be effective in combatting a downturn. The other is that Member States lack sufficient fiscal space for fiscal stimulus on account of weak financial positions at the outset. Of course, the fiscal rules are there to prevent countries from lacking fiscal space when they need it. But, as noted previously, the rules did not prevent some members from going into the global financial crisis with weak public finances.

Today, when the ECB is buying euro members' government debt in secondary markets as part of its large-scale asset purchase programmes, the risk of countries running out of fiscal space is significantly reduced. As alluded to above, it is primarily the increase in interest rates that reduces a country's fiscal space and may eventually result in unsustainable public finances. If the recent rise in inflation turns out to be more persistent than currently forecasted, tighter monetary policy will

[2] The difference in opinion about the meaning of the deal on NextGenerationEU between French president Emmanuel Macron and Dutch prime minister Mark Rutte is brought out in reporting by France24: www.france24.com/en/20200721-eu-rescue-deal-the-most-important-moment-in-the-life-of-our-europe-says-macron.

raise the general interest rate level. Member States with high debt ratios may then find their fiscal space evaporating.

The realization that lifting interest rates in the euro area may produce fiscal problems for some Member States can affect expectations regarding monetary policy and ultimately inflation itself. It may create doubts regarding whether the ECB will in fact decide to tighten monetary policy enough in the face of mounting inflation. This puts the ECB in a somewhat vulnerable position as it may push up inflation expectations to levels that will eventually become too high to be consistent with the ECB's inflation target. The ECB would then have to tighten monetary policy more in order to contain inflation than would be needed without any expectations of an increase in inflation. Whether this is an actual problem remains to be seen.

It is important to note that it is not inevitable that a normalization of interest rates in the euro area will lead to fiscal problems in the most indebted countries. What is needed is sufficiently high economic growth for debt ratios to come down to levels that are sustainable even with higher interest rates. In such a scenario, the ECB will be able to keep inflation low and stable without any fallout on the fiscal side.

> "Without a central fiscal capacity, a well-designed framework for fiscal policy is needed in the euro area."

Without a central fiscal capacity, a well-designed framework for fiscal policy is needed in the euro area. The objective should be to maintain sustainable public finances, since that is the most relevant aspect when considering possible negative cross-country externalities associated with national fiscal policies. The decision on whether to use active fiscal policies to smooth out business cycles should really be up to the individual Member State and not governed at the supranational level.

The current framework with fiscal rules is quite complex and involves heavy bureaucratic processes that are time and resource consuming. There is a preventive arm that entails submission of yearly reports by the members outlining their budgetary plans and country-specific recommendations (CSRs) prepared by the Commission and adopted by the Council. In the preventive arm, there are the well-known threshold limits for budget deficits and debt-to-GDP ratios of 3 and 60 percent, respectively. But there is also a less well-known medium-term objective (MTO) for structural deficits that may vary across Member States and time. If the Commission considers that a Member State is deviating significantly from its MTO or from the agreed adjustment path towards its MTO, it is supposed to recommend that the Council open a Significant Deviation Procedure (SDP) for that Member State.

There is also a corrective arm of the SGP in which members may end up if they breach the deficit rule in the preventive arm. They are then subject to the so-called Excessive Deficit Procedure (EDP), which entails deadlines for bringing the deficit back below the threshold. In principle, a breach of the debt-to-GDP limit of 60 percent or the rule that the gap should be falling by 1/20 per year could also land a Member State in the corrective arm of the SGP, but so far this has never happened.

It is not entirely clear how these rules have impacted on fiscal discipline in the euro area. Having an MTO for the budget deficit and a rule of thumb for how much the deficit should be reduced year by year in situations where there is a deviation is probably a good idea and something that can strengthen the national budget process. However, a complication is that the MTO in the preventive arm of the SGP is defined in terms of the structural deficit, which is a theoretical concept that needs to be estimated. It should capture the size of the budget deficit when the economy is in balance. But it is not easy to determine what macroeconomic balance would imply for public spending and revenues. Thus, there is a high degree of uncertainty regarding the size of a possible deviation and how fast the Member State is actually approaching its MTO. The so-called expenditure rule was added in 2011 to mitigate this problem (e.g., Darvas and Anderson, 2020). It stipulates that public expenditure growth in a country whose structural balance is at or below its MTO should be limited to growth in potential output.[3]

[3] Expenditures should be adjusted for cyclical unemployment benefits, interest payments, new taxation, and the smoothing out of investment expenditures.

Many recent proposals for simplifying the fiscal framework focus on an expenditure rule that ensures a declining trend in the debt ratio while allowing fluctuations driven by cyclical changes in revenue as the single operational rule (e.g., Beetsma et al., 2018; Bénassy-Quéré et al., 2018; Darvas et al., 2018; Feld et al., 2018). This would probably be a significant improvement compared to the current framework but may not be flexible enough to cater to the members' needs.

As an alternative to fiscal rules stated in quantitative terms, Blanchard et al. (2021) have proposed fiscal standards. They argue that there is simply too much variation in what members need at different points in time for using simple rules. Even very complex rules are unlikely to fully capture all the relevant contingencies, especially since these contingencies are to a large extent unpredictable. Their solution is to move to fiscal standards in the form of a statement of the objective of retaining sustainable public finances together with a process for assessing whether the policies pursued by Member States are consistent with that objective. They propose the adoption of stochastic debt sustainability analysis, undertaken at the EU level, as the main tool for assessing whether public finances are sustainable or not. Allowing Member States to adapt fiscal policy to their particular needs is an appealing feature of this proposal, but it may be as difficult to enforce fiscal standards as it is to enforce fiscal rules.

"All these proposals rely on bureaucratic or legal processes that consume resources and are likely to create tensions between members."

All these proposals rely on bureaucratic or legal processes that consume resources and are likely to create tensions between members. The only alternative to such processes would be to rely more on market discipline to incentivize members to comply with the rules. But since markets seem to be prone to overreactions and perhaps even self-fulfilling speculation, full reliance on market discipline is not a realistic option. Currently, market discipline has been overturned by the ECB's entrance into sovereign debt markets as a major buyer of euro member debt. Theoretically, the ECB could provide incentives for compliance by excluding Member States in breach of the rules or standards from its asset purchase programmes. However, a decision to actually exclude a Member State from the programme would be highly politically charged and therefore likely to require even lengthier bureaucratic and possibly legal processes than the ones currently in place.

For these reasons, it is unlikely that one could move away from extensive bureaucratic processes that try to enforce fiscal discipline. The main risk to the framework at hand is that public finances end up being unsustainable in one or more Member States. If that risk were to materialise, there are essentially three available options: fiscal transfers from other Member States, debasement of the euro, and sovereign default. In the Greek case, both fiscal transfers and default happened. Historically inflation has been a common way to get out of excess indebtedness. For that reason, it cannot be taken for granted that inflation will remain low in the future.

5. Conclusion

Clearly, the monetary union is in much better shape today than it was when it was hit by the global financial crisis in 2008. The apparent instability of the monetary union has been addressed and stabilizing mechanisms have been put into place. At the height of the euro crisis, it was uncertain whether any institution was capable of providing a backstop to prevent rampant speculation in sovereign debt. A common mechanism was set up to provide emergency lending in the form of ESM. But, more importantly, the ECB launched large-scale asset purchase programmes that made speculating in rising yields on sovereign debt an unprofitable proposition. This important step to provide a backstop for the euro area, however, has exposed the ECB to some risks when we look ahead. The ECB can only protect Member States from rising yields on government debt as long as inflation remains low. If inflation takes hold while real growth remains anaemic, the ECB will find itself in a difficult situation. Either interest rates are raised and some Member States run into fiscal problems or interest rates are kept low and control over inflation is lost.

An alternative backstop to purchases of government debt by the ECB would be a central fiscal capacity. It would alleviate the risk of the ECB finding itself in the situation where it has to choose between a sovereign debt crisis in the euro area and losing control over inflation. It would also have the advantage of contributing to well-functioning macroeconomic stabilization. Such a capacity, however, would entail fiscal transfers between members and would therefore be highly unpopular in parts of the union. Potentially it could even lead to disintegration of the monetary union for political reasons.

For well-functioning macroeconomic stabilization, it seems safer to build on the existing framework for fiscal rules to try to enforce fiscal discipline so that members have fiscal space to support the economy with fiscal stimuli when needed. The current fiscal rules would certainly benefit from both simplification and more flexibility. Focusing on an expenditure rule as the operative rule seems preferrable to the current medium-term objective set in terms of the structural balance. The threshold limits on deficits and debt of 3 and 60 percent of GDP, respectively, do not really make much sense anymore. But allowing treaty change just to remove or modify these limits carries its own risks.

The area where EMU reform is most lacking concerns breaking the doom loop between banks and sovereigns. With common supervision, the prospects are good for evening out risk levels in national banking systems over time. But the fact that there is still a tendency for sovereign debt to end up on the balance sheet of domestic banks means that there is still a powerful reinforcing mechanism that may come into play in a crisis situation.

“Offering prosperity is what is going to make euro adoption an attractive option for the EU members that are currently outsiders.”

For the monetary union to be stable, it may suffice to have well-functioning financial supervision in place and mechanisms to prevent smaller shocks from developing into full-blown crises. But this raises the question of whether such a stable monetary union also promotes prosperity for its citizens. Offering prosperity is what is going to make euro adoption an attractive option for the EU members that are currently outsiders. But for the monetary union to promote prosperity, being able to avoid severe crises and smooth out business cycles is not enough. There have to be advantages in terms of long-run economic performance. Ultimately, that comes down to creating favourable conditions for carrying out reforms that improve economic performance. On that, the jury is still out.

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