European University Institute

SCHOOL OF TRANSNATIONAL GOVERNANCE

FISCAL RULES AND FISCAL CAPACITY: BREAKING THE POLITICAL GRID-LOCK

POLICY BRIEF

NOTE FROM THE AUTHORS AND POLICY DIALOGUE CONVENERS

There are two possible readings of the current situation in the Eurozone (EZ). The first is to focus on the fact that we have weathered an existential crisis and come out stronger; we are in the seventh year of an economic expansion with unemployment at a 20-year low. Grexit is behind us and there are today more euro area members than at the beginning of the crisis. A slowdown is indeed ahead, but we have the tools and mechanisms to handle it; it is not likely to be a violent asymmetric shock like a decade ago.

The alternative reading suggests that despite putting in place significant reforms which helped defuse the crisis, nothing much has happened in the last five years. The institutional architecture of the euro area remains frozen in its current state since 2014: the banking union is not complete, the "new" fiscal toolkit is clearly in need of an overhaul, the so-called "Euro area budget" is insignificant, and the "backstops" are not at their full potential. The doom-loop between banks and sovereigns is alive and well, and countries continue to diverge rather than converge. To cap it all, we are nearing the limits of what monetary policy and the European Central Bank (ECB) can deliver, while countries disagree strongly on using the limited existing fiscal space.

In a non-crisis setting, policymakers have lost momentum on reform. By doing so, however, they take a large political and economic risk: at worst, we will not be prepared for the next crisis; at best we will watch "eurosclerosis" creep back. Instead, they should rise to the occasion. The right time is now, with a new European Commission (EC) outlining its priorities and unveiling a plan for a "new Green Deal", a new European Parliament (EP) about to discuss the EU medium-term financial framework, and a succession at the helm of the ECB which can take it further on the road so perfectly captured by the "whatever it takes" 2012 statement. And the current environment, with no inflation, negative interest rates, and new conditions for competition, is conducive to bold initiatives.

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But while the timing and conditions may be right, we seem to be stuck. Political “windows of opportunity” have come and gone, and yet we seem to be reverting to traditional stereotypes where the euro area core is from Mars and the periphery is from Venus. The elusive compromise between risk-sharing and risk-reduction seems out of reach; instead we have become deadlocked in all the reform areas outlined in the 2015 Five Presidents report (already a watered down version of the 2012 Four Presidents Report).

In a banking union, the crucial missing piece, the European Deposit Insurance Scheme (EDIS), is facing resistance. Counter-cyclical stabilisation tools, such as the socially appealing European Unemployment Insurance, are still on the drawing board while a European Safe Asset that would help financial stability is lost in the details of the various possible schemes. The proposed euro area budget is a pale version of a central fiscal capacity. And while there is near-consensus that fiscal rules are pro-cyclical, too complex and will likely fail again, we cannot find the political will and common ground to change them.

What is striking in this situation is the stark contrast between clear support of the euro and the EU by Europeans and the political gridlock that prevents us going forward. How does one break this? We submit that the key is two-fold. Firstly, to fund European investment by moving decidedly to give the EU its own resources, divorced from national budgets, and secondly, to focus such investment around European public goods. These steps do not replace the need for a genuine Economic and Monetary Union (EMU) reform, but without them no such reform will be possible.

Giving the EU its own resources is the only way to overcome country divisions on EU spending from national budgets. A survey conducted in 10 member states by YouGov, together with the School of Transnational Governance of the EUI (Florence), backs this. European citizens are deeply divided on the extent to which their national budgets should provide more funding for the EU, but, instead, there is an overwhelming support for new own resources at European level, such as supra-national levies on emissions (a carbon tax), internet companies, or business profits in general. This suggests the best way to push the debate forward would be to sever the link between national budgets and the EU budget and instead develop mechanisms for own resources linked to economic activity at EU level.

The second tool would be using the new “Green Deal,” and the mission ethos it entails, as a way to unblock the fiscal debate. We should be focused on investment capacity where European common goods are at stake. Our aim should be to leverage European capital for an innovative, inclusive and sustainable society which embraces technology. A green pact with public and private investment related to environmental transition, climate adaptation, infrastructure and skills upgrading can provide the lever necessary to reinvent the European economic and social model.

This is not a solution for everything. As stated, the case for the rest of the EMU reform agenda remains strong; there are welfare-enhancing gains from EZ macro stabilisation policies. And green bonds are not a stability instrument; we will still need a central fiscal capacity with ability to tax and borrow. Therefore, a safe asset which would in a sense be the provision of a common good and represent a true leap in EMU. But to move the debate forward, we need to focus on EU own resources and aim for a new “Green Deal.”

OVERVIEW

This policy brief is the outcome of the High-Level Policy Dialogue (HLPD), organised by the School of Transnational Governance of the European University Institute, on "Fiscal Rules and Fiscal Capacity," which took place in Florence on 23 September 2019.

The HLPD brought together a group of policy makers, academics, and members of civil society and the private sector to have an open discussion on this issue. The HLPD took place under the Chatham House Rule, whereby no attribution of opinions expressed can be made. The topics discussed have been summarised for the purposes of this paper.

The School of Transnational Governance wishes to thank the participants for their valuable contribution.

SUMMARY OF PROCEEDINGS

Introducing the seminar, the organisers noted that the timing for holding a seminar on fiscal rules and fiscal capacity was very appropriate: a new EC outlining its priorities, a new EP about to discuss the medium-term financial framework and a succession at the helm of the ECB. It is the right time to take stock of what has been achieved in this regard since the beginning of the crisis, recognise that the work is not complete, and give a fresh impetus to the ongoing debate on the appropriate tools and stance for fiscal policy in the short and long term for the EZ and the EU as a whole.

On substance, the reform debate covers a wide range. In terms of policy tools and the new EMU institutional architecture, the discussion centres around the need (and form) of an EU-wide stabilization function, a central fiscal capacity, a European safe asset, the evolution of the European Stability Mechanism (ESM), a framework for debt restructuring and the need to complete the banking union. This is complemented by a debate about the appropriate fiscal stance and the need to revisit the fiscal rules, as well as to equip the EU with the fiscal capacity necessary to achieve its long-term growth potential.

SESSION 1: TAKING STOCK OF EMU REFORMS

The session kicked off with a short introduction noting that while fiscal reforms characterised the beginning of the crisis, in the last five years little has happened (no repairing the roof when the sun is shining). In general, one can distinguish two reform periods: pre-2012, with emergency reactions/tools; and post-2012 (an attempt at systemic transformation). One important question to pose is why economic science could not convince politics in time on the weaknesses of the system.

> "*We did not repair the roof when the sun was shining*"

The first speaker addressed three issues: why we still need to discuss fiscal reform; the state of play; and what is on the table. The "why" relates to the fact that the job is not done; we have divergence between countries, not convergence. The EZ is not prepared for the next crisis; nor is it able to generate the level of investment required for the transition due to climate change, or population ageing. The current weak fiscal situation is also jeopardising the conduct of monetary policy.

To understand the state of play, we need to go back to the Maastricht Treaty; the rules vs. discretion schism in policy stance across countries has polluted the debate. But the current environment, with no inflation, negative interest rates, new conditions for competition and a need to finance the Green New Deal is an ideal one for a discussion on fiscal rules. This is despite the fact that the crisis has fuelled populism, and that countries such as those in the Hanseatic League oppose any change.

In terms of what is on the table, there are three categories of issues. The first is fiscal rules: the non-implementation of the Stability and Growth Pact (SGP) and the need for its reform/simplification; next to it, the fact that the Macroeconomic Imbalance Procedure (MIP) does not work and that output gaps are problematic. In this vein, the question of investment, an issue identified with the creation of the European Fund for Strategic Investments (EFSI) or InvestEU, needs to be part of fiscal rules; we should think of using the Green New Deal as a way to unblock the fiscal rules debate.

The second category of issues relates to the banking and capital markets union. It used to be about risk-reduction; now more risk-sharing seems to be required before it is completed. It was also a tool to keep the UK in; now this is less of an issue. In any case, the idea that a full banking and capital markets union could avoid having to give the EU a fiscal capacity is wrong. Finally, there is the issue of EZ governance: the European semester, the contract on structural reform, fiscal capacity, etc.

There have been a number of proposals in the context of the Multiannual Financial Framework (MFF); but the EP proposal to use it as leverage for a fully-fledged stabilization function was blocked. The proposal on the table on the other hand (Meseberg) is weak. On automatic stabilisers: the proposal by the Spanish government (inspired by the resolution fund) makes most sense. Regarding the future of ESM: it needs to be fully integrated in the Treaty; but the sovereign debt discussion makes the whole process more complex. Overall, however, it is clear that political constraints have hit in – the Council cannot go further.

The second speaker suggested that the main question which needs to be addressed is whether the current EZ is resilient enough for the next crisis. The speaker outlined the reforms undertaken to date (Six-Pack, Two-Pack, Fiscal compact, etc.) and noted that not all were successful. The crucial ones were the creation and evolution of the ESM as well as Outright Money Transactions (OMT); the most problematic has been the MIP. Since 2014, there has been no reform; the EZ architecture is the same as it was 5 years ago.

The situation today is one where many EZ countries have not recovered fully form the crisis; but where the space for monetary policy is limited – not because there is nothing left to do, but rather because there will not be agreement for further measures. This leaves fiscal policy; but that is characterised by: fragility of sovereign debt; problematic fiscal rules; no EZ stabilization tool and refusal to use available fiscal space; and a still in operation sovereign bank doom loop.

> ***"If we are to push for only one thing, it should be fiscal coordination for the pursuit of public goods"***

The fragility of sovereign debt stems from the fact that the ESM has no instrument for a liquidity crisis. The Precautionary Conditioned Credit Line (PCCL) is not the right tool for this; the criteria in place make it that it could never be accessed. At the same time, OMT is not accessible easily (due to the conditionality criteria); we therefore need a new instrument at the ESM or to reform PCCL criteria. Fiscal rules are pro-cyclical, too complex, but Finance Ministers are not willing to change them; we will therefore have to rely on Commission flexibility. In terms of the EZ stabilization tool: nothing of substance is in sight; the budgetary instrument for convergence and competitiveness replicates what other instruments do.

Finally, the banking union remains incomplete: we may have a backstop but EDIS has been postponed again. Overall, the EMU architecture may be better, but the EZ is still ill-prepared for the next crisis. When the crisis comes, we may have to rely on a joint national fiscal response as we did in 2008-9 as nothing of what was proposed in the Five Presidents report has been decided.

The third speaker reminded everyone that initially the EZ crisis was considered to be a Greek/fiscal crisis; in fact, it was a crisis of excessive borrowing, but the fiscal narrative suited Germany and the Netherlands. It was noted that countries joined what they thought was a convergence union; but is now a divergence union. The model is broken, and the promise is undermined, so that with the next shock, capital will flow north again. The speaker suggested that we put too much focus on the financial element; but the single market only exists for a small fraction of goods, and not for services.

In the same vein, we are focusing too much on second-order problems; not on where growth will come from (how will Bulgaria be able to access German service markets?). We are increasing the mobility of capital but not of labour. Banking union may not be a panacea; if there had been one (with EDIS), it may not have solved the problem but instead made it worse, as the banking union could increase the size of imbalances. Similarly, we may be thinking the wrong way when wanting to break the sovereign-bank loop: if there is no home bias, it amplifies the shock; home bias stabilises the system in the event of a small idiosyncratic shock. Finally, the speaker suggested we need to ask the fundamental questions which have not been addressed, such as the appropriateness of the 3% deficit and 60% debt rule.

> ***"What can be good for one country, may not be for the whole system"***

In the ensuing discussion, the idea that we contracted the union for convergence was opposed by one participant; it was suggested instead that it is simply supposed to create the environment for such a convergence to happen. And over the longer period, there has been convergence (except for Italy and Greece); in the shorter period, possibly also Spain. In general, no-one thought the ECB would play the role it has played; on the other hand, the ESM has not gone far enough.

The issue of convergence was echoed by another participant: convergence was never a promise as such. It was also pointed out that the lack of advancement in EZ governance since 2014 coincided with the upturn. This begs the question of whether to pursue what is doable vs. what is desirable. In the current environment, is it enough to work at the margin? In reality, we need a big leap forward.

How we can best push reform in a reluctant setting was addressed by another participant: use the green new deal as a hook? Try for a limited number of watered-down proposals, or push for more? Another participant responded that it is important to distinguish between tools (old vs. new) and outcomes; the real new elements are the ESM, banking union, and the MIP, while the European semester is not - strictly speaking - connected to the crisis.

The discussion then moved to the question of how well equipped we are for a potential new recession. A participant noted that the period since 2008 has had a strong differential impact on certain countries. But today is a very different situation: 2008 was a breakdown, while today the external imbalances are perhaps less of an issue. The underlying problem remains however; there is an unequal distribution of real economy imbalances. Important countries are not using the available fiscal space and no instruments can be used at EU level. In this environment, if we push, it should be for one point: fiscal coordination around public goods.

Another participant suggested that the problem is not whether we are ready for the next recession; it is that we have a lot of unfinished business. But the transfer union discussion is one that young people do not understand and has no political support.

Instead, we need to focus on creating a new smart fiscal union; leverage European capital for an innovative/inclusive society is what there is support for; it is about the new economic model that Europe needs.

One participant returned to the issue of the convergence promise of EMU not being fulfilled. It was suggested Germany would say that certain countries had the wrong policies; but what can be good for one country may not be so for the whole system. On labour mobility, the question was whether we want to encourage more migration to core countries; new countries and southern countries are currently losing the most skilled people.

At this point in the discussion, it was suggested by another participant that we are focusing on secondary problems; we have the wrong diagnostics. We are focusing on symptoms (the fiscal rules); these are consequences of broader problems. Liquidity is one; capital flows and financial instability is the problem we need to resolve. The Maastricht Treaty was a leap into the future, with many aspects yet to be determined. Now we do not have the US to back us up anymore; it is therefore an opportunity to think ahead.

The huge flaws in the EZ architecture were stressed by one participant, who suggested we distinguish between crisis response vs. architecture issues. The blow can come from capital markets, and in that sense, home bias by banks may not be a bad thing. Convergence was not a promise as such, but we did promise that national economies do not break down. In the EZ, Germany has been the big winner; risk-sharing in this sense is essential and the focus on risk-reduction is misplaced in the context of a union. We need a fiscal policy stance at EU level; the EU budget as it currently stands is completely inadequate.

In recapping the discussion, one of the initial speakers reminded the group that the Maastricht Treaty was about convergence, with SGP as the tool. We have failed to make a common understanding of the fact that in a currency union 1+1 does not equal 2. The European semester and coordination were imperfect substitutes for having a real economic tool. In this context, the Euro area budget proposal on the table is dangerous as it will close the debate.

Another of the speakers referred to the question of tactics on how to move forward: best would be to pick low-hanging fruit but keep the bigger picture in mind. We need to look for new approaches, though it is not clear the political consensus is there.

> ***“Someone needs to buy what Germany exports; not everyone will have a surplus”***

The third initial speaker stressed the “convergence aspiration” at the start of the EZ process. The speaker argued that we have an asymmetric approach to fiscal and trade deficits (bad) and surpluses (good); but someone needs to buy what Germany exports - not everyone will have a surplus. On labour mobility, it was recognised that in the short run, it is a risk for small countries, but in the longer run it has benefits, and so should be encouraged. In contrast, cross-border movement of capital should not be an end to itself; supervision is essential for proper capital allocation.

While concluding, the moderator stressed the importance of all aspects of stocktaking: the tools, outcomes, plus the learning process, which needs to become institutionalised. Reforms and back-pedalling go hand in hand: we need to address this. In this context, there is one question of agency: who can drive the necessary reforms.

SESSION 2: A EURO AREA BUDGET

In introducing the session, the moderator stressed that the issue of the EU having its own resources cannot be divorced from politics. Survey results were presented conducted in 10 Member States by YouGov together with the School of Transnational Governance of the EUI which suggest that while there are strong divisions across countries (north/south) on national vs. EU spending, the picture changes when asked about taxes at the European level (for which there is a clear majority support). This suggests the best way to push the debate forward would be to sever the link between national budgets and the EU budget and instead develop mechanisms for own resources linked to economic activity at EU level, such as a carbon tax, internet companies, or business profits.

The first speaker suggested that the incomplete EMU remains a fragile construction and may not be strong enough to handle the next crisis. In this context, fiscal policy should have a role beyond automatic stabilisers to prevent supply-side damage when multipliers are high and monetary policy is constrained. The EZ fiscal framework should allow for an EZ fiscal stance, as an extra layer on top of national policies. Improving macroeconomic stabilisation should include centralised fiscal capacity and a safe bond.

> ***“In the Eurozone, there are multiple equilibria: the core is from mars, the periphery is from Venus”***

Reviewing the last 10 years, the speaker suggested that before the crisis, fiscal policy was not considered appropriate for economic stabilisation; monetary policy was thought to be a more flexible and effective tool. The Great Recession has led to a change of views; few now question the appropriateness of massive fiscal stimulus to rescue banks, companies and people in 2008-09. Today, the risk of recession is very real; we are back to extraordinary times. Echoing Draghi, fiscal policy will soon be called into action. But the EZ does not have much fiscal space, nor is it well distributed. The overall EZ fiscal stance suggests fiscal policy has been tighter than anticipated. While Germany as a stand-alone country would seem to be doing fine, a much tighter fiscal policy lowers its potential growth.

Overall, the EZ seems to be characterised by multiple equilibria (the core is from Mars, the periphery is from Venus). The redenomination risk has not disappeared, and the doom-loop is alive and well. In this environment, there is a clear case for a European safe asset and fiscal capacity for the EZ; their absence will lead to an amplification of shocks. There are welfare-enhancing gains from introducing EZ macro stabilisation policies (removal of the "doom loop", more fiscal space, smoothing the economic cycle).

The next speaker provided input on the legal perspective, and especially the positions taken by the German Constitutional Court (GCC). Looking back, in the review of the Maastricht Treaty, the GCC managed to avoid the subject of monetary union. The Lisbon Treaty (2009) was deemed compatible with the German constitution, but the GCC laid a lot of red tape. In the European Financial Stability Facility (EFSF) case, the German government must retain control even with inter-governmental decisions (same with ESM). The OMT case was the first reference of GCC to the European Court of Justice (ECJ); the ECJ confirmed OMT was compatible with the Treaty (i.e. did not constitute monetary policy), and the GCC reluctantly accepted this. The GCC is expected to rule on the ECB Public sector Purchasing Programme – PSPP (successor of OMT).

In general, revenues and expenditures need to be under the control of the German government; this will be violated if levies are supra-nationalised "to a considerable extent". Moving forward, the issues at stake revolve around the powers and competences of the German government and EU authority, as well as democracy i.e. the role of the German parliament and increasingly the European Parliament.

The third speaker noted that there is stark contrast between clear support of the euro and the EU by Europeans vs. political gridlock that prevents us going forward. The timing (with a new EC, EP and head of ECB) provides an opportunity to advance; there are significant expectations for concrete action in a context of a recovery with upcoming risks. Migration, climate change, the economy are the top 3 concerns in the Eurobarometer opinion surveys, while the role of digital, fintech, green financing and AI all change the agenda; we need to accompany this change. The EP is committed to putting more into EMU integration, in an environment where the problems are in the Council. But the Instrument for Convergence and Competitiveness proposed by the new EC President-designate is problematic.

> ***"The debate should be focused more on investment capacity than on fiscal capacity"***

In the discussion that followed, there were questions on whether changes in EP representation would be enough to respond to GCC criticism of EP, on why the GCC would object to supra-nationalised levies when it did not seem to object to the financial transactions tax (FTT), as well as on the exact relationship between the GCC and the ECJ. It was also remarked that it is important to make a distinction between downturns vs. a "crisis" requiring a response to a "sudden stop".

One participant noted that the GCC not considering EP to be "fully democratic" in essence undermines European construction. Regarding the German fiscal stance, it was pointed out that according to Commission forecasts for 2019 and 2020, Germany has fiscal loosening; but EC forecasts have been wrong (Germany tightened in 2018). Based on domestic fundamentals, one cannot argue Germany's fiscal stance is wrong, but German fiscal policy does not take into account its external effect on the EU as a whole.

Another participant suggested that a single European asset is too ambitious; it was needed in 2010, but less now. It was argued that the debate is disproportionate between fiscal capacity and investment capacity where it should be focused, and in particular on the role of public and private sectors for ventures and infrastructure investments. There are 16 trillion euro sitting in deposits in European banks; but only 13 euro per capita from InvestEU. In response, one participant noted that the question is how to mobilise the 16 trillion: you need an instrument at EU level such as a safe asset. Another added that what is controversial in the EU is spending on current expenditure; less on counter-cyclical investment spending. Hence it is important to look at tools and sources of capital; there are many positive Net Present Value (NPV) projects going unfunded.

More questions were raised on the functioning of the GCC: whether own EU resources would be easier for it to accept, rather than committing German funds; the distinction in the way it treats the EIB and the ESM (in the former case, no need for scrutiny for each decision, as in the latter); and what happens if the GCC disagrees with some decision of the ECB. It was also suggested that the taxing power of EU presents a political problem in some member states as well as an issue of control.

In response, one of the initial speakers contended that the GCC believes the EP is over-federalised; the EP represents "citizens" (as in the Lisbon Treaty) and not "peoples". The GCC has opposed extending the 5% threshold for entering parliament in national elections in the German EP elections. More generally, the EU as a federal state is not acceptable to the GCC (it is deemed against the German constitution). However, the 1949 German constitution is actually quite open on an EU federal state (but in this respect it is important to look at decisions after reunification). It was also noted that if the GCC (which is still in unanimity mode, even on issues that have Qualified Majority Voting (QMV)) says that some ECJ ruling is not compliant with the German constitution, in principle this should lead to an infringement procedure. Nevertheless, the GCC talks informally with ECJ to avoid such situations.

In general, GCC members believe they are the last stand to defend the constitution (and the GCC enjoys the highest esteem of all institutions in Germany); but they have some margin of manoeuvre as they feel the responsibility of economic consequences of GCC decisions. At the end of the day, if something is necessary, they will come through. Finally, on the ECB, the "functional" argument of ECB independence is respected by the GCC.

SESSION 3: FISCAL OR OTHER STABILISATION TOOLS

Introducing the session, the moderator referred to evidence that the euro area is more unequal today than before the crisis. Strengthening the euro area in this context means addressing four related themes: 1) risk-sharing and stabilization policies in normal times; 2) dealing with severe crises ("a robust crisis management mechanism"); 3) resolving a debt crisis (the euro 'debt overhang'); and 4) developing 'safe assets'. The moderator suggested that addressing the first of these - risk-sharing and stabilization in normal times - through a Stability Fund as a 'constrained efficient risk-sharing mechanism' also in practice helps address the other three.

The first speaker in this session suggested that we should not be as negative about the current situation; the fiscal rules are delivering (and the European Fiscal Board agrees with the EC on this). EMU governance is made of a tripod: rules; market discipline; and institutions – and all three elements need to work.

> ***A European Safe Asset is required for a true leap in EMU***

Regarding fiscal rules, the SGP has gone through a number of phases: SGP0 (1997); SGP1 (2005); SGP2 (2011); SGP3 or SGP 2.1 (20??). Its future reform needs to be focused on delivering simplicity, adaptability and predictability. Market discipline is not working yet; sovereign bonds in the euro area are exposed to self-fulfilling developments. This reflects fragmented and asymmetric national bond markets as well as lack of a (national) lender of last resort leaning against ever greater capital flows. The lack of a common safe asset is one of the drivers of negative interest rates (scarcity of AAA bonds); it affects monetary policy transmission and is also connected to the international role of the euro.

It is time to consider a common safe asset for a true leap in EMU; the EC examines various versions but has not made a proposal. A safe asset would: help financial stability (address banks sovereign exposure, act as common anchor against flight-to-safety flows, eliminate risks or fear of redenomination, help overcome global scarcity of safe assets); foster economic growth (mitigate distortions in financing costs, facilitate monetary policy transmission, create conditions for better allocation of capital, support better risk-sharing); and buttress financial sovereignty/economic security (store of value and payments system, support international role of euro, reduce exchange rate risks for euro area businesses).

In terms of institutions, when they are strong and accountable, they can afford fewer rules. We need a European Representative for Economy and Finance; strengthen the role of the EP; a euro-area Treasury (common issuance); more community method (Fiscal Compact and ESM brought into the Community method – they were both shot down). This would allow us to deliver within the original 2025 objective. But we need to move in all directions (rules/market discipline/institutions and build trust/consensus amongst MS; before that we need to identify what is a "steady-state" EMU and what is needed to achieve it.

The second speaker in the session suggested that the economic case for a central stabilisation function is clear; but it is not only an economic issue. It is also linked to social outcomes; long-term growth; and structural issues. In the social sphere, the lack of social pillar highlights the importance of a European Unemployment Insurance scheme. In terms of growth outcomes, the lack of stabilisation leads to hysteresis effects, skills degradation etc. There is also a link to economic structures: tradable vs. non-tradable sectors.

In this context, it is important to avoid the image of a transfer union (and it is amazing that it is an issue in stabilisation); these are often simply temporary transfers which are subsequently reversed. A lot of asymmetric shocks are endogenous in the EU and linked to structural imbalances. In pursuing the reform agenda, the Green New Deal is one of the new ideas, but care should be taken that it is not unequally distributed.

> ***The lack of an effective social pillar highlights the importance of a European Unemployment Insurance scheme***

The third speaker raised three issues: what type of financial integration we want; the risk-sharing/risk-reduction debate; the need for a range of policy instruments operating jointly. The speaker suggested shadow capital markets have become a problem and that risk-sharing should not apply to finance only; some fiscal risk-sharing is necessary. Regarding the debate around the "transfer union", it was argued that it is important to distinguish between systematic transfers vs. transfers related to dealing with asymmetric shocks.

With respect to the safe asset, the speaker suggested there are problems with (all) different versions; its design should enhance stability of the while area and not just some countries. It was argued that the whole reform approach by EU institutions has been piecemeal, not strategic. On other issues, sovereign debt restructuring should not happen automatically; while macro positions should be addressed symmetrically.

In the ensuing discussion, one participant argued that there are a number of unanswered questions on the European safe asset; amongst these are its objective (liquidity? collateral? contingency?), its underlying liability and the question of what it is in fact funding. It would seem that the preferred ESBies solution would not do the job. In general, the safe asset would not be comparable to US Treasury bonds (no Fed window backing it); risk varies and no government bond without a central bank can address that. ECB deposits in banks could instead act as a proxy for the safe asset. Finally, it was argued that the current distribution of power in the EU (often blocking reforms) should not be taken as given:

Germany used to be the sick man of Europe; it might be so again.

Another participant focused in the issue of policy conditionality, whether it works and how it should evolve. As it stands, conditionality makes sure adjustment takes place, but not the quality of adjustment; there are questions about horizontal measures vs. targeted ones; about too much fiscal, and not enough structural. New instruments should therefore be more focused on real reforms, notwithstanding concerns about intruding on member states.

One participant argued that we cannot escape the issue of burden-sharing and subsidiarity when discussing the safe asset. Furthermore, environmental transition and climate adaptation through a green pact with bonds related to social and green aspects should not be seen as a solution for everything. Such policy tools are future-oriented and not a stability instrument; we will still need a safe asset.

In responding, one of the speakers suggested that the safe asset would in effect transform national bonds into something like municipal bonds. There are multiple objectives of common safe assets and a high-level working group is currently looking at financial stability and safe assets. The discussion will focus on two models: ESBies and e-bonds; the latter bridge fiscal and financial: an entity borrows and then lends to MS, with all other bonds subordinated.

Another speaker pointed out that behind all schemes is a risk-sharing idea; but to politically sell any fiscal stabilisation you need to avoid the idea of chronic payers and chronic receivers. The European Unemployment Insurance is socially very appealing and can be addressed to those most vulnerable; it can get policy momentum, just like skill-building policies. But as always, the devil in the details; its design needs to combine it with company responsibility.

SESSION 4: CAN WE HOPE FOR MORE? PUSHING THE FISCAL DISCUSSION FURTHER

The first speaker started by reminding participants that the euro creation was the highest form of political integration, directed by high politics (German reunification); economics was not central to its creation. The EZ was a French project to contain Germany; instead we have ended up with a German-led system but where the leader is unhappy (even though it has benefited most).

In the euro area, we have always been late in dealing with the crisis (Obama: EU crisis measures are always $1 short and 1 day too late). With existing risks to EMU, we risk making today a huge political mistake by not completing required reforms and fuelling populism. We know the costs of undoing are large, but we cannot advance with reforms because of differing interests, cognitive dissonance and low trust between us. The prospects are that despite the completed reforms, the euro is not robust enough for the next crisis (which would be different); and when the next crisis comes, political elites will find it harder to reach agreements.

> ***“The euro creation was the highest form fo political integration; economics was not central to its creation”***

The second speaker suggested that the euro area has flourished economically in the aggregate but not symmetrically. The Greek debt crisis would not have happened if Greece had not joined the euro; but we solved it. Banking and capital markets union remain disgracefully incomplete; the only capital market that exists is the one coming from London to EU. On public investment and private finance: we need to find better ways of leveraging; a lot of design work needs to be to be done to leverage taxpayer's money to invest in the future.

The third speaker argued that a few things were broken during the crisis that make moving forward harder. Among these is the “permissive consensus” (i.e. moving forward by stealth). But small reform steps are not enough anymore. The first-best response would be a central fiscal capacity with the ability to tax and borrow; it emerged in 2012, then was lost. The counter-cyclical stabilisation function has vanished as well.

> ***“Only in crisis do we have the energy for reform; when not in crisis, the threshold for reform is very high”***

The second-best is better coordination of national policies; we tried (MIP), but this has also failed. EU institutions have also failed (the Commission 2016 proposals were slapped down by Germany; and the ECB has come too late to ask for fiscal stimulus). We are therefore left with third-best: the fiscal rules cannot be met but cannot be reformed; the SGP cannot be strictly followed. This has led to a gradual exasperation by a number of member states.

At this point, it is better to refuse reforms than accept unsatisfactory ones. There is still some space for movement: one is the MMF; the other is the European Unemployment Insurance which is coming back (other participants disagreed on this being the case). Also, fiscal rules can also be tinkered with (and the Green New Deal is an opening). Political and democratic reforms (such as transnational lists) might also help convince Germany to grant the EU more executive authority and own resources.

In the ensuing discussion, one participant suggested that it is useful to play the devil's advocate to the calls for urgent reform: after all, the EU economy is in its seventh year of expansion; unemployment is at a 20-year low; the threat of Grexit is gone; Brexit has solidified the EU; and compared with the rest of the world (US, China, Russia), the EU is doing reasonably well. There may be an economic consensus (outside Germany) for reform, but we need to be able to answer a number of questions: whether we are really in danger (as the tail risk seems to be gone); whether the risk is economic or political; whether it is an extreme risk or simply the EU not realising its potential. And in terms of instruments, we need to make clear distinctions: those required to avoid a crisis; to deal with it when it happens; and to make the system work better in normal times.

Another participant remarked that while policymakers may feel less the urgency for reform, the role of economists is to advise politicians. Brexit represents a withdrawal of European consensus, while during the crisis the fact that we were too late/too little was very costly. The current situation might be sustainable in the short run but is destroying confidence in the EU project. The new leap of integration which is required has a clear political dimension. But it faces obstacles: for example, the euro has loosened the need for structural reforms and the crisis has reduced the appetite. In terms of specific reforms under discussion, EDIS is a question of political trust, while the resulting banking union should allow for the emergence of pan-European banks.

One participant reflected on the fact that the Commission May 2017 EC paper on the future of Europe offered alternatives for moving forward. We are often trying to do too many things: better to do less better. We should be expanding taxes on public goods for the union. We do not have an immediate problem, but if a problem arises, we have little policy space. The EU is facing both internal and external challenges There is a lot of dissatisfaction on what we are getting out of the EU.

Responding to the public goods issue, another participant suggested that in a sense the safe asset is a case for the provision of a common good; it is about Germany leaving the German bund just like it gave up the D-Mark. More generally, it is necessary to recreate a narrative on common goods, based on two elements: the external threat (even Germany realises it cannot do it alone); and the green dimension.

The "crisis conundrum" was raised by one participant: only in crisis do we have the political energy to do reforms, but this is limited (an "urgency bias"); when not in crisis, there is little incentive – i.e. the threshold for reform is very high. This is different from the past (such as in the creation of the Single market); a series of conditions seem to have taken away the political incentives for reform.

Another participant reminded everyone that emerging markets after the 1990s concluded that self-insurance was part of the answer; it is possible the EU will end up with large suboptimal self-insurance mechanisms. There is no existential threat, but delay has a cost. The question is whether we can bear some political and maybe financial cost to come closer to a better equilibrium; and the hope is that we will not need a fresh "existential crisis" to get us going.

The question of whether heads of state and governments are as gloomy as most of the seminar participants was raised. It was suggested that EU economies are probably in a normal slowdown; there is no catastrophe, but also no incentive for wholesale reform. The challenges therefore may be less about crisis management than about going back to eurosclerosis. The business community pushed for change back then; it is doubtful we can rely on that. But populism has mobilised also those that are against it and want to defend Europe; a new constituency (young, educated) will fight back.

> ***"Economically, the situation could continue as if for some time; but politically speaking, the tail risk is very large"***

In responding to the discussion, the first of the session speakers suggested that economically, the situation could carry on as is for some time. Politically speaking however, we are only one election away from a disaster in some country; the tail risk in political terms is very large.

The second session speaker addressed the broader issue of the necessary components for peace and prosperity as the EU moves forwards: embracing the role of technology in society (which changes communications as well); a unitarian (environmentally/socially) society with cohesion and normal politics; and playing to our strengths by combining public and private.

Finally, the last of the session speakers suggested that while it is understandable for politicians to be complacent, it should be recognised that in all the discussion, Germany is the elephant in the room. German politicians they never made an effort to explain to Germans that they are the biggest beneficiaries of the EZ; and Germany may budge only when it feels vulnerable (in terms of external threats, the climate, or its own banks).

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