Fiscal Union in the Eurozone?

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1) Optimum currency areas

Since the creation of the euro was contemplated in the Werner report of 1970, its desirability was assessed from an economic point of view through the lenses of the optimum currency area theory (OCA) - developed by Mundell in 1961 and later refined and extended by McKinnon (1963) and Kenen (1969). The 1961 paper of Mundell laid out the tradeoffs between the benefits, chiefly the reduction in transaction costs following the adoption of a common medium of exchange, and the costs of losing the exchange rate as an adjustment mechanism. The loss of monetary independence was rightly diagnosed as being particularly problematic in the presence of large asymmetric real shocks, whether on the demand or on the supply side. When asymmetric shocks hit, in the absence of a nominal exchange rate, adjustment is eased if there is high labour mobility (Mundell) or fiscal transfers (Kenen).

Subsequently, Frankel and Rose (1997) pointed out that part of the divergence between countries' business cycles was endogenous and due to the prevailing exchange rate regime. Monetary union by boosting intra-industry trade in response to lower transaction costs would deepen financial and trade integration and therefore reduce regional cyclical asymmetry and increase income convergence. Thus asymmetries were bound to decline with the birth of the euro so that countries which would join EMU would satisfy OCA properties ex-post even if they did not ex-ante: the "endogeneity of OCA" paradigm was born. On the other side of the debate, Krugman (1993) had discussed the possibility that increased regional specialization (due to increasing returns to scale and integration) could lead to more divergence across country cycles.

As far as the gains of a common currency were concerned, Rose (2000) estimated huge potential increases in international trade coming from the adoption of a single currency. But his analysis relied on the rather special sample of countries that historically had adopted a currency union – i.e., mainly

small territories. The potential for the euro to rival the dollar as an important international currency was also seen as a positive factor, as it would go in parallel with an enhancement of the liquidity in financial markets for all euro assets and a decrease in the cost of capital in the area (Portes and Rey 1998). Financial integration would be a partial substitute for fiscal integration. On the other hand, there were concerns that the institutional design of monetary union left it vulnerable to financial instability (Begg et al. 1998).

On balance, the assessment was that the euro project was viable, though more political and fiscal integration would be desirable. But they were thought likely to come down the road. The European project had always progressed by leaps of faith, subsequently consolidated by economic necessities and political pragmatism. The discussion at the time was sensible.

2) Banking crises as asymmetric shocks

a) Unbridled financial sector growth

What was not envisaged was the threat to the common currency that would arise from the unchecked growth of bank balance sheets within the euro area in the context of a global financial crisis. The idea that a financial meltdown and large banking failures could lead to the bankruptcy of sovereigns and loss of market access had not been contemplated. Yet, this was potentially the biggest of all possible asymmetric shocks that could hit the euro area.

Financial integration did proceed rapidly, in some dimensions. Fed by massive cross-border financial flows in the euro area, the banking sector assets in many euro area countries swelled to being a multiple of countries' GDPs, as banks took on unprecedented leverage. In 2012 Q2, Ireland's bank assets were still 8 times the Irish GDP, for example, and the Spanish bank assets about 3 and a half times Spanish GDP. Credit growth to the private sector was particularly rapid during the 2003–07 period. The fall of interest rates in most countries of the euro area, as currency risk disappeared in 1999 (in 2001 for Greece), led to increases in borrowing for consumption and purchases of real estate. The decrease in risk aversion in global markets from 2003 onwards, as well as the securitization boom, sustained credit growth in the period immediately before the crisis. In Ireland and Spain, cross-border credit flows interacting with domestic distortions helped fuel real estate investment booms. Neither monetary policy nor fiscal policy were used to offset private credit growth, nor 'macroprudential' measures. In Ireland, property prices increased by about 30 percent between March 2005 and March 2007. As Figure 1 shows, net claims of German and

French banks on Greece, Ireland, Portugal, and Spain amounted to large fractions of GDP in the borrowing countries. For example, in 2008 net claims of German banks were about 50 percent of Spanish GDP, while those of French banks amounted to about 40 percent, helping fuel real estate bubbles (see Rey (2012)).

[Figure 1a,b about here]

As the returns to real estate–related activities increased while the bubbles were inflating, more resources shifted into the nontraded sectors at the expense of the manufacturing sector. Thus resources were drawn away from industries that may have more scope for productivity growth and human capital development, endangering the future potential of the economy. Unit labour costs in the periphery increased relative to those of Germany, eroding competitiveness and widening intra-European imbalances. As shown in Figure 2, in 2007Q4, Spain had a current account deficit of about €28 billion (about 11 percent of GDP), while Germany had a current account surplus of about €54 billion (about 9 percent of its GDP).

[Figure 2 about here]

b) The policy responses: more asymmetry!

The Lehman failure in the fall of 2008 led to a major reassessment of risks, asset prices, and growth forecasts worldwide. For the periphery countries, the shock was brutal. The bursting of the real estate bubbles led to major failures in their banking sectors and to a massive downturn in real economic activity. Given the large size of the banks' balance sheets, the insolvency of the banks threatened the solvency of the sovereigns themselves. The shock, which had already hit the euro area countries asymmetrically depending on their exposures to toxic assets, the size of their banks and the severity of their real estate bubbles, was made *even more asymmetric by the policy responses*. In the Irish crisis case, for example, Irish taxpayers ended up bailing out foreign banks for the most part. This was not only detrimental from a moral hazard point of view, as reckless investors did not have to bear the consequences of their excess lending, but this also meant that most of the adjustment to the shock was shouldered by the debtor countries. There was effectively very little burden sharing. Similarly, as restrictive fiscal policies were adopted everywhere at the same time, including in the countries with market access, this meant that debtor countries were forced into a deflationary adjustment process with high unemployment. Hence the euro area was

faced by a very large financial shock which hit countries' financial systems asymmetrically and whose asymmetric effect was reinforced by the policy responses adopted. Such large asymmetric shocks are precisely of the sort that a currency union cannot cope with in the absence of more fiscal integration.

3) Banking Union as a substitute for a Fiscal Union

When in 1989, the Report on economic and monetary union in the European Community was presented to the European Council, it was judged that a fiscal union was politically beyond reach despite multiple mentions of the necessity of more fiscal integration in previous reports, including the Werner report of 1970 (Vallee 2013). Thus, the Delors consensus was built around the establishment of a minimalist monetary union with no fiscal backbone. There are no reasons to believe that the political willingness to establish a fiscal union is any greater now than it was then. In fact, due to aversion to loss sharing after a crisis it is likely to be even weaker. The current crisis has however established beyond doubt that existing euro area institutions were not strong enough to weather banking meltdowns. A legitimate question to ask is therefore what would be the minimal institutional reforms that would help ensure the survival of the common currency?

A fully fledged banking union might provide such a necessary step. Such a banking union would rest on three pillars: a common resolution fund (to close or restructure any euro area bank), a single supervisory mechanism and a common deposit guarantee. This would fall short of a full fiscal union but would require some pooling of resources. It would take off the table the most destabilizing asymmetric shocks for the euro (the banking shocks). To work, however, a banking union does need some common fiscal backing ready to be used in the case, for example, where ultimately the emergency recapitalisation of large banks by the official sector is needed. It is indeed clear that the current constraint of raising recapitalisation funds from individual national budgets, some of them already overstretched, seriously hinders the process of restructuring of the euro area economies and economic growth. As the GDP costs of banking crises are high (Laeven and Valencia 2012) and the European banking sector oversized, the magnitude of a reasonable fiscal backing for the banking union is likely to be larger than the current European Stability Mechanism (5% of euro area GDP). A banking union without a common resolution fund would be useless, as the power of a supervisor is mostly linked to its ability to put banks, even large ones, in resolution. The ability of supervisors to perform credible stress tests is also intimately linked to the availability of a fiscal backstop.

A well designed banking union would therefore be a partial substitute for fiscal integration. It would deal with the most serious asymmetric shocks (banking crises) which can engulf the currency area as a whole in a deadly crisis. It is the minimum additional set of institutions to keep the euro area together. At the same time, it would not deal with more standard asymmetric real shocks to the cycle (demand, supply) and would therefore fall far short of a full fiscal union. It remains an open question whether even this minimalist reform however is politically feasible.

4) Gradualist approach to fiscal integration

While a meaningful banking union is essential for the survival of the euro, this does not mean that deeper fiscal ties in the euro area would not be desirable. They could substantially improve the workings of the currency union by facilitating risk sharing. The key issue is to design them in a way that a) keeps moral hazard under control and, b) if possible, uses the process of fiscal integration to improve existing institutions at the euro area level.

a) On the issue of moral hazard, there is a choice to be made between having ever more external monitoring by the European Commission and/or by other member states or going down the American route and increasing gradually the euro area budget, while having credible no bail out rules for national budgets. The external monitoring can be made *ex ante* with veto powers on national budgets, for example, or strict budgetary rules endorsed at the euro area level, or *ex post* via sanctions. The *ex post* approach has clearly demonstrated its limits with the serial violation of budgetary rules by Germany and France in particular and no corresponding sanctions. It is important to note that the very fact of centralizing more budget capacity and providing more smoothing devices at the euro area level increases the credibility of no bail out rules at the national level. As usual, if really catastrophic events are insured at the federal levels, it becomes doable and therefore credible to let nations default under the strain of smaller shocks or mismanagement.
b) On the issue of euro area institutions, it would be a missed opportunity not to link any enlargement of the euro area fiscal capacity to reforms in member states. One possibility would be to give flesh to the idea of "contracts for reforms", whereby loans would be made conditional on the realization of certain reforms by member states. Another concrete and more ambitious example of how this could be done is provided by the April 2013 Report of the French Conseil d'Analyse Economique. It is proposed to link a new European unemployment insurance topping the national one to voluntary adoption of a European employment contract.

Workers would be given the choice between the national contract or the European one. The unemployment insurance would take into account structural unemployment levels and differences in compensation (reflected in different levels of contributions), so that countries with low unemployment would not be penalised. The new European employment contract would be designed to have better properties than the prevailing employment contracts in several euro area countries (in which dual labour markets effectively deny jobs to young and long term unemployed workers). Linking fiscal deepening at the euro area level to desirable euro wide structural reforms would also stand a chance to reconcile euro area citizens with the purpose of European integration. After all, since its origins the goal of European integration has been to maintain peace and to increase prosperity for all.

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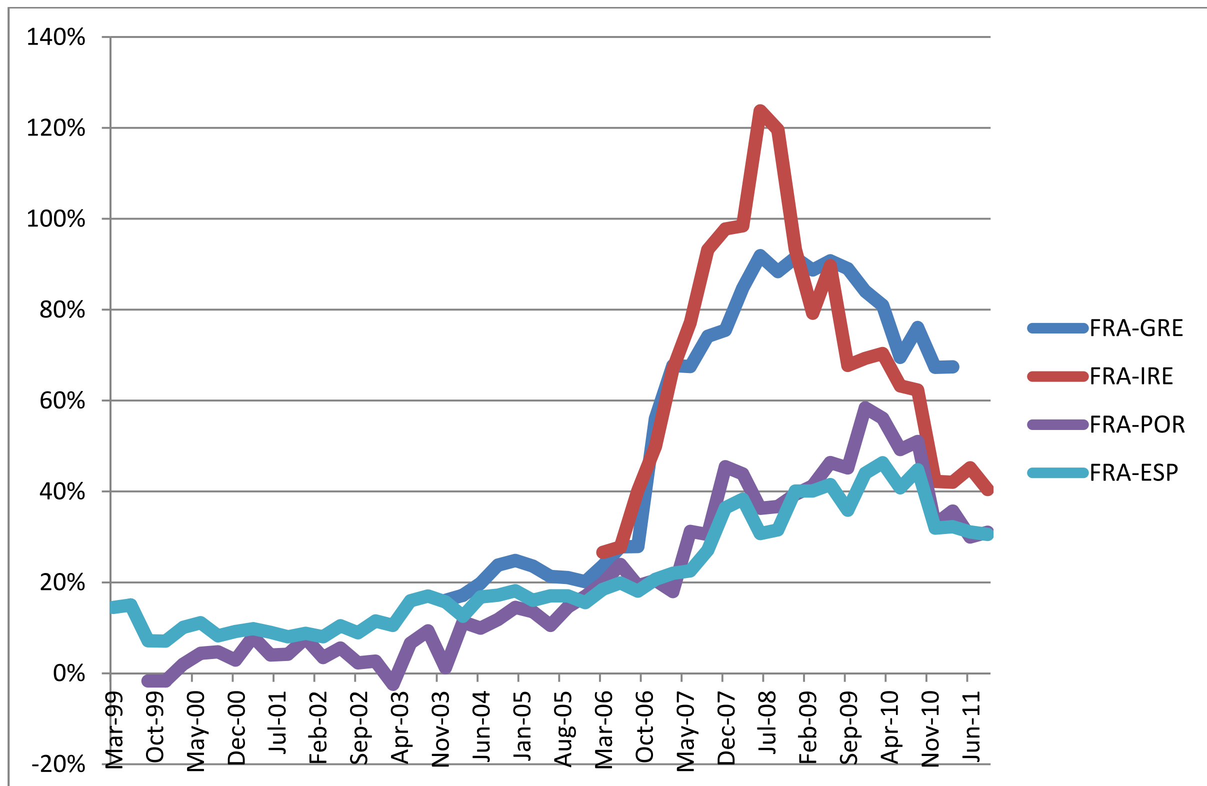
Figure 1a,b: Net Consolidated Claims of German and French Banks on Countries in the Euro-Area Periphery, March 1999–September 2011. (Percent of peripheral-country GD P)



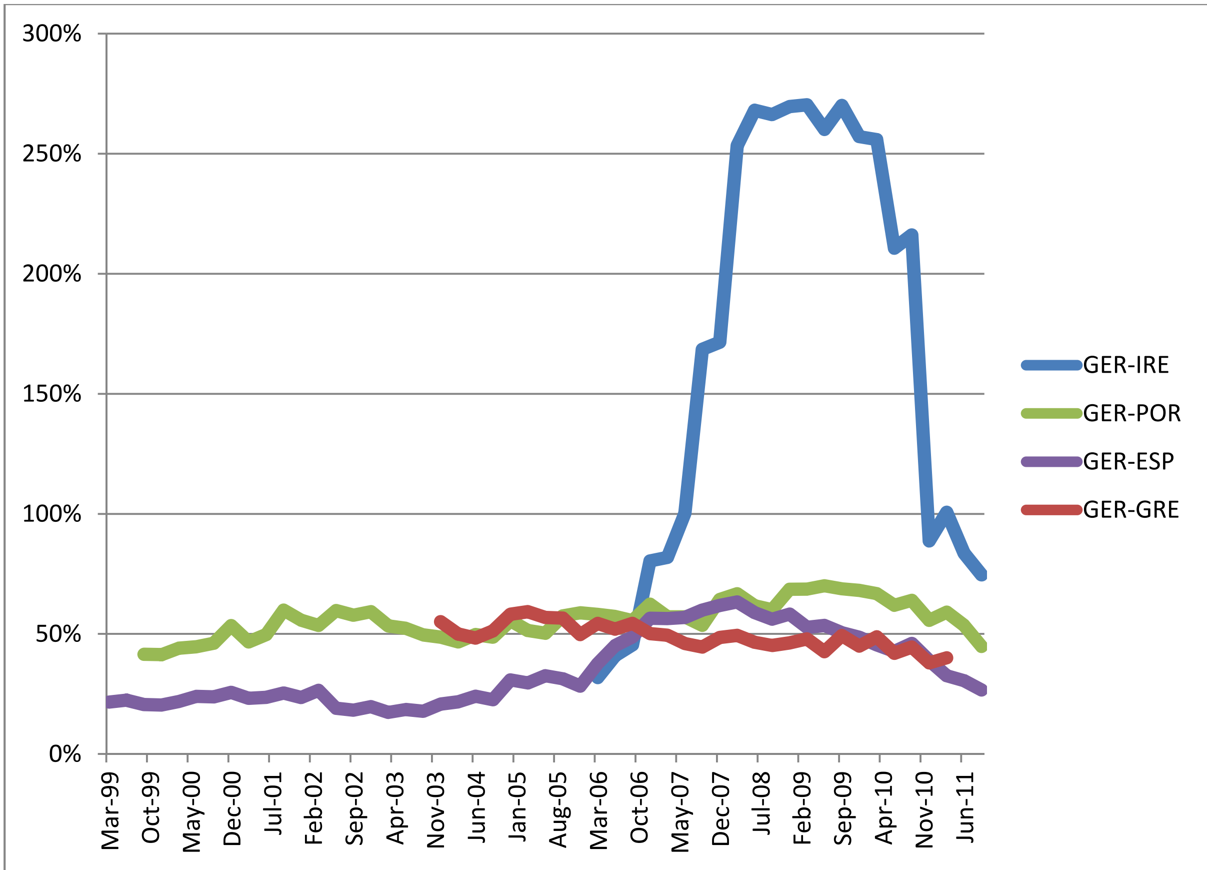


Figure 2: