

A SCHUMAN COMPACT FOR THE EURO AREA

by
Askoka Mody

BRUEGEL ESSAY AND LECTURE SERIES



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Editor: Stephen Gardner

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FOREWORD

With this essay, Bruegel scholar Ashoka Mody invites us to pause and reflect on the direction of, and the approach to, further integration of the euro area. The crisis has moved from a very volatile phase, and it is time consider where we stand and where we want to go. Mody starts from the history of monetary union and shows that Europe's political system has always stopped short of creating a fiscal union to accompany the monetary union. This has not happened by accident, but on the contrary there have been several debates on further integration of fiscal policy. But it has always been deferred to later. So why has Europe not gone further? Mody argues that creating a fiscal union means giving up control over fiscal policy and ultimately surrendering political sovereignty. Also, in the current crisis, though Europe has been able to agree on very significant steps towards more sharing of sovereignty and giving up more control to the European level, Europe has not actually agreed on true risk sharing via fiscal policy. So can fiscal union be achieved through further incremental steps? Mody's answer is a clear 'no'. Fiscal union requires a far-reaching, deliberate step towards a true union or perhaps even a federation.

Together with 10 German economists, jurists and political scientists, the so-called Glienicker Gruppe, I have called for the establishment of a new 'Euro treaty', which would result in a significant transfer of sovereignty to a euro-area economic government. Like Mody, we assess that we are far away from a true solution to the euro-area crisis. None of the fundamental problems underlying the euro crisis have been solved – not the banking crisis, nor the sovereign debt crisis, nor the competitiveness crisis. Our proposal is therefore to take the next, significant,

step. The starting point would be the creation of a fully centralised bank resolution authority. This would allow the financial system to be largely decoupled from national governments, rendering financial stability independent from government solvency risk. This would enable the re-establishment of a true no-bailout clause. Further steps would include insurance against major country-specific shocks and the provision of euro-area public goods.

Mody agrees that this would be a good solution to the crisis and would create a true and deep monetary union. But if Europe is not yet ready to take this step, should Europe's policymakers instead try to take further small steps in the hope of eventually arriving at the destination? Mody argues that this could be a dangerous road. It could lead to a fuzzy concept of sovereignty with ultimate decision-making still residing at national level, while European rules suggest that sovereignty is exercised by Brussels. Can legitimacy of decision making be ensured in such a setting? Isn't there a risk that necessary decisions in bank resolution get delayed in the hope of an eventual European resolution authority? Certainly, 'muddling through' and 'muddle' can be very close to each other, as Mody argues. He therefore proposes a 'Schuman Compact', which leverages sovereignty where it currently is still most pronounced: at the national level. A banking and a fiscal compact would be the start.

I sincerely hope that this essay helps policymakers to reflect on the current approach to crisis resolution. Bruegel's role as a think tank at the heart of Europe is to do exactly this: provide policymakers and citizens with new ideas and approaches to the most burning policy questions of strategic relevance. Decision-makers may decide to continue their current approach, to go forward with a strategy as outlined by the Glienicker Gruppe, or decide to follow the path towards a Schuman Compact as outlined here. Reading well-argued pieces like this essay, and debating the central questions with the Bruegel community, will help in making the right decision.

*Guntram Wolff, Director, Bruegel
Brussels, November 2013*

A SCHUMAN COMPACT FOR THE EURO AREA¹

EXECUTIVE SUMMARY

Five years into the crisis, the euro area remains an incomplete monetary union. The emergency measures taken have stopped the free fall: financial markets have calmed down and the economic contraction appears to be ending. But, especially in the darkest moments of the crisis, a grander idea of Europe was visualised. 'An ever closer' union would build stronger economic structures to close the gaps in the monetary union while also achieving greater political solidarity. That vision is slipping away. A fiscal union with the necessary financial buffers – a sizeable European Union budget, predictable fiscal transfers, Eurobonds, common deposit insurance, a fund to support bank resolution – has been repeatedly deferred with no realistic prospect of a political consensus.

The continued incompleteness of the union should not be a surprise. The euro area has run into a fundamental barrier. The next step to a conventionally-complete monetary union requires the surrender of national fiscal sovereignty – and, hence, of political sovereignty – to achieve an effective federation. Despite more than a half century of Europe's evolution as a Community, and then a Union, the goal of a federation, a 'United States of Europe,' has remained elusive. Five years of the crisis has not changed the political calculus. For this reason, despite the economic healing, the fragilities remain. Robust governance mechanisms and reliable financial shock absorbers remain a (distant) promise.

Some argue that the current halfway house to a genuine fiscal and political union is a 'muddling-ahead' process. Europe, in this view, has a history of 'falling forward,' learning from its setbacks to move ahead. But this view does not account for the hurdle presented by the surrender of fiscal sovereignty. As the pressure of the crisis has receded, the goal has shifted from an 'an ever closer union' to a 'more perfect union.' That new goal is to reinforce the existing governance structure with support from technocratic financial fixes.

The difficulty is that the line between 'muddle through' and 'a muddle' can be a fine one as delays and half-measures become endemic. Whether the concept of 'a more perfect union' is to be the new steady state, or a prolonged transition to the ultimate goal of a 'United States of Europe,' the current half-way house creates major costs.

The centralised governance system in its new incarnation replicates the discredited pre-crisis structure but adds complexity and intrusiveness. This fuzzy 'supranationality' continues to be based on the reasonable premise that the member states will not act in their self-interest and, indeed, may act contrary to the interests of other member states. But it remains wedded to the questionable premise that centralised oversight provides a corrective. Especially because the supranationality bypasses the political process, its ability to enforce discipline lacks legitimacy. Delays are endemic because consensus requires time and member nations have no obligation or incentive to act on their own. Thus, virtually no bank resolution has occurred despite existing national legislation and established practices. Most insidiously, the culture of national dependency militates against political objective of a 'closer union' and, eventually, a federation.

The emergency financial measures to support the distressed nations during the crisis were a major political achievement and did cushion the free fall. But they introduced new fragilities. In particular, the policy of official sovereign loans to repay private creditors followed by official debt forgiveness may have sown the seeds of future problems. The presumption of bailouts is further entrenched by centralised governance,

which is assumed to bear some responsibility for the fiscal stress. Private creditors have learned that, except in the most extreme situations, they will be protected. The incentives for future booms and busts have been strengthened while the financial resources in the emergency mechanisms remain inadequate.

An alternative resting stop on the way to 'a more perfect union' would be based on the recognition of a *de-facto* decentralisation in Europe. The financial costs of the crisis have been borne almost entirely at the national level; that is unlikely to change in the foreseeable future. The alternative resting stop would, therefore, seek to make decentralisation more robust rather than wish it away. A model would be a monetary union that resembles the United States before the Great Depression. Then there was virtually no system of fiscal transfers and states' fiscal discipline was enforced by a 'no-bailout' commitment. The task for the euro area is to leverage sovereign authority where it exists: at the national level. This by no means implies giving up the goal of a federation. But it does mean a redirection. By reducing the political tensions, decentralised governance founded on national sovereignty will improve the prospect of a constructive dialogue. Success of this more decentralised approach requires a 'Schuman Compact,' a set of compacts to voluntarily adopt standards to conduct their own surveillance and operations. The model of the Fiscal Compact already in place would extend to a compact on enforcement of sovereign debt restructuring and a banking compact. The decentralisation would need to be impelled forward by example of 'leader' nations' initiatives to generate necessary peer pressure. The urgent task of bank resolution would be an ideal test case. Such experimental steps would create real forward motion and also foster, as Robert Schuman said in his iconic declaration, a "*de-facto solidarity*".

THE EURO'S FALSE PROMISE

On 9 May 1950, Robert Schuman, then foreign minister of France, called on Europe to pursue the goal of a federation. Motivated by the urgency of safeguarding world peace, his call was at once visionary and pragmatic. He cautioned that Europe *“will not be made all at once”* and spoke of *“concrete steps”* to build a *“de-facto solidarity”*⁷². The concrete step was the establishment of the European Coal and Steel Community (ECSC), which in its pragmatic spirit was a Franco-German initiative but *“open to the participation of the other countries of Europe”*.

The politics was right. The hunger for peace was palpable – and the incentives for Germany and France were aligned. But despite the politics being right, the ECSC dropped the reference to a ‘federation’. Instead, the word ‘community’, was applied and has since been the guiding vision for Europe. A community has powerful overtones; it proposes common interests and bonds. But it does not constitute a federation. So, from the very inception, when the ground for such advance was most fertile, even the founders were unwilling to cross a threshold that compromised core national sovereignty – that relating to fiscal and political authority.

With time, peace was established and the goal of a federation largely receded. In 1970, a group of experts led by Pierre Werner, prime minister of Luxembourg, drafted a blueprint for a European Monetary Union. While the Werner Report proposed a dramatic leap to a single currency, it stipulated that there would be no supporting fiscal union. Presumably, this was an acknowledgement of the political reality. The Delors Report that followed in 1989 was similarly realistic. Thus, for nearly four decades, from the Werner Report to the start of the crisis in 2008, the presumption was that national fiscal sovereignty would not be ceded to a European federation.

The idea of a federation, however, is back in public discourse as the euro area confronts the need for sizeable fiscal transfers between member nations. But the proposals are cautious. For example, Trichet

(2013) advocates the notion of a “*federation by exception*”. Federal powers – jointly exercised by the European Commission, the European Council, and the European Parliament – would be invoked in exceptional cases to discipline errant sovereigns. Thus, even in this proposal, the federal authority would be triggered to censure, not to provide fiscal support.

The history of the past five years is clear: whenever there has been a call to institute a system of fiscal transfers or of open-ended fiscal obligations to serve the community purpose, the process has had no traction. That has been the fate of Eurobonds (in their many variants) and of all aspects of the banking union that required contributions to a common financial pool.

Some argue that it is only a matter of time before the necessary federal structures are established. They see the European project as a process of ‘falling forward’ to a more integrated union. Each crisis generates a functional response to overcome the limitations of the past. The falling forward thesis is bolstered by the lingering perception that the European project is moved forward by long-term ‘political’ goals rather than by merely short-term economic objectives. I argue that the thesis of ‘falling forward’, especially at this critical juncture, rests on shaky ground; and, in any case, equating forward movement with more centralisation is incorrect. I make three propositions:

- 1 The euro was a political decision but had no operational political dynamic in a key sense. There was never a realistic possibility that fiscal – and, hence, political – sovereignty would be surrendered. The technocrats responsible for the design of the common currency understood that limitation and created a quasi-supranational structure with fuzzy boundaries. Nothing since the onset of the crisis has changed that. Indeed, post-crisis responses have hardened the claims on national sovereignty.
- 2 Recognising the improbability of a fiscal union, the fuzzy supranational structures – under the traditional Maastricht framework and,

even more so, the intrusive post-crisis extensions – seek to eliminate the need for Europe-wide fiscal shock absorbers by attempting to induce fiscal discipline via centralised surveillance and coordination. This system acts counter to both the economic and political objectives of the union. The economic costs are two-fold. The inability to impose sanctions against fiscal indiscipline appears innocuous in good times but generates incentives for wilful disregard or for game-playing and deception, which damage credibility. More seriously, in periods of crisis, coordinated decision making causes costly delays while diluting the role of market discipline. The political interests are hurt because the system lacks legitimacy.

- 3 More decentralisation can improve economic incentives, the speed of response, and the democratic legitimacy of the union. These goals can be achieved by: (a) lightening centralised surveillance; (b) creating market discipline for sovereigns through a credible no-bailout mechanism; and (c) since it is particularly risky to await the construction of a banking union – because of incentives to push the hardest decisions into the future – national authorities should be encouraged to use their national bank resolution systems and pragmatic approaches to close down unviable banks.

I argue that the success of this more decentralised approach will require a ‘Schuman Compact,’ a set of compacts under which EU member states would voluntarily adopt standards to conduct their own surveillance and operations. The Fiscal Compact model already in place would extend to a compact on enforcement of sovereign debt restructuring and a banking compact. The decentralisation would need to be impelled forward by the example of ‘leader’ nations’ initiatives, in order to generate necessary peer pressure. The urgent task of bank resolution would be an ideal test case. As the following sections will show, such experimental steps would create real forward motion and would also foster, as Robert Schuman said in his iconic declaration, a “*de-facto solidarity*”.

FINESSING FISCAL SOVEREIGNTY

Peter Kenen argued in 1969 that a monetary union required a fiscal capability to support member countries experiencing economic downturns. This requirement was well accepted in academic and policy circles. Yet, neither the Werner nor the (much later) Delors reports carry a reference to Kenen's advice. This was not a coincidence. Fiscal sovereignty is the signature symbol of political sovereignty and there was no appetite to surrender this. Thus, in its design and operation during its first decade, the monetary union as constructed was understood to be the end point with no path to a more complete union. This core framework has not changed since the onset of the crisis. Technocratic fixes have been used to modify governance structures and add financing mechanisms for emergency response. But because they have consciously side-stepped the question of political legitimacy, these fixes remain partial and potentially counterproductive. In this sense, the euro was never an instrument for furthering the cause of a political union, and, hence, was never a political project³.

Instead, the architects of the euro have consistently sought to finesse the concept of a fiscal union. The plan was that all member countries would exercise the necessary fiscal discipline and, therefore, the need for fiscal support from a centralised fiscal authority would never arise. Countries would have sufficient fiscal buffers to absorb their own shocks. To ensure the necessary fiscal discipline, an institutional structure was created to monitor and discipline the fiscal behaviour of member countries. That task was delegated to the European Commission.

Although the institutionalisation of fiscal discipline under the Stability and Growth Pact (SGP) occurred only after the Maastricht Treaty in 1992, the basic concept was already laid out in the Werner Report. The report did recognise the need for a centralised "*Community budget*", especially at the "*third stage*" when the monetary union came into being. But it emphasised (pp. 10-11) that such a budget would always be small in relation to the needs: "*...its economic significance will still*

be weak compared with that of the national budgets, the harmonised management of which will be an essential feature of cohesion in the union". For this reason, the Werner Report argued that (p. 11) *"...it will be useful to have at the national level budgetary and fiscal instruments that can be handled in accordance with Community directives"*. The Delors Report (1989) was more emphatic. It stated (p. 10) that the Community Budget was likely to remain *"a very small part"* of public spending and much of that would, in any case, not be available for cyclical adjustments.

The International Monetary Fund began its series of Article IV surveillance reports on the euro area in 2003⁴. None of these reports carries a reference to a *"fiscal union"* in the Peter Kenen sense. Instead, the reports unquestioningly accept the SGP as the guiding fiscal framework. The 2008 IMF report, produced when the crisis was still a 'downturn' in Europe, applauded the monetary union's success in its first decade and expressed *"general satisfaction with the operation of the SGP"* as the instrument best suited to dealing with the gathering downturn (p. 3).

Thus, over nearly four decades, from the 1970 Werner Report to the onset of the crisis in 2008, there was never a moment when a fiscal union was even considered, much less as a serious possibility. In December 2012, the German Bundesbank, in its submission to the German Federal Constitutional Court on the European Central Bank's Outright Monetary Transactions (OMT) policy, correctly stated that the European Monetary Union is *"...a community of countries which have assigned responsibility for monetary policy over to the supranational level, but which continue to decide on fiscal and economic policy primarily at a national level, and which deliberately did not enter into a liability or transfer union"*⁵. Although the Bundesbank has often been publicly at odds with the positions of other European Central Bank officials, on this matter there is no disagreement. Mario Draghi, President of the ECB, has reiterated the point (Draghi, 2013, p. 6): *"Fiscal policy has to absorb idiosyncratic or asymmetric shocks at the national level"*.

THE CRISIS AS A SPUR?

But perhaps a crisis was needed to force this issue, and the moment has arrived. Spolaore [2013] asks if the founders of the monetary union foresaw that its incomplete structure would inevitably precipitate a crisis and, hence, force a move to a fiscal and political union. The fiscal union buzz reached a high in December 2011 following the near-paralysis of the European banking system and the relapse into recessionary economic conditions. While much ingenuity was deployed in designing a variety of Eurobonds (see Claessens, Mody, and Valhee, 2012, for a summary), there was limited effort to push for the revenues needed to support such financing mechanisms (see Wolff, 2012). Because the pooling of revenues to support Eurobonds was not a realistic prospect, the concept (rightly) died a quiet death. In the absence of a stable revenue-pooling arrangement, Eurobonds must be backed by national budgets, either directly or as a contingent liability. This requires that national budgets make relatively open-ended fiscal commitments. In the current context, such financial arrangements imply a disproportionate reliance on Germany's willingness to backstop common financial obligations.

The same problem has plagued other similar initiatives, such as funds to back bank resolution and deposit insurance or the possibility of capitalising banks directly through the European Stability Mechanism (ESM). Direct bank recapitalisation was promised at the European Council of 28-29 June 2012; it has ever since remained a moving target and, today, its future is unclear (see Barker, 2013). The ultimate question is a political one. If not the sovereign of the country in which the bank is located, then who bears the financial risk of the direct recapitalisation. Transferring the risk to another sovereign is also a legal matter, possibly contravening the Treaty on the Functioning of the European Union (TFEU), the constitutional basis of the European Union⁶. The ESM's chief executive, Klaus Regling, has questioned the authority of the ESM to act as the financial backstop for undercapitalised banks without changes to the TFEU; German federal finance minister Schäuble has similarly rejected the idea⁷.

The ESM itself was a signature achievement of the crisis. It created limited national obligations to provide liquidity support to sovereigns. Similar to the World Bank, the ESM leverages paid-in capital from member countries to borrow funds from the market and lend these in order to stabilise governments and banks. The ESM's borrowings are backed by member state guarantees. Because the ESM is a public entity that lends to sovereigns, the question arose if it violated the 'no bailout' rule. The German Constitutional Court and the European Union Court of Justice (ECJ) have cooperated in the ESM's evolution, deferring to the policy objective of maintaining financial stability.

Can the ESM be scaled up as a stable and efficient substitute to a fiscal union? At some point, the German Court will worry that German commitments are open-ended and so violate the German constitution. Similarly, the ECJ will need to determine if at some threshold the TFEU injunction against financing other sovereigns is violated. If and when the next crisis prompts a scaling up, the expanded fiscal commitments will come with the knowledge that the support is likely to have a significant concessional element, as this round of lending has demonstrated. Will that larger outlay on more concessional terms be politically viable? Or requiring, as it does, unanimous approval, will there be holdouts?

More seriously, the financial stability consequences of the ESM are troubling. ESM-style funding has deepened the problem of moral hazard in the euro area. Unlike a system of automatic fiscal transfers in a fiscal union, the official loans have been used to repay private creditors. Because the official 'bailouts' did not reduce the high public debt-to-GDP ratios, official debt forgiveness was required to alleviate the debt burden. As Rogoff (2002) says, this is the litmus test of moral hazard. The IMF, Rogoff (2002) points out, has almost always been repaid in full. However, even the infrequent 'evergreening' (or extension of repayment duration) creates some moral hazard, he concludes. In the euro area, the severe stress in sovereign bond markets in July 2011 led the authorities to reduce interest rates and extend maturities on their loans. Even Ireland received a significant reduction in the net

present value of its repayment obligations, and the risk premium on privately-held Irish sovereign bonds fell sharply following the announcement of this reduced official debt burden. In effect, official debt had been subordinated to private debt. Thus, the ‘no bailout’ presumption in the treaty was turned on its head. Since this is now *de-facto* crisis management policy, private creditors can presume that their debt will be restructured only in the most extreme circumstances. Moreover, the excessive dependence of such a system on Germany and risk of sliding credit ratings of other member states make this an inherently unstable financial structure – not a desirable feature for a guardian of financial stability.

Ultimately, as Wolff (2012) argues, there is no substitute for a real European budget that allows predictable and automatic transfers. Similarly, the Van Rompuy Report (2012, p. 12) distinguishes between the ESM’s “*shock absorption*” role and a central fiscal capacity to improve “*overall economic resilience*”. At present, these two roles are conflated. Debt forgiveness appears to be the only politically feasible transfer mechanism because it is opaque; but it is also iniquitous and undermines future fiscal discipline and financial stability.

Wolff (2012) proposes that a European budget equal to two percent of euro-area GDP would be a good start in providing relief and, hence, imparting resilience to distressed economies. This estimate needs to be assessed against realistic benchmarks. In response to the Great Depression, the United States in the 1930s instituted a system of extensive system fiscal transfers – but that was possible within a pre-existing federal framework. An integral feature of the ‘New Deal’, the grants to the states, was rapidly ramped up after 1931, and by 1934 provided about four percent of GDP a year (Wallis and Oates, 1998, p. 166). In the period 2008-10 in response to the Great Recession, federal fiscal support to distressed US states (mainly through a reduced federal tax burden) was of the same order of magnitude.

Is the euro area ready to cross this bridge? The politics has fiercely militated against it. Moreover, as Wolff (2012) notes, even if a series of

technocratic fixes can ultimately simulate the essentials of a common budget and banking union, democratic accountability requires a treaty change. Unless that happens, it is time to move on and allow countries the flexibility of their own adjustment processes.

MORE FISCAL DECENTRALISATION

The starting point of this discussion must be that the euro area has effectively been operating a decentralised system throughout the crisis. The burden of economic adjustment through the crisis has fallen almost entirely on domestic taxpayers. True, there have been transfers via the debt relief. But this was not the intent. Loans through the ESM (and other European funding mechanisms) were made precisely with intent of avoiding transfers. The money loaned to the distressed economies was to be temporary support to tide them over during, presumably, a period of temporary stress. In the event, the reality forced an *ex-post* acknowledgement of the unsustainable debt burden.

If a transparent system of transfers is not politically tenable, then a forward-looking euro-area economic architecture surely cannot be built on the premise of continued official loans that will eventually be forgiven. Not only would the economics of such a structure be perilous, the politics rules it out. This is evident in the strategy of doling out official debt relief in dribbles and in the refusal, as yet, to face a virtually-certain debt write-off in the Greek case (Mody, 2013b). In the September 2013 German elections, the major political parties steered the pre-election debate away from European matters, highlighting the political limits of any form of fiscal transfer (Mody, 2013c). While some anticipated that the German authorities would show greater willingness to open their cheque books once the electorate's scrutiny was lifted, that has also not happened. Reports at the time of writing indicate that the parties likely to form the grand coalition in Germany are agreed that they cannot support financial instruments such as the Eurobond; of immediate relevance, support is absent also for financial backstopping of a bank resolution fund (Peel, 2013).

Thus, if the burden of economic adjustment must fall at the national level, the task is to make that *de-facto* decentralisation work in a more robust manner. A way ahead is to mimic the US fiscal system before the New Deal⁸. Then, there was no centralised fiscal surveillance or fiscal transfers, but there was a credible ‘no-bailout’ commitment. Its limitation was that it did not provide protection against out-sized shocks such as the Great Depression. But neither does the present – or prospective – muddled system in the euro area. Indeed, the governance structure and financial support systems remain fragile. Hence, three steps are needed:

- The delegation of European fiscal governance to the European Commission has long been recognised as counterproductive and, notwithstanding recent initiatives, should be scaled back⁹.
- Fiscal policy should be the responsibility of the member states where the sovereignty lies. This concept is already present in the Fiscal Compact, and is consistent with the principle of subsidiarity.
- And, to minimise the risk of excessive future sovereign borrowing, a credible ‘no-bailout’ regime must ensure that private lenders bear losses when sovereign debt becomes unsustainable.

The premise since the Werner Report has been that countries could not be trusted to follow prudent fiscal policies, and centralised surveillance would provide the necessary discipline. That premise was ill-founded, as is well understood today. The system lacked credibility because peer monitoring created an endemic tendency for procrastination and game-playing, as Tirole (2012) has highlighted. While the ‘big’ member states, Germany and France, wilfully violated the SGP in 2003 without fear of consequences, there was, in general, no incentive within the collective to impose sanctions on another member state. Lacking legitimacy, the system was, at the best of times, irrelevant¹⁰.

Some may argue that significant efforts to upgrade fiscal governance since the onset of the crisis will help. But these initiatives do not deal with the shortcomings of the earlier system: rather they ‘double the bets’. Instead of tackling the core problems, they superimpose a com-

plexity that makes them more – not less – susceptible to earlier deficiencies. In principle, the enhanced fiscal governance (the so-called ‘six pack’ and ‘two pack’¹¹) and the macroeconomic imbalances procedure (MIP) offer a more scientific surveillance framework. But they also render decision making more challenging. For example, the shift from the SGP’s three percent of GDP budget deficit target to the ‘structurally’-balanced budget deficit is technically appropriate. But that requires assessment of a country’s potential output, a nebulous concept especially during periods of economic stress. The risks are high that the assessment to be conducted by a committee of member-country representatives will be politicised. The actions that follow from the assessment also remain subject to discretion. Recently, for example, it has been proposed that the remedies be tied to the vigour with which the culpable country is implementing structural reforms (Buck and Spiegel, 2013). The difficulties are clear. Moreover, the new procedures increase central intrusiveness but create no remedy for the traditionally intractable problem of non-compliance. Trichet (2013) recognises that ensuring compliance remains a largely unresolved task, one that will require surrender of national fiscal sovereignty.

Draghi (2013), faced with this dilemma, has proposed that sovereignty be redefined. The prerogative of nationally-elected governments to act on behalf of their citizens is an anachronistic view of sovereignty, he says; instead (p. 2), “*sovereignty relates to the ability to deliver in practice the essential services people expect from government*”. Simply put, this is a restatement of the premise that national governments cannot be trusted to deliver to their people, and we are back full-circle to the standard rationalisation of centralised European surveillance.

But this is not a politically stable way forward. As the crisis has dragged on, the trust in European institutions has fallen sharply. In the past, public distrust of national institutions has been greater than distrust of European institutions (Roth, Nowak-Lehmann, and Otter, 2013). But that advantage of European institutions has eroded – a finding consistent with the rise of nationalistic parties¹². Roth *et al* (2013) also report that the fall in trust is highly correlated with the rise in unemployment.

Thus, as anxieties and stresses have increased and persisted, European institutions are bearing the brunt of the blame. Moreover, in a public debate with the German chancellor, Angela Merkel, the Polish prime minister, Donald Tusk, expressed the fear that the sovereignty delegated to Europe would be dominated by the larger countries, a fear that other national leaders no doubt harbour (Traynor, 2013). This, then, is not a propitious moment to push for pooling of sovereignty.

CENTRALISATION AND SOVEREIGN DEBT

Central surveillance and regulatory norms on sovereign debt add to the operational challenges of the euro area. Before the crisis, the stated policy was 'no bailout'. The markets may have presumed that there would be a bailout, but the crisis confirmed that that would be the case. Well before the financial responses to the crisis crystallised the moral hazard problem, the euro area's fuzzy governance structure sowed the seeds of the problem. Tirole (2012, p. 228) states: *"...governments have imposed no discipline on each other and markets have long thought that their lending to weak sovereigns would go unpunished"*. More forcefully, von Hagen and Eichengreen (1996, p. 137) had warned that the system *"...will increase the pressure for bailouts and undermine Brussels' capacity to resist"*. That perception could have been proved wrong and a precedent could have been established by enforcing the no-bailout principle as this crisis unfolded. Instead, the policy of official funds to repay private debt in all but exceptional circumstances, followed by official debt forgiveness, has aggravated the moral hazard. Five years into the crisis, there is as yet no clarity on the restructuring of bank and sovereign debt¹³.

This fuzziness remains apparent in the public debate on the regulatory treatment of sovereign debt held by banks. Jens Weidmann, President of the Bundesbank and member of the Governing Council of the ECB, has called for sovereign debt to be treated as risky and for banks to set aside capital to reflect that riskiness (Steen, 2013). Sapir and Wolff (2013) make the same recommendation. In contrast, ECB President

Draghi [2013] has stipulated that the centralised surveillance structure should seek to maintain sovereign debt as a “safe asset”.

A careful consideration of the sanctity of sovereign debt is essential to the broader debate on the future architecture of the euro area. The member states have given up the flexibility of their own exchange rates and, lacking a centrally-funded fiscal capacity to absorb shocks, require the buffer of sovereign debt restructuring. Where loss of confidence in a country might have triggered speculative pressures on its exchange rate, the focus of the speculation will necessarily fall on the price of sovereign debt (see Mody, 2013a, for a discussion).

Committing to sovereign debt as risk-free also has enormous implications for banks. Banks have a strong incentive under the Basel regulatory model to increase their holdings of sovereign debt and thereby reduce their capital requirements. System-wide risk is elevated through two different channels. Caprio [2013] points out that as several banks increase their exposure to the same asset, the covariance of bank risk increases. Moreover, the correlation between the risks faced by sovereigns and banks, which proved so destabilising at the height of the crisis, is strengthened. The policy effort to break this sovereign-bank link is best served by regulatory recognition of sovereign debt risk rather than through the indirect – and politically-elusive – method effort of freeing the sovereign of the obligation of recapitalising domestic banks. The implication also is that the forthcoming asset quality review and stress tests of banks will need to take a position on sovereign debt. Previous stress tests were severely undermined by declaring sovereign debt as risk-free and, hence, outside the scope of the tests.

Treating sovereign debt as risky is economically desirable, and also has clear historical precedents. The possibility of sovereign-debt default is desirable for raising the cost of debt and enforcing fiscal discipline, creating a financial buffer at moments of high stress, and reducing systemic risk. The countervailing threat of contagion is overstated, and is a consequence mainly of an inconsistent and uncertain policy on

default (Mody, 2013a). For over 150 years, state and municipal governments in the United States have repeatedly defaulted on their debt: state governments defaulted in the 1840s and, then, as municipal governments took on more fiscal responsibility, they defaulted in the 1870s and in the 1930s (Inman, 2003). Although, the New Deal at the height of the Great Depression led to a major expansion of central fiscal authority to provide fiscal transfers, the principle of no-bailout of local governments has continued. The state of Arkansas defaulted in 1932 and municipalities have continued to do so to the present.

Some are concerned that a 'no-bailout' commitment is impossible to maintain. The US experience is unusual and difficult to replicate because in a crunch; the perception of 'contagion' and other collateral damage will crystallise the policy incentives in favour of bailing out private creditors (Rodden, 2006). That risk is indeed ever present. Buchheit *et al* (2013) propose measures for orderly bankruptcy procedures for sovereigns. Their proposal remains the most feasible way of moving ahead; the difficulty is that, in the past, such efforts have not alleviated the concerns about contagion and, consequently, the policy tendency to defer restructuring has remained endemic. In the absence of a sovereign bankruptcy court, with a record for timely and fair debt restructuring, default on debt must be built into debt contracts (Mody, 2013a). One approach would be for debt contracts to specify debt relief beyond certain thresholds of debt ratios or risk spreads¹⁴. The key is to allow for pre-emptive debt relief in an automatic and incremental manner. Individual sovereigns will pay higher interest rates, but the reduced indebtedness will help support long-run sustainability. Moreover, the eventual externality – the costs imposed on others – at the moment of stress and default will be reduced.

A DECENTRALISED FISCAL ARCHITECTURE

If centralisation undermines governance credibility and legitimacy while promoting moral hazard and elevating systemic risk, the case for returning fiscal responsibility to national authorities is strong.

Decentralisation (although not risk free) offers a way forward. The standard arguments in favour of decentralisation are that it responds to the local needs of residents, creates opportunities for quicker action, and fosters ‘yardstick’ competition, whereby innovative local governments create peer pressure on laggard governments (Bardhan, 2002). These benefits of decentralisation increase with the heterogeneity of the needs and preferences of local residents¹⁵.

But there is a deeper basis for decentralisation: the preference for maintaining national sovereignty. Drawing the line in fiscal responsibility between levels of government is primarily a political decision. In discussing the practice of subsidiarity in the European Community, Bremann (1994, p. 5) says: *“One’s judgment about whether a measure comports with the principle of subsidiarity is a profoundly political one”*. Similarly, Inman (2003, p. 56) says that the US Supreme Court has been unable to define valid policy domains for federal and local governments because of limited constitutional guidance. In the international context, except when they seek external support, national governments zealously guard their fiscal independence. This is the touchstone of their political independence. The crisis has, in any case, placed the burden of fiscal adjustment at the national level. And no change can be expected in the future. National fiscal independence requires and can foster a more mature relationship with private lenders. Without distance from European institutions, debt restructuring will remain prone to all the problems witnessed during this crisis.

More robust decentralisation is also desirable because a fruitless search for integration has costs. Although he favours decentralisation because it caters to the heterogeneity of preferences, Spolaore (2013, p. 138) reaches the same conclusion as I do. He warns: *“In general, the central problem with the chain-reaction [the functionalist or ‘falling forward’] method is the unwarranted expectation that gradual integration, which has been successful in areas with low costs of heterogeneity [trade liberalisation], can continue unabated when moving to areas with much higher heterogeneity costs”*. He goes on: *“Followers of this [chain-reaction, falling forward] approach are therefore prone to setting*

up incomplete and inefficient arrangements, relying on the overoptimistic expectation that such inefficiencies can always be addressed at a later stage through additional integration". These "inefficiencies" in the context of half-way house fiscal integration, as I have argued, are substantial.

National fiscal sovereignty can be based on commonly-agreed fiscal rules, and the Fiscal Compact provides the way forward¹⁶. In contrast to the two/six packs, which were secondary legislation, using existing Treaties as legal basis, the Fiscal Compact is an intergovernmental agreement (in which EU institutions other than the Council play no role). By signing the Fiscal Compact, some EU member states commit voluntarily to a number of common objectives (in particular a structurally-balanced budget rule). Almost all – 25 of the 28 – European Union members have signed¹⁷. But the interpretation and implementation of the fiscal rule is then left to the member state. The possibility that fiscal indiscipline will arise can best be counteracted by a no-bailout commitment. Under a 'Sovereign Debt Compact', governments would agree to issue debt only with contractual clauses for automatic restructuring. An intergovernmental agreement to adopt such contracts will do more for fiscal discipline than more sophisticated surveillance.

DEALING WITH THE BANKS

The banking sector continues to bear the deepest open wounds from the crisis, wounds that seem fated to persist. In the US, the market value of banks is now well above its book value; in the euro area, the banks remain under water. The number of non-performing loans in the euro area is growing as the recession-like conditions grind on. Corporate and household debt burdens have not fallen; in the countries that started with high debt ratios, these ratios are actually higher today than before the crisis.

All instincts in the system have been to delay and delay again the needed resolution with regulatory forbearance and the availability of

easy liquidity from the ECB. Stress tests and assessments of the additional capital needed by banks were quickly, and rightly, dismissed as not credible.

Any forward movement is stymied by a focus on the vexatious issue of financing a prospective banking union. Common bank resolution and deposit insurance funds require member countries to make financial commitments to a common resource pool; that, in turn, circles back to whether countries are willing to cede some authority over their national budgets. German finance minister Schäuble has cautioned that this step is inconsistent with existing treaties [Schäuble, 2013]. And the political willingness to attempt treaty change is absent. Germany is vital for progress on these initiatives to be made but German leaders have shied away from seeking a political mandate for German support of the needed 'fiscal backstop' of a banking union. Once again, any forward movement can only occur through the political back door, an undesirable and increasingly remote prospect.

In the meantime, with continued regulatory forbearance, a repeat of the Japanese experience of zombie banks becomes more likely. Lending by zombie banks to zombie firms undermined Japanese productivity growth (by propping up the zombie borrowers and hurting their non-zombie competitors); these productivity woes fed back to further undermine the banks (see for example Hoshi and Kashyap, 2004). With borrowers' stress still high in most euro-area economies, the threats to financial stability and growth continue to escalate. Weak banks and a weak economy could continue to drag each other down.

Instead of chasing a goal that is potentially out of reach, attention must shift to the real needs and their feasibility within the current framework. Put simply, a much smaller euro-area banking system is essential to achieve financial stability. Europe's banks have grown on steroids, especially in some countries. The point really is quite simple. Large losses have been incurred and these must be allocated. Financing these losses in the hope that growth will take care of them risks digging a deeper hole. The task now is to pro-actively shut down the growing

crowd of zombie banks, while bolstering viable banks with greater capital and liquidity buffers.

To achieve this objective, an economic case for a banking union – a centralised system of supervision, resolution, and deposit insurance – can be made. But despite its elaborate structure, the current construct of the banking union has circled around the core issues. And the construct itself creates new fragilities.

Common supervision across countries is justified on the principle that domestic regulators will look the other way while their banks act irresponsibly. The excesses of the Irish banking system in the years before the crisis are often cited as an example, and the criticism is valid. But in moving to a common supervisor, what is the guarantee that these same problems will not be repeated? The presumption is that, tasked with responsibility for the Single Supervisory Mechanism (SSM), the ECB will have the incentives and the tools to act as the guardian of banking safety. But the right incentives cannot always be counted upon. As Honohan (2010) highlights, while Irish regulators were evidently at fault, international overseers (with none of the same incentive problems) did no better. Indeed, the IMF's Financial Sector Assessment Programme gave a clean bill of health to Irish banks. The case for common supervision is also made for overseeing cross-border banks. But, as Pisani-Ferry and Sapir (2010) point out, the challenge of dealing with cross-border banks was largely resolved by coordination among national supervisors.

The SSM has gone ahead because it entails no immediate fiscal burdens, but its effective functioning might be compromised by endemic governance problems (Ferran and Babis, 2013, and Troger, 2013). In particular, by establishing the authority in the ECB – in part to circumvent the need for a treaty change – the mechanism dilutes the voice of the non-euro area members, creating the likelihood that they will opt out. The boundaries between the overlapping jurisdictions of the ECB, the European Banking Authority, and national regulators remain unclear. Also, to be credible, the SSM must overcome the political obsta-

cles to reforming the German and French banking sectors. These two nations did undermine the SGP.

Moreover, experts – including ECB officials – are deeply concerned that under the visualised banking union framework, the supervisory mechanism risks being toothless without a properly funded resolution authority. But the resolution funding requires a level of public financial support that is politically impractical. These conundrums have led even the mild-mannered IMF to warn of *“the pitfalls of a piecemeal approach and an outcome that is worse than at the start”* and of the risk that *“missing elements would result in an incoherent banking union and, at worst, an architecture that is inferior to the current national-based one”*. Translation: beware the muddle.

A new approach is needed. Tackling the here-and-now problems must be the priority. This requires moving ahead with national authority for bank resolution while minimising the needs for additional funds through aggressive use of well-understood and practiced methods of debt-to-equity swaps (see Veroseni and Zingales, 2010). Banks’ borrowers will need debt relief (through personal insolvency and corporate bankruptcy procedures) and, while small depositors must be protected, creditors will need to bear losses. The continued ambiguity on these sensitive matters remains the Achilles heel of the banking resolution process. For sure, the allocation of losses requires difficult decisions: but wishing away this challenge will not make it disappear. Moreover, in the transition to a secure deposit insurance system, as Thomas Mayer (2013) has proposed, a larger fraction of deposits would need to be backed by central bank reserves, reducing the scale of required deposit insurance funding. These moves – as well as recognising government bonds as risky assets – will raise the interest rates charged to reflect real operating costs. That, in turn, will force a much-needed scaling down of the European banking system.

‘Getting on’ with bank restructuring using the authority under national legislation along with proactive deployment of debt-to-equity swaps, will shrink the pockets of instability and lift the opacity that has bedev-

illed interbank transactions – and, in doing so, practical next steps will emerge. Following the onset of the crisis, several countries added bank resolution authority to their crisis management toolkit. Yet, bank resolution has been rare. The contrast with the United States is striking. In the US, large numbers of small and medium-sized banks were closed or merged between 2008 and 2010, while larger banks were substantially restructured. The crisis experience, even in Europe, suggests more can be done.

In this light, the recent German proposal for a banking union is intriguing [Schäuble, 2013]. It is a small but sensible step in the right direction. Under the proposal, member countries would agree, and enforce, common standards on bank resolution and deposit insurance. In principle, this approach lends itself to another compact, a ‘Banking Compact’. A voluntary intergovernmental agreement can create standards for countries to act but leave them the option of doing more and experimenting with novel approaches, allowing for the emergence, through peer pressure, of truly rigorous benchmarks for bank ‘good health’ and disciplining powers.

The German proposal offers a practical way ahead, but only if Germany leads by example. If Germany is to lead, it must apply these principles to its own troubled banks and shed its reputation for diluting the new generation of international bank regulatory standards. Germany has multiple deposit-insurance systems, none of which meet international standards of best practice. Long justified by the exceptional nature of German banks, it is inconceivable that common deposit insurance could ever emerge without the German systems being unified. In the meantime, Germany should invite a thorough examination of the quality of its banks’ assets by the SSM. Banks must not be allowed to play with provisioning rules and risk-weighting loopholes to minimise new equity capital requirements.

Such actions would demonstrate a serious commitment to a robust European banking system. That would be good for Germany and for Europe, and would also free the space for a more vibrant forward-looking

agenda on protecting the banking sector from future crises.

Beyond the immediate, a bigger agenda beckons Europe. Worldwide, a concern remains that despite the efforts to learn from this crisis, the steps to strengthen regulation remain inadequate (Caprio, 2013). This is more so in the euro area than in any other major economic jurisdiction. The forbearance on account of the funding stalemate and the preoccupation with establishing complex (and, hence, fragile) governance structures and funding mechanisms have sucked the energies away from a more fundamental discussion of banking regulation. The euro area seems to be doubling down on an increasingly discredited Basel III process. The allegiance to the philosophy of risk-weighting (and assigning zero risk weights to sovereign debt) remains unchanged. Indeed, the European – particularly the German – position on Basel III capital-requirements negotiations has been to dilute standards and go slower (Goldstein, 2012). In the meantime, some, such as Switzerland, have moved ahead with greater emphasis on higher leverage ratios and convertible debt instruments. These considerations must feed into the strategy for reshaping the euro area's banking system.

A WAY OUT OF THE IMPASSE: A 'SCHUMAN COMPACT'

Europe may eventually back into a political union from an incomplete monetary union. More likely, that will prove to be a false promise. Europe has no adequate forum to democratically debate the future of Europe. In the half century before the onset of the global financial crisis, steps towards integration were codified in treaties, which were legitimised by national parliaments and through popular referendums. That was the right but risky way forward. At crucial turning points, one or more nations rejected the next step. Wary of that risk, European leaders have been ever-more reluctant to invite their citizens into a dialogue on charting their common future. The crisis has heightened that wariness.

In the absence of a political mandate, the reliance on technocratic fixes

has increased. These are creating their own anomalies. By adding complexity and intrusiveness, the technical advances in governance have deepened the traditional incentives for delays and half measures; but without political legitimacy, the enforcement and disciplining challenge remains unchanged. The emergency financial measures have stopped the free fall. But in their reversal of 'no bailout', they have deepened the moral hazard risk, with a heightened threat of future financial instability.

A technocratic vision of Europe muddling ahead is economically and politically dangerous. The economics is wrong because the governance and financial sticking plasters tend to come unstuck while the sores fester. Uncertainty persists, the trust in institutions decays, and growth prospects are hurt. The politics is wrong because the costs of each initiative are understated and the surprise deepens resentments. With time, for many, the sense of economic and political dependency becomes more entrenched. In the absence of a legitimate discourse, shrill and nationalistic voices gain ground.

The simple truth is that all crucial decisions that require common funding are being pushed back. No progress has been achieved on enlarging the EU budget; instead, there is pressure to scale it down. Similarly, finessing the overall budget limitation by changing the label to 'banking union' presumes that governments will be willing to commit fiscal resources to a common pool if the funds are designated for maintaining banking stability. But that presumption has found no traction either. On whether the ESM can 'directly' recapitalise banks (without requiring the sovereign to borrow) or on common deposit insurance and bank resolution funds, the decisions have been repeatedly deferred. The profound fiscal surrender required by member states to achieve a credible fiscal union (and a banking union is a fiscal union) will remain a stumbling block not least because the likelihood is high that transfers will be one-directional in the politically-foreseeable future.

Recognising the dangers of the governance and funding gaps, some have warned that the present deceptive economic calm may lull

decision makers into dangerous inaction. The Glienicker Gruppe (2013), for example, have put forward an assessment that is strikingly similar to the one I have outlined, and their warning is stark:

“None of the fundamental problems underlying the euro crisis have been solved – not the banking crisis, nor the sovereign debt crisis, nor the competitiveness crisis. National debt problems continue to escalate. Banks are overloaded with bad loans, crippling the private sector. In the crisis countries, a generation is being deprived of their livelihoods and opportunities. The margins of the political spectrum in these countries are becoming increasingly radicalised. And willingness to find common solutions for the euro area appears to be rapidly on the wane. We – eleven German economists, lawyers and political scientists – cannot accept the prospect of further playing for time and betting – with ever-larger wagers – that the crisis will eventually pass”.

The Glienicker Gruppe calls for far-reaching economic and political integration, achieved through a new ‘Euro Treaty’. Germany has a decisive voice in the future of Europe, and the eleven economists ask that it take the lead. Germans, they say, must recognise that a stronger Europe is good for Germany, and their appeal is to the German public and leadership to move forward with urgency. A bold step such as this may well galvanise action.

A well-functioning fiscal union will, without question, sustain a more stable monetary union. But the history of the past five years bears one lesson: such an outcome – or a reasonable patchwork – is not feasible in a realistic time frame. The German elections have come and gone. The major political parties consciously steered the conversation away from Europe (Mody, 2013c). The post-election coalition negotiations are, at the time of writing, in the process of reaffirming Germany’s position on limiting its financial exposure to Europe (Peel, 2013).

Today, the choice is only between resting stops before a new inspiration regenerates commitment to and goodwill for a more integrated

Europe. The present strategy, viewed sometimes as ‘muddling ahead’, could devolve into a muddle. The alternative resting stop, the one advocated in this paper, transfers fiscal responsibility back to national authorities. Such a decentralised approach disrupts the linear view of the European integration project to initiate a new learning trajectory. The intergovernmental compacts proposed would maintain coherence, but by recognising national governance authority, they would end counterproductive efforts to manage fiscal and financial affairs centrally and create space for the evolution of solidarity.

Importantly, a decentralised approach would allow the critical process of economic adjustment to proceed. For the euro area, the principal economic objective must be to deleverage. Sovereigns must have incentives to borrow less and the banking sector must shrink in size. The implication also is that country differences in borrowing costs must be allowed to emerge. Much of the guiding philosophy today – to render sovereign debt risk-free and to reduce differences in private borrowing costs in different countries – recreates the problems that led to the crisis. Under a decentralised process, member states and their banks will either stabilise or renegotiate with their creditors. The system that emerges will be in a stronger position to consider a forward-looking fiscal union and such frills as Eurobonds. The transition will be painful. But the present approach is inclined to push the decisions into the future and rely on the elixir of growth; the risk is that the problems and choices ahead will become ever harder.

Robert Schuman counselled that constructing a federation required a considered investment in solidarity. That process cannot be forced. Centralised surveillance by supranational technocracy, backed by a system of penalties, is scarcely a stepping stone to solidarity. Instead, decentralisation, which recognises the continued primacy of national sovereignty, would diminish the political frustration and loss of control that is fuelling euro-scepticism. A Schuman Compact that extends the ‘Fiscal Compact’ with a ‘Sovereign Debt Compact’ and a ‘Banking Compact’ offers a way out of this impasse. It creates greater pressure for forward movement than the so-called ‘muddling ahead’ approach, which

is stymied by fiscal and governance problems. A decentralised resting stop would provide an opportunity to reset, reflect, and plot the best course toward a more stable, more integrated Europe. Giving Europeans the time and space to choose more Europe would reinforce the core values that have guided integration for more than six decades. Continuing to stumble forward could lead to a debilitating, if not fatal, fall.

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NOTES

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- 2 <http://europa.eu/about-eu/basic-information/symbols/europe-day/schuman-declaration/>.
- 3 To be sure, the euro was linked with the pursuit of peace. German Chancellor Helmut Kohl and French President Francois Mitterand gave the monetary union the political gravitas for moving forward. And Chancellor Kohl famously made the connection between the euro and European peace. But this was no more than a poetic flight of fancy. France, in particular, has repeatedly walked away from moves towards a United States of Europe.
- 4 The IMF's Articles of Agreement require regular (typically annual) discussions with each member country on the country's economic prospects and policies. The report from these discussions is called the Article IV Report. The concept of a report for the group of member countries constituting the euro area was an innovation.
- 5 Emphasis added. The English translation is from <http://www.antehoc.com/2013/06/bundesbank-letter-to-german.html>.
- 6 <http://register.consilium.europa.eu/pdf/en/08/st06/st06655-re07.en08.pdf>.
- 7 <https://mninews.marketnews.com/content/regling-esm-not-able-back-stop-srm-without-treaty-change>, <http://www.irishtimes.com/business/sectors/financial-services/sch%C3%A4uble-pours-cold-water-over-idea-of-esm-relief-for-ireland-1.1561748>
- 8 James [2013] also concludes that more economic decentralisation is needed to reduce the system's rigidities and make it less fragile. He also looks to the United States before the New Deal. But he proposes achieving greater flexibility through enhancing national monetary autonomy. This would imply, for example, allowing national central banks to tailor the policy rate and collateral requirements for liquidity provision to their domestic economic conditions. Eichengreen [1992] has warned that such autonomy exercised by regional Federal Reserve Banks in the United States weakened the central banks' stabilisation function and undermined the Federal Reserve Board. Undermining the ECB, which remains a respected institution, would have far-reaching consequences.

- 9 Alesina and Perotti (2004) propose that the Commission act as a 'think-tank', akin to the OECD.
- 10 Even the IMF, a 'neutral' agency with no 'skin in the game', largely failed in its surveillance of the euro area, say Pisani-Ferry *et al* (2011).
- 11 For background information on EU economic governance reforms, see http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.
- 12 In Ireland and Spain, national and European institutions have experienced very large but similar-sized loss of trust.
- 13 The principle of imposing losses on bank creditors has belatedly been accepted, but the content and timing of its application remains uncertain. In making the 'bail-in' decision, the announcement says: "*National resolution authorities would also have the power to exclude, or partially exclude, liabilities on a discretionary basis for the following reasons*". The basis for exception includes the ever present threat of "*contagion*"; http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/eco_fin/137627.pdf. The ECB and the European Commission, in the meantime, are engaged on a debate on the application of these rules, <http://www.bloomberg.com/news/2013-10-20/draghi-challenges-eu-bank-aid-rules-over-forced-losses.html>.
- 14 Such convertible debt (cocos) contracts are being implemented for banks to replenish capital when their capital is running low. Calomiris and Herring (2013) recommend that the trigger for conversion should be a market price. In the sovereign 'cocos' context, this could imply, for example, an extension of debt repayment maturity when the 90-day moving average of the ratio of the market value of debt to its face value falls to the 25th percentile of the distribution of this ratio in the past five years.
- 15 See Alesina, Angeloni, and Schuknecht (2002) for a discussion of appropriate decentralisation in Europe.
- 16 Formally, the Fiscal Compact is the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, http://www.consilium.europa.eu/media/1478399/07_-_tscg.en12.pdf.
- 17 The Czech Republic and the United Kingdom did not sign the Fiscal Compact. Croatia acceded to the EU subsequent to the signing of the Fiscal Compact.

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A SCHUMAN COMPACT FOR THE EURO AREA

by
Ashoka Mody

Although it has been put forward as an ultimate antidote to the crisis, a European fiscal union with the necessary financial buffers has been repeatedly deferred with no realistic prospect of a political consensus. This should not be a surprise. The euro area has run into a fundamental barrier. The next step to a conventionally-complete monetary union requires the surrender of national fiscal sovereignty – and, hence, of political sovereignty – to achieve an effective federation.

A realistic alternative would be to seek to make decentralisation more robust rather than wish it away. The task for the euro area is to leverage sovereign authority where it exists: at the national level. A model would be a monetary union that resembles the United States before the Great Depression. This by no means implies giving up the goal of an ‘ever-closer Union’ but it does mean a redirection. To succeed, this more decentralised approach requires a ‘Schuman Compact’, a set of compacts through which EU member states voluntarily adopt standards to conduct their own surveillance and operations on enforcement of sovereign debt restructuring and a banking compact. The urgent task of bank resolution would be an ideal test case. Such experimental steps would create real forward motion and also foster, as Robert Schuman said in his iconic declaration, a “*de-facto solidarity*”.

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