

The fiscal pillar of the Eurozone:
Analysis of the alternatives for the
completion of the economic and
monetary union



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20th April, 2018

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Abstract

The aim of this work has been to analyze the alternatives that the euro area has with respect to the completion of the economic and monetary union (EMU), and more specifically with regards to the fiscal pillar. For the purpose to be fulfilled, a research in this topic has been performed so as to identify the possible solutions to the fiscal union of the euro area and select, among those, different approaches to the same problem. Therefore, the paper intends to identify pros and cons from the chosen alternatives in relation to the current context of the European Union (EU).

With regards to the prospects of a possible fiscal union there is plenty of information and studies performed by economists from all around the world. Thus, one of the main challenges has been to select solutions from all the information available and try to come up with a concise and summarized paper that is able to reflect the current challenge that the EU is facing; as well as the diversity of feasible solutions that can be implemented. As a result, the paper intends to provide with a clearer picture of the needs of the EU and the options it has. The alternatives for the completion of the fiscal pillar have been obtained from a variety of sources, ranging from institutional EU sources to specialized articles. The objective has been to offer a simplified explanation of each alternative in order to provide for a clear image of the solutions and its implications.

The first chapter of the work consists on the basic concepts related to an EMU in order to introduce the reader with the topic that is further developed. The focus of this work is on the fiscal pillar of the EMU, thus, the attention is with regards to this topic. This chapter also describes the legal framework of the EU with regards to fiscal rules, as well as the available tools the EU had, previous to the crisis of 2008, but also after the crisis, in order to coordinate national fiscal policies and provide for macroeconomic stabilization. This chapter was included in the work because it was considered necessary, before analyzing possible reforms or new mechanisms to be implemented, to know which is the starting point of the EU, what are the elements with which the EU has been able to act until the date.

The second chapter of the work is focused on identifying some of the design failures of the EU, more specifically the euro area, that specially affect the completion of the fiscal pillar. This chapter helps to identify the main design failures, or the non foreseen vulnerabilities, the EMU had from the beginning that have supposed a barrier for further integration. Not only that, aside from being a limitation for a more integrated union, these vulnerabilities have brought the euro area in a deeper recession. The recognition of such divergences across the Eurozone countries also helps to understand the resistance towards the implementation of some of the alternatives to solve the fiscal pillar issue, as major convergence needs to be realized first.

Lastly, the third chapter of the work analyzes the possible alternatives to move towards a more coordinated or even an integrated, fiscal policy. The research on the topic has revealed different manners to address this issue, more or less intervening. The work tries to reflect this by choosing three alternatives from less to more intervening, or from less to more integration, in order to show that there are several options available and feasible, and that the first steps to take do not require major sacrifices.

1. What is an economic and monetary union?

1.1 Basic concepts

A monetary union is a group of states sharing a single currency. Strictly, it means a complete abandonment of regional or separate national currencies and full centralization of monetary authority.

The fiscal union entails fiscal federalism among its members which could be either sub national political units or states. It is based on a cooperative arrangement between the members of the fiscal union regarding the design and distribution of taxes and public expenditures.

The Economic and Monetary union was born in 1992 in Europe. The EMU does not apply the same for all the EU member states, the 28 member states are part of the economic union, but only 19 of them have adopted the same currency, the euro. The implications of the EMU are the following:

- Coordination of economic policy making between member states (this applies to the 28 EU member states)
- Coordination of fiscal policies: imposing limitations on government debt
- An independent monetary policy run by the European Central Bank (only affecting Euro area member states)
- Single rules and supervision of financial institutions (within the euro area)
- Same currency for euro area member states

Source: European Commission

1.1.1 The EMU governance

The policy orientations are set by the European Council whilst the Council of the EU is in charge of coordinating policymaking (of all EU member states). The Eurogroup is in charge of coordinating the policies that affect the Eurozone member states, whilst the European central bank sets the monetary policy and is the main supervisor of financial institutions of the euro area. The European Commission is in charge of monitoring the performance of member states and their compliance with the rules set. The European Parliament formulates legislation with the Council. Lastly, member states have the responsibility to provide with national budgets that comply with the rules set by the EU and determine their own fiscal policies and structural policies.

Source: European Commission

Following this governance scheme member states design their own fiscal policy (following the rules in the treaties), taxes that are collected at a national level are used to finance the EU budget, through member states' contributions. The EU budget, "the federal budget" is around 1% of member states' incomes (this is much smaller than for example, the size of a federal budget of a typical federal country).

The European monetary union consists thus, on independent national fiscal authorities and one single central bank. The problem with this system is that, the funding of common public goods it's made at a EU level, but not all member states of the EU are members of the Eurozone. This means that decisions affecting Eurozone members, sharing the same currency, are taken at a EU level which may lead to sub optimal decisions. The EU budget cannot be used to provide financial stability for the Eurozone members for example, nor as a tool to fight against euro area wide shocks in a collective manner.

A fiscal union serves as a mechanism to respond collectively to crisis for example. In the case of federations such as the US or Canada the federal government is in charge of macroeconomic stabilization, federal budget has the function of stabilizing both idiosyncratic shocks and symmetric shocks. While idiosyncratic shocks are economic shocks affecting specifically one state, symmetric shocks are those that affect all state countries and thus can be more easily addressed. In the case of the Eurozone this is not possible, macroeconomic stabilization remains a function of individual member states which allows them to respond to idiosyncratic shocks whilst the ECB is in charge of aggregate shocks. This mechanism might seem optimal, considering that the EU is not a federation and thus there is no federal government as such, or an institution with similar powers, but in reality it has not worked effectively. Countries sharing the same currency need to be able to respond to collective shocks with monetary and fiscal policy adjustments and this was not provided for the Eurozone when it was first established.

1.1.2 EMU objectives

One of the main objectives of the EMU through the ECB is to implement effective monetary policy for the Eurozone, its main objective is price stability. The ECB is in charge of controlling the supply of euro to influence interest rates and exchange rates. The ECB is also in charge of realizing the monetary policy for the euro area member states, whereas for the rest of EU member states coordination of monetary policies is encouraged to strengthen the European single market in order to favor trade.

The EMU and the single currency not only bring economic stability, they also provide for a more effective single market, favoring the free movement of goods, services, capital and labor. The single currency has implications for the banking system, bank deposits of euro area member states should provide for the same levels of confidence because they share the same currency, this is why the supervision mechanisms settled for the banking system as well as other common tools are so important. Another important issue related to banks that needs to be addressed, and is important to highlight, is the tendency of banks to hold sovereign debt from their domestic country. This was one of the causes of the financial crisis in the EU.

1.2 EMU original tools and reactions to the crisis

In 1992 with the signature of the Maastricht treaty the euro was first introduced as the common currency for the EU. The euro was introduced as a common project for European countries, UE constructors had in mind a fully integrated EU and the euro was the biggest representation of such an integration. Five years later the Stability and Growth Pact was born,

with a common currency the coordination of fiscal and economic policies was crucial in order to enforce the rules introduced by the Maastricht treaty, limit to the government deficit of a 3 % and limit public debt level to a 60% of GDP. The SGP was amended by EU lawmakers, after the Commission took the Council to court because of the refusal of the Council to sanction France and Germany for not complying with the SGP rules. The amendment recognized the need of introducing some flexibility, individual circumstances must be better considered.

So far these were the tools that the EMU had to coordinate fiscal and economic policies within the Euro area. When the crisis of 2008 hit the Eurozone the EU reacted with reforms to the already existing tools and by creating new tools that would provide with the needed stability. From the EU reaction it is easily inferred that the designing of the EMU tools for managing coordination of economic and fiscal policies was not enough to address the crisis.

Two years after the official start of the crisis, in 2010, the first European semester was settled, with the aim of integrating and organizing the monitoring and coordination of fiscal and economic policies and in order to organize the Commission's policy recommendations (which are not binding for member states).

In 2011 further changes are introduced, the SGP is reformed with the introduction of six new laws, and the Macroeconomic Imbalances Procedure was created because it was necessary to avoid that macroeconomic imbalances in one country externalize and damage the rest of its colleagues. Just a year after the *Four Presidents' Report* was issued, it called for the completion of the EMU, therefore recognizing its first design was incomplete. The focus is on enhancing economic governance of the EMU and establishing a banking union through the adoption of the Single Supervisory mechanism. The same year the Treaty on Stability, Coordination and Governance introduces the fiscal compact.

In 2013 a further amendment to the SGP is made, introducing the Two pack with the aim to harmonize the realization of national budgets. The European Commission, in 2015, launched a package of measures, which entailed the revision of the European Semester approach, the creation of national competitiveness boards and the European Fiscal Board, and other steps to complete the banking union. The same year the *Five Presidents' Report* proposes the completion of the Economic union, the Financial union, the Fiscal union and the Political union.

The EU has been able to implement a set of tools after the crisis that has been useful to prevent a deep downturn. Although this is true, the fact is that the current settings would not be enough, this is why in Chapter 3 of this work some alternatives would be provided in order to address the fact that the Eurozone does not have an effective mechanism to perform euro area wide fiscal stimulus. Until the moment, the reforms to the current EMU have been focused on coordination of fiscal policies and this is the maximum level achieved with regards to what could be considered a fiscal union.

In the following paragraphs the current tools would be further explained in order to better understand which are the options of the EU in terms of fiscal policies coordination or centralization.

1.2.1 The Stability and Growth Pact

The Stability and Growth pact was the first tool created to address the coordination of national fiscal policies. It consists of two sets of measures: the preventive arm and the corrective arm. Under the preventive arm countries must comply with medium term budgetary objectives (MTOs) or prove that they head towards the objective by adjusting budgetary positions at a rate of 0,5 % of GDP per years. MTOs take into account the situation of each member state in order to ensure that debt levels are sustainable, it also considers the economic situation, so whenever there is a boom, countries would be required to do more so as to have more flexibility when economic conditions are worse and thus be able to slightly deviate from the budgetary objectives. Another rule under this arm of the SGP is the expenditure benchmark, this rule complements the MTOs, when a country spending increases by more of its potential economic growth rate it must complement it with additional revenue measures in order to match the spending (this rule is one of the rules introduced by the Six Pack reform in 2011). Moreover, Euro area countries must inform on how would they reach the MTOs in stability programs, these are later assessed by the European Semester and the Commission. Lastly, the Significant Deviation Procedure, which would be applied to a country deviation from the MTOs to avoid opening an Excessive Debt Procedure.

Under the corrective arm, the excessive debt procedure might be activated, it can be found in article 126 of the Maastricht Treaty. When a member state breaches or is in risk of breaching the 3% of GDP deficit limit, or when it violates the debt level rule (60% level of debt/ GDP limit) the Excessive debt procedure is activated. It might happen that a country breaches the numerical limitations but because the assessment of other relevant factors the procedure is not activated. The Two Pack reform of the SGP in 2013 introduced more monitoring of euro area member states under this procedure. Member states are required to submit more frequent information on the corrective actions to the Commission and the Council. They are also required to report regularly, every 3 or 6 months so that it is easier to detect deviations from the corrective measures or failure to comply with the deadlines. When this risk is recognized, the Commission issues a recommendation to the member state to take further actions. Another reform introduced by these rules is that member states under this procedure need to draft economic partnership programs. These programs include a set of structural reforms that would help in order for the actions to be taken under the excessive debt procedure are effective and most importantly last in time. When a member state does not comply, it may receive revised recommendations with new timelines to address the excessive debt, it might also receive a sanction, usually a fine amounting to a 0,2 % of GDP. If a country continues to non comply, the fine would be incorporated a variable component or it would be imposed every year until effective action is taken. In order to impose actions, a qualified majority of member states is needed to reject a Commission proposal for a Council decision. When the excessive debt is corrected in a manner that is considered appropriate, the deposits are returned to member states.

The current SGP has introduced room for flexibility. The EU realized that setting strict fiscal rules alone was not realistic and did not induce to national fiscal discipline. Member states in an Economic and Monetary Union know that what they do generates externalities to their colleagues but when they implement national fiscal policy they do not consider the effects on the Eurozone fiscal stance or on other member states. At the same time, they might try to

profit from the adjustment efforts of other member states so that they do not have to follow very strict rules or perform unpopular reforms. The main objective of the SGP however, has always been to ensure that member states comply with the rules and maintain sustainable debt levels. Maybe this focus on deficit and debt level rules has been the weakness of this set of rules and the flexibility implemented has not been enough.

1.2.2 The European Semester

The European Semester was introduced as a response to the crisis of 2008, it was introduced in 2010 with the aim to coordinate economic policies throughout the EU. The goals of the European Semester are to ensure sound public finances (avoid excessive government debt), preventing excessive macroeconomic imbalances in the EU supporting, structural reforms and boosting investment.

The mechanism starts in November when the Commission presents the guidelines for the following year. The next phase is the analysis phase, performed by the Commission in which a report for each member state is issued addressing economic and social policies. During the months of March and April, EU countries submit national reform programmes and stability/convergence programmes. During May and July each member state receives tailored economic and budgetary policy recommendations, which are incorporated in their reform plans and national budgets for the following year.

The autumn package is composed of the Annual Growth Survey, the Alert Mechanism Report, the Euro area recommendation, the employment guidelines and the joint employment report.

All the mechanisms in the European Semester are intended to set economic and social priorities for the EU. Guidance is provided by the EU to member states in order to strengthen recovery and to improve convergence in line with the long term growth strategy Europe 2020. There are also alert mechanisms in order to prevent imbalances in some member states' economies and to ensure that the Commission takes action in the countries more vulnerable to such imbalances.

This is one of the instruments that was introduced in the EU after the crisis and that has helped EU institutions to further control fiscal policies of member states and to provide more stability but at the same time it has proven not to be enough, as some member states do not always apply effectively the economic recommendations.

1.2.3 The European Financial Stability Facility

The EFSF was created in 2010 as a temporary crisis resolution mechanism for euro area member states. The assistance was financed through the issuance of EFSF bonds and other debt instruments on capital markets. It does not provide financial assistance anymore since the European Stability mechanism was created (see 1.2.7). The EFSF however, still performs other functions, it receives loan repayments from beneficiary countries from the financial assistance of the ESM, it makes interest and principal payments to the holders of EFSF bonds, and it is in charge of refinancing outstanding EFSF bonds because the maturity of the loans

that were provided to Ireland, Portugal and Greece (from 2010 to 2012) is longer than the maturity of the bonds issued by the EFSF.

The role of the EFSF is to provide for financial stability for euro area countries together with the ESM which is the one currently in charge for the provision of financial assistance.

Source: European Stability Mechanism

This instrument was a rapid response by the euro area member states. Greece, Portugal and Ireland used the EFSF in order to address their lack of liquidity due to their difficulties to access capital markets given the high risk premiums that had to be paid. Spain nearly required this financial assistance because of the same reason too. This first mechanism was a temporary solution because three years after the mechanism was further developed into the ESM in order to respond to the need of a collective safeguard system for the euro area.

1.2.4 Macroeconomic Imbalances Procedure

This procedure was introduced in 2011 in order to closely follow budgetary policies of EU member states, in order to detect, prevent and correct macroeconomic imbalances that might put at risk the correct functioning of the EMU. The European Commission identifies under this procedure the countries that may represent a disequilibrium for the EMU and in the base of that realizes an exhaustive exam. The examination of the member states in question considers all the necessary indicators to perform a good assessment of the countries' situation.

This mechanism pretends to avoid situations such as the one with Greece for example. From past experience, like Greece joining the euro without complying with the necessary requisites, the EU is aware of the need to harmonize macroeconomic measurement, use harmonized methodologies and improve the data quality. This procedure, in the absence of a common Statistical tool for the Eurozone, intends to overcome this barrier and recognize ex ante macroeconomic indicators signaling an unsustainable situation or a possible future downturn.

1.2.5 Treaty on Stability, Coordination and Governance in the EMU

The Treaty was established in 2012 with the aim of completing the economic pillar of the EMU. The set of rules that the treaty includes intend to foster budgetary discipline through the fiscal compact and to improve the coordination of economic policies and the governance of the Euro area. The fiscal compact introduced a mandatory balanced budget rule, member states part of the treaty committed themselves to introduce into their legislation a fiscal rule for which the government budget should be balanced or in surplus (balanced budget if it complies with the MTOs). It states that countries which are not close to the MTOs should take actions towards convergence under a time frame previously set by the Commission. Deviations from the MTOs are allowed under exceptional circumstances. The fiscal rules must be transposed into national law. The fiscal compact strengthens the excessive debt procedure; it increases the automaticity of the procedure by member states committing to support Commissions' proposals to the Council for breaches of deficit limits. It also establishes the benchmark for government debt reduction at the same level as the SGP, 60% of GDP. Lastly, it asks member states to report ex ante on their public debt issuance plans.

The Fiscal compact was introduced to strengthen fiscal discipline in the euro area, by committing to include the rules in internal legislation, member states are binding themselves to this rules. Again, this mechanism is an ex ante preventive measure to avoid unsustainable debt levels, and to provide the EU with tools to recognize a possible failure in a faster manner. But it does not introduce any new tool to perform any collective fiscal action or to strengthen fiscal policies coordination.

1.2.6 Commission package of measures (2015)

In 2015 the European Commission decided to implement a package of measures to start taking steps to implement stage 1 of the *Five Presidents' Report*. The commission proposed the creation of National competitiveness boards which would be in charge of controlling the performance and policies of member states with regards to competitiveness. Also the creation of the European fiscal board, an independent entity that would have an advisory function, it would evaluate the implementation of the EU fiscal framework, advise on the appropriate fiscal stance of the whole euro area, cooperate with national fiscal councils of member states and provide ad hoc advice on request of the President. The board would be composed by independent experts.

From the one hand the establishment of the competitiveness boards was another preventive mechanism to allow the EU to have a mechanism of preventive action, by recognizing the situation of each state and addressing deviations before they become unsustainable. From the other hand, the establishment of a European Fiscal Board is the first tool the EU has to strengthen coordination among member states, it is also a major step towards more integration because is the only tool that considers a collective fiscal stance of the whole euro area.

1.2.7 European Stability Mechanism

This mechanism operates since 2012 for the euro area. The ESM provides for financial assistance with the aim of achieving financial stability. The ESM raises funds issuing capital market instruments and engaging in money market transactions, has a diversified funding strategy, issuing bills, bonds or other funding instruments with maturities up to 45 years. The funds raised are pooled, so that they are not attributed to any particular country. So the financing of the ESM does not come from taxes of Eurozone citizens. Its maximum lending capacity is of 500 billion euros.

The ESM can either provide loans to member states experiencing financial distress, purchase bonds of an ESM member state in primary and secondary debt markets, it can provide for precautionary financial assistance through a credit line (the Precautionary Conditioned Credit Line and the Enhanced Conditions Credit Line), it can provide loans to euro member states to recapitalize financial institutions or recapitalize financial institutions directly under some conditions. When financial assistance of any form is provided the member state receiving it has to implement policy conditions that are specified in the Memorandum of Understanding (made by the European Commission, the ECB, the IMF and the Member state in question).

Financial assistance to member states is provided at a lower cost than in the financial markets, when a country beneficiates from the assistance it only pays the cost of funding of the ESM (the issue of bonds and bills) plus small fees in order to cover operational costs, and a margin reflecting the risk profile of financial assistance instruments.

A part of the ESM capital, the paid in capital, cannot be used to provide financial assistance, it is used to invest in high quality assets, and support the creditworthiness of the ESM as an issuer (this is important because it allows the ESM to borrow at a low price and thus financial assistance provided to member states is provided at a low cost too).

The ESM is governed by the Euro area finance ministers (the Euro group) and each of them appoints one director.

Source: European stability mechanism

This mechanism has been useful during the crisis and after for euro area countries that lost access to market because of the high cost of borrowing they had to face. After the crisis countries like Greece or Spain experienced a substantial increase in their risk premium because financial markets feared that they were going to default because of high levels of accumulated debt that were seen as unsustainable, to compensate for the risk of buying Spanish government bonds, financial markets asked for higher returns. This in turn aggravated the situation of Spain because their indebtedness increased even more endangering the financial sustainability of the country. In situations like that, the ESM is a useful tool because it allows member states to borrow at a lower cost than the one being demanded in financial markets. In the case of Spain, the ESM was used to recapitalize banks, with a disbursement of 41,3 billion euros, the loan from the ESM served to cope with the liquidity problems that banks had in Spain in 2012.

The problem with this tool is that its mandate is to act when there are liquidity problems but not in solvency crisis (as it would undermine the strength of the tool and affect its creditworthiness), and it is not always so easy to differentiate. Another, drawback is that the financial assistance is not provided straightforward, it requires unanimity by the board of governors, in some cases, there are countries that have to approve the provision of financial assistance in their national parliaments, this causes the mechanism to be slow.

1.3 Completing the EMU: The Five Presidents' Report and the Reflection paper on the deepening of the economic and monetary union

1.3.1 The Five Presidents' Report

Since the first effects of the crisis became evident the EU realized of the need of completing the EMU. For this reason, several papers were issued by EU institutions and EU governors to establish the guidelines for the future of the EU, a more integrated monetary and economic union.

The Five Presidents' Report was launched in 2015, by the presidents of the EU institutions, it stated that progress must happen because the EMU was not complete and it could not continue lacking from a real economic union (essential for the correct functioning of the

monetary union), a financial union that increased the risk sharing with the private sector, moving towards a fiscal union and lastly a political union to provide with legitimacy. The report stated that it was necessary to move from a system of rules and guidelines for national policies towards a sovereignty sharing system. It also established the steps to follow in order to initiate the process and orientation for long term reforms.

The four unions reinforce each other and allow for the completion of the EMU. The report divided the process of completion in two stages:

- First stage from July 2015 to June 2017: with regards to the fiscal union, which is the matter of study of this work, the report established the creation of a new advisory European Fiscal Board. The Board was created in 2015 by the Commission, the report proposed that the EFB would provide at a European level for public and independent assessment of national budgets and their execution. It would assess if national governments are complying with the objectives and recommendations set by the fiscal framework of the EU. The EFB would lead to better compliance with the fiscal rules, a more informed public debate and a stronger coordination of national fiscal policies. The advice of the EFB would support the Commission's decision in the context of the European Semester. It is also important to highlight from this first stage, for the purpose of this work, that it also called with regards to the economic union to increase convergence with regards to employment and social performance, and with the euro area system of competitiveness authorities (also established in the package of measures of the Commission in 2015).
- Second stage, starting from 2017 and to be finished before 2025: includes the formalization of the convergence process, make it more binding. With regards to the fiscal union, it called for the creation of a macroeconomic stabilization function for the euro area. In order to access such a system, it would be required convergence towards similarly resilient national economic structures. With regards to institutional strengthening it established that the ESM should be integrated in the EU law framework, and the set up of a euro area treasury.

The presidents of EU institutions would be in charge of following the progression in each of the steps, and in 2017, the Commission would help with the transition to one step to another by issuing the White Paper. The report put emphasis on the fact that the process of completion of the EMU should begin without delay, recognizing the need of strengthening the EMU now in order to be able to be a strong economy and address future crises without being deeply hit.

Going deeply into the fiscal union steps the report stated that fiscal policies are essential for the monetary union. National fiscal policies can affect price stability and financial stability of the euro area and can generate contagion effects. National fiscal policies have to, from the one hand, maintain sustainable levels of public debt and, from the other hand, ensure that there are automatic stabilizers that would address a country specific shock. The sum of all national fiscal policies represent the fiscal stance of the euro area, it is important that the fiscal stance is the appropriate to avoid pro cyclical fiscal policies. National fiscal stabilizers were not enough in the recent crisis to achieve economic stabilization; this is why in the long term the Eurozone should have a fiscal stabilization function. This would require as a pre step more economic convergence and further pooling of decision making on national budgets. The report

established that the design of such a stabilization function required expert in depth research during stage one of the process and also the guiding principles for such an instrument:

- It should not lead to permanent transfers between member states, or transfers in one direction, and not be regarded as an equalization of incomes between member states.
- It should not undermine incentives to perform sustainable fiscal policies at a national level or the incentives to perform structural reforms were needed in order to foster economic convergence.
- It should be created so as to be consistent with the EU fiscal framework.
- It should not be an instrument for crisis management, the ESM already does that. The role of a European stabilization function should be to strengthen the economic resilience of the EMU and of euro area countries.

From my point of view, the Five Presidents' Report is not a vague document, on the contrary, it recognizes the needs of the EMU, establishes what does it need to be completed and even a timeline to do so. The fact that it also emphasizes the need of rapid action and the need of convergence (as a process that should start now) shows that the EU institutions are aware of the weaknesses of the current union and of the fact that it cannot afford to address a future crisis with the current setting. It is also true that it calls for a political union, that I regard as far from the present, but it is true that the creation of a fiscal stabilization capacity would not be possible if convergence is not first achieved.

1.3.2 White paper on the future of Europe

The European Commission launched in March 2017 the White Paper that the Five Presidents' Report established that would serve as a transition from stage 1 to stage 2 of the process of completion of the EMU.

This document includes general information of the EU, of the EU position in the world and what the creation of the EU and the EMU meant in the first place, emphasizing solidarity among member states and the creation of a democratic and strong economic union able to compete with the great nations in the world.

It presents five possible scenarios in which the EU could find itself in 2025 depending on EU jointly choices. The main objective of this paper was thus to generate debate and open discussion throughout the EU.

In the first scenario the EU would not implement major reforms but it would collectively make progress, by making joint decisions in all the current areas in which the EU has sovereignty. In this context the EU would try to make efforts to make progress on the single market, the functioning of the monetary union and ensuring stability of public finances.

The second scenario considers the possibility of the EU focused only in the single market. This would reduce the collective action of the EU, and it might put at risk the single currency.

The third scenario considers the possibility of countries coordinating on specific issues depending on their interests. Some would be coordinated with regards to taxation, others with regards to justice or to defense, in order to allow further progress in those areas they are interested in.

The fourth scenario would be that the EU decides to focus in a number of areas given the available resources. In this areas actions would be taken more rapidly and effectively. But some other areas will no longer be under the EU agenda.

The last scenario envisaged is that member states decide to share more power, more resources and more decision making. So cooperation will go further in every domain.

This paper intended to open a debate on what should the choices of the EU be. It emphasizes on the efforts that have already been made since the EU started as a much simpler project than it is today. It emphasizes solidarity between member states and the uniqueness of the EU project.

I believe that one major problem of the EU after the crisis has been the raise of Euroscepticism. Coping with it is important because it puts in danger the progress that the EU could make towards a more resilient EMU. This paper tries to highlight the advantages that the EU bring to citizens across the whole area, even to those that are only part of the Schengen area, to call for the European identity that seems to have blurred during the past years.

1.3.3 Reflection paper on the deepening of the economic and monetary union

The reflection paper was launched by the Commission in May 2017. It is part of the debate the Commission wanted to initiate after the launch of the White Paper.

With regards to the fiscal pillar it establishes that there is lack of economic and social convergence, which would be necessary to adopt measures more effectively. It proposes that the member states agree on a common approach with regards to convergence, it suggests that they could strengthen the elements already available such as the coordination of economic policies (the coordination should be still established through the European Semester, and it should be reinforced in order to be a tool towards convergence) and the use of financing tools and the enhancement of the macroeconomic stabilization capacity for the euro. The EU single market can also be used to deepen in its advantages and foster convergence.

It also makes reference to the conditions for the creation of a Fiscal stabilization function proposed by the *Five Presidents' Report*. According to the reflection paper the Commission would study the options for the creation of such a function and would incentivize its debate and implementation, with a deadline set for the 2025.

The options included for the stabilization function are the following:

- a European regime for the protection of investments: when a country finds itself in a situation of recession public investments decrease, with this mechanism the investments would be protected. Investment projects affect growth, employment and productivity so if these are protected the crisis could be addressed at a faster pace.
- Unemployment insurance scheme: it would be a re insurance of the national unemployment regimes. This would support national budgets in times of recession and it would support a more rapid recover from the crisis. But previously it would require labor market convergence.
- A European fund for exceptional situations: it would accumulate funds regularly that would be applied discretionally for a addressing a severe situation. The payments would be strictly limited to the accumulated contributions so in case of a severe shock

the funds might be too small. If the fund were to be able to borrow, this limitation could be overcome. If this were the case, the design would establish periods of clear saving in certain moments and a limitation of its indebtedness capacity.

- A Eurozone budget: it would cover stabilization but also convergence functions, it would require a stable flow of capital. It could be a long term objective, taking into account the relation with the EU budget, if the number of euro area participants increases.

Some of the options considered in the reflection paper would be further developed later in this work. With this document the Commission states clearly that the way to move forward is to establish a common mechanism for macroeconomic stabilization, it does not develop further a coordination of fiscal policies alone because it considers it would not be enough in the long run to make the EMU resilient to shocks.

Why is it important to highlight this paper?

The EU has already considered which would be the best solution for the completion of the fiscal union in the context of the EMU. The problem it encounters is that the EU is not prepared to implement the proposed mechanism of fiscal stabilization. In the reflection paper of the Commission some of the options are defined, some of them have been already debated, but again, they cannot be implemented without previous steps. The previous steps require more unity, and unity comes with political will. After the crisis the political will towards more EU convergence seems to be more vulnerable than ever before, member states have realized that they have structural differences that are difficult to address but they have also realized that they need each other in order to make the euro a strong currency and the whole EU a strong economy.

2. Roots of the Eurozone crisis

This chapter will examine how the initial vulnerabilities of the EU and its institutional system have proved to be one of the causes to a deeper crisis and a harder recovery across the EU and more specifically across the Eurozone. The aspects related to the banking sector and the need of financial integration would not be a matter to consider in this work, as the focus is on the fiscal weaknesses that make the EMU ineffective.

It is true that EU institutions responded to the crisis but the response has to be considered as a way of buying time in order to implement reforms with a durable effect.

Before the crisis hit the euro area there already existed divergences both macroeconomic and competitiveness that were ignored, they were not considered relevant for the purpose of a monetary union. It was thought that macroeconomic imbalances within a member state would be automatically corrected and would not affect the whole Eurozone, whilst in fact, the crisis shown that macroeconomic imbalances of a member state in a monetary union cause negative externalities on the rest. Which implies that only fiscal surveillance is not enough and a strong coordination mechanism at a supranational level is needed to control macroeconomic imbalances in a monetary union.

The crisis also revealed that the fiscal rules established in the Stability and Growth Pact do not ensure that national authorities pursue sound fiscal policies, in fact, the contrary was revealed, member states did not take into account the negative externalities that their national fiscal policies would have on the monetary union. When the crisis hit member states, they faced a period of recession, in that context they had to perform restrictive fiscal policies, this means pro cyclical fiscal policies. When a pro cyclical fiscal policy is performed, it implies that the policy enlarges the effects of the economic cycle, when there is a recession it aggravates it and when there is a boom it enlarges it. To avoid a deeper crisis, the Eurozone lacks of a mechanism to manage aggregate demand and provide counter cyclical fiscal policies in order to recover faster from a recession period. Monetary policy, performed by the ECB, is the only instrument that can be used to perform policies at a Eurozone level, but in the current context of zero bound on interest rates, the effects of the monetary policy were insufficient. Which aggravates the fact of not having any tool to perform a coordinated fiscal expansion.

Another weakness identified after the crisis is the lack of a euro area mechanism that is able to provide financial support. It does not exist in the context of a monetary union a proper mechanism of risk sharing, there was no automatic stabilization mechanism that helped the Eurozone cope with the crisis. The euro area was not able either to prevent any contagion effect, in an integrated market with a common currency, the risk of contagion should have been foreseen and the proper tools should have been set in order to prevent the effects of negative externalities from member states to the rest of the euro area participants.

The financial sector played a major role in the crisis, it has become too big, which implies that member states are not able to deal with it with the resources they have. One of the causes of the crisis was the bank-sovereign loop (which means that banks were holding in their asset side of the balance sheet an important proportion of sovereign debt of their national country) in a situation of crisis, this fact aggravates the consequences, if there is currency risk (even in a monetary union can happen, it happened in Greece) there is no instrument for a member state to act and avoid the deposit runs because it can not control monetary policy. If a country had an important accumulation of debt it was exposed to debt runs, because with high levels of accumulated debt and a context of crisis sovereigns suffered a loss of access to the capital markets due to market expectations that raised the risk premium they had to pay, which in turn would imply the activation of the bank-sovereign loop. Thus, a liquidity crisis could lead easily to an insolvency crisis for both the sovereign and the banks. This implies that the Eurozone did not have any tool that provided common fiscal resources to address systemic banking crisis or sovereign debt runs (Tabellini, 2015).

In fact, it has been already recognized by EU institutions and national authorities that the economic and monetary union was not complete. Because of that, it was not able to address the crisis successfully, and even in some cases it was aggravated.

(Peret Praet, 2013).

2.1 Divergences in the Eurozone

When the EMU was implemented a process of convergence among euro area member states started, this process was stopped when the crisis hit the EU and has not been re activated. The objective of convergence was established in the Maastricht Treaty, in article 2 which defines the convergence of economic performance as a task of the EU. The founders of the

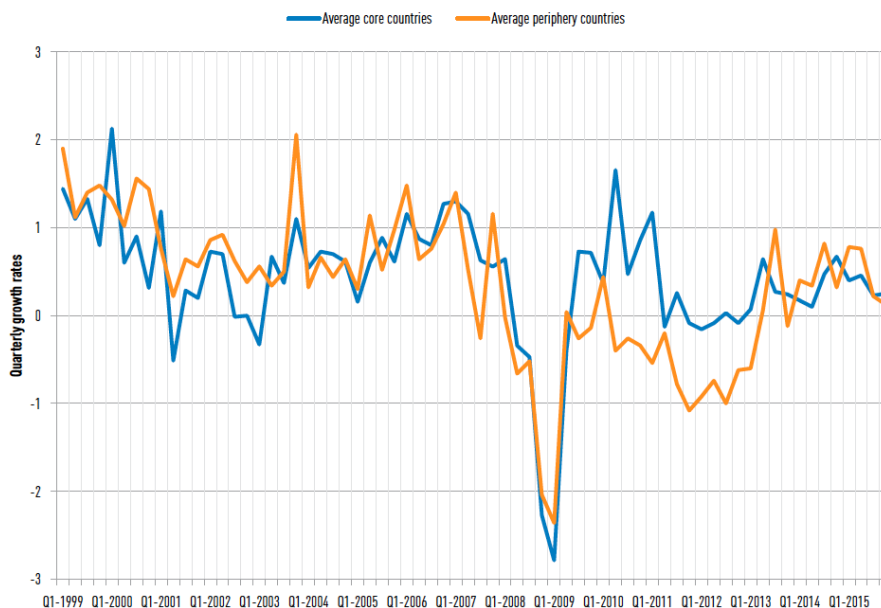
EMU thought that if exchange rate risk was eliminated through the introduction of a common currency and the free movement of goods, services, capital and labor were allowed, the cross border resource allocation would help to incentivize economic growth and would lead to income levels convergence.

However, the current situation is not the same as the one before the introduction of the common currency, the differences among member states are now greater and also the attitude towards more integration has changed, specially in the northern countries of the EU that do not believe that the countries in the south would be able to or willing to implement strict policies to move towards convergence.

In the following sub sections, it would be analyzed how the divergences across the euro area have aggravated the crisis and are the roots of an uncomplete EMU. It is important to understand these divergences for the purpose of choosing what should be the next steps for the EU with regards to the completion of the economic and monetary union.

The main argument that support the fact that the EMU was created on the grounds of a poorly designed union is that the EMU is not an optimal currency area. When member states sharing the same currency are in divergent situations, one is facing a boom the other is facing a recession, which leads to different account balances, members of an optimal currency area would perform structural reforms to make their labor and product markets more flexible. The fact that there has not been business cycle convergence after the introduction of the euro implies that the established framework of rules by the EU has failed in accomplishing the objective and also that in such scenario, having one single monetary policy would only potentiate recessions and booms. If flexibility was introduced, in order to attain business cycle convergence, the asymmetric shocks would be more easily addressed and the EMU would be a proper optimal currency area. The problem is that making labor markets more flexible implies performing unpopular reforms which implies that citizens would choose the party that promises not to perform that adjustments. The result is that real GDP growth in the Eurozone has been lower than in the rest of the EU or even than in the US and the unemployment rate has been higher. So the EMU has failed to provide the promised economic growth and high employment rates.

Figure 1: Quarterly growth rates in core and periphery countries of the euro area



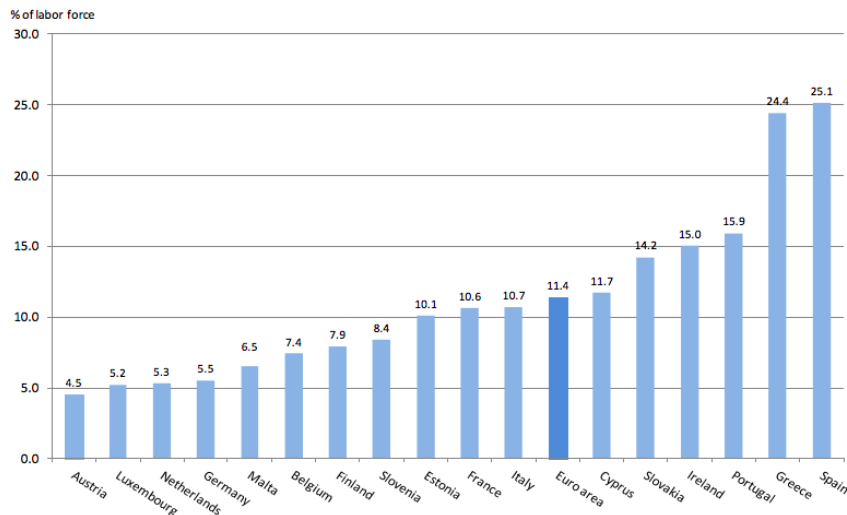
Source: Jacques Delors Institut, 2016

The figure above is an example of the divergences of the business cycle across the euro area. And how it can be divided in core (Austria, Belgium, Finland, France, Germany, Luxemburg and Netherlands) and periphery (Greece, Ireland, Italy, Portugal and Spain). At the beginning of the euro the core countries had lower growth rates than the periphery, at mid 2000s, there was a slight synchronization, but then again, the divergence dominated the panorama (Brinke, Enderlein and Haas, 2016).

2.1.1 Labor market

During the first years after the introduction of the euro it could be identified a convergence process among euro area unemployment rate until the crisis period that the process of convergence stopped. The consequence could be the differences in the unit labor costs and salaries that have caused a different evolution in competitiveness measures and have affected unemployment rates since 2007. At an aggregate level, the unemployment rate had increased four percentage points in 2012 compared to 2008, but looking individually at each country there are very significant differences in the unemployment rates. Although currently the differences are not as significant as in 2012 it is still the case that the range of unemployment rates is around 15 or 20 percentage points. The explanation for these differences are related to the fact that there is low labor mobility inside the euro area and it does not exist a fiscal union that allows for risk sharing (Estrada, Galí, López-Salido, 2012).

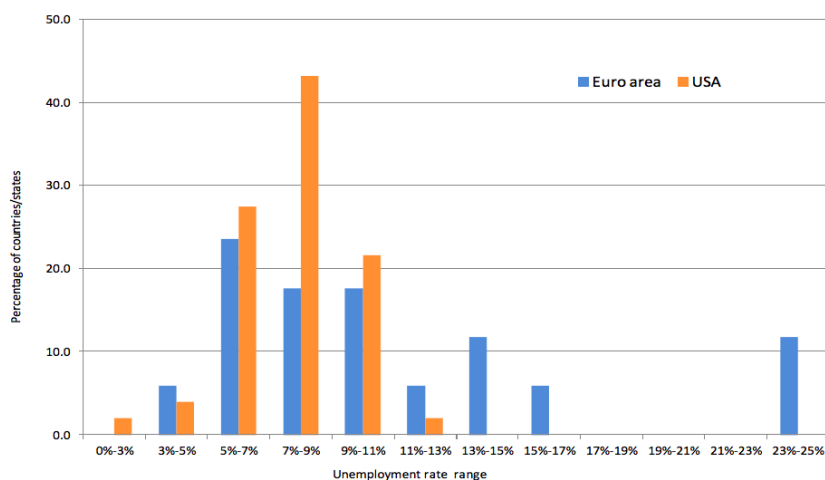
Figure 2: Unemployment rates Eurozone, August 2012



Source: Eurostat

If we compare the euro area with a proper optimal currency area like the US, we can see that the dispersion of unemployment rates among the states is not as high as in the EU, as Figure 3 shows. This is because the US has the needed mechanisms to face the unbalances that may occur. The divergences across euro area member states are related to the fact that they lost control of monetary policy, which means that a country cannot devaluate, which is useful in order to confront asymmetric shocks. Euro area participants lost the control of monetary policy when euro was implemented, control was given to the ECB, which is in charge of controlling price stability above all, but no mechanism was established that could substitute a devaluation. If the EMU were a real optimal currency area labor mobility would allow to produce greater convergence because labor would flow from countries facing difficult situations to ones experiencing less distress, but this is not the case for the euro area.

Figure 3: Dispersion in the unemployment rates within euro area countries and US (2012)



Source: <https://www.imf.org/external/np/res/seminars/2012/arc/pdf/ELS.pdf>

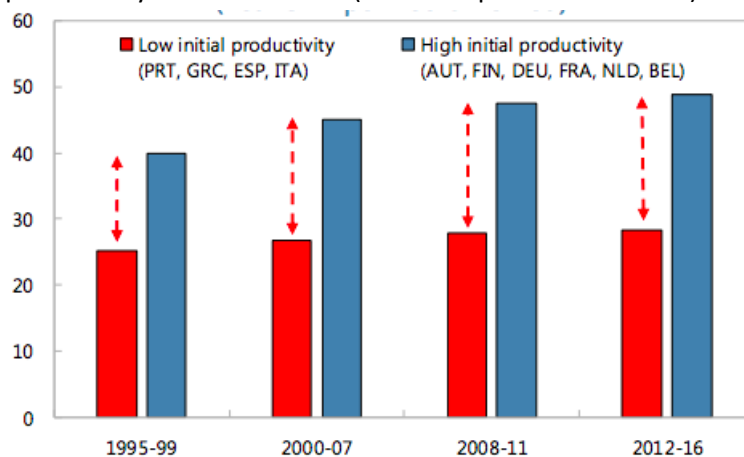
The divergences in unemployment rates are relevant to this work because they are related to the differences in the institutional framework of the labor market across the Eurozone. As said before the optimal solution would be to introduce more flexibility into labor markets, although that is politically very difficult. Moreover, as it would be further explained in section 3, there are significant structural differences in labor markets across the euro area and this have to be addressed before implementing any risk sharing or stabilization mechanism.

2.1.2 Divergences in economic performance

After the global crisis countries in the EU have experienced productivity losses, but not only that, the productivity differentials have been relevant in the euro area. They are not new to the crisis but after the crisis they have become more evident.

Labor productivity within the Eurozone has not converged, in fact it has been permanently divergent throughout the years and they are present at the sectoral level. The gaps are not as big in the service sector than in the manufacturing sector but still they are constant.

Figure 4: Labor productivity in the Euro area (Real GDP per hours worked)



Source: IMF (2017)

Differences in productivity result in differences of the level of real income (which was one of the objectives set by the Maastricht treaty for the creation of the EMU).

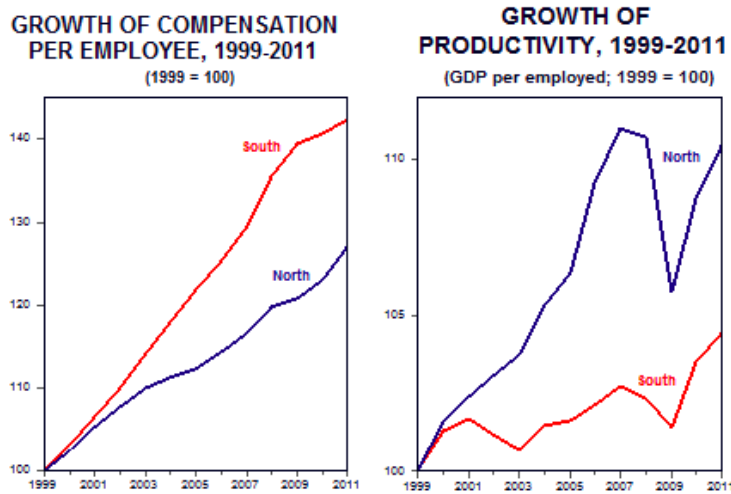
Competitiveness

Another issue that affects the overall Eurozone performance is that inflation rates are different across the euro area and this can provoke differences in competitiveness and economic growth. The problem is that when euro area countries adopted the euro they gave up national monetary policy, so in the case they face a situation of domestic inflation or loss of competitiveness they cannot longer use monetary policy to restore their position. One of the main indicators of competitiveness is the unit labor costs.

Unit labor costs increased when the euro was introduced at different rates across the EU. Whilst in some countries the ULC increased at a consistent pace (mostly in periphery countries) in others they decreased or stayed the same (core countries). Unit labor costs vary depending on the wage growth and on the productivity growth. If ULC increase it can be explained either

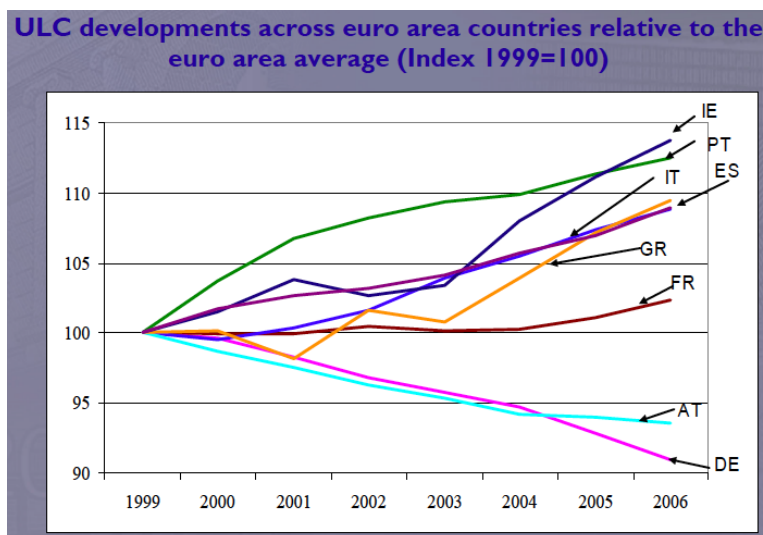
by a wage growth or by a low productivity growth. In fact, the largest part of the differences between ULC growth in the euro area are explained by the compensation per employee or by modest productivity gains (most of them are related to employee's compensations) (see Figure 5).

Figure 5: Growth of compensation per employee and growth of productivity (1999-2011, period after the euro was introduced)



Source: <https://voxeu.org/article/problems-eurozone>

Figure 6: Persistent ULC developments in the euro area (period before the crisis)



Source: ECB

Another observation from the decade after the introduction of the euro is that looking into sectors, the industrial sector (tradable products) cumulated a lower ULC growth than the service sector, whilst the growth in compensation per employee has been similar for the industrial and the service sector. So the growth in ULC in the service sector may have been related to low productivity, which may lead to conclude that the service sector was less exposed to international competition than the industrial sector (ECB, 2007).

The loss of competitiveness affected the current account position of member states, in fact, those that faced a loss of competitiveness because of the growth of ULC were the ones that had current accounts deficit.

The European Commission estimated that the southern intra Eurozone real exchange rate may have appreciated by a 25% relative to the north, because of the above mentioned growth of ULC in the southern countries. The way to close the gap is through an important decrease of wages in the south of Europe, by an internal devaluation, but in the current context of fiscal strictness and low growth it is difficult to implement. It would imply that in a country like Spain with high unemployment rate wages would have to be cut for years, demand would be weakened and inequality would increase (Brinke, Enderlein and Haas, 2016).

The result is that in some countries since 2000 there have been persistent current account deficits (like in Spain) whilst in others there have been current account surpluses since 2000 (like Germany), with no tool to readdress the situation and realize transfers from north to south, that would be the case of a proper fiscal union. After the introduction of the euro, the countries that faced the lowest price levels at the beginning faced a rise of the inflation rate due to the process of convergence that lead to an increase of the unitary labor costs, countries with deficit accounts faced rises of the costs whilst surplus countries had stable unitary labor costs (IMF, 2017).

Thus, divergences in competitiveness increased after the introduction of the euro because of the price convergence effects, and when the crisis hit the euro area these divergences were already in place, which means that they aggravated even more the recession. The ECB as an independent institution and a mandate focused on price stability was not able to address the asymmetries in member states with regards to competitiveness. These are still there, and they are a matter to be addressed before the establishment of a stability mechanism for the euro

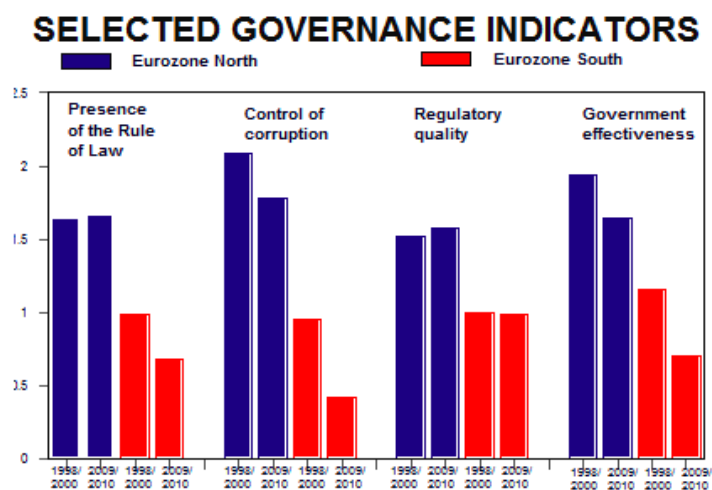
area, northern member states would not be willing to realize transfers to the south in order to converge. It is even more difficult to do so after the crisis because of the rise of Euroscepticism and the loss of the solidarity concept that help to shape the EMU in the first place.

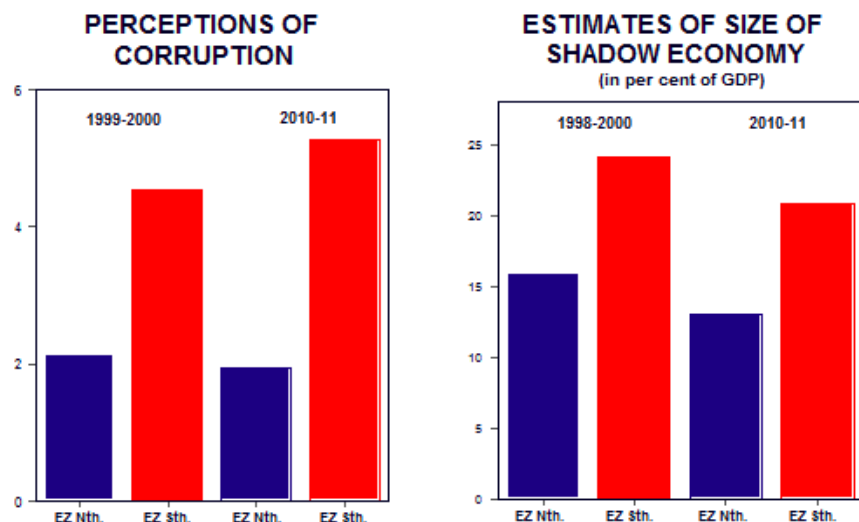
2.1.3 Governance

Before the introduction of the euro the differences in governance were already known, but instead of being reduced, they have increased. For example, if we take a measure of perceptions of corruption and efforts to control it, we would see that during the last decade the levels of both have increased in southern Europe. As observed in Figure 5, the differences between the north (Germany, Benelux, Austria and Finland) and the south (Italy, Spain, Greece, Portugal and Ireland) of the euro zone are substantial. The differences are not only related to corruption perception or control, it has also to do with the rule of law, the efficiency of the public institutions, the regulatory quality and the shadow economy. It is easy to infer from this that in this context divergence is greater than it may seem because it is related with culture, with the roots of each country and the past of its citizens.

Governance is the most difficult variable of convergence to change. It is a reality that culture among the EU is not the same, it should not be intended to be so because each country has its own identity and diversity is one of the factors that makes the EU a great project. It is also one of the founding values of the EU, but what about the European identity? This has not been so much developed, not in the older generations and not even with the youth generation which is the future of Europe. Strengthening the European identity could be a solution with regards to the governance divergence that exists and keeps growing in the euro area.

Figure 7: Governance indicators





Source: <https://voxeu.org/article/problems-eurozone>

Differences in behavior

When the EU was created or the euro was adopted, it was already obvious that countries were different. Their culture, society and background make them different and thus it could be already expected that they would have divergent behaviors. The problem is when these behaviors lead to euro area disequilibrium and put at risk the euro survival. How national fiscal policies have been performed is an example of how these different behaviors affect the well being of the whole Eurozone.

For example, from the nineties on, there was a decline in long term interest rates. Thus, it was an opportunity to reduce government debt. But whilst in the north of Europe they took advantage of this and reduce the level of public debt, in the south the opposite happened, because they took advantage of low long term interest rates to be less fiscally prudent. So instead of reducing debt levels they increased their debt to GDP ratio (Boltho and Carlin, 2012). Thus, if euro area member states are left with freedom to perform national fiscal policies, the result would be very different across the euro area. The consequences are easy to identify, if countries sharing a same currency behave in a very different way, no common stabilization for the zone can be established. This means that the mandate of the ECB becomes more difficult to be successfully applied and that the establishment of rules without any other tool of effective coordination or fiscal enforcement will result in a similar scenario than the one faced with the sovereign debt crisis in the euro area. Northern countries enjoying better fiscal positions coping with the consequences of the behavior of their colleagues and the vulnerability of the euro. However, the fact that they behave differently does not mean that north countries always comply with the fiscal rules established by the EU or that they always come up with the best policies. The issue to be highlighted in the above paragraphs is that they usually behave differently which results in disequilibrium and difficulties to attain a stabilized position as a currency union when this happens.

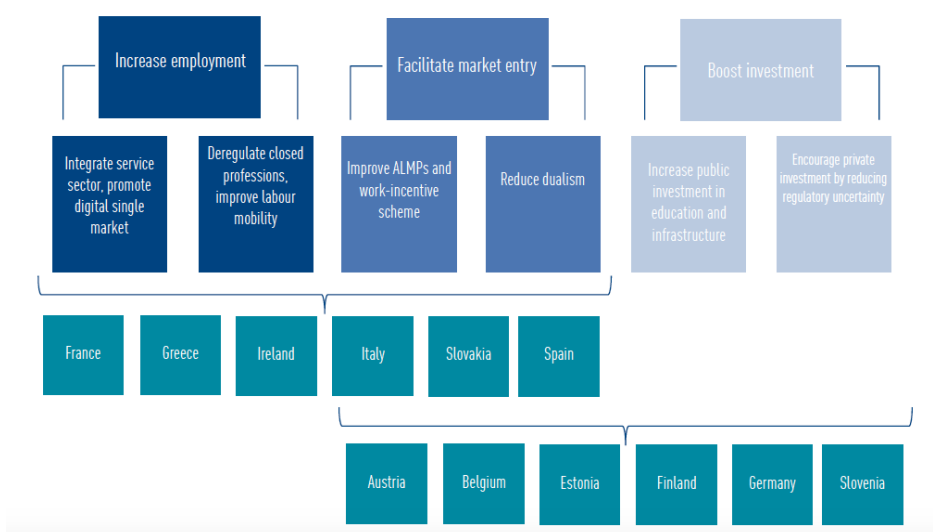
This fact is related with the need of the euro area countries to attain cyclical convergence. Which means that economic cycles are the same across Eurozone members. This is needed for

the correct functioning of the euro. The ECB is in charge of the monetary policy and it bases its decisions on the overall economic performance of the euro area and not on individual cases.

2.2 Business cycle convergence

From the above analysis it can be clearly inferred the need for cyclical convergence in the euro area. The costs of convergence will not be easy to bear but they are necessary for the correct functioning of the EMU.

Figure 8: Structural reform priorities for cyclical convergence in the euro area



Source: Jacques Delors Institut, 2016

There are some structural reforms that have to be prioritized to attain cyclical convergence for the euro area, the ones that are specified in Figure 8. As explained above, the divergence in competitiveness across the Eurozone is an issue to be addressed. The authors suggest that this could be addressed by lowering the barriers to entry to the service sector, which accounts for the 70% of EU GDP but only the 20% is traded across borders, this causes euro area economies to be isolated from each other and with a tendency towards cyclical divergence. Aside from deregulating the service sector, they propose single digital market in order to spread business models that would support the opening of new sectors of the economy that are not possible now because of the competitiveness fact (Brinke, Enderlein and Haas, 2016).

After reforming the product market, the authors suggest a reform of the labor market. As explained above the differences in labor markets, specially with regards to protection, contribute to the divergence of business cycles. The increase of labor market flexibility across the euro area is needed in order to enhance internal adjustments within the euro area. It would support the stabilization of the euro area by allowing for labor mobility (Brinke, Enderlein and Haas, 2016).

The last step of reforms would be to incentivize investment. It is suggested that if there is a lack of private investment is because there is uncertainty in the market with regards to the regulation, and thus, this suggests that the regulation should be modified. Reforms leading to more certainty in the regulatory aspects of several sectors, specially those that have a higher impact on the euro area economies. The second aspect is with regards to private and public

investments, both financing the same project, these are beneficial because of the specific knowledge provided for the project. The potential benefits from these partnerships have to be recognized and thus, greater efforts to perform this type of investments should be considered. Lastly, there are euro area countries that have managed to have a fiscal space after the crisis, these should use it to renew their capital stock and increase the human capital in order to attain a durable recovery and to have potential prospects of growth (Brinke, Enderlein and Haas, 2016).

These are some suggestions to solve the cyclical divergence of euro area member states. Member states may agree to establish these reforms or other ones, but the idea to retain from this is that in order to attain business cycle convergence and thus being able to further integrate and implement more ambitious fiscal mechanism, the Eurozone would have to perform structural reforms. These would be harder for some countries than for others, but the outcome would be a stronger Eurozone able to overcome future crises and to become a greater economic actor in the international sphere.

3. Alternatives to the EU economic and monetary completion

In section 3 I would present three alternatives to perform the completion of the EMU. The first one is the less intervening, it would leave more room to sovereign powers and it could be implemented without major reforms, the second one is a mix between a non union and a complete union that may allow to construct the basis for a future integration and require further changes in the current institutional setting, and the last one would be the implications of a more complete fiscal union.

From the research performed I might conclude that there is consensus among experts in the sense that something has to change. There is broad consensus on the fact that the design of the EMU was not complete and therefore it was not prepared to overcome successfully a crisis like the global crisis that hit the EU in 2008. However, because of the rapid response by EU institutions the EMU has been able to recover from the crisis, however it can be considered a patch to the problem but not a definite solution because the measures were not implemented thinking in the long term.

The three alternatives have aspects in common because of the identification of reforms to be made and what needs to be improved:

- In the first place there is no effective mechanism of risk sharing in the euro area, moreover, the euro area is not able to address local shocks with any tool. Whilst for example the US, Canada or Germany are able to address the 80% compared to the Eurozone that is able to address a 40%. Monetary policy is the only tool at the Eurozone level but addressing asymmetric shocks is not its focus as it is handled by the ECB and it has to consider the situation of the whole Eurozone and no individual considerations when deciding on monetary policy. Neither a fiscal insurance, there are federations like the US or Canada (even Germany) that are able to address a portion of

local shocks through an insurance scheme. For example, Germany can address a 10% whilst the US a 15% or Canada a 25%. The last sense in which the Eurozone lacks of a risk sharing mechanism is related to the role of capital markets and its low participation in fostering risk sharing (because of factors related to the banking sector that are not a purpose of this work) (IMF, 2014). Therefore, experts agree on the fact that actions have to be taken in order to accomplish an effective risk sharing mechanism in the Eurozone.

- Debt restructuring in order to avoid insolvency risk. Legacy debt is one of the main issues with regards to the Eurozone fragility, it makes member states holding legacy debt considerably more vulnerable and compromises the capacity of the Eurozone to respond to future shocks. Moreover, the sole existence of legacy debt compromises the possible adjustments that are suggested in order to increase risk sharing among countries or other reforms more inclined towards more integration, in the scenario of a crisis or some kind of sudden shock member states would have diverse probabilities to subsist (Beck, 2016). Thus, a form to deal with legacy debt would be provided in each of the alternatives presented as all the authors consider that it is a source of vulnerability for the whole Eurozone and a barrier towards performing more reforms because the situation of euro area participants in this regard is very different.
- Raise of populism and Euroscepticism. The inability of the EU and more concretely the Eurozone to manage the crisis, the inability to recover EU growth and to provide equal opportunities along the EU have proven to raise separatism feelings. The EU cannot stand doing nothing in front of this challenge, the opposite should happen. If the EU is able to demonstrate that a future containing further integration would lead us to the best outcomes both in social and economic terms, it would manage to stop the raise of populism and Euroscepticism around the EU. It is clear that the EU is suffering from an identity crisis and the steps to be taken towards addressing fiscal issues are also related to this identity and the need to feed it properly (Beck, 2017 and Underhill, 2017). The fiscal regime implemented until the moment has generated tensions among member states particularly between the so-called “South” states and the “North” states. Whilst the former have a tendency to regard adjustments from Brussels as a management of national policies that tend to generate social and economic harm, the “North” countries consider that the EU is being too flexible with the “South” and it is not complying with its main role, being the guardian of the treaties (Zetterlmeyer, 2017). This issue is not specifically addressed in any of the alternatives below because these are focused on the fiscal solutions for the Eurozone, however most of the authors (not to say all of them) have mentioned at some point of their studies the worrying aspect of the growing reluctance to the EU, and the lack of identity feeling among its citizens. So it is an aspect to take into account if any of the below reforms are put into practice.

3.1 The non establishment of a fiscal union: towards coordination and effective surveillance

The first proposal is abandoning the idea of a proper fiscal union. There have been debates and intentions to complete a fiscal union but all the initiatives have failed primarily because of

the reluctance of member states to delegate further sovereignty to the EU. Member states have already given up monetary policy so it is difficult to imagine a scenario in which they give up fiscal policy too.

Another reason to reinforce the argument of abandoning the idea of creating a fiscal union is that the existing tools in order to address the centralization of fiscal policies, such as the Six Pack, the Two Pack, the European Semester and the Treaty on Stability, Coordination and Governance in Europe have proven to fail, mainly because of countries' differences (*see section 1*). EU member states have different understandings of fiscal policies, they impose taxes in different ways and with different aims, and the investments they make at national level are also very diverse. This means that the idea of a fiscal union is complicated to conceive, how to centralize fiscal policies if they are tight to culture and customs? The EU does not intend to make cultures across Europe to harmonize and thus the idea of centralizing policies that should be accepted across Europe put the idea of the fiscal union into a vulnerable place (Eichengreen and Wyplosz, 2016).

Moreover, the centralization of a fiscal policy might be regarded wrongfully as the provision of a public good. In this context, the argumentation is that there are contagious macroeconomic effects across borders. When there is financial instability in one of the member states it might spread across the rest of member states. Banks in the rest of states might hold sovereign bonds from the country suffering instability and so the effect is spread. In this sense the centralization of fiscal policy will not bring the major returns expected, if for example the public expenditure of country A increases (deficit) the demand for goods of country B will increase but so it would its prices and its interest rates and thus the first effect is offset. Therefore, the authors suggest that the benefits of a fiscal union might be overrated (Eichengreen and Wyplosz, 2016).

And they might be right, given the evident barriers of a creating a stronger union, and the urgency of taking action because a future crisis won't wait until the Eurozone is ready to address it, maybe the best option is to forget about fiscal union and strengthen what we already have to be able to preserve sovereignty but at the same time save the EMU.

Although not making further steps towards a fiscal union is not enough, they argue that banks should be prohibited from holding too much national sovereign debt in their balance sheets. This together with the no bailout rule, that has been working in the US since the second half of the nineteenth century, will make investors more cautious and will increase market discipline, which in turn will generate incentives for governments to reinforce their fiscal institutions and procedures so as to give a better performance in the market (Eichengreen and Wyplosz, 2016).

Therefore, the starting point is that member states are going to remain responsible for their fiscal policy. In this context the Eurozone needs a reform of the SGP (*see section 1*) in order to ensure that discipline is followed (it has not been the case neither before or after the crisis), national fiscal councils will play a major role and also the European Fiscal Board (Andritzky et al., 2016). The function of fiscal councils and the European Fiscal Board would be to improve the current surveillance mechanism. It is argued that the current system is very complex, this is why some member states do not incorporate the rules, because these are not understood at

all levels. There are different rules and norms with regards to deficit and debts, structural benchmarks, the existence of both the SGP and the TSCG generates a complex system. Moreover, the Commission has introduced since 2015 (*see section 1*) more flexibility to the system with new rules that have made it even more opaque. This results in a system with a lack of both legitimacy and credibility, specially with regards to sanctions (Pisani-Ferry, 2016).

3.1.1 Fiscal national councils and the European fiscal board

What would be the future if we leave sovereign power to member states? Fiscal national councils and the introduction of national competitiveness boards (proposal by the Commission in 2015). Fiscal national councils were introduced with the Two-Pack set of rules that complemented the SPG (*see section 1*), and it established a deadline for its creation, October 2013.

These are public independent institutions that have the objective of reinforcing the compromise to maintain sound public finances. The Two-Pack defines them as a mechanism to monitor the compliance with fiscal rules and determine, by assessing the situation, the need to activate the corrective mechanism established by the Fiscal Compact.

Fiscal councils are not exclusive to the EU, there are many countries around the world like Canada or the USA that have decided to create them. Some of them only focus in fiscal policies others make more in depth economic analysis. The common aspects among them is that they do not have decision power, and it is difficult that they do at some point because of the lack of legitimacy and the lack of consensus with regards to fiscal policy. However, they can correct some of the causes for unsound fiscal policies, like the lack of information. They can complement fiscal policies by acting as watchdogs of fiscal policies and alert if there are incentives to deviate from fiscal rules, and sometimes when fiscal rules prove to be very complex and its exact application in the country does not result in the most optimal policy, the fiscal council can determine if it is sensible to deviate from the policy (Calmfors and Wren-Lewis, 2011).

However, the ECB determined in its monthly bulletin in June 2014, the conditions for the EU established fiscal councils to have an effective and positive impact: being fully independent institutions, with no political interference at all, in order to attain institutional credibility. Having a comprehensive mandate, enough resources to deliver the mandate and a public voice, so as to be able to mobilize public opinion and fight against unsound fiscal policies.

The problem is that not all mandates are the same across the EU. In any case the fiscal council is enabled to prepare macroeconomic or budgetary projections of the member state in question, most of them are just in charge of endorsing them (like is the case of Spain for example). In most EU countries another issue is related to the tasks assigned to these councils, in most cases these have gone beyond the regulation under the Two Pack, these include for example determining long term sustainability of fiscal policy, check the compliance with the rules, assess the economic situation of public enterprises, determine the cost of the policies and the quality of public finances. The assignment of these tasks are only adding more complexity to the system and distract the attention of the fiscal council towards other issues (ECB, 2014).

The other disadvantage of the councils is the manner in which they are created is different across the EU, in order to assure its independence, the members of the council should be

appointed by the parliament and not by the government and they should be experts in the field. Also, some member states have few resources in the terms of expertise, they lack of enough experts with the knowledge and experience.

Along with these disadvantages the ECB emphasizes its effectiveness, if fiscal councils manage to be fully independent public institutions they can be effective because they are able to use their position to influence on public opinion. In some member states, even if the recommendations of the council do not oblige, the government is required to “comply or explain”, so if they do not comply with the recommendations they have to offer public explanations for the reason of the deviations.

The idea in order to use them to improve the current fiscal framework is that national fiscal councils would have their mandate amplified with further competences but concretely specified (Pisani- Ferry, 2016).

Governments in turn would rely more in these councils. Councils would be granted gradually more room of maneuver because they would have more authoritative institutions to act in the framework of the SGP. Member states would have more incentives to follow the discipline because they would be following domestic principles, as these councils would be set at the domestic level and thus they are not seen as an imposition from above. The aim is to balance the need of overall policy consistency at the Eurozone level and the need of adaptation, because each country has its own structure and its own needs. How would the councils work? They would imitate competition authorities and specific regulators of each sector, and work as a network of councils around Europe, they would develop common methodologies among all the councils. It is still discussed the independence from the Commission and of their mandate, but the European Fiscal Board would be the hub of the network (Pisani- Ferry, 2016).

The European Fiscal Board was created as a decision of the Commission, after the Five presidents’ report. It exists since October 2015. The tasks of this Board are to advise the Commission on fiscal matters, evaluate the implementation of EU fiscal rules and cooperate with national fiscal councils. Its relation with national fiscal councils is based on cooperation, exchange best practices and facilitate understanding on EU fiscal regulation. Although in the future it could have a more important role with regards to coordination because it would be the institution in charge of ensuring that national fiscal councils not only consider the national fiscal needs but also the Eurozone fiscal stance.

The creation of national competitiveness boards needs to be considered too. In 2015 the Commission made a recommendation for the creation of these boards, for which the Council agreed upon. The deadline for its creation was 6 months after the approval of the recommendation. They recognize the need of a mechanism to correct macroeconomic disequilibrium in the Eurozone and also to adjust asymmetric shocks, the fact that a deterioration of competitiveness would have an impact on potential growth and on the ability of member states to repay debt (*see section 2*). So a good coordination among euro member states would help to align the competitiveness of the Eurozone with the good functioning of the EMU. National competitiveness boards will be independent institutions formed by experts that would follow the policies implemented in each member state with regards to competitiveness and contribute to foster sound policies at national level and at the same time improve the knowledge on which the economic policies of coordination in the EU are based. They would provide with strategic advice, taking into consideration the particularities of their country. Their vision of competitiveness should be broad, including cost aspects, but also

productivity, skills, attractiveness of the business environment and innovation. The boards would follow up competitiveness evolution of each country, provide with expert information to the member state with regards to wage setting mechanisms, without setting wages or interfering with the role and powers of social partners, they would monitor competitiveness policies and provide assessment, inform member states and the Commission throughout the European semester and be transparent by publishing annual reports. These measures are as well as in the case of national fiscal councils, for euro area members, but the rest of members are also encouraged to create them (European Commission, 2015).

They would have an advisory function but again as in the case of the fiscal councils, they would be able to influence on public opinion, so that their recommendations are heard by member states and have an impact. That is why ensuring their independence is so important. The coordination would be held by the Commission that would be in charge of the contact with them and of the coordination of their points of view.

The mechanism suggested in the last paragraphs would allow to avoid further integration but at the same time the European Fiscal Board, in the case of the national fiscal councils, and the Commission, in the case of the national competitiveness boards, should act as the institution defending the fiscal stance of the whole Eurozone and the institution able to coordinate member states and eliminate the vagueness in which many of the objectives or rules have been set, they would defend the fiscal stance of the Eurozone as a whole. At the same time, the mechanism should allow combine the flexibility that the EU Commission recognized is needed for the system, which implies that fiscal national councils and national competitiveness boards would identify for each member state the optimal fiscal policies in line with the rules but at the same time, in line with the member state's structural fiscal set up and economic context. Also, by giving them more competences than the ones they currently enjoy, as explained above, they would be increase discipline. Instead of only endorsing economic projections with regards to fiscal and competition policies they would be able to prepare these projections so that member states would have to hear what they have to say before implementing the policies, and this would enhance the current system, strengthen discipline and above all coordination.

In the sense that the Commission and the European Fiscal Board would act as the hub in the network of national councils and boards it might be considered an agency similar to the Eurostat in charge of harmonizing the methodology of measuring data with the aim of improving its quality. If such an agency for statistics existed, it would be easier for the hubs of the network to coordinate the councils and to compare the data and economic situation of each member state and thus provide better results.

3.1.2 Reforming the SGP

The other matter concerning the no fiscal union alternative is the reform of the Stability and Growth Pact (SGP). As said before the aim is to reduce the complexity and the vagueness of the current system, which might be the reason for its poor performance until the date. Also, if it is not reformed it might not be able to address successfully a future crisis.

Two reforms are proposed to be undertaken with the aim of maintaining fiscal discipline in good economic times, when member states have a tendency towards accumulating low cost debt, and to avoid that national policies try to undermine the effect of Eurozone level policies.

The reforms would intend to give more flexibility to manage national fiscal policy in the short run but preserve solvency in the medium and long term. The first reform aims at replacing the current methods to identify recessions, because these are too mechanic and error prone, and instead appoint one or several independent bodies of experts in charge of identifying recessions using the methods they consider appropriate (more expertise is the key in order to correct the current methodology). These identification task might be given to either the European Fiscal Board or experts appointed by the Commission but in any case they must be independent and impartial. Once the recession is identified some fiscal rules would be modified in order to allow to increase spending in specific categories, for example unemployment benefits or active labor market policies. This modification might result in an increase in deficit but it would be allowed exceptionally, not under normal circumstances. This reform would introduce the flexibility that the current system does not have and that many member states facing financial distress have claimed for. The second reform would be related to the violations of the deficit and debt limits. Countries performing these violations would be allowed to have a set of policy options (if these policies contribute to more fiscal sustainability). It would include fiscal structural reforms that reduce fiscal responsibilities or that broaden revenue base, also reforms that favor growth and allow for a faster increase in GDP than debt. If the reforms presented by the member state are sufficiently strong (and are proven to be so by independent bodies) then the enlargement of the period of fiscal adjustment would be justified and in some cases the temporary increase of the deficit would be permitted (not under the current SGP). If the reforms (that would be divided in steps and closely monitored) are not met, then the fiscal adjustment would be reversed (Zettelmeyer, 2017). In order for his two reforms of the SGP to succeed, the Commission has to be regarded as a strong independent institution (politically speaking), otherwise the SGP would lack of credibility and it may rise political tensions among member states that may have divergent opinions on how to proceed in each case.

3.1.3 Dealing with legacy debt

Lastly, there is a further concern, what to do with legacy debt? Once there is a fiscal stabilization mechanism set, as proposed above and once fiscal rules are reformed, the EMU would still face large amounts of debt.

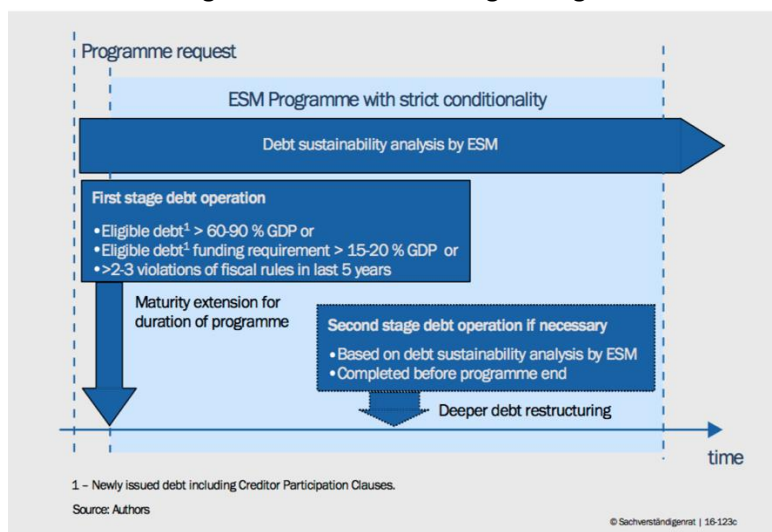
The need of a mechanism to regulate debt restructuring responds to the need of creditors to assess correctly risks and thus demand realistic risk premiums. Also a mechanism like this would impose more discipline to governments with regards to their budgets, and in case of crisis, because the mechanism would be clear and divided by previously agreed phases uncertainty would be reduced. The mechanism would be applied as a part of the ESM, with the purpose of avoiding opportunistic behaviors of member states and make them maintain sustainable fiscal policies.

How would the mechanism work?

In the following paragraphs I would try to explain the proposal by Andritzky, Feld, Schmidt, Schnabel and Wieland, 2016. The mechanism would be implemented through the already existing ESM program. This means that it does not require further political integration or the

creation of any new institution. When a member state requires assistance to the ESM and the assistance is not provided because the assessment of its public debt has determined it is not sustainable (a situation of insolvency), the member state would be required to negotiate a debt restructuring, and its creditors would have to agree to extend eligible debt maturities for the duration of the ESM program. This standstill does not imply debt reductions from the part of creditors, at least not in the first phase, the purpose of debt restructuring is to make access to market durable and that the member state is able to repay ESM assistance. The proposal also considers how the debt sustainability analysis should be performed. It suggests that the ESM should perform the assessment because it would be the first interested to ensure repayment. The decision would imply a two stage system, first, the ESM would decide if it would require creditors to agree to a standstill (as explained before) at the start of the program. In the second stage, during the program, it would be negotiated if the restructuring needs to be deeper (the standstill has to be still in place when a deeper restructuring takes place). This decision system allows to maintain intact the ex ante disciplinary effect.

Figure 9: Mechanism for dealing with debt restructuring through the ESM



Source: <https://voxeu.org/article/mechanism-proposal-eurozone-sovereign-debt-restructuring>

In the first stage of the decision system, the maturity extension would be provided in the case that the debt featuring Creditor Participation Clauses (CPCs) (*explained below) that has been assessed under the mechanism exceeds a range from 60% to 90% of GDP. Currently many member states already exceed the limit established, to solve the legacy issue only debt including new CPCs count towards thresholds. The common anchor for sound fiscal policy, as stated in the SGP and the IMF is around 60%. The need to establish the threshold is also related to ex ante discipline recognized by creditors so that they form clear expectations. The authors consider that it would also be beneficial to include in the requirements not only the threshold but also compliance with fiscal rules. To assess a country capacity to perform fiscal adjustment it would be useful to examine the record of a country under existing fiscal rules. This would incentivize governments to comply with fiscal rules because their past compliance would be taken into account. These measures would have the objective to reduce

threshold effects, that is why they suggest providing limited discretion to policymakers (guided by a technical analysis from the ESM).

In the second stage of the decision, the ESM would decide if the country that has asked for assistance, based on the analysis performed, needs to perform a deeper debt restructuring before the program ends (during the time the standstill is still in place).

The first stage would solve a liquidity problem of a state, whilst the second, requiring more time, would solve a solvency crisis. This represents a major change compared to the current system because the ESM is only able to provide financial assistance in a situation of liquidity but not of insolvency. It also helps to address the issue of the ESM having to recognize in which situation the country requiring the assistance finds itself, because it has already been the case in the past that macroeconomic indicators and data was not as accurate as it should.

These mechanism has one major drawback which is the potential holdouts that might occur due to the standstill agreement by creditors. What could potentially happen is that bondholders (which are very diverse) of government's sovereign debt would try to obtain the best deal possible by negotiating with the state (this happened when Argentina in 2001 did a disordered restructuring of debt). The solution for this are the Collective Action Clauses which is a supermajority amendment mechanism. This implies that bondholders at the time of buying a bond commit on the fact that if the qualified majority of bondholders agree on a restructuring plan that a state submits, the plan would be binding for all of them (Martinelli, 2016). The authors propose to rely on CACs (which they refer to as CPCs) for orderly restructurings and consolidate voting procedures into a single limb (one vote for one bondholder, the new clauses would be called Creditor Participation Clauses. The current system in place in the euro area for CACs require a qualified majority of 75% of bondholders for each bond issues, the single limb proposal aims at avoiding that an investor acquires a blocking majority in small bond issues (which would leave CACs ineffective) and this is likely to happen because of the great number of bonds that are issued. This instrument would allow for one single vote for all the affected instruments, which would eliminate potential blocking minorities. The IMF in October 2014 also proposed the enhancement of the CACs by being able to differentiate among bondholders. The modification would ensure the aggregation across all debt containing CPCs. Other bond reforms would include the pari passu clause modification. The pari passu clause in this context would imply that the debtor, in this case a sovereign government, that had this clause included in old bond contracts, could not give a new creditor better conditions than the ones in the old contracts if these conditions are not recognized to the old creditors (bondholders). It can thus be understood that a clause like this might need to be modified in order to protect the restructuring deal against possible lawsuits of the already bondholders (in the case that old debt is restructured in different terms).

The implementation of the mechanism would be easier than other proposals, it is build on the ESM Treaty that demands private sector involvement to be considered. So the only modification needed would be to amend the ESM guidelines to make the ESM assistance to be provided under the new two stage mechanism.

Over time the mechanism would start to have its results, countries would gradually replace the existing debt with the new debt that include the new CPCs.

The authors emphasize that their proposal would not imply a loss of fiscal discretion in favor of a restructuring mechanism.

All in all, a mechanism like this would increase the credibility of the bail out clause and would allow for an orderly mechanism that could be put into place in a reasonable period of time, which is an advantage compared to other proposals because of the already existing need for member states to reduce legacy debt. It is true that the system requires private sector participation, but the ESM already included the possibility so it is not an impossible reform.

3.1.4 Analyzing the first alternative

This first alternative would be the easier to implement in the short term because it does not require major reforms or collective actions, it is constructed on the basis of already created institutions, which is an advantage if we consider the urgency of providing for euro area solutions.

It would effectively address the need of a strong fiscal coordination mechanism for the euro area, introduce sense of risk sharing among member states, and it would provide with more flexibility with regards to fiscal rules to provide maneuver at the time of addressing country specific shocks. Thus it would serve as a solution to provide for macroeconomic stabilization.

Lastly, it would deal with legacy debt by an orderly restructuring thanks to the introduction of CPCs debt that has a twofold objective setting a framework for effective and orderly debt restructuring and enhancing discipline over national fiscal policy (as the access to the ESM program would depend on ex ante behavior).

Thus, the proposal presented is able to overcome the major challenges that need to be addressed at the euro area. However, it is not evident that the proposal would serve as a durable solution. After all, leaving member states performing fiscal policies alone is risky, even if there is a coordination mechanism set into place. The coordination of fiscal policies might not be enough, specially in times of economic booms or constant good economic situations. The enforcement mechanism might be too weak; it is based on discipline provided by independent councils but sanctions that could be implemented in case of disobedience might not be effective (as has been the case in the last crisis). Also the reform of the SGP rules to allow for more flexibility at times of recession, without the proper control might lead to undesirable outcomes. With regards to the debt restructuring scheme, the advantage would be its rapid implementation, however, in the long term, depending on the future of the ESM program it might not be the best alternative available for the issue of dealing with legacy debt. All in all, the biggest advantage of this package of measures is its ability to meet with the urgency requirements, and the largest drawback might be its lack of durability in the long term.

3.2 Between a coordination mechanism and a future union

This proposal suggests that creating now a common fiscal policy is not viable. It would require constitutional reforms that are hard to accomplish, however more coordination is needed. This alternative is intended to provide the basis for a future fiscal union, the supporters of the creation of a common budget or a common fiscal capacity argue that the Eurozone needs a mechanism that allows for long term sustainability, a Eurozone common budget would provide with this need. The other side of the proposal is related to dealing with legacy debt through the PADRE plan proposal.

3.2.1 A Central Fiscal Capacity for the Eurozone

The ESM is the Eurozone's lending capacity (*see section 1*); the problem with this scheme is that it does not provide for macroeconomic stabilization. In the following paragraphs there is further explanation on why the ESM is not enough for macroeconomic stabilization in the euro area and the proposals related to addressing which mechanism could be established so as to serve as a durable stabilization tool.

The ESM is not enough

First of all, in order to access the assistance programs of the ESM there are several conditions to be met, set by the EU that in most cases imply a loss of sovereignty (*see section 1*). This fact reduces the incentives for member states to ask for help to the ESM as they would likely not be willing to lose more sovereignty in favor of the EU. The other issue is with regards to the perception of member states towards less stable member states after the crisis, the willingness to give assistance through a common instrument might not be appealing for them (Bénassy-Quéré and Giavazzi, 2017). Another fact is that the ESM is regarded by creditors as a mechanism of crisis assistance available for member states which makes them undervalue the risks of lending to member states that are over indebted (Andritzky *et al.*, 2016).

Other issues are related to ESM's governance. In order to activate one of the tools of the ESM to support a member state it is required unanimity (and in some cases prior approval by national parliaments). What does this imply? This means that implementation of the measures may take too long and at the same time it introduces a bit of uncertainty, financial markets do not know for sure if the ESM will support the member state facing distress. Thus, this is a major disadvantage because one of the main objectives of the ESM is to provide with credibility to member states that have lost access to market. Second, its resources. The current lending capacity is of 500 billion euros, which is the equivalent to a 5% of the Eurozone GDP, this amount would not be able to address a systemic crisis. Other issues of reform are related with the role of the ESM. The ESM has faced in the past (2010-2012) some pressures to act and cope with the refinancing of unsustainable debt, due to the lack of clarifying rules related to debt restructuring. This is not the ESM mandate; the ESM was established as a patch to deal with liquidity crises of member states but we cannot forget it is a lending capacity, it does not provide for transfers, and its objective is not to cope with insolvency of member states.

This is why the ESM is unable to provide for an effective macroeconomic stabilization tool and in the following paragraphs the proposals considered in order to create such a mechanism are presented.

The Central Fiscal Capacity

A recent proposal by the IMF considers the creation of a Central Fiscal Capacity (CFC) for the euro area. The CFC proposed by the IMF would have a twofold objective: from the one hand it would act in case of a recession providing for macroeconomic stabilization, and from the other hand it would have a preventive function. The preventive function responds to the fact that

the CFC would be a tool to enhance investors' credibility because of having implemented a tool to deal effectively with future crises. It has been proved that the monetary policy alone is not able to address a crisis, a common fiscal tool would allow to complement monetary policy and avoid pro cyclical policies that in the last crisis led some member states to deeper recessions. The scheme should be automatic to avoid disputes and discretion. If it is not automatic, member states would likely dispute over indicators of the CFC to establish the transfers for example.

Euro area countries would participate in the scheme every year with the objective of building up assets in good times. In times of recession, and conditionally on the deepness of it, member states would receive transfers to offset budget needs of member states. In the context of a crisis and in the case that the funds are not enough, the CFC would be allowed to borrow and the loans that it would commit to would be repaid by member states' future contributions. The main objective would be providing fiscal stabilization, by providing transfers and contributions, revenue fluctuations and cyclical spending would be counterbalanced.

A scheme like this can only be implemented if it is politically feasible so it has to provide the appropriate incentives so that member states want to be part of the CFC; they would take into consideration the opportunity cost of the contributions they would have to make to the scheme. This mechanism would entail moral hazard risks because of the incentives of member states to perform unsound fiscal policies with the prospects of having this tool at the euro area level that would cope with the possible negative consequences. The IMF proposes that member states create medium term fiscal frameworks (MTFFs) that strictly comply with fiscal rules to ensure sustainable fiscal policy at the same time that stability is provided. These MTFFs would be a prerequisite to participate in the scheme and must be consistent with the euro area fiscal rules.

With regards to fiscal rules the IMF suggests a reform of the existing ones to allow for automatic enforcement. According to the IMF, the current fiscal framework is too complex. The complexity makes it difficult to determine when a country does not comply. However, if the rules are simplified the system would become more transparent and thus monitoring would be easier. This would enhance the link between compliance and CFC transfers. There are proposals by the IMF of how to simplify the fiscal rules, focusing on shifting to a single indicator such as debt ratio (focus on debt sustainability), combined with an expenditure growth rule and complemented with a debt correction mechanism to link the expenditure growth rule with the debt ratio anchor. The objective of this reform of the SGP would be to allow for flexibility in times of downturns, when a country is facing a recession it would be using transfers from the CFC in order to maintain the spending that would have been previously set in the medium term fiscal frameworks.

Two concerns would rise with this scheme: permanent transfers and moral hazard.

In order to address moral hazard concerns the IMF proposes that the transfers are conditional on compliance of EU fiscal rules this would provide ex ante incentives to comply, because access to the transfers would depend on past fiscal performance and having taken the appropriate reforms.

In order to address permanent transfers concerns the IMF proposes that the member states that receive net transfers during recessions would have to pay for premiums in good times. So they would make extra contributions based on the usage they have made from the fund and their cyclical position. The indicator that has been suggested to determine the economic situation of a country with regards to recovery is the unemployment rate. It is true that the establishment of the premium has to be carefully set because one of the main objectives of the CFC is to generate fiscal sharing risks and thus this should not be harmed by the imposition of a premium. Another measure to overcome this concern is to limit, from the one hand net cumulative transfers to countries that have increasing structural unemployment (as this would be the indicator proposed by the IMF to determine the transfers), and from the other hand, limit the net cumulative contributions to avoid that a member state becomes a systematically net contributor to the scheme (this implies that the CFC would need to borrow more in order to meet the requirements). The reason justification behind choosing unemployment rate as the trigger to provide transfers is that it is a good measure of the output gap and a harmonized indicator across the Eurozone (IMF, 2018).

The IMF does not include a specific allocation of the funding provided by the transfers as it considers that priorities vary from country to country. If the euro area were to decide to set an allocation for the transfers, such as maintaining public spending during recessions or to finance unemployment benefits it might limit the stabilization function of the CFC and it might also be insufficient for general shocks.

This scheme proposed by the IMF would be beneficial for the euro area because it would provide it with the necessary macroeconomic tool that is lacking now. It would provide the right policy mix between monetary policy and fiscal policy (which is not currently available). The euro area would have an instrument to respond to country specific shocks and also to euro area shocks, with the support of the CFC, member states would be able to perform counter cyclical policies in their countries and at a supranational level the CFC would be used to stimulate expansionary policies at times of systemic shocks. It would also improve fiscal discipline because of the conditionality to participate in the scheme, so countries would have incentives to comply with fiscal rules ex ante in order to access the fund. Lastly, the CFC would help to avoid that a liquidity crisis evolves into an insolvency crisis, by its existence, the CFC will avoid sudden rises in the borrowing costs of member states. The CFC provides with credibility to investors because it is a common system of stabilization backed by all euro area economies.

The IMF proposes three different alternatives regarding the creation of the CFC. The first one is a common unemployment insurance fund (which is included in the last alternative of this work). The second one is the creation of a euro area budget; this idea will be further developed in the following paragraphs by proposals of other authors.

Euro area budget

The common budget would be different from the ESM because it would not be providing loans. The proposal suggests the budget to be financed by an amount of the 2% of the GDP of the Eurozone. There are different proposals to determine the objective of the common budget.

From the one hand, using the common budget as a macroeconomic stabilization tool. The aim of this proposal is to avoid fiscal policies being managed solely by member states who would only take into account their own interest, trying to benefit from the efforts of others. The Eurozone needs to overcome this self interested policies in order to provide for stability at a larger scale. A common budget would be able to do so. Usually federal budgets tend to be larger than the one proposed (a 2 % of Eurozone's GDP) but this has an explanation: they need to provide common public goods. In the case of the Eurozone the public good to be provided would be financial stability. And it would be possible because it would be focused on addressing big shocks and being balanced from cycle to cycle. The focus in big shocks means that in a first phase of its implementation the budget would be established as a tool to support member states during recessions to apply counter cyclical fiscal policies. This would overcome the disadvantages that the IMF poses for this suggestion as it argues that a budget focused on providing common goods (common defense or border protection) will not provide for stabilization.

To consider the the structuration of the budget there are several points to bear in mind. The principle of distributional neutrality which implies no net transfers over certain periods of time. A model like this implies that a member state facing a strong shock during a recession would be receiving net transfers from the budget during a period of time but later on, it would have to compensate so as to balance the transfers that were received. In the long run the net transfers that were received would be zero. Revenues for the budget would come in a first phase from national budgets (as considering a European tax is too unrealistic in the current situation). The key for the system to work would be to link the support from the Eurozone budget to some conditions related to the implementation of certain fiscal policies and to reforms. In relation to the effectiveness of the budget one could argue that it has been the case of counter cyclical fiscal policies that do not deliver the expected results because of forecasting errors. This implies that sometimes discretionary actions are not the best because they require a strong decision making center that uses reliable information and takes the optimal decisions for each state, and that maybe the best option is to implement automatic stabilizers which imply setting ex ante rules to the system. With this mechanism in case of a shock the enforceability is easier (Wolff, 2012).

From the other hand, another proposal is to create a budget used to finance cross border Eurozone level projects, managed by a Eurozone level entity, able to obtain revenues, spend and borrow. This proposal is recognized by the IMF as an alternative to the CFC and it also states that a common budget for the euro area would better provide for macroeconomic stabilization if it is able to borrow because revenues to be paid to the budget would be cyclical. This entity, in order to be politically feasible, would have a budget lower than national ones, it would not be entitled to perform distributive or allocation functions and it would be combined with other mechanisms to reduce risks and improve incentives (Zettelmeyer, 2017).

In the long run, if the funds from such an entity were destined to implement necessary reforms, member states would have more incentives to reform their labor markets (which is a step towards definitive convergence) as the political resistance may be reduced because of the financing by common funds. The common budget would also help the Eurozone to confront future crisis and eventually be the basis for further integration (creation of a European Treasury) (Beck, 2016).

The size of the budget would be like the one of the first proposal, around a 2% of Eurozone's GDP, the author suggested in 2016 that it could be financed with a pre agreed cyclical revenue source like a Eurozone VAT or a Eurozone corporate tax. With regards to spending, this would be controlled by a Eurozone finance minister. The spending of the funds could be agreed upon, by establishing some limits and some guidelines ex ante (the spending should be enough big so as to have a macroeconomic impact). The scheme considers that the funds could be used to realize public investments or to provide national governments with nominally fixed "cheques" that would be set in proportion to national GDPs (so as to avoid permanent transfers). The result would be automatic stabilization, during recessions revenues would be lower than the fixed nominal spending and the opposite would happen during booms.

This scheme includes the possibility of borrowing. The amount that the entity would be allowed to borrow would be limited by rules set ex ante. It would be limited because the revenues assigned to the scheme would be constraining it, with the assigned revenues the debt accumulated would have to be repaid. The advantage of this scheme is that the Eurozone debt accumulation would not be very high because the objective is to be able to perform expansionary policies during recessions, which would imply more Eurozone debts, and maintaining a AAA rating because the asset would be guaranteed by all the Eurozone participants (Zettelmeyer, 2017).

The author (Beck, 2017) proposes a focalization of the spending of the common budget in the European young generation. I found this proposal interesting because it is able to address two issues at the same time. First, the creation of a common fund would imply a risk sharing mechanism, and second the focus on the young generation, which is the future of the Eurozone, would allow to solve populism issues and Euroscepticism. In order to do this, measures incentivizing growth should be taken and at the same time there is need of political courage.

The focus on the young generation is extracted from the fear that there is a lost young generation in the EU that has suffered very hardly the consequences of the crisis. It is true than in some countries more than others, some of them have managed to implement programs, like in the case of Austria or Germany, like vocational training or apprenticeship institutions that have proved to be effective. However, the need to implement more measures has been recognized by the European Commission that in 2013 launched the Youth Guarantee scheme, it relies on successful experiences of some Nordic countries to combine early intervention with activation policies, to improve school to work transition and the labor market outcomes of the youths (Dolado, 2015). These programs and the concerns it generates at EU level justify that the common budget of the Eurozone take into account that for the EU to have a future the young have to feel supported and at the same time be able to access the same (or at least similar opportunities) throughout the EU.

3.2.2 Dealing with debt restructuring

This represents one side of the proposal, the other side includes the issue of debt restructuring and the creation of a collective tool in order to preform the restructurings.

The proposal of a collective restructuring responds to the different situations which member states are facing, there are member states with high and unsustainable debts and other that

hold debts but are far from the unsustainable situation of their colleagues. Also, if countries had to restructure their debt unilaterally, there would be fears of who goes first and who bears first the risks, and thus no one would want to be the first one to act. Moreover, in the case that the restructuring of debt is done in an isolated manner, the negative externalities would not be taken into account by member states. When there is a debt restructuring there are effects for debtholders, which in most cases include banks from other member states, this means that the effect would be spread to other countries that might be facing the losses of the action of the member state doing the restructuring. On the other hand, the collective tool for restructuring debt would take into account these externalities and thus it would be able to assign to the member state facing the restructuring the corresponding losses.

Other advantages of a collective tool include the possibility to agree on a burden sharing, it can be done through transfers, and officials in member states might be able to agree on the share instead of being imposed by an external and foreign authority.

The last argumentation in favor of the collective tool is the reduction of moral hazard actions. The collective tool would give guarantees to member states to avoid unilateral and independent actions of debt restructuring that might generate negative externalities.

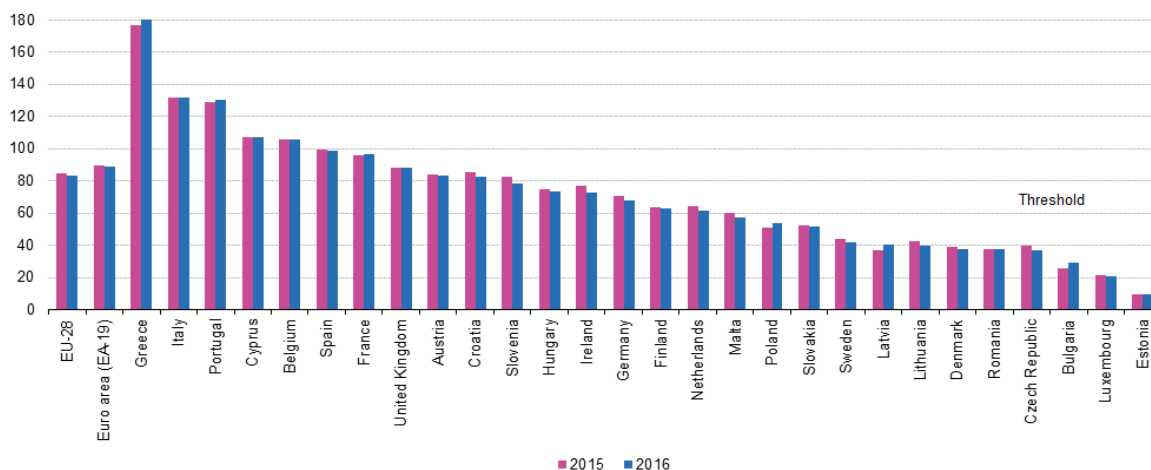
Debt restructuring: the PADRE proposal

The Politically Acceptable Debt Restructuring in the Eurozone was first proposed by Pâris and Wyplosz in 2014. Why do authors agree on the necessity of debt to be restructured?

First of all, they argue that it is not a novelty in history. In the past there have been successful stories of debt restructuring. They argue that in the case that governments default instead of making a debt restructuring consequences would be worse because the costs of the default would be dealt mainly by debt holders. So they consider that not restructuring debt may lead to a scenario of costs that is not desirable.

Another reason is to restructure debt concerns the benefits from sovereign indebtedness. They argue that whilst it is desirable to have a certain level of debt, because it serves for profitable investments that turn out in economic growth, when the level of debt surpasses a certain limit it does not generate economic growth anymore, on the contrary it limits economic growth of the country holding excessive debt. This would imply the existence of a debt threshold, for which at a certain level of debt instead of incentivizing economic growth the opposite effect is generated. In this sense we can observe in a graphic from Eurostat the level of debt across the EU which shows the General government debt for 2015 and 2016, Figure 8. In this graphic the threshold is considered to be between the 60% and 80% of debt as a percentage of GDP. We can observe that there is a considerable number of countries in the EU with levels of debt substantially higher, among them, Spain. This would mean that these countries have unsustainable levels of debt, and that their public spending instead of fostering growth is having the contrary effect.

Figure 10: General government consolidated gross debt, % of GDP, 2015 vs 2016



Source: *Eurostat*. http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_finance_statistics

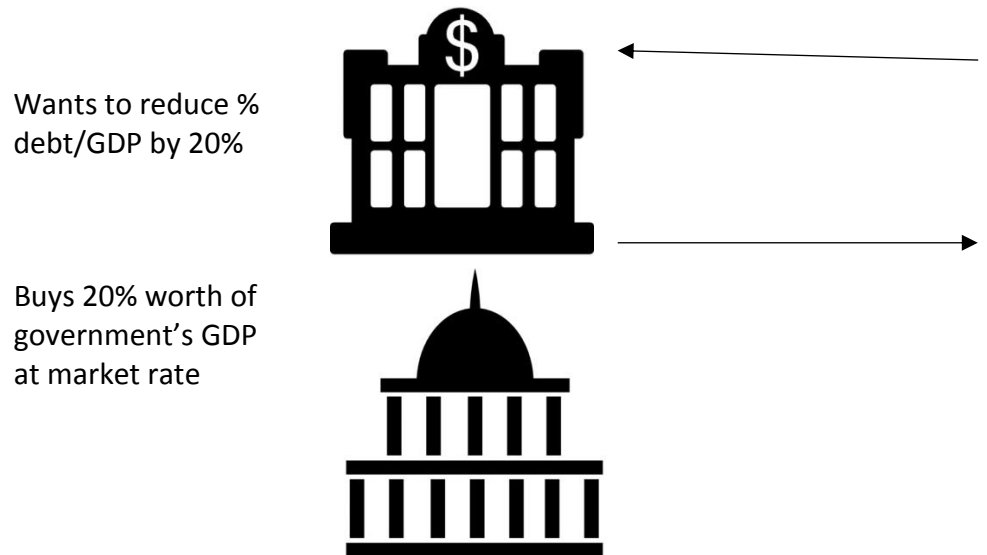
Together with the argumentation that high levels of public debt lead to undesirable limitations of economic growth we find ourselves with another argumentation for debt restructuring. That is, fiscal policy is the only tool left for member states to respond to shocks, they cannot longer use monetary policy as it has been centralized, therefore when they are facing an economic downturn they might respond with expansionary fiscal policies. The problem is that if the starting point is a high level of debt, we would enter into a cycle, in which debt would keep growing to even more unsustainable levels. That is a reason why the starting point of debt should be a sustainable one in order to let member states apply expansionary policies if they wish.

Another argument is that high debt levels can lead easily to debt crisis (which we have in fact experienced since 2010). When there are increases in the interest rates, it becomes more expensive to implement expansionary fiscal policies because the costs of borrowing raise. In turn, when a level of debt is already high, debt markets reflect their fear of failure with higher risk premia, and thus borrowing costs raise even more leading to a debt crisis.

These are the reasons provided to implement the PADRE plan and restructure the debt of EU member states.

The PADRE proposal consists on transferring debt held by the government to debt held by a central bank. In a simple example the idea would be that the Central Bank buys a certain percentage of debt required by their government at face value. The Central bank injects cash into economy worth the percentage of GDP that the government wishes to reduce debt. To avoid inflation, the Central bank issues its own debt at the market interest rate. What has happened is a swap from debt of the government to debt of the Central Bank.

The government pays back the debt to the central bank and the payments serve the Central bank to honor its own debts. The government has no incentives to default because it owns the Central Bank and as economy grows the value of the bond owned by the Central Bank decline as a proportion of the GDP, and eventually the ratio goes to zero.



Central Bank Balance Sheet

Liabilities	Assets
CB notes issued to buy government debt	Government bonds
X \$	X \$

In the case that the CB is able to borrow at a lower interest rate than the government (which usually it is) there would be a benefit for the CB, which in turn, as the CB is owned by the government it is just a transfer from one institution to the other so its irrelevant. The danger in this transformation of debt is that governments may have incentives to accumulate debt with the prospective that it would be eliminated by this mechanism of debt monetization. To eliminate this there has to be an institutional change in order to introduce fiscal discipline.

This is the idea made simple, but how would it be implemented in the Eurozone?

In the case of the Eurozone we have to consider two aspects:

1. There is one central bank for several countries. National central banks are the owners of the ECB (% of the capital).
2. Transfers among countries have to be eliminated. This responds to the fact that if the ECB solely buys bonds from the Spanish government, and then the Spanish government defaults, the losses would be faced by the ECB shareholders which are all the member states participating in the ECB capital.

In the Eurozone it would be necessary that member states agreed and jointly asked the ECB to take action. It has to be jointly because in the case they act separately, as explained before, they would act opportunistically and fear each other's actions causing the eventual inaction and thus the accumulation of debt.

Member states would ask the ECB to buy debt at face value. The face value of a bond is the amount paid to the holder at maturity (date in which the transaction comes to an end). The acquisitions would be made in proportion to the % owned by each national central bank of the ECB. So if the Spanish central bank owns a 15% of the ECB, the ECB would dedicate a 15% of debt acquisition to the Spanish government bonds.

Then the debts acquired by the ECB would be transformed into zero interest perpetuities. This is for two reasons, first in order to avoid country transfers because countries borrow at different interest rates (even more in the current public debt crisis) and thus they start from different positions (the risk premium member states face is different, if the ECB were to buy government bonds at the market interest rate and the corresponding government is unable to repay, the default would be spread among ECB shareholders, that is Eurozone States). The second reason is to avoid governments incentives to accumulate debt or default on their bonds because the losses would be borne by the rest of member states.

Then these zero interest perpetuities would have the same face value as the initial bonds which are replaced. The balance sheet of the ECB would be the following:

European Central Bank Balance Sheet

Liabilities	Assets
ECB notes	Zero interest bonds acquired at face value
X \$	X \$
- carrying costs (= interests paid by the ECB in order to repay its debt)	



ECB income is reduced



The losses are passed to Member States in proportion to their share in the ECB capital

The losses are incurred as time passes, depending on the maturity the ECB has chosen for its notes, thus the present value of the losses would equal the amount of the debt that has been cancelled because of the swap into zero interest perpetuities.

The present discounted value is the current worth of a sum of money (in this case of losses) given a specified rate of return (the market rate at which the ECB has been borrowing).

Eventually we have that the debt is cancelled without any country transfers, because the ECB transfers the losses in proportion to the participation in the ECB capital, and that each member state pays back its debt with reduced profit transfers from the ECB.

The result would be the elimination of excessive debt and the assimilation of government debts by future taxpayers over time.

This would work, as the authors argue, as long as there is a contractual arrangement. This mechanism would generate losses and thus the distribution of these losses might bring some political issues. This might be solved with a previous arrangement among member states.

Another condition for this mechanism to work should be that governments would have to be required to establish fiscal discipline as a pre condition to access this mechanism. The SPG is supposed to require this fiscal discipline but it is not effective or not as much as expected, because in some occasions it has been regarded as a tool against the sovereignty of member states regarding this issue. Maybe another type of institutional reform might be implemented, that respects member states sovereignty over fiscal discipline but at the same time accomplishes the aim of it being effectively implemented in order to access an orderly debt restructuring.

Regarding the control mechanism, we should consider how the system would assure that after the debt is restructured the member state does not incur in debt accumulation and return to unsustainable debt levels. In this case, the proposal is to establish a % limitation (ratio of debt/GDP) that the state cannot increase. The % allowed should be sufficient so as to allow member states to implement fiscal policies to respond to economic shocks (which is one of the main reasons for the creation of this mechanism).

In the case that a member state breaks its compromise and increases the % of debt by more of the allowed amount the ECB would be able to ask for the reimbursement of the perpetuities that it holds from the member state in question. The reimbursement would correspond to the % increase in debt higher than the limit established.

To reimburse this amount, it is probable that the member states needs to issue bonds, thus it needs to accumulate more debt. Together with this increase in the level of debt, the cost of borrowing would also rise as a response to the increase in risk that investors would have to

bear when buying government's bonds. This mechanism would allow to maintain market discipline and a probable moral hazard, with the aim of attaining more responsible fiscal policies to avoid these consequences.

It might be the case that the member state does not recognize the conversion of the perpetuities into bonds. In this case it would be treated as a default situation, and the ECB would have to be entitled to take action. Some of the proposals include the write off from the ECB books, the sale of the bonds at a discount rate (which means that it is sold at a lower value than the face value) to debtors of the violator government (and so the bonds would be used to repay debt to the government) or for example transferring the perpetuities to the EU budget in exchange of financial contributions that are destined to the member state that is defaulting. These ideas try to create an effective sanction system in order to prevent violations to the norms of the mechanism and thus ensure that it will work and attain its objectives.

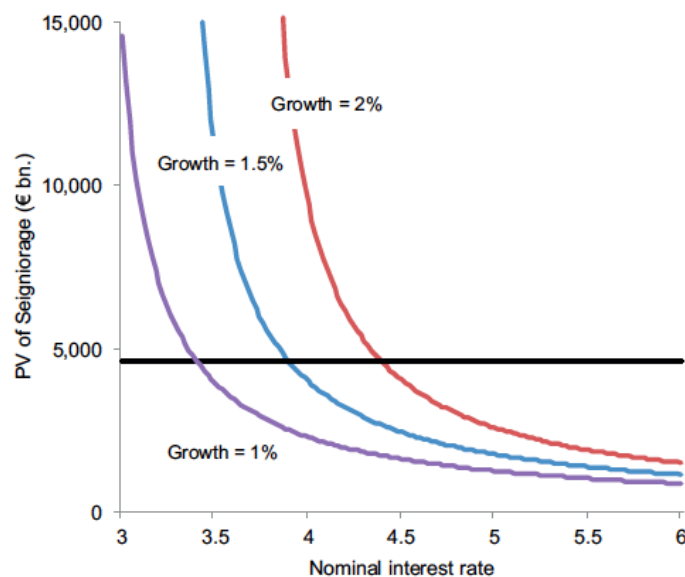
There has to be considered the case of political tension. Meaning that the defaulting government may try to convince its colleagues to waive its obligation to repay back the debt held by the ECB. In the PADRE plan the losses that would result from the default as well as the share to be beard by the member states would be known in advance so that might be an incentive for member states to not accept such behaviors. On the other hand, other clauses might be included in the agreement, to recognize situations in which some member states might decide to waive the payment from the government defaulting. In this case it is necessary to create a mechanism in which the countries signing for this decision are the ones bearing the losses from the reduction in the ECB income because of the default in payments.

The final issues with this proposal are related with the role of the ECB. The proposal is intended to be a one-time action, which means that the debt restructuring would occur only once. For this to be credible the proper market discipline must be implemented, that is why the sanctions system is important so as to member states to behave after the action has taken place. Another risk is related to the independency of the ECB, from the one side it is the EU Council the one that should ask the ECB to implement the PADRE plan, and not a decision of the ECB as that would imply it to incur into political issues. From the other side it is also necessary for an independent agent to be the one automatically converting the perpetuities in interest bonds once violations occur to avoid the risk of politicization.

The costs of the plan are estimated to be of 4,500 billion euros, to determine its feasibility it has to be considered the present discounted value of the costs of the debt restructuring and the present discounted value of infinite seignorage. The seignorage is the revenue attained when the money created is worth more than the costs of producing it. The feasibility will depend on the future economic growth rate and the future interest rate. The way these indicators move determines the value of seignorage. However, the value of the future interest rate cannot be controlled by policymakers, instead it depends on the sum of the inflation rate (which in the Eurozone is expected to remain constant) and the natural real interest rate (which depends on the financial market, global spending and productive investments).

Therefore, in order for the plan to be feasible is important to enhance economic growth in order to increase the need of currency, and thus seignorage.

Figure 11: Estimated present value of seigniorage revenues (billion euros)



Source: *Pâris and Wyplosz (2014)*

The table shows how higher rates of growth it is easier to surpass the costs of the program. As the level of interest rate increases the present value of seigniorage decreases making it more difficult to meet the costs of the program, that is because higher interest rates mean higher discount rate, and thus lower present discounted value of seigniorage.

For example, in the case studied by the authors, with an inflation rate of 2% and a GDP growth rate of 1,5%, the ratio of perpetuities to Eurozone GDP after 20 years would have been reduced at half, and after 50 years it would be of 18%.

All in all, even if the financing of the PADRE program is complex and might need further readjustments, it can be feasible. If nothing is done to stop debt accumulation it would only imply a greater amount of debt to be dealt with in the future, resulting in more difficult implementation of any type of restructuring plan. Most of the authors defending the idea of forgetting about a fiscal union but taking other actions instead, agree on the fact that the current debt ratios are not sustainable and that there is no time to waste. As time passes the solution would be harder to implement and there is agreement about the limits that overall debt accumulation in the EU is limiting economic growth.

This plan also takes into account the need to give member states more sovereignty with regards to fiscal policy. The SPG has resulted in poor results because of this exact reason, member states have already given up the monetary policy tool to respond to economic shocks, giving them sovereignty on fiscal policies would allow them to have a tool of response to disruptions. But this comes at a cost, they have to comply with market discipline, this includes the need to start from lower levels of debt in order to be able at a needed time to implement expansionary fiscal policies.

This alternative is more complex than the first one because first of all it implies the creation of a budget for the Eurozone. This would help to stabilize the financial situation of the Eurozone and if it were created with the ability to borrow it would represent a long term stability

function for the euro area. The proposal of the stability bonds is substitutive of the common budget and it might prove to be more effective as it may address moral hazard more easily. On the other hand, stability bonds would not be needed to reduce legacy debt because the implementation of the PADRE plan could address that issue and so the focus of the stability bonds would be to provide for financial stability at times of crisis and avoid excessive debt accumulations of member states, it will also provide a tool to deal with aggregate demand at the euro level by fostering counter cyclical fiscal policies at a supranational level, using the proceeds from bonds issuance to perform fiscal stimulus at an aggregate level.

3.2.3 Analyzing the second alternative

This second alternative recognizes as the rest of options that the current fiscal framework for the euro area is vulnerable. It does so by emphasizing that the ESM is not a macroeconomic stabilization tool and thus the EMU is not complete because it does not provide with the right policy mix.

The stabilization tool presented in the form of a common fiscal capacity could be effectively implemented without implying a major loss of sovereignty or political challenge. The alternatives to this scheme: the euro area common budget or the common budget with a borrowing capacity are also two alternatives for establishing a common tool to provide for a common stabilization tool. These could be implemented and prove to be durable solutions for the purpose of macroeconomic stabilization. However, with regards to the implementation of the euro area budget the issue would be its relation with the EU budget and the political acceptance it would require. As well as the difficulties from allocating the investments coming from the common budget, again the diversity across the euro area might prove this alternative difficult to be accepted as public investment priorities might be very diverse. This could be solved by focusing the common budget on providing for financial stability but again the contribution system to the budget may be difficult to accept because of the EU budget. Secondly, with regards to a common budget with the ability to borrow and the financing of cross border euro area project, might be confused with the ESM because of its ability to borrow and again, the issue of allocating the funds for specific purposes may undermine the stabilization effect. This is why the mechanism proposed by the IMF might be the best out of the three options, if it is able to cope with moral hazard and permanent transfers (its biggest drawbacks), it would provide for the stabilization tool needed at the euro level. Specially if it is left as an automatic mechanism because the stabilization effect would be quicker and less controversial.

The alternative also introduces the idea of reforming the SGP (the current fiscal framework), if the common fiscal capacity is applied and works as an automatic stabilizer, fiscal rules would have to be simple, clear and allow for flexibility at times of recession. The automatic stabilizer would help to support national fiscal policies so as not to excessively move away from the rule set, but it would be inevitable to provide for more maneuver if pro cyclical policies are to be avoided.

The last measure of this alternative is the debt restructuring by the implementation of the PADRE plan. This requires collective action, and thus a willingness to come together and overcome the situation of debt accumulation in the euro area. This scheme might seem complex but it is an effective solution to ensure member states that all their colleagues would

follow the same orderly debt restructuring by establishing this common tool. The advantage is that it would clean the current balance accounts of member states with unsustainable debts and leave the euro area in a stronger situation to face future economic disruptions.

The major advantages that can be identified in this scheme is that it provides for durable solutions because it takes into account the long term and the reforms would serve as a basis for future integration which means that the steps would be towards a stronger union. However, its major drawback is the lack of political will, therefore the political feasibility of the reforms.

3.3 Towards a fiscal union

The last two alternatives relied on the strengthen of fiscal coordination, maybe going one step further with the creation of a common budget or a common fiscal capacity, to be able to pool Eurozone debt and share risks. However, thinking towards the long term, coordination would not be enough, the Eurozone needs instruments at the supranational level. To do so, a possible solution would be the creation of the European unemployment insurance scheme.

3.3.1 The unemployment insurance scheme

The unemployment insurance scheme would be easier to apply if the common Eurozone budget or the common fiscal capacity already existed, this is why the second alternative presented in this work is useful to take steps towards more integration.

The major drawback of this scheme is that labor markets across the Eurozone are very diverse. Specially with regards to its flexibility, as Figure 10 shows, there is no uniformity across member states with regards to employment protection. Although it is true that some countries have recognized this need and have taken actions to correct it, for example Spain has had a tendency towards lowering the protection, there are no common standards set, and in an economic and monetary union labor mobility should be incentivized. Moreover, the fact that labor markets differ across countries does not foster labor mobility inside the EMU.

Employment protection is related to the costs of hiring and firing so in principle it is not obvious its effect on unemployment rate. In the case of the Eurozone, however, Stähler (2007) observed that the more protected labor markets were in Eurozone member states the higher was the unemployment rate (other also argue that more protections lead to higher unemployment duration, Blanchard and Portugal, 1998). From these observations we may extract that Eurozone member states should make an effort towards more flexibility of the labor market, because they decided to become part of a union, and therefore this implies converging at some point. It is important if the European unemployment insurance scheme were to be applied.

Figure 12: OECD Employment Protection Index 2008 for selected countries

	Protection of permanent workers against (individual) dismissal	Regulation on temporary forms of employment	Specific requirements for collective dismissal	OECD employment protection index
Finland	2.38	2.17	2.38	2.29
France	2.60	3.75	2.13	3.0
Germany	2.85	1.96	3.75	2.63
Italy	1.69	2.54	4.88	2.58
Portugal	3.51	2.54	1.88	2.84
Spain	2.38	3.83	3.13	3.11

Source: Bruegel

Figure 13: Strictness of employment protection- individual and collective dismissals (regular contracts) 2000- 2013

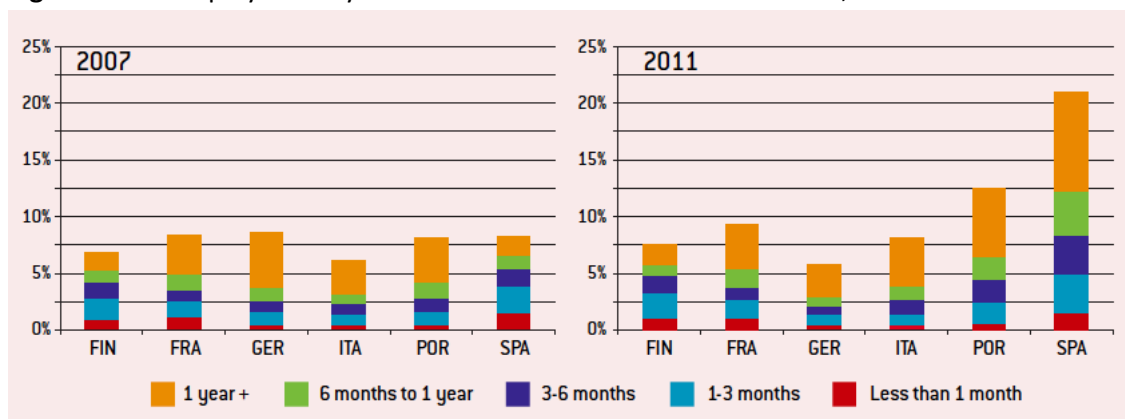
Series Version 1 (1985-2013)														
Unit Index														
Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Belgium	1.85	1.89	1.89	1.89	1.89	1.89	1.89	1.89	1.89	1.89	2.08	2.08	1.89	1.89
Finland	2.31	2.31	2.17	2.17	2.17	2.17	2.17	2.17	2.17	2.17	2.17	2.17	2.17	2.17
France	2.34	2.34	2.34	2.47	2.47	2.47	2.47	2.47	2.47	2.38	2.38	2.38	2.38	2.38
Germany	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68	2.68
Greece	2.80	2.80	2.80	2.80	2.80	2.80	2.80	2.80	2.80	2.80	2.80	2.80	2.17	2.12
Netherlands	2.88	2.88	2.88	2.88	2.88	2.88	2.88	2.88	2.88	2.82	2.82	2.82	2.82	2.82
Portugal	4.58	4.58	4.58	4.58	4.42	4.42	4.42	4.42	4.42	4.42	4.13	4.13	3.56	3.18
Spain	2.36	2.36	2.36	2.36	2.36	2.36	2.36	2.36	2.36	2.36	2.36	2.21	2.21	2.05

Data extracted on 29 Mar 2018 20:05 UTC (GMT) from OECD.Stat

Source: Eurostat (own extraction)

In the below figures unemployment rates are shown, as well as the duration of that unemployment. Unemployment rates are also very diverse across the Eurozone, with Spain being the clear winner both in terms of unemployment rate and in terms of duration. A common scheme like the proposed, could have been able to redistribute the effects of the crisis across the Eurozone. The scheme can be designed towards covering more or less unemployment benefits, addressing short term or long term unemployment, and depending on the design it would be able to address the crisis effects in one magnitude or another. For example, if it were to cover short term unemployment, Finland and Spain, would have received transfers from France, Germany and Portugal because in relative terms they had more unemployed workers for a 3-month period. Again, the explanation for the differences both in unemployment rates and duration of unemployment is because of institutional divergences with regards to the labor market.

Figure 14: Unemployment by duration in selected euro area countries, 2007 and 2011



Source: Bruegel

Figure 15: Unemployment rates across Europe (2005- 2016)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
EU-28	9.0	8.2	7.2	7.0	9.0	9.6	9.7	10.5	10.9	10.2	9.4	8.5
Euro area	9.1	8.4	7.5	7.6	9.6	10.2	10.2	11.4	12.0	11.6	10.9	10.0
Belgium	8.5	8.3	7.5	7.0	7.9	8.3	7.2	7.6	8.4	8.5	8.5	7.8
Bulgaria	10.1	9.0	6.9	5.6	6.8	10.3	11.3	12.3	13.0	11.4	9.2	7.6
Czech Republic	7.9	7.1	5.3	4.4	6.7	7.3	6.7	7.0	7.0	6.1	5.1	4.0
Denmark	4.8	3.9	3.8	3.4	6.0	7.5	7.6	7.5	7.0	6.6	6.2	6.2
Germany	11.2	10.1	8.5	7.4	7.6	7.0	5.8	5.4	5.2	5.0	4.6	4.1
Estonia	8.0	5.9	4.6	5.5	13.5	16.7	12.3	10.0	8.6	7.4	6.2	6.8
Ireland	4.4	4.5	4.7	6.4	12.0	13.9	14.7	14.7	13.1	11.3	9.4	7.9
Greece	10.0	9.0	8.4	7.8	9.6	12.7	17.9	24.5	27.5	26.5	24.9	23.6
Spain	9.2	8.5	8.2	11.3	17.9	19.9	21.4	24.8	26.1	24.5	22.1	19.6
France	8.9	8.8	8.0	7.4	9.1	9.3	9.2	9.8	10.3	10.3	10.4	10.1
Croatia	13.0	11.6	9.9	8.6	9.3	11.8	13.7	15.8	17.4	17.2	16.1	13.3
Italy	7.7	6.8	6.1	6.7	7.7	8.4	8.4	10.7	12.1	12.7	11.9	11.7
Cyprus	5.3	4.6	3.9	3.7	5.4	6.3	7.9	11.9	15.9	16.1	15.0	13.1
Latvia	10.0	7.0	6.1	7.7	17.5	19.5	16.2	15.0	11.9	10.8	9.9	9.6
Lithuania	8.3	5.8	4.3	5.8	13.8	17.8	15.4	13.4	11.8	10.7	9.1	7.9
Luxembourg	4.6	4.6	4.2	4.9	5.1	4.6	4.8	5.1	5.9	6.0	6.5	6.3
Hungary	7.2	7.5	7.4	7.8	10.0	11.2	11.0	11.0	10.2	7.7	6.8	5.1
Malta	6.9	6.8	6.5	6.0	6.9	6.9	6.4	6.3	6.4	5.8	5.4	4.7
Netherlands	5.9	5.0	4.2	3.7	4.4	5.0	5.0	5.8	7.3	7.4	6.9	6.0
Austria	5.6	5.3	4.9	4.1	5.3	4.8	4.6	4.9	5.4	5.6	5.7	6.0
Poland	17.9	13.9	9.6	7.1	8.1	9.7	9.7	10.1	10.3	9.0	7.5	6.2
Portugal	8.8	8.9	9.1	8.8	10.7	12.0	12.9	15.8	16.4	14.1	12.6	11.2
Romania	7.1	7.2	6.4	5.6	6.5	7.0	7.2	6.8	7.1	6.8	6.8	5.9
Slovenia	6.5	6.0	4.9	4.4	5.9	7.3	8.2	8.9	10.1	9.7	9.0	8.0
Slovakia	16.4	13.5	11.2	9.6	12.1	14.5	13.7	14.0	14.2	13.2	11.5	9.6
Finland	8.4	7.7	6.9	6.4	8.2	8.4	7.8	7.7	8.2	8.7	9.4	8.8
Sweden	7.7	7.1	6.1	6.2	8.3	8.6	7.8	8.0	8.0	7.9	7.4	6.9
United Kingdom	4.8	5.4	5.3	5.6	7.6	7.8	8.1	7.9	7.6	6.1	5.3	4.8
Iceland	2.6	2.9	2.3	3.0	7.2	7.6	7.1	6.0	5.4	5.0	4.0	3.0
Norway	4.5	3.4	2.5	2.5	3.2	3.6	3.3	3.2	3.5	3.5	4.4	4.7
Turkey	9.5	9.0	9.1	10.0	13.0	11.1	9.1	8.4	9.0	9.9	10.3	10.9
United States	5.1	4.6	4.6	5.8	9.3	9.6	8.9	8.1	7.4	6.2	5.3	4.9
Japan	4.4	4.1	3.8	4.0	5.1	5.0	4.6	4.3	4.0	3.6	3.4	3.1

: Data not available

Source: Eurostat

http://ec.europa.eu/eurostat/statistics-explained/images/8/8a/Unemployment_rate_2005-2016_%28%25%29_new.png

How would the scheme be designed?

Unemployment is an important economic indicator, if this scheme is designed, its major advantage is that it would become a shock absorber with regards to short term unemployment, and short term unemployment is an indicator that helps to follow in which economic situation a country finds itself. It is an indicator easy to understand, it is also easily measured and the effects of an economic downturn on the unemployment indicator are easy to foresee (Andor, 2016).

A basic scheme would be established to address short term unemployment. National unemployment schemes would be partially pooled. Eurozone taxpayers would receive the unemployment benefits from the common European scheme, for a period of time of around 6 months. The benefits given by the EUI could be complemented, national authorities might decide to increase the duration of the benefit or the amount, it would be up to each member state.

Because of the examples stated above, some minimum standards would have to be set across the Eurozone, the institutional gap with regards to labor markets needs to be reduced. The key would be to require member states to comply with some EU standards that trigger an upgrade in their employment services and labor market institutions. If the scheme only addresses short term unemployment, which implies that it would try to address cyclical unemployment, it would not be needed a high degree of harmonization (although in the long term it would be

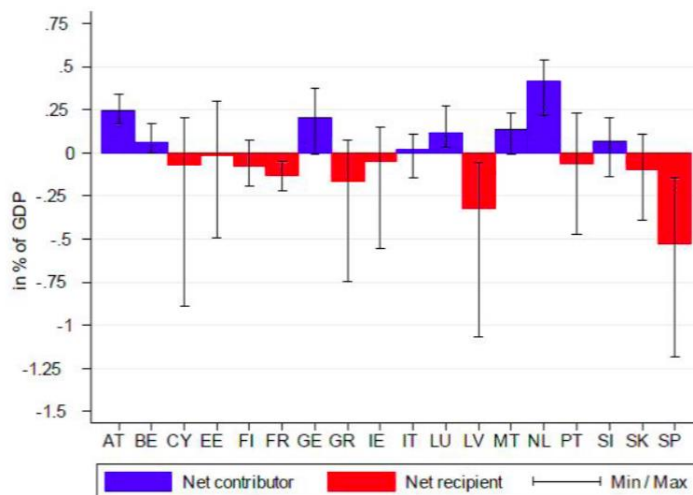
desirable). The EUI would be financed through the contributions of employees and employers (who would pay to their national authorities). With this financing scheme, the unemployment rates fluctuations in each country would be internalized by the system, as for example if there is a shock Spain economy unemployment would raise and so contributions of employees would be reduced and the need of unemployment benefits would increase. The scheme would provide with the required benefits because of the shock, and once the situation of Spain is stabilized again, the collection from the national insurance scheme in favor of the EUI would increase (Andor and Pasimeni, 2016).

The overall volume of such a scheme is considered to be around 1% of Eurozone’s GDP but again, this would depend on the settings that are chosen when it is designed.

There is a risk to be addressed, politicians would not agree on a scheme that puts them in a situation of permanent net contributions, because there would be the risk of free riders in the system.

In the graph below Spain for example would have been a net beneficiary from the scheme during 13 years, whereas other member states like the Netherlands or Germany would have been net contributors.

Figure 16: Average yearly net contributions to the EUI, 2000- 2013



Source: www.iai.it

In order to avoid these imbalances there are two corrective mechanisms to be set (Andor et al, 2014). The first one, experience rating, each member state would be monitored in order to check if they are net contributors to the scheme or net beneficiaries, the objective is to adjust at the beginning of every period the position of member states in order to achieve in the medium term a balanced position. The second one, claw backs, these are established to avoid the situation depicted in the above graph, it is a mechanism that works ex post. A member state like Spain, would be allowed to be a net beneficiary for several years, but after the shock passes or after Spain recovers from the situation it would have to compensate for the net transfers and so their contribution rate would increase notably.

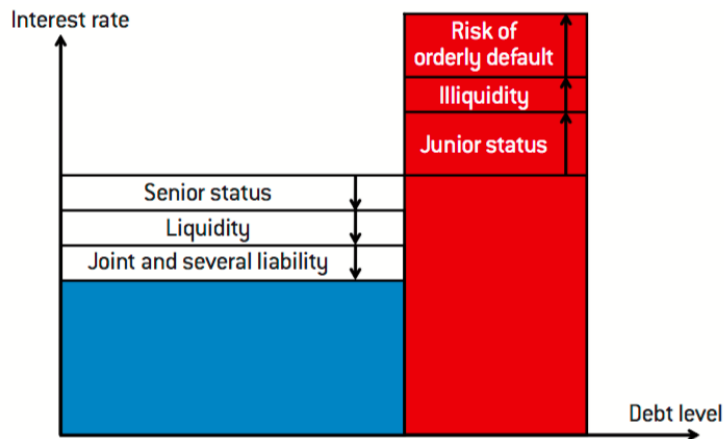
3.3.2 Blue bond proposal

The last proposal to consider in the present work is related to sovereign debt in the Eurozone through the creation of Eurobonds.

The proposal entails dividing national sovereign debt in two:

- A senior tranche conformed by the so called blue bonds which will amount up to 60% of debt to GDP. The senior status, responds to preferential payment. Blue bonds would be jointly guaranteed by the participating countries and so they would be rated as AAA assets. The Eurozone average cost of borrowing would decrease (*the cost of borrowing is equal to the stock of outstanding debt and the average interest rate on the debt stock), it would decrease because the amount of debt outstanding would be lower and countries with unsustainable debt levels would no longer be in that situation (Delpla and Weizsäcker, 2010). Thus, blue bonds would be extremely liquid and safe assets (comparable to the US treasury bond), the implication is that the euro could be raised to a position of major reserve currency which would enable euro area participants to borrow part of sovereign rate with interest rates comparable to the German bond.
- A junior tranche conformed by the so called red bonds that would amount to all the debt above the 60% limit. Red bonds would increase fiscal discipline of member states; their existence would make the cost of borrowing would be more expensive at the margin. Because these bonds would be less safe than blue bonds, when a shock or a default occurs, the first debt affected would be the debt in the red tranche (if this debt is unable to absorb the shock, it would ultimately affect the blue tranche of debt).

Figure 17: Key factors that influence the cost of borrowing in the senior (blue) and junior (red) tranche

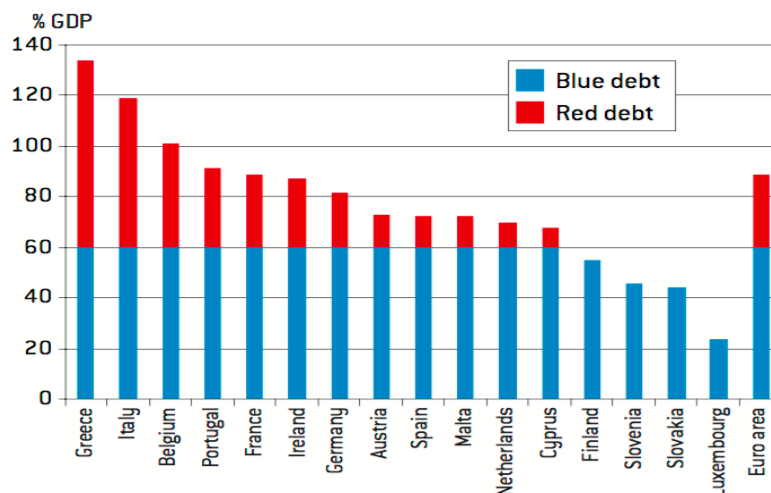


Source: Bruegel

An issue to be handled is that of making an orderly default of debt in the red tranche credible. In order for this to be possible it would be necessary enhancing banking and credit rating agencies supervision at an EU level, also the ECB must be sensible when choosing red bonds for its repo facility considering the appropriate methodologies for assessing the debt (* repo facility: a repo is a repurchase agreement, a form of short term borrowing for dealers in government securities, in this case the ECB would be the party agreeing on selling the asset and agreeing to repurchase it in the future, usually in a day). National governments would be obliged to include CACs in red bond borrowings so that the debt restructuring is orderly performed and less long (Delpla and Weizsäcker, 2010).

With this proposal the member states with highest levels of debt, such as Spain, would have more incentives to be more disciplined in order to have access to the scheme and be able to borrow at a much lower cost, this would reestablish the SGP credibility (which is of interest to countries like Germany). On the other hand, the countries that enjoy the most credible fiscal policies could be able to borrow the total of 60% of GDP (limit on level of debt established by the SGP) with blue bonds, if a country performs irresponsible fiscal policies repeatedly then it would automatically leave the system because it won't be able to borrow with blue bonds (Delpla and Weizsäcker, 2010).

Figure 18: Split of 2011 forecast debt levels into red/ blue debt



Source: Bruegel

Not every country would have the same proportion of debt in blue bonds, so the scheme would not equally beneficial for all the participants it would depend on the situation of each country when the scheme is implemented.

How the blue bonds would be allocated? Each blue bond would be guaranteed by all the participant nations, by their taxpayers specifically, and the decision should be in hands of national parliaments so as to make the scheme legitimate. A Stability council would be created and it would propose an allocation for the blue bond that would have to be approved by national parliaments. This would provide credibility to financial markets. The mechanism would be guaranteed by the strongest economies in the Eurozone so member states would have to proof to the Independent Stability council that they comply with the necessary requirements to be part of the scheme and be able to borrow a determined amount with blue bonds. The Independent Stability council will make a proposal of blue bonds allocation and national parliaments would approve it or decline it, if they decline it, the country that voted against it would not participate in the scheme for that period. This mechanism is useful in order to ensure that no country borrows more than 60% of GDP in blue bonds. In order to avoid many member states opting out of the scheme, because the risk of leaving the scheme would be harming for the whole mechanism, the Stability council would have incentives to act in a sensible manner considering Eurozone taxpayers' interests (Delpla and Weizsäcker, 2010).

To implement this scheme, the current legacy debt (all the debt issued before the implementation) would be treated as senior debt with respect to red debt, but as junior debt with respect to blue debt. This means that the new debt issued after the scheme is implemented would be considered as senior debt, blue bonds, and legacy debt with respect to this new debt would be considered as junior. As time passes, and legacy debt is refinanced it would be gradually replaced by senior blue debt and junior red debt which were issued after the scheme was implemented. As explained before, the annual blue bond allocation would inform each country of how much debt is able to issue as blue bonds. In the case of the high indebted member states the transition period would take more time because of the need of more debt to be replaced (Delpla and Weizsäcker, 2010).

3.3.3 Analyzing the third alternative

The last alternative is the most ambitious one because it requires structural reforms to implement the stabilization mechanism and on the other hand it envisages a system of dealing with legacy debt and at the same time being able to jointly issue bonds at a euro area level.

The first measure, the unemployment insurance scheme would provide for the macroeconomic stabilization that the euro zone needs. The unemployment scheme would allow to absorb country specific shocks effectively it would also allow for discretion for member states, meaning that they would be able to complement it however they wanted. It would not imply more than a 1% of the euro zone total GDP which is not a large amount (although it would depend on its settings when it is designed). Aside from offering macroeconomic stabilization it would also provide for social protection objectives, as well as being a risk sharing mechanism. On the other hand, the proposal of euro bonds would allow the Eurozone to deal with legacy debt and at the same time be able to jointly issue bonds. This would provide more stability as it would decrease the likeness that euro area member states loose access to market in the context of a recession and at the same time it would enhance fiscal discipline. These two measures would be effective as long as they provide the right incentives and above all correctly address the fear from several member states (especially northern countries) of permanent transfers.

The scheme presented in the last alternative would be the culmination of a fiscal integration, which means that it would be durable and able to overcome a future crisis, however the major drawback is the reforms it would require, specially for the unemployment insurance scheme. Labor markets should eventually converge but it is not likely to happen in a near future, and a scheme like this could not be implemented without effective convergence. Political acceptance would not be easy to acquire with regards to labor markets or to the collective emission of bonds.

4. Conclusions

After researching about the current situation of the economic and monetary union of the EU and after gaining knowledge about the possible solutions to address the fiscal pillar of the EMU I believe that the only way forward for the euro area is to take steps together towards stronger cooperation and eventually complete integration.

The EMU was built as a common project, a solidarity project with the aim of converting the European economy in a global leader. The project has not failed, at least for the moment, but it has not succeeded either. The reason lies on its design failures. I believe that the design failures are mainly related to political resistance which have represented a barrier for the integration of the EU since the very beginning. It makes sense though, because the EU represents the unification of a set of sovereign states with their own defined identity, the EU is rich in diversity and the national fears for a possible loss of either identity or sovereign power are greater than the possible willingness to further integrate with the European colleagues. However, the countries that accepted being part of this project have also been able to recognize the benefits it brings to their economic growth and development, countries have experienced a raise in their economic relevance in a global perspective because of their EU membership. The benefits are not only related to economic consequences but also social, the facilities that European citizens have nowadays could have not been foreseen thirty years ago. This is why I believe that it would not make any sense to reverse a process once it has already started. It would imply giving up, and no one said that the EMU would be easy to construct or that the European project would be built from one day to another. The current French Leader Macron already said that if people do not believe in the EU or in the euro it should be dismantled. This is what the EU currently lacks of, it lacks of credibility, support, willingness to move forward, and a common identity, because if this is not achieved the future of the EU is very uncertain.

All the alternatives presented in this work require a degree of political acceptance, in a minor or major degree but it is a prerequisite to move forward. EU institutions have already expressed the urgency of completing the EMU. The IMF has also expressed this urgency and has even presented proposals to support the EU institutions in the measures to fix deadlines and action plans. Political leaders across the EU have also expressed their concerns because the fear that without any reform their economies would not be able to recover, and above all the common currency, the euro, might disappear.

Thus, there is common consensus on the need to take the necessary measures to ensure that the EMU becomes the global economic leader it was intended to be when it was first envisaged. Much has been achieved since then, which means that much can be still achieved. The fact that the EU has realized of the need of completing its current institutional organization because of the crisis does not imply that it is unable to correct the past errors. If the crisis has helped to recognize those defaults, then the EU should take a strong and determined position to readdress these defaults and strengthen the EMU toolkit. Instead of focusing on the tensions rising among member states and on culpability accusations, the EU should foster cooperation to take collective action and leave the past behind because it does not lead to any solution.

The alternatives presented could be regarded as a step by step approach. Some measures are easier to implement because they do not imply a political challenge because they do not

require major reforms nor a need for strong convergence. However, the EU should be ambitious. It should bear in mind the mistakes that have driven it to the after crisis situation, it has to be realistic too and be able to recognize and admit the divergences across the member states.

In my opinion the best option for the euro area, would be to start setting the base for future integration. The long term objective should be convergence, with regards to competitiveness, productivity and labor markets. Thus being able to converge in relation to business cycles. Nevertheless, this is not completely feasible in the present because of the lack of political will, thus, the focus should be establishing the proper tools to allow for a future of further convergence. The establishment of either a common fiscal capacity or a common euro area budget would serve as a macroeconomic stabilization tool. It would be easier to accept in political terms because although it implies risk sharing among member states, they have already realized that the euro area requires a common mechanism because their interconnection already generates externalities from country to country depending on the fiscal policies established; but they do not have a mechanism to deal with these externalities or with country specific shocks. Moreover, the current fiscal rules do not support counter cyclical policies, which has led to a deeper recession in some countries. And at the bigger picture, the ECB with its monetary policy has been unable to address the situation because it is in charge of maintaining price stability at the euro area but it cannot consider the needs of individual member states. The ESM has been a patch during the crisis that has helped some member states that had lost access to market to obtain an alternative source of financing, but it is not a definite solution as it is a lending capacity unable of providing macroeconomic stabilization at the euro area level.

A mechanism like the common fiscal capacity would complement the monetary policy by the ECB because of the provision of macroeconomic stabilization both at the greatest level and in country specific terms. Although the mechanism will only succeed if it provides the right benefits for all the participants, which means that all of them have to be willing to participate because they would gain with the creation of this scheme. Concerns such as permanent transfers and moral hazard problems would be eliminated with the correct measures. The mechanism would work automatically to avoid controversies. And it would be the base for further future integration, like the possibility of creating a European Treasury.

I believe that, if properly presented, the common fiscal capacity would not be as difficult to accept as other options requiring more political acceptance.

However, it won't be enough because of the different levels of accumulated debt across the euro area members. This generates a source of vulnerability for the whole area as they share the same currency so the actions by one-member state or its economic situation have repercussions on the rest. This is something they accepted at the time they adopted the euro as their currency. This is why debt restructuring is necessary. Ideally I would say the best option would be either to follow the PADRE plan which implies a collective action or even more ambitious, to follow the blue bond proposal. The blue bond proposal has a twofold advantage which is providing for a debt restructuring tool whilst providing for a risk sharing mechanism that would increase discipline, enforcement of fiscal rules and the access to financial markets for member states. It would be politically difficult to accept, specially for the northern countries of the euro zone but the advantages to be obtained are greater than the

costs. This is why a first approach by applying the PADRE plan may set the proper grounds for a future Eurobond.

To start with the integration process and eventually deeper convergence, EU institutions should compromise on specific measures establish a deadline for these to be implemented and start to work because there is no time to waste. I would point out that for this process to succeed and have the legitimacy that worries national governments across the euro area, the construction and strengthening of the European identity cannot be forgotten. Future generations need to believe in this project, willingness to complete it is essential for its survival and success, and thus it is EU institutions and national governments responsibility to not forget that European citizens are the basis of this project and they need to believe in it and be reminded of what it makes it a project worth fighting for.

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