Market-preserving fiscal federalism in the European Monetary Union[1]

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Abstract

Responding to the euro crisis, European leaders have put in place an enhanced economic and financial governance framework for the euro area, including the main pillars of a banking union, while they have initiated work on a capital markets union. This should more effectively secure sound national macroeconomic and fiscal policies, a healthy financial sector and the stability of the euro. This paper poses the question whether the status quo of half-way political integration is sufficient to safeguard the cohesion and integrity of the euro area. National governments still have considerable leeway to circumvent the "hard" budget constraint and the strong market competition implied by the euro area's "holy trinity" (one market, one currency and one monetary policy). For example, they might target captive sovereign debt markets or take protectionist measures. This economic nationalism would entrench the crisis-related fragmentation of the single market and frustrate the efficient functioning of the monetary union. A higher level of market-preserving fiscal federalism could prevent member countries from encroaching on markets and foster sustainable economic convergence towards an optimal currency area.

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"The recent crisis has shown that there remains a strong temptation, particularly when times are hard, to roll back the Single Market and seek refuge in forms of economic nationalism."
(Barroso in his mission letter to Monti, 2010)

1 Introduction

From mid-2007 to mid-2012, the European Economic and Monetary Union (EMU) successively saw a financial crisis, economic crisis and sovereign debt crisis, which threatened the very existence of the euro (Mongelli and van Riet, 2013). Responding to this triple crisis, European leaders have undertaken many important reforms to strengthen the institutional architecture of EMU, also giving up national authority over banking supervision and resolution. As a result, the euro area has entered a new era with a substantially upgraded economic and financial governance framework for preventing and resolving new crises (Mongelli, 2013). They nevertheless decided to hold on to national sovereignty in macroeconomic and fiscal policies.

The question this paper poses is whether this half-way euro area political integration, staying within the boundaries of the 2009 Lisbon Treaty, is sufficient to secure the cohesion and integrity of a monetary union in which economic freedom and market pressure are foreseen to drive the process of convergence towards an optimal currency zone. The risk it identifies is that member countries may use their remaining leeway to suppress the free functioning of the single market and free-ride on the euro in order to relax their "hard" budget constraint and protect domestic banks and industries. Such economic nationalism would entrench the market fragmentation observed since the euro crisis and frustrate the efficient functioning of EMU. This risk highlights the need for appropriate supranational institutions to ensure that euro area countries observe sound fiscal policies and that "mercantile competition" between them in a common market without barriers is welfare-enhancing rather than destructive. The corresponding analysis in this paper builds on the requirements for "market-preserving fiscal federalism" which McKinnon (1995, 1997) discussed for the American Monetary Union in comparison with Europe.

The Member States of the European Union (EU) introduced the euro as a political response to the "monetary policy trilemma" which in international economics is also known as the "impossible trinity" facing an open economy. This trilemma states that for countries wishing to embark on financial globalisation the triplet of perfect capital mobility, fixed exchange rates and an autonomous monetary policy is not feasible: they need to drop one of the three elements of this "holy trinity" (as Rose, 1996, called it). Accepting the liberalisation of international capital flows after the breakdown of the Bretton Woods exchange rate system, advanced economies have generally preferred two-corner solutions to this trilemma, adopting either

fixed or floating exchange rate regimes and the associated opposite implications for their monetary policy autonomy (White, 2013). Europe followed a different road. Creating a monetary union allowed the participating nations to uniquely occupy all three corners of the monetary triangle and to enjoy the benefits of a "holy trinity" inside the euro area: a single market, a single currency and a single monetary policy. A combination of market forces and common rules of behaviour was expected to impose policy discipline, as a precondition for both economic convergence and euro area stability, which in turn would bring greater prosperity.

From the outset it was clear that the euro area was not an optimum currency area (Jager and Hafner, 2013; Mongelli, 2013). Moreover, as became evident during the euro crisis, the theory of optimum currency areas as formulated in the mid-20th century was silent about the implications of financial liberalisation, the need for a banking union and the specific political requirements of creating a monetary union in Europe (Eichengreen, 2014). Many member countries were ill-prepared for the opening up of markets inside the EU, the economic consequences of adopting the euro, and the coincident globalisation of trade and finance, which increased competition both inside and outside EMU. At the same time, they had given up their old (imperfect) instruments of currency devaluation and inflation to rebalance the domestic economy and correct current account deficits. In addition, the active use of industrial policies to protect domestic sectors was constrained by EU rules governing the single market and state aid (Bastasin, 2012).

According to McKinnon (1995, pp. 463, 477), the Maastricht Treaty of 1992 and its push for a single currency was a "leap in the dark". This was true especially for the EU Member States with a high public debt. Given open capital markets, in his view, these countries required continued national sovereign control over their currency and their central bank in order to be able to limit capital outflows, devalue the currency and/or use monetary financing of budget deficits so as to prevent financial crises in times of fiscal stress (or to use these policy options during episodes when bank rescue operations strained fiscal resources). With the irrevocable adoption of the euro they once and for all relinquished the option of using inflation and/or devaluation as a last resort to deal with a public debt overhang – also knowing that a supranational replacement in the form of an effective crisis management system was not available, since this "was regarded as superfluous" (Thygesen, 2013, p. 28). Hence, euro area countries in principle faced a "hard budget constraint" (McKinnon, 1995, 1997) and a government default became the only way to resolve a fiscal crisis (Sims, 2012), even though a formal sovereign bankruptcy procedure did not exist.

This EMU architecture implied that the participating countries were bound to observe sound macroeconomic, fiscal and financial policies, both in their own interest and in that of the euro area as a whole. They would need to work hard to increase their economic flexibility, fiscal strength and financial resilience in order to absorb asymmetric shocks and deal with spill-over effects in an integrating currency area

that moreover operated in an increasingly competitive global economic environment. As it turned out, the governance model of the euro area was subject to a "systemic failure" (De Streel, 2013, p. 337). Governments in practice faced only weak market incentives, soft peer pressure and no enforcement to maintain competitive economies, sound public finances and healthy financial sectors. On the contrary, their incentives were misaligned towards preserving economic policy autonomy and pursuing "mercantile" strategies favouring national rather than common euro area interests (see also Bastasin, 2012). Harmful "mercantile competition" (cf. Hayek, 1939; McKinnon, 1995) was widespread in Europe in the decades before the single market and the single currency were established, inter alia with the purpose to overcome this source of fragmentation. There are indications that economic nationalism has ever since remained a (hidden) force of divergence between the euro area countries and that it intensified during the triple crisis. From 1999-2014 there was in any case no convergence of real GDP per capita between the first 12 euro area members (European Central Bank, 2015)

Recent studies have examined the scope for trade-offs between the two-corner solutions given by the monetary policy trilemma and how countries could adopt intermediate policy strategies in order to "round the corners" for some time (see Klein and Shambaugh, 2013). For example, advanced economies concerned about competitive devaluations in a global context of ultra-easy monetary policies could be tempted to apply administrative instruments, such as capital restrictions and financial repression, in order to insulate themselves and regain a degree of policy autonomy (White, 2013). All over the world central banks, regulators and governments appear to be resorting more frequently to national financial sector policies with the characteristics of financial protectionism in order to manage volatile capital flows and financial fragilities (Beck et al., 2015). Many nations have further taken recourse to outright trade restrictions or "murky" forms of beggar-thy-neighbour policies that are difficult to detect, despite the commitment of G20 leaders to resist all forms of protectionism and keep markets open (Evenett, 2014).

The euro area is no exception to this global trend of policy makers trying to reclaim room for manoeuvre in fields where it had been lost. Many member countries looked for national safeguards against macroeconomic, fiscal and financial instability and national policy levers that could "round the corners" of the monetary triangle inside EMU. As the financial crisis struck, governments had to convince markets that they were strong enough to carry the heavy budgetary burden of the bank rescue operations and the Great Recession and hence that their bonds were still safe, also in the face of contagion by weakened member states. Foreign creditors were quick to withdraw their capital from those countries where adverse shocks led to a crisis of confidence in the stability of the banking system, the prospects for a durable economic recovery and the sustainability of public finances. Seeking a way to respond to the crisis, countries in distress considered their participation in the

euro a "strait-jacket" (Bastasin, 2012, p.158), as it left them with an "uncomfortably narrow" policy space (Crafts, 2013, p.713). As there was no supranational stabilisation and rescue mechanism to assist them and the Maastricht Treaty explicitly excluded a bail-out by partner countries, the financial sector, or the European Central Bank (ECB), the countries concerned were in principle left to their own devices to break the self-fulfilling default expectations. Hence, they had strong incentives to encroach on free markets by putting up barriers to competition, subsidising strategic firms, supporting banking champions, promoting captive sovereign debt markets and applying soft capital outflow restrictions (see also Bastasin, 2012; Véron, 2013; Crafts, 2014). While these policy interventions may reflect legitimate domestic stability concerns rather than protectionist intentions, they also had serious negative side effects on economic and financial integration.

An incomplete EMU characterised by fragmented authorities, policies and markets, if sustained, raises serious questions about the long-term viability of the euro (see also Pisani-Ferry et al., 2012). Trade protectionism inside the euro area constrains cross-border competition for goods and services priced in the same currency, which reduces opportunities for increasing firm efficiency and labour productivity. Facilitating the growth of national banking champions supports the build-up of leverage and systemic risk. Shielding public and private sector access to capital from market discipline promotes a bias towards debt-financed spending. Financial market fragmentation frustrates cross-border credit intermediation, hampers monetary transmission across the euro area and undermines the effective conduct of the single monetary policy.

On balance, EMU is bound to move towards a more optimal currency area only when national leaders are willing to further expand their supranational arrangements and adopt a higher level of market-preserving fiscal federalism, subject to adequate democratic control. This means that they should transfer sufficient intervention powers to European institutions charged with the task to guarantee a free, open and stable market economy for the euro area and to ensure a "hard" government budget constraint for member countries. EMU could well move further away from an optimal currency zone when they are unwilling to embark on this path. Creating a fiscal union in a next step would require care to preserve fiscal discipline, as a powerful central government tends to enjoy a "soft" budget constraint and any budget transfers would extend this to the national level.

The paper is organised as follows. Section 2 looks into the implications for member countries of their participation in EMU and the role of the euro area's "holy trinity" in imposing market-based discipline. Section 3 outlines the main reasons why – contrary to most expectations – market incentives for sovereigns were relatively weak in the first 10 years of the euro. Section 4 reviews how some member countries attempted to restore national policy space after sovereign debt markets had turned vigilant again. One typical reaction was to introduce (hidden) barriers

inside the single market. Section 5 argues that a higher level of market-preserving fiscal federalism could remove the ability of member countries to encroach on free markets and align national policies with EMU requirements. Section 6 concludes that embarking on this path requires a social consensus about the limits of a sovereign nation state in a monetary union and national ownership of the reforms necessary to underpin the viability of the euro.

2 The euro area's "holy trinity" imposes market discipline

2.1 Economic policy constraints in an ever-closer union

One may argue that the market-driven liberal economic regime underlying European monetary unification and EMU was derived from Hayek's (1939) analysis of the by necessity limited scope for member state economic policies in an interstate federation. He stressed the importance for a political federation to have adequate restraining powers to prevent individual member states from interfering with the freedom of economic activity and causing a gradual disintegration of the common economic area. Hence, market liberalisation unavoidably meant a transfer of sovereignty over economic policies to the federation and the establishment of an economic union.

Moreover, the federal government would itself have to limit its powers of economic planning and regulation to those activities which enhance the internal coherence of the union and that are grounded in common convictions, ideals, values and traditions. While common economic interests and a sense of solidarity can usually be clearly defined for the citizens of a sovereign nation state, a political union tends to be characterised by diverse economic conditions and much weaker solidarity among its members. The more heterogeneous a federation is, the more complicated it will be to reach agreement on centralised interventions in economic life (such as protection from competition, subsidies for less developed regions, unemployment insurance and labour market regulations), because the benefits would only accrue to specific states, sectors or groups while the costs would be carried by the more dynamic or prosperous other parts of the union. Consequently, "there would have to be less government all round if federation is to be practicable" (Hayek, 1939, reprint of 1948, p. 266).

As pointed out by Hayek, this does not imply extreme laissez faire. But instead of continuously interfering with market forces, the federation's economic policies should provide the framework within which individual initiatives can prosper and supply the common public goods and services that the market mechanism is unable to deliver.

The growing economic policy constraints in "an ever closer union among the peoples of Europe" (as foreseen since the Treaty of Rome of 1957) based on increasing market liberalisation has triggered two opposite reactions. For some observers

the inability to use federal distributive policies to correct the social disparities and regional imbalances accompanying a free market economy is the reason to denounce the whole process of European unification and to reject the single currency. Given the diversity among the participating EU Member States, these euro sceptics favour instead the freedom of sovereign states to intervene in markets and for example to use currency devaluation and other protectionist measures to tackle economic and social divergences.

For other observers the solution is instead a deeper European integration. The euro area countries should share more of their sovereignty by attributing stronger economic intervention powers to the European institutions that could be employed to promote both economic and social progress as well as to address regional imbalances. The historical heterogeneity of European economic cultures and traditions would in their view not stand in the way of erecting a supranational democratic system – or even a European federation – that would legitimate such centralised market interventions.[3]

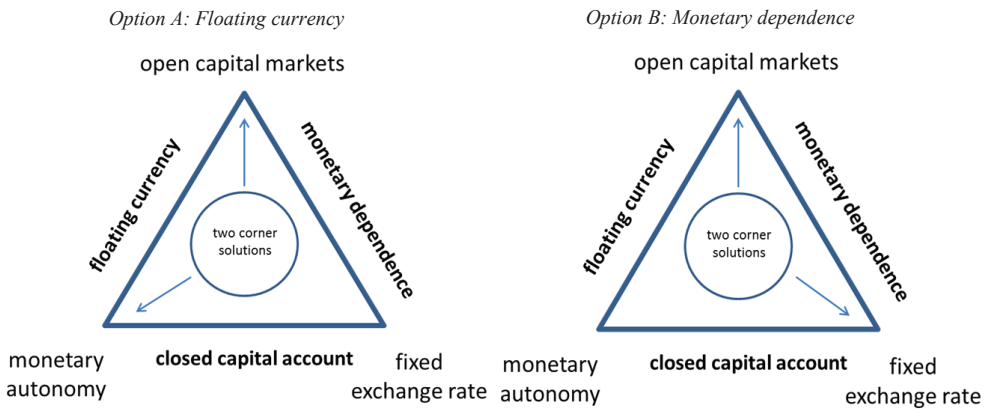
2.2 Solving the monetary policy trilemma

The introduction of the euro in 1999 was a political response to the monetary policy trilemma associated with the Mundell-Fleming model for an open economy. According to this trilemma, a country wishing to maintain free capital movements as well as exchange rate stability cannot simultaneously pursue an autonomous monetary policy; as only two-corner solutions are possible, one of the three elements of this "holy trinity" (Rose, 1996) has to be given up.

For example, Germany combined an open capital market with monetary autonomy and hence accepted a floating currency (see chart 1, option A). By contrast, many of its European trade partners pegged their currencies (more or less tightly) to the Deutsche Mark, seeking to import the high credibility of the Bundesbank's monetary policy aimed at price stability (see chart 1, option B).

[3] For an overview of this debate in Germany, notably between W. Streeck and J. Habermas, see Pistone (2013).

Chart 1: The monetary policy trilemma

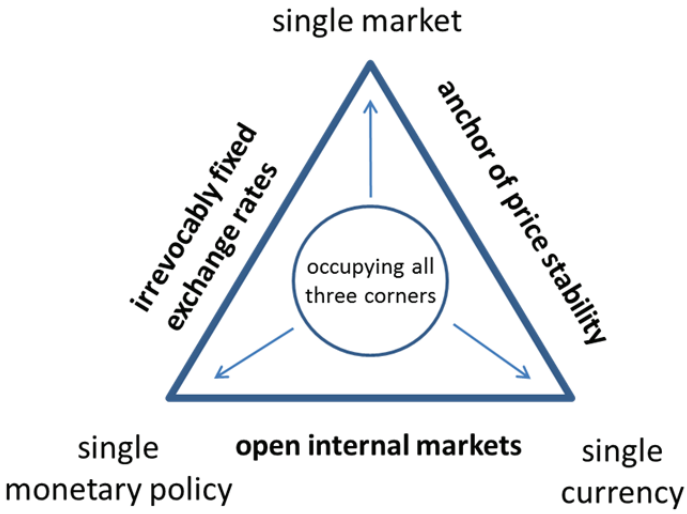


Note: A country can occupy only two of the three corners and the line in between that connects them.

The founding members of the euro were keen to preserve exchange rate stability, reflecting a predominant post-war concern with avoiding trade distortions and promoting trade integration (Wyplosz, 2000). The difficulty to maintain control over both monetary policy and the exchange rate in open financial markets motivated them (after having experimented with exchange rate stabilisation systems since the mid-1970s) to join forces in order to occupy each of the three corners of the monetary triangle and realise a "holy trinity" inside the euro area: by complementing the single market with a single currency and a single monetary policy they could henceforth all enjoy the benefits of a large and open internal market, irrevocably fixed bilateral exchange rates and a credible common anchor of price stability (chart 2).

While all euro area countries gave up their freedom of choice with regard to any of the three corners of the monetary policy trilemma, the pooling of national monetary sovereignty offered them the opportunity to mandate a common central bank to independently preserve monetary stability for the euro area and to manage the euro as a floating currency in globalised markets (the setting depicted in chart 1, option A). By contrast, they decided to retain their national sovereignty in other policy areas (apart from trade and competition in the context of the single market).

Chart 2: The "holy trinity" of the euro area



Note: Euro area countries together occupied all three corners of the monetary triangle and thus each one of them enjoys open internal markets, irrevocably fixed bilateral exchange rates and a credible common anchor of price stability.

This is a unique configuration, as in monetary history a currency was always aligned with a state. On the one hand, the "deep pockets" of the state made it easier to protect the value of the currency in the interests of the economy; on the other hand, the sovereign could then also abuse the currency by debasing its value in order to lower the burden of public debt (see Goodhart, 1998; van Riet, 2015). EMU was to be different. All countries that adopted the euro could expect substantial benefits from economic actors being able to access one wide market with one stable currency and to diversify portfolio risks. However, as a denationalised currency managed by a depoliticised common central bank, the euro was not meant to offer a protective "shield" against market discipline. On the contrary, based on "the principle of individual responsibility" (Weidmann, 2014), all euro area countries were themselves presumed to create the conditions for a dynamic economy, sustainable public finances and a stable financial system. The pursuit of prudent national policies was moreover vital for the entire euro area, as deeper integration also meant a growing exposure to shocks in other member countries and to systemic financial risk. This constellation leads to the conclusion that all euro area authorities shared a common responsibility for the cohesion and stability of the single currency.

2.3 Market-based discipline and rules-based discipline

This EMU architecture in principle left the challenge of countering asymmetric shocks and of dealing with a potential crisis to the national authorities. McKinnon (1995) warned that in particular EU countries with a large public debt overhang would be better off keeping their own currency and central bank, because life in EMU would be too costly for them. McCauley and White (1997) cautioned that the over-investment of European banks and pension funds in domestic government bonds exposed them to rising sovereign credit risk and could trigger financial instability. Countries with weak public finances also lacked the fiscal capacity to deal with a systemic banking crisis. High-debt countries might therefore need to devalue their currency to secure (temporary) economic gains or exploit their central bank to secure market liquidity, low real interest rates and inflation tax revenues in order to address a fiscal breakdown and limit a financial crisis; they might also have to retain exchange controls on capital flows so as to be able to sustain financial repression revenues.

During the transition towards the euro two divergent views were expressed on the nature of this challenge (Issing, 2008). The so-called "economists" argued that deeper economic integration was necessary – as implied by the theory of optimum currency areas – before the euro could be introduced in a final step. This view resulted in economic convergence criteria, laid down in the Maastricht Treaty, which prospective members had to meet on a sustainable basis before being able to adopt the single currency. Low inflation and a sound fiscal position as reflected in low government bond yields and a stable exchange rate featured high among the nominal convergence requirements. An independent national central bank was also part of the entry criteria.

By contrast, the so-called "monetarists" thought that the creation of a single currency would itself be sufficient to enforce the economic adjustments that would make the euro an optimal currency zone. This view placed great trust in market discipline as an endogenous driving force for the sound fiscal policies and structural reforms necessary for successful participation in EMU, supported by the many institutional changes – not least the establishment of an independent European Central Bank – that would accompany the introduction of the euro.

The Maastricht Treaty required the Member States and the EU to act in accordance with the principles of an open market economy with free competition. As in the end Member States were unwilling to sacrifice their political autonomy in the field of economic policy, the final EMU agreement lacked a strong supranational mechanism for promoting structural economic adjustment once countries had renounced their monetary and exchange rate policies. This also reflected confidence in the virtuous influence of a competitive market economy operating under a single currency as the "Trojan horse" for supply-side flexibility (Dyson and Featherstone, 1999, p. 784). In practice, Member States only had to engage in a non-binding coor-

dination of their economic policies, as these were acknowledged to be a matter of common concern. Only in 2009, the Lisbon Treaty arranged that the euro area countries could decide to go much further in this respect, in order to ensure the proper functioning of EMU.

The Maastricht Treaty entailed more binding arrangements for national fiscal policies, on top of the fiscal discipline expected from market forces. A privileged access of the public sector to the funds of financial institutions (other than for prudential purposes) was prohibited. The legal independence assigned to the ECB in the conduct of monetary policy and its statutory focus on price stability secured the ban on monetary financing of governments (making an exception for supplying central-bank reserves to public credit institutions in order to treat them the same as private banks). Moreover, the "no bail-out" rule forbid EU Member States to take over each other's commitments and the same prohibition applied to the EU institutions. This was to avoid entering into a transfer union, whereby wealthier member countries could be called upon to support their weaker partners by equalisation payments (Issing, 2008).

These legal provisions ensured that governments must fund their debt in the open capital market, compete for savings in a way that supports an efficient allocation of funds and spend their resources for productive investments that enhance economic performance and competitiveness (cf. McKinnon, 1997). One could argue that subjecting national policy makers to the powers of the market mechanism was one of the normative objectives of EMU, namely to prevent that unsound national actions could destabilise the single currency (Goodhart, 1998). Governments were thus well-advised to generate positive market expectations about their creditworthiness by building confidence in their stability-oriented fiscal policies, the quality of prudential regulation and supervision and the economic performance of their country. This should enable both the public and private sectors to borrow at affordable, market-determined (real) interest rates and firms to attract equity capital at attractive conditions from international investors.

Governors of European central banks were aware, well before the Maastricht Treaty was concluded, that market discipline may at times be ineffective. The Delors Report had highlighted that free access to a large capital market facilitates the financing of budget imbalances and "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive" (Committee for the study of economic and monetary union, 1989, p. 24). As documented by James (2012, p. 297), when drafting the Statute of the ECB in 1990/91, governors also realised that public entities could still enjoy a privileged access to financial markets as a result of national fiscal, banking and prudential regulation. They were furthermore aware that market participants could expect that euro area governments will ultimately be bailed out by their partner countries when encountering funding difficulties – and that these governments could expect the same, leading to moral

hazard. As a result, markets would not set the correct interest rate on public debt. Hence, governors were sceptical that market discipline would be sufficient to avoid excessive budget deficits and feared that the ECB could then become subject to political pressure to pursue a more accommodating monetary policy and to bail out high-debt member countries.

Such doubts about the effectiveness of market constraints motivated the introduction of EU fiscal rules and surveillance in the Maastricht Treaty as additional safeguards against excessive budget deficits and too high public debt. The importance of coordinating national fiscal policies and of concerted budgetary discipline – needed to prevent adverse interest rate spill-overs of fiscal laxity on other member countries, protect the credibility of the ECB's monetary policy and guarantee a balanced policy mix – motivated further detailed fiscal policy provisions, which were laid down in the Stability and Growth Pact of 1997 (Artis and Winkler, 1998).

At the same time, the European Commission initiated a comprehensive action plan to complete the single market for financial services, enhance EU prudential legislation and strengthen coordination among the national supervisory authorities. This set of legal measures aimed at enhancing market efficiency and a healthy financial sector while offering a precaution against potential market instability that could be triggered by troubled financial institutions.

3 Constrained market discipline over national fiscal policies

3.1 The "hard" budget constraint on euro area sovereigns

Already in the run-up to EMU many prospective euro area countries gave their national central banks an independent mandate to maintain price stability and sought to stabilise their exchange rate vis-à-vis other currencies (above all the Deutsche Mark) that participated in the exchange rate mechanism while opening up their capital markets (see for example Eijffinger and de Haan, 2000). The choice to give up political control over monetary and exchange rate policy became irrevocable with the adoption of the euro. This made their new position comparable to that of subsidiary governments like the American States, and that of developing countries faced with low market confidence in their national currency; i.e. they were all unable to issue bonds in a currency under their own monetary control (McKinnon, 1997; Goodhart, 1998). Euro area countries however remained fully responsible for their own public finances as there was no central fiscal authority that could levy taxes, make transfer payments, absorb asymmetric shocks, rescue banks or pool their sovereign debt.

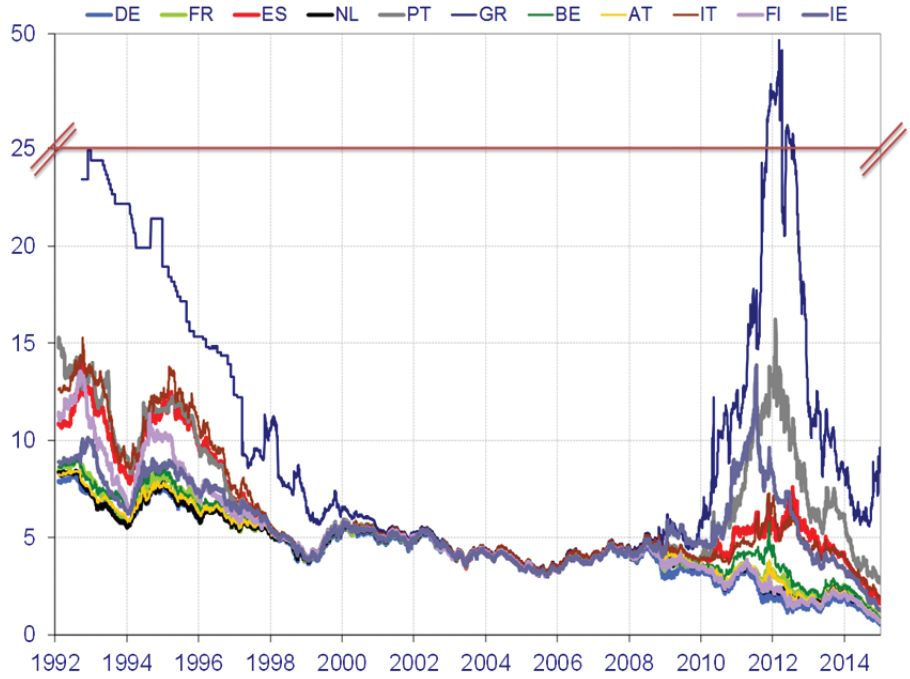
As a consequence, euro area countries replaced a "soft" for a "hard" budget constraint that once and for all ruled out the options of devaluation and inflation and excluded a bail-out by other member countries or EU institutions to deal with episodes of severe fiscal stress. The regime change was much smaller for "safe

haven" countries accustomed to open capital and product markets and with a history of central bank independence and successful stability-oriented policies; it was more significant for those EU-Member States with a tradition of protected markets and the reputation of monetary financing of high public deficits and regular currency devaluations. Especially for the latter group of countries the changeover to the euro raised the default risk on national public debt.[4]

The market funding of euro area governments became thus dependent on the willingness of international investors to roll over the already accumulated sovereign debt that, henceforth, to a smaller or larger extent was characterised by a higher risk profile (McCauley and While, 1997; Arnold and Lemmen, 2001; Gros, 2012). One might have expected that market interest rates would shift upwards for many euro area countries to reflect the apparent higher sovereign default risk, with the most indebted governments seeing the largest increase. Several factors worked against this plausible expectation, contributing to a downward convergence of government bond yields – a process that started well before the euro was introduced in 1999 (chart 3) – instead of leading to persistent interest rate spreads reflecting disparate country fundamentals.

[4] The pre-EMU distinction between sovereign credit ratings for domestic currency debt and those for foreign currency debt disappeared. While Standard & Poor's unified the ratings of euro area countries on the (in several cases lower) foreign currency ratings to reflect the fact that they could no longer turn on the "printing press", Moody's by contrast used the domestic currency ratings as the new basis arguing that governments had already given up this option by granting their central banks independence.

Chart 3: Government bond yields in the euro area countries
daily data, in percentages



Sources: Datastream and ECB.
Note: Chart excludes Cyprus, Luxembourg, Malta, Slovenia, Slovakia and the Baltic countries.

3.2 A new environment for public debt management

One factor was a more professional sovereign debt management in response to the liberalisation of capital markets and the institution of independent central banks. Many European countries had established public debt management offices with operational autonomy in the 1990s, working under specific guidelines from the finance ministry. Their task was in fact to provide the government with a form of insurance against market power (Dyson, 2014, p. 381).

The activities of public debt managers generally focused on promoting a liquid government bond market, minimising borrowing costs at a prudent level of risk and supporting a more efficient asset and liability management of the public sector. They cooperated closely with primary dealers, a selective group of both domestic and foreign banks, which in return for certain privileges had the task to facilitate the placement of government securities in the open capital market.

Another factor contributing to the convergence of sovereign bond yields was the positive effect of a country adopting the euro and anchoring itself to a stability union. The ECB's credible guarantee of price stability made it possible for public debt managers to issue more longer-maturity bonds than previously, thereby reducing roll-over risk. These debt securities also attracted demand from long-term investors residing elsewhere in the euro area, using the new opportunity to diversify their country risk without in parallel having to accept exchange rate risk (see McKinnon, 2002).

Moreover, EU banking legislation allowed national supervisors to assign a very low or even zero risk weight to bank claims on the central government, also when these originated from other OECD countries. While before 1999 exchange rate risk still acted as a barrier, after the inception of the euro banks could make full use of the opportunity to buy government bonds of other participating countries without having to worry about extra capital charges for lower-rated sovereigns. Government bonds were furthermore exempted from the large exposure limit that applied to private assets on bank balance sheets (McCauley and White, 1997; Arnold and Lemmen, 2001). EU prudential legislation entailed similar sovereign exposure privileges for institutional investors. With the introduction of the euro, regulatory requirements to match the currency of their assets and liabilities allowed them to expand their domestic government bond portfolios to sovereign issuers from the whole euro area.

The preferential regulatory treatment of public relative to private sector claims may have led market participants to believe that, no matter the amount purchased, government debt was virtually risk-free. They may have felt reassured by the convergence of fiscal positions in the transition to EMU, the agreement on the Stability and Growth Pact and the possibility laid down in the Maastricht Treaty to impose sanctions on Member States with persistent excessive deficits. Even if imperfect, it arranged for EU surveillance of national fiscal policies and it targeted sound public finances.

For turbulent times, market actors may have counted on a bail-out of troubled member countries, given the dangers of contagion in an integrated capital market and the presumption that EU institutions, the ECB and euro area partners would have little choice but to step in with supporting measures so as to ensure financial stability and preserve the euro (McKinnon, 1995; den Butter and Segers, 2014). This bail-out expectation may also explain the significant "bonus" that appeared in the sovereign credit ratings of EU Member States upon joining the euro, given the evidence that until 2010 their euro-denominated debt was treated more favourably than the national-currency debt of other OECD countries (Körner and Trautwein, 2015).

Once the euro was in place, banks and other financial institutions thus had every incentive to accumulate government securities on their balance sheets and to select

in particular the higher-yielding bonds of those euro area countries that were priced in the market as being subject to higher credit and liquidity risk. As these bonds could now be purchased without currency risk, market participants started a "search for yield" – also driven by a global "savings glut" – that resulted in a general compression of sovereign bond yields, bringing them close to the low levels of the safest member countries (chart 3).[5] As reported by Weidmann (2014), over the period 1999–2007, the average yield spread on the sovereign bonds of EMU countries relative to the German Bund was just 14 basis points.

With the benefit of hindsight, the government debt of several euro area countries was significantly over-rated and the associated credit risk was systematically under-priced before the financial crisis. The view that markets would tolerate a lower public debt than before EMU and discipline national fiscal policies was refuted by reality. For the previous high-interest rate countries the adoption of the euro in fact relaxed budget constraints rather than tightening them, as it made them an attractive target for yield-hungry investors, thereby creating moral hazard. However, market pressure returned with a vengeance following the collapse of Lehman Brothers in September 2008.

4 Rounding the corners of the euro area's monetary triangle

4.1 Countering self-fulfilling default expectations

When a new Greek government took office in October 2009 it surprised markets by disclosing much higher deficit and debt figures than were known before. Growing market concerns about the sustainability of public finances in Greece also affected other exposed euro area countries with a high public and/or private debt, a fragile banking sector and a poor economic outlook. The sudden shift in market sentiment towards these vulnerable members, especially among foreign creditors, caused a rapid increase in their sovereign bond yields as default risk premia were adjusted upwards, in conjunction with falling credit ratings and cross-border contagion effects (chart 3). By contrast, Germany and other euro area countries with a "safe haven" status benefitted from "flight to safety and liquidity" flows and enjoyed falling government bond yields. This experience showed that only after the onset of the sovereign debt crisis, when credit rating agencies repeatedly downgraded vulnerable countries, markets fully recognised again the fundamental default risk attached to subsidiary governments that should have been evident from the start of

[5] Buiter and Sibert (2005) argue that this market failure was also partly due to the fact that the Eurosystem allocated all euro-denominated central government securities in the highest liquidity category without regard to differences in the market's valuation of default risk. Although of relatively minor significance, this artificial liquidity enhancement could have suppressed government bond yields of weak euro area sovereigns.

EMU. Several hedge funds even started to take speculative positions against the euro. Not surprisingly, this was also reflected by a "malus" appearing in the sovereign credit ratings of vulnerable euro area countries as compared to other OECD members (Körner and Trautwein, 2015).

The spreading of the sovereign debt crisis in the euro area closely corresponded to what Kaminsky et al. (2003) describe as the "unholy trinity of financial contagion" in the context of sudden stops in foreign funding: a surprise negative announcement sets off a broad-based reversal of capital inflows as leveraged common creditors reduce their exposure to the sovereign as well as to private borrowers perceived to be vulnerable. The mirror image of the euro area's "holy trinity" in tranquil times was the "unholy trinity" facing troubled members: excluding inflation, devaluation and a bail-out was incompatible with avoiding a sovereign default; at least one "safety valve" for sovereigns under market stress had to be found, as a self-fulfilling default was not only costly but also contagious and endangered the cohesion and integrity of the euro area.

As a solution, the EU institutions and euro area leaders committed to do whatever was required to secure financial stability in the euro area as a whole (see van Riet, 2015). Responding to the sovereign debt crisis they created new fiscal backstop mechanisms subject to strict policy conditions to support member countries that temporarily had lost access to the capital market. Separately, the ECB initiated temporary and limited purchases of their government bonds – the monetary impact of which was sterilised – to repair the fragmenting securities markets and restore an even monetary transmission across the euro area. At the peak of the crisis in mid-2012, as sovereign bond yields appeared to include a currency redenomination risk premium, the ECB made a credible commitment to undertake conditional but unlimited outright purchases of government debt securities within the scope of its monetary policy mandate, which was successful in removing market uncertainty about a possible break-up of the euro.

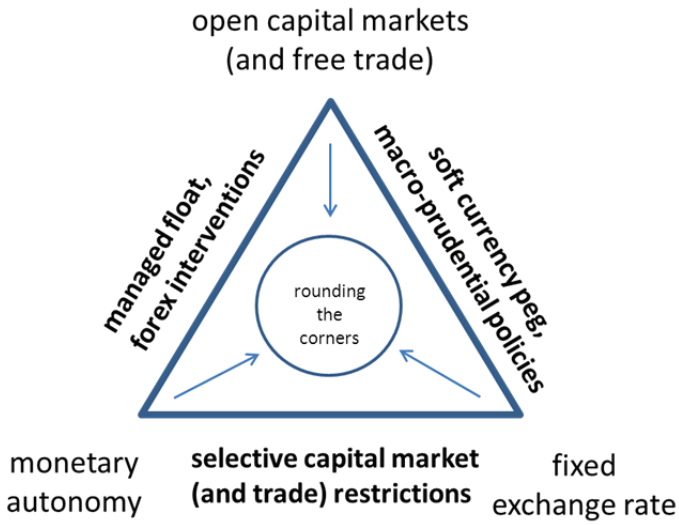
The national authorities on their part looked for (additional) solutions that would buy them time for undertaking the necessary policy reforms and potentially as a more permanent arrangement for easing the severe market pressure. Their own pre-EMU experiences with actively trying to use domestic financial and industrial policies in the presence of currency pegs may have offered them inspiration (cf. Wyplosz, 2000).

4.2 Reducing national policy constraints inside the euro area

As already mentioned, theory suggests that countries can only occupy two of the three corners of the monetary policy trilemma and have to give up their autonomy over the third (chart 1). This impossible trinity can be extended to an "impossible quartet" when free trade is added. Historical analysis largely confirms that the

monetary policy trilemma holds in the longer run and is a useful guidepost for policy makers (Obstfeld et al., 2005). However, recent studies suggest that there may be scope for intermediate policy choices that – using the words of Klein and Shambaugh (2013) – "round the corners" of the monetary policy trilemma and allow some time-bound room for manoeuvre to tackle specific national policy dilemma's. The policy options that address the various trade-offs in responding to significant shocks include for example trade protectionism to create artificial competitive advantages in interconnected product markets, selective capital market restrictions to address financial fragility concerns, macroprudential measures to better control domestic credit growth, soft currency pegs to gain some autonomy over domestic monetary conditions, and management of floating exchange rates to limit harmful currency volatility (chart 4). The appropriateness, feasibility and effectiveness of such "middle-of-the-road" policies are widely debated.

Chart 4: Rounding the corners of the monetary policy trilemma

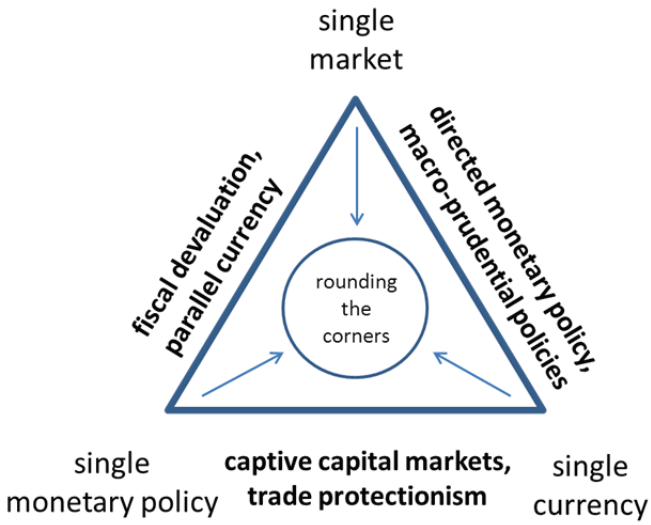


Note: A country that occupies two of the three corners and the line in between that connects them can still achieve some extra room for manoeuvre on the implied policy constraint if it is able to "round" the third corner.

Countries in the euro area have similar incentives to exploit the scope for trade-offs in an integrated single market with a single currency and a single monetary policy in order to restore some margin for national policy manoeuvre (Blundell-Wignall et al., 2013; Crafts, 2014). The possible tools that would "round the corners" of the euro area's monetary triangle include quasi-fiscal, regulatory, prudential, exchange rate, trade and industrial policies. They could be adopted both to prevent and manage

domestic imbalances inside the euro area as well as to respond to asymmetric shocks. During a crisis, participating countries may in particular look for national stabilisation tools that make it easier for them to tackle market turbulence, fiscal distress, and economic adjustment (chart 5).

Chart 5: Rounding the corners of the euro area's monetary triangle



Note: Euro area countries may "round" all three corners of the monetary triangle by trying to relax the constraints implied by open internal markets, irrevocably fixed bilateral exchange rates, and a single monetary policy stance.

For example, (coordinated) national macroprudential policies (such as changes in the required counter-cyclical capital buffer or the maximum loan-to-value ratio), could be used to counter heterogeneous business and financial cycles within EMU, where the single monetary policy is unable to prevent or address these in the member countries (Houben and Kakes, 2013; Herzberg and Watson, 2014). To assist a rebalancing of current account positions, some authors propose a fiscal devaluation as a national substitute to the inability of euro area countries to devalue (Keen and de Mooij, 2012). This policy reduces the relative cost of tradables through a shift in the tax base away from capital taxation and social contributions on labour to taxes on consumption or property. A radical suggestion to regain room for exchange rate manoeuvre is to introduce for some time a parallel currency in distressed countries which could fluctuate against the euro (Richter et al., 2013).

Constraining the free functioning of the single market could also gain momentum. To ease competitive pressures, governments may continue to shield the provi-

sion of services from foreign competition, provide state aid to favoured sectors, or impose administrative requirements that amount to trade protectionism in disguise. They may also be tempted to place restrictions on foreign take-overs of strategic firms and put up barriers to labour mobility within the EU. Bastasin (2012) reports in this respect that in the wake of the financial crisis several euro area countries protected their banks in order to prevent that they could become an easy prey to foreign acquisitions. Some also gave state subsidies or loans at concessional interest rates to their car industries.

Various suggestions have also been made for a more "effective management of capital flows" (see the policy agenda proposed by Lane, 2013, pp. 16 ff.). National policy makers may apply a range of financial sector policies as a tool to restrict cross-border capital movements and create more space to address domestic policy challenges stemming from volatile capital flows and tight financial conditions (Beck et al., 2015). During the sovereign debt crisis, the public debt managers of vulnerable euro area countries generally sought an insurance against rising market expectations of sovereign default (Dyson, 2014, p. 383; van Riet, 2014). This apparently took the form of inducing resident investors, in particular banks, pension funds and insurance corporations, to buy and hold more bonds issued by their own sovereign (see also Bastasin, 2012; Reinhart, 2012). Some euro area countries also used their fiscal capacity to enable weakened domestic banks to expand their role as major investors in government bonds and thereby to counter the risk of capital flight causing a sharp increase in their own borrowing costs (Valiante, 2014).

With the same effect, Koo (2012) proposes to agree at the euro area level to limit the sale of government bonds to citizens and exclude foreigners, while leaving investments in private sector financial assets free for non-residents. He sees this "nationals-only rule" as an alternative to a fiscal union, which could enable the government to run more flexible fiscal policies to fight a recession, as domestic creditors could be more likely to accept the necessary higher budget deficits. The key advantage of such a more captive domestic investor base is that it reduces the fiscal vulnerabilities from having a large and less stable foreign community of government bond holders, albeit at the price of crowding out local private investment and preventing domestic creditors from spreading their risks across a wider range of assets (van Riet, 2013).

Another example of financial protectionism is that national supervisors reportedly placed restrictions on the outflow of bank capital and liquidity, while demanding repatriation of assets held abroad, so as to ring-fence their domestic banking systems and secure credit supply for residents, including for the government (Véron,

2013).[6] As an ultimate solution against a run on bank deposits and citizens moving their savings abroad, Cyprus had to impose administrative restrictions on bank transactions and capital outflow controls in March 2013 that were in force for just over two years. Greece faced the risk of a financial breakdown related to a possible exit from the euro in June 2015 and was forced to temporarily close its banks and the stock exchange while until further notice closing the border for capital exports. Substantial capital flight would also have complicated these governments' future return to the capital market.

4.3 The fragmentation of the euro area

Such "middle-of-the-road" policies reflect attempts by national authorities to relax the constraints associated with the "holy trinity" of the euro area and to reclaim some control over how the triplet of the single market, the single currency and the single monetary policy affects their own economies. Some of the aforementioned interventions are sensible, such as a (budget-neutral) fiscal devaluation to improve competitiveness or national macroprudential actions to deal with localised housing booms. A correction of capital market failures and improper incentives in the financial industry that fuelled the external financing of a credit-driven boom in the crisis-hit countries is also warranted. The financial trilemma[7] associated with the high degree of financial integration in EMU nevertheless demands that member countries coordinate national macroprudential actions and regulatory measures which affect cross-border capital flows and financial conditions across the euro area (see Herzberg and Watson, 2014).

Some other crisis-related national policies, however, may be interpreted as a form of "mercantile competition" that is turning into market repression and protectionism to ease economic adjustment, reduce fiscal stress and solve distributional issues (cf. Hayek, 1939; McKinnon, 1995; Rodrik, 2000 and 2011). Government efforts to nurture the domestic banking and corporate sector or to introduce "hidden" restrictions on cross-border capital flows contribute to a renationalisation of markets, which could lead to growing economic and financial disintegration. The consequent fragmentation of the single market along national lines frustrates the

[6] This supervisory reaction appears to be a global phenomenon, leading to financial protectionism and a "balkanisation" of banking (The Economist, 23 November 2013, pp. 18 and 74). Rose and Wieladek (2014) report evidence that nationalised banks and those benefiting from public sector support after the 2008 financial crisis reduced foreign lending to counterparts in the United Kingdom or charged them higher interest rates.

[7] Following Schoenmaker (2011), the financial trilemma states that an effective management of domestic financial developments when there is full capital mobility is only feasible with international coordination.

efficient allocation of resources, distorts wage and price formation, constrains monetary transmission and complicates the conduct of the single monetary policy.

This in turn could oblige the ECB to take (further) non-standard measures for repairing the monetary transmission mechanism, also using special tools directed at dysfunctional national markets and economies starved of credit (see chart 5). In the same vein, several EU initiatives seek to promote the ability of capital markets to mobilise non-bank long-term financing and to channel it across Europe to regions, sectors and SMEs that are short of bank funding (European Commission, 2014). The steps being taken towards a capital markets union offering equal access to funding and uniform creditor protection also go in the direction of countering financial disintegration and fragmentation (European Commission, 2015).

4.4 The revival of economic nationalism

Altogether there is a risk of euro area countries curtailing the single market and returning to old-style industrial and directed credit policies for national benefit. Crafts (2014) sees the consequent retreat from economic and financial integration as a new political compromise to save the euro, comparable to the Bretton Woods episode when most European countries applied capital controls while pegging the exchange rate to the US dollar and opening up for trade. These capital market restrictions served in his view to preserve monetary policy autonomy and enabled countries to use financial repression as a national strategy to support public debt deleveraging and the build-up of a welfare state.[8]

Similarly, Monnet et al. (2014) interpret the return of financial market restrictions as a reactivation of historical patterns of suasion, interaction and control that in many EU Member States characterised the relations between governments, their central bank and the domestic financial sector for decades after World War II until the changeover to EMU. The objective of such close relationships was to ease the government budget constraint, allocate credit to favoured sectors, conduct industrial policy and stabilise the economy. According to these observers, euro area countries facing distress could again be allowed to use protectionist and repressive measures that facilitate their economic and financial adjustment and reduce the pain of fiscal consolidation.

EU law permits, within limits, taking measures at the European or national level to support the proper functioning of markets, the soundness of financial institutions and the stability of the euro. However, these actions may also have undesirable "side effects" that distort incentives and undermine the ability of markets to impose disci-

[8] Wyplosz (2000) explains the adherence to financial repression in post-war Europe with EU Member States' commitment to stabilise their exchange rates, reflecting a predominant concern with intra-area trade.

pline on national policy makers (van Riet, 2013). Where they are aimed at repairing dysfunctional markets and institutions and at protecting countries against distorted economic and financial conditions, they may be characterised as stabilising. Where the interventions go beyond correcting market and regulatory failures and introduce new distortions, such as government funding privileges or state aid facilities for national economic champions, they undermine the cohesion and integrity of EMU.

Before the crisis, market discipline was weak and the ample availability of cheap financing created political incentives to free-ride on the euro and to delay reforms; following the crisis, the return of market vigilance made financing more expensive, which this time could fuel political incentives in favour of protectionist and repressive measures that undermine the smooth functioning of the euro area. As the European Commission (2012, p. 10) warned: "More than 50 years after the foundation of the European Union the crisis of confidence appears to be reinstating the constraining power of national borders, questioning the Single Market and threatening the achievements and as yet unfulfilled aspirations of Economic and Monetary Union".

4.5 Limits to national policy autonomy and common risk-sharing

Two relevant questions for EMU are therefore whether and to what extent continued national autonomy over key economic policy areas is compatible with building a more resilient and integrated euro area; and to what extent a common risk-sharing mechanism is at all feasible in a heterogeneous monetary union.

The first issue can be illustrated by the fiscal/financial trilemma put forward by Obstfeld (2013): maintaining financial integration, financial stability and fiscal autonomy are mutually incompatible in a context where the health of the banking sector and the creditworthiness of sovereigns are closely intertwined. One of the three desiderata has to give way and moving to some kind of fiscal union appears to him (and others) as the most logical choice.[9]

Piketty (2014, p. 561) sees a fiscal union in this respect above all as an instrument to ensure the effectiveness of financial restrictions in an open international capital market, as the risk of capital flight requires them to be introduced at the level

[9] Pisani-Ferry (2012) draws the same conclusion in favour of a fiscal union on the basis of the new impossible trinity of a national banking system connected to the sovereign, a strict ban on monetary financing and the rejection of co-responsibility for public debt. Beck and Prinz (2012) see a single monetary policy by an independent ECB and the no bailout clause as mutually inconsistent with national fiscal sovereignty. The Tommaso Padoa-Schioppa-Group (2012) calls for a single currency area that combines the single market with a banking union and key elements of a fiscal union. Bindseil and Winkler (2014) argue that a monetary union like the euro area must have a strong underpinning by a banking and fiscal union in order for the common central bank to be able to deal with solvency issues that might arise when it fights a liquidity crisis.

of the euro area: "When countries relinquish monetary sovereignty, it is essential to restore their fiscal sovereignty over matters no longer within the purview of the nation-state, such as the interest rate on public debt, the progressive tax on capital, or the tax of multinational corporations."

Yet, the costs and benefits of moving to a fiscal union also depend on the role assigned to markets and institutions in ensuring budgetary discipline. McKinnon (1997) argues that a supranational fiscal authority in combination with a "hard" budget constraint on euro area countries would put the latter in the position of subsidiary sovereigns like American States. The concern he raises (both for the case of Europe and that of the United States) is that a supranational government in principle faces a "soft" budget constraint, because the federal bonds that it issues will be perceived as "risk free" in the home capital market as long as it has (political) influence over the common central bank. Under these circumstances federal bonds will be the preferred "safe" investment category and hence the supranational government faces little market discipline. To prevent the "federal leviathan" from building up too much debt, it would need to observe a balanced budget rule, possibly together with a constitutional agreement that federal taxes are to be used only for financing truly federal public goods and services.

Moreover, when the common fiscal capacity is used to make transfer payments to equalise economic conditions across the monetary union, the subsidiary sovereigns get indirect access to the common central bank and their own budget constraint will soften accordingly. This benefit is of particular interest to the less fiscally prudent members, who may even adopt strategies to exploit this channel. Bolton and Jeanne (2011, p.190) note in this respect that the wealthier EMU countries will have a strong interest in a form of fiscal integration which imposes as much budgetary discipline as possible, because in a fiscal union they could otherwise be forced to make continuous transfer payments to the weaker countries.

Tirole (2015) believes that, in such an asymmetric situation, the healthy countries have no incentive to conclude joint-and-several liability arrangements. After a negative shock, they will only show solidarity to distressed members out of self-interest, in order to prevent being hit by contagion effects arising in an integrated monetary union, i.e. an environment in which imposing official sanctions is not very credible. Multilateral insurance is in his view only feasible in a symmetrical context where all members have a sound fiscal position, are equally exposed to shocks, face large spill-over effects and market-induced sanctions to over-borrowing are credible. This in turn requires much more progress with real economic convergence.

The conclusion is that the cohesion and integrity of EMU may only be guaranteed if (new or existing) supranational public institutions receive sufficient intervention powers to preserve market-based discipline as a complement to rule-based pressure on member countries. This should promote more similar economic condi-

tions and a more optimal currency zone. In addition, the possible creation of an area-wide fiscal authority should be embedded in an appropriate governance structure to avoid opening the door to a new public debt bias. As a further constraint, recalling Hayek (1939), a common fiscal policy in combination with common risk sharing and solidarity mechanisms must be grounded in common values and preferences among euro area citizens, or at least enjoy democratic legitimacy.

5 Benefits of market-preserving fiscal federalism for EMU

5.1 Political restrictions on discretionary economic policies

The ability of euro area countries to engage in harmful "mercantile competition" jeopardises EMU by moving it away from an optimum currency area. The question is therefore how in practice to counter such protectionist tendencies and how to revive economic and financial integration in a political set-up where so far nation states have largely retained their sovereignty (as they have only transferred common tasks in the fields of trade and competition, monetary policy and banking supervision and resolution to European institutions with limited accountability to the European Parliament).

A possible answer lies in the observation by McKinnon (1995, 1997), Weingast (1995) and Qian and Weingast (1997) that a stable and welfare-enhancing monetary union needs "market-preserving (fiscal) federalism". This amounts to a multi-level governance structure which secures free and open markets, promotes efficient horizontal competition between the member countries and subjects all governments to a "hard" budget constraint (without privileged access to credit, the printing press or a bail-out) while providing financial stability safeguards against disruptive market forces. To prevent that political forces encroach on markets, it places credible restrictions on discretionary economic policy making – both at the national and supranational level – and it simultaneously protects property rights and enforces contracts.[10]

Against this background, taking inspiration from the criteria put forward by McKinnon (1995, 1997), Weingast (1995) and Montinola et al. (1995), one may derive five main characteristics of market-preserving fiscal federalism that could govern the European Monetary Union:

1. There exists a clear *hierarchy between area-wide (federal) authorities and subsidiary authorities* in which each level of government is autonomous in its

[10] Market-preserving fiscal federalism closely corresponds to what Enderlein (2009) calls "competitive fiscal federalism". Among his three worlds of fiscal federalism, this type stands for a federation in which the federal government shares its power with sub-national entities that are responsible for financing their own policies and in which there is no requirement to equalise living conditions through transfer payments.

own jurisdiction and subject to democratic control; *the allocation of their tasks and responsibilities is durably institutionalised* by a common political agreement anchored in primary legislation.

2. Area-wide (federal) institutions provide the *common public goods and services that are essential for the efficacy and stability of the monetary union,* notably a central judiciary to police the common market and enforce competition law and contracts, an integrated capital market with a single set of rules that ensure equal access to finance and offers equal creditor protection, a single monetary policy independent from political interference, a fully-fledged banking union, single supervision and resolution of non-bank financial institutions, a strong capacity for macroprudential interventions, a common sovereign bond that functions as anchor of the financial system, a common fiscal backstop as a fall-back for subsidiary governments and ailing systemic banks that are deemed solvent, and a sovereign bankruptcy procedure involving private creditors in removing a public debt overhang when a member country is clearly insolvent.
3. The area-wide (federal) fiscal authority has a *structural balanced budget* in normal times allowing for modest spending to fulfil its tasks fully backed by its own tax revenues; it ensures that *fiscal and structural policies are aligned* across the union; and it manages a *common stabilisation mechanism* that issues the common sovereign bond (a synthetic instrument secured by a portfolio of subsidiary government debt), provides the common fiscal backstop and implements the sovereign bankruptcy procedure.
4. All subsidiary governments maintain a *structural balanced budget for current spending;* they can borrow for cost-effective capital expenditure[11] and to capitalise the common stabilisation mechanism; their sovereign debt is rationed by the capital market and receives no preferential treatment in financial regulations.
5. Each subsidiary government has *primary responsibility for its own economy;* it can only draw on the common fiscal backstop to absorb exceptionally large asymmetric shocks and excessive financial market reactions and this temporary liquidity support is subject to strict policy conditions that effectively constrain their sovereignty; it can only request to activate the sovereign bankruptcy procedure in exceptional cases subject to common agreement; a sovereign bail-out operation financed by area-wide (federal) institutions or other subsidiary governments to restore solvency is strictly forbidden.

These five characteristics emphasise that political institutions have an economic role to play in EMU by providing a balanced multi-level political system of rights and obligations that forms the basis for a well-functioning open and competitive

[11] This "golden rule" is taken from McKinnon (1995, 1997), but is not feasible in EMU because the Stability and Growth Pact and the Fiscal Compact demand a close to balanced overall budget or surplus in structural terms.

internal market and for sound economic policies that foster sustainable convergence of the participating nation states.

5.2 The need for political checks and balances

To make such a governance structure "self-enforcing", so Qian and Weingast (1997), politicians must have credible incentives to honour the common rules of behaviour. As noted by McKinnon (1997) and Weingast (1995), under an unbalanced political system the central government may have too much discretionary authority to promote its own interests by restricting economic freedom and reallocating income and wealth to the centre. This tendency to overwhelm the subsidiary governments could destroy the federal system and the stability of the common currency – unless a strong central bank takes countervailing measures. Or subsidiary governments may have too much scope to overspend by borrowing against the future, to overtax citizens in an arbitrary way, or to provide distortionary state aid to favoured local industries. This free-riding behaviour at the expense of other members would also undermine the federal system and may oblige the central bank to step in to safeguard the common currency.

To solve these dilemmas of federalism, a proper balance of powers is required: the central government should have a sufficiently strong mandate to police free-riding subsidiary authorities and align their economic policies. The subsidiary governments in turn should be able to resist an encroaching central authority by taking concerted action against abuses (Qian and Weingast, 1997, p. 90). A common central bank and other union-wide bodies removed from direct political control (such as the judiciary) could in both cases tip the balance of this power struggle in favour of economic policy discipline as a precondition for a viable federal system and a stable currency.

Montinola et al. (1995, p. 54) argue in this context that a market-preserving federal system with the right political checks and balances between the central government and subsidiary governments is superior to either complete centralisation with a unitary government or a complete decentralisation with each region being an independent nation state. The reason for this superiority is that in both alternative corner solutions the unitary government or the independent nation may retain the discretionary power to encroach on markets and abuse their central bank to devalue the currency or create inflation when it is looking for ways to circumvent its budget constraint.

This analysis is also relevant for the ongoing discussions on the appropriate degree of political integration in the euro area and the future of the euro as a currency beyond the state: it suggests that a fully-fledged fiscal and political union may be neither desirable, nor necessary. For a sustainable EMU it could be sufficient to have effective common rules and autonomous supranational authorities (separate

from the ECB) for safeguarding and enforcing economic freedom and market discipline, as well as a credible commitment of all national authorities concerned to coordinate their policies at the union level and to do whatever may be necessary for stabilising the euro (van Riet, 2015).[12] This will still require a revision of the Lisbon Treaty to ensure that these supranational bodies have effective restraining powers and are made subject to democratic accountability and control.

The additional condition of democratic legitimacy relates to the "political trilemma" put forward by Rodrik (2000, p.180; 2011, p.200). He highlights that any country wishing to participate in an integrated world economy has to make a choice: either give up national self-determination (replacing it by supranational decision-making under democratic control), or forget about participatory democracy (replacing it by a political system in which sovereign nation states delegate tasks related to the global economy to autonomous international institutions without democratic legitimacy).

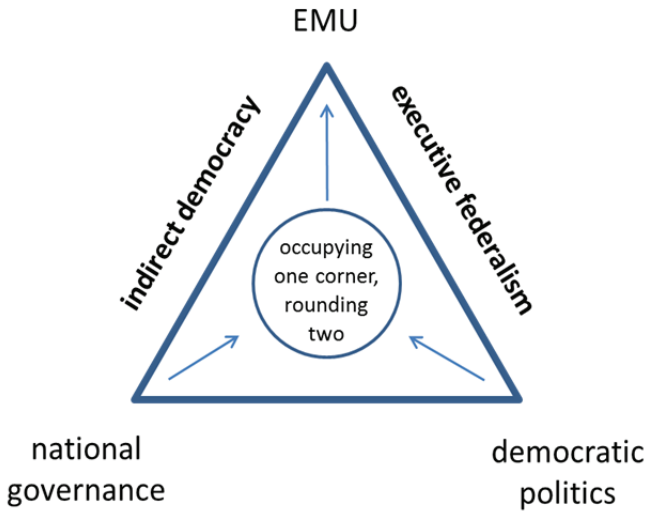
Rodrik (2011, p. 218) sees Europe in this respect as "a half-way house", as it combines deep regional economic integration among the sovereign Member States with an elaborate EU governance structure of many specialised agencies and few democratic institutions. Taking his analysis and focusing it more specifically on the euro area, the intermediate solution adopted for the political trilemma may be seen as another example of how its members are trying to "round the corners" of this triangle, notably with regard to the role of the nation state and of democratic legitimacy, while aiming to meet the economic requirements for a successful participation in EMU (chart 6).

On the one hand, as discussed further in section 5.3, the European leaders have established EU institutions with executive mandates to provide common public goods and services, promote sound public finances, and stabilise the financial system. This EU governance framework of "executive federalism" (the expression used among others by Habermas, 2011) ensures that national policies are geared towards facilitating mutual trade and capital mobility, concerted fiscal discipline and area-wide financial stability rather than towards serving narrow domestic interests. For this purpose, so Rodrik (2011), national regulations are either harmonised according to common standards or structured in such a way that they reduce transaction costs and pose "the least amount of hindrance" to economic integration. In addition, the discipline imposed both by EU surveillance and market forces makes national policies compatible with euro area policies and the requirements for a stable and coherent monetary union.

[12] This is in line with the conclusion of the Tommaso Padoa-Schioppa Group (2012, p. 5) that "the single currency requires as much fiscal federalism as necessary for its appropriate functioning, but as little as possible". See also Allard et al. (2013) for a discussion of the elements of a fiscal union that would be required as a minimum to make future euro area crises less severe.

On the other hand, the growing reach of "executive federalism" has narrowed the domain of national electoral influence. The Lisbon Treaty has therefore strengthened the political infrastructure at the European level, notably by giving greater powers to the European Parliament. Still, democratic legitimacy remains largely vested at the national level. The question remains how to make supranational decision-makers more directly politically accountable for their actions, in particular as this also presupposes the existence of a social consensus among European citizens (cf. Rodrik, 2000, pp. 182, 185; Rodrik, 2011, pp. 214–220; Habermas, 2011).

Chart 6: The political trilemma of the euro area



Note: To manage EMU, euro area countries have transferred specific common tasks to EU executive institutions that are subject to indirect democratic control at the national level rather than directly to the European Parliament.

5.3 The market-preserving rules and institutions of Europe

Europe has many supranational rules and institutions that provide the common public goods and services that a viable monetary union requires and the recent substantial upgrade of its governance framework should be instrumental in better aligning national incentives with market-preserving behaviour. The authority of the European Commission to police the EU internal market and that of the European Court of Justice to enforce competition law are well-established; they secure the cross-border mobility of goods, services, capital and labour. The Single Market Acts of 2011 and 2012 contain initiatives to further deepen the EU internal market. This EU

legislation followed the call in the Monti (2010) report for a new EU strategy to safeguard the single market against a revival of economic nationalism and to extend it to new areas. The envisaged creation of a capital markets union that further harmonises financial legislation and promotes the availability of non-bank sources of investment funding across Europe should also contribute to further integration.

Since 2011, the newly established European System of Financial Supervision (comprising the European Systemic Risk Board (ESRB) and the three new European Supervisory Authorities for banks, occupational pension funds and financial markets) has been given the task to ensure efficient and harmonised macroprudential and microprudential regulation and supervision in Europe. Their aim is to support financial stability and a sound financial system in the EU as a whole.

The ECB is since 1999 in charge of the single monetary policy with an independent mandate to maintain price stability in the euro area. Originally it was foreseen that it would only contribute to financial stability, because prudential supervision remained a national responsibility. Since November 2014, however, the ECB has been mandated with new powers as the single supervisor of significant banks in the euro area and with final responsibility for the supervision of the smaller banks that will remain under national oversight. The ECB now also shares responsibility for macroprudential supervision with the national authorities as coordinated by the ESRB and it may decide to tighten (but not loosen) the macroprudential capital buffers applied nationally to the banking sector when still seeing a risk of financial imbalances. This should remove a "home bias" in banking supervision and the risk that major banks could be pushed into investing in the sovereign bonds of their country of residence. Moreover, the separate Single Resolution Mechanism ensures that as from 2016 bank resolution will follow harmonised procedures.

The Treaty enshrining the Fiscal Compact introduced as from 2014 a structural balanced budget rule in each contracting party's national legislation, complementing the reinforced Stability and Growth Pact. A new EU surveillance procedure, which took effect in end-2011, aims to prevent and correct harmful macroeconomic imbalances. As from mid-2013, euro area countries also face more intrusive supranational surveillance and stronger enforcement in the event that their macroeconomic or fiscal policies would go astray. The newly established European Stability Mechanism (ESM), capitalised by the euro area countries, provides a common fiscal backstop for countries in liquidity stress, subject to strict policy conditions. Given an ESM assistance programme, the ECB might decide to undertake outright monetary transactions in a dysfunctional government bond market, if this was warranted for monetary policy reasons. As a "last resort", the ESM may also directly inject capital in troubled banks, assuming that all other options including a private sector bail-in have been exhausted. Finally, as private investors will be aware, collective action clauses introduced in new sovereign bond contracts should in future facilitate in exceptional cases an orderly public debt restructuring for insolvent countries.

5.4 The limits of half-way euro area political integration

Yet, this enhanced supranational economic and financial governance framework may be neither sufficient nor effective in countering (hidden) market repression and protectionism by euro area governments. Political economy arguments suggest that, as before, they might seek to escape market-based policy discipline and the "hard" budget constraint. As noted before, governments may respond to fiscal stress by inducing a captive domestic investor base or react to an economic downturn by imposing protectionist measures. The enforcement of the single market, the new banking union and the future capital markets union should mitigate these concerns, but it remains to be seen how effective they will be in countering financial protectionism and imposing uniform laws governing securities markets.

Sapir and Wolff (2014) observe in this respect that "the single market is still far from reality in vital areas", pointing to the Commission's limited leverage over the largest EU Member States. Focusing on cross-border finance, the ESRB Advisory Scientific Committee (2014) argues that the application of EU competition policy to banks is only weak, which complicates the task of countering government tendencies to nurture national banking champions and to protect them from foreign competitors and take-overs.

Dickson (2015) highlights that the ECB in its role as single bank supervisor works on creating a common supervisory culture across Europe characterised by a centrality of vision and absence of national bias. However, there is as yet no unified EU legal framework for banking supervision. This means that the ECB is confronted with very diverse supervisory provisions and implementation practices at the national level that create a significant margin of discretion and may interfere with the ECB's supervisory competences. For example, national authorities can still issue binding prudential legislation that may hamper even conditions of bank competition and fragment the banking union.

Posen and Véron (2014) conclude that Europe has established only "half a banking union". There are lingering doubts over the remaining autonomy of national resolution authorities and the adequacy of ESM funds reserved for direct bank recapitalisation. To complete the banking union, further steps will need to be taken to put in place a common fiscal backstop for the Single Resolution Fund as well as a European deposit insurance scheme.

Furthermore, a supranational supervisor for institutional investors is still out of sight, despite their large cross-border financial activities. Also the national rules and supervisory bodies governing financial market structures may still prevent uniform capital market conditions. Altogether this suggests that banks, pension funds, insurance companies and other financial intermediaries may still be vulnerable to moral suasion from national authorities to invest more "at home", such as in housing, energy, infrastructure, and in sovereign bonds.

Moreover, the new national macroprudential authorities in the euro area may not yet fully internalise the spill-over effects of their policies on other member countries. As noted by Angeloni (2014), with central coordination still in its infancy, they could introduce a domestic dimension in their oversight of credit developments. This would distort the allocation of capital and undermine financial integration. Or they might take an overly lenient attitude towards signs of overheating and a large sovereign exposure, especially when the necessary measures are politically sensitive. This could have negative consequences for economic and financial stability, both in their own country and in the euro area.

Arellano et al. (2015) point to weaknesses in the EU legal framework for creditor protection and enforcement of property rights, allowing considerable differences across countries. Member States have also retained the right to impose controls on capital movements on public policy grounds. This situation keeps foreign investors alert to rising sovereign stress and the risk that governments might interfere with private contracts, freeze bank deposits and impose capital outflow restrictions that hinder private borrowers from servicing their external debt. As a result, any sovereign debt crisis is likely to spill over to the private sector and turn into an external debt crisis.

Finally, Crafts (2013) warns that growing anti-European sentiments, rising euro scepticism and falling popular support for a free market economy could fuel protectionist tendencies that damage the euro area's growth prospects.

5.5 The transformation to a more perfect monetary union

Following the negative scenario outlined by Pisani-Ferry et al. (2012), the unwillingness of euro area countries to cede further sovereignty could – not only in a crisis but also in normal times – cause a sustained fragmentation of financial and product markets and lead to a degeneration of EMU. Taking a more positive stance, Posen and Véron (2014) expect that the banking union, even when it is only half completed, will counter nationalist tendencies and have a positive transformational impact on the economic and financial structure of Europe.

As part of this transformation, Trichet (2011) calls for setting up an EMU treasury, with a balanced budget of moderate size. This central ministry of finance could be given the responsibility to align national fiscal policies in the euro areas's interest, carry out surveillance of national economic policies and, when necessary in exceptional cases, enforce the prevailing rules of behaviour upon member countries.

The EMU treasury could also be put in charge of managing the financial support tools of the ESM designed for member countries that face temporary liquidity constraints but are fundamentally solvent. For countries that have an unsustainable public debt it could activate a sovereign bankruptcy procedure involving private

creditors. Phasing in a statutory framework that opens the possibility of an orderly sovereign default inside EMU reinforces the credibility of the temporary and conditional character of the fiscal backstop provided by the ESM. Moreover, it should be expected to increase market discipline on governments which is vital to preserve their "hard" budget constraint (Fuest et al., 2014; Deutsche Bundesbank, 2015).

Brunnermeier et al. (2011) suggest introducing a "safe" common sovereign bond to anchor the financial system and mitigate destabilising cross-border capital flows within the euro area. The EMU treasury could be given a mandate for the ESM to issue a tranche of senior synthetic bonds backed by a maximised portfolio of national sovereign bonds as well as a tranche of junior synthetic bonds that would carry the potential losses. To maintain a "hard" budget constraint for the participating countries, the preferential treatment of government bonds in EU prudential legislation that leads to an under-pricing of sovereign risk in the capital market could be gradually limited and carefully phased out (see also van Riet, 2013; Deutsche Bundesbank, 2015).

Overall, a higher level of market-preserving fiscal federalism is warranted, i.e. a transfer of national sovereignty to the union level as necessary to secure the cohesion and integrity of the euro area. To succeed, however, the principles of economic freedom and market discipline in EMU must be anchored in what Weingast (1995, p. 26) calls "a social consensus about the appropriate limits of the state" – or in the context of the euro area: about the responsibilities of sovereign nations participating in a monetary union. Such a consensus should lead citizens to withdraw their political support for a national government that violated these economic principles and refuses to internalise the positive requirements of a welfare-enhancing EMU and the negative externalities of market-distorting policies for other members. The biggest challenge for the euro area may well be that of "finding a consensus on, and support for, new social contracts among national constituencies" that guide the economic, financial and political transitions that are required to foster convergence towards an optimal currency area and ensure the long-term viability of the euro (Mongelli, 2013, p.7).

6 Conclusion: an imperfect monetary union may entrench fragmentation

This paper examined the role of markets and institutions in disciplining national policy makers and driving EMU towards an optimum currency area. European leaders introduced the euro as a political solution to the monetary policy trilemma known from the economic literature. They expected that this would offer them the triple benefits of a single market with a single currency and a single monetary policy, i.e. a "holy trinity". The price to pay was that national policy makers in principle became subject to stronger market discipline. EU surveillance of compli-

ance with the fiscal rules of the Maastricht Treaty and the Stability and Growth Pact complemented the market forces with peer pressure in support of sound public finances.

The euro crisis revealed the design flaws of EMU, showing that the area-wide control mechanisms to counter complacent national policies and protectionist tendencies were too weak and that supranational authorities to control the financial sector were needed as well as a "last resort" common rescue mechanism for liquidity-stressed sovereigns and failing systemic banks. Moreover, capital markets had exercised insufficient fiscal policy discipline before the crisis erupted. This appears at least partly due to the regulatory presumption that government bonds of all euro area countries were "safe", which seemed to suggest a readiness of euro area partners to support each other in times of fiscal stress and in effect undermined the credibility of the "no bail-out" clause.

European leaders have responded to the euro crisis by putting in place an enhanced economic and financial governance framework for the euro area. This should be more successful in aligning national incentives with EMU requirements and in preventing and correcting unsound national policies, while providing for a common fiscal backstop if member countries nevertheless run into trouble. They also established the main pillars of a banking union and have taken first steps towards a capital markets union. The question is whether these important but still half-way measures of political integration, within the boundaries of the Lisbon Treaty, are sufficient to safeguard the cohesion and integrity of the euro area.

Governments have kept their national sovereignty in the field of macroeconomic and fiscal policies and may try to use this leeway to "round the corners" of the euro area's monetary triangle, i.e. to circumvent the "hard" budget constraint and the strong market competition that they face in EMU. For example, high-debt governments may target more captive sovereign debt markets so as to reduce their exposure to fickle foreign investors and volatile interest rates. Countries may ring-fence their national banking champions or put pressure on institutional investors in order to secure access to credit for residents, including for the government itself. Or they may continue to shield strategic firms from foreign competition and take-overs or use state aid to subsidise favoured sectors.

Those countries that applied such protectionist strategies during the euro crisis in effect turned inwards by promoting a renationalisation of policies and markets to facilitate their adjustment and deleveraging process. This economic nationalism may serve them well as a transitory stabilisation tool, but the longer it is sustained, the more it entrenches the fragmentation of the single market, which in turn frustrates the single monetary policy and the efficient functioning of the European Monetary Union.

To guarantee the cohesion and integrity of the euro area a higher level of market-preserving fiscal federalism is warranted whereby European institutions

with a democratic mandate are empowered to ensure the alignment of national policies with the requirements of EMU. This should prevent individual member countries from encroaching on markets and foster sustainable economic convergence towards a more optimal currency area. Creating a fiscal union in a next step requires care to preserve fiscal discipline, because a powerful central government tends to enjoy a "soft" budget constraint and any budget transfers to subsidiary governments would extend this public debt bias to the national level.

Finally, more fiscal federalism along these lines also requires that the principles of economic freedom and market discipline are supported by a social consensus about the responsibilities of sovereign nations participating in a monetary union. The most important challenge of realising a welfare-enhancing EMU is to create national ownership for the economic, financial and political reforms necessary to secure the long-term viability of the euro.

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