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Tommaso Padoa-Schioppa Group,  
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## Executive summary

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The root cause of the current crisis lies in the contradiction between a single, supra-national currency and the continuation of nation-state-based economic policies. Surmounting that contradiction requires neither the creation of a “European Super-State” nor a return to individual nation-states and national currencies. What is needed is a sui generis form of fiscal federalism, which derives from the functional deficiencies of the current common currency framework while respecting to the largest possible extent the budgetary autonomy of euro area member countries. We argue that the single currency requires as much fiscal federalism as necessary for its appropriate functioning, but as little as possible. We present proposals to achieve this objective, deriving them from the main challenges that the euro area had to face during the first decade of its existence.

The first challenge derived from the primacy of the real interest rate effect over the real exchange rate effect. During the first decade of the common currency, price differentials in the euro area were more persistent than initially foreseen. As a consequence, the interest rate set by the European Central Bank was “one size fits none”: it had adverse and even self-enforcing pro-cyclical effects on most Member States. This led to excessive cyclical divergences and imbalances. The real exchange rate

effect did not trigger a sufficient degree of price convergence and thus failed to stop the imbalances.

The second challenge lies in the area of fiscal policy coordination and fiscal surveillance. Internal imbalances only became a matter of euro area concern when the mechanism of “self-fulfilling solvency crises” set in. As euro area members issue their debt in a currency over which they do not have full control, a liquidity crisis in these countries cannot be solved through devaluation but increases the likelihood of default.

The third challenge derives from the paradoxical set-up of financial markets. Due to the interdependency of banking systems in the euro area, contagion risks are high. At the same time, Member States are individually responsible for banking supervision and potential bailouts. The nexus between national banks and national sovereigns has a self-enforcing effect with strong negative externalities on the rest of the currency union.

To solve these three challenges, policy actions in four areas are required.

- a) The first element is the completion and fostering of the Single Market in order to allow the real exchange rate channel to work more effectively. The euro area needs to become a truly integrated economic area. To achieve this goal, domestic institutional adjustments to increase the responsiveness of wages and prices are also required.
- b) The second element is a cyclical stabilisation insurance fund to counter some of the effects of the “one size fits none” monetary policy. Such an insurance fund, which should be created outside the EU budget and remain under direct control of national parliaments, would work in a largely automatic fashion and, if rightly devised, not lead to long-term transfers in only one direction.
- c) The third element is a rebalancing of fiscal rights and fiscal duties in the common currency area. We argue that euro area countries should become subject to much stricter budgetary surveillance and be willing to give up some elements of their sovereignty when they are cut off from the market. The core principle should

be: sovereignty ends when solvency ends. But at the same time, the euro area as a whole should ensure that adequately priced access to sovereign financing is generally possible, also in times of crisis. To allow for the implementation of that third element, we suggest the creation of a European Debt Agency (EDA) that would allow a flexible refinancing possibility to countries in exchange for a stepwise transfer of sovereignty. The EDA would (i) be jointly and severally guaranteed by all euro area countries, (ii) serve as a normal financing instrument for an amount of 10% of GDP to all countries, (iii) provide relatively easy access to additional funding in crisis times for relatively small amounts (up to an additional 10% of a country's GDP), (iv) but then ask for much stricter conditionality in pre-defined steps of rising debt amounts with additional debt amounts implying a stepwise transfer of budgetary oversight to the EDA. Should a country require more than 60% of its GDP as EDA-backed financing, it would need a green light from EDA before being able to adopt its budget or otherwise exercise its budgetary sovereignty. Not respecting a red light would not be legally excluded, but would automatically entail the exclusion of any EDA financing and trigger a sovereign default. As an alternative, a full transfer of sovereignty to the EDA could also be envisaged for countries reaching a 60% debt to GDP ratio, but this would require far-reaching changes in national constitutional law.

- d) The fourth element is a euro area banking union. To solve the paradoxical set-up of financial market integration and banking supervision, the creation of a euro area banking supervision authority with micro-prudential supervision powers is required. This role could be conferred upon the ECB. In parallel, the creation of an agency administering a European deposit insurance fund would be required.

To make the required changes possible, the euro area will have to agree on a new institutional and legal structure. This goal can best be reached in a new Intergovernmental Treaty. While formally outside the current Treaty structure, it should be closely linked to it and preserve as much as possible the involvement of EU institutions and bodies. It could be transferred into the existing EU legal framework at a later stage.

Most of the changes required for a better functioning of the single currency are of a long-term nature. But they are urgent. What is required today is a road map

leading ultimately but definitively to the desired changes. A short-term “big bang” is unlikely. At the same time, the biggest danger in the current context is excessive short-termism. What is needed is a credible path to necessary change. This would rebuild trust in the single currency and in the continuation of the project of European integration.