

Euro Zone: As Much Integration as Necessary but No More *by Eulalia Rubio, senior research fellow with Notre Europe*

The current euro-zone crisis is partly rooted in the contradiction between a single, supranational 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 Union, capable of correcting the dysfunctions inherent to the original framework of the monetary union but, in line with the principle of subsidiarity, restricting any adjustments to that which is strictly necessary to ensure the euro's survival.

This is the overall principle underlying a report drafted by the "Tommaso Padoa-Schioppa group", set up by the Paris-based think tank *Notre Europe*. Drafted by ~~ten~~ nine top-ranking European experts, the report formulates a series of proposals considered crucial to ensure the lasting success of the euro. Most of the propositions focus on the medium to long term view but the basic message is clear: long-term matters are urgent matters. In other words, we need to clearly establish our longer-term goals if we are going to make valid decisions for the short term. In the context of the current crisis and at a time when long-term issues are surfacing in the European agenda, it is particularly enlightening to study the in-depth analysis and the suggestions enshrined in this report.

In the view of the Padoa-Schioppa group's members, the euro zone has had to face **three major difficulties** in its first ten years of existence. First of all, price differentials within the euro zone were higher and more widespread than initially foreseen. The pro-cyclical impact of the single interest rate set by the ECB has not been corrected by the effect of the real exchange rate, and this has led to excessive and persistent cyclical economic divergences. Second, problems have been encountered in the area of fiscal policy coordination and fiscal surveillance, leading to permanent budgetary imbalances. These imbalances only became a matter of euro area concern when the mechanism of a "self-fulfilling solvency crisis" set in and EMU lacked the appropriate instruments to respond. Lastly, the existence of mainly European financial markets in parallel with basically national systems of bank supervision and resolution has translated into a perverse link between banks' weaknesses and the dynamics of the sovereign debt.

To remedy these problems for the future, the report proposes **policy action in four domains, all of them very ambitious** yet all of them held to be necessary.

The first involves completing and fostering of **the single market** so that the euro zone really can become a fully integrated economic area. The goal is to allow the real exchange rate mechanism to work more effectively, thus alleviating monetary policy's pro-cyclical effects.

According to the Padoa Schioppa group's experts, strengthening the single market is not going to eliminate the risk of cyclical divergences. In order to help countries to address economic downturns more effectively, the second proposal involves the creation of **a cyclical stabilisation insurance fund**. This insurance fund would be created outside the EU budget and would remain under national parliaments' direct control. Financed through contributions from national budgets, it would work in a largely automatic way, providing temporary help to those EMU countries in severe downturns. If properly construed, it would not entail any long-term unilateral funding transfers.

The third proposal involves a rebalancing of budgetary rights and duties within the euro zone through the **creation of a European Debt Agency (EDA)**. On the basis of the principle whereby

"*sovereignty ends when solvency ends*", the EDA would guarantee all euro-zone member states access to the financial markets, even at a time of crises, in return for a gradual transfer of sovereignty. The EDA would be jointly and severally guaranteed by all EMU member states. Under normal times, all Eurozone countries would issue 10% of their GDP through the EDA, thus establishing a very liquid market of EDA bonds, of about half the size of the current market for *Bunds*. The idea is that the more a country's debt rises and the more that country is forced to turn to the Agency for its funding, the stricter the conditionality and control applied by the Agency and the more this control encroach on the prerogatives of that country's national authorities. Thus, if a country needs EDA-guaranteed funding amounting to more than 60% of its GDP, it would need the EDA's formal approval in order to adopt its budget or otherwise exercise its budgetary sovereignty. Not respecting a rejection from the EDA would not be legally excluded, but it would automatically entail the impossibility of seeking funding from the EDA and a sovereign debt restructuring. Another possibility could be a legal transfer of fiscal sovereignty from the national level to the EDA for those countries that reach a debt ratio of over 60% of GDP (i.e. transferring to EDA all powers to conduct the fiscal policy of this country), although such a move would of course demand an in-depth revision of national constitutions.

The fourth major proposal put forward in the report is the establishment of an **EMU banking union**. This would comprise a single bank supervision authority for the EMU (which could be set up within the ECB or closely cooperate with the ECB), and a Euro area banking insurance scheme which, as the US FDIC, would combine the function of a banking resolution agency and a deposit guarantee scheme.

While some of these measures can be adopted in the framework of the current treaty, others would require deeper institutional and legal changes. Thus the establishment of the EDA, for instance, would entail the appointment of an EMU finance minister but also the creation of a new body capable to ensure the democratic legitimacy of EDA. In this respect, the report suggests entrusting supervision of the EDA's action to a joint committee comprising 34 euro-zone national deputies and 17 members of the European Parliament. It also suggests the signature of a Intergovernmental Treaty at 17 to institutionalise these changes, a treaty which could subsequently be integrated into the EU's legal framework.

The report of the Padoa-Schioppa group constitutes a coherent package of measures reflecting a variety of political affinities and interests. Some of its proposals tend to meet the concerns of northern European countries, while others are more inclined to meet southern European countries' expectations; some are traditionally right-wing demands whereas others are closer to the left-wing sensitivity. In that sense, the report looks set to become an important source of inspiration for the "road map" which Herman Van Rompuy and the other three presidents are due to submit to the European Council before the end of the year.