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On the Future of EMU:
Targeted reforms instead of more fiscal integration

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Executive Summary

According to a dominant narrative, the recent crisis has allegedly shown that EMU is not sustainable without fiscal risk sharing. We identify two major hazards associated with this view. First, trust in EMU governance could unduly erode despite major recent achievements, notably if further fiscal integration should prove elusive. Second, the debate on further fiscal integration could distract from additional reforms needed to prevent financial cycles in the future.

In contrast, we suggest that a limited set of reforms (mostly focusing on the financial sector) would suffice to make EMU sustainable. Our train of thought is based on qualifying the proponents' arguments for more fiscal integration in a systematic manner (see figure 1 in the text and the annex table). In brief, we argue that:

- The recent crisis was exceptional, because several extraordinary factors contributed to its severity that are unlikely to repeat: the one-off interest rate decrease at the onset of EMU, the ensuing large credit boom, the severe global financial crisis, the German labour market reforms, and a large globalisation shock emanating mainly from China and the eastern enlargement of the EU.
- The remaining crisis legacy is likely to be temporary and should thus be tackled with temporary instruments only, such as the ECB's unconventional monetary policy, the EFSI that should be made more effective, and bad bank solutions.
- Reforms already implemented and yet to be taken can prevent excessive financial cycles in the future so that future crises in the euro area will be less severe.
- Important achievements in this respect are the new crisis mechanisms (ESM and OMT), the strengthening of the banking system, the banking union, the creation of a new macroprudential framework with a strong SSM together with the new macroeconomic surveillance. Additional reform requirements include ensuring that bail-in-able-capital is largely held outside the banking sector, making sure that banks are not too big to fail, and ending the preferential treatment for sovereign bonds of euro area governments in the medium term, and preventing systemic risks in the shadow banking sector. Moreover, the counter-cyclical capacities of national fiscal policies should be made more effective.
- The functioning of EMU has improved much more in the course of the recent crisis than commonly recognised, so that with some further reforms EMU will be much better able to deal with "standard" idiosyncratic downturns.
- More specifically, the heterogeneity among EMU countries has been reduced in a very important respect, because significant structural reforms in distressed countries have increased the similarity of labour and product market regulations that are highly relevant for wage and price adjustments.
- The potentially detrimental one-size-does-not-fit-all problem of the single monetary policy (and the resulting real interest rate effect) can be tackled in a country-specific with the new macroprudential policy tools in order to prevent new

excessive financial cycles. To effectively achieve this aim, the SSM needs to have access to borrower-based instruments (such as loan-to-value ratios for loans) which are more effective than capital-based instruments. Therefore, borrower-based instruments need to be included in the CRR/CRD-IV package in the course of the pending review.

- The functioning of EMU has also improved more than often realised in terms of adjustment capacities to idiosyncratic shocks:
  - The structural reforms in stressed euro area countries have significantly improved the flexibility of wages and prices. Moreover, recent research based on micro-level evidence generally questions the prevalence of significant downward wage rigidities (Verdugo, 2016).
  - Short term labour migration proved to be much higher in the euro area during the recent crisis than expected, and the short term adjustment capacity of labour mobility to labour demand shocks has been estimated to come closed the US levels.
  - Financial risk sharing, a key adjustment mechanism to idiosyncratic shocks, largely broke down when it was needed during the recent crisis. However, it is promising that the share of intra euro area equity and longer-term financing has increased considerably since the crisis. Nevertheless, financial risk sharing capacities need to improve further in EMU - but without leading to significant systemic risks. On top of the banking union and the capital market union, regulatory incentives are needed for more diversification among asset classes and investors, for more equity (instead of debt) financing and for more long-term (instead of short term) investments.

Overall, the reform pressures of the recent crisis have significantly improved the structural functioning of EMU. In this respect, the OCA endogeneity hypothesis of EMU has eventually proved correct. On this basis, and with the additional reforms suggested here, it is far from evident that EMU is not sustainable without further fiscal integration. The prospect of fiscal integration in EMU thus needs to be discussed as a political choice, not an economic necessity.

1. Introduction

Currently, in the wake of the economic and financial crisis of the past years, an intense debate is ongoing about the future of EMU. In this context, the narrative has taken hold that the crisis has exposed the insufficiency of the EU institutional framework to render the monetary union sustainable. Much of the debate is focused on more fiscal integration, be it by a fiscal stabilisation mechanism or a common unemployment scheme for the euro area.[1]

In our view, the current focus of the debate on fiscal integration entails considerable risks:

- It could detract from continuing the reform process that should particularly focus on the financial sector (see below).
- The narrative that EMU is unsustainable obscures the major achievements obtained in recent years in improving the institutional framework of EMU. This pessimist focus might foster anti-European sentiment, as it might appear that (despite the governance the reforms already taken) the EU has been incapable of delivering solutions to fundamental challenges.
- Anti-EU sentiment might increase, if progress towards fiscal integration proves to remain elusive overall for political reasons. This is particularly true for countries that might expect to be net beneficiaries of fiscal integration.

Figure 1 (centre) shows the line of reasoning of the proponents of more fiscal integration: according to these views, fiscal policy is as a key adjustment mechanism for several reasons. First, EMU is considered highly prone to asymmetric shocks (centre left), while adjustment mechanisms other than fiscal policy are considered to lack effectiveness (centre right). Moreover, it is argued that fiscal policy is of particular importance in the aftermath of the crisis (top part), notably in the context of weak demand and monetary policy at the zero lower bound. Furthermore, national fiscal policy of EU members is claimed to have been largely ineffective (centre), notably due to confidence crises, the restraints of the Stability and Growth Pact (SGP), or coordination failures among members of EMU.

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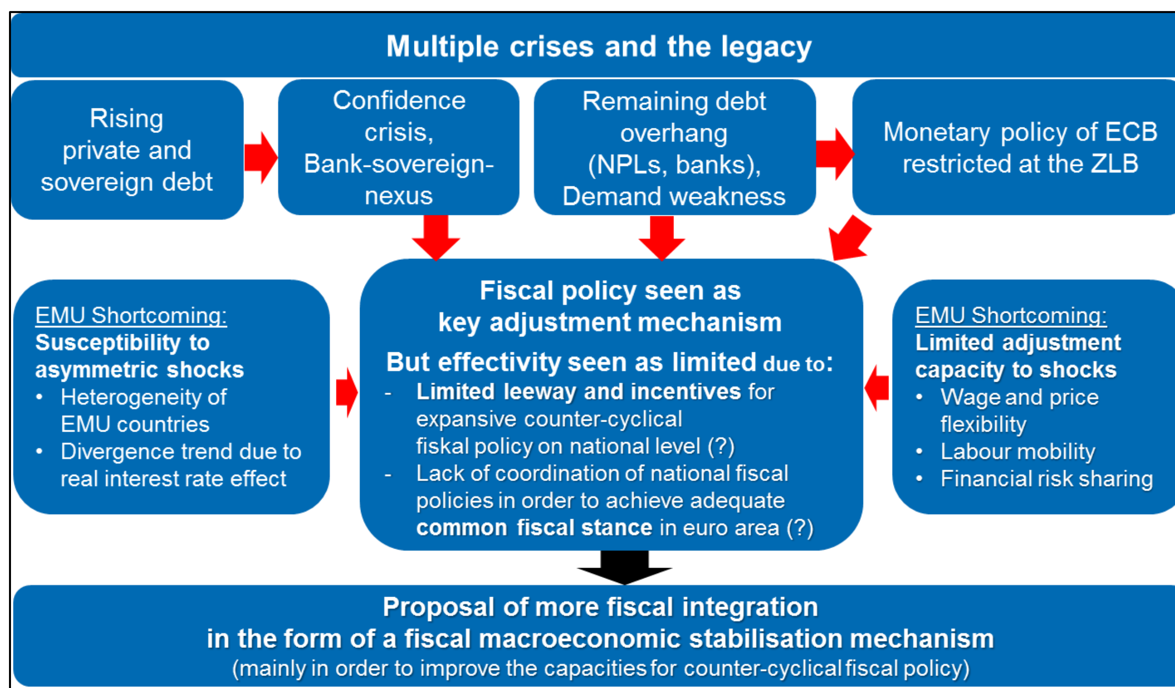
[1] Key contributions to this debate are Wolff (2012), Enderlein et al. (2012; 2013), Allard et al. (2013), Delbecque (2013), Dullien (2013), The Eiffel Group (2014), Andor (2014), Trésor-Economics (2014), Gabriel/Macron (2015), Macron (2015), Berès (2015), Coeuré (2015), Maselli/Beblavý (2015), Dolls et al. (2015), and Bénassy-Quéré et al. (2016).

Figure 1: Arguments for a fiscal stabilisation mechanism



Source: own illustration

Our contribution to the debate on the future of EMU challenges the claim that fiscal integration is indispensable for the long-term viability of the currency union. Specifically we highlight that

- due to its specific historical preconditions the character of the recent crisis has been unique, so that it should not serve as a justification for further reform,
- important reforms have already addressed various shortcomings in the EMU architecture, and
- while there are still reforms to be taken to ensure the stability of the currency area, a common fiscal instrument is not among these exigencies.

In terms of theoretical underpinnings, our analysis is informed by optimum currency area theory (OCA)[2] as well as the analysis of balance of payments crises (Merler/Pisani-Ferry, 2012; Lane, 2013) and private debt crises. These aspects have been recognized among the core factors contributing to the euro area debt crisis (Kuenzel/Ruscher, 2013; Baldwin/Giavazzi, 2015). In fact, credit booms and the private over-indebtedness have regularly been key in the build-up of financial crises, typically followed by deep and long recessions (Schularick/Taylor, 2012;

[2] For the basic references see Mundell (1961), McKinnon (1963), Kenen (1969); for more recent developments see Mongelli (2008), EU Commission (2008), Matthes (2009), Handler (2013).

Gourinchas/Obstfeld, 2012; Koo, 2011). It is this pattern in particular that needs to be prevented in future.

The remainder of this paper is structured as follows.

- Section 2 explains the exceptional nature of the recent crisis and proposes to tackle its legacy with temporary instruments only (top part in figure 1).
- Sections 3 to 5 review the important reforms of the EMU governance framework as well as at the national level and highlight the areas where further reform is needed.
    - Section 3 focuses on measures relevant to ensure that future crises will be less severe in the euro area (top part in figure 1).
    - Section 4 focuses on reforms to mitigate the heterogeneity among EMU countries as well as the one-size-does-not-fit-all problem (centre left in figure 1).
    - Section 5 deals with measures to enhance the adjustment capacities of EMU members to idiosyncratic shocks (centre right in figure 1).
- Section 6 draws conclusions on the future of EMU.

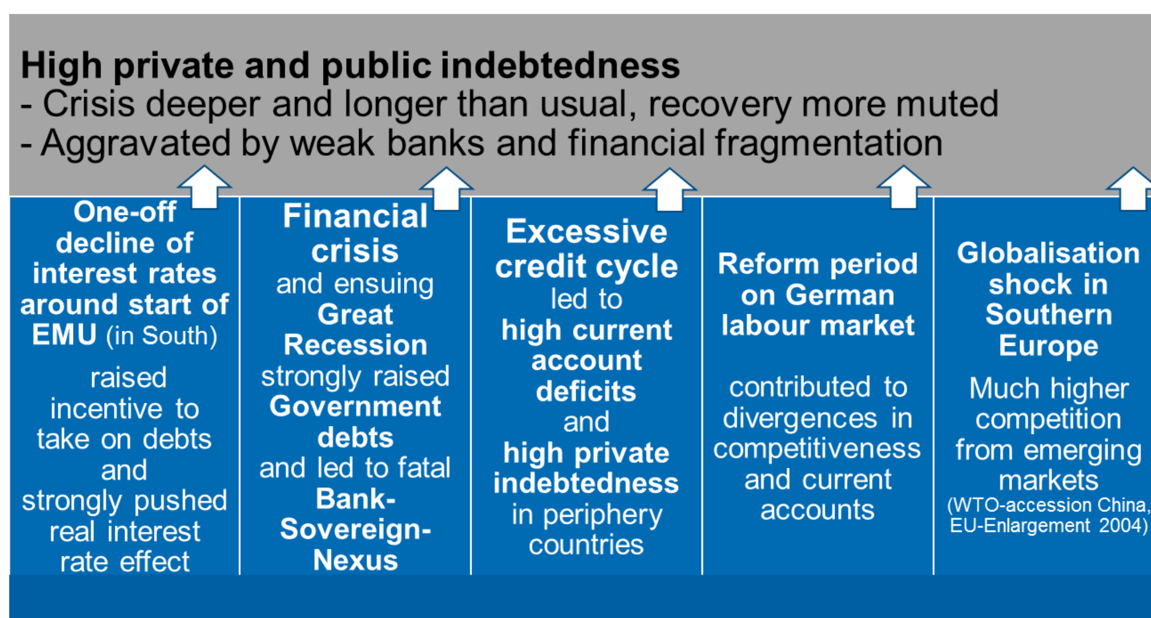
2. An exceptional crisis and its legacy

2.1 Exceptional features of the crisis

By many observers, the recent crisis has clearly shown that EMU is not going to be sustainable without more fiscal integration. Figure 1 (top part) depicts this view, highlighting the features that made the crisis particularly severe: the increase in private and sovereign debt burdens and the resulting confidence crisis as well as a fatal bank-sovereign nexus.

In our view, caution is warranted with regard to this widespread narrative: it ignores the exceptionality of the crisis in the euro area, that was driven by significant extraordinary factors and that are unlikely to repeat (figure 2): first and foremost, the one-off interest rate decrease at the onset of EMU and the ensuing outstanding credit boom, as well as the exceptionally severe global financial crisis. These developments contributed to contagion effects in an incomplete institutional and regulatory framework that has been significantly, but incompletely adjusted since.

Figure 2: Exceptional features of the euro debt crisis



Source: own illustration

The root of the problem was mainly located in the financial sector: In addition to the surge of public debt due to cyclical and financial stabilisation in the course of the global financial crisis, private debt had grown to very high levels in the run-up to the crisis in many stressed countries. This was in part a result of large capital inflows from the north to the south of the euro area that went along with very high current account deficits (Chen et al., 2013; Acharya/Steffen, 2014; Hale/Obstfeld, 2014). At the same time, the windfall gains of the much lower interest rates in most southern EMU countries were mainly used for consumption and an expansion of public expenditure on social spending and public wages (Busch et al., 2011).The build-up of sizeable vulnerabilities eventually resulted in multiple and mutually reinforcing crises: sovereign and private debt crises, balance of payments crises, banking crises, crises of confidence, financial disintegration, and the mutually reinforcing bank-sovereign nexus. In light of the well-acknowledged experience that debt crises are particularly grave and protracted (Koo, 2011; Schularick/Taylor, 2012), the length and depth of the euro area crisis does not come as a surprise.

2.2 Tackling the legacy problems – but only with temporary instruments

To date, social challenges associated with the crisis and the high level of unemployment in stressed euro area countries in particular are still serious, and lingering weaknesses in domestic demand need to be recognised alike. However, we consider these legacies of the crisis to be of temporary nature. Therefore, the legacy

problems should not be seized upon to justify the creation of permanent instruments such as the fiscal stabilisation mechanism on the euro area level currently under discussion.

Nevertheless, the legacy problems need to be addressed effectively. However, this should be done only with temporary instruments. The unconventional monetary policy of the ECB and the EFSI are such instruments. The EFSI should be made more effective in tackling the current weaknesses in public investment, notably with a strengthened focus on genuine needs not addressed by capital markets, but the necessity of this tool will also be time-bound.

Moreover, more efforts are needed to tackle the legacy of private debt and non-performing loans (NPLs). To this end, reforms of private insolvency frameworks have to continue[3] and supervisors should require banks to undertake more effort to recognise NPLs instead of evergreening them. This obviously entails additional recapitalisation needs that have to be met by the market as far as possible. Bad bank solutions might facilitate the cleaning of banks' balance sheets (Hüther, 2012). The question arises who is to shoulder the implied financial risks. One possible solution would be an indirect or a direct programme of the European Stability Mechanism (ESM) focused on the banking sector. Another possibility could be to use an EFSI (EU/EIB) guarantee scheme for the securitisation of pooled NPLs in order to facilitate their sale and to clear the balance sheets of affected banks (EPSC, 2016). Overall, temporary measures need to be employed with a sufficient degree of flexibility. If indispensable, bad bank solutions could also ultimately involve one-off exemptions from European state aid rules.

3. Crisis prevention and mitigation

The repetition of financial crises like the recent one in Europe, must be avoided. Several sets of reforms in the euro area – notably in the area of fiscal policy, macroeconomic surveillance, and banking supervision, and regulation among others – do address the roots of the crisis (see the table in the annex) and have thereby importantly advanced EMU into this direction. On top of this, several additional reforms (mainly in the financial sector) are needed to achieve this aim, and some additional reforms are also required to further improve the functioning of EMU.

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[3] For references see Liu/Rosenberg (2013), IMF (2014), Aiyar et al. (2015), Bergthaler et al. (2015), Jassaud/Kang (2015).

Against this background, our assertion is that once some further reforms are taken (see annex), the build-up of imbalances resulting in extraordinary crises can be avoided, and the currency union should be able to better deal with such "standard" crises. In any event, the outstanding exigencies for the stability of EMU do not entail the creation of a fiscal capacity in our view. We detail the arguments in support of our position below and refer back to figure 1 as a guidance for our train of thought.

3.1 New crisis mechanisms

The ESM and the ECB's OMT are important innovations that close a gap in the institutional framework of EMU. They are essential to avoid the escalation of future sovereign debt crises. Based on the principle of conditionality, these new instruments – together with the Target2 payments system among the central banks of euro area members – can contain confidence crises, self-fulfilling balance of payments and sovereign debt crises respectively, partly because they make speculative attacks against members of the currency union less promising (Grauwe, 2013).

Thus, ESM and ECB can ring-fence countercyclical national fiscal policies in the event of future crises even for highly indebted euro area countries. Allowing for countercyclicality would be a new feature of ESM programmes. This would only be possible, if the affected countries implements well-targeted growth-enhancing structural reforms (see below) and if it adhered to the fiscal rules of the EU – which provide ample room to counteract "standard" recessions. Precautionary ESM programs might suffice to achieve this aim. If not, the ESM could provide cheap prime-grade financing for the countries concerned.

To limit the need for ESM financing, the maturity of sovereign bonds needs to be automatically extended with the start of a three year ESM programme for the duration of the programme (Deutsche Bundesbank, 2011, 73). As a result, no debt refinancing would be required during the programme, while interest payments on sovereign debt would continue. This approach requires changes in the ESM treaty as well as in the terms of contract of government bonds, but it would decrease the size of ESM loans per country and thus enable the ESM to also support large countries. Importantly, it can also prevent that, as in Greece, private creditors are bailed out and official creditors have to bear the bulk of the default risk after the ESM programme.

To enhance their effectiveness, ESM adjustment programmes need to focus more on growth enhancing structural reforms from the outset and consider the possibility of larger fiscal multipliers during deep recessions (Blanchard/Leigh, 2013; Alesina/Ardagna, 2013; Kolev/Matthes, 2013). Particularly, product market reforms should be prioritised which have been shown to be more effective in fostering

productivity and economic growth while at the same time having smaller (or no) negative short term effects (IMF, 2016). Moreover, fiscal stabilisation and structural reforms to improve potential growth should pay attention to equitable policy packages and strive to minimize negative social outcomes. Structural reform packages also need to be encompassing, consider the sequencing of reforms and seek balance in the distribution of losses (Grüner, 2013).

The conditionality principle must be upheld in order to avoid incentives for fiscal mismanagement. The developments in Greece in 2015 were an important precedent in this respect when euro finance ministers did not yield to the former Greek government's refusal of the reform course.

The priority to uphold the conditionality principle must also be taken into account when the proposals are considered to integrate the ESM into EU community law and measures are taken to enhance its democratic accountability. As shown by the experience of the IMF, a sufficient degree of independence is indispensable for the implementation of growth enhancing reforms that affect vested interests. Moreover, the adjustment programs are already democratically legitimised, because they are co-decided by national parliaments of the requesting country on the one side, and by euro area finance ministers representing elected governments on the other.

3.3 Reforms in the financial system

Reforms in the financial system and particularly the creation of the banking union will make future banking crises less severe and also address the bank-sovereign nexus.

The recapitalisation of banks in line with CRR/CRD-IV rules brought forward at the height of the crisis was an important achievement; capital buffers have been significantly increased since (Constâncio, 2015). Supervisors are well advised to actively use their leeway to impose sufficient capital buffers, and to use anticyclical tools in particular. At the same time, increasing capital should not come at the expense of loans to the real economy and to SMEs specifically.

The bank-sovereign nexus has been weakened by many efforts to avoid the likelihood that banks need to be bailed out by national taxpayers in the event of a (near) default. The bail-in rules, the Single Bank Resolution Fund and the direct bank recapitalisation instrument of the ESM are key achievements in this respect. The minimum bail-in requirement of 8 percent of bank’s liabilities, as foreseen in the BRRD, has recently been put into question: but in our view it needs to be implemented at the operational level, also. In addition, in order to prevent systemic

risks in the banking system due to contagion, bail-in-able capital should be held largely outside the banking sector as proposed by the Liikanen report.

However, the sovereign-bank nexus has become even more severe as banks in several stressed euro area countries have significantly increased their exposure to their sovereign. Therefore, limits to the banks' exposure to sovereign debt are a strict necessity, and so is the adoption of appropriate (non-zero) risk weights for euro-denominated sovereign bonds for capital requirements. The EU Commission has started to consider a change of the respective rules in connection with the banking union (EU Commission, 2015c): this work needs to be advanced quickly.

The reform of banks' exposures to sovereign debt should be only implemented in the medium term, but can start soon (e.g. 2018) for *new issuances* of sovereign debt. When applying the new rules only to newly issued sovereign bonds, a major unsettling of sovereign bond markets can very likely be avoided. Moreover, the Single Supervisory Mechanism (SSM) should induce banks with an excessive holding of (domestic) sovereign debt to sell part of the portfolio to the ECB in the course of the current QE program. A reduced exposure to sovereign risk would also contribute to a general reduction of risks in the banking system of the euro area.

Such general risk reduction is also necessary before a European Deposit Insurance Scheme (EDIS) can become fully operational. To this end, an accelerated and rigorous reduction of NPLs is also needed (as proposed above). Moreover, the build-up of national deposit insurance schemes still lags behind as well as the national implementation of the BRRD. Also, a minimal harmonisation of private insolvency rules and national bank restructuring rules is required in the medium term. The introduction of EDIS can only go hand in hand with a reduction of risk in the system and a further implementation and harmonisation of relevant national rules. In the meantime, a limited and well-incentivised reinsurance solution among national deposit funds could be considered to prevent bank runs in case of a larger crisis in a specific banking system.

Caution is needed to prevent that the envisaged fiscal backstop (for the Single Bank Resolution Fund (SBRF) and for EDIS leads to an implicit transfer (and subsidy) in favour of relatively large banking systems in small economies whose governments are unable to contribute significantly to the resolution of banking crises.

The creation of the Single Resolution Mechanism together with the introduction of living wills are major steps to ensure that systemically important banks can also be effectively and rapidly restructured and resolved if needed. However, living wills have to be carefully assessed with regard to their feasibility; in case of doubt about the

newly introduced tools, stronger measures must be considered to mitigate the impact of banking crises on the taxpayers' purse.

Overall, the new instruments of the banking union still have to prove their effectiveness and must be rigorously applied in case of need.

3.4 Macroeconomic Surveillance and macroprudential supervision

By creating a systematic framework of macroeonomic surveillance focused on imbalances, a gap in the institutional architecture of EMU has been closed, thereby recognizing the relevance of external stability also among members of the currency union. Importantly, many indicators in the scoreboard of the macroeconomic imbalances procedure (MIP) relate to the measurement of the financial cycle.

So far, implementation has been commensurate to country-specific challenges overall, despite some criticism e.g. in the case of Spain and Slovenia (SVR, 2013, 195 f.; EZB, 2015b, box 5, 53 ff.; Boysen-Hogrefe et al., 2015). In both countries, excessive imbalances were diagnosed in 2013, but no formal Macroeconomic Imbalance Procedure was started. This appears justified for economic reasons, because, at the time, they made too little progress with the reduction of imbalances, but still progressed in the right direction. Eventually, they exited the category of excessive imbalance in 2014 – already under pressure from the EU, but without a formal procedure.

The real test for the effectiveness of the MIP will come when severe imbalances start to build up again in the future. In this case, the EU Commission will need to rigorously apply the rules. In this respect, the improvements planned by the EU Commission (EU-Kommission, 2015a) to implement the measures proposed in the Five Presidents' Report appear useful. So is the creation of national competitiveness councils that could inform the national public debate about the macroeconomic context of domestic wage policy.

In addition to the macroeconomic surveillance, the creation of the SSM and its important role in macroprudential supervision are also key achievements in order to prevent excessive financial cycles in the future. The introduction of macroprudential supervision has been a key lesson from the recent crises. However, the European Systemic Risk Board (ESRB) can only issue recommendations to national supervisors who still retain their prerogatives. This would possibly be problematic, because national supervisors could still tend to forebear in case of increasing risks as they did before. Therefore, it is of immense importance that the SSM can overrule national supervisors in macroprudential supervision (Deutsche Bundesbank, 2014).

This new institutional feature essentially changes their incentive structure and is very likely to make macroprudential banking supervision in the euro area much more effective.

However, if excessive financial cycles are to be prevented in the future in the euro area, the remaining financial market sections and particular the shadow banking sector must also be covered by more effective regulation and supervision. If the banking sector is more strictly regulated, financial risks tend to move to less regulated parts of the financial market (ECB, 2015a). These parts are generally less systemically relevant than the banking sector for the real economy. However, systemic risks cannot be precluded. For example, in the investment fund sector more risk-taking, higher leverage, and interconnectedness could lead to “too many to fail” problems (Constancio, 2016).

Therefore, various concrete measures need to be taken to avoid the build-up of new excessive risks outside the banking sector, particularly concerning investment funds and derivative markets (ECB, 2015a; Constancio, 2015; 2016). For example, more transparency is needed. On this basis, stress test should be regularly conducted also for investment funds that have become more important as lenders to the real economy and that could suffer from severe liquidity risks or so called margin spirals (Constancio, 2016). As an additional example, a general leverage ratio (adjusted to the financial cycle) should be considered for all financial actors and activities working with a high leverage (Schoenmaker/Wierts, 2015). However, not only leverage risks but also liquidity risks and fire sale problems need to be addressed. As the ESRB and the sectoral financial authorities are not sufficiently strong and independent, a new central financial authority needs to be created in the euro area to cover the whole financial market (SVR, 2014).

3.5 Counter-cyclical fiscal policy

National fiscal policy can and must play a pivotal role in preventing and mitigating future crises by using the counter-cyclical tools available.

In case an economic boom overheats and particularly if an excessive financial cycle gets into motion, national fiscal policy needs to become sufficiently restrictive. This appears unlikely from a political economy perspective, as growing government revenues tend to increase demands for higher expenditure or lower taxes – resulting in fiscal policy to become even pro-cyclical. Instead, governments need to reduce deficits and debts in good times when private debt tends to increase.

To this end, the integration of the financial cycle in the SGP rules might be considered, according to the following principle: potential growth (and the output gap) could be adjusted downwards (upwards) in case a measure of the financial cycle (e.g. growth of private credit) rose (fell) above (below) a certain threshold. The resulting structural fiscal balance adjusted to the financial cycle would provide a clear indication (and the basis for a prescription) that fiscal policy needs to become more (less) restrictive in case of a financial boom (bust). This approach would improve the adequacy of the fiscal stance also relative to the financial cycle. In retrospect, this mechanism could potentially have prevented that the EU Commission gauged the fiscal policies of Spain and Ireland adequate before the crisis. Besides, it would allow for more fiscal leeway for countries suffering from deleveraging processes. At the same time, this approach would make pro-cyclical fiscal policy more difficult to implement, because the SGP rules would be more clearly broken. Moreover, such a correction might improve the measurement of potential growth and could thus potentially reduce the need for ex post corrections of this elusive measure. Despite these important potential benefits, this proposal might appear impractical and technically too cumbersome at first sight. However, studies by the European Commission and the IMF have already ventured on this path in a promising way (Aramendia/Raciborski, 2015; Berger et al., 2015). Therefore, we recommend to further analyse its technical details and political potentials.

In case of an idiosyncratic economic downturn, national fiscal policies can be powerful tools. This is particularly true in the euro area where welfare systems are more encompassing than in the US, so that automatic stabilisers are much more effective (Dolls et al., 2015).[4] However, sufficient fiscal space is needed in order to effectively exploit these counter-cyclical capacities in case of a recession. Therefore, the SGP rule to achieve a balanced fiscal budget in cyclically adjusted terms in normal and good times is of key importance – it is not just an overdone mantra of austerity proponents. Recently, the pace of structural fiscal adjustments towards this target has slowed considerably (or even reversed) in several member states despite the fact that moderate and partly dynamic growth has also returned. This must not be tolerated by the EU institutions, because a generous interpretation of the SGP rules today will backfire tomorrow when the next recession hits.

In case of a negative symmetric shock in the euro area, doubts have been raised whether national fiscal policies will react sufficiently expansively due to the existence of fiscal spillovers that imply positive external effects (Wolff, 2012). However, this

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[4] According to this study, tax and transfer systems (legal basis 2013) compensate for 47 percent of the simulated shocks in the euro area, opposed to only 30 percent in the United States. The IMF (IMF, 2015, chapter 2, Box 2.2) proposes several measures to further raise the effectiveness of automatic stabilisers.

argument does not hold against detailed scrutiny. In fact, empirical evidence suggests that fiscal spillovers are rather small or even negative.[5] And politically, it does not appear very plausible that national governments and parliaments consider fiscal spillovers and design smaller fiscal stimuli than needed for their economy (if fiscal space is available).

More generally, centralised fiscal stabilisation appears questionable with regard to the subsidiarity principle because most member states in favour of this instrument do not appear prepared to create sufficient fiscal space in their national budgets currently.

The fiscal reforms of the six pack, the two pack and the Fiscal Compact are important achievements. This is particularly true for the strengthened rules for highly indebted member states. These new rules rightly take macroeconomic conditions into consideration. However, the Commission's flexibility interpretation of the SGP regarding the relevance of structural reforms and public investment (EU-Kommission, 2015b) had been too vague and left too much discretion (EZB, 2015a). It is therefore positive that scope for manoeuvre has since then been limited again by the Council.

Some discretion is needed when applying the SGP rules, particularly in times of weak growth and private investment. However, it has been widely criticised, that such discretion is overused and that the fiscal rules have thus lost their usefulness. While there is indeed ample room for interpretation due to a complex and intransparent rule book, the leeway is still limited in case the rules are broken to a degree that does not leave room for interpretation. This view will be tested soon in the cases of Spain and Portugal that clearly broke the SGP rules recently.

Overall, the SGP, the macroeconomic surveillance and the European Semester do contribute to better policies in member states. This must not be forgotten in view of the criticism that rules are often bent to some degree. Without these European rules, national policies would fall victim to political cycles, populist pressures, and vested interests to a much larger degree.

At the same time, it has become all too apparent that rules cannot remain the only tools of crisis prevention. In the medium term, reliable, effective, and credible rules for sovereign debt restructuring are required, so that an EMU member state can default while remaining in the euro area. Investors need to factor in this (unlikely) possibility so that risk premia on sovereign bonds reflect this risk and governments

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[5] For references see Bénassy-Quéré/Cimadomo (2006), SVR (2010), Cwik/Wieland (2011), Veld (2013), ECB (2014), EU Commission (2014), Gadatsch et al. (2015).

have the incentive for fiscal soundness. Possible contagion effects can be largely prevented by the ESM and the OMT. Moreover, a bridge financing ESM program would be needed (based on strict conditionality), as economies are usually cut off from international markets during the time of the restructuring negotiations. Busch and Matthes (2015) made proposals on how to design these negotiations and to guarantee an effective restructuring mechanism.

4. EMU improvement: reduced susceptibility to asymmetric shocks

4.1 Structural reforms reduced the heterogeneity among EMU members

The heterogeneity among EMU member states renders the currency union susceptible to asymmetric shocks (Pisany-Ferry, 2012; EU Commission, 2015a). A substantial part of heterogeneity is due to differences in labor and product market regulation, which are important for the ability of EMU member states to adapt to idiosyncratic shocks via wage and price adjustments.[6]

Looking at such heterogeneity, the argument again applies that EMU as of 2008 is not to be taken as a starting point for reflections on the need for further reform to ensure its sustainability. Notably such heterogeneity has been significantly reduced by structural reforms in Southern Europe taken since (figure 3). As the pertinent OECD indicators show, the rigidity of product and labour market regulations has been lowered particularly in the stressed economies during the recent crisis (Matthes, 2015). Thus, Southern European countries have caught up to many other euro area countries with traditionally lower market rigidities. EMU has thus been improved - and moved closer to the theoretical characteristics of an optimal currency area - in an important respect (see also section 5.1).

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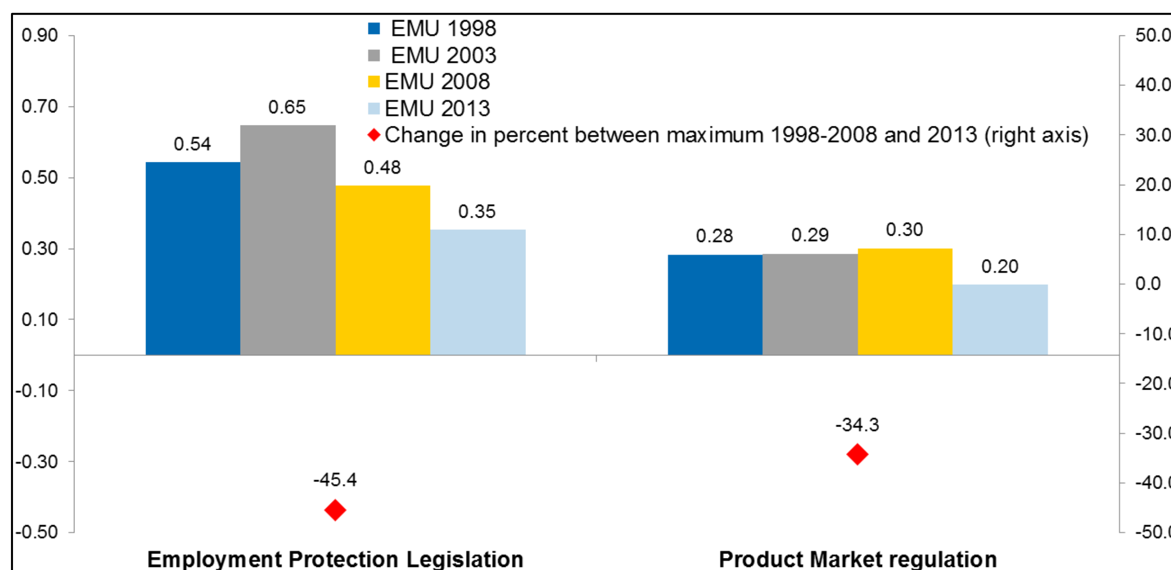
[6] For references see Holden/Wulfsberg (2007, 2014), Babecký et al. (2010), Heinz/Rusinova (2011), Jaumotte/Morsy (2012).

Figure 3: Change in heterogeneity of regulation
Standard deviation among sample of EMU countries*



*Reduced sample due to lack of data availability for 1998 for some countries.
Sources: OECD; IW Köln

4.2 Decentralised macroprudential policy to counter the real interest rate effect

The centralised monetary policy of the ECB is necessarily subject to the one-size-does-not-fit-all problem (e.g. Enderlein et al., 2012). Specifically, the real interest rate effect can fuel cyclical divergences among EMU members. Indeed this effect has been a key problem in the run-up to the crisis: Having been set into motion by the large decline in interest rates at the outset of EMU, low real interest rates in booming countries of the euro area periphery contributed significantly to the build-up of large financial cycles and private indebtedness.[7] It was this development that made the euro debt crisis so severe and long lasting. Tackling this problem is therefore indispensable for ensuring that EMU is sustainable.

To this end, the new macroprudential policy tools can be employed. More specifically, these tools can and should be actively employed in a decentralised and country-specific manner.[8] Doing so can be a cure to the potentially severe repercussions of the one-size-does-not-fit-all problem of common monetary policy.

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[7] For references see EU Commission (2008), Matthes (2009), Maurer (2012), Merler (2015), EU Commission (2016)

[8] For similar recommendations see Maurer (2010), Black (2010), Houben et al. (2012), Horn et al. (2012), Brzoza-Brzezina et al. (2013), Kok et al. (2014), Remsperger (2014), Schoenmaker/Wierts (2015), Constâncio (2015).

It is often argued that macroprudential supervision lacks effectiveness and that supervisors refrain from using their instruments due to political pressures. However, these problems can be qualified:

- As concerns effectiveness, a rapidly growing body of theoretical and empirical academic contributions shows that macroprudential tools are broadly effective in curbing excessive financial cycles and particularly in reining in credit growth. Remarkably, borrower-based instruments like loan-to-value ratios (LTV), loan-to-income ratios (LTI) or debt-service-to-income ratios (DSTI) perform better than capital buffers.[9] However, borrower-based instruments are not part of the CRR/CRD-IV package so that the SSM is unable to impose them, if deemed necessary (SVR, 2014). This shortcoming needs to be addressed during the pending review of the CRR/CRD-IV rules.
- Furthermore, macroprudential instruments tend to become ineffective if they can be circumvented by foreign banks or by other financial actors such as investment funds. This can be prevented for borrower-based instruments. Indeed, they can be applied to all domestic transactions, so that all financial actors, including those based outside the euro area, have to adhere to the imposed limits (ESRB, 2014). This is yet another argument for the active application of such instruments.
- Concerning political pressure, supervisors have indeed often yielded to such pressure in the past (Viñals/Nier, 2014; Kok et al., 2014); Spain's real estate bubble before 2007 is a case in point. However, with the new powers of the SSM and with ECB as a centralised, competent and independent actor, chances have significantly increased that in future financial supervision will resist vested interest to a much larger degree. In fact, the SSM was found to have worked largely effectively and to have exercised tough and more intrusive supervision of larger banks than previous national regimes during the first 18 months of its existence (Schoenmaker/Véron, 2016). Moreover, as pointed out above, the incentive structure has significantly changed for national supervisors as they can be overruled by the SSM. In fact, national supervisors are already active in applying macroprudential measures to address the challenges the current low interest rate environment poses to financial stability (Constâncio, 2015; ESRB, 2015; SVR, 2015). One prominent example is Ireland, where the Irish central bank has introduced a loan-to-value ratio and a loan-to-income ratio in early 2015 (Gerlach, 2015). The Irish central bank explicitly stated that it will decisively prevent another real estate boom.

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[9] For references to model based analyses see Brzoza-Brzezina et al. (2013), Quint und Rabanal (2014), Rubio (2013). For studies based on the actual application of macroprudential instruments see Lim et al. (2011), Vandenbussche et al. (2012), Kuttner/Shim (2013), Claessens et al. (2014), Jácome/Mitra (2015). For evidence on the particular effectiveness of borrower-based instruments see Crowe (2011), Kuttner/Shim (2013), Claessens et al. (2014), Kok et al. (2014).

5. EMU improvement: improved capacity to adapt to idiosyncratic shocks

Without the ability of EMU members to devaluate their currency or to pursue a national monetary policy tailored to their needs, other mechanism need to be effective for an economy to adjust to idiosyncratic shocks. By the insights of optimum currency area (OCA) theory, wage and price flexibility, labour mobility, financial risk sharing, and fiscal policies are key in this regard (see section 1 for references).

Over and above the above-mentioned recommendations to improve counter-cyclical fiscal policy, a number of reform measures have already been taken or are being proposed for adoption. Achieving more with such adjustment mechanisms implies lowering the burden on fiscal policy to deal with cyclical downturns (as well as structural change) (see figure 1).

5.1 Wage and price flexibility

Insufficient wage flexibility is considered a deep rooted and notorious problem of the euro area, notably its southern European members; this applies in particular to downward rigidities, i.e. insufficient adjustment during recessions.[10] Moreover, in the run-up to the crisis, average wage developments exceeded labour productivity increases in those countries, leading to a significant rise of unit labour costs over time (EU Commission, 2011; Carlin, 2013).[11]

In line with the theoretical assertion that that optimal currency areas might emerge endogenously, it was hoped that the constraints associated with the single currency will induce the required changes of wage and price setting institutions. In a future recession, it was argued, EMU members with excessive wage and price rigidity would suffer from high unemployment and would eventually adapt their institutions as a result. Up to the global economic and financial crisis, this hope seems to have been in vain, mainly due to the absence of major recessions.[12]

However, the euro area debt crisis immensely increased reform pressures. As a result, relatively wide-ranging structural reforms in labour and product markets have

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[10] For references see, for example, Dickens et al. (2006), Holden/Wulfsberg (2007, 2014), Matthes (2009), Heinz/Rusinova (2011).
[11] In the context of a single monetary policy, the resulting challenges were compounded by the considerable wage moderation achieved by Germany at the same time (see chapter 2).
[12] For references on the endogeneity hypothesis see Frankel/Rose (1998), Grauwe (2007), Mongelli (2008), Matthes (2009), Willett et al. (2010), Buscher/Gabrisch (2012), Handler (2013).

been taken in most stressed EMU countries (Marginson/Welz, 2014; Matthes, 2015; OECD, 2015). These reforms have raised wage flexibility and have thus also reduced downward rigidities (Anderton/Bonthuis, 2015; Matthes, 2015; ECB, 2016), in particular because wage rigidities are closely related to the rigidity of regulations (as pointed out above).

This is especially relevant for reforms taken in the wage bargaining systems which should allow to better align wages with cyclical conditions, productivity developments, and the needs of smaller companies (table 1). This has been achieved, for example, by reducing the duration of wage agreements, allowing more firm level flexibility in wage negotiations, introducing opening clauses, or raising working time flexibility.

Overall, in our assessment the endogeneity hypothesis remains intact in the sense that labour and product market rigidities in euro area countries have proven not to be sustainable in the face of a significant crisis, so that the crisis became a catalyst of significant reform. In this respect, and despite all the social hardship involved, the crisis has also been an opportunity with regard to the future sustainability of EMU.

Table 1: Reforms of the collective bargaining systems since 2008

	PT	ES	GR	IT
Decentralization / more firm level flexibility				
Priority of firm level agreements	(x)	x	x	
Reducing extension obligations	(x)		x	(x)
(More) opening clauses		x	x	x
Increasing working time flexibility	x	x	x	x
Right of contracting with non-union workers	(x)		x	
Reduced duration of new or expired agreements	x	x	x	
Inflation indexation (repeal or reduction)		x		x
Reducing (freezing) statutory minimum wages	(x)		x	
Further elements of wage moderation	x		x	x

x: notable reform, (x) partial reform.
Source: Own assessments based upon qualitative information from Eurofound, country surveys of the OECD and the IMF, reports by the EU and the IMF on the implementation of reforms in the programme countries, reports within the framework of the European Semester, and from the World Bank's 'Doing Business' data base.

Nevertheless, many researchers still point to the lack of wage and price flexibility as a key shortcoming of EMU and a major justification for a fiscal stabilisation mechanism

(e.g. Sapir, 2016). These views appear to be supported by the array of research on wage and price rigidities pointed out above. A recent study, however, raises substantial doubts about this pessimistic view (Verdugo, 2016). Using household-level data, the author notes that existing findings on downward wage rigidity rely on the study of average wages. These can, however, be distorted by composition effects: in a recession, lay-offs tend to fall disproportionately on less qualified employees with low wages. Therefore, average wages might not fall (and appear downward rigid) even though the wages of those who remain employed do adjust downwards or grow slowly.

This is exactly what Verdugo (2016) finds for Italy, Spain, and Portugal. Even in the years before 2007, the share of full time workers experiencing negative annual (log) nominal wage changes was at around a third; for real wages it was close to half (somewhat less in Portugal). This ratio increased considerably in and after the Great Recession in Spain and Portugal. In other words, wages appear to be considerably less rigid than usually depicted. What is more, wage flexibility increased further during the recent crisis, when it was most needed. Verdugo (ibid.) also shows for eight major euro area countries that real wages are nearly as responsive to the economic cycle (unemployment) as in the United States – and thus much more responsive than often thought. Their responsiveness has further increased during the Great Recession.

In the context of the OCA debate, these findings are highly relevant and reduce the perceived necessity of a fiscal stabilisation mechanism.

5.2 Labour mobility

Labour mobility has been traditionally low in the euro area. However, there were significant improvements already since the start of EMU (EU Commission, 2015b; Trésor-Economics, 2007). Nevertheless, labour mobility is still hampered due to language and cultural barriers, but also due to regulatory impediments. For these reasons, long-term labour migration (measured as the share of euro area citizens working in another EMU country) can be expected to remain lower in the euro area than in the United States for the foreseeable future. But before the crisis, short term migration (measured by migration flows) was also found to be considerably lower than in the US, again fuelling the view that EMU is not sustainable, because labour migration is considered a key adjustment mechanism to idiosyncratic shocks.

In the course of the recent crisis however, short term migration flows have been much higher than expected (Huart/Tchakpalla, 2015¸ Trésor-Economics, 2015). It is striking that the short term adjustment capacity of labour migration to labour demand

shocks has been recently estimated (for a longer term period extending to 2012) to even reach levels comparable to that in the US (Beers et al., 2014). Thus, the excessively negative views on the OCA characteristics of the euro area has to be qualified along this dimension as well. This positive finding is not only due to a considerable increase of short term migration of citizens born in EMU members (which remains rather limited overall), but importantly also to the emigration of immigrants from non-EMU countries (eastern Europe and north Africa) who had formerly moved to the respective countries. Nevertheless, these migration flows also fulfil the function of a pressure valve for quantity adjustment on the labour market.

Nevertheless, initiatives on the EU level need to continue in order to further improve labour mobility of EMU citizens and to reduce the regulatory impediments. In this respect, barriers regarding the recognition of professional qualifications, tax barriers when moving to another country, or the lack of portability of pension rights need to be considered, for example (EU-Kommission, 2012a; OECD; 2012). In some of these areas, promising initiatives are underway, such as a European wide system for the recognition of qualifications (ESCO – European Skills, Competences and Occupations), an extension of EURES (European Employment Services), or ERASMUS+ (Barslund, et al., 2014). These initiatives will have to be thoroughly implemented and critically evaluated with respect to their effectiveness to enhance labour mobility in the euro area.

5.3 Financial risk sharing

Financial risk sharing has been shown to be a central adjustment mechanism in other currency unions (e.g. Asdrubali et al., 1996; Allard et al., 2013; Feld/Osterloh, 2013). In EMU, even though financial integration – and thus the potential for risk sharing - had increased considerably since the outset of the currency union, it largely broke down during the crisis.[13] This is a severe failure that challenges the sustainability of EMU. Therefore, the roots of this development have to be well understood, and reforms have to be taken to ensure the effective operation of this adjustment mechanism in the future.

A closer analysis suggests that the break-down of cross border financial integration in EMU was not evenly spread across asset categories. It was mainly concentrated in

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[13] For references see Balli et al. (2012), Pisaný-Ferry (2012), Allard et al. (2013), Beers et al. (2014), Kalemli-Öczan et al. (2014), SVR (2015), Schnabel/Seckinger (2015). However, the pertinent approach to calculate the contribution of various adjustment channels which is based on national accounts tends to underestimate the adjustment capacities of financial market (Valiante, 2016), mainly because capital gains are not captured which prove to be of relevant size and are also stable over time (Balli et al., 2012).

interbank and wholesale lending, as well as sovereign and corporate bonds. Particularly short term debt-based investments were unwound during the crisis. This appears to be a general problem: short term debt flows also played a key role in the build-up and outbreak of financial crises in emerging markets in the past decades.

In contrast, equity and investment fund exposures remained largely intact, the same is true for direct bank loans (SVR, 2015). In fact, cross border equity holdings in the euro area have even increased during the crisis and are higher than generally considered – they amounted to 42 percent of equity issued in the euro area in 2013 (ECB, 2015b). What is more, this share has nearly tripled since 1997 when it stood at below 15 percent. Similarly, direct foreign bank lending also increased in the euro area from around 15 percent of total foreign bank lending (including wholesale lending) before the outset of EMU to over 30 percent in 2015 (ECB, 2016).

Moreover, long-term investments (which are inherently more stable than short term assets) have further gained importance since the crisis (ECB, 2016). For example, the share of intra euro area long term external debt to total external debt (with all maturities) has risen from around 58 to about 63 percent between 2008 and 2015 – based on an increase of long term external debt by 59 percent. In the same period, the share of FDI in total investment also increased by 5 percentage points to about one third. Taken together, these facts illustrate that financial integration has increased significantly in important respects – more than is often recognised.

Cross-border financial integration is somewhat less deep for stressed euro area countries (ECB, 2016). This certainly reflects the legacy problems of the crisis which should fade over time due to the measures highlighted and proposed here. However, the limited degree of financial integration also pinpoints the need for growth-enhancing structural reforms that are also needed to raise the attractiveness as a location for foreign investments.

Financial risk sharing can be achieved during recessions also when new loans become available without a significant increase in risk premia. In this respect, the crisis play an important role. The OMT of the ECB and a precautionary ESM programme are intended to prevent a sharp rise in interest rates of government (and closely linked private) financing via private markets, and a full ESM programme provides cheap loans to sovereigns. Moreover, the Target2 system of euro area central banks (as well as the full allotment policy of the ECB with reduced collateral demands) give the banking system (and thus principally also the real economy) access to cheap refinancing loans in large volumes. The potentials of these tools for financial risk sharing should not be neglected.

Despite the recent and long term improvements in financial integration, still more progress is needed. In this context, an important trade-off has to be recognized: more integrated financial markets and a higher degree of risk sharing via financial integration imply higher risk exposures and potentially a higher degree of systemic risk, ceteris paribus. Therefore, care has to be taken that cross border financial exposures do not lead to excessive vulnerabilities of individual financial investors of systemic relevance.

In this regard, based on the achievements made lately, specific recommendations for further reform can be formulated:

- The banking union and the capital market union (CMU) (see e.g. Demary et al., 2015; Valiante, 2016) are important achievements and reform avenues in this respect (see below).
- The strengthening of the capital base in the banking sector is key for the risk sharing capacity of the banking sector – and needs to be continued.
- Abolishing the risk weight waiver of sovereign debt and introducing exposure limits is of paramount importance to the containment of such risks (see section 3.2).
- Diversification of cross border exposures among investors and among asset classes is key to reduce the potential systemic risks entailed by financial integration. CMU can be an important instrument to achieve more diversification among investors. To this end, a concrete roadmap with goals and milestones is required for CMU and the objective to foster financial risk sharing should be at par with the aim of CMU to improve corporate funding (Constancio, 2016). However, beside CMU the CRR/CRD-IV framework should be reformed in order to provide more regulatory incentives for diversification among asset classes on the level of individual investors (Demary, 2014).
- Excessive short term debt flows that lead to vulnerabilities need to be contained in the future. The new liquidity regulations on the side of borrowing banks can be regarded as a step in this direction. But closer analysis might suggest the need for additional measures to restrict short term debt flows.
- Financial risk sharing is more effective, if it is based on equity rather than debt instruments, because the variability of equity valuations automatically lets asset holders share risks associated with their investment. Therefore CMU also needs to foster more cross border equity exposures. Moreover, tax systems that unduly favour debt financing over equity financing need to be reformed as soon as possible (e.g. Deutsche Bundesbank, 2015).
- Regarding debt exposures, the new bail-in regime represents a major step forward. In the event of a banking crisis, as a result, creditors will share risks with the debtor bank.

Overall, financial integration in the euro area has recovered in important respects to a larger degree than often realised. However, reforms to improve the sustainability of EMU need to focus particularly on further foster financial risk sharing due to the high relevance of this adjustment mechanism.

6. Conclusion and outlook

A wide range of reforms has addressed the key roots of the recent crisis and further reforms have been suggested to make EMU sustainable. The annex provides a concise and systematic overview.

With reforms of the financial sector aimed at preventing excessive financial cycles, future crises can be made less severe. It has been shown that key shortcomings of EMU have been addressed (see figure 1): The heterogeneity and the divergence among EMU countries have been, or can be, significantly reduced. The various adjustment mechanisms were also shown to be more effective than generally perceived. With the various reforms that improved and are recommended to further enhance the functioning of EMU, the currency union will be much better able to deal with idiosyncratic downturns in the form of "standard" crises". All in all, the authors are of the opinion that the additional reforms pointed out here suffice to make EMU sustainable and that a fiscal stabilisation mechanism is thus not indispensable to this end from an economic perspective.

At the current juncture, debates on convergence among EMU countries are being intensified. In this context, different aspects of convergence need to be distinguished.

- First, regarding income convergence, incomes and also unemployment rates have diverged among EMU countries since the onset of the crisis. This is a cause of concern in view of the European objectives. However, from an economic perspective, this divergence does not come as a surprise, because pre-crisis growth was based on unsustainable trends and on rising private and public indebtedness in particular in many stressed countries. The crisis unveiled these vulnerabilities, and deleveraging still dampens the recovery. However, countries like Spain and Ireland show that once the appropriate policies are taken, income converge can set in again. Both countries benefit from the structural reforms taken, e.g. a wide-ranging labour market reform in Spain.
- As regards convergence in competitiveness and the drivers of growth, sound economic growth models and sufficiently flexible economies are required to sustain income convergence. There is substantial heterogeneity among EMU

countries concerning many important structural preconditions of growth, such as business regulation, the intensity of competition, or the effectiveness of public administration, including judicial systems. In these regards, in a number of euro area members there is scope for substantial reform to be taken to foster the convergence of the drivers of growth, as highlighted by the call for the emulation of best practices across the euro area in the Five Presidents' Report. Therefore, the broad range of structural reforms taken in the euro area periphery gives rise to the hope that growth will resume once the legacy problems of high indebtedness in the banking and private sectors are sufficiently overcome. It is again the example of Spain to show that cleaning up the banking system has great benefits and that structural reforms pay off in the next upswing.

- Finally, concerning the convergence of social systems: in the monetary union, the case can be made for the convergence of social systems towards some minimum standards, yet to be specified. For example, unemployment systems and social safety nets in most southern euro area countries are not well developed to buffer income shocks. Therefore, automatic fiscal stabilisers fall short of their potential. However, such reforms are not costless and will take time - in contrast to administrative reforms to reduce unduly burdensome regulations.

The European Semester is an important instrument to encourage such reforms. However, competence for most of the affected areas rests at the level of the member states. And even though broad-based evidence exists that these reforms foster growth and employment in the medium term, national policy-makers often appear unwilling or unable to implement them. At the European level, the European Semester contributes to a better understanding of the opportunities many reforms offer. Tighter involvement of national stakeholders, benchmarking exercises and sharing knowledge about best practices are important tools to inform national debates and build more ownership for reforms.

Annex

Overview about reform progress and about remaining reform needs to make EMU sustainable							
Required reforms to tackle causes of the crisis	**Prevention of eonomic imbalanes, credit bubbles and excessive private debts**	**Mitigation of risks in the banking and financial system**	**OCA context: Heterogeneity reduced and adjustment capacity increased**	**OCA context: Mitigation of One-size-does-not-fit-all Problem (real interest rate effekc)**	**Improved fiscal governance**	**Mitigation of illiquidity crises of sovereigns and banks**	**Improved economic coordination** and **Reforms to raise competitiveness and growth**
Reform-Progress	**New Macroeconomic Surveillance** with MIP	**Banking union** (SSM, BRRD, Bail-in, SRM, SRB, SBRF, ESM, harmonised nationale deposit insurance)	**Structural reforms of labour and product markets** (More wage and price flexibilty, less heterogeneity among EMU members)	**Improved banking supervision with SSM** (centralised independent SSM strong in microprudence, can overrule national supervisors in macroprudence, less arbitrage and inaction bias)	**Strengthening of SGP** **(**Six Pack and Two-Pack)	Sovereigns: **EFSF, ESM (condtionality)** Banks: **ESM and SBRF**	**European Semester** with Country-specific Recommendations
	New Macroprudential Supervision with new instruments against financial cycles (e.g. counter-cyclial and contingent capital buffers)	**Increase in capital buffers of banks** (Basel III pre-empted since 2011 by EBA and ECB stress test 2014)	**Improved labour mobility** and **Partial financial re-Integration** (due to reforms and ECB intervention)	**Country-specific applicability of new macroprudential instruments**	**Fiscal Compact** with national debt brakes and corrective mechanism)	ECB for Sovereigns: **OMT (condtionality)** ECB for Banks: **Unconventional monetary policy and Target2**	**Competitiveness Councils** (national and central) in case of reform weakness **More surveillance and reform programs** (under MIP or Two pack)
Remaining reform and implementation needs	**Rigorous implementation / Prevention of dilution**						
	Active use of new capital buffer regulations (esp.counter-cyclical buffers, minimum standards for internal risk models, surveillance of risks of interest rate increase)	**Ensure effectiveness of banking union** (**Bail-in:** no diluttion, bail-in-able capital largely held outside banking sector, **SRM:** strenghten, if needed, **EDIS** only in parallel with risk reduction and minimumg harmonisation of insolvency rules)	**Strengthen financial risk sharing** (use CMU for this aim, more regulative incentives for diversification and against short term lending, more equity integration, effective bail-in)	**Active use of country-specific macroprudence** (by national supervisors and possibly SSM)	**Strengthen national counter-cyclical fiscal policies** (Create fiscal space by adhering to MTOs, improve automatic Stabilisers, Ensure restrictive course in booms, correct structural deficit for financial cycle)	**ESM: Ensure conditionality principle** (for new ESM instruments, after programs, ensure IMF participation) If **integration of ESM in community law: ensure sufficient independence**	**Continue reform of European Semester** (in order ot increase implementation of CSRs, more peer pressure needed)
	Eliminate tax distortion favouring debt over equity financing (in order to limit incentives for incurring private debts)	**Repeal privileges for sovereign debt** (Introduce risk adequate capital buffers, exposure limits, abolish liquidty privileges, M**edium introduction** with phase-iin for new issuances from 2018)	**Increase** **-Trade integration** (e.g. foster Single Market) **-Labour mobility** (e.g. better recognition of qualifications and portability of pension rights)	**Amend CRD-IV package: Integrate borrower-based macroprudential instruments** (LTV, LTI, DSTI) (in order to allow their use by SSM)	**Ensure independence and effectivity of EU Fiscal Council** (in order to improve SGP implementation and to limit political discretion of Commission)	**OMT of ECB: Ensure conditionality principle**	**Increase Ownership** (even more discussion with member states, more benchmarking exercises, more intensive exchange on best practices)
	Continue private deleveraging (**Non-banks:** further improve private insolvency regimes; **Banks:** write off NPLs faster, recatpilisation or restructuring, bad bank solutions)	**Create strong Supervisor for whole financial sector** ((Shadow banking, more transparency, stress tests, countercyclical leverage ratio for highly leveraged activities)	**Continue structural reforms** (Reform packages: adequate design and sequencing, for political support and mitigation of social effects, against limited negative short term effects)	**Limit circumvention** (Application of borrower-based instruments to all domestic transactions, maximise use of reciprocity agreements)	Mediujm term **Reliable and effective rules for sovereign debt restructurings** (in order to strengthen the No-bailout-rule)	**Monetary policy of ECB:** Do not delegate financial stability solely to macroprudence	Medium term **Reilable rules for counttries that are unwilling to reform** (and for euro area exit, but only as ultima ratio)

Source: own illustration

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