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Fellowship initiative

The Future of EMU

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Summary

A broad range of economic research papers by leading scholars on the future of EMU concludes that three broad factors contributed to escalating the economic and financial crisis in the euro area.

The macroeconomic risks inherent in a large, internationally integrated and lightly regulated banking system were largely ignored. A range of emerging macroeconomic imbalances and market failures was overlooked, while policy mistakes at the Member State level included imprudent fiscal policy stances in the pre-crisis period.

On the reform options for a deep and more genuine EMU, scholars broadly support the steps taken so far in the EU to overhaul economic governance and accept the need for financial firewalls. Looking ahead, progress towards a full banking union is recognised as a key priority. While this will also have implications for fiscal integration, ambitious plans for a fiscal union are more controversial.

Introduction

DG ECFIN has now published a series of Economic Papers written by distinguished scholars in the context of its Fellowship Initiative on "The future of EMU & Economic growth perspectives for Europe". This note outlines the issues addressed under the first heading of the initiative and presents some key findings of the essays provided by the fellows; discussing them against the background of on-going policy efforts at the EU and euro area level.

The issues

The global financial crisis and subsequent euro area sovereign crisis have had a deep impact on Europe's growth trajectory and macro-financial stability. They have forced a reappraisal of the main macroeconomic forces at play in the euro area, as well as a rethink of the architecture of EMU that has already led to a substantial overhaul of economic governance arrangements. Serious challenges remain, however, and the overhaul remains unfinished business. In a range of Member States, tensions on sovereign markets persist while access to credit by the private sector remains impaired. After a long period of integration, fragmenting forces have resurfaced in several financial market segments. Growth divergences in Europe have reached unprecedented levels as some Member States face protracted and painful adjustment processes. Charting a way out of the crisis requires designing policies that restore confidence and market access where it has been lost and reforming EMU's policy framework to ensure macroeconomic stability and growth while avoiding a socially unacceptable distribution of the burden of adjustment.

In 2008, the European Commission released its EMU@10 report, [1] which acknowledged the benefits brought by the euro during its first decade – notably in terms of financial and trade integration, price stability and

[1] European Commission (2008).

ECFIN economic briefs are occasional working papers by the European Commission's Directorate-General for Economic and Financial Affairs which provide background to policy discussions. They can be downloaded from: ec.europa.eu/economy_finance/publications

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job creation –, but also identified a range of challenges. Among these ranked low potential growth, large macroeconomic imbalances in some Member States, weak adjustment capacity, insufficient fiscal consolidation in good times and a supervisory capacity not keeping pace with financial integration. The report also proposed policy action to deepen and broaden macroeconomic surveillance and promote a more effective functioning of EMU.

There is a need to revisit this analysis in the light of the crises and an evolving architecture of EMU. The remainder of this policy brief highlights key insights from the essays that help to better understand the flaws of the original architecture of EMU (EMU1.0) and to shape the its redesign (EMU2.0). [2]

Key findings of the contributions: assessing the design flaws of EMU1.0

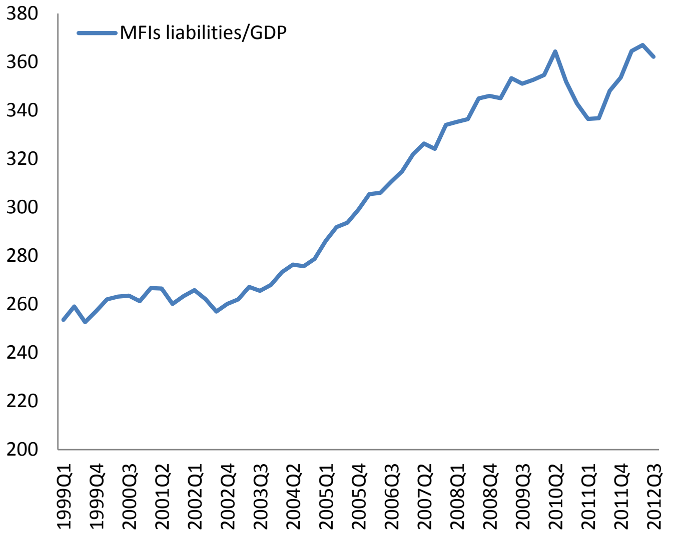
Critical discussions on the design of EMU have been ongoing ever since the signature of the Maastricht Treaty. A pre-crisis assessment culminated in a number of reviews of the first decade of existence of the single currency, including the Commission's EMU@10 report. The global and euro area sovereign crisis have since brought up new challenges and forced a further reappraisal of EMU. Drawing on the evidence from the crises, the essays prepared by the fellows bring considerable refinement to the analysis of EMU's design flaws. Their insights revolve around three 3 major fault lines that have magnified the euro area's exposure to the global and sovereign crises.

Unfettered financial deepening and financial (in)stability

EMU's original pre-crisis architecture was built around the idea that macroeconomic stability was essentially a question of fiscal and price stability and that a common currency would progressively bring about a synchronisation of Member States' business cycles. As argued by Obstfeld and De Grauwe, the financial dimension of macroeconomic stability was largely overlooked. The past two decades have, however, seen a remarkable growth in financial liabilities in advanced economies. This financial deepening increased the fragility of the euro area through two mechanisms: powerful negative feedback loops between banks and sovereigns, and excessive concentration of risks in some Member States.

Surging bank liabilities, euro area

(MFI liabilities as a % of GDP)



Source: ECB, Eurostat.

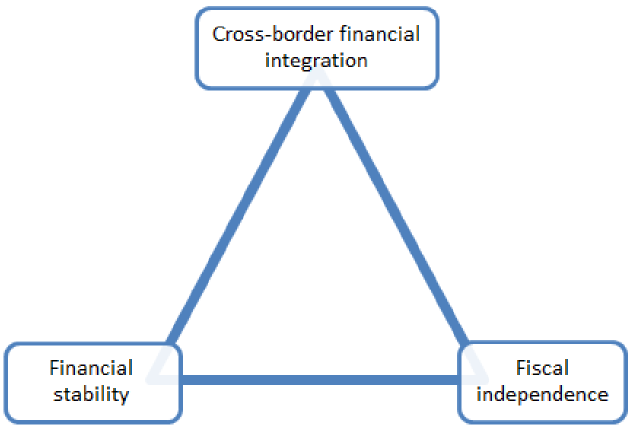
In the absence of possible debt monetisation the sheer size of banks' balance sheets, amounting to several multiple of GDP, can undermine the credibility of fiscal backstops to the banking sector in euro area Member States. Implicit or explicit government guarantees to the banking system can aggravate sovereign markets' susceptibility to multiple equilibria. They pave the way for powerful negative feedback loops (the "doom loop" in Obstfeld's terminology and the "deadly embrace" in De Grauwe's) where risks of a systemic banking crisis lead to rising sovereign yields that in turn weigh on banks' balance sheets and magnify risks of a systemic crisis. As argued by De Grauwe, such damaging feedback loops should not be seen as rare events but are likely to be part and parcel of EMU, at least in its original design, due to the inherent instability of capitalism. As long as boom bust cycles – driven by successive waves of optimism and pessimism and by credit expansion and contraction – continue to cause business cycle divergence across Member States, there will be risks that feedback loops are activated.

[2] This brief cannot give full justice to the very rich material covered by the essays. Rather than summarising this work it selects key findings that are particularly relevant for the ongoing policy efforts to redesign EMU.

As stressed by several fellows (Obstfeld, Lane, Gros and Alcidi), financial deepening in the euro area also had a strong cross-border component which led to an excessive concentration of risks. Cross-border financial integration should in theory have a macroeconomic stabilising role by allowing a better diversification of risks. In practice, however, financial integration in the euro area in the 2000s was associated with large capital flows from the core to the periphery with destabilising features. These flows were mainly intermediated by banks, leading to excessive exposure to the periphery by banks in the core. They also contributed to aggravating domestic credit booms in parts of the periphery and raised peripheral banks' exposure to sudden capital reversals. The reasons for the proliferation of debt (rather than equity) during the euro area's financial integration process need to be better understood, but the associated concentration of risks greatly increased the euro-area's vulnerability to shocks and cross-border contagion.

In the absence of independent monetary policy at Member State level, the combination of deep financial linkages with high debt motivates Obstfeld's new trilemma facing policy makers in EMU: it posits the impossibility of simultaneously maintaining cross-border financial integration, financial stability and national fiscal independence in a monetary union.

A new policy trilemma for the euro area



Source: Obstfeld (2013)

Macroeconomic imbalances revisited

Work by the fellows suggests a fairly consensual view of the main causes of the build-up of external imbalances in the euro area. Large current account deficits and losses in price competitiveness were essentially the result of excessive demand pressures (Obstfeld, Wyplosz, Lane, De Grauwe). Demand pressures were unleashed by the interest rate convergence that preceded the inception of the euro and then prolonged and amplified by the so-called 'real interest rate channel'. This operated in conjunction with an easing of collateral constraints on the back of rising house prices and financial deregulation. Loose fiscal policy also played a role in some Member States, as did differences in Member States' exposure to changing global trade patterns. Pre-crisis external trends in the periphery were clearly not sustainable, not only due to the unprecedented size of the accumulated external liabilities, but also because of the uses that capital inflows were put to. The accumulation of external liabilities was associated with a non-sustainable supply shift towards the non-tradable sector. Overall, this analysis largely squares with earlier work by the European Commission.[3]

An element which has received insufficient attention within the consensus view is the relationship between external imbalances and catching-up processes. Bertola stresses that all the countries that accumulated large external liabilities in the past decade were also engaged in various stages of economic convergence processes. His calculations show that a combination of slow convergence processes – as is generally documented in the related literature – and widespread access to credit may lead to large external imbalances, as agents adjust their consumption to a significant increase in permanent income. The prevalence of such a mechanism in some euro area Member States is backed by empirical evidence provided by Lane, who shows a link between in current account positions and expected growth. As argued by Bertola, there is an intrinsic vulnerability of convergence processes in the euro area because large external liabilities increase the exposure to shocks, and macroeconomic stability can be jeopardised by possible abrupt changes in income expectations and thereby in the perceived sustainability of external debt. Income convergence during the decade preceding the crises was

[3] See for instance European Commission (2010)

actually driven more by unsustainable demand growth than by convergence in productivity. This trend is probably partly attributable to insufficient convergence in the quality of governance of the countries concerned and explains the abrupt reassessment of external sustainability seen since the crises.

Policy mistakes and market failures

The global and sovereign crises changed the perception of risk as well as the attitudes towards macroeconomic imbalances within the monetary union (Gros and Alcidi), exposing a combination of important policy mistakes and market failures that have to be addressed in the re-design of EMU. Part of these mistakes and failures are attributable to Member States' actions and omissions. Some important fiscal policy errors in certain Member States contributed to escalating the crisis and weakened these countries' scope for subsequently pursuing countercyclical stabilisation policies. Fiscal policy was clearly excessively loose in Greece and Portugal in pre-crisis years, directly contributing to excessive demand and price pressures in these countries (Wyplosz, Obstfeld).

But at the same time, the fiscal coordination framework of the Stability and Growth Pact was supposed to prevent such actions from occurring and harming EU partners. The merits and flaws of EU economic and fiscal surveillance in the pre-crisis period represent a central aspect that many fellowship studies examine. A lack of enforcement of existing Stability and Growth Pact (SGP) rules at the Council level meant that the corrective force of EU fiscal rules was never truly brought to bear on Member States in breach of the deficit or debt rules. A further finding in the various papers is that the accumulation of fiscal imbalances since the start of the euro was not the only reason for the crisis. Other macroeconomic vulnerabilities built up in pre-crisis years were not addressed, including external imbalances and excessive house price and credit growth. One may also argue with Wyplosz that implicit liabilities related to public backstops for the banking sector should also be taken into account when assessing the fiscal stance.

Underpinning the prevailing pre-crisis attitude of 'benign neglect' towards wider macroeconomic vulnerabilities may have been a tacit belief that the main disciplining role should fall to financial markets. Recent years have provided ample evidence that markets can send excessively optimistic signals for long periods of time before correcting abruptly and sometimes excessively. As shown by Obstfeld, this is true of sovereign markets, which clearly underestimated risks in pre-crisis years in a range of Member States and have undergone excessive price correction since the sovereign crisis . Bergman et al. also provide econometric evidence that prices on sovereign markets may not always reflect all the available information, especially at times of crisis. Price signals provided by markets can come late and be prone to panic effects and overshooting.

The sovereign crisis has also shown that failures are not restricted to sovereign markets. Contradicting the common wisdom prevailing in pre-crisis years, it is now clear that financial integration in the euro area does not preclude abrupt reversals in cross-border capital flows and cross-border financial contagion (Lane). Since the global and sovereign crises, cross-border financial integration in the euro area has been partly halted or even reversed in some market. These segmentation forces are analysed in depth by Battistini et al. as well as Schoenmaker. Battistini et al. show that the segmentation of debt markets involves complex measurement issues and may actually be smaller than suggested by conventional prices measures, once varying country-specific credit risk is taken into account. But the authors also document a worrying trend towards rising home bias in banks' sovereign debt holdings in times of rising sovereign yield, particularly in those Member States most exposed to market pressure. As argued by Schoenmaker, rising segmentation should not only be seen as evidence of market failure but also as the consequence of inappropriate policies, particularly a national approach to the resolution of financial firms in difficulties.

Finally, a combination of prior market and policy failures is at the root of the macroeconomic adjustment difficulties that now characterise the crisis experiences in peripheral Member States. A number of Member States joined EMU with well-known weaknesses in their adjustment capacity and, until well into the crises, struggled to put in place sufficiently flexible market structures for a smooth functioning in a monetary union. This lack of flexibility substantially increased their exposure to shocks. A lack of flexibility is, however, not the only factor explaining the slow speed of adjustment in the euro area. When comparing the experience of the vulnerable countries in the EMU with that of the Baltic States, Gros and Alcidi conclude that a number of factors, including official funding via the

Eurosystem, have lengthened the process of adjustment in the euro area. For these authors it is not clear whether a slower adjustment will lead to better results in terms of unemployment and potential output when compared to quicker adjustment enforced by higher domestic interest rates and a lower availability of domestic credit.

Key findings of the contributions: shaping EMU2.0

Progress so far: An economic surveillance framework and financial backstops for a post-crisis euro area

Given the lack of effective enforcement of SGP rules and the insufficient breadth of economic surveillance in the pre-crisis period, reforming the economic governance architecture has been a focal point of the Commission's crisis response. Key milestones of this overhaul have been the entering into force of the so-called 'six pack' of regulations and the signing of the 'Fiscal Compact', as well as the more recent agreement between Council and Parliament on the 'two pack' of reforms. The fiscal regulations that form part of the six pack address many of the drawbacks of prior arrangements. SGP rules have been reoriented towards structural fiscal adjustment, i.e. allowing for the effect of business cycle movements and stripping out one-off measures, and a greater emphasis is placed on ensuring an appropriate fiscal effort in good economic times. Fiscal rules have also been made more effective by focussing them more on debt reduction and more stringent by adding semi-automatic fines in cases of infringement. Furthermore, as Charles Wyplosz points out, the strengthening of EU-level fiscal rules as been complemented further through the more decentralised approach of the Fiscal Compact, which (among other things) requires balanced budget rules to be enshrined in all Member States' national legislation.

The six-pack also hands the Commission a critical surveillance mandate for monitoring wider macroeconomic imbalances such as current account divergences, house price developments and private sector credit growth. Obstfeld's essay suggests that the narrow pre-crisis focus on fiscal surveillance was blind to a host of other macrofinancial vulnerabilities and therefore needs widening to other major macroeconomic developments. The Macroeconomic Imbalances Procedure (MIP) established by the six-pack aims to do precisely this by detecting emerging vulnerabilities using a broad-based scorecard system and following up, where necessary, through country-specific reviews and adjustment programmes. Finally, growth-enhancing reforms will continue to be identified and coordinated at the EU level, but have gained a particular importance for euro area Member States. Given the need to ensure that macroeconomic adjustment to shocks and imbalances occurs smoothly and without protracted output losses, Member States will need to remain active partners in boosting growth and promoting adjustment in EMU, and the new governance arrangements will facilitate this.

The strengthening of economic governance brought about by these various reforms is a central element in preventing any future escalation of fiscal and macroeconomic imbalances. However, the ferocity of market turmoil in recent years has shown that better and stricter rules alone cannot solve acute liquidity issues of sovereigns. Various financial assistance facilities have therefore been successively created since 2010 in order to bridge periods of sovereign liquidity squeezes, which otherwise may have precipitated a default with potentially disastrous economic and financial consequences. The thus created temporary lending facilities of the EFSF and EFSM were replaced by a permanent financial assistance mechanism, the ESM, which became fully operational in October 2012. Fellows such as Obstfeld and Lane view these 'firewalls' as a critical complement to the strengthening of EU governance, as the combination of the two both reduces the likelihood of future crises and limits their harmful impact.

Reconstructing the euro area's financial and monetary system

Many of the essays prepared in the context of the fellowship recognise the central importance of large, internationally integrated banking systems in both creating and propagating imbalances and shocks across the euro area. Fellows strongly support the need to comprehensively strengthen and broaden financial oversight in its various facets. There are a number of distinct aspects to this common position, which will all need to be addressed adequately in reforming and completing EMU in future. From an institutional and governance perspective, there are two distinct challenges related to the financial system, which are safeguarding financial stability and protecting the public finances and taxpayers' interests.

The first of these challenges – protecting financial stability – calls for more effective supervision and regulation of banks in the EU and the euro area. After more than a decade of national financial supervision and national resolution policies, which led to financial fragmentation, there is large consensus among the fellows on the need for full banking union. For this, a unitary deposit guarantee scheme and a common resolution regime will have to remain reliably fundable even in adverse scenarios. A full banking union as detailed in Schoenmaker (2013a), would counter fragmentation trends while also disabling negative feedback loops between banks and sovereigns.

As regards the design of macro-prudential policy, Schoenmaker (2013b) suggests giving the lead to the ECB in applying macro-prudential tools in the banking union so as to foster a coherent approach. Moreover, he underlines that the ECB should separate the macro-prudential and micro-prudential functions (the macro-prudential function should be executed by a committee reporting directly to the ECB's Governing Council and the micro-prudential function by the new Supervisory Board). With reference to the potential shape of a new European Resolution Authority, he proposes to combine the resolution and deposit insurance functions for efficiency reasons into a new-established European Deposit Insurance and Resolution Authority (EDIRA). For countries that are part of the EU, but not of the euro area, supervision and resolution would remain national, but Schoenmaker suggests allowing these countries to opt into the banking union, thereby avoiding a two-tier EU banking system.

On the second challenge of protecting the public finances, Obstfeld's and Wyplosz's contributions both view large banking systems as potentially creating large liabilities for the state in the event of banks becoming distressed. As even a single large bank's failure may overwhelm the public resources of a Member State, Obstfeld sees an important role for the ESM to step in for the purpose of recapitalising banks in need. Such direct recapitalisations could also offer euro area taxpayers – whose resources ultimately back the ESM – a potential upside for them taking an equity stake in a rescued bank, and thus need not be associated with financial losses for investors such as the ESM. The European Council meeting of 14/15 March 2013 reaffirmed that any direct recapitalisations through the ESM would first require a single supervisory mechanism (SSM) to have been established, which will be the first step in a sequence of measures towards a comprehensive EU-wide banking union.

An issue discussed by some of the fellows is the role of the ECB in the new financial and monetary system. While the consensus on the ECB's role as a lender of last resort (LLR) for banks is clear, conclusions regarding its role as a LLR for sovereigns are more varied. The ECB's programme of Outright Monetary Transactions (OMT), announced in July 2012, is viewed by most fellows as a positive game changer in reducing risks of multiple equilibria: it ensures that sovereigns can have guaranteed access to funding even if liquidity is draining from the market, and thus eliminates the possibility to speculate to the opposite effect. However, this also raises moral hazard issues. While some fellows argue for a strong role of LLR for the ECB (De Grauwe), others caution against it (Wyplosz).

Moving towards a deeper level of integration

Beyond the advances made on economic governance and short-term priorities for a banking union lie longer-term proposals for further and deeper integration of euro area Member States. In November 2012 the Commission published its 'blueprint for a deep and genuine EMU', which draws up a sequence of possible actions designed to make EMU a more prosperous and stable arrangement.

As a first step along the path proposed by the blueprint, the Commission presented concrete policy options in March in a Communication on a Convergence and Competitiveness Instrument (CCI). This describes two potential instruments that can support structural reform implementation within a shared but limited fiscal capacity, namely by launching contractual relationships with Member States to undertake specific reforms, and financial support to help Member States implement these reforms. Structural reforms are crucial to guarantee a sustainable and durable process of adjustment and rebalancing, and thanks to market pressures and multilateral policy momentum such reforms have gained traction since the start of the crisis. However, as Hans-Peter Grüner argues, reforms undertaken during the crisis may not be politically viable if they lack the necessary long run political support. A CCI-type instrument can therefore help complement structural reforms with other measures that support the social balance. This, Grüner argues, could also help shift the emphasis away from negative incentives for Member States to reform (i.e. avoiding criticism and sanctions) to encouraging structural reforms through positive incentives, and thereby support the notion of a partnership between Member States and the EU/euro area.

One major theme from the blueprint pervades the work of a number of fellows, and this is the question over the extent and shape of further fiscal integration that is required for completing EMU. Wyplosz and Obstfeld approach this question by examining possible arguments in favour of a fiscal union of some kind, concluding that two main justifications can be found for pooling fiscal resources to a certain extent. The first rationale lies in the need to spread often enormous emergency liquidity needs (for banks and/or sovereigns) across a larger fiscal base, while the second reason is the possibility of smoothing out asymmetric macroeconomic shocks, i.e. those affecting only certain parts of the euro area.

While both arguments have their merits, on balance the analysis tends to emphasise the importance of the first argument. The 'common backstop' argument lends support to already existing arrangements such as the ESM, which is viewed by fellows such as Lane and Obstfeld as a necessary feature of EMU in view of fickle capital markets and seismic shifts in risk attitudes. The argument for a common backstop however also extends further to a full banking union, where a unitary deposit guarantee scheme and a common resolution regime will have to remain reliably fundable even in adverse scenarios. Obstfeld and De Grauwe both view a banking union and a fiscal union as inextricably linked, including through a common level of supervision requiring a common level of funding.

On the other hand, the 'cyclical smoothing' argument has its origins in optimal currency area theory. It would suggest that the greater the probability and/or magnitude of asymmetric shocks within a region are, the greater the cause for budgetary transfers from a central facility (partly) compensating for a fall in revenues and/or a rise in expenditure, a consideration echoed by Lane. Obstfeld argues that intra-union transfers may be welfare-improving, but given the large taxation powers that individual Member States possess (in contrast to US federal states for instance) the case for a federal transfer system is not overly compelling. He nevertheless suggests that the ESM itself could serve as a vehicle for a quasi-insurance system with cyclically stabilising effect, whereby payments to the ESM by Member States would depend on country- and time-specific factors. By contrast, Wyplosz maintains that as long as fiscal discipline is ensured and public debt levels are sustainable to begin with, such an insurance system is on theoretical grounds no better than letting national fiscal positions vary with the cycle through the normal play of national automatic stabilisers. This raises an important distinction between short to medium term solutions on the one hand, and longer term arrangements suited to a more benign macroeconomic 'steady state'.

A final issue of interest to some fellows is the question over some form of common asset for the euro area, possibly through pooling sovereign bond issuances. Obstfeld's essay also addresses this question, concluding that partial collective debt issuance or redemption could help break the bank-sovereign doom loop, but should ensure that such arrangements remain efficiency-enhancing and guard against the moral hazard of fiscal recklessness. He further makes an important point relating to any form of fiscal union, which is that the creditworthiness of the union is a direct function of that of its constituent members. Fiscal indiscipline can therefore impose negative consequences on other union members, which is why starting conditions in such a union should be sound and fiscal incentives should promote collectively responsible behaviour.

Getting the balance right on the way ahead

Deepening and extending EMU's policy framework and institutions will involve coming up with concrete responses to many of the challenges and questions raised in this policy brief so far. In devising EMU 2.0 in this way, some fundamental questions of economic and political principle will require addressing, which the specific reform actions discussed so far have not directly acknowledged. Generally speaking, these deeper questions concern the relationship between markets and public policy, as well as the balance between national and centralised powers and resources.

Discussions of fiscal policy and the need to ensure fiscal sustainability will sooner or later have to face the question what role market discipline can play in support of this aim. In principle, investors in government bonds have strong commercial incentives to make sound decisions that balance the expected reward (i.e. interest payments on bonds) with the risk of default. Bergman shows, however, that the quality of market signals is too 'noisy' to be a reliable gauge for assessing fiscal policy, especially during crisis periods. Market pricing and market pressure should therefore be treated as a potentially useful complement, but no substitute, for fiscal rules and rule-based fiscal policy coordination. Some fellows argue however, that signals provided by markets could be improved by appropriate financial innovation, including instruments such as GDP-linked bonds, European Safe Bonds, or housing indices (Obstfeld, Lane)

The complex relationship between markets and policy intervention is of deep significance for the shape of EMU 2.0, as it remains to be decided how far the possibility of Member States (or their banks) receiving publicly funded financial assistance, should extend. The fellowship paper by Wyplosz compares and contrasts two distinct models of fiscal federalism in order to assess the relative merits of a decentralised approach without central bailout possibilities (the US model) and that of Germany, a centralised fiscal federation with a constitutional bailout obligation of the federal state for its *Länder*. The much lower debt levels of US states appear to provide support for the former approach. According to Wyplosz, this analysis calls for restoring a credible no-bail-out rule in EMU.

A final issue that necessarily pervades all aspects of EU integration is that of democratic legitimacy, accountability and subsidiarity. Especially in the acute phases of the sovereign crisis, the public perception of crisis management and decision making in the Council was that of decisions being taken without adequate consultation with national parliaments and other stakeholders. This fact may be defended pragmatically as having been dictated by the exceptional circumstances at the time. Nevertheless, there is a consensus among the fellows that further integration measures towards an EMU 2.0 must rest on a basis of strong national support. Beyond more systematic involvement of national parliaments, the essays offer, however, only limited practical guidance on how to ensure proper democratic legitimacy and accountability.

Concluding remarks

The essays reviewed in this brief have generated a large body of new analysis on critical questions for the future of EMU. There is generally close agreement on the diagnosis of factors that contributed to the euro area crisis. First, fellows note that both markets and policymakers were impervious to the financial stability risks associated with an increasingly international banking system. The implosion of the credit cycle then created enormous actual and contingent liabilities for sovereigns, and this mutual dependence between banks and states became a potent catalyst for an escalation of the euro area crisis. Second, the euro area crisis was made possible by the build-up of wider macroeconomic imbalances such as external imbalances, house price or credit developments. Third, there were clear instances of policy mistakes having been made by Member States in the pre-crisis period, some of whom pursued imprudent fiscal stances. Weak enforcement of SGP rules also contributed to this development as an enabling factor.

Turning to the question of what institutional changes to EMU are needed in order to ensure its viability and success, there is unanimous support among fellows for establishing a full and comprehensive banking union, along the lines of the Commission's Blueprint proposals of November 2012. Backstopping a banking union through mutually funded facilities brings financial regulation into fiscal territory, and fellows generally view attempts to separate a banking union from a fiscal one as either conceptually impossible or economically undesirable. The limits of fiscal integration in the euro area however remain disputed. Ambitious proposals for fiscal facilities bridging not only funding gaps for banks and sovereigns, but also smoothing out asymmetric demand shocks, contrast with more minimal approaches to fiscal integration that emphasise the negative incentive effects of more comprehensive arrangements.

The essays also help to shed new light on important fundamental questions that underpin progress to a deep and genuine EMU. The desired relationship between markets and public institutions will determine how stringent and activist euro area policy coordination and financial assistance will need to be. Power may shift between the central EU institutions and Member States in either direction, which may have profound implications for accountability and democratic legitimacy of an EMU 2.0.

While new insights have been won, and fellows unambiguously support immediate policy action on a banking union, the contributions also map out areas where further research is needed. One such issue concerns the transition from the current arrangements to a stable and sustainable long-term steady state for the euro area. In particular, it is not clear how euro-area Member States should deal with a legacy of historically unprecedented debt levels. While further academic work could elucidate the required macroeconomic adjustments along this path, political decisions will ultimately shape the euro area's progress along the way.

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