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# THE IMPOSSIBLE TRINITY AND THE PROSPECTS FOR AN EUROPEAN FISCAL UNION

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## Abstract

After reviewing some of the recent EU economic governance reform provisions, the paper discusses three main in-built vulnerabilities of the euro area: the absence of co-responsibility for public debt; the strict prohibition of monetary financing; and the vicious circle represented by the fact that states are individually responsible for rescuing banks in their jurisdictions, but banks are exposed to their own governments through their holding of debt securities – the so-called impossible trinity. The paper argues that although changing the European Central Bank's mandate and building a banking federation could theoretically be contemplated, the only practical and feasible solution to the euro area crisis is the fiscal union. But the fiscal union still lacks a consensual blueprint and it would entail some form of a political union as well. With United Kingdom and the Czech Republic not agreeing to become parts of the fiscal compact, and a more self-confident but less European Germany, the prospects for such a solution based on euro solidarity and political will for deepening integration are uncertain.

*Keywords:* Euro crisis, fiscal union, euro solidarity, political will

## 1. Introduction

The Economic and Monetary Union (EMU) has been asymmetrical since its beginning. This feature has been maintained by the Treaty of Lisbon. While the EU has exclusive competence for monetary policy in relation to the euro area, decisions about their economic policies are taken at the Member State level. The European Union (EU) holds competence in their coordination only. The economic and financial crisis, together with the subsequent debt crisis, revealed the structural weakness of the system. Responses to the unfolding crises have included, among others, measures consisting of liquidity support, assistance for the financial sector and economic stimulus measures, as well as other measures focused on the need to strengthen fiscal frameworks at the EU and national levels.

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### *1.1. Reviewing the EU economic governance reform*

Undoubtedly, in its first decade the euro area suffered from a lack of fiscal discipline and the credibility of fiscal rules and corresponding fiscal targets agreed upon in the 1997 Stability and Growth Pact – budget deficits not to exceed 3% of GDP, debts not to exceed 60% – were compromised. Therefore, most of the measures taken since the euro crisis erupted in early 2010 have tried to address this problem. They have also put an emphasis on macroprudential policies and institutions which target the inter-related issues of how risk in the financial system evolves over time and how risk is allocated among financial-system participants at a given point in time [1].

In November 2010, a European Systemic Risk Board (ESRB) as an autonomous EU institution hosted by the European Central Bank (ECB) in Frankfurt and chaired by the ECB's President.

On 4 October 2011, Member States finance ministers approved a set of six proposals shaping the EU economic governance reform package. Adopted by the European Parliament and the Council on 16 November 2011, the so-called 'six-pack' is considered to be the most comprehensive change in the principles of the functioning of the EMU since it was established. Four of the adopted pieces of legislation aim to strengthen budgetary discipline within the Stability and Growth Pact (SGP), which supplements the Treaty rules on fiscal discipline. The other two concern the surveillance of Member States' economic policies, which is based on monitoring and control of major macroeconomic imbalances in the EU Member States. One of the key reform elements is a semi-automatic mechanism for sanctions under both the preventive and corrective aspects of the pact. In response to a recommendation from the Commission, the EU could decide by a vote to impose sanctions on a Member State of the euro area (a deposit or fine in the amount 0.2 % of GDP), unless an objection is voted on by a qualified majority of Council members, not including the state in question. Only the eurozone members may participate in voting. The sanctions are to ensure a more effective enforcement of budgetary discipline and are a big step forward compared to the previous procedure based on political decisions.

The reform envisages deepening the surveillance of macroeconomic imbalances, thus creating a new procedure to deal with excessive imbalances. The surveillance covers the analysis of the surpluses and deficits of a state's current accounts as well as a search for the reasons and solutions to any imbalances. Therefore, while monitoring the data, the possible influence of these imbalances on other Member States will be taken into consideration. The Council will be able to impose sanctions on a Member State that fails to comply with its recommendations (a deposit or an annual fine in the amount of 0.1% of GDP). The 'six-pack' provisions envisage strengthening the national budgetary frameworks in part by obliging Member States to ensure there are adequate accounting and statistical standards and to use multi-annual budget planning [2].

On 26 October 2011, the euro-area heads of state and government decided to go further and committed themselves to adopt near-constitutional rules on balanced budgets in structural terms, to base national budgets on independent forecasts and to allow examination of draft budgets by the European Commission before they are adopted by parliaments.

Later on, on 9 December 2011, EU heads of states and government, with the exception of United Kingdom, committed themselves to introduce fiscal rules stipulating that the government deficit must not exceed 0.5 percent of GDP in structural terms. In addition, they agreed on a new treaty that would allow automatic activation of the sanction procedure for countries in breach of the 3 percent of GDP ceiling for budgetary deficits, unless a qualified majority of euro-area Member States would be opposed to it.

Eventually, the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union – the so-called fiscal compact – was agreed upon at an informal meeting of the European Council on 30 January 2012. Apart from the United Kingdom and the Czech Republic, all Member States declared their intent to join it. The fiscal compact guarantees the participation of the EU institutions in the economic governance. The jurisdiction of the Court of Justice of the European Union (ECJ) covers the obligation to transpose to the national legal orders a balanced budget rule limiting the level of a structural deficit to 0.5 percent of GDP at market prices. The ECJ will also have the power to impose a lump sum or penalty payment up to 0.1 percent of GDP on those parties of the compact that have failed to comply with a judgment of non-compliance with the transposition obligation. The ECJ shall have jurisdiction in disputes between Member States related to the subject matter of the treaties if the case is submitted under a special agreement between the parties. The pact introduced also the obligation to reduce public debt at an average annual rate of 1/20 if the level exceeds 60 percent of GDP [3].

In order to strengthen the coherence of the compact's provisions with the EU *acquis* the compact includes numerous references to EU primary law and the principle of loyal cooperation, which is fundamental to European integration. To enter into force, the compact should be ratified by only 12 of 17 members of the eurozone – a principle which may lead to diverse levels of economic integration not only in the EU as a whole but also in the eurozone itself. The compact's provisions include also the possibility of the future incorporation of the fiscal pact into the EU legal system, which shall be taken within five years after it enters into force.

All these reform steps, crucial as they are, have focused on fiscal aspects. As the enforcement of the fiscal rules is only part of the solution, their influence on the development of the situation in the eurozone is bound to be limited.

## 2. The in-built vulnerabilities of the euro area

A structural perspective highlights the in-built vulnerabilities of the euro area, derived from the principles on which the euro is based, which make euro area countries to appear more vulnerable to fiscal crises than non euro area countries. For the purpose of this paper, three basic tenets are particularly relevant: the absence of co-responsibility for public debt; the strict prohibition of monetary financing; and the vicious circle of state responsibility for supervising and rescuing banks and the holding by the latter of large stocks of debt securities.

### *2.1. Absence of co-responsibility for public debt*

According to Article 125 of the Treaty of European Union (TEU), governments in the euro area are individually responsible for the debt they have issued and cannot assume responsibility for the debt issued by another country. The aim of introducing this 'no bail-out clause' was threefold: to prevent moral hazard; to provide incentives for governments to abide by fiscal discipline; and to ensure that markets would price sovereign risk appropriately. In fact, until the Greek crisis, sovereign bonds were deemed risk-free. Only when the Greek crisis erupted markets realised that Greece might have to default and the sovereign risk began to be priced in the bond market.

### *2.2. Strict prohibition of monetary financing*

Contrary to other central banks, the European Central Bank (ECB) is constrained by the prohibition of purchases of government bonds and does not have an explicit financial stability mandate that could justify intervention on the bond market. The fact is symptomatic for the strict separation between fiscal and monetary policy in the European Union (EU). Article 123 of the TEU strictly prohibits institutionalised fiscal dominance in the form of explicit agreements between a government and a central bank as in the U.S. However, the ECB has made use of the option of buying government bonds on the secondary market in an ineffectual attempt to hold down interest rates. With the launch in May 2010 of the Security Markets Programme, it has purchased first Greek and Portuguese bonds and later, in August 2011, Italian and Spanish bonds. But these purchases were done with reluctance and not so much to preserve financial stability, but rather to prevent disruption to the proper transmission of monetary policy decisions.

### *2.3. Bank-sovereign interdependence*

The crux of the problem of the ongoing crisis in the euro area is market concerns about the sustainability of sovereign debt in eurozone countries [4]. This is the outcome of the bank-sovereign interdependence. Although the euro area is integrated monetarily, Member States which compound it are individually responsible for the rescue of their national banking systems. Moreover, domestic banks hold on their balance sheets a significant share of national government debt. Through their holding government bond portfolios, domestic banks are exposed to their own governments. Any doubt about sovereign solvency immediately affects domestic banks [5]. Conversely, fragility of the national banking system rapidly raises doubts about the solvency of the sovereign. During the crisis, domestic banks in countries subject to market pressure (Greece, Ireland, Italy, Portugal and Spain) substituted non-residents with residents thus increasing their exposure to sovereign risk. The interdependent exposure – governments to 'their' banks and banks to 'their' governments – makes a vicious circle that has proved to be a dangerous vulnerability during the crisis, when the solvency of sovereigns has started to be questioned and the stress on the sovereign bond markets has translated into pressure on the banking system.

The coexistence of these three in-built vulnerabilities form a trilemma or, as it was metaphorically called, an impossible trinity, which makes the euro area especially fragile, prone to liquidity and solvency crises.

## 3. Addressing the trilemma's challenges

The euro area's strategy of budgetary consolidation is indispensable but insufficient. As it was suggested, there is a need to address the three above-mentioned vulnerabilities with a corresponding set of three non-competing options.

### *3.1. Giving the ECB the role of lender-of-last-resort*

The first option would be to change the mandate of the ECB as to give it a role equivalent to those played by other major banks. As a lender of last resort, the ECB would be able to provide liquidity to prevent states from being cut off from financing either by lending for a limited period to a sovereign at a rate that is above the risk-free rate but below the rate the sovereign has to pay, or by providing a credit line to a public entity – the European Financial Stability Facility (ESF), for instance. But such an option would be faced with tremendous legal and political obstacles, including unanimous agreement of the EU-27 Member States for changing the ECB mandate, distributional dimensions in cases of ECB losses on its bond portfolio, lack of appropriate ECB governance structures, and potential moral hazards associated with unconditional support or support with weak conditionality [6]. It goes without saying that the key of such an option would be to ensure that ECB does not become a lender of first resort, as that would remove the incentive for states and banks to manage their own affairs responsibly.

### *3.2. Breaking the banking crisis-sovereign crisis vicious circle*

The second option would be to break the vicious circle associated with the bank-sovereign interdependence by embarking in a bank and insurance regulation reform. This would imply, among other things: setting limits on bank exposure to any single borrower; euro area or EU supervision of large banks; and the creation of a common deposit insurance scheme supported by a common fiscal resource. But this reform would amount to a fundamental transformation of the financial systems of the euro area, being practically the same as setting up a banking federation. The first steps towards moving both the supervision of large banks and the responsibility for rescuing them to European level, i.e. creating fiscal capacity at European level, have already been made with the creation of European Banking Authority (EBA) and the European Systemic Risk Board (ESRB). However, there are no signs that governments in the euro area are ready to give more of their sovereignty by accepting to share in common budgetary resources.

### *3.3. Setting up a fiscal union*

The third option would be to create a fiscal union. The idea was contemplated in the first major report on the subject of the then-European Economic Community (EEC), written in 1970 by a group of experts under Pierre Werner, prime minister of Luxembourg, which set the stage for the first attempt at currency cooperation [7]. Eventually, against the background of the sovereign debt crisis, the idea came back under the guise more or less of a ‘fiscal union by force’ [8].

The fiscal union is meant to put an end to the individual responsibility of each country for its own debt. Instead, debt would be issued in the form of Eurobonds benefiting from the joint guarantee of participating governments. In the case of default of one participating state, the guarantee would be invoked and the other governments would assume the corresponding liability. The other side of the coin is that by subscribing to Eurobonds, states would need to accept a thorough scrutiny of their finances and submit their national budgets for ex-ante approval. But the ex-ante approval implies a major revision of the Treaty as to make it effectively enforceable. In fact, a new institutional framework at the EU/euro area level, which would imply some sort of political union, would be needed.

To be successful, an overhaul of the European Monetary Union (EMU) would require simultaneous moves in advancing all three options. However, the prospects for that are very unlikely. In fact, in terms of feasibility, the three options rank differently, with the first option thought to be the least feasible and the third one, the most feasible – provided that it gathers the necessary political will and support for its implementation.

## 4. A possible blueprint for a fiscal union

Although, as yet, there is no consensus regarding the possible blueprint of a fiscal union, three analysts from Bruegel, a Brussels-based think tank, have already worked out a detailed proposal for it. Their proposal concerns the setting up of a limited fiscal union which would involve both a political authority and fiscal resources to prevent, manage and resolve euro crises. The political authority would take the form of a euro-area finance ministry, with sole supervisory authority over all systemic banks. The euro-area finance minister would have a far reaching veto right power over decisions with potentially significant negative impact on the rest of the euro area, including regarding budgetary issues. He/she would be appointed by the Council and European Parliament in euro-area composition by majority rule. The fiscal resources would be secured by setting up a euro-area deposit insurance corporation (EDIC) with an insurance premium secured by contributions from all euro-area banks that accept deposits. Furthermore, should national policymaking fail to abide commitments, the euro-area finance minister could be given the right to directly access certain revenues. Thus, in case loans provided to an illiquid country were to turn bad or bank recapitalization needs were to exceed the funds available in the EDIC, the euro-area finance minister would need a taxing capacity of about two percent of euro-area GDP. The tax-raising power would be activated only if a country was to default. Otherwise, the euro-area finance minister would borrow on the market at a low interest rate and lend to the country in need at a preferential interest rate, as in the European Financial Stabilisation Fund (EFSF) and its successor, the European Stabilisation Mechanism (ESM).

This overhaul of the EMU will need substantial revisions of the Treaty. A Convention that would prepare the ground for an Intergovernmental Conference (IGC) would precede the adoption of a new Treaty. In order to confer legitimacy to the new political institution, the Convention and the IGC would need to involve governments, national parliaments, European institutions, and civil society representatives. All in all, the process for drafting and ratification of a new Treaty would last 3-4 years. The proponents of this fiscal union blueprint claim that their proposal addresses most of the vulnerabilities of the current responses to the euro-area crisis [9].

## 5. The way ahead: European political will vs. parochial interests

What began as a crisis for the euro has quickly turned into a crisis for the EU. Germany has thus far taken the lead in bankrolling and negotiating Europe's bailout funds, but the question is if Berlin will play a similar role in tackling tough political reforms as the balance of power in Europe continues to shift.

Nowadays, Germany seems to be the political winner, obtaining a strong instrument to discipline other eurozone members. Similarly, other fiscal pact provisions indicating the need to activate measures from the European Stability

Mechanism (ESM) with the ratification of the pact and the transposition of the balanced budget rule to national legal orders are considered compatible with Germany's interests. Approving the compact in the intergovernmental formula corresponds also with the French vision of economic integration.

At the same time, the compact's provisions may introduce some decision-making chaos on the heads-of states- and-governments level, at which meetings will now include talks with the 27 Member States, the eurozone itself (17 Member States), signatories of the fiscal compact (25 Member States) and also those gathered for the forum set by the euro-plus pact (23 Member States). Moreover, as previously, noted, under the fiscal compact provisions ECJ shall have jurisdiction in disputes between Member States related to the subject matter of the treaties if the case is submitted under a special agreement between the parties. But the matter may be brought to the ECJ only by Member State-parties to the compact, which may raise doubts about the future efficiency of such a mechanism based to a large extent on the political will of the euro area Member States.

Such an agreement doesn't have much chance to be reached quickly given the fierce opposition from politicians and the public in the eurozone's relatively healthy economies led by Finland, Germany, and the Netherlands to repeated bailouts of their weaker euro area partners such as Greece, Ireland, Italy, Portugal, and Spain [10]. In addition to this, once the crisis is solved, the enthusiasm for a fiscal union may wane. Furthermore, Germany's refusal to participate alongside the UK and France in the Libya campaign signals not only a renewed pacifist drift in German foreign policy, but a shift towards a more self-confident but less European Germany [11]. In fact, Germany's continuing economic success story, largely unimpeded by the sovereign debt crisis has encouraged Berlin to act with self-confidence in attempts to save the euro. However, Germany is moving towards the position of an inward-looking power, focussed on its own economy. The fears in Berlin are either of boosting inflation or of Germany's becoming the eurozone's paymaster. For that reason, even if prepared to pool some budgetary functions, Germany would insist on imposing strict discipline on what other countries can spend and borrow.

In a largely unfavourable negotiating climate generated by the crisis, as another tough round of negotiations concerning the new EU Multiannual Financial Framework 2014–2020 is ahead, it remains to be seen if major EU Member States in general, and Germany in particular, would have the political will for opting for European joint solutions and transcend their diverging parochial interests.

## 6. Conclusions

In economic and financial matters, the EU faces a dramatic crisis, which will not be resolved overnight. Most analysts of the euro crisis have signalled out its fiscal roots and most of the responses to the crisis were directed to address this problem. However, the in-built vulnerabilities of the euro-area have remained largely unaddressed.

The most feasible solutions for the eurozone impossible trinity represented by the absence of co-responsibility for public debt, the strict prohibition of monetary financing, and bank-sovereign interdependence, is a fiscal union. But a fiscal union would require major revisions of the Treaty, which, in turn would pose significant challenges in terms of political will for the EU Member States.

A more self-confident but less European Germany would probably be less interested in European-wide solutions that inevitably would sacrifice some of its accumulated wealth, unless its partners would provide firm guarantees for accepting complete surrender of budgetary sovereignty.

At the end of the day, the crux of the problem for establishing a fiscal union seems to be to what extent pivotal Member States are politically willing to give up their parochial interests for European solidarity-wise solutions.

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