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**ADB Working Paper Series**

**REFLECTIONS ON FISCAL COORDINATION  
AND INTEGRATION IN EUROPE**

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**Abstract**

This paper provides an overview of the key steps that were made in the European Union toward enhancing fiscal policy coordination and integration prior to the Covid-19 crisis. It especially highlights the key challenges and strategies that should be considered when thinking of further fiscal integration in the monetary union. Compared to economic and financial integration, fiscal integration would require much stronger political support. Fiscal integration is not meant to be achieved overnight but it should take a stepwise approach, which could encompass policy coordination, pooling resources for macroeconomic stabilization and fiscal backstops, debt mutualization and safe assets, and ultimately a common budget. This paper also aims to provide some inspiration for East Asian economies when they consider strengthening fiscal integration in their region. Despite some fundamental differences between Asian and European economies, there are common issues that must be tackled.

**Keywords:** economic integration, fiscal integration, fiscal capacity, safe assets, sovereign debt, backstops, policy coordination

**JEL Classification:** E62, E63, F55, F62, F63

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## 1. INTRODUCTION

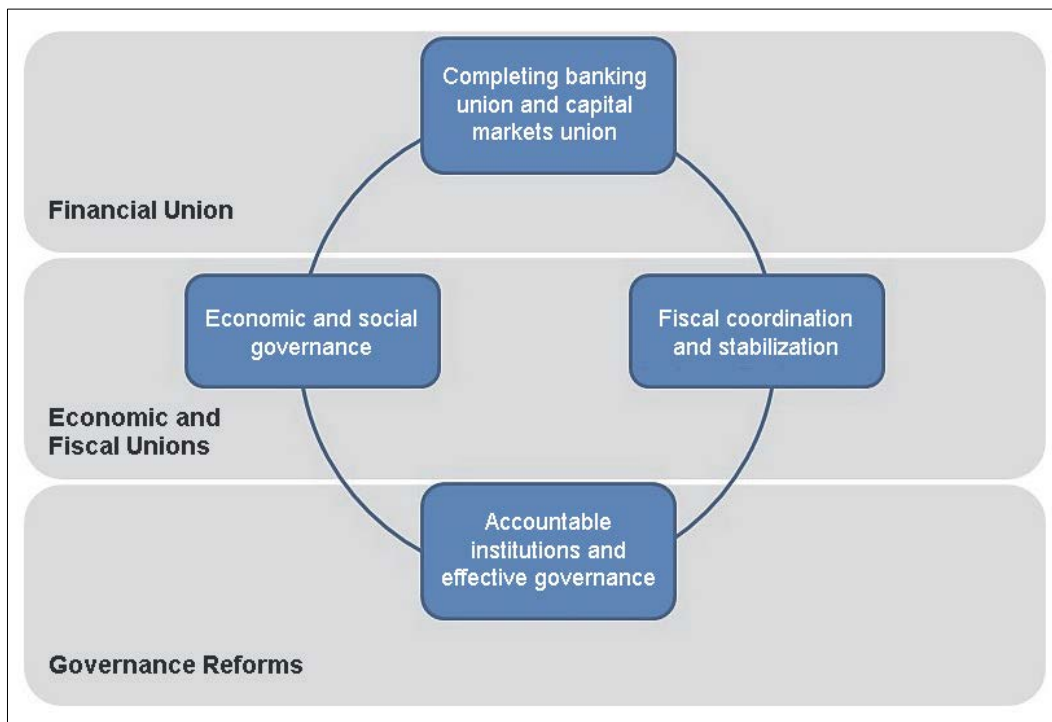
A monetary arrangement that adopts a common currency, or fixes exchange rates, exposes its member countries to spillovers from divergent economic performance. It also requires coordination of policy strategies to ensure competitiveness and real economic convergence. This largely reduces the effective policy tools to fiscal and structural policy areas. The most striking example is Greece, which lost its competitiveness toward its main trading partners and supported its national economy with large public stimulus after the adoption of the euro. This led to macroeconomic imbalances in Greece, while the core euro area countries were making productivity gains. Then, the correction of the Greek crisis was prolonged because successive governments tackled the situation without a coherent plan or social support. The Greek crisis subsequently exposed other members of the Economic and Monetary Union (EMU) that had weak fundamentals to a market shock. The euro area crisis shows that a monetary union requires an advanced safety net to stabilize market expectations, which will allow time to take determined action and correct the imbalances.

In his *The Theory of Economic Integration*, Bela Balassa defines economic integration as a gradual and stepwise process to reduce and eliminate barriers between the countries involved (Balassa 1961). With the willingness to create synergies and to remove barriers, the countries involved in economic integration may achieve the following forms of cooperation step-by-step: a preferential trading area, a free trade area, a customs union, a common market, an economic and monetary union, and ultimately a union with some degree of political and social integration.

European integration has epitomized this stepwise process. From the creation of the Council of Europe to the adoption of the euro by some member states as their single currency, the European Union (EU) has become a well-functioning union with broad prerogatives. However, a decade ago, the onset of the global financial crisis and the euro area debt crisis revealed some institutional shortcomings of the EMU. It also provided a timely opportunity to conduct necessary reforms to make policy coordination among members work better and to make the EU as a whole more resilient to future shocks. Euro area policy-makers have since stepped up efforts to strengthen the architecture of a coordinated economic and fiscal policy.

In their 2015 joint report (European Commission 2015), the presidents of the European Commission, the European Central Bank (ECB), the European Council, the Eurogroup and the European Parliament presented their vision for the design and implementation of these reforms. This road map proposes measures to foster economic convergence and competitiveness in the Economic Union, to improve financial resilience and integration with the creation of the Banking and Capital Market Unions, to move toward a Fiscal Union with an integrated framework for sound and coordinated financial policies, and to enhance the EU's democratic accountability and legitimacy. The purpose of this enhanced integration is to provide regional common goods via policy coordination, sharing and pooling of resources, and where necessary to grant certain national decision-making powers to upper echelons.

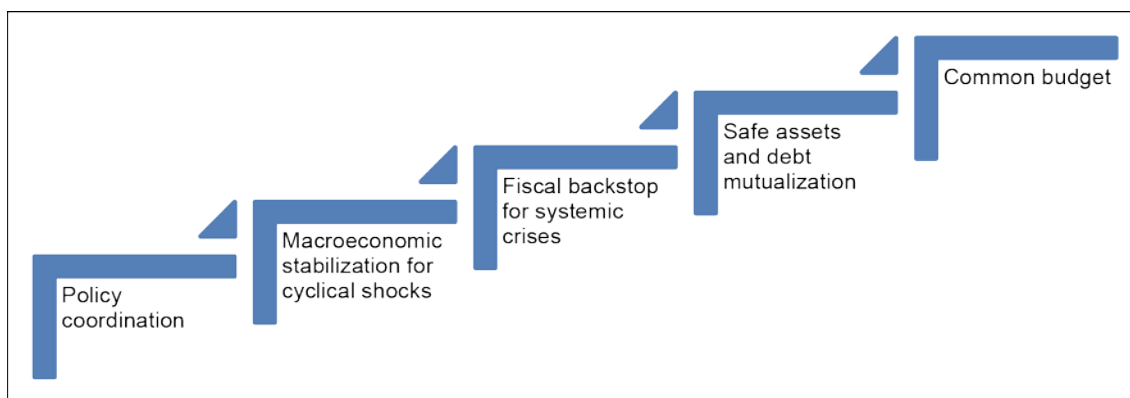
**Figure 1: Road Map to Deepen the European Economic and Monetary Union**



Source: Authors' depiction based on the Five President Report (European Commission 2015).

In this paper, we will present a description of the reforms and policy discussions related to fiscal integration that took place in Europe in the past decade before the onset of the global Covid-19 pandemic. We will especially focus on the key challenges and strategies, both now and in the future. We argue that when compared to economic and financial integration, fiscal integration would require a much stronger degree of political support. In addition, similar to the process of economic integration, fiscal integration is not meant to be achieved overnight but should also take a stepwise approach, building on the political capital available. Figure 2 illustrates the possible steps to propel fiscal integration in Europe. Some of these steps have already been implemented, whereas others are under political discussion, or need longer time for an optimal design.

**Figure 2: Stepwise Fiscal Integration**



Source: Authors' depiction.

In a monetary union such as the euro area, a minimum degree of fiscal policy coordination is necessary to smooth the business cycles and to facilitate convergence. Since the creation of the EMU, this policy coordination has been ensured by the Stability and Growth Pact (SGP). The SGP has been reformed several times, and the most recent enhancement was made during the euro area debt crisis. To go one step further toward regional solidarity, fiscal integration would require temporary “transfers” or insurance mechanisms to deal with cyclical and systemic crises. Ultimately, a common budget would be needed to further strengthen fiscal integration in a monetary union. Finally, a degree of debt mutualization would complete the policy framework. However, to achieve this, voters’ support and political capital would be indispensable. In this paper, we will describe the different steps of financial integration in Europe, including those steps that it will need to think about in the future. We will also present some reflections for East Asia based on the European experience.

The rest of the paper is structured as follows. Section 2 describes the initial post-crisis measures that were taken to strengthen fiscal coordination in the euro area. Section 3 outlines the key proposals for euro area fiscal capacity. Section 4 addresses the question of debt mutualization, which is perhaps the most controversial aspect of European fiscal integration. In Section 5, we present some lessons from the European experience for future East Asian efforts.

## **2. FISCAL COORDINATION: THE MINIMUM REQUIREMENT FOR A WELL-FUNCTIONING MONETARY UNION**

An extensive literature has found that the lack of an effective fiscal policy coordination accentuated shock transmission and spillovers during the previous crises Europe has undergone (see Lane 2012 and Landmann 2017). This section will review the numerous critical attempts that the EU made to enhance economic policy coordination before and during the euro area debt crisis.

### **2.1 Fiscal Coordination within the Stability and Growth Pact**

The SGP was designed as the fiscal backbone of the euro area. However, the SGP worked on the basis of the budgetary deficit, which was seen as the key figure to assess a country’s budgetary and economic policy. Although any country’s deficit is obviously very important, there were other elements that were neglected by the SGP, such as sectorial developments. For example, Spain had been in surplus for many years and its growing real estate bubble went “undetected” by the SGP criteria. We now know that there are other elements, such as competitiveness and contingent liabilities of the government, that need to be taken into account to see the true picture of the public finances.

The decisions that were taken during the crisis reinforced the governance framework in the EU, especially in the detection of fiscal and macroeconomic imbalances, and in the capacity to prevent the European crisis. The Treaty on Stability, Coordination and Governance, the Six-Pack, and the Two-Pack improved the surveillance procedures and incentives for compliance. The Macroeconomic Imbalance Procedure (MIP) also extended the fiscal surveillance framework to other macro policy areas. In addition, the reforms introduced a policy cycle to engage national fiscal policies at an early stage to minimize intra-union spillovers. As we will explain later on, national governments now need to submit their budget plans first to the European Commission. They are then



required to make any necessary adjustments based on the country-specific recommendations issued by the European Commission. However, the first experiences within this governance framework were mixed. The follow-up to the country-specific recommendations is frequently far from complete, particularly in the area of structural reforms. In numerous cases, the implementation of structural reforms required multiple years of constant efforts. Compared with the costs of implementation, measurable benefits only came with considerable delays. Efforts still need to continue in this area.

The amendments to the SGP framework aimed to (i) strengthen and deepen budgetary surveillance by making it more continuous and integrated, also via an intensified sanctions mechanism; and (ii) ensure the correction of any excessive deficits and the integration of the EU policy recommendations in the euro area member states' budgetary processes through additional country surveillance procedures (European Commission 2014).

Consequently, budgetary rules were modified to focus more strongly on the debt trajectory. The crisis years imposed a need to consider exceptional circumstances and led to a more flexible deficit rule. Under the European Semester, member states now submit their budgetary plans to the European Commission before the national parliaments adopt the annual budgets. Some decisions can now only be overturned when a majority of member states opposes the recommendations of the European Commission in the Council. In certain circumstances, for instance when a country exits a financial assistance program with a macroeconomic adjustment, it can be put under enhanced surveillance that allows the European Commission to closely scrutinize any economic and budgetary developments. It also strengthened the enforceability of the framework through the European Court of Justice. In addition, there was a deliberate attempt to increase national ownership. The Fiscal Compact required countries to implement European fiscal rules into national law and install councils of fiscal experts as monitoring and policy advisory bodies.

## **2.2 New Institutional Changes since the Global Financial Crisis**

In addition to the SGP reform, the recent euro area crisis has also propelled improvements in economic policy coordination among the EU member states, especially on the fiscal front. Here, we highlight two sets of reforms: the establishment of the European Semester, and the creation of fiscal boards at the European and national levels.

### **2.2.1 European Semester**

The European Semester is a cycle of economic and fiscal policy coordination within the EU. It is part of the EU's economic governance framework. Its focus is on the 6-month period from the beginning of each year, hence its name—the “semester”. During the European Semester, the member states align their budgetary and economic policies with the objectives and rules agreed at the EU level.

By setting up the European Semester, fiscal policy making in EU member states is expected to incorporate an additional union-wide layer and to contain cross-country spillovers. With this new procedure, the European Commission helps to set priorities for the member states' economic and financial policies, and, to a less binding degree, for their structural and employment policies. The Council of the ministers make country-specific recommendations following the Commission's proposals.

While progress has been made, the European Court of Auditors (2019) has recently assessed that the Commission has limited assurance that national budgetary frameworks are properly implemented and applied. Experience on the implementation of the country-specific recommendations over the years has been disparate and countries often need a considerable amount of time to implement the reforms, and subsequently to meet their medium-term fiscal policy targets. Moreover, the transparency of the Commission's decision-making criteria relevant for the macroeconomic imbalance assessments and the communication of these assessments could benefit from further improvement (European Court of Auditors 2018).

Although the European Semester has improved aggregate attainment of medium-term fiscal objectives, only part of the increase in government revenues contributed to build up of fiscal buffers. In particular, high debt countries have struggled to save increases in revenue generated by the recent recovery in economic activity (European Fiscal Board 2018).

Efstathou (2018) find that countries with excessive imbalances have struggled to implement the reforms. The implementation rates have been highest on recommendations concerning private sector policies and lowest in relation to public administration (e.g., sustainability of public finances, unemployment, tax base, and debt bias). Furthermore, the overall discipline is not supported by a relatively weak implementation rate by the two largest countries, Germany and France.

### **2.2.2 Creation of the European Fiscal Board and National Fiscal Councils**

During the crisis, the EU leaders decided to create a fiscal advisory body at the EU level, the so-called European Fiscal Board (EFB), and they encouraged the member states to set up national fiscal councils as well. The overall purpose of fiscal councils is to strengthen fiscal disciplines in member countries and to prevent contagion from national fiscal policies in times of crisis. Their main task is to provide an independent assessment of budgetary forecasts and policy objectives, and to monitor fiscal stance and the compliance with the relevant fiscal rules. In addition, they play a role in the activation of correction mechanisms. In some cases, they also prepare or endorse macroeconomic forecasts for the purposes of fiscal policy making.

The EFB was established to contribute in an advisory capacity to the exercise of the Commission's functions in the EU's multilateral surveillance. Its work is particularly important for the euro area, which is still developing the effective common practices that will be required in a tighter union.

Within the SGP rules, the EFB informs about the appropriate fiscal stance for the euro area as a whole. It may advise the Commission on the consistent national fiscal stances. It also keeps track of how the EU's fiscal framework is implemented, particularly regarding the horizontal consistency of the decisions, the serious non-compliance cases, and the implementation of budgetary surveillance. In addition, the EFB may make suggestions for the further evolution of the EU fiscal framework. Finally, it is tasked to cooperate with the newly established national fiscal councils to exchange best practices and facilitate common understanding on matters related to the EU's fiscal framework. Ultimately, this cooperation should enhance national ownership of the EU's fiscal rules. Considering that the national implementation of the fiscal councils varies considerably in terms of objectives, resources, and *de facto* powers, the EFB can play a useful role in promoting common standards in surveillance and supporting the performance of the national bodies in influencing the public opinion through transparency of their assessments. Nevertheless, the European Court of Auditor's (2019) review found that

firmer standards for the design and operative capacity of fiscal councils are necessary to ensure their effectiveness and consistency between countries.

The EFB is composed of a chair and four members who are appointed for a period of three years, renewable once. It publishes an annual report of its activities, including summaries of its advice and evaluations rendered to the European Commission. Given that the EFB is advisory, its reputation and effectiveness of its advice will depend on the stature of the member experts. The quality of the advice depends on access to information at the European and national level.

While the EFB's reports have been found of good quality, the follow-up of its recommendations by the European Commission has not been adequately formalized, which reflects its weak statutory position according to the court of auditors (ECA 2019).

### **3. THRUST FOR COMMON FISCAL CAPACITY**

Fiscal integration is a political question. Until now, the European Union has settled on a relatively small EU budget—about 1% of EU27 GNI at 2018 prices—and has focused on convergence, agricultural policy, and supporting growth initiatives (European Council 2019). The EU's budget supports the whole of the EU. Many argue that a larger fiscal capacity is necessary for the euro area. However, expanding the fully discretionary budget further is currently politically challenging. More targeted facilities seem to obtain better traction, which could take the form of a special fund or budget scheme. There have been proposals to increase conditionality related to EU budget allocations. More rules-based arrangements also have appeal.

Fiscal capacity is understood as the ability of governments to raise their own (taxable) resources and fund public goods or redistribute such resources in line with some solidarity objective. This may take various forms of revenue, governance, and execution.

Generally, federations have been understood to establish fiscal capacity for four purposes: (1) pursuit of macroeconomic stability; (2) to avoid that member states underprovide public goods (e.g., control of pollution or clandestine migration, import of counterfeit products or provision of health care against transmissible diseases) for which significant externalities are present in a regional context; (3) explicit equalization of resources between member states, and (4) longer run convergence of member economies.

A number of models have been proposed for the euro area in recent years as members have made efforts to scope for direction. Decision makers have reflected on the idea, despite various concerns regarding political feasibility and effective implementation. The key questions tend to address their governance arrangements and the nature of the support allocated. However, the no bailout rule of the Treaty on the Functioning of the European Union limits the scope for arrangements that would create joint liabilities.

One strand of the debate concentrates on temporary support, which would pose limited fiscal risks. Temporary support can be understood as access to self-insurance or short-to-medium-term loans. In this context permanent transfers (i.e., invariably one-sided flows) are understood as grants or partial subsidies. The latter would be required to address equalization and convergence objectives. Some proposals on potential suspension of budget contributions have also been made but these would lead to temporarily diminished resources while appropriations would most likely have to be made.

Another aspect is the operating target sought, where it is crucial to agree on whether or not the objective would be to compensate for all major losses (costs or missed revenue) or limit damages through an insurance. The basic advantage of an insurance scheme is that it would not react to all shocks and would only indemnify part of the damage caused by an eligible shock, which preserves financial capacity. At the same time, it reassures sovereign bond investors and other market players because it provides a floor for shock impacts. Insurance models can also rely on a rules-based approach, which would limit bias to discretion. Well-designed rules-based models may be particularly appropriate where the participants' influence on decision-making is not equally distributed.

A form of insurance to deal with tail-event risks was set up during the euro area crisis—the European Stability Mechanism (ESM) and its predecessor, the European Financial Stability Facility (EFSF), were created as financial firewalls for the euro area countries. The euro area countries have pooled resources to build a common firewall of EUR 700bn, which is available for financial support by means of various instrument and under appropriate conditionality. So far, EUR 380bn of the lending capacity remains untapped, leaving sufficient room to address any possible future crisis shocks. There is an emerging literature on this type of insurance against tail risks (e.g., Cheng 2020). Therefore, we focus on another type of insurance in this section: macroeconomic stabilization to deal with cyclical shocks.

The most striking missing piece in the EMU architecture is a fiscal capacity that would support the members' ability to withstand idiosyncratic shocks triggered by business cycles. Currently, stabilization burden falls on national fiscal policies, which means that countries should accumulate fiscal buffers during good times to be able to conduct sufficiently active countercyclical policies.

The introduction of cross-border transfers to stabilize business cycles in EMU countries is the frontrunner among the reform proposals. This concept is based on the McDougall report (1977), which highlighted the need for a stabilization function in a monetary union. This need arises when members experience the effects of monetary policy differently or asymmetric events shock the economy.

These arrangements would operate as buffers between mild cycles and crisis times, which would entail a threatened market access and eventually lead to a serious sovereign liquidity crisis. These arrangements are often presented as response tools to more or less well-defined shocks. Some academics even refer to major shocks, while the objective is still limited to dealing with cycles characterized as normal times.

A member state would experience stabilization capacity through two basic processes. First, during downturns, member would receive transfers from the center, which would increase fiscal space under constraining fiscal rules to avoid procyclical budget cuts. The additional fiscal space would avoid excessively harsh adjustments consequent of liquidity crises. Second, during upturns, members should make transfers to the stabilization capacity as constraining fiscal rules force creation of buffers.

This should lead to more synchronized business cycles across the members. Some examples can be found in Allard et al. (2013), Delbecque (2013), Enderlein et al. (2013), Furceri and Zdzienicka (2013), Carnot et al. (2015) and Carnot et al. (2017), Arnold et al. (2018), Beetsma et al. (2018), Benassy Quere et al. (2018) and Lenarčič and Korhonen (2018). Three specific kinds of stabilization funds (i.e., rainy-day funds, unemployment insurance and investment support) merit further attention in light of the evolution of the ongoing debate.

### 3.1 Rainy-Day Fund

Some members of the EU have established practices to build buffers within their national public finance procedures. The efforts to muscle the resilience of the EMU could concentrate on helping member states to accumulate buffers in a common rainy-day fund. Buffers are necessary because market access may become expensive during a slump, when revenues also become scarce. A common fund would allow the amount of self-insurance to be rationalized.

Rainy-day funds are based on the idea of building self-insurance during good times, which is used in a downturn. As cycles change, the balances evolve. In the United States, these funds form the backbone of the states' balanced budget rules. In parallel, the US federal government has established rainy funds that bolster (for example) the state unemployment systems in deeper recessions.

Some of the first proposals for a stabilization fund include the cyclical stabilization insurance fund (by Tommaso Padoa Schioppa Group, see Enderlein et al. 2012) and cyclical shock insurance fund (Enderlein et al. 2013). Allard et al. (2013) sketched out a rainy-day fund for the euro area based on continued collection of contributions and temporary transfers in case of a shock.

A commitment to take advance precautions before significant common resources be made available would support the political acceptability of a rainy-day fund solution. A common fund can also increase transparency of the conduct of sound fiscal policies. Lenarčič-Korhonen (2018) spelled out how the US system could be effectively translated into the euro area framework in a way that empowers the member states to manage their fiscal policies in a more countercyclical manner while profiting from the asymmetric nature of the national business cycles to pool available resources without mutualization. The European rainy-day fund would take the form of a common fund made of national compartments and a mechanism of limited borrowing between the compartments in case of need. Target compartment sizes would reflect the volatility of national economies and access to the funds would be granted based on a trigger. The institutional characteristics and transparency safeguards are important for the arrangement's effectiveness (e.g., to manage moral hazard). Legally, the mechanism could be installed through an intergovernmental agreement with the national components anchored in domestic budget procedures and laws.

### 3.2 Unemployment Insurance

Although the EU has reduced requirements for work-based migration, the euro area's labor mobility rate does not resemble mobility in the US. Unemployment benefits represent a large increase in public expenditure of member states that suffer from economic shocks. Therefore, some form of support to bolster unemployment protection would be politically appealing. However, it would be crucial to differentiate structural and cyclical components of the unemployment problem.

Several types of euro area unemployment insurance arrangements have been proposed: common unemployment insurance (Allard et al. 2013), a common basic benefit scheme (France Trésor 2014), the Complementary European unemployment insurance scheme (New Pact for Europe 2014), and reinsurance of national unemployment benefit schemes (Beblavy et al. 2015). Nevertheless, Dhéret et al. (2013) noted that this scheme would require a stronger role for labor policies in the European Semester. In most cases, this would require harmonization of basic assistance to be considered, or relying on an agreed notional benefit as a basis for indemnity from which member states may divert in

disbursements to citizens, execution of active labor market policies, or even harmonization of labor taxation.

In a genuine insurance model, national contributions would be revised based on the history of usage (experience rating). In view of moral hazard problems, such schemes have to set initial entry criteria. In addition, the pay-outs would be subject to a deductible, which should help the appropriate scaling of assistance and alleviate moral hazard issues.

Given the lack of harmonization among national schemes, a rainy-day fund adapted to react to cyclical unemployment variation would be the most promising way forward (see Carnot 2017; Lenarčič and Korhonen 2018) because the pay-outs can be made as budget support with intrusive strings attached. An alternative would be to agree on a notional compensation by eligible registered unemployed scaled to national earnings or cost of living. These designs could avoid strong interventions in national social policies.

### **3.3 Investment Support**

The crisis period has demonstrated that investment expenditure is the first area where governments have to implement cuts when revenues decline and financing costs increase. The EFB has advised that the option of implementing an investment protection scheme is superior to the alternative fiscal stabilization instruments in the short run (European Fiscal Board 2017).

During the recent crisis, the European Commission devised an investment catalyst initiative, called the European Fund for Strategic Investment, in cooperation with the European Investment Bank and supported by EU budget guarantees. However, this fund is of temporary nature.

For the future framework, there are several proposals under discussion. We will next sketch two most prominent proposals.

The European Investment Stabilization Function is one of the prominent proposals. In this proposal, the European Commission suggests to provide liquidity support to member states affected by an economic downturn to maintain public investment, using subsidized loans that are financed by a fund built-up through national contributions. The member state would be obliged to maintain the average level of public investments of past five years. Eligibility would be subject to meeting an unemployment criterion (European Commission 2018).

Given political constraints for the creation of a euro area specific budget, the member states started to discuss a budgetary instrument for convergence and competitiveness within the EU budget that would be connected to combined reform and investment commitments agreed through the European Semester process. The discussion has received a strong propulsion recently in the context of the common response of the EU to the Covid-19 pandemic, which however, goes beyond the scope of this paper. The availability of the investment support funds would also follow the European Semester's decision-making schedule and the achievement of milestones in agreed reforms (e.g., increasing retirement age, setting up active labor market policy, or implementing a more efficient public administration). The amount would be subject to reduced co-financing by the beneficiary member and part of it could be used to react flexibly to a member's immediate challenges to meet euro area policy priorities. This linked the utilization of the budget to the SGP and the European Semester. The key decision affecting the effectiveness of the instrument will be its degree of redistribution among the members and the size of the instrument, which would be defined in the multiannual financing framework. Because the budget allocation would be limited, the Commission

foresees a possibility of voluntary contributions to augment the support capacity in the future.

#### **4. DEBT MUTUALIZATION: A NECESSARY CHORE REQUIRING STRONG POLITICAL SUPPORT**

Capacity to raise public debt represents yet another fiscal capacity that may be used to promote long-term growth by allowing investment in infrastructure, innovation or human capital, and timely debt issuance would allow accumulation of resources for countercyclical stimulus. In addition, liquid public debt will provide safe assets to the private sector, serving (for example) as a collateral, and it will increase the transparency of financial sector pricing (Kose et al. 2019).

After the introduction of the single currency, many euro area countries profited from rapidly converging financing conditions. Their foreign financed debt balances increased rapidly. In some countries, this was driven by private sector while in others government policies piled on national debt. The onset of the euro area debt crisis revealed that a doom loop between banks' and the sovereign's balance sheets was at work, as many scholars have previously emphasized (Brunnermeier et al. 2016a). On the one hand, when a bank holds a large share of the securities issued by the sovereign state in which it is located, it is exposed to any macroeconomic shocks weakening the sovereign's creditworthiness because of potential bank asset losses. On the other hand, when a country has a large banking sector, potential fiscal needs for bank recapitalization will be an extremely heavy burden and this will deteriorate public finance because of large bailout needs.

Given the architecture enshrined in the EU Treaty, the euro area missed an opportunity to develop sufficiently abundant safe assets as alternatives to the best-rated government paper. In this context intense policy and academic discussions have emerged about how to break the doom loop and to make sovereign securities safer in the monetary union. These proposals range from adjusting sovereign risk weight in banks' balance sheets, offering European safe assets, to debt mutualization. Many economists have already argued that regulation of sovereign exposures (e.g., adjustment of sovereign risk weight) will not be able to lower concentration risk and this will lead to the banks' exposure to domestic government securities (Alogoskoufis and Langfield 2018). Table 1 summarizes a few of the proposals on this broad topic.

In this section, we will discuss briefly the key factors to consider in this public debate on safe asset and potential debt mutualization in the future when there will be public and political support.

##### **4.1 Euro Debt: Crucial Factors to Consider**

To illustrate the factors that would be crucial for the successful implementation of euro area safe asset or debt mutualization, we base our discussion on the European Parliament's study of eurobills and a debt redemption fund (Tumpel-Gugerell 2014).

**Table 1: Proposals on Debt Mutualization or Safe Assets since the Euro Area Debt Crisis**

Proposals	Authors and Date	Key Messages
Blue bond – red bond	Delpla and von Weizsacker (2011)	<ul style="list-style-type: none"> <li>• Debt below 60% could be issued jointly and severally.</li> <li>• Debt markets would be split in very senior blue debt and very junior red debt.</li> </ul>
Stability bonds	European Commission Green Paper (2011)	<ul style="list-style-type: none"> <li>• Partial or total joint and several issuance of debt.</li> </ul>
Sovereign cocos/GDP-indexed bonds	Brooke et al. (2013)	<ul style="list-style-type: none"> <li>• Sovereign cocos are bonds that would automatically extend in repayment maturity when a country receives official sector emergency liquidity assistance.</li> <li>• GDP-linked bonds are debt instruments that directly link principal and interest payments to the level of a country's nominal GDP.</li> </ul>
Debt/equity swap	Allen et al. (2014)	<ul style="list-style-type: none"> <li>• Swap of public debt held by ECB for program countries' properties/developmental projects.</li> </ul>
PADRE plan	Paris and Wyploz (2014)	<ul style="list-style-type: none"> <li>• An agency purchases a given amount of Eurozone public debt at face value according to a predetermined key (e.g. capital share in the ECB) and transforms it in perpetual bonds with no interest rates (assets).</li> </ul>
Eurobill and debt redemption fund	An expert group led by Tumpel-Gugerell (Tumpel-Gugerell 2014), commissioned by the European Parliament	<ul style="list-style-type: none"> <li>• Euro area countries jointly issue short-term bills based on a predetermined key.</li> <li>• Long-term debt can be bought by the debt redemption fund based on a strict and well-defined rule.</li> </ul>
European Safe Bonds (ESBies) and European Junior Bonds (EJBies)	Brunnermeier et al. (2011), Brunnermeier et al. (2016b)	<ul style="list-style-type: none"> <li>• A portfolio of euro area sovereign bonds, issued by each participating member, according to a predetermined rule.</li> <li>• ESBies are the senior tranche while EJBies are the junior tranche.</li> <li>• A union-wide safe asset without joint liability.</li> </ul>
Sovereign bond-backed securities (SBBS)	ESRB (2018)	<ul style="list-style-type: none"> <li>• Securities backed by a diversified portfolio of euro area central government bonds.</li> </ul>
E-bonds	Leandro and Zettelmeyer (2018)	<ul style="list-style-type: none"> <li>• A senior public intermediary (e.g., the ESM) would issue a single bond backed by a diversified portfolio of euro area sovereign debt bought at face value.</li> <li>• Seniority based on the ESM's preferential creditor status.</li> </ul>
Covid debt mutualization	Beck (2020) Bénassy-Quéré et al. (2020) Giavazzi and Tabellini (2020)	<ul style="list-style-type: none"> <li>• Debt mutualization with joint and several liability to raise funds for fighting the global pandemic</li> </ul>

Note: the paper was written in 2019 and thus does not cover new debt mutualization ideas developed during the Covid-19 pandemic. However, we would like to provide our reader with some references to these recent ideas.

Source: Authors' depiction based on the papers cited.

Following a commitment made on 12 March 2013 to the European Parliament as part of the overall agreement on the two-pack legislation, the European Commission established an expert group, chaired by Mrs Gertrude Tumpel-Gugerell, to work on



proposals of debt redemption fund and eurobills. Published on 31 March 2014, the final report of the expert group (referred as the Report hereafter) provides qualitative assessments of the mechanisms, merits, and risks of the joint public debt issuance in the euro area.

The eurobill proposal aims to set up a common Debt Management Office (DMO) in the euro area to issue short-term bills. The protagonists of this proposal expect these common short-term debt instruments to increase confidence effects, enable progress in financial market integration, and enhanced support for monetary policy transmission over time and sustain their benefits. The Tumpel-Gugerell report builds upon a very strong fiscal framework and will set prior conditions for euro area member countries to access the joint short-term bill issuance scheme.

In contrast, the proposal to set up a debt redemption fund or the DRF aims to allow member states to off-load a pre-defined portion of its public debt. According to the Tumpel-Gugerell proposal, the Fund “would issue bonds above a maturity of 2 years so that national debt can be switched into medium- to long-term euro area debt.” After the phase-in, the fund would redeem bonds over 20–25 years during which member states jointly repay their European debt receiving revenues from member states. The Fund would close when all bonds have been redeemed. The DRF would thus deal with long-term debt issuance in the euro area.

It seems to us that there are three sets of key factors for this plan to work in the future, which are also relevant for other proposals of a similar nature. The reader should, however, bear in mind that in the current political context in the EU, the discussions on debt mutualization and safe assets remain an academic topic. Not only do many technical issues remain unsolved but there is also little political consensus in this regard. Certain countries insist on the need to reduce legacy risks (e.g., banks’ high non-performing loans and excessive debt levels) before embarking on further discussions about additional risk sharing (e.g., through debt mutualization).

#### **4.1.1 Member States’ Responsibility**

A key discussion here is to what extent the euro area member states who would eventually participate in issuing joint debt or safe assets would need to assume financial responsibility.

Two guarantee schemes were conceived by the expert group when designing the DRF and eurobills: joint and several guarantee or *pro rata* guarantee. That is, if a participating member state fails to redeem its debt or to pay back eurobills holders, then either all of the participating member states would need to step in and guarantee non-payment or their responsibility would be limited to some predetermined shares.

A joint and several scheme requires that the joint issuance would be fully guaranteed by each member state, while the credit rating of the DRF or eurobills fund would be similar to that of the best-rated participating member(s). This scheme requires the participation of the largest and most solvent countries in the euro area for the guarantee to be meaningful. In the baseline case of the DRF, the maximum size of the DRF after the roll-in phase would amount to €2.85 trillion. It is impossible for smaller countries to carry the payment burden in case a large member state did not participate or failed to pay. It would also affect the rating of all participating countries for large amounts of mutualized debt. The implementation of a joint and several liability scheme requires EU Treaty changes, which can only build upon a solid political support.

A *pro rata* scheme limits each participating member state’s responsibility to a predetermined contribution key. In the DRF, a country’s capital contribution should reflect

its share in transferred debt while in the eurobills fund the contribution key needs to be defined in the founding legal text, according to the existing ESM capital key or not. This guarantee scheme would undermine the overall credit quality of any joint issuance mechanism because some of the country “guarantors” of the *pro rata* liability have relatively high debt and weaker credit ratings. Therefore, credit enhancement measures are needed with the *pro rata* scheme. As credit enhancement measures, the expert group proposes pledging collateral of 20% of the value of the transferred debt or earmarking tax revenues for the servicing of redemption payments in the case of the DRF, or use the ESM as a backstop in the case of eurobills.

The same set of pros and cons applies to other proposals of safe assets. For instance, the ESBies advanced by Brunnermeier et al. (2011) clearly state that they would not require the joint and several responsibility. On the contrary, the stability bond proposal of the European Commission would require partial or full joint and several responsibility.

#### **4.1.2 Membership**

Another recurrent topic is how to motivate countries to participate in the safe asset project. As far as the DRF and eurobills concerned, there are two main considerations relative to the membership of the proposed joint issuance mechanisms: 1) how to motivate high-credit-quality countries, and 2) whether to include ESM program countries. With regard to high-credit-quality countries, they would need to guarantee debt incurred by other countries in a joint and several guarantee structure. In a *pro rata* structure, they might find their sovereign financing costs increasing considerably as the credit quality of the joint issuance mechanism is pulled down by the inclusion of low-credit-quality countries. National parliaments of high-credit-quality countries could face a serious challenge to approve their participation in view of increased financial costs. The second concern regards program countries (this is especially an issue for eurobills). Including program countries is crucial to increase financial resilience in the euro area and create positive incentives working toward exiting an ESM program. However, the participation of these countries, which are highly indebted and low rated, undermines the overall credit quality of the joint issuance schemes and thus raises funding costs for other member states. European safe assets or debt mutualization also require the designers to think whether to limit the membership to euro area countries or to extend the participation to the EU members that have not adopted the euro. This would be a critical question with respect to the proposals involving the ESM as the mechanism issuing euro area safe assets.

#### **4.1.3 Size of Debt Mutualization**

Finally, the size of debt mutualization is critical and requires a fine art of balancing between credibility and effectiveness. On the one hand, if the size is too big, then it would require a large capital structure or a large guarantee scheme. An important amount of mutualized debt would also increase the burden of high-credit-quality countries to ensure the creditworthiness of the scheme, and it would imply higher moral hazard. On the other hand, if the debt mutualization is too small, then it would limit the expected benefits from the joint debt or safe asset issuance. The extent of debt mutualization depends on the definition of debt thresholds (e.g., beyond which national public debt would be transferred to the DRF) in the DRF proposal and on the maturity of issuance in the eurobills proposition. As regards other proposals, such as the blue and red bonds, or ESBies, the optimal size is also related to how to segregate the junior and the senior tranches of sovereign securities.

## 4.2 Dearth of Political Support

The Five President Report also outlined the roles for a euro area Finance Minister and Treasury in joint policy making on fiscal policy with the European Parliament's oversight. The proposed scenario in which member states would have agreed to centralize a larger part of fiscal policy at supranational level proved to lack broad political support. Support resided mainly in centrally governed member states.

It is interesting to consider to what extent such institutionalization of policy making could promote additional regional public goods. However, the country diversity arising from differences in size and structure of the economies, advancement and fiscal traditions poses challenges for alignment of interests. This could provoke conflicts on the mechanisms according to which costs and benefits are shared, and in governance. Sandler (2006) highlights these issues as general challenges for such aggregation mechanisms.

The beneficial effects of the legislation adopted so far lie mainly in raising fiscal awareness and helping voters to better understand fiscal policies and budgets, thereby supporting public scrutiny and political accountability. Even so, the IMF has raised incentives to improve further fiscal transparency across the membership, including the euro area.

Political support for fiscal capacity that would provide permanent transfers has been weak following the euro area crisis and there have been previous challenges to apply the agreed fiscal rules consistently. For example, Pikkarainen (2019) considers that solidarity necessary for such transfers thrives with homogeneity. He argues that the conditions necessary for a potential transfer union in the EMU include more harmonized and lower debt levels stronger controls on budgetary expenditure by voters, and more flexible labor markets and fiscal rules. At the same time, it is worth noting that the intensity of Euro area's regional trade has backtracked since 2007 (UNCTAD merchandise trade statistics).

The United Kingdom's withdrawal process from the EU has been interpreted as sign of reluctance toward weaker political control over its economy (Pereira 2016). Although the UK is not part of the EMU, and it is challenging to identify ultimate sources for the economic dislocations that the European economies have faced in recent years, the so-called BREXIT demonstrates the tribulations of the common institutions to respond to the prevailing variety of member states' needs.

Consequently, the envisaged euro area fiscal arrangements have to adapt to a number of interests. The budget instrument proposal, which faces many strong redlines, should be available for the EMU members and possibly for ERM II member states. One key decision topic will be how the funds will be allocated. The general European practice is to define a distribution key. Given that the instrument would be embedded in the EU budget, its size is to be determined within the negotiation of the EU Multiannual Financial Framework for period 2021–2028.

Macroeconomic stabilization function may be part of the extended reform discussions, although there seems to be no agreement to include it in the reform package to be presented to the Heads of State and Government in 2019. Nevertheless, the proposed budgetary instrument may produce some countercyclical effects as a by-product and reduce vulnerabilities of the national economies.

## 5. CONCLUSIONS AND POLICY RECOMMENDATIONS

### 5.1 Same, Same—But Different

Different strategies have steered Asian and European integrations, despite the same underlying priorities: security and economic benefits. While European integration embodied in the EU and the EMU have emphasized institutionalization, Asia favors “soft integration” and an institution-light approach with few upward delegations of resources or powers. The concept of “open regionalism” represents the possibility for countries to integrate selectively in policy areas fit for their own interest (Berkofsky 2005). This may be necessary for the mechanisms to respond to current global challenges for the provision of various global and regional public goods (Fraga 2019).

Asian integration takes its most advanced form in free trade agreements and in the Association of Southeast Asian Nations (ASEAN), as well as its +3 cooperation encompassing the People’s Republic of China (PRC), Japan, and the Republic of Korea. The shrinking ASEAN trade share with non-ASEAN+3 countries since 2001 (UNCTAD trade statistics) is an indication of increasingly tighter integration in East Asia. ASEAN is largely driven by economic growth agendas. The ASEAN way is characterized by flexibility and consensus-building processes, soft law initiatives, benchmarking, and promotion of best practices. (Acharya 1998; Capannelli and Tan 2012; Gaens and Ruohomäki 2018; Jetschke and Murray 2012) Instead of seeking a monetary union, the members have committed to increased financial market integration since a few years, such as by promoting national currency flows and further opening banking markets to enhance trade and direct investment in the region (ASEAN 2019).

While the EMU has packaged economic and monetary integration together, the two processes occur in parallel in Asia. At the same time, the package approach of the EMU calls for strong and efficient institutions and citizens’ trust in the institutions, which enables progress toward a more pooled sovereignty. A social policy component is also concrete in the European context, while harmonized policies are not the objective. When drawing the parallel between the European and Asian integration, one needs to control for the differences in the membership across these two regions. There are key macroeconomic and structural differences between euro area and ASEAN+3 that merit the readers’ attention. These differences could indicate diverging regional needs or priorities for intra-region transfers and insurance arrangements.

It is particularly striking that East Asia is more diverse than the euro area in terms of per capita GDP and business conditions (World Bank 2018 Doing Business indicators). The same is true for employment conditions measured by the share of vulnerable jobs and salaried workers in their economies. The IMF also forecasts the variance in per capita GDP to increase further among ASEAN+3 countries toward 2024, although even the poorest economies will boost their output.

The clustering of the two regions is most pronounced in public finances. Only one of the ASEAN+3 countries approaches euro area in the level of general government expenditure. Similarly, ASEAN+3 revenue collection remains comparatively low. Most ASEAN+3 countries’ public debt is similar to the better-off euro area member states, with Japan as an outlier. At the same time, one must take note of a rapid increase in public debt in a number of euro area member states during the sovereign debt crisis.

## 5.2 Could Some More Global Lessons Underlie the European Hard Work Around Fiscal Regionalization?

The first part of this paper focused on the key challenges and strategies to enhance the fiscal branch of the EMU. It showed that even when regional institutionalization has made important advances that have allowed great benefits from economic and financial integration, taking steps with fiscal integration beyond initial steps is a major endeavor and needs stronger political support. History shows that harmonizing direct taxes, in particular tax rates, is anything but fast and easy. Alignment of tax reporting or collection procedures and of tax bases has constituted a more effective investment of resources and political capital. The EU has also developed standards for the independence of national fiscal institutions, which is considered a safeguard for outward spillovers from one member to another in the current state, and a catalyst for building trust that would allow further evolution.

Integration in East and Southeast Asia is challenged by important diversity in comparison to the euro area. This both calls for transfers (making a case for fiscal sharing) but also sets certain political and institutional challenges, and may reflect on the form of ultimately desirable and viable solutions. The road to revenue sharing may be long even with political will. Ensuring common standards, especially for corporations, could represent a valuable initial investment when no electronic filing of national corporate income tax returns is currently possible in most East and Southeast Asian countries (OECD 2019).

Business conditions within the euro area are relatively similar in comparison to East Asia. Public finances data depicts the structural differences between the two regions but also the more negative impact of the financial crises of the previous decade on many Euro area economies. It is notable that the IMF World Economic outlook projects differences in national wealth to continue expanding in East Asia. Health care expenditure and vulnerable jobs indicate another dividing line in the role of the government. From the perspective of health care expenditure and old age dependency rate, ASEAN+3 has better prospects with more space to raise (public) health expenditure while not having to make a trade-off with old age care, except for one country. In addition, the region's high share of vulnerable and informal jobs may indicate a susceptibility to welfare losses under business cycle shocks, despite having more flexible exchange rate arrangements.

Given the structural differences, East and Southeast Asia may consider initial steps in developing common minimum standards for basic social safety nets and providing implementation assistance to the least developed members. As the protracted Greek crisis has shown, governments should provide essential social safety nets so that the banks' capacity to finance growth is not constrained by any social policy needs. Sustainable financing of such safety nets calls for reducing incentives for undeclared work. Pigovian taxes may represent another area where common interests for minimum standards could prove effective in the region.

In the midst of global trade tensions, the ASEAN leaders nevertheless reaffirmed their commitment to open trading systems that have underpinned their economic growth. The wealthier members also committed that no one should be "left behind." This creates a link with fiscal solidarity. Some form of stabilization facility, unemployment insurance or support to finance various policy or institutional reforms could be useful long-term policy debates in the region. The member countries would, however, have to agree on how strong and independent institutions are desirable at the supranational level (e.g., Kurlantzick 2012).

As in the euro area, it matters who presents the proposals and how their benefits are seen to be distributed. The tensions related to Japan's proposal for the Asian Monetary Fund (e.g., Lipsky 2003), the PRC's recent initiatives, such as the Asian Infrastructure Investment Bank and the Belt and Road Initiative, are indications of concerns on the regional leadership of both of these countries, and also on the persistent role of the United States in the Pacific. A recent example of working around apparent institutional constraints is a Malaysian proposal for a future common currency arrangement for the purposes of regional trade settlement. Because this currency would not be used within the domestic economies, it would impose lesser constraints for domestic policies and institutions. (Reuters, 2019) The efficiency of such a clearing arrangement likely requires one or more liquidity providers, which could be anchored to a regional public institution or to a private sector solution. Again, the European experience of the ECU hints that there are limitations to private sector solutions.

Harmonizing sovereign bond conditions would nevertheless be another market-based strand for gradual steps toward fiscal integration. The Euro area members (for example) resolved to common collective action clauses when the ESM was established. A common securities market platform for sovereign issuance, trade settlement and registration implemented with a single set of rules and procedures would reduce transaction costs and could ultimately become a thrust to shared issuance, which could start with new initiatives to finance regional public goods, in particular, climate financing to support adaptation actions.

The EU has a tradition of decision-making enabling leap frogging to a new framework in moments of crises. The debate on the AMF demonstrates the importance of process and sticky equilibria. This does not prevent the authorities to prepare alternative strands of reform. The rapidly aging population of the large two East Asian nations and indications of their slowing growth prospects in comparison to the rest of the region may nevertheless provide incentives for more balanced cooperation in the long run. Meanwhile, selected ASEAN members could consider enhanced cooperation.

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