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Reconciling Insurance with Market Discipline: A Blueprint for a European Fiscal Union

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Abstract

This contribution develops a blueprint for a European fiscal union. We argue that a viable European fiscal union can be constructed without joint liability for public debt or a centralized government with a large common budget. Such a fiscal union should combine elements of market discipline with stabilisation in case of asymmetric shocks. Our proposal addresses the shortcomings of most other reform designs, which fail to offer a solution for insolvent or non-cooperative euro countries. We suggest a design which combines limited fiscal insurance with an orderly procedure to restructure the debt of insolvent member states. We show that fiscal insurance and a sovereign insolvency procedure are no contradiction but, on the contrary, are mutually reinforcing. Effective fiscal insurance helps to limit the stability risks involved in the implementation of an insolvency regime for sovereigns. And vice versa, a well-defined insolvency procedure reduces the risk that a fiscal capacity motivated as an insurance against transitory asymmetric shocks degenerates into a permanent transfer system. Moreover, we show that both elements promote the functioning of the European banking union and the new European fiscal governance.

JEL-Codes: H870, H120.

Keywords: sovereign insolvency procedure, European unemployment insurance, euro area debt crisis.

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1. Introduction

More than five years after the outbreak of the euro area debt crisis, the institutional setup of EMU is in a state of flux. Despite various important and innovative reforms (banking union, fiscal and macroeconomic surveillance and coordination), the institutions of the Eurozone are far from providing a solid framework for the common currency. Several developments indicate the need for a more comprehensive redesign of euro area institutions. The responsibility for crisis containment has been shifted onto the ECB to a hardly acceptable degree. In effect, it was the central bank that has stabilised the situation through its Target2 system, a whole battery of new programmes, and by acting as a lender of last resort for governments and banks.[1] The heavy involvement of the ECB has been the object of serious questions regarding the democratic legitimacy or possible conflicts with the Maastricht principles of central bank independence and the prohibition of monetary financing of governments. In addition, the conflict between the euro area and Greece in 2015 has demonstrated that there is a vulnerable element in the rescue strategy applied thus far. This strategy is based on conditionality and on the link between assistance and reforms. The obvious weakness of conditionality is the lack of a strategy in the case that a crisis country refuses to respect the rules of the game.

The academic debate is equally sceptical as to whether the institutional reforms realised or initiated thus far, are really sufficient in their scope. The bottom line of that literature (surveyed below) is that reforms remain incomplete. There are at least two major points of criticism. The first criticism relates to the need for stabilisation and argues that so far, fiscal tools which could help to insure euro members against idiosyncratic shocks, and prevent the resulting self-enforcing dynamics of crises, are missing. It is this failure to provide fiscal insurance which would force the central bank to step in. The second criticism concerns the limited credibility of no bailout provisions. New and refined fiscal rules can hardly be a substitute for effective market discipline. The existing ambiguity about bailouts creates uncertainty and undermines incentives to pursue sound fiscal and economic policies.

Both lines of criticism are often presented as a trade-off where Europe would have to decide between either a solidary system which provides insurance at the cost of weaker incentives, or a ‘fend for yourself’ system which stresses individual responsibility and market discipline but is unfavourable for stabilisation. We do not agree with this view of a trade-off.

In this paper, we propose an institutional reform package which intends to reconcile the need for stabilisation with market-based fiscal discipline. The package addresses the shortcoming of most other blueprints in the literature which do not offer a solution for insolvent or non-cooperative euro countries. Thus, the innovation of our proposal is that it combines fiscal insurance with an orderly procedure to restructure the debt of an insolvent euro member. We

[1] These programmes comprise the Securities Markets Programme (SMP), the Outright Monetary Transaction (OMT) programme, and, recently, its asset purchasing programme comprising government bonds.

show that fiscal insurance and a sovereign insolvency procedure are not contradictory but, on the contrary, are mutually beneficial. Effective fiscal insurance helps to limit the stability risks involved in the implementation of an insolvency regime for sovereigns. And vice versa, a well-defined insolvency procedure reduces the risk that a fiscal capacity motivated as an insurance against transitory asymmetric shocks degenerates into a permanent transfer system. In our view, a viable European fiscal union can be constructed without joint liability for public debt or a centralised government with a large common budget. Instead, a more limited improvement in the euro institutions is sufficient to make it sustain as long as it includes sufficient elements of market discipline and stabilisation in case of asymmetric shocks.

Our blueprint therefore also addresses the major politico-economic obstacle to complete EMU (e.g., along the lines of the recent Five Presidents' Report: Juncker, 2015b). This major obstacle is the fear of an unpredictable transfer burden for countries with relatively stable budgets. In this context, an insolvency procedure might pave the way for more ambitious fiscal insurance projects as it opens up an exit-option for a country with a solvency problem – no matter whether this originates from a long-run economic downturn or ongoing policy failure.

In the following, we shortly survey existing blueprints for a "fiscal union" in order to identify the missing elements (section 2). We then provide an integrated view of various elements of a fiscal union. We start by discussing the single elements before we address the important interactions between these elements. We proceed by analysing how the new set-up of a banking union (section 3) and the reforms in economic and fiscal governance (section 4) have changed the situation, and which shortcomings remain. We subsequently develop our two key pillars; a European unemployment insurance on the one hand, and an insolvency procedure for sovereigns on the other hand (section 5 and 6). Including such an insolvency procedure in our proposal for a viable fiscal union is a key innovation compared to the existing proposals surveyed in section 2. Finally (section 7), we discuss how these building blocks would interact and how they should be integrated in a viable fiscal union.

2. Existing blueprints

The recent crisis opened up a new debate about a fiscal union for the Eurozone.[2] Table 1 and the text below briefly summarise proposals on institutional reforms in the Eurozone (see also

[2] Several older studies discussed the implications of EMU for fiscal policy integration (see De Grauwe, 2009, for an overview). An important early discussion of the key issues can be found in the MacDougall Report (1977), which had the broad objective of analysing the role of public finances in European monetary integration. Eichengreen (1990) compares Europe to the US, emphasizing that the federal income tax in the US provides significant insurance against asymmetric macroeconomic shocks. Many economists warned that the Euro area is too heterogeneous and that the EMU would be fragile and vulnerable to economic shocks unless complemented by more fiscal integration (see Sachs and Sala-i-Martín, 1992; Buiter et al., 1993; Mélitz and Vori, 1993; Bayoumi and Masson, 1995; Masson, 1996; Eichengreen and Wyplosz, 1998; Engwerda et al., 2002; Uhlig, 2003).

Iara, 2015, for an extensive survey of the various proposals).[3] We focus on five dimensions: fiscal rules and governance, insurance and stabilisation in case of asymmetric shocks, banking union and regulation, and Euro bonds (see Fuest and Peichl, 2012, for a survey of the different elements of a fiscal union).[4]

The European Commission (2012) offered a "*blueprint for a deep and genuine economic and monetary union*" consisting of several steps for the short, medium and long-term. The short-term agenda (up to 18 months) included the implementation of the new European economic and fiscal governance framework laid down in the six-pack and two-pack legislations, the adoption of proposals on joint banking supervision and resolution, and the design of a financial instrument to foster economic reform in the Member States. In the medium term (up to five years), the aim was to deepen economic and budgetary policy integration, including the creation of a fiscal capacity for the euro area, a debt redemption fund, and the common issuance of short-term sovereign debt (eurobills). In the long term (beyond five years), the aim was the completion of the bank supervision and resolution scheme and the building of a common deposit guarantee insurance scheme, as well as the implementation of a euro area fiscal capacity for stabilisation against asymmetric shocks. The fiscal integration process would also lead to the common issuance of public debt with longer maturities.

Bordo et al. (2013) analyse the history of successful fiscal federalism and suggest three key elements for a successful economic and monetary union relevant for the Eurozone. Firstly, regional fiscal units can have revenue and expenditure independence, but only in a system of no bailouts by the centre. Secondly, a union-wide bond market with a common bond as a response to an economically disastrous event is necessary. Thirdly, the central government must have a large fiscal capacity and a system for (larger) transfers and equalisation payments.

One exception is Fatás (1998) who argues that the cross-regional insurance potential of a European fiscal union would be limited, based on GDP data prior to the introduction of the EMU. His main objection to other empirical studies is that they fail to distinguish properly between intertemporal transfers (essentially self-insurance through debt financing), on the one hand, and true interregional insurance, on the other hand. Moreover, several authors have proposed an increase in the European budget in order to establish a horizontal fiscal equalisation mechanism (Italiener and Vanheukelen, 1993; Hammond and von Hagen, 1998; Dullien and Schwarzer, 2005; Marzinotto et al., 2011). Schuknecht et al. (2011) emphasise the importance of fiscal discipline, proposing an independent fiscal council for the Euro area with the aim of improving governance and compliance.

[3] Note that we do not include studies that analyse the economic consequences of some proposals in our survey, such as, e.g., Bargain et al. (2013) and Dolls et al. (2015a,b).

[4] Fuest and Peichl (2012) discuss five possible elements of a fiscal union: (1) fiscal rules, policy coordination and supervision, (2) a crisis resolution mechanism, (3) a joint guarantee for government debt, (4) fiscal equalisation and other mechanisms for transfers between countries, and (5) a larger EU budget and European taxes. The authors also discuss how these elements can be combined, and, more importantly, suggest an alternative to a fiscal union based on decentralised responsibility and financial sector stability.

The Tommaso Padoa-Schioppa Group (Enderlein et al., 2012) presented their "*road map towards fiscal union in Europe*" in June 2012. The elements include (i) a cyclical insurance fund to provide automatic stabilisation without long-term redistribution, (ii) expanding the redistributive side of the EU budget by means of increasing the EU's own resources, (iii) a common regulatory, supervisory, and deposit insurance framework for banking, and (iv) a European Debt Agency to issue jointly guaranteed debt.

In December 2012, the Four Presidents' Report "*towards a genuine economic and monetary union*" (van Rompuy, 2012) was presented. The key element was the creation of a "well-defined and limited" fiscal capacity to provide insurance at the central level against shocks, once a common regulatory and supervisory financial framework and stronger coordination of structural reforms have been established (foreseen to happen after 2014). The adoption of a fiscal capacity should be complemented by increasing degrees of joint budgetary decision-making and policy coordination, notably concerning taxation and employment.

Belke (2013) presented two principal, but competing ways to stabilise the Eurozone: Either a centralised control over fiscal policy (including centralised control over some economic policy areas) and joint liability for government debt, or national decisions over public debt which requires a banking union.

Cottarelli (2013) suggests three pillars for a fiscal union. Firstly, stronger constraints on member state deficits and debt, secondly, a larger central budget, and thirdly, harmonisation of non-fiscal policies (e.g. banking union). The IMF (2013) discussed what the banking union should look like.[5]

Rodrigues (2013) discusses how to redesign existing instruments for a sustainable EMU. Her suggestions include an EU budget to provide structural convergence, a complementary Eurozone budget to provide macro-economic stabilisation, and the ESM issuing Eurobonds.

Allard et al. (2013, 2015) suggest "*minimal elements for a fiscal union in the euro area*" to make a future crisis less severe. These include (i) a better oversight of national fiscal policies and enforcement of fiscal rules, (ii) some system of temporary transfers or joint provision of common public goods or services to increase fiscal risk sharing (subject to strong oversight and enforcement of fiscal discipline), (iii) a credible pan-euro area fiscal backstop for the banking sector and (iv) common borrowing to finance greater risk sharing and a stronger backstop and the provision of a common safe asset.

Corsetti et al. (2014) propose "*New Institutions and New Policies for a Workable Eurozone*". Their proposal consists firstly of regulatory changes that discourage and limit the exposure of

[5] The authors suggested three key elements. Firstly, a single supervisory mechanism supervising all banks; secondly, a single resolution authority that can close and restructure banks and intervene well ahead of insolvency, and thirdly, a common resolution/insurance fund to add credibility, facilitate limited industry funding and having access to common backstops for systemic situations.

banks to sovereign debt, complemented by the creation of a European Bond recognised as safe by the ECB. Secondly, it includes a sovereign debt restructuring regime and thirdly, a one-time debt stock operation to rapidly reduce sovereign debt.

In February 2015, in the next Four Presidents' report, Jean Claude Juncker, in close cooperation with Donald Tusk, Jeroen Dijsselbloem and Mario Draghi, suggested "*next steps on better economic governance in the Euro Area*". This included mechanisms for stronger economic policy coordination, convergence and solidarity - (i) more effective commitments to growth-enhancing structural reforms in the euro area, (ii) improved functioning of the single market (i.e., enhancing labour mobility, capital market integration and further initiatives regarding digital economy and energy), and (iii) development of a long-term perspective of how the framework of the EMU should develop (Juncker, 2015a).

Table 1: Overview of proposals

	Fiscal rules / governance	Insurance / stabilisation	Insolvency procedure	Banking union/ regulation	Euro bonds
European Commission (2012)	X	X		X	X
Tommaso Padoa-Schioppa Group 2012		X		X	X
Van Rompuy 2012	X	X		X	
Belke 2013	X1	X1		X2	X1
Bordo et al. 2013		X		(x)	X
Cottarelli 2013	X	X		X	
IMF (Goyal et al.) 2013				X	
Delors 2013					
IMF (Allard et al.) 2013, 2015	X	X	(x)*	X	X
CEPR (Corsetti et al.) 2014	X			X	X
Fuest et al. (2015)			X		
Juncker (2015b)	X	X		X	

Notes: *: Allard et al. (2013) mention the potential involvement of private creditors albeit without making a concrete proposal.

The Five Presidents' report of June 2015, "*Completing Europe's Economic and Monetary Union*" (Juncker, 2015b), suggests four steps, to be taken in 3 stages (up to 2025): (i) structural reforms to achieve and maintain responsible fiscal policies and enhance democratic accountability, (ii) completing the Banking Union and accelerating the Capital Markets Union, (iii) a Fiscal Union delivering both fiscal sustainability and fiscal stabilisation, and (iv) a Political Union that provides the foundation for all of the above through genuine democratic accountability, legitimacy and institutional strengthening.

A feature common to all previous suggestions for a fiscal union in Europe is their failure to address the question of an insolvency procedure for sovereigns. Such a proposal was made by Fuest et al. (2015) in their "*Viable Insolvency Procedure for Sovereigns*" (VIPS). The VIPS consists of two components, a permanent insolvency procedure for the "long-run" and a "bridge", which defines the transition to the full activation of that procedure. Including such a procedure in our blueprint for a fiscal union is a key contribution of our paper (see section 6 for details on VIPS).

Another key difference between our, and other existing proposals, is that we do not believe that a viable fiscal union must necessarily include elements of joint liability for public debt, via a euro bond market serviced by taxes collected by the EU government for example, as suggested by Bordo et al. (2013). In addition, our proposed fiscal union does neither require a centralised government nor a large common budget. Provided that it includes elements of market discipline and stabilisation in the case of asymmetric shocks, a more limited improvement in the euro institutions is sufficient to ensure their survival. This argument will be further developed in the remainder of the paper.

To sum up, as can be seen from Table 1, the various proposals lack an integrated view. The proposals focus on single, or on a limited number of elements of deeper fiscal integration in the Eurozone. It is exclusively the proposals made by Allard et al. (2013, 2015), which touch upon all dimensions. An extensive discussion of the interaction of the various elements is, however, still missing. In addition to incorporating an insolvency procedure, our paper will also provide an integrated view of the interactions between the various elements of a fiscal union.

3. European banking union and financial sector regulation

One of the key lessons of the financial crisis and the Eurozone debt crisis is that there are important links between banks and the financial stability of governments. Due to the no bailout clause and the prohibition of monetary financing of governments through the ECB, national governments and banks do not have a lender of last resort. This increases the vulnerability of both governments and banks to financial stress considerably. Nevertheless, financial sector regulation allows banks to hold government bonds without equity. At the same time, national governments have retained the responsibility of stabilising the banking sector in the event of a crisis. As a result, the financial weakness of banks and governments during the debt crisis in the Eurozone was mutually reinforcing ('death loop of banks and governments') and proved to be a major destabilising factor.

The mutual financial dependence of national governments and banks in the Eurozone also undermined the credibility of the no bailout clause. Because banks were allowed to hold large quantities of government bonds with very little equity, it was evident that applying the no bailout clause in the event of a fiscal crisis would be very costly. The restructuring of government debt would destabilise the banking sector and threaten financial stability. Therefore rational investors expected that governments with excessive levels of debt would be bailed out with a high probability, despite the no bailout rule. This explains the surprisingly high degree of interest rate convergence in the early years of the Eurozone. It also explains why governments with a poor record of fiscal governance were able to borrow large amounts of money.

As a consequence of the crisis, the Eurozone governments introduced banking union. Banking supervision was shifted to the European level (Single Supervisory Mechanism), a European institution for bank restructuring was set up (Single Restructuring Mechanism), and a fund for the recapitalisation of banks was created (Single Restructuring Fund). Under certain conditions, the ESM can provide additional funds for bank recapitalisation, and the banks themselves are required to hold more 'bail-inable' capital than before the crisis. Recently, the European Commission submitted a proposal for the introduction of a bank deposit insurance scheme in the Eurozone.[6]

These are important steps towards a more solid banking sector, and they reduce the mutual financial dependence of banks and their national governments in the Eurozone. Fiscal governance in the Eurozone depends on the interaction between public finances and the financial sector. Most importantly, the no bailout clause will be credible only if it is possible to restructure the debt of an insolvent country without risking a banking crisis. Therefore the ability of banks to absorb losses needs to increase, and the exposure of banks to government debt, in particular to the debt of the countries where the banks reside, must be reduced. The fact that banking regulation still classifies government bonds of Eurozone member states as riskless assets, so that banks need no or almost no equity for positions in government bonds, is a key shortcoming of the financial sector reforms that have been carried out so far.

[6] European Commission (2015).

To summarise, further reforms of the banking sector are of key importance not just for the sake of financial sector stability, but also for the development of fiscal institutions in the Eurozone. Firstly, capital regulations for banks need to be reformed further, increasing the equity banks are required to hold. Secondly, the privilege of zero risk weights for government bonds must go. This is a key condition for the credibility of public debt restructuring institutions, which are, in turn, a central element of Eurozone fiscal governance.

4. Fiscal rules/governance

The Maastricht model for budgetary prudence was based on two pillars: market discipline and fiscal rules. Market discipline was supposed to be underpinned by the no bailout clause (Art. 125 TFEU), the prohibition on monetary budget financing (Art. 123 TFEU) and the ban of government privileges in loan access (Art. 124 TFEU). Fiscal rules were designed to have a double function as an entry condition to EMU through the convergence criteria (Art. 140 TFEU), and as a permanent rule for EMU members through the excessive deficit procedure reinforced by the Stability and Growth Pact (SGP). Over recent years, the euro area debt crisis has demonstrated the weaknesses of this initial two-pillar-framework. Moreover, emergency measures and permanent reforms have led to considerable changes compared to the initial set-up. With respect to the first pillar, market discipline, all three Maastricht foundations are now substantially impaired.

Firstly, the no bailout clause has always suffered from a lack of credibility as indicated by the almost complete absence of risk premia in the euro government bond market in the first decade following the introduction of the euro. Since 2010, the crisis events and subsequent decisions have indicated that investors were right to doubt the credibility of the no bailout clause. Since the 2010 crisis, countries have gained access to loans guaranteed by other euro member countries (EFSF, ESM), the European Union (EFSM) or the IMF, via institutions created on an ad hoc basis. Initially, emergency loan facilities were intended to be available only for a transitory phase. Such facilities, however, have become a permanent institution through the ESM. With the amendment of the TFEU (Art. 136 (3) TFEU), the ESM now has a lasting grounding in primary EU law. And obviously, access to loan facilities has not been confined to countries with a mere transitory liquidity problem. At least in the case of Greece, massive support has been given to a country with unsustainable public finances.

Secondly, the heavy involvement of the ECB in government bond markets has decreased the credibility of the ban on monetary financing. The Securities Markets Programme (SMP) activated in 2010, and the Outright Monetary Transactions (OMT) Programme established in 2012, both imply that the ECB can selectively buy government bonds of highly indebted countries in the secondary markets. Although the Public Sector Purchase Programme (PSPP), introduced in March 2015 as part of the ECB's quantitative easing, is non-selective, it has nevertheless massively increased the ECB's role as a buyer in the euro area government bond market. From a legal perspective, it is disputed whether the heavy ECB involvement in the bond market through all these programmes is consistent with Art. 123 TFEU. Such legal concerns are mirrored in the different interpretations of the German Federal Constitutional Court and the European Court of Justice (ECJ). In its judgment on the OMT Programme in February 2014, Germany's Constitutional Court raised substantial concerns on the programme's compatibility with European primary law (Bundesverfassungsgericht, 2014). According to the Karlsruhe Court, the OMT appears to be out of the European Central Bank's mandate for monetary policy and might be regarded as a mere circumvention of the ban of direct government bond purchases in Art. 123 TFEU. Rather than taking a final decision on its own, however, Karlsruhe submitted the case to the ECJ. In its decision of June 2015, the ECJ had rejected the concerns of the German constitutional judges and ruled that the OMT purchases are compatible with EU law; they do not constitute monetary financing of governments (Court of Justice of the European Union, 2015). In this respect, the ECJ was satisfied with the intention of the ECB to guarantee a minimum period between the issuing of a government bond and ECB purchases on the secondary markets, and to refrain from any precise announcements on planned timing and volumes of purchases.

Even if the ECJ's ruling has legally legitimised the programme, one economic implication is unambiguous: Investors today base their investment calculus at euro area government bond markets on the fact that the ECB is (conditionally) willing to buy crisis country bonds in the secondary market and that this tends to reduce the size of credit risk spreads in this market. One might accept the argument that at the peak of the acute crisis in the year 2012, no other institution than the ECB had the means available to achieve a short-run stabilisation of the euro area. Nevertheless, the resulting lasting involvement of the monetary authority in keeping government market access open is problematic.

Thirdly, the prohibition of a privileged loan access for governments has also lost credibility. This is due to the fact that all the new loan facilities imply substantive privileges for market access. Furthermore, the reforms on banking regulation since the financial crisis have spared the extant zero weighting for euro area government bonds in banking capital requirements.

All this weakening of market discipline has been accompanied by attempts to make the second pillar of budgetary discipline, fiscal rules, more effective (for a concise summary on all reforms see European Commission, 2014). Two comprehensive legislative packages (the "six pack" and the "two pack") have strengthened both the surveillance and enforcement dimension of the SGP. In terms of surveillance, the stock of debt criterion has become more influential. For countries with debt levels in excess of 60 per cent of GDP, a numerical benchmark has been defined for the necessary annual reduction in the debt ratio – one twentieth of the gap to the reference value. The preventive arm of the SGP now also includes a benchmark for the acceptable increase of government expenditure. In terms of enforcement, financial sanctions are to be decided earlier in the process and with a reversed majority – i.e. a sanction proposed by the Commission can only be averted through a qualified Council majority. These new rules are also anchored in the so-called "European Semester" which details the coordination of national budgets with feedback loops from Brussels throughout the year. Finally, the Treaty on Stability, Coordination and Governance in the EMU ("Fiscal Compact") obliged the 25 signatory states to introduce deficit ceilings in binding national laws. As a consequence, national enforcement (e.g. through national constitutional courts) will supplement the enforcement pressure of supranational law.

To sum up, there has been a far-reaching redesign of the Maastricht approach to fiscal prudence over the years of the crisis. While the Maastricht approach had given equal weighting to both pillars, fiscal rules and market discipline, the reformed design is less balanced. Elements which ensure market discipline have been substantially weakened. This has been accompanied by attempts to off-set this by tightening fiscal rules.

In our view, there are clear limits to this compensatory strategy. Empirically, the available evidence supports the view that fiscal rules contribute to a more sustainable fiscal performance (for a meta-analysis on the constraining impact of fiscal rules see Heinemann, Moessinger and Yeter, 2015). However, optimism with regard to the effects of the redesigned fiscal rules is limited by the complexity of the new rules. The numerous refinements and several layers of rules (national and European) create a highly complex system, the effectiveness of which is considerably weakened by a lack of transparency. Moreover, the understanding that strict fiscal rules could make up for the absence of market discipline is mistaken. This expectation that fiscal rules will play a compensatory role is flawed in view of the lack of market discipline, which also damages the credibility of rules themselves, regardless of how strictly they have been formulated. Financial sanctions for the violation of rules, for example, can only be an effective deterrent if a country cannot pass these costs on to its partners in a subsequent bailout. Conditionality of liquidity assistance, a typical element of any rule-based approach, can only be credible if there is a credible alternative to a bailout once a country becomes insolvent. Hence, fiscal rules and market discipline are not substitutes, but rather highly complementary elements of a framework favouring fiscal prudence. Fiscal rules without market discipline are unlikely to be effective. Both historical and recent anecdotal evidence support this view. Historically, the experience in federal countries in Europe, North and South America suggests that close fiscal surveillance in combination with credible no bailout clauses has guaranteed the viability of monetary unions (Bordo et al., 2013). The recent experience with Greece provides anecdotal evidence that all new European provisions implemented since 2010 were not sufficient to prevent the first Tsipras government, elected in January 2015, from simply disobeying the new rules and rolling back numerous reforms. It is clear that this behaviour has been largely motivated by the expectation that European partners will ultimately be forced to continue with an open or hidden bailout of Greece.

5. European Unemployment Insurance Scheme

The EMU is an atypical monetary union because monetary policy is determined at the central (Eurozone) level, while fiscal policy is carried out at the sub-central (member state) level. If the union is hit by an asymmetric shock, the affected member states must, in the absence of exchange rate adjustments, rely on national automatic stabilisers or countercyclical fiscal policy measures. An element typically available in fully-fledged monetary and fiscal unions, which is missing in the case of the EMU, is a fiscal capacity serving as an automatic stabiliser at the central level. Several arguments for a common insurance mechanism in the EMU have been put forward, for example the view that private risk sharing does not provide the Pareto efficient level of risk-sharing due to positive externalities (Farhi and Werning, 2014) and that contagion and self-fulfilling crises could be better contained with at least some fiscal integration (Allard et al., 2015). The Four Presidents' report (van Rompuy, 2012) also emphasised the necessity to improve the economic resilience of the EMU. At the same time, however, it outlined important criteria for any Eurozone-wide fiscal risk sharing mechanism. In particular, such a mechanism should not lead to permanent transfers across countries, or to moral hazard and disincentive effects at the level of individuals, the administration and economic policy (Persson and Tabellini, 1996).

There is a growing body of literature concerning the possible design of a fiscal capacity. The various designs can be broadly categorized into a macroeconomic and a microeconomic approach. The former approach would establish a fiscal equalisation or insurance mechanism with transfers between countries. Recent proposals comprise fiscal insurance mechanisms based on relative output gap differences (Enderlein et al., 2013, Oksanen 2015), stabilisation funds (Furceri and Zdzienicka, 2013), or contingent reinsurance mechanisms (Gros, 2014). The latter approach would directly stabilise household incomes in the event of negative income and unemployment shocks through a (partly) integrated tax and transfer system (Bargain et al., 2013; Feyrer and Sacerdote, 2013; Dolls et al., 2015a,b). The most prominent proposal has been a common European unemployment insurance system (Andor, 2014; Dullien, 2014).

General concerns with most of the proposals made in the literature are related to the risk of permanent transfers and moral hazard. In addition, specific concerns have been expressed concerning individual proposals. Some proposals, such as fiscal equalisation mechanisms, clearly do not fulfil the criteria formulated in the Four Presidents' report. Their implementation would lead to permanent transfers being made between countries (Bargain et al., 2013). Proposals based on the output-gap as an indicator for the cyclical position of the economy face the specific challenge of identifying shocks in real-time. Proponents of this concept argue, however, that the output gap is already a well-established tool in the EU fiscal framework and that a mechanism based on the output gap could therefore be implemented without large administrative costs. Supporters further stress that financial flows at euro area level would be balanced in each year so that no debt capacity would be required. In order to address the concern of permanent redistribution, Oksanen (2015) proposes a rule that ensures that the smoothing mechanism is balanced in the long-run also at the member state level. Specific concerns related to proposals which favour unemployment insurance are that a centrally-administered fund could lead to administrative manipulation at the local level in order to increase the amount of transfers received from the central fund. In addition, a significant degree of labour market harmonisation would be needed to avoid permanent redistribution and moral hazard.[7]

We propose a common insurance mechanism introduced in the form of an EMU-wide unemployment insurance system designed in such a way that it acknowledges the concerns outlined above, but nevertheless fulfils its role as an automatic stabiliser in the event of asymmetric shocks. The key elements of our proposal are that national unemployment insurance systems must fulfil minimum standards and that benefits from the EMU-UI scheme are contingent, co-financed by national unemployment insurance systems and directed only at the short-term unemployed. In addition, no debt capacity would be required as the EMU-UI fund would need to be balanced in each year. Such a scheme would lead to improved stabilisation of household incomes and government budgets in the event of asymmetric shocks and would make the fiscal policy framework in the EMU, together with an insolvency procedure for sovereigns presented in the next section, more sustainable. In the following, we provide further details of our proposal.

Previous research has shown that the stabilisation capacity of national unemployment insurance systems is extremely heterogeneous throughout Europe (Dolls et al., 2012). While unemployment insurance systems in Western or Northern European countries absorb significant fractions of unemployment shocks (25-60 percent), those in Southern and Eastern European member states provide on average very little insurance (less than 10 percent in Estonia, Greece, Italy and Slovenia). Given these significant differences and the low level of insurance in a number of member states, minimum standards for national unemployment insurance systems, in particular with regard to coverage, would reduce the vulnerability of the unemployed. The European Commission should monitor whether member states comply with the agreed minimum standards. Importantly, our proposal does not imply a full harmonisation of national unemployment insurance systems which could potentially be more generous than the rules determined by the minimum standard.

In terms of contingency, two conditions would need to be met to trigger transfers from the EMU-UI system. Firstly, as member states shall be insured against asymmetric shocks, the unemployment shock in a given member state must be larger than the overall change in un-

[7] See e.g., Wolf (2012), Oksanen(2015), and Dolls et al. (2015a,b) for a more comprehensive assessment of the different proposals.

employment in the euro area (trigger 1). Secondly, given that member states should be able to deal with small shocks, whereas large shocks can jeopardise social cohesion and overstrain public finances, transfers from the EMU-UI scheme should be triggered if the surge in unemployment exceeds a certain, pre-determined threshold (trigger 2). In that respect, our proposal is similar to the federal-state Extended Benefit programme in the US, which provides additional weeks of unemployment benefit in states where the unemployment rate has reached certain thresholds.[8] Clearly, the exact triggers would need to be negotiated between member states. Here, we only illustrate how the two triggers could be specified and simulate how often EMU-UI benefits would have been triggered over the period of 2000-13. If the triggers were to prescribe that the percentage increase in the unemployment rate had to be above the Eurozone-average (trigger 1) and larger than 10 percent (trigger 2), each member state would have fulfilled the conditions to trigger transfers from the EMU-UI system at least once. Cyprus (9 years), Portugal and Netherlands (both 8 years) are the member states with the longest periods of benefit receipt from the EMU-UI system. If trigger 2 instead stipulated that the unemployment rate must rise by 2 percentage points, i.e. a larger percentage increase in low relative to high unemployment countries, Cyprus, Spain (both 5 years), as well as Greece and Portugal (both 4 years), would have been triggered for the longest periods. Austria, Belgium, Germany, Finland and France would not have received transfers from the EMU-UI system. In terms of financing, in order to balance the EMU-UI budget on a yearly basis, those member states that do not fulfil the conditions to trigger transfers would need to finance the transfers from their government budgets.

Our proposal resembles the Extended Benefit programme in a further dimension. Historically, states and the federal government have shared the costs of Extended Benefits equally.[9] In a similar way, transfers from the EMU-UI system would need to be co-financed by member states. Precisely, if transfers from the EMU-UI system were triggered in a member state, the EMU-UI system would pay part of the benefits according to the minimum standards monitored by the European Commission. That is, the EMU-UI system would pay 50 percent of the benefits to the short-term unemployed with an unemployment spell no longer than 12 months. A waiting period of 2 months following job loss would exclude seasonal unemployment (like in tourism) from coverage by the EMU-UI system. The rationale for EMU-UI to be based on co-financing and focussing on short-term unemployment including a waiting period is that

[8] Regular state unemployment benefits are usually paid for a maximum period of 26 weeks. According to current US legislation, they can be extended through the Extended Benefit programme by 13 (20) weeks if the unemployment rate in a given state is above 6.5 (8) percent and exceeds that of the previous two years by 10 percent (see e.g. Farber and Valletta, forthcoming). Note that further extensions can be implemented through other federal programmes.

[9] In the Great Recession, the American Recovery and Reinvestment Act (ARRA) allowed the federal government to pay for all Extended Benefits in order to make the programme more appealing to states (Nicholson et al., 2014).

these elements should minimise the risk of permanent transfers, moral hazard and administrative manipulation.

How large would the budget of such an EMU-UI system be? Simulations of Dolls et al. (2015b) for a non-contingent scheme with a replacement rate of 50 percent of previous gross earnings and benefits paid for up to 12 months suggest that a significant scheme could be achieved with a relatively small overall budget. Over the period of 2000-13, it would have amounted to 47 billion euros per year at the Eurozone level with average yearly net contributions in a range between -0.54 percent (Spain) to 0.39 percent of GDP (Netherlands).

6. Viable Insolvency Procedure for Sovereigns

The possible establishment of a sovereign insolvency procedure for the euro area is sometimes debated as if it were a minor technical, or a mere crisis management issue. This reflects a fundamental underestimation of the importance of this issue. The decision for or against such a procedure is nothing less than a far-reaching decision on Europe's fiscal constitution. The credible perspective of a possible sovereign debt restructuring offers a way of shifting the burden of a sovereign insolvency to private creditors. If a sovereign insolvency is not an option, the burden must fall on taxpayers in other euro area countries, be it through an open, or hidden fiscal or monetary bailout. Accordingly, without an insolvency perspective any sovereign insolvency requires the flow of public transfers from other members of the euro area.

One may support or reject the idea of a fiscal constitution with substantial transfers between euro member countries. However, in a democracy the consensus is usually that the establishment of a transfer system should be the result of democratic and transparent constitutional decisions. The problem with transfers as an unintentional side-effect of the absence of an insolvency option is that it lacks democratic legitimacy and transparency. The problem is already virulent under the current status quo, where the ECB has become the lender of last resort for euro area crisis countries. Since with Greece at least one of these countries is in a state of insolvency, the ECB's support implicitly has a transfer character, but the consent from voters or their representatives in parliaments has never been given.

Since the outbreak of the euro area debt crisis, the literature on reforming the institutions of the euro area has repeatedly brought forward the idea of insolvency procedures. This European literature took the IMF proposal for a Sovereign Debt Restructuring Mechanism (SDRM) as starting point (Krueger, 2002). This proposal defines necessary elements of a procedure which would also have to be taken up in the European context like the need of majority creditor decision making, payment moratoria during negotiations, or the need to have one moderating organization like the IMF which could provide fresh money during negotiations.

Gros and Mayer (2010) proposed establishing a European Monetary Fund which would provide both insurance against liquidity crises, and manage the restructuring of insolvent euro members. The design proposed by Gianviti et al. (2010) is more explicit about the organization of the restructuring procedure, and suggests a new chamber at the European Court of Justice as an independent moderator of negotiations. The blueprint developed by the Committee on International Economic Policy and Reform (2013) makes the ESM the responsible institution and elaborates the legal precautions against holdout investors. Such holdouts, specialised "vulture funds" for example, have been successful in past ad hoc restructurings e.g. in Argentina or Greece in litigating for full repayment. They thus also threaten the effectiveness of a well-defined statutory insolvency procedure.

Other suggestions refer to innovative government debt instruments which, to a certain extent, imply an automatic restructuring depending on certain conditions. Barkbu, Eichengreen, and Mody (2012) have proposed sovereign "cocos" (contingent convertible bonds) with provisions for automatic restructuring whenever a country's debt level exceeds a certain threshold. Recently, Fuest, Heinemann and Schröder (2015) have suggested committing euro area countries that have deficits above the medium term objectives of the Fiscal Compact to the emission of "accountability bonds". Accountability bonds are junior to standard government bonds and excluded from any ECB bond purchases. While this literature is developed in several dimensions, it has not paid sufficient attention to the crucial problem of transition. Although an orderly insolvency procedure has substantial merits and is likely to be technically feasible, its introduction in a fragile economic, fiscal and financial environment is not straightforward. Even if the emerging European banking union and new liquidity facilities like the ESM and the ECB's programme have made bond markets more resilient against self-fulfilling panic attacks, there remain substantial system risks. National banking systems are still heavily exposed to their governments because of the continuing regulative privileges of public debtors such as zero weights in bank capital requirements. Furthermore, euro area countries like Spain or Italy have public debt levels which by far exceed the loan capacity of the ESM. Moreover, debt consolidation in the euro area has yet to get fully underway. The establishment of an insolvency procedure in this environment could feed expectations that a restructuring of larger euro countries is imminent. This could in turn instigate new waves of panic-driven bond selloffs with cross-country contagion. The transition problem is therefore characterised by a profound dilemma (as described by Mody, 2013). The ideal timing for establishing an insolvency procedure is a period with high growth, low unemployment, healthy banks and public finances. The need for such a procedure to be implemented, however, tends to be acknowledged only in times of fiscal turmoil.

As a way of dealing with this dilemma, Fuest et al. (2015) have suggested their "Viable Insolvency Procedure for Sovereigns" (VIPS). VIPS consists of two components; a permanent insolvency procedure for the "long-run", and a "bridge" which defines the transition towards the full activation of that procedure.

The VIPS bridge is constructed through lagged implementation: The insolvency procedure is to be codified today in the ESM Treaty but its activation is postponed through a trigger clause. According to this clause, the insolvency procedure becomes fully effective once the euro area average debt-GDP-ratio falls below a critical level of, for example, 80 per cent. As a fall back trigger, a fixed date is added (e.g. the year 2030) as the latest date for the full activation. Clearly, the debt level related trigger is preferable as it would activate the insolvency regime in a fiscally friendly environment of falling debt levels. The fall back trigger is necessary, though, since it safeguards the credibility of the transition against intentional or unintended consolidation failure. The definition of the automatic activation in the ESM Treaty addresses the time inconsistency problem of lagged implementation as far as possible. ESM Treaty changes require an unanimous decision which is a high protection against later political interventions to stop the automatism. Lagged implementation has a double motivation. On the one hand, it addresses the economic problem of the transition dilemma described above. On the other hand, it also serves the politico-economic function of overcoming reform resistance related to the self-interest of today's political decision makers (Buchanan, 1994). The constraints of an insolvency perspective might not be attractive for governments. The acceptance is therefore more likely if the incumbents do not decide on new constraints for themselves, but on those of their successors.

The VIPS bridge also includes elements of immediate action which both prepare the ground for the functionality of the procedure later on, and signal the credibility of the transition today. Among the immediate elements are, firstly, the obligation that all new euro area bond issues must contain modified collective action clauses (CAC) based on aggregate majorities for creditor decision-making. This would replace the issue-by-issue decision making currently used. Secondly, a phasing-out of regulatory privileges for euro area sovereign borrowing must be started immediately, e.g., through a slow but steady introduction of bank capital requirements for euro area government bonds. And finally, euro area countries must be subject to maturity regulation in their debt management, forcing them to substantially increase the average maturity of their debt instruments and thus precluding a critical clustering of maturities in certain future years. These provisions will limit the risks of future ESM liquidity assistance and also make the system more resilient against bond market runs.

VIPS' long-run insolvency procedure assigns the ESM a key role. Contrary to the status quo, VIPS strictly limits ESM liquidity assistance to a maximum duration of three years ("ESM shelter period"). This shelter period has the function of an insolvency test. The empirical distinction between a situation of temporary illiquidity and insolvency is notoriously difficult to make. It is extremely difficult, for example, to predict a crisis country's ability to raise additional revenues from taxation. In this respect, the shelter period's insolvency test will be extremely informative. If a country suffers merely from transitory liquidity problems, then this shelter, together with intense reforms and consolidation, should be sufficient to boost borrower reputation and reopen market access. If three years of shelter fail to provide market access, this is an indication of insolvency and, consequently, shall trigger the insolvency procedure. For debt negotiations, standard rules of insolvency procedures apply. These shall include procedures such as an immediate payment moratorium and equal treatment of all creditors. Throughout the negotiation period, the ESM provides emergency liquidity in order to maintain government operability. These additional ESM loans are senior and excluded from any final debt restructuring. There is a single quantitative rule which applies to the extent of restructuring under the VIPS procedure. Namely, any settlement agreed upon with creditor majority (and an ESM veto right) must not lead to a haircut which lowers the debt-to-GDP level below the Maastricht value of 60 per cent. This rule provides an expectation anchor and gives investors a clear indication of the maximum loss to be expected in case of default. Furthermore, it is consistent with the rules of the reformed SGP with its strengthened role of the 60 per cent debt criterion.

Designs like that of the VIPS model offer a path towards an institutional set-up in the euro area where investors lending money to governments actually take a risk. Moreover, countries which are approaching sovereign insolvency can no longer force open or hidden transfers.

7. Interaction and integration of the different elements

We have so far argued that a comprehensive fiscal union for the euro area should consist of two central pillars, namely an insurance system, and a sovereign insolvency procedure. We have thereby spelled out in some detail how both components might be constructed. In the following, we further explore how these two elements interact, and how they should be integrated. In addition, we argue that insurance and insolvency procedure would complement, and greatly benefit the banking union and modernised fiscal governance. It should be acknowledged that alternative fiscal insurance mechanisms to the one proposed here, could also be beneficially integrated with a sovereign insolvency procedure.

7.1 Insurance and VIPS

One insight gained from the acute phase of the euro area debt crisis in the years 2010-2012 is that a monetary union without insurance is prone to “multiple equilibria”. Vicious circles can evolve with initial shocks escalating into a downward spiral of increasing bond yields, deteriorating public finances, banking sector instability and recession with cross-country contagion. A monetary union is particularly fragile in this respect, as monetary policy ceases to be national. While the issue of multiple equilibria has been discussed mostly with respect to financial markets (De Grauwe and Ji, 2013), similar dynamics can occur in the real economy if bad news induces firms to halt investment and hiring, tipping fragile economies into recession.

The introduction of an insolvency mechanism such as VIPS may increase the risk of market turbulences both when it is phased in, and after its introduction. Stabilisation mechanisms like the ESM would counteract this risk. Stabilisation mechanisms such as the ESM and VIPS are therefore complementary. Institutions providing stabilisation for the real economy, however, would provide additional stability. A common European unemployment insurance scheme which provides protection against transitory asymmetric shocks would constitute a contribution to larger macroeconomic stability in the euro area. It would increase the resilience against the destructive dynamics described above. The existence of a common unemployment insurance scheme of the type described would therefore improve the chance that a model such as VIPS could be phased in without triggering market turbulences. In this sense, a European insurance scheme could contribute to the credibility of the VIPS bridge. This would also increase the chances that an insolvency mechanism will be politically acceptable. With insurance in place, governments (and market participants) would know that countries no longer depend solely on their own financing capacities to counterbalance a transitory shock. This should make it more acceptable for national policy makers to accept harder budget constraints as a consequence of a VIPS activation.

Insurance not only simplifies the transition towards VIPS but also helps that the procedure, once activated, could function smoothly. The insurance scheme would lower the demand for ESM protection insofar as this need originates from transitory country-specific shocks. As a consequence, ESM shelter would tend to be a less frequently used option following the introduction of a common European unemployment insurance.

Equally, there is also the reversed logic that VIPS will facilitate the smooth introduction of a European unemployment scheme. The unemployment insurance developed above is designed with the understanding that it offers insurance, but no permanent transfers. Any such claim, however, will raise suspicions of rich and fiscally sound countries. As argued above, the track record on the reliability of any such institutional promises such as, “no bailout” or “no monetary financing” has been poor over recent years. This less than favourable experience currently feeds general belief that any new fiscal capacity designed for insurance will turn into just another system enabling hidden transfers within the euro area, at the latest with the next acute fiscal crisis. The existence of a viable insolvency procedure for insolvent euro countries will fundamentally change the framework. With such a procedure in place, there is a credible alternative for insolvent countries in place which explicitly excludes public transfers. Hence, once the transition phase to VIPS is incorporated in the ESM Treaty, a European unemployment insurance against transitory labour market shocks should be a more acceptable project for all euro area countries regardless of their particular fiscal situation.

The complementary nature of insurance and insolvency procedures may be further supported by credible integration of both institutions. The following three clarifications are reasonable for full integration:

Firstly, euro countries which do not sign the new ESM Treaty including the insolvency procedure must also be excluded from participation in the European unemployment insurance.

This clarification limits the time-inconsistency problem associated with the VIPS bridge. Namely, countries that leave the ESM Treaty during the transition in order to avoid an insolvency procedure and its consequences, would also lose insurance protection. This provides strong incentives to comply with the ESM Treaty along with full activation of VIPS.

Secondly, countries that violate fiscal rules of either the reformed SGP, or Fiscal Compact, or that do not obey the guidance given in the context of the European Semester, should lose insurance coverage. This rule follows the logic that any crisis assistance must be conditional and that solidarity must be confined to countries accepting the full set of rules.

Finally, payments from the European unemployment insurance should be paid out irrespective of whether a country is covered under the ESM shelter or in insolvency negotiations according to the VIPS scheme. Insurance payments, in order to realise their full stabilising potential, must be predictable and reliable, particularly in times of fiscal stress. Only with this certain support can the insurance system contribute to stabilising expectations and preventing the development of vicious circles.[10]

7.2 Insurance, VIPS and fiscal governance

We have above argued that fiscal rules and market discipline are not substitutes, but rather complementary elements which, together, offer incentives for fiscal prudence.

The limited strategic effectiveness of fiscal rules without the perspective of a sovereign insolvency can be demonstrated by looking at the credibility of available sanctions in this case.

So far, given the constitutional stage of the European Union today, direct coercion, e.g., through binding directives on national taxation or expenditures is not a viable option. Any budgetary guidance from European institutions for national budgets needs to be supported by parliamentary majorities in the member country before it can have an actual impact. This is not the case for fines based on the rules of the SGP. These fines are indeed legally binding, and must be paid. A pecuniary fine only aggravates a persistent insolvency problem, however. Without the option of a debt restructuring, fining an insolvent country simply increases the future need for open or hidden transfers from partners or European institutions, including the ECB.

With an insolvency procedure in place, pecuniary sanctions have a different impact. If a sovereign insolvency is addressed through an orderly debt restructuring, investors will be highly sensitive to any budgetary deterioration. As a consequence, signs of fiscal laxity in a euro member country will be punished through increasing risk premia placed on this country's government bonds. With VIPS in place, this will hold particularly true for countries where

[10] However, it remains the case that investors face the uncertainty that a country might in future lose insurance coverage because it violates the rules of the euro area.

debt levels exceed 60 per cent, as the distance to 60 per cent is the maximum loss in case of default.

With a viable insolvency procedure, rule-based fines and market discipline are mutually reinforcing. The non-compliant country can no longer implicitly shift the burden of fines to its euro partners. On the contrary, the fine immediately increases the pressure on the non-compliant country through rising bond yields. This link is effective through two distinct channels. Firstly, fines signal that a country has violated fiscal rules and acted imprudently. Secondly, fines constitute an additional financial burden by themselves, therefore increasing problems of debt sustainability. Due to the signalling channel, even small symbolic fines shall have a measurable impact on risk premia.

7.3 Insurance, VIPS and banking union

There is a strong complementarity between the VIPS insolvency regime and the project of a banking union. A sovereign debt restructuring mechanism will not be credible if a haircut on public debt destabilises the banking system and gives rise to a financial crisis with negative consequences for the real economy. The fact that the European banking union partly severs the links between sovereigns and their national banking systems, and increases the stability and the loss absorption capacity of the banking system, is of key importance for the credibility of the restructuring regime.

At the same time, the VIPS concept supports the viability of the European banking union. It is a major concern that the banking union may allow highly indebted member states to shift the cost of excessive public debt to other countries via the banking system. One way of doing so would be to oblige governments to bailout their own banks. If the governments themselves were then to get into difficulties, they would then pass on the losses to the rest of the Eurozone, via the bank restructuring fund (the Single Restructuring Fund). The availability of a clear procedure for dealing with sovereign debt crises will ease pressures on banks to buy the bonds of highly indebted governments.

In a similar way, a fiscal shock absorber will complement banking union. The impact of asymmetric shocks on the economy will be somewhat cushioned and banks operating in the effected country will be less affected as bank loans will perform better.

8. Conclusion

In recent years, important institutional reforms such as banking union and fiscal and macroeconomic surveillance and coordination have been implemented. Our blueprint is based on the insight that some of these reforms are still incomplete and that two key elements are missing in the current institutional framework of the Eurozone. Firstly, the Eurozone lacks an insolvency procedure for sovereigns, and a fiscal insurance mechanism against asymmetric shocks.

Including the insolvency procedure in our proposal for a viable fiscal union is a key innovation compared to previous proposals. In addition, we argue that a viable European fiscal union can be constructed without joint liability for public debt or a centralised government with a large common budget as long as such a proposal includes sufficient elements of market discipline and stabilisation in case of asymmetric shocks.

In the banking sector, capital regulations are needed that increase equity requirements, abolish the privilege of zero risk weights for government bonds and require banks to diversify risks when they hold government bonds. This is of crucial importance to making the no bailout clause of the Maastricht treaty credible. In the absence of these reforms, it is likely that a debt restructuring of an insolvent member state still requires fiscal transfers to avoid a banking crisis.

An orderly procedure to restructure the debt of an insolvent member state and a fiscal insurance mechanism are the two central pillars of our proposal. Recent experience has shown that transfers without democratic legitimacy and transparency seriously undermine the support for further integration in Europe. An insolvency procedure for sovereigns is indispensable if taxpayers in other euro area countries are to be protected in the event of debt restructuring. At the same time, a fiscal insurance mechanism in the form of a common unemployment insurance system would strengthen the economic resilience of EMU in case of large and asymmetric shocks. We have argued that, if the rules of both institutions are respected, there is no trade-off between stabilisation and market discipline. To the contrary, our proposed insurance mechanism and sovereign insolvency procedure mutually reinforce each other. A stabilisation mechanism such as a common unemployment insurance system would simplify the transition towards the new regime with an orderly sovereign insolvency procedure by supporting member states in times of economic distress. At the same time, the sovereign insolvency procedure would increase the acceptability of an automatic fiscal stabiliser at the central level as it would ensure that such a mechanism cannot easily be transformed into a system of permanent transfers.

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