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# Reforming the Euro Pragmatically: Towards Sustainable Fiscal Policy and a Revamped Eurosystem

*Heikki Oksanen*

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Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 (0)89 2180-2740, Telefax +49 (0)89 2180-17845, email office@cesifo.de
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# Reforming the Euro Pragmatically:
## Towards Sustainable Fiscal Policy and a Revamped Eurosystem


## Abstract

The conflicting standpoints on reforming the euro are creating more controversies than practical results. Mistrust between the participants led to short-sighted fiscal discipline that has amplified the economic disturbances. Expert analysis on the proposed reforms is often deficient as the potential of conducting policies under the existing institutional features is not adequately analysed. This shortcoming notably concerns the functions of the Eurosystem. In the present article, reforming the euro successfully calls for a convincing high-level commitment to preserve the euro also in unexpected circumstances and pragmatic improvements in its key functions. In fiscal policy the focus should be shifted to long-term sustainability. The tasks of the Eurosystem to promote the smooth operation of the payment systems at all times and to function as the lender of last resort to solvent governments should be confirmed. Adequate smoothing of short-term asymmetric shocks can be based on the automatic stabilisers in national budgets, possibly accompanied by a specific mechanism with a clause to strictly prevent permanent transfers. Public finances should be directed to mitigating climate change and saving energy. The EU should take a leading role globally in meeting these long-term challenges.


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*Heikki Oksanen*
*University of Helsinki / Finland*
*hkk.oksanen@gmail.com*

**The cut-off date** for the material referred to was 17 October 2019.
I am grateful for the opportunity to have discussed this work at various conferences over the past 12 months and privately with several colleagues. This paper is a newly written assessment of reforming the euro, referring to debate articles and official documents until June 2019. I want to thank John Rogers for excellent editorial assistance. I take sole responsibility for any remaining deficiencies or errors.

Heikki Oksanen

# Reforming the Euro Pragmatically:
## towards sustainable fiscal policy and a revamped Eurosystem

**Contents**

## 1. *Introduction*

Numerous proposals for reforming the euro have been presented since 2012 when the survival of the euro was seriously questioned, eliminated only by a bold statement of the European Central Bank Governor Mario Draghi in July 2012 *'to do whatever it takes'*.

Some progress has been achieved (in the banking union), but the reform process is still dragging on and the ambiance is low. The reasons are many, including the handling of Brexit and migration from outside and inside the EU and the attacks of various populist political movements on the euro and the policies associated with it.

On 15 June 2019 the Eurogroup (finance ministers of the euro states, endorsed on 21 June by the Euro Summit of the corresponding heads of states and governments) made some progress, but many initiatives were left for further preparation (Council of the EU, 2019a). Most participants and observers stayed disappointed, among them the group of 7+7 French and German economists who in January 2018 published a report on their joint proposals **(**Bénassy-Quéré et al., 2018). Their key proposals encountered strong criticism by some colleagues, asserting that that some of them were dangerous and could lead to a self-fulfilling financial crisis (Messori and Micossi, 2018; De Grauwe and Ji, 2018; Claeys, 2018; Cohen-Setton and Vallee, 2018; and notably Tabellini, 2018).

Further on, their proposals got cold water at the highest political level of their respective countries on 19 June 2018 when Chancellor Angela Merkel successfully resisted the ambitions of President Emmanuel Macron, and their joint Meseberg Declaration (2018) effectively set the proposals aside or put them on hold. As explained by Pisani-Ferry (2018) the 7+7 Group was greatly disappointed, particularly because they had tried to find compromise solutions acceptable to the two largest euro member states and tolerable for the rest.

In May 2019, obviously anticipating the poor results from the Eurogroup in June, the 7+7 Group repeated their main views and expressed their disappointment on no progress at the political level (Bénassy-Quéré et al., 2019).

The stalemate to a great extent stems from confusing controversies among the politicians (and their advisers). However, also the academic economists as a profession should exercise some self-criticism. Their analysis should duly cover all relevant elements and views in the previous literature. They should also admit that a monetary union is an institution established by a political decision based not only on economic arguments, and its functioning requires a continuous commitment at the highest political level. Pure economic arguments are important but not sufficient for assessing all the relevant factors. Economists should understand that their duty is to produce a large set of well analysed options with the spirit that it is for the political machinery to take the decisions, based also on assessment of non-economic factors.

Pisani-Ferry and Zettelmeyer (2019a) provided a timely service for the debate in June 2019, just when the Eurogroup had its disappointing meeting, by publishing a CEPR eBook of 31 articles selected from more than 40 responses to Bénassy-Quéré et al. (2018), complemented by a short summary by Pisani-Ferry and Zettelmeyer (2019b), notably with a list of the remaining disputes. The eBook, supplemented with a few articles that are not included in it, provides a comprehensive compilation of the state of the euro reform debate until June 2019, including also criticism of the 7+7 Group proposals. We shall benefit from this for what the debate contained but most usefully also for showing that surprisingly many elements which can be regarded compulsory for fruitful analysis and policy advice are missing.

The purpose of the present paper is to provide historical background for the open issues and to try and cover all relevant policy areas as they are always interlinked and require comprehensive coverage. Some of the comments aim to be provocative openings of unchartered issues for further investigation and debate.

After the main content of the present paper was written a heated controversy broke out when the Eurosystem in September 2019 decided to intensify and continue its expansionary monetary policy. The disagreements in the broad public proved the necessity of analysing the reforms to the euro carefully and calmly along the lines to be presented here.

***The approach***

The overarching themes in the present article are (1) the political factors behind the euro, (2) mistrust between the member states whether all the participants are willing and capable of conducting sound fiscal policies, which led to the simple short-righted fiscal rules, (3) several proposals that are presented as indispensable are unfruitful and even harmful as they would require changes to the EU Treaty and therefore would be completely unrealistic, and (4) a skilful analysis requires that the potential of the existing institutions, mechanisms and rules are analysed in full before claiming that some proposed new elements are indispensable; notably the functions of the Eurosystem are often ignored.

The present article is optimistic: as implied by its title, the euro reformed along the pragmatic lines discussed here can well survive and serve reasonably well the Europeans and the rest of the world, while dismantling the euro and going back to national currencies is far worse both economically and politically. Admittedly, proving this view fully convincingly cannot be done by any method due to the complexity of the issues, entailing both political and economic factors in an unknown future.

***Outline***

Section 2 argues that the origin of the short-sighted and procyclical fiscal policy is the deep mistrust between the member states: they do not trust that all are willing and capable of conducting sound fiscal policies. A brief history of the Stability and Growth Pact (SGP) is followed by some comments on the crisis with Greece since 2010.

Section 3 discusses the various problems with shifting the focus to long-term sustainability, which is necessary to allow short-term flexibility. From this a gloomy picture appears.

Section 4 presents a basis for a silver lining referring to the key role of the European Central Bank (ECB). The Eurosystem manages the payments between the national central banks (Target2) and has launched various new monetary policy operations since the declaration of Mario Draghi in July 2012 that within its mandate, *'the ECB is ready to do whatever it takes to preserve the euro'*.

Section 5, the core of the present paper, discusses how focussing on the fiscal sustainability of public finances in the long term should clarify solvency of the sovereigns, giving the basis for the Eurosystem to act as the lender of last resort to solvent governments. Pragmatic improvements in policies are discussed, albeit not indicating that a silver bullet is found. For advancing the debate, several euro area reform proposals presented recently are assessed critically. Finally, the vision of sustainable public finances in the long term is linked to tangible long-term issues of mitigating climate change and saving energy as a policy area where the EU could take a leading role globally.

Section 6 criticises the proposals for a significantly larger EU/euro area budget as both politically unrealistic and economically unproven and continues with assessing the various proposals aimed at smoothing short-term asymmetric shocks without requiring a large budget and permanent redistribution.

Section 7 gives a summary and conclusions, referring to its title: reforming the euro pragmatically is sufficient for its endurance and this can be based on shifting the focus from short-sighted fiscal policy to long-term sustainability and ensuring that the Eurosystem can play the true role of a central bank.

## 2. *The origins of the short-sighted rules*

***From the fall of the Berlin wall to the prolonged depression of 2012-13***

The purpose of the fiscal rules originally stipulated in the Maastricht Treaty (agreed in December 1991) was to ensure the smooth functioning of the single currency. The famous reference values for deficit and debt were set *'in view of identifying gross errors'* (TFEU 126), with the purpose of giving recommendations to correct them. However, '*identifying gross errors'* and recognising also the various other criteria in the same paragraph would not necessarily have led to short-sighted rules and procyclical policies. Instead, it was suspicion and mistrust prevailing among the prospective members in the currency union that led to the short-sighted rules set in the Stability and Growth Pact (SGP) of 1997.

The SGP became inevitable to alleviate the suspicion in Germany that the euro about to be launched in 1999 was not yet sufficiently strongly anchored via fiscal discipline in all prospective member states. This suspicion goes back to the political nature of establishing a monetary union for the EU. The roots go even further back, but autumn 1989 was decisive. President Francois Mitterrand linked acceptance of German reunification to Germany's commitment to join the currency union as outlined in the Delors report in April 1989. Chancellor Helmut Kohl accepted this in the Strasbourg European Council in December 1989, after the fall of the Berlin wall on 9 November had created the momentum for German reunification. He later told that the hard negotiations were one of his darkest moments (Der Spiegel, 1998), and that joining the euro would not have won support in a referendum in Germany (Vasagar, 2013).

The German constitutional court ruled in October 1993 that ratification of the Maastricht Treaty in Germany was acceptable provided that the currency union respects stringent fiscal and monetary policies (Tuori and Tuori, 2014, 200).

This is the historical background for the strict time schedule for correcting excessive deficits set in the SGP in 1997. The implied short-sightedness then led to the procyclicality.

Short-sightedness was strongly demonstrated in the so-called SGP crisis in 2003. This crisis did not happen due to joint violation of the rules by Germany and France as is commonly contended. True, France did not want to obey the rules, but Germany's case was different. Gerhard Schröder's Germany had implemented the previously given recommendations, but new adverse factors impeded attaining the deficit target. It wanted the previous recommendations to be revised and more time to consolidate. However, the European Commission (EC) and some member states maintained that giving more time was illegal. This interpretation turned out to be legally erroneous as the EU Court of Justice (ECJ) later ruled that the EC could indeed have tabled a proposal for revising the previously given recommendations (Court of Justice of the EU, 2004, paragraph 92).[1]

This careful reading of the ECJ ruling has been presented in the literature (Beetsma and Oksanen, 2008, 565; Heipertz and Verdun, 2010, 2, 128-162), but the other narrative that Germany, jointly with France, violated the rules is still constantly repeated as it has been a politically more suitable story to be told.[2]

This episode with the fiscal rules, especially as misleading interpretations still cause confusion and conflicts, exhibits weaknesses in the management of the euro. On balance, a positive outcome was that the SGP was revised in 2005, notably making it explicit that the stages under the SGP can be repeated, the recommendations revised and deadlines for correcting excessive deficits extended if unexpected adverse economic events occur.

When, only three years later the crash erupted, calling it here the Great Crunch 2008-09 following Cassidy (2010), the revision of the rules probably helped to facilitate acceptance of significant increases in deficits. This flexibility in 2009 then remained the only significant exception to the procyclicality of fiscal policy in the euro area in general, while having been especially pronounced in the high debt countries (Carnot and de Castro, 2015a, Annex 2, and 2015b; European Commission, 2019b, 121-130; European Fiscal Board, 2019, 25-62).

All the new rules since the crisis have not led to fundamental improvements. Instead, the diversity of circumstances and differences among member states has led to their overkill complexity (so that also the European Commission, 2017, 12, calls for substantial simplification, although only by 2025).

The policies in the recent past provide ample material for reconsideration. Several experts (Baldwin and Giavazzi, 2015; Bayoumi, 2017, 233, 244-245) question whether the degree of fiscal tightness during the sovereign debt crisis 2011-13 was appropriate in terms of benefits and costs. Fatás and Summers (2018) even conclude that no benefits were reached as fiscal

1 One did not have to be a professor of economics to say that the SGP rules are stupid, as did Romano Prodi in October 2002 (Heipertz and Verdun, 2010, 135). Embarrassingly, in November 2003, Prodi as the EC president had to endorse the strict interpretation of the SGP with respect to Germany that then turned out to be legally unfounded.

2 The dominating narrative of the 2003 SGP crisis constantly also appears in scholarly texts, e.g. by Tooze (2018, 94 and 101), Brunnermeier, James and Landau (2016, 136 and 146-7) and King (2016, 236). Mody (2018, 199-202) covers well the conflicting arguments at the time in 2003. - Very few academics in addition to the 2+2 authors cited above seem to have read and understood the ECJ ruling of 2004, including its paragraph 92. It is true that the ECJ annulled the recommendations given by the Council to Germany and France in November 2003, but the reason was procedural: those recommendations were not preceded by proposals from the Commission as the latter refused to put them on the table. Had the Commission done so, the Council could have acted legally correctly. Also, had the Council not adopted any recommendations to Germany and France at all, but only tacitly held the procedure in abeyance, no legal mistake would have occurred (Court of Justice of the EU, 2004, paragraphs 90-97).

consolidation as executed was self-defeating and rather increased the debt burden.[3] Although the various authors may differ on the details it is fair to say that there is now a wide consensus that tight fiscal policy in the euro area in 2011-13 was unduly harmful.[4]

***Greece as a special case***

Since the problem with Greece erupted in 2010 it has been presented as a case for implementing the fiscal rules firmly, with the accusation that Greece had cheated on its public finance statistics since it adopted the euro. This narrative is only at most half true and a prejudiced identification of the origins of the Greek crisis can fuel further mistakes.

It was not Greece who decided about its membership in the euro area, but rather it was the initial members and the EC who did so. Olli Rehn (2012, 37) as the vice-president of the EC has noted (in his book in Finnish) that an unnamed finance minister told him that in 2000 when the Council unanimously welcomed Greece to the euro area they knew that it did not satisfy the criteria. It remains open whether this will be confirmed from the archives, but what we know is that the Council took its decision on the basis of the convergence reports from the EC and the European Central Bank, ECB). Also, Valéry Giscard d'Estaing later stated that, in particular, the French government insisted on it (while he himself was against it; EurActiv.com, 23 February 2015). France obviously wanted to strengthen the Mediterranean bloc.

Based on this, the collective responsibility for the Greek crisis dates back to 2000, but the euro partners put the main blame on Greece referring to what Greece was doing closer to the year 2010 and provided financial support only under strict conditions (one member state, Finland, requiring special treatment for not blocking the support packages agreed by all others; European Stability Mechanism, 2019, 75, 150, 188, 292-3, 357). More generally, the deficient interpretations of the origins of the Greek crisis fuelled the arguments for fiscal austerity that contributed to the further fall in the GDP in 2012-13 in the euro area (see further discussion below).

According to Eichengreen and Wyplosz (2016, 241), acknowledgement of the collective responsibility at the eruption of the Greek crisis could have led to more efficient policies and the prolonged austerity could have been avoided. Admittedly, a balanced picture of the origin of the Greek crisis and how it was handled still remains to be synthesised. Next, we turn our

[3] Thus, they consider that the estimates for the fiscal multipliers underlying fiscal tightening were erroneous. We should note here that the observed decrease in deficit over the period 2011-2015 in the euro area (and elsewhere) does not disprove their conclusion. Instead, a plausible explanation is that other factors gradually turned supportive to growth and compensated for the negative effects of the fiscal consolidations; see also Blanchard and Leigh (2013).

[4] The official view at the time naturally was that consolidation – adherence to the fiscal rules – was both necessary and useful for preserving the euro. Later, also an official document of the European Commission (2016, 2) accepted that fiscal tightness contributed to the GDP fall in 2012-13, although it added that this was at least partly inevitable as '*many Member States engaged in fiscal consolidation to preserve their access to the markets at the height of the sovereign debt crisis*'. - This latter view is not the full picture. Baldwin and Giavazzi (2015, 47-48) showed that policy was strongly tightened also in countries that had access to the markets, with Germany's share of tightening being more than its relative share in the euro area. Romer and Romer (2019) show that in a large sample of countries it was rather the political choice to contain public debt than preserving access to markets that has led to fiscal tightening in recessions.

attention to more general problems with the benefits and costs of short-term fiscal discipline and how to shift the focus toward the health of the fiscal institutions in the long term.

## *3. Problems with shifting the focus to long-term sustainability*

Eliminating procyclical fiscal policies in cycles and maintaining the capacity to react in the event of a serious crisis, caused by common or asymmetric shocks, are keys for improving the euro.

For durable improvements it is, first, indispensable to recognise that the underlying reason for procyclicality is mistrust, which is leading to short-sightedness. Second, mistrust should be alleviated by assuring sustainability of public finances in the long term sufficiently convincingly – only then can flexibility in the short term be allowed. Several factors obstruct making progress here.

***Competence rests with the member states***

The policies that determine long-term sustainability are mostly in the competence of the member states. Confidence that the state will honour its debt depends on its capability to collect taxes. The level attainable in each situation, including a possible crisis, depends on the quality of the public institutions and the trust they have earned among the citizens.

Apart from taxes, fiscal sustainability depends on public expenditures and the foreseeable measures to keep them under a level that can be covered by revenues and a sustainable level of public debt. Also here, the most relevant policies are under national competence as, for example, they must tackle the pressures of population ageing on public expenditures and require reforms of the public pension systems and health-care financing. The dilemma for managing the euro area is that the governments are not in a position to assure that population ageing-related expenditures will be contained, the reason being that the required changes in policies can only be gradual, stretched over several electoral cycles. Therefore, the risk is that effective actions are delayed (as they are considered to be not urgent, and then they come too late) or that the policies, if triggered by a crisis, tend to be too short-sighted. It is not a coincident that the international institutions (the troika) had to force though drastic pension reforms in the crisis countries where reforms were delayed for too long, and then they might have been too harsh for some segments of the elderly population.

Yet, even under these dilemmas stemming from competence sharing between the member states and the EU institutions, assuring long-term sustainability of public finances has been on the agenda in the European welfare states, say, since the late 1980s. The pressure for further reforms is called for not only for the sake of the sustainability of public finances but also for maintaining the high level of social protection as a crisis in pension and health-care financing could easily trigger disorderly degradation.

For meeting the challenges, joint work on projecting the ageing-related public expenditures in the member states has been undertaken in the EU by the Ageing Working Group of the Economic Policy Committee since launching the euro.

***Problems with the MTOs***

The results of that work are currently used also for setting the medium-term objectives (MTOs) for budget balances, which should in principle be a link between the day-to-day management and long-term sustainability. Unfortunately, the derivation of the MTOs does not give sufficient attention to all relevant factors and policy options. The various reasons for this are understandable but require close attention for avoiding harmful consequences.

Under the rules as codified in the SGP *Vade Mecum* (European Commission, 2019c) the MTOs are built on the sustainability gap calculations which in turn are derived from the expenditure projections based on current policies regarding long-term expenditures. As the second step, when the increase in taxes (or cuts in non-ageing-related current expenditures) to close the sustainability gap looks higher than politically (and economically) acceptable, the MTOs are made less demanding by making an ad hoc adjustment.

This procedure is dubious and can unduly (and unnoticeably) limit the range of the relevant policy options. In most cases it would be more reasonable to move in a few steps: as the requirements for increasing government revenue in the medium term seem too demanding, the policy parameters determining the expenditures in the long term should be reviewed and proposals to change them made, and the medium-term objectives should be derived only from the expenditure projection so revised (Oksanen, 2016b, 383-387).

This sounds like common sense, but systematic monitoring along these lines has not been achieved in the EU, the main reason obviously being that the relevant policies are under national competence and producing options for reforming the pension and health-care systems in the member states is clearly beyond the capacity of the joint work of the experts in the EU committees. Political sensitivity about identifying the reform options prevents this, and also the institutions and political circumstances vary greatly. Therefore, no manageable joint work could fit them all.

Our conclusion is, therefore, that it is better to admit that fully reliable indicators for sound long-term policies are difficult to construct, and that, unfortunately, deficiencies in the current rules and procedures can narrow the scope of policy advice by excluding measures that could be advisable or even indispensable.

***Also other indicators are deficient***

More generally, for policy in both the short and long term a serious problem is that the statistical concepts underlying all the indicators used for policy design suffer from the failure of not making the distinction between government investment and consumption, and regarding the latter, expenditure on education is misleadingly recorded in the national accounts as current consumption although it aims at long-term investment in human capital.

It is also a serious issue that the fiscal indicators fail to treat reasonably the fully funded second pillar pension systems. As they are classified as part of the private sector in the national accounts even if being mandatory, their treatment distorts the current fiscal indicators (Beetsma and Oksanen 2008, 568-9). Under these accounting rules, reversals of pension reforms have taken place in some countries for improving the government balances, especially when the deficit targets became hard to attain (Bielawska, Chłoń-Domińczak and Stańko 2015, 9, 85-91). Linked to this deficiency the pension reserves in the public pension system (significant in Finland and in the mandatory pillar in the Netherlands) are poorly treated under the SGP rules, with the consequence that the policy options are not duly identified.

***Government structural balance is particularly dubious***

The structural balance in government budget has gained a pivotal role in the fiscal policy rules in the SGP *Vade Mecum* (European Commission, 2019c; the latest edition being cut to 95 pages, while in the previous editions presentations of the rules filled more than 200 pages). The purpose of defining and using it makes common sense: their purpose is to derive the underlying budget balance measure by eliminating from the observed (or forecast) budget balance its cyclical component as well as one-off and temporary components.

The cyclical components are non-observable, being derived by the experts based on the output gap (OG) estimates (see Mourre et al., 2014, for references). The OGs on their part are also non-observable, being defined as the relative difference between the observed or forecast GDP and the estimated reference level that is called ‘potential’ or ‘trend’ depending on the method used.

In spite of making sense in principle, the estimated structural balances are obscure for several reasons. The GDP reference level estimates are problematic and a heated controversy about them is now going on. Oksanen (2019 and 2018) discusses the nature of the alternative methods, concluding that none of them is clearly superior. He presents a new simple method for producing new Hodrick-Prescott (HP) trend GDP estimates that contain as a novel element an assumption/view/projection of the GDP in future, making it possible to insert a perception of a possible persistent change in the GDP level and growth into the estimate. Essentially, the new method offers a way to produce alternative scenarios which illustrate the genuine uncertainty of the GDP in future to be dealt with in policy design.

Oksanen (2019 and 2018) does not refute the potential GDP estimation methods used by the major policy making institutions (EC, OECD and IMF) as each of them can offer helpful results if used carefully. For correct understanding and use of all of them, old and new, he notes that all criticism regarding the OG estimates (and the structural balances derived from them) is not fully accurate as most often it is based on the regular and significant retroactive corrections of the OG estimates for any given year and this is considered to make them unreliable.

Oksanen (2019; 2018) argues, however, that the retroactive changes are only natural as the cyclical phase at any point in time should always be reassessed depending on what happened after the event. This naturally produces retroactive changes in the OG estimates compiled by any method.

The problem with the OGs is rather that there is no well-defined, objective and practical method to estimate the reference level for the GDP (‘potential’ or ‘trend’) in real time or afterwards. The alternative methods give alternative results and there is no clear way to judge which one is best. As the differences between them lead to significantly different policy recommendations, the conclusion can only be that all interpretations should be prudent.

Having assessed the meaning of the retroactive changes in the OGs (causing changes in the structural balances estimates), Oksanen (2019 and 2018) considers it as a more serious problem that the estimates of the cyclical and structural components in government budgets ignore the effects of changes in fiscal policy on the GDP and via that to the measured OGs, which are then used to measure the cyclical component. Thus, the loop from fiscal policy to the GDP and further to the OG is missing. This is a serious ambiguity in the analytical work of the experts. This is surprising as the existence of this loop is a core part of conventional economics.

The problems with the OGs and the structural balances derived from them is not a minute problem concerning only the technical work of the experts but rather a major problem with the fiscal rules of the EU, where they have become a centre piece, triggering the launching of the disciplinary excessive deficit procedures. Forceful criticism on this state of the rules has been levied by a number of experts, referring to the ambiguity of the OG and structural balance estimates (for example recent Bruegel Bloc Posts by Efstathiou (2019) and Zsolt (2019), quoting e.g. Tooze, 2019, who calls output gaps nonsense, see section 6 below.).

***Limited mandate of the government and EU officials***

The experts working for the governments and EU institutions – and the academics analysing their work – should keep in mind that their base line scenarios and forecasts normally assume no change in policy, defined in one way or another. The logical consequence is that a number of policy options and the projections based on them should be constructed, but most often this is not done. Although sensitivity tests are often produced, their coverage remains limited notably with regard to the policy options. It is not the role and mandate of, for example, the EU Commission experts to speculate what changes in policies in the EU member states would be relevant to be considered.

***A gloomy picture appears***

What is clear is that the mistrust regarding the willingness and ability of all euro member states to ensure sound public finances first led to short-sighted fiscal rules that did not work. New layers were added, and the rule book became so obscure that any finance ministers trying to explain the policy line based on it in front of their parliaments would fail.

This picture is gloomy as removing all these deficiencies and shifting from short-sightedness to strengthening long-term health of the economies will not be easy. Here, certain functions of the Eurosystem that have been virtually ignored in the debate become utmost important. Bringing this link to designing the reform plans is the next topic.

## *4. Key role of the central bank*

All reform proposals should be based on a solid analysis of what already works in the euro system. Certain reform proposals become void if it is recognised that the European Central Bank (ECB) and the Eurosystem (composed of the ECB and the national central banks in the euro area) are already fulfilling their intended purposes and that only limited enhancements are required for the Eurosystem to perform its proper role as a central bank.

A decisive turning point over the troubled years was the statement of ECB Governor Mario Draghi in London on 26 July 2012 that *'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro – and believe me, it will be enough'*. It was partly improvised, provoked by the euro-sceptic remarks of the Bank of England Governor Mervyn King, who chaired the meeting with hedge fund managers and others from the financial world. Draghi's statement immediately calmed the markets, and in September it was followed by formalising the new role of the ECB as a conditional lender of last resort in provisions entitled ‘Outright Monetary Transactions’, OMT (Tooze, 2018, 437-441, King, 2016, 227-8).[5]

***Target2***

In addition, the ECB/Eurosystem has an important role in distributing liquidity in the euro area (partly also beyond it) through its Target2 mechanism of claims and liabilities of euro area national central banks vis-à-vis the ECB resulting from cross-border payments settled in central bank money (European Central Bank, 2017; Cœuré, 2019).

It is important to understand that the financial flows and stocks under Target2 are not lending from one member state government to another. Instead, the increase in the positive and negative balances in 2008-2013 resulted mainly from the flight of capital from the southern euro area seeking safe havens at the banks in the north. A significant part of this shift was attributable to institutions residing outside the euro area settling these transactions with the banks in the euro area financial centres (European Central Bank, 2017, 22-23). These liquidity flows surged to the respective northern central banks and thereby increased their Target2 claims, while in turn the Target2 liabilities of the southern central banks simultaneously increased, allowing them to provide liquidity and financing to the financial institutions in their countries and via them to their governments (Minenna, 2017).

Since late 2014 the Target2 balances received a new impulse from the various asset purchase programmes (APPs) conducted by the Eurosystem as most of these purchases entail immediate cross-border payments and, interestingly, a large part of them have involved counterparties outside the euro area. Importantly, conducting these asset purchases the Eurosystem implements monetary policy, and the movements in the Target2 balances are an expression of its equally important task to promote smooth operation of the payment systems. These are basic tasks of the Eurosystem as provided in the EU Treaty (TFEU 127.2), and they are conducted under its independence to determine its policy instruments.

Over the recent years the Target2 stocks and flows have been far greater than financing via the special arrangements and the newly created special institution, European Stability Mechanism (ESM). According to the latest data (August 2019), the positive balance of Germany is about 25 % of its GDP, and the negative balances for Spain and Italy above and below 30 % of their GDP, respectively. These balances do not represent stocks of lending and borrowing between countries nor governments, which should be made clear to everybody, especially to the politicians. This point is perhaps best demonstrated by the mere fact that the positive balance of the central bank of Luxembourg is currently (August 2019) more than 300 % of its GDP: private money found a safe haven there.

While the Target2 mechanism seems to be entirely ignored in the more than 40 contributions to the VoxEU debate, its role has been forcefully put into question elsewhere by a few members of the economics profession. Ignoring this is not appropriate as in the worst case those negative views can cause an augmented political pressure to restrict the Target2 flows and this could have disastrous consequences for the euro.

[5] The legality of the OMT was upheld by the Court of Justice of the EU (2015a and b) as it declared that it is compatible with EU law. Interestingly, the OMT has not been activated so far as its sheer existence has been sufficient for restoring ‘the monetary policy transmission mechanism’ by providing confidence in the stability of the euro.

Sinn and Wollmerhäuser (2012) were the first to challenge the role of Target2, raising the fear that the northern states would suffer from defaults of the Target2 debts by the southerners. This was not entirely correct as an event of one member defaulting its Target2 debt would cause a loss to the entire Eurosystem shared by all remaining members according to the capital key but not only by the Target2 creditors.

Recently, Homburg (2019, 11-14) retains the risk of losses for the Target2 creditors by arguing that the mechanism encourages the Target2 debtors to leave the euro and default their debt and, importantly, that they have a 1st-mover advantage to do so, while the creditors are bound to be cautious and refrain from leaving the euro as they would risk losing their Target2 claims. This seems to imply that the northern members should aim at restricting the Target2 claims and debts before it becomes too late.

However, Homburg's argument about the first mover advantage for the debtors is not fully valid, first and foremost because defaulting the Target2 debts would obviously lead to exclusion of the respective government from access to credit on all European and global financial markets. In this turmoil, alongside with possible partial defaults, their financing costs would increase dramatically. As their financing needs are large, they would consequently suffer a high cost, easily much higher than the original (attempted) gain from defaulting the Target2 debt. And as their private sector would also suffer seriously, this would cause a collapse of the tax revenues of the government and hence a further breakdown.

Homburg (2019) refers especially to Italy, citing the threat of the populist government minister, now ex-minister, blackmailing the northern euro area members. Such populist statements may have been presented, but they have ceased as it is now broadly understood how badly the exit from the euro would hurt Italy.

A carefully analysis of Target2 balances taking into account both political and economic aspects is called for as the Eurosystem must have the mandate to settle the transactions across the board. Here, it is useful to remember a precedent which highlights the importance of a convincing commitment at the highest political level to authorise the relevant institutions to fulfil their tasks.

When the new institution, the euro, was about to be launched the issue was that the decision to start the monetary union had to be taken in May 1998, but the currency conversion rates were to be formally determined only on the 31st of December. In the preparations in 1997-98 it was not obvious how exactly it would be possible to avoid speculation and disturbances between these two dates.

Solid economic analysis helped here. De Grauwe and Spaventa (1997) presented the resolution which was then followed by the three EU institutions (Council, ECB and Commission) on the 2nd of May 1998. It was to announce the parity grid (based on the prevailing exchange rates), and the central banks of the member states adopting the euro committed to *'ensure through appropriate market techniques that on 31 December 1998 the market exchange rates'* will coincide with them (European Central Bank, 1998). The *'appropriate market techniques'* meant unlimited interventions if needed. Consequently, no interventions were needed as the declared commitment convinced all players and there was no uncertainty on the market of the conversion rates to be valid on 1st of January 1999.

In a way, Mario Draghi's *'whatever it takes'* statement in London on 26 July 2012 (above) was a similar commitment that turned out to be credible enough.

Target2 requires a similar convincing commitment. The euro can function only under a clear commitment that the euro area central banks will accept any transactions irrespective of the Target2 balances possibly accumulating in one direction or another. Those transactions result from the balance of payments flows, be they buying and selling goods and services or flows of capital. If their clearing by the national central bank had been restricted artificially by limiting the Target2 balances under the fear of a collapse of the euro as the monetary union or for any other reason, this would have already happened.

***The Eurosystem has a large balance sheet***

The Eurosystem has performed its responsibilities in providing liquidity for the euro area as a whole (targeted longer-term refinancing operations, TLTROs and asset purchase programmes, APPs) and distributed it via Target2 to places where it is needed. These operations have enlarged the Eurosystem's balance sheet to currently about 40% of the GDP, while for the US Federal Reserve it is 20% of the US GDP. The large volume reflects not only the greater need for quantitative easing in the euro area as the second fall in its GDP occurred in 2012-13, but also the fragmentation of the financial system in the euro area: as the private financial sector, including institutions outside the euro area, reallocated its credit and financing from the south to the north, the Eurosystem had to step in to dampen the effects of the abrupt transferral.

The EU Court of Justice has confirmed that the extended operations of the Eurosystem, including the OMT, are compatible with the EU legislation (Court of Justice of the EU, 2015a and b). Rightly so as those functions are indispensable for any monetary union to function properly and in the euro area the conditions became even more demanding than in the US.

## 5. *Fiscal sustainability combined with a revamped Eurosystem*

Shifting the focus from short-sighted fiscal rules to genuine long-term sustainability (section 3) and expanding and clarifying the role of the Eurosystem (section 4) now emerge as the twin elements for reforming the euro. In the debate on reforming the euro only little attention has been paid to their intimate links.

The interventions by Claeys (2018) and Cohen-Setton and Vallee (2018) are refreshing exceptions. Referring to the principles of central banking, they emphasise that the lender of last resort function of the Eurosystem should not be unduly restricted by the euro area fiscal rules. This leads them to be critical of Bénassy-Quéré et al. (2018) for not covering the monetary realm properly.

The mandate and commitment of the Eurosystem to act as the lender of last resort to solvent financial institutions and governments is essential as otherwise a liquidity crisis would make them insolvent, leading to a general economic crash (as happened in autumn 2008). The crux of the matter is naturally that all key players should agree sufficiently clearly what solvency means.

Restricting the functions of the Eurosystem as a lender of last resort vis-á-vis the solvent governments to be strictly conditional on their status under the SGP procedures has no economically valid basis. This would mean that being under the excessive deficit procedure (EDP) would indicate that a member state has lost its ability to honour its debts in the long term. How come? As the declared purpose of the EDP is to get the excessive deficit corrected, how could it make sense to judge that they systematically fail to achieve this objective? Such conditionality would effectively be an additional punishment towards a member state that falls under the EDP. This hardly was the original purpose of the EDP as agreed in Maastricht in December 1991.

Neither the EDP nor the preventive arm of the SGP gives an economically reasoned criterion for sustainability. Even though this term is extensively used to describe the purpose of the fiscal rules, the assessments are in practice unduly narrowed to at most the medium term (European Fiscal Board, 2019, 25-50). The MTOs suffer from the numerous deficiencies discussed above, and the medium term is in any case not long enough for assessing solvency in the long term.

The SGP sustainability indicators (sustainability gap, the S2) used in several ways, including deriving the MTOs, suffer from several deficiencies. First, the initial values for the key variables are set by removing the cyclical components, which as such is correct, but as the estimates for the OGs and for the structural balances derived from them are dubious (as argued above), the initial conditions for the long-term projections become questionable.

Secondly and substantively seriously, the sustainability gap indicators (S2) are derived from the expenditure projections which are based on the pension programmes and the policies determining the health-care expenditures etc. that are currently in force. This gives a base line, a description of the starting position, which can be useful if correctly understood. However, being based on the current policy rules and programmes makes this indicator inadequate for assessing the solvency of governments. The reason is simply that those programmes may change and normally do so. An objective assessment of solvency should incorporate a view how the policies can be expected to change in predicted and unpredicted circumstances. Policy options are naturally produced for policy design in governments and other institutions, but the experts working in the EU institutions and in the various EU committees do not have a mandate to speculate broadly on the behaviour of the political decision makers.

Contrasting this limitation in the work of the experts, the Eurosystem as a central bank should have a mandate to assess the solvency of the governments on a much broader basis than the simplistic measures based on the SGP rules. As said above, defining and measuring the solvency of an agent is a much broader issue.

What this means in practice is a demanding question, but there is no way to escape it. As the lender of last resort the central bank must have the mandate to lend to solvent governments. This basic principle has been brought into the debate by many. De Grauwe (2011a and b) wrote in August 2011 that *'only a more active ECB can solve the euro crisis'* and in October 2011 Martin Wolf (2011) published an open letter to Mario Draghi arguing that the ECB must be a lender of last resort in markets for public debt, thereby also stabilising the banks. He concluded that the European Financial Stability Facility set up at the time cannot stop the risks of a tidal wave of fiscal and banking crises, but only the ECB can do it. *'As the sole eurozone-wide institution, [the ECB] has the responsibility. It also has the power',* Wolf wrote (reminding about this again on 11 June 2019, Wolf, 2019b).

More recently, De Grauwe and Ji (2018) argue that the OMT programme of the ECB will not be adequate to provide liquidity in the sovereign bond markets because *'[it] is loaded with austerity conditions, which will be counterproductive ... during recessions'*. Basically, they assert that solvency came to be defined as compliance with the numerous shortcomings of the euro area fiscal rules.

The critical issue of defining solvency as the condition to have access to the lender of last resort window of the Eurosystem is still open and requires careful analysis.

It is fair to admit that it is easier to say how solvency of the sovereigns should not be defined and measured (in order not to make precautionary financing too restrictive) than to offer a generally applicable operational definition.

Another key question is who should be in the position to make the judgement. Here we come to the remarks above on the key role of the Eurosystem. Following De Grauwe (2011a and b) and Wolf (2011) quoted above, it should be emphasised that the European Central Bank/Eurosystem is according to the EU Treaty an institution for performing independently the tasks trusted to it. It has now become clear and accepted that safeguarding the stability of the financial system is its core duty.

There are those who want, flavoured by suspicion and mistrust, to refrain from opening a too easy financing window for the governments, and those who consider that the mandate of the Eurosystem to act as the lender of last resort to solvent governments should not be unduly restricted. Strong tension between these opposite camps remains.

This tension appears in the plans for enlarging the functions of the European Stability Mechanism (ESM) in a way that should not be ignored (for its extensive history see European Stability Mechanism, 2019). An agreement on the draft for revising the Treaty on the ESM was reached at the Eurogroup finance ministers' meeting in June 2019. The 'precautionary conditioned credit line' is to be created for providing financial assistance to ESM members conditional on a list of EDP/SGP criteria, while a parallel line will become available for the members that do not fulfil them all but whose government debt is judged to be sustainable. This judgement will be decisive, and the Eurogroup was informed on the methodological work on the Debt Sustainability Assessment (DSA) to be finalised by December 2019 (Council of the EU, 2019a).

Expert work has been undertaken for some time (European Commission, 2014; Bouabdallah et al., 2017; Checherita-Westphal, 2018; and the Fiscal Sustainability Report 2018 of the European Commission, 2019a). The framework for DSA assessments, which are also used elsewhere for example by the IMF, is partly similar to assessing long-term sustainability of government finances discussed above, except that the DSA is geared more toward the debt. The time horizon of the projections is normally 10-15 years, i.e. shorter than for the public expenditure projections used for the sustainability indicators.

The results of the preparatory work and their adoption by the Eurogroup will have significant effects on ESM lending to governments, especially as they can be expected to influence parallel financial operations more broadly. It should therefore be noted that the DSA criteria will partly be liable to the same type of issues as the sustainability indicators discussed above. The substantive problem is that the policies (and the changes in them) should crucially affect any reasonable outcome for the DSA, but covering an adequate set of policy scenarios in future circumstances goes well beyond normally undertaken technical work. True, this conundrum is mentioned in the DSA guidelines under the criteria for the governance and political risk indicators. This is a helpful reminder of the issue but in practise leaves the final judgement to the political level. This should be acceptable, but if there is no capacity to deal with it, the outcome might depend on an unduly narrow definition of solvency.

Leaving the possible new DSA criteria aside, compliance with the EDP/SGP criteria will affect these planned ESM operations and also other factors may keep it limited. Already earlier, in the VoxEU debate, Vihriälä (2018), considering that liquidity of solvent member states is more important than fiscal stabilisation, called for increasing the size of the ESM window adequately and pondered about giving the ESM access to central bank liquidity to finance precautionary financial assistance to governments. Here, the question arises why this financing from the Eurosystem should be directed via the ESM and not directly from the lender of last resort window of the Eurosystem.

***How to define solvency?***

All this points to the question of how to define and measure solvency of the sovereigns. Basically, it should mean sustainability of public finances in the long term, based on the projections of the key economic factors and, importantly, the changes in policies that can be reasonably expected. Although there is never a full answer, the independent experts in academia and research institutions should provide analysis and arguments, especially pointing out aspects that are or threaten to be ignored.

We turn next to some issues that need open debate, providing both suggestions for extended analysis and critical remarks on various euro area reform proposals.

***Population ageing and retirement schemes***

It is a consensual view that the rising population ageing-related expenditures are the main challenge for long-term sustainability of public finances, and as noted above, joint work on it by the EU and government experts has been undertaken already since establishing the euro. The critical remark here is that uncertainty and narrowness of the projections are not acknowledged clearly enough when using the results at the EU level and in national administrations.

Pensions can be projected relatively accurately, based on the population projection of the statistical experts and the prevailing policy rules, but there is much more uncertainty in projecting the health care and long-term care expenditures. There is also unclarity as to how the question should be the specified. It is analytically not sufficient to project only the effect of population ageing on those expenditures (as is often done), but it is necessary to recognise that also other factors may well propel those expenditures. One indication of this is that the significant increases in health care expenditures in the past cannot be easily explained by population ageing alone. How would the trends in these other factors moderate significantly in future?

It may sound paradoxical, but medical advancements may tend to increase rather than decrease the expenditures as new treatments become available and neutralise the cost-saving innovations. And of course, medical advancements themselves support the increase in life expectancy, which the demographers and statisticians naturally try to incorporate in their projections. Although medical advancements may not moderate the expenditure trends, they generally improve the quality of life. But we also need to emphasise that the projections on the increase in health care expenditures of both the governments and private citizens, should take into account all factors and not only population ageing.

This leads to challenging the common view that it is sufficient to increase the old age retirement age so that the current ratio between participation in employment and time in retirement would be maintained. This may not be sufficient especially as the health care expenditures may increase more than proportionally. Also, a more significant increase in the old age retirement age probably has the positive effect that the participation rates in age groups well below retirement age increase. The argument here is that the expected time of moving to retirement obviously starts to affect the incentives of the employees to undergo training and of the employers to hire and train their employees already much earlier, maybe 10-15 years ahead.

The 2018 Ageing Report presents estimates based on the current rules that the duration of retirement as a share of average working career is still increasing in most countries (with some exceptions for women depending on the employment status of women more generally, and for the countries where retirement age is linked to life expectancy; European Commission, 2018a, 59).

Despite the various arguments for increasing the old age retirement age more significantly than just for following life expectancy no significant progress is being made in the EU member states and it hardly appears on the agenda at the EU level. One reason obviously is that this policy area is clearly under the competence of the member states and any reforms should be based on the institutional arrangements in each of them – thus even an analytical framework that would fit them all is not easy to construct.[6]

The consequence is that setting uniform guidelines for pension policies at the EU level is practically impossible. As pension reform proposals everywhere tend to invite fierce opposition, often angry manifestations, careful political judgement in each country is needed to make any progress at all. Comprehensive advice to the politicians cannot be given here but we can only point out a general lesson: a significant increase in the retirement age can only find acceptance politically if the rights of the current retirees and those approaching retirement age are (broadly speaking) maintained and not mixed with the increases in old age retirement age for younger cohorts to take place in the more distant future; the increase can and should only take place gradually respecting the acquired pension rights (as reasonably interpreted), while making it understood that the currently active population will benefit from the reform in the form of lower pension contributions.

The link to the broad reform agenda is that decisions on increasing the old age retirement age, made in any context at the national level, affects the projected path of public debt and should therefore be taken into account in assessing the solvency of the sovereigns. It is likely that such pension reform programmes increase the government deficit and debt in the short and medium term and may therefore require flexibility in the fiscal rules.

[6] Oksanen (2016b, 386) discusses as an example the pension reform package in Finland agreed in 2014 and implemented in 2017 pointing out that in its preparation some estimates on the effect of an increase in the old age retirement age were biased downwards and therefore the positive effects underestimated. Also, the effects on the relative position of the different groups were deficiently analysed. – Reference to these aspects is made here to highlight the importance of solid expert analysis and the challenge of having a sufficiently detailed knowledge of the institutional circumstances in each country.

***Proposals for a joint liability and safe asset***

Bénassy-Quéré et al. (2018) made a number of proposals which to their great disappointment did not fly (Bénassy-Quéré et al., 2019). They proposed e.g. an orderly sovereign debt restructuring mechanism to revitalise the no bailout rule, creating a synthetic euro area safe asset backed by a standardised diversified portfolio of sovereign bonds with seniority status, limiting issuance of senior bonds by governments that do not comply with the 60 % of GDP debt ceiling, and creating a European deposit insurance scheme (EDIS) for preventing deposit runs in the weak member states.

Although the authors recognised that some of their proposals should be implemented gradually to avoid triggering a financial crisis in high debt countries, Messori and Micossi (2018), Micossi (2018) and Tabellini (2018) criticised the proposals fiercely, maintaining that this dangerous scenario is precisely what would occur. De Grauwe and Ji (2018) asserted that gradual implementation would not help as pushing the high debt governments to rely on junior bonds will in a recession, whenever later, set in motion panic reactions, and those governments would then fall into a self-fulfilling liquidity crisis. They warn that the proposed 'financial engineering' may create a false sense of stability despite being far from sufficient. For them, creating a genuine joint liability of the euro governments is necessary for the stability of the euro, but to their disillusionment, they conclude that such a further transfer of sovereignty is completely excluded politically.

This gives a gloomy picture for the euro. If we agree with De Grauwe and Ji (2018) and many others who consider that a joint liability is indispensable and at the same time politically unrealistic, should we then conclude that the euro should be dissolved?

This is a serious dilemma. The political masters agreed in Maastricht in December 1991 on a vision that the monetary union is viable without large-scale joint borrowing by the euro area governments, leaving each government strictly liable for its own debts (no bailout rule).

Taking this as given Bénassy-Quéré et al. (2018 and 2019) proposed the arrangement for the synthetic bond, gaining support from some others (European Systemic Risk Board, 2018, Lane and Langfield, 2018, and European Commission, 2018b, 34). However, they had to realise that in June 2018 the highest political level of France and Germany did not endorse these proposals but set them effectively aside or put them on hold (Meseberg Declaration, 2018).

So, a gloomy picture appears again.

***The Eurosystem already issues a joint liability and safe asset – to be expanded?***

A silver lining may appear from the unnecessary omission of the constructive role of the Eurosystem: the banks can already now deposit as much as they want at the ECB. Those deposits are obviously a safe asset, as safe as any asset backed jointly by the euro area member states can be, matching the US Treasury bills or any other US dollar assets.

The idea of expanding this function in the Eurosystem by issuing certificates of deposit (CDs) has already been mentioned in the financial press (Sandbu, 2019, and his related previous columns). They have existed in various forms, including those labelled 'debt certificates', which appeared in the Eurosystem balance sheet until 2003, being still today among the instruments at its disposal.

Currently the banks have access to the deposit facility of the Eurosystem. Making CDs issued by the ECB available also for non-banking financial institutions (pension funds, money market funds etc.) would make it possible for them to avoid the costs and risks associated with using banks as their intermediaries.

If and when the ECB issued such CDs, something needs to happen on the other side of its balance sheet. Its various asset purchase programmes (European Central Bank, 2019) would expand according to the needs of setting the monetary stance. Managing the two sides of the balance sheet of the Eurosystem is no rocket science, although sometimes it looks so when the terminology is unnecessarily confused. Sandbu (2019) notes that some of those worrying about creating a 'safe asset', which should refer to securities that are safe to be held by the investors, rather have in mind 'safe liabilities' in the meaning that it would be 'safe' for the governments to be able to borrow from the market. This confusing language should not be allowed to distort understanding the basic elements.

Making Eurosystem CDs available to the market would have several important implications. First, a most concrete direct effect would be that a significant part of the funds seeking safe haven would go to the ECB and not to the German banks and via them to the Target2 balance of the Bundesbank. Thus, some Germans would have to worry a little less about the Target2 balances.

Second, a safe euro asset would have important implications for the international role of the euro. Cœuré (2019) shows that euro's share is internationally, depending on the measure, about one third compared to the US dollar, and it has weakened since 2003. Also the role of the USD has weakened, but it is remarkable that it strengthened after the Lehman Brothers event in autumn 2008 as it was still considered strong and safe relative to other currencies. Cœuré (2019) considers that a safe euro asset would significantly change both the international role of the euro and various features of conducting monetary policy, without taking a position on how it should be created nor giving any hint to the possible issuing of CDs by the ECB.

Third, doing so would make void the arguments for issuing joint liabilities by the euro governments, or at least make them considerably weaker.[7]

Utilizing the Eurosystem's right to issue safe assets could have a greater potential to find acceptance than any arrangement between the governments. The Eurosystem is isolated from direct political pressure and not geared toward transfers (although losses can always occur). The necessary legal elements are most probably already at place. The CDs could be issued, and the asset purchase programmes (APPs) are already functioning.

Issues of the principles should not be great though the increased size of the operations would require practical solutions. If and when the APP operations expand, risk sharing between the national central banks in an event of a (partial) default of any issuer of those assets will be accentuated. Currently about one third of the APP assets are under shared risk. As the

[7] The other motivation of those who propose it is obviously to give leeway for the highly indebted governments, even if shifting some of their legacy debt to the others is an issue that is not openly discussed. The suspicion that it could happen, possibly unplanned as happened with Greece, obviously drives the minds of those who fear that joint liabilities could open a door to a 'transfer union'. Thus, unanimity can hardly be attained and the continued quarrels about this matter only keep the conflicts alive and derail attention away from other possibly constructive reforms.

collective action clauses in the assets acquired gradually become more common, risk sharing arrangements remain to be reviewed.

***European deposit insurance scheme - Target2 already mitigates the risk of bank runs***

One of the disappointments declared by Bénassy-Quéré et al. (2019) is that their proposal for the European deposit insurance scheme (EDIS) has not found sufficient support. The reason for scepticism or opposition comes from those who fear that it could develop into a channel of a massive transfers from the north to some of the southern members (Italy being the primary example), where the non-performing loans (NPLs) threaten the banks. Therefore, until the banks in all member states have been cleaned from excessive NPLs, the prospects for agreeing on the EDIS are meagre. But again here, we can see a silver lining coming from Target2.

First, if deposits flooded out of Italy, they would find a safe haven in the northern banks and appear as positive Target2 balances of the respective central banks. Italy's negative Target2 balances would increase, making it possible for the Italian banks not to cut their lending to Italian businesses abruptly. This increase in Target2 balances could be large.

Second, the outflow of deposits from Italy would remain smaller if the various parties believed that the ECB would provide the necessary liquidity to the Italian banks in case they needed it. Vice versa, if the financial markets believed that the Target2 balances will be restricted, a deposit run could cause, first, a collapse of the Italian banks and then the euro. Thus, a convincing commitment to maintain Target2 helps to avoid a bank run. And importantly, this lessens the arguments to create the EDIS too early, when both economic and political prerequisites are not yet there.

***An expenditure rule would solve the problems barely half-way***

Bénassy-Quéré et al. (2018, 9-11; 2019), among many others, consider that the SGP rules, especially regarding the use of structural balances, are problematic and a source of procyclicality and complexity. They propose replacing the focus on the structural deficit by a simple expenditure rule guided by a long-term debt reduction target. According to the authors, such a rule would help stabilise economic cycles, since cyclical changes in revenues would not need to be offset by changes in expenditures. Beetsma et al. (2018) develop it further, also with the objective of simplifying the rules.

Although the expenditure rule as outlined could alleviate procyclicality of fiscal rules, it does so only partially and leaves several issues open. Monitoring the total public expenditures confronts most of the same issues we discussed above.

Instead of helping in defining and measuring sustainability of the governments in the long term, the expenditure rule proposal seems to focus on the short and medium term, and there they would seem to bring some though limited improvement. However, the links to proper long-term aspects are lacking.

Potentially promisingly, Bénassy-Quéré et al. (2018, 10) mention in passing that the implicit liabilities in the public pension systems could be taken into account. However, what this would mean remains open. In which context is it sufficient to project them according to the prevailing pension system provisions (as is done in the base line calculations of the implicit liabilities)? In order to assess the solvency of the government in a useful way the prospects for changing those rules should also be judged. Who should do this and how?

The rule that public expenditure should grow at most at the rate of nominal GDP in the long term interferes with the sovereignty of the member states for determining the size of their general government. Pension reforms are only one example of policy areas where structural adjustments can affect the size of the government over long periods (and therefore the long-term growth of expenditures; in pensions basically over a generation).

Beetsma et al. (2018) explain as one of the several details to be taken into account that gross fixed investment of the government should be smoothed over four years, but again here, there is no clear link to more long-term investments and their contribution to growth.

More generally, although the expenditure rule would eliminate the serious shortcomings with the structural balances, the various exceptions and detailed corrections needed to make it economically reasonable would again lead to serious complexities. Implementing the possible sanctions on non-compliance would therefore easily lead to conflicts, augment mistrust among all the actors and leave the main problems unsolved.

***Secular stagnation, low interest rates, climate change and long-term public investment***

The need to define (and measure in quantitative terms) the solvency of the governments highlights an even more elementary problem of giving little or no weight to long-term public investment in the fiscal rules under the SGP as it is not duly distinguished from public consumption and transfers. This grave shortcoming is related to the recent new approaches among leading economists to fiscal policies and public debt under the new circumstances which might, evoked by the Great Crunch 2008-09, be turning into a secular stagnation and persistently low long-term interest rates.

Such circumstances, with real interest rates below GDP growth, possibly below zero, leads even under mainstream macroeconomics to a conclusion that *'put bluntly, public debt may have no fiscal cost'*, as Blanchard writes, though making it clear that this holds under the specific assumptions which might be valid over quite a long time horizon from now onwards but not forever. Specifically, he adds that the analysis does not justify indefinitely increasing the public debt ratio as then the precondition of the interest rate being below the GDP growth rate would no longer hold (Blanchard, 2019, 1, 34).

Łukasz and Summers (2019, 1) consider that the mature industrial economies are currently prone to secular stagnation and therefore the policy makers should engage in some combination of greater tolerance of budget deficits, unconventional monetary policies and structural measures to promote private investment.

These recent contributions to the debate should not be ignored. It is worth noting that they rely on quite standard macroeconomics of aggregate demand and supply, while hardly mentioning the possible positive contribution of long-term public investment to GDP growth and welfare. This, however, does not undermine their main conclusions but rather strengthens them.

The angle here is the urgency to improve the economic analysis of policies for containing climate change and saving energy. William Nordhaus has provided a framework for the analysis, but the estimates of the various key parameters regarding the linkages between the use of fossil fuels, $CO2$ emissions, global warming and its economic and broad social effects (including migration) are constantly changing. Therefore, the implications for the required public and private investment and their effects on public finances, directly and indirectly, are still pretty much an uncharted area and deserve attention.

But rightly, it is gaining attention in the financial press (Wolf, 2019a) and the economics profession is starting to recognise it (Calmfors and Hassler, 2019). Promising progress in expert work appears also in an IMF staff policy paper entitled ‘Fiscal Policies for Paris Climate Strategies — from Principle to Practice’ (International Monetary Fund, 2019), though it should also be noted that the discussion on the paper at the IMF Executive Board meeting showed significant divergences in views and indicated a great need for more advanced and more focussed analyses.

Mitigating climate change and saving energy are of pivotal importance for the EU. Most, if not all, of its members are small open economies and therefore the externalities extending over all national borders calls for EU-wide coordination. Free riding among them should be avoided and the joint actions vis-à-vis the rest of the world need to be agreed. Although this is obvious, here again, the initial conditions differ across the EU members states making it a challenge to find and agree on policies acceptable to all. In these policy areas the EU could take a leading role globally as some other important players are trembling.

In this policy area a significant amount of long-term investment is needed. The private sector, including private financial institutions, will have an important role but long-term financing for both public and private projects will be needed. Fortunately, an EU institution to manage such long-term financing already exists, the European Investment Bank. Its capacity to provide such financing, transparently linked to attaining the objectives of mitigating climate change, could be an area where the EU takes a strengthened role. Lending to any projects by the EIB as a financial institution takes place at the shared risk of its shareholders, the EU governments. The long-term investments mitigating climate change are worth the risks involved.

A positive side effect of expanding the role and size of the EIB is that its borrowing from the financial markets is taking place by issuing bonds. They are guaranteed jointly by the EU member states, constituting a safe asset for the investors, thus serving the role of a euro-denominated safe asset called for in several euro area reform proposals mentioned above. Their volume is currently some 3% of the EU GDP, or 4% of euro area GDP, so they already have some significance, and their size would increase if the EIB is given a larger role.

As a general conclusion, the risk of secular stagnation needs to be confronted with policies that tackle both investment and saving in all sectors and over all horizons, short, medium and long.

Mitigating climate change and saving energy are a suitable object for public investment and improve genuine welfare. To put it modestly, a minimum requirement is that the euro area budget rules should take into account what share of public debt and deficits stem from investment in the long-term projects mitigating climate change. This follows from the EU Treaty, which specifies that all relevant factors should be taken into account in the excessive deficit procedure.

The links to monetary policy are twofold. First, assessing solvency of the governments (and also the financial institutions for that matter) in its asset purchase operations should take into account the long-term investments of the governments. Second, mitigating climate change successfully will affect the return on both private and public capital in the long term and help counteract the effects of secular stagnation and low, even negative interest rates with which monetary policy is struggling for the moment.

These interlinkages between public finances and monetary policy stance have now become extremely pertinent.

***Epilogue: the links between the reforms and current policy stance became thorny***

This paper was mostly written in June-July 2019. The most recent controversies in September-October 2019 reveal that the opposite camps respectively see a strong link between their views of the desired institutional reforms and the monetary and fiscal policy stance they deem appropriate.

On 12 September the ECB Governing Council decided to restart its asset purchase programme (quantitative easing, QE) and cut the interest rate on its deposit facility, accompanied by other measures. The package aimed to provide monetary stimulus for supporting the euro area economic expansion, and convergence of inflation to the medium-term inflation target. The ECB assured that this line will be maintained for a prolonged period of time, and that it stands ready to adjust all of its instruments as needed.

This decision triggered criticism by for example a group of former central bankers, with typically hawkish views on both monetary and fiscal policies (Arnold, 2019a). They did not agree with the need of monetary expansion for eliminating the danger of deflation and criticised the ECB for monetary financing of government spending.

The ECB decision was taken by a clear majority in the Governing Council and it found sharp public defence that was equally sharp as the 'roar of the dinosaurs' as the Financial Times put it in their editorial (6 October, 2019). J-C Trichet expressed his support for the ECB line and the row continued as the critics reiterated their views despite calls by others to reduce the noise (Arnold, 2019b).

The backlash on the most recent monetary policy decisions and orientation for the future shows the difficulties in agreeing on coherent views on the role of the Eurosystem in performing its tasks under the apparent threat of secular stagnation and abnormally low interest rates, including its role as the lender-of-last-resort. Without parallel efforts on the side of the public finances tangible results cannot be achieved.

A balanced approach was expressed already before this row broke out by the incoming ECB Governor Christine Lagarde when she commented on both monetary and fiscal policies before the European Parliament on 4 September (Arnold and Khan, 2019). She said that monetary policy is not the only game in the town and the government should also stimulate the economies according to their capacity to do so, pointing to Germany and the Netherlands. She is said to seek closer alignment of monetary and fiscal policy, such as buying governments' bonds in return for investment in infrastructure or climate change mitigation (Arnold, 2019b).

The importance of moderating climate change has over the past few months been stated also by the incoming European Commission president Ursula von der Layen, after it gained attention in the various declarations before and after the European Parliament elections 2019.

These openings to the genuine and real long-term issues set the debate on the reform of the euro in a new light. The extensive debate on reforming the euro so far has hardly at all tackled them. The proposed improvements to the short-term adjustments of fiscal positions leave them short-sighted, and the various deficiencies with the medium-term objectives (MTOs) have not been duly recognised and treated. Giving a proper role for long-term sustainability of governments finances has suffered from the narrowness of the sustainability indicators (S2) as several important links between the key variables are buried under simple assumptions which are not duly worked out, so that their meaning and use is not understood by non-economists and forgotten by economists.

Public investment on mitigation of climate change and renewing production and use of energy affect economic growth and return on private investment. This being positive in general they also gradually change the environment for monetary policy making, though for quite some time the arguments for an expansionary monetary policy stance are strong (even though the warning of a asset bubbles are pertinent, but no policies avoid negative side effects; it is a normal task of the economists to ponder the trade-offs between positive and negative effects).

A return to a more normal relation between the interest rates and GDP growth may happen only in 2030-40 when the long-term goals are being achieved. Until then the circumstances resemble more a secular stagnation and abnormally low interest rates. Public investments should play their role, together with several other policy areas as for example considering seriously increasing the old age retirement age discussed above. As a larger share of the resources should go for innovation and investment, a smaller share is available for current consumption. So, although the governments currently have *a free lunch* as they can borrow at negative interest rates, it should not be understood that there is a free lunch everywhere else.

Methodologically, it is important to note that over the next two decades the economies should not be described with steady state equations even in the hypothetical case that the GDP would grow smoothly. The steady state growth equation that Piketty (2014) famously brought to public knowledge, even to T-skirts, is not applicable as its condition that the rate of return to capital should be greater than GDP growth $(r > g)$ will not be in force for a long time. Drawing policy advice from comparing hypothetical steady states can be dangerous if the dynamics of transition is omitted.

This methodological reminder together with recognising the need for public investment for future wellbeing could at its best help in finding more understanding between the current ECB line and its critics. Recognising the strong interlinkages between fiscal and monetary policy is the key for comprehensive policies which respect both the principle of sound public finances in the long term and the independence of the Eurosystem in performing its tasks, both of these being stipulated in the EU Treaty.

Before closing this paper, we need to note the decision of the Eurogroup in early October 2019 on the fate of the various proposals for creating a specific euro area budget as they have appeared prominently in the debate over several years.

## *6. A large budget for the euro or smoothing asymmetric shocks otherwise?*

### *A large budget for the euro?*

The historical reference for calling for a large budget for the euro goes back to the MacDougall Report in 1977, which argued that starting the monetary union requires a joint budget of at least 5-7% of Community GDP, mainly for permanent redistribution across the member states but also for smoothing asymmetric shocks (Commission of the EC, 1977, 13-14). In 1992 MacDougall (1992, 65) recalled the judgement that the plan for the single currency was not mature until a significant budget became politically acceptable.

This view did not prevail in Maastricht in December 1991. Yet, proposals to multiply the EU/euro budget have come up again, triggered by the Great Crunch of 2008-09 and its consequences (for example, Andor et al., 2018)

After long and difficult negotiations, the Eurogroup agreed on 9 October 2019 to include in the EU budget a new element, the Budgetary Instrument for Converge and Competitiveness (BICC; Council of the EU, 2019b). As several member states were not convinced of its usefulness, it will be included in the EU budget, obviously to assure that it remains quite small, reaching a bare 0.15 % of euro area GDP. This makes it clear that it will not have any macroeconomic meaning, and similarly, its contribution to convergence and competitiveness remains equally dubious.

However, the political capital invested in setting up something was so significant that something had to be reached for the reason of prestige. The compromise thus left the door open for additional volume under a planned inter-governmental agreement. One minister presented the outcome as a ‘game changer’, indicating that the efforts for a larger euro area budget will continue.

This may mean that the debate on this matter was not completely buried with the heavily reduced compromise, which gives us a reason to go back to the earlier debate.

### *Smoothing asymmetric shocks*

The old argument is that a monetary union needs a large joint budget not only for permanent redistribution but also for smoothing country-specific asymmetric shocks. Those who have accepted that in the euro area a large redistributive budget is not realistic have since the early 1990s attempted to construct specific mechanisms that would smoothen asymmetric developments without leading to permanent redistribution (Oksanen, 2016a; Alcidi and Thirion, 2017).

Using the US as the reference it is noted that smoothing there is larger than in the euro area mainly due to capital market integration, while in the euro area the smoothing effect via the government budgets is normally larger than inter-state fiscal transfers via the US federal budget. Importantly, according to (Alcidi and Thirion, 2017, 15), a high degree of smoothing, partly due to the automatic stabilisers, worked in the euro area until all smoothing practically ceased since 2010 in the periphery as the Great Crunch turned into a fiscal crisis.

The studies above give an otherwise quite comprehensive picture, but Target2 in the Eurosystem is an important element to be added. The flows and stocks in Target2 are as important as any other items in the balance of payments and they are so large that they should not be ignored. They partly compensate for the lower degree of financial and capital market integration in the euro area compared to the US.

Several initiatives for smoothing mechanisms were presented in recent past (European Commission, 2017b, 8, 12, and 2019b, 65-70; Bénassy-Quéré et al., 2018, 14-16 and 2019; Andor et al., 2018), without much success as we have now seen. The main reason why the Eurogroup practically rejected them was probably the suspicion among the fiscally stringent governments that some others are trying to open a door for transfers and then multiply their volumes and make them permanent.

However, additional reasons might have been that those proposals were liable to several problems making them unconvincing: many of them propose using unemployment, or the change thereof, as a key indicator, which is problematic as it is a lagged indicator of exogenous shocks and measuring it is not straightforward as the institutions differ across the countries; conditionality to compliance with other schemes and rules (primarily with the controversial SGP rules) easily leads to disputes in implementing them; tackling only large asymmetric shocks and keeping the volume quite small (0.2% of EU GDP as proposed by the European Commission, 2019b, 66) limits their effectiveness; financing the proposed fund is often based on the relative size of the economies while also revenues to the fund could depend on positive asymmetry and thereby contribute to smoothing. Last but not least, even though it is declared that the proposed mechanisms should not lead to permanent redistribution, this is far from being assured especially if they are aimed at large shocks; thus, suspicion of creating permanent transfers prevails.

To overcome these various issues Oksanen (2016a) proposed a scheme where payments in and paybacks depend on an agreed measure of the relative cyclical phase and, most importantly, there would be an overarching rule that the net balances are recorded and after an agreed period, say seven years, netted out in constant instalments over the subsequent seven-year period. He considered that such a strict rule to prevent permanent redistribution is indispensable for a political agreement on any short-term smoothing mechanism. The constant retroactive instalments may reduce the smoothing effect, depending on the circumstances, but this is the price for making sure that permanent redistribution would not take place. After all, if a country performs worse than the euro area on average for two subsequent 7-year periods, then the problem is not short-term asymmetry but something more serious and requires appropriate treatment.

In Oksanen’s (2016a) proposal the transfers were based on the relative output gaps (OGs) of the member states. Having illustrated the scheme with historical data based on OG estimates by the EC he considered that improving the real time OG estimates would be advisable, though not indispensable for starting the mechanism as the details could be improved afterwards.

***Testing the proposals with Spain***

Several of the proposals, including those by the European Commission (2019b, 65-70) are based on the change in the unemployment rate as the decisive indicator instead of its level. The reason is that the levels of unemployment over the long term on average differ across countries due to various institutional and other features making them incomparable across countries.

A litmus test of the proposals based on change in unemployment can be made with the current data on Spain. It currently has the next to the highest unemployment rate in the euro area (after Greece), 13.5% in 2019 according to the EC, and a youth unemployment rate of about 30%. How could Spain accept a euro area change-in-unemployment-based scheme as it would not benefit from it over a long time when it obviously needs to reduce its unemployment using all possible means and measures? Such a scheme would obviously be neither acceptable politically nor well-argued economically.

How about the relative OGs-based proposal by Oksanen (2016a; 2018; and 2019)? First, its main feature is that there is the remuneration clause that assures that permanent redistribution does not occur. This makes it possible to develop the details more easily than with many other schemes.

Second, the relative OGs based either on the EC OG estimates or on the new HP-based OG estimates by Oksanen also encounter problems with the litmus test using the current Spanish data. According to both sets of estimates Spain is having a positive OG in 2018-19, and also its OG relative to the euro area average OG is positive. According to conventional SGP-based reasoning this should mean that the cyclical phase is such that Spain should tighten its fiscal policy, and even more so than the euro area countries on average. And it would currently not benefit from an OG-based smoothing mechanism.

Accepting this is hard as the unemployment rate in Spain is so high. Fortunately, the new HP-based estimates presented by Oksanen (2018, 43-44) could be made to deal with this problem.

To start with, his base line estimates give a picture that is not fundamentally different as compared to the EC estimates. This stems from the way his new HP-based estimates use the EC short-term forecasts and a conventional assumption on long-term growth in future and this data does not take into account the high level of unemployment. Therefore, the implications can be questioned.

As a solution, the method for the new HP-based OG estimates allows to adjust the assumption of the growth rate in future. As an illustration, assume that after taking the official short-run forecast (current year and the next) as the base, the GDP grows for four years at a rate two percentage points higher than in the base line, making the level of the GDP after those four years 8.2% higher than in the base line and then growing at the conventionally assumed long-term rate of 1.6%. Based on this assumption, the new OG estimate for 2019 would be clearly negative, more than three percentage points lower than in the base line (this new result is produced for the present paper without publishing here the details).

This is not to indicate that potentially arbitrary assumptions on GDP growth could or should be used for estimating the OGs or in serious policy making without conditions. But what is illustrated here is the construction of a medium-term policy programme with certainly many elements which would aim at GDP growth two percentage points higher than in the base line for four years. It would not be a conventional forecast based on unchanged policies but a target. Only if it were made a realistic target by new policies would the negative new OG estimates become valid and support expansionary fiscal policy as part of the programme.

This type of adjusted new OG estimate responds to the serious and well-based criticism by Tooze (2019) on the officially produced OGs derived from the potential output estimates based on the past data, calling them ‘output gap nonsense’. Our example aims at using elementary analysis for fruitful policy design which can only be based on a vision of alternative paths for the future and identification of the policies needed to make them happen.

Thus, recognising the issues with the OG estimates in general, the implication is that reasonably adjusted new OG estimates could be used in the proposed smoothing mechanism. Spain would benefit from the transfers until its economy reaches a more normal state.

As the mechanism would be shared by the other euro area countries, all others should accept that the adjusted OG is used for Spain, and possibly for some other member states. This should not be impossible as the overarching principle would assure that no permanent redistribution takes place.

***Conclusion on smoothing mechanisms***

The prospects for a ‘transfer union’ are non-existent. The Eurogroup decision in early October 2019 prove that the specific transfers for the euro area will remain so small that they will not have any macroeconomic meaning. All attempts aiming at significantly large transfers are harmful as they only fuel suspicion and mistrust. If short-term asymmetric developments are considered an issue, the mechanism should contain a clause that it will not lead to permanent transfers, checked over a reasonable period of time. The modest proposal discussed above contains such a clause and it would help the euro function more smoothly by contributing to short-term smoothing alongside with the short-term flexibility in the government budgets, symmetric and asymmetric alike. It is not presented here as a proposal to be necessarily implemented as the euro can function properly also without it. However, it would help in setting aside more controversial reform proposals if they still survive after the Eurogoup compromise in October 2019.

## *7. Summary and conclusions*

The preparations for reforming the euro have been stalling for several political reasons. Also the expert work has not always been helpful as it has not covered all the relevant aspects and identified solutions that would at the same time be politically realistic, economically justified and sufficient for the viability of the euro.

Against this gloomy background, the present paper is optimistic and positive. According to its title the euro can be reformed by pragmatic reorientation, without high-profile institutional changes requiring modifications to the EU Treaty, which would almost certainly fail in the referenda in some countries.

The pragmatic reforms presented here cover both reorientation of fiscal policy and some enhancements to the Eurosystem for performing its proper role as a central bank. Such a reform agenda is considered here to be sufficient for the euro to serve the Europeans and the rest of the world as the second most important currency globally.

*Shifting from short-sighted fiscal rules to long-term sustainability of public finances*

The history of the euro must be known and understood. Mistrust between the member states regarding whether all the participants are willing and capable of conducting sound fiscal policies led to the short-sighted fiscal rules in the Stability and Growth Pact (SGP) adopted in 1997 and subsequently to policies that have amplified the economic disturbances, with the only significant exception being the year 2009 when the GDP fell abruptly. After this exception fiscal tightness returned and contributed to the further fall of the GDP in the euro area in 2012-13.

Replacing short-sightedness in fiscal policy by shifting the focus to long-term sustainability of public finances sufficiently convincingly would mean that short-term flexibility could be allowed.

*Revamping the role of the Eurosystem*

The functions of the Eurosystem have not been duly covered in the debate on reforming the euro. Any monetary union is a politically established institution and it requires a pertinent commitment from the high political level to preserve its essential functions. When the euro suffered from the consequences of the Great Crunch of 2008-09, the declaration of Mario Draghi in July 2012 that *'the ECB is ready to do whatever it takes to preserve the euro'* became as a sufficiently convincing commitment and removed the hesitations.

One of the main tasks of the Eurosystem is to promote the smooth operation of the payment systems at all times. To perform this task, it is required that the Eurosystem will accept any transactions irrespective of the internal balances possibly accumulating between the euro area central banks in one direction or another.

The second main task of the Eurosystem is to function as the lender of last resort to solvent governments and financial institutions. This is its task as otherwise a liquidity crisis emanating from any sources could develop into a public finance crisis marked by illiquidity of the financial institutions, and thereby to a general credit crunch causing poor solvency in large segments of the economy, and ultimately to bankruptcies and a general economic collapse.

Being the lender of last resort to solvent sovereigns is currently based on the provisions on the outright monetary transactions (OMT) as defined and declared to be compatible with EU law, and the various asset purchase programmes (APPs). The key issue is to define sufficiently clearly what solvency means. It should be admitted that there is no way to give it a precise meaning that would cover all circumstances and cases. Some room for interpretation must be left to the Eurosystem, expressed by its commitment to *'do whatever it takes'* in each situation, this being based under its independence to choose its instruments.

The requirement that lending to governments requires their solvency is the link to the reorientation of the fiscal policies towards focussing on long-term sustainability of government finances. It should be recognised and accepted that defining sustainability goes well beyond the technical work of the experts as it requires a vision of not only the uncertain environment but also of the possible and likely government policies in future unknown circumstances.

The experts can, however, serve here by pointing out policy areas where clarifications of the relevant policy options and their extensions are needed. Equally importantly, they should make critical remarks where essential aspects are being ignored.

*Increasing the old age retirement age*

An example of deficient analysis of the policy options concerns raising the old age retirement age, which is a fairly straightforward policy measure to be considered for improving sustainability of public finances. There are understandable reasons why its importance is so poorly analysed: competence being at the member state level hampers its treatment at the EU level and defining the relevant policy options requires a comprehensive knowledge of the institutions and policy environment in each country. As an additional deficiency, the pension reforms as implemented are not duly taken into account in assessing the solvency of the sovereigns as the time horizon for the effects is long, longer than the conventional medium term. While an increase in retirement age improves sustainability of public finances it may, depending on the other elements in the reform package, increase the government deficit and debt in the short and medium term, calling for due flexibility in the fiscal rules.

*Secular stagnation, low interest rates, climate change and long-term public investment*

Another broad question is the weight of long-term public investment in assessing the solvency of the governments, including its financing by public debt. This question has recently been highlighted in the new approaches among leading economists to fiscal policies and public debt under the current circumstances which might, evoked by the Great Crunch 2008-09, be turning into a secular stagnation and persistently low long-term interest rates.

We should not assume that this vision would give leeway for continuous accumulation of public debt for generations (thus it is not a valid argument for not implementing pension reforms). However, the relevant time span for the risk of secular stagnations might be 10-30 years. Responding to this risk would require reorientation of policies in several areas, primarily in mitigating climate change and saving energy.

These policy areas require improved analysis aiming at quantified policy prescriptions. It is urgent to set operational targets for climate policy and identify the required policy measures. They will also affect the orientation of fiscal policy, and as all this concerns long-term effects, the solvency of the governments is at stake, with the link to the operations of the Eurosystem. These issues became prominent in September-October 2019 when the Eurosystem decided to continue its expansionary policy line and was met by fierce criticism. A balanced view requires careful analysis over the long term. These issues are being recognised at the high political level, which needs to be accompanied by a new orientation also among economists for producing good advice.

For the EU, mitigating climate change and saving energy are of pivotal importance as the need for EU-wide coordination is obvious, including taking a leading role globally.

*Need for a joint liability and safe asset – the Eurosystem already issues them*

The proposals for a joint euro area liability and the parallel view that the euro needs a safe asset for the financial system to function properly have led to confusing controversies. It has not been duly recognised that the Eurosystem already provides both of them. The banks can make unlimited deposits at the ECB which obviously are a joint liability backed jointly by the euro area member states, and they are a safe asset for their holders. This function could be expanded if the Eurosystem issued certificates of deposit (CDs) making them directly available also to non-banking financial institutions (pension funds, money market funds etc.).

Expanding these operations would imply expansion also on the asset side of the Eurosystem's balance sheet, for which the various asset purchase programmes are already at place and should be carried out according to the needs of setting the monetary stance.

Making Eurosystem CDs available to the market would have several important implications, including those for the international role of the euro and for conducting monetary policy. The arguments for issuing joint liabilities by the euro governments would become considerably weaker and help dampening the suspicions that the euro would through the back door become a ‘transfer union’, where debts of some members fall on the others.

*European deposit insurance scheme (EDIS) and the functions of the Eurosystem*

Establishing the European deposit insurance scheme (EDIS) is one of the central reform proposals which has not advanced as it is feared that it could lead to massive transfers from the north to some of the southern members and should therefore be postponed until the banks in all member states have been cleaned from excessive non-performing loans (NPLs).

While the prospects for adoption of an EDIS are meagre, the functions of the Eurosystem are pertinent again here. Its normal operations in managing the payment system (Target2) will cushion the consequences of a possible bank run. The confidence that the Eurosystem will fully perform its tasks will help in preventing a bank run as the actors and markets can deem that the liquidity of solvent banks will be guaranteed. This lessens the arguments to create an EDIS prematurely and gives time for cleaning the NPLs in good order.

*An expenditure rule would solve the problems barely half-way*

The present article highlights the need to shift focus from short-term fiscal discipline to long-term sustainability of public finances. In the recent debate on reforming the euro several proposals appear which aim at improvement over a medium term, even if the long-term aspects are poorly treated.

One such proposal is to replace the use of the government structural balances in short- and medium-term fiscal policy by a simple expenditure rule, arguing that setting a ceiling for the growth of public expenditures will help in giving some flexibility for cushioning short-term disturbances as the revenue side is allowed to fluctuate.

The purpose of this proposal is justified as it aims at removing procyclicality that has been identified as one of the inherent problems. However, the proposed rule would help only partially as it confronts most of the same issues as the current fiscal rules. For example, pension reforms affect the justifiable targets for growth of public expenditures in both the short and long terms, depending on the case.

Implementing the possible sanctions on non-compliance, which are retained in these proposals, would require additional provisions which easily lead to conflicts and augment mistrust. Also, although extending the horizon to the medium term can be an improvement, it can lead to complacency and attention to the pertinent long-term issues is reduced further.

*Attempts for a significant joint budget for the euro led to a limited compromise*

Several proposals for a significant joint budget for the euro area budget have been difficult topics of debate, obviously even hampering concentration on more important issues. The long and difficult negotiations in the Eurogroup led finally in October 2019 to a compromise to include in the EU budget an element called Budgetary Instrument for Converge and Competitiveness, reaching a bare 0.15 % of euro area GDP. This size makes it clear that it will not have any macroeconomic meaning.

The main reason why the Eurogroup practically rejected a significant joint budget was probably the suspicion among the fiscally stringent governments that some others are trying to open a door for transfers and multiply their volumes and make them permanent. Additional reasons might have been that the various proposals were liable to several problems making them unconvincing, including provisions that they would be based on the change of unemployment as a factor for receiving transfers. It would not be acceptable for the countries with currently high unemployment as they would not benefit from the scheme even if they are in an adverse position.

The view taken here is that if short-term asymmetric developments are considered an issue, the mechanism should necessarily contain a clause that it will not lead to permanent transfers, checked over a reasonable period of time. Such a mechanism could be designed, and it would help the euro function more smoothly alongside with the short-term flexibility in the government budgets of the member states. However, it is not presented in the present paper as a necessary element for the euro to function properly, as the euro can perform well also without it. However, it would help in setting aside more controversial reform proposals if they still survive after the Eurogoup compromise in October 2019.

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This paper presents the view that the euro can be made to function well with pragmatic reforms that duly cover the interconnections links between fiscal and monetary domains. The challenges are greatest for the long-term future as moderating climate change, renewing production and use of energy and other improvements to infrastructure require resources. Seen positively, they also offer a vision of sustainable growth. Progress can only be gradual as the required investments need innovations and financing, which means that the horizon for tangible effects is two-three decades. This highlights the need to avoid any delays in setting the required actions in motion as otherwise the significant threats become real.

As long-term public investment will help economies to gradually recover from secular stagnation and abnormally low interest rates, also monetary policy can return to a stance practiced in a more normal environment. In the debate on reforming the euro the time horizon has been unduly limited at most to the medium term and assessing long-term sustainability of governments has suffered from serious deficiencies. This should not continue under the serious challenges to the European economies, which require a long-term vision. Sound public finances as a guiding principle and the independence of the Eurosystem in performing its tasks, both being anchored in the EU Treaty, are interconnected and can support each other.

Mistrust between the member states establishing the euro led to short-sighted fiscal rules that were not economically reasonable and led to modified rules that are complex and incomprehensible and lead to incessant disputes in their application. Mistrust is also fuelled by various reform proposals that are disputable and therefore do not find the necessary political support, often also for the reason that they are not economically well-argued. Concentration on pragmatic reforms that primarily concern the long-term performance of the economies would be more advisable for serving the general interests, even though they do not show up as high-prestige initiatives politically.

For the common interest it is necessary that the new orientations of fiscal and monetary policy are communicated to the general public clearly enough. The people must be able to trust that the basic institutions like public finances and the monetary system are managed with a commitment to do whatever it takes to preserve not only the euro but our societies at large.

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