Non-paper for paving the way towards a Stability Union

In parallel to keeping the EU 27 together, improving the short-, medium- and long term governance of the EMU is indispensable, along the following three core principles:

(1) We must keep fiscal responsibilities and control together, to avoid moral hazard.

(2) We need better instruments to foster the implementation of structural reforms.

(3) We need credible stabilization functions to deal with global or domestic shocks.

(1) Fiscal responsibilities and fiscal control belong together, whatever it takes. On the institutional side there are two possible ways that should ensure this symmetry: Either we transfer parts of national sovereignty and control of fiscal rules to the EU level ("Euro Finance Minister"), together with a greater democratic legitimacy. This would certainly require EU treaty changes to be credible. Or we agree on an intergovernmental solution. As long as there is little willingness for treaty changes, we should follow a pragmatic two-step approach: Intergovernmental solution now, to be transposed into EU law later on.

The European Stability Mechanism (ESM) is the right vehicle for such an intergovernmental solution. The ESM has proved its worth since it was established in 2012. It embodies the principle of providing solidarity in return for sound public finances. The ESM has a well-developed crisis-management system with a set of instruments and financial capacities at its disposal. They are kept ready for the ESM's core function, namely to provide temporary financial support under strict reform conditionality.

The ESM, to become a European Monetary Fund, has to devote more resources to better crisis prevention: The ESM does not yet have a mandate to carry out crisis prevention or to help reduce risks at an early stage. It is therefore important to expand the ESM's radar and give it a stronger role in terms of monitoring country risks. The aim is to identify, in cooperation with other institutions, stability risks for and in Eurozone member states more effectively and at an earlier stage than in the past, and to monitor these risks so that they can be reduced by the affected countries themselves. The IMF's Article IV consultations could serve as a blueprint for this new role.

Such a role for the ESM should also include monitoring compliance with the Member States' obligations under the Fiscal Compact that was adopted in 2012. The ESM could *gradually* be given a stronger, neutral role with regard to the monitoring of the Stability and Growth Pact. Tasking the ESM later on with the complete monitoring of compliance with the Fiscal Compact and the European fiscal rules would make it necessary to amend both the Fiscal Compact and the ESM Treaty.

A second new ESM mandate should include a predictable debt restructuring mechanism to ensure fair burden-sharing between the ESM and private creditors. The rationale is: In the future, private investors would benefit from having better risk-related information, which the ESM would provide.

Logically, these investors would then also have to contribute if, contrary to expectations, a country did indeed get into difficulties and required ESM assistance again. As well as the new analysis-related functions, the ESM should therefore also take on responsibility for the future debt-restructuring process and its coordination. The important aim is to provide the private sector with clear and predictable principles ahead of time, to avoid ad hoc solutions.

The following elements should be incorporated into the legal text of the ESM Treaty: (a) the automatic extension of the maturities of sovereign bonds in the event that an ESM programme is granted, (b) the obligation to carry out comprehensive debt restructuring if this is necessary to ensure debt sustainability, and (c) for the purpose of preventing holdouts, an amendment of the collective action clauses that were introduced, moving to “single limb aggregation” (i.e. a requirement for only *one* vote on the debt restructuring of all the bonds involved without additional votes on the individual bond series).

On the Banking Union side, further significant risk reduction is necessary, including the regulatory treatment of sovereign bonds. Current proposals on risk reduction need to be stepped up. Only on this basis the ESM could play a backstop role in financing of bank resolution. If, at the end of the ongoing discussion process, we do decide to mandate the ESM with a backstop function in the form of a credit line for the SRF, it would also require an amendment to the ESM Treaty. This is because the ESM Treaty in its current form only provides for assistance to support *Member States*, but not to support *institutions* such as the SRF.

J.-C. Juncker has currently proposed to alternatively use the EU budget as a back stop. There is a whole range of open questions in this context. If such a backstop is created at the ESM, an amount of approximately €55 billion (= target level of the SRF) would have to be reserved for this purpose. In this respect, it would seem reasonable to carry out, in parallel to the creation of this new instrument, a critical review of direct bank recapitalization, an existing instrument that is less practical, but much riskier (€60 billion is reserved internally at the ESM for this purpose). As part of an overall package, we should be open to eliminate the instrument of direct bank recapitalization.

More ambitious scenarios and plans for the ESM and its financial capacities, either regarding the possible role as an additional backstop for the controversial European Deposit Insurance Scheme, or regarding a brand new fiscal capacity as a transfer mechanism for the Eurozone would put much too great a strain on the ESM and go against its core purpose of bailing-out countries in severe trouble.

(2) On the implementation of structural reforms we have to increase ownership by the concerned countries themselves. Structural reforms are necessary to modernize economies and to catch up with the rest of the Eurozone and with global developments. Mutualizing existing or future challenges instead of tackling them would end up in a weakened currency union as a whole.

Structural reforms might be costly in the short term. We should therefore examine ways to incentivize reforms. Do we need another new and intergovernmental fiscal capacity? Not necessarily. The EU budget is under review anyway and members are expected to contribute more in future times to compensate for the Brexit. Hence there is some leverage to set new and sound priorities towards a future budget, also supporting the Eurozone.

The Commission has made interesting proposals for improving the EU budget. In this respect we should examine whether future Euro members´ contributions to the EU budget could be better linked with structural reforms in the Euro area, based on the Commission`s country specific recommendations (CSRs). This approach based on EU budget and on CSRs would, compared to any alternative intergovernmental approach, ensure the important role of the Commission and allow an integrated EU-policy, linking policy coordination (European semester with CSRs) with cohesion policy (structural funds) and the EU-budget. Following J.-C. Juncker´s speech, this approach could prepare a nucleus for a Eurozone budget. Once established, it should be evolved further, based on solid financing and own revenues.

(3) On the stabilization function we have to much better use the *national* automatic stabilizers to absorb shocks. The flexibility in our fiscal rules exists exactly to allow them to work. Prerequisite for that is of course that member states create the necessary fiscal room for maneuver by sticking to their budgetary objectives. The idea of the Medium Term budgetary Objectives (MTO) is precisely to build buffers for the absorption of shocks.

The IMF is right to conclude in its Art. IV consultation that the European fiscal rules have unfortunately become much too complex and less predictable. This is why we have to develop these rules further, with the debt rule at least on an equal footing with the deficit rule. As long as national debt is on a declining path, national deficits could be treated flexibly.

A macroeconomic stabilization function e.g. through a new fiscal capacity or unemployment insurance is economically not necessary for a stable monetary union. Countercyclical public spending is never in time and a Euro zone-wide unemployment insurance would have to deal with very different income levels in the Euro area. Our developed welfare states in the EU make a large difference to the US: they work as significant automatic stabilizers - if the member state concerned has the fiscal margin (MTO).

In addition to that, we have to look closer at our Single Market of the EU 27. A more flexible single market would be able to better absorb shocks, especially those hitting single member states (so called asymmetric shocks). Banks in a true banking and capital market union can maintain lending even if one member state is in a crisis because banks can better work cross border and are supervised at EU-level. And better migration within the EU 27 could offer a much stronger possibility to keep unemployment - especially for young people - under control in case of crisis.

Decreasing convergence is often due to national structural factors and cannot be overcome through a fiscal capacity. A new stabilization function in form of a new Euro debt capacity would only buy time and repeat national mistakes of the past. It would be much more efficient to support reforms to increase resilience through effective policy coordination and in future through a well redesigned EU-budget (see above).

Debt mutualization would create wrong incentives, raises fundamental legal issues and would therefore put the stability of the whole Euro area at risk. Whatever the future name will be: For European Safe Bonds or Sovereign Bond Backed Securities (some would call them *“new Eurobonds”*) there is no demand in the market. We must be able to create real stability through reforms, not through complex and expensive financial engineering.