UNU-CRIS
Working Paper Series

#06
November
2020

The European Monetary Union after Covid-19: Towards Fiscal Integration Aligned with Monetary Policy

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Comments from a reviewer are gratefully acknowledged.

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The views expressed is this paper are those of the author(s) and may not represent the position of the UN, UNU or UNU-CRIS.

Abstract

Within the Economic and Monetary Union (EMU) of Europe the responsibility for the single monetary policy lies with the European Central Bank (ECB). By contrast, economic policies remained national and must therefore be coordinated to ensure the proper functioning of EMU. A central government that could have taken measures to reduce the burden on monetary policy to stabilise the eurozone in the more challenging economic and financial circumstances since 2008 was and still is missing.

This paper argues that euro area governments could build on the cooperative model of Europe's economic response to the Covid-19 pandemic to establish a permanent fiscal framework alongside monetary policy that is more similar to those found in other currency areas. First, they could create a central fiscal capacity to ensure a euro area economic policy stance that is consistent with the orientation of monetary policy. Second, member countries could introduce a safe sovereign asset for the eurozone in order to anchor financial integration and facilitate the implementation of monetary policy. Third, euro area governments could commit when necessary to recapitalise their NCB and (indirectly) the ECB to underpin the credibility of large central bank balance-sheet operations.

Taking these three steps towards fiscal integration aligned with monetary policy and in full respect of the ECB's political independence would reduce systemic risks and strengthen confidence in the euro.

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Since the strength of a currency – and the public's confidence in it – is closely related to the political structure that supports it, … the Eurosystem's "institutional loneliness" will need to be addressed. Padoa-Schioppa (2000, 37).

1. Introduction

The European Economic and Monetary Union (EMU) is a special currency union in the sense that it has a single monetary policy but no centralised economic policy. The European Central Bank (ECB) has the exclusive competence for the conduct of monetary policy, independent from political interference, with the primary objective to maintain price stability for the euro area as a whole and otherwise to support the general economic policies in the European Union (EU).[1] Awaiting further political integration, EMU has no central government as counterpart to the ECB that in turn could contribute to the efficacy of monetary policy. The conduct of economic policy therefore remains in the hands of the euro area Member States, subject to common requirements for maintaining sound public finances and preventing macroeconomic imbalances to ensure the proper functioning of EMU.[2] This focus on public risk-reduction at the national level relies above all on the embedded monetary solidarity to provide for public risk-sharing at the supranational level as needed to stabilise the eurozone (Schelkle, 2017).

The asymmetry between a single independent institution in charge of monetary policy and a large group of sovereign euro area nations coordinating their economic policies turned into a serious weakness of the EMU architecture when the economic and financial environment became more challenging. Ever since 2008, the lack of an EMU institution in charge of euro area economic policy and the reluctance of member countries to enter into comprehensive public risk-sharing arrangements obliged the ECB to assume a larger share of the economic and financial stabilisation burden (Section 2).

This paper reviews three fiscal areas where euro area countries could build on the cooperative model of the EU's economic response to the Covid-19 pandemic to establish a permanent fiscal framework alongside monetary policy that is more similar to those found in other currency areas, while staying within the boundaries of the EU Treaties. First, member countries could create a central fiscal capacity for macroeconomic management to ensure a euro area economic policy stance consistent with the orientation of monetary policy (Section 3). Second, they could introduce a safe sovereign asset for the eurozone to anchor financial integration, secure an even monetary transmission, and facilitate monetary policy implementation (Section 4). Third, euro area governments could provide an ex ante fiscal backstop to their NCB and (indirectly) the ECB to underpin the credibility of large central bank balance-sheet operations (Section 5). Fiscal integration aligned with monetary policy would support confidence in the euro and could pave the way for a central government as counterpart to the ECB with full respect for its political independence (Section 6).

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[1] The responsibility for eurozone monetary policy lies with the Eurosystem and the Governing Council of the ECB. The Eurosystem is made up of the ECB and the national central banks (NCBs) of the euro area countries.
[2] The Member States of the EU are obliged to conduct their economic policies with a view to contributing to the achievement of the EU's objectives, treat their economic policies as a matter of 'common concern', and to coordinate them within the EU Council. The Treaty of Lisbon, signed on 13 December 2007, introduced economic policy guidelines for the euro area countries as a group and a stronger coordination and surveillance of their fiscal discipline.

2. A Constrained Euro Area Economic and Monetary Policy Mix

On several occasions since 2008, the lack of an EMU institution in charge of economic policy and the limited fiscal space in some member countries constrained the economic and monetary policy mix and placed a larger burden on the ECB to stabilise the eurozone.

First, during the Great Financial Crisis of 2008, the EU authorities and the ECB orchestrated a combined fiscal and monetary expansion to stabilise financial markets, support the banking sector, fight the credit crunch, and counter the unavoidable recession. Since the EU budget is targeted at economic convergence and market integration rather than macroeconomic stabilisation and does not include a specific euro area budgetary instrument,[3] the bulk of any fiscal stimulus has to come from the Member States. However, they must operate within the margins of flexibility of the EU's fiscal rules, which at that point did not include a general escape clause.[4] Although European leaders adopted a European Economic Recovery Plan based on countercyclical national fiscal policies, the countries with a high public debt-to-GDP ratio (notably Greece and Italy) had limited fiscal space and hardly contributed to the collective budgetary expansion (van Riet (ed.), 2010).

Second, the sovereign debt crisis of 2010-2012, which spilled over to fragile banks and threatened to break up the euro, triggered a fragmentation of financial markets along national lines of creditworthiness which hindered an even transmission of monetary policy. European leaders created temporary loan facilities to assist the troubled countries, together with the International Monetary Fund (IMF), on the condition of economic adjustment. They further tightened the fiscal surveillance procedures embedded in the Stability and Growth Pact (SGP) and introduced a Macroeconomic Imbalance Procedure (MIP) for closer economic surveillance. Governments generally embarked on a path of fiscal consolidation to reduce public debt and committed to structural reforms to restore economic dynamism. On aggregate, national fiscal policies were pro-cyclical in 2011-2013, i.e. they suppressed euro area output growth when the output gap was negative (Figure 1), complicating monetary policy efforts to revive the economy.

[3] The EU budget plays only a modest role in cushioning economic shocks since it is small (about 1% of EU GNI) and must be in balance every year.

[4] Member States must adhere to a structural budgetary position that is close to balance or in surplus and avoid an excessive deficit, i.e. government borrowing exceeding the reference value of 3% of GDP and/or government debt exceeding the reference value of 60% of GDP. The Stability and Growth Pact (SGP) comprises the secondary legislation which implements the multilateral surveillance and coordination of their budgetary positions as well as the procedure for correcting excessive deficits.

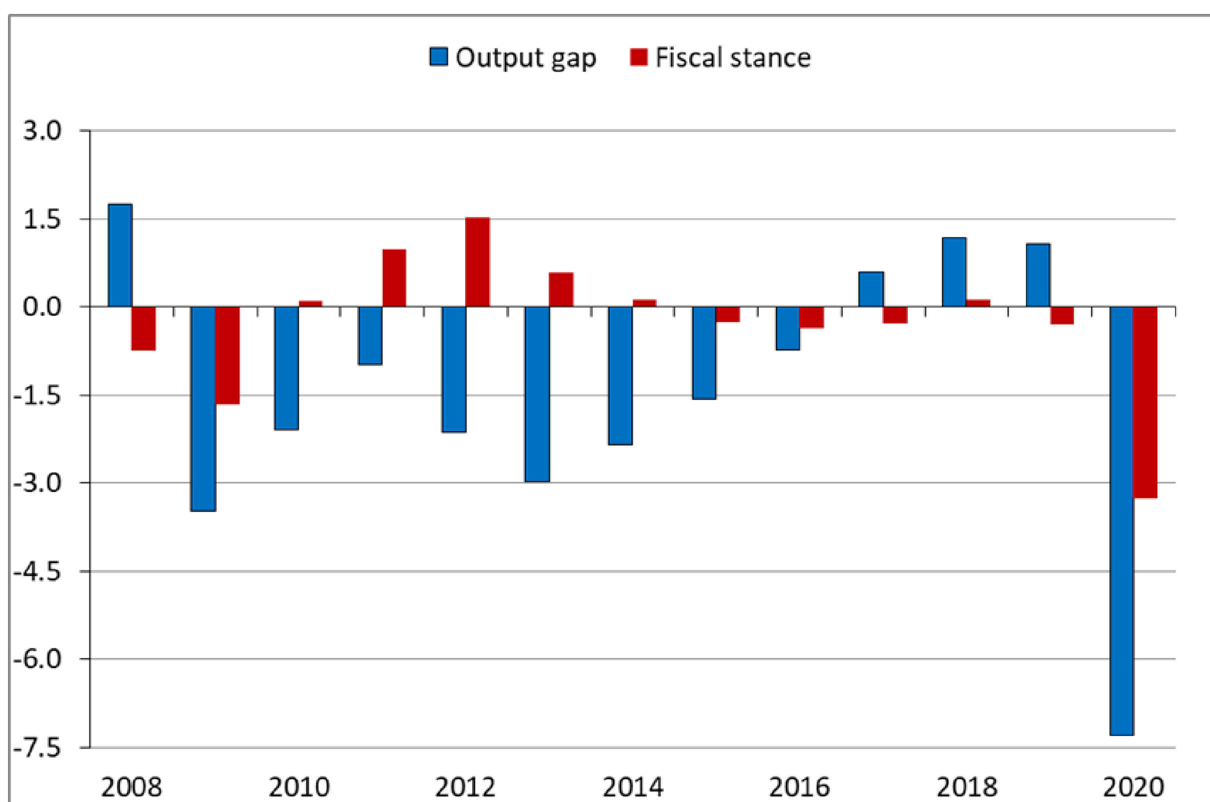

Figure 1. Fiscal stance and output gap for the euro area

Source: European Commission Economic Forecast, Spring 2014 and Spring 2020.

Note: Euro area fiscal stance: annual change in the structural primary budget balance of the 19 euro area countries, in percentage points of potential GDP. Euro area output gap: difference between real and potential GDP of the 19 euro area countries, in percent of potential GDP.

Meanwhile, euro area leaders established a permanent European Stability Mechanism (ESM) in early 2012 with the task to provide conditional financial assistance to member countries in a fiscal crisis. They also agreed in June 2012 to move towards a European Banking Union to break the nexus between vulnerable sovereigns and fragile domestic banks. However, an ECB commitment to unlimited outright monetary interventions in crisis-hit sovereign bond markets was necessary to fully restore investors' confidence in the future of the euro. Comprehensive proposals to complete EMU (Juncker, 2015) – including the creation of a euro area treasury issuing eurobonds to implement a common fiscal policy, assist member countries experiencing a large negative shock, stabilise the financial sector, and secure euro area capital market integration – never gained political momentum; the safe-haven countries insisted that significant public risk-reduction in the vulnerable countries should precede public risk-sharing for all (van Riet, 2016).

Third, the corridor of the ECB's key interest rates reached the zero lower bound in July 2012. Given the constraints on lowering key interest rates (too far) into negative territory, the ECB implemented a series of non-standard monetary policy measures from 2014 to 2019 to further relax private financing conditions in its fight against too low inflation.[5] The further monetary accommodation could have been more effective with a coordinated fiscal expansion (see also Draghi, 2014; Corsetti et al., 2019). However, the euro area average fiscal stance remained broadly neutral over this period (Figure 1) and, accordingly, the ECB

[5] The ECB's non-standard measures comprised in particular a negative deposit facility rate, targeted longer-term credit supplied to banks, and a programme of large-scale asset purchases focused on public sector bonds, coupled with forward guidance on the future monetary policy stance (see Rostagno et al., 2019).

remained the 'only game in town' for macroeconomic management and financial operations at the euro area level (Praet, 2017; van Riet, 2018).

Moreover, the pursuit of low-for-longer interest rates to secure a steady economic recovery and the return of low inflation to a sustained level near 2%, could also have unintended negative side-effects for fiscal discipline, economic dynamism, financial risk-taking, and the distribution of income and wealth (see van Riet, 2017b, 2019b for a discussion). Furthermore, as a consequence of its non-standard measures targeted at reducing economic risks, the Eurosystem accepted ever-more financial risks to its net monetary income.[6] Sudden large losses on its balance-sheet operations might deplete its reserves and capital. An unavoidable recapitalisation of the NCBs and the ECB could be a vehicle for fiscal transfers between the euro area countries and violate the budget rights of national parliaments. Arguably, the ECB exceeded its monetary policy competences, crossed the borderline with economic policy and entered the province of politics (Dietsch et al., 2018).[7] This experience suggested that euro area governments should take more responsibility for economic and financial stabilisation and relieve the burden on monetary policy, especially in an environment of ultra-low interest rates and fragmented sovereign bond markets (Ubide, 2019).

Similar constraints on the euro area macroeconomic policy mix arose after the outbreak of the coronavirus disease (known as Covid-19) in 2020. As some of the hardest-hit countries (again) had little fiscal space to counter its socio-economic consequences, Europe put in place supranational safety nets. However, euro area leaders could not agree on issuing common 'coronabonds' to collectively raise the additional resources in the capital market needed for a sizeable common fiscal stimulus alongside the ECB's large-scale pandemic monetary easing. The political compromise on a European recovery plan for 2021-2023 named 'Next Generation EU', paid for by substantial EU borrowing guaranteed by the EU budget, offered a strong alternative.[8] This unexpected agreement among all 27 Member States was hailed as a momentous step forward in terms of fiscal integration, but remained an exceptional response to an emergency situation and missed a permanent euro area dimension.

3. Towards a Euro Area Fiscal Capacity

Member States adopting the euro are no longer able to exploit monetary and exchange rate tools and must rely on their own budgetary resources and economic strength to adjust to adverse national shocks or common shocks with asymmetric effects. Consequently, they face more stringent requirements for economic policy coordination to contain their sovereign risk and increase their economic resilience, especially when their business cycles are not synchronised.

Since the sovereign debt crisis, the Ministers of Finance and Economics in the Eurogroup explicitly discuss the euro area fiscal stance resulting from the draft budgetary plans of the member countries in the context of the European Semester for economic policy

[6] See Cour-Thimann and Winkler (2016) on the role of the central bank as 'balance sheet of last resort' in reducing risk exposures in the balance sheets of other economic sectors.
[7] The ECB faced legal complaints in this regard, focused on its large-scale public sector purchase programme (PSPP). See Court of Justice of the EU (2018) and German Federal Constitutional Court (2020).
[8] See the conclusions adopted by the Special European Council (Brussels, 17-21 July 2020).

coordination.[9] However, the flexibility embedded in the EU's fiscal rules cannot bridge the gap between strong and weak national public finances when on aggregate a countercyclical fiscal expansion would be warranted. Given the provisions of the SGP, only member countries with a nearly balanced budget or a surplus in structural terms and low risks to fiscal sustainability could be expected to actively contribute with a fiscal impulse on a voluntary basis – unless it would destabilise their own economies. Countries without such fiscal space should first restore sound and sustainable public finances in line with SGP requirements. The organisation of an appropriate euro area fiscal stance is therefore handicapped by the need for governments to find a balance between their fiscal contribution to area-wide macroeconomic stabilisation and domestic requirements for achieving and maintaining fiscal sustainability (European Commission, 2015; Bańkowski and Ferdinandusse, 2017).

This fiscal sustainability constraint on coordinated action could be overcome with a euro area fiscal capacity of sufficient size to assist individual member countries with a lack of fiscal space and to complement the aggregate fiscal stance for the purpose of euro area macroeconomic stabilisation, in concert with the ECB, subject to common decision-making and parliamentary accountability (see, for example, van Riet, 2018; Codogno and van den Noord, 2019; Fabbrini, 2019; Buti et al. (eds.), 2020).[10] In addition, the SGP could be amended to reduce the pro-cyclical bias in national fiscal policies and to create financial incentives to undertake structural reforms and improve the quality of public finances in the interest of future output growth (European Fiscal Board, 2019).

Following up on the five EU presidents' report on completing EMU by 2025 (Juncker, 2015), the European Commission (2017a) reflected on options for enhancing euro area macroeconomic stabilisation via temporary budgetary transfers to member countries hit by a large negative shock, under the condition that they observed sound economic policies. The transfers could in principle be made directly from the EU budget. However, the Commission could also borrow in the capital market on behalf of the EU to finance EU loans and small grants to eligible Member States with the aim to complement national fiscal stabilisers. Alternatively, the EU could introduce a common insurance mechanism that enables eligible Member States to draw on a stabilisation fund, filled with regular national contributions or an own resource of the EU budget, pending a possible role for the ESM (and the future European Monetary Fund) in this field. By contrast, the creation of a fully-fledged euro area budget for the provision of common public goods, including a macroeconomic stabilisation function, was regarded as a goal for the longer term.

Given its objective of fostering economic convergence and market integration over time, the EU budget could also provide extra grants to countries when they commit to implement structural reforms identified as a priority in the European Semester. Structural reforms tackle excessive macroeconomic imbalances, enhance potential output growth, contribute to resilient economic structures and enhance the capacity to absorb shocks, which is

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[9] Regulation (EU) No 473/2013 of 21 May 2013 requires euro area countries to submit a draft budgetary plan to the European Commission and the Eurogroup. The Commission adopts opinions on whether these plans comply with SGP requirements and conducts an overall assessment of the euro area fiscal stance in preparation of a discussion in the Eurogroup. The European Fiscal Board (EFB) advises the Commission on the fiscal stance appropriate for the euro area. The EFB is independent and was established by the European Commission Decision (EU) 2015/1937 of 21 October 2015. The EU Council adopts a euro area economic policy recommendation addressed to the euro area countries individually and collectively.
[10] Kamps and Leiner-Killinger (2019) present a thought experiment on how a central fiscal capacity could be embedded into the EU fiscal framework.

essential for a smooth participation in the euro area and also facilitates the ECB's monetary policy.[11]

As part of an EMU-related package of proposals for the post-2020 EU budget, the European Commission (2017b,c) suggested that a European Minister of Economy and Finance could be given the task to strengthen economic policy coordination in support of monetary policy, under scrutiny of the European Parliament, without calling into question national competences. This coordination task could be facilitated by new budgetary instruments for a stable euro area, in particular a European Investment Stabilisation Function (EISF) and a Reform Support Programme (RSP), which would be accessible for Member States that complied with the EU's economic governance rules (European Commission, 2018b,c). The EISF would enable the Commission to borrow capital and extend loans to individual euro area countries (with ERM II members free to join in) in the event of a large asymmetric shock, so as to stabilise public investment at a time when their fiscal capacity was stretched. The RSP would draw on EU budget resources and provide financial incentives and technical support for growth-sustaining administrative, institutional and structural reforms.[12] Given the legal basis of the EISF and the RSP (specific EU cohesion actions outside the existing Structural Funds), one could argue that the EU's cohesion policies would henceforth be defined in terms of market integration and monetary stability, in addition to reducing regional disparities (van der Sluis, 2019).

Trying to advance the political discussion, the French and German governments (supported by Spain) reached an agreement in the course of 2018 on creating a eurozone budget within the EU framework, without supranational fiscal policy ambitions but to foster convergence, promote competitiveness and contribute to stabilisation of the member countries under strategic guidance from the Euro Area Summit.[13] The eurozone budget – funded with regular national contributions, allocated tax revenues, and new EU budget resources – would co-finance growth-enhancing public expenditures, create financial incentives for reform implementation and protect public investments from budgetary pressure. A separate European Unemployment Stabilisation Fund could lend money to the social-security systems of member countries facing an economic crisis.

The 'New Hanseatic League' of eight smaller member countries led by the Netherlands strongly resisted in particular the stabilisation element of a eurozone budget, because they feared that entering into public risk-sharing without previous public risk-reduction could undermine fiscal discipline and lead to permanent budgetary transfers.[14] As a result, the Eurogroup and the Euro Summit of December 2018 restricted the scope of the agreement to a euro area budgetary instrument for convergence and competitiveness (BICC), to be anchored within the EU budget for 2021-2027.[15] Under the BICC, which was to become

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[11] For a discussion of the benefits of structural reforms for monetary policy see van Riet (2006).

[12] The back-to-back EISF loans of up to €30 bn., guaranteed by the EU budget, could be coupled with a grant to cover the interest costs. The grant component was to be financed by national contributions in proportion to the share of each country's NCB in the monetary income of the Eurosystem based on an intergovernmental agreement. The RSP comprised three elements, with an overall tentative budget of €25 bn.: 1) a Technical Support Instrument as follow-up to the Structural Reform Support Programme; 2) a new Reform Delivery Tool; and 3) a new Convergence Facility for non-euro area countries. While the RSP advanced in the legislative process, political views on the EISF diverged.

[13] See the Meseberg Declaration on a French-German roadmap for the Euro Area, 19 June 2018, and the French-German Proposal on the architecture of a Eurozone Budget within the framework of the European Union, 16 November 2018.

[14] See for example the article "Northern member states unite on euro-zone reform", *The Economist*, 8 December 2018.

[15] See Council of the EU, Term sheet on the budgetary instrument for convergence and competitiveness (BICC), Brussels, press releases 466/19 of 14 June 2019 and 642/19 of 10 October 2019.

part of the European Semester, all euro area countries (as well as the ERM II members wishing to join in) could receive grants for undertaking ambitious structural reforms and public investments, subject to the fulfilment of agreed milestones and targets (European Commission, 2019).[16] The national co-financing rate of 25% could be modulated (cut in half) in case the country concerned experienced a severe economic downturn as defined in the SGP. The EU budget envelope of €25 bn. reserved for the BICC (of which €17 billion was allocated to the euro area countries for reform delivery) could only be increased by voluntary national contributions in line with a new intergovernmental agreement among the participating countries. Technical discussions on adding a stabilisation function to this remit would continue.

Progress with the BICC was overtaken by the EU's economic response to the Covid-19 pandemic of 2020 in tandem with the ECB's massive monetary support aimed at stabilising financial markets and countering the macroeconomic fall-out from the Great Lockdown. The common fiscal response, as also called for by the ECB (Lagarde, 2020), emerged from the political willingness of the Member States to act together in the fight against a common adversary and to avoid the mistakes made during the sovereign debt crisis.

The normal budgetary requirements under the SGP were temporarily suspended (at least for 2020 and 2021) in view of the expected severe economic downturn affecting the euro area as whole and the need to coordinate a supportive fiscal stance both at the national level and the aggregate level. This general escape clause – which was introduced in the SGP as a lesson from the Great Financial Crisis of 2008 – allowed Member States to deviate from their budgetary adjustment path to tackle the health emergency and address its negative socio-economic consequences (European Commission, 2020a). Yet, the SGP also states that taking all necessary budgetary measures should not endanger fiscal sustainability in the medium term.

Governments that entered the Covid-19 recession with healthy public finances were in a much better position to meet this condition than those that already had a high public-debt-to GDP ratio. The lack of fiscal space in the hardest-hit countries (notably Italy and Spain) constrained them in taking sizeable countermeasures, which in turn could lead to a sustained economic divergence that undermined the cohesion of the internal market and the stability of the euro. Following an appeal to their solidarity and self-interest, however, Member States were quick to establish common safety nets for firms, workers, and sovereigns with a total value of €540 bn. (3.9% of 2019 EU-27 GDP).[17]

First, the EU provided regulatory relief. A temporary relaxation of the EU limits on state aid opened the way for Member States to keep firms affected by the lockdown in business. EU supervisors released countercyclical buffers and encouraged banks to use their capital and liquidity reserves to sustain the flow of credit to the private sector.

Second, the European Investment Bank (EIB) activated emergency funds up to €40 bn. to bridge short-term financing needs of small and medium-sized enterprises. In addition, it

[16] The BICC would be integrated within the Reform Support Programme (RSP). The governance framework provided for the EU Council with only the euro area countries having a right to vote (after discussions in the Eurogroup and possibly in the Euro Summit) to set ex ante strategic orientations on the reform and investment priorities for the euro area as a whole and to give country-specific guidance. On this basis, euro area countries could submit proposals for reform and investment packages to be supported under the BICC.
[17] For an overview, see the webpage of the European Council/Council of the EU on the collective economic response to the Covid-19 pandemic: https://www.consilium.europa.eu/en/policies/coronavirus/

created a European guarantee fund of €25 bn. that – in partnership with local lenders and national promotional banks – could lend up to €200 billion to companies.

Third, a new European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) was established, under which Member States could request EU funding for national short-time work schemes until end-2022, or with a later end-date if the pandemic persisted. This EU debt-financed financial assistance for a total amount of up to €100 bn. was made available in the form of concessional loans disbursed in instalments to countries facing a sudden severe increase in public expenditure related to employment protection caused by the coronavirus outbreak.[18]

Fourth, fiscally-constrained euro area countries could draw on a new ESM credit line to receive Pandemic Crisis Support of up to 2% of their GDP specifically to cover the direct and indirect healthcare, cure and prevention costs related to the coronavirus outbreak.

The European Fiscal Board (2020a) observed that these 'timely, targeted and temporary' measures *de facto* performed the initial stabilising role that a central fiscal capacity for the eurozone would play, complementing the national fiscal relief measures and the ECB's monetary stimulus. But further common initiatives to stimulate public investment were called for to protect the region's future growth potential. As long as the low-interest rate environment prevailed, the costs of a centralised fiscal expansion financed by common public debt should also be less than the benefits in terms of higher output growth.

Building on a French-German initiative[19] and European Commission (2020b) proposals, the European Council offered further financial assistance to the hardest-hit countries and regions by redirecting EU budget resources for 2020 and putting together a revamped EU budget of €1074 bn. for 2021-2027 (equal to 7.7% of 2019 EU-27 GDP, i.e. 1.1% per year). European leaders further agreed on an ambitious 'Next Generation EU' recovery plan worth €750 bn. for 2021-2023 (i.e. 5.4% of 2019 EU-27 GDP or 1.8% per year) that involved substantial Commission borrowing in the capital market with a partial repayment through new EU taxes. Under the EU recovery plan, Member States could receive a combination of guarantees, grants and loans, channelled through EU programmes, in particular to promote green and digital investments, finance structural reforms, and strengthen the resilience to future emergencies.[20]

A handful of 'frugal' countries around the Netherlands questioned in particular the size and composition of the EU budget, the need for grants (which ease national fiscal constraints) as opposed to loans (which further increase governments' debt), the distribution criteria, the conditionality, and the governance framework.[21] After an intense political debate, the European Council reached a compromise by cutting back the new EU budget to below the existing level (corrected for the Brexit), splitting the recovery plan into a maximum of €390 bn. in conditional grants and €360 bn. in concessional loans, and allocating the available amount for grants in proportion to each country's population, income per capita, and unemployment or loss in real GDP. Each Member State was given the right to ask the European Council in exceptional cases to verify that the receiving country shows a

[18] The SURE instrument, established by Council Regulation (EU) 2020/672 of 19 May 2020, is the emergency operationalisation of the European Unemployment Reinsurance Scheme and supplements the regular grants for similar purposes under the European Social Fund.
[19] See 'French-German Initiative for the European Recovery from the Coronavirus Crisis', Paris, 18 May 2020.
[20] See the conclusions adopted by the Special European Council, Brussels, 17-21 July 2020.
[21] See 'Non-paper on EU support for efficient and sustainable Covid-19 recovery', published by the Office of Austrian Chancellor, Sebastian Kurz, on behalf of Austria, Denmark, the Netherlands and Sweden, Vienna, 23 May 2020.

satisfactory fulfilment of the milestones and targets of its agreed recovery and resilience plan – although this 'emergency brake' could only delay but not stop the Commission's decision on the payment. This political agreement was hailed as a historical breakthrough for European fiscal integration, since for the first time it combined substantial EU public debt issuance and EU taxes with a fiscal redistribution scheme and oversight of spending.

An open question was whether the EU's economic response to the corona crisis required a euro area dimension. The various safety nets introduced during the pandemic were conducive to macroeconomic stabilisation in the wake of the pandemic but were not designed to address ordinary business cycle fluctuations at the euro area level. Next Generation EU, in particular the Recovery and Resilience Facility,[22] supported national reforms and public investments, similar in spirit to the BICC. But it was a temporary budgetary instrument, designed for EU purposes, funded through Commission borrowing and under political control of the EU Budget Authority (the EU Council and the European Parliament). Coordination in the Eurogroup would have to be expressed through the euro area economic policy recommendation that is part of the European Semester.

The EU's collective response supported market beliefs about the cohesion of the internal market and the viability of EMU, which in itself stabilised sovereign bond markets and increased the efficacy of monetary policy. Yet, it was mostly achieved by sharing public risk at the EU level rather than among euro area countries. Moreover, the sharp rise in national budget deficits, government debt and state guarantees (including to the EU budget) implied an increase in national public risk. At some point in the future, market volatility could again hit the most indebted member countries. Once it was re-activated, the SGP would therefore have to guide national governments onto a credible path to sound and sustainable public finances that makes allowance for the special circumstances of Covid-19.

All in all, a permanent euro area fiscal capacity embedded in the EU framework – funded with regular national contributions, allocated tax revenues, or euro area borrowing – was still needed to secure an appropriate overall fiscal stance aligned with the ECB's monetary policy, for example when widespread austerity measures demanded a fiscal offset at the EMU level. In addition, it could assist a country experiencing a severe recession with macroeconomic stabilisation and target conditional transfers at national structural reforms that strengthen potential growth, economic convergence and market integration. Furthermore, the ongoing EU economic governance review could make the SGP a more effective tool for securing the return to healthy public finances, while leaving governments subject to fiscal sustainability constraints more room for fiscal stabilisation of the business cycle (European Fiscal Board, 2020b). Although the architecture of EMU did not foresee explicit monetary-fiscal cooperation, euro area governments have a common interest in putting in place area-wide fiscal tools to support a consistent economic and monetary policy mix, both in normal times and in an emergency.

[22] The proposed Regulation for a Reform Support Programme, which included the BICC, was withdrawn and its content was replaced by the Recovery and Resilience Facility (with revised objectives and an adjusted reform delivery mode) and a separate Technical Support Instrument. Hence, the proposed Regulation for a governance framework for the BICC was also withdrawn. See European Commission (2020c).

4. Towards a Safe Sovereign Asset for the Eurozone

While a euro area fiscal capacity could be financed through common public debt issuance, a single safe sovereign asset available in sufficient supply that effectively anchors the euro area financial system also benefits the single monetary policy.

First, a common sovereign asset for the eurozone regarded as safe would serve as a stable benchmark for pricing both public and private debt securities, mitigates the risk of volatile intra-area capital flows between safe and risky member countries and promotes financial integration (van Riet, 2017a). A more unified capital market supports an even transmission of monetary policy across the eurozone and reduces the need for the ECB to stabilise national sovereign bond markets in a crisis.

Second, a common public debt security would meet the financial industry's rising demand for high-quality and liquid assets to comply with EU and national prudential requirements. A safe euro area public debt security is also an effective tool to break the negative feedback loop between vulnerable governments and systemic banks holding national sovereign debt on their balance sheet which could decline in value in a fiscal crisis (Brunnermeier et al., 2017). A more resilient euro area banking system enhances financial stability and facilitates monetary policy.

Third, common public debt would function as reliable collateral for secured interbank lending. Banks could also pledge it in credit operations with their NCB if it is accepted as eligible collateral. Given a liquid market of sufficient depth and a complete yield curve, the ECB could conduct outright monetary policy operations in the euro area money and/or capital market using common public debt instead of a basket of safe and risky national public sector securities. A safe eurozone sovereign instrument would furthermore be held as a reserve asset by other central banks, which would facilitate foreign exchange swaps and operations and enhance the international role of the euro (European Central Bank, 2019).

Since the financial crisis of 2008, many proposals have been put forward in the quest for a safe sovereign asset for the eurozone, with or without mutualisation of national public debt.[23] But European leaders excluded the option of issuing genuine eurobonds under joint-and-several liability, because it could only be envisioned as part of a future fiscal union. Until then, common public debt must therefore be created with other safety enhancements.

European supranational institutions like the EIB and the ESM issue public debt securities – also denominated in other currencies than the euro – to acquire funds with which they fulfil a specific mandate. They enjoy the highest credit rating thanks to their strong capital base, as provided by the member countries. The European Commission regularly accesses the capital market to borrow modest sums – guaranteed by the own resources of the EU budget to secure a top credit rating – which are passed on as rescue loans to Member States and third countries. Since the corona crisis, this borrowing activity also covers social bonds for the temporary financing of the SURE instrument of up to €100 bn., which are backed up by at least €25 bn. of bilateral guarantees voluntarily committed by Member States to the EU budget. To fund the European recovery from the pandemic, the Commission will further tap the capital market in 2021-2026 at a range of maturities for a maximum of €750 bn.,

[23] Amtenbrink et al. (2016) and Grund (2020) review the economic and legal aspects of various proposals for common public debt issuance.

also by issuing green bonds. The steady repayment of this EU debt with accrued interest until 2058, in particular the part that is used for grants to Member States, will be secured by an increase in the own-resources ceiling, as well as by the introduction of EU taxes.

Although the Commission is thus set to become one of the biggest supranational issuers in the world, its enlarged borrowing activity is directly related to the Covid-19 emergency. The size and time restrictions that apply to this EU debt make it less suitable for fulfilling all the afore-mentioned monetary policy functions of a safe sovereign asset for the eurozone. Looking ahead, euro area governments could also charge, for example, a European Public Debt Office with the task to issue and refinance an adequate amount of common public debt securities backed up by a diversified portfolio of national sovereign bonds (van Riet, 2017a). Given the different risk profiles of euro area countries, flanking measures are required to ensure that investors perceive this common sovereign bond-backed security as a safe asset at all times, also during fiscal duress or political upheavals.

One option to achieve this objective is to structure the eurozone security into a junior tranche which carries all the credit risks on the underlying portfolio of national sovereign bonds and a senior tranche of European Safe Bonds (ESBies) with a very low probability of default (Brunnermeier et al., 2017).[24] The ultimate safety of the senior tranche could be guaranteed by adding a modest reserve fund to cover the credit losses if ever the absorption capacity of the junior tranche was fully exhausted (Hild et al., 2014). Alternatively, the ESM could be mandated to issue so-called E-bonds and use the proceeds to construct a portfolio of national sovereign bonds. E-bonds could be secured either by an increase in the ESM's capital base or by the financial returns from its status as a senior investor who always gets paid before other creditors. Creating a common safe asset for the eurozone should thus be feasible without asking the member countries to assume an undue common liability to guarantee its safety.[25]

The potential costs from embedding some form of public risk-sharing in a common public debt security must be weighed against the advantages from having a more stable and integrated euro area financial system. The systemic risk-reduction would benefit all member countries, but in particular vulnerable governments and their financial sector. The enhanced stability of sovereign bond markets would, on the margin, also ease the national trade-off between fiscal space and fiscal sustainability and increase the scope for countries with weaker public finances to contribute to an aggregate fiscal stance aligned with monetary policy. Furthermore, an integrated euro area capital market facilitates private risk-sharing with foreign investors and reduces the need for counteracting fiscal measures when firms or households are hit by a negative shock.

A political decision to introduce the common public good of a single sovereign asset requires several disciplinary and regulatory issues to be addressed. For example, to contain moral hazard, a country's participation in the scheme could be made conditional on full compliance with the EU's economic governance rules. Alongside, the preferential treatment of national sovereign bonds in EU prudential legislation for credit institutions as risk-free assets – which gives governments easier access to market funding than

[24] The European Commission (2018a) came with a legislative proposal to enable a private market-led development of common sovereign bond-backed securities (SBBS), remove regulatory impediments, and create a level playing field with national sovereign bonds. Euro area countries feared, however, that their own sovereign debt would become subordinated to the SBBS.

[25] See Leandro and Zettelmeyer (2019), who examine these options in detail and address some legal and practical issues.

corporations – could be carefully phased out for euro area governments.[26] At the global level, the Basel Committee on Banking Supervision should allow supervisors to grant this regulatory privilege to the new common public debt security (as is the case already for EIB, ESM and EU debt) to recognise its quality as a safe asset for investors and to ensure that the eurozone can compete for funds in international capital markets at the same level as third countries.

5. Towards a Fiscal Backstop for the Eurosystem

The net income accruing to the euro area NCBs as a result of their monetary policy function is in principle pooled at the Eurosystem level before it is allocated to them in proportion to their paid-up shares in the capital of the ECB. As shareholders, the euro area NCBs also receive their share of the ECB's profits after its financial buffers have been replenished.

Profit and loss considerations are normally not a key consideration in defining monetary policy. A neutral attitude in this regard is facilitated by the financial independence of the ECB and the NCBs (Amtenbrink, 2005). The Eurosystem naturally manages the financial risks associated with its monetary policy interventions in order to avoid major losses that could undermine its operational capacity and public trust in its activities (European Central Bank, 2015). Yet, the new focus since 2008 on flooding distressed markets and the economy at large with liquidity –even more so during the Covid-19 pandemic – implied a substantial increase in the size of the Eurosystem's balance sheet and hence its exposure to financial risks (Figure 2). On the hand, this ample monetary accommodation increased the risk-bearing capacity of other economic sectors which reduced the likelihood that its own financial risks originating from these sectors could materialise. On the other hand, net monetary income could suddenly turn negative and large losses could in theory even exhaust its financial reserves and capital base, making fiscal backing necessary.[27]

[26] Capital Requirements Regulation (EU) No 575/2013, as amended, allows banks to assign claims on central governments a zero-risk weight without exposure limit and to consider them as high-quality liquid assets. See also van Riet (2019a).
[27] During Covid-19, some major central banks received a full or partial indemnity from their government, which created an equity cushion to absorb large losses. See Bank for International Settlements (2020).

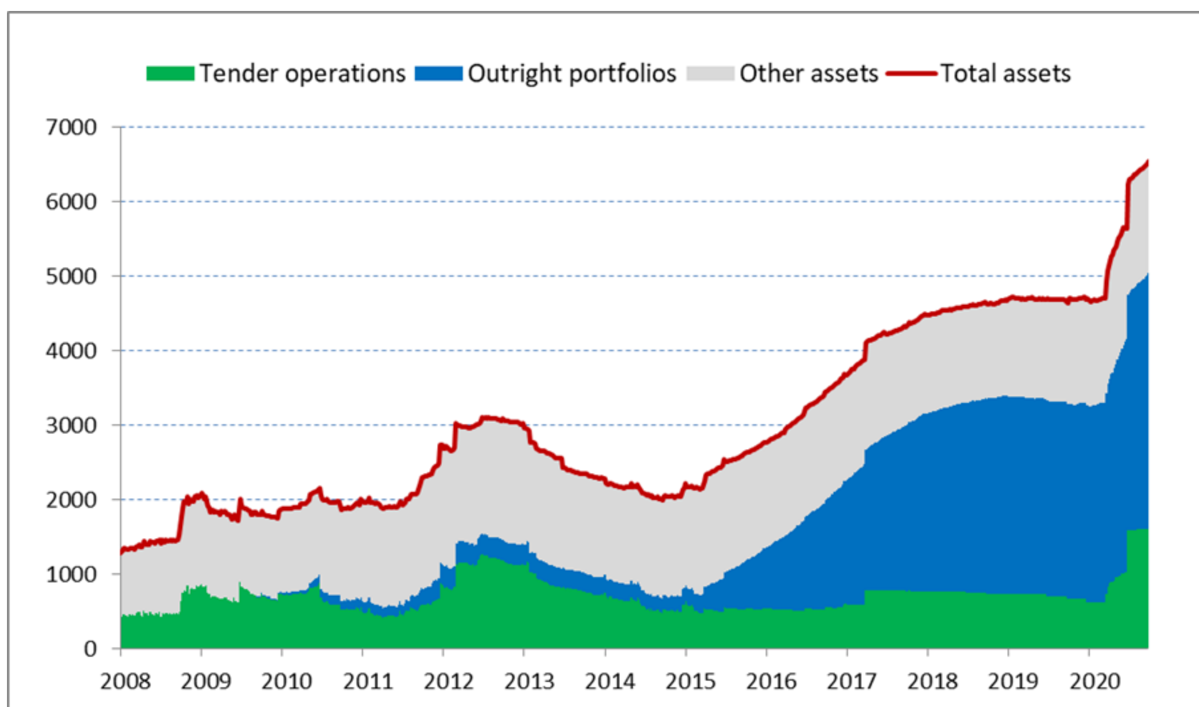

Figure 2. Eurosystem Balance Sheet: Monetary Policy Assets and Other Assets

Source: ECB. Latest observation: week 39, 29 Sept. 2020.

Note: Tender operations = Lending to euro area credit institutions for monetary policy purposes against eligible collateral. Outright portfolios = Public and private sector securities bought in the capital market for monetary policy purposes. Other assets = Gold and gold receivables; claims on non-euro area residents; claims on euro area residents, credit institutions and governments held for non-monetary policy purposes; and remaining assets

The main financial risks from large central bank balance-sheet operations arise from five sources.

First, the Eurosystem provided sizeable refinancing to the banking sector at longer maturities than usual to support lending to the economy, while accepting a wider range of lower-rated financial instruments than normal as eligible collateral, especially in stressed money market conditions. Early in the corona crisis, it adopted an emergency package of collateral easing measures, adding for example Greek sovereign debt instruments as eligible collateral and grandfathering the collateral eligibility of marketable assets that fell below the minimum credit quality requirements. Collateral valuation haircuts and other risk controls were still applied, but the risk tolerance level was increased during the pandemic.[28]

Second, the interest rate that the Eurosystem receives on credit given to the banking sector normally exceeds the interest rate paid on bank reserves that are held in a deposit account with the Eurosystem. However, the net positive effect of these dual interest rates on monetary income was diminished over time. As from June 2014, the ECB's deposit facility rate was cut below zero and then reduced further in several steps to -0.5% in September 2019 while the main refinancing rate was kept at 0%. Every quarter, starting with the Targeted Longer-Term Refinancing Operation (TLTRO) of June 2016, banks meeting the condition of sufficiently expanding their net private lending (excluding loans for house purchases) could get credit for four years at a negative interest rate as low as the deposit

[28] See 'ECB announces package of temporary collateral easing measures', ECB press release of 7 April 2020.

facility rate.[29] This credit subsidy offered the participating banks a partial offset for the tax implied by the negative interest rate on deposited reserves.

Third, starting end-October 2019, a two-tier remuneration system applicable to bank reserves came into effect.[30] Minimum reserves as well as excess reserves held by banks in the deposit account continued to be taxed at the negative deposit facility rate. However, the part of excess reserves held in a current account with the Eurosystem (up to six times their minimum reserves) was exempted from this negative rate and remunerated at 0%. This two-tier system reduced the average interest costs for the banking sector of holding excess reserves and was meant to support the bank-based transmission of monetary policy. During the corona crisis, the Eurosystem kept the deposit facility rate at -0.5% but reduced the lowest interest rate applicable to TLTROs to -1.0% and eased the access conditions.[31] In the following TLTRO of end-June 2020 the ECB allocated €1308 bn. (i.e. 11% of euro area 2019 GDP) of credit with a three-year maturity to the participating banks (or €548.5 bn. after subtracting repayments of maturing loans). Since this additional liquidity could be parked at 0% on a current account or at -0.5% on a deposit with the Eurosystem, this operation entailed significant positive net interest transfers at the expense of net monetary income. As of May 2020, the Eurosystem also offered a monthly series of pandemic emergency longer-term refinancing operations (PELTROs) at an interest rate that was 25 basis points below the main refinancing rate of 0%.

Fourth, the Eurosystem took significant credit risks on its balance sheet as a result of monetary operations in stressed private and public debt markets, although it also took risk containment measures and received interest. Focusing on public debt, it purchased from May 2010 to March 2012 for about €220 bn. in sovereign bonds issued by Greece, Ireland, Portugal, Italy and Spain under the Securities Markets Programme (SMP), o/w €35 bn. was still outstanding at end-July 2020.[32] Although activation of the SMP was not subject to conditions, the ECB took note of or requested fiscal measures and structural reforms that would reduce the sovereign risk of these countries.[33] The ECB replaced the SMP in September 2012 by a commitment to undertake unlimited Outright Monetary Transactions (OMTs) in disrupted sovereign bond markets to counter currency redenomination risk. Activation of this monetary backstop for a specific country was made conditional on strict and effective compliance with a full EU adjustment programme, preferably with IMF involvement, to reduce the likelihood of a sovereign default.[34] The success of these actual and contingent operations in stabilising sovereign bond markets also helped to mitigate credit risks in other parts of the Eurosystem's balance sheet (Caballero et al., 2019).

Fifth, the Asset Purchase Programme (APP) as well as the Pandemic Emergency Purchase Programme (PEPP) – both covering public and private sector debt instruments –significantly increased the Eurosystem's interest income, but also its exposure to corporate and sovereign defaults, especially as the principal payments from the maturing securities were

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[29] See 'ECB announces new series of targeted longer-term refinancing operations (TLTRO II)', ECB press releases of 10 March 2016.
[30] See 'ECB introduces two-tier system for remunerating excess liquidity holdings', ECB press release of 12 September 2019.
[31] See 'ECB recalibrates targeted lending operations to further support real economy', ECB press release of 30 April 2020.
[32] See 'ECB decides on measures to address severe tensions in financial markets', ECB press release of 10 May 2010.
[33] Whereas Greece, Ireland and Portugal had agreed to an EU/IMF adjustment programme, the ECB president (Trichet) sent (leaked) letters in August 2011, co-signed by his successor (Draghi), to the governments of Italy and Spain urging them to accelerate fiscal consolidation and structural reforms.
[34] See 'Technical features of Outright Monetary Transactions', ECB press release of 6 September 2012.

reinvested for as long as necessary. The (expanded) APP for quantitative easing[35] was implemented from October 2014 to December 2018, restarted in November 2019, and scaled up from March to December 2020 when the negative economic impact of Covid-19 became apparent. The ECB launched the PEPP in March 2020 to stabilise financial markets and deliver extra monetary accommodation, at least until mid-2021, as a direct response to the coronavirus crisis.[36] By July 2020, the Eurosystem had acquired in total €2,643 bn. of public sector securities under the APP and the PEPP (o/w 90% issued by central, regional and local governments as well as recognised public agencies of euro area countries and 10% issued by European supranational institutions; see Figure 3) and €594 bn. of private sector securities (together this amounts to 27% of euro area 2019 GDP).

The benchmark for the country allocation of public sector purchases was the ECB's capital key instead of the proportion of national public debt in the capital market, although it was applied with a relatively high degree of flexibility under the PEPP when needed to compress non-fundamental sovereign spreads. The total amount was furthermore subject to issue and issuer ceilings, which prevented the ECB and NCBs from getting a blocking minority in a public debt restructuring and becoming a dominant creditor of public institutions. Again, to preserve sufficient flexibility during the Covid-19 pandemic, these self-imposed constraints were less strictly maintained for the PEPP portfolio.

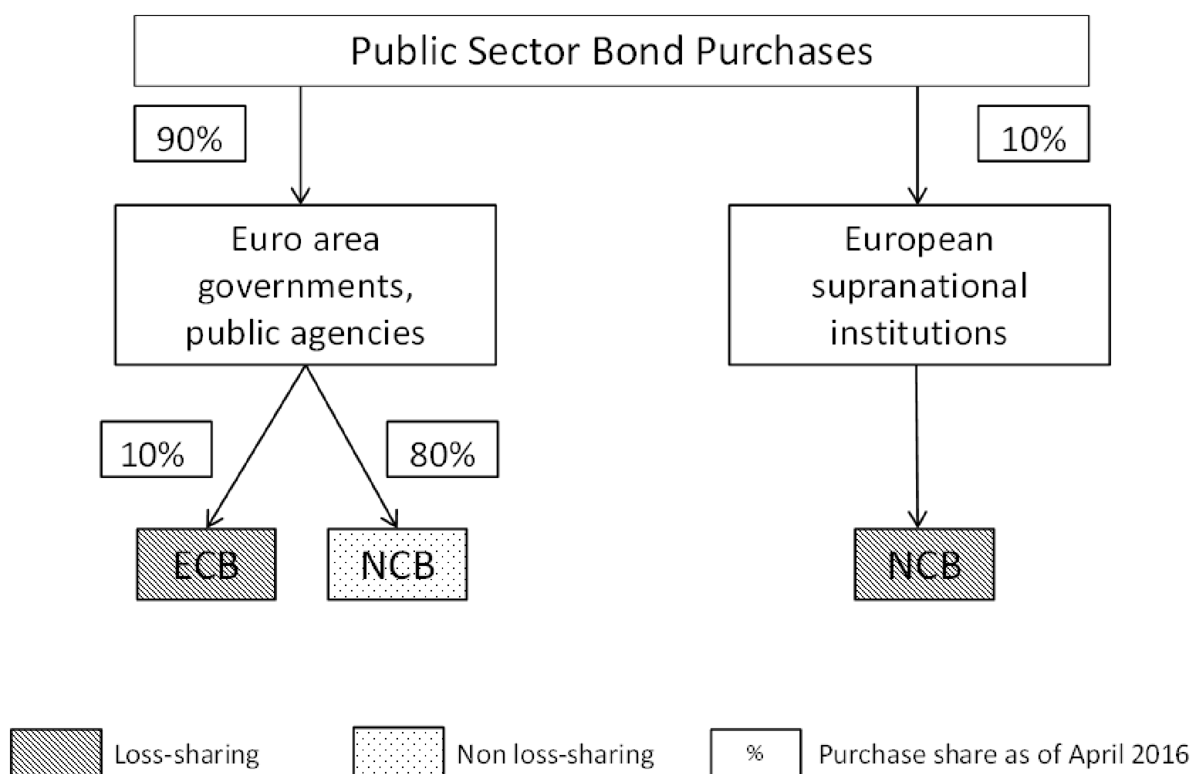

Figure 3. Public Sector Bond Purchases under the APP and the PEPP

Source: ECB.

[35] See in particular 'ECB announces expanded asset purchase programme', ECB press release of 22 January 2015.
[36] See 'ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)', press release of 18 March 2020. The PEPP envelope was increased to €1350 bn. on 4 June 2020.

As another precaution, both the APP and the PEPP were restricted to debt instruments with a minimum credit quality of investment-grade. Government bonds of euro area countries receiving EU/IMF financial assistance, which were rated below investment-grade, benefited from a waiver, provided that their adjustment programme was on track. Greek government bonds were just eligible for the PEPP. Certain losses were so far only incurred on corporate sector bonds that after a credit downgrade to below the investment-grade threshold had to be sold again at a lower price.

The public sector bond portfolio acquired through the APP and PEPP is subject to a special loss-sharing regime which allocates most of the national sovereign risks to the respective NCBs (Figure 3). Financial results on the 10% of supranational bonds and on 10% of the national public sector bonds are fully shared within the Eurosystem. Profits and potential losses on the remaining 80% are for the sole account of the euro area NCBs which bought the public sector bonds of their own country. The decision that each NCB would carry itself most of the direct financial consequences of a possible default by its own country prevented the mutualisation of national sovereign risk as well as monetary financing of the failing government via the Eurosystem's balance sheet (Praet, 2015; Bletzinger and von Thadden, 2018).

A harmonised Eurosystem accounting framework ensures that the ECB and euro area NCBs all apply prudent principles for the recognition of monetary income. The rules for retaining earnings and distributing profits follow ECB and national conventions, respectively (Bunea et al., 2016). Some NCBs are obliged to distribute a high share of their profits as dividend. Others retain the interest receipts on their growing monetary policy portfolio to build extra financial buffers and, hence, they limit the remittances to their government in the short run. This provisioning might be motivated by the political complications of having to ask the treasury *ex post* for a recapitalisation.

An NCB that faces major credit impairments has two main options to replenish its reserves and capital. First, it may decide to carry the losses forward for the part that cannot be covered by its reserves and capital base, until retained future profits enable it to restore the original level of statutory capital. This accounting solution has major political advantages (Durré, 2016). The government of the NCB concerned will face serious constraints in replenishing the NCB's capital base quickly when a restructuring of its own debt outstanding is the cause of the problem. Using scarce financial resources to recapitalise the NCB may be politically contentious, especially when the government has to draw on conditional EU/IMF financial assistance. Second, a distressed NCB may be able to borrow in the capital market or from other NCBs and the ECB to cover the gap, using as collateral its share in the Eurosystem's future monetary income (Buiter, 2020). The NCB concerned would, however, continue to carry the risks related to the public sector bonds that it takes on its balance sheet issued by its own country.

The ECB is independent in managing its finances, has considerable financial buffers in place to support its operations, and normally reports an annual profit. Any loss that it incurs in a financial year may be offset against its general risk provision and general reserve fund. Should its financial buffers ever be exhausted, the ECB may ask the euro area NCBs to cover the shortfall with a contribution from their net monetary income in proportion to their paid-up shares in the ECB's capital. The ECB may record any remaining negative difference on its balance sheet as a loss carried forward. Future seigniorage revenues and other net income would then be used to offset this loss and to replenish the financial buffers before resuming dividend payments to the euro area NCBs (Bunea et al., 2016).

The ECB could also, if necessary, make a call on the NCBs to contribute extra capital within the limits and under the conditions set by the EU Council. Already in the year 2000, following an ECB recommendation, the EU Council approved that at some point in the future it could request further capital of up to €5 bn. beyond its initial subscribed capital of €5 bn.. Amid the sovereign debt crisis in 2010, the Governing Council decided to make full use of this option and increased the ECB's subscribed capital from €5.76 bn. to €10.76 bn., paid-up by the euro area NCBs. A further recapitalisation of the ECB could be complicated to agree *ex post* in a political setting whereby the EU Council must consult with the European Parliament and the European Commission, and all Member States have to give their blessing. Still, a prolonged financial constraint that is not covered by the euro area governments could undermine the credibility of monetary policy (Chiacchio et al., 2018).

Confidence in the ability of the ECB and the euro area NCBs to perform their monetary policy tasks could therefore benefit from an unconditional political commitment to respect not only their statutory independence but also to maintain their financial strength. The related EMU-specific coordination challenge could in principle be overcome with democratically legitimised national fiscal guarantees that respect national budget rights (Illing and König, 2014). The member countries could each make an explicit fiscal commitment when necessary to recapitalise their own NCB and to put it in a financial position to respond positively to an ECB call for additional capital. These *ex ante* fiscal guarantees would demonstrate that euro area governments are ultimately responsible for the financial risks that the Eurosystem takes with its much-expanded balance sheet.[37]

Since their purpose is to underpin public trust in the single monetary policy and its financial capacity to preserve price stability for the euro area as a whole, the fiscal guarantees should in principle be joint–and–several commitments. However, transfers whereby each member country also covers for any other that is unable to do so would be in conflict with the EU Treaty. Moreover, the precarious budgetary position of some countries, especially after the fiscal response to the Covid-19 crisis, reduces the value of their guarantee. Stronger sovereigns may then refuse to make such a pledge (Buiter, 2014). This dilemma can only be solved once all euro area countries have achieved sound and sustainable public finances, and/or when politicians realise that public risk-sharing through a euro area fiscal capacity and a common safe asset can be an effective tool to reduce public risk across the board.

6. Conclusion

The EMU architecture relies above all on the single monetary policy to stabilise the euro area, whereas on several occasions since 2008 it became evident that fiscal assistance was warranted. Building on the EU's economic response to the Covid-19 pandemic, euro area governments acting together could reduce the burden placed on the ECB in three complementary fiscal areas.

First, they could establish a permanent euro area fiscal capacity within the EU institutional framework with the objective to stabilise output movements at the supranational level,

[37] As an exception, the Nederlandsche Bank received in 2013 an *ex ante* guarantee from the Dutch State to cover the gap between the crisis-related increase in risk exposures and the available financial buffers until these risks had returned to normal. This fiscal backstop was available (but never called in) from 1 March 2013 to 1 March 2018 and covered up to €5.7 bn., with the effect that during period this NCB did not have to make special risk provisions that would reduce its regular dividend payments to the State. See the letter of the Dutch Minister of Finance to the House of Representatives on the proposal to grant a guarantee to the Nederlandsche Bank, session 2012-2013, Document 33 548, No 8, 15 February 2013 (in Dutch).

where needed by providing assistance with national stabilisation. Giving member countries financial rewards for structural reforms could further help to raise their potential growth, promote economic convergence and enhance market integration. A supportive euro area economic policy stance both in normal times and in an emergency would reduce the need for the ECB to pursue ultra-low interest rates.

Second, euro area countries could introduce a common public debt security that is backed up by a portfolio of national sovereign bonds and a reserve fund. A safe sovereign asset for the eurozone that is available in sufficient supply would support an even monetary transmission and could play a prominent role in monetary policy operations.

Third, euro area governments could make an unconditional commitment to recapitalise their own NCB as well as (indirectly) the ECB, if ever needed in the context of large central bank balance-sheet operations. This fiscal safeguard would recognise the importance of financial independence for a credible monetary policy geared towards price stability.

These three elements of fiscal integration each entail a certain degree of public risk-sharing between the euro area countries and therefore also require adequate public risk-reduction to be politically acceptable. The fiscal legacy from the Covid-19 pandemic suggests that making national public finances sound and sustainable will take considerable time in some countries. However, fiscal integration aligned with monetary policy would facilitate this task. A balanced euro area macroeconomic policy mix, a safe sovereign asset for the eurozone and an explicit fiscal commitment to indemnify the Eurosystem reduce both country-specific and area-wide systemic risks, and strengthen the euro. Confidence in a more stable EMU could also pave the way for a central government as counterpart to the ECB that would address its institutional loneliness with full respect for its political independence.

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The mission of UNU-CRIS is to contribute to generate policy-relevant knowledge about new forms of governance and cooperation on the regional and global level, about patterns of collective action and decision-making.

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