Repair and Prepare:

Strengthening Europe's Economies after the Crisis

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Foreword

Europe is often portrayed as a ship with sails of different colours from different countries pushing the common boat in the right direction.

From 2010 to 2012, that ship faced the perfect storm: The euro area almost caused the ship to sink, there was massive disagreement on how to get out of the storm, and it was unclear who was steering the ship. However, Euro-Europe eventually managed to buoy the ship while in the eye of the storm, and the decisive action by ECB President Mario Draghi, arguably not the captain of the ship, managed to steer the common project away from imminent danger.

Yet the journey is not over. And the boat is not as solid as it should be. Therefore, we must pose the question: Were Euro-Europe to face yet another storm, would it be resilient enough to weather it?

This is the topic of our report. We believe that further repairs are needed. And we believe that Europe needs to be better prepared for the next potential threat to its very existence.

Therefore, we suggest taking a very systematic look at what needs to be done, which questions we need to answer to make improvements to the common project (the "known unknowns"), and what a possible path towards renovation could look like.

We want neither to sound alarmist and pessimistic nor join those who dream about changing the very nature of the common project into something far beyond what it is today. While the idea of an "ever closer union" clearly is the broad guideline, we do not think that endless debates on "finalité" will resolve today's urgent questions. What Europe needs today is a positive and pragmatic debate on which specific steps to take.

Our report aims at setting the stage for this kind of debate. We have worked on it as two think tanks because we are struck by the absence of this question in governmental circles and the media. There seems to be an extensive "crisis fatigue" and "euro area debate fatigue". This is understandable, given how aggressively the crisis dominated headlines in recent years.

But the simple fact that the storm has subsided doesn't mean that our boat is stable. And it does't mean that another storm is not on the horizon.

So let us get to work now.

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Executive summary

The problem: Europe's economic and monetary union (EMU) is not viable in the long run

- Although the first wave of the euro area's economic crisis has receded, this is no time for complacency. The European Union remains threatened by low levels of investment, sluggish reforms, persistent tensions between EU members and an erosion of EU legitimacy.

- The dynamics driving the crisis in 2009 were a direct result of EMU's paradoxical establishment as a monetary union within a heterogeneous economic space. These underlying dynamics remain largely unchanged and can therefore generate further crises.

The objectives: Repair and prepare

- Europe needs to repair the economic and political damage wrought by the ongoing euro crisis and prepare for future shocks. We propose a framework for an effective reform process and identify priorities in need of further exploration.

- In addition, we present a series of proposals designed to address and overcome the commitment problems and political deadlock that have stymied earlier attempts at reform.

The proposal: A Roadmap and a Modernisation Pact

- The Roadmap: We propose a three-phase reform plan to be implemented over a period of approximately 10 years that includes obligations, incentives and avenues for withdrawal for all euro-area member states. Loosely inspired by the three stages in which the euro itself was introduced, this plan foresees the following three phases: (1) agreement on reforms and convergence goals; (2) implementation of reforms; and (3) introduction of a more integrated and resilient EMU featuring improved institutions that prevent imbalances, strengthen automatic adjustment mechanisms, offer a clear crisis-resolution framework and prevent moral hazard.

- The Modernisation Pact: In recognition that any long-term reform process lacking immediate benefits will be politically difficult, we propose introducing a concerted investment initiative on the EU level, which would include the mobilisation of private capital. Designed to address Europe's investment gap and modernise its infrastructure, this pact would mark a shift in policy towards greater cooperation among euro-area member states. By committing to the reallocation of public spending away from public consumption and towards investment (i.e., "smart austerity"), participating countries would increase their fiscal sustainability.

Next steps: dealing with the "known unknowns"

- One major objective of this study is to identify areas where current knowledge and expertise is not sufficiently developed to guide policymakers towards the right decisions. We therefore identify several areas where further research is needed:

  a. The nature of the required convergence: How much deepening of the single market is needed? What kinds of structural reforms are needed at the domestic level? What instruments can ensure convergence?

  b. The building blocks of a "true" EMU: What additional elements would EMU need to allow it to function effectively even in a crisis? How could the democratic legitimacy of such a new framework be ensured?

  c. The legal implications: Would a treaty change be required? What relationship would exist between the single market and the single currency?

  d. The ability to leave the euro area: As further integration will necessitate some kind of compliance mechanism, could euro-area exit be an option if certain member states failed to comply?

  e. The Modernisation Pact: What are the highest-priority investment areas? What is the best way to mobilise private capital for investment? Who could or should lead an investment initiative?

A. Background: The crisis is not over

Recent developments

1. During the past two years, the immediate dangers presented by the euro-area crisis have seemed to recede. A combination of emergency relief packages, reforms and Mario Draghi's pledge to do "whatever it takes" to save the euro area stabilised the situation to such an extent that a breakup of the common currency no longer appeared to be an imminent threat.

2. In recent weeks and months, however, the situation has started to deteriorate again. One could argue that the complacency created by the easing of the crisis pressure has already started to backfire.

3. Positive signals remain. Risk premiums on sovereign bonds are low throughout the euro area, unemployment rates are high but gradually decreasing, and the first steps towards a banking union have lowered the risks posed by the bank-sovereign nexus.

4. However, no full-fledged recovery is in sight. Growth rates are not rising quickly enough. The euro area's GDP is still below pre-crisis levels, as is the investment rate. Public and private debt levels remain very high. Popular discontent is rising quickly, as was visible in the spring 2014 European Parliament elections.

5. In sum, the crisis has given rise to economic and political developments that, if left unchecked, pose a grave threat to European prosperity and stability, both in the short and medium term. Three developments are especially worrying: (1) a debt and investment gap, (2) a reform gap, and (3) waning EU legitimacy.

The dangers of complacency

High debt levels and investment gap

6. Without growth drivers, the euro area as a whole is likely to remain on a low-growth path. The private sector finds it difficult to invest due to the bleak economic outlook, and banks are reluctant to lend because of their high level of exposure to nonperforming loans. At the same time, fiscal consolidation in the countries hit hardest by the crisis has left little room for public investment. This combination of anemic demand and difficulties on the supply side has served to paralyse the economy, which in turn makes it harder for states to attain a sustainable debt-to-GDP ratio or to bring down unemployment rates. The long-term effects of such dynamics are even more worrying. A country with low levels of public and private investment not only experiences low levels of present economic activity, but also fails to lay the foundations for future growth. It risks falling behind its competitors in key areas such as infrastructure and education.

Reform gap and distrust

7. One widely discussed way out of the vicious cycle of debt is structural reform that raises potential growth rates. However, under difficult economic conditions, governments find it increasingly difficult to overcome resistance to potentially

painful reforms. The situation is today further complicated by mutual recriminations between euro-area member states, which are born from "solidarity fatigue" in some countries and "reform fatigue" in others. Rescuing the euro area is increasingly seen not as a common European project with large potential gains for both sides, but as a zero-sum game.

This rift is deepened by the prominence of intergovernmental politics in the debate over euro-area rescue measures. Some of the euro area's core countries are perceived to be behaving as "political rating agencies," which provokes resentment in the debtor countries. Populist parties across the continent have been able to capitalise on these sentiments and are likely to increase their influence further if there is no change of approach.

Waning legitimacy

8. The prolonged crisis is also affecting citizens' attitudes towards the European Union. As a consequence of the asymmetric adjustment witnessed by Europe in recent years, countries that tried to regain competitiveness have had to engineer a large and painful internal devaluation.[1] Such severe economic hardship would undermine confidence in any nation-state's political system, but it could have an even more deleterious effect on the European Union. Since the EU relies heavily on output legitimacy, high levels of unemployment and prolonged recession are likely to fuel alienation and ever-increasing euroscepticism among a large part of society. The "lost generation" of unemployed youth in Spain, Italy and Greece are in danger of becoming not just a lost opportunity in economic terms, but a threat to the political system that has disappointed them.

Our approach

9. This study takes stock of the euro area's problems, draws up a Roadmap towards a solution and identifies the most urgent questions that have to be solved on the way there. There are numerous proposals for the individual building blocks that make up a solution, even if some crucial questions appear unanswered. What is needed now, especially when taking into account the tight electoral calendar, is a method that shows how the blocks could fit together, sets out priorities and points out the main gaps in knowledge ("known unknowns").

The priorities: Repair and prepare

10. In order to put a definite end to the crisis, Europe needs to pursue two overarching goals. First, it needs to repair the massive economic and political damages wrought by the crisis, and second, the euro area needs to eradicate its systemic weaknesses and prepare for future shocks. In its current form, EMU is not viable in the long run. The current crisis has pushed it to its limits, and the next one may tear it apart.

1 Symmetric adjustment, that is, a devaluation in deficit countries accompanied by a simultaneous revaluation in surplus countries, would imply less severe cuts to prices and wages, and ultimately a less pronounced economic downturn in the deficit countries. See Grauwe (2012) on asymmetric adjustment and Schraad-Tischler and Kroll (2014), Tressel et al. (2014) for empirical evidence.

11. More specifically, Europe needs to improve the instruments, institutional framework and governance of EMU while simultaneously accomplishing four tasks:
    - Increasing growth
    - Reducing debt
    - Modernising economies through investments
    - Modernising economies through structural reforms

    Contrary to what is often said, these goals are not mutually contradictory. Rather, they can complement and strengthen each other if implemented in the right way.

How to get to resilience? Objective and limitations of this study

12. What Europe needs now is a comprehensive vision of the path from crisis to resilience that can serve as a guide for concrete action. This pilot study contributes to such a vision in two ways:

    - The study presents a working method that facilitates cooperation and commitment. It develops a Roadmap towards a sustainable EMU, based on reaching the four goals listed above in the medium term. The idea is to build strong incentives for all euro-area member states (as well as willing EU member states outside the euro area) to implement structural reforms and commit (perhaps even through legal obligations) to an enhanced and more integrated monetary union. In recognition that the current political environment will render difficult any long-term reform process lacking immediate benefits, the Roadmap is accompanied by a Modernisation Pact that focuses on smart debt reduction and a coordinated investment initiative.

    - Moreover, the study identifies "known unknowns," thereby providing a clearer view of questions that need to be answered as Europe moves towards a more resilient monetary union. We outline which areas need to be researched in more detail.

The structure

13. This study is structured as follows: In chapter two, we describe why EMU's current framework is vulnerable to crisis, and propose a set of policies and institutional elements designed to increase its resilience. Chapter three and four discuss the implementation of these elements. They also identify questions that need to be addressed by further research before the reform process can move on.

The principles

14. Our approach is governed by the following principles:

    - What is needed at this stage is not (yet) an inquiry into the technical content of certain reforms or the detailed institutional construction of tomorrow's monetary union. Rather, the objective of this study is to propose a structure for the reform process itself, and to identify priorities for further research.

- The debate over EMU reform should not be burdened by the broader debate over the ultimate end of European integration. Therefore, all reforms and changes need to be derived from the principle of subsidiarity, which can be rephrased as: “As much additional integration as necessary for the effective functioning of EMU, but as little as possible given this constraint.”[2]

- All euro-area countries would be required to commit political capital to the implementation of the agreed-upon measures. In return, they could expect the same of others (“quid pro quo”) and enjoy the benefits of a strengthened monetary union, including a more efficient response to future crises.

2 Cf. Enderlein et al. 2012.

B. Flaws of a Minimalist Monetary Union (MMU): EMU lacks long-term viability

15. This chapter illustrates why reform efforts should focus on the architecture of Europe's EMU by analysing the roots of the euro area's troubles. It provides a brief overview of the causes of the current crisis and an assessment of the reforms undertaken to date. We argue that EMU is still prone to crisis and identify a set of concrete measures that, if implemented jointly, would substantially strengthen its resilience.

16. Why did the financial turmoil of 2008 – 2009 trigger such a deep and prolonged crisis in the euro area? In line with most publications on the subject, we argue that EMU was especially vulnerable to external shocks and contagion because crucial elements of a sustainable currency union were missing. Most importantly, there was no political consensus on far-reaching fiscal and economic coordination when the negotiations over EMU reached their decisive phase in the early 1990s, even though the Delors Report as well as most academic research had stressed the importance of such policies.[3]

17. The framework agreed upon in the Maastricht Treaty could be called a MMU. It introduced a common currency, but was not itself an economic union. Governance was limited to little more than a budget and deficit ceiling, complemented by a no-bailout clause that was meant to encourage fiscal responsibility.

How MMU contributed to the crisis

18. This creation of a monetary union within a heterogeneous economic space gave rise to a number of problematic dynamics that have been described in detail elsewhere and can only be summarised here.[4] In short, MMU contributed to the crisis in three ways: It fostered the emergence of imbalances, failed to facilitate timely adjustment and lacked an efficient crisis-response mechanism.

Emergence of imbalances/vulnerabilities

19. The creation of EMU triggered a massive flow of credit to the euro-area periphery. As markets discounted the default risk of periphery government debt in spite of the no-bailout clause, risk premiums plunged. Cheap financing opportunities spurred demand and inflation. While beneficial in the short run, the credit boom proved to have lasting negative consequences. In a few countries, governments borrowed excessively, undermining the resilience of public finances. In others, the additional funds inflated asset bubbles and encouraged the private sector to take on debt.

20. As inflation differentials persisted, the European Central Bank's (ECB) unitary nominal interest rate became less suitable for individual member states.

3 E.g., Marzinotto et al. 2011; Darvas 2012; Enderlein et al. 2012; European Commission 2012; Allard et al. 2013.

4 E.g., Lane 2006; European Commission 2008, 2012; Enderlein et al. 2012; Lane 2012; Rompuy et al. 2012; Allard et al. 2013.

For high-growth, high-inflation countries such as Spain and Ireland, the real interest rate was too low, and provided fuel to an already overheating economy. For low-growth, low-inflation countries such as Germany and France, the real interest rate was too high, depressing growth and investment. Instead of mitigating economic volatility, monetary policy exacerbated it (the "one size fits none" problem).[5]

Failure to adjust

21. Due to this incomplete economic integration, the real-exchange-rate channel proved too weak to produce a timely adjustment of imbalances within the euro area.[6] At the same time, the MMU's rudimentary framework for cooperation did not encourage the use of (politically costly) anti-cyclical fiscal policy. Quite to the contrary, the "three-percent-rule" of the Stability and Growth Pact tended to be too lax in good times and too tight in difficult ones.

22. Self-reinforcing effects accelerated subsequent negative developments. Inflation differentials vis-à-vis the rest of the euro area undermined the competitiveness of periphery countries' tradables sectors, while productivity growth was depressed by the diversion of capital away from productive investment, which in turn widened the current account deficit further. Over the years, the countries today known as "deficit economies" accumulated an unsustainable amount of foreign liabilities, while other euro-area member states ran large surpluses.[7]

Weak crisis response

23. When the crisis broke, it soon became apparent that the implications of EMU membership, namely the absence of traditional adjustment tools such as exchange-rate devaluation, hampered member states' crisis responses to a greater extent than expected. In the absence of a clear crisis-resolution mechanism, euro-area members spent precious time discussing fundamental questions about competences, process and institutions. In the meantime, markets lost confidence and the crisis spiraled out of control as economies were caught in a vicious cycle of bank failures, skyrocketing public debt and faltering growth.[8]

24. The situation was exacerbated by the predominance of intergovernmental over supranational politics, and the consequent focus on national interests during the height of the crisis. Negotiations over conditionality and emergency assistance were charged with moral overtones that reflected the desire of politicians to appease their domestic constituencies.

5 E.g., Enderlein 2005; Lane 2006; Bertola 2012; Lane 2012, 2013; Obstfeld 2013.

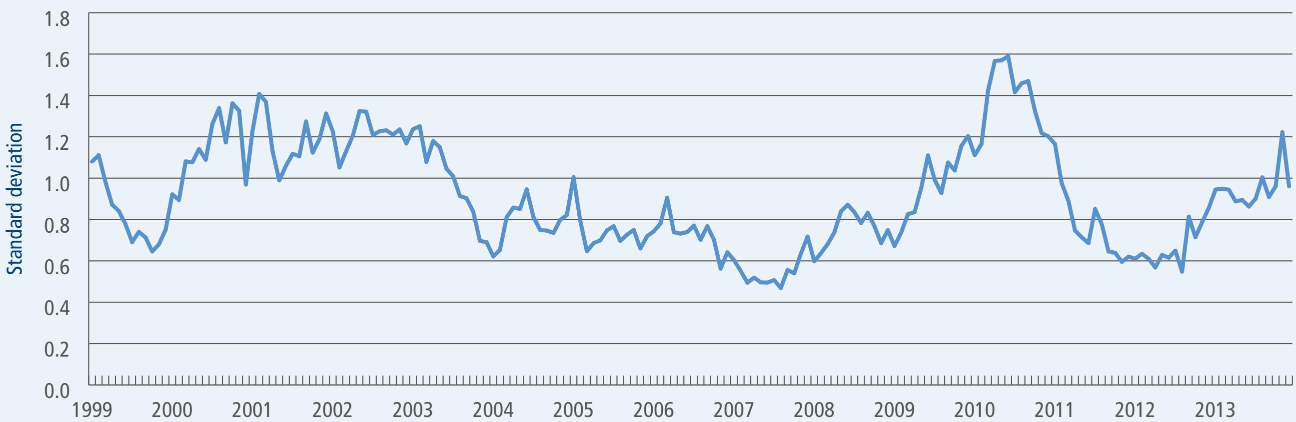
6 In a currency union with a strong real-exchange-rate channel, "high-inflation countries will ultimately face reduced external demand, whereas low-inflation countries will improve their competitiveness. As a consequence, self-enforcing cyclical phenomena will be stopped by a decline (or boom) in exports caused by the real appreciation (depreciation) of the exchange rate." (Enderlein et al. 2012: 16). See Dullien et al. (2009) for an empirical study of the real exchange rate channel in the euro area.

7 E.g., Blanchard 2007; Allard et al. 2013.

8 E.g., Merler and Pisani-Ferry 2012; Shambaugh 2012.

Figure 1: Inflation dispersion in the euro area, 1999–2013

(As measured by the standard deviation of euro-area economies' inflation rates from the GDP-weighted average, based on the Harmonized Index of Consumer Prices.) Excludes countries that adopted the euro after 2001.



Source: Eurostat, authors' calculations.

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EMU and the "one size fits none" paradox

In general, the benefits of a currency union can be expected to outweigh its costs when it encompasses a homogeneous economic area. Specifically, research on "optimum currency areas" has stressed the importance of synchronised business cycles and macroeconomic shocks. Business-cycle synchronisation can be supported by a high degree of economic openness, a high degree of capital and labour mobility, and high levels of price and wage flexibility. Under ideal circumstances, a single monetary policy could be expected to be equally suitable for all members of the currency union – an idea that has been described as "one size fits all."[9]

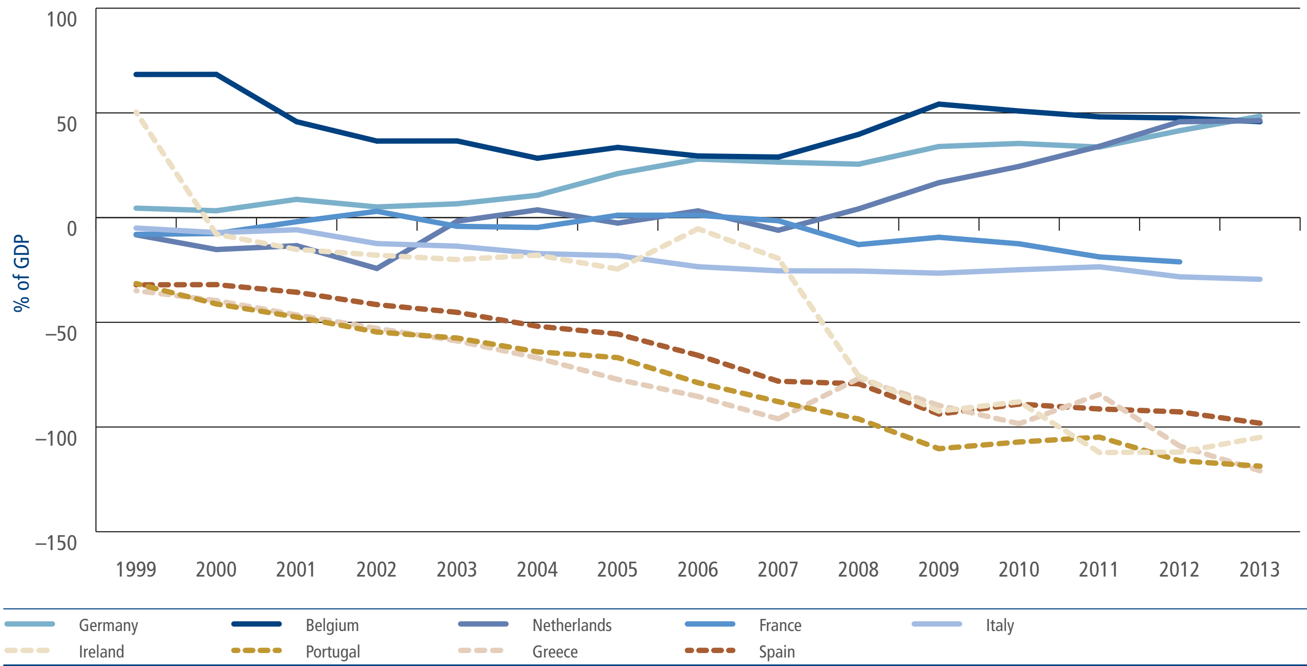
9 E.g., Mundell 1961; McKinnon 1963; Frankel and Rose 1996.

Measured by these criteria, "the euro area has never been an 'optimum currency area'."[10] Although member states are closely connected by internal trade ties, the degree of internal labour mobility and price flexibility is low, and the macroeconomic shocks experienced by member states are significantly more idiosyncratic than is true within a smoothly functioning currency union such as the United States. Contrary to initial expectations, convergence has not accelerated markedly since the start of EMU.[11]

10 Enderlein et al. 2012: 15.

11 Bayoumi and Eichengreen 1992; Frankel and Rose 1996; Mongelli 2002; Enderlein 2005; Lane 2006; European Commission 2008.

Figure 2: Net international investment position of selected euro-area economies, 1999–2013



Source: Eurostat, authors' calculations.

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25. Against the backdrop of a slow political response and general uncertainty, temporary liquidity problems evolved into self-fulfilling solvency crises that became increasingly costly to address. In a 2013 study, the IMF provides an approximation of the costs of an ex post crisis response (as opposed to ex ante crisis prevention) by calculating the implicit transfer payments that became necessary as a consequence of the crisis. The study performs this task by comparing the interest rates creditor countries charged crisis countries with the estimated cost of alternative financing; it consequently estimates an implicit net transfer from creditor to crisis countries of between €43 and €74 billion per year. This does not include "the potentially very large costs (longer crisis duration, lower output, and higher unemployment) that could be associated with the current approach of ex post risk-sharing."[12]

12 Allard et al. 2013: 25.

Have reforms addressed the most relevant issues?

26. In recent years, European policymakers have embarked on numerous reforms intended to remedy some of the weaknesses identified above. To what extent have they been successful?

Imbalances and adjustment: Policy action and evaluation

27. Fiscal surveillance: Reform efforts have to date focused on the prevention of unsustainable budget deficits via measures such as the so-called six-pack and two-pack, and the Treaty for Stability, Coordination and Governance (TSCG).[13] These reforms have aimed at contributing to crisis prevention by making country commitments stronger, thereby strengthening confidence in national solvencies. However, the examples of Spain and Ireland demonstrate that initially sound public finances may not offer protection against a sudden interruption in financing if the underlying current-account imbalances prove too large.

28. Macroeconomic surveillance: While the importance of private-sector imbalances was acknowledged by the introduction of the Macroeconomic Imbalance Procedure (MIP), the extent to which member states are in fact willing and able to comply with its recommendations remains to be seen.

29. Competitiveness: Reforms aimed at improving productivity and lowering unit labour costs have been introduced with the aim of addressing the unsustainable foreign-liability positions held by some euro-area member states. Efforts in this regard have thus far been only moderately successful, according to recent assessments. Whatever the outcome in the long run, periodically improving competitiveness cannot substitute for addressing the underlying destabilising dynamics described above.[14]

Imbalances and adjustment: Missing elements

30. Completion of the single market and policy convergence: The most straightforward way to reduce imbalances is to strengthen the real-exchange-rate channel as an adjustment mechanism. This would address the roots of the crisis by facilitating the transmission of price signals and moving EMU closer to an optimal currency area. In this regard, it is crucial to address the structural preconditions for a truly integrated common market, for instance by increasing trade in services, creating a harmonised regulatory environment and encouraging a higher degree of labour mobility. The Monti Report and the subsequent Single Market Acts I and II represent tentative steps towards deeper economic integration, but much bolder reforms are needed.[15]

31. Business-cycle synchronisation: Since the real-exchange-rate channel works slowly even in fully integrated economies such as the United States, adjustment can be supported

13 The six-pack is a set of EU regulations that specify the budget rules and sanction mechanisms under the Stability and Growth Pact, while the two-pack enhances surveillance of EU member state budgets. The Treaty for Stability, Coordination and Governance (TSCG) is an intergovernmental agreement that introduces further constraints on fiscal policy, including a debt brake.

14 E.g., Lane 2006; Grauwe 2013; Obstfeld 2013; Wyplosz 2013; Gabrisch and Staehr 2014; Tressel et al. 2014.

15 E.g., Monti 2010; Enderlein et al. 2012.

through EMU-wide coordination of demand management. One way to accomplish this would be to institutionalise anti-cyclical fiscal transfers between euro-area member states, thus helping to synchronise their business cycles. Existing proposals include a cyclical-shock insurance mechanism, a Europe-wide unemployment-insurance programme, and a common euro-area budget.[16]

Crisis response: Policy action and evaluation

32. Emergency assistance: The creation of the European Stability Mechanism (ESM) underlines European states' general determination to support euro-area members in financial distress, thereby mitigating the risk of self-fulfilling solvency crises. Nevertheless, the ESM is not based on a principle of joint and several liability, and requires unanimity for decisions to provide stability support (Article 5 ESM Treaty). These features, which were created in the difficult political context of the crisis, render the ESM vulnerable to political deadlock and delays, and thus run the risk of compromising its potential to reduce uncertainty.

33. Limit contagion: The creation of a banking union marked a milestone in efforts to limit the risk associated with the link between banks and sovereigns, thus preventing fragmentation of the financial system in times of crisis. However, the Single Resolution Fund (SRF) is small compared to banks' balance sheets, and the use of ESM resources as a backstop is subject to numerous constraints.[17] Moreover, several commentators have argued that in the absence of a common deposit-insurance system, country risk still plays an important role in investment decisions during crises. Pro-cyclical capital flows and vicious cycles tying banks and sovereigns together thus remain a threat.

Crisis response: Missing elements

34. Clear conditions for assistance: While European policymakers did manage to prevent a disorderly exit from the euro, this success carried a high cost. Relations between euro-area member states have deteriorated markedly. As long as conditionality is negotiated ad hoc and under great pressure from the markets, this scenario is likely to repeat itself. An "ESM+" model that sets out clear conditions under which troubled countries would be provided with access to finance (possibly in return for strict external budgetary surveillance mechanisms) would provide an alternative.

35. Enhanced legitimacy and credibility: Financial crises require quick and credible action. A more prominent role for the Community method, including majority voting, could help guide expectations and reduce uncertainty by limiting the number of veto players. As decisions often touch upon the budgetary sovereignty of member states, credibility and legitimacy would be strengthened by including parliamentary delegates in the process.

16 E.g., Marzinotto et al. 2011; Enderlein et al. 2013; Dullien 2014.

17 E.g., Pisani-Ferry et al. 2013.

Chapter conclusion: What is needed to make EMU viable?

While the euro crisis has resulted in significant reforms, they have thus far focused primarily on combatting symptoms of the crisis, not its causes. Large-scale imbalances are still likely to emerge, adjustment remains slow and emergency assistance is still vulnerable to delays. As a consequence, uncertainty prevails and Europe is fighting a protracted crisis that is expanding from the economic into the political realm.

What is to do? In order to make EMU viable in the long run, Europe needs to address its underlying problems and simultaneously repair the damage the crisis has already wrought. Otherwise, the euro area may implode before long-term reforms can have an impact.

Looking back at the challenges identified in this and the preceding chapter, we can identify a set of needed reforms whose joint implementation would address the most pressing issues (see Table 1). These will guide us in the proposals we develop in the following chapters.

When talking about reforms, it is useful to differentiate not only by policy area, but also by objective. A first set of reforms comprises measures to restore EMU and its member states to their pre-crisis dynamism and prosperity ("repair"). However, in order to ensure resilience in the long run, these policies need to be complemented by a second set of reforms aiming at ensuring the crisis does not repeat itself, for example by completing the banking union ("prepare").

Table 1: Synopsis of the repair and prepare approach

Objective / Policy area	Repair	Prepare
Political-institutional	• Enhance EU legitimacy (see §35) • Reduce tensions between EU members (see §7) • Address national populism (see §7)	• Complete ESM (see §34) • Complete banking union (see §33) • Enhance policy convergence (see §30) • Ensure business-cycle synchronisation (see §31)
Economic	• Complete structural reforms (see §7) • Reduce debt (see §6) • Close investment gap (see §6)	• Complete the single market (see §30) • Modernise economies (see §29) • Enhance monetary transmission (see §33)

Source: Authors

C. The Roadmap towards True Economic and Monetary Union (TEMU): A three-phase approach

Characteristics of a TEMU

36. As argued in the previous chapter, Europe needs to improve EMU governance. The goal is to construct a monetary union able to cope with endogenously arising imbalances as well as exogenous shocks. We call such a currency union a TEMU. TEMU constitutes a pragmatic way of addressing the shortcomings of MMU, not a general call for "more Europe." It should include as much integration as necessary to make monetary union work, but as little as possible within this constraint.[18]

37. At the centre of the debate over the optimal design for resilient currency union lies a disagreement about the right balance between incentives and sanctions. Some argue that incentives cannot ensure lasting compliance with the rules, and instead promote free riding. Others reply that sanctions are equally problematic since they might harden domestic resistance and can act as a deterrent only if they are enforced – something that has proven exceedingly difficult. The ultimate sanction, exit or expulsion from EMU, has so far been a taboo, and it is still unclear to what extent this may change.

38. The goal of this chapter is to outline possible elements of TEMU, while acknowledging that much further research is required to develop a full picture. Indeed, there is ample disagreement in Europe today as to what would constitute a "true" or "genuine" economic and monetary union. However, the need for several core elements is largely uncontested. Two such elements are:

18 For a more detailed discussion of this principle, see Enderlein et al. (2012: 21).

- Efficient adjustment mechanisms that would prevent large imbalances between euro-area member states from arising, for example by strengthening the real-exchange-rate channel and synchronising the business cycles of euro-area member states.

- A clear crisis-prevention and resolution framework that reduces uncertainty and limits contagion, for example by encouraging fiscal responsibility and ensuring the credibility of assistance schemes.

The way to TEMU: A three-phase Roadmap

39. While there may be widespread agreement on the need for these two components, little progress has in fact been made towards them since the introduction of the banking union. The debate is often described as an impasse caused by incompatible preferences between a "northern bloc" of countries favoring fiscal consolidation and structural reforms, and a "southern bloc" of countries demanding increased focus on mutual insurance mechanisms and investments. Each party is hesitant to concede to the demands of the other, as it would thereby weaken its own leverage.

40. However, as we would like to argue, the perception of reform as a zero-sum game is incorrect. EMU would in fact be strengthened if a combination of these "northern" and "southern" positions were to be implemented, and would offer all participants long-run benefits related to reform and risk-sharing. The key issues are credible commitment and

timing. As advocates of fiscal consolidation have argued, governments have an incentive to renege on reform promises as soon as the economic pressure eases, implementing only those measures that are politically expedient in a given situation, and thereby undermining the effectiveness of the entire system. At the same time, the developments described in the introductory chapter of this study amply illustrate that a blunt attempt to push through further reforms under the threat of sanctions or a cessation of assistance would be politically dangerous, if it were feasible at all.

41. Looking back, Europe faced a similar challenge in the 1990s. It was clear that monetary union required a degree of convergence, but credible commitment was an issue. The problem was solved by agreeing on a set of indicators and fixed goals that would constitute the minimum requirements for joining EMU. This combination of clear goals and a strong incentive proved extraordinarily successful. Over the course of the 1990s, inflation rates, budget deficits and debt levels converged at an unprecedented pace, even in those countries that ultimately failed to comply with the Maastricht criteria in full.

42. We propose the introduction of a Roadmap loosely inspired by this run-up to the euro. The idea would be to create strong incentives for all countries to implement structural reforms, consolidate public finances and commit (even through legal obligations) to an enhanced and more integrated monetary union. In return, all countries that complied with a number of key requirements would be offered access to TEMU which, in turn, provides them insurance against instability and self-fulfilling crises. The Roadmap consists of three phases: (1) setting targets for structural convergence, (2) implementation of reforms, and (3) the start of TEMU.

43. A key difference in this initiative as compared to previous efforts would be the use of positive incentives instead of sanctions. Policies that are perceived to be dictated by external actors enjoy little support within domestic populations, and are likely to be reversed or diluted over time if they are implemented at all.[19] They provide fertile ground for populist electoral victories, which in turn make further reforms harder to implement. Conversely, the use of positive incentives increases domestic ownership of reforms.

44. In contrast to the debate over contractual arrangements and the Convergence and Competitiveness Instrument, the three-phase approach offers a clear focus on a stronger real-exchange-rate channel and avoids the pitfalls of financial incentives. Its focus lies on a common effort by all member states (including Germany), and thus provides a positive vision for EMU.[20]

45. As an additional incentive for countries struggling with high budget deficits, the Commission could make clear that efforts to reach the agreed-upon indicators will be taken into account when considering the setting and extension of budget-deficit reduction deadlines.

46. For each phase, we will provide a brief description of the main elements, followed by a discussion of the most relevant "known unknowns."

19 E.g., Grüner 2013.

20 The proposal of Rubio (2014) to overhaul the Convergence and Competitiveness Instrument points in a similar direction.

Phase 1: Setting targets for convergence.

Objectives and time frame

47. Europe needs to identify elements that can ensure a resilient monetary union, and devise suitable indicators to measure progress toward the related goals. Moreover, it needs to agree on a time frame for implementation. The coordination of phase one should be a major focus of the new Commission. The preparatory measures could begin as early as 2015, followed by negotiations over indicators in 2016.

Preparatory measures

48. In a first step, Europe needs to identify the areas in which reform and common standards are absolutely vital to allow the proper functioning of EMU. This debate has not yet taken place in a full and systematic fashion, and is needed on both a domestic and a European level. It is essential to emphasise that all countries need reforms. Examples of areas in which reforms are necessary include the completion of the single market (in particular for services), the transmission of price signals and enhanced labour mobility (see box).

Negotiations

49. A second step would feature negotiations on the issue of suitable indicators and time frames for reform. It would be essential for these to be clearly defined in a common agreement, a process that would be politically challenging. In parallel, an agreement on the characteristics of phase three would be required, creating the incentives for increased cooperation (see below). The more ambitious the scope of the reform, the more viable would be phase-three institutions offering comprehensive crisis prevention – and vice versa.

Need for further research (I): Convergence and structural reform

Deepening the single market

Economic theory suggests that a deepening of the single market could play a central role in efforts to strengthen market-based adjustment. Further research is needed to assess the extent to which this is feasible in practice, and to determine what concrete steps would need to be taken. Current taboos, such as the full implementation of the single market in services, may need to be broken.

Since a genuine single market requires participating countries to construct comparable structures, research is also needed on the question of which areas are most in need of common standards, and on how these standards could best be enforced. Possible areas might include labour-market standards, taxation standards, judicial standards, standards on pension rights, and standards on public-finance rules.

Structural reform

In recent discussions, it has often remained unclear that structural reforms – that is, reforms of product and labour markets – can serve two distinct objectives: They may increase the growth rate at the national level, or they may strengthen the real-exchange-rate channel, resulting in a better functioning of the currency union. It is the latter aspect that we discuss in this study.

Structural reforms are important for adjustment to the extent that they improve price and wage elasticity. However, the trade-offs merit systematic consideration. Some authors warn that individual economies' comparative advantages are founded on a set of complementary institutions such as wage bargaining systems, industrial relations and inter-firm relations.[21] Reforms that strengthen the functioning of EMU may simultaneously destroy complementarities. Further research should therefore analyse whether some reforms are better suited than others to strengthening the real-exchange-rate channel without harming vital aspects of economic coordination.

It may also be fruitful to consider the viability of a second option: Instead of prescribing specific reforms for all countries, member states could address their weaknesses through whatever policies were best suited to their country's specific circumstances, as long as the aggregate result complied with the requirements of TEMU. The debate over reform contracts offers some preliminary ideas as to what such a mechanism might look like. In this context, it would be crucial to develop suitable criteria for judging the extent of a country's "TEMU compliance."

Key research questions:

- How much further deepening of the single market is needed?
- In what areas do we need common standards?
- What policy instruments are best suited for fostering convergence?
- How can the monetary transmission mechanism be enhanced?

21 E.g.. Hall and Soskice 2001.

- How much can labour mobility contribute to adjustment, and how can it be promoted?
- How much structural convergence is necessary?
- What is the right balance between ensuring a high degree of adjustment capacity and protecting the complementarities of existing economic structures?
- Which elements would need to be included in a "TEMU compliance indicator"?

Phase 2: Implementation of reforms

50. During this phase, the reforms would be implemented, and monitored by the European Commission, the euro-area summit, and the Eurogroup or the Economic and Financial Affairs Council (ECOFIN). Joint and parallel implementation of the reforms in all euro-area countries would offer advantages in several regards:

    - Clear and measurable targets channel efforts and allow for comparison. Progress towards the TEMU convergence criteria could become the measure of successful economic policy for the public and the markets, creating pressure to achieve the agreed-upon targets.

    - The principle of "quid pro quo" would become manifest. Each country would invest in a more resilient EMU by addressing unpopular but important reforms. At the same time, each country would receive a return on its investment by profiting from the stability and growth resulting from coordinated policies.

    - Popular support for deep reforms would be strengthened by a simultaneous targeted economic stimulus provided by the investment programme outlined in chapter 4.

51. The details of timing have yet to be discussed, and would depend crucially on the scope of the reforms agreed in phase one. The list of countries participating in TEMU would be decided at the end of phase two. In order to prevent any country from being a formal part of EMU but not a part of TEMU, this list should be regarded as final. The high costs of

the current crisis have made it unlikely that EU policymakers will make the same mistakes as in the run-up to EMU, and be overly forbearing with countries that have failed to fulfil their commitments.

Need for further research (II): Non-compliance and exit

The creation of TEMU will result in a stronger monetary union only if all its members comply with the agreed-upon criteria. Consequently, we need to think systematically about options for those countries that are unwilling to participate in the process or are unable to implement it. A residual minimalist monetary union is undesirable, since it would complicate governance further by effectively splitting the European Union into three parts: TEMU, an MMU and countries that have retained a national currency.

It is therefore important to consider feasible options for an exit from EMU, although any such step would need to be regarded as a last resort after a long and transparent process (thus avoiding "surprise exits").

Further thought must also be given to the creation of a system encouraging compliance in the run-up to TEMU. This might include regular reviews and "traffic light" indicators that would make reform progress easily visible, for example.

Key research questions:

- How can it best be ensured that countries either join TEMU or exit the euro rather than remaining in today's MMU?
- What would an effective review process look like?
- Is a fixed deadline for TEMU accession needed?
- What might an option for orderly exit from EMU look like and what sort of sequence should be employed in introducing it?

Phase 3: Start of TEMU

Objectives

52. TEMU must offer its prospective participants clear incentives to join. Plans for phase three therefore need to contain provisions for strengthened EMU governance, better crisis resilience and stronger structural growth. All countries, but in particular Germany, will have to think about what kind of enhanced solidarity (e.g., guarantees or temporary transfers) and improved institutional framework they would be willing to accept if others transfer in exchange more sovereignty to the European level. The message should be that the new package will offer genuine advantages, but can only work for countries willing to engage in reform.

53. Some of TEMU's benefits would derive solely from reforms undertaken by its members prior to accession. For example, a high degree of convergence will result in gains related to trade and economics of scale, as well as an increased adjustment capacity. For most benefits, however, institutions must first be created or reformed.

Possible elements of TEMU

54. A complete banking union would minimise the risk of financial-system fragmentation, strengthening the role of stabilising capital flows during periods of crisis. This would include a common deposit-insurance scheme and a credible fiscal backstop for the Single Resolution Mechanism (SRM).

55. A European Monetary Fund or ESM+ would protect its members against self-fulfilling crises by providing emergency liquidity on the basis of predefined conditions. Moral hazard could be limited by making assistance above a certain threshold subject to increasingly intrusive external budgetary surveillance. The ESM+ could also provide the backstop for the banking union's SRM.

56. An agreement could also be reached to deal with existing debt (legacy debt) while making sure that future debt increases remain limited under the new TEMU frame-work. Proposals on how to achieve this abound, and many of these could be adapted for integration into the TEMU framework.[22]

57. While problematic structural differences are addressed by the convergence process in phase one and two, cyclical differences are not. Temporary transfer payments may be needed to synchronise TEMU members' business cycles and prevent the emergence of imbalances (see chapter two). This should not be confused with permanent mechanisms such as Germany's fiscal equalisation scheme ("Länderfinanzausgleich"), which is geared towards income convergence. For example, a cyclical mechanism based on output-gap deviations could result in net transfer payments close to zero in the medium term and could contribute to ensuring that the ECB's monetary policy does not lead to divergent inflation rates as it did in the 2000s.[23]

58. Table 2 summarises possible TEMU building blocks and the incentives each offers in terms of crisis prevention and contagion.

22 E.g., Brunnermeier et al. 2011; German Council of Economic Experts 2012; Pâris and Wyplosz 2014.

23 Enderlein et al. 2013.

Table 2: Incentives TEMU could offer to participating countries

Element		Advantages for countries in a strong economic position	Advantages for countries under pressure
Crisis prevention	• High degree of convergence • Strong real-exchange-rate channel	• Automatic correction of imbalances without political crisis, high costs, mutual recriminations, etc.	• Prevents gradual competitiveness loss and painful sudden internal adjustment
	• Cyclical stabilisation	• EMU works as intended • No net transfers over the medium term • Will receive payments during cyclical downturns	• Payments support reform efforts • Prevents divergences in inflation rates and competitiveness
Crisis response	• ESM+/European Monetary Fund with streamlined voting system and clear rules ("sovereignty ends where liquidity ends")	• Provides stability but deters excessive deficits • No hostage situation	• Makes self-fulfilling crises less likely • Conditions for emergency lending are known ex ante • Less uncertainty on the markets
	• Complete banking union, including deposit-insurance scheme and credible backstop	• Lower costs due to market failures and "too big to fail" situations	• Panic and capital outflows become less likely

Source: Authors

Need for further research (III): The final stage of TEMU

Compromise and lasting commitment

A successful compromise would need to provide significant incentives to the countries most in need of reform, while still being acceptable to the countries taking on responsibility for their peers. While the choice of institutional configuration would inevitably be a political decision, further research can provide the foundations for a constructive debate. Many calls for a fiscal or banking union have been bold in their demands but vague in terms of details. More specific information on possible elements would make it easier to identify functional equivalents of contested institutions. It would also reduce uncertainty with regard to possible redistributional effects.

Another as-yet unsolved issue concerns the incentives, positive or negative, that would be needed to keep countries from backsliding on reform commitments after joining TEMU. Previous and current experiences with the Stability and Growth Pact raise the question of whether it is possible to credibly threaten large member states with sanctions, especially since an exit from TEMU should not be an option.

Interaction between institutions

Apart from political considerations, discussion regarding TEMU's necessary and desirable institutional architecture needs to be informed by a comprehensive analysis of its economic implications. We need a clearer understanding of how elements such as a European Monetary Fund or a completed banking union would interact. Additional research could also enable us to make tentative statements about the relationship between the alternative paths towards a viable monetary union: stronger institutions, economic reform and transfer payments.

Monetary union and the single market

The optimal design of TEMU would depend strongly on its membership. The single market may become synonymous with EMU in the long run, but while the euro area is growing, this trend is by no means irreversible. An evaluation would need to take into account the legal considerations discussed below, the United Kingdom's referendum in 2017 and the consequences of a possible British EU exit. It would also have to address the dynamics that could result from agreement on an ambitious Roadmap.

Key research questions

- What is the right balance between incentives for economically strong countries and those for countries under pressure?
- To what extent can convergence and domestic reform realistically provide resilience, and where are institutions needed?
- Which specific solutions should be considered in dealing with existing and future debt?
- Which specific solutions should be considered as a means of completing the banking union?
- Which specific solutions to enhance business-cycle synchronisation should be considered?
- What rules would ensure that countries maintain TEMU compliance over time?

- How would the proposed institutions interact? Which institutions would usefully complement each other and how?
- What would be an appropriate role for transfer payments in specific TEMU configurations? Under what circumstances would temporary transfers need to be supplemented by permanent ones?
- What political dynamics would need to be taken into account when planning the creation of TEMU?

Need for further research (IV): Legal implications

Due to the significant difficulties associated with EU treaty changes, the legal implications of a new TEMU framework would be of major importance. An inquiry would be needed to ascertain whether the stronger governance needed for the euro area would make a treaty change necessary. Theoretically, the options are varied and include implementation within current treaties, the passage of a new protocol, a small treaty change, a large treaty change, a new treaty linked to current ones, as well as an altogether new treaty that would stand outside the current framework. Further research is needed to evaluate these options and their feasibility with an eye towards the 2017 election year.

At the same time, a fresh look at possibilities able to ensure the legitimacy of the new institutions is needed. Beyond oversight through the European Parliament, the greater involvement of national parliaments merits consideration. Any sustainable solution will need to strike the right balance between effectiveness and legitimacy.

Relationship between EMU and EU

A further topic for consideration is the approach to “ins” and “outs” – that is, euro-area members and the remainder of the European Union. This latter group has proven to be sceptical of new institutions and rules for the euro area, as exemplified in the debate over the Fiscal Compact. Further research is needed into avenues of possible compromise between the two groups, and on alternative ways of implementing stronger euro-area governance.

Key research questions

- What elements of TEMU could be implemented under the current treaty? What are the advantages and disadvantages of various forms of treaty changes?
- In what order should legal and political questions be addressed in the sequencing of the debate?
- What is the right balance between legitimacy and effectiveness for the new institutions?
- What kind of relationship between the euro area and the rest of the EU is appropriate and sustainable?

D. Connecting the short and the medium term: The Modernisation Pact

59. Even for a willing government, an ambitious reform agenda such as the one sketched above would be hard to implement in the current political environment if it did not feature a number of early gains. Therefore, a Modernisation Pact needs to accompany phase one's negotiations and phase two's first reform efforts. While the Roadmap aims at enhancing the monetary union's architecture, this pact would serve to guard against the risks that threaten to undermine a sustainable recovery. It may be particularly needed in Europe's most crisis-damaged countries, but would ultimately benefit all euro-area member states.

The dangers of complacency revisited

60. The three trends that were initially identified as dangerous to the European project as a whole also threaten to stymie efforts to improve EMU governance.

- A lack of investment, especially with regard to infrastructure, undermines future potential growth.[24] Europe is in need of a far-reaching infrastructure-investment plan, but governments struggling with high levels of public debt are reluctant to increase spending.

- Tense relations between euro-area governments hinder negotiations over bold European responses to the crisis. A stronger role for European institutions governed by the Community method may be necessary in order to shift the focus of the debate from conflicting national interests to common European goals.

- In the most severely crisis-struck countries, crisis fatigue and legitimacy issues have become formidable obstacles to any political initiative that demands sacrifices in the short run. A strengthening of the economy is needed in order to open up political space by checking populism and encouraging the population to accept further reforms.

24 E.g., Fichtner et al. 2014.

Turning risks into opportunities: The Modernisation Pact

61. We propose a coordinated programme that would modernise Europe in key areas and prevent political deadlock. It has the potential to turn the abovementioned risks into an opportunity by (1) combining an immediate economic boost with lasting value, (2) putting crisis countries' budgets on a sustainable trajectory, and (3) ensuring the credibility of negotiated promises. In the following, we outline the basic elements of such a Modernisation Pact, and consider which aspects regarding its scope and implementation require clarification.

Immediate boost and lasting value

62. A number of recent publications show that Europe could greatly profit from increased public- and private-sector investment.[25] A coordinated investment programme would trigger demand effects and strengthen business confidence. It could thus help crisis-struck countries in particular to sign up to a continued commitment to reform, with the ultimate goal being TEMU accession. Investment in infrastructure, in

25 E.g., DIW 2014; International Monetary Fund 2014.

the broad sense of the word, seems an especially promising target due to its favourable effect on future growth. Examples include information and communications technology, and specifically the high-speed Internet connections needed by international business; a European energy network that could result in positive scale effects and a higher resilience; and education capable of producing long-term social and economic gains.

Debt sustainability

63. In order to ensure the sustainability of euro-area governments' budgets even in the face of higher levels of investment expenditure, each country would pledge to engage in "smart austerity." Usually, governments that wish to reduce a high debt-to-GDP ratio face two alternatives: They can try to increase growth (which may increase spending) or they can reduce spending (which may reduce growth). Under pressure by the markets, most have recently chosen the second option, which has had a strongly negative effect on investment.[26] The pact would instead compel governments to choose a third way, reorienting fiscal policy away from public consumption and towards investment. This option may be politically challenging because it would likely include cutting expenditures on social transfers and public-sector employees. However, it is much more likely to deliver sustainable results in the long term.

64. Investment can be funded in part by a more expansionary fiscal policy. The latest IMF World Economic Outlook suggests that debt-financed investment would be self-financing under the current economic conditions due to its strong positive effect on output. But even countries that are constrained by fiscal rules and market expectations can reasonably hope to lower debt-to-GDP ratios by performing a budget-neutral reorientation of their spending.[27]

65. For maximum effect, the initiative would depend on private savings, which are available but need to be mobilised. The European level could play a major role here. Examples could include public-private partnerships, but also public guarantees for investment in certain sectors, as well as the prospect of favourable tax treatment for specific actions. An ECB intervention in debt markets is only a second-best solution.[28]

Credible commitment

66. The third element of the pact would be credible commitment. Investment is needed immediately, but the reduction of public consumption is feasible only over the medium term, and the completion of reforms would take years – which is one of the reasons why earlier attempts at "smart austerity" have tended to result in no austerity at all. The question of whether future governments can be expected to honour today's reform pledges would be decisive for the pact's effect on business confidence, as well as its political acceptability in countries that favour fiscal consolidation.[29] It would therefore be important to ensure the successful completion of the "smart austerity" programme through

26 E.g., Barbiero and Darvas 2014.

27 E.g., Blanchard and Leigh 2013; International Monetary Fund 2014.

28 E.g., Fichtner et al. 2014; Pisani-Ferry 2014.

29 E.g., Dervis 2014.

measures such as making this one of the requirements of accession to TEMU. For countries currently under review by surveillance mechanisms such as the MIP or the Excessive Deficit Procedure (EDP), the economic boost provided by the pact should be an opportunity to engage in reforms.

Need for further research (V): The Modernisation Pact

Since the start of the euro crisis, numerous investment-initiative proposals have been brought forward, including a plan worth €300 billion by the president-elect of the European Commission, Jean-Claude Juncker. A common weakness of these plans has been their vagueness.

Clear focus areas

The multiple goals of the Modernisation Pact make it essential that it be carefully designed. Before it can be implemented, further research needs to (1) estimate a realistic goal for overall investment that can serve as a benchmark; (2) identify priority areas to enable targeted spending, based on criteria such as the impact of investment on long-term growth and the added value from coordinated European action; and (3) clarify what sources of private financing the initiative aims to mobilise, and design policy instruments accordingly.

Smart debt-reduction strategies

Before smart debt reduction can be put into practice on a European level, a more complete picture needs to be developed concerning the implementation and effects of reorienting public expenditure from consumption to investment. Further research needs to identify best practices and possible pitfalls, such as country-specific structures that may interfere with the process.

Institutional aspects

The institutional dimension of the Modernisation Pact also requires further thought. Who would coordinate and lead the initiative? Commentators have alternately suggested the European Commission, the European Investment Bank and a new agency created specifically for the purpose.[30] These candidates differ not only with regard to institutional capacity, political weight and experience in identifying viable investment opportunities; the choice of leadership would also influence how much room for independent action would be accorded to individual member states within the programme.

30 E.g., Fichtner et al. 2014; Szczurek 2014.

If the investment programme were to include a fiscal expansion, more thought is needed on how higher budget deficits could best be reconciled with the EU's rules on fiscal governance. The options include a more generous interpretation of the flexibility provided in the existing rules, a rule change that allows for higher investment levels, and a financing model that lies outside the budget caps, perhaps through the European Investment Bank.[31]

Key questions:

- How large is the need for investment?
- What areas would benefit most from a coordinated European investment initiative?
- How can private-sector financing be maximised?
- What concrete steps are necessary on the way to smart debt reduction?
- Who would serve as the best coordinator for the Modernisation Pact?
- How could the investment initiative be reconciled with the EU's current fiscal rules?

31 For a review of the flexibility offered by current rules, see Fernandes (2014), Micossi and Peirce (2014).

E. Conclusion

67. In the current context, focusing on procedural priorities rather than on the end goals of longer-term integration could be the right way forward. This pilot study has outlined how a clear Roadmap towards TEMU, inspired by the process of accession to the euro, could provide the framework for a combination of reform, investment and institutional improvements.

68. Our approach recognise the importance of credible commitment as the basis for cooperation, but also takes into account the lack of realism in demanding complete reforms as a precondition for investment and support. The euro area is at a point where meaningful change can only come from within the economies most affected, and external pressure may do more harm than good. Our proposal therefore relies primarily on incentives, not on sanctions. It would mark a change in policy towards a more cooperative approach among euro-area member states, visible both in methods and goals. Thus, the study aims to reconcile demands for reform and fiscal sustainability with calls for increased investment and risk-sharing.

69. Further research is needed on (1) the nature of the required convergence and structural reforms, (2) options enabling exit from EMU if desired or required, (3) the final stage of EMU, (4) the legal framework required for implementation of the Roadmap, and (5) the exact investment priorities and financing instruments to be used in the Modernisation Pact.

70. The table below summarises our overall approach.

Table 3: Summary of the proposal

<table>
<tr><th rowspan="2">Time-frame</th><th colspan="2">Proposal</th><th rowspan="2">Content</th></tr>
<tr><th>Roadmap</th><th>Modernisation Pact</th></tr>
<tr><td>2015–16</td><td>Phase 1:
Setting of targets for structural convergence (see §47–49)</td><td rowspan="3">In parallel:
Investment programme, but with ongoing reduction of debt levels (§59–66)</td><td>Begin discussion of reform contract. What reforms in which countries are needed to enable a better-functioning EMU? Message: All countries need reforms (even Germany). Also, how much policy convergence is necessary to make EMU work? What investments are most needed to modernise European economies?</td></tr>
<tr><td>2016–21</td><td>Phase 2:
Implementation of reforms (§50–51)</td><td>The joint and parallel implementation of reforms in all euro-area countries would have clear advantages:
(1) Dynamics similar to EMU accession: clear targets would channel efforts, increase peer pressure
(2) Principle of quid pro quo becomes clear
(3) Reform efforts supported by economic stimulus derived from investment programme</td></tr>
<tr><td>2022 onwards</td><td>Phase 3:
Start of TEMU (§52–58)</td><td>This is the “carrot.” The content of the package would be determined by discussion, but must include strong incentives. Likely components include: completed banking union, enhanced ESM, completed single market. The main question needs to be answered by Germany: How much integration and solidarity is acceptable? The objective is clear: The compromise needs to envisage a TEMU that features strengthened governance, better crisis resilience and a basis for stronger structural growth.</td></tr>
<tr><td colspan="4">Source: Authors’ research</td></tr>
</table>

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