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# Ten years on: a new roadmap for reforming the European economic governance framework

*After the report of the four presidents in 2012, the euro area remained largely without any agenda for reform of its economic governance. In February 2020, the European Commission then initiated a review of its economic governance, since when the agenda has been dominated by debate on fiscal rules – with a range of academic and institutional suggestions for reform but a lack of consensus. Interestingly, the reform of the fiscal framework is rarely linked to the broader architectural issues in which it should be fundamentally rooted. This chapter argues for a set of ambitious but staged reforms of the Stability and Growth Pact (SGP) that are linked to a comprehensive roadmap for reforming the governance of the monetary union.*

The intellectual and political consensus of the 1980s and 1990s that paved the way for the single currency has shifted radically, but the euro area's architecture has not evolved accordingly. This leaves the single currency profoundly unstable both economically and politically. In 2012, European leaders were convinced that substantial reforms to the architecture of the single currency were needed for the euro to be able to survive, and the four presidents (of the European Council, European Commission, Eurogroup and European Central Bank) were tasked with proposing a roadmap for a comprehensive reform of the euro area's economic governance. This roadmap was incomplete back then, and it was not delivered in full in the years that followed either. Since that time, deeper fault lines have emerged in the EU's economic architecture – in part because of the Covid-19 crisis, and in part also because of the needs imposed on the European economy by our climate and energy transition. The summit of French President Emmanuel Macron in March 2022 could be a fitting opportunity to launch a new roadmap, but this requires urgent planning.

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Euro area integration remains a central feature of the European policy debate for the upcoming decade, and European leaders have a responsibility to chart a new roadmap to buttress its architecture. This roadmap should be structured around five related workstreams:

(i) staged reforms of European fiscal rules;
(ii) enhanced mechanisms for common fiscal policy;
(iii) a rewired framework to buttress the financial system;
(iv) profound evolutions of monetary policy;
(v) democratisation of the economic policy process.

For these reforms to be both credible and timely, Germany's government as well as France's future president must play a leading role in planning, negotiating, and delivering them. However, the reform cannot be limited simply to a bilateral Franco-German agreement. The failure and impasse of the Meseberg declaration in June 2018 proves that the Franco-German engine might be necessary but that it is no longer sufficient to move Europe forward. This should be a sobering lesson on both sides of the Rhine and it calls for a more inclusive planning process.

## A staged reform of the European fiscal framework

The suspension of fiscal rules across Europe with the onset of the Covid crisis has accelerated a long-standing debate about the fitness of these rules. The European Commission has resumed its economic governance review, and it is possible that France will use its rotating presidency of the EU Council and its national presidential election campaign to take a stand on this complex issue. The German election and the resulting coalition agreement has opened the door to a possible reform, but it has not set out the broad direction that this reform could take. Furthermore, the debate in Germany over the *Schuldenbremse* – the country's constitutional debt break – has not progressed, and the current coalition seems intent on trying to create fiscal room within the current rules rather than open a real debate about structural improvements. This is regrettable and will only make the European debate harder, but there is nevertheless space for progress.

### An emerging consensus

Over the last few years, a consensus has emerged about the limits of the current fiscal framework. Most academics, as well as all international institutions, have expressed their criticism of the current fiscal framework. Until recently, however, none of their critiques have truly been taken on board by the European institutions.

Although set up by the EU, the European Fiscal Board (EFB) has led the charge over the last few years for an ambitious reform of the Stability and Growth Pact. It has repeated its plea for a reform revolving around a differentiated expenditure benchmark, and has questioned the decentralisation of monitoring and enforcement by national fiscal councils. The latest EFB recommendations suggest a reform of the one-twentieth rule in favour of a country-specific debt adjustment path instead.

The European Stability Mechanism (ESM)[1] has recently published a set of reforms that are also rooted in an expenditure benchmark, but it has focused its attention on the debt reduction rule, which it views as the most pressing (although not the only) problem to be addressed. The ESM rightly shows that changing the reference debt/GDP level from 60 per cent to 100 per cent and the path of adjustment from one-twentieth to one-thirtieth could make the adjustment path much more sustainable. But it rightly points to the different legal obstacles ahead.

Interestingly, even for countries with a long tradition of fiscal rectitude, the intellectual consensus on these issues has shifted quite considerably. This is the case in Germany or again in the Netherlands, where the need for green investment is now broadly accepted, although not formalised, in a new transparent framework. Perhaps the most illustrative example of this is the latest annual report from the German Council of Economic Experts (Sachverständigenrat), which for the first time presents both a conservative and a progressive view on the issue of fiscal rules – when the progressive view used only to be a dissenting opinion.[2] The Progressives are calling for:

- a new expenditure benchmark rule (that limits the procyclicality)
- a golden rule to safeguard public investment
- a revision of the one-twentieth debt reduction rule (which they find inoperable and undermining for the credibility of the framework).

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The door to reforming the fiscal rules has therefore opened, but a consensus is lacking and the temptation to find a quick fix dominates. Instead, a more ambitious, comprehensive, and staged plan should be developed.

## A more substantive agenda

The current intellectual consensus is relatively narrow and could be summarised as a quick fix that substitutes the current framework by an expenditure benchmark combined with a reform of the debt reduction rule. While this could already be a meaningful step in the right direction, it would nonetheless be an insufficient reform of the fiscal framework. The fundamental question that needs to be addressed is whether the rules should be narrowly focused on fiscal sustainability or whether they should also seek to achieve a broader set of objectives. The original purpose of the fiscal framework was in fact broader than just

1 Francová, O., Hitaj, E., Goossen, J. and Kraemer, R. (2021) 'EU fiscal rules: reform considerations', ESM Discussion Paper 17 (www.esm.europa.eu/publications/eu-fiscal-rules-reform-considerations).

2 German Council of Economic Experts (2021) *Annual report 2021/22. Shaping the transformation: education, digitalisation and sustainability* (www.sachverstaendigenrat-wirtschaft.de/en/annualreport-2021.html).

fiscal sustainability. It was intended in part as a coordination device to prevent freeriding and undue pressure on the monetary authority.

Today, while there are risks that trying to expand the policy objectives of the fiscal framework might result in it becoming a 'complete contract' that attempts to solve for all member states the issues that fiscal policies should address, it is nevertheless essential that this expansion does not prevent the attainment of policy objectives that are critical to monetary union. The Stability and Growth Pact reform cannot therefore only be limited to a strictly fiscal exercise, but must be part and parcel of a broader reform of economic governance.

The European Commission and the member states willing to engage in a real foundational process should take a step back and plan a broader and longer-term reform. This process should have the two aims listed below.

1. Expand the fiscal space today to avoid a return to the rules that could tighten fiscal policy precipitously, given the prevailing epidemic and economic uncertainty. This could be addressed mostly through a communication that sets out the way in which the rules would be reintroduced.
2. Build a more robust long-term framework that not only provides more fiscal space today but also:
   (i) allows the EU's climate objectives to be met by enabling green public investment;
   (ii) enhances the stabilisation capacity of national fiscal policy;
   (iii) improves economic policy coordination, both between fiscal authorities to achieve an adequate aggregate fiscal stance for the euro area and between fiscal and monetary policy by adjusting the speed of adjustment depending on the inflation regime;
   (iv) anchors long-term debt sustainability in a way that is tailored to each member state.

## A short-term fix

The current intellectual consensus, probably best captured in the Marques Report of the European Parliament, does not provide the sort of comprehensive reform that the fiscal framework needs. Importantly, it does not prioritise what must be done now and what can be delivered later.

By spring 2022, when member states start making their budgetary plans for 2023, the European Commission needs to provide clear guidance on the timing and scope of the reintroduction of the fiscal rules. In practice, it has great discretion to do so given the unprecedented nature of the fiscal rules' suspension and the prevailing uncertainty. In fact, the Commission may well decide to postpone the reintroduction of these rules. The best thing the Commission can do is to return to the rules in such a way that they do not tighten policy excessively at a time of great uncertainty.

The Commission's guidance to member states should therefore probably at least include:

(i) a statement that the debt reduction rule will not be applied in order to avoid any debt-based excessive-deficit procedure and nominal annual consolidation until a new legislative package is approved;
(ii) its permission to suspend the 0.5 per cent of GDP structural adjustment (required under the preventive and corrective arm of the SGP) either directly by invoking exceptional circumstances, or indirectly by proposing a general application of the corrective arm of the SGP with a very long adjustment path of 5 to 10 years (the adjustment could be set at 0.1 per cent of GDP, for example);
(iii) its request for the Output Gaps Working Group to review the output gap calculations in depth, to acknowledge the uncertainty prevailing around the current measure of slack, and to provide more fiscal space than is currently offered by the rules.

The combination of these three steps would not only provide fiscal space today, but would more importantly give time for a more ambitious reform of the fiscal framework that would require legislative anThe d possibly treaty amendments.

## A longer-term plan

A longer-term plan needs to break with the idea that fiscal rules are only designed to address fiscal sustainability. Economists like to argue that a single objective with a single instrument is the right way to design policy, but this Tinbergen rule is not always the best guide to policy design. Fiscal policy cannot be boiled down to one objective, and allocation, stabilisation and redistribution cannot come systematically second to sustainability objectives. A longer-term reform should therefore probably build on the nascent consensus amongst economists but cannot be limited to it. Several areas for improvement must be considered.

A longer-term plan needs to break with the idea that fiscal rules are only designed to address fiscal sustainability

First, while an expenditure benchmark is certainly an improvement on the current system, it is not a reform that guarantees much better outcomes. Indeed, expenditure benchmark rules still rely on two problematic variables: a measure of potential growth and a target debt-to-GDP level. While the former is subject to a great deal of uncertainty, the latter should probably be country-specific and even then there is a degree of judgement and arbitrariness in setting it.

Second, an expenditure benchmark – even when based on more refined potential growth and more individualised debt target – would not preserve public investment and in particular green investment in the way it should. This speaks in favour of introducing a green golden rule, which would essentially ensure that green public investment is encouraged. But calibrating this golden rule is difficult. Indeed, the rule would need to be both flexible and dynamic. Setting an arbitrary yardstick, say 0.5 per cent of GDP for example, would be inadequate. Indeed, the measure of today's green investment needs is uncertain and will evolve with time. This green golden rule should thus largely be calibrated on the basis of carbon emissions reduction targets and achievements. One way of doing this is to

revise green investment needs every year along with nationally determined contributions (NDCs) and to flesh out new climate and energy plans. This would root climate policy in the fiscal framework more solidly.

Third, fiscal rules should also take into account the inflation regime in which we operate. Indeed, in an environment of a liquidity trap where the efficacy of monetary policy is constrained by the zero lower bound, fiscal policy should be able to do more. Conversely, in an environment where inflation is running durably above the ECB's target, fiscal policy should turn more restrictive. This can partially be governed by a new rules-based framework that is anchored in nominal GDP targeting, but it is more likely that it would be best operated by some level of discretion exercised centrally.

Fourth, evolutions of the governance area should also be linked to progress on the EU's fiscal integration. A leap was taken during the crisis, but it was designed as temporary and exceptional. The national fiscal rules cannot be designed to operate in quite the same way if European fiscal integration moves in the direction of shifting some national spending to the European level. The nature of this spending also matters – for example, if a partial unemployment insurance scheme emerges at the European level on a permanent basis, the national fiscal stabilisation needs would be smaller.

Last, such a reform would provide the European Commission with more discretionary powers, but it would also require more transparency and accountability. In particular, the Commission should own more clearly the fact that it uses discretion in applying the rules and that this discretion is in part tailored to achieve a certain aggregate stance for the euro area. The Commission's current recommendation for the euro area is weak, and poorly monitored. These greater powers for the European Commission would also require greater accountability to the European Parliament and the latter's economic and monetary affairs (ECON) committee.

These five dimensions for reforming the fiscal rules cannot come into play all in one go. They are both too broad and too complex to be designed and agreed today. A roadmap is therefore needed for reforming governance along these lines, and it should comprise clearly identified stages.

## A staged roadmap

In practice, the Stability and Growth Pact is a multi-layered legal construct, and it would need at least a decade for its substantial revision. Indeed, the SGP takes the form of a minimum of four interwoven layers, and their modification would require different levels of political consensus and legislative action.

The European Commission has discretionary powers to interpret the rules, and over the decades it has produced a long jurisprudence of precedents that form the 'vade mecum'. The Commission's interpretative powers are expansive, thus allowing structural reforms in 2015, for example, and the introduction of flexibility clauses to encourage public investment. These discretionary powers have also allowed application of the debt reduction rule to be sidestepped. With such powers at its disposal, the Commission could issue a communication as early as 2022 that would clarify not only how it intends to re-apply the SGP

Table 1: Summary of a staged governance reform process

| Vehicle | Content | Process | Timing |
|---|---|---|---|
| Communication by the European Commission | - interpretation of reactivation of SGP<br>- treatment of debt reduction rule<br>- flexibility for green investment<br>- reference to evolution of reference values (3 per cent of GDP deficit and 60 per cent of debt-to-GDP)<br>- evaluation of output methodologies to review assessment of adjustments | Consensus in the College of the European Commission | 2022 |
| Joint interpretative declaration of the member states | - temporary suspension of certain provisions of the TSCG, in particular the debt reduction rule | Unanimous declaration of the TSCG signatories pursuant to Article 57 of the 1969 Vienna Convention on the Law of Treaties | 2023 |
| Legislative proposal by the European Commission modifying the two-pack and six-pack | - review entirely semester, macroeconomic imbalance procedure (MIP) and role of national climate and energy plans<br>- remove excessive-deficit procedure (EDP) on sole basis of debt criteria<br>- introduce expenditure rule and golden rule for green investment calculated on the basis of carbon emissions path<br>- remove medium-term objective and 0.5 per cent structural adjustment | Proposal by the European Commission, and ordinary legislative process | 2023-24 |
| Abrogation of the Treaty on Stability, Coordination and Governance | - abolish the TSCG, in particular the reference to the introduction of national constitutional debt break provisions<br>- end reference to debt reduction path | Unanimity of member states and national ratifications | 2024 |
| Modification of national primary laws | - as a result of abrogation of TSCG, modify national primary law accordingly | Depending on national constitutional provisions | 2024-26 |
| Modify Protocol 12 | - remove reference to 3 per cent of GDP deficit and 60 per cent of debt to GDP | Unanimity and national ratification | |
| Reform of the EU Treaty | - modify corrective arm of the pact and move away from sanction regime<br>- establish solid legal basis of policy conditionality / coordination in return for common investments<br>- create strong legal basis for common borrowing and common taxation<br>- enhance fiscal and monetary policy coordination framework<br>- expand legal basis for financial stability and resolution powers | Simplified or ordinary procedure requires unanimity and either national ratification or convention | 2024-29 |

when it is reactivated in 2023, but also how it intends to stage lasting changes to the SGP's application.

The Treaty on Stability, Coordination and Governance (TSCG) – which mandated the introduction of fiscal rules of a constitutional nature, and which introduced the debt reduction rule of one-twentieth – would need to be suspended before it is abolished. A unanimous declaration of the member states would provide a strong legal footing for a temporary suspension, but this would need formal abrogation at a later stage.

Legislative changes to the two-pack and six-pack will also be needed. These changes will require an ambitious proposal from the European Commission, and then undoubtedly protracted negotiations in the ensuing trilogues. This step could be completed before the end of this European parliamentary term, but it would require the introduction of a legislative proposal by the end of 2022. The communication should therefore be viewed as a step towards a profound legislative change that would include in-depth reforms across the European semester, the inclusion of an aggregate fiscal stance as a more clearly defined policy objective, a reform of the macro economic imbalances procedure and the inclusion and elevation of the national climate and energy plans, as well as the national determined contributions as part and parcel of the economic governance framework.

In addition, modifications will also be needed to the European Treaty and Protocol 12 that sets the numerical benchmarks central to the corrective arm of the SGP. This process will require a high degree of political consensus. Indeed, it should be part and parcel of a broader set of treaty amendments that will not only improve fiscal governance but also set the foundations for greater fiscal autonomy/powers for the EU and empower the ECB to play a greater role in financial stability. This is a long agenda, but it must be started today in order to be completed within the next parliamentary mandate (2024-29).

## European fiscal integration must carry on

This debate on the evolution of fiscal rules is also profoundly related to the extent of fiscal integration of the euro area. Over the last decade, the euro area has taken several steps in fiscal integration: the creation of financial assistance mechanisms (European Financial Stability Facility – EFSF, European Stability Mechanism – ESM), the large issuance of common debt, and the underwriting of cross-border transfers with the Recovery and Resilience Facility (RRF). While the euro crisis allowed for the creation of a permanent rescue mechanism, the Covid crisis has shown the limits of this approach. Indeed, in the case of a symmetric shock, where multiple countries require common borrowing, the ESM is inadequate. In addition, the stigma associated with its use is such that many member states are reluctant to apply for financial assistance for fear of excessive conditionality.

This puts the future of the ESM into question and it should lead the EU to think of more substantial reforms than that undertaken in 2020.[3] In particular, the EU should consider the

3 See: www.esm.europa.eu/press-releases/esm-members-sign-revised-treaty-entrusting-institution-new-tasks.

possible transfer of the ESM to the European Commission,[4] so as to put all the borrowing power of the EU under one roof and under community law, as well as under the democratic control of the European Parliament.

But the Covid crisis has provoked two important changes in particular, which are worth exploring as potential avenues for long-term fiscal integration.

The first important change is the creation of temporary support to mitigate unemployment risks in an emergency (SURE),[5] which works as a borrowing facility to finance unemployment insurance in individual member states. SURE can be viewed either as a transitory stopgap to be used only in moments of extreme crisis, or alternatively as the first step towards a supranational European unemployment insurance that would offer European citizens a minimum standard unemployment insurance that is portable across the EU. This latter alternative would require treaty changes and would radically transform the relationship of citizens to the EU by creating the first set of social rights and financial claims of individual citizens on the EU. It would thus mark a considerable leap forward in European economic and political integration.

The second important change is the July 2020 European Council agreement to create common borrowing and centralised spending through the RRF.[6] While this was designed as a one-off instrument specifically to fight the Covid crisis, its basic principle and architecture could be expanded and used for other projects of common interest. A central feature of this plan is that it relies on new own resources (that is, taxes) for the EU budget to back this common debt. While the German Constitutional Court enabled the ratification of the own resources decision that provides these common resources,[7] its final ruling on the conformity of the RRF with the European Treaty has not yet been issued. This ruling will determine the contours of a possible fiscal union to a large extent, thereby clarifying the legal obstacles that must be lifted to make such a borrowing capacity permanent. The German Constitutional Court may not rule on this for another year and is likely to transfer part of the case to the European Court of Justice. Politicians might therefore be tempted to avoid this debate altogether, but in reality the future of fiscal integration is a pressing question for the current government. Decisions by either court might set out legal challenges to be overcome, but the decisions will not settle the political choices that must be made. The political question will therefore continue to exist and must be addressed by the European leaders unequivocally. The question of the EU's own resources and ability to tax is central to the euro area's future architecture. This question has been left unanswered but it will play a key role in framing the agenda, timing and scope for fiscal integration and institutional reforms.

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4 Guttenberg, L. (2020) 'Time to come home. If the ESM is to stay relevant, it should be reinvented inside the EU', Policy Brief, Hertie School - Jacques Delors Centre (www.delorscentre.eu/en/publications/detail/publication/time-to-come-home).

5 See: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en.

6 See: www.consilium.europa.eu/en/meetings/european-council/2020/07/17-21/.

7 Bundesverfassungsgericht (2021) 'Unsuccessful application for preliminary injunction against promulgation of the domestic act ratifying the EU Own Resources Decision ('EU Recovery Package')', Press Release No. 29/2021 (www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2021/bvg21-029.html).

# The financial framework requires deep reforms

## Banking union and its discontent

Despite the EU's continued insistence over the last five years on the need to complete the banking union, this agenda has made virtually no progress – in large part because the roadmap prepared by the Eurogroup is ill-designed.[8] The EU does not need to complete its banking union by adding a common deposit guarantee scheme and changing the regulatory treatment of sovereign debt holdings as it is currently attempting. Instead, it needs to rewire the legal foundations of its common resolution approach entirely – not an easy feat, but one that demands clear-eyed leadership. The combination of a weak Bank Recovery and Resolution Directive with an ineffective Single Resolution Board has left the EU incapable of resolving/restructuring its banks. A common deposit guarantee scheme or the poor arrangements being drawn to endow the single resolution authority with a conditional fiscal backstop will not correct this. A new approach is therefore required. The current focus of the Single Supervisory Mechanism (SSM) on cleaning up the balance sheet might offer a more promising avenue. Indeed, the creation of asset management companies, or the discussions around the need for liquidity in resolution arrangements with the European Central Bank, or the changes to the state aid framework for the financial sector will open areas for more structural reforms. While in the past, Germany has blocked progress on the creation of a common deposit guarantee scheme and has been unduly concerned with sovereign debt in bank balance sheets, the new German government could play a far more constructive role in helping a different roadmap to emerge. Creating the short- and long-term instruments to ensure European banks can be cleaned up when necessary could help avoid difficult issues in Germany like that of a common deposit guarantee scheme, but it will not avoid them all. Indeed, these reforms may also lead to changes to the current supervisory arrangement that leaves most of the German banking system largely outside the direct supervision of the SSM. The changes will also most certainly force a profound review of the financial stability consequences of the national institutional protection schemes that create strong solidarity ties between networks for smalls banks (in Germany *Sparkassen* and cooperative banks are typically part of these institutional protection schemes). It is ultimately in the interest of Germany's financial stability to strengthen the supervision of its own domestic financial system and it is in the interest of the EU that the largest member states do not shelter an antiquated, poorly supervised, and politically captive banking system. Recent financial scandals should support a more ambitious and a less parochial agenda in this area despite this agenda undoubtedly being strongly resisted by regional and local banking lobbies.

8 Council of the European Union (2020) 'Statement of the Eurogroup in inclusive format on the ESM reform and the early introduction of the backstop to the Single Resolution Fund', Press release 30 November (www.consilium.europa.eu/en/press/press-releases/2020/11/30/statement-of-the-eurogroup-in-inclusive-format-on-the-esm-reform-and-the-early-introduction-of-the-backstop-to-the-single-resolution-fund/).

## Shadow banking and a new financial architecture

While the European banking system is central to the European economy, the financial system is slowly evolving towards one where shadow banking and the flow of securities is becoming central to financial and monetary stability. Indeed, the smooth flow of collateral is becoming an essential feature of the financial system. The capital markets union legislative package/agenda is important in this respect, but some elements are more important than others. One essential issue, in particular since the withdrawal of the UK from the EU, is that the bloc restores full sovereignty over critical pieces of its financial architecture, especially its central clearing counterparties that clear trades in securities and arrange repo operations. These are the beating heart of the shadow banking system and must be under full supervisory control and within arm's length of the EU's fiscal and monetary authority in situations of distress. This requires quite an ambitious legislative and supervisory agenda, which should be accelerated.

# Monetary policy requires evolutions

Monetary policy has become a central question for the future of the euro area in large part because the intellectually neat boundary between financial, fiscal, and monetary policy is blurred. The idea of a simple operational framework (refinancing operations), a clear instrument (interest rates) and a single objective (price stability) has been shaken. This evolution has made the ECB's toolkit more complex (targeted refinancing operations, asset purchases) and it has forced the ECB to put in place negative interest rates while *de facto* expanding the ECB's secondary objectives (including financial stability and climate change).

These profound changes create a heightened degree of political, legal, and constitutional tension. Nowhere is this more evident than in the German Constitutional Court ruling against the ECB's public sector purchase programme (PSPP) of 5 May 2020, which effectively ruled that not only the ECB but also the European Court of Justice were acting *ultra vires*.[9] If the ruling had forced the Bundesbank to withdraw from the programme, it could have opened a fundamental rift between Germany and the euro area. Only a careful and astute, yet politically volatile, compromise avoided such an extreme outcome. The ECB thus offered more a formal explanation for its asset purchase programme,[10] the German government stated that the Constitutional Court could not rule on European law,[11] and the Bundesbank sided with the ECB.[12] Despite all this manoeuvring, the ruling exposed the

9 Bundesverfassungsgericht (2020) 'ECB decisions on the Public Sector Purchase Programme exceed EU competences', Press Release No. 32/2020 (www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2020/bvg20-032.html).

10 See: www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200702~87ce377373.en.html.

11 Chazan, G. and Arnold, M. (2020) 'German finance minister move to resolve court stand-off with ECB, *Financial Times*, 29 June (www.ft.com/content/443a14d9-b631-4609-9ad1-7ee98b8249c5).

12 'Bundesbank chief defends ECB bond purchases in wake of court case', *Reuters*, 16 September 2020 (www.reuters.com/article/us-ecb-germany-court-idUSKBN26711R).

potential political tension that lies at the heart of monetary policy, and it highlighted the risks of political friction.

Monetary policy is and will become an even greater area of tension, in part because of the broadening of the ECB's role, and in part because of the legacy that owning large stocks of government debt will create. Germany must accept that there is no going back to the *status quo ante*. The 'normalcy' of the late 1990s and early 2000s may just as well have been an exception to the norm, rather than the actual norm. Fiscal and monetary policy must cooperate much more intensely, and absolutist and rigid rules around independence must evolve. This will require important debate and profound legal changes including in EU primary law in order to grant the ECB a more solid legal basis for financial stability, and to clarify the importance of the ECB's secondary objectives in particular with respect to climate change. The Central Bank of tomorrow will not be the Bundesbank of the 1970s. These important debates cannot be outsourced to the constitutional courts and will require open debates about the future of monetary policy and a new political settlement in Germany and then at European level.

## Conclusion

The euro area's architecture needs profound reform. The further integration of the euro area's banking and financial system that was decided in 2012 in order to absorb and share economic shocks has been abandoned midway. Fiscal integration has taken a 'last resort' – *ultima ratio* – form of financial assistance, and although fiscal risk-sharing and transfers have taken a leap during the Covid crisis, these might only be temporary. Fiscal rules designed for the Maastricht architecture were inadequate then and are worse now. They need to be deeply reformed even if this takes a decade. Finally, political integration and democratisation of the euro area has not progressed in the least. In the meantime, the UK has left the European Union, the euro area has expanded, and the deepening of integration has taken shape in EU27 format rather than by way of intergovernmental arrangements exclusively for euro area members.

Taken together, along with new political realities in Italy, France and Germany, these changes have the potential to open an extraordinary opportunity for action. The European Commission has announced a comprehensive review of European economic governance, and the European Parliament has just issued an own initiative report – but there is limited political support for and consensus around an ambitious and long-term reform agenda. The Conference on the Future of Europe announced in 2019, which could have been an unprecedented chance to launch an institutional debate and Treaty reform agenda, is unlikely to deliver.

This relative void puts considerable responsibility on France and even more on Germany. By virtue of being large and powerful members of the euro area and now (re)electing new leaderships, France and Germany have a responsibility to drive the development of a new roadmap towards fixing the architecture of the monetary union. In 2017, France

and Germany embarked on a set of bilateral discussions that culminated with the Meseberg declaration in the spring of 2018.[13] This effort was not endorsed by the rest of the European Council, and has not been met with action, in large part because the German coalition agreement did not give the federal government a clear mandate. This is not the case today, where the coalition sets out a bold long-term horizon and is open to institutional reforms. This roadmap will certainly take months to be agreed and it will require intense negotiations with European partners. It cannot be simply a Franco-German exercise and neither can it be held back by blocking tactics from unwilling member states. A coalition of the willing must emerge because the euro area cannot continue to fail forward in order to improve its foundations. The March 2022 summit announced as part of France's Presidency of the EU Council could be an ideal moment to set this coalition of the willing in place.

The Conference on the Future of Europe, which could have been an unprecedented chance to launch an institutional debate and Treaty reform agenda, is unlikely to deliver

13 See: www.diplomatie.gouv.fr/en/country-files/germany/events/article/europe-franco-german-declaration-19-06-18.