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Fiscal Union, Monetary Policy Normalization and Populism in the Eurozone

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This article studies the different scenarios for the fiscal union in the Eurozone beyond 2019. It explains the different alternatives that the literature has explored to ensure fiscal transfers within Eurozone states as well as for common debt issuance. It also describes the role that monetary policy has played as a backstop for sovereign defaults and highlights the limits that inflation and an anti-euro backlash impose on public debt sustainability.

1. Introduction

After the election of Emmanuel Macron as French president, the debate about the future of the Eurozone regained momentum. The pro-European policies supported by the French administration found a valid complement in some of the German government's ambitions. On the other side, anti-European parties keep gaining popular support in countries such as Italy, Austria, the Netherlands and even Spain. Furthermore, since the beginning of the recent sovereign crisis, policymakers and researchers have been publishing different proposals on how to enhance the Eurozone's institutional framework to transform it into an optimal currency area (Mundell, 1961).

Among the different policy alternatives currently under discussion, debt mutualization seems to be losing political interest in favour of other proposals connected with the avoidance of a trade war or with the necessity of new fiscal stimuli to avoid a possible recession. Although we welcome those efforts, we believe that the current economic and institutional environment demands some form of common solution from the centre, at the fiscal level, to ease sovereign market conditions and to reduce dependence from the European Central Bank (ECB).

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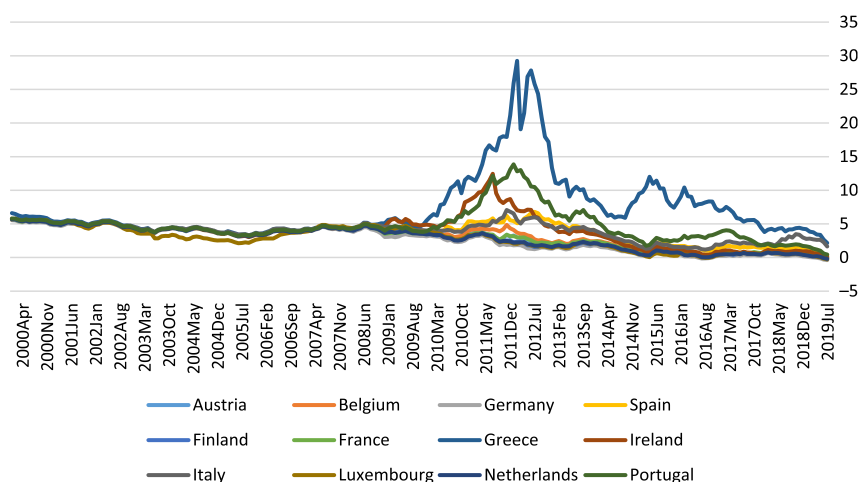

Figure 1. Ten-year sovereign bond yields. Eurozone 12. (To view this figure in colour please see the online version of this journal.)
Source: European Central Bank.

This article studies the different scenarios for debt mutualization in the Eurozone beyond 2019. The main question that we try to answer is whether the current sovereign debt stability is sustainable, given the lack of political consensus about further fiscal integration and the inflation target to which the European Central Bank (ECB) is committed.

This question is particularly relevant for two reasons. The first is that there is an increasing threat to the European integration project from the newly-born populist movements in Europe. The second is that monetary policy is currently playing a fiscal role in the Eurozone. For how long the ECB will be able to control this is a question that remains unanswered.

The current stability in sovereign debt markets, shown in Figure 1, is the result of better macroeconomic fundamentals in the Eurozone and the active role that the ECB has been playing in debt markets. Because of this, sovereign yields are now lower and more stable than in previous years.

There is huge homogeneity on the evolution of default risk, as De Grauwe and Moesen (2009) define it, in the years 2000 to 2009. After that period, there is a group of countries (Portugal, Ireland, Italy and, especially, Greece) that experienced a dramatic surge in their yields. From the second quarter of 2012 on, all countries but Greece returned to the pre-crisis homogeneity. Italy started to threaten this stability soon after the election of Matteo Salvini as Deputy Prime Minister of the country, but not even the growth deceleration in some countries such as Germany is pushing up sovereign yields significantly.

The reduction in sovereign yields is correlated with the announcement, from the ECB, of the Outright Monetary Transactions (OMT) programme and other monetary stimuli designed to alleviate the sovereign debt burden. The stability achieved by

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the ECB's intervention is very fragile, however. This is true, first, because of the ECB's commitment with its inflation targeting. If inflation rises above 2% per year, sovereign debt buying could be reduced or even stopped, as the ECB has repeatedly declared (ECB, 2018).

Second, it is true because populist and anti-European forces are limiting the scope of new reforms and further integration in the Eurozone. The support that the ECB is providing to the sovereign debt markets has reduced the need for a fiscal union and for a common debt issuance mechanism. In the case of monetary normalization, eurobonds and fiscal union would probably be the only solution to keep sovereign markets stable.

Is it possible to achieve a common fiscal policy or to create a mutual public debt asset under the current political pressures? What are the alternatives under this extraordinary set of circumstances? This paper assesses these questions. First, in Section 2, we analyse the literature on fiscal unions and eurobonds. In Section 3, we explain the ECB's role as a backstop for sovereign defaults. We also study the limitations that this approach may have and its connection with the political climate in Europe. In Section 4, we stress the relationship between adjustment costs and populism. In Section 5, we study the different scenarios that the Eurozone faces on the creation of a fiscal union. Section 6 provides a conclusion.

2. Eurobonds: Literature Review and Alternatives

This section examines the different alternatives that the literature and the policy makers have proposed for common sovereign debt issuance in the Eurozone. The International Monetary Fund (Céline *et al.*, 2013) has highlighted the need for a fiscal union as a prior step before the issuance of a common European debt asset.

According to the Fund's view, there are four conditions that must be fulfilled to close the institutional gap that the Eurozone is still suffering from: better design of fiscal policies, discipline and accountability, enforcement of agreements from central authorities and the creation of a mechanism for fiscal transfers. The four of them will be briefly analysed in the following section.

2.1. Minimal Elements for a Fiscal Union

2.1.1. Fiscal Policy Design

Fiscal rules and policies at state level should be coordinated from the centre. Common rules and goals are essential. The fiscal compact is a step in this direction, but the enforcement of fiscal plans is a critical element for the success of the fiscal union. The IMF proposes four policy changes in order to enhance the current fiscal framework.

First, the concept of structural fiscal balance targets, instead of headline ones, should be applied more systemically. All the adjustment paths proposed by member states, as well as policy recommendations from European authorities, should be designed in terms of structural goals.

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Second, the use of structural targets requires careful estimates of the output gap. Independent regional agencies would provide those estimations, in coordination with central oversight, to assess fiscal policy design and its implementation.

Third, fiscal rules must be flexible, but they should be accompanied by medium-term fiscal plans that clearly highlight the path to lower debt levels. They should also include automatic corrective mechanisms designed at the national level and made consistent across countries.

Finally, the harmonization of budget presentation, fiscal reporting and accounting, at all levels of government, would increase transparency and accountability. It would also send a message to the markets about the unity of the fiscal framework in the Eurozone.

2.1.2. Discipline and Accountability

It is essential to increase the accountability of fiscal plans and to enhance the mechanisms already operating. There are two ways of doing this: first, through a centre-based approach complementary to market discipline. This approach, which could take the form of a new common fiscal institution, would also provide technical assistance in case of necessity and prevent fiscal imbalances to appear.

Second, while the new design of fiscal policies and common debt issuance in the Eurozone is ready, the European Stability Mechanism (ESM) still stands as the main tool for fighting against sovereign market disturbances. It is necessary to clarify bail-out rules and conditionality to make sure that the necessary reforms are implemented after interventions.

Cottarelli (2013) stresses that the main goal of a fiscal union is 'to prevent unsustainable fiscal behavior at the local level from exerting negative effects over the entire union', an idea also included in the following condition from the IMF's proposal.

2.1.3. Enforcement

It would be necessary to increase the involvement of central authorities in fiscal decisions to make the design of the potential fiscal union efficient and homogeneous for all member estates. Deeper relations between national and central authorities could take three forms.

- Since fiscal rules are expected to be part of national legal bodies, non-compliance could also be prosecuted at domestic courts. In addition, as the IMF points out, 'EU court jurisdiction over national domestic rules could also be considered'. In all cases, changes in treaties would be necessary, which makes this possibility hard to implement.
- The existence of a central budget would make enforcement easier to achieve. Let's suppose that a given country does not fulfil some of the fiscal targets that have been agreed or that have been imposed from the centre. In this case, it could be possible to reduce transfers until compliance with the established goals.

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- A veto power from the centre is an alternative that would allow a common fiscal authority to revise and to overrule domestic budgets when they do not fulfil fiscal targets or agreements. This mechanism would probably be the most effective, but it would require member states to give up a big part of their sovereignty, which is unlikely under the current political circumstances.

2.1.4. Fiscal transfers mechanism

According to Mundell (1961), currency unions need fiscal transfers as a way to protect countries suffering from asymmetric shocks. Following Céline *et al.* (2013), there are three ways to achieve this goal. First, the creation of a 'rainy-day fund' such as that contained in Enderlein *et al.* (2012). The fund would collect revenues from Eurozone countries and make transfers to those economies affected by an asymmetric shock. It would provide an ex ante support and cross-country insurance without the need of establishing new institutions, which could reduce the political costs involved.

Second, a common unemployment insurance. This would be a socially acceptable way for deeper risk and fiscal sharing in the Eurozone. A common unemployment insurance would require a higher degree of legal harmonization on labour market policies and the overcoming of some technical difficulties; the fund would probably need to be focused on short-term unemployment, given the huge heterogeneity that the Eurozone experiences on long-term rates.

Finally, the deepest way of fiscal risk sharing would be the implementation of a common budget for all Eurozone countries. Risk sharing would come from the expenditure and from the revenue sides at the same time. The high degree of risk sharing that this alternative requires should generate a deeper involvement in the responsibilities attached to the budget management. Coordination would be easier and the impact on the Eurozone's economy would be potentially greater.

There would be two additional strategies to make fiscal risk sharing possible in the Eurozone. The first would be a single resolution mechanism covering all financial systems in the Eurozone capable of disentangling the relationship between sovereign debt and financial institutions. This backstop would be funded by both national governments and industry. This possibility goes beyond the scope of this paper since it has a strong connection with the banking union proposals, and it should be addressed separately.

The second strategy would be borrowing from the centre. This is an option that will be analysed in the following. Debt issuance from the centre, as has been previously pointed out, would require adequate governance, as well as a high degree of social and political support.

2.2. Eurobonds: The Next Step

From the theoretical point of view, borrowing from the centre would be an option not necessarily preceded by the existence of some degree of fiscal risk sharing. Nevertheless, a fiscal union, in any one of the forms previously described, would

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be a good test for the political and social willingness of deeper political and economic integration; some of the technical difficulties that would arise from common debt issuance could be solved ex ante.

Given the fact that the European Stability Mechanism (ESM) issues bonds with a guarantee proportional to each state's participation in the capital of the ECB, some form of Eurobonds already exists. There is not, however, a joint guarantee. De la Dehesa (2011) grouped the main proposals contained in the literature in a briefing note published by the European Parliament. According to his view, there are four different proposals for common debt issuance in the Eurozone. Two other alternatives will also be included in this section: those proposed by di Mauro (2011) and Brunnermeier *et al*. (2016).

2.2.1. The Gros/Micossi Proposal

Since the financial crisis bust in 2008, economic agents have developed a strong preference in favour of public debt. Gros and Micossi (2008) proposed the creation of a European fund as an answer to the American Troubled Assets Relief Program (TARP). This fund would issue bonds with the explicit guarantee of all Eurozone member states. According to Gros and Micossi, the fund would be operative only during a limited time: as long as there was demand for this newly created instrument.

From the moral hazard point of view, this proposal does not necessarily imply that stronger states would have to cover for the mistakes of others, since losses could be distributed according to each case. This is one of the reasons that explains the interest of core Eurozone countries in this mechanism. Gros and Micossi's proposal was partially adopted by the European authorities. On 24 May 2010, the European Financial Stability Facility (EFSF) was officially created. The EFSF is authorized to borrow up to €440 billion, an amount similar to that proposed by Gros and Micossi.

2.2.2. De Grauwe and Moesen: Market Perception

The increasing pressure on sovereign bond yields of the years 2009 and 2010 is behind the proposal of De Grauwe and Moesen (2009). The goal of their common debt issuance alternative was to reduce the pressure that was affecting market perception on sovereign risk in the Eurozone. They expected to create enough fiscal space for public stimuli and to control the side effects generated by the reduction of sovereign debt quality in the financial system.

There would be two ways to achieve this: by opening the door to ECB intervention in sovereign debt markets or by implementing their Eurobonds proposal. The institution in charge of public debt issuance would be the European Investment Bank (EIB) or, alternatively, national governments.

To fulfil its targets, debt issuance should satisfy the following four conditions, as De la Dehesa (2011) summarizes:

> first, each euro area government would participate in the issue on the basis of its equity shares in the EIB. Second, the coupon on the Eurobond would be a weighted

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average of the yields observed in each government bond market at the moment of the issue weighted also by their equity shares in the EIB. Third, the proceeds of the bonds would be channeled to each member government according to the same EIB share weights. Fourth, each government would pay the yearly interest rate on its part of the bond, using the same national interest rate used to compute the average interest of the euro bond.

2.2.3. Weizsäcker and Delpla: Blue Bond Proposal

According to Weizsäcker and Delpla (2011), the only possible solution to the moral hazard problems hidden in previous proposals is via a double-tranche European public debt asset. The senior tranche (blue bond) would be constructed by pooling 60% of the national sovereign debt of the euro area member states, under joint liability and common responsibility. The junior tranche (red bond) would be constructed with the public debt of member states above 60% of GDP. Interest would be higher, and it would work as an incentive to reduce their leverage in order to enjoy the conditions granted on the senior tranche (Weizsäcker and Delpla, 2011)

This proposal has several strong points. First, it splits responsibilities within the euro area, making the 'no-bailout' clause of the Lisbon Treaty more credible, not only de jure but also de facto. The higher cost of borrowing would act as an alarm sign; countries would need to adjust their public balances to gain access to the blue tranche.

Second, it is a politically feasible proposal since the borrowing capacity of the blue tranche would not be polluted by the weak performance of some specific countries. Countries meeting their budget balance and public debt commitments would be less affected by free-riding problems and by asymmetric shocks.

Third, ECB intervention in the market would be limited to blue bonds. This should act as a secondary incentive for countries to achieve public debt issuance in the senior tranche. ECB intervention would depend, however, on the evolution of future inflation and on the political fragmentation that could hit Eurozone countries, as will be shown in Section 3.

The *Financial Times* published the evolution of the Blue/Red Bond proposal in December 2010. According to Juncker and Tremonti (2010), Eurobonds should be issued by a new institution, the European Debt Agency (EDA). The EDA would finance up to 50% of issuance by member states. It would offer a switch between existing national bonds and newly created Eurobonds. The EDA would have a mandate to issue Eurobonds up to a total equivalent of 40% of the total GDP of the European Union and of each member state's GDP.

2.2.4. Eurobills, not Eurobonds

The Eurobills proposal of Philippon and Hellwig (2011) is based on the idea that the introduction of Eurobills – common debt with maturity of less than a year – 'could provide a large part of the benefits' of other assets with longer maturities, 'while allowing for significant checks on the risks, both in terms of magnitudes, and in terms of effective control'.

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The original proposal includes the creation of a new institution that the authors call the Debt Management Office (DMO). This office would be the only issuer of short-term bills for all Eurozone (EZ) countries. The DMO should also manage debt issuance, redemption and debt auctions. It would conduct them in order to satisfy the needs of all EZ countries, subject to the constraint that no country can have more than 10% of its GDP in Eurobills at any given time. Eurobills would be 'the joint-and-several liabilities of the Eurozone' as the authors highlight.

Participation in Eurobills emissions would be conditional to the achievement of the different economic convergence goals established by European authorities. Countries could not issue any more short-term debt on their own. They would continue to issue their own debt for maturities longer than two years.

Eurobills would be senior to other debts. All market participants (investors and governments) should understand this point, since it is a key feature to reduce moral hazard. Philippon and Hellwig (2011) highlight that their proposal would be complementary to budgetary discipline and fiscal surveillance.

They recognize, however, that 'it is important to understand that effective market discipline requires that jointly issued debt be credibly senior to any other debt. Enforcing this is difficult and risky'.

2.2.5. A Debt Redemption Fund?

Following di Mauro (2011), the debt redemption pact would act as a temporary mechanism formed by a pact and funding scheme. The pact would entail a country-specific plan for reforms and public adjustment. It would follow the demands set by the Treaty on Stability, Coordination and Governance (TSCG) and act as a safeguard against moral hazard.

Each country would service its own debt financed via the new fund until it is completely redeemed, and the new fund expires. Participant states would be jointly responsible for debt, which should make refinancing costs affordable.

The Redemption Fund allows countries to refinance public debt in excess of 60% of GDP. Repayment obligations are set as a percentage of nominal GDP to provide some automatic stabilization and backload redemption of debt when growth picks up. By design, the countries with the largest participation would be those which now have the highest debt burden.

Alternative designs of the fund could envisage a higher threshold for mutualization (e.g. 75% of GDP), or setting an equal share of joint issuance at 20% of GDP of every participating country. The redemption fund first accumulates during the 'roll-in' phase and is then gradually drawn down. A fund for all debt above 60% would reach a maximum size of €2.85 trillion after 5 years and the repayment phase would be 20 years.

2.2.6. ESBies: European Safe Bonds

The most complete proposal so far published is that developed by Brunnermeier *et al.* (2016). The main advantage of this proposal is that it does not require major changes to current treaties, which would make it easier to implement.

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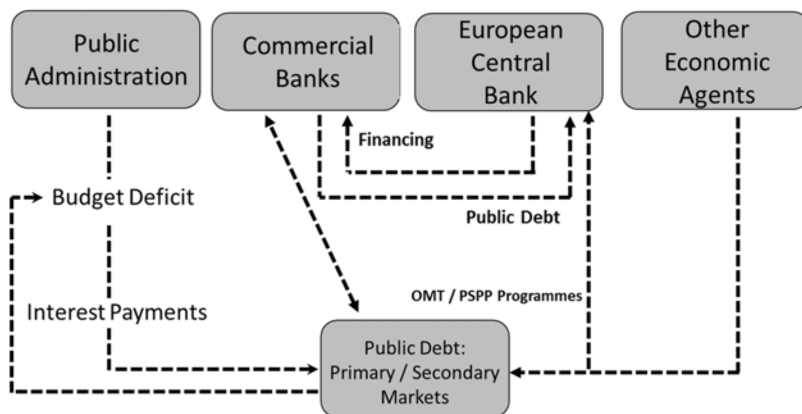

Figure 2. The fiscal role of monetary policy.
Source: Own research.

Mutualized bonds would be issued by a new agency, the so-called European Debt Agency (EDA). It could buy debt from different Eurozone countries and issue, in exchange, two different categories of assets: senior debt, with lower risk, and junior debt, for investors looking for a higher return.

According to the authors,

> the first security, ESBies, would grant the right to a senior claim to the payments from the bonds held in the portfolio. If the cut-off is X per cent, then the first X per cent lost in the pool of bonds because of potential European sovereign defaults would have no effect on the payment of the ESBies. (Brunnermeier *et al*., 2016)

The second security would be sold to willing investors in the market. Any risk that a sovereign state may fail to honour debts would be reflected in yield evolution. Realized losses would be absorbed by the holders and not by the EDA or the European Union nor by member states. This security should be more appealing for those investors wanting to hedge with respect to the ability of European member states to repay their debt.

ESBies offer three important advantages over the different proposals so far discussed. First, they satisfy the demand for safe assets; banks and investment funds are asking for a European asset, as safe as possible, that can minimize default risks. Second, ESBies do not require further fiscal integration. It is a solution that could help to stabilize the Eurozone without an important political cost. Finally, ESBies can help to erode the diabolic loop between banks and states, as described by Altavilla *et al*. (2015).

3. The Fiscal Role of the Monetary Policy

Figure 2 shows the relationship between public administrations, commercial banks and the ECB under the current conditions of public debt issuance. Each country is

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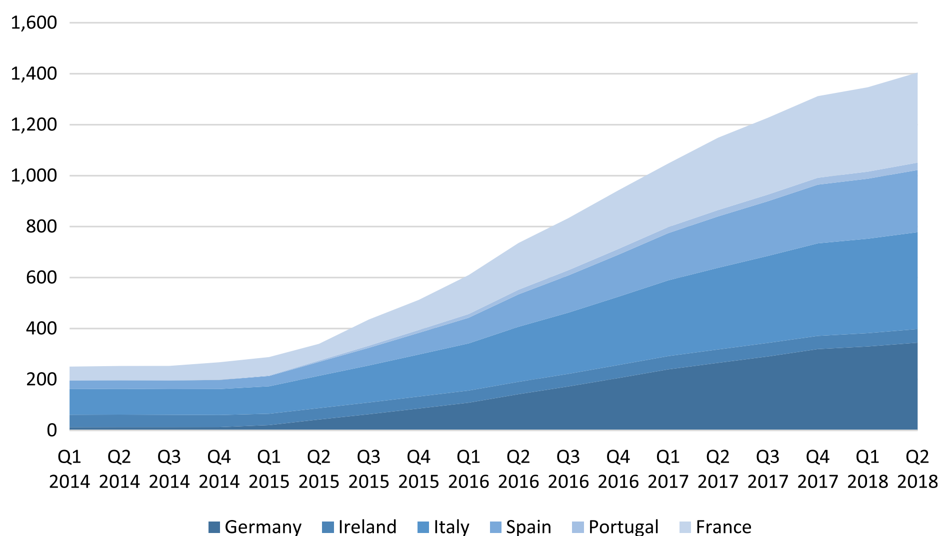

Figure 3. Public debt holdings by the European Central Bank. (To view this figure in colour please see the online version of this journal.)
Source: Bruegel sovereign bond holdings dataset.

responsible for its own debt with no guarantee from the centre. A budget deficit for one independent state is issued in euros with no common guarantee.

When a country runs a budget deficit, it needs to finance it through public debt issuance, which generates higher interests and, then again, more expenditure and a deeper budget deficit. When this situation turned explosive in the years 2010–2012 for some Eurozone member states, commercial banks started to buy sovereign debt with the incentives provided by the European Central Bank through its different quantitative easing programmes. This eased market conditions for a while but soon it was evident that it was not enough.

As De Grauwe and Moesen (2009) point out, the absence of a common backstop mechanism for each country's public debt was a major issue that needed to be tackled. The ECB, through its OMT programme and Public Sector Purchase Programme (PSPP), started to intervene in public debt markets. This reduced market pressures and sovereign yields. Member states started to enjoy cheap borrowing and the risk of default was averted in most European economies.

By the second quarter of 2018, the ECB had bought more than €1400 billion of bonds under its Public Sector Purchase Programme, of which around €155 billion were supranational bonds and €1.3 trillion were national government and agency bonds. Purchases of asset-backed securities surpassed €24 billion, while holdings under the third Covered Bond Purchase Programme (CBPP3) amounted above 213 billion euros. Starting in June 2016, the ECB also added a Corporate Sector Purchase Programme (CSPP), which now stands at €67 billion.

As previously discussed, the implementation of these purchases is split between the ECB and the national central banks. This is reflected in Figure 3, which shows

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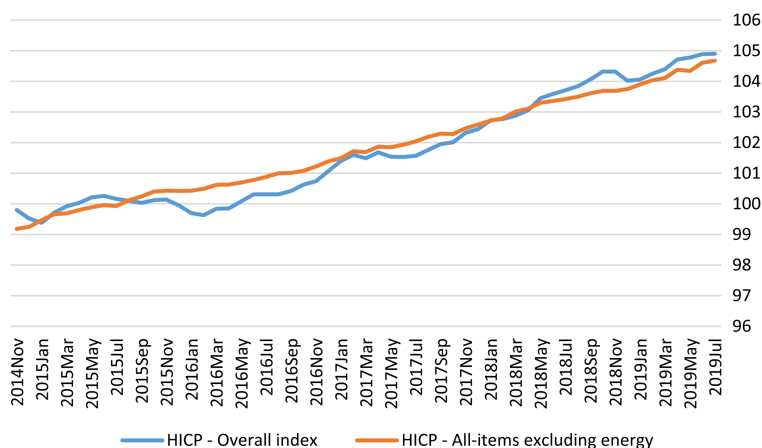

Figure 4. Harmonized monthly index of consumer prices. Seasonally adjusted data. 2015 = 100. (To view this figure in colour please see the online version of this journal.)
Source: European Central Bank.

an increasing trend in central banks' sovereign bond holdings since the start of the PSPP.

According to the ECB's view, through the PSPP the Eurosystem 'intends to conduct purchases in a gradual and broad-based manner, aiming to achieve market neutrality in order to avoid interfering with the market price formation mechanism'.

The PSPP is part of a broader strategy. Asset purchases provide monetary stimulus to the economy in a context where key ECB interest rates are at the lower bound. They further ease monetary and financial conditions, making access to finance cheaper for firms and households. This tends to support investment and consumption, and ultimately contributes to a return of inflation rates towards 2%.

Figure 4 suggests that inflation is not a threat for the ECB's price stability goal at the moment. Prices are growing below the 2% threshold established by the monetary authorities. Still, headline inflation has been growing since March 2016 while core inflation has been steadily increasing since the beginning of 2014. Even in the current weak-growth context, inflation keeps growing at a steady rate.

According to ECB's October 2018 statement:

> The underlying strength of the economy continues to support our confidence that the sustained convergence of inflation to our aim will proceed and will be maintained even after a gradual winding-down of our net asset purchases. At the same time, uncertainties relating to protectionism, vulnerabilities in emerging markets and financial market volatility remain prominent. Significant monetary policy stimulus is still needed to support the further build-up of domestic price pressures and headline inflation developments over the medium term. (ECB, 2018)

It is true that short-term inflationary pressures seem to be currently muted (ECB, 2019), but if inflation rises in the mid-term the ECB will be forced to react and to reduce its market interventions, including those focused on sovereign stability.

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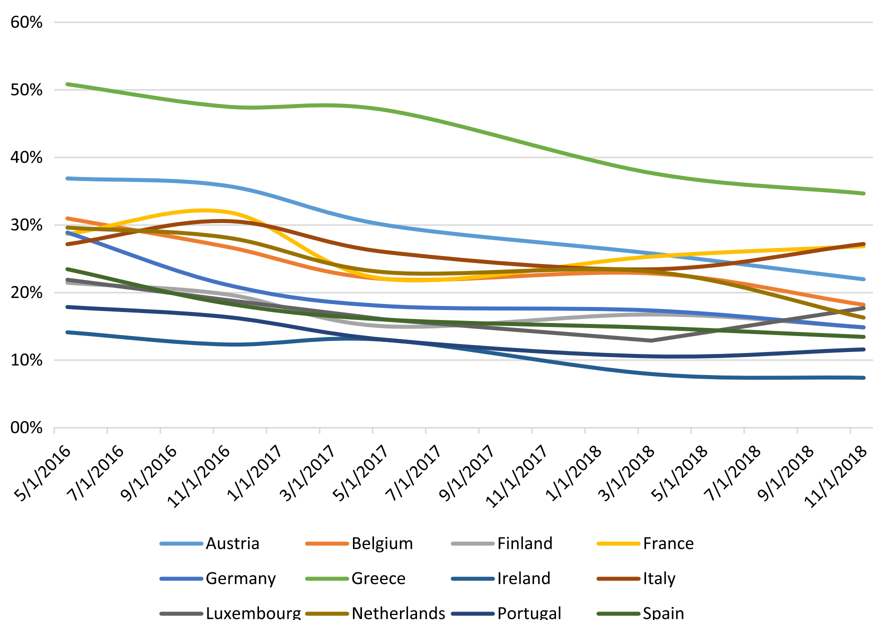

Figure 5. Percentage of citizens with a fairly negative or very negative view about the EU. (To view this figure in colour please see the online version of this journal.)
Source: Eurobarometer.

Therefore, the first risk that could prevent the ECB from implementing fiscal policies through monetary instruments could be the rise of inflation.

There is a second risk associated with political instability and the anti-euro backlash that is currently appearing in some European countries such as France, Germany and Italy: the rise of anti-European parties willing to promote exit votes for leaving the monetary and economic unions.

Those parties have been attracting the growing Euroscepticism in member states since 2006 until the end of 2016. Figure 5 shows the percentage of citizens in each country with a 'fairly negative' or 'very negative' view of the European Union.

Negative views about the European Union experienced their lowest in the years 2003 to 2007. After that, once the crisis began, they grew dramatically to moderate and fell after 2013. Still, animosity towards the European project was, at the end of 2016, higher than in 2000 in most Eurozone countries. There are two cases where negative views were particularly high at that moment: Greece (47.5%) and Austria (35.8%). At the time of writing, the latest November 2018 Eurobarometer data still show that a relevant fraction of the population in those countries declares having negative or fairly negative views about the European Union.

There is also group of countries where negative views are close to 30% of the population: Italy, the Netherlands, France and Belgium. Even after the increase in support shown from 2016 to 2018, in one half of the original Eurozone member

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countries, there is strong opposition to the European project that needs to be managed and that could limit the scope of policies.

It is important to highlight that the current public debt holdings in the Eurozone represent an important vulnerability to Eurozone stability, even after the increase in ECB holdings previously described.

Total public debt holdings by economic agents other than the ECB are relatively stable for the period 2014–2017, moving between €1600 and €1800 million. This fact suggests that even if the impact of ECB's role on sovereign markets has been enough to curb yields, there is still a public debt problem that needs to be seriously addressed. ECB monetary support to fiscal policy needs to be complemented by some kind of guarantee from the centre, as the literature has pointed out (Gros and Micossi, 2008).

4. The Adjustment-Populism Loop

Pro-European parties face an important challenge regarding debt mutualization. States with lower financial needs find that any borrowing from the centre mechanism would require their generosity, since it would mean covering highly indebted states for their excessive risk.

Countries with higher public debt to GDP ratios find that any of the mechanisms currently under discussion could increase the pressure on them to accelerate economic reforms, in exchange for the protection received, through some kind of implicit or explicit conditionality. There is high social pressure on both sides. Countries need to transfer financial sovereignty in a politically feasible way.

Anti-European parties, both from debtor and creditor states, try to take advantage of this situation. The nonexistence of some kind of debt mutualization mechanism increases the cost of the adjustment for member states; economic adjustment is harder to develop in a monetary union without the appropriate institutional framework since it can only be done through spending-switching mechanisms.

The recovery process of the great recession has eased the conditions for the appearance of populist movements in Europe. First, because it was not immediate. Figure 6 shows the evolution of real GDP growth in the period 2007 to 2020.

All the observed countries experienced a W-shaped crisis. After an initial recovery from the financial crisis of the years 2008 and 2009, the sovereign crises that hit the Eurozone from 2010 on, negatively affected economic activity even in counties such as France and Germany. Recovery after 2011 has been uneven. Growth in the most dynamic countries (such as Spain or Ireland) is the consequence of unpopular political reforms and demanding internal adjustments. Figure 7 shows the evolution of nominal unit labour costs between 2007 and 2017.

The comparison between pre-crisis labour costs and post-crisis labour costs shows that workers in the Eurozone experienced a dramatic income change between the years 2007 and 2010. In the case of Ireland, labour costs mostly grew at a 20% rate in the year 2008 and fell dramatically between 2010 and 2017. In Spain and Portugal, labour costs also fell in the period 2011 to 2015, as can be seen in Figure 7.

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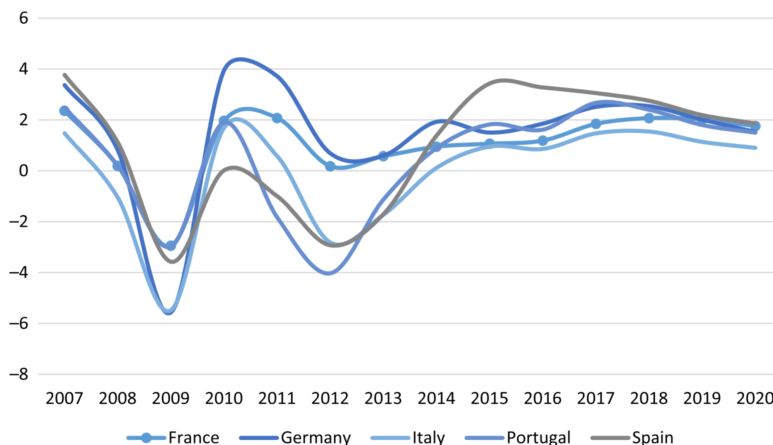

Figure 6. Recovery: GDP growth. (To view this figure in colour please see the online version of this journal.)
Source: IMF, World Economic Outlook. Note: Ireland has been excluded due to its extraordinary GDP growth in the year 2015 (above 25% increase).

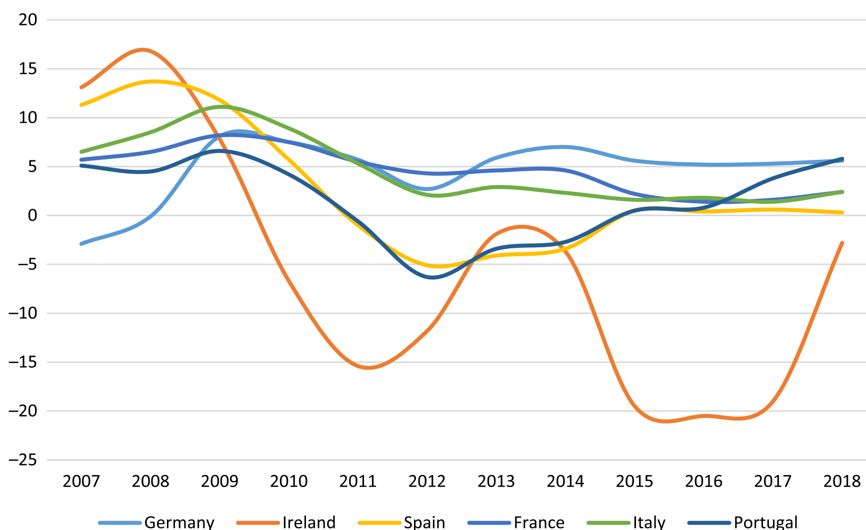

Figure 7. Nominal unit labour cost – 3 years percentage change. (To view this figure in colour please see the online version of this journal.)
Source: Eurostat.

The evolution of nominal labour costs, as well as the low inflation experienced in the Eurozone peripheral counties, transformed their current account balances from deficit to surplus. Figure 8 shows the evolution of this indicator, as a percentage of GDP, from 2007 to 2020. For the first time in their recent history, countries such as Spain were growing with a surplus in their current account balance.

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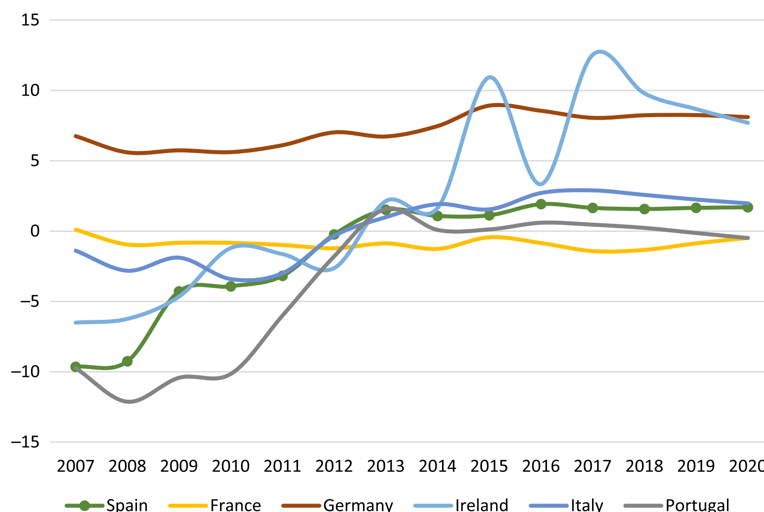

Figure 8. Recovery: current account balance. (To view this figure in colour please see the online version of this journal.)
Source: IMF, World Economic Outlook.

The negative impact of the recession on public income and government spending, through automatic stabilizers, generated budget deficits and explosive public debt dynamics. Figure 9 shows the evolution of both indicators from 2007 to 2020.

The different paths of public debt between core and peripheral countries eased the conditions for populist parties to emerge. Lender countries pushed for austerity reforms in debtor countries as the only possible solution for their excessive debt. Citizens in debtor states felt over-demanded by their Eurozone associates, while citizens in lender states felt that debtor states were not doing enough to solve their economic struggles.

Populist parties in debtor countries use the extra burden of public debt and reforms to undermine the credibility of the European project and to blame the European institutional architecture for the economic situation of their countries. Populists in creditor countries use the fragility in debtor states as an alibi for avoiding further integration; differences are huge, they argue, and convergence is virtually impossible to achieve. Figure 10 shows this populist-debt-adjustment loop.

5. Scenarios for the Fiscal Union

There are two important limitations for the ECB's role in sovereign markets, as we have previously mentioned. The first is the appearance of high inflation that may lead to a monetary normalization faster than expected. The second is the awakening and development of anti-EU parties that can limit ECB market interventions or prevent further sovereign integration.

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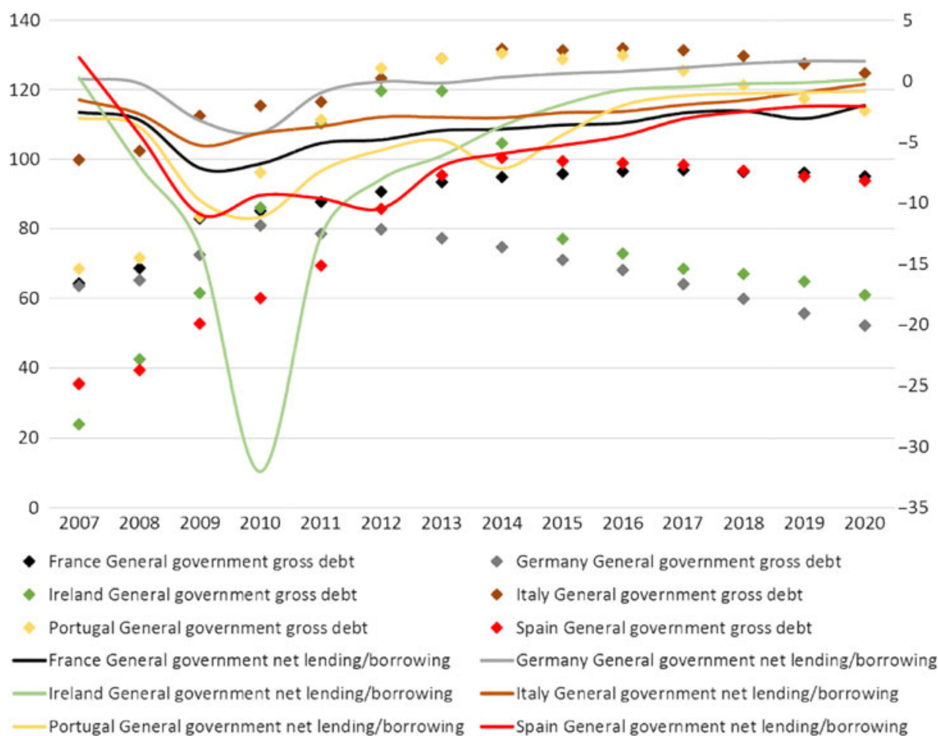

Figure 9. Public Debt (left axis) and Budget Balance (right axis). Percentage of GDP. (To view this figure in colour please see the online version of this journal.)
Source: IMF, World Economic Outlook.

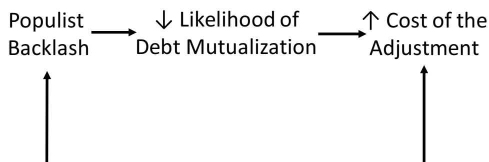

Figure 10. The populist-debt-adjustment loop.
Source: Own research.

The joint analysis of both threats offers four scenarios for the future of debt mutualization. Figure 11 shows those alternatives. The vertical axis stresses two possible outcomes for inflation in the following quarters: inflation rates can rise above ECB's target or stay below the 2% threshold.

The horizontal axis is the political one. It shows the cases of an anti-Euro backlash capable of stopping debt mutualization or ECB's market interventions. During the first months of 2017, there was a huge concern about the possibility that several anti-European parties could win the elections in the Netherlands, France or even Germany.

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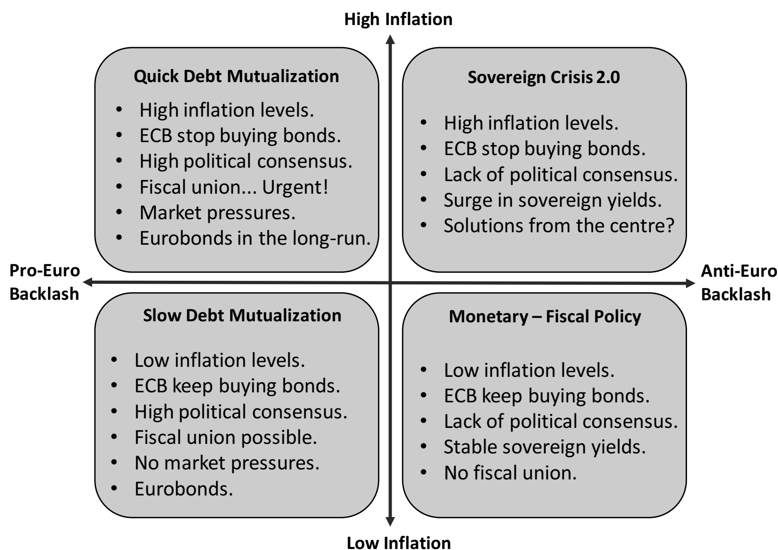

Figure 11. Scenarios for the future of the Fiscal Union.
Source: Own research.

The first weeks of 2018 revealed a more stable political landscape, with pro-European forces dominating the agenda. After the election of a stable government in Germany, a three-year window suddenly opened for deeper economic integration. The results of the elections in Italy, along with the thread of a trade war with the United States, slowed that positive momentum, though.

In the 'Quick Debt Mutualization' scenario, inflation rises above ECB's target and pro-Euro resurgence allows policymakers to deepen fiscal integration without high political costs. Inflation asks for an alternative to the fiscal role that the ECB has been playing since 2012. Eventually, the ECB must abandon its bond-buying strategy. However, thanks to the political consensus, a long-term solution to the public debt problem could be easily achieved. Market pressures would also help to achieve this. The case for Eurobonds would be more plausible.

The top-right scenario in Figure 11 shows a sovereign crisis renaissance. In this case, inflation is again above its target but there is not enough political consensus for implementing any borrowing at the centre mechanism or some form of fiscal union. The lack of action from the ECB plus the absence of solutions from the centre would ease the conditions for a new sovereign crisis.

In the bottom-right scenario the anti-European backlash dominates. This would be the case of a return of the 'Five Star plus Lega' government in Italy, with exacerbated anti-establishment policies. In this 'Monetary-Fiscal policy' case, there are no short-term inflationary pressures. This would be the continuity scenario, with the current recession threats becoming real. The lack of political consensus would not permit the creation of a long-term solution from the centre, but the ECB could continue with its bond-buying strategy. This scenario would prevail as long as inflation

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remained subdued. Instability would be high, since monetary normalization would move the Eurozone to the 'Sovereign Crisis 2.0' alternative.

In the 'Slow Debt Mutualization' scenario, we find low inflation and a high degree of political consensus. The ECB could maintain its bond-buying strategy without price-stability concerns. Social acceptance would offer a perfect environment for a slowly-cooked debt mutualization process, without market pressures. Under these circumstances, the creation of some common debt security would be more possible.

6. Conclusions

This joint analysis takes into account only price stability and popular support for reforms. It disregards other limitations such as political willingness, technical difficulties and other negotiating barriers. From our point of view, the most desirable scenario would be the last one, the so-called 'Slow Debt Mutualization'. It would make the negotiating processes softer and allow member states to reach an agreement without market pressures. At the same time, it would allow the ECB to normalize monetary policy at the right time, when a political solution from the centre would be operational.

Monetary normalization is unstoppable in the mid-run, even if the Eurozone is hit by a new recession in the following quarters. The ECB needs to create monetary space. Inflation will eventually rise and get closer to its threshold. Policymakers need to find a solution from the centre to sovereign debt markets stability that does not rely only on ECB policies. There is a real risk of a new sovereign crisis if the ECB withdraws from debt markets without the implementation of any alternative from the fiscal side. We do not expect the 'Sovereign Crisis 2.0' to dominate during the following years, though.

There is room for optimism for at least two reasons. First, it seems that policy makers understand the relevance of the debate contained in this paper and are working on an efficient and sustainable solution. Second, inflation remains subdued and populism relatively under control.

Even if 'Italexit' was again part of the agenda, which seems unlikely at this moment, European leaders are working closely together to fight new threats, such as protectionism or economic underperformance. The need for some kind of solution from the centre to sovereign debt markets stability is no longer questioned. The 'Slow Debt Mutualization' scenario is the more desirable and likely one, at this moment. In this sense, it is necessary to continue building the framework for fostering economic growth, stability and deeper economic integration. It would contribute to removing the factors that feed populism, economic insecurity and its nationalist reaction. The depth and the scope of that common solution will depend on the evolution of the political debate during the following months.

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