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Forward to a *New Normal:* An overview of the ECFIN Fellowship Papers

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An overview of the ECFIN Fellowship Papers

By Karl Pichelmann, Eric Ruscher and Michael Thiel

Summary

While the great recession appears to be behind us with the effect of structural policy responses gradually kicking-in and long-term solutions coming into sight, the fall-out continues to weigh heavily on growth and jobs, bringing severe hardship to many. Moreover, advanced economies, emerging market and developing economies are, and will be, facing a combination of old and new risks over the medium term. Thus, we are far from "mission accomplished" and a return back to the 'pre-crisis normal' is neither possible nor desirable. Against that backdrop, DG ECFIN has asked eminent scholars to map out the 'new economic normal' in the context of reshaped economic policy frameworks and governance designs, focussing in particular on (i) medium-term growth perspectives, (ii) newly emerging architectures in areas such as finance and (iii) European convergence and integration mechanisms.

In the provision of their services, the Fellows have of course retained complete academic independence and freedom of expression of opinions. Grouping the contributions into the three broad categories set out above, this Economic Brief sketches the main issues addressed and provides a succinct overview of the main findings in the final papers of the Fellows.

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Introduction

While the great recession appears to be behind us with the effect of structural policy responses gradually kicking-in and long-term solutions coming into sight, the fall-out continues to weigh heavily on growth and jobs, bringing severe hardship to many. Moreover, advanced economies, emerging market and developing economies are, and will be, facing a combination of old and new risks over the medium term. Thus, we are far from "mission accomplished" and a return back to the 'pre-crisis normal' is neither possible nor desirable. Against that backdrop, DG ECFIN has asked eminent scholars to map out the 'new economic normal' in the context of reshaped economic policy frameworks and governance designs, focussing in particular on (i) medium-term growth perspectives, (ii) newly emerging architectures in areas such as finance and (iii) European convergence and integration mechanisms.

Each fellowship has comprised the following services: (a) provision of consultancy services in the form of regular interaction and discussions with DG ECFIN staff, including taking part in meetings in Brussels; (b) preparation of an essay/study/lecture notes on a specific subject under the general heading of the initiative; (c) presentation of the essay/study/lecture notes in a conference or similar event. In the provision of their services, the Fellows have of course retained complete academic independence and freedom of expression of opinions. Grouping the contributions into the three broad categories set out above, this Economic Brief sketches the main issues addressed and provides a succinct overview of the main findings in the final papers of the Fellows.

I – Medium-term growth perspectives

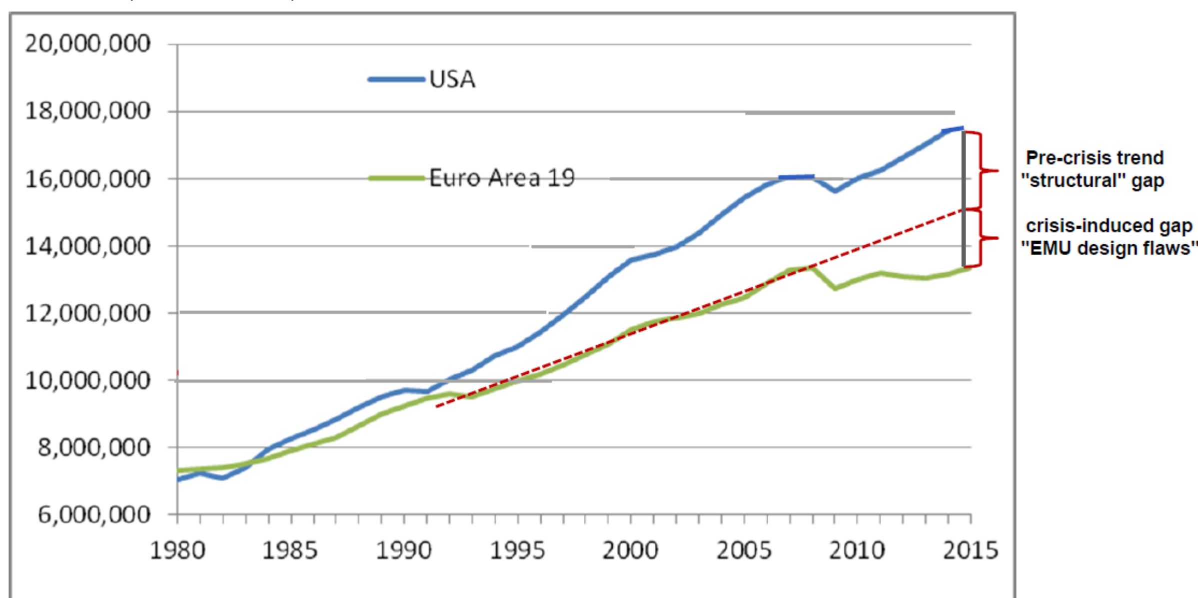
Historical evidence shows that economic recoveries after financial crises tend to be slow and sluggish; typically, the need for financial deleveraging, demands for higher risk premia, inevitable fiscal consolidation to restore sustainable public finances and persistent labour market weaknesses combine to weigh on growth for a prolonged period of time. But already before the crisis, the euro area faced growing macroeconomic imbalances, sluggish productivity growth, and the overall challenges of globalisation, ageing population and climate change. Moreover, growing inequalities in the distribution of income and wealth and of opportunities in life in general have prompted rising concerns, not least in view of the hotly debated possible bi-causal interaction with lacklustre economic growth. All these factors must be expected to impact on potential growth in the EU over this decade and probably beyond. Against that background, fellows' contributions under this theme offer fresh analytical insights on medium-term economic growth perspectives and appropriate economic policy strategies for Europe.

The secular stagnation hypothesis and its fairly far-reaching economic policy implications as opposed to the more traditional diagnoses and policy prescriptions have featured prominently in the discussion. Eventually, the debate with the fellows has facilitated cutting through much of the unproductive demand vs. supply side controversies running high in some quarters. Perhaps unsurprisingly, it is both blades of a pair of scissors that cut. While the overall immediate hit on the level of real GDP has been almost universal, the post-crisis slowdown in growth rates of GDP has been particularly pronounced in Europe. In the euro area as a whole, economic growth has been mediocre at best, hysteresis effects have been significant and monetary and fiscal policies may not have been sufficiently accommodative in view of strong deleveraging pressures on private and public agents and systemic constraints in the set-up of EMU. Obviously, these effects have been even more acute in the vulnerable countries. Encouragingly, policy-makers have already responded to the crisis with a range of measures to improve the functioning of the EMU, but probably still more needs to be done to ensure a sustainable EMU – see section III.

At the same time, though, Europe's structural productivity problem is more than evident. Already before the crisis, trend growth rates of total factor productivity have continuously fallen over the past three decades. And the crisis years

have dealt another blow to productivity growth, not least via the impact of pronounced investment shortfalls. Indeed, with persistent investment shortfalls (over and above the hysteresis-related fallout from the crisis), this is the issue where the demand-side explanations meet with supply-side fundamentals. Growing gaps in public investment in both tangible and intangible infrastructure investment, including education and training, are evident for many observers. Yet it is difficult to imagine that public spending could compensate for persistent weakness in private investment, not least given high levels of public debt. Thus, obviously, a sobering supply-side narrative can also be told. In combination with the stagnant/declining working-age population this results in a dire medium-term projection for potential per-capita growth in the euro area, even under the assumption of a recovery towards pre-crisis productivity growth rates.

Falling behind and drifting apart
Level of GDP, PPP converted, rebased to 2014 $



Data source: Conference Board (2015); Trend/gap decomposition inspired by Sapir (2015)

In his fellowship paper **"From Mind the Gap to Closing the Gap: Avenues to Reverse Stagnation in Europe through Investment and Productivity Growth"**, Bart van Ark (The Conference Board and University of Groningen) looks at the growth stagnation in Europe since the beginning of the crisis, and places it in the light of the longer-term growth slowdown since the 1990s, as well as the projections forward for the remainder of the decade. Using a growth accounting approach, he compares the sources of the growth gap before and since the crisis, noting a particularly rapid decline in the contributions of employment and total factor productivity to output growth. The projections to 2020 show that there is a continued large negative growth contribution from total factor productivity, which appears unsustainable. Looking at the growth gap relative to the United States, he finds that while ICT capital intensity in Europe has largely converged on the US, the productivity effects were severely impacted by the crisis, especially because of a drop in the returns-to-scale from ICT use in non-ICT producing sectors. In the final part of the paper he focusses on one key area to narrow (or even close) the TFP growth gap, by focusing on a shift in investment towards intangible (or knowledge) assets, such as ICT, innovative property and economic competencies. Van Ark finds that at present the intensity of intangible investment in Europe is still much lower than in the United States. In the final section of the paper he draws conclusions with regard to the policy setting to revive long-term productivity growth through supporting the shift in its asset composition towards knowledge assets, notably the need to complete the single market in services, especially in the digital economy.

Stimulating the knowledge-economy is inextricable linked to education and training which more than ever impacts on people's income generation potential and participation chances in the world of work and life in general. This issue is taken up by Torben M Andersen (Aarhus University, CEPR, CESifo and IZA) in his contribution **"Human capital, inequality and growth"**. Income inequality is increasing in most countries at the same time as traditional redistribution policies are under pressure, not least due to strained public finances. What are the underlying causes, and what is the scope to turn the trend? This is discussed from the perspective of the link between inequality and growth running via education and human capital formation. It is argued that imperfections arising from both capital market imperfections and social barriers imply that inequality may be a barrier to education, which in turn makes inequality persistent and reduces growth. In discussing redistribution it is thus important to distinguish between the traditional passive means of redistribution via taxes and transfers to repair on the distribution of market incomes, and active means which affect the distribution of market incomes. The latter may both lead to more income equality and efficiency improvements reflected in higher incomes or income growth.

Policy options to improve educational outcomes and their distribution are discussed. Importantly, as argued by Andersen, there is scope for improvements given the resources already allocated to education. More resources may be called for, but in the first place it is an important policy challenge to exploit the room for improvements given the resources already provided. The most binding constraint for educational performance and achievement does not seem to be educational supply capacity in the quantitative dimension. Most young start on some post-secondary education, the problem is that a large share never complete. The reasons for this are numerous, including insufficient proficiency and motivation as well as social background factors which impede educational performance. There is thus an urgent need for improvements in education in both the quantitative and qualitative dimension to ensure that education is not lagging too much behind in the race against technology.

Holding-up well in the globalised economy makes the agendas for structural reform, greater competition, trade opening, the transition to more knowledge-based economies, and deeper European integration and international cooperation even more necessary, while at the same time less socially acceptable if in this process too many people are left behind. It will be essential to match open and dynamic market economies with the sense of shared purpose and achievement brought by tolerable degrees of inequality. Managing such a combination of market dynamism with effective redistribution is one of the defining political challenges of our era.

Against that background, Wiemer Salverda (Professor, Amsterdam Center of Inequality Studies) focusses his contribution on **"EU policy making and growing inequalities"**. The paper takes stock of important new developments in data sources on income inequality and wealth inequality and sketches long run changes for various inequality measures. It critically discusses limitations and gaps and extends for income inequality in two directions – by considering the distribution of income for the EU as a whole and comparing this to the USA on the one hand, and by scrutinising the effects of income redistribution as well as of equivalisation of incomes for the nature of the receiving household on the other hand. As a result of the former very high poverty rates are found in some countries, which demand a much stronger policy focus than general anti-poverty measures can offer. Increased redistribution and particularly the introduction of a European child basic income is proposed, which also can offer children protection against undue effects of policy making. The latter shows an important role for equivalisation and a potential overestimation of the effects of redistributive policies. In addition, the paper considers the important contribution made to income inequality by households depending on labour earnings.

In the light of these findings the paper discusses future trends in income inequality and evaluates the role of EU policies. These are found wanting because of their narrow focus on risk of poverty and the absence of a role for considering poverty

and inequality in policy made at the European level. Instead it advocates mainstreaming inequality concerns in broad areas of policy making and suggests starting an annual Inequality Assessment of the Union. It concludes by stressing the need for improving the data situation, in particular regarding the distribution of wealth, by introducing a Billionaires Directive for obligatory reporting on top wealth and incomes.

Obviously, views differed with respect to some specifics of the analyses and, perhaps unsurprisingly, with respect to design and priorities in policy responses. But what has become crystal clear in the debates with the fellows – if there were any remaining need of this – is that slow growth prospects and rising inequalities are a real threat to the social fabric in Europe at the current juncture and over the medium-term. This is a fact and denial is not a strategy. Tackling this challenge requires combining monetary, fiscal and structural policies in an integrated approach effectively, acting both on the demand and supply sides of our economies. Perhaps belatedly, policy makers in Europe have taken up the challenge. And more determined action may still be needed.

II – Crisis legacy and financial systems architecture

The turmoil on financial markets that shook the world economy in 2008/09 has left a much more durable trace in the EU economy than in other parts of the world. Among the various candidates to explain the stronger vulnerability of the EU economy, the close relationship between bank risk and sovereign risk has a particular prominent place. Its importance has been particularly evident in Ireland, where fiscal measures to support the banking system overburdened the capacity of domestic public finances. Whereas banks in Greece and Portugal were not at the source of sovereign distress the programmes set up by the EU and the IMF in support of Member states in difficulties had earmarked sizeable amounts stabilising the banking system. Also in Member States that have not been subject to stress on sovereign debt markets the link between sovereign and bank risk turned out to be more intense than anticipated. A major concern of policymakers was the feedback loop, in which adverse shocks to banks led to an increase in sovereign risk, and deterioration in sovereign risk, in turn, raised the funding risk and funding costs for banks. This feedback loop has also been blamed for fragmenting banking markets along national borders and deepening the recession in the Member States concerned. This has made an escape from the crisis ever more difficult and entrenched growth divergence in the euro area.

Though the strong interdependency between sovereign and banking risks as a factor that critically intensified the financial crisis in the euro area is uncontested and has motivated policy steps towards the Banking Union, it has remained somewhat puzzling why sovereign and banking risks have become so interlinked in the euro area. Media devoted a lot of attention to the architecture of EMU, citing factors such as the lack of a central public budget, the prohibition of monetary financing and the complexity of crisis management in the euro area. Fellowship contributions under this theme flag a number of other structural determinants that have played an important role. Their papers provided new analysis and evidence that the bank dependency of the EU economy, the high initial indebtedness of the public sector in some Member States and geographically fragmented retail lending markets impacted on how financial activity interacts with the solvency of the public sector and macroeconomic prospects.

The paper **"Monetary policy, bank bailouts and the sovereign-bank risk nexus in the euro area"** by Marcel Fratzscher (DIW Berlin, Humboldt University Berlin and CEPR) and Malte Rieth (DIW Berlin) documents empirically how the relationship between bank risk and sovereign risk in the euro area developed from 2003 to 2013. For this analysis they distil risk premia for sovereigns and banks from daily changes in credit default swaps (CDS). The analysis confirms that the link has intensified over time and was larger in vulnerable Member States than in those that did not face stress on sovereign debt markets. The approach also reveals two-way causality between shocks to sovereign risk and bank risk, with the former being overall more important in explaining bank

risk, than vice versa. A relevant finding is also that of significant spillover effects from sovereigns in vulnerable Member States to those in the core countries. An exception however is the effect on sovereign risk in Germany, which they explain by impact of safe-haven capital flows within the euro area. This effect seems to be so pronounced that Bund yields tend to decline when sovereign risk in Germany increases.

Their research includes an empirical test of the effect of governments' bank rescue policies and the ECB's non-standard policies on the nexus between sovereign risk and bank risk, asking whether policies have helped to break the nexus, or rather intensified it. Testing specific hypotheses, the authors find that bank bailout policies have reduced credit risk in the banking sector, but partly at the expense of raising the credit risk of sovereigns. By contrast, monetary policy was in most, but not all cases effective in lowering credit risk of both sovereigns and banks. This may however be due to markets having anticipated stronger policy measures than in some cases implemented and the sophisticated research methodology applied by the authors is not able to control for this. Hence, this suggests their verdict on the effectiveness of non-standard monetary policy warrants further research.

Did public or private debt leveraging play a more important role in the euro area's great recession? Opposite to the prevailing view, Alberto Caruso (Université Libre de Bruxelles), Lucrezia Reichlin (London Business School) and Giovanni Ricco (University of Warwick) identify fiscal variables as particularly important in their study **"The Legacy Debt and the Joint Path of Public Deficit and Debt in the Euro Area".** They analyse the joint dynamics of budgetary variables, private balance sheets, public debt, the budget deficit and the business cycle in the euro area over the time period from 1981 to 2013. They exploit the period 1981 to 2008 in order to establish empirical regularities and compare developments since then with a conditional forecast based on their model.

Starting position for their analysis is the observation that public debt and public deficits in the euro area have been inversely related since 2009. This is anomalous with respect to historical experience because usually, budgetary deficits and changes in public debt are closely positively correlated. It is due to special expenditures related to the support of the financial sector, such as interventions related to banks' recapitalisations and the establishment of the European Financial Stability Fund (EFSF). These factors led to a change of public debt that was not generated by the budget deficit. Two types of simulations inform about what this high debt level implies for macroeconomic adjustment in the euro area economy.

Firstly, on the basis of the pre-2008 parameter estimates they simulate how GDP would have developed if it had been hit by the same structural disturbances that have typically generated recessions in the euro area. The deviation of the observed path of GDP from 2008 to 2013 from this conditional forecast informs about other factors, specific to the recent crisis, that have been at work. The model simulation finds that actual budgetary deficit and public debt increased by much more than their model forecast. Since private savings and private debt have since 2008 behaved in line with past experience, the authors question whether the euro area has been subject to a balance-sheet recession, triggered by an increase of savings in the private sector. Though this narrative may apply to some of the countries of the euro area, they argue that the massive public sector adjustment and the persistence of public debt were the key factors for the euro area economy.

They conclude from the model results that the euro area has experienced balance-sheet effects via an increase in public and external savings and negative demand pressure via exceptionally tight monetary and fiscal conditions. As possible reasons behind the outstanding debt-deficit dynamics they flag a number of factors: financial frictions triggered by the financial crisis, non-linear effects due to the unprecedented size of the shock or the rise of economic uncertainty impinging on interest rates.

Secondly, the same framework is used to estimate the size of "legacy debt", which the

authors define as the difference between realised debt and its model-projected value, conditional on estimated pre-crisis parameters and the predicted path of GDP and inflation until 2020. By simulating how public debt will develop if GDP and inflation behave according to the International Monetary Fund (IMF) projection, they find that this legacy debt will in 2020 still account for 15% of total public debt. The high level of legacy debt in combination with the results on how public debt and deficit adjusted in the last years points to the difficulty of dealing with the legacy debt via means of fiscal consolidation. The model results point to possible growth gains that a restructuring of sovereign debt could entail. But obviously, sovereign debt restructuring mechanisms are an issue of intense and fairly controversial debate.

Large banks are not monolith entities, but consist of numerous units, often of different legal character and operating in different jurisdictions. This complicates surveillance and, in case of a bank failing, its resolution. At the same time, since supervisors' resolution policy impacts on banks' incentive to conduct cross-border operations and may have contributed to banks' retrenchment from international and towards domestic activity observed since the financial crisis. In their contribution on **"Cross-Border Resolution of Global Banks"**, Ester Faia (Goethe Universität Frankfurt and CEPR) and Beatrice Weder di Mauro (Gutenberg Universität Mainz and CEPR) examine recent case studies of bank resolutions in EU Member States that entail bail-out and bail-in and analyse a central principle to deal with resolution of cross border banks: the Single Point of Entry (SPE) as opposed to a Multiple Point of Entry (MPE) approach. The SPE establishes that the entity viable to bear losses should be the parent holding company of any banking group, even if the losses occur in a foreign subsidiary of the bank. According to the MPE, losses are imputed to the local subsidiary or branch.

This difference has a crucial impact on various stakeholders' incentives. It shapes banks' funding costs, as equity and (unsecured) bond holders of banks are exposed to different risks of being bailed in, the management's engagement in cross-border activity since it affects their capacity to allocate capital as well as liquidity across entities abroad as well as national supervisors' willingness to cooperate in the assignment of cross-border losses. Since supervisors are accountable to national authorities and ultimately national tax payers, cross-border cooperation may fall short in crisis events and MPE is more likely to be implemented.

Faia and Weder di Mauro argue that policy discussions could benefit from a theoretical framework that allows analysing the consequences of the different regimes. Such a framework was missing and it would be important to fill this gap because the new approach to bank resolution policy obliges various stakeholders to burden sharing in resolution cases. For example, the EU's Bank Recovery and Resolution Directive (BRRD) oblige banks to hold parts of their liabilities in bail-inable financial instruments. This has implications on the price of these financial instruments, and the costs of subordinated debt have indeed increased relative to those of senior debt during the discussion on the BRRD.

The authors contribute to this debate by developing a model of optimal design of resolution regimes, which allows comparing three regimes: SPE with cooperative authorities, SPE with non-cooperative authorities and MPE (ring-fencing). They find that the cost for bondholders of bail-inable instruments is generally higher under non-cooperative regimes and ring-fencing. They also find that in those cases banks have ex ante incentives to reduce their exposure in foreign assets.

A structural difference between the EU and the US economy that could explain why the financial crisis had such a lasting impact on the EU economy is the high bank dependency especially of smaller firms. The research **"Small Firms and Domestic Bank Dependence in Europe's Great Recession"** by Mathias Hoffmann (University of Zurich and CESifo) and Bent E. Sorensen (University of Houston and CEPR) shows that SME's bank dependency prevented a better sharing of risks during the financial crisis.

They argue that euro area banking integration in the years after the creation of the single currency was lopsided in the sense that, until 2008, cross-border lending between banks increased markedly while foreign banks' lending to the real sector stayed relatively flat. This bank-to-bank integration allowed banks to lend to each other in a way that was quickly reversed when crises hit. Especially lending to banks in vulnerable Member States declined strongly during the sovereign debt crisis which made them more rather than less vulnerable to common and idiosyncratic shocks. The impact on the real economy was material because SMEs remained very dependent on domestic banks for credit, in spite of high levels of banking sector integration between Eurozone countries. The empirical results of this study provide evidence that domestic bank dependence indeed made countries, regions, and sectors with many SMEs more vulnerable to banking sector shocks and, at the same time, provided little risk sharing.

To remedy this situation, the authors advocate "real banking integration" that is built on cross-border risk sharing through banks in one country that lend to the retail sector in another country. They acknowledge the political headwinds if the required cross-border consolidation in the banking sector leads to more systemic banks. However, cross-border lending is not predicated on mega-banks and they argue that the benefits of real banking integration will outweigh the costs. Hoffmann and Sorensen question whether better access of SMEs to bond and equity markets would be a complementary solution. Since most SMEs in Europe will remain bank-dependent due to their small size and opaqueness, they reason a working capital market union will still only work in conjunction with real banking integration, even when bond and equity markets were highly developed and more integrated.

III - European convergence and integration mechanisms

The financial and sovereign crises have exposed the limits of the EU's governance framework and slowed pre-crisis integration trends in a number of areas (e.g. financial markets, trade, etc…). They have also shown that, notwithstanding hopes of structural convergence harboured at the launch of the euro, Member States still tend to respond very differently to common shocks. The large country differences in growth performance triggered by the crises have been accompanied by rising income and wealth inequality as well as a drop in popular support for European integration.

Policy-makers have already responded to the crisis with a range of measures to improve the functioning of the EMU. Macroeconomic surveillance has been strengthened to make sure that fiscal and other macroeconomic imbalances are detected and corrected early on. Financial rescue mechanisms have been put in place to prevent sovereign liquidity crises from turning into solvency crises. And the first critical steps towards a full Banking Union have been taken.

However, the resulting construct still falls short of what is needed to ensure a sustainable EMU. The recently published Five Presidents' Report on "Completing Europe's Economic and Monetary Union" maps the way forward. A major novelty is its emphasis on convergence – in terms of economic, financial and fiscal structures. All euro area Member States are encouraged to converge towards the best standards available among their peers. More specifically the Five Presidents' Report sets out the necessary next steps in four areas: first, a genuine Economic Union that ensures that each economy has the structural features needed to prosper in the EMU; second, a Financial Union to complete the Banking Union and accelerate the Capital Markets Union; third a Fiscal Union to deliver both fiscal sustainability and fiscal stabilisation (including through a fiscal stabilisation instrument); and fourth a stronger Political Union, including stronger democratic accountability, legitimacy and institutional strengthening.

Much still remains to be done to turn the Five Presidents' political vision of the future of EMU into concrete institutional and policy changes. Research from academia and think-tanks can provide invaluable guidance in this respect. Research on the design of monetary unions is

rich, varied and not always consensual. The Fellows, whose analyses are presented in the remainder of this section, are not necessarily representative of an "average" academic view but they offer useful insights in a range of areas.

Fiscal federalism provides a normative framework to analyse economic policy integration in the EU. Two Fellows have applied theoretical and empirical insights from the literature on fiscal federalism to give guidance on whether economic policies should be best located at the EU/EA or national levels. In his paper **"The centralization-decentralization issue"**, Charles Wyplosz (The Graduate Institute, Geneva) applies fiscal federalism principles to a few crucial issues, mainly fiscal policy, fiscal discipline and structural reforms, using where possible lessons from existing federations. According to the author, the objective of “an ever closer union” should be replaced by the objective of “a more perfect union”. Fiscal federalism theory argues that the choice between centralisation and decentralisation should ultimately be a balancing act between the externalities and economies of scale that argue for centralised policies and the heterogeneity and information asymmetries that call for decentralisation.

According to Wyplosz, the Single Market is the most spectacular success of European integration and the most obvious case for a transfer of sovereignty. Other areas where fiscal federalism principles clearly justify a transfer of competencies to the EU level include competition and trade policies. The case for full or shared competences at the EU level is, however, less obvious in other policy areas. Fiscal policy is an example of area where, according to the author, centralisation is not necessary. Fiscal discipline is clearly a common good for those Member States participating in the EMU but it is not necessarily best achieved by strengthening surveillance power at the centre. The main objective should rather be to decentralize both the design of fiscal rules and their implementation, while restoring a fully credible no-bailout clause. In other words, fiscal rules should be self-imposed and country specific.

Wyplosz is equally sceptical of the case for bringing structural reforms into the area of common EU policies. He sees both the benefits of centralisation as relatively limited and its costs as quite high. Costs include the existence of powerful information asymmetries between the EU and national levels (Member States should know better) and large heterogeneities in economic structures at national level (so one size cannot fit all). In addition, there are possible reputational costs for the EU as structural policies encroach upon areas belonging to what is generally seen as sovereign territory.

In his paper **"Monetary union and fiscal and macroeconomic governance",** Marek Dabrowski (CSER Warsaw, Bruegel and Higher School of Economics, Moscow) draws on fiscal federalism principles and the experience of existing and past currency unions to assess he cost and benefits of further fiscal and political integration. The author first notes that monetary unions are not necessarily characterised by fiscal and political union. There are examples of monetary unions that have worked successfully for several decades without fiscal and political integration. He also stresses that the economic rationale of potential centralization must be confronted with the limited appetite of EU Member States to delegate new prerogatives to the Union’s level.

As to fiscal integration, Dabrowski stresses the importance of fiscal discipline for EMU sustainability. He argues that historical experience demonstrates that market discipline, supplemented by clear and consistently enforced fiscal rules, is the best way of ensuring fiscal discipline. However, the weakening of the no-bail-out close and the establishment of sovereign financial assistance mechanisms has undermined market discipline in the EMU. This is all the more problematic for fiscal discipline that, according to the author, doubts remain about how strictly EU fiscal rules can be enforced. Overall, Dabrowski concurs with Wyplosz on the importance of market discipline and of effective fiscal rules and is equally critical of the existing fiscal framework although not for the same reasons.

Dabrowski also expresses some doubts about the benefits of coordinating structural policies. Contrary to Wyplosz, this does not seem to reflect misgivings about the theoretical benefits of coordination but rather scepticism about the design of the Macroeconomic Imbalance Procedure and a perceived excessive emphasis on current account imbalances.

In her paper **"The eurozone's crisis of democratic legitimacy: Can the EU rebuild public trust and support for European economic integration?"**, Vivien Schmidt (Boston University) analyses the EU's crisis of democratic legitimacy generated by the crisis using the systems-related terms of democratic theory. Her paper analyses the legitimacy crisis in terms of i) problems with the 'output' performance of EU policies, ii) the EU's responsiveness to European citizens' political 'input,' and iii) the quality of the EU's 'throughput' processes. It then considers how these play out for individual EU institutional actors—including in turn the ECB, the Council, the Commission, and the European Parliament.

Vivien Schmidt's overall argument is that EU actors have sought to fix the economics and calm the politics by progressively reinterpreting the rules without admitting it in the discourse, and that such reinterpretation 'by stealth,' although perhaps beneficial for output legitimacy, risks generating further problems for input and throughput legitimacy. The paper also finds that both EU technical and political actors have generated mixed responses from the public and analysts alike as a result of the disconnection between what they do and what they say.

For the Commission, the paper highlights the need for leadership through greater flexibility and transparency in the reinterpretation of the rules. It also recommends a transformation in the Commission's own approach to administering the rules—from community enforcer to community enhancer/advisor within a more decentralized system of supervision/support. Among the other EU institutional actors, the ECB should limit its focus to euro-related issues of monetary governance, leaving economic policy orientation to the other institutional actors, while doing all the necessary as quasi lender of last resort and bank supervisor. The Council should become a more open and transparent arena for political debate about the rules. The European Parliament should be brought into all Eurozone decision-making, and better tied in with national parliaments, which should also see their role expanded.

Finally, for the medium and long-term future, in addition to greater fiscal solidarity, Vivien Schmidt argues that the EU should end the unanimity rule, replaced by supermajorities with opt-outs, while treaty-based rules regarding the eurozone should become ordinary legislation, and therefore more readily amended.

A final paper by Felix Roth (University of Göttingen) revisits the empirical evidence of a decline in citizens' systemic trust (i.e. trust in the financial, political and economic systems) in the euro area since the global and sovereign crises. The paper **"Political economy of EMU - Rebuilding systemic trust in the euro area in times of crisis"** reports a pronounced decline in trust in the periphery countries of the euro area. In these countries, trends in citizens' systemic trust, as measured by the Eurobarometer survey, have departed from their long-term trajectory and started to decline steadily since the start of the crisis in 2008. The decline has affected trust in both European and national institutions although the former still enjoy a significantly higher level of net trust than the latter. Systemic trust has also decreased in some other Member States, although to a lowest degree. In these countries losses have generally been stronger for trust in European institutions.

These developments raise concern about the democratic legitimacy of economic policies put in place since the crisis and may ultimately undermine political stability. It is therefore important to understand their causes. The available empirical evidence suggests that the decline in trust has strong economic roots. This is confirmed by panel estimations presented in the paper that point in particular to the strong correlation of systemic trust and unemployment. Other economic variables such as inflation and

public debt also appear to be meaningful determinants of trust.

Finally, the paper stresses that public support for the euro has remained strong throughout the crisis in all euro-area Member States. It therefore concludes that it is not the euro itself that has been the focus if citizens criticisms but rather the management of the crisis by the European and national institutions. This provides legitimacy to ongoing efforts to overhaul the governance of EMU.

Overall, the Fellows reviewed in this section do not always agree in their prescriptions but their analyses suggest three lessons for ongoing political efforts to strengthen EMU's foundations. First, any change in EMU's governance system should be based on a careful balancing of the costs and benefits of further centralisation. Much can be learned from the literature on fiscal federalism and from the experience of other fiscal federations and monetary unions. Second, EMU governance is not just about institutions but also about citizens: considerable effort will have to be made to turn citizens' declining systemic trust into strong support for EMU's evolving governance structure. This will notably require abandoning reform by stealth but also delivering on growth and jobs. Third, fiscal discipline remains a necessary condition of a sustainable EMU. Fellows do not fully agree on how to best design effective fiscal rules but financial market discipline should be an important part of any framework.

Concluding remarks

The productive, albeit not necessarily always uncontroversial, discussions in the context of DG ECFIN's Fellowship Initiative 2014-2015 have brought new and better insights on the pertinent economic challenges in EMU. The initiative has certainly helped to strengthen the analytical expertise of the Directorate General, to ensure that its analyses remain at the frontier of theoretical and empirical developments in economics, and to inform its approach to policy-design. Similarly, the Fellows have had an opportunity to experience the policy-making environment in which DG ECFIN operates which can sometimes put constraints on achieving the first-best solutions as derived from purely theorizing. Thus, the initiative has provided a stimulating framework for a highly interactive learning experience for all the participants. On behalf of DG ECFIN, we wish to express our profound thanks to all the Fellows for their contributions at this place as well.

Obviously, as in any good research programme, several questions have remained without a clear-cut uncontroversial answer, and new questions have emerged. The discourse on how best to boost growth and jobs in a sustainable EMU is bound to go on among both pundits and policy-makers; and, certainly, DG ECFIN will strive to continue to play a leading role in the debate.

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