

EUROPE 2017: MAKE IT OR BREAK IT ?

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ABSTRACT

We highlight the drastic downsizing of the ambition to deepen EU and/or EMU integration. These diminished ambitions are an obstacle to blending doses of risk reduction into national policies and pursuing supranational risk sharing initiatives. We maintain that the European Union, and mainly the euro area, cannot tolerate the related stalemate. Hence, our proposal is to concentrate economic and political efforts on producing a set of European public goods, which would be dependent on gradually enlarged and reorganized EU or EMU-controlled resources. By supporting growth, this could aid convergence processes between core and peripheral member states in the internal market and improve trust inside the Union, thus stemming the present dangerous trends of euro-skepticism and populist nationalism. As of now, the banking and capital markets union still fail to provide the most important European public goods that they could offer. The public goods they can deliver would greatly help spur the search for a balance between risk reduction and risk sharing policies. This possible achievement is a preliminary step towards the solving of fundamental institutional and governance problems that must be overcome to build effective European economic and political integration. We propose a way to conceptualize the reform of EU institutions, with the goal of creating a federal union (not a federal state) with a neater supranationalization of certain policies and a clearer distinction between supranational responsibilities and policies that member states must enact with full autonomy. Italy is in a strong but delicate position to contribute to the short-term actions necessary for relaunching integration and has the necessary profile for launching a constructive debate on longer run institutional reforms, also as a way to celebrate the 60th anniversary of the Treaty of Rome.

This paper was jointly produced by the three conveners of the Conference "Europe 2017: Make it or Break it?" held in Rome on January 24th, 2017.

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INTRODUCTION

In September 2016, European Council President Donald Tusk wrote to his colleagues and fellow members: “my talks with you clearly show that giving new powers to European institutions is not the desired recipe”.¹ With unusual clarity, the tentative road, prescribed by the Treaties, towards an “ever closer union” was proclaimed interrupted, as if June’s vote for Brexit would apply to the whole Union.

The European Union (EU)’s “dynamic gridlock”, consisting of repeated summits where only emergencies are dealt with and “giving up any attempt to shape events politically”² is causing a drastic downsizing of ambitions to deepen the Union. Last year started with a remaining echo of the 4 and then 5 Presidents’ “Reports”³ that, from 2012 to 2015, had proposed to deepen the integration of European financial markets and economic policies, to build tools for a shared management of public finance, and to enhance the democratic legitimacy of EU institutions. However, it was just an echo, a whiter shade of pale, as the Reports kept being overlooked in Council meetings, also due to the impact of a new Greek crisis, the worsening of the migration and security problem, and the difficulties faced by a number of banks in the European Economic and Monetary Union’s (EMU) most fragile countries. Let us call the path of ideal integration designed in the Presidents’ Reports and reflecting the substance of the Treaties *Plan A*.

The inaction on *Plan A* gave rise to a somewhat implicit *Plan B*. The idea was to find a balance between *risk reduction* – national actions aimed at reducing imbalances, implementing economic and institutional reforms, and strengthening competitiveness – and *risk sharing* – European actions aimed at developing common institutions that can insure against EU-wide systemic consequences of external or idiosyncratic shocks. Risk reduction would imply the fulfilment of the EU rules (Six Pack, Fiscal Compact, and Two Pack) contained in the 2011 and 2012 governance reforms; risk sharing would include a public backstop for banks and deposit insurance, funds to manage international spill-overs of sovereign debt crises, and financial resources to support investment plans of European relevance with guarantees.

But even *Plan B* did not make due progress. Its two sides, risk reduction and risk sharing, were not able to progress in balance. On the contrary, the emphasis actually remained very much concentrated on risk reduction. With a number of member countries financially unbalanced and excessively divergent (the so-called peripheral member states), the scenario kept being dominated by their governments’ responsibilities to implement financial consolidation and relaunch productivity and growth. It looked like risk sharing had to wait until the risks, transmitted by the peripheral countries and borne by the other Eurozone member countries, are adequately reduced and the lack of trust towards the most fragile peers surmounted. By increasing the general level of risk, the vote for Brexit in June 2016 was the ideal completion of this negative, unbalanced evolution of *Plan B*.

In the following sections, we analyse this evolution and speculate on remaining available ways (a *Plan C*?) to revitalize the EU’s integration (Section 1). We emphasize the crucial role of banking and capital markets union as indispensable vehicles for relaunching growth via

¹ Letter from President Donald Tusk before the Bratislava Summit, 13 September 2016, <http://www.consilium.europa.eu/en/press/press-releases/2016/09/13-tusk-invitation-letter-bratislava/>

² J. Habermas, “Core Europe to the Rescue: A Conversation with Jürgen Habermas about Brexit and the EU Crisis,” *Social Europe*, 12 July 2016, <https://www.socialeurope.eu/2016/07/core-europe-to-the-rescue/>

³ *The Five Presidents’ Report: Completing Europe’s Economic and Monetary Union*, 22 June 2015, https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en

productive investments and improved resource allocation, as well as indispensable means for insuring against idiosyncratic risks in a monetary union (Section 2). Finally, since small pragmatic steps forward must be illuminated by long-run targets, we briefly consider the possible evolution of the EU's institutional setting as it tries to survive the shock of the complex and uncertain Brexit process (Section 3).

1. REDUCED AMBITIONS TO DEEPEN EUROPE: CAN WE REVITALIZE THEM?

The idea of offering EU-wide risk sharing as a compensation for a more stringent national ownership of risk-reducing policies has some merits. The weakness of the integration process also derives from a lack of clarity when distinguishing national from community responsibilities. Hence, the distinction between risk sharing and risk reduction, which is the basis of their supposed equilibrated combination in Plan B, could also serve as a step towards clarifying national responsibilities, as well as the EU's task in a period of integration fatigue and pragmatic minimalism. However, Plan B's equilibrium is quite fragile and can easily degenerate into an unbalanced hierarchy: the non-credible promise of a risk-sharing carrot joined by a minacious stick of a preventive risk reduction entirely entrusted to a decentralized market discipline. In such a framework, financial markets would price sovereign spreads, substituting the failed Commission coordination in monitoring the processes of financial consolidation and structural reforms. Moreover, the involvement of the private sector in bank resolution by means of the "bail-in" would limit the burden for taxpayers and prevent distortions in competition without considering its possible negative impact in terms of macro-financial instability.

Resurrecting full reliance on market discipline means going back more than two decades, i.e., before the signing of the Maastricht Treaty, which acknowledged that European policy coordination, conducive to monetary unification, is crucial for preventing markets from worsening instability by reacting to policy news with permissive delays followed by sudden and exaggerated accelerations. More recently, the financial and real crises following 2008 proved that markets and regulatory failures can be so ravaging as to leave ample room for stabilization actions by central policies. In a short paper published by the LUISS School of European Political Economy (SEP),⁴ the implications of Plan B cum market discipline were considered for Italy, the most important fragile country in the EMU, with the conclusion that exclusive recourse to risk reduction and market discipline would hinder necessary adjustment processes and nourish the instability of the whole euro area, leading to the selection of the worst equilibria.⁵

The Italian government appeared aware of these implications. Its reaction was based on a reappraisal of the scheme to balance risk sharing and risk reduction. In fact, in February 2016, the Italian Minister of the Economy presented the EU Council with a rich document with numerous proposals for risk sharing mechanisms to relaunch a European strategy "for growth, jobs and stability".⁶ However, if we concur that Germany and other big European creditors are behind the proposal to twist Plan B to postpone its risk sharing side, relying on market discipline to force risk reduction, efforts to move in the direction of the Italian

⁴ Bastasin, Bini Smaghi, Bruni, Messori, Micossi, Passacantando, Saccomanni, Toniolo, *Eurozone: Italy's responsibility*, <http://sep.luiss.it/sites/sep.luiss.it/files/EuroItalia.pdf>, 21 January, 2016. The paper also emphasizes that Italy has to make serious efforts to reduce its own risks in order to allow the reappraisal of a balanced Plan B.

⁵ De Grauwe, P., Yuemei J., *Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone*, CEPS Working Document, n.361, January 2012.

⁶ *A Shared European Policy Strategy for Growth, Jobs, and Stability*, February 2016, http://www.governo.it/sites/governo.it/files/ASharedPolicyStrategy_20160222.pdf

government's document would remain ineffective. In 2016, the quest for balance between risk sharing and risk reduction was not at stake in the European debate. Germany was, in fact, pushing to stop the ECB's 'Quantitative Easing' policy (QE) as soon as possible, proposing automatic restructuring procedures for the public debt of EMU countries requiring financial aid through the European Stability Mechanism (ESM) and positive capital ratios for excessive amounts of sovereign bonds in bank portfolios.

One could read at least the spirit of these threats in the letter signed by the French and German central bank governors, published in early February last year.⁷ The letter was gentled and refined by including the proposal to create, as an alternative to market discipline, an EU finance minister to reinforce the coordinating powers of Brussels. However, this was not an actual alternative since the EU finance minister was reduced to a central supervisor for the national management of public debt.

As of now, the downgrading of integration ambitions from Plan A to Plan B, even in a cum market discipline version, does not seem sufficient for making Plan B feasible, for several reasons: the free-riding attitude of a number of peripheral member states (first of all, Italy) when they are asked to exploit the propitious policy setting in order to adjust their macroeconomic fundamentals and improve their competitiveness; the myopic refusal of German leaders to subscribe their share of insurance for systemic risks, to which they are nonetheless exposed given inescapable European interdependencies; a "first mover problem," where the initiatives for risk reduction, requiring efforts by individual member states and mainly by the most fragile countries, and those for risk sharing, implying efforts from the EU's central institutions and core countries, are delayed, with both sides waiting for the other to blink; the continuous short-term bias of European institutions that, instead of monitoring the advancements of Plan B, are continuously distracted by sudden emergencies. However, the most important single obstacle to serious implementation of Plan B is, probably, the extraordinary increase in political and economic uncertainty that took place last year at the global level. Brexit, migration, terrorism are the main culprits, but not the sole ingredients of this radical uncertainty.

The worsening of global geopolitical predictability is well known. Brexit and Trump's election are important examples and symbols of the phenomenon of increasing uncertainty. In both cases, the problem is that nobody is able to forecast how and when things will develop. For instance, there is the feeling that the dramatic changes in fiscal and monetary policies promised by the Trump administration could overheat the US economy and cause a significant increase in medium-to-long term interest rates. Despite the ECB's expansionary and unconventional monetary policy, this increase could impact the euro area, worsening the fiscal stability of member countries with high public debts. The EMU's instability could be worsened by the results of the upcoming elections in France, Germany, and perhaps Italy. Knightian uncertainty is pure ignorance, which is different from risk, and insurance against radical uncertainty is adventurous or impossible. In this framework, risk sharing becomes more difficult to manage *per se*. On the other hand, risk reduction efforts can promise too weak an output, and their costs can become unbearable and un-compensable with the risk sharing elements of Plan B.

The situation is, therefore, such that, at the beginning of 2017, even Plan B seems near death or, at least, ready for a long sleep. Does a Plan C exist? Perhaps. The impression is that a minimalist project is coming together, and we would propose considering it with some hope.

⁷ http://www.bundesbank.de/Redaktion/FR/Standardartikel/Presse/Contributions_externes/2016_02_08_weidmann_galhau.html

Plan C could consist of concentrating the economic and political efforts of both the central EU institutions and the member states on the task of collectively producing a short list of collective European goods undisputedly considered public goods for the EU. Even if the list were limited to the control of migration together with some security and defense policies,⁸ Plan C could serve as a crucial step forward, away from the precipice of the Union's dissolution. Its implementation could have positive economic impacts and earn widespread public approval, proving that the existence of a European Union and a monetary area are, in fact, serving the public interest when they are easily recognizable. Plan C could, therefore, provide substantial help in containing euro-skepticism and eventually come to the point of allowing a return to the path of integration towards Plan B or even Plan A.

While maintaining that a minimalist emergency Plan C, taken seriously, is a necessary condition for revitalizing the European project, we believe that the effectiveness and reliability of such a plan require, as a necessary if insufficient condition, the availability of an adequate amount of Union resources organized and directed towards the production of useful collective goods. In this perspective, a crucial component of Plan C (and, *a fortiori*, plans A and B) is based on the result of the inter-institutional *High Level Group on Own Resources* (HLGOR), chaired by Mario Monti.⁹

Two further conditions for the success of Plan C and possible relaunch of plans B and A are discussed in the last two sections of this paper: some crucial, urgent steps must be made towards progress in European banking and financial union; and an agreement must be reached on some basic characteristics of the medium-long run development of EU institutions. The transparent consideration and discussion of the wider theme of what Europe really wants to be must go hand in hand with the immediate concentration of economic and political efforts towards proving its basic utility in the provision of vital collective goods.

2. THE IMPORTANCE OF BANKING AND CAPITAL MARKETS UNION

We strongly believe that the process of banking and capital markets union produced and can still produce crucial collective European goods. This process is, therefore, an important ingredient of Plan C, as defined above. However, the banking union is far from being completed, and the process of capital markets union is still in its early stages. Delays on this front are dangerous and may put a satisfying implementation of Plan C, and the euro's survival, at risk. Action is urgently needed, and a few options are suggested below.

Apparently, the banking union is one the best examples of European efficiency and progress in terms of integration. In less than two years, a single supervisory mechanism (SSM) for European banks was conceived and implemented. European banking supervision (EBS)¹⁰ became operative at the beginning of November 2014. By the end of 2013, all adherents of the EBS (all EU members except for the UK and Sweden) were also adopting new European resolution rules for banks on the brink of bankruptcy, following the Bank Recovery and

⁸ We will show in the following sections that this is not the case, since at least banking union and capital markets union processes can be important producers of public goods.

⁹ *Future Financing of the EU – Final report and recommendations of the High Level Group on Own Resources*, December 2016, http://ec.europa.eu/budget/mff/hlgor/library/reports-communication/hlgor-report_20170104.pdf

¹⁰ This label, as well as the related denomination of the ECB Supervisory Board as 'European banking supervision' is used by the ECB itself (see European Central Bank, *ECB Annual Report on supervisory activities 2015*, Frankfurt 2016). These labels replaced references to the SSM and are now commonly used (see for instance: D. Schoenmaker and N. Veron (eds.), *European Banking Supervision: The First Eighteen Months*, Bruegel 2016).

Resolution Directive (BRRD).¹¹ The new Single Resolution Mechanism (SRM) became fully operative at the beginning of 2016. SRM implies private sector involvement, through ‘bail in’ or, at least, ‘burden sharing’, and comes with the construction of a Single Resolution Fund, with a gradually increasing portion of jointly committed pooled European funds. The banking union process was able to address, with some success, several delicate problems: cooperation between the ECB and the previous national supervisors; the ECB’s potential conflict of interest, due to its dual responsibilities as monetary policymaker and banking supervisor; the division of labor between the new EBS and the preexisting European banking regulator (EBA), which retains the responsibility of setting the single rulebook for the European banking sector and protecting the rights of EU members not part of the banking union.

Given the deep interconnections between European banks, the achievements of the banking union process are important. Shocks to different parts of the network of European banks can easily become systemic, compromising the financial stability of the Union and the sustainability of the single currency. An example is the case that gave rise to the banking union process, i.e. the serious turbulences of 2011-2, when vicious circles developed between certain national sovereign debt crises and banks’ asset-liability management, leading the whole European interbank market to suddenly stop functioning. The resurgence of segmentation in the euro area along national boundaries would seriously increase disequilibria and financial instability in European markets. In this sense, the outcome of the banking union represents an undisputable public good for the EU. The fact that its architecture is still incomplete is, therefore, a serious problem, to be remedied as soon as possible according to the logic of Plan C.

The resolution mechanism lacks a larger, more independent, and flexibly managed public backstop to promptly and effectively deal with the most complex cases of potential bankruptcies of either individual or chains of troubled banks, thus avoiding panics and stopping contagion. The lack of a backstop also decreases the credibility of the implementation of the bail-in principle, which was not conceived to deal with potentially systemic crises. Moreover, a European deposit insurance scheme (EDIS) is needed to effectively protect small depositors of European banks. At the end of November 2015, the European Commission presented a plan to gradually build EDIS¹². However, this plan has yet to be endorsed by the European Council and approved by the EU Council. Difficulties in moving towards a truly single rulebook have also been encountered (by the EBA, Commission, and ECB). These difficulties mainly refer to euro-wide homogeneous methods to calculate, for instance, bank capital ratios, the value of derivative products, or the value of non-performing loans.

Most of the impediments to the completion of banking union are rooted in the same factors that caused the failure of Plan B (see above). A public backstop, as a player of last resort in the resolution processes, and an EDIS, as a European protection for depositors, are based on risk sharing mechanisms. However, a number of core EMU countries maintain that the banking sectors of peripheral EMU countries are exposed to excessive risks, including excessive holdings of national sovereign debt that could lead to dangerous bank-sovereign interdependence. According to this view, any new risk sharing initiative would have to be contingent on prior risk reduction on the part of the banking sectors of peripheral countries. Also, the resistance to fully harmonizing regulations arouses the suspicion that certain

¹¹ Directive 2014/59/EU, 15 May 2014, <http://eur-lex.europa.eu/legal-content/IT/TXT/?uri=celex%3A32014L0059>

¹² *European deposit insurance scheme*. 2 December 2016. http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index_en.htm

“excessive” risks and weaknesses specific to individual national banking systems are hidden among the remaining differences.

The interconnectivity of European banks is so strong and the probability of financial contagion so high that risks are unavoidably shared. Thus, giving up carefully designed risk sharing rules and mechanisms is an ineffective and dangerous way to conceal reality, potentially worsening the consequences of any episode of instability. This point was explicitly emphasized in certain official plans for completing the banking union¹³. However, as clearly stated in recent European Council meetings¹⁴, the final result is that the core countries imposed an “appropriate ordering” between risk reduction, which has to come first, and the risk sharing that may follow, in order to re-open the debate on EDIS and the public backstop.

In terms of our previous analysis, this stalemate in the completion of the banking union is another failure of Plan B and threatens the implementation of Plan C. However, the methodological approach of Plan C could offer a solution, if that union is recognized as a public good.

Consider the combination of risk reduction and risk sharing that would better serve the completion of the banking union. As of now, the risk reduction required by core EMU countries would set a maximum on the ratio of a bank’s holdings of national public bonds and its total assets. Beyond this threshold, holding public bonds would require an increase in the bank’s capital due to the risk of inadequate diversification. Given the extent of public bond holdings in countries like Italy and the current difficulties and costs related to bank recapitalizations, the required public bond deleveraging, as well as the alternative adjustment of capital requirements, could be traumatic and cause drawbacks. The deleveraging could also weaken the demand for public bonds of peripheral countries with high-debt, especially if coupled with a tapering of QE. Finally, it would reduce the amount of risk-free assets exchanged in the European financial markets, thus causing problems of market incompleteness. We suggest, instead, as a first move aimed at solving the legacy problem of bank-sovereign interdependence, to allow the ESM to ease the deleveraging by absorbing the sovereign bonds that would be sold by the banks to meet the maximum threshold. The ESM would have to purchase this excess of sovereign bonds at market prices, in exchange for a synthetic public bond composed of k-capital shares of all the sovereign bonds issued by countries belonging to the banking union.

If such a measure were to succeed at facilitating the needed completion of the banking union, several European public goods would follow. These would include possibly improving centralized monitoring of public debt management. Moreover, European financial markets would become more complete and efficient, also making it possible to start a gradual substitution of national public bonds with a composite European bond. The development of euro-bonds would nicely parallel the needed significant increase in the EU’s own resources for financing the production of basic public goods (see the analysis of Monti’s Commission, and the previous footnote 9).

It is important to stress that even the completion of the banking union would not be sufficient for an efficient functioning of European financial markets. A new framework is required to

¹³ Duvillet-Margerit, Alienor. *Completing the Banking Union*. PE 574.392. 17 January 2017. [http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574392/IPOL_BRI\(2016\)574392_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574392/IPOL_BRI(2016)574392_EN.pdf)

¹⁴ In particular, *EU Council December Conclusions*, 15 December 2016, point 20.

enlarge and strengthen non-bank financing, with market segments where a rich menu of securities issued by non-financial firms and households may be absorbed.

The quasi-monopolistic role played by the banking sector in European financial markets is becoming increasingly inefficient and unsustainable. Despite the different robustness of national banking sectors, European banks share some common features: a dramatic decrease in interest margins, increasing difficulties in maintaining a primary role in the management of household financial wealth, loss of their monopolistic position in national and European payment systems, and mounting competitive pressure threatening their position as the prevailing lender to non-financial firms and households. Technological changes are obviously important factors in these developments. However European banks, still focused on their traditional business models, are suffering from a lack of profitability, worsened by the fact that many of them seem unable to clean their balance sheets, which hold a significant amount of troubled bonds and/or an excessive amount of NPLs. As a consequence of their legacy problems, they show an excessively cautious attitude in their new lending policies. A decrease in implicit government guarantees (well represented by the introduction of the no-bail-in legislation) is another cause of the slow-down in potential bank credit, which must also cope with increasing minimum capital requirements. A revitalized effort to complete the banking union should also include a centrally directed and monitored plan to restructure the European banking system, possibly aided and stimulated by a rotating pool of shared funds. In any event, banks cannot keep their present dominant role: in the near future, European non-financial firms will have to diversify their financial sources, which are today too reliant on bank lending.

This development is in accordance with the planned Capital Markets Union (CMU), which is still in its infancy. In 2015, the European Commission issued a *Green Paper* and, a few months later, an *Actions Plan*.¹⁵ In these documents, it is clearly stated that the CMU aims to support mergers and business model innovations in the European banking sector, ease diversification in the financial sources of small-medium enterprises by facilitating their entry in European corporate bonds markets, build well-regulated and efficient markets for transparent and standardized securitization, and develop the supply of non-banking financial intermediaries to finance long-term infrastructural and strategic investments. The European Parliament and the European Commission asked for a rapid implementation of these objectives (their horizon is two or three years). The first progress report, published in September 2016, states that the CMU's action plan is roughly on time and has already led to significant progress in terms of securitization.¹⁶ However, many steps have yet to be initiated. Moreover, the progress of CMU is hindered by the resistance of national authorities to harmonizing a vast and complex mix of legislation (including delicate aspects of corporate governance) and relinquishing their powers over the regulation and supervision of non-bank finance, which would allow the establishment of a European authority as autonomous and powerful as the ECB in the banking sector.

The EU would risk losing a great opportunity if these difficulties are not rapidly overcome. In the United States, the financial markets traditionally provide an amount of financing to the 'real' economy larger than that of bank lending. This allows more diversification in the financial sources utilized by the 'real' economy. Even most importantly, CMU could offer an

¹⁵ See, respectively: *Green Paper: Building a Capital Markets Union*, Brussels 2015; *Action Plan on Building a Capital Markets Union*, Brussels 2015.

¹⁶ See Z. Kudrna, *The EU's Capital Markets Union. Unlocking Investment through Gradual Integration*, Atlantic Council, November 2016.

effective risk sharing mechanism through the markets. Local idiosyncratic demand and supply shocks are efficiently absorbed by spreading them all over Europe via cross border financial assets and liabilities. Empirical work has shown that, in the USA, risk sharing via the integrated financial market can play a stronger stabilizing role against real shocks than country-wide fiscal transfers.

Together with the banking union, CMU deserves a significant effort according to the logic of Plan C, as it delivers valuable European public goods. Moreover, CMU allows a serious improvement in the efficiency and effectiveness of the transmission mechanisms of monetary policy, as well as a stronger, modern, and efficient financial support for the ‘real’ economy. Finally, by aiding the absorption and stabilization of economic shocks and thus playing a risk sharing function, CMU represents an essential building block for a Plan B of European integration.

3. QUO VADIS EUROPE?

As we maintained in the previous sections, the EU should immediately take small pragmatic steps forward, coherent with a long-run strategy, in order to dissipate the populist message that European integration is over. Proposals of deeper cooperation might be advanced, according to what we called Plan C, in matters where a consensus clearly exists, particularly in the production of crucial European public goods. For instance, it would be possible to set up an EU intelligence system and to strengthen Frontex, transforming it into a fully autonomous EU border control police. This would imply using the Treaty’s clause for structured cooperation to create a small but effective EU battlegroup for operation in sensitive international areas on behalf of the EU. All these initiatives will become easier, more credible, and sustainable, if financed with a significant expansion and reorientation of the EU’s own funds (i.e. financial resources not dependent on national transfers). We have also argued that speeding up the completion of banking and capital markets union would deliver important public goods.

We are aware that organizations tend to fall captive to their own institutional and policy inertia. The more complex they are (as is the EU), the more the logic of path dependence constrains their daily functioning, making them favor a *muddle-through* approach when confronting problems, i.e. *ad hoc* policy decisions, minor institutional fine-tuning, and postponement of any long-term structural evolution of the institutional setting. Occasional justifications can be utilized to support muddling-through by de-emphasizing the seriousness of the issues encountered. For instance, in Brussels, there is an argument that the effects of Brexit should not be overstated, given that the UK has, after all, always been an outlier. In the same vein, there are those who maintain that the financial crisis, migration problem, and terrorist attacks, though unusually dramatic, will not last forever. Optimism is a resource, but it cannot be an alibi for blindness. Problems require deep decisions on the future of the EU.

There is no *status quo* to preserve. In fact, under the pressure of multiple crises, the EU is rapidly transforming itself and becoming an organization increasingly controlled by national governments. As Donald Tusk said before the Bratislava Summit on 13 September 2016, the Treaty-based supranational model of integration is no longer supported by a significant group of member states. However, the intergovernmental method has been shown to suffer from weak effectiveness and serious doubts about legitimacy. When an agreement between national governments is unreachable, as has been the case with the relocation of political refugees, then even vital and urgent policy processes end in stalemate. Deliberations based on

unanimity or voluntary coordination are constrained by the threat of veto, which allows each member state to stop any undesired decision.

If muddling through is not a solution and inter-governmental governance risks being ineffective and self-blocking, then a debate on a medium-term strategy of institutional reform should follow a different path. Analyzing this new path is necessary as even small, short-term pragmatic steps should take into account the general direction of a chosen strategy for institutional evolution. Moreover, in the current year (i.e. before 1 January 2018), there will be an opportunity to redesign the Lisbon Treaty in order to incorporate one of the recent intergovernmental Treaties (the Fiscal Compact). If EU member states decide to include the Fiscal Compact in the Lisbon Treaty, the latter would have to be reformed, thus opening the possibility of relaunching a discussion on the role of supranational institutions in the economic governance of the EMU. When dealing with the possible institutional evolution, two paradigms can be utilized. Let us call them Institutional Reform 1 (IR1), derived from solving *Rodrik's trilemma*, and Institutional Reform 2 (IR2), derived from dealing with the *Madison's dilemma*.

Rodrik's trilemma states that it is impossible to simultaneously maximize international political integration, national sovereignty, and democratic control. Solving the trilemma in the EU seems easier than at the global level. It requires choosing a combination of non-100% doses of the three elements. A higher level of one of them requires a lower level of one or both of the others – it is a zero-sum exercise. In particular, deeper international integration implies less national sovereignty and/or more indirect and weaker democratic control. The adoption of a single currency or a European minister of finance would, for instance, imply a loss of national sovereignty in exchange for, say, monetary stability and financial solidarity in the event of financial crises. However, the EU being a democratic organization, deeper integration would require strengthening legitimacy at the supranational level. Trade-offs between risk sharing and risk reduction (as in Plan B of the previous sections) might also be negotiated within the logic of solving the trilemma, as the different combinations can have varied impacts on the three elements.

Institutional reform 2 (IR2) consists, instead, of a strategy of *constitutional differentiation*. It is based on Madison's dilemma, which concerns the distribution of power and competences between two distinct and separate sovereign entities – the national and supranational organizations. It aims to identify the policies to be governed by shared supranational institutions and those to be self-governed by nation states. The analytical framework does not imply a zero-sum redistribution of doses of the same sovereignty on different institutional settings. This framework expects that the preferred distribution of policies between the national and supranational levels be negotiated and then enshrined in a constitutional pact. Solving the paradox of sovereign states in a sovereign union brings to mind the Philadelphia Convention debate. The solution of the paradox/dilemma lies in a constitutional decision identifying the dividing line between *self-government* and *shared government*. This approach has an explicit anti-centralizing bias because it fragments sovereignty between distinct institutional entities, rather than transferring a chosen amount of general sovereignty from one level (the member state) to a higher level (the EU or the EMU).

The Rodrick solution (i.e. IR1) seems to be the preferred strategy of the German establishment. Germany looks at the EMU through the lens of its federal state, with its panoply of committees connecting the *Bund* and the *Laender*, with the aim of supervising the latter. The difference, however, is that, in Berlin, as opposed to Brussels, there is a popularly elected institution (the *Bundestag*). The *Bundestag* has the power to legitimize the federal

government's actions to coordinate the committees through its ministries – a role that cannot be taken on by the *Bundesrat*. On the other hand, the EU's Parliament has much weaker powers than the Bundestag, and the executive decisions are mostly in the hands of the Council (in the EMU, the Eurogroup). Although each minister of the Eurogroup is accountable to his/her own Parliament, it is unclear to whom the Eurogroup is accountable as an institution. *De facto*, IR1 tends to abolish the distinction between the two levels of government, theoretically fusing them.

The Madison solution (i.e. IR2), based on a constitutional or political compact, allows the construction of powerful firewalls between the national and supranational levels. According to this view of federalization (or integration, in EU terms), state sovereignties and federal sovereignty are not zero-sum correlated. One can prosper close to the other under the condition of constitutionally distinguishing between their respective competences. For instance, according to IR2, the European minister of finance should take care of European economic policy, manage a European treasury or fiscal capacity, and be accountable to European democratic institutions. His/her duties should not include coordinating the national ministers of finance, who should, instead, act autonomously within their own set of policy functions and responsibilities towards their national democratic institutions.

Although conceptually different, the two strategies are not completely incompatible. On the contrary, they might support each other to help the EU escape the current stalemate. In fact, IR1 can be a useful instrument for identifying those member states that are more willing than others to solve the trilemma by accelerating integration, allowing the immediate start of Plan C's production of European public goods (such as financial assets, security, defense, intelligence, and border control). However, the IR1 strategy, alone, would not succeed in exploiting the potential of Plan C to improve the public's trust in European institutions. There is a risk of confusing political responsibilities and making it more difficult to identify defined spaces of accountability and legitimacy.

Herein lies the importance of IR2, which aims to draw clear distinctions between the policies that fall under national or supranational responsibilities. Once the production of undisputable European public goods has been clearly allocated at the center of the Union, the process of policy and institutional differentiation must proceed. As soon as the constellation of economic and political factors becomes more favorable, and using the opportunities previously identified (with regard to the Fiscal Compact), a Treaty's reform should re-enter the European agenda. This major step requires preparation: a great debate should be launched to identify a unionist paradigm alternative to the standard centralizing interpretation of the "ever closer union" clause. This means that a process of political integration would have to generate a *federal union*, not a *federal state*. As a federation that aggregates distinct and separate nation states, a federal union should conceptually follow the US or Swiss approach, not the German one.

Unions of states are based on the principle of distinct sovereignty between the federal center and the federal states. Each of the two levels has sovereignty over the management of policies under its concern and parallel democratic institutions are needed to implement these different types of sovereignty. A difficult and gradual process of permanently assigning shared policies to the center and to the states must be started. This process might imply a trade-off between the repatriation of specific policies and the setting of a fiscal capacity at the supranational level. It would also counteract the temptation to tolerate a gradual dissolution of the EU or to solve European problems by splitting the Union into different, allegedly homogeneous, parts. A path towards a federal union would dissipate, for instance, the illusion

of dividing the euro area into two subsets, north and south. Moreover, it would prevent the exaggeration of the euro area's separation from other possible groupings inside the EU. Sharing the same currency and related policies does not prevent different subsets of EMU countries from cooperating with other EU members in other fields.

The prospect of a federal union should be open to all member states. However, it cannot be constrained by the potential veto of each potential participant. Brexit taught us that it is not effective to slow down integration to appease the opponents. The formation of a core in the European Union might be a convenient step toward providing a democratic barycenter for multiple forms of cooperation between countries.

The single market must remain a defining and indispensable framework for the federal union and other less integrated forms of cooperation between member states. The single market should preserve its founding principles of free circulation of individuals, goods, services, and capital. Moreover, a globally competitive single market requires the supranationalization of crucial instruments related to financial and labor market regulatory policies, tax structures, international trade strategies, and horizontal industrial policies. It also implies the sharing of some basic values, such as those enshrined at the beginning of the Treaty. On the other hand, acceptance of the four freedoms should not require the commitment to join the single currency as soon as possible, as the Maastricht logic implies when it characterizes the non-euro EU members as members "in derogation".

The situation is currently heading towards confusion: member states, for instance, are bound to follow excessively centralized rules in product standardization and regional fiscal incentives while, at the same time, absurd pressures are developing to re-nationalize crucial decisions on global trade agreements and basic financial regulation. A transparent discussion should be opened on the truly necessary constraints of a single market, as well as the essential policies that characterize a union. For instance, what are the elements of foreign, security, and migration policies that must be assigned to the EU authorities, as opposed to those that should remain under full control of national powers? A clear answer to these types of questions would also aid the search for the right ways to increase the democratic legitimacy of supranational institutions

In sum, Dani Rodrik can help disentangle the EU from the constraints of the trilemma, while James Madison can help build a truly shared and enduringly accepted political and institutional perspective on that disentanglement. An appropriate way of celebrating the 60th anniversary of the Treaty of Rome might be to start an open and constructive discussion on the prospect of a democratic federal union in the context of a plural Europe. As a founding member of the Union and the euro area, Italy has the necessary profile for launching such a constructive debate and preventing it from becoming an additional pretext for deepening divisions or generating misunderstandings and distrust among member states.

CONCLUDING REMARKS

In the preview section we highlighted the drastic downsizing of the ambition to deepen EU and/or EMU integration, which prevents any significant steps in the directions indicated, until two years ago, by the Presidents' Reports, at least until the conclusion of the political cycle that will last through the German elections in Fall 2017. These diminished ambitions are also an obstacle to blending doses of risk reduction into national policies and pursuing supranational risk sharing initiatives, as had been intended until mid-2015.

However, we maintain that the European Union, and mainly the euro area, cannot tolerate the present stalemate for another year. Hence, our proposal is to concentrate economic and political efforts on producing a set of European public goods, which would be dependent on gradually enlarged and reorganized EU or EMU-controlled resources. This could aid convergence processes between core and peripheral member states in the internal market and euro area by supporting growth. As a consequence, it could improve trust inside the Union, thus stemming the present dangerous trends of euro-skepticism and populist nationalism.

We would not be starting from scratch. Limited quantities of European public goods are already available in different fields and are moving towards producing increasing doses of European cooperation. This applies to security, defense, intelligence, and migration controls, even if the improvements in these fields are slowly progressing. On the other hand, the banking union made important initial progress in delivering stability and efficiency to European finance; however, the completion of the banking union and the actual start of the capital markets union are meeting increasing difficulties. It is crucial to strengthen efforts on all these fronts to enhance the production of European public goods. In this sense, European institutions and member states should urgently accelerate required decisions and implementations.

We must stress the importance of banking and capital markets union. As of now, they still fail to provide the most important European public goods that they could offer. However, as we stress in Section 3, their potential contribution to Europe's welfare, competitiveness, and growth is vast. Moreover, the public goods they can deliver would greatly help spur the search for a balance between risk reduction and risk sharing policies, giving it a more solid foundation and elements acceptable to all member states.

Are we suggesting that these short to medium term productions of European public goods offer solutions that exempt it from the need to tackle longer run problems? Our answer is quite the opposite, for two related reasons. First, the production of European public goods is just a preliminary step towards the solving of fundamental institutional and governance problems that must be overcome in order to build effective European economic and political integration. Second, a transparent discussion and clarification of a targeted redesign of EU institutions, and possibly of the Treaties, even if defined and implemented over a relatively long period, would greatly enhance the effectiveness of shorter term moves.

Using the logic of both Rodrik's trilemma and what we call Madison's dilemma, we propose a way to conceptualize the reform of EU institutions, with the goal of creating a federal union (not a federal state), along two complementary lines: a neater supranationalization of certain policies and a clearer distinction between supranational responsibilities and policies that member states must enact with full autonomy.

Italy is in a strong but delicate position to contribute to the short-term actions necessary for relaunching integration. By accelerating its financial consolidation and structural reforms, Italy can greatly benefit European stability and, thus, reinforce its credibility and influence over supranational actions. Moreover, as a founding member of the Union and the euro area, Italy has the necessary profile for launching a constructive debate on longer run institutional reforms, also as a way to celebrate the 60th anniversary of the Treaty of Rome.