9

Progress toward Fiscal Union

Until the spring of 2012, the discussions on bailout packages and eurozone issues in Ecofin meetings had generally been peaceful—that is, if one did not count the occasional raised voice and finger-pointing by Austrian finance minister Maria Fekter (dubbed "The Witch of the South" by the German media) and the forceful comments by Finnish finance minister Jutta Urpilainen, when the subject of Greece's lack of progress with reforms was broached. These discussions took a decidedly different turn when the new Spanish finance minister, Luis de Guindos, joined Ecofin. He would lash out at any finance minister who dared to suggest that the new Spanish government was taking too much time to decide on the size of its bailout package. German finance minister Wolfgang Schäuble was especially insistent on quick action in Spain, pointing out that further delay would endanger the whole eurozone because the size of a delayed package could be larger than what the eurozone countries could afford. Tempers flared quickly anytime Spain was discussed.

And for good reason. The experience with the bailout packages had been disappointing. The packages had always been smaller than the markets needed, and each bailout announcement had helped only temporarily. It was also clear that the European Stability Mechanism (ESM) had insufficient funds to cover all of Spain's banking problems, let alone deal with those of Italy or France. Moreover, nothing we did in Ecofin seemed to calm investors long enough that we could focus on broader solutions such as the fiscal union or the single banking supervisor. We had to take a bigger step.

Fifth Tipping Point

And that step was taken on July 26, 2012, when European Central Bank (ECB) president Mario Draghi announced that the bank would do whatever was necessary to save the euro. That did the trick—it saved the eurozone. Whether it was Draghi's decision, or whether—as I suspect—he did it at the urging of Germany, the bank's move enabled European leaders to turn to broader solutions to the euro crisis such as a fiscal union. This, then, was the fifth tipping point in the euro crisis (see chronology of events at the back of the book).

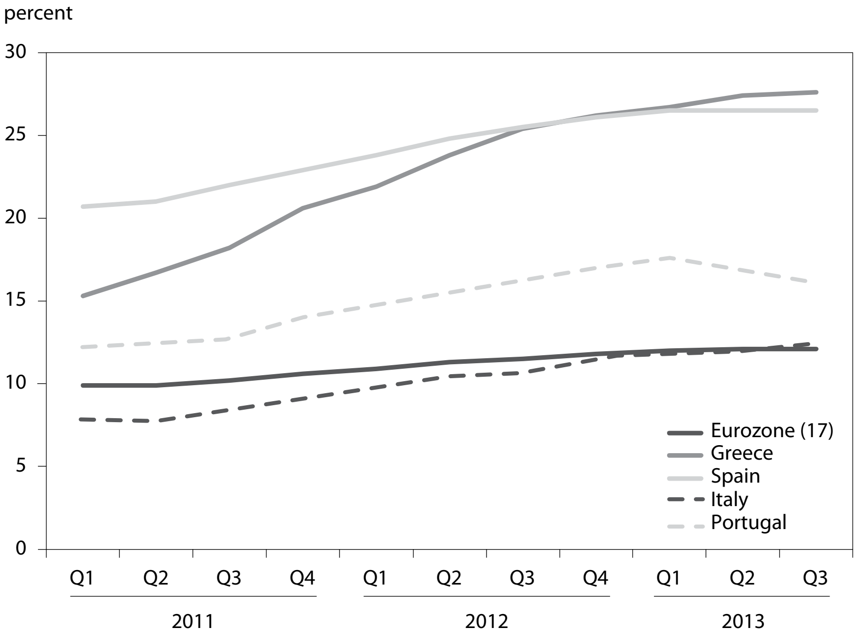
On June 27, 2012, the new Spanish government led by Mariano Rajoy finally requested financial assistance from the eurozone. The request was a long time coming. Since January, we had devoted time at every Ecofin meeting to discussing what assistance Spain would need and when it would be appropriate to request this assistance. Jean-Claude Juncker and Schäuble thought it should be done immediately, whereas Luis de Guindos argued that his government needed to wait until the summer so that it had a better idea of the financing needs of the banking sector. However, the social situation in Spain was deteriorating—action was needed now.

On July 11, thousands of coal miners converged on Madrid to protest the reduction in mining subsidies. Dozens were injured as demonstrators clashed with police. Later that day, Prime Minister Rajoy announced an austerity budget that included €65 billion ($90 billion) in additional spending cuts and tax increases. Spain's value-added tax was raised 3 points, to 21 percent, and unemployment insurance payments and government wages were slashed. By the end of the second quarter of 2012, the unemployment rate had reached 26 percent (figure 9.1).

On July 20, 2012, the eurozone finance ministers agreed to give Spain the financial assistance it needed for the recapitalization of the country's financial institutions. The discussion then moved to Ecofin. We agreed that the funds would be channeled to the financial institutions in the Spanish Fund for Orderly Bank Restructuring. That decision seemed to have a calming effect on the markets for a day or two, and then they began to slide again because of doubt that the Spanish bailout was large enough to cover the bad assets in the banking sector.

This kind of doubt arose regularly during the euro crisis. The agreed-on packages would always be smaller than the markets wanted, and each bailout announcement would calm the waters only a few days before another panic started. The other reason for this uncertainty was the lack of a fund large enough to cover possible future bailouts. For example, it was clear to Ecofin ministers that the money in the ESM would barely cover an earnest bailout of the Spanish banking sector, not to mention the Italian or French banking sector. And with no solution in sight for possible calamities in the near future, no single decision, no matter how well designed, could calm investors. They needed to hear that the eurozone would be saved as a whole.

Figure 9.1 Quarterly unemployment rate in the eurozone, 2011–13



Source: Eurostat, http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database (accessed on February 27, 2014).

By July 26, 2012, the crisis was getting out of control. That was when Mario Draghi, in the fifth tipping point in the crisis, announced that the ECB would do "whatever it takes" to keep the eurozone together. The markets gave a sigh of relief, and yields in the troubled European countries fell sharply. With Draghi's statement, investors became more comfortable buying bonds issued by the region's southern rim governments. Draghi's announcement was the single key act that saved the eurozone and changed the course of the crisis. Had he been more reticent, as Jean-Claude Trichet was before him, some eurozone members might have exited by the end of 2012. Draghi's determination made everyone more confident that the remaining issues could be resolved over time.

How much of this was Draghi's own doing and how much of it was a German decision (it was clear that Jörg Asmussen had a major role in it) I do not know. What I do know is that the ECB gained a lot of credibility and overnight became Europe's most trusted institution. This enhanced credibility would be useful later in the discussion of the banking union. And in my view, it explains why Ecofin shifted toward work on the banking union, thereby abandoning two years of effort on the fiscal union. For the banking union, it was clear who would play the major role—the ECB. That was another main turning point in the euro crisis.

Outright Monetary Transactions

On September 6, 2012, a month after Draghi's announcement, the ECB issued a description of the technical features of the Outright Monetary Transactions (OMT) program, which allowed unlimited bond purchases in secondary sovereign bond markets. Participation in the program was conditional on countries taking part in either a full European Financial Stability Facility (EFSF) program, a full ESM program, or a precautionary program. The OMT program applied to bonds with a maturity of one to three years.

The OMT program was similar to the quantitative easing programs of the US Federal Reserve. The Fed had implemented quantitative easing by buying financial assets from commercial banks and other private institutions, thereby increasing the monetary base. Brussels and Frankfurt had carefully watched the Fed programs since the launch of the first program in November 2008. Because that program was judged a success, the heads of state of the southern rim countries demanded a similar program in Europe. Apparently, however, the Fed's first program proved to be insufficient, and so it launched another round two years later, in November 2010. The second program began to raise doubts about diminished efficiency. Quantitative easing was presented as an unconventional tool for Fed policy. If it was continually needed, then it would become a standard monetary policy. But such a tool distorts market signals—for example, the interest rate becomes less meaningful. The launch of the Fed's third program of quantitative easing in September 2012, soon after Draghi's announcement, was not met with enthusiasm.

Sensing that the momentum had shifted, the European Commission decided to move quickly on other issues as well. At the next Ecofin meeting, in October, the financial transaction tax was put up for discussion again. An enhanced cooperation agreement, supported by 11 eurozone states representing more than 90 percent of eurozone GDP, was tabled. Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain signed the agreement, but Finland, an early supporter, did not. Domestic politics had shifted since the first debates in the summer of 2010, and the True Finns Party had managed to change public opinion. The tax was now seen as one on disciplined countries and transactions in their markets—that is, a handout of sorts to undisciplined countries. This view was most strongly and consistently voiced by Czech president Vaclav Klaus, who also pointed to the Swedish experience in 1983–91 as a deterrent. Still, the agreement was approved by the European Parliament in December 2012, with a new expected start date of January 2014. It would soon run into difficulties, however.

The ECB's decisive actions changed the markets' sentiment, but left the issue of the already bankrupt Spanish banks to Spain's government. Simply buying its bonds would not help because the share of nonperforming loans was too high. The government would have to step in and manage the assets. For this reason, on November 28, 2012, Spain agreed to the terms of a bailout.

According to the European Commission, the bailout would allow three lenders—BFA-Bankia, NCG Banco, and Catalunya Banc—to become viable in the long term without continued state support. Their balance sheets would be reduced by 60 percent by 2017. The fourth, Banco de Valencia, would be sold to CaixaBank and would cease to operate independently.

Steps toward a Banking Union

With the immediate danger of a meltdown in Spanish banks past, Jean-Claude Juncker and Mario Draghi turned to the issues remaining around the earlier proposals on a single banking supervisor. On December 17, 2012, at the last Ecofin meeting of the year, we struck a deal with member states on the structure of the new banking supervisory agency. The aim in setting up a supervisor was to tighten oversight of the eurozone's 6,000 banks and to prevent a repeat of the financial crises that had hit Cyprus, Greece, Ireland, and Spain. Non-euro-area members could also sign up. Under a deal reached by eurozone leaders in June 2011, once the supervisor was fully set up by mid-2014, the ESM could start directly recapitalizing regional banks. That could break the link between the sovereign and bank crises that some countries were facing.

Michel Barnier, the EU internal markets commissioner who pushed the proposal through Ecofin, declared that the deal was the first fundamental step toward a real banking union that would restore confidence in eurozone banks and ensure the solidity and reliability of the banking sector. In reality, though, it was a first small step. The two accompanying reforms—the creation of a restructuring fund and a deposit guarantee fund—were too contentious. But without these, the banking union could not function. Supervision could be guided by officials in Frankfurt, but who would follow up on their recommendations? A single supervisor without a common restructuring mechanism would mean that the burden of dealing with banking troubles would once again fall on the national authorities.

And yet even German finance minister Wolfgang Schäuble acknowledged that this was an important beginning. Just as the adoption of the Fiscal Compact was the foundation for a future fiscal union, the agreement on the single banking supervisor laid the foundation for a future banking union. Together with the existing, albeit imperfect, monetary union, Europe now had the parts it needed for a true economic union—something that had not been achieved in the previous decades of European integration.

There were some reasons for optimism. The year 2012 was better than the preceding one, something that had not seemed possible at the midyear mark. Still, Chancellor Merkel's New Year's address was the soberest yet. "I know that many are also heading into the new 2013 with trepidation. And indeed, the economic environment next year will not be easier, but more difficult. That should not discourage us, but—on the contrary—serve as an incentive." She went on to say that "the European sovereign debt crisis shows us how important this balance is. The reforms we have agreed to are beginning to take effect. But we still need a lot of patience. The crisis is far from over."[1]

After a brief pause in January 2013, bad news started coming in from Portugal. Portugal's woes had been discussed many times at Ecofin in previous months, so the bad news was no surprise. Still, many of us—including me—thought that the actions of the ECB would stave off a crisis in Portugal. But perhaps these actions came a bit too late for Portuguese banks. In early February, the Portuguese government bailed out Banco Internacional do Funchal SA (Banif), its third largest bank, to the tune of €1.1 billion ($1.5 billion). Unemployment in Portugal had reached 18 percent by the end of 2012, and 240,000 people had left the country over the previous two years in search of work and a better life—mostly young, highly educated people fleeing to Switzerland, Brazil, or the oil-rich former Portuguese colony of Angola.

With little new on offer from the ECB, Germany decided to push forward with the idea of a fiscal union. I say Germany because by the time François Hollande's government began to work on eurozone issues, the Franco-German duo had ceased to strive for all-eurozone solutions. Perhaps French and German policymakers were simply too tired to do it on their own, or perhaps they got the message that the rest of the eurozone and of Ecofin did not think highly of their two-step approach: France and Germany would make a decision, and then the rest of us would rubberstamp it. By late 2012, Germany was the only leader in the eurozone.

> The main problem which we politicians are facing is that the public debt crisis in the Eurozone makes people and investors lose confidence in Europe. They do not understand why decisions in Europe take so long. But this is a constitutional element of Europe: Europe is complicated, and if decisions are taken with democratic legitimation, they simply take time. And the longer the crisis in the Eurozone lasts, the more people question whether the euro is worth all the rescue efforts—in terms of painful reform programs conducted by countries in trouble and in terms of credits guaranteed by taxpayers' money of "solid" countries.

These were the words of Wolfgang Schäuble, Germany's finance minister, in his speech to the European Parliament in September 2012. By February 2013, the southern rim countries were much more sympathetic to the idea of a fiscal union for two reasons. First, Greece, Italy, Portugal, and Spain had new political leaders, and they saw a benefit in further integration. Second, the new finance ministers from these countries were better qualified to negotiate within Ecofin the text of a future fiscal union.

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1. Graeme Wearden, "Eurozone Live: Angela Merkel Warns Crisis Is 'Far from Over,'" *Guardian*, December 31, 2012.

Toward a Fiscal Union

The solution Schäuble proposed was pragmatic: build the fiscal union alongside the existing monetary union block by block. Three such blocks were built during my time as finance minister: the European semester, the Fiscal Compact, and the ESM.

European Semester

The European semester was a new procedure for coordinating national budgets within the European Union. It spanned the first six months of each year when, according to a timetable, member states would receive expert advice and then submit their national reform programs and stability or convergence programs for assessment in Brussels.

Member states also would receive individual recommendations on when to prepare their next year's budget, and, if necessary, recommendations on correcting macroeconomic imbalances. Countries that received financial assistance would not be required to submit stabilization programs or reviews on macroeconomic imbalances. They would only follow the prescribed measures in their adjustment programs.

The European semester focused on three types of policies: (1) structural reforms that brought about growth and employment; (2) fiscal reforms that were consistent with the goals of the Stability and Growth Pact; and (3) macroeconomic reforms that prevented a country from entering the macroeconomic imbalance procedure. The European semester had its roots in 2011, when an attempt was first made to coordinate the different policies using one procedure. Prior to 2011, countries had submitted their lists of reforms only after their national budgets were approved, and so the European Commission was unable to recommend any changes.

The recommendations arising from the European semester were published in the *Annual Growth Survey* (European Commission 2013b). In the March 2013 survey, for example, the European Council advised countries to focus on five goals: (1) pursuing growth-friendly fiscal consolidation; (2) restoring normal lending to the economy; (3) promoting competitiveness; (4) tackling unemployment and the social consequences of the crisis; and (5) modernizing public administration.

For the second goal, restoring normal lending to the economy, possible steps included promoting new sources of capital such as issuing corporate bonds and facilitating access to venture capital funds. Another measure was to reduce payment delays by the public administration. In June 2012, the European Union introduced a directive on late payments that limited them to 30 days. In the banking sector, suggestions included protecting vulnerable households from individual changes in mortgage conditions, thereby avoiding a foreclosure and using project bonds as instruments to fund large infrastructure and transport facilities. For municipal projects and transnational infrastructure projects, countries could use the instruments available at the European Investment Bank.

The measures the European Commission proposed for achieving the third goal—promoting competitiveness—were limiting the tax burden on low-skilled labor and introducing subsidies for hiring new workers, especially the long-term unemployed or low-skilled. The Commission also recommended simplifying labor legislation and developing flexible working hours. In linking education to market needs, proposals included reducing the number of early school leavers and facilitating transition from school to work through the development of traineeships (Germany's vocational training in high schools was cited as worthy of study). Yet another proposal introduced a "youth guarantee" that would ensure work or the continuation of education for all those under 25 years of age. It was pointed out that some of these initiatives could be financed by the European Social Fund.

Countries could choose the ways in which to achieve these goals; the Commission would track implementation. In 2011 the Netherlands proposed establishing the position of European commissioner for budgetary discipline who would control the budgets of the member states. Germany supported the idea, but France and the United Kingdom did not, and it was shelved.

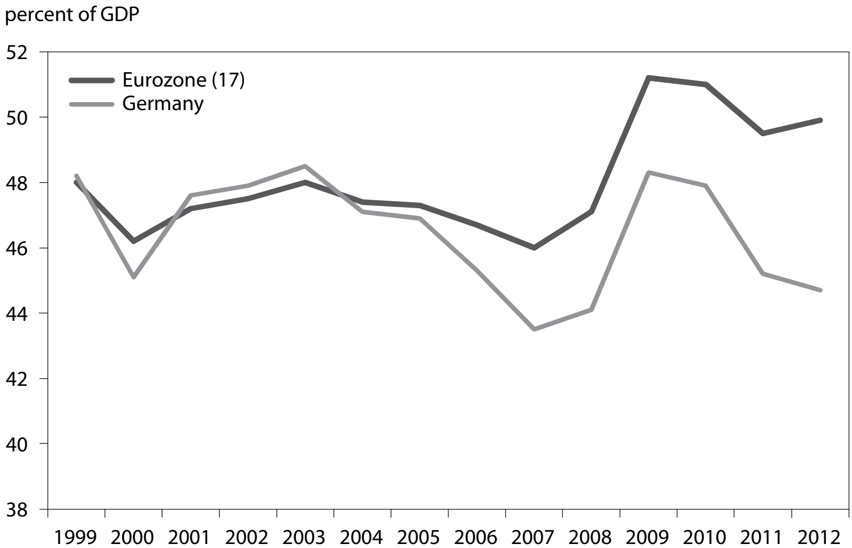
In January 2013, the idea resurfaced when the new head of the Eurogroup, Dutch finance minister Jeroen Dijsselbloem, announced that the European Commission would install a so-called European semester officer. The semester officer was intended to act as a watchdog over the national governments, without the status of commissioner.

Fiscal Compact

The second block was the Fiscal Compact. It is widely considered a symbol of German chancellor Angela Merkel's European austerity drive, but in fact it was not responsible for shaping fiscal policy in the eurozone. The Fiscal Compact treaty (formally, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) was approved on March 2, 2012, by 25 EU states and entered into force in January 2013. It included many aspects of EU legislation already in place. Ratification by at least 12 eurozone members was required for it to take effect. Finland was the last one to do so, in December 2012.

The Fiscal Compact drew on the "golden rule" that Germany had enacted in its constitution in July 2009. New Article 109 of the German Constitution, besides reaffirming the budgetary autonomy of the Federation and the Länder, stated the general rule: "The budgets of the Federation and the Länder shall in principle be balanced without revenue from credits. The Federation and Länder may introduce rules intended to take into account, symmetrically in times of upswing and downswing, the effects of market developments that deviate from normal conditions, as well as exceptions for natural disasters or unusual emergency situations beyond governmental control and substantially

Figure 9.2 Total government spending in the eurozone, 1999–2012



Source: Eurostat, http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database (accessed on February 27, 2014).

harmful to the state's financial capacity. For such exceptional regimes, a corresponding amortization plan must be adopted."

Such limits were useful at all times, but especially during crises when public spending in European countries typically increases. A longer-term trend of increasing expenditure was evident as well: Since introduction of the euro, 17 countries in the eurozone had seen government spending rise from €3.3 trillion ($4.6 trillion) to €4.7 trillion ($6.5 trillion) in current euros, or by nearly 40 percent. As a percentage of eurozone GDP, spending increased from 47 to 51 percent of GDP between 1999 and 2009 (figure 9.2).

And yet if one looked at Germany or Finland, the pattern was different. Between 2001 and 2010, government spending in Germany went up by 18.5 percent, from just over €1 trillion ($1.4 trillion) to €1.2 trillion ($1.7 trillion). As a result, the share of public expenditure to GDP remained roughly constant in Germany, despite the crisis and bank bailouts, aid to automakers, and wage increases for public employees. Government spending remained fairly high (48 percent of GDP), but in size it was the same share of GDP as it was in 2001. In Finland, spending actually decreased substantially as a share of GDP during the same period—by about 3 percentage points of GDP.

The data on Germany imply that in the rest of the eurozone without Germany public spending went up at a much faster pace, by 41.5 percent, between 2001 and 2010. This was an increase of 23 percentage points more than that in Germany. For that reason, Chancellor Merkel and Finance Minister

Box 9.1 New rules in the Fiscal Compact

First, eurozone member states had to commit to a budgetary position in "balance or in surplus." They further had to pass a national law or an amendment of the national constitution that would limit the structural budget deficit to 0.5 percent of GDP—a deviation was allowed only in "exceptional circumstances." This was similar to Article 115(2) of the German Constitution, which states that "[r]evenues and expenditures shall in principle be balanced without revenue from credits," and clarifies that "[t]his principle shall be satisfied when revenue obtained by the borrowing of funds does not exceed 0.35 percent in relation to the nominal [GDP]."

The treaty allowed for a transition period, but its length was not specified. For countries with a debt-to-GDP ratio "significantly below 60 percent of GDP," the structural budget deficit could be as high as 1 percent of GDP.

Second, a member state could bring another member state before the European Court of Justice if it believed that the other state had not fulfilled the treaty provisions calling for passing a national "debt brake" into national law. For states found guilty, the court could impose a fine of up to 0.1 percent of GDP.

Third, a new 1/20 rule allowed the opening of an excessive deficit procedure if countries with a debt-to-GDP ratio of more than 60 percent did not bring that ratio down quickly enough. The requirement was defined as an annual reduction of the debt ratio by 1/20th of the difference between the actual debt-to-GDP ratio and the 60 percent threshold. In addition, countries were given a three-year grace period after the correction of their current deficit below the 3 percent target before the 1/20 rule went into effect.

Schäuble insisted that the eurozone adopt the Fiscal Compact and its new rules (see box 9.1).

The new Fiscal Compact among the euro countries was supposed to make budget rules more binding by inserting them into laws and constitutions at the national level. But biased forecasts could defeat budget rules, as had been demonstrated repeatedly since the creation of the euro (Frankel and Schreger 2013). Penalties for inaccurate forecasts were considered during the discussions on the Fiscal Compact. In the end, however, this idea was dropped for two reasons. First, the forecasts were typically done by independent agencies and thus governments could not—at least directly—shoulder the blame. Second, the errors were typically found several years after the forecast was made, so fines could not be given on the spot.

Several governments quickly adopted the Fiscal Compact. The Spanish government rushed a constitutional amendment through its parliament that established a balanced budget requirement. New Article 135 of the Spanish Constitution, which was approved in less than two weeks and entered into force on September 27, 2011, affirms in its first two paragraphs that "all public administrations will conform their actions to the principle of budgetary stability. The State and the Autonomous Communities shall not incur a structural deficit that exceeds the standard established by the European Union."

Spain did, however, make the "golden rule" of a balanced budget subject to an exception clause. Article 135(4) states: "The limits of the structural deficit and of the volume of public debt can only be exceeded in cases of natural catastrophes, economic recession or situations of extraordinary emergency beyond the control of the State which considerably endanger the financial situation or the economic and social sustainability of the State, to be assessed by the absolute majority of the members of the Chamber of Deputies."

Italy quickly adopted the prescriptions of the Fiscal Compact as well. The Constitutional Revision Act was signed into law on April 20, 2012. New Article 81 states: "The State ensures the balance between revenue and expenditures in its budget, considering the upswings and the downswings of the economic cycle. The State can resort to the emission of debt only with the purpose to consider the effects of the economic cycle and, upon authorization of the two chambers of Parliament adopted at the absolute majority of its members, in cases of exceptional events."

France was not as eager to adopt the Fiscal Compact. During his election campaign in 2011, François Hollande vowed to renegotiate the compact. A year later, in September 2012, Hollande, now president, explained his longstanding opposition to a constitutional amendment: "I do not consider that a commitment that is obligatory for a few years should be written in stone in our texts." These words notwithstanding, France amended its organic budget law and submitted it to parliament for approval, together with the Fiscal Compact, the EU stimulus package, and the ESM. All were approved in November 2012.

The Fiscal Compact was considered to be a building block of a future fiscal union. "The fiscal compact . . . can create and can be a necessary pre-condition but it will not be sufficient in itself to save the euro," Chancellor Merkel said in a televised interview on June 7, 2012. It could be viewed as an expansion of the Stability and Growth Pact, but primarily focused on debt sustainability. By contrast, the Stability and Growth Pact primarily dealt with the deficit.

European Stability Mechanism

The third building block was the ESM, Europe's permanent bailout fund. It has capital reserves of €700 billion ($970 billion), with €80 billion ($111 billion) in paid-in capital and the rest used as needed. Germany, France, Italy, and Spain contribute the majority of the capital because of their large GDPs. These payments are made periodically.

The ESM itself was authorized to approve bailout deals of up to €500 billion ($693 billion) when all of the paid-in capital is received. In situations in which relying on the public sovereign debt markets is prohibitively expensive, eurozone countries can instead obtain funding through this mechanism at a lower and more stable interest rate. Only countries that agreed to the Fiscal Compact may access the funds.

The €500 billion ($693 billion) ESM was declared operational on October 8, 2012, in Luxembourg. The birth of the fund was eased by the ECB's offer in August 2012 to buy bonds of fiscally struggling countries. This drove down interest rates in Spain and Italy and bought European governments time to address the root causes of the crisis.

The ESM has some advantages over the EFSF. The fact that it was established by treaty gives it legal security relative to the EFSF. The fact that the ESM has paid-in capital, rather than relying, like the EFSF, on contingent guarantees to underpin its lending, also adds to its credibility.

European Monetary Fund

In early 2010, when the bailout for Greece was discussed, German politicians first raised the possibility of creating a European Monetary Fund, an expanded version of the ESM serviced by a wider pool of experts. At the time, they thought that more cooperation was preferable to accepting intervention from the IMF, an option not accepted by Greek prime minister Georgios Papandreou. Such a new fund was also endorsed by President Nicolas Sarkozy—his most potent domestic political rival, Dominique Strauss-Kahn, was at the time managing the IMF. Perhaps Sarkozy believed that the creation of the European Monetary Fund would reduce the power of the IMF.

As German leaders saw it, the European Monetary Fund could also serve as a vehicle for imposing tougher sanctions on eurozone countries that defied the limits on debt. "Accepting help from the IMF would be an admission that the euro countries don't have the strength to solve their own problems," Jean-Claude Juncker told *Welt am Sonntag* in September 2010.

The idea was first suggested by Daniel Gros at the Centre for European Policy Studies in Brussels and Thomas Mayer, the chief economist of the Deutsche Bank in London (Gros and Mayer 2010). They proposed creating a fund with the power to, among other things, lend money to ailing eurozone members or guarantee their bonds and impose sanctions such as cutting off other forms of aid. When a government was in imminent danger of default, the fund would have the power to issue replacement debt. But it would impose a so-called haircut on investors, who would receive only a fraction of the face value of government bonds.

"We have agreed to create the beginnings of a European Monetary Fund," Sarkozy boasted. The move to do so did indeed mean that the EFSF would increasingly resemble the Washington-based IMF. It would be allowed to grant preemptive lines of credit to countries under pressure on the financial markets. It would also be allowed to assist in the recapitalization of stricken banks. Even Chancellor Merkel, who had long been opposed to the idea of a European Monetary Fund, admitted that "one could draw such a comparison" to the IMF.

In 2012 France, Germany, Italy, and Spain were among the European countries that jointly prepared a document that proposed establishing a European

Monetary Fund and urged EU member states to give up some of their national sovereignty in order to increase their solidarity in crisis situations. The report, prepared by Austria, Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Portugal, and Spain, was sent to the European Commission, the ECB, the Eurogroup, and the European Council. The country concessions would include giving EU institutions the power to supervise national financial and budget policies, as well as ceding some autonomy to decide on economic policies related to the sustainability of the eurozone's economic and employment growth.

The ESM appeared to be a step toward a European Monetary Fund. However, it left several questions unanswered. First was its coverage. Jean-Claude Juncker had insisted that it be retroactive in cases of bank recapitalization. "There is a heavy question mark on the legacy from the past. Can the ESM recapitalize banks by retroactively applying the arrangements that it has, or must we limit the European mechanism's intervention to the new problems that arise? I have a personal point of view to express. I think we must ensure certain retroactivity for the mechanism; otherwise it loses a great part of its meaning."[2]

The issue was especially important for Ireland, which wanted the ESM to cover at least some of the huge debt overhang incurred when the government tried to save banks that were collapsing. It was relevant for Cyprus, Slovenia, and Spain as well. And perhaps over time for Italy.

The second question to be answered was the fund's size. From the outset, the Eurogroup and the IMF wanted a larger fund, as large as €750 billion ($1.04 trillion). The reason was the mounting banking problems in Spain, and the possibility, however remote, of having to aid Italy's banking sector. Germany balked at the need for a larger mechanism, but left open that possibility should the need arise. European Parliament president Martin Schulz, a Social Democrat from Germany, summarized the situation: "The euro backstop fund will be enlarged, whether Angela Merkel wants it or not. In the end, Angela Merkel is always prepared to take the necessary steps. But only in the end. It would be better if she were to take the necessary steps in the beginning."[3]

The establishment of the mechanism was met with stiff resistance from Germany, where many politicians believed they had already been asked to pay too much toward solving the debt crisis. A petition calling for creation of the ESM to be delayed until it was certain it would be subject to democratic control had attracted 37,000 signatures, and a German opposition party and conservative lawmaker had also filed complaints stating that the measure could be unconstitutional.

2. EPP TV, "Juncker Sees Difficult 2013, Backs More Flexible European Stability Mechanism," January 10, 2013.

3. Spiegel Online, "Juncker Piles on the Pressure: Merkel Stuck in the Euro Firewall Trap," February 29, 2012.

The German Constitutional Court in Karlsruhe overturned the challenges in September 2012 and ruled that the ESM could be signed into law. But it also imposed several restrictions. First, it set a maximum German contribution of €190 billion ($263 billion) that could not be raised without the approval of the government. Second, the ruling stated that there must be no unlimited liability. Chief Justice Andreas Vosskuhle declared, "The review has concluded that the laws that were challenged, with high probability, do not violate the constitution. Hence the motions for a temporary injunction were to be rejected."[4] The court also gave the go-ahead for a European fiscal treaty designed to force eurozone governments to exert budgetary discipline.

I am a supporter of a fiscal union in Europe; it may push the European Union into a true discussion of competitiveness. If member states were limited in their ability to adopt populist policies—that is, to spend money beyond their means—a focus on competitiveness would become necessary by default. Brussels, then, might decide to concern itself with productivity growth, something that has not been on the European agenda at all. So I view fiscal union as a path toward a more productive Europe. Various discussions with Jean-Claude Juncker, Wolfgang Schäuble, and Jörg Asmussen seemed to indicate that they had that idea in mind as well, but they did not disclose it for fear of further alienating the southern rim governments.

4. Matthew Sparkes, "German Constitutional Court Ratifies ESM with Conditions," *Telegraph*, September 12, 2012.