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## How a mini fiscal union could end instability

By Wolfgang Münchau  
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How do you square this one? Most economic historians and international economists I know believe a monetary union would fail unless it develops into a fiscal union. Yet, almost all political and legal experts who specialise in the European Union believe a fiscal union is Utopian. If both are right, a fiscal union is simultaneously necessary and impossible. And that would mean – again if both are right – that **the euro is doomed to fail**.

Of course, it is not clear that both are right. But we should not be surprised to find that investors, when confronted with such informed opinion, avoid the bond markets of peripheral Europe. This is a perfectly rational response to even minimal uncertainty. I am hearing accounts of wealthy families switching their entire savings portfolios into Swiss banks. A quiet bank-run is under way in large parts of the eurozone, not only in Ireland.

### EDITOR'S CHOICE

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The return of investor confidence requires clarity about the future of the euro and the future institutional set-up. This is why the debate about fiscal union is so important. I have yet to be convinced that any rules-based system, that obsesses with fiscal deficits and nothing else, can prevent private sector imbalances and financial instability. A well-constructed fiscal union, by contrast, could deal with the sources of instability. Here is how.

The key issue is not the size of a fiscal union but its content. A simple increase in the EU's budget, with lots of cash for research and development, motorways and environmental projects, would be counterproductive, creating resentment among net contributors and not dealing with the underlying problem. The latest **co-ordination proposals** by German chancellor Angela Merkel and French president Nicolas Sarkozy are of the same category. More tax harmonisation, or industrial policy co-operation, may solve their problem, but not those of a eurozone torn by internal imbalances. Any sensible fiscal union must deal with economic instability directly. Its three most important sources are the financial sector, asymmetric real economic shocks and a lack of incentives to avoid excessive and persistent current account imbalances.

So how could a fiscal union stabilise the financial sector? The UK economist Charles Goodhart once described banks as international in life, but national in death. I would make them European in death. We have a rather incomplete single market for financial services. Retail banking is more national than the military. Wholesale banking is genuinely cross-border. German and UK banks have crippling exposures to Ireland, French and German banks to Greece, Spanish banks to Portugal. If one peripheral country defaulted, we would see a contagious banking crisis that would overwhelm some governments' ability to cope.

So why not shift responsibility for all systemically relevant banks – not just the cross-border banks – to the EU? This would not only require EU-level regulation and supervision, but most importantly a liquid bail-out fund. One could, for example, extend the remit of the European financial stability facility. It is logical to deal with a crisis at the level it arises – and this is a cross-border crisis.

The second component would be a policy to address asymmetric shocks. Here, my proposal would be more modest. A short-term cyclical unemployment insurance system, covering, say, the first six months of unemployment, would help stabilise the eurozone economy after a sudden asymmetric shock. It would not necessarily replace national systems or include structural spending, except perhaps to boost cross-border labour mobility. Because of the six-month limit, the scheme would not benefit countries with persistently high unemployment. But it would protect countries against a sudden rise in unemployment. It would not cost much. Germany spends much less than 1 per cent of gross domestic product on its relatively generous short-term unemployment insurance. This scheme could be much leaner.

My third proposal would be a tax on excessive and persistent current account imbalances. Revenues could be used to co-finance the bank bail-out fund. The most important feature of such a tax is symmetry. It must target current account deficits and surpluses equally.

How much would the first two measures cost? This is hard to pin down, because we do not know the true scale of **the mess our banks are in**. The unemployment scheme could even be self-financing, in the form of a contributory insurance system.

If you start with those measures, you end up with a small fiscal union indeed. You could call it something else, if it makes you happier. This is all minimalist, pragmatic stuff. The purpose would be to end the crisis and protect against the next one. It would end the uncertainty of investors and savers, which has become a crisis propagator. Once you accept the idea of a small fiscal union, the idea of a common European bond is not strange any more, or the need to co-ordinate labour market policies. Crisis over. But if you think it is Utopian, then, frankly, so is the euro.

*Many thanks to readers for offering translations to überfordert, mentioned in last week's column. My favourite was "out of one's depth". It captures the hopelessness – though überfordert also implies that you cannot cope with a specific demand you are expected to fulfil*

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