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The impact of surging inflation:

The future of debt, money, and banking in the EU

Abstract

This paper sheds light on key topics pertaining to the future of debt, money, and banking from the EU from a liberal perspective. It consists of six sections. The first two sections deal with underlying factors behind the recent bout of inflation in the EU. While the first section finds them in the supply shocks that have recently buffeted EU economies, the second section provides a counterpoint and outlines the role of demand shocks. The third section summarises the previous findings and enumerates key lessons from the current crisis for both the ECB and EU policymakers in charge of structural and fiscal policies. Section four sketches the vision for the reform of fiscal rules in the EU and how to ensure better division of work between common monetary and national fiscal policies. Section five is focused on the role of the financial sector in ensuring dual goals of financial stability and growth. The roadmap for the reform of the banking union, as well as for the creation of the capital markets union is presented to the reader. This section also briefly touches upon the issue of financial innovation, with the concomitant trend of digital private currencies and pioneering efforts on behalf of central banks to introduce CBDCs. The final section concludes the analysis.

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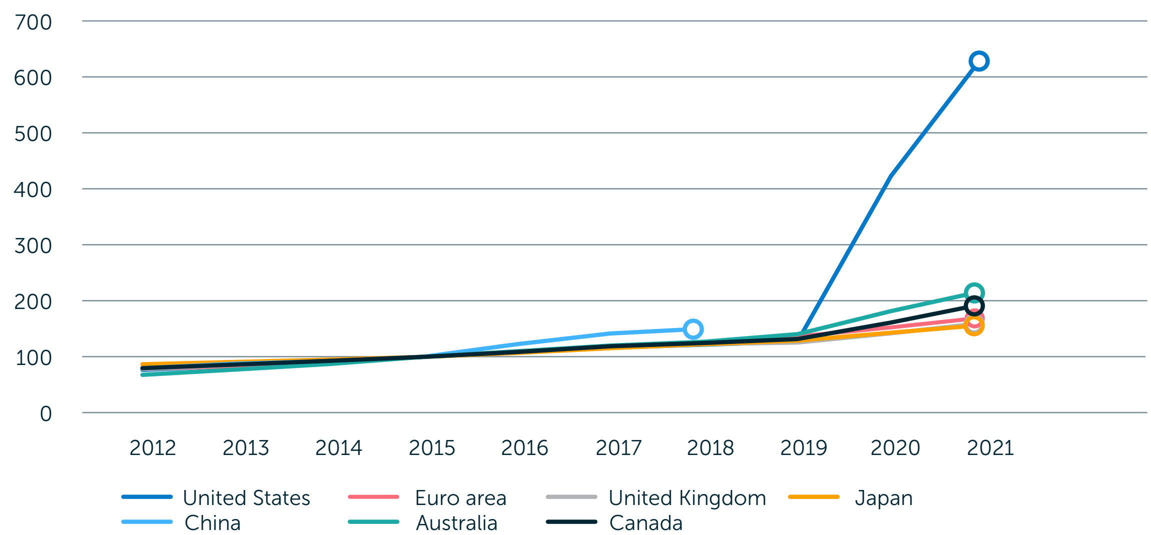
Underlying factors behind the recent bout of inflation: the role of supply shocks (I)

Soaring inflation in the global economy generally and in the Eurozone can be specifically attributed to both supply-side and demand-side shocks. There is certainly truth to the statement that the ECB's monetary policy could have been less expansionary in the wake of the pandemic-induced shock and that interest rate normalisation should have started much earlier. This will be the focus of the following section. However, the OECD's data on both narrow and broad money growth (i.e., M1 and M3) demonstrate that the Eurozone's spiralling inflation can't be first and foremost ascribed to monetary factors. *See Figure 1* and *Figure 2*.

Comparatively speaking, in the wake of the COVID-19 pandemic the US macroeconomic stabilisation policies played a far bigger role in overheating global demand. Correspondingly, the EU simply imported a large chunk of demand and supply side shocks as a small and open economy in the context of a much broader global economy. The growth of narrow and broad money in the US was both excessive and far higher than in the Eurozone and other major reserve currency issuers. Similarly, if we look at total non-financial sector debt statistics published by the Bank for International Settlements, we can see that the Eurozone's total non-financial sector leverage has not grown at a faster rate than in the US and China, while the same can be said for the average figure comprising all advanced economies (*Figure 3*). Moreover, the real estate prices also account for this difference in money growth trajectories of major currency blocks (*Figure 4*).

Figure 1

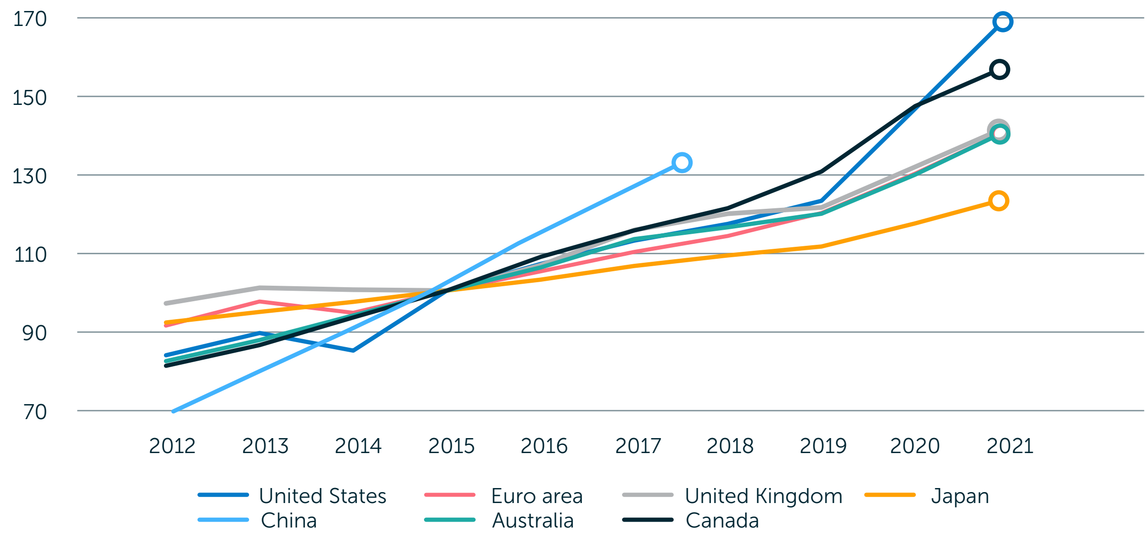
M1 Narrow money growth (2015=100)



Source: OECD (2022a)

Figure 2

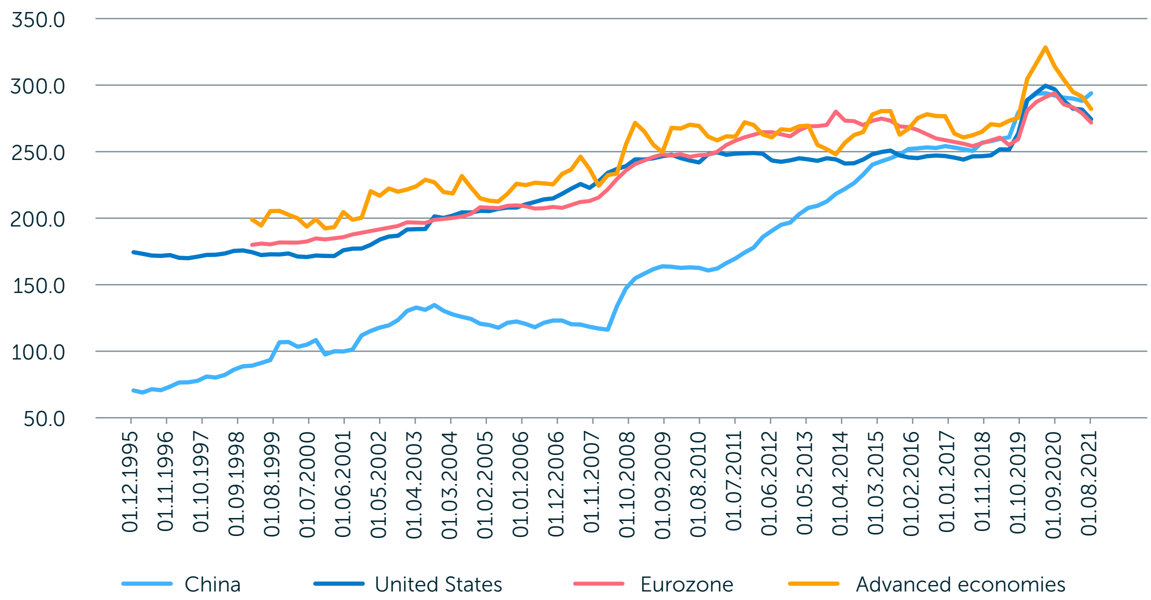
M3 Broad money growth (2015=100)



Source: OECD (2022b)

Figure 3

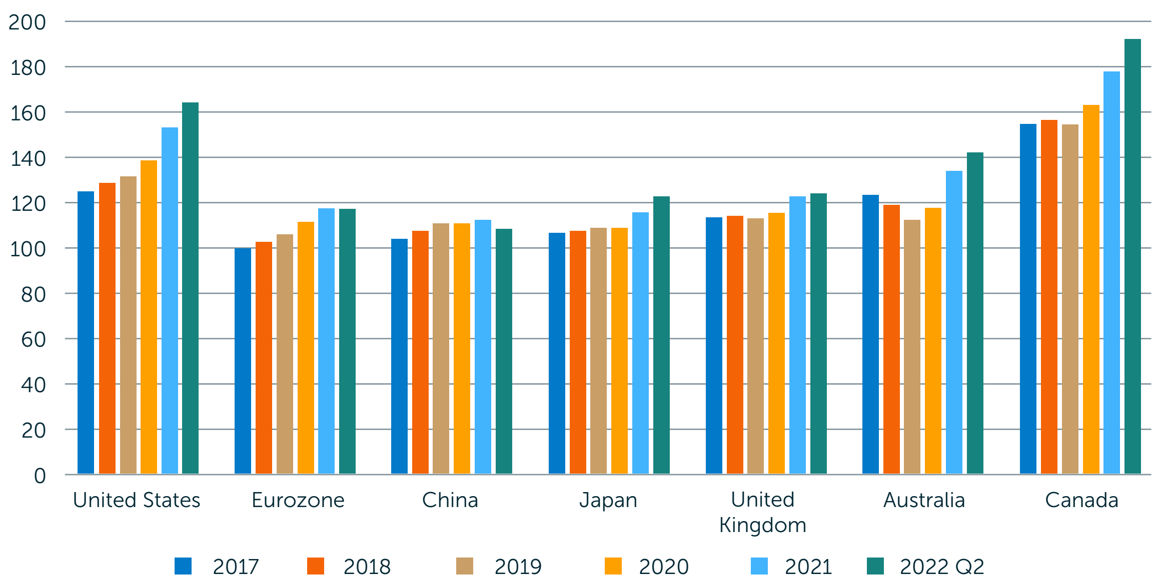
Total non-financial sector indebtedness (% GDP)



Source: Bank for International Settlements (2022b)

Figure 4

Real residential property prices (2015=100)



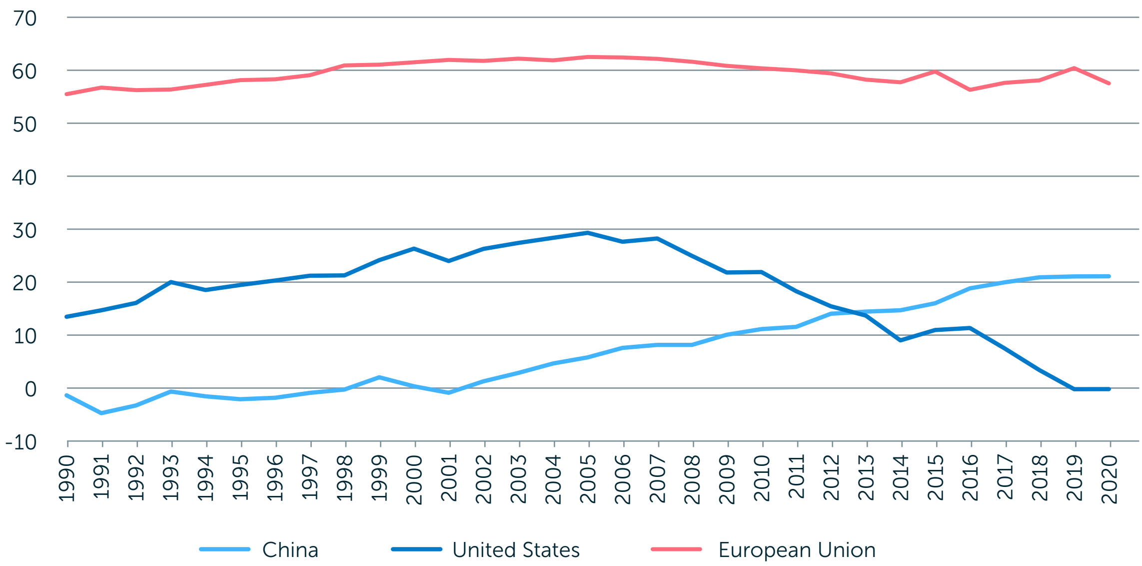
Source: Bank for International Settlement (2022a)

After taking into account the comparative monetary growth statistics, we can see that both the EU's and the Eurozone's inflationary woes have been significantly supply-driven. The role of external shocks such as the COVID-19 pandemic or the War in Ukraine has grown tremendously in the context of the rapidly changing global economy and decreasing global share of their respective GDPs. Although at first glance labelling the Eurozone as a small and open economy seems quite counterintuitive, the data speaks for itself.

The EU's energy import dependency is staggering, especially when compared to its slightly larger economic peers, the US and China (*Figure 5*). In comparison to China's rising dependency (albeit much lower than that of the EU), as well as to the US' progress in becoming a net exporter of energy over the past 15 years, the EU's dependency ratio has fluctuated in the very high range of 55-65% over past three decades. The situation has become especially precarious with regard to the supply of natural gas, whereby the dependency ratio surged from less than 50% in 1993 to almost 90% in 2019 (Eurostat Statistics Explained, 2022a).

Figure 5

Energy import dependency (%)



Source: World Development Indicators (2022a), International Energy Agency (2022) and Statista Research Department (2022a); author's calculation

Food dependency has been less of a challenge since the EU is still a net exporter of food (*Table 1*). However, escalating costs of energy imports have also heavily impacted the price of food for EU consumers. Another important cause of galloping prices is that approximately 85% of the EU's energy imports are paid in US dollars (Guarascio and Zhdannikov, 2019). Rising the US dollar exchange rate amidst FED's rapid rate hikes weakened the euro. And so, an additional large portion of inflation was imported through this channel.

Table 1

Food imports, exports, and net exports in billion USD (2021)

	Food imports	Food exports	Net exports
EU	581.4	729.3	147.9
USA	246.6	369.6	123
China	242.1	192.5	-49.6

Source: World Development Indicators (2022b; 2022c; 2022d and 2022e)

Previously stated claims largely explain the large difference in core inflation rate on both sides of the Atlantic. While the US headline and core inflation amounted to 7.75% and 3.02% in September 2022, the same figures for the Eurozone equalled 9.9% and 6.34% (Wolf, 2022). Therefore, 40% of the US headline inflation rate can be accounted for by costly food and energy items, while the share of these volatile items in the Eurozone's CPI climbs to 64%. This underlines the conclusion that inflation expectations in the Eurozone have not been completely de-anchored, but there are growing signs that they may do so in the absence of strong anti-inflationary policies designed by both the ECB and national policymakers.

Chapter 2.

Underlying factors behind the recent bout of inflation: the role of demand shocks (II)

The role of monetary policies in managing inflation comes primarily through demand creation and destruction via interest rate policy. It is important to note that this policy-lever has a certain time lag and does not deliver desired outcomes instantaneously. It normally takes 12-18 months to notice a reaction in key economic variables. In that sense, if the ECB had started rising interest rates in the fall of 2021, inflation would remain close to the levels recorded throughout 2022, since it was primarily supply-driven. Many misplaced lockdown policies undermined well-oiled supply chains, which were difficult to rejig once the worst of the pandemic passed (Šonje and Kotarski, 2021). Nevertheless, the delayed interest rate hikes, indicate that inflation might get out of control and grow persistently higher in the coming years.

In December 2021, in spite of optimistic growth forecasts for 2022, and with core inflation already surpassing 2.6%, the ECB's Governing Council refrained from implementing restrictive monetary policy (Darvas and Martins, 2022). Surprisingly, this course was taken at a time when the unemployment rate in economies that constituted 70% of the Eurozone's GDP was at equal or higher levels as compared to Q4 2019. Given this lack of action, one looks carefully into the ECB's very own overview of monetary policy strategy dating from the summer of 2021. Therein lies the statement: *The monetary analysis has shifted from its main role of detecting risks to price stability over medium to longer-term horizon toward a stronger emphasis on providing information for assessing monetary policy transmission. This shift in focus reflects a weakening link between monetary aggregates and inflation*...(European Central Bank, 2021).

Unfortunately, this complacency and misjudgment served as a useful academic justification for the continuation of the fiscal dominance regime, whereby the

ECB cannot or will not raise interest rates to neutralise national expansionary fiscal policies, or it simply supports low-interest rates on peripheral governments' bonds. E.g., during 2020 and 2021 the ECB bought more than 120% of net eurozone sovereign debt issuances (Buiter, 2022). Indeed, a staggering amount. Similarly, the newly announced Transmission Protection Instrument (TPI), which promises to narrow the disorderly spreads between German Bunds and peripheral bonds, risks turning the ECB into the Eurozone's ATM. Moreover, the steps undertaken via both the Pandemic Emergency Purchase Programme (PEPP) and Asset Purchase Programmes (APP) additionally amplified the long-existing trend of European states becoming a collateral factory for private finance. The bank-sovereign doom loop has thus been made even stronger, while at the same time it exposed the ECB to financial instability repercussions. As a willing participant, the ECB cornered itself and became the poster child for what is neatly termed as the *Zugzwang* central banking (Gabor, 2022). The ECB must make a move as a chess player, but each move potentially makes the situation worse. It must decide between rising rates, quantitative tightening, balance sheet reduction, and leaving rates unchanged while hoping the economic storm passes and admitting the current macroeconomic framework is broken. Unless the SGP is truly reformed to achieve a healthier balance between monetary and fiscal policymaking in the Economic and Monetary Union (EMU), the ECB will reach its brink and become either too dovish or too hawkish, both of which are undesirable.

Chapter 3.

Key lessons for policymakers from the current inflationary context

To improve the monetary policy transmission within the Eurozone and avoid major divergence in key macroeconomic indicators, it is vitally important to fix the structural component of the equation. The ECB's monetary policy must not fall hostage to structural and consequently fiscal problems of the member states. Besides making considerable progress in the standard list of governance-related issues within the reinvigorated European Semester, a special emphasis must be put on reforms promoting energy efficiency and renewable energy production. Streamlining and fast permitting nuclear and renewable energy production will meet two major goals for the future of European integration.[1] First, increased production of both nuclear and renewable energy, as well as less energy intensity in the production process for other goods and services will reduce vulnerability to external shocks. Overall, it will also signify lower import bills, as well as increased international competitiveness and higher living standards. There is no way for

[1] Among others, this will certainly encompass common sense spatial planning rules, streamlined judicial frameworks that allow maximum two legal appeals, and application of the principle of 'positive silence' to all renewable energy projects, etc.

the Eurozone and the rest of the EU to stay competitive and wealthy if the huge ongoing wealth transfer from energy importers to exports continues unabated. E.g., the EU's monthly average energy imports in 2021 were around €25 billion, while in the second quarter of 2022, this sum crossed the €60 billion threshold (Eurostat Statistics Explained, 2022b). Over the last ten years, both China and US have increased the share of renewables in the energy mix more rapidly than the EU, which brands itself as a leader in sustainability. In the 2012-2021 period the renewables share in the EU increased by 70.3%, China's share by 96.2%, and finally, the US share rose by 82.4% (calculation based on data provided by Richie, Roser, and Rosado, 2022).

Second, narrowing the gap in energy intensity of economic production between member states (especially between new members), as well as their widely diverging speeds of the energy transition, would help to synchronize their respective business cycles and make setting the appropriate policy rate for the whole monetary union much easier. RePowerEU needs to tackle existing institutional bottlenecks and enable the steady convergence of solar and wind energy production per capita within the EU. Harnessing the Wright law, stipulating that for every cumulative doubling of units produced costs will fall by a constant percentage, will be of key importance. Finally, nuclear power needs to be expanded to provide base-load electricity generation during wind lulls or cloudy days.

The renewed push to decrease the vulnerability of all member states to energy and geopolitical shocks will make the EU much more resilient. Also, the ECB's monetary policy shall become more effective. If the Eurozone is not able to introduce a fully-fledged banking union and potentially even some form of fiscal union, allowing for the euro to seriously rival the US dollar as a reserve currency, it can still defend itself from energy and currency volatility. This can be primarily achieved by decreasing energy import dependence. Furthermore, creating structural conditions that enable the ECB to match changes in US interest rates and to escape the global dollar financial cycle, reduces excessive exchange rate swings and their cascading effects. Structural changes, especially in the domain of energy markets can indeed go a long way toward improving the ECB's manoeuvring space in future crises. Consequently, it eases pressure on monetary policy to be the only game in town.

However, the economic heavy-lifting to be done on behalf of executive branches of EU member states should not serve as an excuse for the ECB to look away from its problems and start building a reinvigorated and stability-oriented monetary framework. This framework should set some quantitative anchor for broad money growth (Greenwood, 2022). The official target of a 2% annual rate of inflation cannot be ensured by double-digit rates of M3 growth as seen in 2020 and early 2021 (European Central Bank, 2022). Henceforth, this implies the return to 'economic and monetary analysis' tradition of the Bundesbank instead of totally committing to interest rate management (or adjusting policy to prevailing financial conditions). Exactly the latter approach creates the wrong set of incentives for the total level of debt in the economy, as rising stocks of debt increase the political power of debtors and create a vicious cycle of 'rising debt – financial instability – and more debt.'

To restore credibility, there is no alternative to continuing with moderate interest rate hikes until inflationary expectations are stabilised again. Precisely postponing this course of action will mean more unnecessary economic hardship in the future. However, this will need to be carefully calibrated to avoid hampering the EU's structural transformation. Financial stability is a precondition for price stability and in that light, the ECB must rethink its refinancing rates and collateral policies. Those policies and rates need to refrain from stimulating excessive and often wasteful investments in real estate (van 't Klooster, 2022). In contrast, targeted long-term refinancing operations (TLTRO) should make a greater emphasis on investments in energy efficiency and renewable energy production, as well as the role of commercial banks in facilitating this process.

Finally, the ECB's renewed monetary policy strategy should consider the new price stability anchor of 3% in a world permeated by structural challenges that put upward pressure on prices (Blanchard, 2022). The imminent threat of de-globalisation amidst growing geopolitical tensions, rising premiums on resiliency vs. efficiency, aging populations, and labour shortages will all contribute to elevated inflation in the coming years. In that context, it is better to set a realistic goal at the outset instead of constantly overshooting the previous ambition and jeopardising central bank credibility.

Chapter 4.

Reform of the existing SGP framework: ensuring improved monetary and fiscal policy coordination

Even before the global pandemic, the SGP framework suffered from overengineering. The rules and their application lacked predictability, consistency, and credibility. On the side of more fiscally frugal states, there was a tendency to fetishize the law, thereby making it a norm independent of facts on the ground and the prevailing political dynamic. In a similar and counterproductive vein, some fiscally profligate member states tended to subvert the rules, especially given their lack of ownership over fiscal adjustment paths. This political logic led to the common pool problem and stretched public finances too much after the overexploitation of the EU's collective debt-generation capacity.

Thus, reformed fiscal rules should be simpler and tied to credible incentives and sanctions, e.g., losing access to a portion of ESIF funds for offenders not willing to cooperate. They should ensure fiscal sustainability over the long term and contribute to much-needed investments into projects of common European interest. One way of giving this kind of spending a boost is to reconsider the German tradition of adherence to a golden rule - used in designing public budgets that permit structural deficits beyond the cycle and equivalent to net public investment. Looking at the green transition, the SGP could entail a green golden rule that excludes net green public investment from the deficit and debt calculations (Darvas and Wolff, 2022).

Medium-term or four-to-seven-year budget plans will inevitably lead to more political contestation of what counts as good investments contributing to debt reduction. However, the return of the healthy debate is more politically justified than simply fudging numbers (Sandbu, 2022). As previously mentioned, the approach also offers prospects for better coordination of public investments at the EU level. Since their change would require a Treaty revision, the existing 3% and 60% thresholds pertained to fiscal deficit and public debt-to-GDP ratios should remain in place. However, they must be reinforced by new examples of institutional flexibility and adaptation. In that regard the following considerations can be taken; setting annual net-expenditure ceilings as a replacement for opaque cyclically adjusted fiscal balance used by the current SGP, insisting on a country-specific approach that considers long-term growth potential, and finally, proposing an integrated framework which allows for interchangeability between short-term fiscal adjustment and combination of growth-enhancing structural reforms and public investments. (Blanchard, Sapir and Zettlemeyer, 2022). Nevertheless, a better definition of what constitutes a plausible reduction in public debt-to-GDP ratio and the obligatory introduction of national independent fiscal watchdogs as a powerful complement to the European Commission's role is also required. The latter bodies' role must be reduced to formally checking public accounts and their compliance with the agreed path of fiscal consolidation. They also need the capacity to question fiscal and structural policies for their future-proofness. Forward-looking governance is essential for tackling the polycrisis that the world is currently entangled in. Independent fiscal watchdogs are necessary for creating and ensuring such ample fiscal space.

The SGP also needs an update due to its blind insistence on upholding fiscal stability criteria for every single member state (horizontal coordination), while neglecting whether the EU's overall fiscal stance is at times pro-cyclical or anti-cyclical. Unfortunately, this approach focused on stability only in name but not in essence. Supplementing national fiscal policies with vertical coordination that allows for a very modest common counter-cyclical tool at the EU level would be useful in case of future asymmetric shocks to employment (Messori and Buti, 2022). The design mechanism which avoids the moral hazard would be a condition *sine qua non*, which is always a challenge. Nevertheless, irrespective of the potential of this tool, national policies are the best protection against fragmentation risk, as evidenced by a recent study of Italian politics (Sgaravatti, Tagliapietra and Zachmann, 2022). Bond spreads are predominately determined by the character of national governments.

The TPI outlined by the ECB sets atrocious fiscal incentives in place (Garicano, 2022). In the absence of clearly delineated and transparent criteria for establishing *unwarranted, disorderly market dynamics that poses a serious threat to the transmission of monetary policy across the euro area*, the ECB is cornered by its ingrained bias against debt restructuring. Instead of using the existing OMT

(Outright Monetary Transactions) facilities borne out by the Euro crisis, and applying conditionality on the receiving member state, the absence of strict criteria suppresses price discovery and valuable information. This lack of input into democratic policymaking ensures that holding politicians accountable to their electorate is next to impossible. Besides hardwiring moral hazard into national fiscal policies, this decision undermines momentum for the improvement of the euro's economic architecture, such as the completion of the banking union. Even worse, in its current guise, the TPI is burdened by redistributive steps lacking proper democratic deliberation and consent, confounding the role of fiscal and monetary policy.

Therefore, fiscal decentralisation serves as the bulwark against two unfeasible scenarios, both emerging fiscal dominance in the Eurozone and bureaucratic dominance in the EU. The latter comes with the attendant concentration of power and a problematic distance of power structures from EU citizens (Šonje, forthcoming). The most recent example of excessive fiscal expansion implemented by the United States serves as confirmation. Creating a fiscal union, side by side with a monetary union, especially in the case of weak central bureaucracy, does not automatically guarantee macroeconomic stability, especially if the EU falls victim to the misperception of being a large and closed economy. In that regard, fiscal stability can be better ensured in a mostly decentralised EMU. The feedback from the bond market has been reasonably accurate since institutional reforms were conducted between 2011-2014. This development can be ensured by setting the right incentives in place.

At the end of this section, it is also important to refer to the emerging lack of coordination between monetary and fiscal policy in the context of the ongoing energy and inflationary crises. Since the start of the energy crisis in September 2021, all EU member states have collectively earmarked €600.4 billion to alleviate the impact of the crisis on businesses and households. €264 billion, almost half this amount, was earmarked by Germany (Sgaravatti, Tagliapierta and Zachmann, 2022). While the role of fiscal policy in stabilising the impact of external shock has been indispensable so far, especially in the form of means-tested support for poor households, too much support has gone into measures such as fuel subsidies or outright price controls. It is quite inconsistent to simultaneously support renewables while spending on fossil fuels or artificially keeping their prices low. In sum, under the current inflationary landscape, common monetary and national fiscal policies started to work at cross-purposes. While the ECB has been timidly raising interest rates since this fall, almost two-thirds of member states earmarked equal to or more than 3% of their respective GDP on fiscal support measures. Unfortunately, Germany's figure of 7% seriously threatens the integrity of the Single Market. In summary, there is simply no space for 'whatever it takes' fiscal policy as seen during the pandemic. A more effective division of work between monetary and national fiscal policies (to avoid both monetary and fiscal dominance) has become a necessity if the future of EU integration is to be safeguarded.

Chapter 5.

Keeping financial stability and creating less debt-driven growth trajectory: the roadmap for the European Banking Union and Capital Market Union

Under these writings, the EU banking sector appears to be in reasonably strong shape. At the beginning of December 2021, the tier 1 capital ratio of banks in the EU spanned from the lowest ratio recorded in Greece (13.2%), up to the highest ratio as measured in Latvia (30.4%). For comparison, the median value amounts to 19.7% in Belgium (Statista Research Department, 2022b). Large European banks have an excess capital of more than €500 billion. However, those European banks' shares trade on an average valuation of 0.6 times their book value (Legras, 2022), suggesting that something is, in fact, unsound at the heart of EU banking.

An often-invoked explanation for this mess is the years of persistently low-interest rates. While true, there was not much of a market upbeat even after the ECB's gradual interest rate hikes, as shown by the STOXX Europe 600 Banks Index (MarketWatch, 2022). Indeed, there is a deep sense of uncertainty over the future direction of the EU's banking sector. Apart from sporadic and detrimental initiatives such as the planned introduction of windfall taxes on banks in Spain and the Czech Republic or the current attempt at dilution of global banking rules, already agreed upon in the form of Basel III (Legras, 2022; Noonan, 2022), the much bigger elephant in the room is the future shape of the banking and capital market union. There is no alternative to the comprehensive reform of the existing banking union.

There are three notable proposals for reforms, which differ in their level of ambition (Beck et al., 2022). First, incremental reforms would expand the Single Resolution Mechanism (SRM) to all EU banks, not only 100+ biggest banks in size. This move cuts the possibility for national bailouts via national insolvency regimes and puts private liability in place of implicit government guarantees. It would also encourage a level-playing field and prevent Single Market distortion. Better data sharing between banks, the SRM, and the wider public are also of utmost importance. As opposed to the current pressure to water down loan loss provisions, the revamped banking union skeleton must also enhance the loss absorption capacity of bail-in capital, minimising the risk to expose uninsured depositors to potential losses.

Second, the most important part of banking union reform is to sever the bank-sovereign doom loop. The extent of the problem is illustrated by the statistic that 75% of the bank's sovereign exposure is booked at amortised exposure. In other words, the decline in bonds' value does not translate into their profit and loss account and does not impact supervisory capital (Resti, 2022). Precarious situations like this can be dealt with by relying on the following mix of reforms: merging national deposit guarantee systems into a single mandatory entity based on a two-tier waterfall loss absorption capacity (both the at national and the EU level), applying sovereign concentration charges for banks holding bonds to eliminate manipulation with zero risk-weights, to drastically reduce incentives by states to come to the rescue to particular nationally based banks and, finally, creating a common fiscal backstop for the SRB to address potential tail-risks, besides already counting on the aid offered by the ESM (European Stability Mechanism).

Third, the most future-oriented and most difficult to implement reforms (Treaty changes) are aimed at creating a single banking market. They encompass: the single system of bank taxation, the incorporation of large banks at the EU level (which discards the narrative of national banking champions), the single system for corporate and personal insolvency, and the single framework for housing and mortgage finance.

In conjunction with the reformed banking union, the EU also needs a leap into the capital market union. We need to make equity financing sexy again. This approach offers numerous advantages over the current situation, whereby the EU banking sector's assets are at least two times the size of its GDP, a ratio that is higher than that of the US. This means equity should play a much bigger role in financing aggregate demand as opposed to debt. Equity financing would tackle rigidities and the potential disruption of default and bankruptcy processes, as well as prevent local thinking or myopia on behalf of investors blinded by fixed-debt contracts (Kotarski, 2021).

There are two important steps on this journey. First, the EU needs to end the existing tax bias towards debt financing that not only increases systemic risk but also distorts the capital structure of companies and offers possibilities for profit-shifting via a transfer of debt. Further, equity financing is still not on equal footing due to the existing preference offered by the tax deductibility of interest payments on debt. Furthermore, regulatory frameworks for pension funds and life insurance funds should also be adapted to this new reality. Second, harmonising rules that allow for an easier cross-border flow of equity would provide precious financing to various promising enterprises and allow for new rounds of recapitalisation.

In addition, reinforcing the edifice of the banking union and building the capital market union from scratch, it is impossible not to say a couple of words about the future of finance and how to cope with it. If one considers that the EU should strive for a realistic goal of the European banking ecosystem nurturing inter- and intra-sector collaboration that takes place in a safeguarded sandbox environment for innovation, as a good balance between stability, innovation, and competition. Fintech can find its space, but the regulatory framework needs to protect traditional banks as providers of vital infrastructure (Deloitte Deutschland, 2022).

When it comes to issuing a digital euro, things are not as straightforward as they seem. Policymakers face a fundamental trilemma: to have a digital currency, to ensure the confidentiality of transactions, and to keep financial stability (Eichengreen, 2022). There is no easy way around sacrificing some of the options, at least partially, while prioritising the others. It is therefore commendable that the ECB is threading slowly with the digital euro introduction to avoid disintermediating banks and to prevent the digital euro from becoming a form of investment, rather than just a means of payment (Panetta, 2022). Quantitative limits on individual holdings seem inescapable. Ticking all the boxes is essential for upholding EU-wide financial stability. Yes, issuing the digital euro will enable the ECB to provide an anchor to the monetary system, aligned with cryptocurrency expansion and other central bank digital currencies (CBDC). However, it is more important to ensure effective long-term change, rather than being first to the finish line.

Chapter 6.

Conclusion

External shocks such as the COVID-19 pandemic and the War in Ukraine have put immense pressure on the EU's ability to adapt its macroeconomic framework to changing circumstances. The analysis offered in this paper demonstrates that the current bout of inflation is both demand-side and supply-side driven. In reality, the EU is a small and open economy in the context of a much bigger global economy. However, the Union is confronted with a major task to reduce its vulnerability to external shocks, especially energy shocks. Besides the environmental benefits stemming from the green transition, the gains are also macroeconomic. Less asymmetric economic and energy structures of member states shall enable the ECB to enjoy more credibility and focus its attention on keeping prices stable, true to its original mandate. On the demand side, the ECB's monetary policy must escape the fiscal dominance trap and establish a robust framework for managing broad money growth. It is easily forgotten that there is an empirical link between inflation figures and broad money growth, even though it might sometimes come with a lag in our globalised world.

On the fiscal side, this paper gives an overview of reforms required to return to strong fiscal rules embodied in the new SGP. Those rules must be simple, predictable, credible, and growth-oriented. National ownership over fiscal consolidation plans and a multi-annual approach are important. A less technocratic approach is laudable, but credible sanctions for opportunistic behaviour must be in place. Smarter structural reforms and less moral hazard shall reduce political tensions between countries that are net recipients and net payers to the EU budget, safeguarding the political goodwill for further integration steps in the future. There is no way the EU can endure crises and prosper unless the issue of fiscal dominance is seriously addressed. The central bank is indeed the last resort broker in times of crisis. Nevertheless, it should never accept to be at the hands of the schemes of fiscal policymakers. And so, the ECB can play an important stabilisation role within a mostly decentralised EMU but must stay away from redistribution conflicts.

The third leg of the stool to ensure economic stability and prosperity is the role of macroprudential policy in tackling systemic risks and increasing resilience of the financial system. One cannot envisage an instance of a strong EU banking union without the suspension of the current bank-sovereign doom loop. The main tools are the European Deposit Insurance Scheme (EDIS), more loss-absorption capacity on the part of banks via bail-in-able financial instruments, and the coherent implementation of bank resolutions across all member states. While the banking sector shall remain the main source of financing for European businesses, households, and states, more emphasis must be put on developing and fostering capital markets. Less debt-financed growth will be a boom for the European economy, but the harmonised institutional set-up is a prerequisite to arrive at that point.

The EU desperately needs a new macroeconomic framework for a myriad of crises that descended onto the European continent. The founding father of European integration, Jean Monnet, once quipped: *Europe will be forged in crisis, and will be the sum of the solutions adopted for those crises*. While there is still no widespread federalist sentiment among the EU citizens, and there might never be one, the recent crises show that citizens increasingly prefer joint EU action over self-reliance in many areas. Thus, there is a demand for EU public goods and stability furnished by the common EU macroeconomic framework. Let us hope these findings will spearhead and galvanise policymakers to move steadfastly in the right direction, for the sake of past, present, and future European generations.

About ELF

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