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THE OPTIONS FOR A TRUE ECONOMIC AND MONETARY UNION
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Scheme of the presentation

I. **What do we need from a fiscal union?**
   a. **Optimal vs. satisfying fiscal set-up**
   b. **To complement monetary and banking union or wider?**
   c. **The role of other mutualisation mechanisms**
   d. **Control/direction of national budgets or federal budget?**

II. **What do we have in terms of fiscal union?**
   a. **Fiscal Compact, European Semester and all that**
   b. **ESM**
   c. **Eurosystem lending**

III. **What is the difference between what we have and what we need and how do we fill it?**
   a. **More control and guidance on national budgets?**
   b. **Federal budget?**
   c. **What about Eurobonds?**
   d. **What about political feasibility?**

IV. **Conclusions**

I. What do we need from a fiscal union?

There are as many reasons to desire a fiscal union as there are different types of fiscal union. Given this range of options it is useful to start with some kind of taxonomy and definition of what kind of fiscal union, for which purpose we should pursue.

a. Optimal vs. satisfying fiscal set-up

A first answer we should give to identify which type of fiscal union we should pursue is whether we are looking for an optimal fiscal set-up, something that would maximize some general objective, such as the welfare of the euro area citizens, or whether we are aiming at something more modest, something that would just be satisfactory, in the sense of being sustainable and not producing damages.

In a way, this distinction is in the same vein as something that is written in the EU Treaty. When this talks about the "broad guidelines of the economic policies of the Member States and of the Union" to contribute "to the achievement of the objectives of the Union, as defined in Article 3 of the Treaty on European Union" it does so in an optimizing mode: the objectives in article 3 define what is the "economic welfare" of the Union`s citizens and the broad guidelines are one tool to pursue this general aim. However, when the Treaty says that: "The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States

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with a view to identifying gross errors" we are clearly in a satisfying mode, the purpose is not to pursue optimality but to avoid damages.

In making the choice between an "optimization" and a "satisfying" mode we have to deal with a difficult trade-off. On one hand, why should we aim at anything short of optimum? Do not the citizens of the Union deserve it? On the other hand, we should be realistic and not pursue an objective we cannot under any plausible circumstance and within any foreseeable time horizon achieve. The way to solve this dilemma is to think that the two modes should be pursued in sequence: first satisfying, then optimizing. According to this approach, one can deal with the process in phases.

My own sense is that it is most fruitful to pursue, for the time being, a satisfying approach: we are far enough from it that just pursuing it would be at the same time difficult and rewarding. In addition, Bergsten and Kirkegaard have argued, convincingly in my view, that the essence of the European construction is the cession of sovereignty that, at any point in time, is the minimum necessary to sustain progress towards the Union.

b. To complement monetary and banking union or wider?

A second question to be asked, which is in a way a specialization of the previous one, is whether we should try to build the kind of fiscal union that would just remedy the design limitations of the Maastricht Treaty, which built a perfect monetary union with only an embryo of fiscal union and not even a beginning of banking union, or should we pursue a fully fledged fiscal union, which would allow the Union to target the triad of fiscal objectives: efficiency, stability and equity? Do we want, specifically, to enter into a discussion on the economic and political rationale of Robin Hood transfers, from rich to poor regions?

In analogy with the previous point, and for similar reasons, I would concentrate efforts on doing what is necessary to complement monetary union. If we do this, fiscal union should fulfil three basic functions:

1. Avoiding national budgetary mistakes (risk reduction),
2. Mutualisation of idiosyncratic shocks (risk sharing),
3. Providing "ultima ratio" back stops for the consequences of banking union[2].

Let me cover these three points in turn.

Already during the preparation of the Maastricht Treaty it was clear that there is a risk that national budgetary policies cause significant negative externalities for countries tied by a single currency. The question was what to do about this risk, with some asking for stronger protection against national "errors", while others not willing to go very far in that direction. With hindsight, the crisis showed that the protection eventually chosen was not strong enough, but this does not mean that it was a mistake not to foresee stronger measures: one can make the point that monetary union would have never come if one would have insisted going all the way in building protections against national errors before embarking in monetary union instead of waiting, as it indeed happened, to remedy the limitations when this would have manifested itself.

[2] This the same choice made by the IMF: *"this paper analyses the critical gaps in EMU architecture exposed by the crisis, derives from that the minimal elements of a fiscal union to address them, and discusses the immediate priorities in the current crisis context."* However the IMF paper on fiscal union has a longer list of needed functions: 1. Better oversight and stronger incentives for sound fiscal policies; 2. Some system of temporary transfers or joint provision of common public goods or services; 3. Credible European backstop for banks; 4. Some form of common borrowing.

The point about mutualisation of exogenous shocks, or risk sharing, derives from one of the strong criticisms of monetary union in Europe, based on the "traditional" Optimal Currency Area theory. The idea here is that, once one loses the exchange rate as a tool to offset idiosyncratic shocks because of the common currency, another tool must be found for this purpose. In the US this function is provided by federal fiscal transfers, credit and financial integration and internal migration. In the EU there are no similar tools as migration and credit and financial integration, as I will mention in a moment, do not have the potency they have in the US while the EU budget is too small and has no elasticity to cyclical fluctuations to offset shocks. It is important to recall here that any budgetary tool to offset shocks should not lead to permanent transfers from one country to the other. It is reassuring that the insurance approach studied by Enderlein and others as well as the rainy fund examined by the IMF do not lead, in the simulations carried out, to permanent transfers as there, is over the long run, sufficient ebbing and flowing of national fortunes to avoid that one country is always on the supporting side and another always on the supported side.

The third necessary function of fiscal union, which was, in a sense, discovered only recently, is to provide a backstop of last resort when a bank lacks capital. Of course, in the waterfall that follows the discovery of a capital gap, EU money should be the last one to be tapped. First would come private money, in the form of equity capital from the private sector, then bailing-in funds (junior bonds, senior bonds, unsecured deposits), then national budget and at the end the EU budget. Still, one has to foresee the possibility that, in some cases, one would need to have recourse to the EU budget to avoid the negative consequences that a disorderly bank bankruptcy would have

e. **Role of other mutualisation mechanisms**

When thinking about a fiscal set-up for the EU that would fulfil the function of mutualizing idiosyncratic shocks, one has to take into account that, as mentioned above, there are other mechanisms that can, at least to some extent, carry out this function:

i. financial and credit market integration,
ii. migration flows.

The strengths of these two mechanisms has arguably changed during the crisis, the former has lost it, the latter has gained it.

The hope that financial integration could give a substantial contribution to the mutualisation of idiosyncratic shocks was justified before the crisis, as the European financial system was integrating quite significantly. However, the losses in terms of integration caused by the crisis, just when the shocks drastically increased, reduced the effectiveness of this tool when it was most needed. The doom loop between banks and their sovereign is a specific aspect of market fragmentation caused by the crisis and witnesses of the impaired ability of financial and credit markets to offset idiosyncratic shocks.

Migration flows are traditionally considered of minor importance in the euro area, as there are too large costs, including in language and qualification terms as well as pension portability, to move around Europe looking for better employment opportunities. Anecdotal evidence shows that this may have changed at the margin during the crisis, but probably remains a factor with insignificant macroeconomic relevance when one only considers the "natives". It can become more significant if one considers the migration flows from outside the euro area. In the EU currently about 10% of the population (not far from the 13% prevailing in the US) is made from non-natives and it is plausible that the individuals composing this sizable share of the population are more mobile than the natives. In addition, new migrants will tend to go where there are better employment opportunities, thus exercising some kind of offsetting mechanism.

I am not aware, however, of an overall measurement of the part of the mutualisation work that is done by migration flows, when also taking into account the mobility of non-natives. While it would be useful to have a more precise measurement here, the fact that the IMF paper devotes only a passing reference to this aspect can be taken as an indirect sign that the buffering power of migration is low, even taking into account extra-euro area migration flows. This is not to deny that liberal immigration policies are essential and that the long-term economic welfare of a country depends more on its immigration policies than on its monetary policy. But this is the subject of another speech.

As regards the financial market, the IMF estimates that the insurance through the capital market is very small in the euro area while that through the credit market is somewhat larger but still insufficient to buffer shocks to the same extent as in other federations like Canada, the US or Germany. The end result is that (also thanks to fiscal transfers) some 80 per cent of shocks are offset in these federations, while the percentage is half that in the euro area.

My sense, consistent with my reading of the IMF and the Enderlein paper[3], is that the contribution of migration and financial integration is significant but not large. Of course, once Banking Union will have been achieved, the financial system overall will be able to better offset idiosyncratic shocks. Full banking Union, however, including single supervision, single resolution and common deposit guarantee is not here as yet and, also when implemented, its ability to mutualize shocks should bot be exaggerated. I venture a guess: if total mutualisation, meant as a zero coefficient of consumption to GDP movements, is 100, in the €-area the overall mutualisation power of financial and credit market integration and immigration will be less than 60% also when Banking Union will have been achieved. Right now it may not be more than the 40% estimated by the IMF for credit and financial market integration. So, even if the 100 is an unattainable theoretical maximum, there remains a lot to be done by the fiscal set-up. At the end I agree, also on the basis of the experience during the crisis, with Pisani-Ferry, Virhiala and Wolff and Enderlein that a monetary union requires some form of budgetary approach for fiscal stabilisation in case of shocks and as a backstop to the banking union

d. Control/direction of national budgets or federal budget?

When it comes to defining a fiscal union by its tools instead of its purposes, the main distinction is between a European fiscal set-up that disciplines, controls and directs national budgets and one which builds a macro-economically relevant EU, or rather €-area, federal budget.

Among the proposals of Pisani-Ferry and others, a federal budget with unemployment and corporate taxes shifted to euro-area level and a support scheme based on deviations from potential output as well as the CSI (Cyclical Shock Insurance mechanism) of Enderlein[4] and others would belong to the second category. The proposal, instead, to build an insurance scheme whereby governments would issue bonds indexed to GDP belongs more to the second one while the scheme

[3] *"We can therefore assume that factor mobility alone is unlikely to achieve desirable levels of cyclical stabilization. Instead, governments will still have to take on a major role in macroeconomic stabilization even after banking union will be completed."*

[4] The two schemes are analogous but differ in a number of ways. For instance the scheme of Enderlein generates payments proportional tot he deviation of one country´s output tot he aggregate €-area deviation. The proposal of Pisani-Ferry and others, instead, scales them tot he absolute deviation, to avoid a country in recession having to transfer funds to a country that is in a graver recession. A drawback of the Pisani-Ferry and other papers is that it is not balanced year after year but also, if well calibrated, over an entire business cycle.

in which access to jointly guaranteed borrowing is combined with gradual withdrawal of fiscal sovereignty would be something of an hybrid between the two types.

While it is useful to distinguish the two types of fiscal union, it should be recognised that there are interactions between the two. Henning and Kessler, drawing from the historical experience of the United States, stress that there is a need for consistency between national and federal set-ups. Specifically they write that: "*we believe that creating stringent state-level debt brakes in Europe without a capacity for countercyclical stabilisation [at federal level] would be a serious mistake."* Pisani-Ferry commenting on this point observes that, *"as the authors point out, it may seem obvious to recall that states in the US can abide by strict budget balance rules to the extent the federal government is responsible for stabilisation and the bail-out of insolvent banks, but this simple lesson is sometimes overlooked in European discussions"*.

One can put the two types of fiscal union (control of national budgets or federal approach) on a trade-off between effectiveness and political realism. Any set-up requiring controlling and guiding national actions necessarily relies on a degree of compliance and willingness to enforce the rules by member states. This weakness was clearly manifested when France and Germany refused to comply with the Growth and Stability Pact and thus substantially weakened its force. The manoeuvre of a macroeconomic relevant federal budget, instead, does not have this vulnerability, as its effects are direct. There is some analogy here to the difference between directives and regulations: the former ones have to be translated into national legislation, the latter are directly applicable. However, the political bar to achieve a macro-economically relevant federal budget is clearly higher, as demonstrated by the very difficult recent negotiations on the budget of the EU, which have not increased but, if anything, decreased its size.

II. What do we have in terms of fiscal union?

a. Fiscal Compact, European Semester and all that

As shown in the table below we have now an assortment of acronyms and underlying pieces of EU legislation that try and remedy the weaknesses of the Growth and Stability pact.

In my view, the main innovations in this host of legislation with respect to the Growth and Stability Pact are the following:

1. The role of the Commission in assessing budgetary developments is substantially increased,
2. The commitment to fiscal prudence is now enshrined into national legislation, often of constitutional nature,
3. The community procedures kick in before a country fixes its budget plans not only after they have been implemented and the actual developments are recorded by statistical offices,
4. Countries commit to implement structural reforms and the delivery of such reforms is subject to a check by Community instances.
5. The obligations to correct imbalances are operationalized in much greater detail and regularly checked.

All these pieces of legislation belong to the category of "control and guidance" of national budgets but they promise to be more effective than the Growth and Stability Pact. Yet one cannot be totally assured that they will work as required. At the end, the tension between member states that still long for their untrammelled sovereignty (against all evidence I would say) and the apparatus of EU legislation may produce undesired results.

b. ESM

The categorization of the ESM (and before it of the EFSF) in the category of a federal budget is not obvious. Not obvious for institutional reasons, because the ESM is an intergovernmental creature and not a genuinely federal one. Not obvious for economic reasons, because the ESM does not have the nature of a budget financed by taxes. In addition, the ESM and the EFSF were created ex-post to deal with the crisis and not ex-ante as an insurance mechanism[5]. Yet, I am tempted by this definition, if we take it with some liberty. There is no question, in fact, that the ESM uses public money that, although indirectly, is covered by taxpayer resources. There is no doubt, either, that that public money is used on the basis of political choices: helping Spain deal with its bank, possibly providing additional help to Greece, Portugal and Ireland, serving as an ultimate backstop for the Asset Quality Review and the Stress Test that the ECB is about to start. Indeed any time there is a mention of the need for EU or €-area money, there is a reference to the ESM. This is also somewhat in analogy to the fiscal budget, which in some quarters is seen as an inexhaustible source of money.

It should also be recognised that in the ESM/EFSF set up there is an element of common bond issuance as the responsibility of each member state is higher than its share in the borrowing (as the total capital is 700 billion, about 7.5 per cent of €-area GNP, while the maximum lending capacity is 500 billion), while remaining well short of a joint and several responsibility. Finally, it is worthwhile recalling that there is some ambiguity in the ESM construction between an insurance and a burden sharing mechanism. While in principle it should be an insurance mechanism, in the sense that it should mutualize future exogenous risks, in practice it has taken some aspects of a burden sharing mechanism, as it “insures” after the fact, i.e. against a risk that has already taken place, as noted by the IMF and others. In fact when lending money to Spain for the recapitalization of its banks and, even more, when admitting that, in special circumstances, the ESM could directly recapitalize banks, we are no longer in the insurance business but in the burden sharing one.

c. Eurosystem lending

If putting the ESM in the category of federal budget is controversial, putting Eurosystem lending in that category is close to heretical. I am myself uneasy doing this, as I value a lot the distinction between monetary and fiscal policy and am convinced that the ECB has remained faithful to its monetary policy function during the crisis. Yet one can not deny that the very large lending by the Eurosystem, in particular to banks in the periphery, which gave rise to the famous Target balances, has to some extent, as a by-product of the monetary policy action, served to mutualize idiosyncratic shocks. The sudden stop of capital flows towards peripheral banks and countries was offset, at least in part, by very large ECB funding: at the end of 2012, the Target 2 balances, which are a reflection of the liquidity support provided by the ECB, exceeded one trillion euro in aggregate and amounted, country by country, to around -50 per cent of GDP for Ireland and Greece, around -40 per cent of GDP for Portugal and Cyprus and -32 per cent of GDP for Spain. Correspondingly, creditor countries had very large surplus balances. In addition, the amounts that the ECB lent were not only very large, but also very cheap: for some peripheral banks the 50 basis point interest currently charged by the ECB is a fraction of what they would have to pay to raise the same amounts in the private market, if they ever had indeed been able to raise it. In aggregate terms, the IMF estimates the implicit transfers from creditor countries to debtor countries because of interest rates on support lending lower than on the market, through all inter-government and Eurosystem facilities, in a range between 44 and 75 billion €, corresponding to 0.7 to 1.2 per cent of the creditors GDP. But it is useful to recall that the IMF hastens to clarify that fiscal union is not a zero sum proposition in which some necessarily loose what other gain. Indeed, as in the CSI of Enderlein and others, also in

[5] Enderlein and others

the IMF simulations there is sufficient alternating between contributing and receiving countries to avoid net permanent transfers.

Finally, one should also recognize that by "borrowing in the market" through the issuance of reserves and lending to banks in the periphery, the Eurosystem in a way issued common debt, as it is obvious that the central bank could issue such large amount of debt because it is supported by its own financial strength, that was contributed by national central banks, and by some market conviction that national governments stand by the Eurosystem

At the end, overall, while ECB funding cannot be properly said to belong to a "federal budget", it surely shared some of its characteristics, in particular it played the mutualisation function that federal funds could have played.

What is the difference between what we have and what we need and how do we fill it?

My approach has been so far, and will have to remain, qualitative. I am not aware that someone has been able to provide a measure of the degree of "fiscal union" that we would need, compared with what we already have to measure what the gap is. My sense is that we already have quite something of a fiscal union, partly based on the control and guidance of national budgets, partly based on a sort of federal approach, as I have described it. I do not believe, however, that this is quite enough, even if we limit our expectations to what is needed to complement the monetary and banking union. Quantitatively we may need more. Qualitatively the ad hoc, ex post approach that was followed is surely sub optimal. There is still a, significant but not huge, gap, especially of institutional nature, to be filled. What would be the most promising way to do this? Over what time horizon and in what sequence should we plan to reach the target?

It is useful to recall here the direction indicated by the Four Presidents' Report: *"The Four Presidents' Report published in December 2012 argued in favor of a macroeconomic stabilization mechanism for the Euro area. It stipulated that such a mechanism should*

- *not lead to unidirectional or permanent transfers;*
- *not undermine incentives for structural reforms;*
- *be implementable within the framework and the institutions of the Union;*
- *not be an additional crisis-solution mechanism, but rather a complement the ESM;*
- *not lead to an overall increase in tax and expenditure levels. "*

d. **More control and guidance on national budgets?**

A first way to enhance fiscal union would be to try and do more under the rubric of control and guidance of national budgets. The proposal, for instance, to have a EU financial Minister who could prevail over a national government non-complying with the common rule would be an example. This would be consistent with the common sense principle that sovereignty ends when solvency ends. My sense, however, is that there is not much more that can be done in this area. The tension between common control and national sovereignty, however empty this concept has become in practice, puts a clear limit on what can be done in this area and, with the adaptations and reinforcements achieved during the crisis, I think we are close to that limit, at least in principle. In addition, as argued by Pisani-Ferry and others, the experience of the crisis has shown that a purely national approach to stabilization is too weak on the occasion of a really serious crisis[6].

[6] : *"The limits to purely national stabilisation policy became very visible as entire economies were priced out of the market."*

What remains to be seen is how the new instruments will be used in practice. The failure in the implementation of the Growth and Stability Pact is too serious to be fully confident in this respect, also because only a thorough application would give effectiveness to the new tools.

e. Federal budget?

I believe, instead, that there is room for some incremental improvement in the area of federal budget. I find, in particular, appealing the idea to transfer, as in Pisani-Ferry and other and in the IMF paper, some cyclical revenue/expense from national budgets to a federal budget. The example of unemployment benefits on the expense side is an obvious one, but there may very well be other candidates, such as federally funded public infrastructures. On the revenue side, instead, taxes on firms profits or on real estate activity may be interesting candidates. A somewhat larger federal budget should not add to total (national + federal) public budget, since the federal component would substitute, not be added, to the national one, and could also be used to promote discipline, control and guidance of national budgets if access to federal money was conditional on respecting federal rules. Distinguished, but in the same line of thinking, is the Cyclical Shock Insurance scheme of Enderlein and others, which however is, in my view, of more difficult political implementation.

For banks there should be an ultimate federal backstop, which could come after all other lines of defence will have proved insufficient: equity holders, junior bonds, senior bonds, not guaranteed depositors and national budgets.

One difficult question is whether the move of some revenue and expenses at federal level would require a different governance set-up, like a union finance minister[7], or whether the existing institutional set-up would be sufficient. Overall my sense is that if the rules determining the federal taxes and expenses are clear and precise enough, the current set-up would be sufficient, with the Commission taking the needed decision making responsibilities. The issue, however, clearly deserves deeper thoughts.

f. What about Eurobonds?

Putting issuance of government bonds on a federal level with a joint and several guarantee would have a strong mutualisation effect: countries hit by a positive shock would implicitly lend part of their borrowing strength to countries hit by a negative shock. Unfortunately, there is no way to precisely distinguish the case in which a genuinely exogenous shock hits a country from the case in which the difficulties derive from national wrong policies. Hence the moral hazard consequences of moving to federal issuance would be gigantic unless, or until, a form of fiscal union well beyond what is now conceivable will be attained. The kind of tight fiscal union prevailing in the United States would be a model here.

The necessity to maintain a balance between joint responsibility and joint decision-making is not, however, limited to the extreme case of perfect fiscal union and joint and several issuance. This holds also for intermediate cases. Indeed I believe there must always be a balance between progress towards fiscal union and towards common issuance. In particular I think the degree of fiscal union we have already reached would allow some small step towards common issuance. The ideas abound here: the blue-red bonds, the issuance of €-bills, promoted by Graham Bishop, the sinking fund proposed by the German Wise-Men, the Union-bonds of Collignon are examples here. The problem is to precisely match the progress on common decision making with the move towards common issuance.

[7] Marzinotto and others go in this direction with the proposal to have a €-area finance minister availing himself of federal fiscal revenue.

Some mild form of common issuance would also support the move to federal level of some expenses and revenue sources, as there cannot always be a perfect match between the two and borrowing may be needed to buffer temporary gaps. For instance this would be needed to transfer the unemployment benefit system to federal level in the form proposed by Pisani-Ferry and others.

g. What about political feasibility?

The idea of relatively modest progress towards more federal component in the €-area fiscal union accompanied by some limited steps towards common issuance can easily be put on paper, as I just did. When it comes to implementing it technical, but, even more, political difficulties emerge with force. Indeed similar ideas were put forward in the European Commission Blueprint and, as recalled above, in the Four Presidents report for implementation over the medium term, defined as an horizon of something between 18 months and five years. Answering the question whether these innovations will indeed be implemented or not requires political acumen and clearly exceeds my competence. I can only rely here on a fairly indirect reasoning. Bergsten and Kirkegaard have developed the On-the-brink theory, according to which Europeans will do what is necessary to sustain the Union when they are just forced to do it because they are on the brink of the abyss. If Bergsten and Kirkegaard theory will continue to be empirically verified and my conclusion is right that some movement towards a federal component in fiscal union and towards common issuance is needed, then, on the brink, this will be done.

III. Conclusions

During the crisis, progress towards fiscal union has been realized, in both the federal and the control of national policies domains. This is, however, not enough to complement monetary and banking union, leave alone to reach an optimal setup. In particular, the move towards a federal approach to fiscal union during the crisis has been only implicit and institutionally weak. Bringing some cyclical sensitive expenses and revenues to federal level, achieving some small progress towards common issuance, and the provision of an ultimate federal backstop for banks are necessary further steps, easy to conceive, difficult to implement. Whether Europe will manage to achieve these progresses is a justified hope more than a certainty.

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