In the autumn of 2017, a group of seven French and seven German economists (the 7+7) undertook to put together a joint proposal for reforming the euro area. Their common conviction was that ‘French views’ and ‘German views’ on the drawbacks of the European currency union each pointed to real problems. Instead of aiming at a midpoint between often radically different views, any serious attempt at euro area reform had to address concerns raised by economists from the two countries.

Their central argument was that risk sharing and market discipline could not only be reconciled but were in fact complementary. A credible no bailout rule required the possibility of sovereign debt restructuring as a last resort, but this was not credible without well-functioning financial and fiscal safety nets. Furthermore, mitigating any unintended consequences of greater market discipline required reliable stabilisation and liquidity instruments.

The publication of their joint proposals in early 2018 triggered a considerable debate. Over the following twelve months, prominent economists from academia and policy institutions contributed both critical comments and alternative or additional proposals, which were published in a dedicated VoxEU debate.

This volume offers a selection of these contributions together with a summary of the original proposal. It covers six main topics: (1) breaking the doom loop between sovereigns and banks, (2) a common safe asset, (3) liquidity provision to sovereigns, (4) reforming the fiscal rules, (5) the pros and cons of a central fiscal capacity, (6) the pros and cons of market discipline, and (7) alternative views on euro area reform. It also includes an analysis of the debate, and a recent analysis of the state of play on euro reform by the 7+7.

The continued fragility of the euro area calls for a rigorous debate on the reform options. This volume provides a comprehensive, state-of-the-art, and accessible overview of the current discussion on such reforms.
Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?

A Debate
Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?

A Debate

Edited by Jean Pisani-Ferry and Jeromin Zettelmeyer

A VoxEU.org eBook
Centre for Economic Policy Research (CEPR)

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# Contents

*Foreword* viii

**Introduction**
Jean Pisani-Ferry and Jeromin Zettelmeyer 1

## The 7+7 Proposal

1. **How to reconcile risk sharing and market discipline in the euro area**
   Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, and Jeromin Zettelmeyer 10

## The Debate

### Section 1: Breaking the doom loop: European deposit insurance and regulation of sovereign exposures

2. **Breaking the stalemate on European deposit insurance**
   Isabel Schnabel and Nicolas Véron 18

3. **Building a stable European Deposit Insurance Scheme**
   Dirk Schoenmaker 25

4. **Refocusing the debate on risk sharing under a European Deposit Insurance Scheme**
   Jacopo Carmassi, Johanne Evrard, Laura Parisi, and Michael Wedow 32

5. **Regulating the doom loop**
   Spyros Alogoskoufis and Sam Langfield 39

### Section 2: How to create euro-area safe assets?

6. **The feasibility of sovereign bond-backed securities for the euro area**
   Philip Lane and Sam Langfield 51

7. **Beyond ESBies: Safety without tranching**
   Jeromin Zettelmeyer and Álvaro Leandro 62

8. **Delivering a safe asset for the euro area: A proposal for a Purple bond transition**
   Lorenzo Bini Smaghi and Michala Marcussen 68
<table>
<thead>
<tr>
<th>Chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 3: Ensuring an adequate provision of liquidity</strong></td>
</tr>
<tr>
<td><strong>10</strong> EMU: Liquidity of solvent member states more important than fiscal stabilisation</td>
</tr>
<tr>
<td>Vesa Vihriälä</td>
</tr>
<tr>
<td><strong>11</strong> The role of the ECB in the reform proposals in CEPR Policy Insight</td>
</tr>
<tr>
<td>Emmanuel Farhi and Philippe Martin</td>
</tr>
<tr>
<td><strong>12</strong> Make euro area sovereign bonds safe again</td>
</tr>
<tr>
<td>Grégory Claeys</td>
</tr>
<tr>
<td><strong>13</strong> Euro area reform cannot ignore the monetary realm</td>
</tr>
<tr>
<td>Jérémie Cohen-Setton and Shahin Vallee</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 4: The case for better fiscal rules</strong></td>
</tr>
<tr>
<td><strong>14</strong> Fiscal rules and the role of the Commission</td>
</tr>
<tr>
<td>Thomas Wieser</td>
</tr>
<tr>
<td><strong>15</strong> Refocusing the European fiscal framework</td>
</tr>
<tr>
<td>Lars Feld, Christoph Schmidt, Isabel Schnabel, and Volker Wieland</td>
</tr>
<tr>
<td><strong>16</strong> The economic case for an expenditure rule in Europe</td>
</tr>
<tr>
<td>Zsolt Darvas, Philippe Martin, and Xavier Ragot</td>
</tr>
<tr>
<td><strong>17</strong> Reforming the EU fiscal framework: A proposal by the European Fiscal Board</td>
</tr>
<tr>
<td>Roel Beetsma, Niels Thygesen, Alessandro Cugnasca, Eloïse Orseau, Polyvios Eliofotou, and Stefano Santacroce</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 5: Do we really need a central fiscal capacity?</strong></td>
</tr>
<tr>
<td><strong>18</strong> Whither a fiscal capacity in EMU</td>
</tr>
<tr>
<td>Lars Feld</td>
</tr>
<tr>
<td><strong>19</strong> A more stable EMU does not require a central fiscal capacity</td>
</tr>
<tr>
<td>Michel Heijdra, Tjalle Aarden, Jesper Hanson, and Toep van Dijk</td>
</tr>
<tr>
<td><strong>20</strong> A European fiscal capacity can avoid permanent transfers and improve stabilisation</td>
</tr>
<tr>
<td>Jan Stráský and Guillaume Claveres</td>
</tr>
</tbody>
</table>
## Section 6: Could market discipline do more harm than good?

<table>
<thead>
<tr>
<th>21</th>
<th>The crux of disagreement on euro area reform</th>
<th>166</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Stefano Micossi</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>22</th>
<th>Deepening EMU requires a coherent and well-sequenced package</th>
<th>171</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Marco Buti, Gabriele Giudice, and José Leandro</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>23</th>
<th>Risk sharing and market discipline: Finding the right mix</th>
<th>178</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Guido Tabellini</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>24</th>
<th>Could the 7+7 report’s proposals destabilise the euro? A response to Guido Tabellini</th>
<th>184</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jean Pisani-Ferry and Jeromin Zettelmeyer</td>
<td></td>
</tr>
</tbody>
</table>

## Section 7: Do we need to think even bigger?

<table>
<thead>
<tr>
<th>25</th>
<th>Blind spots and unintended consequences of the 14 economists’ Policy Insight</th>
<th>194</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sebastian Dullien</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>26</th>
<th>Europe needs a broader discussion of its future</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Guntram Wolff</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>27</th>
<th>Euro area reform: No deal is better than a bad deal</th>
<th>206</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Peter Bofinger</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>28</th>
<th>Beyond risk sharing and risk reduction: A Spanish view of EMU reforms</th>
<th>215</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rafael Doménech, Miguel Otero Iglesias, and Federico Steinberg</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>29</th>
<th>Fixing the euro needs to go beyond economics</th>
<th>222</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Anne-Laure Delatte</td>
<td></td>
</tr>
</tbody>
</table>

### A Response

<table>
<thead>
<tr>
<th>30</th>
<th>Euro area reform: An anatomy of the debate</th>
<th>228</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jean Pisani-Ferry</td>
<td></td>
</tr>
</tbody>
</table>

### Epilogue

<table>
<thead>
<tr>
<th>31</th>
<th>Euro area architecture: What reforms are still needed, and why</th>
<th>236</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, and Jeromin Zettelmeyer</td>
<td></td>
</tr>
</tbody>
</table>
Foreword

In late 2018 CEPR established a new type of research network – a Research and Policy Network (RPN) – with the main aims of building a community of researchers around a particular topic and ensuring that policy issues are considered over a longer time period than is often the case when a single piece of output is produced and the researchers involved then move on. An RPN consists of 15-30 experts, many of whom are CEPR Research Fellows or Affiliates, with an interest in a topic of high policy relevance and where academic research and collaboration with policymakers can have a high impact.

The RPN on European Economic Architecture, established on 1 September 2018 for an initial three-year term, is led by Jeromin Zettelmeyer (Peterson Institute for International Economics and CEPR), who is the editor of eBook together with Jean Pisani-Ferry (Bruegel, EUI; Hertie School and Sciences Po). The main goal of the network is to generate, coordinate and disseminate academic research related to the broad issue of the reform of the euro area. It aims to become the leading forum for constructive contributions in this area and a key source of expertise on policy issues and in particular to help bridge national divisions in views on reform.

The RPN led on naturally from the CEPR Policy Insight published in January 2018 by the “7+7”, seven French and seven German economists who had developed a proposal for reforming the financial architecture of the euro area1. This paper led to a large number of critical and constructive comments, which were brought together in an online debate on VoxEU (https://voxeu.org/debates/euro-area-reform), moderated by Zettelmeyer and Pisani-Ferry.

The present volume publishes a selection of these contributions. The purpose of publishing them as a standalone volume is both to bring them together in a coherent manner, and to emphasize the links between them. It focuses on potential reforms to the euro area financial architecture in four specific areas: a European deposit insurance, a European safe asset, liquidity provision to governments, and EU fiscal rules. The debate seeks to come up with practical ways of implementing specific reforms, rather than discussing whether the reforms themselves are desirable.

CEPR thanks Jeromin Zettelmeyer and Jean Pisani-Ferry for their editorship of this eBook, Anil Shamdasani and Sophie Roughton for their work on its production, and Kirsty McNeill for her efforts in administering the network’s activities. The contributions in this eBook reflect the views of their authors and not necessarily those of any bodies or institutions that the authors may be affiliated with. CEPR, which takes no institutional positions on economic policy matters, is glad to provide a platform for an exchange of views on this topic.

Tessa Ogden  
Chief Executive Officer, CEPR  
May 2019
Introduction

Jean Pisani-Ferry and Jeromin Zettelmeyer
Bruegel, EUI, Hertie School, and Sciences Po; PIIE and CEPR

In January 2018, seven French and seven German economists (the 7+7 for short) published a proposal for reforming the financial architecture of the euro area. We started from the two philosophies on euro area reform that have usually been in conflict: the ‘Northern’ view that effective crisis prevention required that euro area members face stronger incentives to fiscal discipline; and the ‘Southern’ view that macroeconomic and financial risks should, to a much greater extent, be shared across countries rather than borne individually.

The essence of the proposal was to argue that as a conceptual and practical matter, these two objectives were not necessarily in conflict; in fact, they could even be regarded as complementary. Effective enforcement of the ‘no bailout’ principle required a credible sovereign debt restructuring option, as a last resort, without threatening euro area membership. This was impossible without better safety nets that would mitigate the financial and economic costs of debt restructuring, both for the restructuring country and other members. At the same time, stronger discipline involved the risk of an under-provision of stabilisation, which had to be addressed by creating common budgetary or liquidity mechanisms. These safety nets would have to be designed to ensure that they themselves would not distort policy incentives. Our paper claimed that this was feasible and made some suggestions on how to do so.

Having argued that the prevailing philosophies on euro area reform were both wrong (or at least no more than half right), we expected a great deal of push back. We also hoped that our ideas would trigger additional, deeper work on how to reform individual pillars of the euro area architecture. We were not disappointed – as we presented our paper to various academic and policy audiences in the Spring of 2018, we were inundated with both criticism and constructive comment. To make this comment and criticism publicly accessible, VoxEU launched an online debate in March of 2018,1 which we had the privilege to moderate.

1 See https://voxeu.org/debates/euro-area-reform.
Over the next twelve months, we received, and for the most part published, more than 40 contributions on euro area reform. Some provided general comments on our paper, but most addressed specific points for discussion. To us as moderators, the most gratifying aspect of these contributions was that they soon began to refer to each other, rather than just to our paper or the previously existing literature. In other words, the collection of contributions became more than the sum of its parts. This volume publishes a selection of these contributions in a way that emphasises the links between them.

The volume begins with specific reform areas and ends with broad questions of philosophy and feasibility. Within each section, contributions are reproduced in the order in which they were originally published on Vox.

Following a summary of the 7+7 ideas (Chapter 1), the contributions focus on reforms of the euro area financial architecture in four specific areas: a European deposit insurance, a European safe asset, liquidity provision to governments, and EU fiscal rules. The question debated in these sections is generally not whether the corresponding reforms are desirable, but how to go about them.

Breaking the doom loop: European deposit insurance and regulation of sovereign exposures

Section I starts with an elaboration of the 7+7 proposal on European deposit insurance, by Isabel Schnabel and Nicolas Véron (Chapter 2). The essence of that plan is to create a single insurance that would offer the same level and quality of protection to every euro area depositor while adopting a funding framework that recognises national differences in risk. Riskier national banking systems would contribute higher insurance fees than less risky systems. The most straightforward way of implementing this would be through a ‘waterfall’ structure in which risks are in the first instance covered by national compartments, which are in turn backed by a fully mutualised common compartment.

Dirk Schoenmaker (Chapter 3) and Jacopo Carmassi, Johanne Evrard, Laura Parisi and Michael Wedow, all of the ECB (Chapter 4), both argue against such a waterfall structure. Schoenmaker agrees that nationally differentiated deposit insurance fees are desirable, but argues that implementing this through national compartments could

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2 The volume contains most of the contributions that were published on the Vox debate, but not all. A few – including some excellent ones – were not included because they either did not fit into the structure of the volume or had strong overlaps with other contributions, forcing us to choose in the face of space constraints. Two contributions – “Refocusing the European fiscal framework”, by Lars Feld, Christoph Schmidt, Isabel Schnabel, and Volker Wieland; and “The feasibility of sovereign bond-backed securities for the euro area”, by Philip Lane and Sam Langfield – were not specifically written for the Vox debate, but subsequently published on the Vox debate page and included in this volume.
destabilise national banking systems in a crisis and undermine the uniformity of depositor protection across euro area countries. The point made by Carmassi and co-authors is more fundamental: they argue that if deposit insurance fees are risk-based at the bank level, there is no need to additionally differentiate risks at the national level. As long as bank-level risk is assessed right – which in their view is feasible, based on standard risk indicators – national differences in risk will be automatically captured.

In Chapter 5, Spyros Alogoskoufis and Sam Langfield examine the other side of the ‘doom loop’ between banks and sovereigns: sovereign exposures of banks. Based on a model that simulates sovereign debt portfolio reallocations in response to a change in regulation, they argue that mainstream proposals to reform the regulatory treatment of sovereign exposures face a tension between reducing concentration and reducing credit risk. While concentration charges would induce banks to hold more diversified sovereign portfolios, this can create a channel for contagion. In the authors’ view, this can only be avoided by creating a common euro area safe asset and adopting regulation that will induce banks to hold it.

**Safe assets**

Section II collects ideas for creating a sovereign debt-based euro area safe asset – an idea that has been, and remains, controversial, in part because it evokes debt mutualisation. The 7+7 proposal argued for such a safe asset to help insulate the financial system from sovereign risk but did not dwell on design options. One such option, going back to Brunnermeier et al. (2016), would be to create a regulatory framework that would allow private entities to issue sovereign bond-backed securities (SBBS) in several tranches. The most senior of these tranches (referred to as ‘European senior bonds’, or ‘ESBies’) would play the role of the safe asset. At the time of the publication of the 7+7 proposal, this idea had just been subjected to an extensive feasibility study by the European Systemic Risk Board. Two of the authors of that study, Philip Lane and Sam Langfield, describe their findings in Chapter 6. In Chapter 7, Alvaro Leandro and Jeromin Zettelmeyer describe an alternative idea, which would be to have the European Stability Mechanism (ESM) issue single-tranche debt securities (referred to as ‘E-bonds’) backed by senior loans to euro area members. Like ESBies, E-Bonds would be made safe due to a combination of seniority and diversification, but seniority in this case rests with an institution – the ESM, recognised in bond contracts – rather than being created through tranching. Both proposals would avoid debt mutualisation, in the sense that any losses that cannot be absorbed by junior debt holders would be passed on to the holders of ESBies and E-bonds, respectively.
Lorenzo Bini-Smaghi and Michala Marcussen (Chapter 8) also propose the introduction of two-tranche national debt, but their objective is different. What they are primarily aiming at is a way to organise a smooth and incentive-compatible transition to a lower public debt regime. They propose to do this by imposing a gradually declining debt limit on euro area members. Debt issued within the limit would enjoy a public guarantee. This would initially be in the form of an ESM commitment not to seek the restructuring of this debt so long as the country abides by an ESM programme, and eventually – once the limit has declined to 60% of GDP – by a full guarantee jointly backed by the members of the euro area.

Finally, Julien Acalin (Chapter 9) argues for two tranche debt-backed securities along the lines proposed by Lane and Langfield, except that they would be backed on GDP-indexed bonds issued by all euro area members rather than plain bonds. GDP risk that cannot be diversified (as well as any default risk) would be absorbed by the junior tranche(s), making the senior tranche safe. At the same time, coordinated issuance of GDP-indexed bonds would lower issuance costs compared to a situation where countries issue such bonds individually.

### Liquidity

Section III deals with sovereign access to liquidity. The 7+7 had called for pre-qualified access to ESM credit lines, on the understanding that the ECB’s Outright Monetary Transactions (OMT) policy – a promise to purchase sovereign bonds to stem a panic – would neutralise any self-fulfilling fears that a country might need to exit the euro area (see Chapter 11). In Chapter 10, Vesa Vihriälä argues that the ESM is too small for this to be a credible option, while the OMT is at the discretion of the ECB Governing Council and requires a full-fledged ESM programme. The solution, in his view, is to give the ESM access to ECB liquidity to finance precautionary financial assistance.

Grégory Claeyss (Chapter 12) and Jérémie Cohen-Setton and Shahin Vallée (Chapter 13) see a similar problem: ECB liquidity is conditional on an ESM programme, and hence not only on a technical assessment that the debt is sustainable but also on a political agreement on policy going forward. The solution, in Claeyss’ view, is a richer menu of ESM facilities – including a track for ‘pure’ liquidity crises, without any conditionality, that would nonetheless allow ECB asset purchases to be activated. Cohen-Setton and Vallée go further, arguing for a broad reassessment of the fiscal and balance considerations that in their view hamper the ECB in its monetary policy and
liquidity roles, including replacing the “current ECB doctrine of financial independence by a fiscal carve-out” that would specify how ECB losses would be covered by member states.

**Fiscal rules**

Section IV discusses the reform of fiscal rules. Thomas Wieser (Chapter 14) broadly concurs with the 7+7 assessment. He lays out the basic case for reforming the rules, which he argues have become “nearly unmanageable” and force the European Commission to take actions based on shaky forecasts and output gap estimates. In Chapters 15, 16 and 17, three sets of authors – most of which are affiliated with the German Council of Economic Experts (GCE), the French Conseil d’Analyse Economique, (CAE) and the European Fiscal Board (EFB), respectively – offer blueprints for how to reform the rules. These turn out to be fairly close to each other and to the proposal by the 7+7. All would involve setting a maximum path for public non-interest expenditure based on medium-term projected output growth and a medium-term debt reduction target. Changes in revenue would not affect the expenditure ceiling, unless they are based on changes in the tax system (that is, tax hikes or cuts would be offset by increasing or decreasing the expenditure ceiling, respectively). The proposals disagree on whether a structural fiscal balance floor should be retained in some form (the GCEE members argue yes; the CAE and EFB members both argue no); on whether countries should be given some discretion – subject to approval by the European Commission – in determining their debt reduction target over the medium term (CAE members: yes; GCEE and EFB members: no); and on whether governments should be required to finance spending over and above the rule by issuing junior bonds (CAE members: implicitly yes; GCEE and EFB members: no).

**Do we really need a central fiscal capacity?**

The last three sections pose more fundamental questions. A key claim of the 7+7 proposal is that euro area safety nets can be strengthened without creating moral hazard. In Chapter 18, Lars Feld, who was originally a member of our group, argues that there is a significant risk that the fiscal stabilisation mechanism proposed by the 7+7 – i.e. one that would provide conditional transfers, rather than just loans, to countries hit by large shocks – would in fact lead to moral hazard. Michel Hejdra, Tkalle Aarden, Jesper Hanson and Toep van Dijk (Chapter 19), all Dutch government officials, agree with Feld, while arguing that the combination of financial integration – facilitating private risk-sharing – and automatic fiscal stabilisers at the country level obviates the
need for fiscal risk-sharing. Rather than worrying about a central fiscal capacity, the euro area should focus on banking and capital markets union and on reducing national debt levels to a point where all members have adequate fiscal space for national stabilisation policies. Jan Stráský and Guillaume Claveres, both from the OECD, take the other side of this argument (Chapter 20). In their view, as long as private risk-sharing remains incomplete, a central stabilisation mechanism can raise welfare – even with well-functioning national stabilisation – because it diversifies risks. Furthermore, a central fiscal capacity would help stabilise euro area output when monetary policy is constrained by very low interest rates.

**Could market discipline do more harm than good?**

Section VI includes three contributions that argue that the 7+7 have gone too far in the other direction – that is, in pushing for market discipline. Stefano Micossi (Chapter 21) and Guido Tabellini (Chapter 23) are both uncomfortable with the 7+7’s suggestion that the national banking system should no longer play the role of a lender of last resort to the domestic sovereign. Tabellini goes as far as saying that it is illusory, and counterproductive, to pretend to cut the loop between banks and sovereigns. While not averse to the notion of market discipline per se, Marco Buti, Gabriele Giudice and José Leandro (Chapter 22), all from the European Commission, argue that the 7+7 do not pay enough attention to reform sequencing. “Market forces must be handled with caution”, requiring, in their view, that both European deposit insurance and a euro area-wide safe asset are introduced prior to any regulation to reduce concentrated sovereign exposures of banks.

More fundamentally, Guido Tabellini (Chapter 23) takes issue with a cornerstone of the 7+7 proposal, namely, that sovereign debt restructuring in the euro area should be feasible as a last resort. In his view, the idea that a large euro area member could undergo an “orderly debt restructuring inside the euro area” remains a dangerous fantasy, even with the reforms proposed by the 7+7. At the same time, some of these reforms – particularly discouraging sovereign bond holdings of banks – could make sovereign debt crises more likely by reducing sovereign access to liquidity. In a rebuttal (Chapter 24), we argue that keeping national banking systems in the role of providers to specific sovereigns amounts to rejecting banking union. Liquidity access by sovereigns should instead be insured by collective arrangements involving the ESM and the ECB.
Do we need to think even bigger?

Section VII contains four contributions that argue that the 7+7 proposals are too timid, too narrow, or both. Sebastian Dullien (Chapter 25), Peter Bofinger (Chapter 27) and Rafael Doménech, Miguel Otero and Federico Steinberg (Chapter 28) criticise the 7+7 for proposing a fiscal stabilisation fund rather than a central fiscal authority that would be able to borrow in capital markets. Peter Bofinger and Guntram Wolff (Chapter 26) both argue that the proposed reform of fiscal rules does not go far enough, by not questioning the appropriateness of 60% debt-to-GDP as a long-term target (Bofinger) and by failing to call for fiscal rules that allow larger expansions when monetary policy is at the zero lower bound (Wolff). In addition, Wolff criticises the 7+7 for ignoring questions such as what public goods should be provided at the European level, and how macroeconomic imbalances and structural weaknesses inside the euro area should be addressed (a point also made by Rafael Doménech and co-authors).

Anne-Laure Delatte (Chapter 29) takes a different tack. Her issue is with neither the specifics nor the economic philosophy of the 7+7 plan, but rather with the presumption that a reform proposal that appears to offer something to both sides can succeed politically in the euro area today. Writing ten months after the publication of the plan, she notes that while the June 2018 declaration of French and German leaders at Meseberg included some elements of the proposal, it fell far short of the hopes of the 7+7 (while still facing opposition from other euro area members). Her diagnosis is that the EU has exhausted its potential for inter-state bargaining, at least on matters pertaining to euro reform, in which seemingly Pareto-improving proposals are viewed as risky by both sides. From this, she concludes that political reform of the euro area must precede economic reform: “The current situation requires a referee with a capacity to pursue the common interest across national borders”. One way of achieving such a reform, in her view, would be to co-opt national parliamentarians within a new parliamentary chamber at the European level.

A response

The last two chapters of the volume reflect on this debate and look forward. In Chapter 30, Jean Pisani-Ferry summarises the debate on the 7+7 proposals. He points out that controversies triggered by the paper have focused on five major issues: (1) which strategy should be adopted to address legacy problems; (2) whether the combination of concentration charges, a safe asset, and a common deposit insurance would adequately complete the reform of the euro area’s financial architecture; (3) whether the fiscal architecture inherited from the Stability and Growth Pact should be overhauled; (4)
whether euro area reform should be limited to financial and fiscal reforms, or include a monetary dimension; and (5) whether the 7+7 proposal is biased towards the views and interests of the Northern member states. He also corrects some misperceptions, such as the notion that we advocate quasi-automatic debt restructuring, which is not true, and the idea that we do not take into account the redenomination risk.

Finally, in Chapter 31 – the most recent contribution in the volume, published in early May 2019 – the 7+7 re-examine their ideas in light of events in the intervening 15 months. They conclude that most proposals continue to apply – if anything, more urgently than they did in early 2018. At the same time, the economic policy debate in the EU has moved into new areas, including a debate on the proper reaction of the EU to economic nationalism in the US and in China. While this debate is necessary and welcome, some of the proposals that have been floated – in particular, promoting national and European champions and weakening EU competition policies – raise major concerns. Furthermore, problems triggered by China or the current US administration must not distract from the fact that most of the euro area’s economic weaknesses continue to be home-grown, and that the means for addressing them are fully within the collective control of its members.

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The 7+7 Proposal
1 How to reconcile risk sharing and market discipline in the euro area

Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, and Jeromin Zettelmeyer

After nearly a decade of stagnation, the euro area is finally experiencing a robust recovery. While this comes as a relief – particularly in countries with high debt and unemployment levels – it is also breeding complacency about the underlying state of the euro area. Maintaining the status quo or settling for marginal changes would be a serious mistake, however, because the currency union continues to suffer from critical weaknesses, including financial fragility, suboptimal conditions for long-term growth, and deep economic and political divisions.

While these problems have many causes, a poorly designed fiscal and financial architecture is an important contributor to all of them:

• The ‘doom loop’ between banks and sovereigns continues to pose a major threat to individual member states and the euro area as a whole. An incomplete banking union and fragmented capital markets prevent the euro area from reaping the full benefits of monetary integration and from achieving better risk sharing through market mechanisms.

• Fiscal rules are non-transparent, pro-cyclical, and divisive, and have not been very effective in reducing public debts. The flaws in the euro area’s fiscal architecture have overburdened the ECB and increasingly given rise to political tensions.

1 All authors contributed in a personal capacity, not on behalf of their respective institutions, and irrespective of any policy roles they may hold or may have held in the past.
• The euro area’s inability to deal with insolvent countries other than through crisis loans conditioned on harsh fiscal adjustment has fuelled nationalist and populist movements in both debtor and creditor countries. The resulting loss of trust may eventually threaten not just the euro, but the entire European project.

**The deadlock over euro area reform**

The members of the euro area are deeply divided on how to address these problems. Some argue for more flexible rules and better stabilisation and risk-sharing instruments at the euro area level, such as common budgetary mechanisms (or even fiscal union) to support countries in trouble. Others would like to see tougher rules and stronger incentives to induce prudent policies at the national level, while rejecting any additional risk sharing. One side would like to rule out sovereign-debt restructuring as a tool for overcoming deep debt crises, while the other argues that market discipline is indispensable for fiscal responsibility, and ultimately for financial stability. The seeming irreconcilability of these positions has produced a deadlock over euro area reform.

We believe that the choice between more risk sharing and better incentives is a false alternative, for three reasons. First, a robust financial architecture requires instruments for both crisis prevention (good incentives) and crisis mitigation (since risks remain even with the best incentives). Second, risk-sharing mechanisms can be designed in a way that mitigates or even removes the risk of moral hazard. Third, well-designed risk-sharing and stabilisation instruments are in fact necessary for effective discipline. In particular, the no bailout rule will lack credibility if its implementation leads to chaos, contagion, and the threat of euro area break-up – as euro area members experienced in 2010-12 and again during the 2015 Greek aftershock. Well-designed risk-sharing arrangements and improved incentives, in the form of both better rules and more market discipline, should hence be viewed as complements not substitutes.

**Six areas for reform**

Achieving this complementarity, however, is not straightforward in practice. It calls for stabilisation and insurance mechanisms that are both effective and do not give rise to permanent transfers. It also requires a reformed institutional framework. In a new CEPR Policy Insight (Bénassy-Quéré et al. 2017), we outline six main areas of reform to the European financial, fiscal, and institutional architecture that would meet these aims.
First, breaking the vicious circle between banks and sovereigns through the coordinated introduction of sovereign concentration charges for banks and a common deposit insurance.

The former would require banks to post more capital if debt owed by a single sovereign creditor – typically the home country – exceeds a certain proportion of their capital, incentivising the diversification of banks’ portfolios of government securities. The latter would protect all insured euro area depositors equally, irrespective of the country and its situation when the insurance is triggered. Incentives for prudent policies at the national level would be maintained by pricing country-specific risk in the calculation of insurance premiums, and through a reinsurance approach – common funds could be tapped only after ‘national compartments’ have been exhausted.

At the same time, mechanisms to bail in creditors of failing banks need to be strengthened, supervisory pressure to reduce existing non-performing loans needs to increase (including on smaller banks), and bank regulatory standards should be tightened and further harmonised. To give capital markets union a push, the European Securities and Markets Authority (ESMA) should receive wider authority over an increasing range of market segments, and its governance should be reformed accordingly. Together, these measures would decisively reduce the correlation between bank and sovereign risk and pave the way for a cross-border integration of banking and capital markets.

Second, replacing the current system of fiscal rules focused on the ‘structural deficit’ by a simple expenditure rule guided by a long-term debt reduction target.

The present rules both lack flexibility in bad times and teeth in good times. They are also complex and hard to enforce, exposing the European Commission to criticism from both sides. They should be replaced by the principle that government expenditure must not grow faster than long-term nominal output, and should grow at a slower pace in countries that need to reduce their debt-to-GDP ratios. A rule of this type is both less error-prone than the present rules and more effective in stabilising economic cycles, since cyclical changes in revenue do not need to be offset by changes in expenditure.

Monitoring compliance with the fiscal rule should be devolved to independent national fiscal watchdogs, supervised by an independent euro area-level institution, as elaborated below. Governments that violate the rule would be required to finance excess spending using junior (‘accountability’) bonds whose maturity would be automatically extended in the event of an ESM programme (the status of the existing debt stock would remain unaffected). The real-time market pressure associated with the need to issue such bonds
would be far more credible than the present threats of fines, which have never been enforced. And the cost at which these junior sovereign bonds are issued will depend on the credibility of government policies to tackle fiscal problems in the future.

Third, creating the economic, legal and institutional underpinnings for orderly sovereign-debt restructuring of countries whose solvency cannot be restored through conditional crisis lending.

First and foremost, this requires reducing the economic and financial disruptions from debt restructuring – by reducing the exposure of banks to individual sovereigns, as described above, and by creating better stabilisation tools and a euro area safe asset, as described below. In addition, orderly and credible debt restructuring requires legal mechanisms that protect sovereigns from creditors that attempt to ‘hold out’ for full repayment, and ESM policies and procedures that provide an effective commitment not to bail out countries with unsustainable debts.

When introducing such policies, it is essential that they do not give rise to instability in debt markets. For this reason, we do not advocate a policy that would require automatic haircuts or maturity extensions of all maturing debt in the event of an ESM programme. Furthermore, tougher ESM lending policies and sovereign concentration charges for banks should be:

- phased in gradually;
- announced at a time when the debts of all euro area countries that depend on market access are widely expected to be sustainable, as is currently the case if fiscal policies stay on track; and
- combined with other reforms that reduce sovereign risk, such as the risk-sharing mechanisms proposed in our blueprint.

Fourth, creating a euro area fund, financed by national contributions, that helps participating member countries absorb large economic disruptions.

Since small fluctuations can be offset through national fiscal policies, pay-outs would be triggered only if employment falls below (or unemployment rises above) a preset level. To ensure that the system does not lead to permanent transfers, national contributions would be higher for countries that are more likely to draw on the fund, and revised based on ongoing experience. This system would maintain good incentives
through three mechanisms: ‘first losses’ would continue to be borne at national level, participation in the scheme would depend on compliance with fiscal rules and the European semester, and higher drawings would lead to higher national contributions.

Fifth, an initiative to create a synthetic euro area safe asset that would offer investors an alternative to national sovereign bonds.

‘Safety’ could be created through a combination of diversification and seniority; for example, financial intermediaries would purchase a standardised diversified portfolio of sovereign bonds and use this as collateral for a security issued in several tranches. Introducing such assets in parallel with a regulation on limiting sovereign concentration risk would further help avoid disruptive shifts in the demand for euro area sovereign bonds, and hence contribute to financial stability. Risks associated with the introduction of such assets must be mitigated both through careful design and by completing a test phase before the generation of such assets is ‘scaled up’.

Sixth, reforming the euro area institutional architecture.

We propose two main reforms. The first is an improvement of the institutional surveillance apparatus. The role of the watchdog (‘prosecutor’) should be separated from that of the political decision-maker (‘judge’) by creating an independent fiscal watchdog within the European Commission (for example, a special Commissioner) or, alternatively, by moving the watchdog role outside the Commission (though this would require an overhaul of the treaties). At the same time, the Eurogroup presidency role (judge) could be assigned to the Commission, following the template of the High Representative of the Union for Foreign Affairs.

In addition, the policy responsibility for conditional crisis lending should be fully assigned to a reformed ESM, with an appropriate accountability structure. The latter should include a layer of political accountability – for example, by requiring the ESM Managing Director to explain and justify the design of ESM programmes to a committee of the European Parliament. Financial oversight should remain in the hands of ESM shareholders.

**These proposals should be viewed as a package that largely requires joint implementation.** Cutting through the ‘doom loop’ connecting banks and sovereigns in both directions requires the reduction of concentrated sovereign exposures of banks together with a European deposit insurance system. The reform of fiscal rules requires stronger and more independent fiscal watchdogs at both the national and European
level. Making the no bailout rule credible requires not only a better legal framework for debt restructuring as a last resort, but also better fiscal and private risk-sharing arrangements, and an institutional strengthening of the ESM.

**Concluding remarks**

Our proposals do not venture into territory that requires new political judgements, such as which public goods should be delivered at the euro area level, and how a euro area budget that would provide such goods should be financed and governed. Their adoption would nonetheless be a game-changer, improving the euro area’s financial stability, political cohesion, and potential for delivering prosperity to its citizens, all while addressing the priorities and concerns of participating countries. Our leaders should not settle for less. Authors’ note: All authors contributed in a personal capacity, not on behalf of their respective institutions, and irrespective of any policy roles they may hold or may have held in the past.

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Section 1: Breaking the doom loop: European deposit insurance and regulation of sovereign exposures
2 Breaking the stalemate on European deposit insurance

Isabel Schnabel and Nicolas Véron
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In the wake of the European financial and sovereign debt crisis, the euro area embarked in 2012 on establishing a banking union. Its aim was to elevate parts of banking sector policy from the national to the European level, particularly bank supervision and resolution. Successive EU-level reports, including the Four Presidents’ Report of 2012 (Van Rompuy et al. 2012) and the Five Presidents’ Report of 2015 (Juncker et al. 2015), have highlighted a European Deposit Insurance Scheme (EDIS) as a necessary component of banking union. In 2015, the European Commission published a legislative proposal (hereinafter EC 2015) to set up a fully integrated, country-blind deposit insurance system by 2024.

A number of different proposals have arisen in this area. A recommendation by Daniel Gros (Gros 2015), director of the Centre for European Policy Studies, would retain a permanent autonomous role for the existing national deposit insurance schemes in a re-insurance system. Meanwhile, none of these options has met sufficient consensus among euro-area countries, producing a deadlock in the policy discussion, with no apparent progress in the legislative discussion of the EC (2015) proposal.2

In a Franco-German report in January (Bénassy-Quéré et al. 2018), we proposed, jointly with our co-authors, to end the deadlock with an EDIS design that is institutionally integrated but financed in a way that is differentiated across countries. Our recommendations are outlined here and compared with EC (2015) and Gros (2015).3

1 This column first appeared as a blog post on the Bruegel website.
2 A more recent Communication of the European Commission on banking union (October 2017) attempted to break this deadlock, but proposes only transitional arrangements.
3 While this blog post was jointly written by the two of us in personal capacity, it was reviewed by the entire group of the report’s coauthors and there were no disagreements within that group about its content.
**EDIS as part of a broader policy package**

Our EDIS proposal is tied to the introduction of sovereign concentration charges and tighter treatment of nonperforming loans (NPLs). It calls for “the coordinated introduction of sovereign concentration charges for banks and a common deposit insurance” (N.B. all quotes in this column are from the Franco-German report). This connection is necessary to prevent the system from being “abused by governments that can force or nudge domestic banks to grant them preferential credit conditions by using their access to deposit funding.” By contrast, EC (2015) does not include any proposals on the regulatory treatment of sovereign exposures. In his own proposal, Daniel Gros observes that he “has not addressed the issue of the large holdings of banks of the debt of their own government” while hinting at “strict diversification limits,” which echo our recommendation of sovereign concentration charges. As for NPLs, our proposal calls for the ECB to foster better accounting for these loans on banks’ balance sheets and reduce their aggregate volume, including for smaller banks principally supervised by national authorities. The report calls for “full implementation of a uniform regime for NPL provisioning covering both legacy and new NPLs.”

**A fully integrated institutional setting**

A major difference between our proposal and Gros (2015) is that in our proposal, national deposit insurance schemes disappear after a transition period, replaced by a system with “a single authority at the European level,” which we suggest should be the Single Resolution Board (SRB) with due adjustments, and the existing “separate national deposit insurance institutions would be phased out.” In the event that the EDIS scheme would need to make direct payouts to individuals, it would rely on national authorities, e.g. the national resolution authority, but this arrangement would be purely for implementation purposes and the European authority would make all the significant decisions.

As a complement to our EDIS proposal, new EU legislation should eliminate the widespread practice of geographical ring-fencing of capital and liquidity by national authorities, which hinders the emergence of cross-border banking groups in the euro area. Since the protection of national deposit insurance schemes is the main reason cited to justify such practices, their phasing-out would make this reform possible and increase the potential for cross-border banking acquisitions, contributing to breaking the bank-sovereign vicious circle.
Our proposal envisions country-blind protection of insured deposits. After the end of
the transition period, Cypriot or Greek insured deposits would be protected identically
to German or Finnish ones, without any qualification or conditionality. This is essential
to establish trust. We fear that the deposit re-insurance concept in Gros 2015, which
perpetuates autonomous policy decision-making on deposit insurance by national
authorities, could lead to uncertainty as to the automaticity of payouts, especially in
cases where a country’s politics or policies are controversial in the rest of the euro
area—a possibility that was illustrated in March 2013 in Cyprus. Thus, the operation
of the system from the insured depositor’s perspective must be fully insulated from
national political vagaries, as it is in our proposal (and in EC 2015).

A funding framework that recognises national differences

The system would not be country-blind in terms of its funding mechanism, a
key difference with EC (2015) but a similarity to Gros (2015). Our analysis is that
despite the progress towards the completion of banking union, differences in national
environments that affect banks’ business models will persist in terms of taxation,
corporate and individual insolvency frameworks, housing finance, pension finance, and
macroprudential policies. (All such policies are comparatively harmonised in the US, in
which there is correspondingly no need for state-level differentiation within the federal
deposit insurance system.) This justifies differentiated assessments of bank risks and,
correspondingly, deposit insurance fees across euro-area countries. As in most existing
deposit insurance schemes and in EC (2015), there would also be fee differentiation at
the level of individual banks to account for diverse risk profiles.

We have received objections that this would make EDIS different from its sibling, the
Single Resolution Fund (SRF), which is already in place and will be fully mutualised
by 2024. But since the EU has chosen to distinguish resolution funding from deposit
insurance (a distinction that does not exist in some other jurisdictions, e.g. the US), and
political sensitivities are evidently different about the two areas, there is no need for
identical policy responses to the challenges tackled by EDIS and the SRF respectively.
We do suggest, however, that both be managed by the same EU authority, namely the
SRB.

Our proposal calls for two separate modalities for such country-level differentiation:

• First, a fee component depending on country-specific risks, such as the quality of the
country’s legal framework for creditor protection, “based on structural indicators of
creditor rights, such as the effectiveness of insolvency and foreclosure processes.”
With harmonisation of legal frameworks, fees would also converge. These indicators
would have to be designed and measured at the European level, possibly by the SRB itself, or by an ad hoc independent advisory body reporting to the SRB. The aim is to establish good structural credit policies in foreclosure and other areas, underlined by developments in Greece and Cyprus.

- Second, a structure requiring the cost of payouts associated with a bank failure to fall on banks in the same country in case of limited idiosyncratic shocks but to be mutualised in case of a larger crisis. The EDIS system would contain national compartments, akin to the ones that exist in the SRF during the current transition but which (unlike at the SRF) would be kept in the longer run. Two possible designs are a mutualised compartment alongside the national ones, similar to the transition-state SRF (“option 1”), or a joint payout by all compartments in case one of them is depleted (“option 2”). In option 1, the ex-ante deposit insurance fee (i.e. in the absence of any bank failure triggering the insurance) would be split between the national and mutualised compartments, with a fixed allocation key set in the EDIS legislation that would apply identically to all member states. In both options, if a national compartment is depleted by payouts, there will be an ex-post fee paid only by banks domiciled in the corresponding country, until it is replenished. If the European compartment is itself depleted (option 1), or the joint capacity of all compartments to step in is extinguished (option 2), the ESM would step in as a backstop (as with the SRF)—which would not be a loss to the ESM, as it would be reimbursed by banks thanks to appropriate ex-post fees. The economics of this system are similar to those in Gros 2015, even though the institutional arrangements are fundamentally different. This difference is why we refer in the report to “the spirit of a re-insurance system,” with a first loss at the country level. The legal arrangement would be one of direct insurance, not re-insurance. Thus, unlike in Gros 2015, the national compartments we propose would be very different from the existing national deposit insurance schemes, which would no longer exist in the steady state as explained above.

Country-level differentiation would create sound incentives. Banks could choose to operate in a given member state either through a locally capitalised subsidiary or through a branch of an entity established in another (home) country. If it is a subsidiary, the deposit insurance (or in our proposal, the national compartment) would be that of the host country; if a branch, that of the home country. If a country has frequent bank failures that trigger deposit insurance payouts, or if its structural credit policies are unsound, the higher resulting deposit insurance fees may encourage banks to serve clients in that country through branches rather than subsidiaries. Such a country’s national compartment would correspondingly decrease in size, due to the reduction in the country’s total covered deposits, while other countries’ compartments would grow. This is how it should be.
Importantly, our proposal of country-level differentiation would have nothing to do with a country’s sovereign credit, and would therefore not contribute to the bank-sovereign vicious circle. The proposal would also create incentives for countries to reduce competitive distortions, such as those resulting from national housing finance and pension finance frameworks, insolvency law, or bank taxation.

Our EDIS proposal can accommodate the present diversity of banking structures in the euro area. In 14 of the area’s 19 countries representing together more than half of total covered deposits, there is currently one single national deposit insurance scheme. But in five other countries, there are two or more schemes serving different segments of the national banking sector. We suggest that these “could be treated as separate compartments, on a case-by-case basis under general criteria to be set to deter abuses.” These criteria could also create incentives to merge such schemes on a cross-border basis, e.g. to protect deposits in all the cooperative banks of several euro-area countries. Voluntary top-up regimes could also continue to exist, either on a national or a cross-border basis, with the understanding that our EDIS proposal (including any separate compartments for specific banking structures) only covers insured deposits up to the common limit currently set at €100,000.

Conversely, we advise against carving out small banks from the scope of EDIS (as is currently the case with the SRF), even those that participate in institutional protection schemes. Such small banks, or less significant institutions (LSIs) as they are called in the jargon of the banking union, contribute at least as much as SIs to the bank-sovereign vicious circle, because their activities are typically less diversified across borders. We recommend that “an asset quality review of all LSIs, directly involving both the ECB and the European authority entrusted with EDIS [i.e. the SRB], would be performed as part of the implementation of the EDIS legislation, as was the case for SIs in 2014.” This step is important to ensure that the risk-sharing involved in EDIS is not abused to rescue banks that would be unsound from the start.

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4 Based on European Banking Authority (EBA) data as of end-2016. The 14 countries are Belgium, Estonia, Finland, France, Greece, Ireland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Slovakia, Slovenia, and Spain.

5 Specifically, and based on the same EBA data as of end-2016 as in the previous footnote, there are five separate deposit insurance schemes in Austria (respectively for savings banks, Raiffeisen banks, Volksbanks, regional mortgage banks, and commercial banks; there is an ongoing process to merge the mandatory components of these into one single national system); two in Cyprus (for cooperative banks and other banks); four in Germany (for cooperative banks, savings banks, public-sector banks, and commercial banks); two in Italy (for credit cooperative banks and other banks); and two in Portugal (for mutual agricultural banks and other banks). As per the EBA dataset, every single one of these dedicated insurance schemes has more covered deposits than the national deposit insurance scheme of Estonia.
### A winning option for all euro area member states

The combination of country-blindness for the insured depositors but not for the contributing banks has not previously been proposed, as far as we know. But it would effectively serve to reconcile the twin objectives of risk-sharing and market discipline, the leitmotif of the entire report.

Our proposal is realistic and ready to be adopted in 2018. It would make retail bank runs much less likely in sovereign stress scenarios, and would thus reduce the redenomination risk exposed during the euro-area crisis. All euro-area countries would benefit, especially those with high debt or perceptions of credit risk, vastly offsetting any perceived downsides of introducing the sovereign concentration charges that are an indispensable complement to EDIS.

There is of course a need for further technical elaboration, not least on the transitional arrangements. The transition should not be too short. Somewhere between five and ten years is probably apt. For practical reasons, the legislative process probably has to wait until after the European Parliament election of 2019, but the Council could give a firm mandate, including a set duration for the transition, after a negotiation that need not last more than a few months. As our report puts it, “the key decisions in this area can and should all be taken in 2018.”

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Building a stable European Deposit Insurance Scheme

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A key function of deposit insurance is to provide a credible safety net for depositors which is beyond doubt, including in times of crisis. At the same time, deposit insurance, like any insurance scheme, raises moral hazard concerns. When depositors are protected by a supranational deposit insurance scheme, participating countries may be less strict with national banking policies. It is important to address these moral hazard concerns.

However, current proposals for a European Deposit Insurance Scheme (EDIS) with national compartments to address moral hazard (e.g. Gros 2015, Bénassy-Quéré et al. 2018, Schnabel and Véron 2018) may defeat the purpose of the scheme. The idea of national compartments is that the first part of the loss is borne at the national level, only above a certain threshold are losses shared at the supranational level. The viability of particular national compartments may be questioned during a crisis and thereby worsen the crisis dynamics. A good deposit insurance should be a beacon of stability during a crisis, not a source of lingering doubts.

Basics of deposit insurance

In their seminal article, Diamond and Dybvig (1983) show that bank runs can happen in a fractional reserve banking system, whereby banks hold only a fraction of demand deposits in liquid funds and the remainder in illiquid loans. If rumours start about a bank’s quality of assets, depositors will run on the bank as they are served on a first come, first served basis. A credible deposit insurance scheme prevents banks runs, as depositors can rest assured that their deposit is guaranteed up to a certain amount.
A deposit insurance scheme only works if it is beyond doubt for depositors. That is ultimately dependent on a credible fiscal backstop by the government (Schoenmaker 2018). Once the market starts to question a country’s capacity (not only the fiscal capacity but also the political willingness) to support its banking system and related safety nets, then a deposit flight is difficult to stop. We have witnessed that during the euro sovereign crisis, for example in the cases of Ireland, Portugal, and Spain. The same happened during the Great Depression in the US. State-level deposit insurance funds went bankrupt because of lack of geographic diversification and size, intensifying the banking crisis. One of the first actions of the then incoming President Franklin Roosevelt was the establishment of a deposit insurance system at the federal level, the Federal Deposit Insurance Corporation (FDIC), as part of the New Deal legislation in 1933 (Golembe 1960).

Moving to the banks, it is important to contain the impact of the failure of one or more bank(s) with subsequent deposit insurance payouts on the remaining banks. Such payouts can weaken the banking sector, as banks fund the scheme both ex ante and ex post. A large failure with uncertain payouts (the exact losses at the failing bank(s) are not directly known because of fluctuating asset values in times of crises) can set out a negative trust spiral in the case of smaller deposit insurance funds.

Finally, the adverse selection and moral hazard aspects of deposit insurance should be addressed to minimise the exposure of the government as fiscal backstop of deposit insurance. To counter adverse selection, weak banks should not be allowed in. Existing banks need to be cleaned by removing, or full provisioning of, non-performing loans. Once banks are in, supervisors should monitor them in the day-to-day supervision.

So smaller deposit insurance funds are more vulnerable, as witnessed in the early 1930s in the US and more recently in Europe, while a large fund with a credible fiscal backstop stabilises the banking system (Schoenmaker 2018).

**National compartments are destabilising**

Notwithstanding the weakness of smaller funds, several authors (Gros 2015, Benassy-Queré et al. 2018, Schnabel and Véron 2018) propose keeping national compartments in EDIS. The idea of national compartments is to limit cross-border solidarity, because of lack of political support for a full EDIS. It means that the first part of the loss is borne at the national level, including partial clawback (Gros 2015) or ex-post fees (Benassy-Queré et al. 2018, Schnabel and Véron 2018).
As banks often fail in times of recession, payouts typically happen when the surviving banks are also not in very strong shape. The surviving banks have to refill the national compartment through future contributions (regular contributions and ex-post contributions). This could destabilise the national banking system, also in comparison with the other banks in the euro area. So, a national compartment may be self-defeating and reduce the stability of the national banking system.

A second-round effect may be that the credit function of banks is hampered as they become capital constrained (credit crunch). This has a negative impact on the economy. Figure 1 shows the vicious cycle between a national banking system and the domestic economy.

**Figure 1**  Bank–sovereign linkages


### Addressing moral hazard

Moral hazard can be addressed in several ways. First, concentration limits on banks’ sovereign bond holdings are crucial to reduce the sovereign risk in bank balance sheets (Véron 2017). Second, current efforts of the ECB and European Commission to reduce the share of non-performing loans (NPLs) should be pursued with vigour. Banks should ‘come clean’ before they enter a fully mutualised EDIS. A transition period is instrumental to reducing sovereign concentrations and NPLs, while building up the mutualisation of risks in EDIS. Third, the ECB as central supervisor in the Single Supervisory Mechanism should be tough in its licensing and supervision of banks.
(ex ante prevention). For future NPLs, the ECB should, for example, lay down tough provisioning rules (with mandatory write down after a few years).

A final mechanism to mitigate moral hazard concerns is the introduction of a country component in the risk-based premium for deposit insurance, as proposed by Benassy-Quéré et al. (2018) and Schnabel and Véron (2018). If a country has weak banking policies – such as weak creditor rights, lengthy insolvency procedures, lax provisioning policies, or permissive housing finance – the country risk premium can be higher for that country (providing an incentive to improve banking policies and phase out differences). The risk-based premium would then have a bank-specific risk component and a country-specific risk component. Importantly, the risk premium should be set by the integrated Single Resolution and Deposit Insurance Board, outside the political arena.

**EDIS integrated in Banking Union**

EDIS should become an integral part of a completed Banking Union. Figure 2 provides a schematic view of such a completed Banking Union. In earlier work (Sapir and Schoenmaker 2017), my co-author and I propose that the ECB should become the lender of last resort providing ELA and the European Stability Mechanism (ESM) should become a European Monetary Fund (EMF), providing a credit line to the new Single Resolution and Deposit Insurance Fund when needed (in addition to its main task of backstopping countries in need).

**Figure 2** European institutions for financial supervision and stability in a Banking Union

![Diagram of European institutions](image)

*Note:* The framework illustrates the five stages from rulemaking to the fiscal backstop. The bottom line shows the agency for each function.

Here, we elaborate on the idea to integrate the Single Resolution Board (SRB) and EDIS into a Single Resolution and Deposit Insurance Board (SRDIB). Moreover, we also recommend to integrating the two funds – the Single Resolution Fund (SRF) and the European Deposit Insurance Fund (EDIF) – into a Single Resolution and Deposit Insurance Fund (SRDIF) in line with our earlier proposal (Gros and Schoenmaker 2014).

A first advantage is that we simplify crisis management. There are currently too many players, which makes crisis management more difficult. Experienced crisis managers know that crisis management complexity increases quadratically with the number of players and the speed of action slows down accordingly. The SRDIB could apply the least-cost principle, which requires the resolution authority to choose the resolution method in which the total amount of the expenditures and (contingent) liabilities incurred has the lowest cost to the resolution and deposit insurance fund (Gros and Schoenmaker 2014).

A second advantage is that an integrated fund fully exploits the pooling potential of insurance. Not only national funds, but also resolution and deposit insurance funds are pooled into one fund. After a transition period, we should have a proper functioning Banking Union with a fully funded Single Resolution and Deposit Insurance Fund. We propose a 2% target fund ratio for the joint fund of SRDIF, similar to the FDIC. The current target fund ratios are 1% for SRF and 1.5% for EDIF (see Table 1).

### Table 1  Target size of the Single Resolution and Deposit Insurance Fund (end-2017)

<table>
<thead>
<tr>
<th></th>
<th>SRF</th>
<th>EDIF</th>
<th>Total</th>
<th>SRDIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target fund ratio</td>
<td>1%</td>
<td>1.5%</td>
<td>2.5%</td>
<td>2%</td>
</tr>
<tr>
<td>(as % of covered deposits)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Target size (in € billions)</td>
<td>54.6</td>
<td>81.8</td>
<td>136.4</td>
<td>109.1</td>
</tr>
<tr>
<td>Available funds (in € billions)</td>
<td>17.4</td>
<td>20.1</td>
<td>37.5</td>
<td>37.5</td>
</tr>
<tr>
<td>Available funds as % of target size</td>
<td>32%</td>
<td>25%</td>
<td>28%</td>
<td>34%</td>
</tr>
</tbody>
</table>

*Note: Covered deposits of the Eurozone banks amount € 5,456.6 billion at end-2017. The figures are for end-2017, except (1) available funds at DIF are for end-2016. Source: Author calculations based on EBA (2017) and SRB (2017).*
Conclusions

We need to address moral hazard concerns arising from European deposit insurance. These justified concerns can be alleviated through a country-specific component in the risk-based premium for deposit insurance and limits on sovereign bond exposures on bank balance sheets. But proposals to maintain national compartments in a new European Deposit Insurance Scheme are self-defeating, as such compartments can be destabilising in times of crisis.

References


**About the author**

Dirk Schoenmaker is a Professor of Banking and Finance at the Rotterdam School of Management, Erasmus University Rotterdam, a Non-Resident Fellow Bruegel, and a CEPR Research Fellow.
As the deadline for the June Euro Summit is approaching, expectations are rising on European leaders to see whether or not the Banking Union will finally be completed with its third Pillar: a European Deposit Insurance Scheme (EDIS).

In recent months, we have seen many proposals (e.g. European Parliament 2016, Bénassy-Quéré et al. 2018, Schnabel and Véron 2018, Schoenmaker 2018) to break the deadlock by suggesting alternative designs for an EDIS, which would cater for the concerns that such a scheme would lead to some banking sectors having to bear the costs of bank failures in other member states.

But are those fears well-founded? In a recent paper, we seek to put such concerns into perspective (Carmassi et al. 2018). To do so, we follow a two-step approach. In the first step, we calculate the exposure of the EDIS to bank failures using banks’ estimated probabilities of default and loss given default. This allows us to measure the resilience of the EDIS. In a second step, we estimate risk-based contributions to the EDIS based on the European Banking Authority (EBA) Guidelines developed for the Deposit Guarantee Scheme Directive (DGSD). Comparing the EDIS’s exposure derived in the first step to banks’ contributions allows us to identify whether there is cross-subsidisation, in the sense of some banking system systematically contributing less than they would benefit from the EDIS under certain simulated loss scenarios.

1 For doing so, we are using an early warning model that accounts for different bank-specific, aggregate banking sector and macro-financial variables.
Would an EDIS be big enough in another financial crisis?

We look at how a fully mutualised EDIS, with a target size of 0.8% of covered deposit, would be affected in a crisis in the steady state. We simulate various shocks, among which is a scenario under which the 10% riskiest banks in our sample simultaneously fail. Our analysis considers losses from 5% to 25% of total assets for resolved banks (bail-in), which is an extremely conservative range if compared to the values observed in the last crisis. In addition, we also consider the same amount of losses simultaneously affecting all the failing banks.

We find that a fully-funded deposit insurance fund would be sufficient to cover losses in crises even more severe than the 2007-2009 Global Crisis. And this would also be true in case of simultaneous country-specific shocks.

This is partly due to the substantive risk reduction that has already taken place in the banking system – notably the introduction of bail-in and the corresponding increase in banks’ loss absorbing capacity, the creation of a resolution framework, and the super-priority provided to covered deposits. These all contribute to reduce the likelihood of tapping into the EDIS.

This doesn’t mean that the EDIS would not be relevant. On the contrary, its purpose is precisely to enhance depositors’ confidence, thereby avoiding risks of bank runs and contagion, and to serve as a credible line of defence in case of large shocks that would overwhelm national schemes.

Would a fully-fledged EDIS lead to cross-border subsidisation?

The way banks’ contributions to the deposit insurance fund are designed is crucial: we calculate risk-based contributions according to different risk-adjustment factors and benchmarked at the banking union level, following a ‘polluter-pays’ principle. Comparing these risk-based contributions to the EDIS exposure shows that there would be no unwarranted systematic cross-subsidisation across member states. While there are some cases in which the contributions of a banking system are lower than the amounts which would be received from the EDIS, this is only the case in extreme scenarios. Two elements are driving these results.

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2 As a term of comparison, the European Commission estimated average losses for 23 banks over the period of 2007-2010 to be 2.5% of total liabilities; the Financial Stability Board found that for G-SIBs losses as a fraction of total assets ranged from less than 1% to 4.7%, with most banks in a 2-4% range.
• First, the methodology used to calculate contributions can take into account several indicators linked to risk reduction in the banking system, such as the level of banks’ loss-absorbency, their ratio of non-performing loans, or the strength of national insolvency frameworks. We show in our analysis that the existing EBA methodology developed for DGS can be used for these purposes.

• Second, bank contributions are benchmarked on a banking union basis, and are not exclusively related to national peers. This makes it possible to take into account the relative riskiness of the banking sectors, and to reduce the risk of unwarranted cross-border subsidisation.

We have received the criticism that our proposed bank contributions would be procyclical, as weaker banks would by design have to pay more into the deposit insurance fund. While this is a theoretical possibility, one has to keep in mind that the deposit insurance fund has to be built up over ten years. As a share of banks’ total assets, this represents an average contribution equal to 0.58%, roughly corresponding to yearly contributions equal to 0.06% of each bank’s total assets. We thus view this concern not as a first order issue for the design of the EDIS.3

Would a ‘mixed’ deposit insurance system better address concerns?

Some recent policy discussions have considered alternative approaches to the EDIS, notably a design under which national deposit guarantee schemes (as in the draft report by MEP Esther De Lange; see European Parliament 2016) or national compartments of EDIS (as in the proposal by Bénassy-Quéré et al. 2018, further investigated by Schnabel and Véron here on Vox) would intervene first, and the European deposit insurance fund would be a second line of defence. The rationale for these proposals would be that a mixed scheme would better align incentives and avoid risks of moral hazard.

Our empirical analysis shows that risks of cross-subsidisation under a fully-fledged EDIS are unfounded in the first place. Nevertheless, we analysed how a mixed deposit insurance system would fare. Under our assumptions, which are substantially in line with the draft report by MEP De Lange, such a system could consist of national deposit insurance schemes and a European deposit insurance fund, each with a target level of 0.4% of covered deposits. The European fund would intervene only after the depletion of at least one national fund. The key change with respect to a fully-fledged EDIS

3 However, this concern would be relevant in the case of a mixed scheme with national compartments, where ex-post contributions have to be called to replenish the national compartment.
would be that the contributions paid by banks to reach the national 0.4% target level would be risk-based relative to their national benchmark, and not to their banking union peers.

We find that cross-subsidisation would increase in such a mixed system relative to a fully-fledged EDIS, as shown in Table 1. The red cells indicate an increase in cross-subsidisation under the mixed system, and this would affect Belgium, Cyprus, Spain and Greece.

This is the direct consequence of a mixed deposit insurance scheme designed with fixed national target levels, and under which contributions to national compartments are benchmarked at the national level. Following this approach, banks are compared only to their national peers and banks’ contributions are bound by the risk-insensitive limit of a fixed share of covered deposits. Hence, having a mixed scheme for the EDIS with fixed target levels for national funds could in fact lead to more cross-subsidisation than a fully-fledged EDIS, rather than less.

It would of course be possible to have other designs for a mixed scheme. In our view, to fully take into account the relative riskiness of banks, the national target levels would in any case need to be flexible, i.e. allowed to vary with the relative riskiness of the banking systems with respect to the banking union benchmark.

However, the fact that national compartments have to be emptied first under a mixed scheme strongly diminishes the appeal of the EDIS in terms of ensuring a uniform level of confidence across the banking union, and maintains an element of bank-sovereign nexus. In that respect, we agree with Schoenmaker (2018) that preserving national compartments would go against the spirit of EDIS and that moral hazard is better addressed via other ways, in our case through well-designed risk-based contributions.

4 In the first case, cross-subsidisation is measured as the ratio between the exposure of the deposit insurance fund and the contributions paid to the deposit insurance fund in each country; in the second case, cross-subsidisation is measured as the ratio between the exposures of the European fund and the contributions paid to the European fund only.


<table>
<thead>
<tr>
<th>Loss resolution (%TA)</th>
<th>Loss Insolvency (%TA)</th>
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<tbody>
<tr>
<td>5%</td>
<td>7.50%</td>
</tr>
<tr>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>15%</td>
<td>22.50%</td>
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<tr>
<td>20%</td>
<td>30%</td>
</tr>
<tr>
<td>25%</td>
<td>37.50%</td>
</tr>
</tbody>
</table>

Table 1 Cross-subsidisation: Fund exposure per euro contributed under a ‘mixed’ deposit insurance scheme and fully-fledged EDIS – 10% riskiest banks failing

Banks’ contributions based on DGS sliding scale method and DGS-baseline indicators, calibrated at the European level for the fully-fledged EDIS and for the European compartment in the “mixed” scheme, calibrated at the national level for the national compartments in the “mixed” scheme

<table>
<thead>
<tr>
<th>Country</th>
<th>AT</th>
<th>BE</th>
<th>CY</th>
<th>DE</th>
<th>EE</th>
<th>ES</th>
<th>FI</th>
<th>FR</th>
<th>GR</th>
<th>IE</th>
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<th>LT</th>
<th>LU</th>
<th>LV</th>
<th>MT</th>
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<th>SK</th>
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<tbody>
<tr>
<td>5%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>10%</td>
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<td>0</td>
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<tr>
<td>15%</td>
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<tr>
<td>20%</td>
<td>0</td>
<td>1.27</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>25%</td>
<td>0</td>
<td>1.37</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0.26</td>
<td>0</td>
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<td>0</td>
<td>0.63</td>
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<tr>
<td></td>
<td>0</td>
<td>10.84</td>
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<td>1.99</td>
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<td>0</td>
<td>21.81</td>
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<td>0</td>
<td>0</td>
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<tr>
<td></td>
<td>0</td>
<td>6.15</td>
<td>2.03</td>
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<td>1.45</td>
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<td>0.01</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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</tbody>
</table>

Note: Under the fully-fledged EDIS, the EDIS exposure per euro contributed for each country is calculated as the sum of EDIS exposures to all banks within a country divided by the sum of contributions of all banks’ of that country. Under the mixed system, cross-subsidisation is measured as the ratio between the exposure of the European fund and the contributions paid to the European fund only. Source: ECB staff calculations based on COREP and Bankscope data, 2015:Q4.
Conclusions

In conclusion, a fully-fledged EDIS would offer major benefits in terms of depositor protection while posing limited risks in terms of EDIS exposure. The EDIS would also play a key role in terms of confidence building, by avoiding risks of self-fulfilling prophecies on bank runs and ensuring that one euro saved in one country is worth the same as a euro saved in another.

Most importantly, even a fully-fledged EDIS would not lead to some banking systems subsidising others, as well-designed risk-based contributions grounded on the polluter-pays principle and benchmarked at the Banking Union level would protect the EDIS from systematic cross-subsidisation. And this is even more the case than under a mixed system where a portion of the contributions is benchmarked at the national rather than at the banking union level.

This finding strongly diminishes the case for having a mixed EDIS where national deposit guarantee schemes or national compartments are taking the first hit, as the key concern underpinning calls for such scheme seems unfounded. In addition, cross-subsidisation should be seen as a form of desirable risk-sharing in extremely adverse scenarios, as pooling resources ensures that national schemes are not overwhelmed in case of severe crises, thus reducing the bank-sovereign nexus. This is different from a systematic unwarranted cross-subsidisation.

References


**About the authors**


**Laura Parisi** is financial stability expert at the Directorate General for Macroprudential Policy and Financial Stability of the European Central Bank.

**Michael Wedow** is Adviser at the Directorate General Macroprudential Policy and Financial Stability of the European Central Bank.
Sovereigns are exposed to bank risk and banks are exposed to sovereign risk. During crises, this two-way risk exposure interacts in a ‘doom loop’ to create additional risk endogenously (Farhi and Tirole 2018). At a leaders’ summit in June 2012, euro area governments recognised the imperative of breaking the doom loop. But bank regulation still treats sovereign debt as risk-free and does not penalise concentrated portfolios.

This column, based on a model of portfolio reallocation by euro area banks following hypothetical regulatory reforms (Alogoskoufis and Langfield 2019), sheds light on two questions. First, would banks reduce portfolio concentration in response to reforms? Second, would they reduce exposures to sovereign credit risk? Simulations show that the answer is never an unambiguous and simultaneous ‘yes’ to both questions under reforms envisaged by the Basel Committee on Banking Supervision (2017). In fact, under plausible conditions, portfolios become substantially more concentrated or risky, highlighting potential unintended consequences of regulatory reforms that focus only on concentration or credit risk in isolation.

Reform design can be improved by incentivising banks to reduce both concentration and credit risk. Yet all designs face a common constraint: the incompleteness of euro area sovereign bond markets. With the current investible universe, it is impossible to assemble a portfolio with levels of concentration and credit risk that are sufficiently low to avoid a doom loop. The intuition is that a low-risk portfolio would be highly concentrated (in German bonds), whereas a low concentration portfolio is moderately risky. A new asset that embeds both properties – either through fiscal or contractual innovation – would therefore make financial markets more complete. We show that regulation can complement a common safe asset by enhancing incentives for banks to reinvest into it.
Portfolio concentration and credit risk

Most euro area banks’ sovereign portfolios are heavily home biased. Brunnermeier et al. (2017) show that national doom loops can be avoided if moderately well capitalized banks were to diversify their portfolios. For this reason, several policy experts – including Véron (2017) and Gros (2018) – have advocated a regulatory regime that encourages banks to diversify, for example with positive risk-weights for concentrated sovereign portfolios. A bonus feature of diversification in the euro area is that cross-border portfolios do not bear currency risk.

However, diversification can give rise to contagion. Banks are vulnerable to the re-pricing of both domestic and foreign sovereign debt when such securities are widely used in repo markets (Bolton and Jeanne 2011) or when equity levels are low relative to sovereign portfolios (Brunnermeier et al. 2017). Under these conditions, an international doom loop can occur in which sovereign distress anywhere affects banks and sovereigns everywhere. This has significantly more devilish implications for financial stability than merely national doom loops, since in the latter case sovereign distress affects only domestic banks.

Outstanding repos backed by euro sovereign bonds amount to approximately €4.5 trillion;1 the average euro area bank holds nearly 200% of its book equity value in sovereign bonds.2 Hence, the dark side of diversification – contagion – is an empirically relevant concern. Breaking national doom loops while avoiding an international one requires banks to hold sovereign portfolios that embed low credit risk in addition to low concentration. This is the central insight against which regulatory reform ideas should be evaluated.

Measuring sovereign portfolios

The European Banking Authority regularly discloses banks’ sovereign bond holdings. We use data on mid-2017 holdings for a sample of 95 euro area banks; the appendix uses data from other vintages. Guided by theory, we measure portfolios according to their concentration and credit risk. Concentration is measured as the sum of squared deviations from portfolio weights given by the ECB capital key (which is based on the relative economic and population size of member states). Credit risk is measured as the

1 Source: International Capital Market Association data.
2 Source: European Banking Authority data.
five-year expected loss rate using a stochastic model of sovereign default introduced to the literature by Brunnermeier et al (2017). (Our main paper also reports alternative measures of concentration and credit risk.)

Figure 1 plots these two portfolio measures for our main sample. While there is wide cross-sectional dispersion, no bank’s portfolio has both low concentration and low credit risk. In fact, such a portfolio cannot be created from existing securities. The minimum value of the expected loss rate (ELRate), 0.5%, can be achieved only with a portfolio comprised exclusively of German sovereign bonds – but this portfolio has a very high deviation from the ECB capital key (KeyDeviation). Conversely, a portfolio weighted by the ECB capital key has a material ELRate of 4.4%. This insight provides early intuition for the tension between concentration and credit risk.

**Figure 1** Concentration and credit risk in sovereign portfolios

*Note: Crosses refer to the sovereign portfolios of sample banks as of mid-2017, measured by concentration (i.e. KeyDeviation, the sum of squared deviations from the ECB capital key) and credit risk (i.e. ELRate, the five-year expected loss rate). Banks are grouped by the rating of their home country. As a benchmark, the black diamonds denote the two corner solutions: \( \min(\text{KeyDeviation}) = 0 \), at which \( \text{ELRate} = 4.4\% \); and \( \min(\text{ELRate}) = 0.5\% \), at which \( \text{KeyDeviation} = 18.5 \).*
Modelling endogenous portfolio reallocation

How might portfolios change in response to regulatory reform? Despite the abundance of reform ideas, there is little analysis of the impact on sovereign portfolios. Schneider and Steffen (2017) provide insightful quantitative assessments of the impact of reforms on capital requirements. However, they assume that banks maintain their current sovereign portfolios – the elasticity of holdings with respect to capital requirements is taken to be zero. Hence, such analyses characterise only a special case of banks’ reaction functions.

To provide a more general characterisation, we model endogenous portfolio reallocation in response to regulatory reform. In the model, banks deviate from their extant portfolio allocation insofar as reallocation achieves lower capital requirements. Corner solutions are characterised by banks choosing a sovereign portfolio allocation that globally minimises capital requirements. We also quantify the full range of intermediate elasticities whereby banks partially reallocate portfolios.

While portfolio allocation is endogenous in the model, total holdings of sovereign bonds are inelastic with respect to their regulatory treatment. This assumption is motivated by the insight that banks use euro area sovereign bonds as liquid stores of value and as collateral. In addition, regulation requires banks to hold liquid assets, such as sovereign bonds, to comply with liquidity requirements.

These conditions generally allow for multiple solutions because banks can minimise capital requirements with many different portfolio allocations. For example, a regulatory penalty for holding securities rated below a critical threshold can be avoided by any arbitrary portfolio comprising securities rated above that threshold. To establish unique solutions, we focus on three illustrative cases, which apply insofar as portfolio reallocation can lower banks’ capital requirements:

- **Prudent case:** banks reinvest into the lowest-risk sovereign bond that attracts the lowest capital charge. This provides a limiting case of the most conservative portfolio allocation under a given regulatory reform.
- **Base case:** banks reinvest into the sovereign bond that most closely matches their initial portfolio characteristics and attracts the lowest capital charge.
- **Imprudent case:** banks reinvest into the highest-risk sovereign bond that attracts the lowest capital charge. This provides a limiting case of the greatest credit risk exposure that banks would assume under a given regulatory reform.
Substantial portfolio reallocation is likely to affect relative prices. One would expect the price of sovereign bonds to increase (decrease) when banks are on aggregate net buyers (sellers). Our model abstracts from these general equilibrium effects on relative prices. In that sense, our results can be interpreted as a lower bound on the unintended consequences of regulatory reform.

**Results for post-reform portfolio allocation**

The model is applied to two regulatory reforms envisaged by the Basel Committee on Banking Supervision (2017). In the first (shown in Table 1, Panel A), risk-weights are an increasing function of single-name holdings. In the second (Panel B), risk-weights are set according to sovereign credit ratings. (In Alogoskoufis and Langfield (2019), we also apply the model to quantitative restrictions on sovereign portfolios.)

**Table 1** Options to reform the regulatory treatment of sovereign exposures

Panel A: Concentration-based risk weights

<table>
<thead>
<tr>
<th>Exposure as % of Tier 1 capital</th>
<th>&lt;100%</th>
<th>100-150%</th>
<th>150-200%</th>
<th>200-250%</th>
<th>250-300%</th>
<th>&gt;300%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marginal risk weight</td>
<td>0%</td>
<td>5%</td>
<td>6%</td>
<td>9%</td>
<td>15%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Panel B: Ratings-based risk weights

<table>
<thead>
<tr>
<th>Credit rating</th>
<th>AAA to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>0%</td>
<td>4%</td>
<td>7%</td>
</tr>
</tbody>
</table>

Note: The table reports calibrations of two ideas to reform the regulatory treatment of sovereign exposures, as mooted by the Basel Committee on Banking Supervision (2017).

For each of these proposed reforms, the model determines a new set of sovereign portfolios which can be summarised by their concentration and credit risk. Figure 2 plots the results for concentration-based risk-weights, and Figure 3 for ratings-based risk-weights. In each figure, the fan represents the cross-sectional dispersion across bank portfolios. The horizontal axis captures the extent of reallocation: at 0%, banks just hold their mid-2017 portfolio; at 100%, banks hold the capital requirement minimising portfolio. This can be interpreted as the elasticity of portfolio allocation with respect to regulation.

Concentration-based risk-weights unambiguously reduce concentration. Nevertheless, portfolios remain concentrated relative to ECB capital key weights even after 100% reallocation (Figure 2, top panel). Moreover, in the base case and particularly in the
imprudent case, concentration-based risk-weights are consistent with banks increasing their sovereign credit risk exposure (bottom panel). Such an outcome could strengthen the doom loop and lead to its international propagation.

**Figure 2**  Concentration-based risk-weights and portfolio reallocation

![Concentration-based risk-weights and portfolio reallocation](image)

*Note:* The fan represents the cross-sectional dispersion across 95 euro area bank portfolios of concentration (measured by KeyDeviation, i.e. the sum of squared deviations from the ECB capital key) in the top panel and credit risk (measured by ELRate, i.e. the five-year expected loss rate) in the bottom panel. The horizontal axis captures the extent of reallocation: at 0%, banks just hold their mid-2017 portfolio; at 100%, banks hold the capital requirement minimizing portfolio.

By contrast, ratings-based risk-weights can exacerbate portfolio concentration (Figure 3, top panel), although credit risk is generally declining in the prudent and base cases and stable in the imprudent case (bottom panel). High concentration – even in ostensibly low-risk sovereigns – can be problematic insofar as idiosyncratic sovereign credit risk is time-varying. Thus, concentrated holdings of foreign sovereign debt can generate cross-border contagion.
**Common safe assets**

A feature of reform designs mooted by the Basel Committee on Banking Supervision (2017) is that they target only concentration or credit risk in isolation. This drives our findings concerning the potential unintended consequences of regulatory reform. In principle, it is possible to improve on the Basel designs, for example by setting risk-weights as a function of both concentration and credit risk.

However, even a first-best design is constrained by a missing feature of euro area sovereign debt markets. A portfolio with both low concentration and low credit risk can only be assembled if the investible universe is expanded to include a security that entails both properties. We refer to such an *area-wide* and *low-risk* security as a ‘common safe asset’.

Note: The fan represents the cross-sectional dispersion across 95 euro area bank portfolios of concentration (measured by KeyDeviation, i.e. the sum of squared deviations from the ECB capital key) in the top panel and credit risk (measured by ELRate, i.e. the five-year expected loss rate) in the bottom panel. The horizontal axis captures the extent of reallocation: at 0%, banks just hold their mid-2017 portfolio; at 100%, banks hold the capital requirement minimizing portfolio.
In the absence of fiscal innovation, a common safe asset must be financially engineered through contractual innovation. Contract design options include ‘pooling-then-tranching’ existing sovereign debt (as in the feasibility study of the High-Level Task Force on Safe Assets 2018) or ‘tranching-then-pooling’ it (as suggested by Buti et al. 2017 and analysed by Leandro and Zettelmeyer 2018). With appropriate calibration, either option can be designed to have negligible levels of both concentration and credit risk.

**Figure 4**  Portfolio reallocation into a common safe asset

Note: The fan represents the cross-sectional dispersion across 95 Eurozone bank portfolios of concentration (measured by KeyDeviation, i.e. the sum of squared deviations from the ECB capital key) in the top panel and credit risk (measured by ELRate, i.e. the five-year expected loss rate) in the bottom panel. The horizontal axis captures the extent of reallocation: at 0%, banks just hold their mid-2017 portfolio; at 100%, banks hold the capital requirement minimizing portfolio. Note that in this application of the model there is no variation across the prudent, base and imprudent cases, because a portfolio comprised of a common safe asset always represents the unique solution to the constrained optimization problem.

Would banks reinvest in such an asset? In a final step, we apply our model to a world in which a common safe asset exists alongside national sovereign debt. Surprisingly, neither of the two reforms envisaged by the Basel Committee on Banking Supervision
(2017) would provide strong regulatory incentives for banks to reinvest into a common safe asset, since they allow multiple solutions to the constrained optimisation problem. To strengthen regulatory incentives, one option would be to set a positive risk-weight floor on all single-name sovereign holdings (either on its own or in combination with other reforms). In this way, holding a common safe asset uniquely minimises capital requirements, regardless of the reallocation rule that banks adopt. Therefore, at 100% reallocation, sovereign portfolios are comprised entirely of the common safe asset, implying minimal levels of both concentration and credit risk, as shown in Figure 4.

Policy conclusion

Mainstream approaches to reform the regulatory treatment of sovereign exposures face a tension between concentration and credit risk, as summarised in Table 2. This tension implies that reform could backfire. If portfolio concentration is too high, banks will be vulnerable to time-variation in idiosyncratic sovereign credit risk. If credit risk is too high, banks will be vulnerable to both domestic and foreign sovereign debt re-pricing, potentially giving rise to an international doom loop.

Table 2 Summary of results

<table>
<thead>
<tr>
<th></th>
<th>Change in concentration</th>
<th>Change in credit risk</th>
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<tbody>
<tr>
<td>Concentration-based risk weights</td>
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<tr>
<td>Ratings-based risk weights</td>
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<tr>
<td>Area-wide low-risk asset</td>
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Note: The table summarises the main results in Alogoskoufis and Langfield (2019).

All regulatory designs are constrained by the incompleteness of euro area sovereign debt markets, which make it impossible to assemble a portfolio that has sufficiently low concentration and credit risk. Hence, breaking the doom loop requires the portfolio opportunity set to include a common safe asset. Well-designed regulatory reform complements such an asset by incentivizing banks to reinvest into it. This policy conclusion supports the approach of Bénassy Quéré et al. (2018), who advocate a common safe asset for the euro area alongside regulatory reform. The complementarity between safe assets and regulation was also acknowledged by the European Commission (2019) in its contribution to the recent EU27 leaders’ meeting in Sibiu. If policymakers act on this insight, Europe’s devilish doom loop may yet be broken.
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**About the authors**

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Section 2: How to create euro-area safe assets?
The euro area is growing faster than it has for a decade. But policymakers cannot
be complacent – while the single currency has been successful, its macro-financial
framework is incomplete. This structural incompleteness gives rise to fragility (Draghi
2016).

In particular, Europe does not enjoy a truly common market for banking services. The
idiosyncrasies of local banking systems can amplify national differences in exposures
to adverse shocks. Segmented banking systems can also give rise to adverse feedback
loops between weak fiscal positions and weak banks.

These inherently destabilising features stand in contrast to the US, where a common
banking system helps to dampen idiosyncratic shocks. The monetary policy of the
Federal Reserve can therefore be transmitted across the entire US, regardless of local
differences in economic conditions.

One source of shock amplification in the euro area is that banks tend to hold large
amounts of domestic sovereign debt. This home bias ties the stability of banks to the
fortunes of governments – and vice versa. In 2012, governments committed to cutting
this Gordian knot, which was responsible for worsening the financial crisis from which
Europe is still recovering. Since then, progress towards a full banking union – in which
country-level circumstances do not determine bank-level risks – has been substantial.
But progress has nevertheless been insufficient. New ideas are needed to move Europe
forward by completing banking union.

In this context, a High-Level Task Force of the European Systemic Risk Board (ESRB)
has investigated one promising way to cut the knot. The idea under investigation is
to bundle sovereign bonds – assembled from countries able to issue debt to private
investors – and use it to back the issuance of new securities with different levels of
seniority. The most senior component would be protected by mid-tier (‘mezzanine’) and first-loss (‘junior’) securities. The existence of these sovereign bond-backed securities (SBBS) would allow banks to reduce their domestic sovereign risk exposure (by gradually swapping their holdings into senior SBBS) without needing to reduce their overall holdings of sovereign debt-related instruments or engineer sudden and asymmetric adjustments in the composition of those holdings. They therefore offer a gentle path to the completion of banking union that respects the principle of national responsibility for fiscal policy.

These securities were originally proposed by a group of European economists (Brunnermeier et al 2011). The idea has since been elaborated in other papers (Garicano and Reichlin 2014, Brunnermeier et al. 2016, 2017, Bénassy-Quéré et al. 2018). But ‘ivory tower’ ideas do not always work in practice. That is why the ESRB commissioned a High-Level Task Force to investigate the feasibility of these securities in the euro area. This column summarises – in the authors’ own words – the findings of that feasibility study with respect to security design, regulation and market development.

**Security design**

The payoffs accruing to investors in SBBS arise from central government debt. This makes them unique relative to other securities that currently exist in financial markets. Designing SBBS and assessing their risk properties therefore requires a fresh analytical approach. There are two basic design choices:

- First, which weights should be used in the portfolio of sovereign bonds that backs the securities?
- Second, which seniority structure should be used, and therefore how much protection should the senior component receive from loss-absorbing securities?

These two design parameters determine the risk properties of the securities. For example, Kraemer (2017) assesses the case of a debt-weighted underlying portfolio and concludes that senior SBBS would require substantial protection from loss-absorbing securities. By contrast, the ESRB High-Level Task Force on Safe Assets (2018) recommends that portfolio weights be guided by the ECB capital key (calculated based on GDP and population). This is very different to debt weights, mostly due to Germany’s higher weight and Italy’s lower weight in a portfolio guided by the ECB capital key.

The second design choice relates to the seniority structure. To achieve low-riskiness, how much protection would senior SBBS require from the loss-absorbing securities?
This is an empirical question. To make an assessment, it is necessary to perform stress tests by subjecting different levels of protection to extreme default scenarios.

As a first step, Figure 1 plots the losses due to sovereign defaults that would accrue to SBBS backed by a portfolio of sovereign bonds weighted by the ECB capital key. Two insights emerge. First, no single sovereign default can impose losses on senior SBBS when they are protected by 30%-thick mezzanine and junior SBBS. Second, under the strong assumption that multiple countries default in ascending order of their credit rating, the marginal defaulters with respect to 70%-thick senior SBBS are Spain (if loss rates following default are assumed to be 100%), France (if loss rates are 70%) and Germany (if loss rates are 40%). Given that the average loss rate in historical sovereign debt restructurings is 37% (Cruces and Trebesch 2013), these findings suggest that 70%-thick senior SBBS would be more robust to extreme default scenarios than any individual sovereign.

Figure 1  Hypothetical sovereign default scenarios and their effect on SBBS
Two additional tests confirm that 70%-thick senior SBBS would behave like other low-risk sovereign bonds.

- First, the risk properties of senior SBBS are assessed through the lens of a simulation model in which sovereigns default with a higher frequency and severity than has occurred historically. In these simulations, 70%-thick senior SBBS are shown to have slightly lower risk than German sovereign bonds. For example, in an adverse calibration of the simulation model in which default correlations are high, investors in German sovereign bonds should expect to lose 37% in the worst 1% of outcomes, whereas holders of senior SBBS should expect to lose 26%.

- Second, the historical yields on senior SBBS are estimated using a static copula approach. At the 10-year maturity point, yields on 70%-thick senior SBBS are estimated to have been 0.13% as at October 2016, when yields on equivalent German sovereign bonds were 0.08%. De Sola Perea et al. (2018) use these estimated yields to quantify the performance of senior SBBS when sovereign risk was in its tails historically. From this perspective, senior SBBS are similar to German and other low-risk sovereign bonds. During the sovereign debt crisis, senior SBBS would have had a negative beta (i.e. their value would have increased as the value of higher-risk assets declined). Moreover, senior SBBS would become more insulated from shocks to non-senior SBBS during financial crises (Cronin and Dunne 2018).

The embedded diversification and low-riskiness of senior SBBS makes them promising securities for banks to hold instead of domestic sovereign debt. By swapping into senior SBBS, banks would reduce their domestic sovereign risk exposure, thereby shutting down the contagion channel from national governments to banks. To show this quantitatively, the right-hand side of Figure 2 plots the credit risk of banks’ sovereign bond portfolios depending on the fraction that they re-invest into senior SBBS. If banks reinvest 100% of their portfolios into senior SBBS, their credit risk exposure becomes minimal. By contrast, if they were to reinvest into a diversified portfolio (without any seniority), most banks would see their credit risk exposure increase, as shown on the left-hand side of Figure 2. This highlights the stabilisation benefits arising from the seniority embedded in SBBS.
The feasibility of sovereign bond-backed securities for the euro area
Lane and Langfield

Figure 2 Credit risk of banks’ sovereign bond portfolios reinvested into a diversified portfolio (left-hand side) and a portfolio comprising senior SBBS (right-hand side)

Note: The figure plots the cross-sectional distributions of the estimated expected loss rates of banks’ sovereign bond portfolios under two reinvestment scenarios. In the left-hand panel, banks are assumed to reinvest a given percentage of their sovereign bond portfolios into a diversified portfolio of euro area central government debt securities weighted by the ECB capital key. In the right-hand panel, banks instead reinvest into senior SBBS. Expected loss rates are estimated according to a benchmark calibration of a default simulation model, which is described in Volume II. In both panels, 0% reinvestment refers to the cross-bank distribution of expected losses based on banks’ sovereign bond portfolios as at mid-2017 according to the EBA transparency exercise (2017). Black lines refer to the median euro area bank and grey lines to percentiles at 10 point increments.

Regulatory policy

At present, SBBS would be treated more harshly than sovereign debt in regulation. This is true across the board – both capital and liquidity requirements and bank and non-bank regulation would treat holdings of senior SBBS more severely than sovereign debt, despite their lower risk. This unfavourable treatment is sufficient to explain the current nonexistence of the securities.

To pave the way for the securities, it is necessary to remove the regulatory obstacles that currently impede their development. Because these obstacles pervade many different financial regulations, the most elegant solution would be to provide for a new treatment in an SBBS-specific enabling regulation. This new regulation would supersede existing regulations and allow for a new approach that recognises the risk properties of the securities, including the diversification and low-riskiness embedded in senior SBBS and the higher risk of the mezzanine and junior securities.

In addition, reforming the regulatory treatment of sovereign exposures would substantially enhance demand for SBBS. This is because banks could use senior SBBS to mitigate the resulting impact on capital requirements. For example, imagine that policymakers decide to impose capital charges on banks’ holdings of sovereign debt as a function of concentration risk. For a particular calibration of such a reform (defined in
Table 5.4 of Volume II of the Task Force report), the 105 largest euro area banks would need to raise €37.6 billion in additional capital in order to keep their capital ratios constant. This equates to an increase in their common equity tier 1 of approximately 2.7%. Banks could avoid this incremental capital charge by switching into senior SBBS, which are inherently diversified and would be treated as such in an enabling regulation. Qualitatively similar considerations apply if the regulatory treatment of sovereign exposures were sensitive to credit risk, given the low riskiness of senior SBBS.

In the Task Force, views were mixed as to whether concentration and/or credit risk charges for bank sovereign exposures are necessary to stimulate SBBS market development and to ensure a prudentially adequate treatment. While some Task Force members considered regulatory reform to be critically important, others were sceptical on the grounds that it could prevent banks from stabilising bond markets. Yet, members agreed that the SBBS initiative does not independently justify reforms to the regulatory treatment of bank sovereign exposures, since such reforms should be evaluated on their own merits (Basel Committee on Banking Supervision 2017).

Euro area banks are not the only investors in sovereign debt. In fact, they hold just 17% of euro area sovereign debt securities, as shown in the top chart of Figure 3. Non-euro area investors hold half of outstanding supranational debt securities (see the bottom chart of Figure 3). These insights suggest that a substantial proportion of the demand for SBBS could come from non-banks and investors resident outside of the euro area. This is particularly true for mezzanine and junior SBBS – ECB data indicate that nearly two-thirds of high-yield euro-denominated debt securities are held by investment funds, compared with about 15% held by banks. Investment funds buying SBBS would not help to weaken the nexus between bank risk and sovereign risk, but it would assist in developing a well-functioning market for the securities.
Figure 3  Holdings of euro area general government debt securities (top) and supranational debt securities (bottom) by sector


Note: The figure shows the breakdown by sector of holdings of euro area general government debt securities (top) and supranational debt securities (bottom) as at Q2 2017.
Market development

Developing markets from scratch is no easy task. Demand is to supply as chicken is to egg: each wants to succeed the other. The curious case of missing ‘macro markets’ is evidence that markets do not always emerge spontaneously (Shiller 1998).

Yet, Europe has form. In 2012, euro area governments signed the treaty establishing the European Stability Mechanism (ESM). Five years later, the market for securities issued by the ESM had grown to over €80 billion. Market development was assisted by three factors, which could also be applied to the case of SBBS.

- First, regulation treats ESM debt securities on a par with sovereign debt. Hence, regulation does not impede investor demand. A similar approach should inform the treatment of senior SBBS.
- Second, the ESM developed a broad investor base and a well-functioning infrastructure to facilitate successful placements in primary markets. For example, the ESM has attracted more primary dealers than any individual sovereign bond market. In the case of SBBS, internationally active primary dealers may find it advantageous to exploit their scope economies by making markets in the new securities and potentially participating in their arrangement.
- Third, the ESM market developed gradually. Just €10 billion of securities were issued in the first year, allowing investors to acquaint themselves with the new securities. This is small relative to the €800 billion of debt securities issued by euro area governments in 2016. Similarly, the SBBS market could develop gradually by arranger(s) of SBBS purchasing a small fraction of sovereign bonds in primary markets (or by assembling similarly small volumes in secondary markets). The mechanics of issuing SBBS are described in Section 4.1 of Volume II.

SBBS market development would be demand led. If investor demand for the securities proves substantial, the market could grow over time. To succeed in enhancing financial stability, the SBBS market would need to become large. This is desirable as long as it does not unduly impair liquidity in secondary markets for sovereign debt by reducing turnover. The quantitative importance of this concern can be gauged from the Eurosystem’s public sector purchase programme (PSPP), which has a similar effect on secondary markets. Owing to the careful implementation of this programme, there is no evidence of any meaningful adverse effect on market liquidity, as Figure 4 indicates. As such, a carefully developed SBBS market of approximately €2 trillion could be expected to have similarly benign liquidity effects.
Some commentators have asserted that SBBS would drive up government financing costs. This view is mistaken for several reasons. First, the PSPP analogy suggests that the adverse effect of SBBS on liquidity premia is likely to be minimal. Second, there is an offsetting effect arising from the fact that SBBS would be new securities with liquidity of their own. Senior SBBS could therefore be used to collateralise repo and derivatives transactions, thereby alleviating scarcity of low-risk collateral. The securities could also be combined by dealers to hedge price movements in sovereign bonds, thereby creating a positive liquidity externality for national markets, as shown by Dunne (2018). Third, SBBS could crowd-in demand for euro area sovereign risk from foreign investors, as suggested by their disproportionately large holdings of supranational debt securities. Fourth, with a prudentially adequate regulatory treatment, SBBS could help to stabilise the banking system, and thereby avoid a re-emergence of the endogenous risk that characterised the euro area sovereign debt crisis.
Conclusion

SBBS are a promising tool to weaken the nexus between bank risk and sovereign risk. By providing a truly euro area-wide benchmark asset, a well-functioning market for senior SBBS could also help to complete other aspects of monetary union. The report of the ESRB High-Level Task Force on Safe Assets (2018) sets the foundation for an informed policy discussion on the feasibility of paving the way for SBBS in the euro area.

The Task Force’s main finding is that a gradual development of a demand-led market for SBBS might be feasible under certain conditions. One necessary condition is for an SBBS-specific enabling regulation to provide the conditions for a sufficiently large investor base, including both banks and non-banks. To enhance financial stability, this regulation would need to treat SBBS according to their unique design and risk properties. For banks, regulating senior SBBS no more severely than sovereign bonds could incentivise them to hold these low-risk securities. The regulatory treatment of mezzanine and junior SBBS should reflect their greater riskiness. In this way, SBBS could contribute to enhancing financial stability and the completion of monetary union.

References


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In a recent paper entitled “ESBies: Safety in the tranches”, Brunnermeier et al. (2017) proposed the creation of tranched securities backed by a diversified pool of euro area sovereign bonds. By choosing a sufficiently high subordination level (i.e. ‘thickness’ of the junior tranches), the senior tranche – called a European Senior Bond, or ESBie – could in principle be rendered as low-risk (in terms of expected loss rate) as a German government bond, without requiring either member state guarantees or a euro area budget. It could also be issued in sufficiently large volumes to replace national sovereign bonds in bank balance sheets, hence contributing to financial stability and reducing financial fragmentation in the euro area.

In spite of these qualities and the fact that many of the technical questions surrounding sovereign-bond backed securities (SBBS) have recently been addressed by a task force of the European Systemic Risk Board (ESRB 2018), ESBies continue to be heavily criticised (e.g. De Grauwe and Ji 2018). Critics focus mainly on three arguments.

• First, in a crisis involving correlated sovereign risks and multiple defaults, the supposedly ‘safe’ senior tranche might end up being much less safe than its proponents claim.
• Second, SBBS envisage the simultaneous issuance of senior and junior tranches, but would anyone want to buy the junior tranches, particularly in a crisis?
• Third, ESBies might upset the functioning of national bond markets, raising sovereign borrowing costs.

Are the criticisms justified? Are there better alternatives to SBBS/ESBies? In a new CEPR Policy Insight (Leandro and Zettelmeyer 2018), we answer these questions by comparing SBBs/ESBies to three alternatives. Like ESBies, the alternatives all avoid joint and several guarantees, but unlike ESBies, they do not require financial engineering to achieve safety.
• **Bonds issued by a capitalised intermediary** (‘capitalisation approach’). The safe asset could consist of a single-tranche bond issued by a public intermediary backed by a diversified pool of euro area sovereign bonds. Rather than through tranching, it would be made ‘safe’ through a sufficiently thick capital cushion. The required size would depend on how the capital is invested: if invested in the same portfolio that backs debt issuance, it would be exactly the same as that of the junior tranches in the SBBS proposal – namely, about 30% of total assets. If it is kept in cash, capitalisation could be a little lighter, in the order of 25%. The need to provide this large public capital cushion can be interpreted as the cost of avoiding tranching.

• **E-bonds.** In an idea going back to Monti (2010), a senior public intermediary would issue a single bond backed by a diversified portfolio of euro area sovereign debt bought at face value. The funding costs of the bond would be passed on to the sovereigns in proportion of volumes of debt held in the portfolio of the public intermediary. As in the SBBS proposal, safety would hence be created through a combination of diversification and seniority, except that seniority now refers to the seniority of the issuer of E-bonds in the sovereign bond market, not to a senior tranche debt instrument. In a variant of this proposal, the safety of E-bonds could be increased further by endowing the senior public intermediary with some capital. This would make it similar to the capitalisation approach, except that much less capital would be required.

• **Bonds issued by a leveraged euro area sovereign wealth fund.** As in the capitalisation approach, a publicly owned, capitalised institution would issue debt backed by a portfolio of assets. However, this portfolio would be internationally invested to maximise long-term returns subject to a desired risk level. This would allow the intermediary to start small, based on some ‘seed capital’, and gradually grow in size by reinvesting its earning and leveraging its capital subject to maintaining a prescribed capital adequacy. Once the desired size has been reached, the fund could start paying a dividend.

**Safety**

Using a default simulation model, all approaches can be calibrated to target a particular expected loss rate. In that sense, all can be made equally safe. However, they differ in how these losses are distributed, particularly in the risk tail. This can be illustrated using the ‘value at risk’ (VaR), a common measure for unexpected losses. The VaR at probability p measures the maximum loss occurring with probability p or higher. Figure 1 shows VaRs for ESBies, the capitalisation approach (assuming that capital is kept in cash) and E-Bonds (in two versions, including a ‘capitalised’ version).
The figure shows that ESBies (and bonds issued by an equivalently capitalised intermediary) are more effective than E-bonds or national tranching in protecting their holders against a wide range of tail risks, but are more vulnerable to extreme tail risks. This is because ESBies are fully protected against individual or multiple defaults by euro area member states whose total losses-given-default do not exceed the size of the non-senior SBBS tranches. Once this cushion is depleted, however, holders of ESBies would bear the full cost of further defaults. In contrast, E-bonds and national tranching bear losses any time the losses-given-default of a single country exceed the portion of its debt held by subordinated debt holders. At the same time, they continue to offer partial or even complete protection (depending on loss-given-default assumptions) in the very unlikely event that a country such as France, Germany, or the Netherlands were to default in addition to lower rated countries.

To offer better protection against severe defaults by smaller countries or combinations of smaller countries, the E-bond intermediary could be capitalised. Figure 1 shows that a 2% capitalisation (at least ten times less than required in the pure capitalisation approach) would offer almost the same protection as ESBies for moderate tail risks but much higher protection against extreme risks.

**Borrowing costs**

To the extent that safe assets replace sovereign bonds on bank balance sheets, they should lower the risks of crises and hence reduce borrowing costs. Offsetting effects are possible – for example, by reducing bond market liquidity – but likely small, with one main exception. Since the E-bond proposal implies that investors would bear higher losses-given-default, the marginal cost of debt issuance for countries that have reached their debt issuance limit to the E-bond intermediary would go up. However, this does not necessarily translate into a rise in overall borrowing costs. The reason is that a share of the debt would be borrowed from the E-bond intermediary at the much lower cost, assuming that E-bonds are designed to match the expected loss rate of a German bund, and the E-bond issuer passes its low funding costs on to its borrowers. It can be shown that the net effect is to slightly raise average borrowing costs for the highest rated borrowers and to slightly lower average borrowing costs for the lowest rated borrowers.

**Redistribution**

Assuming that they operate as intended, the SBBS and capitalisation approaches rule out redistribution, as bond purchases occur at market prices. A euro area sovereign wealth fund will also avoid redistribution, provided that profits and losses are distributed in proportion with the capital shares.

In contrast, the E-bond proposal would lead to redistribution because the funding costs of the intermediary are distributed to its debtors according to their portfolio weights, regardless of how much risk each debtor contributes. However, because of the E-bond intermediary’s senior creditor status, the redistributive effect would be quantitatively small. Simulations indicate that total redistribution could be in the order of €10 billion over five years, mostly at the expense of Germany (-€3 billion) and France (-€2.2 billion) and to the benefit of Greece (€4 billion), Spain (€1 billion) and Portugal (€1 billion). Redistribution could be reduced by excluding exceptionally risky borrowers, such as Greece, from the portfolio, or by capitalising the intermediary in a way that reflects the contribution by each member state to the risks borne by the intermediary.
Unintended consequences

A frequent criticism of SBBS is that the junior tranches might not attract buyers in future debt crises, or perhaps even in normal times. It is easy to show that the latter is unwarranted, because SBBS would generally reduce, rather than increase, the net supply of lower-rated sovereign and sovereign-based securities (they ‘use up’ bonds in the same rating categories that would correspond to the junior tranches). In debt crises, the junior tranches might indeed lose market access, but only if some of the countries in the SBBS portfolio also lose market access and/or sovereign issuers discriminate against SBBS intermediaries in a default situation. Furthermore, even if SBBS were to lose market access, the consequences would be benign, as countries could continue to issue plain sovereign debt directly to the markets.

Conclusion

Most criticisms directed at SBBS/ESBies appear exaggerated. SBBS do well compared to several alternative proposals to create safe assets that would not require tranching. They would protect their holders against a wide range of risks including correlated defaults, would not lead to redistribution across countries, and would not require public capital.

At the same time, some competing proposals could be superior to ESBies in at least some dimensions. In particular, a lightly capitalised version of Monti’s (2010) ‘E-bond’ approach would have two advantages. First, it would offer the same protection as ESBies against moderate tail risks, but higher protection in extreme cases. Second, it would have a fiscally disciplining effect on sovereigns, by raising marginal borrowing costs in countries with high debt levels, without however raising their average borrowing costs. Unlike SBBS, however, capitalised E-bonds would imply some (if modest) redistribution, have a much larger impact on national bond markets than ESBies, and require some public capital.

References


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Eurobonds are today politically unfeasible...

Genuine Eurobonds with joint and several liability would bring significant benefits and stability to the euro area. Top of this list is credibility, further cementing that the euro is here to stay. Such an instrument would also price counter-cyclically as investors seek refuge herein during periods of market stress, just as we observe for US Treasuries today. This countercyclical property is important also for systemically important institutions, such as banks. The ECB would, furthermore, be able make ‘unlimited’ purchases of genuine Eurobonds for monetary policy purposes. A deep and liquid Eurobond yield curve would, moreover, offer a pricing reference for other financial assets and thus support the development of Europe’s Capital Markets Union. Genuine Eurobonds, however, do not appear to be politically feasible in the foreseeable future.

...but the status quo leaves the euro area vulnerable

At the same time, the status quo leaves the euro area highly vulnerable in the event of a major shock. The European Stability Mechanism (ESM) with potential support from Outright Monetary Transactions (OMT) are certainly welcome additions to the euro area’s crisis management toolbox. To avoid moral hazard, the ESM Treaty leaves the door open to private sector involvement (i.e. debt restructuring) for the sovereign debt of any member states that applies for an ESM programme. Our concern, however, is that in doing so the ESM Treaty creates a situation that could amplify stress in crisis.

1 The views expressed are attributable only to the authors and to not any institution with which they are affiliated.
If market participants see a high probability that a member state will apply for an ESM programme, then the perceived risk of debt restructuring will likely increase. Experience shows, that when markets place a high probability on debt restructuring, governments often lose market access. While the ECB can purchase on secondary markets, the European Court of Justice (2015) has made it clear that “the purchase of government bonds on secondary markets must not have an effect equivalent to that of a direct purchase of such bonds on the primary market”. We thus deem it unlikely that the OMT could be used to restore market access for governments. Indeed, as highlighted by Wolff (2018), the issue of debt restructuring is often treated all too lightly.

A proposal for a 20-year Purple bond transition

The reality outlined above has triggered a search for a euro area safe asset without joint and several liability. Alvaro and Zettelmeyer (2018) offer a very useful analysis of the four main approaches set out in the literature. In contrast to these various proposals, ours does not aim to deliver a single safe euro area asset today. Instead, we propose a 20-year transition that leverages the Fiscal Compact’s requirement to reduce the excess general government debt above 60% of GDP by 1/20 every year. The amount of national sovereign debt consistent with the Fiscal Compact’s annual limit would be labelled ‘Purple’ and protected from debt restructuring under an eventual ESM programme. Any debt above the limit would have to be financed with ‘Red’ debt, that would not benefit from any guarantees. At the end of the 20-year transition period, when Purple bonds will stand at 60% of GDP, these could become genuine Eurobonds as set out in the initial Blue-Red bond proposal by Delpla and von Weizsäcker (2010).

During the Purple bond transition, each member state would continue to issue its own debt and be fully responsible here for. Moreover, the proposal does not require any changes to the existing government debt stock; the only changes required are to the ESM Treaty and the prospectus of the new Red bonds. The characteristics of the Purple bonds should allow this segment of the bond market to price counter-cyclically and remain open for new issuance even when a member state applies for an ESM programme. This, in turn, would lower the eventual financing burden placed on the ESM. Banks, for their part, would hold Purple bonds thus limiting contagion. At the same time, the limits on Purple debt ensure discipline as Red debt would be more expensive to finance. Moreover, the protection against debt structuring only applies under the conditionality of an ESM programme.
An illustration of the Purple bond proposal

To illustrate our proposal, assume that a member state has a 100% debt-to-GDP ratio on 1 January 2018. The Fiscal Compact aims to anchor fiscal discipline and thus secure public finance sustainability. The Compact’s debt brake rule requires that general government debt falls by 1/20 of the gap to the 60% debt-to-GDP target every year on average. Let’s assume, however, that the country fails to adhere to this and debt remains at 100% of GDP during the first 20 years and then declines by 1pp every year over the next 20 years. For simplicity, we assume all debt is bond financed.

**Figure 1** Purple and Red debt: A hypothetical example (bars show the general government debt stock at year-end)

![Diagram](image)

*Source: Own calculations*

On 1 January 2018, the entire initial debt stock is labelled as Purple. At the end of 2018, the Fiscal Compact limit on the sovereign debt stock will stand at 98% of GDP = (100% - (100%-60%)/20). The country will need to refinance the maturing debt stock, here set at 19% of GDP, plus the budget deficit, here set at 1% of GDP, i.e. a total of 20% of GDP. Given the Fiscal Compact limit of 98% of GDP, the country can only finance an amount equal to 18% of GDP in new Purple bonds and must finance the remaining 2% of GDP in Red bonds. As seen from Figure 1, the stock of Purple debt will, by construction, stand at 60% of GDP in 2038 while Red debt, in our example, equate to 40% of GDP.
**Purple bonds offer a path to genuine Eurobonds...**

Purple bonds are still a far cry from genuine Eurobonds as there is no joint debt issuance and no joint and several liability. Our proposal does, however, offer a path hereto and importantly, one that avoids the ‘juniorisation’ of any of the existing sovereign debt stock that could otherwise see current bondholders seizing the courts, generating market disruption. Moreover, by gradually restricting the size of Purple debt in line with the Fiscal Compact, moral hazard should be avoided. Indeed, member states that fail to meet the Fiscal Compact goals would be forced to issue the more expensive Red bonds.

To implement our proposal, the ESM Treaty would need to be amended to introduce a no restructuring clause on Purple bonds. There would be no need, however, to alter the existing debt stock contracts which we see as an advantage. The new Red bonds would need to be issued with a clause making it clear that these fall outside the no restructuring clause that our proposal introduces to the ESM Treaty and contain Collective Action Clauses (CACs) to facilitate restructuring if needed. We advise strongly against any automatic debt restructuring rules as these might bring unnecessary disruption and render Red bonds more expensive than fundamentals may warrant.

**...and greater stability today than status quo**

The question is not just whether Purple bonds offer a politically viable transition to genuine Eurobonds, but also whether they would strengthen the stability of the euro area today compared to the status quo. For this discussion, we need to distinguish between two types of risk; the risk that a member state may be required as part of an eventual ESM programme to restructure its sovereign debt, and the risk that a member state may decide unilaterally to restructure and/or redenominate its debt in the context of a euro exit.

**Purple and Red bond prices would converge under euro exit fears**

Consider first the risk scenario where the financial market prices in a significant probability of a euro exit. As detailed in the annex of Bini Smaghi and Marcussen (2018), the pricing of Purple and Red bonds of the member state in question would converge as the two bond types are essentially identical in this case and banks holding these bonds would suffer contagion. We would, however, expect to see less contagion to the sovereign debt of member states where euro exit fears are not present.
Low risk of contagion between Red and Purple debt under an ESM programme

Return now to the case where a member state applies for an ESM programme. Under our proposal, the member state’s Purple bonds would be fully protected from any debt restructuring, thus alleviating investor fears. Furthermore, there should thus be no problem for the ECB to conduct quantitative easing (QE) in these Purple bonds (if such a QE programme is warranted by the overall euro area conditions), to offer an LTRO that the national banks could then use to buy Purple bonds and/or for the ECB to provide support via the OMT programme, given ESM conditionality. As banks would hold only Purple bonds, there would, moreover, be no contagion to banks via their sovereign bond portfolios.

Red bonds would price very differently as these would be subject to restructuring risks and not enjoy the full spectrum of stabilising support from the ECB. As such, Red bond spreads would rapidly deteriorate and the government would lose access to Red bond financing. Given our assumption that the government in question would retain access to the Purple bond market, the ESM programme would only fund the share of debt issuance that would otherwise have been funded by Red bonds. The conditionality of the ESM programme should ensure progress on structural reforms and address unsustainable fiscal policies. This will take time to deliver, but once achieved should allow Red bond markets to re-open.

A point worth note is that at the onset of the Purple bond proposal, the overall cost of funding for government debt should decline, ultimately making it less likely that an ESM programme would be required in the future if governments use this window wisely.

The final point that we make is that as Purple bonds would benefit from the no restructuring guarantee this could allow the ECB to increase the issue limit from the current 33% on such instruments under the QE programme to the 50% awarded to EU supranational bonds. All the more so, if the one-limb CAC proposed by Bénassy-Quéré et al. (2018) is implemented. Given that Purple bonds would still be subject to redenomination risks, it would nonetheless be reasonable to maintain the current risk allocation, where 80% of the risk linked to the Public-Sector Purchase Programme still sits on the national central banks’ balance sheet. Red Bonds would not be eligible for QE. One criticism here is that more QE could result in a further build out of Target II imbalances. The ECB has already made it very clear, however, that any member state leaving the euro area would need to settle such obligations in full.
References


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About the authors

Lorenzo Bini Smaghi is Chairman of Société Générale.

Michala Marcussen is Group Chief Economist at Société Générale.
In a recent Vox eBook, leading economists re-examined the case for issuing GDP-linked bonds (Benford et al. 2018). The theoretical benefits are well known: a reduction in the risk of a sovereign default (Shiller 1993), the ability to implement a more countercyclical fiscal policy¹ (Borensztein and Mauro 2004), and an increase in the fiscal space (Ostry and Kim 2018).

However, sovereign state-contingent bonds, in particular growth-indexed bonds (GIBs), have rarely been issued in practice despite their theoretical benefits. In a recent paper (Acalin 2018), I suggest a possible explanation for this apparent sovereign noncontingency puzzle² by deriving the impact of GIBs on the upper tail of the distribution of the public debt-to-GDP ratio.

GIBs have two effects on the debt distribution:

1. First, they narrow the support of the debt distribution. Thus, for a given expected value, they decrease the upper tail of the distribution, implying a lower risk of a debt explosion (Blanchard et al. 2016). Introducing GIBs on a large scale in advanced economies could substantially reduce ‘tail risks’ associated with explosive debt paths starting from today’s high ratios.

¹ Assuming GDP-linked bonds are held by nonresidents. However, if residents hold such indexed bonds, their interest revenue will increase during good times and decrease during bad times. This procyclicality in their income may reinforce, rather than smooth, the economic cycle if not more than offset by an appropriate and well-targeted countercyclical fiscal policy.

² The term ‘noncontingency puzzle’ was originally coined by Levy (2016).
• Second, and going the other way, they likely require a premium, which leads to a higher expected value of debt, shifting the distribution of debt and its upper tail upwards, and thus increasing the risk of a debt explosion.

**What is the reduction in the ‘tail risks’ associated with the issuance of GIBs? Size matters**

In a first set of simulations, I assume that GIBs do not require a premium compared to traditional plain-vanilla bonds. Put another way, I assume a no-arbitrage condition for risk neutral investors: the expected return on GIBs is equal to the return on plain vanilla bonds.\(^3\) Using the methodology developed in Blanchard et al. (2016), I simulate the debt distribution after ten years under three scenarios: non-indexed debt, fully indexed debt, and partially indexed debt. I assume in the third case that 20% of the stock of debt, a proportion similar to inflation-indexed bonds in some countries, is composed of GIBs. Figure 1 shows the result of the simulations for Belgium and Spain.

In order to compare the reduction in ‘tail risks’ across countries, I define the following metric: I take the value of the 99th percentile of the debt distribution after ten years under (full and partial) indexation and find the percentile of the non-indexed distribution associated with this value (Table 1).

For example, if France converts all its debt into GIBs, the value of the 99th percentile of the indexed debt distribution after ten years is equal to the value of the 91st percentile of the non-indexed debt distribution. Put another way, if there is a 9% probability that the debt-to-GDP ratio will reach a level higher than a given threshold after ten years, this probability drops to less than 1% if all debt is composed of GIBs.

Unsurprisingly, the gains from indexation vary from one country to another. Countries with a high debt-to-GDP ratio and/or a volatile interest-growth differential – such as Greece, Italy, and Spain – are more likely to benefit from indexation. On the other hand, countries with a less volatile interest-growth differential, a more volatile primary balance, and/or a low debt ratio – such as Austria or Belgium – are less likely to benefit from indexation.

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\(^3\) For example, if the expected nominal growth rate over ten years is 2% while the ten-year interest rate on plain vanilla bonds is 4%, then the GIB pays the nominal growth rate plus a constant \(k\) equal to 2\%:  
\[
rate_{\text{ind},t} = rate_t + k.
\]  
This constant \(k\) is different from what I refer to as a premium.
Figure 1  Debt-to-GDP ratio forecasts for different shares of growth-indexed debt

Note: The lines represent the 1st and 99th percentiles of the debt-to-GDP distribution for debt that is non-indexed debt (grey), all growth-indexed (black), and 20% growth-indexed (red). By construction, the 50th percentile (baseline) is the same for all cases (blue). Source: Author’s calculations.
Table 1  Percentile of the distribution of non-indexed debt corresponding to the 99th percentile of the distribution of growth-indexed debt, selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>100% indexed debt</th>
<th>20% indexed debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>75</td>
<td>97</td>
</tr>
<tr>
<td>Japan</td>
<td>78</td>
<td>97</td>
</tr>
<tr>
<td>Portugal</td>
<td>85</td>
<td>97</td>
</tr>
<tr>
<td>Italy</td>
<td>89</td>
<td>98</td>
</tr>
<tr>
<td>Spain</td>
<td>89</td>
<td>98</td>
</tr>
<tr>
<td>France</td>
<td>91</td>
<td>98</td>
</tr>
<tr>
<td>Germany</td>
<td>91</td>
<td>98</td>
</tr>
<tr>
<td>United States</td>
<td>92</td>
<td>98</td>
</tr>
<tr>
<td>Austria</td>
<td>92</td>
<td>98</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>96</td>
<td>98</td>
</tr>
<tr>
<td>Belgium</td>
<td>97</td>
<td>98</td>
</tr>
</tbody>
</table>

Source: Author’s calculations.

More strikingly, for all countries in the sample, an indexation of only 20% of the stock of debt to the nominal growth rate would provide almost no reduction in the upper tail of the distribution. Thus, GIBs would offer little protection against spikes in the debt ratio unless they constitute a large share of the debt stock – and even then, only in countries in which growth volatility is high relative to the volatility of the primary balance.

What is the maximum acceptable net premium?

In a second set of simulations, I assume that debt is fully indexed and GIBs require a premium. In this case, the baseline debt-to-GDP ratio under indexation is higher than under non-indexation. This potential cost can come from two different factors: the investors’ risk aversion and the market structure. Following Blanchard et al. (2016), I define the net premium as the additional cost resulting from novelty, liquidity, and GDP-risk premia minus the reduction in the default risk premium.4

More specifically, I compute the premium that equalizes the values of the 99th percentile of the indexed distribution using GIBs to that of the nonindexed distribution after ten years (Table 2). For euro area countries, the net premium ranges from 30 basis

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4 More research on the different components of the net premium would be valuable. Again, sovereign risks reflected in plain vanilla bonds are fully priced in GIBs and reflected in the constant $k$ added to the indexed return.
Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?

points for Belgium to 300 basis points for Greece. However, the maximum premium drops substantially and is below 100 basis points for most countries as we take a longer horizon (20 years) or a more conservative value for the upper tail of the distribution (95th percentile).

Table 2  Maximum premium on growth-indexed bonds that would equalise the upper tail of the distribution in the non-indexed and index cases

<table>
<thead>
<tr>
<th>Country</th>
<th>99th percentile, 10-year horizon</th>
<th>95th percentile, 20-year horizon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>3.0%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Spain</td>
<td>2.3%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.6%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Germany</td>
<td>1.3%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Japan</td>
<td>1.2%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Italy</td>
<td>0.9%</td>
<td>0.5%</td>
</tr>
<tr>
<td>United States</td>
<td>1.0%</td>
<td>0.5%</td>
</tr>
<tr>
<td>France</td>
<td>0.8%</td>
<td>0.4%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.8%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Austria</td>
<td>0.7%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.3%</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

Source: Author’s calculations.

Put another way, an increase in annual interest expenditures by 1% of GDP, considering a representative country with a debt-to-GDP ratio close to 100%, may prove to be too high to justify the issuance of GIBs. A high premium would increase the risk of a debt explosion rather than decrease it.

The relatively low benefits implied by a small issuance of GIBs and a potentially high premium could explain the apparent noncontingency puzzle. This suggests that a large and coordinated action is a necessary condition to move the equilibrium from a situation of non-indexed to growth-indexed sovereign debt.

A proposal to strengthen the euro area

Although there is renewed interest in GIBs in the euro area context, it seems unlikely that they will be issued by individual countries. A main impediment to market development is overcoming the first-mover problem and the stigma associated with it. A joint issuance through securitisation could take care of the problem while reducing
the potential premium and allowing countries to issue such bonds at a large scale. The scheme is presented below and summarised in Figure 2.

**Figure 2**  The role of the European Debt Agency

<table>
<thead>
<tr>
<th>European Sovereigns</th>
<th>European Debt Agency</th>
<th>Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue GIBs</td>
<td>Issues European bonds /Buys GIBs</td>
<td>Buy European bonds</td>
</tr>
<tr>
<td>Austria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td></td>
<td></td>
</tr>
<tr>
<td>...</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Austrian GIBs</td>
<td>European Safe Asset</td>
<td></td>
</tr>
<tr>
<td>French GIBs</td>
<td>European Risky Asset</td>
<td></td>
</tr>
<tr>
<td>German GIBs</td>
<td></td>
<td>More risk averse investors</td>
</tr>
<tr>
<td>Greek GIBs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spanish GIBs</td>
<td></td>
<td>Less risk averse investors</td>
</tr>
</tbody>
</table>

The mechanism I describe is an extension of the securitisation scheme described by Brunnermeier et al. (2011, 2017) at the euro area level. The coordination of debt issuance can be made by a European Debt Agency (EDA). This agency could be the ESM, an ad hoc entity, or even private financial intermediaries. However, it seems more natural to delegate these operations to a European debt management office. Each country would issue GIBs up to 60% of their own GDP. Above this threshold, countries would continue to issue individual traditional plain-vanilla bonds.

On its assets side, the EDA buys GIBs from the euro area countries. The buying price of country-specific GIBs should be such that the expected return on a GIB (adjusted for forecasted GDP volatility) is equal to the return on a plain vanilla bond over the maturity of the bond. This guarantees that sovereign risk is not mispriced, and that there is no ex ante redistribution by pooling debt from countries with a low sovereign risk and countries with a higher risk. Thus, this mechanism would still impose some market discipline on highly indebted sovereigns. On its liabilities side, the ESM issues two kinds of bonds: a European safe asset (paying a fixed interest rate) and a European junior asset (paying a variable interest rate).

Theoretically, by pooling all GIBs and collecting a small premium on national GIBs, the EDA can issue a safe European bond paying a fixed and low interest rate. The junior bonds carry all the GDP risk – the return of junior bonds will depend on the deviations of average euro area nominal growth rates to forecast. To be more explicit, if the average euro area growth is higher than expected then junior bonds pay more (as countries will pay more on their GIBs to the EDA). Conversely, junior bonds pay less if average growth is lower than expected. Moreover, the higher the share of safe asset issuance then the higher the volatility of the return on junior bonds.

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5 The threshold could be different than 60%.
The two debt instruments issued by the EDA are more likely to find potential buyers than individual GIBs. On the one hand, the case for a European safe bond is clear and many propositions have already been proposed to create such an instrument (Leandro and Zettelmeyer 2018). On the other hand, this European junior debt could be less risky than country-specific GIBs for two reasons. First, by pooling idiosyncratic risks from different countries, the variance of the return should be lower as growth rates are imperfectly correlated across countries. Second, and more importantly, the fact that the value of junior bonds is indexed to the euro area performance should provide some reassurance to investors that the probability of high losses is limited. Indeed, if the European junior bond pays a lower return, i.e. if the euro area is performing poorly on average, it is more likely that the ECB will decrease its main interest rate (to the extent that down breaks in growth are cyclical rather than structural), which would support the price of the junior bond.

**Conclusion**

GIBs are unlikely to substantially decrease the risk of a debt explosion in advanced economies if not issued in a large and coordinated way, which can explain why they have not been issued so far. The proposition introduced in this column may have side effects, and even in the presence of large growth-indexation of its bond stock, the euro area would still require a backstop for dealing with unsustainable debt cases. Yet, the proposition presents some clear advantages:

- It allows sovereigns to issue a large share of GIBs while keeping the premium at a low level, thus maximising the benefits from GIBs.
- It offers a fiscal space to countries which need it, and when they need it, while avoiding a mispricing of sovereign risk and ex anteredistribution among European countries.
- It implies the creation of a European safe asset while keeping the junior bond attractive to investors.

The persistent effects of the global financial crisis as well as the current limits on fiscal and monetary policies in advanced economies are forcing us to think about innovative frameworks. The combined use of growth-indexed bonds and securitization could prove fruitful in the euro area context. Going forward, this proposition would also be consistent with a broader rethinking of monetary policy from inflation targeting towards nominal GDP targeting as recently recommended by prominent economists (Summers 2018).
References


About the author

Julien Acalin is a PhD Candidate at Johns Hopkins University.
Section 3: Ensuring an adequate provision of liquidity
The recent CEPR Policy Insight by Bénassy-Quéré et al. (2018) makes debt restructuring of insolvent sovereigns an essential part of the crisis management structure while also proposing strengthening risk sharing between the member states through a new fiscal capacity and a modification of the precautionary lending facility of the ESM.

The proposals have been criticised for relying too much on debt restructuring and market discipline while paying too little attention to the problems of liquidity of solvent sovereigns in times of financial turbulence (eg. Messori and Micossi 2018). In my view, it makes sense to emphasise market discipline and a credible debt restructuring mechanism as a precondition for it. Yet the liquidity problems of solvent sovereigns could indeed be a problem. However, my suggestion for a remedy, as well as the likely outcome, differs from that which Messori and Micossi seem to prefer.

**Market discipline needed but hard to establish**

The impotence of the fiscal rules necessitates strengthening market discipline on sovereigns as a complement. This again requires a credible mechanism for the debt restructuring of insolvent member states. Simultaneously, debt restructuring would reduce the need for fiscal consolidation in the affected country. The proposal by Bénassy-Quéré et al. is well-founded.

However, mandating the ESM/EMF to implement debt restructuring is, by itself, unlikely to sufficiently increase the credibility of restructuring and thus market discipline. A key challenge remains: the potential for panic reactions. To avoid such reactions, decision makers are under strong pressure to resort to a bailout even when debt sustainability is clearly questionable.
To alleviate this risk, the decision-making process should be predictable and rapid. Eliminating the unanimity rule of the ESM decisions would help, as would more comprehensive (one-limb) common action clauses in the debt contracts. At least as important is limiting banks’ exposure to sovereign debt, as proposed in the Franco-German paper.

**Liquidity support for solvent member states inadequate**

Even with these elements in place, one cannot exclude significant contagion effects on other sovereigns. To prevent this, the restructuring decision would have to be accompanied by extensive liquidity support to solvent member states.

Currently, only the ECB has the resources to provide sufficient liquidity to other countries under pressure. The ESM can in principle provide such support in the form of precautionary financial assistance. However, its resources could quickly be exhausted, particularly if a significant part of the €500 billion capacity is tied to supporting the state which is subject to debt restructuring.

This situation is problematic. First, any decision by the ECB, including in particular the OMT asset purchases, is at the discretion of the ECB Governing Council. While the collaboration between the ESM and the ECB could function smoothly, no mechanisms are in place to ensure it is so.

Second, the role of the ECB as a lender of last resort directly to the member states gives it substantial power over sovereigns. This is difficult to reconcile with the independence of the central bank.

Third, a precondition of the activation of the current OMT promise is that the member state applies for ESM assistance and agrees on an adjustment programme. The last requirement may delay the activation of any assistance, thereby allowing market conditions to deteriorate unnecessarily.

**ESM/EMF access to ECB funding should be explored as a solution**

One should be able provide effective liquidity support to solvent member states while limiting the problematic role of the ECB. This could potentially be achieved by giving the ESM/EMF access to central bank liquidity to finance precautionary financial assistance.
If one wants to avoid expansion of the overall ESM capital commitment by the member states, ECB lending to the ESM could utilise the debt instruments of borrowing states as a form of collateral and be without recourse. This arrangement would not leave the ECB worse off in regard to credit risk when compared to the current OMT, which involves direct purchases of such debt instruments.

To further limit the risk to the ECB, the ex-ante conditionality of the current precautionary assistance could be sharpened. In particular, there should be a strict upper limit for the ratio of government debt to GDP for any country willing to make use of the facility. Given that there is no such constraint in the OMT, this would reduce ECB’s credit risk relative to the current situation. One might also use the member state’s share in the future seigniorage income as collateral for the precautionary assistance. In addition, a fraction of the €700 billion capital commitment could be allocated to credit enhancement on a first-loss basis.

The new arrangement would make a clear distinction between normal financial assistance, conditional on an adjustment programme (and the associated strict monitoring), and precautionary lending subject to ex-ante conditionality. The former would have a definite aggregate upper limit and be financed by the member states. The low-risk precautionary lending facility would be financed by the ECB alone and would be more flexible with regard to the aggregate size. The member states which would not fulfil the ex-ante criteria but remained under market pressure, would be required to resort to ordinary ESM assistance.

An obvious key challenge is whether the ECB financing of member states through the ESM would be consistent with both the no-monetary-financing rule and the independence of the ECB. The fact that the credit risk would be smaller than, or at most the same as, in the current OMT programme should help to ensure that the arrangement is no more in violation of the Treaty than is the OMT.

Still, decision making remains a problem. The OMT is an independent decision of the ECB and has been motivated by maintaining “appropriate monetary policy transmission and the singleness of the monetary policy”. The question is whether one could find a way to separate two decisions: (1) the decision by the ECB about determining when the financial market conditions are deteriorating so as to require a special liquidity facility to be made available; and (2) the ESM/EMF decision on the activation of the facility. While difficult, squaring the circle might not be impossible given how many other legal problems have been solved in the EU.
Fiscal stabilisation function not very useful

Risk sharing in the form of a fiscal stability mechanism would naturally help badly affected member states to bolster aggregate demand. Nevertheless, to be effective, the size of the mechanism would have to be large when compared to the current EU budget of 1% of GDP. In the proposal by Benassy-Guéré et al. the support remains clearly insignificant. With the given parameters, the support would have been on average about 1/10 of the actual deficits of the worst hit countries in 2009 to 2013 (Vihriälä 2018).

On the other hand, there is a risk that the unconditional support from a fiscal stabilisation mechanism could result in unintended transfers, with the associated political consequences. These factors speak against relying on a fiscal stabilisation mechanism as a major help in financial crises, especially when taken together with the observation that fiscal smoothing has played only a minor role in stabilising asymmetric shocks across the US states in comparison to the stabilisation through the capital and credit markets (Alcidi et al. 2017).

Concluding remarks

The Franco-German paper addresses some of the key shortcomings of the current EMU in a sensible way. Nevertheless, the proposed additional risk sharing is, in part, wasted in an area where it does not provide much benefit (fiscal stabilisation), while risk sharing in an area where it is essential (liquidity provision to solvent member states under financial pressure) is likely to remain inadequate. The willingness to share risks across the member states has limits. Therefore, risk sharing should be employed in fighting the real enemy, financial instability.

Abandoning the fiscal stabilisation instrument and creating a stronger instrument of liquidity provision to solvent member states, based on ESM access to central bank financing, could improve on the efficiency of risk sharing. How to achieve the latter is a tricky issue in many ways. Creative thinking should focus on this problem rather than ever more elaborate schemes of fiscal stabilisation, which is best accomplished by prudent member states themselves.

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**About the author**

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One criticism of our paper on euro area reform (Bénassy-Queré et al. 2018) is its supposed silence on the role of the ECB (Bini Smaghi 2018, De Grauwe and Ji 2018). However, the reforms proposed in the paper actually have significant implications for the ECB’s role, in a way that would make it easier for the ECB to fulfill its mandate.

It is true is that in Bénassy-Queré et al. (2018) we did not recommend significant changes to the way the ECB operates monetary policy or to the way the ECB, since 2012, has reacted to the euro crisis and the risk of disintegration of the euro area. Among the co-authors of the report, we may have different views on the necessity and efficacy of quantitative easing and on the pace at which ECB should normalise its monetary policy. There are standard debates among economists regarding the state of the cycle, the level of output gap, and the risk of inflation. Regardless of how one stands on these issues, however, an important benefit of our recommendations would be to mitigate the risk of overburdening the ECB, by making the euro area more sustainable.

Redenomination risk, self-fulfilling expectations, and multiple equilibria were key destabilising mechanisms during the euro area crisis. At the same time, the explosion of spreads between core and periphery countries also had fundamental underpinnings, including for some countries a lack of fiscal prudence and/or lack effective macroprudential policies (for a quantitative assessment of the respective roles of public debt, private debt, and spread dynamics in different countries, see Martin and Philippon 2017). These fundamental forces were compounded by self-fulfilling dynamics. It took the famous “whatever it takes” declaration of the ECB to stop them and to coordinate investors’ expectations on the ‘good’ equilibrium without redenomination and without exit.

A euro area where the ECB does not take into account the possibility of financial instability through self-fulfilling crises and does not act against it with a mix of strong commitments and actions, such as the Outright Monetary Transactions (OMT)
programme, is not sustainable in the long term (Aguiar et al. 2015). The proposals in Bénassy-Queré et al. (2018) should clarify and facilitate the exercise of this responsibility in terms of financial stability, in three ways.

First, by allowing and facilitating debt restructuring inside the euro area as a last resort action in case of unsustainable sovereign debt, our proposals make it easier to differentiate between a debt crisis due to redenomination risk and a debt crisis due to sustainability. The ECB should only intervene in the first case and not in the second. Our proposals will reduce the financial and economic cost of a debt restructuring and the collateral damage of a sovereign debt restructuring. From this point of view (Gourinchas et al. 2018), this should reduce the pressure on the ECB to intervene and the probability of the actions of the ECB stretching its legal mandate by morphing into partial bailouts for countries with unsustainable fiscal positions.

We fully recognise the difficulty of differentiating between the two risks. Our proposals fit in with an institutional framework where the ESM deals with sovereign liquidity crisis (through lending) and sustainability crisis (through restructuring), while the ECB deals with redenomination risk generated by self-fulfilling expectations. Our proposal to facilitate fast lending by the ESM to pre-qualified countries should reduce the need and pressure for the ECB to step in.

Second, by weakening the ‘doom loop’ between banks and sovereigns through the introduction of concentration charges on sovereign debt, our proposals mitigate one of the key mechanisms that may catalyse self-fulfilling expectations of exit of financially fragile countries (Farhi and Tirole 2018).

Third, our proposals for new fiscal rules, combining more flexibility and more responsibility, and for a fiscal capacity to help countries in case of large negative shocks should also prevent a situation where the ECB is the sole institution with the possibility to provide macroeconomic stimulus. These rules should also contain the ex ante moral hazard incentives (debt reduction targets and junior bonds to finance excessive spending) to prevent countries from running irresponsible fiscal policies and putting themselves at risk of relying on ex post ECB or ESM interventions.

Overall, by clarifying its mission and by reducing the need for intervention, our proposals allow the ECB to pursue its inflation mandate and allow the integrity of the euro area to be better preserved.
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12 Make euro area sovereign bonds safe again

Grégory Claeys
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The proposal for how to complete the monetary union’s architecture, made by a group of 14 economists from France and Germany (Bénassy-Quéré et al. 2018), constitutes a timely attempt to build a consensus position between economists from the two largest euro area countries and from a broad political spectrum.

Overall, most of the measures advocated in the paper are sensible and form a coherent package in which the various pieces complement each other. Actually, the main proposals of the paper are broadly similar to the ones I made in a paper published last year (Claeys 2017). Basically, to make the monetary union more resilient, it is necessary to complete the Banking Union, develop a Capital Markets Union to increase private risk sharing, reform the European fiscal framework, build a euro area stabilisation tool to deal with large asymmetric shocks, and reform the European Stability Mechanism (ESM).

However, one problematic element of the ‘Franco-German’ package is the implicit view on what should be considered as a safe asset in the euro area. This position is exemplified in the group’s inclination to introduce sovereign bond-backed securities (SBBS) to play the role of safe asset in the euro area.

What is a safe asset?

A safe asset is a liquid asset that credibly stores value at all times, and in particular during adverse systemic crises. There is a high demand for this type of asset: from savers in need of a vehicle to store their wealth for the future, from domestic financial institutions to satisfy regulations and to post collateral in financial operations, as well as from emerging market economies looking for means to invest foreign exchange reserves.
Thanks to their high liquidity and simplicity, sovereign debt securities can play that role as long as two conditions are fulfilled: 1) the country’s fiscal policy is sustainable; and 2) its central bank stands ready to play a backstop role in the sovereign debt market in case of a self-fulfilling crisis, while having an impeccable record in maintaining the value of the currency (i.e. low inflation and stable foreign exchange rate).

However, in the euro area, these two conditions have not always been fulfilled: 1) Greece clearly did not have sound public finances before the crisis; and 2) a strict interpretation of the prohibition of monetary financing, coupled with the difficulty of disentangling liquidity and solvency issues, prevented the ECB from offering a backstop to solvent sovereigns at a crucial moment (from 2010 to 2012). While the prohibition of monetary financing is justified to avoid unsustainable fiscal policies in the monetary union, this left the door open to self-fulfilling sovereign debt crises in some countries – at least until Draghi’s “whatever it takes” promise in the summer of 2012 and its formalisation as the Outright Monetary Transactions (OMT) programme. This put some euro area countries at a disadvantage to issue safe assets and extract the main benefit from doing so, i.e. the possibility to put in place countercyclical fiscal policies at low cost during recessions.

**Which asset should play that role in the euro area?**

Given the inability of some euro area sovereign bonds to play the role of safe assets during the crisis, ideas on how to create synthetic euro area-wide safe assets emerged. In particular, proponents of SBBS suggested pooling sovereign bonds from all euro area countries and using them to provide cash flows for securities issued in several tranches of different seniorities, in order to supply safe assets (senior SBBS) in large quantities to economic agents needing them.

However, the idea remains untested and politically controversial. Despite the support of the European Systemic Risk Board (ESRB) and the Commission, policymakers and public debt management agencies in many euro area countries are afraid of the unintended consequences that such a drastic change could entail for the sovereign bond markets of the euro area.

But in my view, the main argument against SBBS is that they are unnecessary and represent a distraction in the current debate. Instead, making all euro area sovereign bonds safe again, and for good, is the most desirable way to increase the supply of safe assets and avoid intra-euro area flights to safety during bad times.
What would it take for all euro area bonds to be considered safe again? As mentioned earlier, sovereigns need to fulfil two conditions, they must have 1) sustainable fiscal policies; and 2) a credible (inflation-targeting) central bank ready to play a backstop role in a liquidity crisis.

For public finances in the euro area to be sustainable, respecting fiscal rules is necessary. But current rules need to be drastically improved to play their role – ditching the flawed structural deficit rule and replacing it with a reformed expenditure rule would be a step in the right direction. However, good fiscal rules are not sufficient. To ensure sound public finances in the long run in the Economic and Monetary Union (EMU) it is also essential to have:

• effective macroprudential policies to avoid bubbles that end up weighing heavily on public finances when they burst;
• a completed Banking Union to make European sovereigns immune to domestic banking crises (thanks to the European Deposit Insurance Scheme and a credible Single Resolution Fund);
• and a euro area stabilisation instrument to deal with large asymmetric shocks.

This corresponds to some of the proposals in Bénassy-Quéré et al. (2018).

However, the authors do not offer a convincing solution to fulfil the second condition. Even though it was never activated, the creation of the OMT programme was crucial to end the self-fulfilling crises taking place in several countries in 2012. However, its setup remains fragile and could limit the possibility for some euro area sovereign bonds to qualify as safe assets in a crisis. It is thus essential to reform the ESM/OMT framework to make sovereign debt markets genuinely liquidity-crisis-proof in the EMU.

The necessary reform of the ESM

The problem of the OMT programme is that it is difficult to distinguish liquidity from solvency issues. If the ECB were using the OMT in all cases in which yields increase significantly, without being confident that they are related to a self-fulfilling issue and not linked to fundamentals, this could lead to moral hazard. A strong presumption ex ante that debt is sustainable is thus necessary to justify an OMT programme. To solve that problem, the ECB decided that the implementation of an OMT programme would be conditional on participation in an ESM programme. This implies that the Commission, in liaison with the ECB, would have to assess first whether the public debt of the country requesting help is sustainable, before the ESM programme can be approved. More importantly, given that the ESM board – composed of the finance
ministers of the member states – needs to approve the programme, this means that there must be not only a technical assessment but also a political agreement that debt is sustainable. The ESM thus plays a fundamental role in the current setup, not primarily because of its capacity to lend to countries (which is relatively small) but because it provides the political validation of the debt sustainability necessary for the ECB to act.

However, the current options available at the ESM are not appropriate to solve a liquidity crisis, which would be highly problematic if the OMT ever needs to be used. Thus, the role of the ESM must be clarified and its functions should be differentiated depending on whether countries face liquidity or solvency crises. As I proposed in Claeys (2017), there should be three distinct ESM tracks:

1. A track for ‘pure’ liquidity crises, in which the ESM would just be used as a political validation device for the ECB’s OMT programme, without any conditions attached or any debt restructuring.

Conditionality would not be needed because there would no ESM loans involved and therefore no need to ensure the country’s capacity to repay its European partners. On the contrary, the current situation is problematic because a country might be forced to implement policies to access an OMT programme solely because of a problem of multiple equilibria for which it might bear little responsibility. In principle, today, to be eligible for the OMT, countries could apply to an ESM precautionary credit line instead of a full programme, but credit lines are still conditional on the signature of a Memorandum of Understanding. Moreover, the criteria for accessing credit lines is overly restrictive as it requires “market access on reasonable terms”, which might not be the case in a liquidity crisis. In practice, the criteria could be interpreted loosely and conditionality could be very light. But, for the sake of clarity, it is better to create a new track reserved for pure liquidity crises to ‘authorise’ OMT programmes by the ECB (the central bank would retain its independence as the Governing Council would be the one ultimately activating the asset purchases once debt sustainability is technically and politically validated). In the absence of such a track, countries facing a self-fulfilling crisis and in need of an OMT programme might be reluctant to apply to the ESM for fear of losing economic sovereignty. Adding a liquidity track to the ESM toolkit would increase the credibility of the OMT and reduce the likelihood of it ever being used.
2. A track for situations in which countries could be ‘at risk of insolvency’ in the future.

The ESM would offer a precautionary credit line under relatively light conditions, which would also make the country eligible for OMT once there is no doubt remaining on the sustainability of the country’s new debt trajectory. This track will be particularly useful in the cases in which liquidity and solvency issues are difficult to disentangle. This type of programme could be activated at an earlier stage with light conditionality, and no debt restructuring, to avoid full-blown crises and last-minute decisions.

3. A track for clear solvency crises, in which the ESM would provide funding conditional on a full macroeconomic/fiscal/financial adjustment programme and on the restructuring of the sovereign debt held by private institutions, which would also enhance market discipline ex ante. In that case, the ESM would provide a loan to help the country smooth the shock of losing market access.

Bénassy-Quéré et al. make some suggestions to reform the ESM in a direction that would lead to a set-up with two tracks broadly similar to track 2 with a flexible ESM facility (for countries with good policies ex ante and with light policy conditionality ex post), and to track 3 with a basic ESM programme conditional on sovereign debt restructuring. Unfortunately, they do not go as far as introducing an option similar to track 1, i.e. without ESM loans and without any conditionality, neither ex post nor ex ante. This track is, in my view, essential if financial markets were to call the ECB’s bluff one day and the OMT actually needs to be used to solve a liquidity crisis. The absence of such a track in their proposal to reform the ESM is problematic because it makes debt restructuring and/or policy conditionality compulsory to access the ESM and thus the OMT.

More generally, making debt restructurings the norm in the euro area could have dangerous implications. First, frequent debt restructuring would make it impossible for countries to borrow in bad times to run countercyclical fiscal policies (while ESM loans would not be sizeable enough to compensate for market access loss). Second, it is difficult to believe that public debt restructuring can be painless (even if banks are more protected thanks to concentration charges), given the crucial roles played by member states as a benchmark in domestic financial markets and in the real economy through the provision of safety nets and essential public goods (health, education, defence, etc.).
Conclusions

Overall, an improved euro area architecture – with a completed Banking Union, effective macroprudential policies, improved fiscal rules, a euro area stabilisation instrument, and a reformed ESM/OMT framework – would, in the long run, make all euro area sovereign bonds safer and thus limit drastically the intra-EMU flight for safety observed during the crisis. This would make the provision of safe assets through untested and potentially disruptive SBBS unnecessary.

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13 Euro area reform cannot ignore the monetary realm

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The authors of CEPR Policy Insight 91 (Bénassy-Quéré et al. 2018) are right to argue that the euro area needs an alternative anchor than the current system of fiscal rules and financial penalties to discipline fiscally wayward members. But by refusing to complement their proposals with recommendations in the monetary realm, they miss an opportunity to provide a balanced reform package that would not only increase fiscal discipline and risk sharing, but also enhance liquidity provision. The responsibilities and operating procedures of the Eurosystem cannot stay outside of debates about the future architecture of EMU.

The view that the proposals in Bénassy-Quéré et al. (2018) would increase rather than decrease “redenomination risks connected to acute liquidity and credibility crises” (Buti et al. 2018) results in part from the authors’ silence on the role of the ECB and national central banks in the provision of liquidity when needed. That 14 economists would have different views on the appropriate stance of monetary policy and their preferred choice of instruments is not surprising (Farhi and Martin 2018). But there should be broad agreement on some basic principles about ways to improve the lender of last resort function in a reformed EMU.

Principles for improving the Eurosystem

In our view, the following four principles should guide such rethinking:

- **The central bank of a monetary union should be able to backstop financial markets in sovereign bonds** if it considers that panicked investors are threatening the integrity of the single currency (Eichengreen 2016). Being an unconditional lender of last resort for solvent governments (Mody 2014) – instead of making the

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1 The authors thank Madona Devasahayam, Adam Posen, and Jeromin Zettelmeyer for useful feedback.
activation of Outright Monetary Transactions (OMT) conditional on a European Stability Mechanism (ESM) programme – necessarily requires drawing a difficult line between liquidity and solvency. If this judgement is completely left to governments, it creates a risk of fiscal dominance. If it is completely left to the ECB, it creates a risk of monetary dominance. If it is shared between several institutions, it creates risks of indecision, delays and uncertainty. Claeys and Goncalves Raposo (2018) recently proposed relying on a debt sustainability analysis, which would be done by the ESM, to determine eligibility of government bonds in refinancing operations. Under the current intergovernmental structure of the ESM with unanimity, this approach seems unsuitable for OMT. But options along these lines should be explored to improve predictability of the sovereign backstop and to remove the ECB from a position where its actions can be interpreted as attempts to discipline governments.²

- **Monetary policy and liquidity operations should be fully centralised and mutualised.** That “remnant[s] of national sovereignty in monetary policy” (Draghi, 2018) still exist in the risk-sharing arrangements of the Eurosystem governing the provision of emergency liquidity (Emergency Liquidity Assistance), some aspects of its collateral framework (Additional Credit Claims), and its most important asset purchases programme (the Public-Sector Purchase Program) is troubling and should be removed. The renationalisation of these policies has limited their effectiveness and increased redenomination risks by suggesting that there could be “conditions […] in which one [national central bank] would be reluctant to build up claims indefinitely on some other national central bank” (Kenen 1999).

- **Balance sheet considerations should not constrain a central bank’s ability to perform its monetary and lender of last resort functions.** The current ECB doctrine on financial independence should be revised and replaced by a Fiscal Carveout, as suggested by Tucker (2018), which would specify how losses would be covered by the fiscal authority. Alternatively, it could be replaced by a more blanket statement of support from European governments for ECB actions and the potential risks associated with them. This would make clear that recapitalisation arrangements matter not because the notion of central bank solvency makes sense, but because they reveal the sovereign’s political support of the monetary authority.

- **The operational framework should not reinforce doom loops.** Since 2005, the ECB has relied on ratings made by private credit-rating agencies to determine eligibility and haircuts. This reliance has led to abrupt swings in haircuts that have been destabilising (Claeys and Goncalves Raposo 2018). To counter some of the

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² For this same reason, we think that the ECB should no longer participate in troika programmes.
built-in procyclicality of its collateral framework, the ECB has often relaxed these constraints ex post by introducing waivers, lowering haircuts, and expanding the collateral pool (Cohen-Setton et al. 2013, Wolff 2014). A more robust, predictable and countercyclical framework could, however, be designed to deal with these problems ex ante rather than ex post. It would also help avoid the risk of the ECB appearing politicised in its eligibility decisions.

**How the Great Depression changed the Federal Reserve System**

As we argue in a recent paper (Cohen-Setton and Vallée 2018), these principles draw on important lessons from the history of the US Federal Reserve System, whose initial design was also problematic and was only corrected after its failures became obvious during the Great Depression. Because the Federal Reserve Act of 1913 created a decentralised system of 12 regional Federal Reserve Banks (FRBs) owned by commercial banks in their respective districts, risk-sharing of profits and losses linked to monetary operations did not occur automatically. In fact, what was still a decentralised system of regional central banks with 12 individual balance sheets only became de facto unified when the federal government eventually clarified in 1933 that FRBs – if faced with important losses – would *not* have to be recapitalised by the member banks of their respective districts but by the US Treasury.

In the words of President Franklin D. Roosevelt, “it [was] inevitable that some losses may be made by the FRBs in loans to their member banks […] [but] there is definitely an obligation on the Federal Government to reimburse the 12 regional FRBs for losses which they may make on loans made under these emergency powers. I do not hesitate to assure you that I shall ask the Congress to indemnify any of the 12 FRBs for such losses” (Silber 2009).

In fact, the preceding weeks had illustrated the extent to which autonomous regional FRBs could behave in uncooperative manners to protect their own reserves leading (Eichengreen 1992). In early 1933, a speculative attack against the New York Fed’s gold reserves had led to a reduction of its gold ratio towards the statutory limit. In refusing the New York Fed’s request to rediscount government securities, the Chicago Fed precipitated a cascade of state bank holidays that culminated with the National Banking Holiday (Wigmore 1987).
Only when regional monetary autonomy was eliminated, and when the compact between the central bank and its sovereign was clarified, did regional considerations eventually become subordinated to national ones. Together with these institutional changes, technical improvements in its operational framework were also critical in transforming the Federal Reserve into a fully-fledged lender of last resort. Recognising, for example, the procyclical bias of a collateral framework that “require[ed] substantial amounts of excess collateral” (McKinney 1960) against the deterioration of economic activity, the Federal Reserve Board adopted a new regulation specifying that credit be instead extended liberally “at times when the value of assets held by banks may be decreasing because of a downward turn in the nation’s business and a decrease in the national income” (Board of Governors of the Federal Reserve System 1937).

The initial design of the Eurosystem is stronger than that of the initial Federal Reserve System. The ECB has also clearly moved some distance to complement its framework and enhance its lender-of-last-resort function and to provide some level of backstop to the sovereign bond market. Yet this remains incomplete and the renationalisation of some aspects of its operational framework have generated new institutional risks that need to be addressed in the context of reforms of the architecture of the euro area. There can be no such thing as the completion of the monetary union without profound reforms in the conduct of monetary operations and its interactions with fiscal and political authorities.

**References**


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3 Between 1913 and the New Deal reforms of the Fed regional Feds enjoyed autonomy in setting discount rates, in participating in open market operations and in their lender of last resort policies.


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Section 4: The case for better fiscal rules
The 14 French and German economists have put forward a well-argued Policy Insight on reforms of the euro area (Bénassy-Quéré et al. 2018). One of its merits is that it could be a practical blueprint for a set of reforms that are doable even in the short run, and offers important trade-offs for both Calvinists and Catholics.

Amongst others, the proposals on fiscal frameworks and rules deserve a wider discussion as they showcase the multiple dimensions of the fundamental dilemmata we are confronted with in the governance of the euro area. Important amongst these issues are the challenges to the central role of the Commission that have arisen as the rules-based fiscal framework has been severely compromised.

The present situation is well characterised in the Policy Insight. Absent a political union, an internal market – let alone a monetary union – requires a set of rules that governs the fiscal behaviour of member states. Markets alone are not suitable for the task as they react too late and then overreact. They may play a certain role at the margins to the extent that sovereign debt restructuring is not ruled out ex ante.

The present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors. This has had negative repercussions on the role and standing of the Commission and its ability to operate as a guardian of the Treaty – even beyond issues of fiscal policy governance. Needless to say, the Council has also proven unwilling to play its role under the Treaty.

The set up of rules and procedures forces the Commission into actions designed for grief: fiscal adjustment paths are designed on the basis of forecasts of potential output growth, and thus deviations occur with remorseless logic. The choice is thus of proposing sanctions on the basis of shaky forecasts, or of not proposing sanctions despite the rules requiring them. If the Commission does not wish to sanction such deviations, it again
and again has to devise a new rule that explains why fiscal reality is in conformity with rules. Whatever the Commission ends up doing is seen as contravening its role and duties under the Treaty by some member states.

This ‘political’ behaviour contrasts with a fairly stable rules-based system, up to around 2010, where the Commission by and large executed the rules without an overly use of discretion. Under the old system the member states took a fairly active role in the discussions, sometimes even the voting, on individual country cases. Under the new system, with a considerably stronger role of the Commission, member states have turned passive, in the meetings largely accepting whatever the Commission proposes. Outside the room, however, they complain bitterly about whatever the Commission proposes.

**Streamlined rules**

The present system produces fiscal policy short termism, fine tuning of the rule book, and political loss of legitimacy. Bénassy-Quéré et al. propose a system of streamlined rules, based on debt levels and an expenditure rule, stronger national institutions, and market-based incentives, leading up to possible debt restructuring.

The proposed simplified rules are in accordance with proposals made by a wide variety of economists and institutions, including detailed work on the issue by the IMF. The details are not so important in the context of this comment. Such rules, however, should be able to deal with the tension of

- providing a steady medium-term framework that does away with the present system of permanent readjustment of targets in light of reality,
- whilst preventing that fiscal prudence only occurs in the medium term, and never in the short term.

This can rest on political enlightenment of the individual actors, on the threat of market sanctions, on the threat of Treaty-based sanctions, or by increasing the political costs of ‘bad’ fiscal policies. Political costs increase with transparency and information, and through critical dialogue.
How to stick to the rules: Increasing political costs

This should be a two-way system. For one, finance ministers should regularly explain their fiscal policy to a hearing in the European Parliament – less frequently if policies appear to be well on track, more often if not. If there are repeated or significant deviations the European Parliament may also wish to invite heads of state or government to such a hearing.

Transparency should also work better from Brussels to capitals. Both the commissioner in charge of this dossier, as well as the president of the Eurogroup, should be regular visitors to national parliaments in order to explain the euro area dimension of national fiscal policies. In the case of the latter that might well call for the installation of a full-time president of the Eurogroup.

The proposal by Bénassy-Quéré et al. relies on the good offices of national fiscal councils, which would be under the auspices of a central fiscal council. Experience to date with the fiscal councils has been quite mixed. Few have been able to establish themselves as independent, well-staffed institutions that increase critical transparency over national fiscal policies. Relying too heavily on such institutions appears mostly as another swing of the pendulum, handing back more responsibility to the member states as disenchantment with the Commission has spread.

Counting on these institutions to play a major role in ensuring good fiscal policies may be somewhat optimistic. What would be required, as a minimum, would be an agreement on staffing, expertise, independence, access to data, and methodological toolkits. Some of these already exist on paper, but are also followed only on paper. For these institutions to function well, as envisaged by Bénassy-Quéré et al., they would need to be perceived by the member states as an irritating control mechanism that is well heard in the national political discourse. Even in Spain and Portugal, where the fiscal councils are first rate, this is only partially the case. The European Fiscal Board could play an important role at the centre of such a system. Note that its present design ensures that it cannot influence current decisions.

An important institutional suggestion in the paper deals with separating the roles of ‘surveillance watchdog’ and political decision maker within the Commission, or even by moving the watchdog out of the house. Ultimately what counts is not the analysis, but how it is acted upon. This works well in the field of competition policy, which may influence the attractiveness in using this model for fiscal policy. Most important is transparency of what the rules require in terms of adjustment to fiscal policies. Put differently: if the watchdog barks, does anybody outside the Commission hear him barking? Such transparency could be achieved without extensive institutional reforms.
How intrusive?

Finally, one needs to reflect on the degree of intrusiveness of a system of fiscal rules, also in light of constitutional issues. Every presumed breaking of the rule book has resulted in further refinement of our rules. The Vademecum now has 244 pages. Granularity does not increase discipline. There may even have been at some stage a tendency to cover every conceivable situation through detailed rules, therefore putting national fiscal policies on something of an autopilot. The world does not work this way, politics even less so. This reinforces the view that interventions should deal with gross error, or significant deviations, not with issues that are somewhere behind the comma.

How effective?

The other side of the coin is the extent to which member states are willing to change the course of fiscal policy in light of interventions by ‘outsiders’. Past experience is mixed, and has shown on balance a larger degree of willingness of smaller member states to take criticism on board. Some member states find it outright inconceivable that their constitutional sovereignty on budgetary issues may be compromised by having to follow instructions from ‘Brussels’.

These issues show that the choices we are faced with in a number of areas also surface in the fiscal area:

• The community method versus intergovernmental cooperation: what should be the role of the Commission, and its relation with the Council (and the Eurogroup)?
• Is the concept of (constitutional or nominal) sovereignty compatible with membership of the euro area?
• Do we want to discipline ourselves through rules, through institutions, through market forces? Or a mixture?

In summing up:

As correctly analysed, the present system of fiscal rules is no longer workable and its application increasingly incurs political costs to the member states and the Commission.

• This calls for simpler rules that actually can be understood by those who are responsible for fiscal policy in member states
• Relying on a system of fiscal councils to act as watchdogs disregards the efforts of many member states to keep them as weak as possible. Strengthening them, and putting the European Fiscal Board at the centre of such a system, has its merits but one should not expect too much in practice.

• Increasing political costs for governments through structured discussions at the national and euro area level would be an additional incentive for keeping to agreed fiscal paths.

• The Commission will need to remain at the centre of the system, and needs to be strengthened. This needs to be seen in the wider context of the discussions on a ‘political’ Commission. This ‘political’ Commission should be given a wider margin of discretion of applying the fiscal rules; if there are noticeable deviations that the Commission does not act upon, then it should have to publicly explain itself before the Council, the Eurogroup and also the European Parliament.

Most actors who work with these rules agree that they are severely compromised. Governments in turn do not appear to be willing to reform them. They do not realise the costs of maintaining the status quo.

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About the author

Thomas Wieser was President of the Euro Working Group and of the European Financial Committee of the European Union until February 2018.
The current fiscal framework of the EU is insufficiently transparent and highly complex. There are many different rules in place at the national and supranational level, and affairs are made even more intricate by a multiplicity of exceptions and escape clauses. Consequently, the rules are not sufficiently effective in confining the deficit bias of governments and ensuring sustainable public finances. This should not be mistaken, however, as an inherent weakness of pursuing a rules-based approach. It is rather the result of its poor implementation. Yet, already a limited reform of the European fiscal framework would help to alleviate these problems, neither a repeal nor a radical reform of the framework would be necessary.

The German Council of Economic Experts (GCEE) has repeatedly pointed out the need for a reform of the fiscal framework and outlined the framework guiding this column in its latest annual report (GCEE 2017). The call for reform of the current framework is shared by a broad range of academics and institutions, including the European Commission (2017), the IMF (Eyraud et al. 2018), the European Fiscal Board (2017) and the French Council of Economic Analysis (Darvas et al., 2018). However, no consensus has emerged to date on a concrete redesign of the European fiscal framework. In the view of the GCEE, the most recent reforms of the Stability and Growth Pact have been moving in the right direction, most prominently through the ‘six-pack’ and ‘two-pack’ regulations, and the Fiscal Compact (GCEE 2015, Feld et al. 2016).

Yet, neither these reforms nor subsequent interpretations by the European Commission and the Council of the EU have led to an increase in compliance or a stricter enforcement of the rules. Rather, they have come at the expense of increased complexity and practical implementation problems. In this column, we outline a possible redesign of the fiscal framework, addressing the shortcomings of previous reforms and the need to enforce
the current framework. The background paper by Christofzik et al. (2018) provides additional analyses and technical details for the addressed shortcomings of the existing and the design of the proposed framework.

The refocused framework (as depicted in Figure 1) builds on the premise that to ensure fiscal sustainability, while sovereignty in fiscal policy remains with member states’ governments, it is necessary that levels of public debt do not exceed some threshold. While its precise magnitude remains obscure, our proposal uses a long-term debt limit as an approximation, such as the 60% threshold in the Stability and Growth Pact.

**Figure 1 GCEE proposal for a reformed European fiscal framework**

[Diagram showing the GCEE proposal for a reformed European fiscal framework]

In contrast to other proposals (Andrle et al. 2015, Claeys et al. 2016, Benassy-Quéré et al. 2018; Darvas et al. 2018), it also retains as a key element the structural balanced budget rule as stated in the Fiscal Compact. The general government budget should be close to balance over the business cycle. This is considered to be the case if the structural deficit does not exceed 0.5 % of GDP, or 1% of GDP if the debt ratio is significantly below 60%, and if risks to long-term fiscal sustainability are low. Since methods of cyclical adjustment are highly prone to error in real time but more reliable in the medium term, the proposal regards compliance with the structural balance rule as a medium-term target.

For monitoring purposes, the long-term debt rule and the medium-term structural balance rule need to be operationalised at the annual level. Our proposal works with an expenditure rule in the form of an annual ceiling (Figure 2). While other proposals are also based on an expenditure benchmark, they usually abandon one or both of the other rules. Instead, we establish the link to the long-term debt limit via a debt-correction
Refocusing the European fiscal framework
Feld, Schmidt, Schnabel, and Wieland

This proposal might not require a complete overhaul of the European framework and treaties, and would therefore be easier to put into practice than other proposals. Moreover, it would simplify the public debate about the adherence to fiscal rules, as the focus would be shifted towards the easy-to-grasp expenditure rule and the adjustment account, while drastically reducing exceptions and escape clauses. Another, quite similar expenditure rule is already part of the current framework of the SGP, but receives much lower public attention. Furthermore, the framework would be consistent with the existing national rules introduced in the member states owing to their participation in the Fiscal Compact. Our proposal contains several additional simplifying elements aimed at increasing both transparency and the political costs of non-compliance.

**Operational expenditure rule**

At present, the debt ceiling and the (structural) balanced budget rules are at the centre of public perception and debate. However, ex-ante compliance with these rules is difficult to ensure. Parts of the variables constrained by the balanced budget rule are not under the government’s direct control. They cannot be forecast reliably, as revenues and thus public deficits are highly dependent on the state of the business cycle. This applies even more to those cyclically adjusted measures involving cumbersome estimates, such as

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**Figure 2 Elements of a reformed expenditure rule**

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factor that ensures a reduction of the current debt ratio towards the long-term threshold. Moreover, we specify a multi-purpose adjustment account, which ensures compliance with the structural deficit rule in the medium term by capturing deviations from the rule, with the requirement to offset them within a certain period of time.

**Figure 2 Elements of a reformed expenditure rule**

Elements of a reformed expenditure rule

This proposal might not require a complete overhaul of the European framework and treaties, and would therefore be easier to put into practice than other proposals. Moreover, it would simplify the public debate about the adherence to fiscal rules, as the focus would be shifted towards the easy-to-grasp expenditure rule and the adjustment account, while drastically reducing exceptions and escape clauses. Another, quite similar expenditure rule is already part of the current framework of the SGP, but receives much lower public attention. Furthermore, the framework would be consistent with the existing national rules introduced in the member states owing to their participation in the Fiscal Compact. Our proposal contains several additional simplifying elements aimed at increasing both transparency and the political costs of non-compliance.
the structural deficit. Their estimates suffer from large margins of error, especially in real time and in forecasts.

By contrast, government expenditures can be directly influenced by governments; they are largely independent of the business cycle, and forecast errors are relatively smaller (Christofzik et al. 2018). Expenditures on unemployment is the only spending category that deviates from this pattern; its cyclical component should therefore be subtracted. As interest payments are not under the direct control of the government, they should be subtracted as well. A well-calibrated fiscal rule, however, that is complied with and thereby induces a reduction in the debt-to-GDP ratio will automatically put interest expenditures on a downward path as well.

In consequence, the operational fiscal rule which is the key element of our refocused European fiscal framework could build on the existing expenditure rule. That rule would only require some minor, albeit indispensable modifications, particularly relating to exceptions and escape clauses. Furthermore, formal links need to be established to the debt level and the structural deficit rule. The proposal incorporates both aspects through a debt-correction factor and a new multi-purpose adjustment account. This account would collect the deviations of all government expenditures from the forecasts made during the budgetary process. The government would be required to offset these deviations within a certain period of time; the same would apply to deviations from the structural deficit rule. While other proposals, such as Claeys et al. (2016) or Bénassy-Quéré et al. (2018), also include an adjustment account, it has less scope and is used to offset small deviations between actual and budgeted public expenditures.

Specifying a well-founded rule is one thing, ascertaining its credibility in the vicissitudes of practical policy implementation is quite another. A fundamental prerequisite for credibility is that assessments regarding compliance remain consistent over the course of time. In the current framework, this assessment often changes when the perspective changes from real-time data to ex-post data. This phenomenon reflects its reliance on output-gap estimates. They are indispensable for calculating the structural deficit, but unfortunately they are typically prone to large revisions as better data become available. Consequently, assessments based on the concept of the aggregate output-gap can lead to significant policy errors. By contrast, revisions of public expenditures tend to be considerably smaller (Andrle et al. 2015). It is therefore highly sensible to concentrate on expenditures for monitoring purposes.

A major drawback of the original rules in the Maastricht Treaty, such as the 3% deficit rule, is their procyclical nature. Originally, this was not a major issue, as the original intention of these rules was to pre-specify concrete numerical limits for exceptional times that might or might not arise eventually. In practice, however, these limits mutated
Refocusing the European fiscal framework
Feld, Schmidt, Schnabel, and Wieland

into regular benchmarks to be utilised in good as well as in bad times (Reuter 2015). As governments typically exhaust the limits in normal times, in bad times they don’t have any leeway to manoeuvre within the limits. In effect, the rules exhibit procyclical effects. The original deficit procedures already address this problem by the introduction of the structural deficit rule, at the expense of the necessity to use failure-prone output-gap estimates.

Our procedure is avoiding procyclicality more directly. Primary government expenditures net of cyclical unemployment payments are largely acyclical anyway, i.e. they hardly change systematically with the business cycle (Christofzik et al. 2018, Mourre et al. 2013). Yet, while discretionary fiscal policy is often unsuitable for counteracting regular cyclical fluctuations (Elstner et al., 2016), automatic stabilisers should be able to react as freely as possible. This can be guaranteed by specifying the expenditure rule to exclude cyclical unemployment expenditures. Residual expenditures should be included, though, as they are largely free of automatic stabilisers. Thus, constraining expenditures leads to a rule design that is much less procyclical than the original 3% rule and restricts automatic stabilisers even less than the structural balance rule.

Adjustment account: Linking the expenditure rule and the structural balance rule

The main focus of the current fiscal framework, and especially its reforms after the Great Recession, lies on the structural deficit rule. It has been introduced in national legislation throughout the EU member states in the context of the inter-governmental Fiscal Compact. The rule has a clear theoretical rationale. The key idea is that public finances should be close to balance over the cycle. Yet, it is admittedly difficult to implement in year-by-year monitoring due to complexities in measurement. Nevertheless, the structural balance rule remains important as a medium-term benchmark. This would serve several objectives.

Retaining the structural deficit rule in the medium term corresponds to the spirit of regulations at the national (Fiscal Compact) and supranational (SGP) levels. In addition, there are circumstances in which augmenting an expenditure rule just by a mechanism for debt correction would not be enough to ensure a close-to-balanced budget over the cycle. For example, if an economy exhibits a positive output gap and its expenditure growth is below the ceiling, then its debt-to-GDP ratio is decreasing, but it does not need to have a positive structural balance.

Estimation errors of the structural balance are most severe in real time. Immediately after the first two years following a specific year, the revisions are already substantially
smaller (Christofzik et al. 2018). The current European framework implemented a complicated system of adjustments to the excessive deficit procedure—so-called alpha- and beta-corrections—in an attempt to take this into account. This has increased the complexity of an already cumbersome system even more. The European Commission’s Vade Mecum, the official handbook on the European fiscal framework, needs more than 200 pages to explain the calculations employed to determine whether a country is complying with the rules (European Commission 2018).

A multi-purpose adjustment account could be used to circumvent this problem, while retaining the structural balance rule as the benchmark in the medium term. Any deviation from the rule would be captured in this account and earmarked separately for compensation over the course of the subsequent years. In subsequent years, revisions of past structural balances (that could have a positive or negative effect) would also be captured and might offset past deviations. This procedure would substantially mitigate the impact of real-time estimation errors, retain a balanced budget over the cycle as the medium-term benchmark and make the relevant calculations more transparent. Net inflows to the adjustment account would have to be balanced over the medium term (e.g. five to ten years), setting a natural cap to the annual size of the adjustments. One could also limit positive additions in exceptionally good years to mirror the escape clause for exceptionally bad years.

As long as member states do not shift budgetary sovereignty to the European level, the size of the public sector—i.e. the ratio of public expenditures to GDP—should be the decision of national electorates. However, in order to allow for this flexibility within expenditure rules, additional expenditures need to be financed by additional revenues. The latter has to be estimated to determine compliance with fiscal rules. As can be observed in the current European framework, these estimates are prone to considerable uncertainty. In our proposal, maintaining the structural deficit rule addresses the problem as revenue developments are considered over the medium term. Furthermore, the realisation of discretionary revenue measures could be tracked and previous estimates revised accordingly. These revisions would then also be collected in the multi-purpose adjustment account.

Figure 3 provides an example documenting the records in the multi-purpose adjustment account for four EMU countries from 2013 to 2017. Details regarding these calculations are provided in Christofzik et al. (2018). The account would collect four elements: i) violations of the structural balance rule based on real-time estimates (blue bars), ii) revisions of these estimates for previous years (orange bars), iii) revisions of the estimated revenue impact of discretionary tax measures (green bars), and iv) short-term deviations between actual and budgeted expenditures which occur during the budgetary
process and are typically small (not shown in the figure). Each year a fraction of past changes to the adjustment account, which could also be positive, would be offset: the benchmark specified in the expenditure rule would be adjusted in reaction to the net entries to the adjustment account which occurred during the previous five years (Figure 1). In Figure 3, the simplifying assumption is that net inflows of one year would be reduced proportionally in each of the subsequent five years (red bars).

Figure 3 Recording of entries in the multi-purpose adjustment account

![Recording of entries in the multi-purpose adjustment account](image)

The example shows that France had a structural deficit larger than the threshold in all five years and thus a positive addition to the adjustment account (blue bars). Germany, on the other hand, had a structural deficit lower than the threshold, which leads to negative additions. In both countries, revisions of structural balances in previous
years (orange bars) would have altered the adjustment account in various years. These revisions can be quite substantial. An example is Spain in 2014, where the revisions of past structural balances are larger in total than the real-time violation of the structural balance rule in this year. Every country in our example experienced some revision of estimates of discretionary revenue measures (green bars). In this example, a fifth of the net inflow to the adjustment account needs to be offset in each of the five following years. The red bars show the respective sum for a specific year. This value is the basis for the correction of the benchmark of the annual expenditure rule.

**Sustainability: Long-term limit and compliance**

Fiscal rules are generally introduced to confine the deficit bias of politicians and governments and ensure the sustainability of public finances. The latter can be secured by keeping the debt-to-GDP level below a certain threshold (e.g. 60% of GDP in the Stability and Growth Pact), or at least putting it on a path towards this threshold. To operationalise this long-term limit, the expenditure rule could entail a markdown relative to the difference between present debt levels and the long-term limit. This also forms part of various other proposals (Andrle et al. 2015, Benassy-Quéré et al. 2018, Claeys et al. 2016).

Regarding implementation, a gradual adjustment path could be envisaged that splits the debt-reduction requirement into equally sized parts. The simulation in Figure 4 considers a symmetric debt correction of 1/75 and 1/50. This grants countries with a lower debt-to-GDP ratio additional freedom, because it would relax the structural deficit rule. However, given the current debt-to-GDP ratios, this would not apply to any country in the near future. More detail and additional scenarios are presented in Christofzik et al. (2018).

The structural balance rule with a structural-deficit ceiling of 0.5% of GDP puts the debt-to-GDP ratio on a downward path during normal times. However, a debt-correction factor increases the speed of adjustment. The current rule in the Fiscal Compact sets the lowest limit for the structural deficit at 0.5% of GDP in general, and at 1% of GDP if public debt is significantly below 60% of GDP. Without a debt-correction factor, convergence below the 60% limit would take a very long time for countries with currently high levels of public debt. For example, in the case of Italy's debt of more than 130% it would take 34 years to arrive at the 60% limit assuming a 3% growth rate of nominal GDP. With a debt correction of 1/50 and a growth rate of 3%, Italy would approach this level after 29 years.
**Figure 4** Simulation of debt-to-GDP ratios and budget balances for different assumptions¹

Simulation of debt-to-GDP ratios and budget balances for different assumptions¹

1. – Assumptions: Debt increases by 0.5% of nominal GDP if the debt ratio in the previous year is larger than 40%, otherwise it increases by 1% of nominal GDP. The debt correction factor is multiplied with the distance of the debt ratio in the previous year to 60%. The resulting term is subtracted from the allowed deficit. 2. – In % of nominal GDP.

Source: own calculations.

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**Increasing political costs to ensure compliance**

Compliance with European fiscal rules and their enforcement have been weak. A significant increase in the political costs of non-compliance is therefore key. If a violation of rules has political consequences, the effect on the behavior of politicians and compliance with fiscal rules can be expected to be much stronger than legal sanction mechanisms. But to increase the potential for consequences, voters, politicians and the media need to be able to assess government plans relative to the fiscal rule in real-time. Transparency and simplicity are therefore essential so that the rules can be binding and serve their function as an anchor for the public, the media and financial markets. By
contrast, today’s rules are characterised by such extreme complexity that even experts can barely determine whether member states meet all the requirements of the fiscal rules.

A simplified framework and a focus on one central rule would constitute a significant step towards more political accountability. Reducing the ever-growing number of exceptions and escape clauses in the current framework would be another. Many such exceptions and escape clauses are currently being applied (Figure 5). This is not in the spirit of the rules, increases complexity, and makes judgements on compliance subjective and non-transparent. Examples include exceptions for pension and structural reforms and various types of investment expenditures. The legal provisions for these exceptions and escape clauses have been introduced in various EU regulations over time and are detailed by the European Commission. Thus, presumably, they could also be abolished without a treaty change. An appropriately designed rule would mean that no exceptions and just two escape clauses would be necessary: one for natural disasters and one for exceptionally severe economic crises. A decision on the latter could be based on a specific set of economic indicators.

**Figure 5** Application of the exemption clause in the SGP since 2012

*Application of the exemption clauses in the SGP since 2012¹*

1 - Analysis based on reported figures in the Assessments of the Stability Programmes by the EU Commission. 2 - Exemptions for refugees, security-related measures and natural disasters constitute the exemptions for unusual events. 3 - No size figures are reported by the European Commission in case of the exemptions for adverse economic conditions and small deviations. 4 - Reported size refers to a single observation, namely Italy in 2017.

Sources: European Commission, own calculations
Independent monitoring institutions can support this process and draw attention to worrisome developments. In particular, the national fiscal councils introduced recently have considerable potential for increasing transparency and the accountability of governments. However, the design of these councils is very heterogeneous across member states. Many of them lack essential features they need to act effectively as watchdogs. They require a minimum set of standards with respect to factual independence and their mandate. The European Fiscal Board would also need an overhaul before being entrusted with additional tasks. Its (political and factual) independence from the European Commission would have to be firmly established. Furthermore, it would need a significant increase in staff and financial resources to perform such a task independently (Asatryan et al. 2017).

Giving either the national councils or the European fiscal board additional responsibility with respect to fiscal rules, as suggested for example in Bénassy-Quéré et al. (2018), could be problematic in their current state. In addition, democratic accountability plays a key role in the public acceptance of fiscal rules, which makes a complete delegation of tasks to technical experts unfeasible. However, the actions of the political body of the EU, the Council, have shown in the past that time inconsistency and peer pressure make it unreliable in the enforcement of the rules. A way out would be democratically legitimised rules with small discretionary and larger automatic parts.

Thus, sanctions should be more automatic and suitable to increase political costs for governments of non-compliance with the rules. The enforcement of current sanctions is time inconsistent as they are at the discretion of the Council of the EU or a politicised European Commission. This might be one reason why there have been no sanction payments to date. The current modalities with regard to sanctions have been introduced especially in one of the six-pack regulations (Regulation (EU) No 1173/2011). A way to make sanctions more credible would be to introduce more automaticity through a new EU regulation. The size and design of sanctions could be predetermined and not set by the European Commission. This would prevent cases like Spain and Portugal in 2016, when a violation of the rules was declared but the sanctions were set to zero euros.

Furthermore, the assessment about compliance and non-compliance should not be conducted by a political European Commission. Instead the European Commission could bind its assessment to the verdict of an independent fiscal council, like a reformed European Fiscal Board. The European Council would, as foreseen today, at the end still vote on the imposition of sanctions based on a reversed qualified majority. In addition to greater automaticity, various ex-ante possibilities could enhance compliance with the rules. Among others, a requirement to comply with fiscal rules could be a pre-condition
to gain access to a precautionary credit line of the ESM or the history of compliance with fiscal rules could be a criterion used in the evaluation of a debt restructuring mechanism of the ESM (Andritzky et al. 2018).

**Implementation**

In contrast to many other proposals, the one presented in this column does not call for a radical repeal and restructuring of the European fiscal framework. It builds on various elements that already exist today, but calls for a shift in focus and changes in implementation. This might make it easier and more realistic to realise than a complete change in design. Many procedures and specifications causing the complexity of the current system are not enshrined in the European treaties or in inter-governmental treaties, but are rather based on regulations and guidelines laid down by the European Commission or the Council of the EU. These elements could be abolished without treaty changes. The other elements, such as fiscal rules apart from the expenditure rule, would move out of focus, but in accordance with the treaties still be enforced through their link to the expenditure rule. Nevertheless, the proposal would achieve the goal of having a consistent, more transparent fiscal framework with stronger incentives for compliance that counteracts the deficit bias of governments and ensures the sustainability of public finances.

**References**


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Proposals to reform the euro area are on the agenda again (see, in particular, Benassy-Quéré et al. 2018). An overhaul of the complex set of European fiscal rules should be on high on this agenda, because the fiscal framework in place has not worked well.

**The current fiscal framework suffers from massive problems**

It has generated excessive fiscal austerity during the crisis, thereby contributing to aggravating and prolonging its economic, social, and political consequences. Either because countries did not abide by the rules or because the rules were not sufficiently stringent during good years, there was insufficient debt reduction in many countries in the 2000s, and this reduced fiscal capacity during bad years. In addition, these rules suffered from large measurement problems. The structural budget balance (the budget balance cleaned from the impact of the economic cycle and one-time budget measures like bank rescue costs), which is the cornerstone of current rules, is a nice theoretical concept, but it is not observable and its estimation is subject to massive errors. The typical annual revision in the change of the structural balance is larger than half a percent of GDP, while half a percent of GDP is the baseline fiscal adjustment requirement for countries in breach of EU fiscal rules. Such huge revisions and other problems related to its measurement highlight that this indicator is not suitable for policymaking.

The policy mistakes generated by the fiscal rules also led to overburdening the ECB as the main remaining stabilisation instrument. The fiscal framework has also put the European Commission in the difficult position of enforcing a highly complex, non-transparent and error-prone system, exposing it to criticism from countries with both stronger and weaker fiscal fundamentals. The rules are used as a scapegoat by anti-European populists because they are seen as a centralised micro-management which infringes on national sovereignty.
However, fiscal rules to ensure debt sustainability in the euro area are a necessity. The main reason is that the no-bailout clause is not credible in a monetary union because of the specific collateral damage generated by a fiscal crisis that may lead the breakup of the common currency (Gourinchas et al. 2018). However, fiscal rules are not a silver bullet and cannot be substituted to the national democratic debate on fiscal choices and debt sustainability but should help framing this debate. Fiscal rules should be as transparent and simple as possible, should set targets under the direct control of the government, should allow countercyclical fiscal policy and should generate incentives to reduce excessive public debt.

**How to change the rules?**

In a recent study, we assess the current framework and propose a major overhaul (Darvas et al. 2018). We recommend substituting the numerous and complex present rules with a new, simple rule focused on limiting annual growth rate of expenditures. Other economists (Claeys et al. 2016, Benassy-Quéré et al. 2018, Feld et al. 2018) have made similar recommendations and international organizations – such as the IMF – have published positive analysis on such rules (Debrun et al. 2018).

Our expenditure rule requires that nominal expenditures not grow faster than long-term nominal income, and that they grow at a slower pace in countries with excessive levels of debt. This translates into a two-pillar approach: (1) a long-term target debt level, such as 60% of GDP; and (2) an expenditure-based operational rule to achieve the anchor.

The expenditure rule could take the following form: the growth rate of nominal public spending (net of interest payments and of unemployment spending and after properly taking into account public investment) is the sum of real potential growth and expected inflation, minus a debt brake term which takes into account the difference between the observed debt-to-GDP ratio and its long-term target (which we take to be 60% from the EU Treaty).

1 Formally:

\[ \hat{g}_{i,t} = \hat{y}_{i,t} + E_{i,t} \pi_{i,t} - (d_{i,t} - d^*) \]

where the growth rate of nominal public spending (net of interest payments and of unemployment spending and after properly taking into account public investment) \( \hat{g}_{i,t} \) for country \( i \) in year \( t \) is the sum of real potential growth \( \hat{y}_{i,t} \), expected inflation \( E_{i,t} \pi_{i,t} \) minus a debt brake term which takes into account the difference between the observed ratio of debt to GDP \( d_{i,t} \) and the long term target \( d^* \). The parameter \( \gamma_{i,t} \) is important as it drives the speed at which the country converges to its long-term debt target.
The key parameter in this formulation is the speed at which the country converges to its long-term debt target (i.e. the debt-brake parameter). In our simulations of this formula (see footnote and the original paper for details), we found that a public spending rule with a constant and homogenous debt brake parameter to reach the 60% target does not generate realistic fiscal policy recommendations for certain European countries. In countries with debt levels significantly higher than the 60% of GDP, the necessary initial budgetary effort is unrealistically high if, for example, the debt brake parameter is chosen to fit France or Germany.

By recognising this limitation, instead of a set-in-stone numerical formula, we recommend an expenditure rule based on a rolling five-year country-specific debt reduction target in a properly designed institutional framework. This would work in practice as follows:

Each year, the government proposes a rolling medium-term (e.g. five-year-ahead) target of reduction in the debt-to-GDP ratio. This could be part of the existing Stability Programme provided each year by member states to the European Commission. Both the national independent fiscal council and the euro area fiscal watchdog are consulted and provide a public assessment of the target in terms of both feasibility and ambition. A discussion follows with the European Commission. The discussion should be based on an economic analysis where the important parameters would be (1) the distance between the actual debt-to-GDP ratio and the long-term target of 60% (the higher the gap, the more ambitious the adjustment); (2) a broader analysis of fiscal sustainability (in particular, to give credit to countries that undertake solvency-improving entitlement reforms, or major reforms expected to raise potential growth); and (3) an economic analysis of the economic situation and the relevant path of debt reduction. As a result, the pace of medium-term debt reduction should not be determined by a formula. The Commission then presents its conclusion for the debt reduction targets for each country to the Council that can vote against it by a reverse qualified majority.

The national fiscal council would prepare a medium-term nominal GDP growth projection based on expected potential output growth, expected inflation, and a possible cyclical correction in case initial conditions depart markedly from long-run equilibrium. Given the medium-term target on debt reduction, the national fiscal council provides a consistent medium-term nominal public expenditure path and uses it to set a nominal expenditure ceiling for the coming year, for use in the preparation of the corresponding budget.

Nominal expenditures are calculated net of interest payments, of unemployment spending (except when these are due to discretionary changes to unemployment benefits), and of the estimated impact of any new discretionary revenue measures
(changes in tax rates and tax bases). The first two adjustments allow for more countercyclicality, while excluding the effect of expenditure-increasing structural measures. The last adjustment is meant to preclude the manipulation of tax rules (for example, tax cuts ahead of an election) that are not compensated by offsetting expenditure measures. It also allows elected governments to make fiscal policy choices (implying different but consistent long-term levels of expenditures and taxes) that reflect political preferences.

It is also important to properly account for public investment, which tend to vary a lot from one year to the next. For example, when a big infrastructure project is launched, public investment can be huge in that year and small in subsequent years. The best way to treat such public investment is the same as private companies treat private investments: the cost of investment is distributed across years during the service life of the capital good purchased.

Limited deviations between actual and budgeted spending could be absorbed by an ‘adjustment account’ that would be credited if expenditures net of discretionary tax cuts run below the expenditure rule, and debited if they exceed it. These types of accounts exist in Germany and Switzerland. If a country passes a budget with no excessive spending but realised spending is above the target, the overrun could be financed without breach of the rule, provided that the deficit in the adjustment account does not exceed a pre-determined threshold (e.g. 1% of GDP). If the threshold has been breached, the country violates the fiscal rule.

We show (see also Claeys et al. 2016) that structural budget balance estimates are subject to large revisions, partly due to the uncertain estimates of the output gap. Based on that finding, one might argue that the medium-term potential growth estimates, which are the basis of our proposed expenditure rule, could be also subject to large revisions – but this is not the case. With the exception of the year 2008, even European Commission estimates were subject to rather small revisions. For example, for the EU15 core countries, the typical revision in the medium-term potential growth rate is about 0.15 percentage points per year. A 0.15 percentage point downward revision in medium-term potential growth estimate would imply that if in spring 2018 a country is allowed to increase expenditures by 3.0%, in spring 2019 the allowed growth rate of expenditures is revised downward to 2.85% per year. Given that public expenditures amount to about half of GDP, a 0.15% revision in expenditures implies an impact of 0.075% of GDP on the budget balance, which is rather small and well below the impact of revisions in the structural balance.
The properties of our proposed new rule

We assess the consequences of an application of an expenditure rule through several quantitative simulations by the Observatoire français des conjonctures économiques (OFCE 2018). Examples of the simulations run by OFCE of France’s debt dynamics and real public expenditures growth rates under three objectives (a -2%, -4%, or -6% decrease in debt over GDP at a five-year horizon) suggest that, depending on the degree of ambition of the five-year debt reduction target, an expenditure rule can generate debt reduction dynamics that are similar or less stringent than the present rule. In all cases of the proposed expenditure, the real growth rate of expenditures for France would converge to a bit less than 1% (i.e. less than the potential growth rate assumed to be 1.1%) but with more front loading of the adjustment in the first years.

Next, we analyse the cyclical properties of the rule on a calibration based on French data. The rule has good countercyclical properties for unexpected demand shocks. First, the nominal growth rate of expenditures is not affected by the shock and automatic stabilisation is at work due to lower revenues and higher deficits. Second, a negative demand shock generates inflation below expectations. As the growth rate of nominal public spending is based on expected inflation, such a shock induces a higher real growth rate of public expenditure and therefore a positive fiscal impulse. Concerning supply shocks, such as oil price shocks generating a fall in output and an increase in inflation, the expenditure rule is still stabilising because it induces a budget deficit but the higher unexpected inflation slightly reduces its stabilising properties (relative to the current rule). Overall, if, as is mostly believed, demand shocks are predominant in the euro area, we conclude that the expenditure rule has a better cyclical properties than the current rule.

To illustrate the better countercyclical properties of the expenditure rule, Figures 1 and 2 show the observed growth rate of primary public spending in France (in black) and of the fiscal impulse and a counterfactual simulation performed by OFCE of these two series (in colour) as generated by an expenditure rule.

Both figures suggest that the rule would be more countercyclical than was observed in France. During good years, the growth rate of public expenditure as well as the fiscal impulse would have been lower; and vice versa, in the period 2011-2013 French fiscal policy would have been more expansionary. Note however that in 2009, the rule would have implied less fiscal stimulus and this is the reason we advocate to keep an escape clause in case of exceptional circumstances.
Figure 1  Nominal growth rate of primary public spending in France for the period 1998-2017 (%) in current euro

![Nominal growth rate of primary public spending in France for the period 1998-2017 in %, current euro](image)

Sources: INSEE, OECD, Budget Bill, OFCE’s calculations.

Source: INSEE, OECD, Budget Bill, OFCE calculations.

Figure 2  Fiscal impulse in France for the period 1998-2017 (% of potential GDP)

![Fiscal impulse in France for the period 1998-2017 in % of potential GDP](image)

Reading: The simulation consider actual tax measures as given, like tax cut in 1999 and the tax increases in 2011-2013.

Sources: INSEE, OECD, Budget Bill, OFCE’s calculations.

Note: The simulations consider actual tax measures as given, such as the tax cut in 1999 and tax increases in 2011-2013. Source: INSEE, OECD, Budget Bill, OFCE calculations.
Enforcement of the rule

The European experience suggests that enforcing compliance through penalties imposed by what is seen in many countries as bureaucracy from Brussels or political might from Berlin has major deficiencies. Instead, we advocate for a credible enforcement of fiscal rules, mixing several instruments pertaining to surveillance, positive incentives, market discipline, and increased political cost of non-compliance.

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While today the need for fiscal rules is higher than ever, it is increasingly recognised that the Stability and Growth Pact (SGP) is not up to its task and requires a deep overhaul. In 2016, the Dutch presidency of the Council first stressed the need to simplify the rules and strengthen their medium-term orientation (Dutch Council Presidency 2016). In May 2017, the European Commission also called for a review of EU fiscal rules as part of the overall process of completing the EMU (European Commission 2017). The European Fiscal Board published its proposal for reforming the SGP in the 2018 Annual Report (European Fiscal Board 2018). Recommendations from international institutions (IMF, OECD) and the lively VoxEU debate on euro reform suggest that some convergence of opinion is beginning to emerge, both on the need for reform and on the main direction this reform should take (e.g. Bénassy-Quéré et al. 2018, Conseil d’Analyse Économique 2018, German Council of Economic Experts 2018, Heinemann 2018).

Reforming the rules is particularly important at the present juncture – governments must take advantage of the current environment to prepare for the next crisis. Further, it is important to recall that EU fiscal rules are part of a broader set of policy tools. For instance, the precautionary credit lines of the ESM require compliance with the SGP as one of the eligibility criteria.¹ The same is true for the European Investment Stabilisation Function (EISF) recently proposed by the European Commission as part of the new multiannual financial framework (European Commission 2018a). A simpler, more transparent and more predictable framework is thus an essential component of the whole process of EMU deepening.

¹ See https://www.esm.europa.eu/sites/default/files/esm_guideline_on_precautionary_financial_assistance.pdf
What have we learned from the SGP so far?

Today, the SGP features five main building blocks.

• First, two ‘anchors’ guide fiscal policy over the medium term: the budget deficit and the debt ratio.

• Second, these anchors imply overlapping fiscal requirements that occasionally offer conflicting signals: a structural adjustment and a target for debt reduction.

• Third, policies are monitored using a multitude of indicators, which inevitably cause conflicting signals; the assessment of compliance is therefore a judgement-based approach that weighs the pros and cons of the different indicators.

• Fourth, a complicated system of flexibility arrangements allows member states to negotiate reductions in their fiscal requirements, for instance in exchange for structural reforms and certain types of public investment.

• Finally, there is an escalating system of warnings and sanctions for non-compliance, although the latter have never been used (European Commission 2018b).

This framework is the result of several reforms throughout the years, which gradually increased the complexity of the rules. Of some concern is the fact that the reforms added pro-cyclical features. First elements of flexibility and cyclical corrections were introduced in 2005, when the euro area economy was in good shape, but the framework was substantially tightened during the crisis with the six-pack and two-pack reforms. As the economy began to recover again in 2015, further elements of flexibility were introduced, leading to a relaxation of the fiscal targets. This back-and-forth in the rules mirrors the underlying pro-cyclicality of fiscal policies in the euro area (see Figure 1) and highlights the difficulty of enforcing a supra-national fiscal framework. Ultimately, the SGP is the result of a political compromise among member states; perhaps for this reason it is time-inconsistent – ex-post the rules are relaxed to accommodate difficult cases. A renewed fiscal framework needs to go beyond compromise to reach a shared understanding of what constitutes good governance and to ensure ownership and democratic support for the rules.
More concretely, several problems need to be addressed.

- First, today the rules are too complex and this has hampered their effectiveness; indeed, there is a common perception that the rules are applied unevenly, even when they are not.
- Second, the transparency of the framework has decreased. The use of multiple indicators, some of which unobservable, has increased the scope for discretion and judgement.
- Third, the separation that once existed between the Commission and the Council – the former in charge of legal and economic analysis and the latter in charge of policy decisions – has become less clear cut, as the Commission has been given more enforcement powers. In particular, the introduction of reverse qualified majority voting for the imposition of sanctions has de facto given the Commission important responsibilities for policy outcomes.
- Fourth, the enforcement of the rules through sanctions has not worked so far. While imposing sanctions on Member States may feed political and public resentments, a fiscal framework without any correction mechanism is not credible.
Proposal for a new framework

In its 2018 annual report, the European Fiscal Board proposes a major overhaul of the EU fiscal framework. The proposed new framework relies on a single fiscal anchor: the 60% reference value for the debt ratio. This is directly translated into a single operational target: a constant ceiling on the growth rate of primary nominal expenditure net of discretionary revenue measures, ensuring that the debt ratio would reach 60% in, say, 15 years if the economy were at its potential and inflation at 2%. The expenditure ceiling thus includes a built-in debt brake. The ceiling is fixed for a three-year period to ensure a medium-term orientation of fiscal policies; at the end of the three years, it is recalculated based on what is needed to reach the 60% reference value 15 years ahead. The debt reference value is therefore reached asymptotically.

This reform can be implemented by changes in secondary legislation, not the Treaty itself. The 3% Treaty reference value for the budget deficit therefore remains, but it is no longer used to set fiscal targets. While a member state could still face an excessive deficit procedure, this would require deviation from the expenditure rule outlined above. The only difference between the preventive and the corrective arms of the SGP consists in stronger enforcement, but not in more stringent fiscal targets. Finally, the expenditure rule will not apply to member states with debt below 60% of GDP; in this case, the 3% deficit ceiling remains the only constraint.

Compliance with the rule is assessed on the basis of a single indicator of net primary expenditure growth. In line with the current methodology used in the expenditure benchmark of the SGP, the impact of cyclical unemployment benefits is excluded, together with EU-funded investments. At the same time, gross fixed capital formation is smoothed over four years to avoid penalising public investments. Under the preventive arm, deviations from fiscal targets are recorded in a compensation account and need to be corrected in later years. A breach of the rules will occur whenever the cumulative deviation in the compensation account exceeds, say, 1% of GDP. Under the excessive deficit procedure, any deviation above the net expenditure ceiling will be considered a breach and may lead to sanctions.

A general escape clause should replace the complex system of waivers and flexibilities currently embedded in the rules. This escape clause will allow member states to deviate from the expenditure ceiling under a limited set of exceptional circumstances, such as during a severe economic downturn or following highly unusual events outside the control of the government, such as natural disasters.

Sanctions for non-compliance will apply equally in the preventive and the corrective arm. A revamped sanction framework could involve removing the discretion that exists
when setting fines under the SGP. Additionally, the economic conditionality currently foreseen for European Structural and Investment (ESI) funds could be extended to the whole EU budget. Finally, positive conditionality should be introduced, for instance, adherence to the rule could allow access to the recently proposed European Investment Stabilisation Function, or any other future central fiscal capacity. Figure 2 presents a stylised representation of the proposed framework.

The Board finally proposes to reform the overall governance of the rules by assigning a greater role to independent institutions in assessing compliance, particularly in relation to the use of the escape clause. This would strengthen the framework by providing a greater separation between the ‘assessor’ and the ‘decision maker’. Concretely, whenever a breach of the expenditure rule is observed, it will be up to an independent assessor to conduct an evaluation of whether the escape clause can be triggered. Such assessor could for instance be an EU-level independent fiscal institution (IFI), possibly in combination with national IFIs. The European Commission and the Council will then take the ultimate policy decision based on this independent assessment and, in case they decide to deviate from it, they will explain the reasons for such deviation.

Figure 2 Stylised representation of the expenditure rule

The implementation of the full reform package will result in a simpler and more transparent framework thanks to the use of a single budgetary anchor and a single observable operational target. Enforcement will also be more effective, because a stronger system of sanctions – which applies also under the preventive arm – and a limited use of escape clauses are backed up by the need to comply or explain by the decision makers. Moreover, the three-year interval for recalculating the expenditure ceiling enhances the medium-term orientation of the budget.

**Illustrative example**

Figure 3 presents a simulation of the expenditure rule for several euro area countries, and compares it to the current debt rule embedded in the SGP. The expenditure rule seems to strike an appropriate balance between debt sustainability and economic stabilisation. It helps to stabilise the economy, because the expenditure ceiling is calculated assuming that growth is at its potential and that inflation is at 2%; during a downturn, spending is allowed to grow at a higher rate than the economy, and vice versa. For example, in Italy and Spain nominal growth is still below its potential, leading in the short run to higher net expenditure growth than under the current debt rule, which is based on eliminating one-twentieth of the gap between the actual debt-to-GDP ratio and 60%.

Our rule implies that these countries are initially required to run only relatively low primary surpluses, and fiscal targets will become more demanding only when growth and inflation return to normal. By stabilising net expenditure growth, the rule allows for a steady improvement in the primary balance, as public debt gradually converges towards 60%. The need to bridge the sizeable gap with the 60% debt anchor in 15 years’ time requires Italy in particular to run substantial primary surpluses. This confronts the country with an arduous task. However, the severity of this task is mitigated by the fact that the required increase in primary surpluses is lower in countries in which the economy is growing below its potential. Over time, as the debt ratio keeps falling, the rule allows for increasingly higher rates of net expenditure growth while still maintaining adequate primary surpluses.
**Figure 3** Simulating the expenditure rule for high-debt countries

Notes: The adjustment path under the expenditure rule is computed every three years, assuming that the economy is growing at its potential rate and that inflation is at 2%, so as to bridge the gap to 60% debt-to-GDP in 15 years. Implicit interest rates are computed assuming that long-term nominal rates converge to 5% over ten years, and interest expenditures increase in line with the expected roll-over schedule of debt. ‘Net expenditure growth’ refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits. The adjustment under the debt rule in the SGP is computed every year on the basis of the current macroeconomic outlook, so as to reduce the gap between the actual and the 60% debt-to-GDP ratio by one-twentieth. In both the current SGP and under the proposed debt rule, the adjustment is hence asymptotic. Under the current SGP, the short-run adjustment requirement is tempered by gradual adjustment of the structural balance to a medium-term objective, while under the expenditure rule, gradual adjustment occurs automatically by setting the growth rate of expenditures, rather than a structural balance target, and by allowing faster growth in expenditures relative to revenues in economies that are growing below potential.

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Section 5: Do we really need a central fiscal capacity?
18 Whither a fiscal capacity in EMU

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Originally, I was part of this endeavour. I was the eighth German member of what has become the 7 + 7 Franco-German group. In December 2017, before the Policy Insight by Bénassy-Quéré et al. (2018) was finished, I quit the group although I still had been a co-author of an op-ed in newspapers in September 2017 in which the basic goal – i.e. to balance risk sharing and market discipline – was outlined. It has been one part of the Policy Insight which does not convince me and finally triggered my resignation: the proposal for a fiscal capacity in European Monetary Union (EMU).

This was not the first time that I engaged in a cooperation which targeted policy trade-offs regarding EMU by proposing a package deal, a grand bargain, a balanced approach. As a member of the German Council of Economic Experts (GCEE), I am an author of the Council’s debt redemption pact (GCEE 2011, 2012). This pact balanced the need for stabilisation of the euro area by mutualising public debt of EMU member states to some extent with provisions to keep moral hazard at bay, i.e. provisions for collateral, the endorsement of an adjustment programme by participating countries, and so on. With the requirement of an adjustment programme, member countries should ensure that they reduce their public debt-to-GDP ratios to below 60%.

The GCEE was fully aware that without such a fiscal solution to the crisis of 2011 and 2012, the ECB would act – with heavily restricted possibilities to reduce member states’ moral hazard leading to a possible over-burdening of monetary policy in EMU. In particular, the ECB could not ensure that member countries reduced their over-indebtedness. The announcement of the Outright Monetary Transactions (OMT) provided such a ‘monetary solution’ (making the debt redemption pact obsolete), but debt-to-GDP ratios in the euro area have remained high. In efforts to warn against over-burdening monetary policy, the two reports by Corsetti et al. (2015, 2016) aimed at striking other balances between market discipline, i.e. a sovereign debt restructuring mechanism, and macroeconomic and financial market stability. Coping with legacy debt
problems was central to these approaches. Any proposal for a reformed architecture of EMU must address this issue and ask what the best design would be if they were to be solved.

The balanced approach

The proposal by Bénassy-Quéré et al. (2018) is focused on a compromise between market discipline and risk sharing, but it fails to address the legacy problems convincingly. These high legacy problems in national banking systems and in national public finances currently prevent more market discipline from being introduced in EMU. In the approach of the Franco-German group, legacy debt will be only slowly reduced given the incentives provided by market discipline and the reformed fiscal rules, while a fiscal capacity helps countries to deal with shocks. It might be possible to prevent financial markets from reacting excessively if mechanisms to enhance market discipline were accompanied by risk-sharing mechanisms completing Banking Union or by introducing a fiscal capacity. But it is far from certain that this particular proposal avoids financial market turmoil.

More precisely – and some of the criticisms of the Franco-German proposal in this VoxEU debate show this – the risk-sharing mechanisms of this proposal do not directly deal with the legacy problems. Rather, the authors insist that they must be solved as a precondition for an introduction of risk sharing, for example in the case of the European Deposit Insurance Scheme (EDIS), or they remain vague regarding the introduction of the new lending policy (Bénassy-Quéré et al. 2018: 14). It is unclear to me, for example, how the transition problem to this new architecture of EMU will be solved without forcing Italy into financial market turmoil. Recent financial market concerns after the new Italian government came to power question the perception that Italian debt is expected to be sustainable. In contrast, Andritzky et al. (2018) explicitly show how a transition period could look like that finally leads to a sovereign debt restructuring mechanism. The Franco-German group, however, does not fully endorse that proposal either. Instead, they present their ideas for a fiscal capacity.

The need for additional fiscal capacity

In a situation in which EMU member states do not have much fiscal space to cope with idiosyncratic shocks, additional fiscal space could be created by a European fiscal capacity. The precondition formulated in this sentence is crucial, however, because it underlines the moral hazard problem of a fiscal capacity for the euro area. Originally,
EMU counted on member states’ individual fiscal space to cope with economic shocks by expansionary fiscal policy. Arguing that in the status quo, some countries have accumulated excessive debt such that they are unable to provide fiscal impulses from national budgets reveals that the problem is insufficient consolidation of public finances in those states in the first place. It also indicates that the creation of a euro area fiscal capacity now would serve as a premium for countries with profligate fiscal policies in the past.

The moral hazard problem is more or less severe depending on the individual proposal, but it cannot be eliminated. If a euro area fiscal capacity sets in after an above-average economic shock measured by output gaps, the problem of measuring output gaps in real time is insurmountable. The fiscal capacity then provides incentives for biased estimates of output gaps and it will lead to systematic transfers (Feld and Osterloh 2013). If the fiscal capacity is connected with above average unemployment rates, in the sense of an unemployment reinsurance scheme, biases emerge because unemployment increases are higher the less flexible the labour and product markets in a member state are. Incentives to conduct liberalising structural reforms will diminish. Even a fiscal capacity based on trade is prone to some moral hazard (Beetsma et al. 2018). The experience with Germany’s fiscal equalisation system shows that such moral hazard problems are strong (e.g. Baskaran et al. 2017).

The proposal by Bénassy-Quéré et al. (2018) aims at containing moral hazard incentives. The proposal ensures that first loss is borne at the national level. There is conditionality ex ante and ex post. Member states’ contributions to the fiscal capacity follow a kind of experience rating requiring that they pay back the amounts drawn. Still, and similar to Arnold et al. (2018), it would take a very long time before a member state that withdrew money from the fiscal capacity will finally have filled it up by its contributions. Too much may happen during this decade or more such that transfers finally provide adverse reform incentives. This scheme will not be able to prevent redistribution over the long run. By failing to address the legacy debt problems and instead proposing a fiscal capacity, the Franco-German group rather creates new problems that the Maastricht assignment did not have.

The introduction of a fiscal capacity would finally induce a basic constitutional shift. For the first time, a European institution would get the competence to conduct macroeconomic stabilisation, and thus possibly far-reaching fiscal competencies without the accompanying democratic and legal control. If the fiscal capacity is organised as an unemployment reinsurance scheme, there is also a social union component without further European competencies in labour market or social policies. This is different in the case of credit lines offered by the European Stability Mechanism (ESM) and
accompanied by conditionality. The ESM is backed by democratic decisions of the member states whose legislatures are controlled by the rule of law in their countries. This construction actually depends on conditionality such that it cannot be fully eliminated in efforts to make a precautionary credit line more attractive. Put differently: in the first case of a fiscal capacity, liability and control fall apart; in the second case of ESM credit lines with conditionality, liability and control are aligned.

**Risk sharing by completing the Banking Union: Isn’t it fiscal?**

It is well known from the literature on risk sharing in existing federations that factor markets (through the free movement of capital and labour) as well as credit markets provide for the largest share of inter-regional risk sharing. Poghosyan et al. (2016) provide fresh evidence on risk sharing in the US, Canada, and Australia. They report an offset of 4-11% of idiosyncratic shocks (risk-sharing) and 13-24% of permanent shocks (redistribution) by fiscal transfers. This risk sharing mainly stems from automatic stabilisers from the central budget, i.e. from federal taxes and transfers to individuals, rather than from fiscal transfers from the central to the regional budgets. Similarly, in a study for the Swiss federation (Feld et al. 2018), my co-authors and I find a combined redistributive effect of about 20% while the stabilisation effect of short-term income fluctuations amounts to less than 10%. Again, the stabilisation effect runs largely through the old-age pension system and, to a much lesser extent, via direct transfers in the Swiss fiscal equalisation system. In contrast, Hoffmann et al. (2018) show that risk sharing in EMU via the credit channel collapsed after 2008. The break-down of the inter-banking market in EMU is the main problem.

The completion of Banking and Capital Market Union in EMU follows as a logical conclusion from this evidence. The revitalisation of the inter-banking market is the dominant policy proposal directed at the actual problem at hand. Bénassy-Quéré et al. (2018) consequently propose to complete the Banking Union by introducing a fiscal backstop to the Single Resolution Fund (SRF) using a credit line of the ESM and EDIS (also backed by the ESM). Both proposals come with many strings attached regarding preconditions and regulation in order to cope with moral hazard. Moreover, the Franco-German group wants to reduce the bank-sovereign loop by introducing concentration charges providing incentives to reduce bank exposure to sovereign debt.

Without going into the details, these proposals are well-taken. My disagreement regarding completion of the Banking Union is probably small. I simply do not understand why a credible fiscal backstop of the SRF must be complemented by EDIS. Both may aim
at different problems. The SRF is thought to step in if there is a banking crisis in one country that is about to spillover to the whole union. It is activated if the cascade of 8% private liability and (implicit) national fiscal backstops, like in the case of Italian banks in 2017, may have been used. It aims at resolving or restructuring banks, while the ECB acts as lender of last resort to cope with banks’ liquidity problems. EDIS already steps in for a single bank with either liquidity or solvency problems in order to prevent it from inducing a European banking problem. However, if it is not a European problem, national deposit insurance schemes (which are about to be created) should cope with their own banks. If the bank has a liquidity problem with European spillovers, the ECB will serve as lender of last resort anyway. In case of a solvency problem with European spillovers, the SRF and its backstop will serve. Finally, the Single Resolution Board (SRB) has some discretion as to the extent of bail-in demanded from a bank’s creditors. Although this must be criticised, this discretion exists. Thus, if there exists a credibly large fiscal backstop, EDIS might in fact not be necessary.

Bénassy-Quéré et al. (2018) do not consider this interaction between these two elements of their proposal. This is a first shortcoming. EDIS might not be necessary if member countries do what they ought to do. A second shortcoming consists in the transition regime for cutting the bank-sovereign loop. The introduction of concentration charges will do little in the beginning. A considerable risk for a fiscal backstop of the SRF, but also for EDIS, arises from the large amount of government bonds held by banks in several member countries. If a member state has fiscal troubles, it will affect its banks too quickly for the banking union suggestions of the Franco-German group to work – despite its awareness of this problem that is signalled by the introduction of concentration charges.

**Conclusion**

The introduction of a fiscal capacity would repeat the mistakes made by the introduction of EMU – later steps towards European integration would take place before the first steps have been taken. The experience during the euro area crisis shows how important it would have been to have elements of political union first. This holds even more strongly with regards to fiscal union. The necessary steps to increase the resilience of EMU consist in the completion of Banking Union by a fiscal backstop to the SRF on the one hand, and member states’ reforms and budgetary consolidation on the other. For the time being, this must suffice – and it would be no small achievement.
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19 A more stable EMU does not require a central fiscal capacity

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The need for a central fiscal capacity is a recurring element in the discussion on reform of the Economic and Monetary Union (EMU). Bénassy-Quéré et al. (2018) argue that, as part of a package of measures to enhance risk sharing and risk reduction in the EMU, such a central fiscal capacity can provide much needed budgetary support if one or several member states experience a large economic shock. Others also argue that the EMU needs a central fiscal capacity (e.g. European Commission 2018a, Berger et al. 2018). However, there is no consensus about the usefulness and necessity of a central fiscal capacity, as the President of the Eurogroup recently reported (Centeno 2018).

One objection is that in light of a high degree of convergence of euro area business cycles (ECB 2018), and negative side-effects through risks of moral hazard and permanent transfers across Member States (Feld 2018, Beetsma et al. 2018), the advantages of a central fiscal capacity are outweighed by its disadvantages. Another objection, developed in the remainder of this column, is that the potential stability benefits of a central fiscal capacity can be achieved without any additional fiscal risk sharing: namely, through stronger financial market risk sharing and more effective use of fiscal stabilisers. Completing the Banking Union, building the Capital Markets Union, and ensuring the build-up of buffers in national budgets will deliver a more stable EMU, while the ESM already acts as lender of last resort.

**Strengthening financial channels is the most effective way to improve stabilisation**

The argument for a central fiscal capacity in the euro area is often inspired by cross-state fiscal transfers in the US. However, capital markets in the US are much more important for shock absorption than fiscal transfers. Figure 1 shows that fiscal transfers
across states absorb 9% of asymmetric shocks in the US, while capital markets (cross-border factor income and capital depreciation) absorb 48% and credit provision to the private sector absorbs another 17%. In the euro area, the contribution of capital and credit markets to absorption of asymmetric shocks is limited to 12%. Shock absorption through financial channels is therefore more than five times as small in the euro area compared to the US. Strengthening these financial channels is the most effective way to increase the resilience of the euro area (Buti et al. 2016).

The Banking Union will enhance shock absorption by credit markets. Credit provision to the private sector absorbs on average 17% of asymmetric shocks in the US versus a negligible contribution in the euro area (Figure 1). The limited contribution of credit markets in the euro area can be linked to pro-cyclical credit flows and the break-down of interbank lending during the euro area crisis. Completing the Banking Union will strengthen the ability of the banking sector to absorb shocks. The stability and resilience of the banking sector can be increased further through adequate buffers for bail-in and measures to address non-performing loans. The Banking Union will be underpinned by fiscal risk sharing through the establishment of a common backstop to the Single Resolution Fund. Plans for further risk sharing through a European Deposit Insurance Scheme, which is linked to discussions on the regulatory treatment of sovereign exposures on bank balance sheets, would further sever the link between sovereigns and banks.

Building a Capital Markets Union will strengthen capital market shock absorption. Capital markets account for 48% of absorption of asymmetric shocks in the US, compared to only 12% in the euro area (Figure 1). Integrated capital markets contribute to risk sharing through cross-border asset holdings. In addition, well-developed capital markets provide borrowers with alternative financing options if bank lending contracts during a crisis. Adrian et al. (2013) document such substitution from loans to bonds in the US between 2007 and 2009. Despite the relatively low degree of capital market integration, Cimadomo et al. (2018) show that cross-border equity and FDI holdings in the euro area were powerful shock absorbers during the sovereign debt crisis. This is why the development of a Capital Markets Union, supporting cross-border equity and FDI flows, is a promising avenue for further risk sharing. It may take a long time to converge to US levels of capital market integration. However, narrowing only a quarter of the 36%-point gap with the US would already have a stabilisation effect that is similar to the full effect of fiscal transfers in the US.

1 However, with the establishment of the Banking Union, shock absorption on credit markets is strengthened through European supervision and a common rulebook that enhances the resilience of the European banking sector, and a resolution framework that ensures an efficient and orderly private sector loss-sharing in case of serious problems.
Automatic stabilisation at the national level can be powerful if sufficient buffers have been built

Fiscal policy can also provide stabilisation in the wake of a downturn. National fiscal policy in the euro area currently provides twice as much stabilisation compared to federal transfers in the US. Comparing the federal level in the US with the national level in the EU is relevant. In the US, fiscal stabilisation mainly takes place through the federal budget, while stabilisation through state and local level budgets is very limited (Follette and Lutz 2010). In the euro area, anticyclical disbursements from the EU budget provide some indirect stabilisation, but national budgets are the most important channel for fiscal stabilisation. Alcidi and Thirion (2017) show that federal transfers in the US absorb around 10% of regional shocks, while national automatic stabilisers absorb 20% of country-specific shocks in the euro area. Looking at total stabilisation across levels of government, Dolls et al. (2015) find that fiscal stabilisation in the euro area absorbs roughly 47% of combined income and unemployment shocks, versus only 30% in the US.
While the degree of national automatic stabilisation in the euro area is much higher than in the US, the differences between Member States are rather pronounced: the budgetary elasticity of Member States varies from 0.3 to more than 0.6 (Figure 2). Member States with low budgetary elasticities have relatively more room to enhance the stabilization properties of their budgetary frameworks, for example by better aligning domestic unemployment benefit systems to the economic cycle.

Ensuring a sufficient build-up of buffers along the cycle enables automatic stabilisation during a downturn. Doing so removes the need for pro-cyclical fiscal tightening. This is why the preventive arm of the Stability and Growth Pact (SGP) is centred around a country-specific Medium-Term Objective (MTO) for the structural budget balance. The MTOs are set to ensure sustainable debt levels and enough room to manoeuvre for automatic stabilisers, as they provide a safety margin against breaching the SGP’s 3% nominal deficit limit (European Commission 2018b).

Figure 2   Automatic stabilisation across Member States

![Figure 2](image)

Source: Mourre et al. (2014)

Figure 3 shows that countries at their MTO can absorb virtually all shocks with automatic stabilisers without breaking the 3% nominal deficit limit. The simulation in the figure is based on current budgetary elasticities and ex-post output gaps of the EA12 between 1965 and 2016. The results show that for countries at their MTO, automatic stabilisers can operate fully without breaking the 3% limit in 96% of all cases (98% if cases where financial assistance through the EFSF and ESM was provided are excluded). Figure

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2 The structural deficit corrects the nominal budget for business cycle developments and the effects of temporary measures.
3 MTOs are defined in structural terms.
4 In Ameco, output gaps for the Member States that adopted the euro after 2007 are not available from 1965 onwards. For Greece, we assume an MTO of 0.
3 shows these results for six Member States. This simulation illustrates that buffers in national budgets can be a very effective shock absorber, and underline the importance of building-up fiscal buffers.

It should be noted that the output gap – which is used in the calculation of the structural balance to correct for business cycle developments – is a volatile indicator that is often revised ex post. Moreover, the budgetary elasticity can deviate in practice from the elasticity that follows from models, for example in the case of large cyclical fluctuations. Different proposals have been made to give prominence to an expenditure rule as an operational target for national budgetary decision-making and fiscal surveillance (for instance, by Bénassy-Quéré et al. 2018, Darvas et al. 2018, the European Fiscal Board 2018, and the Dutch presidency in the first half of 2016, among others). An expenditure rule combined with a debt target is more under the direct control of policy makers, although the design of such a framework would also require a balancing act in order to take account of the cycle. In the end, any framework must ensure that Member States build sufficient buffers in good times, because this allows them to stabilise in bad times.

**Figure 3** Shock absorption capacity if at MTO

Over the past years, efforts have been taken in many Member States to reduce their budget deficits, but a further effort is required as 12 euro area Member States had not reached their MTO in 2017 (Figure 4). The low interest rate environment provides ample additional fiscal space to build these buffers in national budgets, and bolster the ability of national policies to stabilize the economy.
The cases of Ireland and Spain call for macro prudential policies and orderly bank resolution

Some argue that the cases of Spain and Ireland provide an example that even Member States with a sound fiscal position can run into trouble (Dullien 2015, European Commission 2017). However, both Spain and Ireland were confronted with contingent liabilities stemming from a real estate boom and the banking sector. If anything, the cases of Ireland and Spain illustrate the importance of preventing the emergence and materialisation of contingent liabilities through policies to prevent macroeconomic imbalances and the establishment of the Banking Union. The bursting of the real estate boom in Spain and Ireland had a permanent negative effect on fiscal revenues. The effect on government finances was significant due to a high sensitivity of tax revenues to declines in construction activity and asset prices (Lane 2012). The reduction in fiscal revenues was permanent, hence a fiscal capacity would not have alleviated the need for a structural budgetary adjustment. Instead, preventing the emergence of imbalances carries a high premium. The pre-crisis governance framework of the EU did not include preventive frameworks, such as the Macroeconomic Imbalances Procedure (MIP) and the macroprudential surveillance by the European Systemic Risk Board. The aim of the MIP is to detect the emergence of imbalances on

5 Lane (2012) explains the permanent nature of the income reduction in Ireland and Spain: “In some countries (Ireland and Spain), the credit and housing booms directly generated extra tax revenues, since rising asset prices, high construction activity, and capital inflows boosted the take from capital gains taxes, asset transaction taxes and expenditure taxes. Faster-growing euro member countries also had inflation rates above the euro area average, which also boosted tax revenues through the non-indexation of many tax categories. Finally, low interest rates meant that debt servicing costs were below historical averages.”
Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?

the housing market in an early stage and could recommend corrective actions. In this light, it is important that the MIP is used to its full potential.

Moreover, bail-outs of the domestic banking sector had an upward effect on government debt of up to 49% of GDP in Ireland, and further increased government debt through an indirect effect on sovereign bond yields. The principle of bail-in, which is a central element of the Banking Union, prescribes that instead of taxpayers, first private investors and then the privately filled Single Resolution Fund absorb losses in case of a bank resolution. This significantly lowers the risks for public finances.

As a last resort, the ESM provides funding, subject to conditionality to countries with liquidity needs

If Member States can no longer stabilise their economy due to a loss of market access, the European Stability Mechanism (ESM) can act as a lender of last resort at the euro area level to provide financial assistance. Milano and Reichlin (2017) find that loans by the ESM and its predecessors stabilised no less than 55% of asymmetric shocks in the euro area between 2007 and 2014. A downside of substantial financial support by the ESM is the effect on government debt levels in programme countries. In analogy to the bank resolution framework with loss-sharing through bail-in, a strengthened framework for orderly restructuring of unsustainable sovereign debt would enhance private loss-sharing in case of unsustainable debt levels and prevent a disproportionate adjustment due to debt overhang. This would also allow ESM programmes to focus less on fiscal adjustment and more on growth enhancing reforms. To conclude, the euro area should focus on completing Banking Union, developing a capital market union, and ensuring that its members have the fiscal space to use automatic stabilisers in a downturn. Doing so would strengthen both financial and fiscal stabilization mechanisms and obviate the need for a central fiscal capacity. Authors’ note: This column was prepared when all authors were employed at the Ministry of Finance of The Netherlands and represents the authors’ views. A similar article was published in Economisch Statistische Berichten (Aarden et al. 2018).

References


A more stable EMU does not require a central fiscal capacity
Heijdra, Aarden, Hanson, and van Dijk


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Despite the recent progress in financial integration and some debt reduction in many countries, the architecture of the euro area remains incomplete, especially when it comes to dealing with macroeconomic shocks. In a monetary union, countries cannot use independent monetary policy or exchange rate flexibility to mitigate shocks and support growth or employment. In the euro area where labour mobility remains low, partly due to language differences, private risk sharing mainly takes place through cross-border flows of capital and credit, which are not always sufficient to deal with large negative shocks. Furthermore, financial markets in Europe remain fragmented along national lines, so that quick reversals of cross-border interbank lending can occur in periods of crisis – precisely when private risk sharing would be needed the most (Furceri and Zdzienicka 2015).

**Fiscal risk sharing would complement other policies**

The critics of a central fiscal capacity usually dismiss its usefulness by pointing out the strong role of national fiscal stabilisers and the need to deepen the ongoing financial integration (Heijdra et al. 2018, Feld 2018). Indeed, automatic fiscal stabilisers to dampen shocks are more powerful in the euro area than in the US (Alcidi and Thirion 2018). Adopting a balanced budget in structural terms, in adherence to the Medium-Term Objective, should provide enough room for automatic stabilisers in ordinary cyclical situations. Following that rationale, what would be needed is basically a faster debt reduction and more sound public finances in all euro area countries brought about, if necessary, by introducing a sovereign debt restructuring procedure (GCEE 2018).
Moreover, the argument goes, private financial flows are now more stable than prior to the crisis because of the progress in the Banking Union and the public risk sharing provided by the European Stability Mechanism (ESM), whose salutary effects can already be observed in the data (Milano 2017, Cimadomo et al. 2018). Hence, it could seem that instead of devising further public risk-sharing instruments, the highest priority should be a deepening of financial integration – most importantly, swift completion of the Banking Union and Capital Markets Union.

On closer look, however, there are good reasons for complementing the national automatic stabilisers and the ongoing financial integration with a common fiscal instrument.

First, financial integration in the euro area – through both the Banking Union and the Capital Markets Union – will only be achieved gradually given the cultural, linguistic and institutional hurdles, and will require further tax harmonisation, insolvency law harmonisation and an increased supply of pan-European investment products (Véron and Wolff 2016, OECD 2018).

Second, and more importantly, fiscal risk sharing is a clear complement to national fiscal stabilisation from a welfare perspective as long as financial integration does not achieve complete financial markets (which is not the case even in the US). Fiscal risk sharing diversifies risk across a group of countries, while national automatic stabilisers only amount to self-insurance. Indeed, with a common fiscal tool, the resources available to address a negative shock are no longer tied to domestic income but to that of all union members, and this is true even with sound national fiscal policies and well-functioning financial markets. Moreover, private risk sharing via financial markets may be in short supply, as private agents may not internalise indirect effects of their actions on aggregate macroeconomic stability. The problem is particularly severe in a currency union, where neither national fiscal policy nor financial integration alone are necessarily sufficient for an efficient outcome (Farhi and Werning 2017). The difference in stabilisation outcomes can be substantial, with the combination of fiscal risk sharing and national stabilisers improving welfare outcomes by about one third compared to using national stabilisers alone.

We are able to confirm similar stabilisation gains in our general equilibrium model implementing a negative demand shock in the periphery (see the appendix for a description). With national fiscal stabilisers only (black lines in Figure 1), periphery consumption drops by 1.3% and union consumption drops by 0.2%, both compared to
the steady state. The central bank reacts to the shock by cutting its interest rate down to -0.4%, as for now we assume that there is no zero lower bound on monetary policy. We compare this baseline case with a scenario where a fiscal capacity entitled to borrow in financial markets provides support in times of shocks (blue lines in Figure 1). Both countries finance the fiscal capacity, implying fiscal risk sharing. The same negative demand shock now triggers fiscal transfers to the periphery of about 1% of its GDP. This support upholds periphery consumption, which drops by only 0.9% compared to the steady state, while union consumption decreases by only 0.1%. Hence, the fiscal capacity complements existing national stabilisers and further mitigates the negative shock. Fiscal risk sharing brings risk diversification and improves consumption of the households who optimise inter-temporally, while transfers support the current disposable income of those without access to financial markets.

**Figure 1**  Fiscal capacity improves stabilisation compared to national policies only

The theoretical insights are confirmed by empirical work showing that national automatic stabilisers may not be sufficient to counter big demand shocks. As cyclical changes in headline balances in the euro area typically exceed 3% of GDP every 10 years and 5% of GDP every 20 years, fiscal risk sharing would indeed provide insurance for the benefit of the whole Economic and Monetary Union (Carnot and Buti 2018).

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1 There is no demand shock in the core, hence the interest rate cut by the central bank produces an expansion in the core, not shown here. The core expansion translates into a muted reaction of union consumption.
The weak potential growth and inflation outlook for the euro area also suggests that nominal interest rates may stay close to zero for a prolonged period of time and return close to zero more often in the future (Rachel and Smith 2017). In a situation when policy interest rates face an effective lower bound, a common fiscal stabilisation instrument would amount to an important addition to macroeconomic stabilisation. We quantify this effect with the second DSGE simulation.

We implement the same negative demand shock in the periphery as before, but now with a zero lower bound on monetary policy, which curtails the stabilisation power of the central bank. Starting with a baseline without fiscal risk sharing (black lines in Figure 2), periphery consumption now drops by 1.6% compared to the steady state while union consumption drops by 0.5%. Then, as the fiscal capacity steps in (red lines in Figure 2), transfers of about 1.3% of GDP flow to the periphery, and consumption drops by 1.2%, while the union consumption decreases by only 0.3%, both compared to the steady state. Hence, the fiscal capacity improves macroeconomic stabilisation when the central bank is constrained. When the central bank faces an effective lower bound, the fiscal capacity is then effective at complementing monetary policy on top of existing national stabilisers.

**Figure 2** Fiscal capacity improves stabilisation when the monetary policy is constrained

![Graphs showing nominal interest rate, real transfers (periphery), consumption (periphery), and consumption (union) with and without transfers.]

*Note: Black lines: scenario without transfers; red lines: scenario with transfers.*
Avoiding permanent transfers through a careful design. In our companion paper (Claveres and Stráský 2018b), we discuss a common fiscal stabilisation instrument in the form of an unemployment benefits reinsurance scheme. Our design combines elements of several existing proposals, which have not yet been analysed within one scheme (Table 1). In particular, we use a double condition trigger that activates the support from the scheme when the unemployment rate is both increasing and above a long-term average (European Commission 2018). Other features include stop-go contributions depending on the level of the fund balance (Beblavý and Lenaerts 2017) and an experience rating system charging higher contributions after pay-outs (Arnold et al. 2018).

Our scheme addresses moral hazard through several channels. The double condition trigger implies that the common scheme only covers part of negative shocks—those where the unemployment rate is increasing at high levels compared to the past. This feature represents a form of deductible, since the shocks occurring when the unemployment rate is low, compared to the long-term average, are stabilised at the national level. Then, we insist on past compliance with EU fiscal rules (although this condition is switched off in the counterfactual simulations). We also incorporate experience rating, whereby contributions increase gradually after pay-outs, and we limit the cumulated net transfers to 5% of national GDP.

Our scheme also does not require a strong convergence in labour market institutions across EU countries or adjustments in national insurance policies. Although payments towards countries are proportioned to the size of the unemployment increase, they are also capped (cumulated payments cannot exceed 5% of the country’s GDP), ensuring that pay-outs to individual countries are limited. These features, together with a mechanism charging higher contributions to countries that draw more frequently on the fund (experience rating), effectively prevent permanent transfers in the medium term.

Using counterfactual simulations of the proposed mechanism for individual euro area countries on annual data from 2000 to 2016, we show that the scheme would have delivered stabilisation gains, both at the individual country level and euro area level. As usual in the literature relying on simple counterfactual simulations (e.g. Carnot et al. 2017), our calculations based on historical data leave out dynamic and general equilibrium effects but provide an approximate assessment of the stabilisation potential. The standard deviation of euro area real GDP growth from 2000 to 2016 amounts to 1.8%. We calculate a counterfactual standard deviation (when transfers are added to actual GDP) of 1.6%, roughly a 10% reduction.
### Table 1: Overview of the existing proposals for euro area fiscal capacity

<table>
<thead>
<tr>
<th>Contributions</th>
<th>Pay-out size</th>
<th>Trigger for pay-outs</th>
<th>Pay-out size</th>
<th>Pay-out size</th>
<th>Pay-out size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claveres and Stráský (2018)</td>
<td>0.1% of national GDP per year when the fund balance drops below 0.5% of euro area GDP; furthermore, 0.05% of GDP for each time a country drew on the fund in the past 10 years</td>
<td>UR above 10-year moving average and increasing</td>
<td>1% GDP for each 1ppt increase in the UR above the moving average</td>
<td>5% of GDP in cumulated support</td>
<td>Yes</td>
</tr>
<tr>
<td>Arnold et al. (2018)</td>
<td>0.35% of national GDP per year</td>
<td>UR above 7-year moving average</td>
<td>0.5% of GDP for each 1ppt increase in the UR above the moving average</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>European Commission (2018)</td>
<td>6% of the last year’s seignorage per year</td>
<td>Once per year and per state, if quarterly UR exceeds 15-year moving average and increases by at least 1ppt compared to the previous quarter; funds must flow into public investment</td>
<td>Payment to a country limited to 30% of available capital; proportional to the UR level above the threshold multiplied by eligible public investment</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Bénassy-Quéré et al. (2018)</td>
<td>About 0.1% of national GDP per year, depending on the volatility of the trigger variable over a rolling window</td>
<td>Substantial increase in the UR, employment or wage bill (e.g., 2ppt change for the UK)</td>
<td>One-off payment proportional to the increase in the relevant threshold (e.g. 0.25% of GDP for each 1ppt); proportional reduction of pay-out if no available funds</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Moral hazard mitigation</th>
<th>Borrowing</th>
<th>Pay-out size</th>
<th>Trigger for pay-outs</th>
<th>Pay-out size</th>
<th>Pay-out size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past compliance with fiscal rules; experience rating; increase after pay-outs; 5% GDP limit on cumulated net transfers</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compliance with the SGP and the macroeconomic imbalance procedure in the last 2 years; the scheme provides only loans, albeit at concessional rates</td>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compliance with the SGP and the recommendations of the European Semester; earmarking; experience rating; increase after pay-outs</td>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
A European fiscal capacity can avoid permanent transfers and improve stabilisation

<table>
<thead>
<tr>
<th>Source</th>
<th>Contributions</th>
<th>Trigger for pay-outs</th>
<th>Pay-out size</th>
<th>Borrowing</th>
<th>Moral hazard mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dullien and Pérez del Prado (2018)</td>
<td>0.1% of national GDP per year: 80% into a national compartment and 20% in a common compartment;</td>
<td>National compartments: UR more than 0.2ppt above a 5-year moving average; common compartment: UR more than 2ppt above a 5-year moving average</td>
<td>National compartments: at the discretion of the country, e.g. 25% of average wage per employee; common compartment: a progressively increasing pay-out the larger the increase in UR.</td>
<td>Yes</td>
<td>Countries with cumulative deficits of national compartments exceeding 0.5% of GDP required to pay higher contributions; 2% of GDP limit on deficits of national compartments</td>
</tr>
<tr>
<td>Beblavý and Lenaerts (2017)</td>
<td>0.1% of national GDP each quarter when the fund balance drops below 0.5% of euro area GDP; furthermore 0.01% of GDP for each time a country drew on the fund in the past 10 years</td>
<td>Various thresholds (0.1%, 1% and 2%) for the deviation of UR from 10-year moving average</td>
<td>50% of the last gross monthly wage of all the unemployed who have worked at least 3 out of the last 12 months</td>
<td>Yes/No</td>
<td>Claw-back (doubling of standard contributions) after 3 years of negative cumulative balance of more than 1%, until the cumulative balance declines below 1%; experience rating: contributions increase after pay-outs</td>
</tr>
<tr>
<td>Dolls et al. (2016)</td>
<td>Uniform contribution rate to national social insurance (annual)</td>
<td>National UR must increase more strongly than in the euro area; duration of unemployment between 2 and 12 months</td>
<td>Up to 50% of unemployment benefits for the short-term unemployed</td>
<td>No</td>
<td>Payments must be co-financed from national sources; Exclusion of seasonal or frictional unemployment through a waiting period of 2 months</td>
</tr>
</tbody>
</table>

*Source: Authors’ compilation.*
Macroeconomic stabilisation would be timely in most cases and achieved at the cost of limited debt issuance (less than 2% of the euro area GDP), with average annual contributions not exceeding 0.17% of GDP (Figure 3). It would have also avoided permanent transfers among countries, as none of them would have been a major net contributor or receiver with respect to the scheme. It is also interesting to note that most countries would have benefited from the scheme at one point in time, including fiscally prudent countries such as Germany or Luxembourg.

**Figure 3** Pay-outs can be significant at times, but the average net transfers are close to zero (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>AUT</th>
<th>BEL</th>
<th>DEU</th>
<th>ESP</th>
<th>EST</th>
<th>FIN</th>
<th>FRA</th>
<th>GRC</th>
<th>IRL</th>
<th>ITA</th>
<th>LUX</th>
<th>LVA</th>
<th>NLD</th>
<th>PRT</th>
<th>SVK</th>
<th>SVN</th>
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</thead>
<tbody>
<tr>
<td>Maximum</td>
<td>1.01</td>
<td>0.79</td>
<td>1.04</td>
<td>3.02</td>
<td>-0.10</td>
<td>0.45</td>
<td>1.64</td>
<td>3.00</td>
<td>3.60</td>
<td>2.07</td>
<td>0.96</td>
<td>-0.10</td>
<td>1.08</td>
<td>1.53</td>
<td>0.17</td>
<td>1.27</td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.35</td>
<td>-0.35</td>
<td>-0.30</td>
<td>-0.40</td>
<td>-0.10</td>
<td>-0.30</td>
<td>-0.40</td>
<td>-0.35</td>
<td>-0.35</td>
<td>-0.45</td>
<td>-0.10</td>
<td>-0.40</td>
<td>-0.55</td>
<td>-0.15</td>
<td>-0.30</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>0.04</td>
<td>-0.01</td>
<td>0.00</td>
<td>0.20</td>
<td>-0.10</td>
<td>0.00</td>
<td>0.04</td>
<td>0.28</td>
<td>0.21</td>
<td>0.16</td>
<td>0.02</td>
<td>-0.10</td>
<td>0.09</td>
<td>0.19</td>
<td>-0.09</td>
<td>0.32</td>
</tr>
</tbody>
</table>

**References**


Heijdra, M, T Aarden, J Hanson and T van Dijk (2018), “A more stable EMU does not require a central fiscal capacity”, VoxEU.org, 30 November.


Appendix: The DSGE model

In Claveres and Stráský (2018a), we adopt a two-region New-Keynesian DSGE model of the euro area and use it to quantify potential stabilisation benefits offered by a euro area fiscal capacity. We do so both in normal times, from the point of view of monetary policy transmission, and when monetary policy becomes constrained by a zero lower bound. The model features imperfect risk-sharing mechanisms as well as various sectors and frictions to reproduce a rich set of general equilibrium effects. Two countries, which we call core and periphery, compose the union. In each country, a national government can run a counter-cyclical tax policy and issues debt on financial markets bought by households. Only a fraction of households has access to these financial markets, while others are financially constrained and only consume current disposable income, which reduces private risk sharing. Both household types consume a basket made of core and periphery goods with a degree of home bias. Firms produce goods and post vacancies in frictional labour markets. Unemployed people receive benefits from their respective national government. We calibrate the model to reproduce key euro area stylised facts at the steady state and over the cycle. The core represents 60% of total union size, and is more productive with a more efficient labour market than the periphery. The share of credit constrained households is set to 50%. In the scenario with fiscal capacity, we introduce a common scheme that provides support directly to households in times of shocks. In that sense, the capacity could represent a form of common unemployment insurance scheme providing emergency benefits when a crisis hits. A transfer rule ensures that transfers only occur outside the steady state. These transfers are financed by debt issuance as well as taxes on both countries, bringing a channel of fiscal risk sharing compared to the baseline.

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Section 6: Could market discipline do more harm than good?
21 The crux of disagreement on euro area reform

Stefano Micossi
Assonime, LUISS School of European Political Economy, and College of Europe

The discussion on feasible reform of euro area governance entered into high gear following the publication in January of an important paper by seven French and seven German high-powered economists (Bénassy-Quéré et al. 2018). Two Italian economists (Messori and the author of this column) criticised those proposals (Messori and Micossi 2018), mainly claiming that in their quest to eradicate moral hazard, the authors weren’t paying sufficient attention to the liquidity dimension of financial market stability and that, as a result, euro area defences against idiosyncratic shocks could be weakened, rather than strengthened, by that governance framework. On behalf of the 7+7 economists, Pisani-Ferry and Zettelmeyer argued in a pointed response that their proposals had been factually misrepresented, and that many of the recommendations in Bénassy-Quéré et al. (2018) were in fact designed in light of the Italian situation and the imperative to reconcile the need for bold reforms with the necessity to avoid triggering turmoil (Pisani-Ferry and Zettelmeyer 2018).

Subsequent discussions with some authors of Bénassy-Quéré et al. (2018) have clarified certain critical aspects where in my view there is room to strengthen the 7+7 economists’ recommendations in view of the paramount need to make the euro area more resilient to idiosyncratic liquidity shocks. In this column I first discuss some specific recommendations by the 7+7 economists, and then comment on the overall implications of those proposals for the euro area financial stability.

On debt restructuring

A key pillar in the 7+7 recommendations is that the euro area governance needs a fallback position for the case of insolvency of a member state, and that fallback is the no-bailout rule; that the no-bailout rule is not credible unless the system includes a sovereign debt restructuring mechanism (SDRM); and that this requires a financial architecture where restructuring is possible without major disruptions in the financial system. Accordingly,
they want to introduce sovereign concentration charges to disincentivise own-sovereign debt holdings by banks, and to go ahead with supranational deposit insurance (EDIS). These proposals are reasonable.

The hard question is how to avoid falling again into the ‘Deauville trap’ whereby the new SDRM is read by financial investors as the promise that debt restructuring for some highly indebted countries is inevitable, triggering financial instability. The line separating temporary liquidity problems in the sovereign debt markets from insolvency of the debtor is fickle and depends on investors’ expectations that there is a lender of last resort willing to intervene to stabilise markets unsettled by a liquidity shock. Thus, ESM policies on debt restructuring must dispel beyond any doubt the notion that financial distress, possibly including loss of access by the sovereign to capital markets, will likely lead to debt restructuring.

**On sovereign concentration charges and the ‘safe’ asset**

I have myself advocated the introduction of sovereign concentration charges to encourage banks to reduce the exposure to their sovereign in a recent CEPS Policy Insight (Misossi 2017), albeit with softer calibration of key parameters. However, I remain uneasy at the 7+7 stated goal that the reduction in sovereign charges “should be viewed as a structural change” whereby national banking sectors would lose the specific role of default absorbers of domestic sovereign debt (Bénassy-Quéré et al. 2018: 7). Whether this would happen ‘naturally’ as a result of the new disincentives to own-sovereigns holdings by the banks or following new regulations is not specified. This is consistent with another stated goal of the 7+7 economists, which is to accelerate the day of reckoning for insolvent sovereign debtors by narrowing the room to postpone hard decisions.

It seems to me that this is unnecessary and indeed counterproductive since it would have the distinct effect of reducing liquidity in some sovereign debt markets, especially as long as financial fragmentation and adverse risk spreads on high-debt sovereigns persist. To push (gently) for low concentration of own-sovereigns in banks’ assets in steady state is one thing; it is an entirely different thing to try to exclude banks from cushioning a temporary shock in national sovereign markets in conditions of distress,

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1 Following their promenade on the beach of Deauville on the eve of a European Council meeting, in October 2010, Chancellor Merkel and President Sarkozy announced that henceforth sovereign bailouts from the European Stability Mechanism would require that losses be imposed on private creditors. That announcement and the subsequent application in the Greek rescue package triggered turmoil in financial markets, with contagion spreading to Ireland, Portugal, Spain and Italy.
precisely when foreign investors might run for the door. This is a concept that in my view would weaken the resilience of the euro area and its ability to cope with idiosyncratic liquidity shocks.

Let me also note that the provision of a safe asset to accompany the diversification of banks’ portfolios – the so-called ESBies – would not change this conclusion, unless asset substitution between ESBies and national sovereigns were to be undertaken on a truly massive scale. Otherwise, the provision of the safe assets would broaden the menu of asset available to banks but would not necessarily make national sovereign markets more liquid.

**On tightening the screws on state aid for banks and bail-in rules**

The 7+7 economists advocate the tightening of the rules governing resolution, state aid to banks, and precautionary recapitalisations to strengthen the change in policy regime from bailout (taxpayers pay) to bail-in (shareholders and creditors pay) (Bénassy-Quéré et al. 2018: 6). These proposals make sense; however, care is needed to avoid that these changes go beyond their purpose and end up limiting the financial stability exception provided for by the 2013 Guidelines on state aid to banks (point 45) and the resolution directive (Article 31.4.d in the BRRD).²

**On the European Deposit Insurance Scheme (EDIS)**

The 7+7 recommendations on EDIS depart from the original Commission proposal in two important respects. First, full loss-sharing through the deposit insurance fund is excluded even in the final stage of the system (and the mutualised compartment could not be tapped until the national compartment had been fully utilised to cover ‘first losses’). Second, deposit insurance fees would include a component based on country risk, where the latter is related to certain national features like creditors’ rights and the effectiveness of insolvency and foreclosure procedures (but not sovereign debt levels). This approach clearly is a concession to German concerns on sharing national banking

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² Footnote 4 in Bénassy-Quéré et al. (2018) specifies that that the possibility to use state aid to remedy a “serious disturbance” in the economy “should no longer be generally presumed but be assessed on a case by case basis”, and that “in cases where there is no ‘serious disturbance’, all relevant instruments would be bailed in”. This language raises the possibility that such assessment be left in the hands of the competition authorities, which of course have little taste for recognising the possible presence of a systemic stability issue; it would be useful to clarify that the proper institution to make such assessment should be the ECB, which has all the instruments and capabilities required to evaluate the presence of a systemic shock. On this, see Micossi et al. (2016).
losses; however, it is likely to perpetuate an adverse risk premium on banks from certain countries, and therefore maintain an element of financial fragmentation even in steady state – as long as certain weaknesses in national banking systems were not eliminated – despite the uniformity across the euro area of depositors’ rights of reimbursement in case of bank failure.

**On the overall impact on euro area financial stability**

In the final equilibrium, the 7+7 economists recommendations entail, on one hand, stricter discipline on sovereign indebtedness, adjustment programmes for crisis lending, and the room for state aid; on the other hand, they offer improved risk sharing thanks to the introduction of EDIS, an ESM backstop for the Single Resolution Fund and the new deposit insurance system, a new ESM credit line for countries in compliance with common policies, and a ‘rainy day’ fund granting one-off transfers in case of a large unemployment shock. There is thus a need to assess the likely impact on investors’ confidence, and hence on financial fragmentation, of the resulting balance of measures designed on one hand to mitigate moral hazard and strengthen market discipline, and on the other hand to provide countries with financial assistance in meeting idiosyncratic liquidity shocks – in an environment in which the ability of the ECB to intervene as lender of last resort after the end of QE may be diminished.

The critical measures to consider in seeking an answer are the specificities of the SDRM, on one hand, and the liquidity impact of the new ESM credit line for ‘pre-qualified’ countries respecting country specific recommendations and not at risk of losing market access on the other. Clearly, there is a need to dispel the notion that financial distress conditions are a likely harbinger of debt restructuring; and there is a need to ensure that the size and access conditions to the new ESM credit line meet strict requirements of certainty and speed. Moreover, the ESM already has powers to intervene in the primary and secondary markets of sovereigns which have never been used but could be added explicitly to the tool box to combat financial instability.

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22 Deepening EMU requires a coherent and well-sequenced package

Marco Buti, Gabriele Giudice, and José Leandro
European Commission

The debate on EMU deepening is entering a critical stage. The contribution of 14 French and German economists (Benassy-Quéré et al. 2018) is therefore timely. It suggests ways for reconciling risk-sharing with market discipline – where the biggest divisions lie. Their initiative overlaps in spirit and with much of the substance of the European Commission’s May 2017 Reflection Paper on Deepening EMU (European Commission 2017a) which identified indispensable components of a comprehensive reform of EMU (see Buti et al. 2017) and underpins the subsequent Commission’s initiatives (European Commission 2017b).

Benassy-Quéré et al. put forward several attractive ideas on how to reform EMU. At the same time, the mix of proposals seems unbalanced and carries significant risks. The diagnosis of the crisis overlooks crucial issues such as macroeconomic imbalances and adjustments within the euro area and the redenomination risk connected to acute liquidity and credibility crises. As such, the proposals are mainly geared at increasing market pressure on fiscal policies, and are aggregated without appropriate sequencing necessary to contain macroeconomic and financial risks.

Building on the progress made

As a starting point, the progress made in reducing risks in Europe – in parallel with, or ahead of more risk sharing – should be more clearly recognised. Achievements at both the EU and national level are in line with, and sometimes surpass, the ECOFIN Council’s June 2016 roadmap for the BU and July 2017 Action plan to tackle non-

1 The authors are writing in their personal capacity and their opinions should not be attributed to the European Commission.
performing loans (NPLs), as also acknowledged by the Eurogroup in February 2018. Several packages have been tabled and are being implemented to further reinforce banks’ prudential management and strengthen market discipline, to improve insolvency frameworks, restructuring and second chances, to define a more gradual path to risk sharing reflecting progress in risk reduction, and to support the ongoing fall in non-performing loans (see Figure 1) and prevent their resurgence.2

**Figure 1** Evolution of non-performing loans in selected countries and the EU

<table>
<thead>
<tr>
<th>Non-performing loans in % of total loans in selected countries</th>
<th>Q3 2016</th>
<th>Q3 2017</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>36.8</td>
<td>32.1</td>
<td>-12.7</td>
</tr>
<tr>
<td>Spain</td>
<td>5.8</td>
<td>4.7</td>
<td>-19.7</td>
</tr>
<tr>
<td>Greece</td>
<td>47.4</td>
<td>46.7</td>
<td>-1.5</td>
</tr>
<tr>
<td>Ireland</td>
<td>14.4</td>
<td>11.2</td>
<td>-22.5</td>
</tr>
<tr>
<td>Italy</td>
<td>16.1</td>
<td>12.1</td>
<td>-24.9</td>
</tr>
<tr>
<td>Portugal</td>
<td>17.7</td>
<td>14.6</td>
<td>-17.3</td>
</tr>
<tr>
<td>Slovenia</td>
<td>14.4</td>
<td>10.8</td>
<td>-24.8</td>
</tr>
</tbody>
</table>

**EU total gross non-performing loans and advances, in % of total gross loans and advances, end of quarter values**

Preserving financial stability is of the utmost importance

Benassy-Quéré et al. aim at making the ‘no-bailout’ clause (Article 125 TFEU) more credible, which is a desirable objective. A country not respecting its fiscal targets would face heightened market pressure, as ultimately it would be forced into outright default. They focus therefore on defining ‘when’ or ‘how’ default should take place, through the equivalent of a Sovereign Debt Restructuring Mechanism, or SDRM (Corsetti et al. 2016): governments missing their expenditure targets would issue junior national debt, which would be automatically restructured should the country require ESM crisis support.

But market forces must be handled with caution. Financial markets tend to operate along horizontal (benign neglect) and vertical (overreaction) lines. The proposals by Benassy-Quéré et al. concentrate both liquidity and credit risks on a very narrow tranche of national debt. This would take Europe into uncharted waters and raises significant questions. While in theory the proposals concern only the flow of debt, the crisis showed that markets fail with critical spillovers across assets issued by a country, and across jurisdictions. These proposals could generate self-fulfilling prophecies, with uneven market reactions to changes in perceptions and credibility of governments, destabilising financial markets.

As costless defaults are an illusion, rather than forcing defaults it would make more sense to work to reduce the economic, financial, and political costs in the extreme and unlikely case that a sovereign debt default becomes inevitable in the euro area. This alternative approach would involve: (1) making the financial system more resilient to such a default event (see below); (2) improving the EMU architecture to make defaults even less likely; and (3) clarifying ex ante ‘who’ would bear the cost of a government default.

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3 Such as: What happens if fiscal targets are missed because of forecast errors or surprise elements, rather than wrong policies? If bonds are meant to be issued only rarely (as countries would normally stick to the fiscal targets), how easy will it be to issue them in a very thin market? Who would enforce their issuance? What happens if there is no buyer at any price (something that we also experienced during the last crisis)?
Making the financial system more resilient

Sovereign bonds have a particular role in funding public expenditure and as benchmarks for national financial systems, which explains why they enjoy a risk-free status across all advanced economies. If the regulatory treatment of bank sovereign exposures were to be changed in isolation, or with an inappropriate combination or sequencing, the consequences could be material and unpredictable for financial stability.

A regulatory reform to reduce excessive concentration of sovereign bonds in the banks’ balance sheets could reduce the impact of government defaults, improve incentives for governments and avoid any possibility of indirect financing, but only if such reform were implemented wisely, gradually, and as part of a well-sequenced package. The right sequencing would depend not just on having a deal on the deposit insurance, as proposed by Benassy-Quéré et al., but on key steps to improve the functioning of financial markets: completing Banking Union, progressing towards the Capital Markets Union and reaching an agreement to launch a genuine European safe asset. This should not be seen as a way to delay progress but rather as an argument that all these elements of the package should be considered as soon as possible.

A stone that could hit many birds

A genuine European safe asset would create a large, homogenous, and hence liquid euro area-level bond market; it would avoid ‘sudden stops’ and reduce the financial fragmentation that blunts the transmission of monetary policy; it would replace sovereign bonds on the banks’ balance sheets, hence mitigating the sovereign-bank loop; and it would increase the total supply of European and global safe assets. It would therefore improve debt dynamics across the Euro area. Mutualised solutions such as Eurobonds (De Grauwe and Ji 2018) or Blue-Red bonds (Delpla and von Weizsäcker 2010), while appealing, have limited political traction at this juncture and would require a change to the EU treaties. Sovereign bond-backed securities (Brunnermeier et al. 2016, ESRB 2018), while increasing diversification and the supply of safe assets, are unlikely to fulfil all the objectives of a genuine European safe asset, as many market analysts, academics and sovereign debt managers have highlighted, even if regulatory barriers are removed. In addition, introducing SBBS alongside Accountability bonds, as proposed by Benassy-Quéré et al., would also dangerously fragment bond markets even more.

A recent paper (Leandro and Zettelmeyer 2018) concludes that safe assets could be produced without mutualisation in sufficient quantities to replace the euro area banks’
current holdings of sovereign bonds, which would make them more immune to defaults. Among the non-mutualised options, so-called E-Bonds (Monti 2010: 61-65, Juncker and Tremonti 2010) – whereby the whole national debt is subordinated to any funding received from the common issuer, which may well be the ESM or the EIB – could directly exert fiscal discipline (by raising the marginal cost of sovereign debt issuance, without raising the average costs for lower-rated borrowers). Against the current lack of trust among European countries, an option balancing and indissolubly binding significant common issuance with market discipline could overcome the reciprocal fear among member states that others may backtrack on agreed reforms (see Figure 2). Its introduction would facilitate a progressive implementation of concentration charges, the prospect of which could help a rapid agreement on both the deposit insurance and the backstop, while it may also smoothen the reduction of the ECB’s balance sheet.

**Figure 2** Possible forms for a European safe asset

![Diagram showing possible forms for a European safe asset]

*Source: Buti et al. (2017).*

**Conclusion**

The proposals in Benassy-Quéré et al. (2018) are welcome and the main message should be heard loud and clear: there is a need to strengthen EMU through parallel risk reduction and risk sharing, complementing each other within a package of reforms. Risk reduction has to continue, but one should avoid changing the goalpost before risk sharing takes place.
In the paper the exact sequencing is however unclear, not all necessary elements are covered, and some proposals create risks. The diagnosis overlooks some key aspects of EMU (internal imbalances, liquidity flows, redenomination risks) and the focus of the proposals on reducing fiscal risks could rather lead to financial distress ultimately requiring more, not fewer, rescues. After all the effort to regain financial stability, there is a need to advance without delay, but with a coherent and well-sequenced package, avoiding unsafe steps in the dark.

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Deepening EMU requires a coherent and well-sequenced package
Buti, Giudice, and Leandro


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The debate on the reform of the euro area concerns a key question: what is the right mix between risk sharing and market discipline? The answer depends on how large the stock of outstanding debt is. Market discipline works very imperfectly – it is completely absent in some circumstances, and then all of a sudden confidence can collapse and countries fall victims of sudden stops, without any change in their fundamentals. The risk that this happens is strongly correlated with the stock of outstanding debt. Even with sound fundamentals, the larger the outstanding debt, the higher the risk that market discipline degenerates into a debt run. This risk weighs on high public debt countries even in the absence of debt runs, raising the cost of capital for the whole economy, reducing growth, and making self-fulfilling debt runs more likely.

The CEPR Policy Insight by 14 French and German economists (Bénassy-Quéré et al. 2018) reflects the nationality of its authors, i.e. two countries that belong to the core of the euro area and are not exposed to a considerable risk of a sudden stop on their sovereign debt. The compromise that they have found, however, is not suitable for a country where the risk of a debt run is much higher. In this column, I explain why.

Before doing that, however, I emphasise an obvious but important point. A confidence crisis that hits a country in the euro area is likely to spread to other countries as well. The resilience of the euro area is not much higher than that of its weakest member. For this reason, reforms that increase the vulnerabilities of the weaker countries may be counter-productive for all.
The doom loop

An important amplification mechanism at the heart of debt runs is the ‘doom loop’ between a sovereign and its banks. Can this vicious circle be broken by imposing that banks reduce their exposure to the domestic sovereign? The answer is no, for two reasons.

The first reason is well known. Any bank is unlikely to survive the default of its sovereign, irrespective of how much domestic debt it holds. A debt default is a dramatic event accompanied by extreme economic and political disruptions. A defaulting country could choose to exit the euro area. No bank would survive this event, because its non-deposit liabilities cannot be re-denominated since they are subject to international law. Even if euro exit does not occur, the fear that this could happen (or the fear of capital levies on private wealth) will lead to capital flights and banking panics. A recession will unavoidably occur, and many bank debtors will be insolvent. In such circumstances, the doom loop cannot be avoided simply by holding a diversified portfolio of bonds.

One could argue that portfolio diversification can help to insulate banks from financial volatility due to sovereign risk in circumstances less extreme than in the event of a default. This may be true in principle, but the question is how large this benefit is in practice. The evidence during the financial crisis suggests that it is very small. According to Constancio (2018), “[f]or European countries, CDS [credit-default swap] premia of non-financial firms and banks are impacted in a similar way when the sovereign credit rating severely deteriorates. During the crisis, CDS premia do not even show that banks with higher ratios of domestic public debt did significantly worse than others with lower ratios”. Similarly, using a rich data set for Italian banks and firms during the financial crisis, Bofondi et al. (2018) show that credit growth from banks operating in Italy to non-financial corporations is explained by the nationality of the bank (whether it is a foreign subsidiary or not), and not by the composition of its bond portfolio.

Second, asking banks to reduce their exposure to their sovereign can be counter-productive. As shown by Lanotte and Tommasino (2018), periphery banks increased their purchases of domestic government bonds during the crisis, when no one else was willing to buy them and when foreign investors were large sellers. It is not difficult to explain why this happens. Any bank discounts the risk of a default of its sovereign compared to the assessment of financial markets. The reason is limited liability, not irrationality, inside information, or moral suasion (although the latter could also play a role). Since a bank is unlikely to survive the default of its sovereign, limited liability imposes a lower bound to the losses incurred in the event of a default, while the upside risk is fully internalised. This is not true for an international investor, who would
survive a foreign default and who fully internalises both losses and gains. Thus, during a financial crisis, foreign investors rush to the doors, while domestic banks act as shock absorbers and are residual buyers of sovereign debt.

Gros (2017) objects that banks can hardly be a stabilising force, since their cost of financing is typically higher than that of their sovereign. But banks can get cheap liquidity from the ECB. The *carry trade* financed through the long-term refinancing operation (LTRO) during the crisis amounted to an implicit debt monetisation. This restored confidence in the public debt market and allowed periphery banks to make large profits. The euro area does not have a lender of last resort to cope with a sovereign sudden stop. Domestic banks can play such a role, and we should not close or discourage the use of this safety valve.

**Debt restructuring and the ESM**

The Policy Insight and ongoing debates repeatedly make the following argument: there is a time-inconsistency in the assessments of debt sustainability as a precondition for ESM lending. Because debt restructuring is so costly, there is an incentive to procrastinate over a judgement of unsustainability and to keep lending to an unsustainable sovereign. This creates moral hazard and weakens market discipline. To avoid this inconsistency, the criteria for assessing debt sustainability should be clarified and made more rigorous, and the ESM should take a more proactive role in its assessment.

Note first of all a logical implication of this argument: debt restructuring should become more likely. Otherwise, the alleged time-inconsistency would not be addressed and any reform would be irrelevant. But this is an obvious problem for countries with high legacy debts. An increased likelihood of a debt restructuring also implies that the cost of servicing the existing debt increases and that debt runs are more likely. For this reason, earlier discussions of this kind were also accompanied by (unrealistic) proposals of how to reduce legacy debts (eg. Buccheit et al. 2013). In the current debate, instead, the issue of high legacy debts is either totally forgotten, or – as in Bénassy-Quéré et al. (2018) – there is a vague and inconclusive discussion of gradual implementation.

The idea that the ESM should play a more proactive role in the assessment of debt sustainability (and perhaps also monitor all member states to clarify who can or cannot access a credit line with the ESM) also raises a political problem. With all due respect to its employees, the ESM is an intergovernmental institution that inevitably represents the interests of the stronger member states who are more likely to act as creditors. Assessments of debt sustainability are a powerful weapon that can move financial markets. What if this weapon is used to extract political concessions in other
controversial policy areas? The mere suspicion that this could happen would have devastating consequences for mutual trust in the EU. The same problem applies to the design of conditionality clauses. More generally, the issue of the governance of the ESM is inextricably linked with its function. Any proposal to reinforce the role of the ESM should go hand in hand with proposals to transform it from an inter-governmental body into a full-blown European institution that operates under majority rule and is accountable to the European (rather than national) Parliament.

Elsewhere (Tabellini 2017) I criticised the idea that Europe needs a Sovereign Debt Restructuring Mechanism, and I will not repeat my arguments here except to emphasise two important points. First, most euro area sovereign debt is issued under national law. This facilitates debt restructuring relative to debt issued under international law, even in the absence of a commonly agreed restructuring procedure. In fact, the introduction of collective clauses has lowered the yield on government debt, the opposite of what it was meant to achieve.

Second, a seniority structure on public debt is desirable, but it should be achieved through explicit verifiable contingencies (such as with indexation clauses to nominal GDP), rather than by making junior debt more easily defaultable. Sovereign default is very different from a corporate bankruptcy. Ultimately it amounts to a political decision to break a sovereign promise. As such it has devastating consequences on the legitimacy and functioning of democratic institutions. Moreover, a default on junior debt could also trigger a debt run and have contagion effects on more senior debt in circulation. This is why the proposals in Bénassy-Quéré et al. (2018) to force countries to issue junior (more easily defaultable) debt if in violation of institutional debt brakes, or to create a seniority structure through tranching, are dangerous and could have unpredictable consequences.

**Concluding remarks**

The euro area has two main fragilities.

- First, because it does not have a lender of last resort that can support the sovereign, it is exposed to risks of financial crisis induced by sudden stops.
- Second, it does not have a fiscal stabilisation tool to help monetary policy when interest rates are at the zero lower bound.

The risk-sharing mechanisms financed by rainy day funds and the ex-ante ESM lending facility suggested in the Bénassy-Quéré et al. (2018) are too modest to address these fragilities. On the contrary, the proposals to enhance market discipline may destabilise
the entire euro area, because they increase the vulnerabilities of countries with high legacy debts. More ambitious reforms are probably not politically feasible now. What should be done, then?

• First, we should not make the system even more fragile, by removing shock absorbers or increasing the risk of debt runs. The CEPR Policy Insight is not careful enough in this respect.

• Second, a fast reduction of legacy debts should be a priority for all. The asymmetries between countries induced by such debts are the main obstacle to reforms, and high debts are one of the main sources of instability. To achieve a faster debt reduction, institutional constraints on national fiscal policy can be strengthened. It is not true that external constraints have been ineffective. Fiscal policy in the euro area has been more disciplined than elsewhere, and progress in reducing public debts has taken place in several countries. Bénassy-Quéré et al. (2018) contains some useful ideas on how to make such institutional constraints less pro-cyclical and more effective.

• Third, there is no reason not to complete the banking union, with the ESM acting as a fiscal backstop for the Single Resolution Fund and initiating a system of European deposit re-insurance.

References


**About the author**

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24 Could the 7+7 report’s proposals destabilise the euro? A response to Guido Tabellini

Jean Pisani-Ferry and Jeromin Zettelmeyer
Bruegel, EUI, Hertie School, and Sciences Po; PIIE and CEPR

In the opening contribution to the VoxEU debate on euro area reform, we and twelve other French and German economists proposed a package of reforms aimed at increasing the stability of the euro area (Bénassy-Quéré et al. 2018). These pursue three objectives:

- The first is to eliminate the ‘doom loop’ between sovereigns and national banking systems, by combining the introduction of a European deposit insurance with concentration charges forcing banks to diversify their sovereign exposure and exploring the creation of a euro area safe asset.
- The second is to improve the resilience of members to adverse shocks, by making European fiscal rules less pro-cyclical and introducing risk sharing mechanisms such as a European unemployment re-insurance.
- And the third is to ensure that if all else fails – fiscal rules and common banking supervision in preventing a crisis, and risk-sharing mechanisms in mitigating its blow – the worst that can happen is an orderly debt restructuring inside the euro area, as opposed to a euro area exit.

As with any reform of the euro financial architecture, the benefits and risks of our proposals are not equally shared across members. Common deposit insurance and fiscal risk sharing could, in principle, come at the expense of countries that are less likely to require fiscal support, such as Germany or the Netherlands. Raising the credibility of debt restructuring could raise the borrowing costs of countries with higher debts and sovereign risk spreads, such as Italy or Greece. We attempt to mitigate these problems in two ways: through the design of individual reform proposals, which seek to minimise these risks and ensure that each country’s core interests are respected; and by ensuring that every single euro area country would be amply better off if our proposals were implemented as a package. We also emphasise that the transition to the new regime
should be carefully managed – for example, by exempting bonds currently held in bank portfolios from concentration charges.

As the contributions to the VoxEU debate attest, not everyone agrees that we have succeeded. Peter Bofinger rejects our scheme out of hand. Lars Feld argues that our proposal for fiscal risk sharing does not sufficiently deal with moral hazard concerns. Sebastian Dullien, Guntram Wolff, Gregory Claeys and several others argue that our risk-sharing ideas do not go far enough, particularly in the fiscal area. Jérémie Cohen-Setton, Shahin Vallée and Vesa Vihriälä find that we should have said more about the role of the ECB. Finally, several Italian colleagues, including Lorenzo Bini-Smaghi, Stefano Micossi and Guido Tabellini, consider that our proposals to reform ESM policies and regulate sovereign exposures of banks would create unacceptable stability risks for Italy, and hence for the euro area as a whole.

We are particularly concerned by this last line of criticism, for two reasons.

• First, it gives us a failing grade on an issue that we are sensitive to and aimed to address. We, too, are weary of the potentially unintended consequences on high-debt countries of increased market discipline, and we fully agree that sovereign defaults can have devastating costs and should never be considered a routine instrument for resolving debt crises.

• Second, these critics question less the specifics of our reform ideas, or even the balance of our reform package, but the fundamental desirability of two of our three reform objectives – breaking the doom loop, and making debt restructuring a viable option if all else fails. Eliminating these two prongs would result in the collapse of what we consider a logically balanced approach.

In the remainder of this column, we focus on these two broad issues, reiterate the logic of what we are proposing, and respond to these critics.

**Debt restructuring as ‘ultima ratio’**

One aim of our proposals is to ensure that unsustainable debts can actually be restructured (or at least rescheduled) as a last-resort option. To achieve this, we propose to lower the output costs and financial stability risks of such restructurings for the countries involved and the euro area as a whole, through stronger safety nets (euro area deposit insurance, and a fiscal rainy-day fund) and by limiting the exposure of banks to any individual sovereign. We also propose changes to bond contracts, and possibly the ESM treaty, to allow debt restructuring to become legally binding with the agreement of a supermajority of creditors and shield the debtor from legal risks. Finally, we advocate
creating liquidity lines with the ESM, so that prequalified countries retain access to liquidity even when confronted to adverse market reactions.

Unlike others (see Zettelmeyer 2018 for a survey), we do not suggest ‘hard’ commitment devices, such as an automatic rollover of maturing bonds whenever a country receives conditional assistance, or a debt ratio above which ESM support would require a debt restructuring. Commitment devices of this kind could force countries to restructure unnecessarily and induce financial panics when the criteria that would require a restructuring are close to becoming binding. Instead, we propose an ESM lending policy analogous to the policy currently used by the IMF in deciding whether to extend large-scale loans to its members. If the ESM staff finds, based on a pre-agreed methodology, that a crisis country is unlikely to be able to repay its debt, then a debt restructuring should become a condition for ESM financial support. In doubtful cases, a maturity extension should be sought, maintaining the option of a deeper restructuring in the future.

In his criticism of our proposal, Guido Tabellini (2018) makes five arguments. First, as a matter of logic, he claims that debt restructuring should become more likely in our proposal, raising the costs of borrowing for high-debt countries. Second, the change in ESM policy that we are contemplating could be abused politically; hence, “any proposal to reinforce the role of the ESM should go hand in hand with proposals to transform it from an inter-governmental body into a full-blown European institution that operates under majority rule and is accountable to the European (rather than national) parliament”. Third, a sovereign debt restructuring mechanism along the lines that we propose is unnecessary, because most euro area debt is issued under national law. Fourth, our approach to make debt “more easily defaultable” is wrong because “it amounts to a political decision to break a sovereign promise. As such it has devastating consequences on the legitimacy and functioning of democratic institutions.” Finally, and in part for this reason, solvency problems of sovereigns would be better addressed by adding “explicit verifiable contingencies (such as with indexation clauses to nominal GDP)” to debt contracts.

Contrary to Tabellini’s first assertion, our proposals do not imply (much less require) that debt restructuring will become more likely. Conditional on a situation of unsustainable debt, the probability of a debt restructuring at the expense of private creditors should indeed rise. At the same time, the chances that debt becomes unsustainable would be reduced by the fiscal risk-sharing mechanisms that we propose, the presence of a well-designed euro area deposit insurance, and the fact that the prospect of losing market access – if markets believe that sovereign debts are on an unsustainable trajectory –
may trigger an earlier fiscal adjustment, without a debt restructuring, than is presently the case. All that would likely reduce sovereign risk premia.

Furthermore, the possibility of orderly debt restructuring would make it much less likely that a deep debt crisis results in an exit from the euro area – because resolving it inside the euro area would require less austerity, and because it would avoid a situation in which the ECB may be forced to choose between discontinuing support to the banking system of an insolvent country and accepting de facto fiscal dominance. Sovereign borrowing costs of euro area members reflect not only restructuring risks but also redenomination risks. Our proposals reduce the latter.

Hence, the net effect of our proposal is more likely to be a reduction than a rise in borrowing costs, even from the perspective of today’s high-debt countries. To manage any risk to the contrary, a transition period for the proposed changes in ESM policies could be defined, giving high-debt countries time to avoid any jump in borrowing costs by demonstrating that their debt ratios remain on a downward trajectory.

With respect to Tabellini’s third point, he is right that most euro area sovereign debt is presently issued under local law, but wrong to suggest that this is a substitute for a pre-defined orderly procedure to restructure debts that have become unsustainable. True, local law was used to facilitate Greece’s 2012 restructuring (especially through setting a supermajority threshold for decisions that are binding on all debt-holders), but in so doing it set the basis for a European framework that should apply to similar cases if and when they occur. Furthermore, euro area bonds issued after 2012 carry collective action clauses that make it more likely that restructurings based on acts of the local legislature will be subject to legal challenge (Grund 2017). More importantly, using the local legislature to in effect change the terms of bond contracts and depart from commonly agreed principles would constitute precisely the kind of “political decision to break a sovereign promise” that Tabellini rightly seeks to avoid.

The fourth of Tabellini’s points mischaracterises what we are proposing. Far from promoting default, we seek contractual and treaty changes that would make it possible to restructure debt within the law – for example, through the ‘one-limb’ collective action clauses proposed by the International Capital Markets Association, promoted by the IMF and endorsed by France and Germany, but not yet adopted in the euro area. Furthermore, we envisage debt restructuring only in rare circumstances – namely, when governments cannot repay, even assuming ample financing and time (e.g. three years) to make policy reforms. These proposals seek to minimise the inevitable reputational loss to governments and democratic institutions that arises in a deep insolvency.
We are more sympathetic to Tabellini’s remaining two points. The governance of the ESM should indeed be reformed to enable its staff and management to take independent decisions, subject to policies agreed by its board. However, transforming the ESM into “a full-blown European institution that operates under majority rule and is accountable to the European (rather than national) parliament” should not be put as a precondition. The creation of the ESM resulted from a refusal by member states and their national parliaments to assign the corresponding fiscal responsibilities to the EU level. Its transformation is unlikely in the absence of democratically legitimate fiscal decision making at the European level. And if we had that, the approach of our paper – which tries to improve the euro area fiscal and financial architecture in a setting in which national parliaments are not willing to cede much control – may not be needed in the first place. Integrating the ESM into the EU framework also presupposes reforming the European institutions, as the larger member states feel diluted in the current institutional set-up and are unlikely to unilaterally cede unilaterally the power they enjoy in the ESM.

We are also sympathetic to GDP indexation and other forms of explicit contingencies in sovereign bonds. But such bonds are not a panacea. New research shows that they would offer little protection against spikes in the debt ratio unless they constitute a large share of the debt stock – and even then, only in countries in which growth volatility is high relative to the volatility of the primary balance (Acalin 2018). This is not true for most euro area countries. Hence, even in the presence of full GDP indexation of its bond stock, the euro area would require a backstop for dealing with unsustainable debt cases.

**Regulating banks’ sovereign exposures**

A cornerstone of our proposals is to introduce regulation that penalizes concentrated exposures of banks to specific sovereigns (but not aggregate sovereign exposures, provided they are diversified). The stability rationale is to weaken the ‘doom loop’ – the transmission of sovereign risk to banks, who will pass it on to private economic activity (via reduced lending) and eventually back to the sovereign. One can also justify the need to regulate sovereign exposures through a limited liability argument of the type that Tabellini uses to explain why bank exposures to the domestic sovereign shot up in the crisis – the risks that concentrated sovereign exposures of banks pose to the financial system are not fully internalised by banks purchasing risky debt.

Tabellini argues that regulation of this type would make no difference, because “[a]ny bank is unlikely to survive the default of its sovereign, irrespective of how much
domestic debt it holds. A debt default is a dramatic event accompanied by extreme economic and political disruptions. A defaulting country could choose to exit the Eurozone.” We agree that it is possible to imagine a default so cataclysmic that it would create havoc in the entire banking system. But the purpose of our proposals is to avoid such cataclysmic defaults, instead seeking orderly, ‘pre-emptive’ debt restructurings that do not force the country to leave the euro area. Furthermore, Tabellini’s claim is not correct as an empirical matter. To start with, Greece is a counterexample; more broadly, only 17 of 91 sovereign defaults between 1978 and 2005 considered by Kuvshinov and Zimmermann (2017) – defined as failure to make a payment on the due date contained in the original terms of issue – coincided with systemic banking crises. Systemic banking crises following pre-emptive restructurings – where no payments are missed – are even rarer (Asonuma et al. 2018). When such crises did occur, however, they greatly raised the costs of default or restructuring, underlying the need to avoid banking crises as a condition for orderly restructuring.

Citing a thoughtful speech by Vitor Constâncio (2018) and a stimulating study by Bofondi et al. (2018), Tabellini also argues that direct exposure of banks to sovereigns had no significant effects on the transmission of sovereign risk during the European crisis. However, Constâncio (2018) is careful to acknowledge that “[i]ndisputably, the credit risk situation of sovereigns affects banks via several channels, including the amount of debt they hold”. Indeed, Constâncio’s assertion that “CDS premia do not even show that banks with higher ratios of domestic public debt did significantly worse than others with lower ratios” is contradicted by two papers that examine this evidence directly (Beltratti and Stulz 2015, Schnabel and Schüwer 2016). Bofondi et al.’s (2018) finding that direct exposure to the sovereign made no difference in explaining lending behaviour of banks operating in Italy in 2011 is striking, but it appears to be an outlier. Using somewhat different datasets, Gennaioli et al. (2014a,b) and Altavilla et al. (2017) find that higher sovereign exposures of banks did indeed magnify the impact of sovereign distress on the real economy. A possible interpretation is that Italy was indeed a special case in 2011 – prior to the OMT announcement – in which debt restructuring and euro area exit were viewed as joined at the hip. But with an appropriate crisis management framework, there is no reason why a debt restructuring, particularly a pre-emptive one, should result in euro exit.

1 Based on a panel data set of emerging and advanced countries between 1980 and 2005, Gennaioli et al. (2014a) find that post-default declines in private credit are stronger in countries where banks hold more public debt. Using bank-level data for 20 sovereign default episodes between 1998 and 2012, Gennaioli et al. (2014b) find that there is a large and significant correlation between banks’ bond holdings and subsequent lending reductions. Also using bank-level data, Altavilla et al. (2017) examine the relationship between sovereign stress and bank lending in five euro crisis countries (Greece, Ireland, Italy, Portugal and Spain) and find that “banks’ domestic sovereign exposures in the stressed countries were associated with a statistically significant and economically relevant amplification of sovereign stress transmission to corporate lending, which cannot be attributed to spurious correlation or reserve causality.”
The core of our disagreement is Tabellini’s claim that access to the domestic banking system will remain an indispensable ‘safety valve’ as long as the euro area is not equipped with a lender of last resort for sovereigns. This amounts to saying that, short of a fundamental change to the mandate of the ECB, no collective safety arrangement can substitute the privileged relationship between a sovereign and the national banks. The logical conclusion from this view is that Banking Union is a misguided project. It is also a perfect justification for ring-fencing and avoiding the sharing of risk. Whereas we perfectly understand, and even share the Italian argument that the national ‘safety valve’ cannot be abandoned if not substituted by strong and credible collective safety arrangements, we fail to see how a monetary union where each sovereign’s ultimate creditor remain its banking system would avoid falling again into the same type of crisis it experienced in 2011-2012.

This all said, we agree that direct exposure to sovereigns is clearly not the only channel through which sovereign stress is transmitted to banks. Furthermore, diversification will only partly shield the banking system even from direct exposure (Alogoskoufis and Langfield 2018), which is one of the reasons why in Bénassy-Quéré et al. (2018) we favour the introduction of a euro area safe asset as a complement to regulatory reform. Regulatory penalisation of concentrated sovereign exposures is not sufficient to eliminate the doom loop, but it is certainly necessary.

**Conclusion**

Guido Tabellini and other analysts are right to insist that any attempt to raise market discipline in the euro area needs to be mindful of its potentially destabilising effects. But they are wrong to conclude that for this reason, it is best to continue with an approach in which the sovereign effectively borrows from its national banking system in a distressed situation, and the handling of crises involving unsustainable debt remains unspecified.

- Failure to outline a procedure for the orderly restructuring of unsustainable sovereign debts implies that in a crisis, these countries would continue to be ‘rescued’ in the standard way, through a conditional loan by the ESM. To avoid openly violating the ESM’s charter, which prohibits such loans, the EU would need to pretend that – with sufficient fiscal adjustment – the debts of the crisis country are in fact sustainable. As witnessed by the failed first programme with Greece, this would lead to exceptionally harsh austerity, high unemployment, and large output declines. In spite of these efforts, restoring solvency will eventually require significant official debt relief.
• Continued reliance on the national banking system as an informal lender of last resort would enshrine the ‘doom loop’ between sovereigns and domestic banks. It is inconsistent with a genuine banking union, in which the ‘nationality’ of banks within the euro area should not matter. Instead, it would be better to strengthen official liquidity provision in a crisis. While the combination of ESM conditional assistance and the OMT goes a long way towards addressing the euro area’s lack of a lender of last resort, it does not help countries that would like access to emergency liquidity without having to negotiate a formal conditional support program. For this reason, we argue for precautionary credit lines that a country such as Italy could qualify for provided that its fiscal and other policies remain on track.

Bailouts of countries with unsustainable debts and reliance on national banking systems as a ‘safety valve’ are inconsistent with a stable, financially integrated euro area. They will weaken the resilience of the euro area and eventually lead to euro exit either of creditor countries that do not want to pay the redistributive price, or of a crisis country that is being subjected to unreasonable austerity. The rise of anti-euro parties in central and northern Europe and Greece’s near-exit in 2015 are warning signals that should not be ignored. It is time for the euro area to address its remaining vulnerabilities head on.

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Section 7: Do we need to think even bigger?
After months of tedious negotiations between its mainstream parties, Germany has finally managed to get a new working government. With a delay of almost half a year, the debate on the reform of the euro area is thus to start in earnest.

For this debate, the recently published CEPR Policy Insight (Bénassy-Quéré et al. 2018) will certainly be a major point of reference. The authors, a group of 14 well-known and well-connected German and French economists, present their package of reform proposals as compromise paper taking into accounts concerns of both the ‘French position’ as well as the ‘German view’ and, politically, from economists from the left as well as from those from the right.

The authors make the basic point that the euro area needs both risk sharing and risk reduction (or crisis mitigation and crisis prevention), and that reforms need to make progress on both fronts in order to be acceptable to both Germany and France.

In short, they propose the following measures:

- **Completion of the Banking Union**: Cleanup of banks’ balance sheets; streamlining and strengthening the framework for bank supervision and bank resolution; establishment of a common deposit insurance with the ESM as a backstop; removal of obstacles for cross-border bank mergers; strengthening of the bail-in requirements in cases of bank restructuring.

- **Completion of the Capital Union**

- **Reform of the treatment of sovereign bonds in banks’ balance sheets**: Regulations to limit banks’ exposures to government bonds; creation of European Safe Bonds (ESBies), structured credit products based on a portfolio of sovereign bonds.
• **Reform of fiscal rules**: Nominal expenditure rules instead of deficit rules; spending overshoots will have to be covered by junior sovereign bonds which will be restructured first in times of payment difficulties

• **Facilitating sovereign debt restructuring**: Changes in voting rules to make holdouts less likely; automatic extensions of junior bonds’ maturities when a country receives an ESM loan

• **Fiscal capacity for the euro area**: A fiscal stabilisation scheme (or unemployment reinsurance) offering one-off transfers to national budgets in case of deep recessions

Many of the package’s elements make sense. No one can really oppose the cleaning up of banking sectors still burdened by large amounts of non-performing loans, nor turning the ESM into a fiscal backstop for a common deposit insurance. Also, streamlining the decision procedures and strengthening the competencies of the ESM is a no-brainer.

Nevertheless, as a whole, the package is not convincing. In the end, too many questions remain open, and the package fails to address a number of central problems of EMU architecture.

The three most important problems are that the package:

• does not address the issue of boom-and-bust cycles in the euro area;
• puts an excessive trust in the ability of financial markets to stabilise national economies and to discipline governments in a sensible and desirable way; and
• proposes fiscal rules and rules for sovereign debt restructuring which run the risk of reducing governments’ policy space.

Let us start with the problem of boom-and-bust-cycles. The package does not address the argument that EMU might have led to longer and deeper national business cycles. In a monetary union, all participating countries have to live with the same nominal central bank interest rate. If cycles are not completely synchronised, this interest rate will always be too low for some countries and too high for others. If a country is in a boom, inflation in this country will pick up and the common nominal interest rate will translate into a lower real interest rate, further fuelling the boom. If a country is in a recession, inflation will fall. This will increase the real interest rate and prevent a quick recovery. Overall, this leads to longer and deeper business cycles, with overheating booms and long recessions or at least periods of stagnation.

This logic is important as in all countries affected by the euro crisis (maybe with the exception of Greece), boom-and-bust-cycles played a central role. Both Spain and Ireland experienced a real estate boom prior to the crisis. The construction sector of these countries expanded strongly, and wages and consumption increased. The good
labour market situation attracted immigrants, the demand of which further increased real estate prices. As the ECB could not react to the overheating of these economies (but had to set its interest rate with regard to the whole euro area), the boom ran much longer than it otherwise might have. While the construction sector grew far beyond its normal (or appropriate) size, export competitiveness deteriorated.

Problems in the Irish and the Spanish economies emerged when the boom came to an end and the real estate bubble deflated. Suddenly, banks were faced with large amounts of non-performing loans and, as a consequence, they cut back lending. Consumption, employment and tax revenues imploded. And as national governments were seen as responsible for bailing out banks, the banking crisis turned into a sovereign debt crisis.

The paper by the 14 economists addresses this problem only by asking for the completion of the Banking Union. The implicit hope here seems to be that under better supervision, in the future banks will not fuel real estate bubbles again. Moreover, in the future, European institutions will provide funds so that even severe national banking crises can be solved by resolution and recapitalisation without pushing national governments to the brink of default.

Yet, it is highly questionable whether all this is sufficient to prevent deep boom-and-bust cycles at the national level in the future. Historically, in major economies, even after reforms, banking regulation and oversight has not been able to permanently prevent real estate bubbles. Moreover, it is unlikely that a resolution of banks in Ireland and Spain according to the new rules would have prevented the deep downturn these countries have experienced.

It is even questionable if under a completed banking union, Spain would have dodged the confidence crisis in its sovereign bond market. From 2007 to 2016, Spanish public debt increased by €723 billion. The fiscal cost of bank restructuring in Spain has last been estimated to have been slightly more than €40 billion. It is plausible that markets would have turned against Spain even without this extra €40 billion of additional public debt.

The authors of the Policy Insight might claim that their proposed fiscal stabilisation scheme could have helped. According to their proposal, countries in which unemployment rises in a single year by more than a certain number of percentage points (they propose a threshold of two percentage points) would receive a one-off transfer. However, upon closer inspection, it quickly becomes clear that the proposed scheme is much too small to be able to have a significant impact. First, pay-outs are supposed
to be capped above a certain amount, and second, if a number of countries go into a recession simultaneously and reserves are not sufficient, pay-outs are scaled down to prevent the fund having to go into debt.

A simple rule-of-thumb calculation with the parameters proposed by the 14 economists yields that this scheme would not have made much difference in the case of Spain and Ireland. Over the whole crisis period, in an ideal case, Spain would have received a total of about 1.3% of GDP (roughly €14 billion), and Ireland of less than 1% of GDP.

If one puts these numbers into comparison with the drop in tax revenues (Spain’s annual tax revenues after 2007 dropped by about €70 billion, or 7% of GDP), one quickly sees the inadequacy of this proposed scheme. Again, the transfers would hardly have made any difference in terms of debt sustainability.

One gets the impression that the 14 economists here have thrown out the baby with the bathtub. Being afraid of moral hazard in a transfer system, they have shrunk it to a level at which it does not yield any real benefits anymore.

Some economists might claim that the proposed completion of capital market union would do the trick. The hope here is that more cross-border financing outside the banking system might help to bolster growth in times when domestic investors and banks cut back lending. Yet, while the hypothesis of cross-border financial market integration as a stabilisation tool is very popular, it is empirically questionable (see Dullien 2017). Instead, most empirical evidence points to cross-border capital flows being extremely pro-cyclical. In the run-up to the euro crisis, foreign capital propped up real estate bubbles. When the crisis hit, these flows quickly dried up.

This links to the second major criticism. In many aspects, the 14 economists count on financial markets to stabilise economies and correctly discipline governments. The central idea of forcing governments to finance overshooting expenditure with junior bonds is that markets will allow such borrowing if the funds are put to good use and prohibit this borrowing if funds are wasted. Yet, as we have seen prior to the euro crisis, in good times, financial markets tend to lend to governments irrespective of imbalances (as they did to Greece), while in bad times, they might cut off financing indiscriminately.

The third problematic point is the facilitation of debt restructuring and the automatic maturity extension which could actually make sovereign debt crisis more likely, not less likely, relative to the status quo with ESM and OMT in place.

The underlying idea of the 14 economists is that public expenditure (except cyclical costs for unemployment and interest rate) above a certain nominal public expenditure path has to be financed by junior bonds which can easily be restructured and the maturity
of which is extended automatically if the country gets an ESM loan. The expenditure path is to be set taking into account potential growth rates, and would be lower for countries with large debt-to-GDP ratios.

In principle, the public expenditure rule has the advantage over the current rules that fiscal policy most likely would be less pro-cyclical. However, the automatism of maturity extension carries the risk that it actually creates new incentives for speculation. According to standard procedure, rating agencies would count a maturity extension as ‘default’. Hence, if fears of an ESM programme grow among market participants, they will have an incentive to dump these bonds, pushing up the interest rate and potentially cutting countries off from market access. This might then make the ESM programme necessary, and turn the fear of debt restructuring into a self-fulfilling prophecy.

As a result, one could expect more frequent, smaller-scale sovereign debt restructurings in the euro area which actually make the expenditure path a hard boundary. Hence, over time, the 60% debt-to-GDP threshold of the Maastricht Treaty would finally be enforced.

However, whether this leads to better economic policy in the euro area is questionable. The 60% threshold always has been arbitrary. Pushing highly indebted countries today quickly towards this threshold by limiting public expenditure growth would mean years of constrained public expenditure, and because of political economy considerations, it is likely that this will first be seen in further cuts to public investment. (The 14 economists might argue that countries could still increase taxes to finance more public investment, but empirical evidence with expenditure rules like the PAYGO system in the US in place during the 1990s shows that these rules carry an inherent bias to cut public investment). Given that public investment in the euro area is already at a record low, and given the fact that demand for government bonds overall remains strong, it is questionable whether such a strong push for a quick return to a debt-to-GDP level of 60% is sensible.

So, in conclusion, while the package contains a lot of good ideas, it will hopefully not be taken at face value by politicians. A compromise between the archetypical German and French position might have the virtue that it has better chances of being implemented. However, if the compromise is struck at the expense of adding some elements to the euro area architecture which will weaken the already wobbly structure, it might not be worth implementing it.
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When thinking about what will determine the prosperity and well-being of citizens living in the euro area, five issues are central. The Franco-German paper (Bénassy-Quéré et al. 2018) makes an important contribution to two of them but I find it overall unbalanced. Let me take the five issues in turn.

1. **Providing adequate public goods**

The well-being of citizens will depend on whether European institutions, together with national institutions, will provide European public goods. Yet the debate on these issues is often superficial. How to provide border protection, fund immigration, how to divide national and European competences or how to advance the Single Market are topics often lacking thought leadership.

One may argue that such public goods are not directly connected to the euro. Yet, political cohesiveness crucially depends on them. And without political cohesiveness, the foundations of the euro will be more fragile than ever. Moreover, public goods often play a role in macroeconomic stabilisation as Bénassy-Quéré et al. acknowledge but unfortunately don’t pursue. To my mind, the political debate rightly puts a strong focus on these issues at this stage.¹

¹ See for example Emmanuel Macron’s speech at the Sorbonne or Mark Rutte’s speech in Berlin.
2. **Ensuring that the fiscal stance of the euro zone is appropriate when monetary policy is at the zero lower bound**

One of the key reasons for the dissatisfactory macroeconomic performance of the euro area has been its inability to run a sensible fiscal policy for the euro area as a whole. It is well established in standard macroeconomic models that when monetary policy hits the zero lower bound, the role of fiscal policy becomes more important in ensuring a proper macroeconomic stabilisation. Without proper macroeconomic policy, recessions will be deeper than necessary, unemployment will be higher and hysteresis effects in labour markets can lower growth potential for many years to come.

The EU’s institutional set-up ignores this issue and there is no mechanism to ensure that the sum of national fiscal deficits makes sense for the euro area as a whole. International institutions such as the IMF have repeatedly asked stronger countries to contribute more to fiscal stabilisation in the recession years.

Attempts to address this institutional weakness have gone nowhere. Unfortunately, Bénassy-Quéré et al. put the topic aside and do not confront the significant political resistance on the issue – a missed opportunity to shape the debate. For example, one could propose to amend the expenditure rule and increase expenditure in countries with fiscal space when monetary policy is at the zero lower bound (Claeys et al. 2016).

3. **Ensuring that macroeconomic imbalances and structural weaknesses are addressed**

One of the key fragilities of the euro area is the fact that prices and wages have diverged so substantially across different countries. The past divergence in the smaller countries of the euro area has been addressed as they have adjusted to the euro area’s core. But the divergences between Germany, France, and Italy remain a major liability.

Adjustment is ongoing, but at a low inflation rate and slowly. The low inflation rate of the euro area has made relative price adjustment more painful, forcing some countries to be close to deflation. As real rates rise as a consequence, the debt burden increases, weighing further on economic performance. Debt-deleveraging in a low-inflation environment is difficult and painful.
Addressing these significant divergences more quickly and with a lesser economic cost requires bold structural and macroeconomic policies at the national level. It requires an acceptance in the national political debates, including in Germany, that national structural and macroeconomic policies matter not only for the domestic economy but also for the euro area as a whole.

It remains a key priority that Germany addresses its low investment, France its overly high and inefficient government expenditure, and Italy its low productivity growth and the weakness of its institutions. Failing to address any of these issues will mean a structurally weak euro area that remains fragile and susceptible to further crises, no matter what is achieved as a compromise on how to deal with sovereign debt. These issues deserve academic debate, which I had hoped my 14 colleagues would bring.

4. Completing banking union and advancing capital markets union

The most convincing section is that on banking union. The idea of sovereign concentration charges (Veron 2017) is well thought through and would reduce the link between banks and sovereigns without creating major financial instability. The introduction of a European deposit insurance scheme – once exposure to sovereign debt is reduced and legacy problems with non-performing loans are addressed – is also sensible. Differentiating the fee structure for the insurance according to country characteristics would sensibly acknowledge that we remain a union in which country policies matter for banks despite being in a banking union.

Yet, one should not claim that introducing such insurance is a major concession by stronger to weaker countries. Introducing insurance after legacy issues are addressed and allowing for differentiated fees depending on risk is just simple, good-sense economics. Unfortunately, it also means that banks in countries with weaker institutions will continue to face higher costs of deposit financing (Wolff 2016). This would cement funding-cost differences for banks across countries, but it would usefully preserve incentives to improve country institutions. It may also be the necessary political condition to get insurance introduced. Overall, it should not be considered a substantial concession to the weaker countries as many strings have been attached.

In terms of political economy, the spreading of sovereign debt across euro area countries may make debt restructuring more difficult though. The financial system may be more easily able to cope with the restructuring when the debt is widely spread in the system, but influential owners of debt in many countries would be affected and will make their political influence heart.
Still, completing banking union with such deposit insurance and fiscal backstop to the resolution fund would increase the financial stability of the euro area and should therefore be pursued. Banking union should be complemented with strong steps that would make capital markets union a reality (Sapir et al. 2018).

5. Dealing with sovereign debt

The core of the paper is about how to reconcile risk sharing with market discipline and here the paper makes an important contribution. It takes up a strand of work that was perhaps first advanced by the Glienecke Gruppe. My main concern is that the paper is not sufficiently courageous in arguing the case for significant integration steps needed to manage the consequences of major debt restructuring. In particular, banking union would not be sufficient to ensure that the economic and political fall-out of a major debt restructuring would be manageable and the other parts of the proposals appear too half-hearted and weak to manage such fall-out.

I have two main worries in this section.

The first is that the paper is explicit about debt restructuring with clear criteria that would remove current constructive ambiguity on when such restructuring would happen. This would mean that market participants can more easily calculate when and how to speculate against a country. Earlier market panic is a likely result. It is notable that the Outright Monetary Transactions (OMT) programme is not explicitly mentioned. Willingly or not, this creates an imbalance where debt restructuring is explicit while OMT is at best implicit. Yet, a euro area without OMT or a true safe asset would be susceptible to bad equilibria problems. (A small rainy-day fund is hardly worth mentioning in this context). Removing constructive ambiguity and not mentioning OMT and the conditions under which it is used could render the euro area more fragile.

Second, I missed a more comprehensive discussion of the implications of debt restructuring in a major country. The authors somehow lightly discuss debt restructuring but do not seem to reflect much on its major consequences. Cruces and Trebesch (2013) find that restructurings involving higher haircuts are associated with significantly higher yield spreads and longer periods of capital market exclusion. Trebesch and Zabel (2016) find that hard defaults are associated with steep output costs.

The authors suggest that the ESM could ensure the funding for the basic provisioning of public services and the support needed to reduce the impact on the economy. Yet, the ability of the ESM to fund a major country for several years after a restructuring may be more limited than the authors assume, at least in the absence of the ECB’s OMT and
in the absence of the IMF. Contagion effects to other countries may further erode the capacity of the ESM. The proposals to experiment with a synthetic safe asset would also not help in providing funding to a country in difficulties. The ESRB report on ESBies (ESRB 2018) even acknowledges that countries losing market access would be excluded from ESBies.

All of this does not mean that debt restructuring cannot and should not be a measure of last resort. In fact, the ESM treaty does foresee it and bond spreads currently do price risk. But it is a measure of very last resort and constructive ambiguity currently prevents unwarranted market speculation. If it had to happen in a major country, major political decisions would be needed to preserve stability.

Europe needs to discuss the broader horizons of its future. The starting point needs to be an understanding that a shared currency comes with many spill-overs and therefore shared responsibilities. It is about keeping one’s own house in order but also about taking into account effects on neighbours of one’s own policies.

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A team of prominent French and German economists have presented a paper which they regard as “a game changer for the euro area” (Benassy-Quéré et al. 2018). Their proposals have initiated an intensive debate (Bini Smaghi 2018, Micossi 2018, Buti et al. 2018, Pisani-Ferry and Zettelmeyer 2018).

While several shortcomings of CEPR Policy Insight 91 have already been discussed, in this column I argue that the specific insolvency risk of euro area membership is the main risk that should be covered by a joint risk sharing. The authors’ modest proposals for a public and private risk sharing are insufficient in this regard. With a strengthening of market discipline, this risk could even be increased. So far, there is little evidence that financial markets could play a stabilising role in the euro area. The proposal for an expenditure rule has its merits as it focuses on a target which governments can control effectively. But it requires a sensible debt-to-GDP target, for which the completely arbitrary 60% value of the Maastricht Treaty should not be slavishly adopted. For a productive compromise between France and Germany, the German side has to take the first step by allowing at least some debt financing of public investments within the fiscal framework of the euro area.

**The specific insolvency risk of euro area membership**

Given the focus on ‘risk sharing’, it is surprising that the authors do not explicitly explain what specific risks they want to be shared. Their proposals focus on the risk of idiosyncratic demand shocks and the risk of a national banking crisis. But this neglects the **unique and existential risk of euro area membership**. Monetary union exposes its member states to an **insolvency risk** which is absent for similar countries which have a national currency. When a country adopts the euro, its debt is redenominated
from the national currency into the euro. Thus, member states are in a similar situation as emerging market economies which can only lend in a foreign currency (‘original sin’). In a crisis they can no longer rely on the support of their national central bank.

This specific risk is aggravated by an easy exit option that the single currency provides for investors. If, for example, a Japanese pension fund is no longer willing to hold Japanese government bonds and decides to hold US treasuries instead, it is confronted with a currency risk. For institutional investors that are required to hold safe assets, this ‘currency wall’ is difficult to surmount. Within the euro area this wall has been removed so that investors can exchange domestic bonds into bonds of other member states without an exchange rate risk.

The combination of the insolvency risk with the easy exit option leads to a denomination risk (Bini Smaghi 2018) which has manifested itself in the euro crisis. Only with Mario Draghi’s commitment to save the euro “whatever it takes”, which was regarded as an implicit insurance against this risk, could the stability of the euro area be maintained. It is important to note that this risk is not due to “a poorly designed fiscal and financial architecture”, as Benassy-Quéré et al. see it. It is due to the fact that the monetary union is a building which is not yet finished. It would require more political integration to become a stable building.

Above all, Germany must have a strong interest in the integrity of the euro area. The euro has protected German manufacturing against exchange rate shocks vis-à-vis the other member states. One can also assume that the Deutsche Mark would have been a stronger currency than the euro, so that the protection has also been effective vis-à-vis other countries. Thus, one should expect that a proposal by German and French economists for ‘risk sharing’ would address this risk. But as the Policy Insight not even mention it, proposals for such risk sharing (Delpla and von Weizsäcker 2010, German Council of Economic Experts 2011) are also not discussed.

**Two not very effective proposals for political risk sharing**

The proposal for a European Deposit Insurance Scheme (EDIS) envisages insurance premiums which are pricing country-specific risks. It also requires that first losses should be borne by the relevant national compartment. Common funds should be provided only “in large, systemic crises which overburden one or several national compartments”. But in such a situation, the risk sharing provided by the EDIS (with a target size of 0.8% of covered deposits of participating banking systems) would soon reach its limits. An
insurance scheme is effective only if risks are uncorrelated. In ‘large, systemic crises’ risks are correlated, and the scheme breaks down. Thus, only the ECB as lender of last resort would be able to stabilise the system effectively.

The second proposal envisages a European fiscal capacity for “large downturns affecting one or several member states”. The authors compare it to a “catastrophic loss insurance”. With total annual contributions of 0.1 % of euro area GDP, the size of the fund is limited as a borrowing possibility is explicitly excluded. As a result, even in a severe recession a country would receive rather limited transfers. For an increase of the national unemployment rate by 4 percentage points, a one-time transfer of only 0.5 % of national GDP is envisaged. But this makes a country only better off if it is hit by the shock within the first five years of the existence of the fund. In addition, due to the limited size of the fund the shock must not affect too many member states simultaneously. As a specific hurdle, access to the fund requires that a member state complies not only with the fiscal rules but also with the country-specific recommendations. In a situation with a very large shock, this is very unlikely. And for such an ideal country it should be possible to finance a temporary cyclical deficit on the capital market without major problems.

Both forms of risk sharing resemble the idea of establishing a fire brigade which can only be activated in the case of huge fires. But at the same it is designed with such limited capacities that it will never be able to deal with such fires.

The limits of market risk sharing

Benassy-Quéré et al. propose market risk sharing as another stabilising factor. One element is the completion of the Banking and Capital Market Union: “Euro area citizens and corporations should be able to hold their savings in instruments whose returns are independent of unemployment and output declines in their home country.” But this is already possible under current institutional arrangements. As already mentioned, the single currency has removed the ‘currency wall’ for portfolio investors. And it was an excessive cross-border bank lending, above all by German and French banks in the years 2000-2007, which contributed to the crisis. More generally, it is not clear how bond and equity markets can provide significant risk sharing given the very asymmetric distribution of wealth in the member states. For households with very little or no financial wealth at all, Capital Market Union cannot provide an effective insurance for the risk of unemployment.
The second element of market risk sharing is the creation of euro area safe assets (ESBies). The authors believe that a “safe asset in the euro area would create a source of demand for euro area sovereign debt that is not ‘skittish’ in the face of changes in market sentiment.” But they also admit that this is only the case “so long as sovereigns do not lose market access since this triggers exclusion from the collateral pool of new issues.” And they see the risk that “it may be difficult to find buyers for the junior tranches in time of crisis”. In other words, their scheme for market risk sharing would fail exactly in the situation when the fundamental insolvency risk of the area becomes manifest.

**Market discipline: Governments under the control of markets?**

The authors regard risk sharing and market discipline as complementary pillars for the euro area architecture. But this raises the question of whether ‘market discipline’ can be regarded as a stabiliser at all. For Benassy-Quéré et al., this seems out of question. But almost 20 years ago the Delors Report came to the following assessment:

“[…] experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.”

The developments since the start of the euro have confirmed this prediction. The market reaction to the chronic lack of fiscal discipline in Greece came much delayed in the year 2010, and then the reaction was so sudden and disruptive that the system could only be saved by Marion Draghi’s intervention. More generally, it is surprising that the economists’ trust in market discipline could survive the financial crisis almost unscathed.

In addition, one must ask whether ‘market discipline’ is an adequate concept for the organisation of the euro area. In the context of the banking sector it may have its merits, but in the context of the monetary union it implies that markets are assigned a disciplining role over states. This turns the traditional relationship between state and markets on its head. In the past there was a consensus among economists that markets must be under
the control of the governments. Market discipline calls for governments that are under the control of markets. This concept is especially questionable as financial markets are dominated by mighty players like Goldman Sachs or Blackrock.

In sum, the whole concept of stabilising the euro area by combining enhanced market discipline with homeopathic elements risk sharing is not convincing. While the elements of risk sharing do not address the euro area’s most fundamental risk of insolvency, the strengthening of market discipline has the potential to even increase this risk. The authors are aware of this problem, but they regard it as a transition problem only: “The main lesson is that the ‘transition problem’ – getting to a state of more effective market discipline and higher stability, without triggering a crisis on the way – needs to be firmly recognised and addressed in proposals to raise market discipline”.

But how should the transition be managed? The authors propose that the new regime should be introduced “at a time when the debts of all euro area countries that depend on market access – particularly those of high debt countries – are widely expected to be sustainable with high probability […]”. As such a situation is very unlikely for the foreseeable future, this looks much like an escape clause for the French economists.

**An expenditure rule set by wise men and women**

A third element of the report is a new framework for fiscal policy. The proposal is based on the assessment that the fiscal rules “have not worked well”. While this is true for Greece, which published incorrect statistics, for the large member states this not so obvious. Comparing the fiscal balances of Germany, France, and Italy on the one hand and of Japan, the UK, and the US on the other, the much lower deficits of member states speak for a pronounced fiscal discipline.

The authors propose a two-pillar approach with a long-term debt target “such as 60% of GDP, or a more bespoke objective” and an expenditure-based operational rule to reach this target. For this purpose, an independent, national-level fiscal council shall be established. It shall propose a rolling medium-term debt reduction target, chart a consistent medium-term expenditure path, and use this to set a nominal expenditure ceiling for the coming year. If a country exceeds the target path all excessive spending must be financed by junior sovereign bonds.
Figure 1  Fiscal balances of large member states compared with Japan, the UK and the US (% of GDP)

Source: IMF World Economic Outlook.

Figure 2  UK Debt-to-GDP ratio, 1700-2016

There is no doubt that expenditure rules have their merits as they are easier to follow than deficit rules. But it is not clear why the rule should be set by an expert council and not by an elected government or parliament. Economists have ideological biases which influence the judgements that must be made given the limitations of the science of economics. Thus, the nomination of specific experts for the council has a strong influence on the outcome of the debt target and the corresponding expenditure path.

In addition, it is far from obvious that the 60% target for the debt level is a sensible medium-term target for the fiscal policy. For the Maastricht Treaty it was derived as the average debt level of the member states at that time. The attempt by Reinhart and Rogoff (2010) to derive a target scientifically failed. Renowned economists have made the case for evidence-based economics. David Eddy (1990) , who coined the term ‘evidence-based medicine’, puts it as follows:

“[E]xplicitly describing the available evidence that pertains to a policy and tying the policy to evidence. Consciously anchoring a policy, not to current practices or the beliefs of experts, but to experimental evidence. The policy must be consistent with and supported by evidence. The pertinent evidence must be identified, described, and analysed. The policymakers must determine whether the policy is justified by the evidence.”

The Maastricht 60% target is obviously based on current practices and beliefs of experts and it lacks any pertinent evidence (for example, in the UK the long-term historical average from 1700 to 2016 is 99.5%; Figure 2). Thus, any strategy that tries to make the euro area more stable should entail an intensive analysis of an adequate debt target for the member states. Substituting the 60% target by a target which is closer, say, to the debt-to-GDP level of the US could fundamentally change the perception of the financial soundness of the member states.

The way forward

The instability of the euro area architecture is not due to a “poorly designed fiscal and financial architecture”. It reflects an unfinished building with a supranational monetary policy and 19 independent national fiscal policies. Thus, the only way to make it stable is to go ahead with political integration. This would allow a comprehensive debt mutualisation which would remove the specific insolvency risk of euro area membership. With the transfer of fiscal policy responsibilities to the supranational level, fiscal discipline of the member states would be enforced by a democratically legitimised euro area finance minister and not by myopic financial investors. In the
current situation progress towards a fiscal policy integration is not very likely. But for economists this is not an excuse for not making explicit what is really required to stabilise the architecture of the euro area.

For a productive Franco-German compromise, the German side must make a first step by allowing some flexibility concerning the ‘black zero’. This would allow more room for the golden rule in the Stability and Growth Pact so that at least a limited debt financing of public investments would be possible. As another step forward, one could envisage projects with large euro area externalities (infrastructure, defence, research, industrial policy, environment) which are financed by bonds with a joint liability. Finally, a thorough and open-minded analysis of the adequate targets for public debt to GDP would be very helpful.

CEPR Policy Insight 91 calls for “a shift in the euro area’s approach to reconcile fiscal prudence with demand policies, and rules with policy discretion”. But it presents a framework that limits the scope for demand policies by the introduction of fiscal rules and “sovereign concentration charges”. And it reduces the scope for national policy discretion not only by the establishment of independent fiscal councils and but also by exposing governments to more ‘market discipline’. The proposal could indeed be a “game changer”, but into the wrong direction.

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**About the author**

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The euro remains a vulnerable construction. Despite the enormous progress in improving its governance achieved in the last years, its present architecture cannot ensure its long-term survival (Matthijs and Blyth 2015). Much more needs to be done, and the June summit is an opportunity that we cannot afford to miss to advance towards a more genuine monetary, fiscal, economic, and political integration.

The European Commission’s reflection paper for deepening EMU (European Commission 2017) and the recent proposal by 14 French and German economists (Bénassy-Quére et al. 2018) on how to reconcile risk sharing with market discipline have revitalised an intense debate on euro area reform. A recent manifesto, signed by more than 20 Spanish experts (Almunia et al. 2018), contributes to this debate, emphasising the need of deeper integration beyond the narrow view in some quarters of just completing the banking union and using the ESM as a bank backstop, both necessary in the short run but not enough in the long term. As the manifesto points out, in the long run “there needs to be further fiscal coordination and discipline and a joint facility for macro stabilisation within the currency area, an unconditional lender of last resort and an effective mechanism to break the link between banks and sovereigns, ensuring financial stability, more effective macroeconomic surveillance and coordination, and greater legitimacy in the overall governance structures”.

However, this cannot be achieved overnight. European construction only moves forward in small, gradual steps. That is why, from the political point of view, it would be a great achievement if all EMU countries could agree that the above-mentioned list constitutes indispensable long-term goals, and then build a strategy to achieve them gradually with consistent steps in the short run. In this vein, Buti et al. (2018) have stressed the need
Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?

for a “coherent and well-sequenced package, avoiding unsafe steps in the dark”. A shared and clear vision on the euro’s end goals would make the long journey towards deeper economic and political integration easier and help re-establish trust between the member states. In other words, the principle of “ever closer union” of the first architects of EMU cannot be lost (Dyson and Maes 2016).

We share with the French and German economists’ proposal the view that risk sharing and risk reduction need to proceed simultaneously. In fact, the interconnection between the euro area countries’ economies is so intense that they already share many risks, but they do not yet share the costs. Many of these risks (geopolitics, terrorism, globalisation, protectionism, digital revolution, demography, immigration or climate change, among others) may have significant economic, social, and political consequences. They require a proper response by the EU and EMU in particular, and the improvement of their institutions and governance.

In the case of EMU, as the sovereign debt crisis highlighted, most of the challenges and structural problems can only be tackled with common instruments at the European level, whose mere existence would reduce the risks and their effects. As Lane (2012) and many others (e.g. Doménech and González-Páramo 2017, Martin and Philippon 2017) have noted, the differences in the response to the financial crisis between the US and EMU appeared after 2010, when the euro area experienced sudden stops, financial fragmentation, and sovereign debt crises coupled with the redenomination risks of national currencies and the potential breakup of the currency union. Despite all the important advances in recent years, the redenomination risk is likely to remain a major problem if EMU institutions, rules and governance are not improved (Bini Smaghi 2018). This is a risk that Benassy-Quéré et al. (2018) tend to underestimate.

The need for a central fiscal authority

In the long run, the euro area needs a central fiscal authority (CFA) with its own sources of revenue and the ability to issue joint debt. We understand that this institution will not fit easily in the currently existing governance structure. That is why we suggest that its president be proposed by the Eurogroup to become the Commissioner for the euro and that a newly created Committee for EMU affairs in the European Parliament specifically ratify his/her appointment to ensure democratic legitimacy. Input legitimacy at the European level is important because the CFA’s president, who would be in fact the euro finance minister heading an embryonic euro area treasury, would be responsible for enforcing fiscal and macroeconomic rules. These rules, which should be simplified, as suggested by Bénassy-Quéré et al., have to be more credible, and should be monitored
at a technical and independent level by a reformed Fiscal European Stability Board (FSB) that would absorb the current ESM and integrate it into EU law.

Despite significant progress in fiscal and macroeconomic governance, countries still have incentives to delay fiscal consolidation as much as possible. There is still a widespread view in Europe that the main problem is the lack of willingness or inability of countries to comply with the rules. Nevertheless, experience shows that even strict adherence to fiscal rules (which is clearly necessary) is insufficient to guarantee a well-functioning and stable monetary union.

Going beyond the existing intergovernmental structures of the Eurogroup and the ESM within EMU would facilitate both decision making and legitimacy. We need a common European approach, not that of 19 European countries. The FSB would, therefore, be in charge of the technical analysis of macroeconomic and fiscal stability, while the CFA would take the ultimate political decisions on these matters under the following incentive and governance structures – countries that abide by the rules receive counter-cyclical fiscal support in downturns, but countries that break the rules do not. The president of the CFA would set the overall fiscal stance for the euro area as a whole, with a view to ensuring an adequate stimulus in recessions and consolidation in expansionary periods.

Given its broad mandate, decisions by the CFA should be taken by qualified majority of the euro area member states. Moreover, crucial ones such those related to debt limits, sums destined to pan-European projects or countercyclical support measures should be approved by the Committee for EMU affairs of the European Parliament.

**Banking union and the role of the ECB**

We also agree with other proposals in the need to complete the Banking Union with a common deposit guarantee mechanism, further convergence in bankruptcy laws, deepening the capital market union, and a credible fiscal backstop, ultimately provided by the CFA mentioned above. As Schnabel and Veron (2018) have argued, in the short run, a limited package aimed at breaking the doom loop between banks and sovereigns would be a great success.

We agree with Bénassy-Quéré et al. that debt restructuring should be possible as a last-resort option. However, this should not raise expectations that some of the present debts of high-debt countries will inevitably be restructured. Moreover, we disagree with their proposal of transparent and consistent across countries ESM criteria for debt restructuring based on a data-driven method that can be reproduced and checked by the public, because that would contribute to create the conditions for financial instability.
As Wolff (2018) points out, constructive ambiguity currently prevents unwarranted market speculation. ESM rules may be useful to assess the potential risks of debt sustainability. However, it should also be clear that these rules would not trigger insolvency automatically. There is a need for some discretionality since, at the end of the day, the commitment of a country to honour its public debt depends on political and social factors and uncertainties that are difficult to measure and to impose systematically upon all countries. All these factors make quantifying how close different countries are to their fiscal limits very challenging (Leeper and Walker 2011).

We think that, as long as there is no large euro area treasury with a sizable budget capable to deal with asymmetric shocks, all euro area sovereign bonds should continue to be considered risk-free assets, implicitly backed by the ECB, leaving the possibility of public debt restructuring as a very last-resort option and preserving the current constructive ambiguity. Questioning the risk-free nature of public debt carries the risk of instability in the bond markets, worsening the current financial fragmentation and threatening to create another episode of market turmoil.

We therefore think that the ECB needs to be able to act as the lender of last resort for illiquid but solvent member states stressed by financial markets but not under a CFA programme of debt restructuring, as it does for the banking sector. Building on its current Public Sector Purchase Programme (PSPP), the ECB has to be the ultimate provider of unconditional liquidity, through the secondary sovereign debt markets, for circumstantially illiquid countries that might suffer market panics or speculative attacks. As Constancio (2018) has recently emphasised, after the experience of the sovereign debt crisis, the ECB has no excuse not to fulfil its mandate by intervening in the sovereign bond market.

However, in the event of an official insolvency of a member state, the CFA would take control of its public finances and negotiate a memorandum of understanding with the country under stress, which would lose part of its sovereignty. The CFA, drawing on the independent technical work of the FSB, would then be in charge of monitoring and implementing the adjustment programme under the parliamentary scrutiny of the Committee for EMU affairs of the European Parliament.

**Economic convergence and structural reforms**

Finally, there is a need to promote more economic convergence between different euro area countries. Therefore, positive incentives need to be put in place for countries to undertake unpopular structural reforms on an ongoing basis so that their economies are sufficiently flexible, innovative, and socially inclusive to live within a single
monetary area. The CFA, with its capacity to issue joint debt and raise its own fiscal resources (under the supranational democratic control explained above), could provide finance for pan-European public goods, such as security, border protection, the digital transformation, and country-specific reforms that are essential for the area as a whole. The work of the European Semester and its country-specific recommendations could be useful, but they need to be enforceable by designing an intelligent incentive structure.

The euro area experience has shown that countries joining the currency union have insufficient incentives to implement the structural reforms needed to make their economies more flexible and convergent, and that external pressure only works in exceptional circumstances. In order to provide the adequate incentives and avoid the problem of moral hazard, only countries that commit to reforms should be able to receive financial support from the CFA to help stabilise their economies cyclically. This conditional mechanism would facilitate politically difficult structural reforms and reduce the risk of deflation.

Of course, this unavoidable level of deeper integration will require a greater degree of political union to provide democratic legitimacy and accountability. We are fully aware that our proposals imply a significant transfer of sovereignty from member states to European institutions, some of which will require a treaty change. However, we believe they are necessary for the euro's long-term sustainability. This is the consensus in Spain, both among the elites and the public at large. Ultimately, the euro area needs to create its own sovereignty, for only a European sovereign can make EMU last for centuries, as in the case of the US.

Such reforms require in the long run the support of the people, expressed in the approval of the treaty change in each of the member countries. Euro area citizens need to be given a real choice between continued fragmentation (which leaves the euro exposed to structural weaknesses and recurrent crises) and greater integration (which pools more sovereignty at the same time as it strengthens EMU governance). In a world subject to ceaseless technological transformation and revived geopolitical tensions, with increased rivalry among the great powers, kicking the proverbial can much longer down the road is no longer an option.

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Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?


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The euro area is stuck in a situation of conflicts of interests between creditor and debtor countries. The political economy of such a situation requires coordinating creditor and debtor countries to distribute the burden of adjustment. Creditor countries require debtors to repay their debt with domestic resources, pushing for spending cuts and tax increases. In turn, debtors are better off if they can delay adjustment and rely on the official euro area safety net if needed.

Benassy et al. (2018) have designed a plan to eliminate precisely this conflict of interests. Their reform proposals aim at creating a consensus between countries calling for more market discipline (the creditor countries) and those calling for risk sharing (the debtor countries). They argue that a compromise can make both creditor and debtor countries better off. Countries can reach a new steady state without getting through significant changes in the current political governance because their plan, they argue, produces gains for both sides. In a similar vein, before them, scholars have designed alternative economic plans to reduce debt overhang and neutralise contagion in case of a crisis (Pâris and Wyplosz 2014, Corsetti et al. 2015, Brunnermeier et al. 2016, Corsetti et al. 2016).

In the end, the Meseberg declaration in June 2018 included a few of their objectives but faced strong opposition by the group of creditor countries forming the ‘Northern alliance’. In sum, none of these plans has managed to create a consensus around a common political agenda. In turn, the reform agenda has remained frozen since the Banking Union discussions in 2015. National governments with divergent interests stand against one another and the debt of several countries is drifting away. The contention between debtor and creditor countries grows: the wider the divergence, the further the compromise about who should bear the burden of adjustment. As a result, redenomination risks kick back when political tensions rise (Gros 2018).
These pervasive conflicts of interests hamper fixing the crisis and keep the euro vulnerable to a shock. The euro is stuck in an inefficient equilibrium where both creditor and debtor countries are worse off.

There are two reasons why these smart economic plans have not generated a consensus. First, the management of the euro crisis since 2010 has relied on inter-state bargaining. Second, even if the deals produce ‘gains on both sides’, these might consist only in a reduction of net losses compared to the current situation, which makes the status quo a safer solution from a political standpoint.

The euro crisis has been managed by governments within the Euro Summits between euro area heads of states, and within the Eurogroup meetings between the finance ministers of the euro area (the latter met 206 times between 2010 and 2017, i.e. every two weeks on average). While the European Commission has reinforced its role as a provider of economic expertise, it has not managed to politically bring forward their proposals of issuing common bonds, a form of risk-sharing and of a common unemployment regime, a form of transfers. The only supranational institution which played a key role in keeping the single currency together is the ECB Mario Draghi’s “whatever it takes”. It was only possible because of the relative isolation of the ECB from the political process (although a political controversy was not totally avoided, a fact that defied the principle of its independence).

Inter-state bargaining has brought European integration forward so far so why would it be an issue now? Indeed, Morascvick (1998), who examined five history-making episodes in the evolution of the EU, argues that a liberal inter-governmentalism has driven European integration in a “series of pragmatic inter-state compromise on different national preferences” (p. 479). National preferences were indeed different with respect to customs union, with Germany and Britain seeking industrial liberalisation and being reluctant with regards to agricultural liberalisation, while France held the reverse position. In the end, agreements had distributional consequences reflecting the compromises made by national governments, but the total net outcome was positive and pareto-efficient at the inter-state level, Morasvick argues.

In contrast, national preferences today are not only different but in conflict. This implies that setting the adjustment burden between creditors and debtors involves both losses and gains for both sides, with high uncertainty on the net outcome. For example, the G7+7 argue for a regulation that penalises concentrated sovereign exposures in bank balance sheets as a quid pro quo for a euro area deposit insurance. This measure carries liquidity risks for the sovereigns under financial market pressure (the debtor countries) as peripheral banks have substituted for the markets by increasing their exposure during periods of tension (Lanotte and Tommasino 2018). Conversely, a euro area deposit
insurance is viewed as involving potential losses for creditor countries. In sum, while a compromise could make both creditor and debtor countries significantly better off, both view the final net outcome as risky. Hence, even if the status quo is detrimental for both sides, it is politically preferable to a new deal carrying so much uncertainty.

As a result, while inter-state bargaining can be efficient in a negotiation on trade tariffs implying a positive net outcome on both sides, this decision-making process is arguably unable to produce a compromise in a debt overhang negotiation. The current situation requires a referee with a capacity to pursue the common interest across national borders.

Reforming the political governance of the EU, rather than just its economic governance

The euro crisis is one of a series of crises seriously threatening the European project and feeding the rise of nationalist euro-sceptic political parties. Similarly, the management of the migration flows since 2015 has been plagued by serious coordination failures as Europe is deeply divided on how to share the migration burden. The fact that the countries located on external borders of the EU are both exposed to the largest migration flows and are also the largest debtor countries (Italy, Spain and Greece) adds complexity. It is misleading to deal with the euro and the migration crises as two isolated issues. Unable to act in concert, the current governance has pushed crisis management down to the national level and impeded the provision of transnational compromises.

We need coordinated, representative decision-making to make Europe functional again.

But national governments are very reluctant to transfer sovereignty to non-national parliamentarians. In order to go beyond this either-or logic of integration or sovereignty, we need to co-opt the members of elected national parliaments within a new, second, parliamentary chamber at the European level. This new parliament, composed of national MPs, could arguably do better at creating transnational compromise on policies in three ways:

- First, by **transferring responsibility**: A European Assembly would fix the inefficient asymmetry between the EU-wide interaction of heads of government and the domestic parliamentary check when they are back home. It would also create a direct interaction between national MPs who would have the double responsibility of representing their constituents in national arenas and in the Europe-wide body.

- Second, by **creating affectio societatis**: The Assembly would bring national MPs together and contribute to form habits of co-governance.

- Lastly, by **fostering information and accountability**: The chamber’s regular meet-
Fixing the euro needs to go beyond economics

Delatte

ings and public debate on European and domestic issues would be brought at the same level of attention. It would arguably increase transparency compared to emergency summitry prone to deal making behind closed doors.

In sum, enhancing accountability would restore legitimacy and breaking the opposition between national and supranational political agenda would help create a greater capacity for interest-generalisation across national borders.

This new legislative body would arguably have the legitimacy to vote new common European taxes to finance common public goods. Citizens expect Europe to break the stalemate, to deliver macroeconomic stability and inclusive growth, to implement efficient measures against global warming, and to enforce a coordinated migration policy and a human hosting of refugees. To reduce the potential creditor-debtor conflict of interest, a cap on transfers could be introduced in order to avoid permanent transfers between creditor and debtor countries (a maximum of 0.1% of GDP, for example). Giving the EU a capacity to deliver common public would contribute to address the anti-elite and restore the citizens confidence.

Not all member countries may presently be willing to go along with reforms to the political governance. It may therefore be sensible to come up with legal solutions allowing the Assembly to start with a subset of countries willing to go forward and not wait for a new Treaty to be signed. These solutions exist (Henette et al. 2017).

In sum, reforming the economic governance is not enough; we need to reform the political governance. The plan as sketched above has limits worth discussing. The 2019 European elections will offer a platform for a debate. It is time to debate alternatives.

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**About the author**

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A RESPONSE
A year ago, a group of 14 French and German economists, of which I was one, joined forces with the aim of forging common proposals for euro area reforms. Our fear, as expressed in an initial op-ed, was that their two countries would settle on a “small bargain” that “would not make the euro area more stable” and that might “induce a false sense of security”.1

The ‘7 + 7 group’ saw the discussion over trade-offs between German-inspired responsibility and French-inspired solidarity as essentially pointless as long as the solution set under discussion remained situated inside the efficiency frontier. There was, in our view, room for simultaneous improvement on both accounts.

Our joint report of January 2018 (Bénassy-Quéré et al. 2017) advocated reconciling “fiscal prudence with demand policies and rules with policy discretion”. Claiming that “market discipline and risk sharing should be viewed as complementary pillars of the euro area financial architecture”, we put forward a series of proposals (Box 1).

The gist of the report was not endorsed by the French and German governments. France was uncomfortable with the acknowledgement that debt restructuring had to feature as a last-resort option, because it feared being dragged into accepting some form of automaticity. Germany was politically unhappy with the emphasis on a European deposit insurance scheme and had reservations about the proposal for a stabilisation fund, whose functioning would involve at least temporary fiscal transfers.

The report, however, gave rise to a lively discussion among officials and academics, and a debate opened up here on Vox that has attracted many contributions. Selected controversies are summarised below.

Box 1  Key proposals of the 7 + 7 report

1. Reform of fiscal rules, including of the enforcement device
   • Introduce debt-corrected expenditure rule (acyclical discretionary spending)
   • Ditch EU sanctions, assign more individual responsibility to countries

2. More and better risk sharing
   • Reduce home bias in bank sovereign portfolios through concentration charges
   • Introduce common deposit insurance with national compartments
   • Promote ‘safe asset’ based on diversified sovereign debt portfolio (e.g. ESBies)
   • Create low-conditionality access to ESM liquidity for pre-qualified countries
   • Create unemployment/employment reinsurance fund

3. A targeted role for market discipline
   • Enforce the fiscal rule via mandating the issuance of subordinated (junior) bonds for the financing of excess spending
   • Make sovereign debt restructuring a credible last resort when debt is clearly unsustainable

4. Clarify role of institutions
   • Separate ‘prosecutor’ (watchdog) and ‘judge’ (political)
   • Upgrade ESM to IMF-like institution, introduce political accountability
   • Strengthen national fiscal councils

Legacy versus system design

The 7 + 7 group did not emphasise legacy problems but ideas for a better permanent regime, conceived in such a way that was intended to allow countries with high public debt or weak banking sectors to take part in it.

An alternative strategy would be to start by addressing the legacy issues head on, through some sort of stock operation (a debt work-out and the cleaning up the bank balance sheets) even at the cost of accepting a degree of mutualisation. According to Lars Feld, it is preferable to show a limited amount of solidarity to restore national fiscal space now and to make the Maastricht system viable again than to commit to open-ended solidarity in the future (Feld 2018).

Our proposals, however, are not simply – or even primarily – intended to find a way around the present lack of fiscal space. They aim at addressing systemic weaknesses in the Maastricht system that were revealed by the crisis. Furthermore, the political
feasibility of trading off one-time solidarity for a return to the prior fiscal discipline regime is questionable. Even in the case of Greece, no agreement has been found to proceed to a genuine stock operation and to get rid of the long shadow of the past. To put it simply, states’ revealed preference is to avoid paying now.

**Debt restructuring as a last option**

Our ‘7 + 7 report’ has been criticised by officials and observers for advocating quasi-automatic sovereign debt restructuring and for taking the risk of corresponding financial trouble lightly. In fact, it emphatically rejected both numerical thresholds and procedural automaticity, but made two proposals:

- Debt restructuring should be considered as a last-resort option for insolvent sovereigns. The no-bailout rule – that is, the principle that the ESM does not lend to an insolvent state – would be upheld exactly in the way the same principle is implemented by the IMF.
- Debt restructuring should be made less disruptive financially and economically. This would be achieved by better protecting the financial system from sovereign risk and by introducing ‘single-limb’ collective action clauses (that allow creditors to pass a single vote on a restructuring proposal and avoid blockage by hold-outs).

Some contributors to the debate (De Grauwe and Ji 2018) argue that it is impossible to decide whether a government is actually insolvent and that the very existence of a sovereign restructuring procedure may trigger panic. This is a fundamental debate. The no-bailout rule, one of the core principles of EMU, prohibits official lending or indirect central bank support to an insolvent state. To renege on this principle because insolvency is hard to diagnose in real time would amount to endorsing fiscal dominance. So, there is in fact no choice but to operationalise the principle that as a last resort, an insolvent sovereign must undergo debt restructuring. When and how it should be enforced is a matter of judgement.

Guido Tabellini’s critique is more subtle. The 7 + 7 group explicitly stated that our proposals aimed at making a last-resort restructuring financially less disruptive and economically less damaging, and therefore a more credible option. Tabellini (2018) argues that this would be reflected in the risk premia applied to high-debt countries. The proposed solution would therefore impose a penalty on countries like Italy. For these countries it would not make things better, but worse.

In a response, Jeromin Zettelmeyer and I acknowledge that for any given solvency situation of a country remaining in the euro area, the 7 + 7 group’s proposals would
increase the probability of restructuring (Pisani-Ferry and Zettelmeyer 2018). We argue, however, that the solvency of the participating countries cannot be regarded as exogenous, but is likely to improve as a result of the proposed policy regime through stronger incentives to fiscal responsibility and the weakening of the perverse loop between banks and sovereigns. We also argue that providing for orderly restructuring inside the euro area may well reduce the probability of an insolvent country being expelled from it. This should diminish the currency redenomination premium priced on the bond market.

**Redenomination risk**

Oddly, the 7 + 7 report has been criticised for not addressing this redenomination risk. It is true that in the report, it is mentioned only once. But as explained by Farhi and Martin (2018), one of our important aims was in fact to address and diminish it.

The report adamantly advocates resolving sovereign debt crises through restructuring inside the euro area rather than through exiting from it. Indeed, the reduction of the cost of restructuring the report called for would logically diminish the threat of exit. Furthermore, proposals to break the ‘doom loop’ for good (through concentration charges on bank balance sheets, a common deposit insurance and the introduction of a safe asset) would help contain the risk of self-fulfilling exit expectations.

**Fiscal stabilisation**

The Maastricht policy assignment was remarkably clear and simple: reflecting the consensus of the time, monetary policy was regarded a strong enough instrument for addressing area-wide shocks whereas, provided governments played by the rules, national fiscal policies were supposed to enjoy sufficient margins of manoeuvre within the constraints of the SGP to tackle country-specific shocks.

These hypotheses have been seriously questioned by the economic developments of the last decade. Contrary to the view of the early 2000s, fiscal policy is increasingly regarded as a necessary complement to monetary policy, especially in situations when the latter is constrained by the zero lower bound; and market reactions, or the fear of them, can prevent national fiscal policy from playing its stabilisation role when a country is hit by a large shock. Hence the need to reconsider the role of fiscal policy in EMU.
The 7 + 7 report aimed to provide a response to the second problem by proposing a fiscal stabilisation scheme based on the evolution of employment or unemployment indicators. It would take the form of a fund, financed by national contributions, that would provide one-off transfers to countries experiencing a sudden and large change in employment.

Many commentators generally regarded the stabilisation proposals of the 7 + 7 report as positive, but insufficient. Several would have liked the report to propose either a proper budget or a central fiscal authority capable of monitoring and steering the aggregate fiscal stance. This would also address the first problem – that of the aggregate fiscal stance. The challenge here, however, is not to demonstrate that the euro area would be macroeconomically better off with a common budget. It is to overcome either one of two major obstacles: the fact that coordination is toothless whenever it comes to telling a surplus country that it should relax its stance; and the fact that a proper budget requires agreeing on the common public goods, revenue, and accountability procedures.

**Safe asset**

As far as banking union is concerned, the 7 + 7 report advocated (i) concentration charges so that banks exhibiting (home) bias in the composition of their sovereign bonds portfolio would be required to post more capital (but no risk-weighting of individual assets, which implies that all sovereign bonds would continue to be treated in the same way); and (ii) a common deposit insurance scheme that would guarantee all bank deposits equally but for which banks would continue paying different fees depending not only their specific risk, but also on the safety of the national banking systems.

Concentration charges would primarily affect countries, such as Italy, where banks have behaved as the residual buyer of domestic government securities. In order to avoid destabilising corresponding bond markets, the 7 + 7 report advocated a gradual phase-in of concentration charges and a grandfathering of existing holdings, and it considered the introduction of a sovereign bond-backed safe asset.

Despite having been endorsed by the European Commission and the European Systemic Risk Board, SBBSs remain controversial and that they are especially unpopular with debt management agencies. They were discarded out of hand in the Franco-German roadmap of June 2018. As pointed out by Zettelmeyer and Leandro (2018), there are three main reasons for this distrust: first, the fear that the senior tranche would lose safety in a crisis; second, the fear that in adverse market conditions, the issuance of synthetic securities could be blocked by the lack of buyers for the junior and mezzanine tranches; and third, the potential spillovers from the synthetic asset on the demand
for national bonds and the liquidity of the corresponding markets. Simulations by Zettelmeyer and Leandro (2018) suggest that these fears are not without rationale but that they are largely exaggerated.

**Northern bias**

As Frieden (2018) points out, any reform programme for the euro area must address the concerns of both core and periphery countries. Though they intended to help unlock the French-German discussion, the 7 + 7 group endeavoured to propose solutions that would suit all euro area members. Several contributors, however, implicitly regarded our report as unbalanced and biased towards the perspective of Northern member states. The critique was most explicitly formulated by Tabellini (2018) who argues that the compromise found by the 7 + 7 group is not suitable for a country exposed to the risk of a debt run and that its proposals would in fact increase the vulnerabilities of countries with high legacy debt.

Tabellini argues that the 7 + 7 group’s obsession with breaking the doom loop is a bad idea in the first place. He claims that through acting as residual buyers of domestic sovereign bonds in situations of stress, national banks play a stabilising role that should not be hampered by concentration charges or other provisions aiming at the same goal. This is in fact a fundamental critique of the direction taken by EMU reforms since 2012, when the heads and state and government decided to opt for banking union. If domestic banks are to remain the safety valve of the sovereign bond market, it is fully rational for the markets’ assessment of their solvency to be correlated to that of the sovereign. This in turn creates a major conduit for overreaction in times of economic stress and elevated risk aversion.

Some have also criticised the 7 + 7 report for what it does not address: chronic external surpluses or deficits, structural divergences in growth, and endogenous boom-bust cycles. The authors of the report are certainly the last to deny that these are major issues for the sustainability of the euro area. But concerns about them should not prevent serious discussions about the flaws or vulnerabilities policy system.

**Conclusion**

With the 7 + 7 report, we were aiming at breaking the deadlock in Franco-German discussions and at changing the broader policy conversation on euro area reform. It is fair to say that we had limited success on the first point.
We had more success with our second aim. Within the group of economists who participated in the endeavour, there is no longer a German position and a French position. All the 7 + 7 group stand by what we have proposed. Nobody can claim anymore that French and German economists behave as the prisoners of their respective national crisis narratives. This is not a minor achievement.

Furthermore, the report has served as a reference point for a much-broadened discussion among policymakers and academics. Through its questioning of the relevance of well-established quarrels and because it has put forward new options, it has helped to break the status quo bias that is so pervasive in European policy discussions and to clarify which ideas command wide consensus and which remain a matter for controversy. Some feel that the 7 + 7 group’s proposals are insufficient, some that we have gone too far, some that we have taken the wrong direction. But such controversies are definitely useful.

References


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EPILOGUE
31 Euro area architecture: What reforms are still needed, and why

Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, and Jeromin Zettelmeyer

In January 2018, we published a paper recommending euro area reforms to the French and German governments (Bénassy-Quéré et al. 2018). The motivation for the paper was the continued financial and political fragility in the euro area, notwithstanding the economic recovery and important reforms such as common banking supervision, the creation of the European Stability Mechanism and the broadening of the ECB’s policy toolkit. The financial system remains fragile because of the continued exposure of sovereigns to domestic banks, as well as banks to their national sovereigns, and limited room for manoeuvre by the ECB. Political fragility prevails because the key grievances of the crisis remain unaddressed. Crisis countries feel that excessive austerity was imposed on them, and that the euro area does not provide a level playing field for their banks and corporations, whose access to credit is relatively expensive. Creditor countries feel that they live in a system that does not ultimately enforce the no-bailout clause of the European treaties, exposing them to large fiscal liabilities.

As a solution to these problems, we proposed a set of reforms that would both increase risk sharing and strengthen market discipline in the euro area. The key idea was that risk-sharing mechanisms, such as European deposit insurance (EDIS) and a European unemployment re-insurance, could actually strengthen discipline, provided that first losses would continue to be borne at national level, and provided insurance premia were aligned with risk. The reason for this is that, in the presence of stronger safety nets, it becomes possible to solve severe fiscal crises through orderly debt restructuring,

1 All authors contributed in a personal capacity, not on behalf of their respective institutions, and irrespective of any policy roles they may hold or may have held in the past.
obviating the need for both self-defeating austerity and enormous crisis loans that might not be repaid.

We also argued for regulatory ‘concentration charges’ that would reduce the domestic sovereign exposures of banks, and for a reform of EU fiscal rules to ensure that they provided enough discipline in good times, while not magnifying economic downturns. And we argued for better enforcement mechanisms; imposing fines on nations is rarely credible. A better approach would be to require countries that spend more than the ceiling allowed under the rules to finance the extra expenditure by issuing subordinated bonds, raising the costs of such issuance, and protecting incumbent bondholders.

**What is new?**

Since we wrote our paper, four things have happened that are relevant to our initial worries, the proposed solutions, and economic reform in the EU more broadly.

First, we received broad support both for the general strategy proposed in our paper and for some of the proposals, along with some criticism (Pisani-Ferry 2018). For example, IMF authors published a paper advocating a very similar approach (Berger et al. 2018). There seems to be consensus among policy economists on how to reform the Stability and Growth Pact, namely, to focus on expenditure ceilings set to slowly reduce the debt ratios of overindebted countries. Most importantly, the Meseberg declaration by German Chancellor Angela Merkel and French President Emanuel Macron of June 2018, and a subsequent EU summit, seemed to take some of our concerns and solutions on board. Fixing the euro area’s banking system was recognized as a high priority, leading to a reaffirmed commitment to a backstop from the (ESM) for bank crisis resolution, as well as explicit reference to a European Deposit Insurance Scheme. Referring to a prior letter by the Eurogroup’s president, political leaders also signalled openness to more flexible forms of ESM lending to countries that do not experience a full-blown crisis as well as bond clauses to allow for orderly sovereign debt restructuring and the bail-in of private creditors, without automaticity.

Second, despite these promising signals, the implementation and follow-through of euro area reform have been largely disappointing. There was an agreement on

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2 Changes in tax revenue would not affect the expenditure ceiling unless they are the result of tax policy (e.g. via a tax cut). A collapse in revenue in a downturn would hence be fully absorbed by an increase in the fiscal deficit. Conversely, during a boom, expenditures would remain constrained by the ceiling, leading to high fiscal surpluses. As a result, automatic stabilisers would be more effective than they are today (Beetsma et al. 2018, Feld et al. 2018, Darvas et al. 2018).

implementing the ESM backstop to the common resolution mechanism, but it may be
too small, especially when faced with liquidity issues, and is subject to national vetoes.
EDIS and sovereign concentration charges are still largely considered taboos in the
political debate. The very principle that a common currency area may need a fiscal
component, such as a common unemployment re-insurance, continues to be rejected by
some euro area members. As of April 2019, a consensus may be emerging for a small
budget within the EU’s regular multi-year budget, possibly in an order of magnitude of
around €20 to €30 billion, earmarked for specific support for member states in the area
of innovation and in the form of loans. While such a budget may constitute a first step,
it would not fulfil any euro area macroeconomic stabilisation function, nor would it be
a suitable tool to support national fiscal policies in case of an economic slowdown or
recession.

On other key issues there has been virtually no progress. Despite the intellectual
consensus there seems to be no appetite to change common fiscal rules to make them
more transparent and less intrusive, but rather to give national governments more
flexibility to use national fiscal policies.

Third, the economic outlook for the euro area has darkened. The slowdown of major
euro area economies, including Germany, in the second half of 2018 has led the ECB to
put the normalisation of interest rates on hold. Protectionism in the US is a significant
concern, both because the war trade war with China undermines investor confidence
and may be contributing to the cooling of the Chinese and US economies, and because
of concerns about at trade war between the US and Europe. With interest rates already
near zero and government bond holdings close to the limits that the ECB had set itself in
order to avoid pushing private lenders to the sidelines, the ECB’s room for stopping the
next recession is limited. Any new instruments may be increasingly controversial. At
the same time, the EU lacks fiscal stabilisation mechanisms. Unless the next recession
disproportionately hits the stronger members – those that have fiscal room to respond –
the euro area will be short of instruments to contain the crisis.

Fourth, the discussion on economic policies in the EU and the euro area has recently
broadened, in part in reaction to economic nationalism in China and the US. Germany’s
Economy Minister Peter Altmaier published a National Industrial Strategy 2030
in February 2019, which was followed by a joint “Franco-German Manifesto for a
European industrial policy fit for the 21st century”. President Macron made a new
push for European reforms in early March 2019, which abstained from returning to
euro area issues but contained additional proposals in the area of EU trade and public
procurement policies, and argued for a revision of European competition policies. While
the new focus of these policymakers on raising productivity growth and innovation
maintaining EU economic sovereignty in the face of external challenges is welcome, some of the proposals that have been floated – in particular, promoting national and European champions and weakening EU competition policies – raise major concerns (Feld et al. 2016, Fratzscher and Duso 2019, Pisani-Ferry 2019, Zettelmeyer 2019).

To summarise, the problems that prompted our January 2018 paper are still there, new problems are on the horizon, and the current state of the policy conversation on euro area reform is disappointing. Leaders and ministers seem to lack the sense of urgency and the sense of purpose that would be needed in the current situation. They do not seem to appreciate the lingering fragility of the euro area, the proximity of the economic risks, and the danger of relying excessively on the ECB for addressing problems that political leaders are unwilling to solve.

Priorities going forward

In light of the weakening economic cycle, the deficiencies of the euro area architecture may thus come to the fore sooner than we had expected a year ago. Four priorities on euro area reform should be at the centre of the discussion.

First, euro area leaders must finish the job started in 2012 of breaking the vicious circle between banks and national governments. This requires making EDIS a reality but also breaking another important taboo, namely the lack of meaningful regulation of bank exposures to sovereigns. This could be achieved by limiting how much domestic sovereign debt banks can hold (for example, through sovereign concentration charges). Moreover, the creation of a safe asset for the euro area, without mutualising sovereign risk, should be explored further. This would contribute to severing the financial link between national governments and banks and reduce the costs of restructuring government debt in cases where debt is unsustainable. It could also prevent destabilising cross-border flights to safety.

Second, there should be a discussion both on the reforms of the fiscal framework for the euro area, but also about the appropriate fiscal policy amid the economic slowdown and the substantial downside risks facing Europe at the moment. The current fiscal rules have proven to be overly complex, hard to enforce, and procyclical. The EU should move towards simple public expenditure rules guided by a long-term debt reduction target.

Third, priority should be given to the creation of a proper macroeconomic stabilisation tool for the euro area. An important reason why some countries experienced crises that were far more severe than necessary over the past ten years was the lack of fiscal
Risk Sharing Plus Market Discipline: A New Paradigm for Euro Area Reform?

stabilisation. The Eurogroup had raised the possibility of introducing an unemployment insurance scheme that might fulfil such a stabilisation function – irrespective of whether or not it is labelled a ‘euro area budget’. Such a scheme could play an important role in helping countries avoid a deep recession and crisis. It can be set up without creating a ‘transfer union, thus addressing concerns of Germany and other northern European countries. The objective now should be to better explain the economic benefits of such a stabilisation mechanism.

Fourth, the EU should focus on completing the Single Market, including through Banking Union and Capital Market Union, and an integrated research and investment strategy (in particular, to fight climate change). The reforms of the euro area emphasised in our previous work make a contribution towards this objective. A particularly important dimension is the integration of the banking market. Beyond technicalities, euro area countries share a common interest in having banks that diversify risk rather than concentrating it along national lines. The tendency towards within-country concentration of the banking market is not a sound development.

The push by the French president and other EU politicians to strengthen other economic dimensions of the European Union in the areas of climate change, external security, competition, trade, and industrial policy is important and timely. However, these initiatives should not undermine European competition policy.

These priorities, which concern the euro area as a whole, are a vital complement to reform efforts aiming at enhancing productivity, growth and fiscal consolidation at national level. Without stronger efforts both at the euro area and the EU level, Europe will not prosper.

References


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In the autumn of 2017, a group of seven French and seven German economists (the 7+7) undertook to put together a joint proposal for reforming the euro area. Their common conviction was that 'French views' and 'German views' on the drawbacks of the European currency union each pointed to real problems. Instead of aiming at a midpoint between often radically different views, any serious attempt at euro area reform had to address concerns raised by economists from the two countries.

Their central argument was that risk sharing and market discipline could not only be reconciled but were in fact complementary. A credible no bailout rule required the possibility of sovereign debt restructuring as a last resort, but this was not credible without well-functioning financial and fiscal safety nets. Furthermore, mitigating any unintended consequences of greater market discipline required reliable stabilisation and liquidity instruments.

The publication of their joint proposals in early 2018 triggered a considerable debate. Over the following twelve months, prominent economists from academia and policy institutions contributed both critical comments and alternative or additional proposals, which were published in a dedicated VoxEU debate.

This volume offers a selection of these contributions together with a summary of the original proposal. It covers six main topics: (1) breaking the doom loop between sovereigns and banks, (2) a common safe asset, (3) liquidity provision to sovereigns, (4) reforming the fiscal rules, (5) the pros and cons of a central fiscal capacity, (6) the pros and cons of market discipline, and (7) alternative views on euro area reform. It also includes an analysis of the debate, and a recent analysis of the state of play on euro reform by the 7+7.

The continued fragility of the euro area calls for a rigorous debate on the reform options. This volume provides a comprehensive, state-of-the art, and accessible overview of the current discussion on such reforms.