EUROPEAN ECONOMICS

Six reforms for the Eurozone

Risk sharing and market discipline in the euro area

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

L'ex ministre grec de finances Yanis Varoufakis, a Brussel·les, durant una reunió del Consell de la Unió Europea. Font: EU Council Eurozone

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. First, 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. Second, 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. Lastly, 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.

I. Breaking the vicious circle between banks and sovereigns through the coordinated introduction of sovereign concentration charges for banks and common deposit insurance

The former would require banks to post more capital if the 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.

II. 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.

III. 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.

IV. 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 pre-set 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.

V. Foster 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'.

VI. 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, irrespective of any policy roles they may hold or may have held in the past.

This article first appeared in CEPR Policy Portal.

REFERENCES

Bénassy-Quéré, A, M Brunnermeier, H Enderlein, E Farhi, M Fratzscher, C Fuest, P-O Gourinchas, P Martin, J Pisani-Ferry, H Rey, I Schnabel, N Véron, B Weder di Mauro and J Zettelmeyer (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No. 91.

Agnès Bénassy-Quéré

Agnès Bénassy-Quéré is a Professor at the Paris School of Economics —University of Paris 1 Panthéon-Sorbonne. She is also a Member of the French macro-prudential authority, the board of the Banque de France, a fellow the Institute for the Study of Labour (IZA) and a member of CESIfo. Els seus àmbits d'estudi inclouen els sistemes monetaris internacionals, els tipus de canvi, la política econòmica i la integració europea. L'any 2000, la seva investigació va ser guardonada amb el premi al Millor Jove Economista francès pel *Cercle des économistes* i el diari *Le Monde*.

Beatrice Weder di Mauro

Beatrice Weder di Mauro is Professor of International Economics at the Graduate Institute of Geneva and Distinguished Fellow at the INSEAD Emerging Markets Institute, Singapore. Since July 2018, she is serving as President of the Centre for Economic Policy Research (CEPR), a network based in different european universities which includes 1300 researchers.

Clemens Fuest

Clemens Fuest is President of the ifo Institute --*Institute for Economic Research*--, Professor for Economics and Public Finance at the Ludwig Maximilian University of Munich, Director of the Center for Economic Studies (CES) and Executive Director of CESifo GmbH. Since 2003, Clemens Fuest is a member of the Academic Advisory Board of the German Federal Ministry of Finance.

Emmanuel Farhi

Emmanuel Farhi is a Professor of Economics at Harvard University, a member of the French Economic Analysis Council to the French Prime minister, a Research Associate at the National Bureau of Economic Research, the Center for Economic Policy Research, the International Growth Centre, as well as a Fellow of the Toulouse School of Economics. He is also an Associate Editor of the *American Economic Review*

Henrik Enderlein

Henrik Enderlein is Professor of Political Economy at the Hertie School of Governance and Director of the Jacques Delors Institut – Berlin. He has also taught at Harvard University, where he stayed as *Pierre Keller Visiting Professor of Public Policy* at Kennedy School of Government and at Weatherhead Center for International Affairs, duirng 2012 and 2013. Moreover, he has also been visiting professor at Duke University (*Fulbright Distinguished Chair*, 2006-2007).

Isabel Schnabel

Isabel Schnabel is an economist, Professor of Financial Economics at the University of Bonn and Member of the German Council of Economic Experts, an independent advisory body of the German government. She is Research Fellow at the Centre for Economic Policy Research (CEPR) and at the CESifo, and Research Affiliate at the Max Planck Institute for Research on Collective Goods, in Bonn.

Jean Pisani-Ferry
Jean Pisani-Ferry is an economist and an expert in public policies. He is also *Mercator Senior Fellow* at Bruegel and Tommaso Padoa-Schioppa chair at the EUI in Florence, as well as professor of economics with the Hertie School in Berlin and Sciences Po in Paris. From 2005 to 2013 he was the founding director of Bruegel, a think tank of economic nature, based in Brussels.

Jeromin Zettelmeyer
Jeromin Zettelmeyer is a senior fellow of the Peterson Institute for International Economics, a CEPR research fellow, and a member of CESIfo. From 2014 until September of 2016, he served as Director-General for Economic Policy at the German Federal Ministry for Economic Affairs and Energy.

Marcel Fratzscher
Marcel Fratzscher is an economist and President of DIW Berlin, a leading research institute and think tank in Europe. He is also Professor of Macroeconomics and Finance at Humboldt-University Berlin, and Member of the Advisory Council of the Ministry of Economy of Germany. Previously, he had been head of International Policies Analytics at the European Central Bank.

Markus K. Brunnermeier
Markus K. Brunnermeier is professor at Princeton University, where it holds the position of *Edwards S. Sanford Professor*. He is a faculty member of the Department of Economics and director of Princeton's Bendheim Center for Finance. He is or was a member of several advisory groups, including to the European Systemic Risk Board, the IMF, the Federal Reserve of New York, the Bundesbank and the U.S. Congressional Budget Office.

Nicolas Véron
Nicolas Véron cofounded the think tank Bruegel in Brussels in 2002-05. He joined the Peterson Institute for International Economics in Washington DC in 2009, and currently serves as a Senior Fellow on equal terms for both organizations. He is also an independent board member of the global derivatives trade repository arm of DTCC. He appeared in Bloomberg Markets as one of the 50 most influent people in the world in 2012.

Hélène Rey
Hélène Rey is an economist. She is currently a professor at the London Business School, where she holds the position of Lord Bagri Professor of Economics. She is member of the British Academy, the Econometric Society and the European Economic Association. She is a researcher on the CEPR European Network and is also an associate researcher with the NBER - National Bureau of Economic Research.

Philippe Martin
Philippe Martin is a Professor of Economics at the Sciences Po University in Paris. He is also a member of the French Economic Advisory Board and a researcher on the CEPR European network. During the period 2015-2016, he was Emmanuel Macron's Economic Adviser to the French Ministry of Economy, Industry and Digital Affairs. He is a member of the *Conseil d'Analyse Economique* and the *Conseil National de Productivité*.

Pierre-Olivier Gourinchas
Pierre-Olivier Gourinchas is a professor in Global Management and director of the Clausen Center for International Business and Policy at UC Berkeley. He is also co-director of the NBER International Finance and Macroeconomics program, chief editor of the Journal of International Economics, a member of the Bellagio Group of International Economics, and a researcher on the CEPR European network.