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, Jeromin Zettelmeyer 17 January 2018

The euro area continues to suffer from critical weaknesses that are the result of a poorly designed fiscal and financial architecture, but its members are divided on how to address the problems. This column proposes six reforms which, if delivered as a package, would improve 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.

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.
- 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.

Related

ESBies: Safety in the tranches
Markus K Brunnermeier, Sam Langfield, Marco Pagano, Ricardo Reis, Stijn Van Nieuwerburgh, Dimitri Vayanos

Sovereign and banking risk
Giorgio Barba Navaretti, Giacomo Calzolari, Alberto Pozzolo

Reinforcing the Eurozone and protecting an open society
Giancarlo Corsetti, Lars Feld, Ralph Koijen, Lucrezia Reichlin, Ricardo Reis, Hélène Rey, Beatrice Weder di Mauro

New VoxEU eBook: How to fix the Eurozone
Richard Baldwin, Francesco Giavazzi

ESBies: A realistic reform of Europe's financial architecture
Open Letters

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

Agnès Bénassy-Quéré
Professor, Paris School of Economics - University of Paris 1 Panthéon-Sorbonne

Markus K Brunnermeier
Edwards S. Sanford Professor at Princeton University

Henrik Enderlein
Professor of Political Economy, Hertie School of Governance; Director, Jacques Delors Institut - Berlin

Emmanuel Farhi
Professor of Economics at Harvard University and CEPR Research Affiliate

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

Marcel Fratzscher
President, DIW Berlin; Professor of Macroeconomics and Finance, Humboldt-University Berlin; and Member of the Advisory Council, Ministry of Economy of Germany

Clemens Fuest
President of the ifo Institute, Professor for Economics and Public Finance at the University of Munich, Director of the CES and Executive Director of CESifo

Pierre-Olivier Gourinchas
Professor of Global Management and Director, Clausen Center for International Business and Policy, UC Berkeley; CEPR Research Fellow

Philippe Martin
Professor of Economics, Sciences Po; CEPR Research Fellow

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 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.

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

Jean Pisani-Ferry
Mercator Senior Fellow, Bruegel; Tommaso Padoa-Schioppa chair, EUI; Professor of Economics, Hertie School and Sciences Po

Hélène Rey
Lord Bagri Professor of Economics, London Business School and CEPR Research Fellow

Isabel Schnabel
Professor of Financial Economics, University of Bonn; Member of the German Council of Economic Experts; CEPR Research Fellow

Nicolas Véron
Senior Fellow, Bruegel and Peterson Institute for International Economics

Beatrice Weder di Mauro
Distinguished Fellow, Emerging Markets Institute, INSEAD Singapore and Economic Policy and International Macroeconomics Professor, Gutenberg University Mainz; CEPR Research Fellow

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.

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.

Topics: EU institutions EU policies Financial regulation and banking

Tags: euro area, Risk sharing, fiscal architecture, financial architecture, euro area safe asset

Related

ESBies: Safety in the tranches
Markus K Brunnermeier, Sam Langfield, Marco Pagano, Ricardo Reis, Stijn Van Nieuwerburgh, Dimitri Vayanos

Sovereign and banking risk
Giorgio Barba Navaretti, Giacomo Calzolari, Alberto Pozzolo

Reinforcing the Eurozone and protecting an open society
Giancarlo Corsetti, Lars Feld, Ralph Koijen, Lucrezia Reichlin, Ricardo Reis, Hélène Rey, Beatrice Weder di Mauro

New VoxEU eBook: How to fix the Eurozone
Richard Baldwin, Francesco Giavazzi

ESBies: A realistic reform of Europe's financial architecture
Open Letters

Jeromin Zettelmeyer
Senior Fellow, Peterson Institute for International Economics; CEPR Research Fellow

Don't Miss

Reconsidering the 'China shock' in trade
Feenstra, Ma, Sasahara, Xu

How to reconcile risk sharing and market discipline in the euro area
Bénassy-Quéré, Brunnermeier, Enderlein, Farhi, Fratzscher, Fuest, Gourinchas, Martin, Pisani-Ferry, Rey, Schnabel, Véron, Weder di Mauro, Zettelmeyer

Robots and jobs: Evidence from the US
Acemoğlu

How merchant guilds became obsolete
Raj

The geopolitics of international currency choice
Eichengreen, Mehl, Chiţu

The social origins and IQ of inventors
Aghion, Akcigit, Hyytinen, Toivanen

Economists relaxed about Bitcoin: New CFM-CEPR survey
den Haan, Ellison, Ilzetzki, McMahon, Reis

Globalisation may soon accelerate again – time to get domestic policies right
Baldwin, Vihriälä

Events

Political Economy of International Organizations
8 - 10 February 2018 / Wisconsin-Madison, United States / University of Wisconsin-Madison

Spring Meeting of Young Economists 2018
30 May - 1 June 2018 / Palma de Mallorca (Mallorca) - Spain / EAYE (European Association of Young Economists) - University of the Balearic Islands

envecon 2018 - Call for Abstracts
9 - 9 March 2018 / The Royal Society, London / UK Network of Environmental Economists (UKNEE)

10th ECB Workshop on Forecasting Techniques:

Economic Forecasting with Large Datasets
18 - 19 June 2018 / European Central Bank, Frankfurt am Main, Germany / European Central Bank

ICSD 2018
12 - 13 September 2018 / Rome, Italy / European Center of Sustainable Development , CIT University

CEPR Policy Research

Discussion Papers | Insights

Homeownership of immigrants in France: selection effects related to international migration flows
Gobillon, Solignac

Climate Change and Long-Run Discount Rates: Evidence from Real Estate
Giglio, Maggiori, Stroebel, Weber

The Permanent Effects of Fiscal Consolidations
Summers, Fatás

Demographics and the Secular Stagnation Hypothesis in Europe
Favero, Galasso

QE and the Bank Lending Channel in the United Kingdom
Butt, Churm, McMahon, Morotz, Schanz

Subscribe

@VoxEU

RSS Feeds

Weekly Digest