Centre for Economic Policy Research
POLICY INSIGHT No.91
January 2018

Reconciling risk sharing with market discipline: A constructive approach to euro area reform

Agnès Bénassy-Quéré, Paris School of Economics and University of Paris 1; **Markus Brunnermeier**, Princeton University; **Henrik Enderlein**, Hertie School of Governance and Jacques Delors Institute Berlin; **Emmanuel Farhi**, Harvard University; **Marcel Fratzscher**, DIW and Humboldt University Berlin; **Clemens Fuest**, Ifo Institute and University of Munich; **Pierre-Olivier Gourinchas**, University of California at Berkeley; **Philippe Martin**, Sciences Po, Paris and Conseil d'Analyse Économique; **Jean Pisani-Ferry**, Bruegel, EUI, Hertie School of Governance and Sciences Po; **Hélène Rey**, London Business School; **Isabel Schnabel**, University of Bonn and German Council of Economic Experts; **Nicolas Véron**, Bruegel and Peterson Institute for International Economics; **Beatrice Weder di Mauro**, INSEAD and University of Mainz; and **Jeromin Zettelmeyer**, Peterson Institute for International Economics[1]

Jean Pisani-Ferry and Jeromin Zettelmeyer
Rome, 15 March 2018

Outline

1. Motivation
2. Financial issues
3. Fiscal issues
4. Institutional issues

1. Motivation

Where we stand today

1. Progress, but key euro area vulnerabilities remain.
    - Divisive and not very effectual fiscal framework
    - Bank-sovereign doom loop. No EDIS
    - Underprovision of stabilisation
    - One-size-fits-all approach to crisis mitigation (austerity + crisis lending)

- Papered over by ECB. But QE is ending

2. Euro area divisions on how to move ahead
    - Creditors vs. Debtors mindset
    - Antagonistic crisis narratives based on alternative models (Brunnermeier, James and Landau 2013)
    - Antagonistic views on how to move forward
        - “North”: country-level responsibiliy, “risk-reduction”
        - “South”: solidarity, stabilisation, risk-sharing

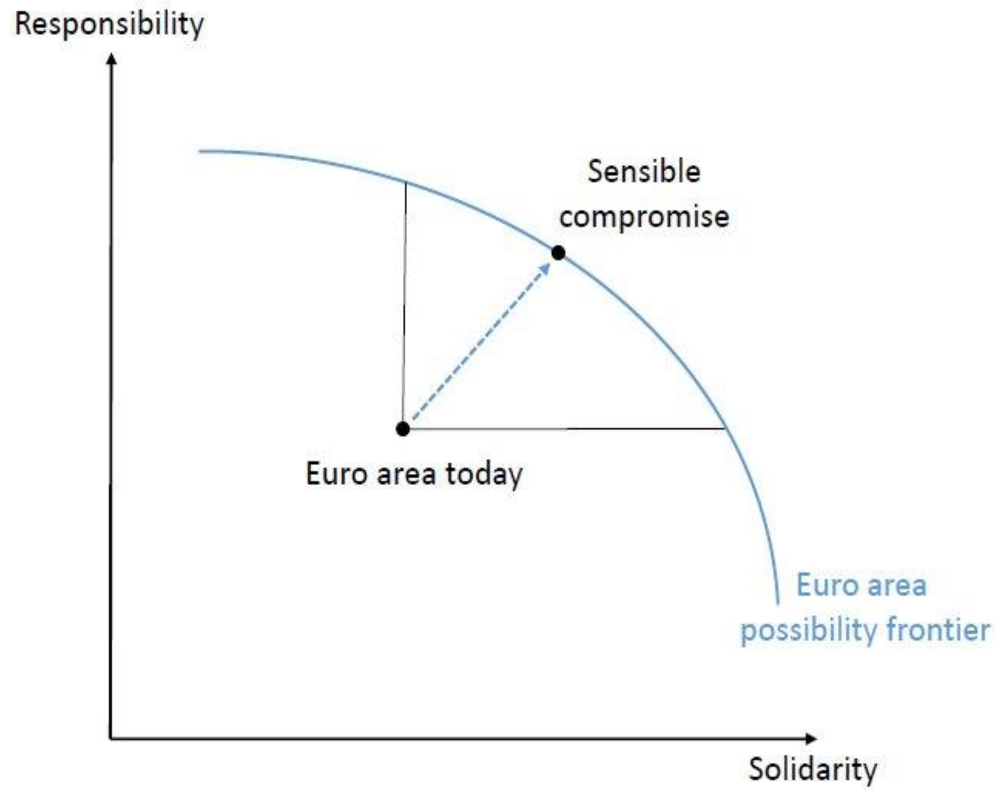
Aims of our report

- Propose a way to fix Euro area vulnerabilities that takes concerns of both sides on board
- Targeted to French and German governments. Why?
  - Their *rapprochement* is necessary, but not sufficient, for any progress on reforms
  - Window of opportunity after F+G elections.
  - Determines composition of our group (politically and nationally).
- Minimalist approach. Does not discuss
  - Euro-area political institutions
  - Euro-area public goods and budget
  - Economic convergence and long term growth (only indirectly)

Key idea: no trade-off between responsibility and solidarity

1. Current set-up unsatisfactory on *both* accounts -> room for improvement on *both*

2. Properly designed risk-sharing arrangements can *improve* discipline, because they make the no-bailout-rule of the Treaty more credible



The logic of the report

1. Absent full fiscal and political union, national policies exert fiscal and financial externalities exist that can threaten a currency union
2. One approach to dealing with these externalities: common rules, including fiscal rules. We need to improve these.
3. However, rules will always remain imperfect. This requires ”an anchor”: a fallback position for the exceptional case of national insolvency. Per the Treaty, this anchor is the no-bail out clause.
4. If the no-bail-out clause is empty (not credible), the system will fail (euro exit of crisis country, or euro exit of creditor countries)
5. To make no-bail-out credible, sovereign debt restructuring needs to be feasible when debt is unsustainable.
6. This requires a financial architecture which limits the disruptions of debt restructuring on the debtor and other countries – by reducing concentrated sovereign exposures of banks and through adequate risk sharing and stabilization mechanisms

Our proposals

1. Reform of fiscal rules, including of the enforcement device
   - Create expenditure rule (acyclical on discretionary spending)
   - Ditch politically decided sanctions, move responsibility to countries
2. More and better risk sharing
   - Financial sector reform (including deposit insurance, CMU)
   - Unemployment/employment reinsurance fund
   - Broaden conditions of access to ESM for pre-qualified countries
   - “Safe asset” based on diversified sovereign debt portfolio (e.g. ESBies)
3. A *targeted* role for market discipline
   - Enforcement of fiscal rule via issuance of subordinated (junior) bonds
   - Sovereign debt restructuring as a credible last resort when debt is clearly unsustainable
4. Clarify role of institutions
   - Review role of Commission, ESM reform, national fiscal councils

2. Financial Issues

Breaking the ‘doom loop’ for good

1. Reducing *concentrated* sovereign exposures
   - Require capital charge based on exposure to individual sovereigns (Sovereign Concentration Charges, Véron, 2017)
   - Induces diversification, but not necessarily aggregate reduction of sovereign exposure of the euro area banking systems
2. European deposit insurance
   - A single European entity. Unconditional equal protection of all insured deposits, regardless of country. *For the depositor*, equivalent to a fully mutualized entity.
   - *Within* this entity, a waterfall structure. Mutual compartment tapped once national compartments are empty.
   - Risk-based insurance premiums. Based on structural indicators such as the effectiveness of insolvency and foreclosure processes

A euro-area safe asset

- Create – or incentivize creation – of a euro area debt instrument backed by national bonds
- Safe due to a combination of diversification and seniority – no mutualization of risk. Example: ”ESBies” (senior tranche of sovereign bond backed securities)
- Advantages compared to simply imposing diversification:
  1. Creates large market for homogenous euro area debt.
  2. Safer. Much less potential for contagion across euro area.
  3. Reduces volatility of cross-border capital flows inside euro area.
- Possible risks: implicit guarantees (?), complexity.
- Requires careful design, accompanying regulation, pilot phase
  - See ESRB High Level Task Force Report published on 29.1.2018

3. Fiscal Issues

A better fiscal framework

Objectives

1. Better macroeconomic properites:
   - Medium term debt reduction *without procyclicality*
2. Fewer errors, easier implementation
   - Estimating potential output *level* in real time is very error prone (Claeys, Darvas and Leandro 2016).
3. Better, less conflict-prone surveillance and enforcement.
   - Abolish both micro-management from Brussels and current apparatus involving “escalation”/sanctions, political discretion.

Proposed solution: an expenditure rule, implemented primarily at the national level (national fiscal council), requiring excessive spending to be financed through junior bonds.

Implementation of the expenditure rule

1. 5 year D/Y reduction target
   - Based on distance to 60% and broader analysis of sustainability
   - *Proposed* by independent national fiscal councils; *Approved* by euro-area-level fiscal watchdog
2. Expenditure growth ceiling
   - Defined by national fiscal council based on 5 year D/Y target, potential growth projection, expected inflation, cyclical correction
3. Expenditure calculation
   - net of interest expenditure, non-discretionary changes in unemployment spending, revenue impact of tax changes
   - Monitored by national fiscal council
   - Implies governments free to increase spending provided they finance it
4. Expenditure above ceiling mandatorily financed with junior bonds
   - Legally subordinated
   - Automatically rolled over in case of ESM programme
   - Can be bought back when a country complies (up to annual ceiling)

Junior bonds

Features:

- Fixed maturity (5 years)
- Contain one-limb collective action clause
- Automatic 3-year maturity extension if ESM programme
- Specific, low exposure limit for banks

➢ Hence, more expensive than regular bonds.

Advantages over sanctions:

- Not just a deterrence instrument. Economically meaningful even ex post (protection of existing creditors).
- Risk premium will depend on reasons for rule violation; overall credibility of government fiscal and economic policies.
- No discretion, hence higher credibility.

A disadvantage:

- Risk premium also depends on market sentiment and risk aversion. May be too low in “risk on” times.

Making the no-bail-out rule credible

No-bail-out rule (which is still in the Treaty): no official lending to countries with unsustainable debts unless accompanied by sovereign debt restructuring.

Credibility requires:

1. Reducing financial and economic disruptions associated with debt restructuring. Requires reduction of concentrated sovereign exposures, better stabilization tools

2. A legal device to protect sovereigns against holdout creditors (CACs)

3. A more IMF-like ESM that is able to develop its own lending policies and stick to them

Dealing with the “transition problem”:

- Phase-in new polices. To apply only to new stock of debt, and only after new stock exceeds e.g. 60-90% of GDP
- Announce in good times (now)
- Announce in combination with risk-sharing reforms

Broader access to liquidity

Rationale: Response to future “sudden stops” should not rest on conditional assistance alone. Would involve risks of:

- Self-insurance (cash reserves)
- Underprovision of stabilization in downturns

Response: **Liquidity lines with ESM**

- For pre-qualified countries with strong policy record and compliance with the fiscal rule
- Low cost (no penalty rate), low trigger (if at all)
- Short-term (three years)

A reinsurance fund for large shocks

- Prequalification: requires meeting minimum standards of policy making (respect of fiscal rule, country-specific recommendations)
- Trigger: large increase in unemployment (e.g. 2 percentage points) or collapse in employment
- Payout: one-off transfer, e.g. 0.25% of GDP for each percent increase of unemployment above trigger level. Not repayable.
- Conditions related to use of funds (e.g. unemployment benefits, or public investment).
- National contributions depend on volatility of ”trigger variable”; experience rated. Order of magnitude: 0.1% of GDP per year of participating countries.

Incentives preserved through (1) prequalification, (2) reinsurance character, and (3) experience-rated contributions.

4. Institutional Issues

Clarify role of institutions: Reform of EU surveillance and crisis management process

1. Separation of “prosecutor” (watchdog) and “judge” (political).
   - Watchdog: needs to be politically independent. Could be achieved:
     - ➢ inside the European Commission (independent commissioner)
     - ➢ Outside, via fiscal council or ESM (would require treaty change).
   - Political decisions by Eurogroup, chaired by a Commission VP.
2. Upgrading of ESM to IMF-like institution
   - Fully responsible for design and negotiation of programmes and decisions on debt sustainability.
   - Operational independence.
   - Political accountability to European Parliament
   - Financial accountability to its shareholders, as now.

5. Conclusion

Conclusions

- Central idea:
    1. Risk-sharing arrangements can be designed to be consistent with good incentives.
    2. By creating such arrangements, one can make the no-bail-out rule credible and remove a source of division and political polarization.
- Consequence: complementarities across proposals. Maximum benefits reaped by implementing all
- This is a package – but this does not mean that everything needs to or should be implemented at the same time:
    - Frontload financial sector reforms
    - Fiscal rule can be improved independently of other reforms
    - When strengthening debt restructuring option, be mindful of the transition problem

Backup

Our diagnosis on the EMU fiscal framework

1. The **record of the SGP is disappointing**
   - **Technically** (structural deficits are neither reliable nor cycle-insensitive)
   - **Economically** (too stringent in hard times, too lax in good times)
   - **Politically** (pits national governments against “Brussels”)
2. The **no bail-out clause lacks credibility**
   - The no bail-out clause serves as **fiscal anchor** to monetary union
   - But it cannot be credible as long as restructuring remains a highly damaging nuclear option
   - Restructuring is **not desirable**, but it should be **feasible**
3. The EMU **lacks risk-sharing and stabilization**
   - Highly constrained stabilization at national level
   - No fiscal stabilization at euro-area level

Political economy features of new fiscal rule

- Easy to communicate and translate into budgetary decisions
- Individual responsibility
- Room for autonomy (subject to market assessment)
- Decentralisation of discipline to national fiscal councils
- No discretion (except in catastrophic circumstances)
- Market signal instead of politically hazardous sanctions

Annex 1: Concentration charges (calibration by N. Véron)

Concentration Charges

Pillar 1

Parsimonious scope: only concentration risk

- No sovereign risk-weights (unless future breakthrough in Basel)
- A euro-area solution to a euro-area problem: home bias in monetary union
- Thus: only concentrated euro-area exposures of euro-area banks

Adds second term to denominator or risk-based capital ratios, in addition to RWAs

- Limited extent of double counting

Exposures charged (weighted) based on concentration

- Based on exposure ratio = sovereign exposure / Tier-1 capital (for each country)
- SCC = 0 under exemption threshold set at 33% of T1
- Marginal SCC increases with exposure ratio

Bucket	1	2	3	4	5	6	7
Sovereign exposure ratio	< 33%	33%-50%	50%-100%	100%-200%	200%-300%	300%-500%	> 500%
Sovereign concentration charge	-	15%	30%	50%	100%	200%	500%

Calibration

Deter exposures above ~150% of T1
- Median haircut 37% (Cruces & Trebesch 2011)

Not reduce overall sovereign exposures

Not force overly complex diversification
- i.e. very small impact for exposures ~50%

Not cripple market-making

Exposure ratio (%)	Marginal SCC	Average SCC	Capital impact (bp) (Tier-1 ratio = 10%)	Capital impact (bp) (Tier-1 ratio = 15%)
50%	15%	5%	-3	-6
100%	30%	18%	-17	-38
150%	50%	28%	-41	-90
200%	50%	34%	-63	-138
250%	100%	47%	-105	-225
300%	100%	56%	-144	-301
350%	200%	76%	-211	-430

Transition

Long phase-in

– One bucket per year, starting from last

Bucket	1	2	3	4	5	6	7
Sovereign exposure ratio	< 33%	33%-50%	50%-100%	100%-200%	200%-300%	300%-500%	> 500%
Sovereign concentration charge	-	15%	30%	50%	100%	200%	500%

Grandfathering

– All debt issued before cutoff date

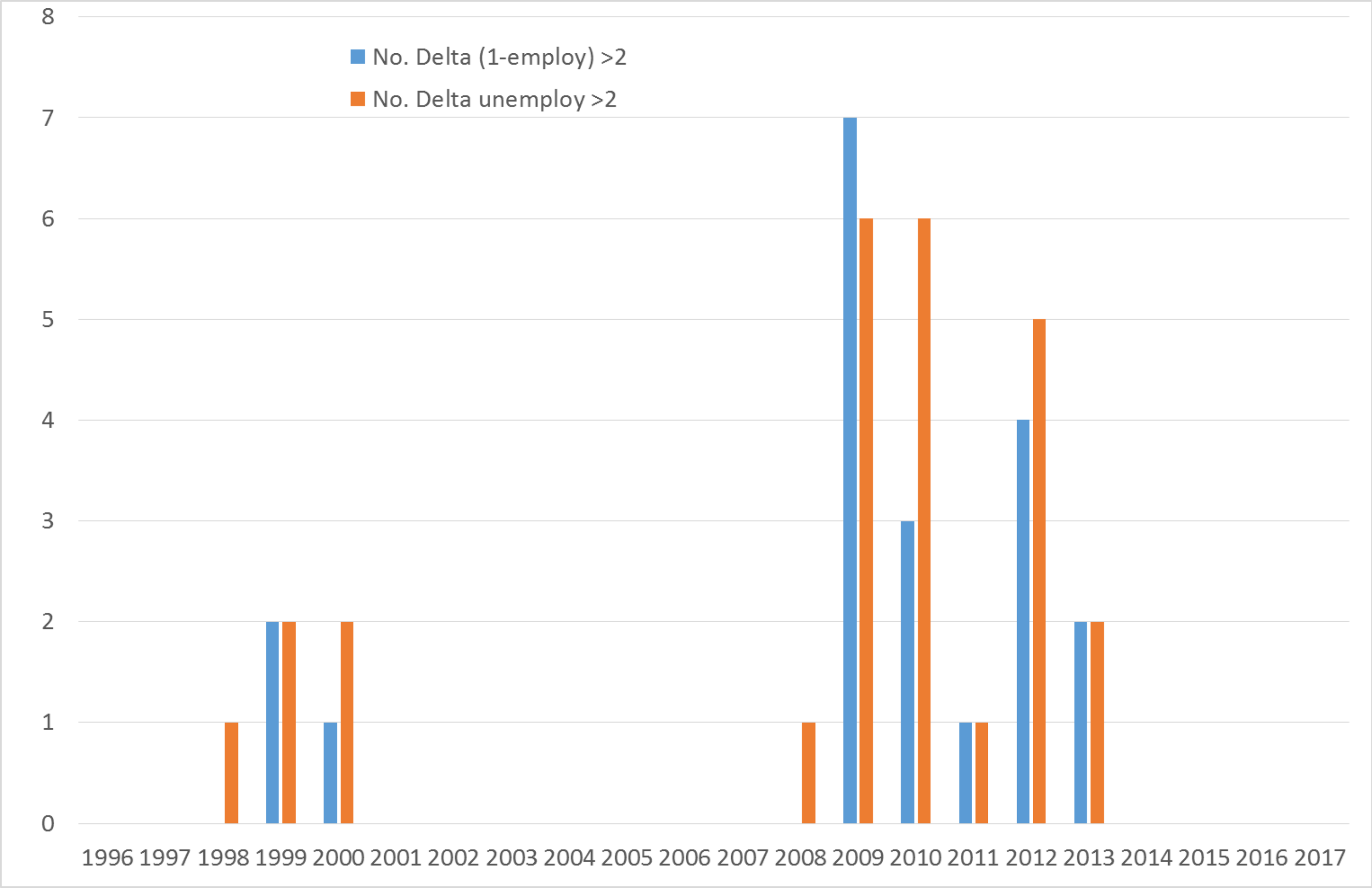
– Sunset clause at 10 years?

Extensive consultation (no Deauville)

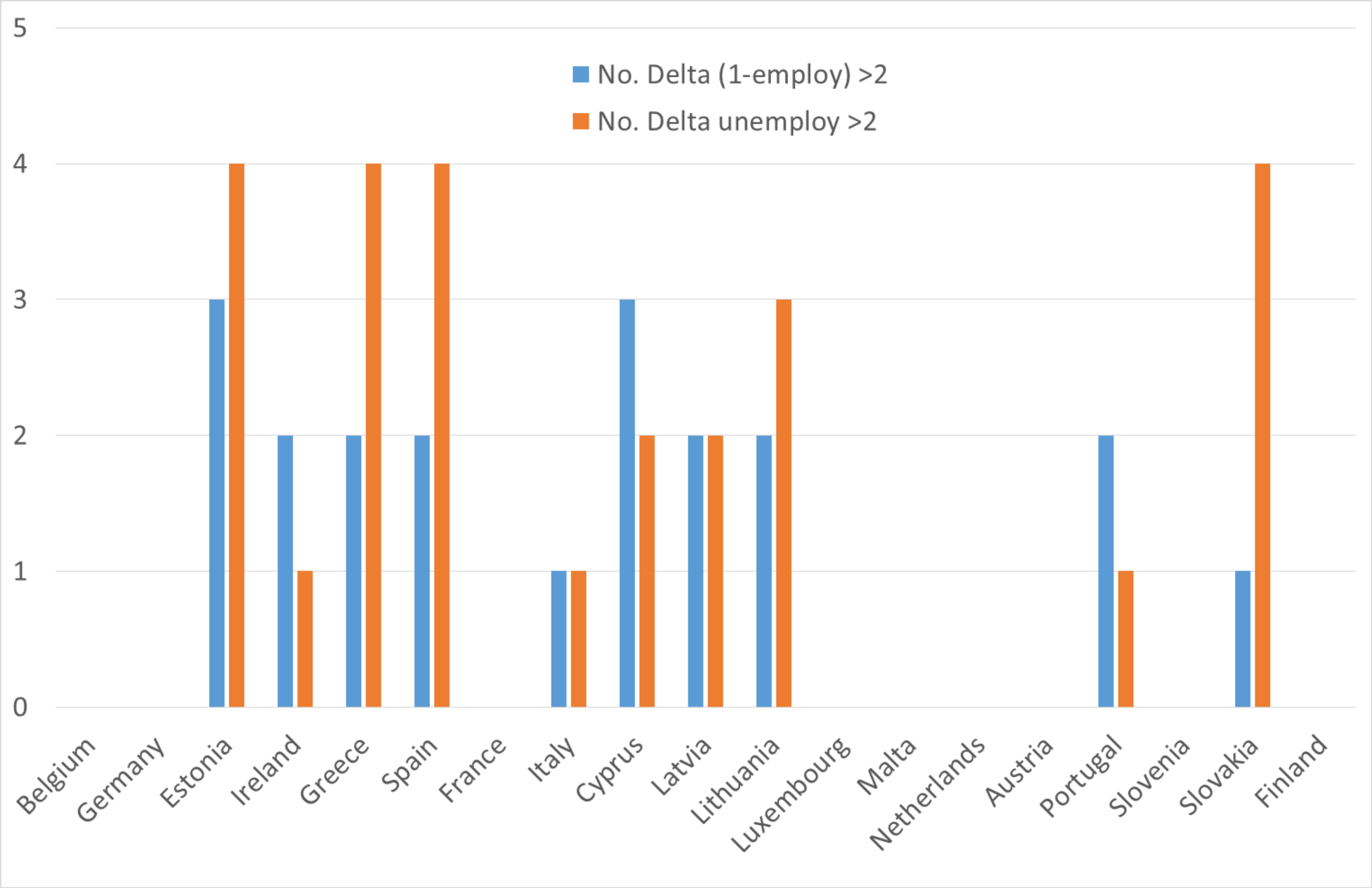
Risk of “front-loading”?

Annex 2: Stabilization fund

A reinsurance fund: frequency of payouts



A reinsurance fund: countries benefitting



A reinsurance fund: size of fund (1.0% payout)