

Counterproductive Proposals on Euro Area Reform by French and German Economists

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Summary

In their CEPR Policy Insight No. 91, Bénassy-Quéré et al. (2018) offer a comprehensive and sophisticated attempt to bridge the gap separating French and German policy-makers on European Economic and Monetary Union by completing Banking Union and establishing a credible system to enforce budgetary discipline and bring down sovereign debt-to-GDP ratios.

Our comparison between Bénassy-Quéré et al. and Schäuble's October 2017 non-paper – which we have taken as the unmitigated expression of the German *ordoliberal* view – indicates a quasi-complete coincidence of policy recommendations. Prior sovereign debt restructuring is at the centre of the proposed new governance arrangements, a sure harbinger of renewed instability. The understandable concern to establish a harder budget constraint on national fiscal policies has in our view been pushed too far.

Even more worrisome, in their quest to uproot moral hazard, Bénassy-Quéré et al. propose to eliminate from the euro-area governance arrangements all room for meeting shocks with liquidity instruments. They want banks to be “structurally” excluded from purchasing own national sovereigns in situations of distress. And they want to all but remove the financial stability exceptions for the activation of bail-in in the Bank Recovery and Resolution Directive (BRRD) and the related provisions for state aid to the banks. They would thus create an environment in which any idiosyncratic shock hitting a highly-indebted country would push it into the arms of the European Stability Mechanism (ESM), where its sovereign debt would be mercilessly restructured before any financial assistance could be considered.

Investors would no doubt take notice and flee well in advance. Their proposed new lending window at the ESM does not address this issue since the new facility is limited to member states that are not at risk of losing market access.

Thus, far from succeeding in their stated goal of making the euro area more stable, these proposals heighten the risks of financial instability and weaken euro area defences against financial shocks. Therefore, in our view they do not offer a basis for a viable compromise on the future governance of the euro area between France, Germany and the other member states of the euro area.

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1. Introduction

In their CEPR Policy Insight No. 91, Bénassy-Quéré et al. (2018) – henceforth PI 91 – offer a comprehensive and sophisticated attempt to bridge the gap separating French and German policy-makers on European Economic and Monetary Union (EMU) by completing Banking Union and establishing a credible and lasting system to enforce budgetary discipline and bring down sovereign debt-to-GDP ratios to manageable proportions. As we will argue, however, their proposals heighten the risks of financial instability and weaken euro area defences against financial shocks, potentially opening the way to a renewed existential crisis of the common currency.

To facilitate the discussion of highly complex arrangements, we have found it expedient to compare the proposals in PI 91 with those contained in the ‘non-paper’ circulated by the former German Minister of Finance, Wolfgang Schäuble, to his colleagues in the Eurogroup just before moving to his new post as Chairman of the Bundestag.¹ The non-paper provides an unmitigated expression of the German *ordoliberal* view, whereby the euro area financial stability depends on making individuals and countries accountable for their actions, avoiding the *moral hazard* implicit in any ‘lending of last resort’ intervention or debtor bail out and adopting binding fiscal rules on public debts and deficits to shield monetary policy from fiscal dominance. This view has always been opposed by leading policy circles in France since the start of European monetary cooperation. In the French view, rules should always be subject to political review, crisis management requires flexibility and discretion in the application of rules and, in a world of multiple equilibria, common policy rules should not push the economy onto a perverse path of low growth and financial instability.²

The results of our exercise, summarised in the table below, is that the proposals in PI 91 do not differ in substance from Schäuble’s on the critical issues of financial stability in the euro area and the balance between risk reduction and risk sharing, and in some respects are even more rigid. This is illustrated in the table with respect to four policy areas – Banking Union, the tasks of the European Stability Mechanism (ESM), sovereign debt policies and fiscal discipline. Therefore, we doubt that PI 91 can offer a basis for compromise between the French and the German positions or, more broadly, for an acceptable balance between risk sharing and risk reduction in the forthcoming negotiations within the Eurogroup.

Before turning in detail to these four policy areas, we will briefly discuss the nature and sources of financial instability in the euro area, which is of paramount importance in deciding the proper economic governance for decisive progress in Banking Union and EMU.

2. Financial instability and redenomination risk in the euro area

Several years have passed since the 2010-12 crisis that almost broke the common currency, and yet financial fragmentation persists in the euro area, hindering economic convergence and the implementation of Capital Markets Union (CMU). One dire consequence of financial fragmentation is that it feeds home bias in investors’ portfolios and hampers private risk sharing through cross-

¹ Schäuble (2017).

² For a discussion of the cultural roots of the different French and German approaches, see Brunnermeier et al. (2016).

border banking and capital markets transactions. Another consequence is that fragmentation hinders the redeployment within the euro area of the enormous external surpluses accumulated by Germany, the Netherlands and other member states in their external accounts.

Financial fragmentation is visibly driven by political uncertainty (European Central Bank, 2017, Micossi, 2017). It worsened in 2016, as the expected results of general elections in Austria, the Netherlands and France and the Brexit referendum raised the spectre of Europhobic populist forces winning the day and calling into question the future of Europe. It has receded in 2017 and early 2018, with the general improvement in the political climate after Macron's resounding victory and the likely *groko*³ agreement in Germany, but has not disappeared; and Italian elections in early March 2018 may give rise to a new phase of uncertainty leading to widening interest rate spread against domestic sovereigns (Bastasin & Messori, 2017).

The European crisis of 2010-13 provides egregious confirmations of this view. The (in)famous Deauville announcement by Merkel and Sarkozy in October 2010, that private sector participation in the losses on sovereigns would become a permanent component of the new crisis management procedures, prompted a run by investors that toppled Ireland and Portugal and spread contagion to Spain, Italy and even France. The 2012 announcement by Mario Draghi that the European Central Bank (ECB) would have done "whatever it takes" to halt speculation against sovereigns ended distress in sovereign markets without spending a single penny in market interventions. Brunnermeier et al. (2016) hint at the possibility that in certain phases Germany may have consciously used public statements to raise market pressure on fellow euro-members and forced them to swallow tighter budgetary policies.⁴

The fundamental variable driving these oscillations in investors' views is *redenomination risk*, the risk that at some stage a given member state cannot service its sovereign debt and is forced out of the common currency. Redenomination risk depends to an important extent on the fact that additional liquidity might not be available to counter market pressures in case of distress, as its deployment requires a consensus within the governing board of the ECB. Therefore, a temporary liquidity shock on a sovereign market may turn into a solvency crisis.⁵

³ The *große koalition* between the CDU/CSU and the SPD.

⁴ On this see also Carmassi & Micossi (2010).

⁵ On the expectation-driven 'doom loop' between sovereign debts and banking crises in 2010-11, see Baldwin & Giavazzi (2015). For an analytical framework with multiple equilibria, see De Grauwe (2011). The theoretical conditions for exit and contagion in a monetary union are studied by Canofari & Messori (2018).

Comparing proposals for reforming euro area governance

Schäuble	French and German economists
<i>Banking Union</i>	
<ul style="list-style-type: none"> a. Significant risk reduction necessary, including regulatory disincentives for sovereign bond holdings by banks b. ESM back-stop for Single Resolution Fund (SRF) but not for a European Deposit Guarantee Scheme (EDIS) 	<ul style="list-style-type: none"> a. Stepped-up SSM powers on NPLs (non-performing loans) and removal of national options and discretion b. Concentration charges to reduce large sovereign exposures c. Stronger bail-in provisions and reduced financial stability exceptions in BRRD d. Power to directly manage bank resolution assigned to SRB e. Elimination of buffer role of banks in cushioning distress in sovereign bond market f. EDIS with country-risk-related fees and no mutualisation of losses; mutualised compartments only for systemic crisis
<i>ESM tasks</i>	
<ul style="list-style-type: none"> a. ESM core purpose: to bail-out countries in severe troubles b. ESM entrusted with full crisis prevention and crisis management powers c. Financial back-stop for SRF (€55 billion) after significant bank risk reduction d. Elimination of the direct bank recapitalisation window 	<ul style="list-style-type: none"> a. ESM to help countries only when they have lost or may lose market access b. Full responsibility for crisis lending and related policy conditionality to the ESM c. Financial back-stop for SRF d. Lending facility for national EDIS compartments after exhaustion of funds, conditional on asset quality review
<i>Sovereign debts</i>	
<ul style="list-style-type: none"> a. Obligation to carry out comprehensive debt restructuring if necessary to ensure debt sustainability b. Extension of maturity of sovereign bonds in case of an ESM assistance programme c. Amend collective action clauses to move to 'single limb aggregation' (one vote on all debt restructuring bond involved) d. No common safe assets 	<ul style="list-style-type: none"> a. Crisis mitigation in ESM Treaty to include early debt restructuring b. Debt restructuring in case of resort to ESM when debt sustainability is uncertain c. Obligation to issue junior bonds when expenditure ceiling is exceeded, also with automatic maturity extension in case of ESM support d. Privately issued safe asset: European Safe Bonds (ESBies)
<i>Fiscal discipline</i>	
<ul style="list-style-type: none"> a. Increased ownership in the implementation of structural reforms, with support from the EU budget b. Link policy coordination (European semester and CSRs) with cohesion policy and EU budget c. Macroeconomic stabilisation function not necessary 	<ul style="list-style-type: none"> a. Fiscal rules centred on sovereign debt reduction <i>cum</i> ceiling on public expenditure; managed either by national fiscal councils and European Fiscal Board or by the ESM b. Rainy-day fund to provide one-off transfers for large labour market shocks, subject to <i>ex-ante</i> policy conditionality and automatic trigger based on employment indicator

The paradox is that governance arrangements that limit the availability of liquidity to counter financial shock are likely to increase financial fragmentation, thus reducing private risk sharing in capital markets and raising the risk of a need for public bail-out (Micossi, 2017). PI 91 flatly ignores this paramount issue and hardly mentions redenomination risk. For this reason, rather than making the euro area more resilient, its proposed governance architecture would likely increase its fragility.⁶ A brief review of the four sections in our table will illustrate the point.

3. Banking Union

On Banking Union (BU), the Schäuble non-paper is rather skimpy, advocating significant risk reduction in banks' balance sheets and "the regulatory treatment of sovereign bonds", and excluding any ESM support for the 'last resort' financing of bank resolution. ESM support for the cross-border European Deposit Insurance Scheme (EDIS) is not even mentioned. PI 91 goes much further. It suggests strengthening the powers of the Single Supervisory Mechanism (SSM), to exclude national options and discretion, and entrusting the management of bank resolution directly to the Single Resolution Board (SRB); and we agree with these proposals. However, we cannot entertain the further request in PI 91 to all but remove the financial stability exceptions in the BRRD, notably in the activation of bail-in and the related provisions for state aid to the banks.⁷

We find the latter suggestion unacceptable. The financial stability exception is already circumscribed to exceptional circumstances of a systemic nature, and the judgement on whether to grant the exemption is firmly in the hands of European institutions. Were this possibility and the related state aid to be unduly restricted, the European institutions and the national governments might be unable to confront an idiosyncratic shock with a systemic impact – almost by definition such an eventuality cannot be handled by looking at individual banking institutions on a case-by-case basis. In certain circumstances, it is also possible that systemic instability might be triggered by the EU policy action, e.g. when the application of bail-in within a fragile banking system may scare off investors and unduly depress all bank stock valuations (Micossi, 2016).

Under PI 91, banks' large exposures towards national government bonds would have to be reduced to bring the 'doom-loop' between sovereigns and banking risks under control. This proposal to introduce prudential-risk concentration charges has merit and should be heeded, as we have argued elsewhere (Micossi, 2017), especially if it granted full exemption from the charges for sovereigns held to meet the new Basel III Liquidity Coverage Ratio (roughly equivalent to 100% of bank capital; see Enria et al., 2016). We leave aside the fact that the introduction of these charges would require legislation amending the CRD IV. It is instead important to stress that its possible implementation would have to be flexible and be entrusted to the ECB on a case-by-case basis, as suggested by Bini Smaghi (2018), and perhaps also require the involvement of the ESM as purchaser, as discussed below.

⁶ In this regard, PI 91 pays lip service to the need to establish fully integrated European financial markets under the Commission's CMU programme. This appears in fact to contradict many policy recommendations by PI 91 and would likely perpetuate market fragmentation.

⁷ On state aid, the authors of PI 91 seem unaware that a Treaty provision – such as that in Article 107.3(b) TFEU – cannot be modified or limited in its scope either by the Commission guidelines (August 2013) on the application of state aid to banks, or even by a Directive.

On the other hand, it is difficult to accept the view – as suggested by PI 91 – that concentration charges should become a tool to ‘structurally’ prevent banks to use their sovereigns as collateral to obtain access to their ECB (emergency) credit facilities in conditions of special distress. In 2011-12 this channel played an important role in limiting the credit crunch in countries under distress as foreign private capital flows dried up (Micossi, 2015); had it not been available, economic dislocations could have been even more devastating.

Finally, the central PI 91 proposition on EDIS is to continue imputing banking losses to national compartments even in the final stage, as well as to charge banks with deposit insurance fees reflecting country risk. Both these features would be counterproductive as they would perpetuate the stigma on weaker national banking systems with attendant country-risk premium, thus perpetuating market fragmentation and frustrating the fundamental goal of Banking Union to make banks and their deposits equally valued across the euro area and the European Union. The purpose of EDIS is to limit fears among depositors and investors of an idiosyncratic shock hitting one national banking system; its confidence-building effects would be much weakened under PI 91 provisions.

A more constructive approach has been outlined by the European Commission (2017b), namely to jump-start EDIS by excluding risk sharing in an initial phase while making available to national deposit insurance schemes an ESM liquidity line, to be tapped after they had exhausted their funds. Loss sharing would only be envisaged in subsequent phases; transition to loss-sharing would be preceded by a fresh asset quality review to ascertain whether banking risks had been sufficiently reduced.

4. ESM tasks

On ESM tasks, Schäuble and PI 91 are fairly well aligned, despite some minor differences. Their main common point is to transfer the full responsibility for crisis lending to the ESM, thus eliminating the present Commission role in defining structural disequilibria of a member state, proposing consequent adjustment programmes and implementing them after Council decision. ESM lending should be limited, as a rule, to countries that have lost or risk losing market access. PI 91 adds that requirement that the ESM’s programmes have to be approved by its shareholders, i.e. the member states. On the other hand, it envisages that, in order “to increase the operational independence of the ESM”, the Board of Directors of the latter “should operate at arm’s length from the governments that appoint them” (p. 20). The implication is that PI 91 makes the ESM a direct instrument of creditor countries. It is utterly unclear to us how this could ever lead to greater democratic accountability vis-à-vis the European Parliament.

PI 91 maintains that when there is a ‘significant risk’ that a European assistance programme might not suffice to restore solvency, the ESM will have to insist on debt restructuring by means of private-sector involvement. We will come back to the potential destabilising effects of this approach, if not properly designed. What must be noted here is that such a need for public debt restructuring would be assessed “based on a data-driven method that can be reproduced and checked by the public”. Once again, one sees a quest for an objective and quasi-automatic assessment that is able to bypass policy judgement and discretion – as if public debt sustainability

could be ascertained independently of the adjustment policy package and the financial means required for an orderly roll-over of the outstanding debt stock.

The rigidity of PI 91's provisions on ESM lending are somewhat mitigated by the proposal to establish an additional lending facility to assist member states that are not at risk of losing market access and that pose no imminent stability risk to the euro area. Access to this facility is conditional on a policy record of the country potentially involved that is so stringent that any actual use appears rather unlikely. What is more interesting is that PI 91 (p. 16) goes on to state that "ESM borrowing through this window ... would not trigger the automatic re-profiling of the junior sovereign bonds". This statement makes it clear that ESM lending would be normally subject to some prior debt restructuring.

Both Schäuble and PI 91 accept that the ESM should stand as a backstop for the Single Resolution Fund (SRF) after an appropriate risk reduction, but do not want ESM to perform the same function for EDIS – thus crippling the role of EDIS in taming fears of a systemic shock hitting a national banking system. On this, PI 91 concedes that the ESM might lend money to national compartments that have exhausted their funds. Obviously, this falls well short of a loss-absorbing backstop.

5. Sovereign debts

While the Schäuble non-paper is straightforward on the requirement that ESM assistance be accompanied by sovereign debt restructuring, PI 91 maintains some ambiguity as to the circumstances that would trigger restructuring. The French-German paper states "the ESM should [...] develop its own criteria for deciding when there is a significant risk that an assistance programme might not restore solvency to a crisis-struck country" (p. 13). Moreover, whether this is the case would be decided with a "data-driven method". Finally, the decision would be taken prior to the extension of financial assistance. Therefore, the authors of PI 91 seem to be seeking a quasi-automatic trigger of restructuring based on quantitative indicators. The latter implication is not explicitly stated; however, as was recalled, a statement on p. 16 indicates that ESM lending would normally entail some debt restructuring.

In a recent Vox column, Tabellini (2017) summarises the main arguments against prior debt restructuring for countries under distress. On the one hand, there is no evidence that over-borrowing by countries is worsened by moral hazard; on the other, any prior debt restructuring mechanism would likely set in motion destabilising speculation – which is precisely what happened after the Deauville announcement by Merkel and Sarkozy. In addition, Tabellini notes that debt restructuring is hard to achieve: collective action clauses (CAC), meant to facilitate restructuring, lead to the opposite as CAC bonds yield a lower return than comparable bonds without CAC.

PI 91 is aware of the danger that prior debt restructuring clauses might prove destabilising and recognises the need for appropriate 'transition arrangements' to mitigate this danger. Eventually, they acknowledge that the efficacy of such mitigation devices is questionable and may entail perverse incentives, and their solution boils down to a suggestion to delay the entry into force of the restructuring mechanism.

A separate but related question, addressed by both PI 91 and Tabellini (2017), is how to design arrangements that would create sovereign equity-like borrowing instruments able to absorb losses in case of adverse events affecting debt sustainability. The effect of these instruments would be to

introduce a seniority structure for outstanding sovereigns that could reassure investors that restructuring would not involve senior debt. Tabellini's preferred scheme involves issuing bonds indexed to GDP,⁸ while PI 91 takes up the accountability bonds proposed by Fuest & Heinemann (2017). Accountability bonds would need to be issued by a euro area member that is exceeding its public spending targets. Both schemes could be useful – provided however that their issue contract specified clearly the restructuring clauses and these excluded any other reason for restructuring.

While this is the case for Tabellini's scheme, as has been described, PI 91 junior bonds would leave open the possibility of broader restructuring affecting the total debt stock, following a decision by the ESM. Moreover, since member states would be required to issue junior bonds as a sanction after violating the expenditure rule, investors might well read the sanction as a promise of greater trouble in the future, and hence raise interest rate premia on all outstanding sovereign bonds of that country, thereby precipitating a fiscal crisis.

One aspect where IP 91 differs from Schäuble's non-paper is in the proposal to make available a safe asset that could become the vehicle for banks' portfolio diversification and set in motion, more in general, a smooth process of portfolio substitution entailing some risk sharing by private investors. An ESRB high-level task force has recently re-proposed the underlying scheme, which entails the pooling and tranching of euro area sovereigns in securitised structures providing for the creation of a 'safe' (low-risk) senior tranche that banks could purchase to de-risk their balance sheets (ESRB, 2018). The scheme is ingenious and does not entail any mutualisation of sovereign risks; however, so far it has failed to elicit broad support by investors. S&P Global Ratings (2017) has examined the safe tranches of the securitised structure and has concluded that it would command a rather low rating, due to the small number of securities involved and the high correlation between their risk levels.

Moreover, it is unclear to us that any such scheme can fly without some support from EU/euro area institutions. One possibility would be to envisage a first-loss guaranty on the senior tranches, perhaps provided by the EU budget; another one would be to open an ESM facility where banks could exchange their excess sovereigns either with 'safe' ESM bonds (again, with appropriate guarantees against first losses, see Micossi, 2017) or with a simple ABS (asset-backed security) composed of the k-capital portions of the euro-area government bonds.⁹

6. Fiscal discipline

On fiscal discipline, besides the recommendations already discussed for prior debt restructuring and junior 'accountability' bonds, PI 91 proposes to adopt a simpler governance system centred on a debt rule underpinned by a public expenditure ceiling over the medium-term. The system has merits and deserves consideration, although its impact in simplifying current arrangements must be demonstrated.¹⁰ Since the Six Pack and the Two Pack already contain provisions placing

⁸ On GDP-linked bonds, see also Barbieri Hermitte (2018).

⁹ In this last case, ESM would play the role of a 'clearing house' (see Messori, 2017).

¹⁰ For one thing, the new system would still require calculating the potential growth rate of the economy, which is not much different from calculating the output gap that has led to endless controversies in the present system. In addition, agreeing on the proper definition of public expenditures would likely reopen the discussion on the need to exempt public investment

emphasis on public expenditure and the potential growth rate, conceivably the new system could evolve out of the present one in that direction in the implementation of the Stability and Growth Pact (SGP).

PI 91 also recommends the introduction of a rainy-day stabilisation fund for large labour market shocks, a suggestion also advocated in various forms by the European Commission (2017a) and some member states. At the same time, PI 91 does not pick up Schäuble's idea to link access to cohesion and structural funds to progress in structural reforms, thus for once taking a softer approach.

However, governance arrangements that are proposed for the new system immediately dispel this impression. The key point is that under PI 91 the fiscal targets would be set by independent technical bodies, i.e. national fiscal councils and the European Fiscal Board control; monitoring and enforcement would be entrusted to the ESM or to a new independent watchdog established within the European Commission. The transparent objective is not only to exclude the Commission from any role in negotiating policy goals with member states within the European Semester procedures, but also to wrest control of the process from the hands of national parliaments. Technocratic control of national budgets is of course the cherished dream of well-meaning economists, but it is not likely to happen (Bini Smaghi, 2018).

7. Concluding remarks

In September 2017, almost the same group of authors as in PI 91 issued an open letter advocating a Franco-German compromise to move forward with EMU (Bénassy-Quéré et al., 2017). The main message was clear: a compromise between France and Germany would require the acceptance of greater risk sharing by Germany and greater fiscal and market discipline by France. Seven Italian economists reacted favourably to the open letter but stressed that a feasible compromise should abandon the idea of prior debt restructuring as analytically faulty and utterly destabilising (SEP Economists, 2017).

In publishing PI 91, we believe that the authors were motivated by the laudable intention of expanding the common ground and broadening the space for compromise. This is evidenced by the fact that they stress in the first three sections their aim of finding a compromise between risk mitigation and risk sharing by avoiding liquidity stress and by allowing domestic policies to exercise "greater flexibility". In the final analysis, however, PI 91 has gone precisely in the opposite direction. Our comparison between PI 91 and Schäuble's non-paper – which we have taken as the unmitigated expression of the *ordoliberal* view – indicates a quasi-complete coincidence of policy recommendations. Not only is prior sovereign debt restructuring positioned at the centre of the proposed policy recommendations, a sure harbinger of renewed instability. Even more worrisome, in its quest to uproot moral hazard, PI 91 wants to eliminate from the euro-area institutional arrangements all room for meeting shocks with liquidity instruments. Such a move would surely create an environment in which any idiosyncratic shock would push a country under distress into the arms of the ESM, where its sovereign debt would be mercilessly restructured before any

(or at least investment certified to yield a return higher than its financial cost) from the expenditure ceiling (Bini Smaghi, 2018).

financial assistance could be considered. Investors would no doubt take notice and flee well in advance.

Quite obviously, PI 91 cannot serve as the basis for a balanced compromise to complete EMU between Germany, France, Italy and the other euro area partners.

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