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]

FBF online seminar, 15 February 2018

Outline

- Objectives and Strategy
- Key proposals
  1. Breaking the “doom-loop” between banks and sovereigns
  2. Reform of fiscal rules
  3. Making the no-bailout-rule more credible
  4. A euro area safe asset
  5. A reinsurance fund for large economic disruptions
  6. Reform of EU institutions
- Conclusion

What we are trying to fix

1. Underdeveloped private and public risk-sharing (for a currency union)
   - Limited financial integration, lack of fiscal stabilization tools,
2. An inefficient and politically divisive approach to maintaining fiscal discipline
   - Based on fiscal rules that are error-prone, procyclical, require micromanagement from Brussels, and are hard to enforce.
   - No device to effectively enforce the no-bailout clause. Implies overreliance on rules and a potential big inefficiency ex post.

But can risk sharing be improved without undermining discipline? *Answer*: Emphatically Yes.

- ➢ Properly designed risk sharing arrangements *improve* discipline, by making no-bail-out rule easier to enforce.

How we propose to fix it

1. Reform of fiscal rules (including enforcement device)
   - Expenditure rule: inherently acylical. Ditch sanctions
2. A targeted role for market discipline
   - Enforcement of fiscal rule via issuance of subordinated bonds
   - More credible no-bail-out rule (sovereign debt restructuring as a credible last resort ***when debt is unsustainable***)
3. 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)
4. Strengthen role of institutions
   - National fiscal councils; ESM reform

The logic of the report

1. Fiscal externalities are important in a currency union
    - monetization risk, redenomination risk
2. Absent full fiscal union, these externalities cannot be fully dealt with by fiscal rules and other coordination devices.
3. This requires ”an anchor”: a fallback position in case these devices fail. In the EU treaty, this anchor is the no-bail out clause.
    - alternative anchor: euro exit. Destabilizing and undesirable.
4. The no-bail-out clause is empty (not credible) unless sovereign debt is actually restructured when debt is unsustainable.
5. Need a financial architecture which limits the disruptions of debt restructuring on the debtor and other countries – by reducing bank exposures to their own sovereign, and through adequate risk sharing and stabilization mechanisms

What is really new?

1. The logic of step 5 above.
    - In the past, there have been calls for stricter enforcement of the no-bailout-clause and calls for more risk sharing, but no attempts to link the two.
2. An attempt to address both moral hazard and financial stability concerns that currently block euro area reform, via:
    - ➢ The design of some proposals, including:
        - European deposit insurance
        - regulatory treatment of sovereign exposures,
        - The "debt restructuring regime"
    - ➢ The balance and sequencing of various proposals.

Outline

- Objective and Strategy
- Key proposals
    1. Breaking the “doom-loop” between banks and sovereigns
    2. Reform of fiscal rules
    3. Making the no-bailout-rule more credible
    4. A euro area safe asset
    5. A reinsurance fund for large economic disruptions
    6. Reform of EU institutions
- Conclusion

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

Replace SGP by an expenditure rule managed mostly at the national level

1. National fiscal councils:
   - define medium term (e.g. 5 year) D/Y reduction target based on distance from 60% D/Y, but also broader analysis of fiscal sustainability
   - forecast medium-term potential output growth
2. Expenditure growth ceiling = potential output growth + inflation target + debt correction (+ possible initial cyclical correction)
3. Expenditure calculated net of non-discretionary changes in interest expenditure, unemployment benefits and changes in tax rates/administration.
4. Limited deviation between budgeted and actual expenditure absorbed by an “adjustment account” (max. deficit: 1% of GDP).

A better way to enforce the expenditure rule

- Abolish current apparatus involving "escalation"/sanctions
- Expenditures in excess of ceiling must be financed by the issuance of "junior bonds" that are:
  1. Legally subordinated
  2. Subject to automatic maturity extension in case of ESM program
  3. Subject to capital charge and a low maximum exposure limit.
- Advantages compared to current system.
  1. No discretion (except in catastrophic circumstances). Therefore, more credible, less politically costly.
  2. Not just a deterrence instrument. Economically meaningful even ex post (protection of existing creditors).
  3. Extent of "market sanction" will depend on reasons for rule violation and overall credibility of government fiscal and economic policies

Making the no-bail-out rule credible

No-bail-out rule: no official lending to countries with unsustainable debts unless accompanied by sovereign debt restructuring. 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
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.

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

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.

Reform of EU surveillance and crisis management institutions

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.

Conclusion

- 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 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