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In the euro area, discipline is of the essence, but risk-sharing is no less important

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A more robust euro area demands a reconciliation between rules and discipline on one hand, and risk-reduction and risk sharing (private and public) on the other hand. Risk-sharing is to be designed in such a way as to reduce moral hazard while, simultaneously, considering asymmetric shocks, different strengths of national budgets and of member states' economies, all of which do vary over time. An adequate calibration between rules and risk-sharing, between private and public risk-sharing, is an open question. Only private risk-sharing schemes would not make the euro area more robust since financial markets are too fickle and produce systemic risks recurrently.

[1] The text presents personal views and should not necessarily be interpreted as the position of the NBR.

A significant economic recovery in the euro area (EA) has been underway in recent years. Nevertheless, major challenges still remain as the Banking Union (BU) is incomplete and the EA is not yet robust enough when it comes to its tools and policy arrangements. This reality is acknowledged by high-ranking European officials and key official documents (the Five Presidents' Report of 2015, the European Commission's Reflection Paper of 2017, etc) as well.

In the economies in distress, corrections have been made by implementing belt-tightening programmes and external balances have been restored to *equilibrium*, yet at the cost of an upsurge in unemployment; external imbalances have been *internalised*, thereby putting pressure on the social fabric and the political domestic setups. Banks, in general, are better capitalised, but the size of overall debt afflicts their balance-sheets. It should be pointed out that the current economic recovery, which includes a cyclical component, is largely reliant on ECB's non-standard policies, i.e. very low interest rates and purchases of sovereign and corporate bonds. A new economic downturn will be felt again quite painfully in the EA if adequate policy arrangements are not put in place.

1. Two approaches to the reform of EA functioning

The euro area removed the currency risk, which was a big headache for the countries that formed the EU and sought deeper economic integration. The crisis of the Exchange Rate Mechanism (ERM1) speeded up the preparations for euro introduction. While, prior to the EA creation, external imbalances were corrected mainly via exchange rate adjustments (which fanned inflation) and budget cutbacks, adjustments during the current crisis have taken place via "internal devaluations", whose costs are not necessarily lower[2]. Hence, trying to mend the EA functioning is more than warranted.

EA reforms reveal essentially two approaches[3]. One approach emphasises financial discipline and rules. In a narrow sense, this approach boils down to balanced budget executions throughout the business cycle; in a broader sense, it implies rules that would not allow public and private imbalances to get out of control. But the financial crisis that erupted a decade ago has revealed vulnerabilities in the EA that cannot be attributed to soft budget/financial constraints alone; resource allocation in a monetary union which features large development gaps among member states comes into play strongly. This is why the emergence of bubbles and their subsequent effects have to be considered. The other approach to reforms focuses on "risk sharing" within a union which is marked by heterogeneity, by member states' uneven capacity to absorb shocks. The EA is pretty diverse in this regard and the non-existence of key policy tools (e.g., an autonomous monetary policy and own lender of last resort) can be a big nuisance. The fact is that, except for Greece, wide imbalances in some EA countries were caused primarily by private indebtedness, by cross-border capital flows in search of higher yields that led to speculative bubbles, to boom and bust cycles.

Across the EA, there is a so-called "doom loop" between sovereign bonds and banks' balance sheets[4]. This loop is more of a problem when competitiveness gaps among member states are large and local banks show a proclivity for acquiring "local" government bonds (a bias which is enhanced by the zero-risk weights for sovereigns as well)[5].

[2] Willem Buiter sees the EA as a system of currency boards ("The Euro Area: Monetary Union or System of Currency Boards", Global Economics View, 19 March 2015). He argues that "profit and loss sharing" is indispensable for a viable monetary union.

[3] What lies behind these two approaches is dealt with in "The Euro and the Battle of Ideas", Markus Brunnermeier, Harold James and Jean Pierre Landau , Princeton University Press, 2016. But the authors seem to downplay the role of the euro area flawed design.

[4] Sovereign bonds, when they are solid assets, strengthen banks' balance sheets and vice versa; banks count on state capacity to step in, when needed, either directly or indirectly (via central banks' operations).

[5] Though one can argue that in exceptional circumstances, when market access is restricted, this preference can perform a significant shock-absorber function.

2. Risk reduction and risk sharing

The non-standard operations of the ECB (including its lender of last resort (LoLR) operations) have rescued the EA. A big question is what will happen when the ECB normalises its policy, when interest rates revert, be it very gradually, to positive real levels. Although the correction of external imbalances (deficits) should not be underestimated in judging the reaction of financial markets, it is sensible to think that the current sovereign bond spreads of the "periphery" over the German *Bunds* (as a benchmark) do not illustrate member states' economic performances accurately; the ECB's operations have quite likely diminished these spreads.

Euro area creditor countries highlight the need to reduce NPL stocks (*a legacy problem)* as a *risk reduction* measure, prior to implementing a *risk-sharing* scheme (a collective deposit insurance scheme) in the banking sector. By the way, this scheme is the key missing link in the BU architecture, though considerably higher resources for the Resolution Fund would also be needed. But, over time, the flow of non-performing loans hinges, essentially, on economic performance, and not on a particular level of NPLs, which can be brought down through various means.[6] In the absence of mechanisms and instruments that foster economic convergence in the EA, NPL stocks at national level would tend to diverge widely again.

One can imagine a diversification of banks' loan portfolio that would diminish the threats posed to their balance-sheets by activities in weaker economies. However, a complete decoupling of banks from weaker member states' economies is not realistic and not welcome, and contagion effects can still be significant. And if a decoupling by banking groups were attempted, that would cause further fragmentation in the EA – where finance is largely bank-based. Moreover, there are small- and medium-sized banks whose activity remains quasi-local/national.

A concern of creditor nations is that certain EA reforms would lead to systematic income transfers to some countries, to a "transfer union", which would call into question the political legitimacy of such arrangements. But a key distinction should be made in this respect: systematic transfers that would stick the "financially assisted" label to some economies should be distinguished from transfers that help cushion asymmetric shocks and narrow performance gaps. This distinction chimes with the logic of the social insurance system: every income-earner contributes to a pool of resources that should be used when some contributors are in need of justified assistance, not *sine die* (leaving aside social benefits recipients) transfers.

It is worth mentioning, in this context, the *bailing-in* scheme (creditors' and shareholders' involvement in loss sharing, or haircuts) in contrast to the *bailing-out* scheme, with the latter being prohibited by the Treaties (as the EA was conceived). *Bailing in* is meant to protect tax-payers from costly resolution operations. But *bailing in* can trigger contagion effects unless it is done with utmost care - and it is not clear that implacable rules are to be applied in this respect. The ECB was forced by a grim reality to take on a de facto LoLR function from 2010 onwards; and one should not rule out bailouts under exceptional circumstances, when contagion effects may become very threatening.

If banking groups diversified their government bond portfolios while considerable competitiveness gaps persist among member states, and if sovereign bond ratings were no longer "risk-free", a strong preference for holding safer bonds would ensue. Capital would favour better performing economies, although speculative funds would eye higher (riskier) yields. Banks would discriminate among countries, thus harming economic activity in some member states. It can be inferred that, unless economic divergence among member states is mitigated, peripheral economies would become even more fragile once non-zero risk bonds come into being. The non-existence of proper risk-sharing schemes would only strengthen such perilous dynamics.

[6] As when non-performing loans in banks' balance sheets drop sharply when they are recognised as such (through write-offs), and not because the performance of the economy improves miraculously.

3. A European "safe asset"

The need to reduce the bank-sovereign doom loop as much as possible lies at the root of attempts to come up with a European safe asset. For years now, Eurobonds have been mentioned as risk-pooling assets that would make the EA more robust. However, mutualisation of risks is rejected by creditor nations, which do not accept the idea of a "transfer union". Hence the idea of a synthetic financial asset (sovereign bond-backed securities – SBBS) came up; this synthetic bond is derived from the pooling and slicing of sovereign bonds into three tranches: a senior one (deemed to be equivalent in strength to the German Bunds), a mezzanine (medium-risk) tranche, and a junior (seen as highly risky) tranche, with the latter bearing the brunt of losses in case of default (*Sovereign bond-backed securities: a feasibility study*, ESRB, Frankfurt am Main, January 2018[7]). This financial asset is intended to be attractive for banks and other financial institutions and to replace much of the current sovereign bond holdings.

But SBBS present a problematic feature: the supply of senior tranches depends fundamentally on the demand for junior tranches, and this demand is likely to fall dramatically during periods of market stress, when some member states' market access may be severely impaired. In those instances, demand will swiftly shift towards top-rated sovereign bonds, towards other safe assets. This is a weak trait of this synthetic asset. In times of crisis, the demand for solid financial assets (such as the German Bunds) would go through the roof, while the demand for periphery bonds would plummet, which would translate into a collapse in the demand for junior tranches as well. Sure, one can envisage a variation of the composition of SBBSs as a function of member states' market access, but this would make the whole scheme extremely cumbersome to implement. The fact is that, unless market access is secured for all member states, the supply of SBBSs turns too unreliable to make them a workable asset. Moreover, were SBBSs to come into being, their volume would be too small to make much of a difference in financial institutions' balance-sheets, for the foreseeable future at least.

Apart from its functioning under conditions of market stress, the introduction of a synthetic asset (SBBS) should be judged in conjunction with a package of EA policy redesign measures. This package should cover *inter alia*:

- liquidity assistance available during times of market stress;
- schemes to cushion asymmetric shocks, such as an unemployment benefit scheme (as part of a "fiscal capacity");
- sovereign debt restructuring should not be triggered automatically (some suggest that automaticity should be a condition for an ESM support programme), for it may cause panic in the markets, more fragmentation in the EA;
- rules for adjusting imbalances should not be pro-cyclical;
- the macroeconomic imbalance procedure should operate symmetrically, for both large external deficits and surpluses countries;
- a euro-area-wide macroeconomic policy that should reflect in the fiscal policy stance over the business cycle;
- investment programmes should foster economic convergence;
- no de-reregulation of finance (as it is attempted in the US currently).

EA reform proposals must consider the transition to a steady state. A smooth transition can be hampered if reform measures disregard correlations among them; for instance, if the introduction of sovereign bond-backed securities (SBBS), or of other measures, does not take into account side-effects of setting non-zero risk weights for member states' bonds.

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[7] This idea was first formulated by Brunnermeier. M, L. Garicano, Ph, Lane., M. Pagano, R. Reis, T. Santos, D. Thesmar, S.Van. Nieuwerburgh, and D. Vayanos, European Safe Bonds (ESBies), The Euronomics Group (2011).

[8] Aging does not provide a convincing argument for rationalizing high external surpluses since this demographic phenomenon is occurring all across Europe.

4. What sort of financial integration?

Financial integration in the EA, the establishment of a banking union that includes a collective deposit insurance scheme, raise a fundamental issue: whether the BU can overcome market fragmentation and economic divergence in the absence of fiscal arrangements that would enable accommodation of asymmetric shocks and foster economic convergence. Some argue that a complete BU would dispense with the need of fiscal integration in the euro area.[9] But is it sufficient for a robust economic and monetary union that risk-sharing applies to finance (banks) only? And would private risk-sharing be sufficient to cope with systemic risks in financial markets? Relatedly, it is not clear that a collective deposit insurance scheme (EDIS) would involve private money only, under any circumstances; some fiscal risk-sharing may be needed in worst case scenarios.[10] What if economic divergence persists, or even deepens, since banks may discriminate among economies not least due to perceived risks that originate in *bailing in* schemes and other vulnerabilities? A disconnect between a Banking Union, in which "'risk-sharing" operates, and real economies is hard to imagine; if economies would continue to diverge and risk-sharing would not apply to them too, that would undermine further the EA.[11]

Fiscal integration is the biggest hurdle to overcome in the EA since it calls for more than institutional cooperation; it involves institutional integration and a significant EA budget as a form of risk-sharing. But the latter leads to a huge political conundrum, as it faces strong political and constitutional constraints. And here lies a deeply going fragility in the design of the EA, in the spirit of Dani Rodrik's trilemma, namely that there can be no integration (globalisation via a "single market") in cohabitation with an autonomous economic policy and democratic accountability at national level; something must be given up in this triumvirate . It is fair to argue that this trilemma simplifies things and that compromises can be found. And yet, it raises a formidable challenge to the EA functioning unless financial integration is accompanied by policy arrangements and mechanisms that combat growing divergence between member states. For excessive divergence would increasingly eat into the social fabric and fuel extremism, populism, Euroscepticism.

The progress of the EA, of the BU, demands a reconciliation between rules and discipline on one hand, and risk-reduction and risk sharing[12] (private and public) on the other hand. Risk-sharing is to be designed in such a way as to reduce moral hazard while, simultaneously, considering asymmetric shocks, different strengths of national budgets and of member states' economies[13] - all of which do vary over time. It is noteworthy that reform proposals coming up from Berlin and Paris highlight the two approaches mentioned above. **But an adequate calibration between rules and risk-sharing, between private and public risk-sharing, is an open question.**

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[9] Martin. Sandbu, ""Banking Union would transform Europe's politics"', Financial times, 25 July 2017; as he puts it, "Banking union mimics the fiscal risk-sharing".

[10] In the US, the FDIC (The Federal Deposit Insurance Corporation) is funded by private money, but it has behind it the US Government as the most trustworthy institution (the only one that has taxation power).

[11] L. Bini Smaghi makes an insightful observation, that the most threatening doom-loop is between redenomination risk and sovereign risk; that this doom-loop can be contained by improving economic convergence and shock-absorbers ("Reconciling risk-sharing with market discipline", Policy Brief, LUISS, SEPE, 30 January, 2018

[12] See Benassy-Quere, A., Brunnermeier, M., Enderlein, H., Fahri, E., Fratzscher, M., Fuest, C., Gourinchas, P.O., Martin, Ph., Pisani Ferry, J., Rey, H., Schnabel, I., Veron, N., Weder di Mauro, B., Zettelmeyer, J., "Reconciling risk sharing with market discipline: a constructive approach to euro area reform", CEPR, *Policy Insight* No. 91, January 2018.

[13] How to combine market discipline with risk-sharing is an open question and the fears of what may be an inadequate calibration between the two elements is obvious in Marcelo Messori and Stefano Micossi' "Counterproductive proposals on Euroarea reform" CEPS Policy Insight, No.2018, Brussels, February 2018. Their view drew a strong rebuttal from J.Pisani Ferry and J. Zettelmeyer (Messori and Micossi's reading is a misrepresentation", CEPS Commentary, 19 February, 2018. The fact is that unless adequate risk-sharing is achieved, bad dynamics in the EA would further cripple it.

Only private risk-sharing schemes would not make the EA more robust. Financial markets are too fickle and produce systemic risks recurrently; the Great Recession showed that public intervention was needed, ultimately, in order to avoid a catastrophe. Unless it will get adequate risk-sharing schemes, the EA will continue to be very rigid (like the gold standard regime) and prone to experience tensions and crises recurrently.

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