Euro area architecture: What reforms are still needed, and why

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 02 May 2019

In January 2018, CEPR published a Policy Insight recommending euro area reforms which received broad support as well as some criticism. In this column, the authors argue that the problems that prompted their paper are still there, new problems are on the horizon, and the current state of the policy conversation on euro area reform is disappointing. They also identify priorities that should be at the centre of discussions on reform.

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In January 2018, we published a paper recommending euro area reforms to the French and German governments (Bénassy-Quéré et al. 2018). The motivation for the paper was the continued financial and political fragility in the euro area, notwithstanding the economic recovery and important reforms such as common banking supervision, the creation of the European Stability Mechanism and the broadening of the ECB's policy toolkit. The financial system remains fragile because of the continued exposure of sovereigns to domestic banks, as well as banks to their national sovereigns, and limited room for manoeuvre by the ECB. Political fragility prevails because the key grievances of the crisis remain unaddressed. Crisis countries feel that excessive austerity was imposed on them, and that the euro area does not provide a level playing field for their banks and corporations, whose access to credit is relatively expensive. Creditor countries feel that they live in a system that does not ultimately enforce the no-bailout clause of the European treaties, exposing them to large fiscal liabilities.

As a solution to these problems, we proposed a set of reforms that would both increase risk sharing and strengthen market discipline in the euro area. The key idea was that risk-sharing mechanisms, such as European deposit insurance (EDIS) and a European unemployment re-insurance, could actually strengthen discipline, provided that first losses would continue to be borne at national level, and provided insurance premia were aligned with risk. The reason for this is that, in the presence of stronger safety nets, it becomes possible to solve severe fiscal crises through orderly debt restructuring, obviating the need for both self-defeating austerity and enormous crisis loans that might not be repaid.

We also argued for regulatory 'concentration charges' that would reduce the domestic sovereign exposures of banks, and for a reform of EU fiscal rules to ensure that they provided enough discipline in good times, while not magnifying economic downturns. And we argued for better enforcement mechanisms; imposing fines on nations is rarely credible. A better approach would be to require countries that spend more than the ceiling allowed under the rules to finance the extra expenditure by issuing subordinated bonds, raising the costs of such issuance, and protecting incumbent bondholders.

What is new?

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

Marcel Fratzscher
President, DIW Berlin; Professor of Macroeconomics and Finance,

Since we wrote our paper, four things have happened that are relevant to our initial worries, the proposed solutions, and economic reform in the EU more broadly.

First, we received broad support both for the general strategy proposed in our paper and for some of the proposals, along with some criticism (Pisani-Ferry 2018). For example, IMF authors published a paper advocating a very similar approach (Berger et al. 2018). There seems to be consensus among policy economists on how to reform the Stability and Growth Pact, namely, to focus on expenditure ceilings set to slowly reduce the debt ratios of overindebted countries.[1] Most importantly, the Meseberg declaration by German Chancellor Angela Merkel and French President Emanuel Macron of June 2018, and a subsequent EU summit, seemed to take some of our concerns and solutions on board.[2] Fixing the euro area's banking system was recognized as a high priority, leading to a reaffirmed commitment to a backstop from the (ESM) for bank crisis resolution, as well as explicit reference to a European Deposit Insurance Scheme. Referring to a prior letter by the Eurogroup's president, political leaders also signalled openness to more flexible forms of ESM lending to countries that do not experience a full-blown crisis as well as bond clauses to allow for orderly sovereign debt restructuring and the bail-in of private creditors, without automaticity.

Second, despite these promising signals, the implementation and follow-through of euro area reform have been largely disappointing. There was an agreement on implementing the ESM backstop to the common resolution mechanism, but it may be too small, especially when faced with liquidity issues, and is subject to national vetoes. EDIS and sovereign concentration charges are still largely considered taboos in the political debate. The very principle that a common currency area may need a fiscal component, such as a common unemployment re-insurance, continues to be rejected by some euro area members. As of April 2019, a consensus may be emerging for a small budget within the EU's regular multi-year budget, possibly in an order of magnitude of around €20 to €30 billion, earmarked for specific support for member states in the area of innovation and in the form of loans. While such a budget may constitute a first step, it would not fulfil any euro area macroeconomic stabilisation function, nor would it be a suitable tool to support national fiscal policies in case of an economic slowdown or recession.

On other key issues there has been virtually no progress. Despite the intellectual consensus there seems to be no appetite to change common fiscal rules to make them more transparent and less intrusive, but rather to give national governments more flexibility to use national fiscal policies.

Third, the economic outlook for the euro area has darkened. The slowdown of major euro area economies, including Germany, in the second half of 2018 has led the ECB to put the normalisation of interest rates on hold. Protectionism in the US is a significant concern, both because the war trade war with China undermines investor confidence and may be contributing to the cooling of the Chinese and US economies, and because of concerns about at trade war between the US and Europe. With interest rates already near zero and government bond holdings close to the limits that the ECB had set itself in order to avoid pushing private lenders to the sidelines, the ECB's room for stopping the next recession is limited. Any new instruments may be increasingly controversial. At the same time, the EU lacks fiscal stabilisation mechanisms. Unless the next recession disproportionately hits the stronger members – those that have fiscal room to respond – the euro area will be short of instruments to contain the crisis.

Fourth, the discussion on economic policies in the EU and the euro area has recently broadened, in part in reaction to economic nationalism in China and the US. Germany's Economy Minister Peter Altmaier published a National Industrial Strategy 2030 in February 2019, which was followed by a joint "Franco-German Manifesto for a European industrial policy fit for the 21st century". President Macron made a new push for European reforms in early March 2019, which abstained from returning to euro area issues but contained additional proposals in the area of EU trade and public procurement policies, and argued for a revision of European competition policies. While the new focus of these policymakers on raising productivity growth and innovation maintaining EU economic sovereignty in the face of external challenges is welcome, some of the proposals that have been floated – in particular, promoting national and European champions and weakening EU competition policies – raise major concerns (Feld et al. 2016, Fratzscher and Duso 2019, Pisani-Ferry 2019, Zettelmeyer 2019).

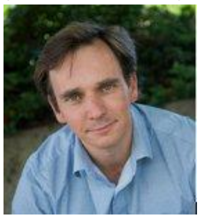
To summarise, the problems that prompted our January 2018 paper are still there, new problems are on the horizon, and the current state of the policy conversation on euro area reform is disappointing. Leaders and ministers seem to lack the sense of urgency and the sense of purpose that would be needed in the current situation. They do not seem to appreciate the lingering fragility of the euro area, the proximity of the economic risks, and the danger of relying excessively on the ECB for addressing problems that political leaders are unwilling to solve.

Priorities going forward

ght of the weakening economic cycle, the deficiencies of the euro area architecture may thus

Humboldt-University Berlin; and Member of the Advisory Council, Ministry of Economy of Germany

Clemens Fuest
President, ifo Institute; Professor of Economics and Public Finance; University of Munich; Director, CES; Executive Director, CESifo; Speaker, EconPol Europe



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 and Chair French Council of Economic Analysis; CEPR Research Fellow

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

come to the fore sooner than we had expected a year ago. Four priorities on euro area reform should be at the centre of the discussion.

First, euro area leaders must finish the job started in 2012 of breaking the vicious circle between banks and national governments. This requires making EDIS a reality but also breaking another important taboo, namely the lack of meaningful regulation of bank exposures to sovereigns. This could be achieved by limiting how much domestic sovereign debt banks can hold (for example, through sovereign concentration charges). Moreover, the creation of a safe asset for the euro area, without mutualising sovereign risk, should be explored further. This would contribute to severing the financial link between national governments and banks and reduce the costs of restructuring government debt in cases where debt is unsustainable. It could also prevent destabilising cross-border flights to safety.

Second, there should be a discussion both on the reforms of the fiscal framework for the euro area, but also about the appropriate fiscal policy amid the economic slowdown and the substantial downside risks facing Europe at the moment. The current fiscal rules have proven to be overly complex, hard to enforce, and procyclical. The EU should move towards simple public expenditure rules guided by a long-term debt reduction target.

Third, priority should be given to the creation of a proper macroeconomic stabilisation tool for the euro area. An important reason why some countries experienced crises that were far more severe than necessary over the past ten years was the lack of fiscal stabilisation. The Eurogroup had raised the possibility of introducing an unemployment insurance scheme that might fulfil such a stabilisation function – irrespective of whether or not it is labelled a 'euro area budget'. Such a scheme could play an important role in helping countries avoid a deep recession and crisis. It can be set up without creating a 'transfer union, thus addressing concerns of Germany and other northern European countries. The objective now should be to better explain the economic benefits of such a stabilisation mechanism.

Fourth, the EU should focus on completing the Single Market, including through Banking Union and Capital Market Union, and an integrated research and investment strategy (in particular, to fight climate change). The reforms of the euro area emphasised in our previous work make a contribution towards this objective. A particularly important dimension is the integration of the banking market. Beyond technicalities, euro area countries share a common interest in having banks that diversify risk rather than concentrating it along national lines. The tendency towards within-country concentration of the banking market is not a sound development.

The push by the French president and other EU politicians to strengthen other economic dimensions of the European Union in the areas of climate change, external security, competition, trade, and industrial policy is important and timely. However, these initiatives should not undermine European competition policy.

These priorities, which concern the euro area as a whole, are a vital complement to reform efforts aiming at enhancing productivity, growth and fiscal consolidation at national level. Without stronger efforts both at the euro area and the EU level, Europe will not prosper.

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Hélène Rey
Lord Bagri Professor of Economics, London Business School and CEPR Vice President and 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
Professor of International Economics, Graduate Institute of Geneva; Distinguished Fellow, INSEAD Emerging Markets Institute, Singapore; President, CEPR

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

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Endnotes

[1] Changes in tax revenue would not affect the expenditure ceiling unless they are the result of tax policy (e.g. via a tax cut). A collapse in revenue in a downturn would hence be fully absorbed by an increase in the fiscal deficit. Conversely, during a boom, expenditures would remain constrained by the ceiling, leading to high fiscal surpluses. As a result, automatic stabilisers would be more effective than they are today (Beetsma et al. 2018, Feld et al. 2018, Darvas et al. 2018).

[1] See https://www.elysee.fr/emmanuel-macron/2018/06/19/meseberg-declaration-renewing-europes-promises-of-security-and-prosperity.en, as well the EU Commission roadmap for EMU reform at https://ec.europa.eu/commission/sites/beta-political/files/euco-emu-booklet-june2018_en.pdf.

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