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Euro-area Governance Reform The Unfinished Agenda

Miranda Xafa



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The Unfinished Agenda

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CIGI Masthead

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About the Author

Miranda Xafa is a CIGI senior fellow. She is also chief executive officer of EF Consulting, an Athens-based advisory firm focusing on euro-zone economic and financial issues. At CIGI, Miranda focuses on sovereign debt crises and drawing lessons from the Greek debt restructuring for future debt crises. From 2004 to 2009, she served as a member of the executive board of the International Monetary Fund in Washington, DC, where she had previously worked as a staff member. Miranda served as chief economic adviser to Greek Prime Minister Konstantinos Mitsotakis, from 1991 to 1993. From 1994 to 2003, she was a financial market analyst and senior expert at Salomon Brothers/Citigroup in London. Miranda holds a Ph.D. in economics from the University of Pennsylvania and has taught economics at the Universities of Pennsylvania and Princeton. She has published several articles and papers on international economic and financial issues.

About the Global Economy Program

Addressing limitations in the ways nations tackle shared economic challenges, the Global Economy Program at CIGI strives to inform and guide policy debates through world-leading research and sustained stakeholder engagement.

With experts from academia, national agencies, international institutions and the private sector, the Global Economy Program supports research in the following areas: management of severe sovereign debt crises; central banking and international financial regulation; China's role in the global economy; governance and policies of the Bretton Woods institutions; the Group of Twenty; global, plurilateral and regional trade agreements; and financing sustainable development. Each year, the Global Economy Program hosts, co-hosts and participates in many events worldwide, working with trusted international partners, which allows the program to disseminate policy recommendations to an international audience of policy makers.

Through its research, collaboration and publications, the Global Economy Program informs decision makers, fosters dialogue and debate on policy-relevant ideas and strengthens multilateral responses to the most pressing international governance issues.

Acronyms and Abbreviations

BRRD	Bank Recovery and Resolution Directive	SGP	Stability and Growth Pact
CAC	collective action clauses	SIFMA	Securities Industry and Financial Markets Association
CFC	Central Fiscal Capacity	SRB	single resolution board
CMU	Capital Markets Union	SRF	Single Resolution Fund
DISs	deposit insurance schemes	TFEU	Treaty on the Functioning of the European Union
EC	European Commission	TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union
ECB	European Central Bank		
EDIS	European Deposit Insurance Scheme		
EDP	Excessive Deficit Procedure		
EFB	European Fiscal Board		
EFSSF	European Financial Stability Facility		
EMU	Economic and Monetary Union		
ESAs	European Supervisory Authorities		
ESM	European Stability Mechanism		
ESMA	European Securities and Markets Authority		
ESRB	European Systemic Risk Board		
FDIC	Federal Deposit Insurance Corporation		
IMF	International Monetary Fund		
MIP	Macroeconomic Imbalance Procedure		
MREL	minimum requirement for own funds and eligible liabilities		
MTOs	medium-term budgetary objectives		
NPLs	non-performing loans		
OMT	Outright Monetary Transactions		
PEPP	Pan-European Personal Pension Product		
RSP	Reform Support Program		
SBBS	Sovereign Bond-Backed Securities		

Executive Summary

The resilience of the single currency has improved considerably since the debt crisis of 2010–2012. Important reforms to the euro area’s architecture have been introduced to end the crisis that threatened the existence of the euro itself. The European Stability Mechanism (ESM) was set up in October 2012 as a successor to the temporary European Financial Stability Facility (EFSF) to help fund weak sovereigns. Jointly, the two institutions disbursed more than €250 billion to five countries hit by the crisis, helping to keep the euro area together. At the peak of the crisis in June 2012, euro-area leaders agreed to consider proposals for “a specific and time-bound road map toward a genuine Economic and Monetary Union (EMU)” to ensure the irreversibility of the single currency. Following this commitment, the European Central Bank (ECB) acted as a lender of last resort by standing ready to provide theoretically infinite liquidity support through its Outright Monetary Transactions (OMT) program.

New EU rules on banking supervision and resolution adopted in the aftermath of the crisis have significantly reduced the likelihood and potential impact of bank failures. The launch of the banking union in November 2014, involving the transfer of supervisory authority from the national level to the ECB, was a key initiative to advance euro-area integration. New bail-in rules took effect to avoid taxpayer-funded bailouts of failing banks, and a Single Resolution Fund (SRF) was set up to cover any residual bank losses. In September 2015, the European Commission (EC) launched an action plan to build a Capital Markets Union (CMU) in order to reduce the dependence of European companies on bank funding and diversify risks across EU countries through cross-ownership of assets. These initiatives constitute fundamental steps toward financial union — a necessary complement to EMU — and helped loosen the “doom loop” between overindebted sovereigns and undercapitalized banks.

Sustained efforts toward deeper integration, supported by accommodative monetary policy, helped promote the recovery of the euro-area economy and dispelled fears of a breakup of the single currency. Fiscal rules were tightened and macro surveillance tools were set up for crisis prevention. Yet significant challenges remain to be tackled. Gaps remain in the euro-area architecture; limited progress has been made in establishing

CMU and the banking union remains incomplete. The ongoing Brexit negotiations make it all the more urgent to build a CMU among the remaining 27 EU members (known as the EU27), including stronger central oversight to avoid regulatory arbitrage as some financial services migrate to the continent. The bank-sovereign doom loop is not completely broken, as deposit insurance remains national and banks still hold a considerable amount of bonds of their own sovereigns. Public debt has stabilized at relatively high levels, posing significant risks, and the fiscal framework requires reform. Unemployment has declined but remains high in crisis-hit countries, in particular among young people, and income inequality within many countries has increased. Voters in richer countries are increasingly reluctant to bail out the countries hit by crisis. Coupled with the massive flow of refugees and migrants from the Middle East and Africa, these trends gave rise to Euroscepticism and the emergence of populist and nationalist governments in several EU countries. So far, however, the room created by the strong economic rebound has not been used to strengthen the reform momentum. An EU leaders’ summit on June 28–29 focused on immigration and security issues, but failed to reach agreement on significant euro-area reforms, putting the threat of an eventual euro breakup back on the table. The focus has now shifted to the December 2018 EU leaders’ summit, which is expected to make some progress toward a common deposit scheme and a more effective bank resolution process.

Today’s environment of solid growth remains an ideal time to advance the reform agenda. There is wide agreement that building a well-functioning and resilient monetary union in Europe requires further steps to break the bank-sovereign doom loop and to increase risk sharing among members of the union. Potential stabilization channels include improved counter-cyclicality through a reform of the Stability and Growth Pact (SGP) and inter-regional or intertemporal smoothing through a Central Fiscal Capacity (CFC). Many competing proposals have been tabled to make the governance of the euro area more robust. Views differ on the shape and sequencing of reforms, and on the degree of integration that is ultimately desirable, with some observers arguing for a full fiscal union with shared risk, and others going all the way to full political union through the creation of a federal state. This paper assesses and prioritizes key proposals that are economically sound and politically feasible. They can be grouped under three headings:

→ **Macro stabilization and dealing with shocks:**

This heading includes French President Emmanuel Macron's proposals for a euro-area budget, various other proposals for "a rainy day fund," as well as proposals on sovereign debt restructuring, risk sharing through cross-ownership of assets, reducing the pro-cyclicality of the euro area's fiscal framework establishing a common unemployment insurance fund, and implementing structural reforms at the country level to increase resilience to shocks.

→ **Banking and financial sector reforms:** Proposals for common deposit insurance to avoid bank runs and complete the banking union, dealing with non-performing loans in banks, breaking the bank-sovereign doom loop, promoting financial sector stability through the creation of safe assets, reducing the "home bias" in bank balance sheets and centralizing capital market supervision at the EU level, fall under this heading.

→ **Institutional reform:** This is a vast area that includes steps toward political union, which some observers consider critical in order to reduce the "democratic deficit" in the European Union, that is, the delegation of policy making to unelected, technocratic bodies such as the European Commission, the European Central Bank and the European Court of Justice. This paper focuses narrowly on President Macron's proposal to create the position of euro-area finance minister and on proposals to broaden the mandate of the ESM, which would evolve into a European Monetary Fund.

The paper is descriptive rather than normative; it aims to lay out the issues and stimulate further dialogue on the subject of euro-area reform.

Introduction

The euro-area debt crisis erupted with a bang in the spring of 2010, when it became clear that Greece could not meet its debt service obligations. As the crisis spread to other countries in the European periphery, the euro area's initial policy response was to negotiate rescue packages as needed to address the funding needs of each individual country subject to agreement on reforms. Greece was the first to receive official

financial assistance in May 2010, followed by Ireland in November 2010 and Portugal in May 2011. By the fall of 2011, the crisis had spread to Spain and Italy, whose borrowing costs had become prohibitive. As the crisis became systemic, the need for a comprehensive approach to resolve it became apparent.

The original euro-area architecture was built around a common monetary policy and national responsibility for fiscal policies, subject to common rules to safeguard fiscal sustainability. Bank supervision was also left to national authorities, subject only to common capital adequacy and other regulatory requirements. This governance structure proved problematic because it failed to prevent the buildup of economic and financial imbalances whose unwinding caused massive upheaval and almost led to euro-area breakup. The fiscal rules were not strictly enforced, centralized banking supervision and resolution were lacking, and the crisis management tools to deal with the crisis once it erupted were missing. The buildup of private and public sector debt in the run-up to the crisis triggered two severe and closely interrelated crises: a sovereign debt crisis and a banking crisis that were mutually reinforcing, culminating in a crisis of confidence.

The crisis revealed several weaknesses in the euro-area architecture. First, policy makers were shocked to realize that loss of market access is not limited to emerging markets but can occur in developed European countries, whose financing needs far exceeded plausible contributions by the International Monetary Fund (IMF), with no additional backstop in place. Second, contagion could propagate the crisis faster and more widely than was previously believed. Third, a doom loop between overindebted sovereigns and undercapitalized banks could seriously undermine investor confidence and market access, with causality running both ways: In Greece, an overindebted sovereign undermined the capital adequacy of banks heavily invested in Greek government bonds, which were eventually recapitalized with public funds. In Ireland, undercapitalized banks undermined the debt sustainability of a sovereign who guaranteed not only bank deposits but all bank liabilities, including junior debt, in a misguided effort to restore confidence. The overarching theme of the crisis was the inability of individual countries, the banking sector, or even the euro area as

a whole to absorb shocks. Countries hit by crisis had insufficient fiscal space, banks were inadequately capitalized, and the euro area had little or no private or public risk-sharing mechanism. Important steps have been taken to address the gaps in the euro area's governance structure, but much remains to be done.

Early Policy Response and Reform Proposals

When Greece requested financial assistance from official creditors in early 2010, euro-area countries initially invoked the “no bailout” clause enshrined in Article 125 of the Treaty on the Functioning of the European Union (TFEU), but eventually agreed to provide financial assistance in the form of bilateral loans to Greece. The EFSF was set up in a rush in August 2010 as a Luxembourg-based Special Purpose Vehicle to backstop other sovereigns that might need official financing. It was superseded by a permanent mechanism, the ESM, which was established by intergovernmental treaty and became fully operational in October 2012.¹

The crisis also demonstrated that contagion can propagate the crisis far more widely than was previously believed through negative confidence effects. It also showed that private sector borrowing costs could differ substantially across the euro area despite a single monetary policy, as the fear of sovereign defaults impacted the private sector. Addressing the gaps in the functioning of the monetary union would help prevent, or at least soften, such confidence crises in the future.

Policy makers eventually recognized that a common backstop, with shared risk, would be needed to break the doom loop between banks and sovereigns. At their June 2012 summit, euro-area leaders asked the EC and the president of the European Council for proposals “to develop a specific and time-bound road map toward a genuine Economic and Monetary Union (EMU),” including greater fiscal and financial integration, to ensure the irreversibility of the EMU (European Council 2012). This commitment was reaffirmed with the Rome Declaration in March 2017, in which EU leaders committed to “working towards completing EMU; a Union where economies converge. Now, this promise must be delivered. This requires political courage, a common vision and the determination to act in the common interest” (European Council 2017a).

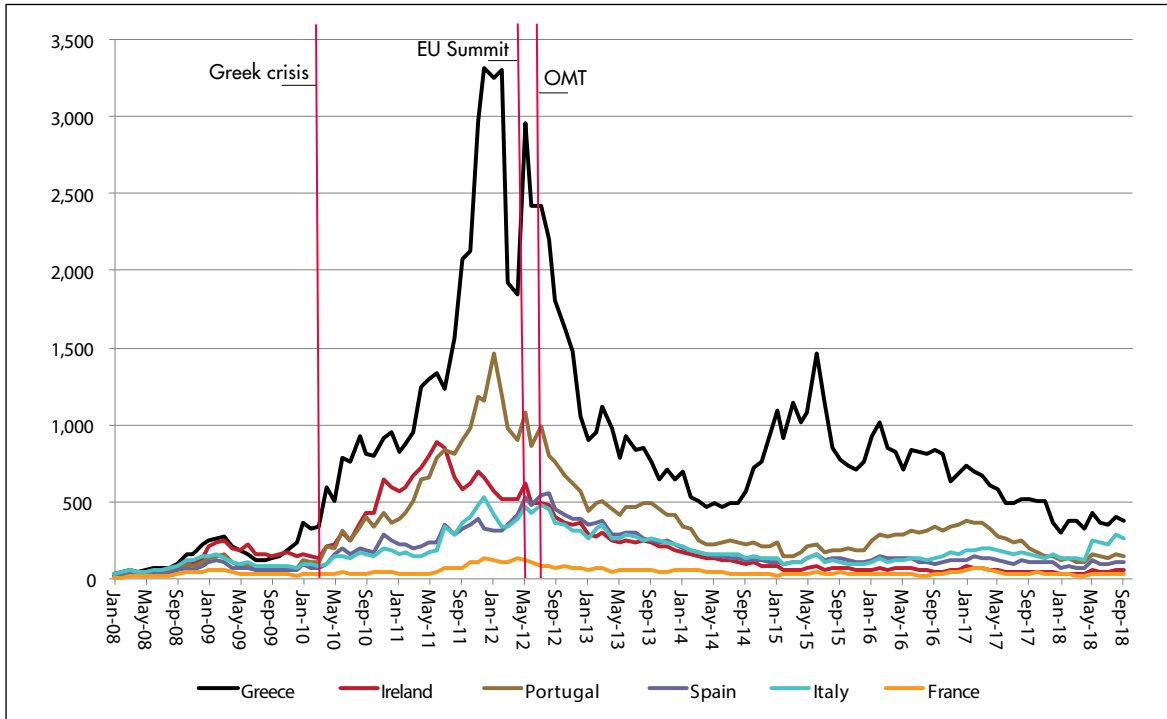
The move toward deeper integration by committing to a specific, time-bound road map to complete the EMU, including banking union, signalled the strong commitment of European leaders to the euro. It marked a shift from “firefighting” through rescue packages for individual member states to addressing the systemic causes of the crisis, notably the bank-sovereign doom loop. This shift was the game-changer that is widely viewed as enabling ECB President Mario Draghi to ease market tensions by committing to do “whatever it takes” to save the euro, within the ECB’s mandate. Interpreted as a commitment to provide a theoretically infinite backstop, Draghi’s statement and the subsequent announcement of a bond-buying program, known as OMT,² in early August had an immediate impact in calming markets. Credit spreads tightened considerably in all countries in the euro-area periphery as redenomination risk receded (see Figure 1).

The crisis took a heavy toll on growth: real GDP of the euro area as a whole took seven years to return to its 2007 level (see Figure 2). Within this total, the performance of individual countries varied widely: Ireland’s miraculous recovery was V-shaped, whereas real GDP in Greece and Italy had yet to reach their 2007 level in 2018. The euro area’s economic rebound since 2014

¹ The EFSF is a temporary crisis response and assistance mechanism, created by the euro-area member states as a limited liability company under Luxembourg law on the basis of an Economic and Financial Affairs Council decision on May 9, 2010. Funded with an initial capital of €440 billion, the EFSF became fully operational in early August 2010. This EFSF was an interim expedient until a permanent mechanism, the ESM, was created by an intergovernmental treaty that entered into force on October 8, 2012. After the creation of the ESM, the EFSF stopped undertaking new commitments but continued to fund existing programs until they expired. The mandate of the ESM is to safeguard financial stability in Europe by providing financial assistance to member states subject to an adjustment program. It may also intervene in the primary and secondary bond markets, act on the basis of a precautionary program, and finance recapitalizations of financial institutions through loans to governments. It is funded by issuing bonds in international capital markets with the guarantee of member states.

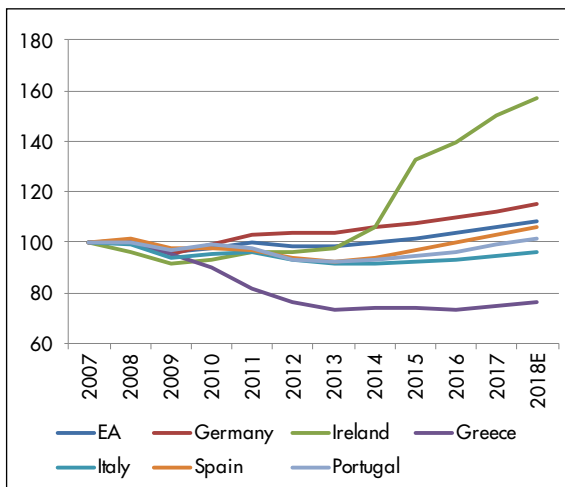
² The OMT program of euro-area sovereign bond purchases in the secondary market differs from its predecessor, the Securities Markets Program, in two important respects: it is subject to appropriate conditionality under an ESM-supported program, and ECB bond purchases do not have seniority over private bondholders, thus addressing the subordination concerns of private bondholders.

Figure 1: Credit Spreads over 10-year German Government Bond (Basis Points)



Source: Bloomberg.

Figure 2: Selected Euro-area Economies – Real GDP, 2007=100



Source: IMF, World Economic Outlook database.

has yet to reverse the economic and social divergence that emerged from the crisis.

The lessons of the crisis were clearly identified in the “Reflection Paper on the Deepening of the Economic and Monetary Union,” known as the

“Five Presidents’ Report” (EC 2015a), prepared by the president of the EC in close collaboration with the presidents of the European Council, the Eurogroup, the ECB and the European Parliament. The report articulated the renewed ambition to strengthen and deepen the union as the key to lifting the euro area’s growth potential and shock-absorbing capacity. It outlined the actions needed to improve economic and fiscal governance and to promote financial integration in order to achieve full EMU by 2025 at the latest. Banking union should be completed by setting up a credible common backstop to the Single Resolution Fund, and by launching a European Deposit Insurance Scheme (EDIS) — the third pillar of a complete banking union, alongside bank supervision and resolution.

After banking union, launching CMU was seen as a priority in order to ensure a truly single monetary policy in the euro area and to diversify risk across EU countries. In cases of severe crisis, such as those encountered by the countries that adopted stabilization programs, national budgets can be overwhelmed; to address these cases, the Five Presidents’ Report called for public risk sharing to be enhanced through a mechanism of fiscal stabilization for the euro area as a whole.

It cautioned that steps toward fiscal union “should be the culmination of a process that requires, as a precondition, a significant degree of economic convergence, financial integration and further coordination and pooling of decision making on national budgets, with commensurate strengthening of democratic accountability. This is important to avoid moral hazard and ensure joint fiscal discipline” (EC 2015a).

Building on the Five Presidents’ Report, the EC followed up with a number of reflection papers on key topics in euro-area reform. The third paper in the series (EC 2017) presented possible ways forward for deepening and completing the EMU until the 2025 deadline set out by the Five Presidents’ Report. It spelled out concrete steps that could be taken by the time of the European Parliament elections in 2019, as well as a road map for the following years.

Donald Tusk, president of the European Council, presented the priorities for euro-area reform to EU heads of state in September 2017 (European Council 2017b) as follows:

There is no silver bullet to complete the Economic and Monetary Union once and for all. But I am convinced that we have the obligation to improve the functioning of the EMU and strengthen it step by step. Our priority should be to complete the Banking Union in line with the agreed roadmap so that the euro area is strengthened structurally. This means that we have to prepare a common backstop to the Banking Union, to advance further risk reduction and pave the way for a European deposit insurance scheme. We should also enhance Europe’s capacity to act, which could involve developing the ESM towards a European Monetary Fund. A number of ideas on governance and budgetary resources specific to the euro area have been introduced, on which much more discussion will be needed. In order to advance this agenda I will call a Euro Summit in December in an inclusive format. Concrete decisions on these issues should be taken at the European Council by June next year at the latest.

However, other priorities prevailed. The June 2018 summit of euro-area leaders focused on migration and security issues, largely sidelining euro-area reform. Nevertheless, debate of the euro area’s future remains lively and many proposals have been tabled on the way forward. Hopefully at least some of them will be adopted before the next economic downturn.

Macro Stabilization and Dealing with Shocks

A key message of the crisis is that a monetary union cannot function smoothly without sustainable fiscal policies. Stability-oriented monetary policies and integrated financial markets are no guarantee that sudden stops in capital flows will not occur. As Greece’s experience amply demonstrated, unsustainable fiscal policies can endanger price stability and harm financial stability both in individual member states and the euro area more broadly. Responsible national fiscal policies are therefore essential to avoid contagion and financial fragmentation. They should guarantee the sustainability of public debt and ensure that fiscal automatic stabilizers can cushion country-specific economic shocks. Greater risk sharing would obviously be dependent on stronger controls on national budgets.

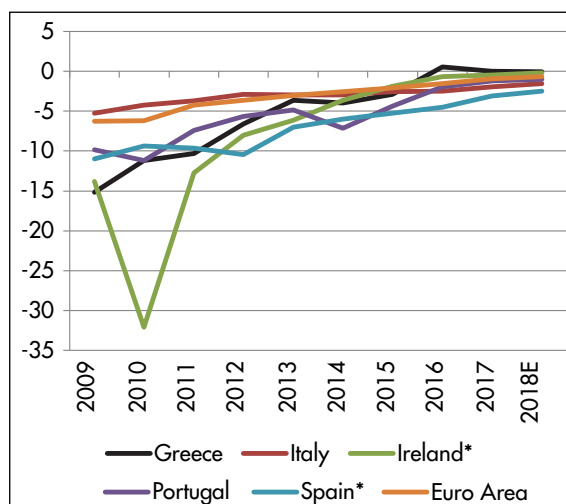
Another message of the crisis, however, is that even countries with prudent fiscal policies and moderate debt levels can be engulfed in a crisis. This was the case of Ireland and Spain, both of which entered the crisis with low fiscal deficits and debt levels, but felt compelled to use massive fiscal resources to rescue their banks. The buildup of public debt subsequently limited their ability to respond to shocks. To address this weakness in the euro area’s architecture, the Five Presidents’ Report called for the establishment of a central fiscal capacity to deal with shocks when fiscal space at the country level is limited and macroeconomic conditions call for fiscal support.

The Stability and Growth Pact

The Stability and Growth Pact (SGP) is the euro area's anchor for fiscal stability. It includes a preventive arm to ensure that fiscal policy is sustainable and a corrective arm (the Excessive Deficit Procedure [EDP]) that provides for sanctions and corrective action to eliminate the excessive deficit. As originally conceived, the SGP called for a ceiling on fiscal deficits of three percent of GDP and a debt ratio "tending towards" 60 percent of GDP. While a "structural" medium-term objective was also pursued, which was cyclically adjusted and excluded one-off revenues and expenditures, the binding target applied to the headline fiscal balance and was therefore defined independently of the position in the cycle. This led to counter-cyclical policies: once member countries easily achieved a deficit of three percent of GDP during good times, they were forced to unduly tighten fiscal policy during the next downturn to meet that same target. During the strong expansion in the run-up to the global financial crisis, euro-area countries tended to relax their fiscal efforts by adopting a pro-cyclical expansionary stance, only to be forced to shift to pro-cyclical fiscal consolidation when the crisis hit and many of them were placed in the EDP (see Figure 3). The deep recession triggered by the crisis made it hard to stabilize their debt ratios even with fiscal tightening (see Figure 4). This problem highlighted the need for medium-term targets to establish the credibility of fiscal plans, allowing for some flexibility to spread consolidation efforts over the business cycle.

However, the SPG was not strictly implemented to ensure that the fiscal stance remained appropriate over the business cycle. It also failed to provide sufficient incentives for governments to build buffers during good times. The fiscal stance has tended to be pro-cyclical, with the structural primary balance tending to deteriorate when the output gap is positive and to improve when the output gap is negative (Beetsma and Stéclébout-Orseau 2018). Political interference in the enforcement mechanism is part of the problem, as became apparent when France and Germany were allowed to run deficits above the three percent limit with impunity in the aftermath of German unification in 2003. A reform of the SGP in 2005 increased its flexibility by taking into account the country's cyclical position, but enforcement mechanisms remained inadequate. The reform introduced the structural budget balance as a measure of the action taken by

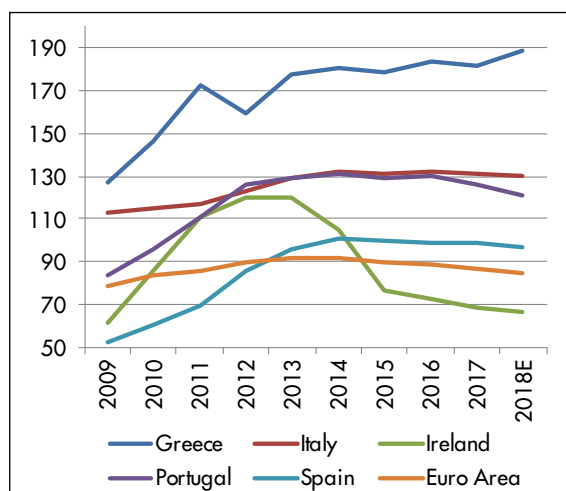
Figure 3: Selected Euro-area Countries: General Government Balance (% GDP)



Source: IMF Fiscal Monitor.

Note: * Includes financial sector support.

Figure 4: Selected Euro-area Countries: General Government Debt (% GDP)



Source: IMF Fiscal Monitor.

a member state to correct an imbalance (the "effective action" clause). Country-specific medium-term budgetary objectives (MTOs) were set, and the transitory costs of certain structural reforms (for example, a transition from pay-as-you-go to funded pensions) were taken into account in the trajectory to the MTO.

Subsequent refinements under the Fiscal Compact (see Box 1), adopted in the aftermath of the crisis,

took into account both the cyclical position and the debt sustainability assessment when setting the MTO, added a norm for expenditure growth, enhanced oversight of national budgetary processes and introduced a corrective procedure in case of deviation under the preventive arm. However, the fiscal framework remained too complex and loosely implemented to avoid pro-cyclicality; it was based on unobservable variables, such as the output gap and the cyclically adjusted balance, which could only be roughly estimated *ex ante*. The accumulation of incremental rules and amendments created risks of overlaps, inconsistency and confusion (Eyraud and Wu 2015). As noted in the Five Presidents' Report, the addition of numerous "packs," "pacts," "procedures" and reporting requirements has blurred the SGP's rationale and effectiveness. In response to these shortcomings, several proposals have been advanced to improve the SGP.

First, the flexibility introduced in the 2005 reform of the SGP and in the Fiscal Compact allows for the focus to be placed on structural, rather than headline, fiscal balance targets; but assessing a country's cyclical position in real time is not an easy task. Both the European Fiscal Board³ and the International Monetary Fund have noted that greater flexibility to provide room for countercyclical policies in a downturn has come at the price of complexity and more discretion (IMF 2018, EFB 2017). They have recommended simplifying the rules to focus on a single fiscal anchor (deficit or debt) and a single operational target (for example, the deviation of the debt ratio from its long-term target) to assess compliance. To preserve simplicity while retaining flexibility to deal with adverse shocks, the EFB has proposed introducing escape clauses, to be triggered on the recommendation of an independent institution like the EFB. Simpler rules would increase the credibility of the fiscal framework by facilitating both compliance and enforcement, but so far the EC has not made specific proposals in this regard. Greater reliance on expenditure targets, which stipulate that primary spending (which excludes interest payments) may not

exceed potential growth plus inflation, can help preserve countercyclical policies while acting as a brake on nominal deficits. A recent IMF study illustrates how nominal budget balance rules can trigger procyclical policies, and how rules allowing for automatic stabilizers to operate freely can contribute to preserve countercyclical policies (Eyraud et al. 2018).

Second, enforcement remains lenient: country-specific recommendations are often not sufficiently concrete and ambitious, and lack a time frame and expected outcome. In the cases of Spain and Portugal, which did not take effective action to reduce their deficits under the 2013 EDP, the EC decided to cancel the fines in 2016. This precedent sends a signal that member states may not be held accountable for the implementation of their commitments. Part of the problem is that the EC monitors the SGP implementation and makes recommendations, but it does not have power to enforce compliance, as the EU Council of Ministers makes the final decision. Sanctions are relatively mild, and fines have never been used. The Fiscal Compact tightened the rules for sanctions by adopting a "reverse qualified majority" voting procedure whereby EC recommendations are deemed to be approved by the council unless a qualified majority of member states votes against them. Moreover, disbursement of European structural and investment funds became contingent on effective action under an EDP as of 2013. Even so, the EC does not have direct control over national budgets and appears reluctant to propose the imposition of sanctions in the face of opposition from the council, as the example of Spain and Portugal demonstrated.

Stricter enforcement of fiscal rules would require stronger central control on national spending and/or borrowing plans (Allard et al. 2013). To provide stronger incentives for governments to comply, the EFB has proposed making all transfers from the EU budget (including for agricultural support) contingent on SGP compliance, with disbursement automatically terminated in the event of non-compliance (EFB 2017). The EFB also has pointed out that fiscal discipline could be strengthened if the euro area had a central fiscal capacity (CFC) mandated to stabilize the economy in case of major shocks (see below). Making access to the CFC conditional on adhering to the SGP would provide a strong incentive for countries to comply. Compliance could be

3 The EFB is an independent body mandated to advise the EC on the overall direction of fiscal policy of the euro area and to evaluate how the EU fiscal governance framework is implemented. It was set up following the Five Presidents' Report (2015) with the aim to strengthen the economic governance framework of the euro area. The EFB publishes an annual report that assesses SGP compliance and enforcement at the national level and the appropriateness of the euro area's overall fiscal position.

Box 1: The Fiscal Compact

The Fiscal Compact is the fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), an intergovernmental treaty outside the framework of EU law aiming to improve fiscal discipline and economic policy coordination. The TSCG was signed by all EU member states in March 2012, except for the United Kingdom and the Czech Republic, which opted out, and Croatia, which joined the European Union the following year. The Fiscal Compact introduced a stricter version of the SGP and required euro-area members to transpose its provisions into national law in order to increase ownership and compliance. It preserved the SGP's maximum headline deficit of three percent of GDP and cyclically adjusted balance rules, but mandated that the structural deficit should not exceed 0.5 percent of GDP for countries with debt levels exceeding 60 percent of GDP. An automatic adjustment mechanism was established in the preventive arm of the SGP to correct significant deviations and sanctions for non-compliance with the SGP were strengthened. A national fiscal advisory council was mandated to provide independent fiscal surveillance. Two subsequent regulations (the "Two-Pack") envisaged that member countries could be requested to revise their budget plans if they were not deemed to be in compliance with the EC's country-specific recommendations, and that countries exiting adjustment programs or facing financial stability risks could be subject to "enhanced surveillance."^{*}

The Fiscal Compact also included a debt brake rule requiring member states to reduce their debt ratios to 60 percent of GDP within 20 years. The debt brake was first introduced in the "Six-Pack," a set of European regulations to strengthen the SGP and introduce tighter macro surveillance, which entered into force in December 2011. The Six-Pack reform also introduced a Macroeconomic Imbalance Procedure (MIP) that serves as an early warning signal to prevent and correct imbalances due to fiscal deficits, loss of competitiveness or real estate bubbles before they lead to crises. The Six-Pack is an essential part of the Fiscal Compact; its procedures — including the MIP — are part of the European Semester, the annual cycle of reporting and surveillance of EU and national economic policies.

In order to ease the tension between tighter rules and surveillance on one hand and the need for counter-cyclical stimulus on the other, the Fiscal Compact introduced greater flexibility for member countries to respond to cyclical developments. "Relevant factors" that could justify non-compliance under both the preventive and the corrective arm of the SGP were introduced, and more discretion was given to the EC to interpret the rules. The introduction of reverse qualified majority voting by the council on sanctions also strengthened the hand of the EC as "guardian of the Treaties" — at least in theory. Tighter EU rules and enforcement, combined with greater flexibility, have increased the complexity of the rules. Since the Fiscal Compact was adopted, the EC publishes an annual handbook explaining the SGP rules and operational details for policy makers and analysts who want to gain in-depth knowledge of its functioning (at 220 pages, the 2018 edition testifies to its complexity; see EC 2018a).

^{*} This provision was first activated for Greece when it exited its ESM-funded program in August 2018.

further strengthened through the checks and balances offered by the national fiscal councils and the EFB, provided their autonomy and funding are safeguarded. But it remains to be seen whether fiscal rules enshrined in domestic legislation will be effective in generating enforcement during the next downturn.

Proposals for a CFC

A CFC may be needed for the provision of public goods, such as security, defence or border control, in addition to a macro stabilization function. This section focuses narrowly on the stabilization function. Most proposals on macro stabilization focus on building a fiscal buffer to absorb country-specific shocks, which monetary policy cannot address in a monetary union. Examples include EC proposals for a central fiscal capacity (EC 2017),

IMF proposals for “a rainy day fund” (Arnold et al. 2018), Daniel Gros’s proposal for a “stormy day fund” (Gros 2018) and President Macron’s proposals for a euro-area budget covering the provision of various public goods, including macro stabilization (Macron 2017). There is broad agreement that the fiscal buffer should be designed to improve the overall economic resilience of the euro area and individual member countries, and thus help to prevent crises; and should not lead to permanent transfers or be construed as a mechanism to equalize incomes across member countries. But strong differences of view persist as to the desirable size and modalities of the fiscal buffer. In the German view, “adjustment starts at home;” a CFC would only weaken the incentive for Italy and other heavily indebted euro-area countries to undertake growth-enhancing reforms. Another concern is that Macron’s proposals would marginalize non-euro-area EU members and play into the hands of Eurosceptic, populist-led governments in Poland, Hungary and the Czech Republic.

Rainy day fund: The IMF has proposed a rainy day fund financed by annual contributions from national budgets that would make transfers to countries in bad times (Arnold et al. 2018). The fund would be able to borrow in the event of an exceptionally large shock that depletes its assets. Transfers would be triggered on the basis of a cyclical indicator, the unemployment rate relative to its moving average (the “unemployment gap”), which rules out permanent transfers due to structural unemployment. Additional safeguards against permanent transfers include a premium on frequent users and/or a cap on cumulative net transfers and contributions. Simulations suggest that with an annual contribution of 0.35 percent of GDP and a transfer rate of 0.50 percent of GDP for each percentage point of unemployment gap, the fund could help smooth 30–60 percent of a common shock (depending on whether monetary policy is constrained or not), and up to 50 percent of country-specific shocks. The simulations also confirm that the assets built up during a typical expansion should be sufficient to cover the prescribed transfers except during an exceptionally severe downturn.

Catastrophic insurance: Daniel Gros (2018) has argued that what the euro area needs is not a mechanism that offsets all shocks, however small, but insurance against large, potentially catastrophic events. Frequent minor cyclical

shocks that do not lead to major disruptions can be smoothed out by borrowing at the national level. He points to the Greek debt crisis as an example of a catastrophic event that led to a deep recession, high unemployment, widespread bankruptcies and loss of market access. The proposed mechanism would provide insurance by triggering a transfer payment when the shock materializes, against premium payments during good times. All shocks above a certain threshold (the “deductible,” to use an analogy from the insurance industry) would be fully compensated. Simulations using historical data show that permanent transfers would not have occurred under this system, not least because the risk premium to be paid would be determined by a rating system and would increase after a payout. By providing transfer payments, this insurance policy would not aggravate the debt overhang of the affected country, in contrast to ESM loans. A possible way to operationalize this insurance policy would be to launch a system of reinsurance for national unemployment insurance systems, under which the national systems would pay regular premiums to a central euro-area fund.⁴

Common unemployment insurance scheme: Another widely discussed reform proposal is a common unemployment insurance scheme that would help cushion asymmetric shocks and thus improve economic resilience within the euro area. Two broad options have been proposed: First, a common euro-area fund with shared risk, funded by either annual contributions from member countries or by borrowing, covering a basic unemployment insurance benefit that could then be supplemented by national unemployment schemes; benefit levels would thus not need to be harmonized across euro-area countries. Alternatively, a scheme akin to “catastrophic insurance” could be set up, involving payouts only for large shocks that exceed a pre-agreed threshold that exceed national fiscal capacities. This scheme could be funded by insurance premiums paid from member countries to a European “re-insurance” fund, or by borrowing when shocks occur and repaying during good times through levies on wages across the euro area. Both options would preserve the need for national unemployment insurance funds, and rule out permanent transfers

⁴ Gros (2013) has proposed that his reinsurance principle could be applied in the area of deposit insurance, which could remain in the first instance national.

to safeguard the credibility of the “no bailout” rule and the incentives for labour market reform.⁵

Simulations based on micro data during the period 2000–2013 find that 10 percent of the income fluctuations caused by transitions into and out of unemployment would have been cushioned through inter-regional smoothing within the euro area (Dolls et al. 2015). The results suggest that during this period the inter-regional smoothing potential was as important as intertemporal smoothing through borrowing. However, smoothing gains are unevenly distributed across countries, ranging from minus five percent in Malta to 22 percent in Latvia, raising concerns about permanent transfers and moral hazard. Indeed, the simulations reveal that Austria, Germany and the Netherlands would have been the largest net contributors with average annual net contributions of 0.2–0.4 percent of GDP. By contrast, under a contingent benefits scheme, triggered only when unemployment rates increase significantly, no country would be a permanent recipient or permanent contributor. Along similar lines, simulations by Grégory Claeys (2017) show that a European unemployment insurance scheme built for large shocks would have required net payments of €51 billion in 2009 — the year of the deepest output decline — equivalent to just 0.5 percent of euro-area GDP, and cumulative net payments of €46 billion (also 0.5 percent of euro-area GDP) over the entire period 2000–2013. The added value of such a scheme is that it would make the overall fiscal position of the euro area more counter-cyclical through risk sharing.

Current status of CFC implementation: At their June 2018 summit, EU leaders agreed in principle that the ESM would provide the common backstop to the SRF, which is funded by banks (European Council 2018a). In every major jurisdiction, such funds are backstopped by the national fiscal authority to ensure an orderly resolution process in the event their resources are depleted in a deep banking crisis. The modalities of such fiscal support usually involve a credit line that should be repaid over time by banks, as is the case with the Federal Deposit Insurance Corporation (FDIC) in the United States, which is also the resolution authority. Implementation modalities for the ESM

are expected to be agreed by the next EU summit in December (see also the section on banking union).

Discussions also are ongoing on a CFC for euro-area countries. Germany has supported a French proposal for a euro-area budget within the EU budget to ensure convergence and stabilization, but differences of views persist on its size and modalities. The EC recently included a European Investment Stabilization Function and a Reform Support Program (RSP) in its seven-year EU budget proposal for 2021–2027 (EC 2018b). The European Investment Stabilization Function would guarantee loans of up to €30 billion through the EU budget to help maintain public investment levels in countries experiencing a large asymmetric shock and complying with strict eligibility criteria for sound fiscal and macroeconomic policies. It would be accompanied by an interest rate subsidy to cover the costs of the loan, funded from a share of the seigniorage⁶ that EU member states collect. The RSP is a new instrument designed to foster the implementation of reforms in EU member countries, starting with country-specific priority reforms identified in the European Semester. The RSP will provide financial and technical support, with an overall envelope of €25 billion distributed to each member state on the basis of its population share. The EC proposals are in line with German Chancellor Angela Merkel’s acceptance of a euro-area investment budget in the “low double digits of billions” (*Financial Times* 2018a), but they fall short of a full CFC.

Labour Market and Price Rigidities

Member countries can strengthen their resilience to shocks by pursuing structural reforms. There is no “one-size-fits-all” prescription, so reforms should be tailor-made to fit country circumstances. Reforms aimed at boosting competition in product and service markets, increasing labour market flexibility and reducing the tax wedge on labour should be prioritized to reduce rigidities that prevent the economy from adjusting to shocks. Productivity-enhancing policies can help restore external competitiveness, raise potential output and improve fiscal performance.

⁵ Payouts could be triggered by an increase in the unemployment rate of a member country of at least 0.5 or 1.0 percent over its five-year average level (the typical length of an upswing).

⁶ Seigniorage is the income on the assets held by central banks against the banknotes they supply.

An optimum currency area requires price and wage flexibility to enable the real exchange rate to adjust in response to country-specific shocks, even as the nominal exchange rate remains permanently fixed. However, prices and wages display strong downward rigidities in most euro-area countries, preventing the real exchange rate adjustment that may be needed after a negative shock (IMF 2018). These rigidities allowed the accumulation of large external imbalances within the euro area that were at the heart of the crisis.

Between the launch of the euro in 1999 and the euro-area crisis in 2010, inflation in periphery countries remained above the euro-area average. Large and persistent inflation differentials gave rise to loss of competitiveness, which undermined the tradeable sector and gave rise to growing current account deficits. In the absence of exchange rate adjustment in a monetary union, the loss of competitiveness could only be offset through a painful process of internal devaluation. This raises the question of how euro-area countries can help prevent and/or correct diverging adverse developments in their domestic inflation and international competitiveness.

Economic theory suggests that labour and product market characteristics influence the dynamics of real wages and marginal costs of production that drive the price-setting decisions of firms. Empirical research supports the view that regulations reducing price and wage flexibility through minimum wages, union density, wage bargaining structure and employment protection impede relative price adjustment to idiosyncratic shocks and increase inflation persistence (Jaumotte and Morcy 2012). Labour market rigidities, which characterize the labour markets of most high-inflation euro-area countries, have contributed significantly to the high and persistent inflation differentials of these countries in the run-up to the crisis and prevented a quick downward adjustment of inflation when the crisis hit, thus worsening the inflation-output trade-off. These results suggest that reforming labour market institutions would improve the functioning of the euro area by reducing the risk of persistent inflation differentials that undermine competitiveness.

If left unaddressed, persistent inflation differentials that lead to a buildup of external debt can lead to a policy dilemma. On one hand, the loss of competitiveness would require internal deflation to return to an equilibrium

position. But internal deflation in a situation of debt distress would increase in the real value of debts, with destabilizing effects. While deflation is necessary to restore competitiveness, inflation is needed to reduce the real value of debts — an option ruled out by membership in a monetary union. In these situations, debt restructuring is necessary, as was eventually recognized in the case of Greece (Xafa 2014).

Banking and Financial Sector Reforms

The European Union aspired to build a single financial market in which companies, banks, fund managers and investors operate seamlessly across national borders ever since the single market project was launched in the 1980s. Presumably some form of banking and capital markets union were at the centre of this vision, but there was strong resistance to surrendering national sovereignty over banking and financial sector policies to a pan-European institution. Banking union was a major step, ultimately agreed at the peak of the crisis in June 2012 when the breakup of the euro area was at stake. CMU was launched in early 2015, soon after EC President Jean-Claude Juncker assumed office.

Much progress toward banking union has been achieved. The ECB became the single licensing authority for all banks in the euro area and took over the direct supervision of systemically important banks in November 2014. Previously, significant divergences in national rules and practices created a patchwork that gave rise to regulatory arbitrage, distorting competition and making it burdensome for banks to operate across the single market. The crisis also demonstrated that effective crisis management requires a single rule book and stronger central oversight. New bail-in rules took effect for loss sharing by shareholders, bondholders and ultimately depositors to deal with failing banks while protecting taxpayers.⁷ A single resolution board (SRB) became operational

⁷ The Bank Recovery and Resolution Directive (BRRD) (EU Directive 2014/59), which took effect in May 2014, is the single rule book for the resolution of EU banks and large investment firms.

as of January 2016, and a bank-funded SRF that would permit burden sharing of bank losses is slowly being built up. As already mentioned, at their June 2018 summit, EU leaders agreed that the ESM would provide the backstop to the SRF. However, the third leg of banking union, common deposit insurance, appears unlikely to be agreed until further progress is made in resolving legacy issues, notably non-performing loans (NPLs) in banks' portfolios. Losses on these loans must be fully acknowledged, and banks fully capitalized, before pan-European deposit insurance can be introduced. A common deposit insurance scheme is an essential part of banking union. Without it, the doom loop would not be broken because confidence in the banks would depend on the solvency of their sovereign if national budgets are the only available backstop for deposit insurance.

CMU is less advanced than banking union, partly because it was launched later and partly because the initial vision lacked ambition. The EC Green Paper (EC 2015b) and subsequent Action Plan (EC 2015c) set out the goal of achieving CMU for all 28 EU member states by 2019 to help restart growth and job creation. It kick-started the process through a €315 billion EU-funded investment package co-financed with the private sector (the "Juncker fund"). It presented the building blocks of a "well-regulated and fully functioning Capital Markets Union" in the European Union by 2019, when a new Parliament and Commission will take office. The proposed reforms were incremental, first tackling the "low-hanging fruit" and gradually building consensus to address more contentious issues in the longer term — an approach that risked running out of steam.

The project's mid-term review in June 2017 recorded some progress, notably on reviving the market for high-quality securitizations and simplifying prospectus requirements, but other key initiatives were delayed, including harmonizing insolvency procedures across EU members. A true CMU requires far-reaching changes in national laws, including harmonization of accounting and auditing practices, and removal of barriers in areas such as insolvency law, company law and property rights. EU capital markets remain fragmented as asset managers face barriers in selling their funds across national borders, including diverse tax regimes across jurisdictions and national barriers on clearing, settlement and custody services. The CMU agenda must

ultimately include the transfer of authority over capital markets regulation and supervision to a pan-European authority (probably the European Securities and Markets Authority [ESMA], whose mandate is currently limited to a coordinating role), but this was not part of the EC's vision.

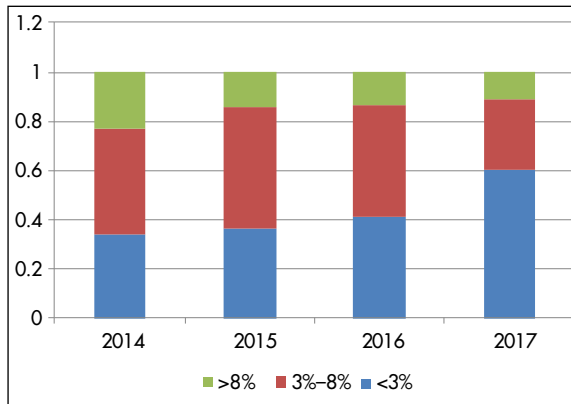
Banking Union

Efforts under way aim at completing the banking union while reducing risks in the banking sector. The council agreed in June 2016 that it would consider setting up a common backstop to the European Union's single resolution fund for failing banks ahead of the 2024 agreed start date; and starting negotiations on a proposed EDIS as soon as sufficient progress has been made on risk reduction. In line with these commitments, ongoing discussions focus on four areas:

→ **NPLs:** The asset quality of European banks has improved, but NPLs remain a key source of vulnerability (see Figure 5). Banks under the supervision of the ECB have raised €234 billion of additional capital since 2014 and the stock of NPLs declined from a peak of €1.2 trillion at end-2013 to €722 billion at end-2017. NPLs declined further to €688 billion in the first quarter of 2018, amounting to 4.8 percent of risk-weighted assets (ECB 2018). While the average NPL ratio is relatively low, the dispersion among countries remains wide — ranging from 45.3 percent in Greece to 1.7 percent in Germany. Moreover, the pace of decline is relatively slow partly as a result of banks' reluctance to sell loans to distressed debt funds at fire-sale prices that could give rise to the need for recapitalization and dilution of existing shareholders. NPLs thus remain one of the key legacy risks in the European banking system, and their reduction has become an integral part of the process of completing the banking union by sharing and reducing risk in parallel.

Following up on an action plan adopted by the council in 2016, in March 2018 the EC proposed new risk reduction measures aimed at reducing both the level of NPLs and their buildup in the future (EC 2018c; 2018d). The proposals include changes to the Capital Requirements Regulation that would require new unsecured loans to be fully provisioned within two years, and new secured loans within eight years, after they are declared non-performing. If a bank does not meet the applicable minimum level,

Figure 5: NPLs in the EU Banking Sector (Share of Banks in Each Category)



Source: European Banking Authority (2018); share of banks with NPLs in each category (<3%, 3%-8%, >8% of risk-weighted assets); weighted average of 190 European banks.

deductions from banks' own funds would apply. The proposals also aim at the development of efficient out-of-court settlements to expedite value recovery on secured loans to businesses, and distressed debt markets to help unload NPLs from banks to authorized credit servicers and investors. A blueprint for the governance and operation of asset management companies is provided for member states that wish to establish them, including permission to provide state aid under exceptional circumstances.

→ **Regulatory standards:** In addition to dealing with NPLs, the latest EC banking reform proposals also aim to incorporate important elements of the global regulatory reform agenda in EU legislation. The reform package would substantially strengthen the regulatory architecture, thus contributing to risk reduction that would pave the way for parallel progress on risk sharing. The package includes proposed amendments to EU regulations in line with international standards agreed under Basel III, such as the introduction of a leverage ratio and other changes aimed at achieving international comparability and a level playing field. Also included are proposals to harmonize the EU requirements for own funds and eligible liabilities (minimum requirement for own funds and eligible liabilities [MREL]) with the international standard for total loss absorbing capacity.

The SRB is in the process of setting binding minimum requirements for MREL for banks in the euro area (SRB 2017), with banks being given up to four years to cover any MREL shortfall. The EU bank resolution framework (BRRD) requires minimum burden sharing of eight percent of total liabilities (including equity) before a bank in resolution may receive any funds from the SRF. This framework protects senior debtholders and depositors from losses only if a bank goes into resolution with sufficient capital and junior debt to remain below the eight percent threshold. The new minimum MREL requirements should ensure that there is a sufficient buffer of loss-absorbing capacity to make depositor bail-ins very unlikely. They initially comprise "external MREL" at the level of the ultimate parent of a banking group, but will later also include "internal MREL" at the level of subsidiary banks within a group, which may be located in different countries. Adequate MREL buffers are critical to effective resolution, but the process of setting minimum requirements based on detailed resolution planning has been slow. Adoption of the full package of banking sector reforms (including NPL reduction proposals) is expected by year-end. It is hoped that the reforms will address gaps in EU and national legislation, which allow national authorities to apply discretion and exceptions, undermining the common supervisory standards (Bini Smaghi 2018).

→ **Backstop for the SRF:** The SRF became operational in January 2016 and has since collected €17 billion in fees from euro-area banks. Its target size of €55 billion, to be reached by end-2023, would represent one percent of covered deposits. The SRF comprises national compartments, which are being gradually mutualized until national compartments cease to exist by 2024. To ensure sufficient funding during the transition to full mutualization, in 2017 the SRB concluded loan facility agreements with euro-area members who committed to provide transitional credit lines up to the full €55 billion target level in case of a funding shortfall. The credit lines would be repaid by bank contributions levied in the country where the resolution occurred. Even with this transitional safeguard in place, the SRF resources might be depleted in a systemic crisis. In this event, reliance on national resources would affect public finances and revive the

doom loop. EU leaders therefore agreed at their June 2018 summit that a common backstop to the SRF would be provided by the ESM — an institution that has the lending capacity and creditworthiness needed to fulfill this function effectively. In line with international practice, public risk sharing through a backstop from the fiscal authority is intended to ensure that sufficient funding for an orderly resolution process is available in periods of stress. Support is typically provided through a credit line from the Treasury, to be repaid by the banking sector over time. Even if the credit line is not drawn upon, its mere existence provides confidence that depositors would be compensated, and bank runs would be avoided.

The experience of the United States during the Great Recession is instructive in this regard: In 2008–2013, 489 FDIC-insured banks failed in the United States, yet the FDIC did not draw on its credit line with the Treasury (FDIC 2017). When the \$52 billion bank-funded Federal Deposit Insurance Fund was depleted, the FDIC preferred to impose a special assessment on banks and ask banks to prepay their normal risk-based assessments in order to ensure that the fund would remain solvent and liquid. Nevertheless, the fact that the credit line was available surely helped maintain confidence that disorderly failures would be avoided. This suggests that the need for risk sharing and risk reduction go hand in hand. With an appropriate governance framework, these goals are mutually reinforcing.

→ **EDIS:** The Five Presidents' Report called for the establishment of a common EDIS that would help protect retail investors and avoid bank runs, thus promoting stability and avoiding contagion. The report also pointed out that a common deposit guarantee scheme is more likely to be fiscally neutral over time than national insurance schemes (deposit insurance schemes [DISs]) because risks are spread more widely, and private contributions are raised from a much larger pool of financial institutions. In November 2015, the EC published a proposal to establish EDIS (EC 2015d). The proposal provided for the creation of a Deposit Insurance Fund (DIF) with a target size of 0.8 percent of euro-area deposits and the progressive mutualization of its resources until a fully-fledged scheme is achieved in 2024, which coincides with the year the SRF will be fully

phased in. Banks covered under the scheme would make risk-based contributions set by the SRB — providing an incentive to reduce home bias — the practice of banks to hold large exposures of the debt of their own sovereign. The transition to full EDIS would be structured in three stages: re-insurance, co-insurance and full insurance. Subsequent modifications to this proposal envisaged a more gradual phase-in to address member states' concerns about risk reduction. Only two stages were envisaged, a re-insurance phase, during which EDIS would provide loans to DISs if needed to ensure full payouts in a crisis, followed by a co-insurance phase in which EDIS would progressively cover losses, subject to risk-reduction requirements. Discussions on EDIS continue, focusing on a road map for risk reduction, with a target date for full phase-in remaining at 2024. Agreement in principle on a set of risk-reduction measures was reached in May 2018 (European Council 2018b), and the adoption of a package of measures aimed at reducing risk in the banking sector is expected before year-end.

Despite progress on all these fronts, further steps are needed to ensure uniform application of EU rules across the euro area and ensure the independence of the SRB. Currently, SRB decisions (for example, on MREL requirements) go through national resolution authorities instead of being applied directly to banks, and the resolution process remains complex and fragmented. In particular, unlike the common SRM framework for resolution, national insolvency procedures for liquidation differ widely (SRB 2018). Recent experience with failing banks in Italy and Spain has shown that national bank insolvency rules are too fragmented and burden-sharing rules too inconsistent (Merler 2018; IMF 2018). Under the current EU framework (BRRD), a bank that is failing or likely to fail would normally be liquidated under national insolvency proceedings, unless it provides critical functions to the economy or when its liquidation might threaten financial stability. If so, the SRB would place the bank under resolution to ensure continuity of critical functions and avoid financial instability. An important difference between resolution and liquidation is that the use of public funds through the SRF in resolution is subject to bail-in of at least eight percent of bank liabilities (including equity), whereas national liquidation procedures vary widely in terms of the hierarchy of creditor claims and burden-

sharing requirements. If the bank is solvent it could qualify for precautionary recapitalization, which permits the use of public funds in compliance with state-aid rules⁸ without triggering resolution and the associated eight percent bail-in requirement. Creditors may thus receive more favourable treatment under liquidation than resolution, at the expense of taxpayers. The IMF has recommended the introduction of a more unified bank liquidation regime by aligning the state aid burden-sharing requirements with those of the SRM, and adopting a common creditor hierarchy for bank liquidation to ensure that no creditor can be better off in liquidation than in resolution. Finally, the proposal to have a fully-fledged EDIS in 2024 coincide with the year the SRF will be fully phased in is a positive development, insofar as integrating deposit insurance and bank resolution would simplify crisis management, as demonstrated by the FDIC in the United States.

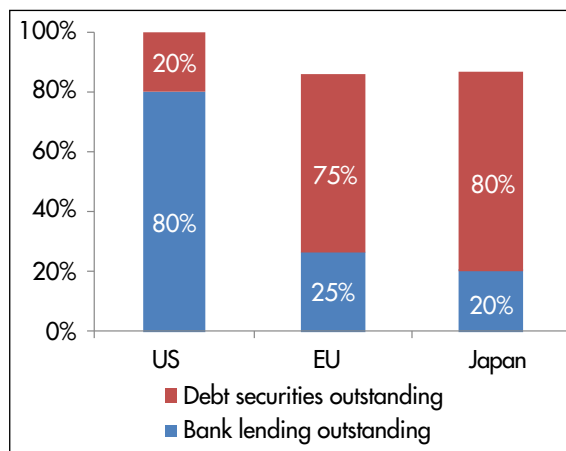
Capital Markets Union

Impetus for CMU was provided by the slow recovery from the balance sheet recession triggered by the global financial crisis. Noting that, compared to the United States, European businesses rely much more heavily on banks than on capital markets for funding (see Figures 6 and 7), the green paper launching CMU argued that deeper capital markets would help unlock more funding for investment, including from the rest of the world. It also noted that capital markets offer an important channel for risk sharing, because the more geographically diversified is a portfolio of financial assets, the less volatile the returns and the less correlated with domestic income. Consumption smoothing in a recession occurs through the financial returns residents receive on assets. Member countries can smooth their consumption by adjusting the composition of their asset portfolio in response to shocks — for example, by purchasing equity in better-performing parts of the union.⁹

⁸ A Banking Communication from the Commission was adopted in 2013 based on Article 107(3) of the TFEU, which provides that some types of state aid under exceptional circumstances are compatible with the Single Market.

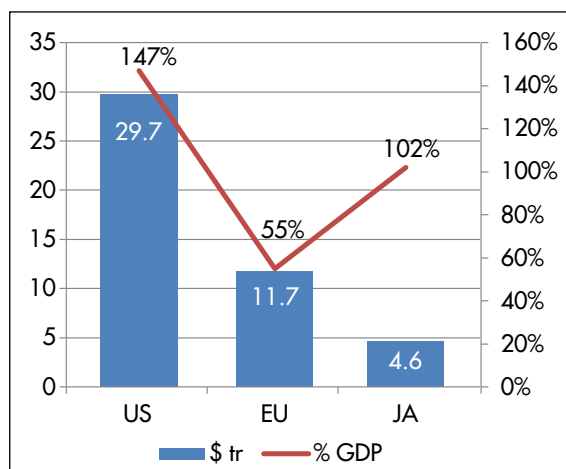
⁹ Private risk sharing can also occur through an integrated banking system: if domestic banks lend to foreign borrowers, the flow of interest payments from abroad provides a cushion in the lending country. However, risk sharing via international credit markets tends to be lowest when it is most needed, because credit markets have a tendency to freeze up during crises.

Figure 6: Corporate Debt Financing, 2016 (%)



Data source: Securities Industry and Financial Markets Association (SIFMA).

Figure 7: Market Capitalization of Listed Shares, 2016



Data source: Bloomberg and SIFMA.

The Five Presidents' Report included Europe's financial union among the top policy priorities for the future governance of EMU. It pointed out that strong buffers created through private risk sharing are a substitute for public risk sharing through fiscal transfers. In contrast to public risk sharing, which provides fiscal transfers after the crisis hits, private risk sharing is *ex ante* — that is, it provides insurance against shocks through financial markets. The report also recognized that the gradual strengthening of the supervisory framework should ultimately lead to a single European capital markets supervisor.

The EC's CMU Action Plan (2015c) aims to identify and remove obstacles to cross-border capital markets transactions. A few milestones in the process of building CMU have been completed, but much remains to be done. The Brexit vote in mid-2016 was a clear setback, primarily because London is the European Union's financial centre but also because key elements of the CMU project were delayed to avoid pre-empting the Brexit negotiations. The flagship Simple and Transparent Securitization initiative aimed at diversifying funding sources for SMEs — originally due to be completed in the third quarter of 2015 — was bogged down with complex bargaining over provisions linked to access rights for non-EU members. Agreement on this crucial milestone was finally reached in May 2017 (EC 2017) but will only take effect in 2019, after the related secondary legislation on technical standards and guidelines is issued.

The CMU agenda must ultimately include the transfer of authority over capital markets regulation and supervision to a pan-European authority. Unlike banking union, however, this objective was not part of the Action Plan, largely because of UK opposition. The United Kingdom's eventual exit from the European Union thus provides an opportunity to relaunch the CMU project with a more ambitious agenda that goes well beyond putting in place some of the necessary "building blocks" for CMU.

The project's mid-term review in June 2017 recorded some progress, notably on reviving the market for high-quality securitizations and simplifying prospectus requirements for initial public offerings and secondary offerings, to make it easier and cheaper for SMEs to raise funds. Other key initiatives were delayed, including harmonizing insolvency procedures across EU members. Four new legislative initiatives were tabled to advance the CMU agenda, aiming to address the regulatory and supervisory fragmentation that implies companies are faced with different requirements in each member state:

→ **A Pan-European Personal Pension Product (PEPP):** This aims at laying the foundations for a standardized and cost-efficient "third pillar" personal pension scheme that can be managed on a pan-European scale. Such a scheme would help develop deeper pools of capital by tapping pension savings.

→ **Legal certainty for cross-border securities' ownership rights:** The EC has tabled proposals to remove the uncertainty surrounding securities ownership in cases when the securities issuer and the investor are located in different EU countries, or when debt claims are used as cross-border collateral. This initiative overlaps with the EU Council's Action Plan on NPLs, discussed above, which includes steps to develop distressed debt markets and ensure secured lenders' ability to attach collateral.

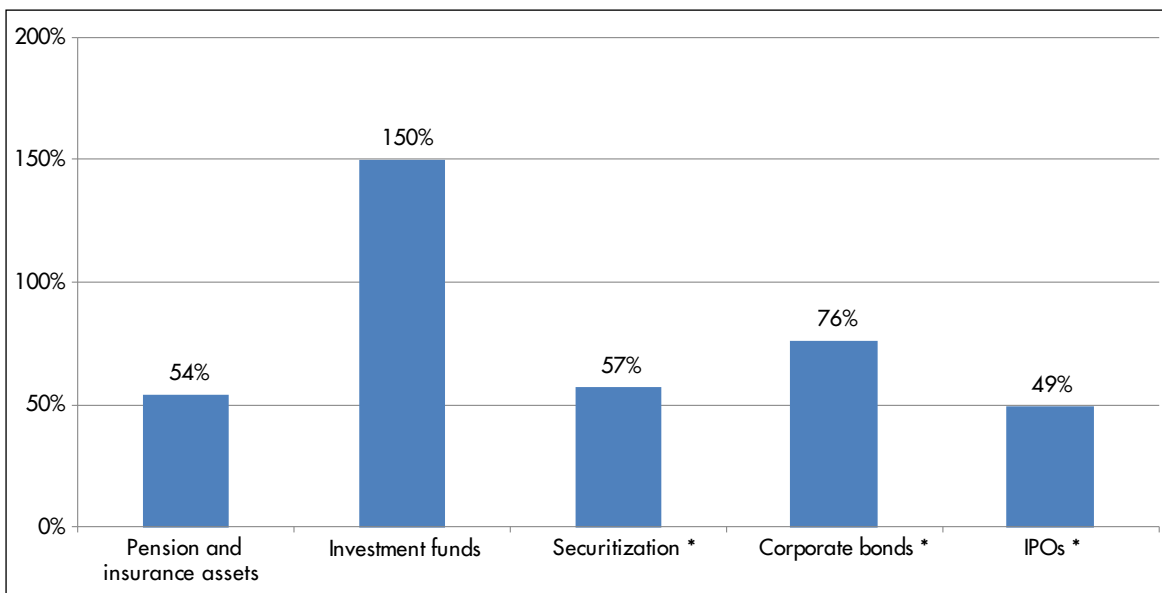
→ **EU framework for covered bonds:** The aim is to create a more integrated market for covered bonds¹⁰ in the European Union by setting uniform requirements and strengthening investor protection.

→ **Capital markets supervision:** Strengthening ESMA's ability to ensure consistent supervision across the European Union is essential for the Single Rulebook to be implemented in a uniform way across the single market. The aim is to apply the same supervisory standard to financial entities with similar business size and risk profiles regardless of where they are located in the European Union, thus avoiding regulatory arbitrage.

These initiatives are awaiting approval by the European Council and Parliament. Meanwhile, in September 2017, the EC submitted legislative proposals to strengthen the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB) to ensure consistent supervision and uniform enforcement of the Single Rulebook. While most supervisory responsibilities would remain at the national level, the proposals would enhance the ESAs' powers to promote convergence of supervisory practices, increase the independence of their executive boards, and expand their budgetary resources through contributions from the private sector. A few areas would be directly supervised by ESMA, including central counterparties, approval of prospectuses, and funds regulated at the EU level. Separately, in December 2017, the EC issued new guidelines on withholding taxes that aim to facilitate refund requests by EU cross-border investors in the event of double taxation.

10 Covered bonds are debt securities typically issued by a bank and collateralized against a pool of assets that can cover claims in case the bank fails. Unlike asset-backed securities created in securitization, covered bonds remain on the issuing bank's balance sheet subject to a capital charge, i.e., they do not create room for new lending.

Figure 8: Depth of EU27 Capital Markets Relative to the United Kingdom (GDP-adjusted, three-year average 2014–2016)



Source: Wright and Asimakopoulou (2018). Reproduced with permission.

Note: * Issuance.

The election of pro-reform governments in France and Germany last year seemed conducive to accelerated implementation of the CMU agenda, at a time when Brexit highlighted the urgency of developing deeper capital markets in the EU27. A recent study found that markets in EU27 countries are just over half as well developed as the United Kingdom relative to GDP, with bond markets three-quarters the size of the United Kingdom and equity markets only about half as deep (Wright and Asimakopoulou 2018). On average, markets in the EU27 are just over half as developed relative to GDP as in the United Kingdom, and are only deeper in the value of investment funds by domicile — a sector in which Luxembourg and Ireland account for 45 percent of all EU activity (see Figure 8).

EU officials are concerned that the departure of Europe’s largest financial centre from the European Union could have adverse consequences on continental European companies that rely on London for their capital-raising needs. There is also concern about the need for stronger central oversight to ensure consistent application of regulatory principles in the EU27 as the influx of businesses from the City of London to continental Europe continues. These prospects make it urgent to refocus the Action Plan on achieving CMU among the EU27. Such a project should be viewed as part

of a long-term agenda rather than as a short-term expedient to overcome the reluctance of banks to lend and boost investment. Near term, however, efforts should focus on those outstanding items of the CMU Action Plan that are urgently needed post-Brexit and can be completed quickly, such as efforts to improve data comparability, increase legal certainty and harmonize rules for marketing investment products. Longer term, progress toward CMU is possible without impinging on contentious issues involving fiscal backstops. Unlike prudential supervision, which needs to be accompanied by a resolution framework with fiscal implications, enforcement of capital market rules such as those governing authorization of funds for retail distribution or issuance of securities does not generate fiscal responsibilities.

However, headwinds have prevented rapid implementation of the CMU agenda, with key legislative proposals languishing at the European Parliament. Some of the proposals touch on sensitive national areas, such as pensions and business insolvency, and governments are reluctant to transfer power from their own financial supervisors to an EU institution. The new Italian coalition government that took office in May 2018 does not support further European integration, while the incentive to

seek alternative funding sources for investment is weakening as bank balance sheets gradually recover. In August 2018, EC Vice President Valdis Dombrovskis warned that, at the current pace, the building blocks of CMU might not be in place by the end of the current commission's term in November 2019 (*Financial Times* 2018b).

A successful CMU will emerge through market forces, once regulatory and legal impediments are removed. The initiatives in the CMU Action Plan are steps in the right direction. At the current pace, however, the building blocks of CMU are unlikely to be in place by 2019. Priority should be placed on deepening financial market integration, as opposed to helping SMEs access market-based finance, tackling investment shortages and promoting infrastructure investment, green bonds or energy-efficient mortgages. As the author has argued elsewhere (Xafa 2017), these are valid objectives, but they are not central to the CMU project. More effort has to be made in harmonizing insolvency proceedings, improving market infrastructure (Giovannini barriers¹¹), developing venture capital and harmonizing taxation of financial products. Better harmonized insolvency laws and bankruptcy rules could make it easier for cross-border investors to recoup losses in case a business fails. The World Bank's "Doing Business" report for 2018 shows that the recovery rate in insolvency cases ranges from 33.6 cents on the euro in Greece to 88.3 in Finland. The CMU agenda also needs to attract and incorporate more actively household and corporate sector savings in vehicles that will invest in capital markets and encourage them to diversify across the European Union, along the lines of the proposed PEPP product. A fragmented financial sector is not only inefficient but also unable to attract investments from overseas.

11 The persistence of multiple stock exchanges and market infrastructure is clearly not optimal for a single-currency area, as different national rules and practices hinder cross-border trading. As a result, the euro area's financial market cannot reap the full benefits of risk diversification and competition that arise from the single currency. Consolidating legal entities would help reduce barriers and pool liquidity across various markets. Market infrastructure barriers were identified in two reports by the Giovannini Group, a group of financial market experts who advised the EC in the early 2000s. The reports identified several regulatory, tax and legal barriers that prevent efficient EU cross-border post-trading services (clearing and settlement).

Creation of Safe Assets

The absence of a genuine euro-area yield curve makes cross-border risk sharing more difficult. The creation of a genuine euro-area safe asset, comparable to the US Treasury bond, would be instrumental in building such a yield curve to have a price benchmark for the CMU; it would help financial institutions diversify their sovereign risk exposures and promote private risk-sharing. Before the crisis, when a credit event in the euro area's sovereign bond market was unthinkable, regulators assigned a zero-risk weight to all sovereign bonds in the euro area. The bonds of Greece and Germany in bank balance sheets were (and still are) treated as equally safe when calculating regulatory capital, even though their credit ratings and market prices differ widely. This treatment contributed to home bias, as it did not provide any incentive for banks to diversify their holdings of sovereign bonds. During the crisis, the increase in the sovereign yields of fragile member states created a negative feedback loop by raising bank borrowing costs and deepening the recession, thus adding to sovereign stress. In the absence of a European safe asset, flight to quality took the form of capital flows from the periphery to the centre, magnifying the crisis. Even in normal times, the lack of a common safe asset is an impediment to the uniform transmission of monetary policy, as differences in sovereign risk across member countries lead to differences in bank funding costs and lending conditions.

Several ideas have been floated on how to create synthetic euro-area-wide safe assets, some of which involve shared risk while others do not (see Leandro and Zettelmeyer 2018 for an overview). Some of these proposals have been criticized by fiscal conservatives as an effort to introduce Eurobonds with shared risk through the back door, in the guise of a safe asset. A proposal that has gained the support of the EC was put forth by a high-level task force under the auspices of the ESRB, chaired by the governor of the central bank of Ireland (ESRB 2018). The proposal involves pooling, packing and tranching of cross-border portfolios of national sovereign bonds to create safe assets, referred to as Sovereign Bond-Backed Securities (SBBS). SBBS are collateralized debt obligations backed by a portfolio of sovereign bonds of all euro-area member states, with a senior super-safe tranche and junior more risky tranches. The relative weights of the bonds backing the safe asset would be in line with each member state's contribution to the capital of the ECB (which in turn reflects a simple average of

their contributions to the euro area's GDP and population), with German debt accounting for about 30 percent of the total. To the extent that it would help reduce home bias, SBBS would help loosen the “doom loop” between sovereigns and their banks. They would also help avoid capital flight from the euro area's periphery to its core, which reduces fiscal space in the periphery when it is most needed. “Flight to quality” episodes would take the form of shifts in demand from junior to senior tranches, with junior tranches first in line to bear any losses on the underlying securities.

Opponents of this proposal point out that a repackaging of the risks of sovereign bonds through financial engineering cannot stabilize a financial system that is fundamentally unstable (De Grauwe and Ji 2018). They argue that the ESRB proposal creates the illusion that the sovereign bond markets in the euro area can be stabilized without the need to share the risk among sovereigns, when in fact risk sharing through fiscal union is necessary to stabilize bond markets. Also, a safe asset is not indispensable for banks to diversify their holdings of sovereign bonds. Concentration charges would be a powerful instrument to promote diversification (Véron 2017). They would need to be phased in gradually, to provide time for banks to sell excess debt of their own sovereign without disrupting the rollover of sovereign debt.

To help develop the market for SBBS, the EC has put forward a legislative proposal to remove regulatory impediments to their origination (EC 2018e). SBBS are securitized financial products that could be issued by a commercial entity or an institution subject to certain regulatory requirements. As such, they would be treated significantly less favourably than the underlying portfolio of euro-area sovereign bonds (via higher capital requirements, limited eligibility for liquidity coverage and collateral, and so on). However, since the underlying assets are well-known and the SBBS structure is simple and standardized, the EC proposed to align its regulatory treatment with that of the underlying sovereign bonds, i.e., attach zero-risk weights on SBBS regulatory capital requirements.

A limitation of the EC proposal is that SBBS would need to be produced on a massive scale to significantly reduce home bias and capital flight to the core. However, their issuance would be constrained by very low debt levels in countries such as Estonia and Luxembourg, and eventually by Dutch and German debt levels (Claeys 2018).

This would imply that significant amounts of the bonds of high-debt countries, notably Southern European countries, would be excluded from SBBS, putting them at a disadvantage and increasing rollover risk. Any regulatory advantage given to SBBS to incentivize banks to hold them could create instability by triggering a sell-off of weak sovereign bonds. The same concern would apply to any preferential haircut valuation offered to SBBS over individual bonds in ECB refinancing operations.

The key for an asset to be considered safe is sound fundamentals; no amount of financial engineering can change this fact. The first best policy therefore remains prudent fiscal and structural policies in individual euro-area countries. A safe asset in the euro area can help diversify risks but remains untested by markets and is viewed with suspicion by fiscal conservatives. Political opposition from the core countries remains strong, while countries in the periphery are concerned that the proposed change in the SBBS regulatory treatment could have adverse market implications for their own bonds. No decision has therefore been made so far on creating a euro-area safe asset.

A more direct route to promoting risk diversification in the long run would be to replace the current zero-risk weights attached to the regulatory treatment of euro-area sovereign debt by risk-adjusted capital requirements. In the current environment — in view of political developments in Italy and high debt levels in the euro-area periphery — such a policy could not be realistically implemented as it would trigger a bond sell-off that would create instability. Over time, however, as remaining elements of the banking union and CMU are completed and differences in sovereign risk perceptions across euro-area countries are reduced, risk-adjusted capital requirements would provide a strong incentive for banks to diversify their sovereign holdings and reduce home bias.

Institutional Reform

When the euro-area crisis erupted, European policy makers (and the IMF) were faced with a dilemma: lending to a country whose debt sustainability was in doubt, or refusing to lend to a country that posed a systemic threat. They opted for the former for fear of contagion, confirming that

the “no bailout” clause of the EU treaty was not credible because spillover risks were very high. With the ESM now in place, potentially supported by the ECB’s OMT program, and with the banking union nearly completed, bail-in appears to be a reasonable alternative to bailout. Several proposals have been made to expand the mandate of the ESM in crisis resolution, while others focus on the need for a euro-area finance minister to manage a common budget for macro stabilization and other public goods. Some of these proposals require steps toward political union as a prerequisite for expanded risk sharing. Other proposals focus on the more modest objective of expanding the ESM’s loan facilities. Changing the ESM’s legal status to bring it within EU law also is part of the debate.

Euro-area Finance Minister

President Macron visualized a common EU budget providing public goods in the areas of security, defence, border controls and so on, placed under the political guidance of a common finance minister who would be subject to strict parliamentary control at the European level (Macron 2017). Macro stabilization for euro-area countries could be one of the functions of the common EU budget but its reach would be much broader. EC President Juncker had a different vision for the role a finance minister could play, outlined in his 2017 state of the union address (Juncker 2017). In addition to presiding over a euro-area budget (a line item in the EU budget), the finance minister would be the commissioner for economic and financial affairs and vicepresident of the commission, would chair the Eurogroup, and be accountable to the European Parliament. In this role, they would presumably also provide recommendations to the Eurogroup and the member states on their national fiscal policies, based on the SGP. The euro-area finance minister would thus chair a group of ministers who have the power to overrule their recommendations. Juncker also proposed merging the roles of president of the commission and the council. These proposals would mix the roles of the EC (as impartial guardian of the Treaty) and the Eurogroup or the council (who have ultimate decision-making power), and upset the delicate balance between common European interests versus national interests.

Juncker’s proposal would clearly strengthen the hand of the EC, but it is institutionally problematic and could lead to potential conflicts of interest (Wolff 2018). Instead of creating an ill-designed finance minister role, Guntram Wolff

has proposed making the Eurogroup president a full-time position with a clear European mandate, accountable to the European Parliament. This proposal is based on the belief that the current practice of appointing a national minister to chair the Eurogroup does not necessarily safeguard the common interest and can lead to conflicts. However, appointing a full-time Eurogroup president would not guarantee improved fiscal coordination or a better fiscal stance for the euro area as a whole. This would require the Eurogroup president/finance minister to have access to budgetary resources, which would require a CFC. As discussed above, however, a CFC is not in the cards at present because it is viewed as favouring only the countries with limited market access.

A European Monetary Fund

Strengthening the ESM is viewed as a way of making the monetary union more robust and for Europe to take on more responsibility to solve its own problems, while de-emphasizing the role of the IMF. The mandate of the ESM as a crisis resolution mechanism already has evolved from just raising funds in capital markets and disbursing it to program countries to also providing policy advice. In addition, the ESM has built an early warning system to monitor debtor countries in which it has exposure. Institutionally, it would make sense to unify the functions of program design and monitoring with the provision of financial support under a single roof, the ESM. However, under the current institutional setup, economic and financial surveillance are currently conducted by the EC and the ECB, respectively, although a recent agreement between the ESM and the EC calls for close collaboration on surveillance and debt sustainability assessments (ESM 2018). In case the collaboration does not yield a common view, the agreement empowers the commission to make the overall assessment of debt sustainability, and the ESM to assess the capacity of the debtor country to repay ESM loans. This division of labour would obviously not resolve the conflict, since debt sustainability and the debtor’s capacity to repay the lender go hand-in-hand, but would call on euro area finance ministers — who also constitute the ESM’s board of directors — to make the final decision.

Discussions on how to strengthen the euro area’s crisis management mechanism have brought different perspectives to the fore. How to convert the ESM into a European Monetary Fund dominates the headlines, but this debate is misleading. The

ESM's resources come from market borrowing with the guarantee of member states, not from monetary sources. The ESM is a fiscal, not a monetary backstop but — unlike a common Treasury — it can only act after a crisis has erupted. Be that as it may, the EC has proposed creating a European Monetary Fund anchored within the European Union's legal framework (EC 2017). The EC proposal would also replace the current unanimity requirement in the ESM treaty with a “reinforced qualified majority” voting procedure, in which 85 percent of the votes is required, to speed up decisions on stability support, disbursements and the deployment of the backstop. If adopted, this voting system would give veto power to the three largest euro-area countries (France, Germany and Italy). However, it is not clear that this would greatly expedite decisions, as the unanimity requirement has not so far prevented timely assistance to program countries. A sovereign debt restructuring scheme is not part of the EC's proposal.

The ESM was established by intergovernmental treaty in October 2012 and it thus not part of the EU treaty. Changing its legal statute is a contentious issue that distracts from the reform debate. As a revision of the treaty is unlikely at present, the EC proposal is to incorporate the ESM into the EU framework through a council regulation, subject to the consent of the European Parliament, under Article 352 of the TFEU¹² — a sort of emergency clause that would bring the ESM under the purview of the EC instead of the euro-area governments. However, this proposal is not supported by a majority of member states, and its legal basis is questionable. The managing director of the ESM has proposed to eventually integrate the ESM into the EU framework along the lines of the European Investment Bank, an institution with its own capital (i.e., not funded from the EU budget) and its own governing bodies, which provide the independence and flexibility needed to operate in markets and function efficiently, but this would require changing both the ESM treaty and the EU treaty (Regling 2018). The German government has endorsed the idea of turning the ESM into a regional version of the IMF, but believes the European Monetary

Fund should remain an intergovernmental institution like the ESM (*Financial Times* 2018a).

Various new mandates for the ESM have been envisaged, ranging from helping program countries regain market access to providing a macro stabilization function through a new loan facility (Andritzky and Rocholl 2018). European leaders already agreed at their June 2018 summit that the ESM would backstop the SRF, and technical details are being worked out. The ESM could assume the role of backstop for the banking union by also backstopping EDIS, when and if it is agreed. Reforms of the ESM's lending tool kit have been proposed, including new loan facilities in connection with the investment stabilization and structural reform support functions proposed by the EC. The ESM could also play a role if member states were to define more clearly a sovereign debt restructuring framework to manage sovereign crises. Assuming such a framework were agreed, the managing director of the ESM has suggested that the ESM could provide the debt sustainability analysis and help organize debtor-creditor negotiations aiming at fair burden-sharing (Regling 2018). With these additional tasks, the role of the ESM would mirror more closely the role of the IMF in crisis resolution. But managing sovereign debt crises has turned into one of the most contentious issues in the reform debate.

Managing Sovereign Crises

Managing sovereign debt crises is one of the key battle lines over euro-area reform, with two groups holding diametrically opposing views. A German-led group of countries, including the Netherlands and other Northern countries, contend that ESM-funded bailouts must be accompanied by debt restructurings that impose losses on private bondholders. This group believes that imposing haircuts on private creditors is essential to enhance market discipline and to protect euro-area taxpayers from possible losses on bailout funds. Another group, led by France and Italy, believe that automatic debt restructurings would throw financial markets into turmoil and risk the euro area's breakup. They argue that the mere existence of a restructuring framework could trigger or deepen a confidence crisis. Italy has reason to be worried, as its public debt amounts to 130 percent of GDP and is mostly held by domestic banks and investors.

12 Article 352 of the TFEU contains a provision allowing the European Union to adopt an act necessary to attain objectives laid down by the treaties in case the treaties have not provided the powers of action necessary to attain them.

Strong policy conditionality is embedded in the ESM treaty to ensure that the debtor country restores debt sustainability and market access. In the event conditionality is not observed or downside risks materialize, the ESM needs to guard against credit losses and moral hazard at the expense of the European taxpayers through a credible debt restructuring framework. The need for such a framework was first hinted at the Deauville Franco-German Summit in October 2010, and used in an ad hoc manner in the 2012 Greek debt restructuring, but is not embedded in the ESM mandate for dealing with sovereign debt crises.

The German Council of Economic Experts has proposed a debt restructuring framework similar to the framework adopted by the IMF in 2015 (IMF 2015). The new IMF lending framework for large loans removed the “systemic exemption” that was created in 2010¹³ and called for debt reprofiling (i.e., an extension of maturities falling due during the program period) under certain conditions, for countries in the “grey area” where debt is assessed to be sustainable but not with a high probability. The objective is to avoid lending to a country whose debt eventually proves to be unsustainable and thus safeguard IMF resources. Maturity extensions reduce funding needs for the rollover of private claims while the debtor’s solvency remains in doubt. In the event downside risks materialize, a haircut on private debt claims can be negotiated at a later stage during the program period if it proves necessary to restore debt sustainability and durable market access. This framework ensures that liquidity and solvency issues are addressed in two stages to avoid imposing unnecessary costs on debtors and creditors. Postponing deeper debt restructuring until it proves necessary offers more time for reforms in the debtor country to take hold and for creditors to build buffers against an eventual default. The new IMF policy does not automatically presume that a reprofiling would

be implemented at the outset when debt is in the gray zone. In cases where the member has not lost market access, or where the maturities falling due during the program period are relatively small, private exposure could be maintained without the need for a restructuring of their claims. The new policy strikes a delicate balance between a framework that provides sufficient discretion to deal with severe debt crises on a case-by-case basis, and one that is sufficiently rules-based to prevent undue political influence.

Noting that creditor bail-in has become an accepted principle for banking crises but not for sovereign debt crises, the German Council of Economic Experts has proposed an operational framework similar to that of the IMF, which explicitly sets out when and how debt restructuring is activated (Andritzky et al. 2016). Such a framework is intended to help promote more efficient crisis resolution and improve crisis prevention by strengthening market discipline *ex ante*. Unlike the IMF approach, which preserves discretion, the proposed framework sets pre-established triggers to activate maturity extensions if the debt-to-GDP ratio or gross financing needs exceed a particular threshold at the outset of the program. The second-stage decision — the need for deeper debt restructuring — would be based on the ESM’s revised debt sustainability analysis. The terms of the restructuring would be jointly agreed between the debtor country, bondholders and the ESM. To ease the transition to the new framework, the authors propose that it would be phased in gradually; it would not apply to legacy debt but only to debt issued under the new framework. The new debt would be issued under “single-limb” collective action causes (CACs)¹⁴ to minimize the scope for holdout creditors to block or frustrate a restructuring. To

13 The IMF modified its exceptional access framework in 2010 by introducing a “systemic exemption” clause, which permitted lending to Greece despite the fact that the Fund did not assess Greece’s debt to be sustainable with high probability. Up-front debt reduction was ruled out because there were serious concerns that this could lead to severe contagion in the euro area. The systemic exemption allowed large-scale financing to go ahead without a debt reduction operation in cases where the risk of international spillovers was high. However, the exemption did not mitigate contagion because it left market concerns about debt sustainability unresolved. Also, by replacing maturing private sector claims with official claims, it increased “subordination risk” for private creditors (i.e., the risk that private claims would rank lower than official claims in case of default), making it harder for the country to regain market access.

14 Article 12 of the ESM treaty provides for the mandatory inclusion of standardized and identical CACs in all new euro-area sovereign bonds, irrespective of their governing law, as of January 1, 2013. By facilitating debt restructurings, CACs can shift some of the costs of financial distress on to private creditors. CACs allow the financial terms of a bond to be modified if a qualified majority of bondholders agrees. The euro CACs make it easier to reach a restructuring agreement compared to English law or New York law bonds by having a lower majority requirement in each bond series to change the terms (66.67 percent versus 75 percent voter approval, based on the face value of the original claims), and by including a cross-series modification mechanism that constitutes a weak aggregation clause. The IMF has proposed an enhanced CAC that includes a more robust “aggregation” feature designed to limit the scope for holdout creditors to obtain a blocking minority. While traditional CACs operate on a series-by-series basis, the enhanced CACs include a “single limb” voting procedure that would enable debt to be restructured on the basis of a single vote across all series of bonds (IMF 2014).

enhance market discipline, countries that fail to comply with SGP fiscal rules could be required to ask their bondholders to extend maturities as a precondition for ESM assistance. In this view, compliance with fiscal rules is a relevant factor in assessing debt sustainability because it can be interpreted as proxy for the economic and political capacity to deliver fiscal adjustment.

A Franco-German reform proposal by academics and policy makers recommends a softer approach, without automatic triggers as a precondition for a country to receive conditional assistance from the ESM (Bénassy-Quéré et al. 2018). Their proposal is essentially identical to the IMF's new lending framework: maturity extensions should be sought only for countries in the “grey area” of debt sustainability, with large bond rollovers falling due in the program period, while maintaining the option of a deeper restructuring in the future.

The various proposals for a debt restructuring framework are seen as part of a package aimed at increasing the euro area's resilience to shocks, together with the completion of banking union and the removal of regulatory privileges for sovereign debt. However, several Italian economists (including Lorenzo Bini Smaghi, Stefano Micossi and Guido Tabellini), consider that the proposals to reform ESM policies and regulate sovereign exposures of banks would create unacceptable stability risks for countries with high legacy debts, such as Italy, and hence for the euro area as a whole. They also note that regulatory changes would be insufficient to break the doom loop; even if banks had limited holdings of government bonds, they would nevertheless suffer disproportionately from a shock affecting their own country since banks' ratings, credit risk and market access are closely linked to the respective sovereign (Bini Smaghi 2018).

In an attempt to find some common ground, two of the authors of the Franco-German reform proposal acknowledge that any attempt to improve market discipline in the euro area needs to be mindful of its potentially destabilizing effects, but they also point out the benefits of an orderly debt workout. A debt restructuring framework would represent an improvement relative to the ambiguity and ad hoc solutions prevailing today, and a last resort before debtor countries consider exiting the euro area as a possible solution to their debt problems. The transition to the new regime should be carefully managed,

for example, by exempting bonds currently held in bank portfolios from concentration charges (Pisani-Ferry and Zettelmeyer 2018). Daniel Gros and Thomas Mayer (2017), who proposed the establishment of a European Monetary Fund as early as February 2010, use the example of Greece to argue in favour of a standstill in debt service payments when a program country has a very high debt burden (which was the case for Greece and Portugal but not for Cyprus, Ireland or Spain), as well as in favour of a limit on the amount of debt that their own sovereign banks should be allowed to hold. In the first Greek bailout, between May 2010 and March 2012 some €60 billion of private debt was rolled over with official financing, before a deep restructuring that left Greek banks with a capital shortfall of more than €30 billion. The authors conclude that while there may have been no alternative to the Greek bailout in 2010 for fear of contagion, debt restructuring can now be contemplated dispassionately, after the euro-area reforms — notably the ESM, OMT and banking union — have limited the scope for spillover risks.

Conclusion

After years of low or negative growth, the euro area started recovering in 2014, with output growth expected to remain above potential through 2019. The upswing has reduced risks of a new flare-up, but the litmus test of the recent reforms in the euro area's architecture will come at the next downturn. At the country level, deep structural issues continue to impede medium-term growth prospects and hinder income convergence. The IMF has urged countries to address country-specific challenges by stepping up structural reform efforts to boost productivity and employment (IMF 2018), while the EC has proposed a new Reform Support Facility to provide financial and technical support for reforms (EC 2018d). Global risks, including slower global growth and trade frictions with the United States, also weigh on medium-term economic prospects.

Crisis legacies — notably high public debt and NPLs in bank balance sheets — have damaged trust and undermined the political feasibility of implementing proposals for more risk sharing. Perhaps the biggest threat to the resilience of the euro area is the rise of Eurosceptic political

parties that advocate exit from the euro, hindering progress toward more integration. The risk of a new existential crisis in the euro area triggered by the populist coalition government that took office in Italy in May 2018 appears to have receded for now, but it remains unclear whether the coalition will stick to the European playbook or attempt to deliver on unrealistic pre-election promises.

Whether sufficient progress in euro area reform can be made before the next downturn remains an open question. Brexit has made some aspects of reform more urgent, in particular steps toward CMU among the remaining EU27, but full CMU remains a long-term goal. The banking union will likely remain incomplete until enough progress is made toward risk reduction to permit some form of EDIS to move forward. Ideally, EDIS and sovereign exposure limits should be implemented simultaneously to avoid the impression that EDIS is, in effect, a European guarantee for national debt in bank portfolios. Modest steps are being taken toward a central fiscal capacity through the EC proposal for a European Investment Stabilization Function to help maintain public investment levels in countries experiencing a large asymmetric shock. Further steps toward simplification of the SGP targets and stricter compliance would help rebuild fiscal space and improve debt sustainability.

The slowing pace of the euro area's economic recovery and investor fears over the risks of a no-deal Brexit make the completion of the euro area's architecture more urgent. While the overall reform commitment to the European project remains high, the risks of non-reform are considerable:

- First, the euro area's economic rebound helped economic convergence among member countries to resume, but it is far from reversing the social and economic divergence that emerged from the crisis (see Figure 2). These centrifugal forces have weakened citizens' support for the euro and fuelled populist movements that fault the euro for shortcomings in domestic policies. The populist coalition in Italy faults the euro for austerity and bank bail-in rules, when in fact Italy's low growth is the result of inadequate investment and slow productivity growth (Alphandéry 2018).
- Second, there are no quick fixes to the euro-area architecture; this is a process that will take a long time. Private investors are patiently awaiting the outcome of this process, but

their patience may run out if external events, such as an escalation of the trade war with the United States, reduce their risk appetite.

- Third, risk reduction needs to address a number of challenges: rebuilding fiscal buffers and ensuring more robust fiscal governance; addressing NPLs; and improving productivity and ensuring a sustainable external position. This process would be greatly facilitated by a parallel move toward risk sharing, but there is little appetite for any initiatives in that direction.
- Fourth, the institution-building process in Europe has historically accelerated during periods of crises, not during good times. This pattern suggests that completion of the euro area governance reforms may await the next severe downturn. This risk will be tested at the December 2018 summit of EU leaders, who will be called upon to decide on the unfinished business on euro-area reforms.

There are no quick fixes to ensure that a major euro area crisis does not recur. This paper has argued that structural reforms in the euro-area architecture and in the periphery are urgently needed to improve resilience, increase potential growth and deal with Brexit. Market participants are looking for assurances that policy adjustments — both at the pan-European and country level — can and will be made to put the European project onto a sustainable footing.

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