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Reforming the European Monetary Union: The Challenge of Reconciling Risk Sharing with Market Discipline

by Nicola Bilotta

The economic crisis has underscored the need to reform institutions charged with regulating the financial architecture of the Eurozone. Since the introduction of the Single Resolution Mechanism (SRM) in 2014, however, all attempts at meaningful reform have failed.

Recent discussion has centred around the trade-off between market discipline, which implies the strict fulfilment of EU rules and regulations (the Six-Pack, Fiscal Compact and Two-Pack), and risk sharing, which calls for a European public backstop for banks and deposits and a common European plan of investments.

The disagreement between Euro area members reflects the larger, deep-seated conflict over the future of the European Monetary Union (EMU), which in turn further undermines the political feasibility of reform.

In 2015, the debate was institutionally re-launched with the so-called document of the Five Presidents, which stressed the urgent need for deeper integration within the EMU.[1] Two years later, the European Commission published a roadmap that built on the Five Presidents document.[2] While the documents constitute interesting reflections, they did not set up a clear compromise between the two opposing views.

More recently, in January 2018, 14 French and German economists sought to find common ground between market discipline and risk sharing.[3]

[1] Jean-Claude Juncker et al., *Completing Europe's Economic and Monetary Union* (Five president's report), 22 June 2015, http://europa.eu/!cY66kX.

[2] European Commission, *Reflection Paper on the Deepening of the Economic and Monetary Union* (COM/2017/291), 31 May 2017, http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex:52017DC0291.

[3] Agnés Bénassy-Quéré et al., "Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Area Reform", in *CEPR Policy*

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Their proposal emphasizes that market discipline and risk sharing are two sides of the same coin: a reformed framework needs to simultaneously target stabilization and insurance mechanisms.

Their core proposed reforms focus on reducing risk however, reflecting strong European supervision to reduce sovereign debt exposure and non-performing loans (NPLs). In the current European institutional architecture, the fragmentation of power between the European Central Bank (ECB) and national authorities undermines effective supervision, since the ECB does not supervise smaller banks even though it has the sole power to revoke their banking licence.

Secondly, the document of the 14 Franco-German economists proposes a Single Resolution Board (SRB) with the authority to implement bank resolution schemes and not just to design them. In addition, the document introduces "sovereign concentration charges" which set up legal limits for banks in their sovereign exposure (a third of their tier-one capital). At the same time, it promotes a risk reducing strategy accompanied by the creation of a European deposit insurance scheme (EDIS), so as to avoid asymmetry in deposit protection across the Euro area.

A further set of proposed reforms seek to enhance the effectiveness of fiscal supervision in Europe. They include new "discipline-improving" and "stabilisation-improving" approaches that aim to combine easier fiscal rules with new fiscal stabilization instruments. The core of this reformed framework would be the improvement of monitoring instruments and the enforcement of fiscal rules and (semi-automatic) debt restructuring.

In the event that a country exceeds its debt target, it must finance its debt with junior sovereign bonds, characterized by fixed maturity and risk-weighting. Concurrently, the document calls for a more credible enforcement of the no bailout rule, which does not allow financial aid to insolvent countries if they do not implement prior debt reducing strategies. The European Stability Mechanism (ESM) would have the full responsibility for crisis lending and it would lend only to countries after prior private debt restructuring.

While the document of the Franco-German economists is presented as a synthesis between market discipline and risk sharing, two Italian economists, Messori and Micossi,[4] have argued that there are no structural differences between this proposal and Schäuble's *non-paper*, the manifesto of "the return to Maastricht" camp written by the former German Finance Minister in October 2017.[5]

The *non-paper*'s proposal is focused on the strict implementation of fiscal

Insights, No. 91 (January 2018), https://cepr.org/active/publications/policy_insights/viewpi.php?pino=91.

[4] Marcello Messori and Stefano Micossi, "Counterproductive Proposals on Euro Area Reform by French and German Economists", in *CEPS Policy Insights*, No. 2018/04 (February 2018), https://www.ceps.eu/node/13438.

[5] Wolfgang Schäuble, *Non-paper for Paving the Way towards a Stability Union*, 10 October 2017, http://media2.corriere.it/corriere/pdf/2017/non-paper.pdf.

rules, risk reduction and sanctions. In particular, the document emphasizes the need to diminish risk and to combine fiscal responsibilities with control, avoiding moral hazard. The ESM should expand its intergovernmental functions with stronger responsibilities on risk prevention and debt restructuring. Simultaneously, the ESM should neutrally monitor the compliance of the Fiscal Compact's obligations. Secondly, the Banking Union needs a prior risk reduction strategy that includes the introduction of disincentives for sovereign bonds held by banks.

Messori and Micossi argue that similarities with Schäuble's *non-paper* include the focus on prior sovereign debt restructuring and better enforcement of fiscal rules. The only mechanisms of risk sharing proposed in the paper are: the European deposit insurance scheme and the ESBies, the so-called safe bonds.

As noted by Micossi and Messori, the former is just a transnational regime that establishes national funds to cover initial loss while common funds are introduced only in case of systemic shock, resembling a private backstop after all.[6] The ESBies aim to reduce large exposure of sovereign debt in banks, allowing them to purchase ESBies to de-risk their balance sheet. However, without joint liability, there is a risk of increasing spread between ESBies and national sovereign bonds in times of stress.[7]

Pisani-Ferry and Zettelmeyer, two authors of the Franco-German proposal, have argued that Messori and Micossi's critique misrepresented their views. The Franco-German economists acknowledge their policy recommendation is mainly an attempt to convince the German public of the opportunity risk sharing provides to reduce common exposure, but they strongly reject Messori and Micossi's criticisms.[8]

Pisani-Ferry and Zettelmeyer maintain that the two Italian economists have exacerbated specific proposals in order to align interpretations of the paper with Schäuble's views. They do not explain how their policy recommendations represent a compromise between market discipline and risk sharing, however, considering that the paper keeps championing prior risk-reducing strategies.

Despite the Franco-German attempt to harmonize the national interests of European countries, it seems that peripheral European states are left out of the discussion. The asymmetric monetary union is causing issues that require more ambitious mechanisms of risk-sharing to align economic cycles and promote overall stability. Additionally, as clearly acknowledged by the 14 Franco-German economists', their paper emphasizes the political feasibility of reforms, avoiding

[6] Stefano Micossi, "The Crux of Disagreement on Euro Area Reform", in *VoxEU*, 5 April 2018, https://voxeu.org/node/62692.

[7] Marcello Minenna, "Why ESBies Won't Solve the Euro Area's Problems", in *FT Alphaville*, 25 April 2017, https://ftalphaville.ft.com/2017/04/25/2187829/guest-post-why-esbies-wont-solve-the-euro-areas-problems.

[8] Jean Pisani-Ferry and Jeromin Zettelmeyer, "Messori and Micossi's Reading of the Franco-German 7+7 Paper is a Misrepresentation", in *CEPS Commentaries*, 19 February 2018, https://www.ceps.eu/node/13453.

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proposals which may be unrealistic or politically controversial.

A systematic reform of the EMU framework should however be more ambitious and aim for deeper integration to accomplish financial stability as well as economic growth. Now is the time to be ambitious and forward looking, while Europe is experiencing mild economic growth.

The debate on reforming the EMU underlines the interplay between the economics of constraint and the politics of reform. Over the past years, the weakest Eurozone economies have already implemented economic adjustment programmes to encourage fiscal stability and reduce public debt. Nevertheless, the rigid position of country creditors in the institutional discussion still represents a key veto in the context of risk-sharing reforms. Unfortunately, in light of the recent elections in Europe, no major political change has occurred. Thus, macro-level governance that has led to a piecemeal restructuring of the EMU has not changed, further complicating the chances of reform.

Until the precondition of prior debt restructuring is seriously discussed and synthesized with simultaneous risk-sharing mechanisms, the political feasibility of any compromise between EU member states remains unlikely. The ongoing discussion based solely on national interests increases the perceived distance between European institutions and the public. The recent victories of populist and anti-European parties across Europe show the need for a new constructive approach to reform the EMU in which the requests of core and periphery states are equally considered. The risk otherwise is that yet another opportunity will be missed for European reform, leaving the EMU as an incomplete and imbalanced union in which many European citizens feel they do not belong.

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