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Reconciling risk sharing with market discipline: A constructive approach to euro area reform

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1 Introduction

The need to improve the euro area financial architecture to make it less vulnerable to crises and to deliver long-term prosperity to all its members remains as strong as ever. Nevertheless, no meaningful reform has been enacted since the Single Resolution Mechanism was created in July 2014 as part of the banking union initiated in 2012. This reflects a deep disagreement among euro area members on the direction that reforms should take – including between its two largest members, Germany and France. France (along with other members such as Italy) has called for additional stabilisation and risk-sharing mechanisms as well as stronger governance and accountability at the euro area level. In contrast, Germany (along with other members such as the Netherlands) takes the view that the problems of the euro area stem mostly from inadequate domestic policies, that additional euro area stabilisation and risk-sharing instruments could be counterproductive, and that what is really needed is tougher enforcement of fiscal rules and more market discipline.

This Policy Insight was written by a group of independent French and German economists with differing views and political sensitivities but a shared conviction that the current deadlock must be overcome. Reform of the euro area is needed for three reasons: first, to reduce the continued vulnerability of the euro area to financial instability; second, to provide governments with incentives that both encourage prudent macroeconomic policies and deliver growth-enhancing domestic reform; third – and perhaps most importantly – to remove a continuing source of division between euro area members and of resentment of European institutions such as the European Commission and the ECB, which has contributed to the rise of anti-euro populism and which could eventually threaten the European project itself.

We start from the premise that both the French and German positions have a point. To make progress, the major concerns of both sides need to be addressed. The challenge is to do so without ending up with a collection of half-baked compromises. This requires a shift in the euro area's approach to reconcile fiscal prudence with demand policies, and rules with policy discretion. The current approach to fiscal discipline – an attempt to micro-manage domestic policies through complex and

1 All authors contributed in a purely personal capacity, irrespective of the policy roles they may have or have had in a recent past.

often divisive fiscal rules – needs to be replaced by a combination of streamlined rules, stronger institutions, and market-based incentives, with the aim of strengthening national responsibility.

Creating such incentives requires a *credible* application of the no bailout rule of the European treaty. Countries with unsustainable debt levels should not expect, and not be expected, to receive fiscal assistance – whether through the European Stability Mechanism (ESM) or any other mechanism — unless they restructure their debts. But this requires an environment in which debt restructuring becomes feasible without large collateral economic damage. In turn, this necessitates more effective euro area-level protection of the viable part of the financial sector, fire-walls, stronger macroeconomic stabilisation, more predictable liquidity support when needed, and more risk sharing – through both private and fiscal channels.

In short: the central argument of this Policy Insight is that market discipline and risk sharing should be viewed as complementary pillars of the euro area financial architecture, rather than as substitutes. Achieving this complementarity, however, is not easy. It calls for stabilisation and insurance mechanisms that are both effective and cannot give rise to permanent transfers. And it requires a reformed institutional framework. It is in these areas that we hope to contribute.

Our contribution is confined to an essential but relatively narrow public good: macroeconomic, financial and fiscal stability. An important related question concerns the other public goods that a politically viable euro area must deliver to its citizens. Which of these public goods belongs to the euro area remit – as opposed to the EU remit or to that of particular countries – requires political judgement which is outside the scope of this Policy Insight. By the same token, we do not discuss the possibility of a euro area budget. Whereas a common budget could have desirable stabilisation properties, no budget has ever been created mainly for macroeconomic stabilisation purposes. A proper budget could only grow out of political decisions to finance defined common public goods and to design an institutional framework ensuring adequate accountability to a legislative body. This is why, although highly relevant, such issues are not addressed in this Insight – nor their deeper political implications, namely, to what extent a monetary union should develop into a political union.

The following section explains why the euro area remains fragile, and why the case for a reform of the euro area architecture is strong, despite the ongoing economic recovery. We next lay out the argument for a shift in the fiscal and financial governance of the euro area and the areas for which this has implications. This is followed by a set of specific proposals.

2 A euro area that remains vulnerable, underperforming and divided

Notwithstanding its recent cyclical recovery, the euro area continues to be financially vulnerable, is likely to underperform with respect to long-term growth, suffers deep political divisions, and is increasingly challenged by populist and nationalist movements. While these problems have many causes, a poorly designed fiscal and financial architecture is an important contributor to all of them.

First, the euro area continues to face significant financial fragility and limited institutional capacity to deal with a new crisis. Stabilisation and recovery have relied mainly on monetary easing by the ECB. At the same time, legacies of the global and euro area crises remain, including high sovereign debt, high stocks of non-performing loans in some countries, and high exposure of many banks to the debts of their own governments. As price stability is gradually restored, the ECB will remove stimulus, and interest rates will rise, making it more difficult to grow out of debt. Renewed difficulties in the sovereign debt market could promptly translate into difficulties for the financial system, and hence the real economy. Conversely, the public safety net for banks, including deposit insurance, remains primarily at the national level, creating scope for contagion from banking sector fragility to national sovereign debt distress. Five years after the leaders of the euro area claimed that it was imperative to break the 'doom loop' between banks and sovereigns, that vicious circle still poses a major threat to individual member states and all of the euro area.[2] The capacity of the ECB to provide a bulwark against this and other crisis risks is limited, because it may affect member countries asymmetrically and because the central bank may not have enough room for additional monetary easing. Fiscal policy, in turn, remains constrained by both high debts and the poor design of European fiscal rules.

Second, the euro area lacks adequate institutional conditions and incentives for long-term prosperity. Incomplete banking union and fragmented capital markets prevent it from achieving full monetary and financial integration, which would boost both growth and stability. Its instruments for promoting sound domestic policies are not effective. This is

2 This vicious circle is sometimes also referred to as the 'diabolic loop' and the 'sovereign-bank nexus'; see Mody (2009), Gerlach et al. (2010), Brunnermeier et al. (2011), Acharya et al. (2014), and Farhi and Tirole (2017).

true for the fiscal rules embedded in the Stability and Growth Pact, which both lack teeth in good times and flexibility in bad times, and the 'macroeconomic imbalance procedure' aiming to prevent the build-up of lasting external surpluses and deficits and encourage growth- and stability-enhancing reforms, which has been largely ineffective since its inception. The incentives that ultimately underpin these rules and procedures – financial penalties – are generally not credible, in part because they serve no purpose other than penalisation, and can be counterproductive both politically and economically.

Third, and perhaps most worrisome, the flaws of the euro area's fiscal architecture have given rise to political problems. This has to do partly with the poor design and complexity of the EU's fiscal rules and partly with the euro area's inability to deal with insolvent countries other than through crisis loans conditioned on harsh fiscal adjustment. The latter has produced misery in crisis countries and contributed to a flight to political extremes, fuelling nationalist and populist movements in many euro area countries – including creditor countries, where there are concerns that risky loans will turn into transfers. The former has put the European Commission in the difficult position of enforcing a highly complex and error-prone system, exposing it to criticism from both sides. At the same time, the rise of populism and nationalism makes a policy system that relies on centralised micro-management increasingly hard to manage. Enforcement of EU fiscal and macroeconomic rules requires a shared respect of procedures.

The next euro area crisis may still be years away. But when it returns, perhaps on the occasion of the next cyclical downturn, it could come with a vengeance. While current European rules and procedures are not effective enough to reduce current vulnerabilities and prevent new ones, they sow divisions and fuel populism. Unless they improve, the next crisis will hit at a time when the EMU's political capital and trust among participating countries are lower than in 2008. And unless the euro area's crisis mitigation tools are reformed in the meantime, the crisis will be painful and divisive, because the main instrument to deal with it will again be a combination of large-scale crisis lending combined with prolonged austerity, leading to further resentment in both creditor and debtor countries.

3 A balanced solution: Combining risk sharing with better incentives

One side of the current reform debate is focused on crisis mitigation, arguing for better stabilisation and risk-sharing instruments at the euro area level and rules that allow domestic policies greater flexibility. The other side is focused on crisis prevention, arguing for stronger incentives to induce prudence at the domestic levels and force countries to help themselves, including through reforms that may raise long-term growth. In that view, flexibility should be taken away from the domestic level and risk sharing reduced at the euro area level. It is the seeming irreconcilability of these positions that has produced the present deadlock on euro area reform.

A choice between crisis mitigation and crisis prevention is generally a false alternative. The policy regime should provide both. No crisis prevention system can be safe enough to eliminate the need for crisis mitigation; and no crisis mitigation tool can be powerful enough to dispense from crisis prevention.

To break the deadlock, however, it is important to begin by recognising that trade-offs between risk-sharing arrangements and good policies exist and can, in fact, be a serious problem. A euro area federal budget with public investment responsibilities but without effective control of national-level spending *would* be an invitation for national authorities to free-ride, either by neglecting their own spending responsibilities or by running up large debts, in the hope that the federal level will bail them out. A fully mutualised European deposit insurance system *could* be abused by governments that can force or nudge domestic banks to grant them preferential credit conditions by using their access to deposit funding. A European unemployment insurance based on unemployment levels *could* result in systematic transfers to countries with higher unemployment levels, undercutting incentives for labour market reform. And ESM assistance to countries with unsustainable debts *would* amount to redistribution from both the European and national taxpayer – who bears the costs of austerity – benefitting private holders of sovereign debt and encouraging future lending booms to countries with unsustainable policies.

However, this is not the whole story, both because safety nets can be designed to ameliorate these trade-offs, and because effective market discipline may *require* some risk sharing, as well as effective fire-walls:

First, it is possible to design risk-sharing arrangements that minimise, or even remove, the trade-off between crisis prevention and mitigation. One such strategy is to make support conditional on the implementation of good policies, including by applying conditionality ex ante (that is, based on policies or the state of the economy before the crisis) rather than just ex post. Another strategy is to define the event that triggers support in a way that makes it very hard to manipulate through policies. It is also desirable to require that a country has 'skin in the game' and bear a cost as a condition for receiving support. Using insurance terminology, this is analogous either to requiring a 'co-payment', or to offering only catastrophic risk (re-)insurance, so that the 'first loss' is always borne by the insured itself. An additional approach consists in private risk-sharing arrangements, particularly through more deeply integrated banking and capital markets. Euro area citizens and corporations should be able to hold their savings in instruments whose returns are independent of unemployment or output declines in their home country. Provided these markets are well-regulated and supervised, such arrangements would not lead to any transfers except between the consenting parties to such financial contracts.

Second, risk-sharing and stabilisation instruments are necessary for effective discipline. To see this point, consider the event of sovereign debt crises in the euro area. The current crisis mitigation architecture, as laid out in the ESM treaty, envisages debt restructuring for countries with unsustainable sovereign debts and conditional crisis lending for all others. However, even successful debt-restructuring operations are usually associated with large economic dislocations, both because they have an impact on financial institutions directly and indirectly exposed to the sovereign, and because they trigger uncertainty and capital flight. This makes it more likely that restructuring will either be postponed – usually at great economic cost – until there is no alternative, or replaced by an official bailout at the expense of taxpayers in both creditor and debtor countries. To make early debt restructurings more credible, it is essential to reduce their economic costs and contagion effects to other countries. This requires limiting the direct exposures of banks to their domestic sovereigns, ensuring that confidence in the financial system – including in the protection of deposits – is maintained, and helping countries get through a cyclical downturn triggered by collapses in private investment linked to crisis-related uncertainty. Just hardening the rules is not enough; in the European context, even the hardest rule will not be credible if its implementation leads to chaos, contagion and the threat of euro area break-up.

Third, in the presence of high legacy debts, market discipline can backfire unless effective risk-sharing arrangements are put in place at the same time. This was the lesson of the 'Deauville beach walk' in October 2010, after which President Nicolas Sarkozy of France and Chancellor Angela Merkel of Germany announced their intention to establish a European mechanism that would ensure adequate "private sector involvement" in European debt crises "by 2013". The intentions of the two leaders – to strengthen market discipline by creating a debt restructuring mechanism – may have been laudable, but the contagion effects were costly: sovereign spreads rose sharply in several euro area countries, triggering loss of market access in Ireland, soon followed by Portugal. The main lesson is that the 'transition problem' – getting to a state of more effective market discipline and higher stability without triggering a crisis on the way – needs to be firmly recognised and addressed in proposals to raise market discipline.

Based on the logic of the preceding paragraphs, the proposals outlined in the next sections are an attempt to simultaneously improve discipline and risk sharing in the euro area. Reflecting the fact that crises can have both financial and fiscal causes and that disturbances in both sectors can reinforce each other, they focus on financial and fiscal architecture, as well as institutional reforms to make euro area surveillance and crisis management more legitimate and effective:

- Reform of the financial sector architecture
  - *Strengthening the credibility of mechanisms to bail in creditors of failing banks*
  - *Reducing the home bias in sovereign exposures of banks through regulatory disincentives, without causing disruption to either sovereigns or banks*
  - *Ensuring equal protection of insured deposits throughout the euro area, even in crisis-struck countries*
  - *Deepening cross-border financial integration through the banking system and capital markets, to allow more risk sharing based on private contracts*

- Reform of the fiscal architecture
  - *Reforming fiscal rules to make them less pro-cyclical, increase national 'ownership', and make them easier to enforce*
  - *Creating the legal and institutional preconditions for restructuring unsustainable sovereign debt while preserving financial stability*
  - *Expanding fiscal stabilisation options in a way that creates good incentives for national economic policy*
  - *Exploring a euro area-level 'safe asset' that could be scaled up in conjunction with the regulatory incentives to reduce the home bias of banks*

- Reform of the institutional architecture
  - *Separating the role of the surveillance watchdog and political decision-maker by either creating an independent watchdog within the European Commission or by moving the watchdog role outside the Commission*
  - *Assigning the responsibility for conditional crisis lending fully to a crisis management institution built on the current ESM, with an appropriate accountability structure*

These proposals should be viewed as a package that largely requires joint implementation. This is true for obvious political reasons – the purpose is to break a deadlock – but also for reasons of economic logic. First, both crisis mitigation and crisis prevention continue to be a problem in the euro area; hence, a balanced approach would be required even if there were no complementarities between proposals to address each set of issues. Second, complementarities are in fact present: weakening one side (risk sharing) would compromise the other (discipline). Third, moving to higher discipline in a context of high legacy vulnerabilities can trigger crisis risks unless it is part of a broader strategy in which these risks are recognised and mitigated.

Applying this logic, one can distinguish three reform 'packages' within which complementarities are particularly strong. First, the first three bullets related to financial sector reform (that is, risk-reduction measures together with a specific approach to establish a European deposit insurance system, described in detail below). Second, the reform of fiscal rules (first bullet in fiscal architecture) together with stronger and more independent fiscal watchdogs at both national and European levels (first bullet, institutional architecture), since the latter are required to make the proposed rules credible. Third, better legal and institutional conditions for debt restructuring as a last resort, better fiscal and private risk-sharing arrangements, and the institutional strengthening of the ESM (second, third and fourth bullets in fiscal architecture, the fourth bullet in financial as well as both bullets in institutional architecture). Importantly, however, there are also complementarities *across* these packages. Sovereign debt restructuring – part of the third package – requires the implementation of the first package for credibility and stability reasons. Conversely, the first package would benefit from the implementation of the second and third, since the reduction of fiscal risks contributes to reducing risks in the financial sector. Hence, all three packages should ideally be implemented in parallel.

4 A blueprint for reform

4.1 Financial sector architecture

A well-functioning monetary union both enables and ultimately requires an integrated financial market and financial intermediaries whose cross-border development is not hindered by national borders. This integration in turn requires common regulatory and supervisory institutions. The lack of such an architecture was both a contributing cause of the 2010-2012 euro area crisis and hampered the crisis response. This motivated the decision, by European heads of state and government in June 2012, to launch the creation of a European banking union.

Financial sector reforms since the height of the euro area crisis have been significant but have not come far enough. The effort to bring the banking sector back to soundness (referred to as 'risk reduction' in the policy debate) is well underway but unfinished. Its continuation is crucial to establishing the trust necessary for the next major policy steps, including further risk sharing. These should address the core linkages at the root of the doom loop, by ensuring that future sovereign debt restructurings will not automatically trigger banking panics, and conversely, that future large-scale banking crises will not automatically trigger sovereign debt distress. As developed below, that means strengthening the bank resolution regime, reducing the exposures of banks to their domestic sovereigns, creating a European deposit insurance scheme, and removing disincentives to the geographic diversification of banks beyond their home country. In the longer term, capital market integration is necessary to improve the financial system's ability to absorb asymmetrical shocks.

This section outlines a substantial financial reform agenda, on top of significant other reforms in that area that have been recently implemented or are in the process of legislative discussion or implementation. In light of complaints (not least from financial firms themselves) about reform fatigue, it may be argued that now is not the time to initiate a new effort. However, the banking union, in its current unfinished state, is too fragile and at risk of being reversed. The bank-sovereign vicious circle nearly led to the break-up of the euro area in 2011-12, and remains deeply entrenched even after the encouraging early development of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) (Battistini et al., 2014; Brutti and Sauré, 2016). Furthermore, the current benign economic environment in the euro area provides a near-ideal context for ambitious financial sector reform, and the corresponding window of opportunity must not be wasted.

Here, as elsewhere, the key to success is to ensure that risk reduction, market discipline, and risk sharing go hand in hand. Proposals in one area will often not be feasible – or not even desirable – without progress in the others. Policymakers should accelerate the effort to de-risk the banking sector, in particular by solving the non-performing loan (NPL) problem, strengthening bank resolution, reducing incentives for sovereign concentration risk, and adopting a European Deposit Insurance Scheme (EDIS). These elements form the core of our proposed reforms. They require specific arrangements to mitigate risks during the transition, which may be stretched over several years. Yet, the key decisions in this area can and should all be taken in 2018.

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4.1.1 *Finishing the task of restoring banking sector soundness*

The progress achieved since 2012 in de-risking the euro area banking sector is significant, with banks' capitalisation much higher than before the crisis. Lingering problems are increasingly at the level of individual banks rather than entire countries (with the exception of Greece, which is still under an assistance programme, and Cyprus). In Portugal, all significant banks have been either strengthened or sold, and the 'de-zombification' of the system has contributed to the incipient recovery. In Spain, the banking sector was restructured under an ESM programme initiated specifically for this purpose. In Italy, however, the banking sector is still under strain. But even there, the successful capital raising of UniCredit a year ago demonstrates that well-managed banks suffer no intrinsic limitations to their equity market access. Weak significant banks have either been closed (Banca Popolare di Vicenza, Veneto Banca), nationalised (Monte dei Paschi di Siena), or forced to recapitalise even if that implied a major dilution of existing shareholders (an ongoing process at Carige). This has contributed to substantially reducing the stock of NPLs in the Italian banking sector. The market for bank NPLs is increasingly active, disproving claims of an extensive market failure that would require massive public intervention, such as a pan-European bad bank, which we view as neither desirable nor necessary.

4.1.1.1 *Accelerating the clean-up of banks' balance sheets*

Even so, NPLs are not being reduced as quickly as desirable, and their outstanding volume remains large. The primary instrument to reduce the stock of NPLs is stronger supervisory pressure. For *significant institutions* (SIs), this is largely in the hands of ECB Banking Supervision, even though national authorities should also be supportive of that effort. ECB Banking Supervision has tended to internalise national political constraints, for example, by waiting until after the December 2016 Italian referendum on constitutional reform to take decisive action on Monte dei Paschi and the two Veneto banks. This was understandable given the difficult Italian environment, but ultimately at odds with the vision of an independent supervisor. At the current juncture, Italy and other member states are no longer at immediate risk of systemic turmoil, and supervisory forbearance would be even less justified than a year or two ago.

For smaller banks, or *less-significant institutions* (LSIs), the supervisory system remains fragmented, raising doubts about its effectiveness. LSIs are not supervised by ECB Banking Supervision on an ongoing basis, but the ECB has ultimate responsibility for their soundness – and is the sole authority to revoke their banking licenses. In particular, there is a widespread perception of fragility of Italian LSIs, which the ECB should actively dispel.[3]

Overall, it is important that European leaders and the public are reassured in the course of 2018 that legacy NPLs are being firmly addressed. For all institutions (SIs and LSIs), supervisors should increase the pressure to reduce existing NPLs, based on credible valuation standards, and to provision new ones appropriately. Otherwise, the trust deficit will prevent critically needed progress on breaking the doom loop as we suggest below.

4.1.1.2 *Improving the framework for bank crisis management and resolution*

Lessons should be drawn from the first cases of euro area bank crisis resolution under the Bank Recovery and Resolution Directive (BRRD) in the course of 2017, including the above-mentioned Italian banks and Spain's Banco Popular. The comprehensive reimbursement of all senior creditors of the two Veneto banks may have been technically compliant with both the BRRD and state aid requirements, but this very observation shows that the policy effort to move from bailout to bail-in still has some way to go.

Five separate reforms should be completed in this respect: (1) a revision of the SRM regulation to give the SRB direct authority for the execution of bank resolution schemes, not just their design as is currently the case; (2) a tightening of the European Commission's stance on state aid control in the banking sector;[4] (3) a requirement that any future cases of precautionary recapitalisation should include a full asset quality review and stress test, unless made impossible by considerations of emergency;[5] (4) a long-term effort to harmonise and ultimately unify bank insolvency law in the banking union, phasing out idiosyncratic national crisis-management regimes that allow for circumvention of the intent of BRRD; and finally (5) the architecture of the SRM should

3 As of mid-2016, LSIs represented 18% of Italian banks' total assets (source: https://www.bancaditalia.it/media/approfondimenti/2016/less-significant/less-significant-institutions-en.pdf?language_id=1).

4 The currently applicable Banking Communication, which was published in July 2013, includes (paragraph 6) an assessment of general applicability of Article 107(3)(b) of the Treaty, i.e. the possibility to use state aid to remedy a serious disturbance in the economy of a member state. In the future, this exception should no longer be generally presumed, but be assessed on a case-by-case basis. In cases where there is no "serious disturbance", all relevant instruments would be bailed in, including senior debt and uninsured deposits, as has been the practice in Denmark since 2010.

5 In the case of Monte dei Paschi di Siena, ECB Banking Supervision did not conduct an asset quality review prior to the precautionary recapitalisation, even though it would arguably have had enough time to do so.

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be completed with the granting by the ESM of a backstop to the Single Resolution Fund (SRF), in line with the ECOFIN statement on an SRF backstop of December 2013.

4.1.1.3 Improving the single rulebook

Bank regulatory standards should simultaneously be tightened and further harmonised, beyond the banking legislative package currently under discussion. A greater effort should be made to eliminate prudential regulatory options and national discretion (as has been proposed by the ECB), or at least fully transfer their consideration to supervisors so that the SSM is legally empowered to achieve the required convergence. The EU legal framework should be made more compliant with the Basel standards, in areas that include the definition of capital and the capital treatment of insurance operations (namely, a repeal of the so-called Danish compromise).[6] Auditing standards and supervision should be tightened to increase audit quality.[7] Mandatory standards on minimum requirements for own funds and eligible liabilities (MREL) and, for the largest banks, total loss-absorbing capacity (TLAC), should be finalised and enforced.

4.1.2 Breaking the doom loop for good

The (unfinished) shift from national bailout to bail-in in the handling of banking crises, embodied in the BRRD legislation, has somewhat weakened the bank-sovereign vicious circle. But it is very far from having 'broken' it, as has been the stated intention of euro area leaders since their landmark declaration of 29 June 2012. As with other reform aims covered in this Policy Insight, this can only be achieved with a balance of market discipline and risk sharing. The main disciplining initiative is to prevent national governments from using 'their' domestic banking systems for non-commercial purposes of national economic policy (or financial repression), through a regulation that penalises concentrated sovereign exposures. The main risk-sharing item is to protect all insured deposits equally across the euro area.

4.1.2.1 Eliminating the home bias in sovereign exposures

To reduce home bias, bank regulation should create incentives to reduce concentrated exposures to specific sovereigns. One option would be to introduce 'sovereign concentration charges' which would require euro area banks holding sovereign exposures to any euro area country in excess of a threshold of, say, a third of their tier-one capital to hold additional capital.[8]

A mandatory (in the Basel jargon, Pillar 1) regulatory instrument of this type was considered in earlier discussions, particularly during the Dutch Presidency of the Council in early 2016 and in a high-level working group of the EU Economic and Financial Committee (EFC), but no consensus was found at the time. To make its adoption achievable, it should be untied from the separate issue of sovereign credit risk-weighting (which is not specific to the euro area)[9] and focused on the issue of concentration risk: in a monetary union, in which there is no exchange rate risk, banks can and should diversify their exposures away from their home country and include bonds of other members of the monetary union in their asset portfolio. The European Commission should make a legislative proposal in this regard with the same level of specificity as it did in 2015 with respect to EDIS.

The diversification of banks' sovereign exposures is not merely a matter of handling the crisis legacy, or a risk reduction from its current level associated with high sovereign debt ratios. It should rather be viewed as a structural change, in which the loss of the specific role of national banking sectors as default absorbers of domestic sovereign debt[10] is more than offset by the resilience gains from a well-designed EDIS and the corresponding sharp reduction of redenomination risk.

Any change in the regulatory treatment of sovereign exposures carries the risk of changes in relative yields during a transition period in which banks realign their exposures. Compared to proposals that penalise sovereign holdings *per se*, this risk is lower in the approach proposed here, since this would incentivise diversification rather than the reduction of sovereign bond holdings in the aggregate. Nonetheless, given high sovereign debt levels and sovereign exposures, utmost care must

6 This refers to the possible double-counting of the regulatory capital of a diversified financial group's insurance operations at the consolidated level, a deviation from the global Basel III framework that was endorsed under the Danish Presidency of the Council in 2012.

7 This objective is not specific to the financial sector but is particularly critical for banks, as their financial reporting involves more judgment and modelling than many other companies, and is a key basis for prudential supervision.

8 This differs from either sovereign risk weighting or applying large exposure limits (e.g. 25% of tier one capital); see Véron (2017) for a detailed proposal.

9 The regulatory framework allows to address sovereign credit risk through other instruments. Notwithstanding the Basel Committee's recent failure to reach a global consensus on sovereign risk-weighting, the mitigation of sovereign credit risk can be improved in the euro area and the rest of the EU through better disclosures of sovereign exposures and Pillar 2 (bank-specific) requirements that take into account market developments. In addition, credit risk-weights could be introduced for riskier junior sovereign bonds, as proposed below as a way of enforcing revamped fiscal rules.

10 Depending on circumstances, this specific role can contribute to the absorption of sovereign debt market shocks or to their amplification. On the drivers of the home bias in euro area sovereign exposures, see Altavilla et al. (2017) and Ongena et al. (2016).

be exercised to prevent financial disruptions during the transition period. The purpose of introducing concentration charges is not to incentivise bank divestment away from the securities issued by the most indebted countries. It is, rather, to protect all banks, and the financial system as a whole, from the possible consequences of disruptions on the government bond market of their home countries.

One option for the transition would be to keep the calibration of the concentration charges relatively mild, possibly combined with 'grandfathering' of all already outstanding debt instruments, and a very gradual phasing-in of the permanent regime.[11] Alternatively, a higher calibration and/or shorter transitional arrangements could be envisaged together with the simultaneous introduction of a European 'safe asset' – for example, senior securities backed by diversified pools of sovereign bonds – that would be exempted from the concentration charges altogether. The case for a European safe asset – and potential pitfalls, which its design would need to address – is examined in more detail below.

4.1.2.2 Protecting all deposits equally

A European deposit insurance system should be implemented in a way that unambiguously creates equal protection for all insured euro area depositors and precludes geographical ring-fencing.[12] For these reasons, it should be managed by a single authority at the European level.[13] At the same time, so long as some sources of risk remain under the control of national authorities, some elements of the system will need to be differentiated across countries, as follows:

- First, the European Deposit Insurance Scheme (EDIS) should maintain sound incentives for national governments by pricing country-specific risk in the calculation of insurance premiums. This national component would be based on structural indicators of creditor rights, such as the effectiveness of insolvency and foreclosure processes.

- Second, in the spirit of a re-insurance system, losses should first be borne by the relevant 'national compartment' of EDIS, while common funds (either a separate mutualised compartment, or all other compartments jointly) can be tapped only in large, systemic crises which overburden one or several national compartment(s).

Notwithstanding this differentiation, the system would be under a single institutional framework, and the insurance itself should be fully unconditional to ensure trust. Separate national deposit insurance institutions would be phased out by the EDIS legislation, but unlike for the SRF, the national compartments would be kept in the steady state. Separate collective deposit insurance schemes (e.g. associated with national or cross-border institutional protection schemes) could be treated as separate compartments, on a case-by-case basis under general criteria to be set to deter abuses.

The EDIS system should in turn be backstopped by the ESM, like the SRF. An asset quality review of all LSIs, directly involving both the ECB and the European authority entrusted with EDIS, would be performed as part of the implementation of the EDIS legislation, as was the case for SIs in 2014. The transition to the new deposit insurance regime should also include full implementation of a uniform regime for NPL provisioning covering both legacy and new NPLs.

4.1.2.3 Removing barriers to banking sector integration

Banking union requires geographically diversified banking groups within the euro area. This has to be a market-driven process, but public policies should not hinder it. For all SIs, the ability of national authorities to impose geographical ring-fencing of capital and/or liquidity within different entities inside the euro area should be entirely phased out. The prudential framework, including stress test scenarios, should also better acknowledge the financial stability benefits of banks' geographical diversification within the euro area.

Such cross-border integration should not, however, lead to an excessive size of the largest banking groups that would then benefit from a perceived 'too big to fail' status. As a disincentive, the leverage ratio should be tightened for very large banking groups, as is the case in the United States and as recently agreed within the Basel Committee.

4.1.3 Capital markets union

The European Commission's promotion of a capital markets union agenda since 2014 has been useful to foster an analytical consensus on the need for both more capital markets development and more capital markets integration. But it has not yet led to major policy breakthroughs. It is now generally accepted that the capital markets

11 Grandfathering would consist of exempting all exposures issued before a given cut-off date from the corresponding calculation. This option is the one recommended in Véron (2017).

12 Geographical ring-fencing refers to capital and/or liquidity requirements imposed by the SSM or national authorities on specific entities within a banking group, in addition to the requirements at the consolidated group level. Such country-specific requirements within the euro area are an obstacle to cross-border integration of the banking system, and ultimately antithetic to the banking union.

13 This authority could be entrusted to the SRB, with due operational adjustments in order to enable it to credibly provide deposit insurance in all euro area countries.

union and banking union are complementary projects and should together lead to a European financial sector that is less reliant on bank finance, more resilient, and more integrated across borders. At this juncture, sustainable and risk-absorbing cross-border capital flows, for example in the form of equity financing, are of particular significance.

The corresponding policy agenda is multifaceted, including reforms of insolvency law, taxation, accounting and auditing, housing financing, pension financing, financial infrastructure, investor protection, and more – all both important and difficult.

The catalyst for progress should be a more independent and authoritative European Securities and Markets Authority (ESMA) as a hub for both policy development and consistent enforcement. This could ensure that the harmonisation of financial regulation would not be counteracted by diverse implementation. A stronger ESMA should gradually be granted wider authority over an increasing range of market segments, and vigorously promote a single rulebook which at this point remains more aspiration than reality. This is particularly important to avert the risk of market fragmentation because of Brexit, especially if the United Kingdom confirms its intention to leave the single market as well as the European Union. If some of the activity that is currently in London is redeployed to several rather than one financial centre, having a stronger enforcement hub at ESMA becomes much more important than in the recent past, when this function was practically delegated to the UK authorities.

4.2 Fiscal architecture

In addition to the proposed reforms to the financial market architecture, improving the stability and growth prospects in the euro area also requires reforms to the fiscal architecture. Our reform proposals in this area fall in two categories. First, what might be called 'discipline-improving' proposals. Fiscal rules should become simpler, less procyclical and easier to enforce, and sovereign debt restructuring should be feasible, but as a last resort. Both will reduce the risk of fiscal crises, and the latter should also reduce their depth and length. Second, we propose reforms that would enhance macroeconomic stability – our 'stabilisation-improving' proposals. In addition to more stabilisation-friendly fiscal rules, these consist of two new fiscal stabilisation instruments at the level of the euro area, one of which would allow temporary – but not permanent – transfers to hard-hit countries. These instruments would be designed in a way that gives countries incentives to reform and/or adhere to the fiscal rules. We also suggest exploring the creation of a debt-based safe asset that would reduce contagion in case of sovereign debt crises.

4.2.1 Reform of fiscal rules

Fiscal rules, laid out in the Stability and Growth Pact (SGP), have been part of the euro area architecture since the inception of monetary union. Despite several reforms, they have not worked well. Excessive public debts have accumulated because of banking crises and the Great Recession, but also because either countries did not abide by European fiscal rules or the rules were not sufficiently stringent in good times. At the same time, the SGP has constrained fiscal stabilisation policy during the euro area crisis of 2010-2013, overburdening the ECB as the main remaining instrument of macroeconomic policy in the euro area and contributing to low growth in many countries, which aggravated the public debt accumulation.

The poor functioning of the current fiscal rules is partly due to their design even after numerous reforms, and partly due to the way in which they are monitored and enforced. Deficit targets give rise to pro-cyclical fiscal policy – for example, higher expenditures in good times and lower expenditure in bad times – unless deficits are cyclically adjusted. But such adjustments are notoriously imprecise and difficult, even more so in the post-crisis environment than before. For this reason, recommendations to adjust fiscal policy by a given amount can turn out to be wrong ex post, and the fiscal indicator that is being targeted – the 'structural' deficit – is hard to control and subject to major ex post revisions (Claeys et al., 2016; Coibion et al., 2017). Attempts to address these weaknesses by creating additional contingencies and exceptions have had the effect of making the rules increasingly complex, and hence difficult to implement and monitor.

A further problem relates to enforcement, which is based on the threat of fines. These fines serve no economic purpose other than penalising a violation of the rules, and may further aggravate an already weak fiscal situation. As a result, large fines are not credible. To wit, no such fine has ever been imposed. For all these reasons – pro-cyclicality, which hurts countries for which the rules bind; complexity, which makes them hard to explain and leads to micromanagement by the European Commission; and poor enforcement, which upsets countries that tend to comply – the rules have become a source of political friction.

At the same time, fiscal rules are necessary. Many countries outside the EU have national fiscal rules because they help commit government to not overspending. In a monetary union, there is an additional rationale for fiscal rules: excessive debt accumulation can lead to messy default and potential exit from the currency union, triggering contagion and collateral damage for all members. One answer to this problem, as will be argued in the next section, is to create structures that limit the economic costs of debt restructuring inside the currency union both to the crisis country and to other members. Another answer is to put in place better fiscal rules. Because either of these solutions is bound to be imperfect, one should aim at both.

4.2.1.1 Expenditure rules with a debt target

Fiscal rules should (1) be as transparent and simple as possible; (2) set targets in terms of fiscal indicators under the direct control of the government; (3) allow countercyclical fiscal policy to stabilise macroeconomic shocks; (4) generate incentives to reduce excessive public debt; and (5) embed an escape clause in case of very large shocks. In the European context, monitoring should occur to a significant extent at the national level – by an independent national fiscal council – under the oversight of a euro area fiscal watchdog (see the final section of this blueprint for details). Finally, enforcement cannot rely solely on the threat of penalties that are unlikely to be credible.

Recent research shows that rules on nominal public expenditure growth ceilings consistent with a public debt reduction target are better suited to meet these conditions than a system relying on a superposition of debt targets, nominal deficit targets, and cyclically adjusted deficit targets, such as the present one.[14]

The basic principle underlying an expenditure rule of this type is easy to describe: nominal expenditures should not grow faster than long-term nominal income (that is, the sum of potential output growth and expected inflation), and they should grow at a slower pace in countries that need to pay down their debts. Unlike the cyclically adjusted deficit, expenditure is observable in real time. Furthermore, expenditure rules embed countercyclical stabilisation both because cyclical revenue increases have no effect on the expenditure ceiling – inducing stronger fiscal discipline in good times compared to the current rules – and because they do not require cyclical revenue shortfalls to be offset by lower expenditure.

This suggests a two-pillar approach, consisting of (1) a long-term target debt level, such as 60% of GDP, or a more bespoke objective taking into account, for example, implicit liabilities arising from pay-as-you-go pension systems; and (2) an expenditure-based operational rule to achieve the anchor. In practice, this could work as follows:

1. Each year, an independent, national-level fiscal council proposes a rolling medium-term (e. g. five-year-ahead) debt reduction target for approval to the euro area fiscal watchdog. The target would depend on (1) the distance between the actual debt-to-GDP ratio and the long-term target of 60% (the bigger the distance, the more ambitious the adjustment); and (2) a broader analysis of fiscal sustainability (in particular, to give credit to countries that undertake solvency-improving entitlement reforms, or major reforms expected to raise potential growth). As a result, the medium-term debt reduction pace should not be determined by a formula. However, discretion could be constrained, for example, by requiring that the medium-term debt ratio target never exceeds the current debt ratio until the long-term target has been reached.

2. In parallel, the national fiscal council would prepare a medium-term nominal growth projection based on expected potential output growth; expected inflation, consistent with the ECB's price stability objective; and a possible cyclical correction, in case initial conditions depart markedly from long-run equilibrium.

3. After the medium-term target and the nominal growth projection have been approved, the national fiscal council charts a consistent medium-term nominal expenditure path and uses it to set a nominal expenditure ceiling for the coming year, for use in the preparation of the corresponding budget.

4. Nominal expenditures are calculated net of interest payments, of unemployment spending (except when these are due to discretionary changes to unemployment benefits), and of the estimated impact of any new discretionary revenue measures (changes in tax rates and tax bases). The first two adjustments allow for more counter-cyclicality, while excluding the effect of expenditure-increasing structural measures. The last adjustment is meant to preclude the manipulation of tax rules (for example, tax cuts ahead of an election) that are not compensated by offsetting expenditure measures. They also allow elected governments to make fiscal policy choices (implying different long-term levels of expenditures and taxes) that reflect political preferences and social compacts.

5. If a country passes a budget with spending above the target, all excessive spending must be financed by junior sovereign bonds.[15] These would (1) be legally subordinated (i.e. first to

14 See, in particular, Andrle et al. (2015), Claeys et al. (2016), Ayuso-i-Casals (2012) and Holm-Hadulla et al. (2012).

15 Requiring countries to finance budget deficits with junior sovereign bonds was first suggested by Fuest et al. (2015) under the heading of 'Accountability Bonds'; see also Fuest and Heinemann (2017).

be restructured in case a debt reduction is deemed necessary to ensure sustainability); (2) contain a so-called one-limb collective action clause (see next section); (3) be issued with fixed maturity (e.g. five years, albeit with an early-repayment option, see below), (4) contain a clause that specifies an automatic three-year maturity extension if the country receives a standard ESM-supported conditional assistance programme; and (5) not benefit from existing regulatory privileges of 'normal' sovereign debt (e.g. zero risk-weighting) and in addition be subject to enhanced large exposure limits (e.g. 5%), substantially below the Basel framework's cap at 25% of tier-one capital. Junior sovereign bonds would also be included in the calculation of sovereign concentration charges. Because the market for such junior bonds will likely be small, their yields may also reflect a liquidity premium. For all these reasons, the price of junior sovereign bonds should be significantly lower than those of regular sovereign bonds.

6. Limited deviations between actual and budgeted spending could be absorbed by an 'adjustment account' that would be credited if expenditures net of discretionary tax cuts run below the expenditure rule, and debited if they exceed it.[16] If a country passes a budget with no excessive spending but *realised* spending is above the target, the overrun could be financed without issuing junior bonds, provided that the deficit in the adjustment account does not exceed a pre-determined threshold (say, 1% of GDP). Once this threshold has been breached, all excessive new expenditures would need to be financed by junior sovereign bonds in the following year.

7. Once the government returns to compliance with the rule, it would be allowed to buy back the junior bonds, or repay them early, up to some annual ceiling. This ceiling would be calibrated to ensure that the junior sovereign debt stock of countries that have violated the expenditure rule repeatedly (or to a greater extent) would take several years to eliminate, while one-time (or minor) violations could be eliminated as soon as countries return to compliance.

8. An escape clause would allow countries to deviate from the rule in case of 'exceptional circumstances'. The activation of such a clause would have to be agreed by the Eurogroup, after consultation with the euro area fiscal watchdog.

9. Compliance would rely not just on implicit penalties (the need to issue junior sovereign bonds), but also on 'carrots'. This could include preferred access to ESM loans (see the next section).

16 Such accounts exist in the German and Swiss fiscal rules.

This system would exhibit better stabilisation properties than the current one. It would not make room for additional spending when tax revenues are temporarily buoyant. Nor would it require cutting spending in bad times, even if there is a temporary revenue shortfall over and above what mechanically results from the output decline. It would also be easier to control and less dependent on unobservable variables than the current system based on structural deficits.

Apart from these better stabilisation properties, the key advantage of this system compared to the current one is the enforcement mechanism.

- At present, imposing a sanction on a country that violates the SGP requires political will both on the side of the European Commission and of the European Council. This creates a time consistency problem: ex ante (before a violation), everyone agrees that credible sanctions are important to enforce the SGP, but once the SGP is violated, imposing that sanction may do more political and economic harm than good. In contrast, the circumstances that require a country to issue junior sovereign bonds will have been laid out in advance. With the junior sovereign bond rule, no action is required except by the country itself, which is asked to respect a specific contractual format. Even that could be dispensed with, since the conditions under which the bonds are issued (i.e. in compliance with the expenditure rule or not) are observable, banks and the ESM would be required to treat these bonds accordingly (i.e. hold capital, or require a reprofiling), and the ECB would require a higher haircut for its refinancing operations.
- Unlike sanctions, requiring countries that violate the fiscal rule to issue junior bonds has a clear economic rationale: it protects the existing bondholders, by creating a buffer of junior sovereign debt that will be restructured first. This is akin to debt covenants protecting the interests of creditors in privately issued debt, and could in fact *lower* the average cost of debt issuance (Borensztein et al., 2004 , Section IV).
- The cost at which junior sovereign bonds are issued will depend on the reasons why they were issued and market expectations about the future fiscal path. If a government has a compelling argument for exceeding its expenditure ceiling – for example, an investment and reform push that is likely to raise future growth and hence reduce the debt-to-GDP ratio in the medium term – the market may not require a significant risk premium. Furthermore, the faster markets expect the country to return to compliance with the fiscal rule, the smaller the penalty,

because the government will generally have an incentive to repay their junior bonds early once they can do so. This is a further reason why this system creates good incentives.

No system is perfect, and the proposed system is no exception. One drawback is that the cost of issuing junior sovereign bonds may depend not only on the motives and credibility of the government, but also on market conditions largely outside the control of the government. Market discipline may be (too) low when monetary conditions are easy and/or risk spreads are compressed, and (too) high when monetary conditions are tight and/or risk appetite vanishes. Yet, unlike the current system, this is unlikely to induce pro-cyclical behaviour, since monetary conditions tend to be easier in bad times. Another potential drawback is that the system might create incentives to 'cheat' through the tax administration system (under-collecting revenues in lieu of cutting taxes). To prevent this from happening, the national fiscal council needs to be empowered to monitor such cheating and adjust the expenditure ceiling accordingly.

More generally, successful monitoring and enforcement of the new system will rely on the quality and power of national fiscal councils and their cooperation with the euro area fiscal watchdog. However, because the system itself is easier to justify, it produces fewer situations that run counter to the national interest (such as cutting expenditures in a recession) and relies on a time-consistent enforcement mechanism. Thus, it should stand a much greater chance of success than the current one. This also implies that the share of junior bonds should remain a small fraction of total sovereign debt.

To ensure proper enforcement, the obligation to finance spending overruns with junior sovereign bonds should become part of the national legislations governing the budget process. Failure to comply should be subject to judicial enforcement and contestable both before national constitutional courts and the European Court of Justice.

4.2.2 *Strengthening the institutional and legal underpinnings of sovereign debt restructuring*

The second element of the fiscal architecture reforms proposed in this blueprint is a more credible enforcement of the no bailout rule – understood to mean that insolvent countries should not receive financial assistance from other countries unless they first restructure their debts. This is important for two reasons:

- It will provide stronger incentives for responsible fiscal policies, complementing the reform of fiscal rules proposed at the beginning of this section. Importantly, this argument does not rely on the assumption that markets price sovereign risk correctly or that policymakers dutifully adjust in response to changes in risk premia. Rather, the essential condition is that insolvent countries lose access to finance faster if the no bailout rule is credible than if it is not. Furthermore, implicit guarantees can fuel booms in capital flows and credit, which in turn increase crisis risks and lower both market discipline and policy discipline.[17] The financial and fiscal architectures of the euro area should hence avoid such implicit guarantees.
- It will prevent economically destructive 'gambles for redemption', in which insolvent countries delay restructuring through ESM- or IMF-supported attempts at fiscal adjustment that ultimately prove fruitless. As the case of Greece shows, such gambles can not only put an economy into a tailspin, but produce long-lasting social and political scars.

The most important condition for the credibility of the no bailout rule is to reduce the economic and financial disruptions that result from a debt restructuring, since it is the fear of these disruptions that pushes countries into gambles for redemption. Several of the proposals suggested above – most importantly, reducing the direct exposures of banks to their domestic sovereign and fostering private-sector risk sharing through banking and capital markets union – will contribute to this objective, and so would two of the proposals discussed in the sections that follow (an incentive-friendly fiscal capacity that supports countries in the face of a large rise in unemployment, and a euro area-level safe asset).

While mitigating the economic and financial disruptions of debt restructuring is a necessary condition for the credibility of the no bailout rule, it is not sufficient, for two reasons. First, the effectiveness and potential costs of debt restructuring depend not only on their economic impact but also on the legal framework. Second, even with the right economic and legal framework, debt restructurings may look unattractive to policymakers if official lending continues to be available as an alternative. Top policymakers often lose their jobs in a fiscal crisis leading to default (Borensztein and Panizza, 2009; Livshits et al., 2014), and debt restructurings can have reputational consequences that are, or appear to be, costly even with better risk sharing and a less-exposed financial sector. As a result, the proposals made so far need to be accompanied by legal reforms and more credible ESM lending policies.

17 See Fernández-Villaverde et al. (2013) and Weder di Mauro and Zettelmeyer (2017) for a discussion and additional references.

4.2.2.1 Better protections against 'hold-out creditors'

The most important legal risk in a debt restructuring comes from the fact that 'hold-outs' may refuse to take part in the restructuring. The sovereign is then faced with a difficult choice. It can refuse to pay the holdouts, which may lead to protracted legal battles and restrict its ability to issue debt internationally, or it can repay them, which reduces debt relief and may be viewed as unfair burden sharing. The option of 'holding out' also gives some creditors additional bargaining power, which can make it tougher to achieve a deal restoring debt sustainability.

In recognition of the hold-out problem, the ESM treaty commits euro area countries to include a standardised collective action clause (the 'Euro-CAC') permitting a restructuring of the payment terms of the bond with the agreement of a qualified majority of creditors (Gelpern and Gulati, 2013). While Euro-CACs have not been tested, the experience with very similar (English law) CACs in the 2012 Greek restructuring has not been encouraging: out of 35 English law bonds only 17 were restructured, because the required supermajorities can easily be blocked by specialised investors buying a large share of a specific bond at very low prices. The holders of the remaining 18 bonds have since been repaid in full – setting a precedent that hold-out strategies can work in the euro area (Zettelmeyer et al., 2013).

Legal reforms to deal with holdouts can take several forms. Some authors have argued for a full-fledged, treaty-based sovereign bankruptcy court (Gianviti et al., 2010; Paulus and Tirado, 2013). However, the hold-out problem could also be resolved without any new institutions. One approach would be to change collective action clauses to allow bonds to be restructured with the consent of a qualified majority of *all* bondholders (i.e. without requiring bond-by-bond supermajorities; this is sometimes referred to as 'single-limb aggregation'). CACs of this type have been endorsed by the IMF and the International Capital Markets Association and adopted by many countries, but not in the euro area (Gelpern, 2014; IMF, 2014, 2017). Another approach would be to change the ESM treaty in a way that would extend immunity from judicial process to sovereigns whose debt restructuring has been negotiated in the context of an ESM programme and/or agreed by a (super)majority of creditors (Buchheit et al., 2013a, 2013b; Fuest et al., 2014). These approaches could be complementary, since the first approach would apply only to new bonds, while the second would also apply to the existing stock.[18]

4.2.2.2 An ESM policy preventing lending to insolvent countries unless accompanied by debt restructuring

In theory, the ESM is committed not to lend to countries with debt-servicing problems unless the combination of ESM lending and conditionality is either very likely to restore debt sustainability or is accompanied by a debt restructuring. Two elements of the present ESM treaty attempt to provide such a commitment. First, as a precondition for crisis lending, the ESM treaty requires the European Commission to assess whether public debt is sustainable, "wherever appropriate and possible … together with the IMF." Furthermore, the treaty preamble states that "a euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF".

Hence, the present treaty effectively assigns the IMF the role of a commitment device. However, this device has by now failed twice: in 2010, when the IMF changed its lending policy to allow itself to co-lend with European crisis lenders despite doubts about Greek debt sustainability; and in June 2015, when the ESM approved a new programme with Greece without IMF participation, despite IMF and European Commission warnings that the Greek debt may not be sustainable. The euro area should not subcontract substantial parts of its conditional assistance policy to the IMF anymore. Co-lending with the IMF may be desirable, but it should not be regarded as indispensable.

The ESM should hence develop its own criteria for deciding when there is a significant risk that an assistance programme might not restore solvency to a crisis-struck country. When this is the case, it should insist on a private debt restructuring – at least in the form of a maturity extension – as a condition for financial support. The criteria used to make this decision must be transparent and consistent across countries. One option could be to follow the example of the new IMF exceptional access policy (introduced in 2016) and require a maturity extension of privately held debts for the duration of an ESM-financed programme whenever debt sustainability is uncertain (IMF, 2015, 2016;

18 For bonds issued under local law, there is also the option of using the local legislature to implement a class-voting mechanism across the entire stock of locally issued sovereign bonds, which was used in the 2012 Greek restructuring. However, substantial stocks of euro area government debt are governed by foreign law. Furthermore, the fact that local law bonds issued after 2012 carry CACs makes it more likely that restructurings based on acts of the local legislature will be subject to legal challenge. Finally, enacting class voting ad hoc is clearly less desirable, in terms of creating stable expectations, than writing such a mechanism into law or contract.

Weder di Mauro and Zettelmeyer, 2017). Whether this is the case would need to be assessed based on a data-driven method that can be reproduced and checked by the public. Should the programme fail to restore solvency, a deeper restructuring would have to follow as a condition for further support.

When introducing such a policy, it is essential to ensure that it does not give rise to the expectation that some of the present debts of high-debt countries will inevitably be restructured, triggering financial instability in debt markets. To address this 'transition problem', some proposals suggest committing to the policy immediately (for example, in the context of a change in the ESM treaty) while delaying implementation until a specific date.[19] However, this approach is problematic because it can create incentives to exploit the weaknesses of the previous policy before the new one becomes effective, and it is unlikely to be time consistent as there will be a temptation to extend the deadline as it draws closer.

While there is, in fact, no completely clean solution to the transition problem, it can and must be mitigated in several ways. First, there can be ways of phasing in new policies gradually, in a way that does not lead to the perverse incentives and reduces the time consistency problem just described. For example, the new lending policy could apply only after *newly issued* debt has reached a minimum volume (e.g. 60% of GDP) (Andritzky et al., 2016; Corsetti et al., 2016). Second, the new policy should be introduced at a time when the debts of all euro area countries that depend on market access – particularly those of high-debt countries – are widely expected to be sustainable with high probability,[20] assuming policies stay on track.[21] Third, the new policy should be announced in combination with other reforms – such as the risk-sharing mechanisms proposed in this blueprint – that help to prevent and mitigate deep debt crises, and hence reduce sovereign risk. The chances of a negative market reaction to reforms as a *package* should be low.

4.2.3 Creating incentive-friendly fiscal stabilisation tools

The euro area currently possesses only one tool that can potentially provide fiscal support to countries in downturns and crises, namely, the ESM. However, the ESM's function is defined very narrowly. It is meant to help countries only when they have lost market access or are in danger or doing so, when this "is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States", and when the debt of the country is sustainable. This '*ultima ratio*' logic creates two problems:

- First – and partly because of the lack of alternative instruments – there may be pressure to use the ESM inappropriately to lend to countries with doubtful debt sustainability.
- Second, there are situations in which risk sharing across countries may be fruitful but that do not meet the conditions for ESM support.

Addressing the first problem requires a viable debt-restructuring regime as described in the preceding section. In what follows, we present two tools that could address the second problem without creating permanent transfers or distorting incentives. Indeed, both facilities presented below are intended to create incentives for growth- and stability-improving reforms, because they could only be accessed by countries that undertake such reforms and do not slide back over time.

4.2.3.1 A European fiscal capacity for large economic shocks

Consider a large economic downturn that affects one country more than other euro area countries. In such a case, national governments may find it difficult to stabilise their economies because monetary policy will not react (or not react enough). Countries should, of course, use national fiscal instruments – particularly if the reform of fiscal rules proposed in the previous section is adopted. Depending on the nature of the downturn, they may or may not have access to the ESM. But both options are based on borrowing only, which, in the absence of an independent monetary policy, may not be enough to deal with large shocks. A mechanism that would provide temporary relief in case a country is hit by a significant disturbance would help strengthen the economic value of, and the political support for, continued membership of all current members in the euro.[22]

We hence propose a fiscal stabilisation scheme that would offer one-off transfers in case of large downturns affecting one or several member states. It would be designed as a *re*insurance fund for large shocks affecting the labour market in euro area countries, and could be conceived as a line in the EU budget, or as a subsidiary of the ESM. 'Reinsurance' means that covering the 'first loss' associated with a particular shock remains the responsibility of the country itself. The fund would therefore be activated only if the shock exceeds a specified level, and cover only a portion of the losses above that level. In insurance terms,

19 See Weder di Mauro and Zettelmeyer (2017) for a survey.
20 Blanchard and Zettelmeyer (2017) argue that this is true for Italy today.
21 The initial Franco-German commitment (at Deauville in 2010) to "involve the private sector" in the rescue of insolvent countries backfired in part because it was announced in the middle of a crisis.
22 See Farhi and Werning (2017), who show that mechanisms of this type can substantially improve a currency union's ability to deal with large asymmetric shocks.

this is akin to 'catastrophic loss' insurance with a large deductible. This approach makes sense for two reasons: first, the welfare gains from insurance against small shocks are small, and grow disproportionately with the size of the shock; second, countries would continue to have strong incentives to prevent a downturn (Beblavý et al., 2015).

More specifically, the arrangement would set conditions for participation, a trigger for the activation of transfers and a rule determining the size of transfers, conditionality on the use of transferred funds, and a rule determining contributions, as follows:

1. *Conditionality ex ante*. To participate in the scheme, member states would need to meet relevant minimum standards, including compliance with the fiscal rules and country-specific recommendations of the European semester.

2. *Trigger*. While real GDP carries the advantage of being simple and hard to manipulate, it is revised several times after the first estimate, observable only with a significant lag, and is sometimes affected by accounting. We therefore propose to base the fiscal stabilisation instrument on employment-based indicators: changes in the unemployment rate, employment, or the wage bill, using a common definition.[23] For example, if in year *t* a member state experiences a year-on-year increase in its unemployment rate or decline in employment which exceeds a certain threshold (for example, 2 percentage points), it would receive a one-off transfer to be paid out in years *t*+1 and *t*+2.[24]

3. *Payouts*. There would be a one-time transfer of a fixed percentage of national GDP for each percentage point increase in unemployment or decline in employment or in the wage bill beyond the specified threshold. For example, a 3 percentage-point increase in the annual unemployment rate – one percentage point above the trigger level – would trigger a 0.25% of GDP transfer, while a 4 percentage-point increase would trigger a 0.5% of GDP transfer. If unemployment stays at that level in the following year, or continues to rise but below the threshold of 2%, there would be no additional transfer. The fund makes payouts up to its depletion (to protect the fund from early depletion, annual payouts could be capped at a maximum percent of recipient country GDP). There is no borrowing. If several countries are entitled to a transfer summing up to more than the accumulated funds, the transfers would be reduced proportionally.[25]

4. *Conditionality ex post*. There would be conditions ensuring that the transfer is used to finance relevant spending – such as active or passive policies related to unemployment, or public investment – and raises total spending.[26] One option would be to transfer payments directly to a pre-assigned group of beneficiaries, such as the short-term unemployed or underemployed. National fiscal boards would monitor the conditions. If fiscal rules are reformed along the lines suggested in the previous section, spending associated with the transfer would not be included in the nominal expenditure that is constrained by the rule.[27]

5. *Contributions*. The system would be financed through contributions based on GDP (or alternatively, on GNI). The level of national contributions should depend on the volatility of the variable that is used to define the trigger, based on a rolling time window, since this determines the probability that the country will in fact receive a payout. The higher that probability, the higher the contribution. The volume of *total* annual contributions could be in the order of 0.1% of GDP of the participating countries. Contributions would be made every year, even during crises.[28]

To give one example, starting in a period with low unemployment, with zero interest rates, the fund would have accumulated 0.5% of the GDP of participating countries after five years. If

23 Using declines in employment (defined in terms of hours) or the (market) wage bill as the trigger variable has the advantage that it would not create incentives against labour market policies such as subsidised 'short work' (Kurzarbeit), which lower the rate of unemployment at a fiscal cost.

24 The inevitable delay in making payments may not be a big problem, for the following reason: if a shock occurs, countries can usually react by letting automatic stabilisers work – it is one or two years after when budget constraints may bite and force countries to consolidate too early. In addition, the prospect that transfers will come will immediately improve the ability to borrow.

25 An important question is whether the lack of a borrowing capacity would be credible, assuming a severe crisis in which the fund runs out of money. We think that the answer is yes, because in a setting in which the fund has run out of money, it would not be possible to establish creditworthiness without a prior borrowing track record unless the members give explicit guarantees, which is politically implausible. The more likely outcome will be an ad hoc arrangement to either raise contributions from the fund or to have the fund borrow from its members rather than from the market (for example, this is how the IMF's resources were temporarily increased in 2009 to avoid it being financially constrained during the crisis).

26 Conditionality of this type is always imperfect because it is impossible to know what the counterfactual would have been without the transfer, hence the 'additionality' of the required spending increases. However, it can be designed to ensure a minimum fiscal stimulus over time.

27 Under current, deficit-based fiscal rules, there is no need for any adjustment since the transfer would not raise the deficit.

28 While countries experiencing large shocks could be granted a reduced or even a zero contribution, the same effect can be achieved by increasing the payout rate.

countries representing a half of participants' GDP were to subsequently suffer a 4 percentage point increase in their unemployment rates, transfers net of continuing contributions would amount to 0.5% of GDP for the affected countries, i.e. 0.25% of participants' GDP, depleting 50% of the fund. Of course, different trigger values, transfer and contribution rates are possible, as long as they follow similar principles as outlined in the example given.

Three characteristics of our proposal would help maintain good incentives. First, the 'first loss' is borne at the national level. Second, participation in the scheme depends on the quality of policies, including the possibility of exclusion if policies deteriorate significantly and persistently. Third, contribution levels would depend on the probability of drawing, updated each year to reflect the evolving experience (in this sense, the proposed system would embed an 'experience rating' along the lines of insurance arrangements, in which premia rise after the insured draws). This ensures that the scheme cannot give rise to permanent transfers. The latter is important not just to avoid moral hazard (i.e. countries setting policies to capture such a transfer) but also to maintain the stability of the arrangement. If countries were to find that their contributions significantly exceed their drawings even after a long time, they might ask themselves whether it is worth staying in the system.

One issue that would need to be addressed is how the fund should be invested. One the one hand, the fund should earn a return; on the other, liquidity is important to enable payouts in reaction to unforeseen events. Possible investment strategies range from low-risk, high-liquidity strategies (investment in liquid money market assets) to a more long-term strategy taking higher risks (a euro area sovereign wealth fund) so long as the liquidity of the fund is assured. The latter could happen either by maintaining an adequate cash buffer or by allowing collateralised short-term liquidity support from the ECB.

4.2.3.2 Broadening access conditions to the ESM for countries with good policies

The proposed fiscal capacity has two important limitations: it can be accessed only in the case of very large shocks, and it has no borrowing capacity, meaning that it can run out if unemployment rises in many countries at the same time and/or there are successive increases in unemployment. These limitations are motivated by concerns about incentives and a wish to refrain from creating a capacity to borrow that is neither backed by a tax resource nor under the control of a legislative body. But they leave a gap that country-level stabilisation policies may not be able to fill, including because member countries may have incentives to engage in fiscal contraction in a downturn for fear of losing market access, or because market conditions deteriorate due to contagion from another country.

One way of addressing this gap would be to broaden the access criteria to low-cost ESM lending for pre-qualified countries – that is, to allow conditional lending from the ESM even when countries have not lost market access and when there is no imminent financial stability risk to the euro area as a whole, as the current conditions require. Such lending would have a fiscal impact because it would typically happen at significantly lower rates than borrowing from the market (reflecting the lower funding costs of the ESM). Unlike standard lending from the ESM, ESM borrowing through this window, by pre-qualified countries, would not trigger the automatic re-profiling of the junior sovereign bonds described in the previous section.

Another benefit of such a capacity would be to deter countries from self-insuring through the accumulation of cash reserves. It is well known in international finance that self-insurance is costly and that collective insurance is preferable. The same applies within the euro area: a country that hoards cash instead of paying down its debt incurs an efficiency cost.

Conceptually, a 'flexible' ESM facility of this sort would follow the same structure as the fiscal capacity just described, except that there are no contributions (only repayments of loans). However, the various elements would be defined somewhat differently compared to both the fiscal capacity and to standard ESM programmes, as follows:

1. *Conditionality ex ante*. Unlike standard ESM borrowing, only countries with strong policy records and full compliance with the fiscal rule would be allowed to access the facility.

2. *Trigger*. The economic 'shock' allowing access to the facility would be less stringently defined than both the current conditions for ESM access (a financial crisis threatening the entire euro area) and the trigger for the fiscal capacity. With strong ex ante conditionality, one could even consider not requiring a quantitative trigger at all – instead, countries may simply be asked to make an argument for why they need the capacity. Access would be given based on the strength of that argument compared to the costs of granting the request, which is the commitment of ESM funds.

3. *Payouts*. Low-interest lending over a specified time period (e.g. three years), repayable over a longer period. However, this period should be kept commensurate with cyclical developments. At any rate, it should be much shorter than

current maximum weighted average maturity period of the ESM of 32.5 years, to maintain the ESM's capacity to lend in the face of potentially greater use. Furthermore, the total lending capacity of this window of the ESM should remain limited, so that drawings on it (which might typically occur in the early phase of a recession) would not deplete the resources available for conditional lending.

4. *Conditionality ex post.* Given conditionality ex ante, and the fact that countries supported under the facility would be in much less dire situations than those of countries that have accessed the ESM and EFSF in the past, this could be much lighter than in current ESM programmes. However, it would be more stringent than for the fiscal capacity, in the sense that it does not merely seek to regulate the use of funds. Rather, its purpose would also be to ensure continued good economic policies in a broader sense, and hence the country's capacity to repay the ESM.

4.2.4 A euro area safe asset

In recent years, there have been several proposals for the creation of a euro area safe asset backed by sovereign bonds. While early proposals envisaged some form of mutual guarantee that would ensure the safety of these assets – but could also lead to redistribution and moral hazard – more recent proposals dispense with this feature. Instead, 'safety' is achieved by some combination of diversification and seniority. In the best-known and most developed proposal, financial intermediaries would purchase a standardised diversified portfolio of sovereign bonds (not including any junior sovereign bonds, as those proposed in the section on fiscal rules) and use this as collateral for a security issued in several tranches.[29] The 'subordination level' (that is, the size of the junior and mezzanine tranches) could be calibrated so that the five-year expected loss of the most senior tranche – referred to as European Senior Bonds, or ESBies – is about the same as that of a AAA-rated sovereign bond.

Because assets of this type should both be attractive to banks seeking to reduce concentrated sovereign exposures and create demand for the bonds of these sovereigns, they should ideally be introduced in parallel with a regulation on limiting sovereign concentration risk in a way that would avoid disruptive shifts in the demand for euro area sovereign bonds. In other words, safe assets could help to ensure financial stability during a transition period in which banks reduce large exposures to specific sovereigns (see above on financial sector architecture). At the same time, they could also increase the stability of both potential crisis countries and the euro area after the transition period – that is, in the steady state – for two reasons.

First, they would offer a higher level of protection for the banks that hold them than a diversified portfolio of sovereign bonds, because their holder would benefit not only from diversification but also from seniority (depending on the proposal, either of the claim that they are holding or of the intermediary issuing this claim). This would significantly reduce the risk that a crisis in one country could lead to contagion to other countries through the bonds that banks hold as part of a diversified portfolio.

Second, they would reduce the impact of shifts in market sentiment against vulnerable euro area members, helping them to maintain market access and avoid sharp spikes in borrowing costs. Although this report advocates more market discipline in response to deteriorating fundamentals, changes in borrowing conditions that are triggered or magnified by changes in investor risk appetite are a threat to financial stability. A European safe asset could reduce such undesirable volatility by dampening the mechanism through which it operates: the sharp reduction in the desired exposures of investors to riskier countries. This can magnify the impact of financial and economic shocks on borrowing costs – and potentially trigger loss of market access – beyond what would be justified by deteriorating fundamentals. A European safe asset would dampen this effect by introducing a class of investors (the intermediaries issuing safe assets) that would purchase sovereign bonds based on a fixed set of portfolio weights. Hence, creating a safe asset in the euro area would create a source of demand for euro area sovereign debt that is not 'skittish' in the face of changes in market sentiment.[30]

Like any major financial innovation, introducing a European safe asset such as ESBies would carry the risk of unintended consequences. One risk is that any asset that is introduced with the aim of 'safety' might be viewed as carrying an implicit guarantee by the European official sector, even if it does not carry any explicit guarantee. Another risk is that it may be difficult to find buyers for the junior tranches in times of crisis. There may be further risks related to the regulatory environment of the new assets and the intermediaries that issue them.

These risks must be mitigated by appropriate design and experimentation. The risk of implicit

29 See Brunnermeier et al. (2011, 2017) and Corsetti et al. (2015, 2016). This proposal has undergone extensive study by a task force appointed by the European Systemic Risk Board, which is expected to issue its report shortly. For a comparison between the Brunnermeier et al. proposals and other proposals, see Leandro and Zettelmeyer (2017).

30 At least so long as sovereigns do not lose market access (see below), since this may trigger their exclusion from the collateral pool of new issues. Until that time, however, portfolio weights would be fixed.

guarantees can be reduced by relying on many private issuers rather than a single public issuer. At the same time, the activities of these private issuers must be regulated to avoid new counterparty risks. Private issuers must remain pure risk pass-through vehicles that buy and issue according to a prescribed protocol. To ensure that the junior tranches retain market access, bonds of countries that lose market access should no longer be eligible for purchase by safe asset issuers, and regulation must ensure that these issuers are treated no worse than any other investors by the debtor countries. Regulation should dissuade, or tightly limit, bank holdings of the junior (or mezzanine) tranches. Finally, a phase of evaluation and experimentation (i.e. an issuance in small amounts) should precede any 'scaling up' of issuance. And as discussed previously, a prerequisite for the latter is the regulation of banks' concentrated sovereign exposures, which would create a strong incentive to hold safe assets such as ESBies in the first place.

4.3 Institutional architecture

Institutions matter because governance cannot rely on rules alone. A functional governance must rest on legitimate and accountable institutions endowed with a defined mandate and equipped with the means necessary to fulfil their mandate.

The euro area, however, suffers from an institutional imbalance. Whereas in the area of monetary policy a clear governance approach was developed, fiscal and macroeconomic governance suffers from considerable complexity and a lack of clarity in the match between institutions and functions. This is in part inevitable – there is a single monetary policy, but not a single economic or fiscal policy. However, the present level of confusion exceeds the inevitable.

In monetary policy, beyond the well-known features of institutional independence and a clear mandate, there is a dual structure combining national actors (national central banks) and European actors (ECB and its Executive Board); a clear voting system (mainly *ad personam* voting – one member, one vote); a clear majority principle (simple majority); and a straightforward channel of accountability from the ECB to the European Parliament. Even if some of these features were contested at times and some ECB decisions were criticised, the ECB was always fully capable to act and even to take controversial decisions.

In other fields of euro area governance – fiscal policy, macroeconomic coordination, the monitoring of structural policies and the provision of conditional assistance – such institutional clarity is currently missing:

- There is no unified legal basis. The fact that the ESM and TSCG treaties are currently not part of community law implies that corresponding provisions fall outside the scope of the European Court of Justice (ECJ).

- There is a confusion between the legislative and the executive functions of the Eurogroup.

- As far as fiscal surveillance is concerned, there is no clear separation between the watchdog (prosecutor) and the political decision-taker (judge); the Commission and the Eurogroup share those roles. There are too many fora bringing together member states (Euro summits, ECOFIN, Eurogroup, ESM board) and a dizzying array of decision rules (unanimity, consensus, ESM supermajority, EU QMV, euro area QMV, reversed euro area QMV).

- There is too little clarity about which level of governance represents the EU interest, the euro area interest, and national interests. In particular, it is unclear if the President of Eurogroup is the guardian of the euro area interest or just a *primus inter pares*.

- There is a lack of clarity over the democratic control mechanisms. National parliaments are endowed with the *ex-ante* power to block ESM programmes, but the European parliament does not exercise *ex post* control.

- There is a lack of clarity over who controls whom. Depending on the subject matter, principals and agents are trading places – in fiscal matters, the Commission is controlling member states, but as part of the Troika it serves as an agent of the Eurogroup.

This lack of clarity has had the effect of undermining transparency and accountability. New institutions have been created or developed out of mistrust in existing ones, rather than for functional reasons. In particular, the ESM owes in part its strength to a lack of trust in the European Commission. This leads to mission creep and turf battles. Trust is missing – in particular, many member states do not trust the Commission, and the European Parliament does not trust the Eurogroup or the ESM. This weakens the overall governance system.

The history of fiscal surveillance illustrates the problems associated with this situation. In the pre-SGP era, the Commission enjoyed an assessment monopoly and was not bound by rules. In the late 1990s, the SGP was introduced to tie the hands of the Commission (its assessment leeway was largely removed), but the Eurogroup kept full freedom to decide whether or not to follow the recommendations of the Commission. In particular, it decided in 2003 to refrain from stepping up the excessive deficit procedure for France and Germany, and to put the Stability and Growth Pact “in abeyance”. But in 2013 the Treaty on Stability, Coordination and Governance (TSCG) introduced a reversed majority rule to limit the Eurogroup’s ability to depart from the Commission’s recommendations and submit the rules to political compromise. The result was that the Commission has now recovered major powers. Yet it is itself subject to political bargains among the member states.

4.3.1 Euro area surveillance of fiscal and economic policies

On 6 December 2017, the Juncker Commission tabled a comprehensive package of institutional reforms, including a proposal to bring the TSCG and the ESM under community law, which would solve the legal heterogeneity problem. The Commission also proposed creating the office of a euro area finance minister.[31] The minister would:

- serve as vice-president of the Commission and chair of the Eurogroup as well as the Board of governors of an upgraded European Stability Mechanism (see below – this is sometimes referred to as the future ‘European Monetary Fund’);
- oversee the implementation of the EU’s economic, fiscal and financial rules;
- pronounce on the adequate fiscal stance for the euro area as a whole;
- oversee the use of EU and euro area budgetary instruments such as the structural funds; and
- represent the euro area externally.

While we do not oppose the assignment of the chair of the council of ministers to a Commissioner – a model that is already used in the case of the High Representative of the Union for Foreign Affairs and Security – we are opposed to merging the roles of prosecutor and judge, as this would violate basic principles of good governance. A clear delineation of roles, not only between the Commission, the Council and the European Stability Mechanism, but also between the watchdog/prosecutor and the political decision-maker, is an essential requirement of a stronger institutional system. In principle, three options can be envisaged:

1. *Strengthening the fiscal and macroeconomic watchdog role of the Commission, together with the establishment of a full-time Eurogroup president who is not simultaneously a member of a government.* The problem with this option is that it would not depart significantly from the current model, as the Commission would continue to be a provider of both independent assessments and political compromises. It also carries the risk that the Eurogroup president would develop into a new bureaucracy (or expand the role of the ESM in support of the Eurogroup presidency), thereby creating a lasting institutional rivalry between the Commission and the Eurogroup presidency.

2. *Assigning the fiscal and macroeconomic watchdog role (the prosecutor) to an independent body (such as the European Fiscal Board or the ESM), together with the assignment of the Eurogroup presidency role (the judge) to the Commission* (following the ‘double-hat’ model in place for foreign policy). Such a system would provide institutional clarity and avoid new bureaucracies (albeit at the price of a large increase in the role and staff of either the European Fiscal Board or the ESM). However, it would require a major overhaul of the European Treaty, which currently explicitly assigns the fiscal and economic surveillance roles to the Commission.

3. *Splitting the two roles within the Commission, together with the establishment of a Chinese wall between the Commissioners and services in charge of the two roles.* This would require assigning the fiscal and macroeconomic watchdog roles of the Commission to a special Commissioner who would bear exclusive responsibility for surveillance and the issuance of recommendations in accordance with the existing fiscal and economic rules. The exclusive character of this responsibility would be guaranteed by a special status within the Commission.[32] The responsibility of this Commissioner would extend well beyond the current remit of the European Fiscal Board, which fulfils an exclusively advisory role. He or she would play the fiscal watchdog role envisaged by the reformed fiscal rules, and have responsibility for economic coordination procedures in accordance with the responsibility assigned to the Commission by the Treaty. Being relieved of the prosecutor role, the ECFIN Commissioner could then serve as Eurogroup President (‘double-hat’) and steer political decisions based on recommendations of the fiscal and economic watchdog.

Both the second and the third model would be preferable to the first. Furthermore, from the point of view of ensuring the independence of the watchdog, the second model would be preferable to the third,

31 “A European Minister of Economy and Finance”, COM(2017)823, 6 December 2017.

32 Article 3 of the Rules of Procedure of the Commission states that: “The President may assign to Members of the Commission special fields of activity with regard to which they are specifically responsible for the preparation of Commission work and the implementation of its decisions.”

since protecting a fiscal watchdog located within the Commission from undue political interference would require a high degree of discipline. That said, there are precedents – in particular, in competition policy – that show that independent functions can be carried out successfully within the structure of the Commission. Furthermore, the third model has the advantage that it could be implemented without major treaty changes, as fiscal surveillance is currently a Community competence. Reassigning responsibilities currently assigned to the Commission would imply a much more fundamental overhaul of the existing legal architecture.

4.3.2 Crisis management

The responsibility for conditional assistance should be fully assigned to the ESM, with an expanded mandate and institutional framework:

- It should take over from the Commission and the ECB the exclusive responsibility for the design and the negotiation of conditional assistance programmes. This would imply, as is *de facto* already the case, that the normal operation of fiscal and economic surveillance be suspended for the duration of the programme.[33]

- It should be subject to the political (but not financial) oversight of the European parliament. In practice, this would mean that the ESM Managing Director would be asked to explain and justify the design of ESM programmes to the relevant parliamentary committee. As long as funding for ESM assistance is provided by the member states, financial oversight, and the right to approve programmes, would remain in the hands of the ESM's shareholders.

- It should be governed by a sufficiently compact Board of Directors, appointed or elected by the members via an IMF-like constituency system. To increase the operational independence of the ESM, directors should operate at arm's length from the governments that appoint them, as is formally the case for all Board members of the IMF (and de facto for board members elected by multi-country constituencies).[34]

33 This would apply to 'standard' ESM programmes. Countries that receive ESM loans based on pre-qualification and lighter ex post conditionality, as suggested in the section on fiscal instruments, would continue to participate in the standard surveillance process, complemented by ESM surveillance focused only on compliance with the conditions of the loan.

34 See Gianviti (1999) and Martinez-Diaz (2008), who compares the governance structure of the IMF to that of other international institutions.

5 Conclusion

Building a monetary union of sovereign states is an ambitious endeavour, even when these states are closely integrated and already share common institutions. The crisis has simultaneously revealed the weaknesses of the euro area's initial architecture, the strength of the member states' and citizens' commitment to its integrity, and the depth of disagreements over its reform. The task ahead is to embed the revealed collective preference for integration in institutional arrangements that are both robust and acceptable for all participating members. We think that this is a feasible task.

Our proposal should be regarded as a package comprising six main elements:

First, breaking the vicious circle between banks and sovereigns through the coordinated introduction of sovereign concentration charges for banks and a common deposit insurance. The former would incentivise the diversification of banks' portfolios of government securities, while the latter would protect all insured euro area depositors equally. Incentives for prudent policies at the national level would be maintained by pricing country-specific risk in the calculation of insurance premiums, and through a reinsurance approach: common funds could be tapped only after 'national compartments' have been exhausted. Together, these measures would decisively reduce the remaining correlation between bank and sovereign risk, paving the way for the cross-border integration of banking and capital markets. In addition, mechanisms to bail in creditors of failing banks should to be strengthened, the reduction of existing non-performing loans needs to accelerate, and bank regulatory standards should be tightened and further harmonised.

Second, replacing the current system of fiscal rules focused on the 'structural deficit' by a simple expenditure rule guided by a long-term debt-reduction target. A rule of this type is both less error-prone than the present rules and more effective in stabilising economic cycles, since cyclical changes in revenue do not need to be offset by changes in expenditure. Monitoring compliance with the fiscal rule should be devolved to national fiscal watchdogs supervised by an independent euro area-level institution. In case of no compliance, a government should be compelled to finance excess spending through the issuance of junior sovereign bonds, whose maturities would be automatically extended should the country be subject to an ESM programme.

Third, allowing orderly sovereign debt restructuring of countries whose solvency cannot be restored through conditional crisis lending – and hence a more credible no bailout rule. This requires lowering the economic and financial disruptions of a restructuring, adopting legal mechanisms that protect sovereigns from creditors that attempt to 'hold out' for full repayment, and developing ESM policies and procedures that provide an effective commitment not to bail out countries with unsustainable debts. To prevent any instability in sovereign debt markets, such policies need to be phased in gradually and combined with other reforms that reduce sovereign risk, such as common deposit insurance and fiscal risk-sharing mechanisms.

Fourth, creating a euro area fund, financed by national contributions, that helps participating member countries absorb large economic disruptions. Payouts would be triggered if employment falls below (or unemployment rises above) a pre-set threshold. To ensure that the system does not lead to permanent transfers, national contributions would be higher for countries that are more likely to draw on the fund, and revised based on ongoing experience. This system would maintain good incentives through three mechanisms: 'first losses' would continue to be borne at national level, participation in the scheme would depend on compliance with fiscal rules and the European semester, and higher drawings would lead to higher national contributions.

Fifth, an initiative to create a synthetic euro area safe asset that would offer investors an alternative to national sovereign bonds. Safety could be created through a combination of diversification and seniority – for example, financial intermediaries would purchase a standardised diversified portfolio of sovereign bonds and use this as collateral for a security issued in several tranches. Introducing such assets in parallel with a regulation on limiting sovereign concentration risk would help smooth the transition away from excessive concentration on home-country government bonds.

Sixth, reform of the euro area institutional architecture. The role of the watchdog ('prosecutor') should be separated from that of the political decision-maker ('judge') by creating an independent fiscal watchdog within the European Commission (for example, a special Commissioner) or, alternatively, by moving the fiscal watchdog role outside the Commission. At the same time, the Eurogroup presidency role (the judge) could be assigned to the Commission. The policy responsibility for conditional crisis lending should be fully assigned to a crisis management institution built on the current ESM, with an appropriate accountability structure.

Implementing these reforms would be a game-changer for the euro area, significantly improving its financial stability, political cohesion and potential for delivering prosperity to its citizens, all while addressing the priorities and concerns of the participating countries. Our leaders should not settle for less.

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