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Euro area reform: An anatomy of the debate

Jean Pisani-Ferry

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The euro is nearly 20 years old – ten quiet years followed by ten tumultuous ones. The end of the first decade was marked by glowing, oddly uncritical reviews.² Ten years later, however, complacency has largely vanished from assessments of the state of the euro area and disagreements over its future remain unsolved. Already six years ago, the heads of the European institutions issued a blueprint for the future, the *Four Presidents' Report* of June 2012 (Van Rompuy *et al.*, 2012), and in a statement on 29 June 2012 the euro area heads of state agreed on “breaking the vicious circle between banks and sovereigns” by establishing a banking union.³ Much has been done for sure, but the agenda endorsed by the leaders has not been completed and the roadmap for the future remains a matter of fierce controversy. At their June 2018 summit, despite the prior Franco-German rapprochement and the joint ‘Meseberg Declaration’ by President Macron and Chancellor Merkel,⁴ the euro area heads of state could only agree to call for further work on a series of still-divisive issues.

The nature of disagreements

Why is it so difficult to agree? Why is it so difficult for countries that jointly decided almost 30 years ago to embark on what they knew was an extremely ambitious endeavour to find agreement on directions for reform? The architects of the euro were fully aware of the incomplete nature of the contract written down in the Maastricht Treaty. They knew, or at least they suspected, that

the launch of the European currency would mark the start of a journey and that further decisions on economic integration, financial policy, the creation of a fiscal capacity and the coordination of national policies would be needed down the road. But they assumed that participation in the euro would create momentum and help to tackle future issues. It is therefore striking that discussions have proved so difficult and that since the crisis erupted in 2010, so many decisions were only taken on the edge of the precipice.⁵

There are essentially two possible theories for this enduring state of controversy: the ‘battle of interests’ and the ‘battle of ideas’. The first posits that problems are fundamentally distributional – decisions are controversial because they pit creditors against debtors, high-debt against low-debt states, stable against crisis-prone countries, or global banks against local banks. The second emphasises cognitive issues. According to this reading, a major factor behind disagreements is that actors do not share the same representation of reality, but rather work with different implicit or explicit models of it.

As with any zero-sum game, divergent interests may be hard to reconcile but they are analytically simple to deal with, because the settling of a dispute is regarded by both sides as a purely transactional matter. Divergent representations may be substantially less divisive because the protagonists may ultimately all gain from cooperating, but agreement is often harder to reach.

¹ This Policy Insight originates from remarks prepared for the conference “*Institutions and the crisis*” held in Florence in April 2018. A previous version of it was published under the title “*Euro area reform: Reflection on an initiative*” in Allen *et al.* (2018). I am grateful to Agnès Bénassy-Quéré and Isabel Schnabel for comments on an earlier draft and I am especially indebted to Jeromin Zettelmeyer, with whom I extensively discussed the relevance and implications of the contributions to the VoxEU debate that we moderated jointly between April and July 2018.

² I must admit that I contributed (modestly) to this literature.

³ <http://www.consilium.europa.eu/en/press/press-releases/2018/06/29/20180629-euro-summit-statement/>

⁴ <https://www.bundesregierung.de/Content/EN/Pressemitteilungen/BPA/2018/2018-06-19-meseberg-declaration.html>

⁵ The authoritative account is James (2014). The first chapters of Mody (2018) provide a (very) critical review of the discussions leading up to the launch of the euro.

Worse, because they reason with different models, participants may agree on a solution that leaves them actually all worse off.⁶ As emphasised by Baldwin and Giavazzi (2015), it is essential to settle on lasting and effective responses, to start from an intellectual consensus on the causes of the crisis.

Richard Cooper's study of nineteenth century international cooperation in public health provides a telling example of a battle of ideas (Cooper, 1989). Public health is an interesting case to study because there cannot be any doubt that all countries share a common interest in containing the propagation of diseases. Distributional dimensions can therefore be assumed to be minimal. However, it took no less than five decades and seven international conferences to reach an effective international agreement on the prevention of cholera, because participants in the negotiations adhered to opposing models of disease transmission. The *contagionist* school assumed that transmission essentially takes place through contact and advocated long quarantines, whereas the *miasmatic* school emphasised poor sanitary conditions and advocated local sanitation. On several occasions, fierce negotiations resulted in a compromise on a short quarantine. This was an ineffective solution under both models, and for this reason it was not implemented. It is only when the intellectual dispute was resolved (essentially by acknowledging that the *miasmatic* school was right) that a lasting solution could be found.

In the euro context, the 'battle of interests' view offers an appropriate lens for analysing controversies over legacy issues – debts, non-performing loans (NPLs), real exchange rate misalignments and imbalances – and in general everything categorised as 'risk reduction issues' in the jargon. But as analysed by Brunnermeier *et al.* (2016) and Mahfouz and Pisani-Ferry (2016), there are other, long-standing controversies over the rules of the policy game and the role of policy institutions that cannot be understood until their genuinely cognitive dimension is taken into account.

This type of reading is particularly suited to the analysis of Franco-German debates. True, official views on banking union on both sides are coloured by interests – France is home to several of the largest European banks, whereas the German banking system is characterised by a much lower degree of concentration and a mostly regional reach of the

vast majority of banking institutions. Discussions on supervision and deposit insurance, for example, are therefore best read within the framework of the 'battle of interests', even more so because of the closeness between national banking lobbies and national ministries of finance. But other disputes, especially on the resolution of the euro crisis and the reforms needed to avoid further crises, cannot be understood within this perspective. Although the two economies have grown dissimilar, particularly over the recent decades, it is hard to pin down French and German stances over stabilisation, moral hazard or the role of discretionary policies as the naked expression of interests.⁷ France and Germany have genuinely different perceptions of risks and their propagation.

The 7 + 7 initiative

This difference is one of the reasons why a group of 14 French and German economists (hereafter the 7 + 7 group) joined forces in September 2017 with the aim of forging ambitious proposals for euro area reforms. Their fear, as expressed in an initial paper, was that the two countries would settle on a "small bargain" that "would not make the euro area more stable", that "would not address the fundamental causes of why fiscal rules have not worked well" and that might "induce a false sense of security, hindering needed reforms both at the national and European levels" – in other words, a sort of short quarantine.⁸ Four months later they issued a joint report (Bénassy-Quéré *et al.*, 2018) that started from the recognition that "both the French and the German position have a point" and stated that making progress without ending up with a collection of half-baked compromises required "a shift to reconcile fiscal prudence with demand policies and rules with policy discretion". Claiming that "market discipline and risk sharing should be viewed as complementary pillars of the euro area financial architecture, rather than as substitutes", the 7 + 7 group put forward a series of proposals for the financial, the fiscal and the institutional architecture of the euro area (Box 1).

Throughout their joint work, the 7 + 7 group never actually bargained over different interests. Their common aim was to overcome intellectual disagreements stemming from different appreciations of risk or different implicit models. As is standard among economists, they started from the desirable properties of the target regime, rather than from the current situation.

⁶ This is a classic result from the theory of international coordination (see, for example, Frankel and Rockett, 1986).

⁷ Burda (2015) claims that German economists do not differ from their European colleagues because they rely on a different analytical framework but because they stand for a different national interest. His demonstration, however, fails to convince.

⁸ https://www.lemonde.fr/idees/article/2017/09/27/europe-la-france-et-l-allemande-doivent-viser-davantage-qu-un-mini-compromis_5192086_3232.html

Box I

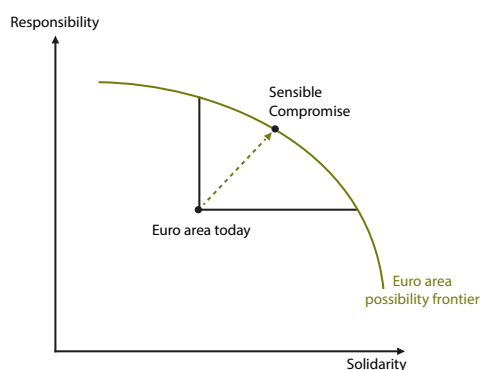
Key proposals of the 7 + 7 report

- 1. Reform of fiscal rules, including of the enforcement device**
 - Introduce debt-corrected expenditure rule (acyclical discretionary spending)
 - Ditch EU sanctions, assign more individual responsibility to countries
- 2. More and better risk sharing**
 - Reduce home bias in bank sovereign portfolios through concentration charges
 - Introduce common deposit insurance with national compartments
 - Promote 'safe asset' based on diversified sovereign debt portfolio (e.g. ESBies)
 - Create low-conditionality access to ESM liquidity for pre-qualified countries
 - Create unemployment/employment reinsurance fund
- 3. A targeted role for market discipline**
 - Enforce the fiscal rule via mandating the issuance of subordinated (junior) bonds for the financing of excess spending
 - Make sovereign debt restructuring a credible last resort when debt is clearly unsustainable
- 4. Clarify role of institutions**
 - Separate 'prosecutor' (watchdog) and 'judge' (political)
 - Upgrade ESM to IMF-like institution, introduce political accountability
 - Strengthen national fiscal councils

Legacy issues such as the high public debt ratio of some euro countries or the strong home bias exhibited by bank balance sheets were taken on board at a later stage, when addressing transition from one equilibrium to another.

In the 7 + 7 group's view, a reason why such improvement on both axes was regarded as possible was a strong, but generally neglected complementarity between risk-sharing and fiscal discipline. Far from being antagonistic, they thought that both aims could go hand in hand for the following reasons:

Figure I Trade-offs versus efficiency: A stylised representation



The 7 + 7 group furthermore shared the conviction that negotiation on the basis of national 'objectives' and 'red lines', as traditionally practiced, was bound to constrain the outcome to inferior solutions. As illustrated in Figure 1,9 they saw for example the discussion over trade-offs between German-inspired responsibility and French-inspired solidarity as essentially pointless as long as the solution set under discussion remained situated inside the efficiency frontier. There was, in their view, room for simultaneous improvement on both accounts.

- A common deposit insurance – a solidarity device – protects banks from runs and helps to break the 'doom loop'. Hence, debt restructuring becomes a more feasible option, which strengthens market discipline.
- A common safe asset helps banks to diversify away from domestic sovereign bonds. Hence, it contributes to delinking sovereigns from 'their' banks and to making market discipline more credible and more effective.
- Precautionary liquidity lines for pre-qualified countries help to cushion shocks but also incentivise fiscal responsibility.
- Temporary stabilising transfers to cushion severe economic disturbances alleviate the burden on national fiscal policies, therefore contributing to fiscal sustainability.
- Overall, risk-sharing arrangements make the no-bailout rule easier to enforce and therefore more credible.

9 This representation was first proposed by Jakob von Weizsäcker in a comment on the 7 + 7 report.

The debate over the report

Although it was discussed at various stages with senior officials from both sides, and although ideas therein – such as debt one-limb collective action clauses for sovereign debt, ESM liquidity lines for prequalified countries, and employment-based or unemployment-based temporary stabilisation mechanisms – made their way to the French-German roadmap issued by the ministers of finance a few days before the Meseberg meeting,¹⁰ it is fair to say that the gist of the report was not endorsed by the French and German authorities. France was circumspect on the concentration charges and uncomfortable with the acknowledgement that debt restructuring had to feature as a last-resort option, because it feared being dragged into accepting some form of automaticity. It was sympathetic to deposit insurance, but unwilling to spend much political capital on it. Germany was politically unhappy with the emphasis on a European deposit insurance scheme and had reservations about the proposal for a stabilisation fund, whose functioning would involve at least temporary fiscal transfers. Both governments were doubtful of the junior bonds and the common safe asset (and they actually closed the door to sovereign bond-backed securities, or SBBSs, in their joint June 2018 roadmap). And neither France nor Germany was keen on questioning the effectiveness of the Stability and Growth Pact in the way the report did.

The report was influential, however, in that it helped to structure discussions on euro area reform. Presentations have been made at the European Parliament, the European Commission, the Economic and Financial Committee (EFC), the European Stability Mechanism (ESM), the ECB and the IMF, as well as to treasuries and central banks in Belgium, France, Germany, Ireland, Italy and Spain. It was discussed in a series of seminars, elicited significant interest in the community of economists and triggered a series of discussions within the profession. In April 2018, a [debate](#) was opened on [VoxEU](#) which¹¹ had attracted 25 contributions by the end of August.¹²

The contributions to the VoxEU debate provide an interesting collection of views and are indicative of the discussions triggered by the proposals of the 7 + 7 report. The sample is admittedly biased – few contributions emanated from the Northern European conservative school, whose strong reservations towards the very principle of a new stabilisation instrument were forcefully

expressed in the paper by eight finance ministers at the initiative of the Netherlands.¹³ Although well-represented at the national level in several countries – and despite invitations to contribute – this school of thought largely abstained from entering the debate on EMU reform.

In contrast, several of the contributors criticised the report for not going far enough, especially on fiscal stabilisation and liquidity provision. In one contribution to the debate, Bofinger (2018) even expressed the view that the balance between stabilisation and discipline was so tilted towards the latter that implementing the report's proposals would make the euro area worse off. The opinion that in a steady state, it would be a “game-changer in the wrong direction” was not shared by the other contributors, however.

The main debates triggered by the report can be grouped under five headings:

- First, which is the right strategy for addressing legacy problems?
- Second, should the debate on euro area reform focus on its fiscal and financial features, or is there a need for a significant discussion for the monetary dimension, too?
- Third, should the fiscal architecture be overhauled or reformed at the margin?
- Fourth, what are the conditions for completing the reform of the financial architecture undertaken in 2012 with the launch of the banking union?
- And fifth, do the 7 + 7 group's proposals suffer from a Northern bias? Legacy versus system design

Legacy versus system design

As already indicated, the 7 + 7 group did not emphasise proposals to address problems inherited from the past (what economists call legacy problems), but rather proposed ideas for a better permanent regime. This does not mean that they started from a clean slate and overlooked these legacy issues. Rather, the features of the proposed permanent regime and the transition leading to it were conceived in such a way that it was intended to allow countries with high public debt or weak banking sectors to take part in it.

¹⁰ https://www.economie.gouv.fr/files/files/PDF/2018/Finances-Euro_Area_Roadmap-EN.pdf

¹¹ I moderated the debate jointly with Jeromin Zettelmeyer.

¹² New contributions have been posted since September. However, they are less about the report than about further proposals and the debate about them.

¹³ <https://vm.fi/documents/10623/6305483/Position+EMU+Denmark+Estonia+Finland+Ireland+Latvia+Lithuania+the+Netherlands+and+Sweden.pdf/99e70c41-6348-4c06-8ff8-ed2965d16700/Position+EMU+Denmark+Estonia+Finland+Ireland+Latvia+Lithuania+the+Netherlands+and+Sweden.pdf.pdf>

Because of its public finances and relatively recent banking sector troubles, Italy is an especially testing case. Bini-Smaghi (2018) and Micossi (2018) implicitly or explicitly wonder if the proposed regime would increase its vulnerability; Tabellini (2018) goes one step further and argues that it would be dangerously destabilising for high-debt countries and the euro area as a whole. But the proposed solution has also elicited criticism from the opposite angle: as explained in his contribution, Lars Feld, who was initially part of the 7 + 7 group, did not endorse the final report because he thought it involved the risk of a distributional bias in favour of high-debt countries (Feld, 2018). His reasoning is that lack of fiscal space at national level would inevitably lead them to draw disproportionately on common fiscal facilities. As his contribution makes clear, he is not convinced that the devices introduced to limit this risk – prequalification, co-payment, thresholds, etc. – would be sufficient to control it.

An alternative strategy could have been to start by addressing the legacy issues head on through some sort of stock operation (a debt work-out and the cleaning up the bank balance sheets) even at the cost of accepting a degree of mutualisation. This was the logic behind the debt redemption pact proposed in a report by the German Council of Economic Experts (GCEE, 2012) co-authored by Lars Feld, Beatrice Weder di Mauro (one of the 7 + 7 group, and at that time a member of the GCEE) and others – get rid of the shadow of the past, so that the steady-state system can remain based on the original Maastricht assignment that made individual member states responsible for stabilisation. Under this logic, it is better to show a limited amount of solidarity to restore national fiscal space now than to commit to open-ended solidarity in the future.

An objection to Feld's approach is that the 7 + 7 group's proposals are not simply – or even primarily – intended to find a way around the present lack of fiscal space. They aim at addressing systemic weaknesses in the design of the Maastricht system that were revealed by the crisis. These problems would persist even if all public debt were magically reduced to 60% of GDP and all bank NPLs were suddenly eliminated. The vulnerability of individual sovereigns that was revealed by the crisis was not exclusively the result of excessive debt accumulation, but also of their inherent fragility in the context of a monetary union. Such problems must be addressed systemically.

Another objection to the approach of proposing one-time solidarity in exchange for a return to the Maastricht system is its questionable political feasibility. The proposal for a debt redemption pact was first formulated seven years ago. Even at

the height of the crisis, it was at best considered with polite interest in policy circles. Even in the case of Greece, for which debt unsustainability remains manifest, no agreement has been found to proceed to a genuine stock operation, and the long shadow of the past will affect policy choices in the decades to come. To put it simply, states' revealed preference is to avoid paying now.

Monetary dimensions

Redenomination risk

The 7 + 7 report has been criticised for not addressing redenomination risk (Bini Smaghi, 2018; Cohen-Setton and Vallée, 2018; De Grauwe and Ji, 2018; Domenech *et al.*, 2018; Watt, 2018). It is true that in the report, the risk that markets would price an exit from the euro area – as opposed to pricing merely the solvency risk – is mentioned only once and that the corresponding response, the ECB's Outright Monetary Transactions (OMT) instrument, is not mentioned at all. But as explained by Farhi and Martin (2018), one of the important aims of the authors was in fact to address and diminish redenomination risk.

Although this aim should have been spelled out more explicitly, there is in fact little substantial ambiguity on this point. The report adamantly advocates resolving sovereign debt crises through restructuring inside the euro area rather than through exiting from it. Indeed, the reduction of the cost of restructuring the report called for would logically diminish the threat of exit. Furthermore, proposals to break the 'doom loop' for good (through concentration charges on bank balance sheets, a common deposit insurance and the introduction of a safe asset) would help contain the risk of self-fulfilling exit expectations.

The role of the ECB

A related criticism is that the 7 + 7 report did not discuss the role of the ECB and did not mention the Outright Monetary Transactions programme (Cohen-Setton and Vallée, 2018; Wolff, 2018). Again, this is factually true, as the report's focus was on the agenda for intergovernmental Franco-German discussions, which were (fortunately) not expected to cover issues related to the way an independent ECB fulfils its mandate. But whereas the 7 + 7 group deliberately abstained from discussing central bank policy, they worked under the assumption that the ECB would continue tackling the risk of self-fulfilling crises, including through activating the OMT if necessary (Farhi and Martin, 2018). So, there is in fact no neglect of central bank policy matters.

A number of issues do, however, deserve further discussion. Cohen-Setton and Vallée (2018) argue that the ECB should backstop the sovereign bond market of a solvent country even in the absence of a conditional assistance programme. While the 7 + 7 group argue that a 'prequalified' solvent country should be granted access to an ESM liquidity window without being required to change its policy, the official ECB doctrine remains that the OMT can only be activated in complement to national reform efforts (Cœuré, 2013). If access to ESM liquidity is granted to a prequalified country without ex-post conditionality, this should logically apply to the OMT as well. This point could have been made explicitly in the 7 + 7 report.

An alternative approach, argued by Vihriälä (2018), would be to give the ESM access to ECB funding for the financing of precautionary lending (as opposed to standard conditional assistance, which would continue being financed on the basis of the resources provided by the member states). Both approaches would address a number of concerns with the status quo: that the €500 billion ESM capacity may quickly be exhausted in a liquidity crisis, that it is not appropriate to endow the ECB with the responsibility of deciding whether or not to provide support to sovereigns, and that conditioning liquidity support on an adjustment programme is likely to delay its activation excessively.

Fiscal architecture

Debt restructuring

The 7 + 7 report has been criticised by officials and observers for advocating quasi-automatic sovereign debt restructuring and for taking the risk of corresponding financial trouble lightly. In fact, it emphatically rejected both numerical thresholds and procedural automaticity (such as the automatic roll-over of standard bonds coming to redemption during an ESM programme). As far as debt sustainability is concerned, the 7 + 7 report made two proposals:

- Debt restructuring should be considered as a last-resort option for insolvent sovereigns. The no bail-out rule – that is, the principle that the ESM does not lend to an insolvent state – would be upheld but exactly in the way the same principle is implemented by the IMF (i.e. lending would be decided on the basis of a debt sustainability analysis and would be conditional on a high enough probability of sustainability).
- Debt restructuring should be made less disruptive financially and economically. For the most part, this would be achieved by better protecting the financial system from sovereign risk (eliminating concentrated exposures and

creating a safe asset that banks would be induced to hold) and through risk sharing mechanisms such as euro area deposit insurance. In addition, the report argued for the introduction of 'single-limb' collective action clauses (that would make it possible to let creditors pass a single vote on a restructuring proposal instead of voting separately on the treatment of each issuance, which offers the opportunity to retain a blocking minority).

A portion of these proposals was endorsed in the Franco-German Meseberg declaration and can now be regarded as being part of the two countries' policy consensus. Several contributors (De Grauwe and Ji, 2018; Tabellini, 2018; Wolff, 2018), however, argue that the very existence of a sovereign restructuring procedure may trigger panic. Furthermore, De Grauwe and Ji – recalling that in the early 2010s, Ireland, Spain and Portugal were regarded by some as insolvent, whereas they were in fact suffering from a liquidity shortage – argue that it is impossible to decide whether a government is actually insolvent (a point also alluded to by Micossi, 2018).

This is a fundamental debate. The no-bailout rule, one of the core principles of EMU, prohibits official lending or indirect central bank support to an insolvent state. To renege on this principle because insolvency is hard to diagnose in real time would amount to endorsing fiscal dominance. In the eyes of the German constitutional court, such an acknowledgment would in turn amount to an infringement of the core EMU contract. So, there is in fact no choice but to operationalise the principle that as a last resort, an insolvent sovereign must undergo debt restructuring. When and how it should be enforced is a matter of judgement. For this reason, this decision should be bestowed to a technically apt and politically legitimate institution. What institution this should be, what would guarantee that it decides even-handedly and consistently, and what methodology should guide its assessment are admittedly matters for further work; but the principle should not be regarded as a matter for discussion. Indeed, in his counterfactual account of the Greek crisis, Papaconstantinou (2018) points out that the lack of an agreed framework for debt restructuring contributed to unhelpful gambles for redemption.

Tabellini's critique is subtler. The 7 + 7 group explicitly stated that their proposals aimed at making a last-resort restructuring financially less disruptive and economically less damaging, and therefore a more credible option. Tabellini argues that this would be reflected in the risk premia applied to high-debt countries. The proposed solution would therefore impose a penalty on countries like Italy. For these countries it would not make things better, but worse.

In their response, Pisani-Ferry and Zettelmeyer (2018) acknowledge that for any given solvency situation of a country remaining in the euro area, the 7 + 7 group's proposals would increase the probability of restructuring. They argue, however, that this need not imply a higher risk premium. First, the solvency of the participating countries cannot be regarded as exogenous, but is likely to improve as a result of the proposed policy regime through stronger incentives to fiscal responsibility and a reduction in the chances that countries will become insolvent as a result of bad shocks or self-fulfilling panics, given the risk-sharing mechanisms and weakening of the link between banks and sovereigns. Second, Tabellini neglects the fact that providing for orderly restructuring inside the euro area may well reduce the probability of an insolvent country being expelled from it, and the corresponding currency redenomination premium paid by sovereign borrowers.

Fiscal rule

Had the 7 + 7 group's criticism of the Stability and Growth Pact (SGP) been formulated a few years ago, it would certainly have elicited a strong rebuttal, especially from official circles. The fact that few commentators disputed it is indicative of the evolution of the debate. Only Bini-Smaghi (2018) regards its negative assessment as unjustified, whereas Beetsma and Larch (2018) speak of an "excessively complex system of rules that few understand", and Wieser (2018) bluntly claims that the present rules-based SGP has become "nearly unmanageable". Wieser is even harsher than the 7 + 7 group, arguing that the present system has produced short-termism, fine tuning of the rule book and political loss of legitimacy.

Beetsma and Larch point out a "surprising convergence of views" on how to overhaul the SGP. They regard the essential tenet of the 7 + 7 group's proposals – an expenditure rule based on potential GDP growth but adjusted to address situations of excessive public debt – as a potentially consensual solution that would reduce procyclicality, provide a basis to streamline the current system and help to limit the recourse to escape clauses.

The proposed rule was criticised by some for continuing to depend on unobservable variables. It is true that potential output growth is not directly observed, so that controversy on the proper assessment of it would remain. But an expenditure ceiling based on potential output would create much less noise than the current approach based on the current and projected output gaps.

Two further controversial points in the 7 + 7 group's proposals are, first, the possibility left to governments to depart from the agreed rule provided they finance additional expenditures

through the issuance of junior bonds and, second, the reform of the institutional set-up.

Junior bonds

In agreement with the view taken on the SGP and the need to make governments more responsible for their own mistakes, the 7 + 7 report advocated the introduction of fixed-duration junior bonds for the financing of expenditures over and above the ceiling given by the national spending rule. These bonds – and *only* these bonds – would undergo an automatic maturity extension in case of an ESM programme. But as they would presumably be issued in small quantities to finance departures from the agreed expenditure rule, the bulk of the public debt stock would remain unaffected.

The idea stems from political considerations – at a time when the policy consensus of the 1990s has eroded, the EU should avoid being held responsible for imposing a fiscal straightjacket that would offer an easy target to populist grievances. Rather, governments should be free to make their own choices and try to convince markets that their policies might actually work. But they would be legally compelled to finance additional expenditures or tax cuts through standardised five-year bonds that would be subject to automatic maturity extension in case of an ESM programme and would be the first to suffer a haircut in case of restructuring.

Echoing concerns often heard in official circles, Buti *et al.* (2018) fear that junior bonds, though clearly distinct from standard bonds, would provide a conduit for transmitting destabilising market reactions. Increased probability of an ESM programme, the reasoning goes, would lead to a freeze of the secondary junior bond market that could spill over onto the market for standard bonds. Although not subject to maturity extension, the latter would suffer from the deteriorating reputation of the issuer. Ultimately, the entire bond market could freeze prematurely.

There is indeed no experience of issuance of such bonds by sovereigns, and even private-sector experience is limited in this regard. The proposal in the 7 + 7 report is that junior bonds would be (i) optional in the sense that countries can avoid them by observing the pre-announced expenditure ceiling; (ii) standardised, so that they would be clearly distinguishable from regular bonds; and (iii) subject to a specific regulatory treatment. These provisions should limit the risk of spillover onto the regular bond market.

Other objections are that the market for junior bonds would be thin, that financial markets are subject to wide gyrations in their assessments, and that it would be hard to establish and enforce a legal

obligation to finance excessive deficits by junior bonds. These are real concerns, but the proposal by Beetsma and Larch to suspend the disbursement of EU funds to a country in infringement of the rules would not be easy to implement either. Ultimately, what must be found is a balance between two imperfect institutional arrangements: one that relies on peer pressure underpinned by legal obligations, and one that relies on market pressure. Neither is failproof.

Purple bonds

A dual sovereign bond market structure is also advocated by Bini-Smaghi and Marcussen (2018), but in a different way. Drawing on the 'blue bonds-red bonds' proposal of Delpa and Weizsäcker (2010), they propose the introduction of 'purple bonds' that would benefit from a non-restructuring guarantee under an ESM programme. In a permanent regime, to be reached at a 20-year horizon, each sovereign would be allowed to issue such bonds up to 60% of its GDP. Additional bonds (dubbed red) could be issued, but as they would not benefit from the same guarantee, the risk of restructuring would be priced in and, as in the case of junior bonds, they would serve as a channel for market discipline.

To avoid destabilisation, Bini-Smaghi and Marcussen envisage granting the purple bond status to the entire stock of public debt outstanding. Gradually however, new issuances would be guaranteed only for an amount corresponding to compliance with the Fiscal Compact. The rest, if any, would have to be issued in the form of red bonds. To be concrete, a country that starts from a 100% debt-to-GDP ratio would need to reduce it by two percentage points per year to bring it to 60% within 20 years. The stock of purple debt would therefore be gradually reduced over this 20-year transition period.

The purple bonds proposal would in a way achieve the stock operation mentioned earlier. Apart from the fact that objections to the junior bonds proposal would also apply to the red bonds, it raises the question of whether the ESM can extend a no-restructuring guarantee to all existing public debt. This would commit it *ex ante* to the type of concessionary lending currently granted to Greece, to the benefit of any country whose present level of public debt would prove unsustainable. Initially, the introduction of such a guarantee would remove market incentives to discipline altogether. It would therefore need to be accompanied by a significant strengthening of the institutional fiscal framework, whose likelihood appears uncertain. And as also discussed already, political appetite for an *ex ante* transfer, even a contingent one, seems limited.

Institutional set-up

The 7 + 7 report claimed that the institutional architecture of fiscal surveillance should be reformed, first by assigning more fiscal responsibility to national fiscal councils, and second by better separating the role of 'prosecutor' and 'judge'. The latter would be done either by assigning different tasks to the Commission and the chair of the Eurogroup or, if the role of chairing the Eurogroup were assigned to the ECFIN Commissioner, by separating functions within the Commission. The discussion of these issues is bound to gain in importance as there seems to be wide agreement that the role of the ESM should be strengthened. It is also easy to be sceptical, as Wieser (2018) is, about the actual degree of independence of national fiscal watchdogs. Further debate is likely on how to avoid duplication and rivalry between European institutions, and how to ensure that fiscal responsibility is better rooted in credible domestic institutions.

Tabellini (2018) raises an important institutional point when observing that decision making for the granting of ESM assistance is dominated by the creditors. Could then the ESM be endowed with the responsibility of assessing debt sustainability? Or should a more neutral institution be in charge of this assessment? Pisani-Ferry and Zettelmeyer (2018) share his concern about the independence of the sustainability assessment provided by the ESM staff, but disagree on the precondition that the ESM be transformed into an EU institution operating under majority rule and accountable to the European Parliament. In their view, this is simply too high a bar.

Fiscal stabilisation and fiscal capacity

The Maastricht policy assignment was remarkably clear and simple: reflecting the consensus of the time, monetary policy was regarded a strong enough instrument for addressing area-wide shocks whereas, provided governments played by the rules, national fiscal policies were supposed to enjoy sufficient margins of manoeuvre within the constraints of the SGP to tackle country-specific shocks.

These hypotheses have been seriously questioned by the economic developments of the last decade. Contrary to the view of the early 2000s (Taylor, 2000), fiscal policy is increasingly regarded as a necessary complement to monetary policy, especially in situations when the latter is constrained by the zero lower bound (Furman, 2016); and market reactions, or the fear of them, can prevent national fiscal policy from playing its stabilisation role when a country is hit by a large shock. Hence the need to reconsider the role of fiscal policy in EMU.

The 7 + 7 report aimed to provide a response to the second problem – how to help individual countries deal with large shocks – by proposing a fiscal stabilisation scheme based on the evolution of employment or unemployment indicators. The idea was also endorsed by the IMF (Arnold *et al.*, 2018). The proposed system would take the form of a fund, financed by national contributions, that would provide one-off transfers to countries experiencing a sudden and large change in the employment or unemployment rate. Contributions would be set in such a way that it would not give rise to one-way recurring transfers. A similar idea was outlined in the French-German roadmap, but without transfers. In the ministers' proposal of June 2018, large shocks would merely elicit loans. Loans, however, may not provide effective stabilisation in a situation where countries fear being cut off from access to liquidity,¹⁴ and furthermore they could result in lasting disputes between creditors and debtors.

As to the first problem, the report fell short of proposing a euro area budget or a central fiscal capacity able to cover aggregate shocks. It recognised that aggregate fiscal support might be desirable, but argued that a euro budget could only be the result of decisions regarding common public goods and the institutional underpinnings of their financing.

Apart from Peter Bofinger, commentators generally regard the stabilisation proposals of the 7 + 7 report as positive, though insufficient (Dullien, 2018; Doménech *et al.*, 2018; Watt, 2018; Wolff, 2018). Dullien, for example, points out that had the proposed scheme been in operation prior to the crisis, Spain would have received in total a transfer amounting to 1.3% of its GDP and Ireland less than 1%. Though some in Northern Europe would regard this number as high, it is certainly not commensurate to the stabilisation provided by the US federal budget. Several would have wished the report propose either a proper budget, or a central fiscal authority capable of monitoring and steering the aggregate fiscal stance. The challenge here, however, is not to demonstrate that the euro area would be macroeconomically better off with a significant common budget. It is to overcome either one of two major obstacles: the fact that coordination is toothless whenever it comes to telling a surplus country that it should relax its stance, and the fact that a proper budget requires agreeing on the common public goods, revenue, and accountability procedures.

Financial architecture

As far as banking union is concerned, the 7 + 7 report advocated precise steps aiming to break the

'doom loop' for good. It proposed introducing (i) concentration charges so that banks exhibiting (home) bias in the composition of their sovereign bonds portfolio would be required to post more capital (but no risk-weighting of individual assets, which implies that all sovereign bonds would continue to be treated in the same way); and (ii) a common deposit insurance scheme that would guarantee all bank deposits equally but for which banks would continue paying different fees depending not only on bank-specific risk, but also on the safety of the national banking systems.

Concentration charges would make it costly for national banks to continue to disproportionately hold bonds issued by their sovereign. For this reason, their introduction would primarily affect countries, such as Italy, where banks have behaved as the residual buyer of domestic government securities. In order to avoid destabilising sovereign bond markets, the 7 + 7 report advocated for concentration charges to be phased in gradually, possibly after having granted grandfathering to all existing holdings, and ideally in combination with the phase-in of a sovereign bond-backed safe asset which would create demand for sovereign bonds during the transition phase. Here especially, the aim was to define the target of the long-term regime and to work out the transition very carefully.

Deposit insurance

As detailed in Schnabel and Véron (2018a, 2018b), the scheme for deposit insurance was also designed in order to combine the guarantee that all deposits are equally safe – a strong deterrent to bank runs – and a financing system avoiding full mutualisation for as long as national authorities can influence bank solvency through a variety of policy provisions such as company and household bankruptcy procedures. The 7 + 7 scheme therefore combined a fully integrated setting with differentiated contributions (based on structural indicators of creditor rights) and a two-tier waterfall financing structure with national compartments and a common compartment that would start to pay out once the national compartment has been depleted, and that would be reimbursed over time so that the operation of the system would not involve any permanent transfer.

Some critics have argued that this scheme would be complex, unnecessary and potentially inadequate. Building on simulations, a team of economists at the ECB argued that a single fee structure could be designed that would ensure a high degree of safety and avoid any cross-subsidisation (Carmassi *et al.*, 2018). They even claim that a reinsurance-type structure could have undesirable distributional consequences, but their assumed structure differs

¹⁴ Research has provided evidence of significant multiplier non-linearities in conditions of market concerns over a country's fiscal sustainability.

from that proposed in the 7 + 7 report (because it assumes fixed target levels for the national compartments). Schoenmaker (2018) also criticises the proposed system on the ground that the replenishment of national compartments could be procyclical. So even if an agreement could be reached on the principle of a common deposit insurance, its design would remain a matter for economic debate.

Safe asset

The 7 + 7 report proposed common synthetic safe securities be introduced in parallel to the concentration charges so that banks would be incentivised to purchase them as diversification assets. The safe asset issue has been part of the euro discussion at least since Delpla and Weizsäcker (2010) formulated their blue bonds–red bonds proposal. Over time several variants were put forward, discussed and (generally) discarded but, as observed by Buti *et al.* (2018), versions of the idea that involve pooling and tranching but no mutualisation have not been fully explored yet.

The version endorsed in the 7 + 7 report did not involve any mutualisation. Instead, the authors advocated introducing privately issued but regulated sovereign bond-backed securities (SBBSs) based on a diversified portfolio of euro area sovereign bonds. The senior tranche of the synthetic asset – what Brunnermeier *et al.* (2017) called ESBies – would constitute a euro area safe asset. It would be introduced in parallel to the phasing-in of bank concentration charges, from which it would be exempt, and would therefore constitute an investment vehicle for banks aiming at reducing their home bias. The creation of euro area safe assets would therefore neither be left to private-sector initiative (because of the creation of a specific regulatory framework) nor be taken charge of by an official institution (as in some proposals that envisaged them being issued by the ESM).

Claeys (2018) rightly observes that despite having been endorsed by the European Commission and the European Systemic Risk Board, SBBSs remain controversial and that they are especially unpopular with debt management agencies. As pointed out by Zettelmeyer and Leandro (2018), there are three main reasons for this distrust: first, the fear that the senior tranche would lose safety in a crisis; second, the fear that in adverse market conditions, the issuance of synthetic securities could be blocked by the lack of buyers for the junior and mezzanine tranches; and third, the potential spillovers from the synthetic asset on the demand for national bonds and the liquidity of the corresponding markets.

Simulations by Zettelmeyer and Leandro (2018) suggest that these fears are not without rationale – indeed, the SBBS’s junior tranche could lose market access and the senior tranche could be hit by extreme tail risks – but that they are largely exaggerated. Distrust remains however, as demonstrated by the Franco-German roadmap of June 2018, which discarded SBBSs out of hand. Zettelmeyer and Leandro (2018) also point to alternative ideas for creating safe assets that would avoid some of the potential disadvantages of SBBS while still avoiding mutualisation, albeit at the cost of requiring a large public intermediary such as the ESM. Whether these ideas stand a better chance politically is not clear, however.

Northern bias

As Frieden (2018) points out, any reform programme for the euro area must address the concerns of both core and periphery countries. Though they intended to help unlock the French-German discussion, the 7 + 7 group endeavoured to propose solutions that would suit all euro area members. Several contributors, however, implicitly regarded their report as unbalanced and biased towards the perspective of Northern member states. The critique was most explicitly formulated by Tabellini (2018), who claims that the 7 + 7 report “reflects the nationality of its authors, namely two countries that belong to the core of the euro area and are not exposed to a considerable risk of a sudden stop on their sovereign debt”. He argues that the compromise found by the 7 + 7 group is not suitable for a country exposed to the risk of a debt run and that its proposals would in fact increase the vulnerabilities of countries with high legacy debt.

Tabellini’s critiques of the knock-on effect of the acceptance of sovereign restructuring as a last-resort option and of the junior debt instrument echo those formulated by other commentators and officials. He goes further than these critics, however, in arguing that the 7 + 7 group’s obsession with breaking the doom loop is a bad idea in the first place. He claims that through acting as residual buyers of domestic sovereign bonds in situations of stress, national banks play a stabilising role that should not be hampered by concentration charges or other provisions aiming at the same goal. This is in fact a fundamental critique of the direction taken by EMU reforms since 2012, when the heads and state and government decided to opt for banking union. If domestic banks are to remain the safety valve of the sovereign bond market, it is fully rational for the markets’ assessment of their solvency to be correlated to that of the sovereign. This in turn creates a major conduit for overreaction in times of economic stress and elevated risk aversion. If Italy and countries in similar high-debt situations reject the very idea of a bank balance

sheet diversification, the logical implication will be for regulators in financially stronger countries to perpetuate, or even intensify, ring-fencing in order to protect their financial systems from the fallout of financial disorder across borders. That is exactly what policy architects in the EU have been trying to avoid since the crisis erupted in 2010.

Finally, some commentators (especially Doménech *et al.*, 2018; Dullien, 2018; and Wolff, 2018) have criticised the 7 + 7 report for what it does not address: chronic external surpluses or deficits, structural divergences in growth and endogenous boom-bust cycles. The authors of the report are certainly the last to deny that these are major issues for the sustainability of the euro area. But concerns about them should not prevent serious discussions about the flaws or vulnerabilities policy system. Both must be tackled.

Conclusion

The authors of the 7 + 7 report were aiming at breaking the deadlock in Franco-German discussions and at changing the broader policy conversation on euro area reform. It is fair to say that they had limited success on the first point. Some of their proposals certainly found their way to the Meseberg Declaration; their plea for an ambitious agreement that exploits the hidden complementarities between the 'French' and the 'German' agendas was at least heard. But the overall architecture of the official French-German compromise is quite different from the one proposed in their report. The logic put forward by the 7 + 7 group was intellectually coherent, but probably not palatable enough politically for officials from France and Germany to endorse it and build on it. As illustrated by some of the contributions prompted by the report, it also elicited several guarded or even negative reactions from other countries, especially Italy.

The 7 + 7 group had more success with their second aim. As this survey illustrates – and despite uneven willingness to engage in the debate on the part of the various schools of thought – the tone of the discussion has changed in comparison to what it was a year ago when Emmanuel Macron's ideas started being discussed. Within the group of economists who participated in the endeavour, there is not a German position and a French position anymore. All the 7 + 7 group stand by what they have proposed. Nobody can claim anymore that French and German economists behave as the prisoners of their respective national crisis narratives. This is not a minor achievement.

Furthermore, the report has served as a reference point for a much-broadened discussion among policymakers and academics. Through its questioning of the relevance of well-established

quarrels – such as the dispute between the advocates of risk reduction and the proponents of risk sharing – and because it has put forward new options, it has helped to break the status quo bias that is so pervasive in European policy discussions and to clarify which ideas command wide consensus and which remain a matter for controversy. Some feel that the 7 + 7 group's proposals are insufficient, some that they have gone too far, some that they have taken the wrong direction. But such controversies are definitely useful.

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