Risk sharing and/or market discipline: What future for euro area?

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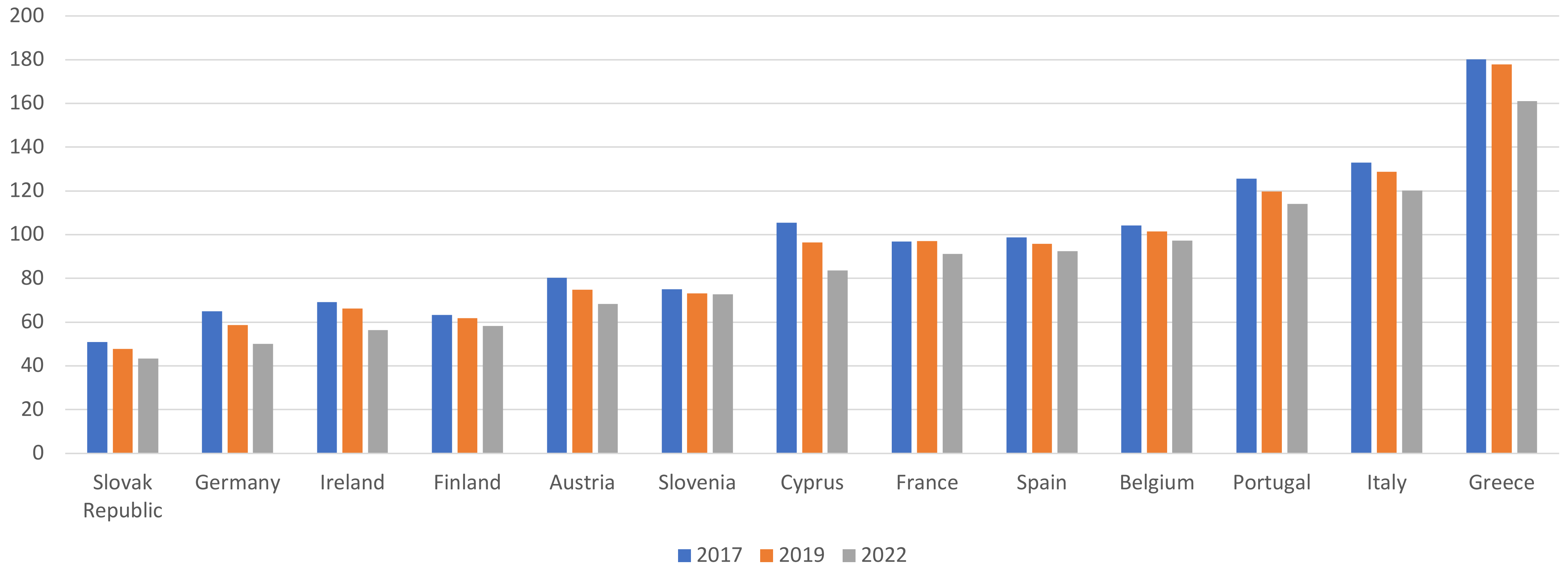
What are the major risks of being a euro area member state?

- Idiosyncratic demand shocks without a national monetary policy (interest rate/exchange rate policy) and a restrained national fiscal policy
- Bad equilibria on financial markets due specific features of euro area member ships
  - insolvency risks („original sin“)
  - easy exit option of bond investors.
  - redenomination risk,

Public debt ratios will remain high



Polar views on the insolvency problem

Maastricht 2.0:

Insolvency risk is a positive feature: necessary for achieving full market discipline

- Strict no-bail out and formal insolvency procedures for sovereigns
- Fiscal competences at the national level

Euro 2.0

Insolvency risk is a negative feature: exposes member states to unpredictable effects of destabilizing market forces

- Debt mutualisation
- Transfer of fiscal competences to EZ-level (EMF, EFI, European Finance Minister)

Two views on market discipline

Feld et al. (2016, p.55):

“An insolvency mechanism for sovereigns that credibly stipulates a creditor bail-in would not only help with burden sharing (similar to the bail-in rules for the banking sector), but also give creditors incentives to assess the default risks of government bonds and loans accurately and factor them in when calculating risk premiums. This should result in ex -ante disciplining of government budgetary policy and would, thus, support crisis prevention.“

Delors-Report (1989):

“ (...), experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.”

Underlying assumptions of reform proposals

	More integration ("risk sharing") is not possible/desirable	More integration ("risk sharing) is possible/desirable
Market discipline more effective than political discipline/Markets self-stabilizing	**Maastricht 2.0** Insolvency regime for euro area (GCEE majority)	**Euroreport** Improve discipline and risk sharing (Bénassy-Quéré et al. 2018)
Political discipline more effective than market discipline/Markets need stabilization by state	**Muddling through** Stabilising the the Status quo which relies on heavy ECB support (QE/OMT)	**Euro 2.0** Debt mutualisation. Transfer of policy competences to the euro area level

Euroreport: Main theses

- A poorly designed fiscal and financial architecture
- Market discipline and risk sharing should be viewed as complementary pillars of the euro area financial architecture
- Reforming fiscal rules to make them less procyclical

Euroreport: More market discipline

- Strengthening the credibility of bank restructuring mechanisms to bail-in creditors of failing banks
- Reducing home bias in sovereign exporures of banks through regulatory disincentives
- Creating the legal and institutional preconditions for restructuring unsustainable sovereign debt: ESM lending to insolvent countries only if accompanied by debt restructuring
- Expenditure rule where all excessive spending must be financed by junior sovereign bonds

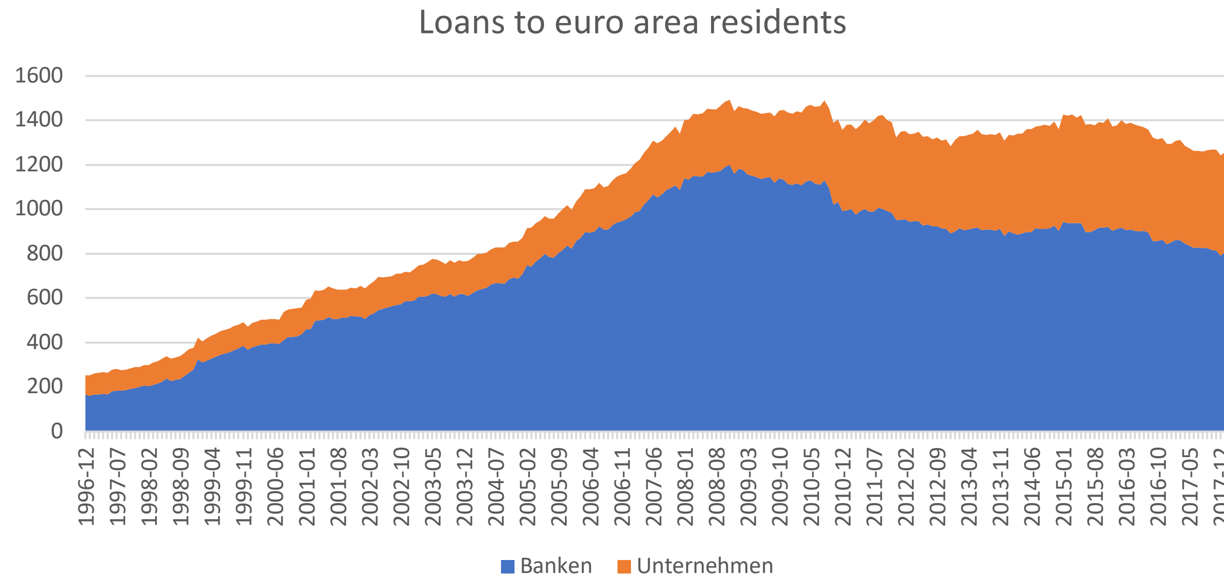
But: The 7+7 are sceptical of market discipline

- 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.
- 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.
- 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.
- 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, assuming policies stay on track

Euroreport: More private risk sharing

- Banking and capital markets union fostering private risk sharing

➢ "Euro area citizens and corporations should be able to hold their savings in instruments whose returns are independent of unemployment and output declines in their home country."



Euroreport: ESBies

- ESBies: safety is achieved by some combination of diversification and seignority
  - „Changes in borrowing conditions that are triggered or magnified by investors risk appetite are a threat to financial stability.“
  - „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. At least so long as sovereigns do not lose market access since this triggers exclusion from the collateral pool of new issues.“
  - „It may be difficult to find buyers for the junior tranches in time of crisis.“

Euroreport: Very limited public risk sharing but only for very large schocks

- European deposit insurance system (EDIS)
  - Insurance premiums pricing country specific risks
  - Losses should be first borne by the relevant national compartment
  - Common funds only „in large, systemic crises which overburden one or several compartments“

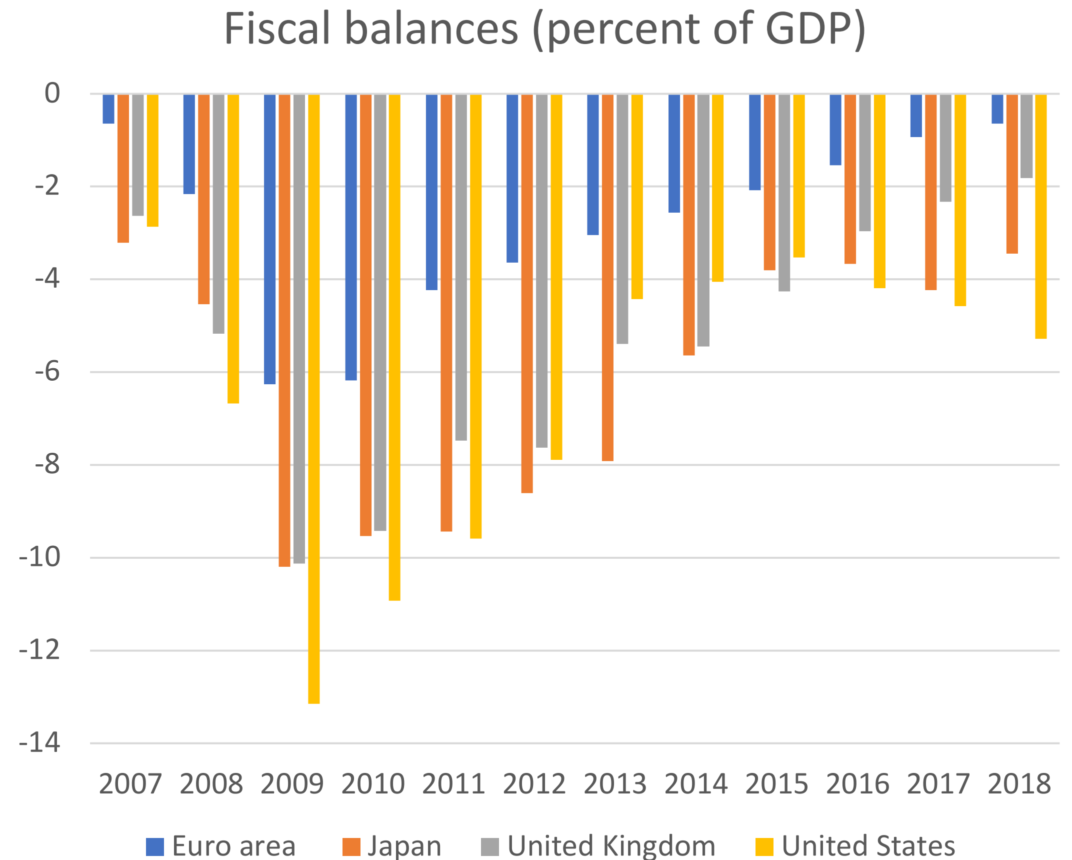
- European fiscal capacity for large economic shocks („catastrophic loss insurance”)
  - Member states have to comply with fiscal rules and Country Specific Recommendations of the Commission
  - Only in the case of very large shocks (e.g. annual increase in unemployment rate of > 2 percentage points)
  - First loss is borne at national level
  - National contributions of 0.1 % of GDP p.a. depending on economic volatilty.
  - No borrowing of the fund

Overview of country specific recommendations 2018

Broad Category	Policy areas	AT	BE	BG	CY	CZ	DE	DK	EE	ES	FI	FR	HR	HU	IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK	UK
Public finances & taxation	Fiscal policy & fiscal governance	X	X				X		X	X	X	X	X	X	X	X			X		X	X	X	X		X	X	X
	Long-term sustainability of public finances, inc. pensions	X	X			X	X					X	X		X	X	X	X		X	X	X	X			X		
	Reduce the tax burden on labour	X					X							X		X			X									
	Broaden tax bases												X		X	X	X											
	Reduce the debt bias						X																					
	Improve tax administration, fight against tax evasion & tackle tax avoidance			X			X					X				X	X		X					X				
Financial sector	Financial services			X	X										X	X				X			X					
	Housing market														X						X				X			X
	Access to finance				X											X							X			X		
	Private indebtedness										X												X		X			
Labour market, education & social policies	Employment protection legislation & framework for labour contracts									X											X	X	X					
	Unemployment benefits													X														
	Active labour market policies		X	X	X	X				X	X		X	X		X										X	X	
	Incentives to work, job creation, labour market participation	X	X			X	X		X		X	X	X			X		X				X						
	Wages & wage setting						X		X			X	X								X			X				
	Childcare														X	X											X	
	Health & long-term care	X	X	X	X						X				X		X		X	X			X	X		X	X	
	Poverty reduction & social inclusion	X	X	X					X	X		X	X	X			X		X					X		X	X	
	Education		X	X	X	X	X			X		X	X	X		X	X						X	X			X	
	Skills & life-long learning	X		X	X		X			X		X			X	X	X		X			X	X	X		X	X	X
Structural policies	Research & innovation					X	X		X	X		X			X	X	X				X	X					X	
	Competition & regulatory framework									X				X									X					
	Competition in services	X	X				X	X				X	X	X		X		X										
	Telecom, postal services & local public services						X																					
	Energy, resources & climate change														X									X				
	Transport		X												X									X				
Public administration & business environment	Business environment	X	X			X				X		X	X	X	X	X		X				X		X		X		
	Insolvency framework			X	X														X				X					
	Public administration				X	X				X			X			X			X				X	X		X	X	
	State-owned enterprises			X	X								X			X			X				X	X		X		
	Civil justice				X								X			X							X				X	
	Shadow economy & corruption			X		X								X		X			X	X				X			X	

Euroreport: Fiscal rules with less democratic accountability

- „Fiscal rules have not worked well
- „Make fiscal rules easier to enforce“
- Independent, national fiscal council
    - proposes a rolling medium-term debt reduction target,
    - charts a consistent medium-term expenditure path
    - uses it to set a nominal expenditutere ceiling for the coming year
- Independent body (European Fiscal Board, ESM) assuming the fiscal and macroeconomic watchdog role of the Commission



Assessment

- Euroreport provides no additional risk-sharing for the most serious risk of shifts in market sentiment against vulnerable euro area members
- Instead it increases these risk by „strengthening the credibility of mechanisms to bail in creditors of failing banks”
- The public risk sharing that it offers is limited to extreme situations where the size of the facilities would be insufficient
- The report admits 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“. But it does not provide solutions for the transition

What should be done?

- Instead of more market discipline, the political discipline and the rationality of the rules in the euro area should be strengthened
- Expenditure rules are a promising alternative to deficit rules
- But the 60 %-target for the debt/GDP ratio should not be uncritically adopted. Why not 100 %?
- Sanctions should be related to transfers from the EU, not junior bonds
- Providing room room for debt-financed investment in the SGP