Published on *VOX, CEPR's Policy Portal* (http://voxeu.org)

New eBook: Europe's Political Spring: Fixing the Eurozone and Beyond

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The euro's economic architecture is still incomplete, meaning that any number of large shocks could reignite the crisis in the Eurozone. This column introduces a new VoxEU eBook which summarises the main issues that need to be addressed to make the euro work and identifies, for each issue, the degree of consensus among experts.

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Emmanuel Macron's election opens the door to a 'reboot' of the Eurozone. This is urgent. The Eurozone Crisis is not fully behind us. The euro's economic architecture is still incomplete, and this means that any number of large shocks could reignite the Eurozone Crisis. Economists differ on the details of 'how', but there is wide agreement on 'what' needs fixing.

A new VoxEU eBook "Europe's political spring: fixing the Eurozone and beyond" (with contributions by Thorsten Beck, Agnès Bénassy-Quéré, Francesco Giavazzi, Paul De Grauwe, Daniel Gros, Barry Eichengreen, Patrick Honohan and Charles Wyplosz) summarises the main issues that need to be addressed to make the euro work and identifies, for each issue, the degree of consensus among experts.

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The election of Emmanuel Macron offers an opportunity to move forward on the European agenda. Macron was elected on a platform that combines structural reforms at home and a re-orientation of the EU towards a "Europe that protects". This platform will have to be discussed with all EU partners, especially those who consider that Europe should do less, not more, in the area of social rights and tax coordination, and those who view a common budget essentially as a 'transfer union'.

The inevitable starting point is that EU countries have different preferences in terms of the efficiency–equity trade-off. The question, then, is whether making progress in parallel along the two sides of this trade-off may be acceptable politically, given that progressing along only one dimension is unlikely to be on offer.

In the coming months, this fundamental questioning of European integration will likely be at the forefront of political debates, and rightly so. The technical fixes that are still needed to make the euro resilient cannot be forgotten, however. To make progress on the future of European integration, European leaders will need political space, and to not be distracted by emergency decisions related to a new crisis. Reciprocally, political momentum for a new, consistent integration strategy will help break the deadlocks that currently prevent the technical decisions that need to be made for the Eurozone to become more resilient. Hence a two-handed strategy should be followed: fix the Eurozone to make it more resilient; and, simultaneously, start a wide consultation on the future of Europe, along a growth/protection agenda – one that hopefully is capable of making Europe 'popular' again.

Four fault lines that need to be urgently addressed to make the euro sustainable

- The ability of the Eurozone to withstand a financial shock arising from a sudden stop in capital flows, from a shift to a 'bad equilibrium', or from a banking crisis;
- The absence of a tool to control aggregate demand when interest rates reach zero and monetary policy becomes largely ineffective;
- A clarification of the debt-restructuring rules for sovereigns which, together with the elimination of the 'doom loop' linking banks and sovereigns, are essential to make the no-bailout clause credible;
- Completion of the banking union, which means the size of the Single Resolution Fund, the enforceability of the bail-in rules foreseen in the Resolution directive, a solution to the non-performing loans issue, and the introduction of a stabilising, 'safe' asset.

These four issues do not represent and exhaustive list of the problems faced by the Eurozone. For example, they do not address the issue of how to deal with the legacy of exceptionally high sovereign debt levels. But they are, in our opinion, the minimum set of fixes needed to avoid the risk of a blow-up of the Eurozone were a new crisis to erupt.

To address these fault lines, four actions are needed: (i) reinforcing the European Stability Mechanism (ESM); (ii) clarifying debt restructuring rules and eliminating the bank–sovereign 'diabolic loop', (iii) completing the banking union; and (iv) creating a Eurozone fiscal "capacity". We briefly delineate these four elements, the latter being the most controversial.

Reinforcing the ESM

There are three problems with the ESM today: (i) the unwillingness of member states to ask for emergency assistance, given the perceived loss of sovereignty related to the associated conditionality; (ii) the unwillingness of member states to extend new assistance to countries whose debt sustainability may appear doubtful; and (iii) the lack of resources for the ESM to play its stabilising role. To address these problems, a reform of the ESM is needed, including a reform of the governance (to circumvent the unanimity rule and raise the democratic legitimacy of the decisions made), an increase in its resources (to strengthen its ability to address crises), and an extension of its tools (for instance, with the introduction of precautionary credit lines to address pure liquidity crises).

Clarifying debt restructuring rules for sovereigns and

solving the 'diabolic loop'

Debt restructuring is a necessary threat if fiscal discipline is to be enforced by financial markets. It is also necessary to reduce the risk of the ESM being forced to refinance debts that are non-sustainable (Corsetti et al. 2016). To make debt restructuring a real possibility, it is necessary to clarify how and when it could happen and, simultaneously, to eliminate (or at least significantly attenuate) the bank–sovereign 'diabolic loop' arising from the high concentration of national sovereign risk in the banks of some countries.

The idea that markets can enforce fiscal discipline remains highly controversial – the risk is that markets, if put in charge of enforcing fiscal discipline, might fluctuate from good to bad equilibria. And the idea of orderly debt restructuring when debt is at 130% of GDP could prove an illusion. This is why the issue of debt restructuring cannot be separated from that of making banks resilient to a debt restructuring.

Making sovereign debts truly 'defaultable' will have a destabilising effect on the banking sector. To overcome this downside effect, it is not enough to apply large exposure rules to sovereign bonds holdings by banks, or to introduce risk weights (indeed, both ideas could actually be counter-productive). Some form of 'safe asset' will have to be introduced, for example through tranching domestic sovereign bonds (or a basket of such bonds) to create a senior (safe) bond and a junior (unsafe) one, the former being exempted from large exposure or risk-weighting rules.

Although the practicalities differ and there is disagreement over some proposals – in particular, over the risk associated with waiving the exception to the large exposure rule – there is broad consensus among experts on the necessity to make progress simultaneously on the clarification of debt restructuring rules and on the elimination of the 'diabolic loop'.

Completing the banking union

The banking union has allowed a centralisation of bank supervision alongside a single rulebook and common bail-in rules to reduce moral hazard and protect taxpayers' money. These were important first steps, but the banking union still misses a credible backstop (i.e. a more powerful resolution fund), a solution to the problem of non-performing loans (see the contribution to the eBook by Daniel Gros), on the top of a 'safe asset' already mentioned. If these three elements are put in place, introducing a common deposit insurance mechanism would likely be of secondary importance.

To the extent that they involve some pooling of resources and risks, these different elements are controversial, although some solutions exist to reduce the risk of permanent transfers. A complementary, less-controversial strategy is to accelerate the building-up of a European capital market union, which will give companies across the Eurozone access to a common pool of market financing. The capital market union will require structural reforms at the national level (common rules for bonds issuances, bankruptcy proceedings, etc.) and a centralisation of market supervision in a similar manner to the way the Single Supervisory Mechanism has organised bank supervision across the Eurozone. These changes are not particularly controversial among experts, and they would not involve treaty changes.

The fiscal union issue

Although there is broad consensus on the need for counter-cyclical fiscal policies (at least through automatic stabilisers), experts have different views on how to set them up. Barry

Eichengreen and Charles Wyplosz, in their contribution to the eBook, argue that fiscal policy should be returned to national governments. Alternatively, Paul de Grauwe and Thorsten Beck both argue in favour of a small budget at the Eurozone level to provide macroeconomic stabilisation (de Grauwe) or funds for investment projects (Beck). Such proposals are highly controversial, however, especially since common debt would have to be issued at least in bad times, which in turn would have to be served based on a common resource.

The problem is made more difficult by the extraordinarily high levels of legacy public debt in some countries. Some experts argue that, as long as interest rates remain very low, high debt ratios are not an issue (except for the need to roll them over). Others, in contrast, highlight the fragility of indebted Eurozone countries which will not have the capacity to react to shocks. Legacy debts also tend to block any form of insurance scheme across member states, since they involve different probabilities of crisis across countries.

So far, the “corrosive distrust between debtor and creditor countries”, as Patrick Honohan puts it in his contribution, has blocked any progress in the area of fiscal union, which clearly does not belong among the ‘easy fixes’. These difficulties should not represent an excuse to muddle through, but rather an invititation to link the fiscal union agenda to structural issues.

Structural surveillance: Too much or too little?

The question of structural reforms raises similar issues to those raised by fiscal policies. To what extent should the EU be involved? On the one hand, low growth in one Eurozone member state may raise a systemic issue, since this will involve rising debt burdens. This justifies an involvement of the ‘centre’ in national affairs. On the other hand, the EU level has poor instruments to enforce structural reforms at the national level, and its action may invite a backlash due to a rejection of intrusions by ‘Brussels’ in national affairs. To overcome this dilemma, in her contribution, Agnès Bénassy-Quéré suggests launching the comprehensive project of a ‘jobs union’ whereby structural reforms at the national level would go hand-in-hand with a level playing field on the European labour market and further protections at the individual level. As with the Schengen project in 1985, a few countries could volunteer to make the first steps through informal cooperation, then moving to enhanced cooperation, and finally to an EU-wide scheme.

The issue of structural reforms has been much less widely discussed among experts than those of banking union, debt restructuring, or fiscal union. It is time for the experts to make concrete proposals in this area.

How to use the new political capital

The political malaise across the EU goes beyond the malfunctioning of the euro. It has to do with real and perceived inequalities; but also with the lack of understanding of who decides in the EU and with discontent over intrusions by ‘Brussels’ in national affairs, at a time of slow growth and rising insecurity. Fixing the euro cannot be the only objective of the new European leaders. However, making the Eurozone more resilient should definitely be part of a comprehensive strategy for Europe. Negotiations on Brexit will already absorb part of member states’ energies, and possibly divide them. In an environment where monetary policy will progressively become less accommodative, it is important to secure the euro so that the heads of states and governments can envisage the future with more serenity and concentrate on what really matters for the people: jobs, equity, and security. Reciprocally, the new impetus of EU’s integration strategy could help break the deadlocks that currently prevent technical decisions that need to be made for the Eurozone to become more resilient by encompassing them into a broader the design of a common future.

Fixing the Eurozone is a very delicate task, however, with conflicting interests and the risk of taking steps in the wrong direction. The differences of opinion highlighted where are a feature of the different weights various experts attribute to the various risks the Eurozone has to face. We hope that by highlighting them, we have provided a useful service.

Europe's Political Spring: Fixing the Eurozone and Beyond

Contents

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