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What risk sharing and macroeconomic policy instruments in the Economic and Monetary Union?

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The slowness and setbacks of the euro area financial integration process prevent it from playing a stabilising role, or even contributing to economic convergence. The priority is therefore to accelerate the emergence of a financing union, via pan-European banking groups, and a genuine capital markets union that removes the obstacles to the cross-border allocation of savings within the euro area. The complementarity between private and public risk-sharing in a monetary union also leads to the recommendation that current surveillance and coordination mechanisms be strengthened, by creating new stabilisation instruments, under the aegis of a genuine macroeconomic authority for the euro area.

In the twentieth year of the single currency and more than five years after the peak of the crisis, there is a broadly shared assessment that the economic component of the euro area is too weak. Reform proposals, however, reveal a bipolarisation. Some give priority to the reduction of private and public risks by cleaning up bank balance sheets and strengthening fiscal discipline as a precondition for pooling those risks. Others favour the implementation of European risk-sharing instruments, regarding these as essential for the smooth functioning – and even future existence – of the euro area. This bipolarisation has resulted in inaction. Recent attempts by the European Commission, and by a group of French and German economists (Bénassy-Quéré et al., 2018), to find a way out of this deadlock are welcome, but focusing too much on public risk-sharing would be misleading.

In this *Rue de la Banque*, we propose to reverse the order of priorities, on the basis of two observations: first, the complementarity between private and public risks in a monetary union; and second, the slow process of financial integration which has even reversed since the crisis. It cannot therefore play a stabilising role in the euro area, nor even contribute to structural convergence.

As part of the preparatory work for the Economic and Monetary Union (EMU), the Emerson Report (European Commission, 1990) described perfectly how the single currency was an indispensable complement to a single market nearing completion. The paradox is that today the single currency is a reality, but is circulating in a fragmented economic and financial area (Buti et al., 2016).

Private and public risk-sharing

The literature on optimum currency areas has been concerned from the outset with the importance of asymmetric shocks across heterogeneous economies, and hence about the existence of mechanisms for sharing risks between economic agents, or countries, so as to foster convergence.

At the microeconomic level, if households are subject to shocks that force them to adjust their consumption, but have access to financial instruments that are affected by different shocks, they can easily insure themselves against such risks: this is Mundell's (1973) argument in favour of financial integration to support monetary union.

At the macroeconomic level, fiscal transfers facilitate risk-sharing between economies facing different shocks within the same bloc: this is Kenen's (1969) argument in favour of fiscal integration as a complement to monetary union. Persson and Tabellini (1996) analysed the issue of fiscal federalism using collective choice theory, pointing to the risks of moral hazard, but also of an inadequate level of insurance with public risk-sharing. The complementarity between private/public risk-sharing has in particular been highlighted by Farhi and Werning (2017): even when financial markets are complete, purely private risk-sharing is inefficient, and there is thus a role for government intervention.

What do we learn from the empirical literature? Pisani-Ferry (2012) and Allard et al. (2013) pointed out the persistence of large asymmetric shocks within EMU, while Furceri and Zdzienicka (2013) showed that risk-sharing mechanisms were little effective in the euro area.

In the case of the United States, Asdrubali, Sorensen and Yosha (1996) showed that between 1963 and 1990 the shocks affecting production in each state were mostly absorbed by capital markets (39%) and credit markets (23%), with the federal government playing a limited role (13%). In a survey of studies on the topic, Mélitz and Zumer (2002) estimated the contribution of federal fiscal transfers within a range of 13%-20%. However, this methodology applied to the euro area confirms the inadequacy of the savings channel as a factor of risk absorption in the 2007-2014 period. Indeed, the increased role of this channel since the 2009-2012 crisis is driven by lending via the European Financial Stability Facility (EFSF), then the European Stability Mechanism (ESM).

The original model of EMU was based on: (i) the rejection of the public pooling of risks (discipline by rules, no fiscal solidarity, and the "no bail-out" rule), which remains relevant, and (ii) the assumption that the pooling of private risks would happen spontaneously in parallel with the completion of the single market, which did not happen.

Nonetheless (one could say by default), an implicit pooling of risks has emerged, first under the aegis of intergovernmental institutions for crisis management (e.g. the ESM); second due to the mobilisation by the Eurosystem of various instruments: exceptional refinancing operations, sovereign debt purchasing programmes in response to the crisis, and non-standard monetary policy involving the purchase of private and public debt securities. Last but not least, the Eurosystem has ensured the circulation of central bank money, and thus the integrity of the currency area, through the management of the real-time gross settlement system Target2. These mechanisms have de facto compensated for the lack of pooling and diversification of private risks in EMU.

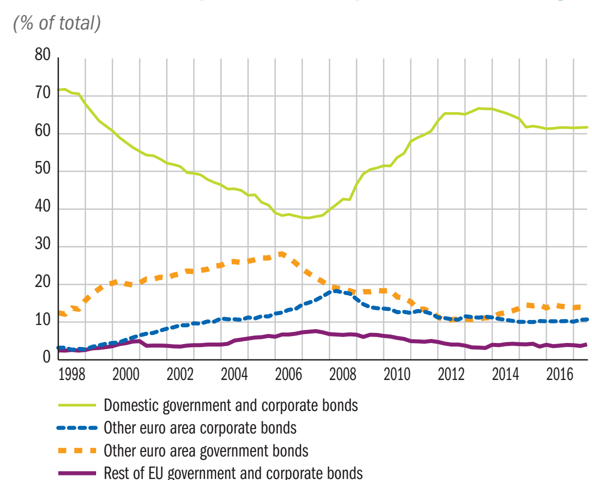
"One money, one market"[1], or the need for a Financing Union

As regards the issue of convergence in EMU, the dynamics of financial integration have mainly remained in the blind spot of European surveillance.[2] The expansion of intra-area capital flows before the crisis was akin to an optical illusion. It mainly reflected the financing of peripheral country debt by savings from the core euro area. Rather counterintuitively, the strongest economies bought "insurance" in the form of securities deemed to be low-risk from economies that were relatively vulnerable, on account of their very negative net external position (Garnier, 2016). This process led to the "sudden stop" episodes in 2010-2012.

The national bias in banks' holdings of sovereign debt was thereafter reinforced, which led to the persistence of the "doom loop" that was also clearly identified in this period (see Chart 1).

C1 Share of monetary financial institutions (MFI) cross-border holdings of debt securities issued by euro area and European Union corporates and sovereigns

(% of total)



Source: European Central Bank.

1 *In reference to the Emerson Report (European Commission, 1990) entitled "One market, one money".*
2 *Likewise, labour mobility and labour market convergence dynamics have been overlooked, which goes beyond the scope of this paper.*

Above all, banking systems remain strongly compartmentalised. Euro area banks mainly finance resident economic agents and very marginally agents in other euro area economies (see Chart 2). Their risks are therefore very undiversified. This is a source of vulnerability for them as they are strongly exposed to idiosyncratic shocks affecting their economies, without being able to smooth their activities across the rest of the area. It is also a source of macroeconomic vulnerability when economic agents in a country are excessively dependent on hazards affecting banks in their country, in a context in which the supply of market financing is itself fragmented.

At the macroeconomic level, the persistent imbalance between savings and investment reflects an asymmetric bias in the area's aggregate economic policy. The euro area posts an annual current account surplus of over 3% of GDP (i.e. nearly EUR 350 billion), which masks a very heterogeneous distribution of national current account balances, while the overall investment rate remains lower than its pre-crisis level.

The emergence of a genuine Financing Union (Villeroy, 2017) is therefore a crucial element for the smooth functioning of EMU. It is based on the dynamic combination of three components: (i) completion of the banking union; (ii) acceleration of the Capital Markets Union (CMU); and (iii) a public lever to mobilise private investment, drawing on the Juncker Plan.

The Banking Union, with the institution of a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), is endowed with a legal, regulatory and prudential foundation. Yet the Resolution pillar remains to be completed with a common backstop for the Single Resolution Fund (SRF). In this respect, the Commission's proposal of a credit line by the ESM, or a future European Monetary Fund (EMF), with a responsive decision-making mechanism, seems to be the most operational one. Further, the setting-up of a European deposit insurance-reinsurance scheme would help to facilitate the homogenous circulation of bank liquidity within the euro area.

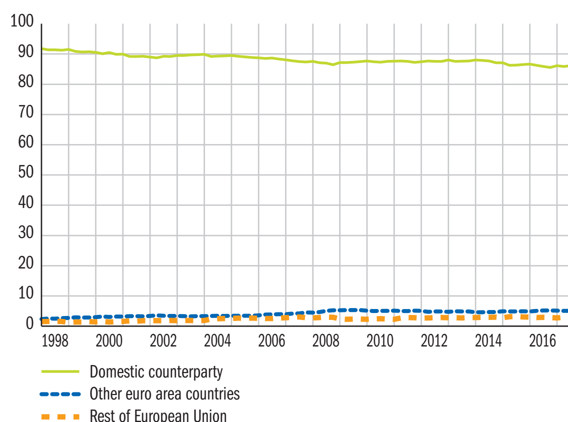
However, institutional advances are only a first step. The emergence of a pan-European banking sector, in particular, requires removing the obstacles to the creation of cross-border banking groups such as national normative options with respect to equity and liquidity, which continue to hamper a truly integrated management of financial institutions and their subsidiaries.

The CMU appears even less advanced. National regimes of regulatory and tax incentives currently constitute a major obstacle to the growth of equity financing (e.g. the tax bias in favour of debt financing, or the case of regulated savings). They tend to subsidise liquid savings, to penalise risk-bearing and long-term investments. They also contribute to the compartmentalisation of markets, as evidenced by the scarcity of pan-European savings vehicles, and the structure of equity holdings in the euro area (see Chart 3).

Another characteristic of the euro area is that the share of net equity in corporate financing remains much lower than that observed in the United States (respectively about 18% vs. 56% of their aggregate balance sheet).

C2 MFI loans to non-MFIs: outstanding amounts by residency of the counterparty

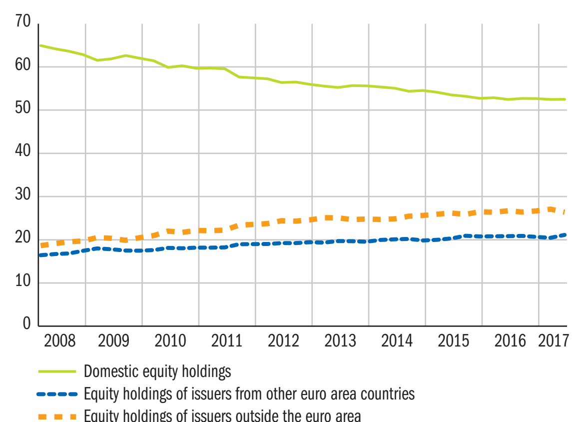
(% of total)



Source: European Central Bank.

C3 Euro area equity holdings by geographical issuer counterparty

(% of total)



Source: European Central Bank.

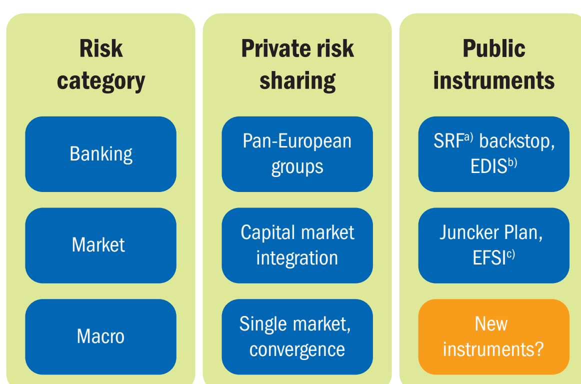
The "Juncker Plan" for investment via the European Fund for Strategic Investments (EFSI) constitutes the third component of the Financing Union. With around EUR 50 billion in financing approved via the EFSI, it already contributes more than EUR 250 billion in approved operations, at an annual rate of around 5% of investment in the euro area. It constitutes an important element of synergy in which public risk-sharing (in limited proportions and particularly in the form of guarantees) can contribute to the financing of projects towards which European private capital would not spontaneously flow at present.

The complementarity between private diversification and instruments for the public sharing of macroeconomic risks is twofold. First, some macroeconomic risks, when they relate to common shocks affecting the whole of the euro area, are difficult to diversify within EMU. In addition, some types of shocks are liable by virtue of their magnitude to trigger the simultaneous unwinding of private investors' diversified positions. Faced with these risks, the existence of mechanisms aimed not only at crisis management, but above all at stabilisation, should facilitate private risk-sharing through the reduction of macroeconomic risk (see Diagram 1).

Targeted and complementary macroeconomic instruments

What are the collective instruments that can potentially be mobilised in the euro area? Musgrave's typology (1989), which distinguishes the functions of allocation, redistribution and stabilisation performed by public finance, is still useful in this regard. In EMU the first function falls primarily within the scope of market dynamics, and depends on the progress in financial integration. The second can only be envisaged in a federal context, hence over the long term. All in all, only a centralised macroeconomic stabilisation function appears appropriate and realistic within EMU's current framework, alongside the single monetary policy and in support of national cyclical stabilisers. It could have two components: the absorption of asymmetric shocks that impact national economies most brutally, and the optimisation of the euro area's aggregate fiscal policy.

D1 Risk-sharing instruments



Source: Banque de France.
a) SRF: Single Resolution Fund.
b) EDIS: European Deposit Insurance Scheme.
c) EFSI: European Fund for Strategic Investments.

Such a collective stabilisation capacity should meet several conditions: (i) it is meant to complement rather than replace national fiscal policies, to avoid windfall effects; (ii) it should avoid moral hazard that encourages governments to postpone the adjustments needed to restore their own fiscal stabilisers; (iii) it should allow market discipline to operate, while preventing its destabilising and self-fulfilling effects; (iv) it should also be neutral in terms of redistribution between countries, at least over the economic cycle. In the light of these conditions, two complementary instruments appear to be adequate.

A contingent borrowing facility

This facility, financed by the issuance of securities either by the European Union (EU) or within the intergovernmental framework of the ESM, would open up to eligible Member States a line of credit in order to relieve them of excessive interest rate costs associated with situations of stress that are unjustified in view of the quality of their fundamentals. It would not lead to pooling Member States' public debt, and would preserve the operation of market discipline. In due course, the issuance could be managed by a future EMF, and form the embryo of a safe and liquid pan-European asset market, of interest to investors.

This type of instrument, aimed at stabilisation and crisis prevention, would be distinct from the ESM's crisis management tools; first in terms of conditionality, as Member States would all be eligible in principle, subject to pre-qualification consisting of compliance with common rules and the joint macroeconomic strategy set out within the framework of the European Semester; second, the protocol for triggering the facility would be simplified to ensure rapid disbursement; finally, intervention thresholds would be set with reference to average borrowing conditions in the euro area. As regards calibration, the cost of a borrowing facility should remain moderate. The EU should only take the place of the national borrower under strictly defined circumstances, for capped amounts and short periods. And the mere existence of such a facility could reduce the risk of financing stress without necessarily having to be activated.

A "rainy day fund"

Unlike the borrowing facility dedicated to the absorption of asymmetric shocks, the purpose of a "rainy day fund" would be to smooth the effects of cyclical fluctuations common to the entire euro area. It is therefore a form of intertemporal risk insurance, which would need to be pre-financed by building up reserves of liquid assets.

The fund could be financed by dedicated tax receipts from national governments, with the possibility of incorporating an automatically countercyclical effect as it is built up – without prejudice to European fiscal policy commitments. The receipts would be collected when actual growth is higher than its potential (or when there is a positive output gap), and recycled when actual growth falls below its potential (or when there is a negative output gap).

The calibration of a cyclical stabilisation fund may vary greatly depending on different parameters, such as the macroeconomic variables chosen as reference values, the threshold for and probability of triggering the facility, and the allocation of the stabilisation effort between the EU level and national policies, etc. The commonly assumed critical mass of 2% of euro area GDP could only be reached at the end of a growth cycle lasting several years, which raises the issue of how to prime the facility. One possibility would be to endow it with subscribed capital in order to give it a borrowing capacity (adopting the method used when the ESM was set up).

A coherent combination of instruments

A contingent borrowing facility would be assigned to absorbing asymmetric shocks affecting national economies. It would play the role of a safety net in the face of market fluctuations, and would be very responsive. A cyclical stabilisation fund would serve primarily to absorb symmetric shocks and manage macroeconomic policy in the euro area. These different levers for action would not be redundant, and would facilitate the emergence of a coherent policy mix for EMU. Dealing with major shocks would require the use of specific crisis management instruments.

Institutional conditions for implementation

Given that the European Union does not have sole competence in terms of economic policy, two major options can be envisaged. A new intergovernmental treaty (or a revision of the treaty establishing the ESM) could entrust an EMF-like institution with the task of managing a crisis prevention instrument such as a contingent borrowing facility, and even a cyclical stabilisation fund. Yet, an EU-based approach seems preferable for a permanent mechanism. This is also the rationale behind the Commission's proposal to bring the ESM into the framework of EU law. However, this solution would not lift the ambiguity associated with instruments that aim primarily at improving the functioning of the euro area, but are under the control of the EU-27.

In its recent "roadmap", the Commission (2017) set out different options for the creation of fiscal instruments specifically designed to support stability in the euro area, within the EU budget. Besides, articles 136 and 175 of the Treaty on the Functioning of the European Union (TFEU) provide a legal basis for the adoption of new coordination and surveillance mechanisms for the economic policies of euro area Member States.

The proposed new instruments should be incorporated into the reinforced surveillance framework of the European Semester put in place in 2010-2012, which provides the appropriate framework for assessing the pre-qualification of countries that might potentially benefit from the stabilisation mechanisms. Setting up a mechanism aimed at smoothing the impact of cyclical fluctuations should facilitate Member States' compliance with fiscal rules (and remove an excuse for them not to abide by them). Yet, the economic policy assessments and recommendations should be founded on expertise whose quality and legitimacy are indisputable, coming from a genuinely independent and recognised institution; the European Fiscal Committee might play that role.

Lastly, governance of the new instruments needs to be responsive, and have the authority and resources that give it real autonomy with respect to national administrations. This argues in favour of the creation of a Minister of Economy and Finance for the euro area, which would combine the functions of the Commissioner in charge of economic policy and the President of the Eurogroup, as proposed by the Commission in its roadmap. Given the scope of his/her mandate and position at the junction of the intergovernmental and federal levels, it is crucial that the Minister has an undisputed democratic legitimacy. He/she should therefore be accountable before the European Parliament and engage in regular dialogue with national parliaments.

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