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A three-stage plan to reunify the Euro area

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During 2012, the Euro area began a coherent strategy to end the crisis based on enhanced macroeconomic and fiscal surveillance (fiscal compact, six-pack, two-pack), the creation of a banking union and the announcement, by the European Central Bank (ECB), of a conditional programme of bond purchases (Outright Monetary Transactions, OMT), which supplements the European Stability Mechanism (ESM). Although the solutions provided calmed the financial markets by considerably reducing the yields on government bonds, they did not lead to resumption in growth and they still leave the Euro area at the risk of a new financial crisis.

To cope with this risk while addressing the debt overhang problem, we propose a plan in three stages: bank cleaning-up, an anti-crisis mechanism and a fiscal stabilisation capacity. The first stage consists of restructuring the banks that need it under the leadership of the ECB with broad private creditor participation, while respecting deposit insurance and doing this as quickly as possible. Conditional on this stabilisation, the second stage is to provide, in case of a resurgence of the sovereign debt crisis, a mechanism for exchanging national debt against bonds that are guaranteed jointly and severally by the member states of the Euro area, limited to 20% of GDP over 25 years, with earmarked resources and repayment programmed from the 10th year. The last stage consists of recovering, at the end of the stabilisation phase, a shared sovereignty in terms of fiscal stabilisation.

These stages may be addressed without immediate treaty changes, albeit this is the suggested direction. This process aims primarily to allow the Euro area to implement fiscal stabilisation policies, while strengthening the incentive for Member states to clean up their banks and comply with their fiscal commitments. Its implementation would contribute, without delay, to the reintegration of the financial markets and the resumption of investment in the Euro area.

[1] With the participation of Jézabel Couppey-Soubeyran, scientific adviser to the Council of Economic Analysis. The authors would like to thank Sylvie Goulard, Muriel Lacoue-Labarthe, Arnaud Mares, René Repasi and Shahin Vallée for having shared their expertise with them. The usual disclaimer applies.

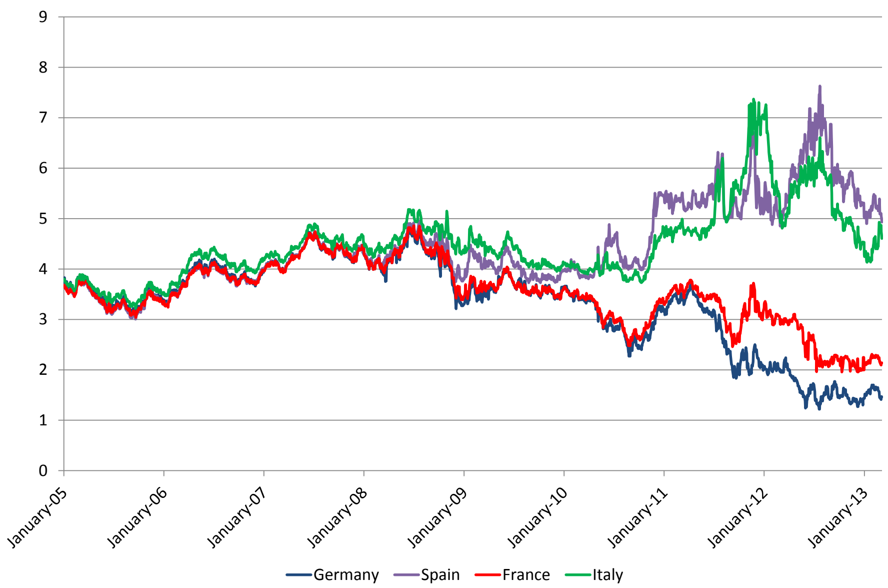
Introduction

During 2012, the Euro area began a crisis-exit strategy involving greater integration and based on four key elements:

- Enhanced budgetary and macroeconomic surveillance implemented prior to the national decision-making process (European semester, budgetary treaty, six-pack, two-pack).[2]
- The stage-by-stage construction of a banking union: centralisation of bank supervision with the ECB, establishment of a unified bank resolution regime, with the possibility for the ESM to directly recapitalise banks under certain conditions, and the establishment of a mechanism for sharing the budgetary cost of resolutions.
- The establishment of common financial assistance through the European Stability Mechanism (ESM).
- The announcement, by the ECB, of a programme to purchase sovereign debt (Outright Monetary Transactions, OMT), conditional on compliance with national obligations but for potentially unlimited volumes.

This strategy had a spectacular impact on the markets, and interest rates for government bonds dropped considerably after the summer of 2012 (Figure 1).

Figure 1: Rates for 10-year government bonds (in %)



Source: Global Financial Database, 1 January 2005 to 7 March 2013.

[2] See the summary presentation available on http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

The drop in interest rates in troubled countries is beneficial in two respects:

- it slows the accumulation of public debt; and
- it lowers the rates at which companies borrow, which might lead to stabilisation or resumption in activity.

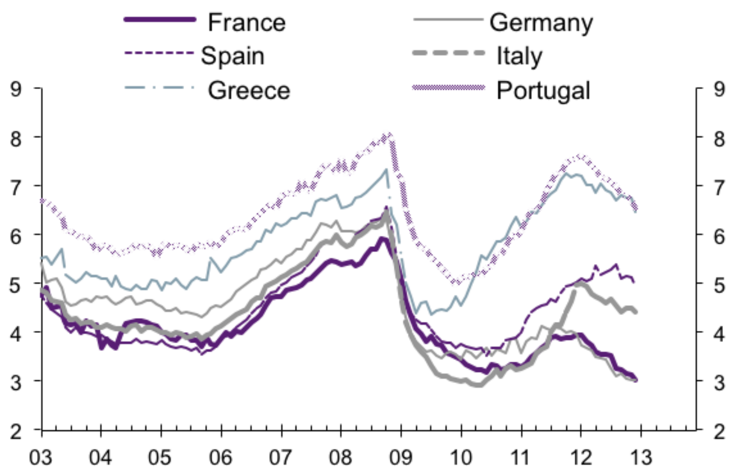
At the same time, the efforts to adjust public finances began to bear fruit in certain countries, as did the efforts to improve competitiveness. However, the situation remains extremely fragile. First, the Cyprus crisis has shown that the Euro area is still poorly equipped to cope with a bank solvency crisis. Second, although the announcement on OMT co-ordinated the markets around a "good" equilibrium (whereby investors are reassured by the sustainability of public debt and have no reason to demand higher rates to compensate the risk of default), the "bad" equilibrium could reappear in case of difficulties implementing OMT or of non-compliance with the conditions attached to it. This risk is still present, for three main reasons (other than political instability related to the economic and social crisis):

- The fragmentation of the financial markets in the Euro area: investing is more expensive in the countries that most need it. For instance, for companies, the average rate of five-year loans at fixed rates at the end of 2012 was about 3% in Germany and France, against 5% in Italy and Spain and nearly 7% in Greece and Portugal (Figure 2). According to a regular survey from the ECB, access to funding is mentioned by more than 20% of SMEs in peripheral countries as the greatest difficulty they face (nearly equal to that of lack of demand), against only 10% in Germany.[3] This situation harms not only investment, but also household debt reduction, particularly when this debt is at variable rates: in Spain, the ratio of household debt to income at the beginning of 2013 was the same as in 2007 (130%), while in the United States, thanks to interest rates much lower than the GDP growth rate as well as debt restructuring, household debt has returned to the same level as in 2003 (115%), before the property bubble (Figure 3).
- The increase in non-performing assets on bank balance sheets, linked with the property crisis, and the rise in unemployment and company bankruptcies. This potential deterioration in bank balance sheets interacts with the situation of the governments: on the one hand, the bank risk is still borne by each Member state; on the other one, the banks have increased their exposure to national sovereign risk; so sovereign and bank risks remain strongly correlated within each country.
- The poor prospects for growth. Take the example of Italy: with public debt of 130% of GDP in 2013 and nominal growth of zero, Italy would need a permanent primary budget surplus of 5.7% of GDP to stabilise its public debt ratio, at current interest rates. The corresponding figure for Spain (with public debt of 95% of GDP in 2013) is 3.8% of GDP – levels not seen for a long time. Yet, fiscal adjustment itself slows growth. The countries that succeeded with sharp budgetary adjustments in the past (such as Denmark and Ireland) could count on dynamic world demand. This is not the case for European countries today.

To eliminate the "bad" equilibrium permanently, we believe that current arrangements must be supplemented so as to improve the situation on these various points and give the market a long-term prospect of integration and solidarity, together with discipline.

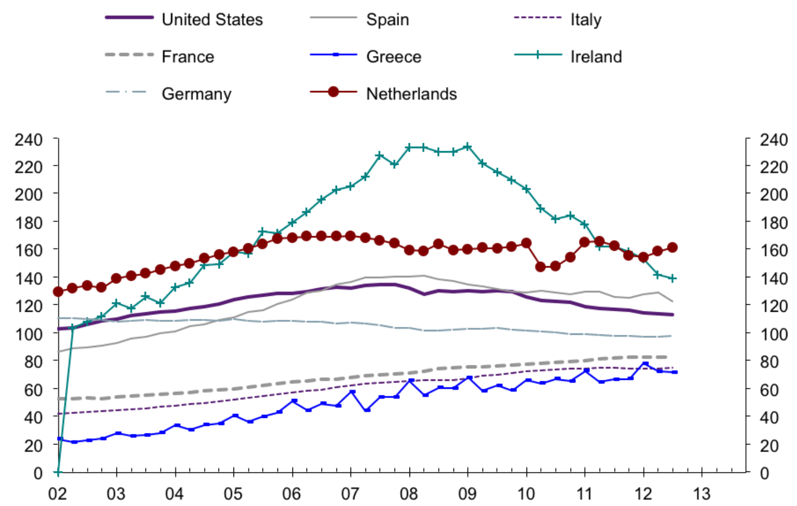
[3] Source ECB, Access to Finance Survey, November 2012 (period April to September 2012).

Figure 2: Five-year lending rates for companies in the Euro area (fixed-rate loans, rate in %)



Source: Eurostat.

Figure 3: Household debt (in % of gross disposable income) in the countries of the Euro area and in the US



Source: Federal Reserve (US), BDE (Spain), Banca d'Italia (Italy), BdF (France), Bank of Greece, CSO (Ireland), Destatis (Germany), DNB (The Netherlands).

The current crisis-management mechanism: clear but fragile

Let us suppose, and we have just seen that this is a plausible hypothesis, that a country again gets into difficulty concerning financing its public debt. What would happen? The current mechanism is clear but it seems to raise various issues.

A clear mechanism

In the event of a serious sovereign debt crisis, for intervention to take place, the country must first request a European support programme from the ESM. This request would be handled in several stages:

- Analysis of the country's fiscal situation: is it a solvency crisis or a liquidity crisis[4]? We know that this analysis is complicated and ambiguous: it depends on assumptions on interest rates, potential growth and whether the country is able to produce the necessary primary budgetary surpluses. The usual response to this ambiguity[5] is to combine a programme of fiscal adjustment with emergency loans. In an extreme case, however, debt restructuring may prove necessary (which is provided for in the statutes of the ESM).

- The new ESM programme must be approved by a unanimous vote of Member states, after approval by certain national parliaments such as the Bundestag.

- Lastly, the ECB may intervene in the secondary market for the country's public debt, mainly by purchasing securities with maturities of between one and three years (OMT programme). This hierarchy of decisions was required by the ECB to clearly show that it had no intention of monetising public debt. We must remember that ECB purchases of sovereign debt are a form of mutualisation of sovereign risk because any losses by the ECB will be covered by all of the budgets of the Euro area member states (in the form of foregone seigniorage revenue[6]). The OMT programme is therefore not unlimited or unconditional mutualisation of public debt, in contrast to what investors in the financial markets sometimes believe.

A fragile mechanism

The sequence of decisions presented above is coherent insofar as it combines the assessment of solvency, conditional aid and the effectiveness of this same aid through the potentially unlimited intervention of the ECB in the secondary markets (while the ESM, with limited resources, cannot alone counter a speculative attack). A detailed analysis nevertheless highlights various difficulties:

- The risk of delays due to the complexity of procedures.

[4] A government is considered insolvent if prospects for tax receipts and public expenditure are incompatible with the stabilisation of its debt related to GDP. A state is illiquid if it is unable to find, in the market or from its taxpayers, the necessary resources to cope with its debt repayment instalments. The two concepts are related: a government considered to be insolvent no longer has access to the market and therefore becomes illiquid; conversely, an illiquid government has to cope with high interest rates, which can tip it into insolvency. However, we can draw a line between illiquidity and insolvency by producing debt accumulation scenarios according to different assumptions of interest rates and growth rates.

[5] For this, Europe has an approach similar to that of the International Monetary Fund.

[6] Seigniorage is the profit made by the central bank because its asset pays interest while the currency issued in exchange (its liability) pays practically none. This profit is reassigned to Member states, which are the shareholders in the ECB.

- The conditional nature of the intervention: if it is too severe, the country under pressure has little incentive to request aid, which increases tension in the markets, with possible contagion effects. Once the country is under the ESM programme, if the conditions are not met, can the ECB stop its purchasing programme, at the risk of triggering a new financial crisis? Conversely, if the conditions are too lax, the ECB may be accused of unconditional mutualisation of public debt, which contradicts the current institutional organisation, and which could encourage some Member states to oppose the programme.

- The risk that the sustainability analysis might reveal a needs for debt restructuring before the intervention of the OMT; such restructuring would come as a surprise to the financial markets (which have been repeatedly told since the beginning of the crisis that Greece would be a unique case), and given the still-strong link between sovereign risk and bank risk, it would be destabilising for the banking system.

- The fact that ECB purchases of securities would supposedly be limited to a maturity of three years (much less than the average maturity of public debt in the Euro area, which is between six and seven years) could encourage governments to borrow at shorter maturities. This shortening of maturities would be destabilising because the issues would become more frequent, at interest rates that could vary widely. A reduction in the average maturity of debt would also eventually mean that Member states would run the risk of large refinancing needs all at the same time.

- Lastly, the ECB is caught in a trap between wanting to get rid of excessive sovereign risk premiums, related to expectations of a breakup of the Euro area, and needing to maintain sufficient risk premiums to encourage member states to continue their efforts to reduce public deficits and carry out the necessary reforms to support potential growth.

Therefore, the current mechanism means that Europeans still run the risk of a financial panic and crisis contagion. Neither does it remove the risk that the member states might reduce their adjustment efforts. We believe it is necessary to supplement it, without delay, with a process of further integration.

Euro area 2.0: a solution

When the euro was created, it was decided that monetary integration would not be accompanied by fiscal integration other than that already carried out through the budget of the European Union. European leaders added a Stability and Growth Pact to the treaty, to reduce the risk of a sovereign debt crisis in a Member state and the potential consequences for the whole of the Euro area. At the same time, they affirmed the lack of fiscal solidarity between Member states through the "no bailout" clause that was enshrined in the treaty.

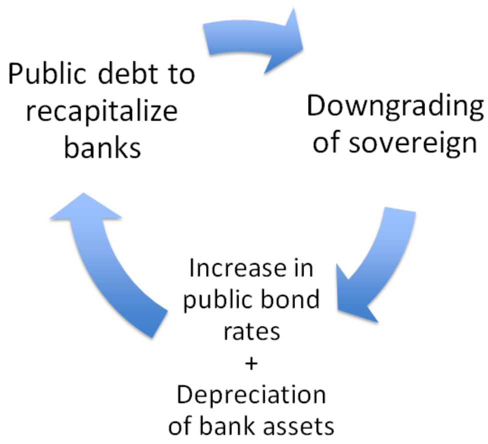
Ten years later, the Europeans have discovered the incoherence of their approach. The stability pact in no way prevented sovereign debt crises. Yet, due to the no-bailout clause combined with the ECB's prohibition on monetising deficits, such crisis could only be resolved by sovereign default leading to a banking crisis, with the risk of contagion to the entire area. To avoid a new banking crisis, the Europeans then had no other choice than to reappraise one of the two pillars of their architecture: no-bailout or no-monetisation. Although they have not directly called into question the no-bailout clause, they have accepted the principle of solidarity through bilateral loans to Greece, then through the European Financial Stability Fund (EFSF) and the European Stability Mechanism. Although they have not directly called into question no-monetisation, they have agreed for the ECB to intervene in the secondary public debt markets, through debt purchase programmes.

During the autumn of 2012, a communication from the European Commission and a report from the President of the European Council[7] constituted a turning point in this approach, suggesting a new organisation of economic policy in the Euro area and a revision to the treaty. This new approach incorporates the banking union proposed during the June 2012 meeting of the European Council, but goes further by suggesting a future form of fiscal union.

Banking union

The main motivation for constituting a banking union is the requirement to "break the vicious circle between banks and sovereigns"[8], shown in Figure 4 below. The banking union would be built around three principles: (1) centralised bank supervision (performed by the European Central Bank); (2) common principles for bank resolution, with emphasis on participation by the private sector (as opposed to bailout by the public sector); and (3) possible access to a common resource if the absorption capacities of the private sector and the government concerned are exhausted.[9]

Figure 4: The vicious circle of debt between states and banks



Source: authors.

The vicious circle between banks and sovereigns strengthened during the crisis because of public intervention in the banks and because the latter tended to reduce their cross-border positions in favour of holding national assets. This fragmentation of the financial market within the Euro area means that companies that are comparable in terms of credit risk finance themselves at very different rates depending

[7] "Detailed proposal for a genuine and deep economic and monetary union", communication from the European Commission, 25 November 2012. "Towards a genuine economic and monetary union", report presented by H. Van Rompuy, President of the European Council, 5 December 2012.

[8] Extract from the first sentence of the declaration of Heads of state and governments following the European Summit on 29 June 2012.

[9] This European safety net would concern both bank restructuring and deposit guarantees. These three principles are complementary to the strengthening of common regulations (in particular, the transposition of the Basel 3 agreement into European law).

on where they are located (see above). Such a situation is harmful both to the economic recovery of countries affected by the crisis and to the efficient allocation of capital in the Euro area.[10]

The European Council meeting of December 2012 confirmed the centralisation of bank supervision within the ECB for the Euro area (directly for 150 banks and through national supervisors for the others), and set a timetable for adoption of principles related to bank resolution. On the other hand, European leaders did not address the fiscal implications of a banking union. And yet this aspect is essential to the credibility of the resolution mechanism.[11] Faced with a certain degree of reticence since the European Council meeting of June 2012,[12] it is imperative that the single resolution mechanism for banking union is based on a common fiscal resource, particularly under normal conditions of operation, once the question of the "legacy" debts has been dealt with. This resource could be the ESM (based on its ability to directly recapitalise banks) and/or rules on budgetary "burden-sharing" in the case of bank resolution (for example, consistent with the volume of business of subsidiaries and branches located in each country). It is necessary to comply with the pecking order proposed by the European Commission to resolve banking crises (first involving the private sector in an order going from shareholders to senior creditors, then, if needed, appealing to public resources in the concerned country). However, the mechanism will only be credible if it is backed by a European capacity to provide help during bank resolution when the Member state cannot cope without triggering a sovereign debt crisis, as happened in Ireland.

Fiscal union

The debate on fiscal union is an old one. Already in 1977, the MacDougall report advised putting in place a federal budget of around 5-7% of GDP to accompany monetary union.[13] This debate re-emerged in 2012, when it appeared that the crisis in public finances had prevented several member states from using fiscal policy to support activity, as Keynesian theory recommends when demand drops.

Completing monetary union via a Euro area budget would be justified with regard to the three conventional functions of public action (allocation, stabilisation and redistribution):[14]

- **Allocation:** The allocation function is already partly fulfilled at the level of the UE27, with EU intervention in the areas of infrastructure and research. For the Euro area, it would concern financing the production or preservation of a specific public good. Financial stability can be considered a Euro-specific public good, although some non-Euro countries have shown interested in participating in a banking union.

[10] Capital is considered to be allocated efficiently if priority is given to funding the investment projects that are most profitable over the long term.

[11] See Pisani-Ferry and Wolff (2012), "The fiscal implications of a banking union", Bruegel, for an explanation of the requirement to supplement the banking union with a budgetary mechanism. Several banking crises at the end of the 1990s and the 2000s cost between 30 and 40 points of GDP for the public finances concerned. Even though the cost of a banking crisis may be considerably reduced by reselling bank assets after the crisis (see the Swedish experience) and by mechanisms to involve the private sector, this cost may prove prohibitive for a country. In a monetary union, this eventuality is extremely destabilising. See L. Laeven and F. Valencia (2012), "Systemic Banking Crises Database: An Update", IMF working paper WP/12/163.

[12] The European Commission has recommended keeping the cost of recapitalisation at the national level as far as possible, going back on initial proposals to recapitalise banks via the ESM (see the communication from the European Commission "Detailed proposal for a genuine and deep economic and monetary union", 30 November 2012).

[13] *Report of the study group on the role of public finance in European integration*, chaired by Sir Donald MacDougall, EC Economic and Financial Series no. A13 and B13, 1977.

[14] See Musgrave R. and P. Musgrave, *Public Finance in Theory and Practice*, McGraw-Hill, 1989. Allocation aims to raise the level of income over the long term; stabilisation is intended to limit the fluctuation of activity around its long-term trend; redistribution is aimed to correct the distribution of income related to the free play of the market.

- **Stabilisation:** Stabilisation through a federal budget cab be envisaged to deal with very large shocks affecting either a specific member state (if it cannot borrow enough to cope) or the Euro area as a whole (if monetary policy alone is not sufficient).[15] Delpla et al. (2013) proposed, for example, establishing a pre-qualification mechanism for a country to access a credit line from the ESM.[16] A genuine budget should be based on an own or near-own resource,[17] if possible, strongly correlated with the business cycle in the area, and on the possibility of issuing common debt. This budget would not need to be high: limited to unemployment insurance, it would be around 2% of GDP. If, over the years, the areas covered extended, for example, as much as in Switzerland, it would be only 10% of GDP.[18]

- **Redistribution:** This third function, which consists in organising transfers which, if not permanent, can be long-lasting between individuals located in different countries, is justified by Article 3.3 of the treaty: "It [the Union] promotes economic, social and territorial cohesion, and solidarity between member states". The European Union budget already carries out a form of redistribution in favour of poor regions and farmers. Extending redistribution within the Euro area is not on the agenda and is opposed in principle by certain countries including Germany. If the single currency, combined with the single market, leads to an aggregation of activities and income at the centre of the Union, it is nevertheless legitimate to think about solidarity with regard to the peripheral regions.

Of these three functions, stabilisation is probably the one that most warrants Euro-area intervention: fiscal stabilisation is particularly important for member states that share a currency. Also, the Euro area as a whole should implement a policy mix that would allow it, in certain circumstances, to combine the effects of monetary and fiscal policy. Nevertheless, any consideration of fiscal union in the Euro area runs up against institutional difficulties: the Euro area is not organised to vote and then execute a budget. This would require a finance minister to propose and execute, and an assembly (possibly a sub-assembly of the European Parliament) to vote and control.

A non-federal version of fiscal union would consist in setting, in a centralised manner, a certain fiscal balance for each member state for the following year, with national governments and parliaments responsible for applying this in terms of income and expenditure. In the case of a forecast economic slowdown, a greater deficit would be authorised, while public finances would have to be tightened in the case of a boom in activity. As such, this type of arrangement, which builds on new governance arrangements, concentrates on the stabilisation function, without providing for any solidarity or risk sharing. Under these conditions, the countries under pressure would find it impossible to carry out counter-cyclical fiscal policies. To genuinely recreate the conditions of an active fiscal policy within the Euro area, this centralisation of decision-making must offer the counterpart of access to funding through the issue of common debt for those member states that need it.

This second view of fiscal union is, however, no less demanding than the first in terms of institutional reforms, since such a mechanism would mean that national parliaments would no longer be allowed to set

[15] See J. Pisani-Ferry, E. Vihriälä and G. B. Wolff, "Options for a Euro-area fiscal capacity", *Bruegel Policy Contribution* 2013/01, 10 January 2013.

[16] Delpla, J., Farhi, E., Gourinchas, P.-O. and J. Tirole, "The reforms necessary to complete economic and monetary union", working document, CAE.

[17] From the project of a common, consolidated corporate tax base (CCCTB), it is possible to design a corporate tax that would be national in law but in European in fact.

[18] See Shahin Vallée, 2013, "From mutual insurance to fiscal federalism", manuscript presented at the Euro50 seminar, Brussels, 22 March 2013.

the level of the annual deficit, while the Member states would become jointly liable for the flow of new debts decided at central level.

Less ambitious on fiscal matters than the report from the four Presidents, which envisaged a "fiscal capacity" for the Euro area, the European Council meeting of December 2012 approved the idea of "contractual arrangements" fostering national structural reforms in exchange for a financial incentive.[19] Under this approach, it set itself the objective of presenting the European Council meeting of June 2013 with a proposal on "solidarity mechanisms that can enhance the efforts made by the Member States that enter into such contractual arrangements for competitiveness and growth". The actual solidarity mechanisms remain to be defined; for example, a system targeted at reforms to the labour market and the mobility of workers could be envisaged.[20]

Eurobonds

The mutualisation of national public debt is justified by the fact that the overall debt in the Euro area remains reasonable (Figure 5). The sovereign debt crisis could probably have been avoided if the excessive debt of certain countries had appeared as part of a euro sovereign debt with joint liability. Consequently, numerous proposals to mutualise sovereign debt have flourished as an efficient solution to the crisis.[21] These proposals, under which part of the debts would become joint and several,[22] have encountered three objections:

- **An institutional and political objection:** Such mutualisation, even if it were not contrary to the treaty (article 125), would at least be contrary to the principle according to which taxpayers must be (indirectly) consulted on commitments concerning them.[23]
- **An objection based on fairness:** Virtuous countries would gain nothing or risk losing, while profligate countries would have an incentive to reduce their effort to adjust.
- **An economic objection:** Mutualising a large part of the debt would be tantamount to making this part senior (meaning that it would be reimbursed first in case of default); the rest of the debt, which would remain national, would become junior and risk not finding a market, except at very high interest rates, which would not resolve the problem of the unsustainability of the debt.

[19] See the communication from the European Commission of November 2012, *op. cit*.

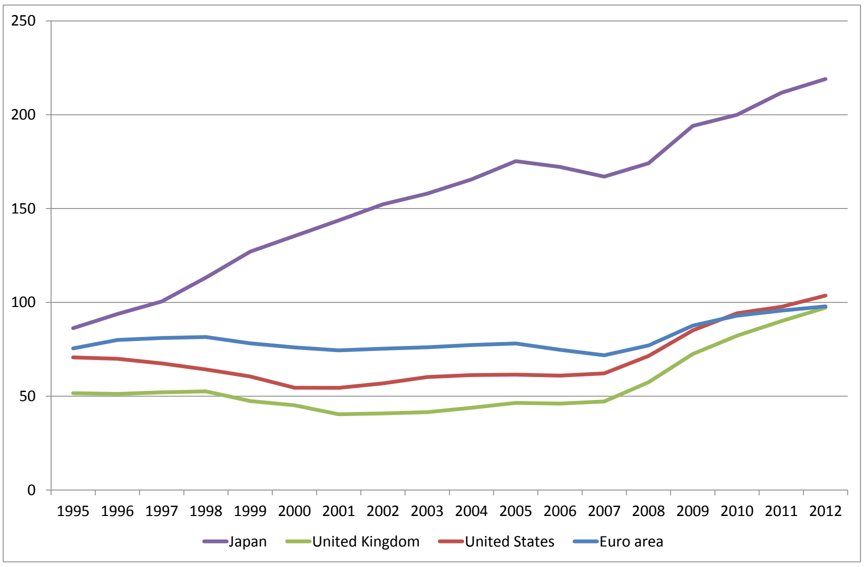
[20] See Delpla, et al. (2013), *op. cit*.

[21] The most widely known are the proposal for blue/red bonds (Delpla, J. and von Weizsäcker, J. (2010) "The Blue Bond Proposal", *Bruegel Policy Brief*, 2010/03, Updated 21 March 2011), the proposal for a sinking fund from German experts (German Council of Economic Experts (2011) "A European redemption pact", Working Paper 2/2012, February) and the proposal for eurobills (Hellwig, C. and Philippon, P. (2011) "Eurobills, not Eurobonds", VoxEU.org, December).

[22] "Joint and several" means that all of the stakeholders are liable to repay the common debt if one sovereign defaults. In an extreme situation, if only one country remains solvent, it is liable to repay all of the common debt.

[23] "No taxation without representation", a democratic principle dating to the American Revolution.

Figure 5: Gross public debt as a percentage of GDP



Source: OECD Economic Outlook 62, 2012 (forecast for 2012).

In response to these three objections, three conditions have been put forward for the mutualisation of national debts: (1) a change to the treaty; (2) a reform of governance (to avoid free rider behaviour); and (3) a stabilisation of public finances. From being a crisis-management instrument, eurobonds would become the instrument for financing an integrated Euro area (banking union, fiscal union), once legacy problems have been completely resolved.

We believe that strict sequencing between banking union, fiscal union and the issue of common debt, in connection with institutional change, could prove inappropriate, for two reasons: (1) the lack of a fiscal safety net at the level of the Euro area makes bank resolution during the adjustment phase difficult; and (2) the institutional debate risks getting quickly bogged down in the absence of sound progress in dealing with the crisis and its social consequences. We propose reviving the European tradition of integration by conditional stages in order to plot a path towards integration that complies with the various constraints mentioned above.[24]

[24] The idea of a process by stages refers to the Maastricht process that led to monetary union. It is present in the Van Rompuy report and the communication from the European Commission mentioned above, and in the Goulard report proposing the implementation of Eurobonds (6 December 2012). Our approach is faithful to the spirit of Maastricht in that it plans sequential, conditional stages.

Our proposal: a three-stage path towards a Euro area 2.0

The no-bailout clause (article 125 of the treaty) is strict. However, the heads of state and government have stated that there would be no restructuring of sovereign debt for any country other than Greece and that no country would be forced to leave the Euro area. These two statements imply that, as a last resort, there would be a bailout, directly or via the banking system and the ECB. The case of Cyprus shows that without this, the introduction of capital controls is inevitable. We believe that this difference between rule and practice is unhealthy. We propose ending this incoherence between no bailout, no restructuring and no Euro area exit using an integration programme with three interdependent stages.

Stage 1 (by the beginning of 2014): complete the cleaning up of national banking systems

The decisions of Euro-area heads of state and government concerning banking union (Council meetings of June and December 2012) have given impetus to an important process, which includes four key phases (see Véron and Wolff, 2013):[25]

1. **Integrated surveillance:** The single surveillance mechanism that should begin in April 2014 will be accompanied by a reform of the European Banking Authority and new prudential regulations.[26]

2. **A harmonised framework for the resolution of banking crises:** An "operational framework" for the direct recapitalisation of banks by the ESM, which specifically isolates "inherited" assets and debts, which will not receive the same treatment as "new" assets and debts; and the adoption of two directives concerning (1) bank resolution and (2) deposit insurance. This harmonised framework should be decided "before June 2013".

3. **A single resolution mechanism:** This mechanism would be based on the contributions of the financial sector itself, with a fiscal safety net for excessive risks. The Commission has committed to publish a first proposal before summer, the timeframe being the end of the current term of office of the European Parliament (namely, June 2014).

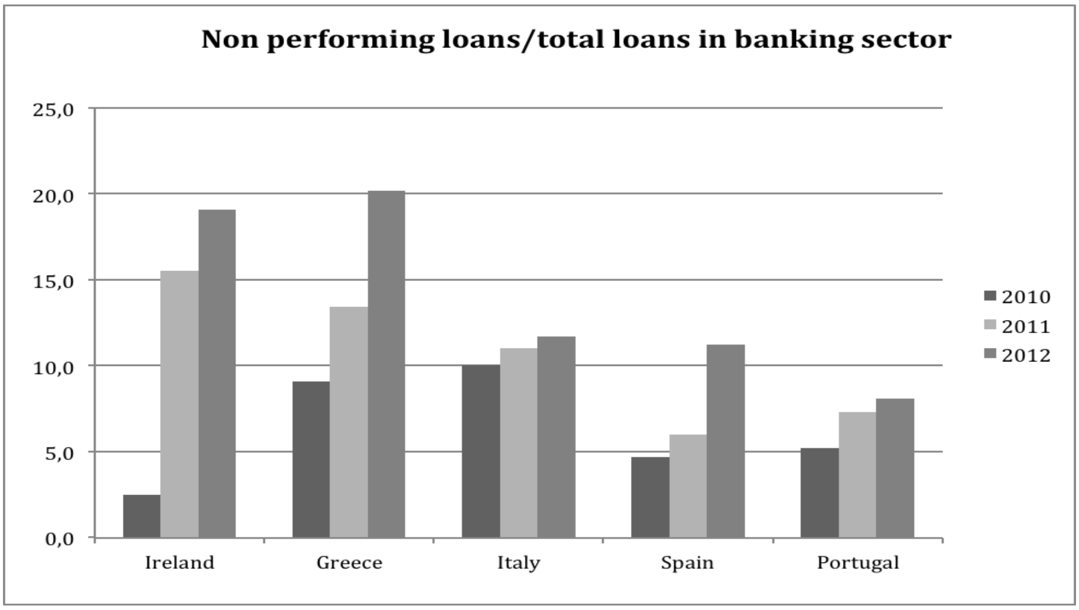
4. **Finalisation of the banking union:** Although it is not explicit in the conclusions of the Council, the banking union will require more integration for bankruptcies and deposit insurance (Pisani-Ferry et al., 2012[27]).

The programme is ambitious. Only first component was ratified at the Council meeting of December 2012. From March 2014, the ECB will directly supervise 150 large banks in the Euro area and will coordinate the supervision of other banks. The two other components of banking union (harmonization of national resolution mechanisms, and the single resolution mechanism) are currently far from being on track, not to mention deposit insurance. On the other hand, the draft directive "establishing a framework for the recovery and resolution of credit institutions and investment firms"[28] already constitutes progress. Establishing a harmonised framework is extremely important to avoid cross-border arbitration in the process of restructuring. The creation of a single mechanism for crisis resolution is also important. A mechanism with a high degree of centralisation would be desirable so that difficult decisions can be made quickly. At the same time, it would be difficult, within the framework of the current treaty, to envisage a system within which a single institution could implement all restructuring. More fundamentally, this phase would require progress in fiscal integration, which risks delaying implementation.

[25] Véron and Wolff (2013), “From Supervision to Resolution: next steps on the road to European Banking Union”, *Bruegel Policy Contribution* 2013/4.
[26] "CRRD" *(Capital Requirements Regulation*) directives and “CRD4”.
[27] J. Pisani-Ferry & G. B. Wolff “The fiscal implications of a banking union”, Bruegel Policy Brief, 14th September 2012.
[28] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:EN:PDF

Anyway, we believe it is imperative for bank cleanining-up to continue in the Euro area. Economic recovery requires the resumption of funding on the basis of properly controlled and priced risk. Yet the banking situation continues to worsen in many countries in the area. During 2012, the proportion of non-performing loans in total bank loans went from 6% to 11.5% in Spain, increased in Italy and Portugal to close to 11% and 8%, respectively, and reached the highest levels of around 20% in Ireland and Greece (Figure 6).

Figure 6: Share of non-performing loans in total loans in the banking sector



Source: International Monetary Fund.

With negative growth in the peripheral countries in 2013, there is a high risk that this situation will worsen. Bank balance sheets must therefore be cleaned up. This assumes that it is possible to draw up an unquestionable appraisal of the banking sector in each country in the Euro area.

The establishment of a single surveillance mechanism (SSM) is an excellent opportunity to conduct stress tests and restructure non-viable banks. Indeed, article 27(4) of the surveillance mechanism provides for such tests as a prior condition for bringing each bank within the mechanism. The ECB, which will be in charge of establishing the SSM, could make use of independent audits to ensure transparency and the fair valuation of the depreciated assets.[29] This appraisal should allow recapitalisation requirements to be assessed according to credible unfavourable scenarios. It requires an analysis of the valuation of assets, and an accurate mapping of creditors and shareholders (for example, by type of holder and by geographical area). This list is essential to be able to assess the contribution required by private investors.

Except in very special cases, depositors should be excluded from the field of private investors who may have to contribute. In this spirit, the draft directive mentioned above could be improved by including a "preference for the depositor". Enhanced protection for deposit guarantees could also help to avoid panic, which we know can constitute a serious factor in systemic risk. Conversely, even senior creditors should have to contribute, even if this contribution endangers their solvency, providing they are not considered as systemic. Asset depreciation may give rise to several types of measures that are not mutually exclusive: recapitalisation by private shareholders, restructuring the debts borne by the creditors, and transfer of

[29] In Spain, two independent audit companies (Roland Berger and Oliver Wyman) have been commissioned to assess bank recapitalisation requirements. Greece and Ireland have also been subject to independent audits.

assets to a bad bank for which a significant part of the funding should consist of equity and quasi-equity subscribed by private investors.[30]

A contribution from the public sector should be envisaged only if the resources of the private sector prove insufficient, either because there is a real risk to the solvency of creditors who are themselves systemic, or the debt reduction amounts are too low. In the latter case, a second level of loss sharing would apply between the country of origin and the countries concerned by the bank in difficulty (activity of subsidiaries, for example) with, as a last resort, the option to appeal to the ESM.[31] Providing for the possible involvement of the ESM in the recapitalisation of certain banks is necessary to make the process credible and, if applicable, avoid another episode of sovereign debt crisis. The Cyprus crisis shows that it could prove impossible to maintain the integrity of the single market without the support of a common fiscal resource.[32]

To summarise: Complete the first stage of the banking union by the beginning of 2014: independent audits of all banks in the Euro area, under the control of the ECB/SSM; necessary restructuring, respecting the structure of the liabilities and limiting public financing to "systemic" cases and as a last resort.

Stage 2 (from 2014): for all countries having completed stage 1, provide for a debt exchange mechanism in the case of a resurgence of the sovereign debt crisis

The greatest short-term risks for the public finances of Member states relate to private debt via the banking system, and lack of growth, which automatically raise debt ratios. This is why we cannot envisage fiscal solidarity without a restructuring of the banking system, both to remove the banking risk and resume the funding of economies. However, the restructuring of bank debts, even though largely supported by the participation of the private creditors of the banks, is likely to aggravate the indebtedness of certain member states. Yet, in the case of a resurgence of market distrust vis-à-vis a Member state, the Euro area is still poorly equipped: it can propose aid from the ESM supplemented by the ECB's purchase programme (OMT), conditional on a programme of reforms. But no tool currently exists for restructuring public debt in an orderly manner, which raises the problem of whether the OMT programme is of a monetary (to counter a liquidity crisis) or a budgetary nature (to counter a solvency crisis).

We propose that a country that has completed stage 1 be offered, if required, a limited and temporary exchange of public debt.[33] A European Debt Agency (EDA), specific or integrated into the ESM,[34] would

[30] The experience of the Spanish bad bank nevertheless shows that it is not easy to call for equity from private investors. Restrictive rules will therefore have to be used. For example, the largest institutions in the market should mandatorily have to subscribe to the capital of the structure for an amount according to the size of their balance sheet totals. Such a measure would facilitate the funding of bad banks, while encouraging banking groups to reduce their size. This concept is similar to that of a local bank resolution mechanism supplied with resources from the banking system in the form of contributions that are mandatory, regular or contingent (only in case of crisis).

[31] This loss-sharing between countries has, for example, been proposed by Charles Goodhart and Dirk Schoenmaker (2009), in “Fiscal Burden Sharing in Cross-Border Banking Crises”, *International Journal of Central Banking*, vol. 5 no. 2, pp. 141-165. The "systemic" character of a bank is defined according to size, complexity of activities and the intensity of links with other institutions. Remember that this difference between "systemic" and "non-systemic" could encourage certain states to re-qualify banks from the second to the first category, to the benefit of the stability of the whole.

[32] see Guntram Wolff (2013), “Capital controls in Cyprus will put euro at risk”, *Financial Times*, 26 March.

[33] It is actually a debt exchange, not a debt repurchase transaction. The difference between the two mechanisms is that in the first case, the creditor would receive a new bond in exchange for the national bond, while in the second case, the creditor would receive a cash payment. The debt exchange operation avoids any potential problem of access to markets that the debt agency could be confronted with if it had to finance repurchase transactions. If the market is liquid, both options are equivalent.

carry out the exchange: it would acquire national sovereign bonds in the secondary market and at market price, against bonds that were joint and several at the Euro area level. Carrying out the exchange at market price (rather than at face value) would allow restructuring to be performed in an orderly manner in the case of a crisis, because the price of the exchange is determined by the market rather than by the debtor country. The haircut, and therefore the reduction in debt, would then be directly related to the loss of confidence of the markets. The holders of sovereign bonds would be offered, in place of their bonds, bonds from the EDA of a value equal to the market value of the bonds sold, the haircut being partly composed of a drop in interest payments and an extension of the maturity. The exchange would be limited in terms of amount (20% of the GDP of the country concerned) and duration (25 years).[35] The regular payment of interest corresponding to the bonds exchanged would be based on the same principle as in the ESM. For the countries under a programme, compliance with the commitments to the ESM would also be imperative. If these conditions are satisfied, bonds reaching maturity could be renewed under this mechanism during the first 10 years.[36] Repayments would be spread over 15 years, from the 10th year. The value of the bonds to be repaid would be frozen to the market value at the moment of the exchange, so that the debt reduction would be effective.

A conventional objection to a proposed exchange of part of public debt is that the exchanged part of the debt would become senior, meaning it would have priority for repayment, compared with the rest of the debt, which would become junior at an interest rate that could increase. This effect is nevertheless minimised if the exchange covers debt that does not exceed 20% of GDP (see Box). Also, it could be partly offset by the mechanism's incentive to continue fiscal adjustment, related to the government to make regular exchanges with the EDA for matured bonds. Should a sovereign not meet its obligations in terms of payment to the EDA (and in relation to the ESM programme), it would be required to repay national bonds at face value at their maturity; on the other hand, a country following the path of adjustment would benefit from falling interest rates as its bonds are refinanced. In any case, the exchange would be organised to minimise the effect of making other debt junior ("juniorisation").[37]

The benefit for the fiscal sustainability of the Member states concerned would come from three mechanisms:

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[34] The ESM has the advantage of already existing and being based on a treaty. However, the debt exchange that we propose does not form part of its duties and its size and structure would have to be considerably increased. The proposed mechanism could come under article 352 of the treaty.

[35] The limits imposed on the mechanism should allow the European Court of Justice and the court at Karlsruhe to validate it, as in the case of the ESM, even though the amounts envisaged here are much higher. We can calculate (see Box) that in an extreme scenario where six peripheral countries having benefited from the mechanism all default on the exchanged debt, the loss for Germany and France would remain less than 10% of the GDP of these two countries.

[36] The exchange would cover all maturities of the debt in order not to affect the maturity structure of the non-exchanged debt (and therefore in order to effectively extend its average maturity). At the maturity of the exchanged bonds, the government concerned would "repay" the EDA with a new bond of the same maturity as that exchanged, for a value corresponding to the price paid by the EDA during the first exchange operation and with an interest rate indexed on the market rate of non-exchanged bonds of the same maturity. It is only from the 10th year that the government would have to repay the matured bonds using fiscal resources.

[37] Techniques exist to limit this effect, such as "cross-default" clauses, or by removing its right to vote at the EDA in any negotiation on debt restructuring. In any case, the EDA must not benefit from senior status, which could be compensated by partial collateralisation of the exchange. Collateralisation must, however, be used with prudence and in compliance with legal and political constraints. For example, the explicit use of sureties may, in certain cases, trigger default on bonds with negative pledge clauses.

- The haircut at the time of the exchange. For example, if the market price is 40% below the face value at the time of the exchange, the debt reduction would be 40%×20%=8% of GDP, for a rate of interest and a maturity that would be unchanged.[38]

- Extension of the time frame: part of the debt would be put aside for 10 years, allowing the country to concentrate on the debt that remains national; after 10 years, the repayment conditions would be easier, for example, because the value of public assets that may be privatised would have recovered.

- Increased credibility of fiscal adjustments, due to the risk of renationalisation of the debt in case of default by the beneficiary state, and the pressure maintained via market interest rates during transactions to refinance the exchanged debts.

In addition to these three factors is the positive effect of European integration and availability of an instrument for crisis-management and solidarity.

This exchange of debt naturally conflicts with article 125 of the treaty, according to which member states are not responsible for each other's debt. Although this question must ultimately be decided by lawyers, at this stage, opinions diverge on whether or not a mechanism implying fiscal solidarity is compatible with the treaty.[39] In any case, our proposal falls short of the redemption fund proposed by the German Council of Economic Experts, which envisages mutualisation for all debts exceeding 60% of GDP over 25 years.[40] It relies on conditionality in terms of action already carried out by governments (stabilisation of bank balance sheets), which provide both incentives and security.

At the same time, the mechanisms that we propose would be likely to protect the ECB against the risk of having to intervene massively and sustainably under the OMT (which, as we have seen, would constitute a *de facto* and potentially greater mutualisation of national debts via the ECB's balance sheet).

The prospect of accessing this solidarity mechanism in the case of a crisis could be a powerful incentive to member states to proceed quickly with cleaning up their banking sectors (stage 1). In return, this cleanup would reduce both the off-balance-sheet risk for the public finances and the risk of a long Japanese-style economic crisis. It is also a logical step towards the implementation of the SSM. This mutualisation, *conditional on bank restructuring*, also allows the conditions to be worded in terms of actions by the states that are based on work to be performed (bank restructuring) rather than on results that have actually occurred (reduction in public debt).

To summarise: Conditional upon stabilisation of the banking sector, provide a mechanism for exchanging the national debt of countries in difficulty for bonds jointly and severally guaranteed by the Member states of the Euro area, limited to 20% of GDP over 25 years, with assigned resources. The mechanism may be operated in the case of a crisis, to be decided by the ESM. The repayment of this debt would be programmed from the 10th year.

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[38] This discount mechanism raises the free-rider problem: by reducing total debt, the haircut improves the prospects for the repayment of the debt that has remained national, which risks encouraging the holders of this debt to keep it rather than exchange it and increases the price of the bond at the time of the exchange, reducing the effectiveness of the exchange in terms of debt reduction. In an extreme situation, the price could increase to a level where the exchange would become pointless. In this case, the absence of an exchange would not mean that the mechanism has failed, because the price increase would reflect a *de facto* recovery in confidence. Thus, the proposed mechanism could play a stabilising role, even if it is not operated.

[39] For the European Parliament ("Report on the feasibility of introducing stability bonds" by Sylvie Goulard, adopted on 16 January 2013), this type of exchange could occur under article 352 of the treaty.

[40] German Council of Economic Experts (2011) "A European redemption pact", Working Paper 2/2012, February.

Box: Impact of the exchange on interest rates

To understand the problem of "juniorisation", we may, as a first approximation, assume that the average interest rate of the debt is not affected by the debt exchange. To begin with, we assume that the exchange is performed with no haircut. Let us take the case of Italy. The apparent rate on Italian public debt in 2011 was 4%, for a total gross debt of 120% of GDP.[41] After the exchange, Italy would have 20% of GDP of senior debt and 100% of GDP of junior debt. Let us suppose that the interest rate on the senior debt fell to 2.5% (the lowest implicit rate seen in the area in 2011). The risk of default on the Italian debt remains the same after the exchange, but it is concentrated on the junior debt. The interest rate paid on this junior debt is r so that:

$$4\% \times 120 = 2.5\% \times 20 + r \times 100$$

We find $r = 4.3\%$: the interest rate on the junior debt increases by 0.3 percentage point.

Now suppose that, at the time of the exchange, the Italian debt is discounted by 40%. In this case, a debt of 20% of GDP at market price corresponds to 20/0.6=33% of GDP at face value. The junior debt is no longer 100% of GDP, but 120-33=87% of GDP. The corresponding interest rate is r so that:

$$4\% \times 120 = 2.5\% \times 33 + r \times 87$$

We find $r = 4.6\%$. The effect of "juniorisation" is more pronounced for a country that is less indebted (because the risk of default is concentrated on a smaller volume of bonds), but these countries are also less likely to call upon the mechanism. The table below gives an illustration of the problem of "juniorisation" for a certain number of member states, supposing that, in case of an exchange, the interest rate on the EDA debt is 2.56%, the lowest apparent rate observed in 2011. The right part of the table gives the results of this calculation for an exchange of between 10 and 60% of GDP. With an exchange of 60% of GDP (corresponding to a project for "blue" debt or a redemption fund), the effect of "juniorisation" is massive: the interest rate on the junior debt increases by more than five percentage points (500 basis points) in three countries (Austria, Spain and the Netherlands) and more than one and a half points in three other countries (Germany, Belgium and Portugal). With mutualisation limited to 20% of GDP, in contrast, the "juniorisation" effect rarely exceeds 40 basis points. Note that, automatically, the "juniorisation" effect is more pronounced for countries with relatively low debt, which are fortunately least likely to have to call upon the mechanism.

[41] The figures are shown rounded for greater readability.

Table: Impact of different debt exchange scenarios on interest rates for junior public debt

	GDP (2011, €bn)	Debt (end 2011, €bn)	Net interest paid (2011, €bn)	Implicit interest rate in 2011 (in %)	Increase in rates on the junior debt (in basis points), depending on the exchange scenario (in % of GDP)					
					10%	20%	30%	40%	50%	60%
Germany	2592.6	2088	65.9	3.16	9	22	39	65	107	192
Austria	300.7	217.8	7.8	3.58	17	41	76	133	241	522
Belgium	369.8	361.6	12.8	3.54	12	27	46	72	109	165
Cyprus	18	12.8	0.4	3.13	10	24	46	80	148	338
Spain	1063.4	736.5	26.1	3.54	18	42	80	143	271	676
Finland	189.4	92.8	2.7	2.91	11	28	65	182	-	-
France	1996.6	1717	52.6	3.06	7	17	30	49	78	130
Greece	208.5	355.7	15	4.22	11	23	37	53	71	93
Ireland	159	169.2	5.2	3.07	6	13	23	35	51	74
Italy	1579.7	1906.7	76.3	4.00	14	30	50	74	106	148
Luxembourg	42.6	7.8	0.2	2.56	8	-	-	-	-	-
The Netherlands	602	394.2	11.9	3.02	9	23	44	81	168	568
Portugal	170.9	184.7	6.9	3.74	13	28	47	73	106	154
Euro area	9421	8297.2	285.7	3.44	12	28	49	79	124	202

Source: Natixis.

This approach nevertheless tends to maximise the effect of "juniorisation" because it does not take into account the potential drop in the average cost of the debt related to the credibility effect mentioned above.

Implications for partner countries

Here we try to determine the risk that solidarity would pose to the fiscal sustainability of the countries of the non-crisis based on an extreme scenario in which the six countries affected by the public debt crisis (Ireland, Greece, Spain, Italy, Cyprus and Portugal) benefit fully from the mechanism but subsequently default. As the aggregate GDP of these six countries was about €3,150bn in 2012, an exchange for 20% of their GDP is about €630bn. In the extreme case of a default on this debt, the increase in debt would be 32% of this amount for France and 42% for Germany, representing a 10% increase in the volume of the debt of the two countries (as a reminder, 2012 debt is estimated at 90.3% of GDP for France and 81.6% for Germany). The impact of this hypothetical increase in debt on the interest rates of these two countries is extremely difficult to quantify.

Stage 3 (from 2017): if there is no new sovereign debt crisis, or subject to the success of the anti-crisis mechanism established in stage 2, sharing sovereignty in matters of fiscal stabilisation

Although stages 1 and 2 relate to crisis management, stage 3, which concerns normal operating conditions, must be defined quite quickly to give some perspective to the member states that are subject to harsh adjustment efforts and to the markets, which lack a longer-term point of reference.

The challenge for stage 3 is to recover a shared sovereignty for fiscal stabilisation. To do this, two avenues are possible (see above):

- **The avenue of fiscal coordination:** each year, the EDA would issue, on behalf of each country, an amount of debt corresponding to the authorised deficit. This would associate the ex-ante surveillance of the governments with an incentive not to exceed the agreed deficit limits (because the government would then have to issue the additional debt itself, without the benefit of its partners' guarantee). Each new issue would demand a commitment to increase the tax resources for the EDA. This mechanism, which does not imply permanent debt for the Member states (because deficits would only be authorised in response to worsening economic conditions, with surpluses being required at the top of the cycle), could be put in place under article 352 of the treaty with, if necessary, enhanced cooperation.[42] The deficit of each country could be decided by the Council, according to a proposal from the European Commission and after consultation with the independent budgetary committees of the Member states concerned. This proposal takes up the idea of "blue/red" debt by applying the principle of new flows of debt: "blue" debt is that issued under the European agreement; "red" debt is that issued in excess. It would not be in the interest of the state concerned to use "red" debt, which would probably incur much higher funding costs than "blue" debt.

- **The federal avenue:** the fiscal balance required in each member state would be compensated by establishing a Euro area budget based on own or near-own resources, with the possibility of cyclic imbalances financed by the issue of common debt. The budget would be proposed by a Euro area Treasury and voted either by the Council (under current institutions) or by the European Parliament in the Euro area (under a new treaty). Although a change of treaty would be consistent, eventually, with such an approach, it is not essential in an intermediate phase, because no permanent debt is programmed and it is possible to rely on the legitimacy of the Council.[43]

The three-stage process described above may leave some members of the Euro area by the wayside, either because they have not managed to stabilise their bank balance sheets within the given time, or because they do not wish to participate in fiscal integration. In the same way as for monetary union, it is important to make it possible for a country to join the group subsequently. Nevertheless, the risk of market mistrust would be high for a country that did not participate, if the others did. We think it is probable that the prospect of collective fiscal sovereignty would act as a powerful incentive to carry out stabilisation within the given time.

To summarise: At the end of a four-year stabilisation process, construct shared fiscal sovereignty through a Euro area budget or by centralising decisions on national budget balances, with the possibility of financing authorised deficits using issues of common debt.

[42] Enhanced cooperation would promote the legitimacy of the mechanism by involving the European Parliament.

[43] In a subsequent phase, extending the ambition of the Euro area budget may be envisaged, particularly by having it take charge of allocation expenditures financed by debt. An advantage of this would be to create a liquid market for this Eurobond. However, such a development would lead to a redefinition of the division of roles between the Euro area and the European Union; furthermore, it would require a treaty change because the member states would become jointly and severally liable for a common and permanent debt.

Conclusion

The proposal explained in this document is not intended to substitute for a political process aimed at defining a new integrated Euro area. However, we believe that this political debate will be irrelevant if Europe does not manage to find a robust solution to the crisis, which is having a harsh effect on its citizens, particularly the youngest. A successful transition to banking and budgetary union would be a decisive element in relaunching European integration. However, European leaders will have to offer people something more than just banking and fiscal union. From this point of view, it is essential to supplement the transitory mechanism with social initiatives (such as a European pillar for unemployment insurance, full portability of pensions and unemployment insurance, a facilitation of labour mobility for the youth), and with initiatives in favour of growth (enhanced action by the European investment bank, particularly intended for SMEs). These questions are outside the scope of this paper but must not be forgotten if we wish to recover the momentum of the EU founders.