Eurozone members must be serious about risk-sharing

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In December last year, the European Commission unveiled proposals for “deepening Europe’s economic and monetary union”. In truth, the package put forward by the commission was rather vague. But it was followed in January by a document assembled by 14 leading French and German economists containing a blueprint for reform of the eurozone.

The 14 economists proposed reforms intended to reconcile risk-sharing in the eurozone with risk reduction. Their intervention was welcomed by politicians in both France and Germany. However, the document is less original than it looked at first. It largely rehearses established German concerns and only pays lip-service to the principle of risk-sharing.

The economists give priority to strengthening the no-bailout rule. They propose the creation of a fiscal watchdog separate from the commission and a reform of the European Stability Mechanism, the bailout fund created in 2012 at the height of the crisis in the eurozone, based on so-called creditor participation clauses.

Fiscal discipline, the economists argue, should be based on a debt target complemented by a new expenditure rule. Governments that breach this new rule would be forced to finance excess spending with high-yield junior bonds (also known as “accountability bonds”).

On the banking sector, the emphasis in their proposals falls on the introduction of a “sovereign concentration charge”. This would require banks to post more capital if debt is issued by a single creditor, such as a home-country sovereign.

The suggestions on risk sharing are much less ambitious. These include the creation of a eurozone “safe asset” that would be an alternative to government bonds, common deposit insurance and a European rainy day fund to support countries experiencing significant crises. And that is it. There is no mention of joint liability on sovereign bond-backed securities, nor is the budget for the rainy day fund specified.

Reading the deliberations of these 14 experts, one is led irresistibly to the conclusion that Germany and France are concerned primarily with preserving their dominance in the eurozone. The periphery, one infers, is to be left alone to manage the problems created by an asymmetric monetary union, especially a programme of quantitative easing which has undermined confidence in the ability of the European Central Bank to intervene.

However, it is clear that risk-sharing is the only way to ensure that the future of the eurozone is secure. Member states should take advantage of the economic upturn to reform existing institutions and align their economic cycles.

The first step would be to turn the ESM into a supranational guarantor of the public debt of members of the single currency. The total amount of risk in the system would be reallocated across all countries according to an insurance scheme: states at risk would transfer to the ESM any excess risk over the eurozone average and pay the market price for this protection in the form of annual premiums.

This should happen gradually. By the end of the process, national public debts would be replaced by a federal eurozone asset with no more room for sovereign spreads. The mark-to-market of the premiums paid by risky countries would compensate Germany for the temporary deterioration of its credit standing, as well as meeting its expectation of more fiscally responsible behaviour on the part of other members. On the other hand, the joint liability commitment would change investors' expectations, triggering convergence trades on eurozone sovereign bonds. An enlarged capital endowment for the ESM and greater financial soundness would allow the creation of new liabilities to finance profitable investments in member countries.

In order to close the competitiveness and productivity gaps that have accumulated in the eurozone during the past decade, the allocation of these funds should be proportional to the premiums paid by peripheral countries for the ESM guarantee. This reformed stability mechanism would be the forerunner of a single finance minister responsible for the public debt of the eurozone as a whole, and for a federal budget sufficient to allow for the stabilisation and harmonisation of member economies.

This is certainly a much more ambitious proposal than anything either the commission or the 14 economists have put forward. But it answers to market logic and would advance the cause of European integration. And that is something we will never achieve as long as risks are not shared.

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