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Completing the Euro

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The sovereign debt crisis that has threatened to unravel the Euro area since 2009 has revealed a number of institutional weaknesses of the European monetary construction. The initial architecture of the Euro area, as designed by the Maastricht Treaty, allowed some serious imbalances to develop: real estate bubbles, credit booms, excessive expansion of bank balance sheets, and fiscal drift, despite the Growth and Stability Pact. Since the summer of 2012, a coherent scenario for exiting the crisis has emerged, based on strengthened macroeconomic and budgetary supervision, a banking union and the ECB's announcement of a sovereign debt purchase programme with conditionality, supplementing the European Stability Mechanism. Although these steps appeased financial markets and lead to a considerable reduction in government bond yields, economic growth has not returned and the Euro area is still vulnerable.

The sustainability of the Euro area requires significant progress in three areas: banking regulation, fiscal governance and structural reforms. On banking regulation, we recommend committing firmly to a banking union, while paying particular attention to governance and funding. On fiscal governance, we recommend establishing an independent European fiscal committee, in coordination with national fiscal committees. A European fiscal committee would set the criteria under which States could access automatic precautionary credit lines from the ESM. Finally, on structural reforms, we propose that States that carry out labour market reforms be given access to a European system of unemployment insurance.

These various measures, providing macroeconomic and financial stability, will not necessarily prevent the sovereign debt crisis from re-emerging. To cope with this risk while undertaking a credible process of clearing legacy assets, we propose a three-point plan: a swift bank clean-up, an anti-crisis mechanism and fiscal stabilisation. Our first point calls for banks in need to be restructured as soon as possible, under the auspices of the ECB and widely involving private creditors, in a specific order. Conditional on this clean-up, the second component is to provide –in case of a resurgence of the sovereign debt crisis– a mechanism for exchanging national debt at market price for bonds jointly and severally guaranteed by Euro area Member States, limited to 20% of GDP over 25 years, with resources assigned and repayment scheduled from the 10th year. Finally, the fiscal component consists of recovering, once banks' balance sheets have been cleaned-up, some shared sovereignty in terms of fiscal stabilisation through a Euro area budget or centralised decision-making for national budget balances, with the possibility of financing authorised deficits through issuance of common debt.

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A Euro area that remains incomplete

A shared diagnosis

The root causes of the Euro area crisis are now well understood. Monetary integration led to serious imbalances, both internal and external, for three main reasons:

- free capital mobility and the convergence of interest rates favoured the emergence of real estate price bubbles financed by bank credit. Capital flows from the Euro area centre to peripheral countries financed unproductive investments in sectors that are largely sheltered from international competition (construction in particular);
- free capital mobility and the convergence of interest rates also favoured certain countries (Greece) and, despite the Stability Pact, fiscal recklessness;[1]
- the credit boom contributed to an excessive expansion of banks' balance sheets in comparison to the size of economies. For the entire Euro area, the assets of commercial banks rose from 197% to 268% of GDP between 2002 and 2009, with even greater increases for some countries in the area.[2] With such high liabilities, the fiscal consequences of bank failures jeopardised the solvency of public finances. By extension, a deterioration of public finances has a direct impact on the balance sheets of banks holding these sovereign bonds, creating a self-fulfilling banking crisis.

These three elements have made borrowing countries doubly vulnerable to a sudden reversal of private capital flows and to a feedback loop between bank balance sheets and State solvency. The divergence in competitiveness between the North and the South should not be misunderstood –it is largely the consequence, rather than the cause, of the widening external imbalances in 1999-2007.

A response gradually taking shape

The ferocity and intensity of the Euro area crisis took European policymakers by surprise, forcing them to define, often in emergency situations, the elements of an adequate response. In the summer of 2012, a strategy emerged to deal with the fallout of the debt crisis, based on four key elements:

- phased construction of a banking union with centralised banking supervision by the European Central Bank (ECB), and establishment of a unified bank resolution regime;
- macroeconomic and fiscal supervision strengthened ahead of the national decision-making process (European Semester, fiscal treaty, six-pack, two-pack);[3]
- the establishment of joint financial assistance through the European Stability Mechanism (ESM);
- the announcement, by the ECB, of a sovereign debt buy-back programme (OMT[4]), conditional on compliance with national commitments, for a potentially unlimited volume.

The plan had a dramatic impact on the markets and the interest rates of peripheral countries fell significantly. In parallel, efforts to rebuild public finances allowed for a partial reduction of deficits, at the expense of a considerable reduction in economic activity, while discrepancies in competitiveness began to close. It might be tempting to conclude that these measures are enough to finally prevent a new debt crisis, averting the prospect of a break-up of the Euro area. We think this verdict is premature.

A strategy that remains inadequate

The Euro area is far from out of the woods, as the continuing rise in the unemployment rates in nearly all the countries reminds us,[5] as well as, most recently, the crisis in Cyprus. As of March 2013, the macroeconomic situation remains extremely fragile. On the one hand, the predicament in Cyprus has shown that the Euro area is still poorly equipped to deal with a banking crisis. On the other, although the OMT announcement has centred markets around the 'good' equilibrium (one where investors are reassured about the sustainability of public debts and therefore have no reason to demand high rates to compensate for the risk of default), the 'bad' equilibrium is still a danger in the event of difficulties related to implementation of the OMT (Box 1). This risk remains for several reasons:

- the segmentation of markets that has increased the cost of credit in countries in difficulty, despite the relative reduction of interest rates on public debt;
- the increase on banks' balance sheets of non-performing assets in connection with the real estate crisis, rising unemployment and business bankruptcies;
- poor growth prospects in a context of fiscal austerity which is increasingly difficult for citizens to accept.

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[1] The reduction in interest rates and the inflows of capital result in part from the initial exuberance of the markets for the single currency project, in part from decisions by the ECB and regulators to handle the sovereign debt of different States in an identical manner and in part from the low credibility of the no-bailout clause in the Treaty (by Treaty, we mean in this Note the Treaty on the Functioning of the European Union).

[2] Ref. IMF (2012): *Global Financial Stability* Report, Table 1.

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

[4] Outright Monetary Transactions.

[5] Forecasts for February 2013 from the European Commission project an unemployment rate of 14.6% in Ireland, 17.3% in Portugal and 27% in Spain and Greece; the unemployment will severely affect the young people of these countries (between 30 and 50%).

1. Risks related to OMT implementation

A detailed analysis of the OMT reveals a certain number of difficulties:

- the risk of delay due to cumbersome procedures;
- the conditionality of intervention: if it is too severe, the country under pressure has little incentive to ask for help, which increases tension on the markets with the risk of possible contagion. Additionally, a conditionality that is too strict is less credible. Conversely, if the conditionality is too light, the ECB will be accused of pooling public debt in an unconditional manner, in contradiction with the no-bailout clause in the Treaty;
- the risk that the sustainability analysis reveals that debt needs to be restructured before OMT intervention; such restructuring would take the financial markets by surprise (it has been repeated since the beginning of the crisis that Greece would be the only case) and, given the still strong link between sovereign risk and banking risk, this would be destabilising for the banking system;
- the fact that securities purchases by the ECB are in principle limited to a three-year maturity (while the average maturity of public debt in the Euro area is six to seven years) could encourage governments to borrow more in the short term. This shortening of maturities would be destabilising since issues would become more frequent, at an interest rate that could be highly variable. A reduction of average debt maturity would also increase, after termination of the OMT, the risk of high refinancing needs at the same time.

Faced with this poor economic situation, the OMT announcement poses two problems:

- by lowering interest rates, the OMT reduces the political will to put the necessary reforms in place for adjusting public finances and resuming growth. The credibility of OMT conditionality is a great unknown;
- guarantees provided by a central bank ultimately represent a commitment of the national treasury. This drawing right therefore opens the door to implicit transfers, in violation of the no-bailout clause of Article 125 of the Treaty.

To permanently eliminate the 'bad' equilibrium, the current system must therefore be complemented in such a way as to improve the situation on all the points mentioned above and to make progress towards greater integration.

Integration, for what purpose?

Aware that the single currency could lead to perverse fiscal incentives with potentially destabilising effects (which is the reason for the Stability Pact), the architects of the Euro area nonetheless underestimated the strengthening of interdependencies related to monetary union. A sovereign default or a banking crisis in a Member State very strongly affects the other Member States directly (due to losses on their investments) and indirectly (due to the effects of contagion and, beyond that, the political consequences). Conversely, adoption of structural reforms, which increase the potential for growth in a country, creates external benefits: the gain in activity stimulates trade, contributes to the area's economic and political stability and reduces crisis risks. However, the reforms are often financially or politically costly in the short term for a country and external gains are not taken into account.

The creation of the Euro area has strengthened these externalities: common monetary policy, increased financial integration, and finally a joint project to which the political class is strongly committed. It has thereby made the States more dependent on one another, increasing the requirement for de facto solidarity without the counterpart of common governance.

Sharing national and European responsibilities in the Union follows a principle of subsidiarity: only economic decisions whose effects on partner countries are not properly taken into account nationally (internalised) must be transferred to the Community level. Because the single currency has strengthened the externalities of Member States, we think the border between national and European responsibilities needs to be moved in the following areas:

- *regulation of national banking systems.* Since the crisis is largely financial, the heart of the matter must be addressed: financial and banking regulation, with the establishment of a true banking union;
- *setting overall fiscal policies.* In return for establishing systemic crisis resolution mechanisms, with sufficient resources, it is essential to credibly strengthen the Euro area's fiscal framework, to eliminate opportunistic behaviour, while restoring the ability of fiscal policies to stabilise the economic cycle;
- *growth policies.* With restoring growth in southern Europe being a key issue for all partners, it is legitimate to set, at the area level, policies favourable for growth and jobs, and to encourage Member States to undertake the necessary reforms to comply, under contractual programmes that allow the external benefits generated to be internalised.

Policies that we recommend in these three areas will allow Euro area countries to be stabilised, through establishment of "Mundellian"[6] macroeconomic insurance mechanisms.

[6] In reference to Robert Mundell, economist who originated the theory of optimum currency areas. See Mundell R. (1961): "A Theory of Optimum Currency Areas", *The American Economic Review*, vol. 51, no. 4, pp. 657-665, Kenen P. (1969): "The Optimum Currency Area: An Eclectic View" in *Monetary Problems of the International Economy*, Mundell and Swoboda (eds), University of Chicago Press, 405 p. or, more recently, Farhi E. and I. Werning (2012): *Fiscal Unions*, Mimeo MIT.

The beneficial effects of these mechanisms are well known: they can partially compensate for the loss of exchange rates as an instrument for macroeconomic stabilisation within a monetary union. We insist however on the fact that each of our proposals, by increasing common shared resources, increases the risk of opportunistic behaviour and therefore requires a framework of very strict governance.

A further difficulty for any integration project today is the question of clearing the past: any mutual insurance mechanism (against major banking or macroeconomic risks) faces a fundamental asymmetry between creditor and debtor countries. In a word, the risk of being insured is not symmetrical, so that the North is reluctant to what it interprets as a way to make it pay for the over-indebtedness of countries of the South. We will begin by examining how to complement the economic architecture of the Euro area to incorporate into it the three areas mentioned above in which closer integration seems necessary to us. Then we will propose a strategy for the transitional period.

Completing the Euro area architecture

Section written by Jacques Delpla, Emmanuel Farhi, Pierre-Olivier Gourinchas and Jean Tirole

As we have seen, the Euro area's architecture must be completed in three areas with strong externalities between Member States: banking regulation, fiscal governance and structural reforms.

Regulation of banks

The banking union is the cornerstone of the new Euro area architecture. It responds to several motivations:

- breaking the vicious circle between banks and sovereign borrowers;
- limiting the risk of abrupt reversals of private capital flows within the area;
- avoiding fragmentation of capital markets at the time of a crisis;
- increasing independence and limiting the capture of national regulators by the banking industry.

A banking union is articulated around three principles:

- centralised supervision;
- a common mechanism for resolution of banking crises, with access, as a last resort, to a European budget resource;
- deposit insurance.

In December 2012 the European Council agreed to implement, by March 2014, a centralized banking supervision authority located within the ECB, for a group of European institutions representing 80% of the Euro area banking assets. The Council also set a timetable for harmonisation and strengthening of national restructuring regimes, while discussions on a common mechanism are under way.

These decisions represent substantial progress. However, the situation in early 2013 remains unsatisfactory and it is our responsibility to point out the measures that remain to be taken.

The Single Supervisory Mechanism (SSM): all banks in the Euro area and in countries wishing to join the banking union should be covered by this mechanism, whose Governing Council should be chosen according to a procedure similar to that used for the ECB Executive Board. Insurance companies and financial markets should also be subject to real European supervision, possibly by other organisations. To reinforce this European mandate, the federal level should control directly the national levels, and the key officials of the national supervisory bodies should acquire a European status and be supported locally by ECB staff.

In addition to the potential withdrawal of a banking license, the SSM must have graduated powers to impose sanctions: for instance, in case of undercapitalisation, the SSM should be able to impose the suspension of dividends, the replacement of management or the divestment of activities or lines of business with excessive risk.

A European banking resolution mechanism: the vicious circle between banks and sovereign borrowers will only be broken by establishing a common resolution authority. This resolution authority should have the ability to liquidate a bank in difficulty, to transfer all or part of its activities to a temporary bridge bank or to merge it with a stronger institution; to involve private creditors in the restructuring (bail-in) according to a transparent set of rules and, as a last resort, by relying on a common budget resource.

Best practices would call for this resolution authority to be distinct from the SSM, to avoid the temptation to cover-up potential supervision errors, and to better preserve the independence of the ECB.

With regards to financing, we propose a two-tiered system:

- a deposit insurance fund, pre-financed by the banks, which would cover individual bankruptcy risks (see below);
- in the event of a systemic problem and as a last resort, the ESM would take over, thus playing the role played by national treasuries.[7] The financial capacity of the ESM, which currently represents 5% of the Euro area GDP, should therefore be substantially strengthened, preferably through drawing rights on national treasu-

[7] In the short term, the ECB also must play a major role in providing liquidity.

ries, less costly than pre-financing. Countries outside the Euro area that wish to join the banking union would contribute to ESM capital through a tranche reserved for bank operations.

The deposit insurance fund: A European Deposit Insurance Fund, pre-financed by the banks, should be quickly put in place. We recommend studying the possibility of modulating the levy rate on the basis of the cycle, which would strengthen the macro-prudential aspect of current premiums. These contributions would be invested in a basket of bonds of Euro area States, in proportion to insured deposits.

Proposition 1. Commit to a quick and decisive implementation of a full banking union, paying particular attention to its governance and financing: independence of the Single Supervisory Mechanism, European mandate and status for key officials, both at the national and European levels, graduated powers to impose sanctions, separation between supervisory and resolution authorities, co-financing of resolution through a European Deposit Insurance Fund contributed to by the banks (individual bankruptcies) and by a reinforced ESM (systemic crises).

2. Fiscal governance: outstanding issues

Implementation of sanctions
Under the Council's responsibility, which has never approved sanctions in the past, despite the numerous violations of the Stability Pact.

Type of sanctions
Financial sanctions, counter productive when they affect a country that is already facing financial difficulties.

Off-balance sheet
A narrow measure of States' deficits and debts is misleading. The European safety net provided by the ESM is inadequate in the event of systemic banking crisis.

Definition of sustainability
Still based on an ad hoc figure (structural primary deficit 0.5% of GDP) while it depends on many factors (ability to raise taxes, proportion of the debt held within the country, growth potential, etc.).

Fiscal policy bias
The governance model induces an austerity bias, with Member States seeking, for the purposes of self-insurance, to avoid ESM conditionality, or fearing insufficient resources in times of crisis.

Fiscal governance

In a highly interdependent Euro area, fiscal policies are no longer solely national issues. If each country remains free to choose the level of expenditure and tax burden as well as the distribution between these two aggregates, it is imperative that the balance remains on a sustainable trajectory. Europe must therefore have the means to prevent excessive risk-taking by Member States. This is what the Stability Pact was supposed, and failed, to achieve.

Since the onset of the crisis, fiscal supervision has been reformed multiple times. The Fiscal Compact signed in March 2012 was an important step towards stronger fiscal discipline for each Member State.[8] However, a number of questions remain outstanding (Box 2).

In light of this analysis, we conclude that an additional and substantial sharing of sovereignty is necessary in the fiscal area. We propose undertaking the following reforms:

- establishing an independent European Fiscal Committee, coordinating national fiscal committees, with a status similar to the one proposed for the single supervisory mechanism (federal level directing the national levels, with European status for the main players on both levels);
- clear, extensive and uniform mandates for these national and European committees, with credible implementation. These committees must be able to invalidate an unrealistic growth rate in the budget, conduct studies on the economic consequences of policies and on the sustainability of public debt, alert the European Parliament and the European Court of Justice about these matters;
- establishing a pre-qualification process that automatically opens a precautionary financing line. We propose that the European Fiscal Committee sets recommended debt issuance ceilings by country, I n coordination with the national debt agencies.[9] Countries that satisfy the ceiling set by the European Fiscal Committee would automatically and unconditionally qualify for a precautionary financing line from the ESM.[10] The automatic

[8] The Fiscal Pact provides for a primary deficit (that is, ignoring debt service) of 0.5% of GDP, adjusted to the economic cycle, a rule of semi-automatic sanctions (by reverse majority vote), and implementation by the European Court of Justice.

[9] Such a process would be compliant with Article 6 of the March 2012 Fiscal Pact, recommending that countries provide, for the purposes of coordination, their program of debt issuance to the European Council as well as to the Commission, and with the recently proposed measures in the "two-pack" (ref. memo/13/196 of the European Commission on March 12, 2013).

[10] According to Article 14 of the ESM Treaty of February 2, 2012.

3. Some quantitative elements for calibrating a European unemployment insurance

In order to provide some quantitative elements for calibrating a European unemployment insurance fund, we have used the following assumptions, assuming that all workers have already adopted the European employment contract (fully operational system):

- the replacement rate for the European unemployment regime is set at 20% of a worker's salary;[a]
- it follows that each country would receive from the European fund an amount approximately equal to 20% of the aggregate payroll multiplied by the unemployment rate in the country;
- to avoid any permanent transfer, countries' contributions to the European fund must therefore be set to 20% of the aggregate payroll multiplied by the structural unemployment rate in the country;[b]

The table below presents a simulation for 2012. This simulation shows that:

- the unemployment insurance fund can represent a significant net transfer for countries whose unemployment rate is above their natural unemployment rate (Spain, Greece, Portugal, Ireland, Italy). By way of comparison, national unemployment insurance expenses for these countries vary between 1% of GDP (Greece) and 4% (Spain);
- countries with low structural unemployment rates contribute proportionately less. Thus, the Netherlands receive a net transfer, despite a much lower unemployment rate than the Euro area average;
- the insurance fund would be in deficit in 2012, since a large number of countries have deteriorated labour markets. A return to equilibrium of the fund over the cycle would require an exceptional contribution of 0.2% of GDP from each country in the high phase of the cycle. This adjustment would have a modest effect on the program's net transfers.

	GDP	Unem-ployement rate	Structural unemployement rate	Contributions		Receipts		Nets receipts from contributions	
	€ bn	%	%	% of GDP	€ bn	% of GDP	€ bn	% of GDP	€ bn
Germany	2,649.0	5.3	7.1	0.79	20.9	0.58	15.4	– 0.21	– 5.6
Austria	308.8	4.4	4.3	0.54	1.7	0.55	1.7	0.00	0.0
Belgium	377.0	7.4	7.9	0.90	3.4	0.83	3.1	– 0.07	– 0.3
Spain	1,052.8	25.0	16.5	1.83	19.3	3.10	32.7	1.27	13.4
Finland	194.3	7.7	8.4	0.94	1.8	0.86	1.7	– 0.08	– 0.2
France	2,029.6	9.9	9.0	1.06	21.5	1.18	23.9	0.12	2.3
Greece	194.2	23.6	12.2	0.90	1.7	1.99	3.9	1.10	2.1
Ireland	162.6	14.8	10.5	0.98	1.6	1.46	2.4	0.48	0.8
Italy	1,563.8	10.6	7.6	0.71	11.0	1.01	15.8	0.30	4.8
Luxemburg	44.6	6.1	5.5	0.53	0.2	0.59	0.3	0.05	0.0
Netherlands	601.9	5.2	3.7	0.40	2.4	0.56	3.4	0.16	1.0
Portugal	165.2	15.5	11.0	1.20	2.0	1.79	3.0	0.59	1.0
Euro Area	9,469.1	11.1	9.1	0.94	89.0	1.14	108.4	0.20	19.4

Source: Authors' calculations from *OECD Economic Outlook*, December 2012.

[a] This rate is sufficiently low to avoid excessive total replacement rates (national and European). National replacement rates vary between 40 and 75% in the Euro area.

[b] In this simulation, the structural unemployment rate is the NAIRU (Non-Accelerating Inflation Rate of Unemployment) calculated by the OECD. Other definitions are possible. We propose leaving this decision to the European Commission. Care should be taken to adopt a clear and easily calculated definition. A simple and robust solution would be a moving average of unemployment rates seen over a fixed window (five or ten years).

nature of the process would remove the stigma attached to a request for financial assistance, even as a precautionary line. Debt issued by countries would remain their sole responsibility. Such a mechanism will require special vigilance from the European Fiscal Committee so that countries do not move their debt issuance off balance sheet;

– democratic oversight of the process at the European level. Although implementation of fiscal governance can be entrusted to the European Court of Justice, with the necessary expertise provided by the European Fiscal Committee, a democratic validation is still very much needed. The most natural solution is to reform the treaty to give the necessary powers to a sub-chamber of the European Parliament representing the Euro area; this sub-chamber would vote 'en bloc' on the proposed debt issuance ceilings set by the independent European Fiscal Committee; in the event of a negative vote, countries would lose their prequalification. This solution is politically cumbersome. In the interim, a solution would be to rely on Article 13 of the fiscal treaty, to validate the proposals of the European Fiscal Committee by a conference of representatives of the European Parliament and the finance commissions of national parliaments.

Proposition 2. Create an independent European Fiscal Committee, empowered with a European mandate and coordinating the national fiscal committees; provide these European and national fiscal committees with clear, extensive and uniform prerogatives; grant the European Fiscal Committee the power to authorize automatic precautionary financing lines with the ESM, after validation by the European Parliament.

Structural Reforms

Beyond the crisis, the return to sustainable growth will determine the success of the European project. Reducing unemployment and consolidating public finances can only be done if economic growth is sustained. Without economic growth, the stabilisation of public debt will require lasting and painful primary surpluses. The recessionary effects of the fiscal consolidation will make the task even harder to accomplish. It is therefore necessary to identify and overcome the obstacles to growth as quickly as possible.

Structural reforms that support long term growth are often politically costly and difficult to implement (otherwise they would undoubtedly already have been adopted). The obstacles are significant and arise mostly from the re-distributive aspect of structural reforms: there are often many winners but they are rarely mobilised since the benefits from the reform can be diffuse. The losers, on the other hand, are often highly mobilised against the reforms.

In the context of the labour market, the dividing line is between those who have a stable job and are seeking to protect it and those who do not have a job or are marginally attached to the labour market (trainees, interim, workers with temporary or fixed-term contracts). This dualism leads to a great injustice in the burden of adjustment in the labour market, which falls most heavily on the least protected categories of workers. Empirically, there is clearly a positive relationship between the degree of job protection and the unemployment rate, especially the unemployment rate for young people.[11]

An ambitious labour market reform therefore requires a dual approach. First, it must provide firms with the flexibility they need to create today's jobs.[12] Second, it must better protect workers against job insecurity. In France, the January 11, 2013, agreement on labour market security, negotiated by the social partners, is moving in this direction and is a promising step forward. But much remains to be done, in France and elsewhere in Europe.

We propose that Europe implement an ambitious reform of the European labor market, based on three pillars.

The first pillar is a European unemployment insurance. This European unemployment insurance would be in addition to the national regimes of unemployment insurance. It would be financed by the States, through a European Unemployment Fund. The contribution of each states would be calculated on the basis of

- the country's «structural» unemployment rate, so as to take into account persistent cross country differences in the structure of labor markets and to avoid permanent transfers;
- the average national salary, so that wealthier countries with higher nominal levels of insurance, contribute more (see Box 3).

The second pillar is a European employment contract. This contract, negotiated by the European partners, would directly incorporate the elements necessary to a better functioning of European labor markets. It would be an indefinite duration contract, but with flexible separation criteria, and subject to a layoff tax so that firms internalize the social cost of their firing decisions.[13]

[11] The economic theory is ambiguous on the relationship between employment protection and unemployment, ref. Blanchard O. (2000): "The Economics of Unemployment: Shocks, Institutions and Interactions", *Introduction, Lionel Robbins Lectures*, London School of Economics. Employment protection naturally leads to reduction in layoffs and hiring, otherwise called labour market sclerosis. However, employment protection also tends to increase the duration of unemployment. The two effects act in opposite ways on overall unemployment. This being said, employment protection favours increased labour market segmentation, increasing unemployment of less-skilled employee categories.

[12] See Blanchard O. and J. Tirole (2003): *Protection de l'emploi et procédures de licenciement*, CAE Report no 44, La Documentation française, and Cahuc P. and F. Kramarz (2004): *De la précarité à la mobilité : vers une Sécurité sociale professionnelle*, Report to the Minister of Finance and Industry and to the Minister of Employment, Labour and Social Cohesion, La Documentation française, for reform proposals in this direction.

[13] See Blanchard and Tirole (2003), *op.cit*.

The third pillar is the conditionality. The adoption of the European labour contract would automatically open rights to the European unemployment insurance, in addition to the existing rights to national unemployment insurance.

An essential aspect of the proposed mechanism is that the choice of the labor contract would reside solely with workers. Employers would have the legal obligation to offer employees the European labor contract, alongside a national labor contract of their choice.[14]

The choice of the European contract would thus be made entirely by workers, on a voluntary basis.

Such a system has the advantage of coupling reform and solidarity at the micro- and macro-economic levels. If the European contract is not adopted, there is no disbursement through the European Unemployment Fund. This ensures that creditor countries only contribute if the reform is adopted. In addition, this system will have the additional effect of reducing structural unemployment rates over time, further relieving public finances.[15] The proposed reform fits in well with the proposed «mutually agreed contracts for competitiveness and growth» discussed by the European Council in December 2012.

In addition to its effect on employment and long term growth, this mechanism would help to restore an ability in the Euro area to dampen cyclical fluctuations both for Member States and the entire Euro area. The European insurance fund would have the objective of balancing its accounts across the Euro area cycle, by adjusting as needed the contribution rate in the high phases of the cycle.[16]

Subsequently, establishing similar European incentive systems could be considered to encourage other policies to promote long term growth and stability of member countries. Among the avenues to be explored are seniors' participation rates, education and research, or even geographical mobility.

> **Proposition 3.** Establish a European employment contract, of indeterminate duration, but with flexible separation criteria, that opens the right to a European unemployment insurance. The choice of a European contract would be made on a voluntary basis by workers. Financing of the European unemployment insurance fund will be calculated to avoid any permanent transfer.

Managing the transition

Section written by Patrick Artus, Agnès Bénassy-Quéré, Laurence Boone, Jacques Cailloux and Guntram Wolff

The reforms proposed above are intended to complement the Euro area architecture, beyond today's crisis situation. Some of them, such as creating a bank crisis resolution fund with access to a common fiscal resource, clash with the characteristics of the current crisis which is characterised by a wide asymmetry between creditor and debtor countries. Moreover, the proposed reforms, although stabilising in macroeconomic and financial terms, will not necessarily prevent a resurgence of the sovereign debt crisis. We propose herewith a strategy combining the creation of a crisis management tool and the cleaning up of legacy assets in the banking sector. This strategy is designed to address the limitations in the current policy response while complying with the various constraints faced by the area today: precarious public finances in many countries, fragility of the banking system, large legacy assets in some countries, the no-bailout rule enshrined in the treaty, necessity for further adjustments while stimulating growth.

The no-bailout clause (Article 125 of the Treaty) is strict. However, the Heads of States and Governments have stated that no restructuring of sovereign debt should take place in any country other than Greece and that no country will leave the Euro area. These two statements suggest that as a last resort, bailouts will have to happen, directly or through the banking system and the ECB. We believe that this gap between what the rulebook says and the need for a practical approach is not healthy. To overcome this inconsistency between no bailout, no restructuring and no exit of member states from the Euro area, we propose a three pronged strategy:

- banking sector clean-up;
- sovereign debt crisis management mechanism;
- restoration of the fiscal stabilisation function.

Banking sector clean-up

The establishment of the banking union (see above) will take time. Above all, it will encounter the thorny issue of the legacy assets. Faced with a continuing deterioration in bank balance sheets in peripheral countries[17] and with the resulting behaviour of credit restriction, the cleaning-up of banks' balance sheets must be considered as a matter of urgency. To do this, a thorough and transparent assessment of the banking sector's situation must be drawn up in each country in the Euro area. In that respect, one could use Article 27(4) of the Single Supervisory Mechanism (SSM) which sets out stress tests as

[14] Note that any reform of this type presupposes that it is possible to insert the European employment contract in national labour law.

[15] It is possible that such a system could make the cost of unemployment insurance more cyclical since the criteria for separation are relieved with the European contract. It may therefore be necessary to provide mixed financing, one part being directly paid by employees and another covering expenses of the national unemployment insurance system.

[16] To this end, the fund's accounts should be approved by the European fiscal committee.

[17] The weight of non-performing loans in total bank loans rose from 6 to 11.5% in Spain during 2012, continued to grow in Italy and Portugal to levels close to 11 and 8% respectively, as well as in Ireland and Greece where the highest levels were reached, close to 20% (ref. IMF).

4. Impact of the debt exchange on interest rates

To understand the problem of "juniorisation" or "subordination", as a first approximation one could assume that the average interest rate of the debt is not affected by the exchange. To begin, it is assumed here that the exchange is conducted with no discount. Take the case of Italy. The apparent rate on the Italian public debt in 2011 was 4%, for a debt totalling 120% of GDP.[a] After the exchange, Italy has 20 points of GDP of senior debt and 100 points of GDP of junior debt. Suppose that the interest rate on the senior debt falls to 2.5% (the lowest apparent rate observed in the area in 2011). The risk of default on the Italian debt remains the same after the exchange, but is concentrated on the junior debt. The rate of interest paid on this junior debt is r, where:

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

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

Now suppose that at the moment of the exchange, the Italian debt incurs a 40% discount. In this case, 20 points of GDP at market value corresponds to 20/0.6 = 33 points of GDP of debt at face value. The junior debt is no longer 100 points of GDP, but 120 – 33 = 87 points of GDP. The corresponding interest rate is r, where:

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

We find $r = 4.6\%$. The effect of juniorisation is more pronounced for a less indebted country (since the risk of default is concentrated on a smaller volume of securities), but these are also the countries that are the least likely to use the mechanism. It is worth noting that this rather simplistic approach to simulate the impact on interest rates on junior debt tends to exaggerate the effect of juniorisation since it does not take into account the potential decrease in the average cost of the debt related to the credibility effect mentioned earlier.

With regard to the risk posed on the fiscal sustainability of "core" countries, an extreme scenario can be used to quantify it where the six countries affected by the public debt crisis (Ireland, Greece, Spain, Italy, Cyprus and Portugal) would fully benefit from the mechanism but would then default. French and German debts would increase by about 10%. The impact of this hypothetical increase in debt on the interest rates of these two countries is extremely difficult to quantify.

[a] Rounded figures.

a prerequisite to banks entering the Mechanism. This audit must allow for an evaluation of recapitalisation needs on the basis of credible adverse scenarios. It requires an analysis of the value of assets as well as an accurate mapping out exercise of creditors and shareholders (for example, by type of investor and by geographical area). This mapping is essential for evaluating the contribution involvement of private investors in the restructuring phase.

Except in very specific cases, depositors are to be excluded from private investors who may be compelled to contribute. With this in mind, the proposal for a "establishing a framework for the recovery and resolution of credit institutions and investment firms"[18] should include a "seniority element for the depositor". Strengthened protection via the deposit guarantee could also help to assuage any fear which we know can be a serious systemic risk factor.

All other bank creditors must contribute, including senior creditors (and even when a non-systemic institution's solvency is questioned). Impairment of assets can give rise to several types of measure that are not mutually exclusive: recapitalisation through private shareholders, restructuring of debt borne by creditors, transfer of assets to a bad bank, of which a major portion of the funding should consist of equity and quasi-equity subscribed by private investors.[19]

Only when private sector resources prove to be insufficient, either due to a real danger to the solvency of creditors who are themselves 'systemic' or because the amount of debt reduction would be too small, should a bail out by the public sector be considered. In this ultimate case, a second level of loss sharing would apply, sharing the burden between the country of origin and the countries affected by the bank in difficulty (due to the presence of subsidiaries, for example)

[18] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:en:PDF, June 6, 2012

[19] The experience of the Spanish bad bank shows that it is not easy to appeal to private investors' equity. Binding rules are therefore necessary. For example, the largest institutions of the country should mandatorily subscribe to the structure's capital.

would be considered with, as a last recourse, the possibility of accessing the ESM.[20]

Proposition 4. Complete the first phase of the banking union by the beginning of 2014: Independent audits of all Euro area banks, under the control of the ECB/SSM; restructuring when needed, respecting the pecking order of debt instruments and limiting public funding to 'systemic' cases as a last resort.

A new crisis management tool

In the event of a new loss of market confidence vis-à-vis a Member State, the Euro area is still poorly equipped. It can offer the assistance of the ESM supplemented by the ECB purchase programme (OMT), conditional on a reform programme. But aside from the fact that this mechanism is heavy and unattractive for the States, no tool currently exists to restructure public debt in an orderly manner. In the absence of an explicit sovereign debt resolution mechanism, it is difficult to know for sure whether the OMT programme is a monetary policy tool (to counter a liquidity crisis) or a fiscal one (to counter a solvency crisis). And yet, the cleaning up of banks' balance sheets could increase public debt further for some Member States, raising the risk of a resurgence of the sovereign debt crisis.

We propose a mechanism whereby a country that has gone through the cleaning up of its banking sector validated by the ECB can become eligible to a limited and temporary exchange of its public debt.[21] A European Debt Agency (EDA), created as a stand-alone institution or integrated within the ESM,[22] would undertake the exchange: it would acquire, on the secondary market and at market price (through reverse auctions), sovereign national bonds, against jointly and severally guaranteed euro area bonds. Conducting the exchange at market price (and not at face value) allows for an orderly restructuring in the event of a crisis since the exchange price would be determined by the market. The discount, and therefore the debt reduction, would thus be directly linked to the loss of market confidence. Sovereign bond holders would be offered bonds issued by the EDA in exchange of their old securities with a value equal to the market value of the security sold. The reduction in net present value post transaction would reflect partially a lower flow of interest and a longer maturity. The exchange would be limited in its amount to 20% of the GDP of the country concerned and in time (25 years).[23] Regular payment of interest on the bond would apply on the same principle as for the ESM. For countries under an ESM programme, compliance with the programme would also be mandatory. If these conditions are satisfied, maturing bonds could be renewed under this mechanism during the first 10 years.[24] Repayments would be spread over 15 years, from the 10th year. The value of bonds to be repaid would be linked to market value at the time of exchange, so that debt relief is effective.

A classic objection to any proposed debt exchange is that the portion of the debt exchanged typically becomes 'senior', that is, it gains priority in terms of repayment, relative to the rest of the debt, which then becomes 'junior' –even if only implicitly- with an interest rate that risks rising sharply. This effect is however severely limited if the exchange involves an amount of debt that does not exceed 20% of the GDP (Box 4). In addition, it could be partly offset by the incentive structure of the mechanism to pursue fiscal adjustments. Indeed, each State would regularly need to conduct new exchanges with the EDA for maturing securities and any failure to pay the EDA in time or any significant departure from ESM reform obligations would be severely penalised with the country in question forced to to repay its national bonds at their due date at face value. Conversely a country pursuing its path of adjustment would benefit from decreasing interest rates as its repayments are made. In any event, the exchange should

[20] This distribution of losses between countries has, for example, been proposed by Goodhart C. and D. Schoenmaker (2009): "Fiscal Burden Sharing in Cross-Border Banking Crises", *International Journal of Central Banking*, vol. 5, no. 1, pp. 141-165. Providing for the potential involvement of the ESM in recapitalisation of certain banks is needed to make the process credible and, if applicable, to avoid a new outbreak of the sovereign debt crisis, or even a challenge to the single market.

[21] Our tool is indeed a debt swap and not a debt buyback transaction. The difference between the two mechanisms is that in the first case the creditor receives a new bond in exchange for the national bond while in the second it would receive a payment in cash. The debt swap transaction avoids potential problems of access to the markets that the debt agency could face if it were to fund buyback transactions. If the market is liquid, both transactions are equivalent.

[22] The ESM has the advantage of already existing and being supported by a treaty. However, the debt swap we are proposing is not part of its mandate and it would be necessary to significantly increase its size and structure. The mechanism proposed could fit into the framework of Article 352 of the Treaty.

[23] The limits imposed on the mechanism should allow the European Court of Justice and the Court of Karlsruhe to validate it as in the case of the ESM, even if the amounts considered here are much higher. It can be calculated (ref. Box 4) that in an extreme scenario where six peripheral countries that have benefitted from the mechanism default on the swapped debt, the loss for Germany and France would still be less than 10% of the GDP of these two countries.

[24] The swap would cover all debt maturities in order to avoid distorting the maturity structure of the debt not swapped (and therefore to effectively extend its average maturity). At maturity of the securities exchanged, the State concerned would "repay" the EDA with a new security of the same maturity as that matured, for a value corresponding to the price paid by the EDA at the time of the exchange transaction and at an interest rate based on the market rate for transactions not exchanged with the same maturity. Only from the tenth year would the State repay the matured securities using fiscal resources.

[25] Techniques exist to limit this effect, such as "cross default" clauses or by suspending the voting rights of the EDA in any negotiation for debt restructuring if it were to occur. In any event, the EDA must not have the status of "senior" creditor, which can be compensated for by partial collateralisation of the exchange.

be shaped to minimise the effect of implicit or explicit subordination.[26]

Benefits for the fiscal sustainability of the Member States concerned would come from three mechanisms:

- the discount at the time of the exchange. For example, if the market price is 40% below face value at the time of the exchange, the debt reduction is up to 40% x 20% = 8% of the GDP, assuming unchanged interest rate and maturity ;
- extension of maturity: indeed there would be a moratorium on interest payments on part of the debt for 10 years (the part swapped with the EDA), allowing the country to focus on the debt that remains national. At the end of the 10 year period, repayment conditions would be easier. For example, the value of public assets eligible for privatisation would have likely recovered;
- fiscal adjustments with greater credibility, due to the risk of renationalisation of the swapped debt in the event of default by the beneficiary State and the pressure maintained through market interest rates during exchanged debt refinancing transactions.

Added to these three factors are the positive effects of a European integration process and a readily available crisis and solidarity management tool.

Another potential challenge to our debt exchange mechanism is Article 125 of the Treaty under which a Member State cannot be jointly responsible for the debt of another. Although this question must ultimately be answered by lawyers, at this stage opinions diverge on whether a mechanism involving fiscal solidarity is compatible with the Treaty or not.[27] In any event, our proposal falls short of the redemption fund proposed by the German Council of economic experts, which envisages pooling of all debts in excess of 60% of GDP over 25 years.[28] Furthermore, it relies on *ex ante* conditionality in terms of past actions by States (cleaning-up of bank balance sheets) which is both incentivising and safe.

Finally, the mechanism we are proposing would protect the ECB from the risk of having to intervene massively and permanently under the OMT (which, as we have seen, would constitute a *de facto* and potentially greater pooling of national debts via the ECB's balance sheet).

Proposition 5. Conditional on the cleaning-up of the banking sector, create a mechanism allowing the exchange of national debt for bonds guaranteed jointly and severally by Euro area Member States, limited to 20% of the GDP over 25 years, with assigned resources. The mechanism could be activated in times of crisis, upon a decision by the ESM. Repayment of this debt would be scheduled from the 10th year.

European capacity for fiscal stabilisation

Beyond crisis management arrangements, it is necessary for European policy makers to consider how to collectively restore a capacity for fiscal stabilisation against fluctuations in activity of each Member State as well as the area as a whole. Some proposals put forward above (prequalification mechanism automatically opening a precautionary financing line with the ESM, European unemployment insurance) go along these lines. At the end of a successful transition, these mechanisms could be reinforced to give rise to a European fiscal stabilisation capacity, that is, a capacity to adjust the fiscal balance over time to mitigate fluctuations in activity. Two paths can be envisaged, both based on the changes in governance suggested above:

- the path of fiscal coordination: the EDA would issue annually, on behalf of each country, an amount of debt corresponding to the authorised deficit. This would allow ex ante supervision of States with an incentive not to exceed the agreed deficit limits (since the State should then issue the additional debt itself, without the benefit of its partners' guarantee). Each new issue would require a binding commitment to increase fiscal resources for the EDA. This arrangement, which does not lead to any permanent rise in debt for Member States (since only deficits in response to a deteriorating economic situation would be authorised with surpluses being required in the upper part of the cycle), could be implemented under Article 352 of the Treaty, with, if applicable, enhanced cooperation;[29]

[26] This discount mechanism raises the problem of "free riders": by reducing total debt, the discount improves the prospects of repayment of the debt that remains national, which risks encouraging holders of such debt to retain it rather than bringing it to the exchange and raising the price of the bond at the time of exchange, reducing the effectiveness of the exchange in terms of debt relief. Ultimately, the price could rise to a level at which the exchange becomes useless. In this case, the absence of exchange does not reveal a failure of the mechanism, since the rise in price translates de facto in renewed confidence. Thus, the proposed mechanism can play a stabilising role, even if it is not activated.

[27] For the European Parliament (Report on the feasibility of introducing stability bonds, Sylvie Goulard, adopted January 16, 2013), this type of exchange could be done under Article 352 of the Treaty.

[28] German Council of Economic Experts (2011): "A European Redemption Pact", *Working Paper GCEE*, no. 2/2012, February.

[29] Enhanced cooperation would favour the arrangement's legitimacy by involving the European Parliament.

– the federal path: the fiscal balance required for each Member State would be compensated by establishing a Euro area budget based on own resources,[30] with the possibility of cyclical imbalances financed by issuance of common debt. The budget would be proposed by a Euro area Treasury and voted on either by the Council (in the framework of existing institutions) or by the European Parliament within the framework of the Euro area (under a new Treaty). Note that if a change in the Treaty is consistent over time with such an approach, it is not necessary in an intermediate phase, to the extent that no additional permanent debt is created and where the legitimacy of the Council can be relied upon.[31]

The three pronged approach described above could leave some Euro area members on the side-line, either because they were not able to clean up their balance sheets within the allotted time or because they did not wish to participate in the fiscal integration process. As for the monetary union, it is important to allow countries to join the group later. Nonetheless, the risk of a loss in market confidence would be high for a country that does not participate, if the others do participate. One could think that the prospect of collectively recovered fiscal sovereignty will act as a powerful incentive to participate in the process over time.

Proposition 6. At the end of a four-year fiscal consolidation process, rebuild a shared fiscal sovereignty through a Euro area budget or the centralisation of national budget balances' decision making, with the possibility of financing approved deficits through issuance of common debt.

Conclusion

The proposals recommended in this Note are intended to complement the institutional architecture of the Euro area, which the sovereign debt crisis has revealed to be inadequate and fragile. The proposed measures affect areas in which the interdependencies have become so strong that the principle of subsidiarity is no longer able to support the structure: regulation of banks, coordination of fiscal policies and growth policies. The proposals also provide a response to a potential resurgence of the crisis, which complement a credible process of addressing legacy issues and a transition to restoring shared fiscal sovereignty. ●

[30] Based on the proposed Common Consolidated Corporate Tax Base (CCCTB), a corporate tax could be designed, for example, that is *de jure* national but *de facto* European.

[31] In a later phase, extending the ambition of a Euro area budget could be envisaged, in particular by having it take charge of allocation expenses financed by debt. An advantage would be to create a liquid market for Eurobonds. However, such a development would lead to redefining the division of roles between the Euro area and the European Union; in addition, it would require a change to the Treaty to the extent that Member States would become jointly liable for a common and permanent debt.

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