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WHAT MODEL FOR THE FUTURE OF THE EUROZONE?

CRITICAL ACTIONS

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While the euro area has undertaken reforms since 2010 that have allowed it to avert a breakup, its current institutional makeup lacks coherence. Member states are going to have to rethink the Maastricht compromise if they are to set this predicament right. Three different models, which are each coherent in their own right, could realistically be considered. The first one would seek to return to the original principles, combined with complementary mechanisms to guarantee the credibility of the strict rule of non-solidarity on member states' sovereign debt. It would reestablish fiscal sovereignty but with the risk of undoubtedly more frequent and costly public finance crises. The second model, which would consist of reinforced fiscal integration and joint liability regarding sovereign debt, would provide stability but imply placing national parliaments' fiscal sovereignty under the control of a European legislative body. The third model would seek to replicate the US model of fiscal federalism to the eurozone: macroeconomic stabilization would be provided by a common budget, but member states would be solely responsible for their debts in return for wider latitude in defining their national fiscal policies.

CHOICES AND MODELS FOR THE STRUCTURE OF THE EUROZONE

	Central stabilization Eurozone budget	Coordinated stabilization Fiscal coordination	No stabilization of the eurozone
No solidarity + Fiscal sovereignty	US model (Option 3)	*Ineffective*	Maastricht 2.0 (Option 1)
Solidarity + Rules framework	Reinforced integration (option 2)	*Current situation*	*Ineffective*

Faced with the threat of breakup several times since the outbreak of the crisis in 2010, the euro area has responded with incremental adjustments aimed at buttressing its institutional structure. It created the European Stability Mechanism (ESM), providing financial assistance to Greece first and then to others to avoid a disorderly default that would have proven fatal for the European financial system. Having failed to prevent the excessive buildup of public debt, it responded by strengthening fiscal discipline, namely the Stability and Growth Pact (SGP). This came however at the cost of added complexity through more detailed rules and stronger penalties. The euro area also created a new procedure to identify, prevent and correct for macroeconomic imbalances, recognizing in the process that it had overlooked the consequences of its internal economic divergences. However, the corresponding mechanism has not been activated. The decision to create the Banking Union in 2012 was the last phase in this institutional overhaul. As yet unfinished, this wide-reaching reform consists of an integrated framework for supervising and resolving bank failures to prevent national banks from bringing down states when they fail during a crisis.

These incremental adjustments have taken the euro area further and further away from how it initially shared out different mandates. Monetary policy was to be entrusted to a single independent central bank, with the expectation that it would provide sufficient macroeconomic stabilization in the event of an economic shock affecting all member states equally (so-called "symmetric shocks"). In the event of an asymmetric shock, member states would be free to use their national budgets to provide stabilization on condition their deficits didn't exceed 3% of GDP.[1] It was up to the member states to ensure their deficits and public debt would not jeopardize their ability to respond in the event of a crisis. The no-bailout clause of the Maastricht Treaty, which prohibits joint liability on member states' public debt – but was widely interpreted as precluding financial assistance for a state having difficulty accessing the bond markets – was supposed to help enforce market discipline and prevent countries from pursuing policies that would put them at the risk of insolvency.

The reforms undertaken since 2010 to avert a breakup of the eurozone come at the cost of an incoherent institutional makeup. By coming to the aid of member states in difficulty and ruling out the possibility of a default, the euro area legitimized reinforcing fiscal discipline. However, a number of states today cannot shore up their economies because of the rules in place, which threatens their ability to handle a full-on crisis. ***The logic of the initial Maastricht setup, which intended to preserve the stabilization capacity of national budgets in the event of an asymmetric shock, is for all intents and purposes ineffective in several eurozone countries.*** Recent experience shows that in certain circumstances fiscal policy may need to buoy monetary policy action, but this could mean waiving the rules on fiscal discipline. To sum up, the framework for action initially attributed to fiscal policy is outdated despite its necessity for guaranteeing the zone's integrity in a crisis.

Because the recent reforms have not fundamentally refashioned the balance struck by Maastricht, they have made the eurozone incoherent without resolving the problems undermining it. One of the reasons the eurozone is struggling to move forward today is because it has reached the limit of what can be done without reassessing the very institutional paradigm it is based on.

Member states are going to have to reexamine the Maastricht compromise and clarify the terms of the contract made between them if they are to build a more stable institutional base.

The choice can be summed up by the answer to two questions that determine the zone's overall institutional structure:

- Are member states willing to abide by the common rules of fiscal discipline? If so, are they willing to take on a form of joint liability on their public debt? Or would they rather keep responsibility for public debt strictly national?

- Do member states want fiscal stabilization for the euro area as a whole? If so, do they want this to be centralized via a common budget? Or would they prefer it to be decentralized by coordinating national fiscal policies?

France's position is not without its ambiguities and contradictions. Its unwavering support for an unclear 25-year-old concept – "economic government" – is no longer enough to deal with the current challenges. If it hopes to weigh in on the future of the euro area, France must take a stand with respect to these strategic choices. Once it has done so, it must accept the inherent trade-offs to maintain the coherence of the project as a whole. Only when French preferences have been clarified can it engage in dialogue with Berlin and our other partners.

Moreover, none of the available options can be implemented without addressing the issue of legacy debt, in particular that resulting from the financial crisis. This problem is in part responsible for the blockages preventing the eurozone from making progress towards a more coherent institutional structure. The temptation to deal with this obstacle is legitimate, but by focusing discussions on zero-sum games, it could well lead to an impasse. It is first necessary to flesh out the characteristics of a permanent system: only with a framework agreement on the objective will it be possible to resolve the problem of legacy debt.

1. National budgets were to ensure stabilization in the event an economic shock hit one or a group of countries. On the other hand, if a shock were to hit the euro zone as a whole, monetary policy was also to act as a stabilizer.

OPTION 1 — RETURN TO THE ORIGINAL PRINCIPLES, COMPLEMENTED

The initial compromise was defined by the following two principles: fiscal sovereignty at the national level, constrained only by a small number of non-binding rules in practice; and an ex ante prohibition of bailouts, which was supposed to encourage prudent fiscal policies. In this context, the main constraint on fiscal policy was to be provided by market discipline, and national budgets would be in charge of fiscal stabilization as long as market access was not compromised.

It would be possible to return to the original principles, especially as the banking union now better protects governments from banking crises. But a revamped compromise wouldn't simply mean a return to the original institutional structure because the crisis has revealed its fragility. Markets have failed to ensure fiscal discipline through interest rates either because they were short-sighted or because the no-bailout clause was not credible[2].

2. Events have proven them right: European leaders in the end judged the collective costs of a Greek default to be too high for the euro area to bear.

Additional features are therefore indispensable if the eurozone model is to weather a new crisis. Adding on more restrictive rules is not a politically acceptable solution because it would amount to renouncing part of fiscal sovereignty with nothing in return. ***The features would need to guarantee the effectiveness of market discipline and therefore the credibility of a strict principle of non-solidarity in the event a member state's debt level puts it at risk of default.*** The necessary condition for this is the euro area – and more specifically its banks – be ready to absorb the economic cost of a potential default. Two courses of action are inevitable if these demands are to be met:

- On the one hand, regulatory treatment of sovereign debt would need to be modified to make banks less vulnerable to a potential sovereign default. Current regulation encourages bank holdings of sovereign debt by assigning such bonds a zero risk weight, entailing no capital surcharge. This special treatment should be discarded and regulation should encourage greater portfolio diversification to avoid excessive bank exposure to any single sovereign.

- On the other hand, the renewed institutional structure would need to provide ex ante for the possibility of a sovereign debt restructuring, coupled with a mechanism to provide liquidity until market access is resumed.

Under normal conditions the only limits on fiscal policy at the national level would be those imposed by markets, as was already the case at the time of the European Monetary System (ESM). European fiscal rules – namely the 3% and 60% rules for the deficit and debt – would cease to be restrictive without resulting in moral hazard. ***In the event of a sovereign debt crisis, public debt would automatically be rescheduled in exchange for temporary liquidity assistance provided by the ESM*** and potentially restructured in case of a default. This would not cause financial instability as the financial system would have been forewarned of the risks and would be able to absorb the losses.

This system, however, has its risks and limits. The possibility of debt restructuring would likely amplify public finance crises, with a risk of strongly restricting the ability to respond fiscally in the event of an asymmetric shock. By explicitly allowing for the possibility of a sovereign default, this option would amount to questioning sovereign debt's status as a safe asset. Solutions could perhaps be found in financial engineering,[3] but they pose their own set of practical challenges.

3. For example, creating a "synthetic" financial instrument made up of different sovereign bonds, with favorable regulatory treatment, or creating junior and senior debt for each country, the latter being backed by a debt instrument identical for all eurozone countries. See, for example, J. von Weizsäcker and J. Delpha (2010), "The Blue Bond Proposal", *Bruegel Policy Brief*.

OPTION 2

FURTHER PROGRESS IN EUROPEAN FISCAL INTEGRATION

A stricter approach to the principle of individual responsibility on member states' debt would increase the likelihood of sovereign debt crises. Experience has shown that ***markets are prone to sudden and disproportionate changes in sentiment when a state's solvency is on the line***, leading to crises in countries that were previously considered solvent.

Significantly reducing this risk would require some form of joint liability on all or on part of member states' public debt. The exact mechanism for implementing this joint liability is not that important: in each instance it is likely to lead to a permanent transfer of wealth from one member state to another in the event of a major crisis. In other words, this means taxpayers of one member state may be called on to bail out another country. This is not an undesirable side effect of joint liability; on the contrary, it is joint liability's defining feature.

It is evident that such joint liability – even if it were partial – on public debt would need to be underpinned by more binding constraints on national budgets and would imply strengthening the democratic legitimacy of the procedures designed to enforce this discipline at the European level. As the current rules have shown their limits, this option would imply some sort of co-decision mechanism on national budgets to ensure that supranational scrutiny becomes legally binding at the national level. In effect, the fiscal sovereignty of national parliaments would be put under the control of a European legislative organ, at least for the overall fiscal envelope. This right of scrutiny would probably need to apply to a wider field of economic and social policies to prevent macroeconomic divergences, which, if allowed to deepen, would increase the risk of permanent transfers of wealth between countries.

Where would macroeconomic stabilization come from with this setup, given that national sovereignty on fiscal matters would be constrained by rules at the European level?

A member state with high public debt would have little fiscal space available for macroeconomic stabilization due to the risk that larger deficits might imperil fiscal sustainability and increase the likelihood of financial transfers between member states. ***Macroeconomic stabilization could in theory be implemented in two ways: through a centralized fiscal capacity or through the coordination of national budgets.*** The first option would imply transferring part of national budgets to the European level, along with the corresponding competencies, whereas the second option would imply fewer degrees of freedom in the definition of national fiscal policies. Given that joint liability would require a more binding framework for national budgets, it would seem logical to opt for fiscal coordination to achieve stabilization through the spillover effects of national fiscal policies on other countries.

Adapted by Richard Venturi, based on *"Quelle architecture pour la zone euro ?"* by Christophe Gouardo Vincent Aussilloux

There is, however, substantial controversy on the size of these spillover effects,[4] which makes coordination problematic. As a result, a central budget or a common borrowing capacity would most probably be necessary.

This option has solid intrinsic coherence. It is likely to significantly reduce the probability of sovereign debt crises and the severity of negative shocks. In effect, if a state were to see its ability to implement policies aimed at macroeconomic stabilization hampered by excessive borrowing costs on the markets, high public debt or simply the fiscal rules, it would benefit from the stabilizing effect of other national budgets combined with a common fiscal capability.

This setup would imply making substantial progress towards economic integration and sovereignty sharing. This is why the governance of the euro area would need substantial reform to ensure the new setup is imbued with sufficient democratic legitimacy.

OPTION 3 — COMBINE NATIONAL AUTONOMY AND A EUROPEAN FEDERAL BUDGET

In the United States, the responsibility for public debt at the state level lies with the states themselves. In return, despite the fact that most states have developed their own fiscal rules, the federal government does not impose fiscal rules on them. However, when a crisis does occur, transfers from the federal budget – in particular in the form of unemployment insurance – provide some degree of macroeconomic stabilization.

This setup could be replicated in the euro area to combine the desire to reinforce fiscal sovereignty at the national level – no longer constrained by European rules – and the need to create an instrument tasked with macroeconomic stabilization at the level of the eurozone. This model would share some of the features of the first model, namely a strict prohibition on bailouts, implying rules to prevent excessive exposure of banks to public debt and a mechanism to restructure sovereign debt if needed.

The stabilization function would require setting up a centralized budget with its own resources and spending responsibilities, which would substitute for certain taxes and spending currently implemented at the country level. To ensure a budget of a sufficient size, it could be complemented by a borrowing capacity that could be used in times of crisis to raise funds and invest or spend them in crisis-ridden countries.

What would the minimal conditions be for a stabilization mechanism of this type to be created while preserving the principle of no joint responsibility on national sovereign debts? Taking into account limited progress in terms of political and economic integration and solidarity, ***the stabilization function would need to be designed in such a way so that it does not lead to permanent transfers between countrie***s. Each member state could either be a net contributor or a net beneficiary depending on their economic circumstances. These flows would be balanced out over time so that on average each country would pay in as much as it receives. A large body of research on unemployment insurance schemes, for example, has shown that in practice it would be possible to design such a system.[5]

Unconstrained by European fiscal rules, member states would be free to define their fiscal orientation. They would, however, suffer the consequences in the event of a crisis. In the case of an asymmetric shock, macroeconomic stabilization could still be implemented at the national level but would be complemented by transfers from the eurozone budget. If an excessive debt burden or high interest rates forced a member state into fiscal adjustment, a central budget would protect part of the stabilization capability, helping to prevent national spending cuts or tax increases from amplifying the effects of the economic cycle. If a country were to lose market access, it would turn to the ESM for liquidity support in exchange for a restructuring of its debt.

This setup would not be the most efficient at preventing sovereign debt crises, but it would help to dampen the effects of such crises were they to occur more than in the first scheme. Moreover, it would allow more autonomy in conducting national fiscal policy. However, given the possibility for a sovereign default and the limited size of the budget, cyclical variations would be much larger than in the second option.

4. See in 't Veld J. (2016), "Public Investment Stimulus in Surplus Countries and their Euro Area Spillovers", *European Economy*, Economic Brief 016, October (http://ec.europa.eu/economy_finance/publications/eeeb/eb016_en.htm), for a review of recent research on this.

5. For example, see Dolls M. (2016), "Chances and Risks of a European Unemployment Benefit Scheme", *ZEW Policy Brief* No. 7 (http://ftp.zew.de/pub/zew-docs/policy-brief/pb07-16.pdf)

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France Stratégie launched its "2017/2027" project to both foster and inform debate among citizens ahead of the 2017 presidential elections. It aims to zero in on what is likely to shape policy over the next decade and examine the different choices facing the country and the divergent paths it may take. It has published on a dedicated website a series of papers on key issues since March 2016. Experts and civil society representatives have also made contributions. None of the documents published reflect the government's official positions.