Counterproductive Proposals on Euro Area Reform by French and German Economists

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Marcello Messori (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=290487)
University of Rome Tor Vergata - Faculty of Economics

Stefano Micossi (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=796658)
Associazione italiana delle società per azioni

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Abstract

In this contribution, Marcello Messori and Stefano Micossi find that the latest proposals by a group of French and German economists for euro area reform, despite the authors' best intentions, would heighten the risks of financial instability and weaken defences against financial shocks.

In their CEPR Policy Insight No. 91, Bénassy-Quéré et al. (2018) offer a comprehensive and sophisticated attempt to bridge the gap separating French and German policy-makers on European Economic and Monetary Union by completing Banking Union and establishing a credible system to enforce budgetary discipline and bring down sovereign debt-to-GDP ratios.

Our comparison between Bénassy-Quéré et al. and Schäuble's October 2017 non-paper – which we have taken as the unmitigated expression of the German ordoliberal view – indicates a quasi-complete coincidence of policy recommendations. Prior sovereign debt restructuring is at the centre of the proposed new governance arrangements, a sure harbinger of renewed instability. The understandable concern to establish a harder budget constraint on national fiscal policies has in our view been pushed too far.

Even more worrisome, in their quest to uproot moral hazard, Bénassy-Quéré et al. propose to eliminate from the euro-area governance arrangements all room for meeting shocks with liquidity instruments. They want banks to be "structurally" excluded from purchasing own national sovereigns in situations of distress. And they want to all but remove the financial stability exceptions for the activation of bail-in in the Bank Recovery and Resolution Directive (BRRD) and the related provisions for state aid to the banks. They would thus create an environment in which any idiosyncratic shock hitting a highly-indebted country would push it into the arms of the European Stability Mechanism (ESM), where its sovereign debt would be mercilessly restructured before any financial assistance could be considered.

Investors would no doubt take notice and flee well in advance. Their proposed new lending window at the ESM does not address this issue since the new facility is limited to member states that are not at risk of losing market access.

Thus, far from succeeding in their stated goal of making the euro area more stable, these proposals heighten the risks of financial instability and weaken euro area defences against financial shocks. Therefore, in our view they do not offer a basis for a viable compromise on the future governance of the euro area between France, Germany and the other member states of the euro area.

Keywords: Euro Area Reform, Financial Instability, Banking Union, Sovereign Debt

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