2 A European Stability Fund for the EMU

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There are two related issues currently on the EMU agenda: the need to strengthen the European Stability Mechanism "as a robust crisis management mechanism" (European Commission 2017a), and the need to enhance the EU's capacity to provide risk sharing and fiscal stabilisation (Junker et al. 2015). Building on our ADEMU work "On the optimal design of a Financial Stability Fund" (Ábrahám et al. 2018), my co-authors and I show that the most efficient design would be to merge both functions into a *European Stability Fund (ESF)*, which would effectively transform current risky debt liabilities into safe *fund contracts*, taking the form of long-term state contingent bonds subject to endogenous constraints, to avoid undesired redistribution or implicit bailouts and moral hazard problems. With this design as a *constrained efficient mechanis*m, the ESF should also confront two additional pending issues: the 'debt overhang' problem, and the development of EU safe assets. Furthermore, the ESF can be implemented with minimal changes to the current structure and legal status of the ESM. In this chapter, I briefly summarise these findings.

One recognised problem with the EMU design is how country- or region-specific shocks can be smoothed, given that there is a common currency and there are limitations on fiscal national policies (the *Fiscal Compact*). Even under the present, more flexible interpretation of the Stability and Growth Pact, the ability to share risks is very limited compared with federal systems, where the same federal budget provides some risk

sharing to imperfectly correlated shocks across the federation.[1] Ferrari and Rogantini (2017) have shown, using counterfactual analysis, that being in the euro area has not helped to smooth consumption – in particular for countries on the periphery. The development of the European Banking Union can help to pool risks, but it is unlikely that it will have the smoothing effect that pro-cyclical local tax revenues have in federal tax systems. Similarly, it can be argued that the ESM can help to smooth consumption, but it is not designed as a risk-sharing mechanism, rather as a crisis-resolution mechanism. As we will see, there are gains to be had from integrating both functions.

A well-designed European Stability Fund must, on the one hand, take into account the constraints within which it will operate and, on the other hand, deliver the desired outcomes, which should constitute its mandate. In particular, three constraints need to be accounted for:

- First, ex post solidarity in a heterogeneous union is limited (i.e. risk-sharing transfers should not become persistent transfers beyond some mutually accepted limits).

- Second, as with any insurance scheme, there may be moral hazard problems, since idiosyncratic shocks (for example, welfare state commitments) can have an important endogenous component but, due to limited information or to sovereignty, the contract cannot be made 'conditional on the effort' that best policies require.

- Third, a 'union of sovereign heterogeneous countries' means that risk profiles and policies can be very different. In other words, what is needed is the design of a *constrained efficient risk-sharing mechanism for heterogeneous participants*.

In our quantitative models, efficiency is measured in welfare gains (more specifically, consumption equivalent gains), but it is important to list other tangible desired outcomes, and we mention five: i) risk sharing and consumption smoothing; ii) fiscal

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1   Furcieri and Zdziencka (2015) estimate that in the EA15 over the period 1978–2010, 70% of countries' business cycle shocks were not smoothed, while the percentage is substantially lower in US states (25%) and in German Landers (20%). Using their methodology, the estimate for the EA19 for 1995–2015 is 83% (M. Lanati, Max Weber postdoctoral Fellow of the EUI).

stabilisation (i.e. fostering countercyclical fiscal policies); iii) a high capacity to absorb severe shocks; iv) minimisation of productive and social distortions (often associated with fiscal consolidations); v) building up trust across the union.

The proposed European Stability Fund sets a long-term contract with each participating country according to its risk profile, specifying state-contingent countercyclical transfers designed in such a way that neither the country nor the fund has any incentive to break the contract at any point in time (for example, by stopping making their payments), so the country exercises the right amount of effort to reduce country risks, and at any point in time the present value of the contract for the fund is non-negative (i.e. there is no mutualisation of losses for participating countries).

It is interesting to note how the ESF mechanism compares with (*de facto* defaultable) long-term uncontingent sovereign debt contracts currently in place, when the risk-averse 'borrowing' country is subject to similar shocks that the euro area 'stressed' countries have been exposed to in the last ten years. As our calibrations and simulations show, without debt crises the real euro crisis would not have been so severe – for example, there would have not been the severe contraction of consumption that we have observed – and therefore the welfare of the borrowing country would have been better, even if *ex post* permanent transfers from the risk-neutral fund had been set to zero.

ESF risk-sharing transfers take the form of long-term (state-contingent) bonds, and the fund has an important capacity to absorb existing (non-contingent) debts; therefore it can also be seen as an institution that transforms non-contingent risky debts into contingent debts – effectively non-defaultable debts, to the extent that ex post, neither the debtor nor the lender wants to breach or renegotiate the contract. In other words, without questioning that highly excessive debts may need to be restructured, a fund contract has a much greater capacity to absorb existing debts (i.e. to deal with the 'debt overhang' problem) than a new, possibly very long-term, non-contingent debt contract. Furthermore, by its very design, the debt contract is a safe asset in the balance sheet of the ESF, which should make ESF debt offerings highly rated in the international market

and, if (when) it gains sufficient capacity, the ESF should be able to act as a backstop in the EMU, say, to the European Banking Union, or act as a fund of an European Unemployment Insurance System (EUIS).[2]

Why is all this possible? A simple answer is: because we show it theoretically and with a well-calibrated model of the euro area 'stressed countries'! A deeper answer is: because well-designed long-term (ex post) contingent contracts are powerful 'carrots' for participating countries, in a similar way that access to the ECB and ESM has been a key 'carrot' in the resolution of the euro crisis. However, the similarities and differences between these existing institutions and the proposed ESF are important. As with the ECB, participation of an EU country in the ESF should not be compulsory, neither should participation in it be a 'stigma'; on the contrary, it should be the normal stabilisation, crisis-prevention mechanism that EU countries use on a regular basis. In contrast with the ECB, and more similar to the ESM, it is a fiscal mechanism, not a monetary one (and hence its name). However, there are two important differences with the current ESM. First, an ESF contract does not presuppose, or require, a crisis situation. Second, the conditionality of an ESF contract is ex post (i.e. performance based) and not ex ante (e.g. conditional on agreeing to an austerity/reform programme); the former builds up *trust*, the latter *stigma and resentment*.

It is always possible? The obvious answer is: no! As with any constrained efficient mechanism, there are trade-offs, which can be of two types. The first type is between *the constraints themselves and efficiency*: the more stringent they are, the lower the gains of a fund contract, and at a certain point the stringency wipes out the gains altogether. For example, participation constraints become more stringent if a borrowing country can achieve the above objectives on its own, or if the political risks – say, of exiting the union – are high; and similarly, if the acting lender, the ESF, is obliged to be more stringent or must satisfy additional (e.g. legal) constraints.

The second type of trade-off is between *simplicity and efficiency*, which can take two related forms: the 'conditionality' of the contract, and 'how comprehensive' the fund contract is with respect to other government liabilities. A less contingent contract is

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2   See Chapter 3 in this eBook.

simpler in its design, but this entails a potential loss of efficiency and possibly an ex post, costly and complicated execution, as happens with uncontingent defaultable debt. But even if the latter cost is not present – say, with a 'rainy day' or 'large economic shock' insurance fund – there is a loss of efficiency in terms of implementing a countercyclical fiscal policy and smoothing consumption, since less contingency translates into more stringent participation constraints and less sensitive moral hazard constraints.

Similarly, it is simpler if the fund contract only covers a (small) fraction of a government's liabilities, without accounting for the rest; the 'rest' can be covered by standard debt contracts, for example. However, as happens with existing proposals for a European safe asset, these residual debt contracts may become more risky as these debts accumulate, threatening the same stability of the fund contract, unless the ESF can commit to a strict mandate of not rescuing countries in this situation. Unfortunately, such a strict mandate may not be possible, and a better – although more complex – design would be to properly limit the external debt capacity of a country with an ESF contract.

As can be seen, there are many risk assessment and contract engineering issues that need to be dealt with in designing ESF contracts. Our ADEMU work, building on current dynamic macro-contract quantitative theory, has developed the basic tools to make country risk assessments and to further develop ESF contracts. It will be the ESF's task to tailor them, in their specific technical and legal details, and implement them. EU law (a change of the ESM Treaty may suffice) and political accountability (also possibly similar to the ESM) can, and should, define the operational framework of the ESF. In any case, the ESF should be responsible for its contracts and, correspondingly, for its balance sheet. This will provide credibility to the ESF in the execution of its contracts, since it will be in its own interest to preserve the safety of its assets, namely, the ESF contracts.

A short comment on how our ESF proposal relates to two existing proposals to reform the ESM. With respect to the European Commission's proposal (European Commission 2017b),[3] our focus here is on the mission and design of the ESF and its contracts, not on

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3   See Chapter 10 of this eBook for a more in-depth discussion of the Commission's proposal.

whether it should be integrated into the EU Treaties or whether the ESM Treaty should simply be adapted, although the latter should suffice. More importantly, our proposal envisions a broader role for the ESF: to be the central institution to implement what the Commission calls the "Stabilisation Function" of the EMU (European Commission 2017c). With respect to the *French and German economists'* proposal (Bénassy-Quéré *et al*. 2018), we provide an overall framework into which their proposals for "a European fiscal capacity for large economic shocks" and "rainy-day fund providing liquidity" are integrated, and can be assessed; in particular, we consider constrained efficient, not just ad hoc, policies and contracts. It also differs in how fund contracts and 'residual debt contracts' should complement each other.

In summary, we have provided a theoretical and quantitative basis for the design of a European Stability Fund as a 'constrained efficient mechanism' which should substantially enhance the capacity of the European Union to: i) provide risk sharing and fiscal stabilisation in normal times; ii) provide insurance against severe country, or regional, shocks (in other words, the ESF would be a 'robust crisis-management mechanism)'; iii) absorb existing risky sovereign debts and transform them into safe fund contracts (i.e. it would confront the 'debt overhang' problem); and iv) develop a safe EU fiscal institution (i.e. it would be able to issue the 'safest' EU asset in the international financial market).

The strength of the design relies on considering the ESF as a key institution of the EMU, which is a 'long-term partnership' of sovereign countries. The credibility of the design relies on the fact that it accounts for existing EU constraints: first, in the heterogeneity across member countries (their structure, policies and liabilities); and second, in the respect for 'sovereignty', which implies that it should always be in the interest of the participating countries – and of the ESF – to satisfy the contract; that is, to neither default on, nor renegotiate, it (although country risk profiles may, and should, be updated if needed). This, in turn, imposes ex ante and ex post limits on redistribution (there is no redistribution in our benchmark design). Furthermore, having independent national policies may result in moral hazard problems that cannot, indeed should not, be solved by imposing 'austerity plans' or financial fines. The flexibility of the design relies on the fact that it can be accommodated to different degrees of risk sharing, or levels of severity of the constraints (robustness), although this may be

at the cost of losing efficiency. Finally, the proposed ESF can be developed out of the existing European Stability Mechanism (for example, by modifying its Treaty), and steps towards this transformation should in fact be improvements with respect to its current capacity and practices (e.g. ESM contracts), which have already been proved to be very valuable in the resolution of the euro crisis.

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