Fiscal union and the long road towards Eurobonds

Despite the reforms implemented over the past few years aimed at improving the euro area's institutional architecture, the Economic and Monetary Union remains incomplete.[1] This is shown by the constant stream of statements made by Europe's major political leaders in favour of making progress towards reforming the euro area institutions. Fiscal union is one of the areas that attracts most attention, because of its importance and because, over the past few months, some detailed proposals have been made.

A fiscal union includes many different elements and often proposals are made in only one or two areas. The reforms that need to be implemented can be divided into two broad areas. On the one hand, the improvement of the mechanisms that guide and support fiscal policy in Euro area economies. This includes both the set of rules that guide each country's fiscal policy as well as, eventually, setting up a body at a European level which could take over some economic policy competences. The other broad area of fiscal union is related to the financing of such competences.[2]

Over the past few months, the debate has intensified on both fronts. On the one hand, Chancellor Angela Merkel has come out in favour of setting up a European Finance Ministry (for euro area member states) provided that the current rules that govern the fiscal policy of euro area countries are reinforced. Her French counterpart, Emmanuel Macron, has gone one step further and specified what areas this Ministry should be responsible for: infrastructure investment, emergency financial assistance and support for member states in a recession. The French President, who is familiar with the German vision, also added that this Ministry should only be able to give aid to those countries that comply with the common fiscal rules. Although a definitive move towards fiscal union is still far from defined German and French positions appear to be nounc closer together make further progress, it is important to define the future Finance Ministry's rules and responsibilities with enough precision to secure the approval of the German position. At the same time, however, the French position will also require this Ministry to have enough room for manoeuvre so as to ensure that any policies implemented are truly effective.

The second broad area of fiscal union is even less defined. Little has been said on whether the future European Finance Ministry will be funded via ordinary transfers from member states or whether, alternatively, the via partial or total revenue from some tax. On the other hand, an interesting debate has certainly arisen regarding whether the creation of a Finance Ministry could be accompanied by the creation of a European debt instrument, a so-called Eurobond. Interest in this area is twofold. On the one hand, this could increase the scope of the policies carried out by the future Ministry of Finance. In recessionary periods, for example, when available resources are more limited but, at the same time, more necessary, the budget could be maintained or increased by issuing debt.

On the other hand, Eurobonds could contribute to increase financial stability in the euro area. This is because a significant share of each country's public debt is held by banks whose business is concentrated in that very same country. During the crisis, this meant that shocks were passed on from the public sector to the banking sector (and vice versa), amplifying its overall economic impact.

Thus, the creation of a European safe asset could encourage banks to diversify their sovereign bond holdings, which would help to break the loop between banks and sovereigns. Ultimately, it is also believed that the commitment countries would acquire when creating Eurobonds could help to eliminate the risk of a euro break-up – this weighed very heavily on the banking and public sectors of peripheral countries at the height of the crisis.

In this context, the European Commission proposed, in a recent article, the setting up of a euro area Treasury which would be responsible for jointly issuing a common debt instrument. However, this is seen as a medium and long-term goal. First, an agreement must be reached regarding the creation of a future Finance Ministry. In other words, before euro area countries can accept a new asset whose risk is shared by all members, an agreement must be reached regarding the use of these funds.

1. Specifically, changes were made to the governance framework at an EU level by setting up the European Semester, aimed at coordinating economic policies, and the Six Pack, to reinforce fiscal compliance. The Fiscal Compact and Two Pack were also approved to increase supervision and coordination of fiscal policies in euro area countries. Mechanisms were also set up to handle crises, such as the ESM (to recapitalise banks and provide member states in difficulty with liquidity), as well as making important advances towards financial union.
2. See, for instance, Allard, C. et al. (2013), «Toward a Fiscal Union for the Euro Area», IMF Discussion Note, September.

In the shorter term, the European Commission suggests that it might be useful, and feasible to introduce sovereign bond-backed securities or SBBS.[3] This proposal is based on the one made a few years ago by M. Brunnermeier *et al.*, whereby one or more credit institutions (public or private) would buy a diversified portfolio of euro area sovereign bonds on the secondary market using a transparent and predictable weighting system.[4] In order to finance this portfolio, two types of security would be issued: senior (European Safe Bond Assets or ESBies) and junior (European Junior Bonds or EJBies).[5] The latter would be the first to absorb any losses resulting from a country defaulting on its debt.

This initiative is unrelated to the creation of a European Finance Ministry and is aimed at improving financial stability in two ways. First, through an increase in the supply of risk-free assets in the euro area (assets denominated in euros with an AAA rating). Second, through a reduction in bank's exposure to sovereign risk in their home country by providing them with an instrument to help diversify their bond portfolio. This second element is important because, as it breaks the link between each country's sovereign risk and bank risk, economic shocks would have a lower impact.

To sum up, although fiscal union may seem like a distant goal that is difficult to achieve, some of the pieces of the puzzle are, little by little, being put in place. Europe has always progressed slowly. Nevertheless, there are moments in its history when far-reaching decisions have been taken. We are probably on the brink of one of those moments. And fiscal union is one of the areas where real progress could be made over the next few years.

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3. See Brunnermeier, M. et al. (2011), «European Safe Bonds», The Euronomics Group, abstract available at voxeu.org.
4. For instance, Brunnermeier, M. et al. (2016), «The Sovereign-Bank Diabolic Loop and ESBies», American Economic Review Papers and Proceedings, vol. 106, no. 5.
5. SBBS would be completely guaranteed by the underlying portfolio. In other words, the nominal value of ESBies and EJBies would equal the total nominal value of the member state sovereign bonds underlying these securities.