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ELEMENTS TO ADVANCE AGREEMENT ON EDIS

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The political situation in France (and hopefully in Germany) is creating a window of opportunity that must be seized.

The completion of the banking union with a joint deposit insurance (in Community parlance, EDIS) should be given the highest priority, and, indeed, be brought forward by the European Council under the new Leaders' Agenda. This is feasible if the main players in the Council accept the need to address the stumbling blocks holding us back with fresh eyes and constructive determination.

Completing the banking union should be recognized as a top priority because the current system remains exposed to potentially disruptive confidence and liquidity shocks hitting the banks of a member states, since depositors do not enjoy equal protection within the eurozone. More generally, persistent market fragmentation – a very adverse legacy of the twin financial crises of recent years that is too often underestimated – reduces the scope of private risk sharing through capital markets; leaving governments exposed to the fresh need of public resources when their banks are hit by idiosyncratic shocks, which in return raises the danger of reigniting the 'doom loop' between banking and sovereign crises.

EDIS would delink banking and sovereign risks and free banks to compete on equal terms throughout the eurozone; it would also encourage them to diversify their balance sheets and reduce home bias, including in their sovereign portfolios. The current tendency of national governments to postpone bank restructuring for fear of generating bank runs and contagion would be eliminated at the source.

[1] Opening remarks on eurozone governance presented by Stefano Micossi at the High-level meeting between French, German and Italian delegations on Europe, Paris, 26 October 2017.

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The objection whereby EDIS would be an instrument of sovereign risk sharing and, hence, by necessity, entail moral hazard is not well founded. Suffice to recall in this regard that the activation of deposit insurance would not be automatic but would be decided by a European deposit insurance authority – probably brought under the same roof with the Resolution Authority, the Single Resolution Board. Moreover, in the eurozone, bank capital has already been raised remarkably by the new CRR/CRD legislation, while the Single Supervisory Mechanism has proved to be an effective agent in holding bankers to proper prudential behaviour and has pressured them to strengthen their balance sheets. Appropriate prudential incentives could be set up to incentivize this diversification of banks' balance sheets – as has been proposed by recent influential studies - while shying away from measures that could introduce fresh asymmetries in banks' liquidity risks, adversely impacting sovereign paper markets; such as the attribution of positive risk weights to sovereign portfolios.

Specific safeguards could be built into EDIS to exclude any burden sharing for bank losses during an initial, appropriately long transition period. In this regard, it is worth mentioning the recent Commission paper updating their proposals for EDIS. Under this revised proposal, losses would be entirely born by national insurance systems in the initial phase, and EDIS would only provide liquidity assistance in cases of need. Any such loan would then be paid back by raising banks' insurance fees 'post factum', once the national insurance fund had been depleted. Moreover, the transition to the 'coinsurance phase', entailing burden sharing across national schemes, would be made conditional on a new in-depth examination of banks' balance sheets to assess whether legacy risks had been appropriately reduced.

It really seems that these proposals have the potential to overcome the different views of the member states and allow the EU to move forward to complete the banking union – a step of paramount importance for the stability of the eurozone.

There are also many other issues in eurozone governance that deserve attention, including the review of the Stability and Growth Pact and related ideas about a eurozone budget, minister of finance and special parliamentary procedures for decisions affecting the eurozone.

An important issue to be raised concerns the role of ESM in the new eurozone governance. The first aspect of this concerns what the distinctive functions of ESM would be in its possible, new role as a fully-fledged European Monetary Fund with an EU budget. It seems that a clear conceptual distinction must be established, whereby the EU budget would be devoted to the provision of European public goods, while all functions entailing the provision of liquidity, financial assistance and last-resort financial back-up within the eurozone would be entrusted to ESM. Thus, the EU budget should retain its present functions in the domains of structural reform, research and innovation, education, and agriculture (hopefully to be further reformed away from production and farm income subsidies). New revenue sources could be devoted to these tasks at the European level with appropriate 'own' taxes, of which includes the carbon tax and European share of the proceeds of the VAT, or, possibly, resource transfers from national budgets to cover the expense for functions transferred to the European level (e.g. defence expenditures). An open question remains on whether or not to envisage a new budget line for anti-cyclical budgetary interventions to complement national stabilizers for employment and investment protection when confronting a sharp recession. These functions would be undertaken on behalf of the entire Union and therefore properly belong to the Union budget.

On the other hand, ESM could be looked at as an instrument to not only provide financial assistance in time of distress to its members and banks, as already provided for in its statutes, but also to related tasks such as providing the needed back up to the Single Resolution Fund (under negotiation in the Council) and the Deposit Insurance Fund (to be set up with EDIS). Even further, ESM tasks could also be extended to the provision of liquidity to sovereign debt markets, e.g. to smoothen the diversification of sovereign portfolios by banks, thus preventing unwanted adverse consequences on spreads – keeping also into account that over the same period the demand for sovereigns in the eurozone will be reduced substantially by the end of QE. Two key conditions should be respected in the provision of assistance by ESM: they should only entail financing of a temporary nature, and they should not entail capital losses for the ESM. For instance, ESM could intervene to back up a national deposit insurance fund, but the resources would later be paid back by charging ex-post fees to national banks. Similarly, any losses falling on ESM from interventions in sovereign markets, in order to smoothen the diversification of banks sovereign portfolios, should be covered by national deposit insurance funds. In sum, ESM should not become a vehicle for the transfer of resources between eurozone members.

The final point concerns the role of ESM in economic policies and its relationship with the Commission's tasks in the surveillance of implementation of common economic policy guidelines. It is proper and appropriate that ESM financial assistance to distressed sovereigns within the eurozone be accompanied by adequate conditionality to restore a viable economic situation. However, the proposal to entrust ESM with broader powers in the implementation of budgetary discipline *in lieu* of the European Commission should be rejected – as it would push the governance of the eurozone in the undesirable direction of intergovernmentalism and weaken the legitimacy and acceptability of common policies in the eyes of the public opinion. However, this does not entail that the requests for more reliable application of common rules are unfounded and that the application of the SGP does not require some strengthening.

Useful References:

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