Approaches to strengthening the regulatory framework of European monetary union

The financial and sovereign debt crisis has confronted the euro area and its member states with major challenges, and has yet to be overcome. Reforms have been carried out and measures taken in many policy spheres. However, earlier calls to create a political or fiscal union and to fundamentally reform the EU treaties seem to have been silenced by the decision to set up a banking union. There appears to be insufficient political support for a significant transfer of sovereign powers from the national to the European level. As long as that remains the case, it is crucial to shape and strengthen the existing regulatory framework of monetary union over the medium to long term in such a way that it can reliably and lastingly deliver on its promise to act as a union of stability.

Despite all the coordination mechanisms in place, the euro-area member states have more or less free rein in economic and fiscal policy. Conversely, individual member states are responsible for their own debt, and both monetary financing and joint liability are prohibited. This accords with the fundamental principle that governments – and investors – should be accountable for their own actions. This implies that monetary union also has to be able to withstand the extreme scenario of a member state becoming insolvent. The original framework did not take adequate account of this aspect or, notably, its repercussions for financial stability. Although numerous reforms have been launched to combat the crisis, in many areas they have tipped the balance towards increased elements of joint liability. All in all, a number of challenges still lie ahead on the road to constructing a more cohesive framework that can better prevent future crises and, in particular, ensure that monetary policy remains focused on price stability.

This article outlines various approaches to making the European monetary union more resilient to crises in future. Strengthening financial stability is a key part of this process, and should include steps to curb the risks that sovereign solvency problems pose to particularly systemically important banks, eg by reducing the preferential regulatory treatment of sovereign exposures in the medium term and eliminating it altogether in the long term. Equally, the negative impact of bank distress on sovereigns should be minimised. To achieve this, banks' loss-absorbing capacity needs to be further strengthened. Where necessary, orderly resolution must be possible even for large, interconnected financial institutions without tapping public funds. In the area of fiscal policy, budgetary surveillance and the implementation of fiscal rules should be improved, and consideration given to an overhaul of the institutional framework. It also appears necessary to reinforce the disciplining effect of the financial markets on fiscal policy and to develop crisis management mechanisms which reduce moral hazard. Stability-oriented monetary policy crucially relies on its ability to resist pressure to step into the breach for overindebted banks or sovereigns.

Overview

Sovereign debt crisis an acid test for monetary union

The financial and sovereign debt crisis was an acid test for monetary union. At the height of the crisis, some member states lost access to the capital market, and there was speculation that some countries might exit the euro or even that monetary union itself was in jeopardy. While the situation in Greece has flared up again, the acute threats on the financial markets have receded on the whole, and the macroeconomic outlook has brightened. Nonetheless, the public finance situation in some member countries remains problematic. Just under half of the member states are still posting excessive deficits, and government debt has reached extremely high levels in some countries. At the same time, economic growth in the euro area is low. Although unemployment has been trending downwards since mid-2013, it remains very high. Structural reforms are necessary, and the private sector, which is still burdened by very substantial debt levels, needs to deleverage. The task of acute crisis management has largely been left to the central bank. Although the raft of non-standard monetary policy measures have helped to contain the crisis and its repercussions, in some areas, the central bank is now operating at the very limits of its mandate. Among other measures, the Eurosystem has launched purchase programmes which are expressly targeted at the government bonds of countries facing high risk premiums.[1] It has greatly expanded the collateral framework for monetary policy refinancing operations and taken contingency measures to provide massive liquidity.

Article focuses on proposals to stiffen monetary union's resilience to crises and better safeguard the role of monetary policy

This article first reviews the key causes of the crisis and the shortcomings it revealed in the regulatory framework underpinning European monetary union. Next, it briefly outlines the action taken in selected fields to prevent similar crises from occurring in future (see pages 15 to 37). It then looks at various complementary proposals to contain ongoing sources of risk and to fundamentally improve the monetary union's resilience to crises going forward. A key aim in this must be to allow monetary policy to focus on its mandate and its core objective of safeguarding price stability and prevent it from being misappropriated to solve problems in other policy areas. The article focuses on the need to fill in important missing links in the areas of financial stability (see pages 22 to 29), which has proved to be an Achilles' heel in the current regulatory framework, and fiscal policy, which lay at the heart of the sovereign debt crisis (see pages 29 to 34). In addition, it touches upon macroeconomic policy aspects (see pages 34 and 35) and monetary policy facets (see pages 35 and 36).

Loopholes in the original regulatory framework, and reforms launched

Pillars of the existing regulatory framework

Maastricht Treaty safeguarded stability-oriented monetary policy by giving central bank a clear mandate, extensive independence and …

The euro-area regulatory framework for monetary and economic policy, enshrined in the Maastricht Treaty in 1992, is founded on two pillars.[2] First, the Eurosystem was granted extensive independence and given a clear mandate to focus on the objective of price stability. It was concurrently forbidden to lend to government entities or to directly purchase government debt instruments (prohibition of monetary financing). These strictures were designed to prevent the objective of price stability from being subjugated to competing political interests. The rationale behind this was the insight that a clear focus on stable prices is, in the long term, the best way for monetary policy to contribute to sustainable economic growth and lasting high employment and that central bank

1 This applies to the Securities Markets Programme (SMP) and the Outright Monetary Transactions (OMTs).
2 See European Union (2010), consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, Charter of Fundamental Rights, and European Commission (2015), Economic and monetary union and the euro – For stability, growth and prosperity across Europe, The European Union Explained, publication series.

independence must be legitimised by a clear and narrowly defined mandate.

… providing incentives to achieve sound public finances through …

Second, the Maastricht Treaty sought to safeguard the Eurosystem's independence not just on paper but also in practice. Thus where an imprudent fiscal policy threatens to drive a state to insolvency, even a theoretically independent central bank can come under substantial pressure to avert the high short-term economic costs of a sovereign insolvency by resorting to monetarisation. To avoid this danger, public finances should be sound enough to fully ensure the government's solvency at all times without the need for support from the central bank.

… fiscal rules and …

The intention was to safeguard sound public finances in the euro-area member states in two ways. First, budget rules were agreed – including, notably, ceilings on government deficit and debt ratios. A budgetary surveillance procedure was set up to identify and promptly correct problematic developments. Sanctions were established to penalise sustained and severe infringements of the rules. However, there are no tools at the European level for direct corrective intervention in national budgets.

… the disciplining effect of the financial markets

Second, it was hoped that market mechanisms would provide key incentives for sound fiscal policy.[3] It was thus assumed that markets would impose interest rate premiums on countries pursuing unsound public finances so as to compensate investors for increased risk, which in turn would encourage fiscal policymakers to apply fiscal discipline. Not least to allow this corrective mechanism to take effect, a "no bail-out" clause for both the member states and the monetary union as a whole was introduced alongside the prohibition of monetary financing. The fiscal framework of the Maastricht Treaty thus centres on the individual responsibility of both investors and national fiscal policies; it rules out monetary policy measures aimed at shoring up fiscal sustainability and bail-outs at the expense of the union as a whole or of other member states. These provisions are designed to ensure that policymakers also bear the consequences of their decisions (balance between liability and control). Implicitly, the possibility *in extremis* of a member state that is unwilling or unable to service its debt becoming insolvent is therefore integral to the framework of European monetary union.

Shortcomings of the original regulatory framework

Insufficient incentives for strict implementation of fiscal rules and …

This regulatory framework failed to prevent the sovereign debt crisis. Although the fiscal rules are, in principle, a suitable means of strengthening fiscal discipline, they were not rigorously implemented and enforced in the past. In addition, amendments and exemptions made the rules opaque and undermined their binding force.[4] Consequently, it was difficult for the general public to judge whether there was a valid excuse for specific infringements of the limits. Even before the financial and economic crisis erupted in 2008, member states often failed to adhere to the fiscal rules, and there was little political pressure to comply. Many countries' public finances were therefore already in fairly poor shape in the run-up to the crisis. The true problems were also obscured to some extent by inadequate statistical data. Creative accounting and, in Greece's case, prolonged, massive massaging of the official figures sometimes portrayed the public finance situation in an overly positive light.

… inadequate statistical data

Not enough attention paid to impact of macroeconomic imbalances, …

Doubts about the solvency of some governments during the debt crisis were not solely the result of unsound fiscal policy developments, however. In the first ten years of monetary union, major macroeconomic imbalances had built up in some member states. As domestic demand and unit labour costs grew relatively

3 See Committee for the Study of Economic and Monetary Union (1989), Report on economic and monetary union in the European Community.
4 For example, France and Germany blocked an escalation of their excessive deficit procedures in 2003. As a result, the rules of the Stability and Growth Pact were diluted in 2005.

strongly and some countries' real estate markets boomed, price competitiveness deteriorated substantially, dependence on capital imports rose and the factors of production became increasingly concentrated in sectors with a domestic focus. The interest rate environment encouraged a sharp rise in household and corporate debt, which was mainly funded via domestic banking systems. All in all, the sustainability of the prevailing economic situation was substantially overestimated, as were income prospects and the long-term value of many investments and assets. Public budgets initially benefited significantly from the strong domestic demand, robust wage growth and more favourable funding conditions. But the public finance situation then worsened with the onset of the crisis as huge corrections had to be made to macroeconomic imbalances, misallocations came to light and the outlook for growth deteriorated dramatically. The original assessments of the structural budget position and the available fiscal leeway thus proved *ex post* to be far too optimistic.[5]

… support measures for financial institutions, …

In a number of countries, extensive government measures to shore up financial institutions contributed to a huge deterioration in the situation and outlook of public finances. These institutions encountered financial distress in the wake of the financial and economic crisis because the high household and corporate debt they had co-financed turned out to be unsustainable. The governments concerned mostly argued that an injection of public money into these institutions and the associated conversion of private into public debt was the only way to avert a threat to the stability of the financial system.

… insufficient disciplining of fiscal policy by the financial markets, …

Overall, it was a long while before the financial markets began discriminating more strongly between sovereigns (and banks) with different credit quality profiles. Prior to the onset of the financial and economic crisis, long-term interest rates on sovereign bonds showed hardly any spread, and fiscal policymakers were undaunted by the prospect of rising risk premiums. One reason for this may have been that the markets believed from the outset that a sovereign insolvency was highly unlikely and that a European rescue operation would be launched if the situation were to deteriorate sharply. Another reason was that the markets seemingly misjudged the sustainability of macroeconomic growth and thus the underlying robustness of some countries' public finances. Once they began to reappraise individual states' public finances, however, interest rate spreads widened sharply and abruptly in some cases as the markets increasingly lost confidence in the sustainability of debt levels. Some countries failed to counter these developments rapidly and sufficiently through a radical and credible switch in their fiscal policy stance.

… and dangers posed by unsound public finances to financial stability

This left some sovereigns facing the prospect of solvency problems. In addition, large amounts of funds were withdrawn from the banking systems in a number of euro-area countries. Given substantial dangers to financial stability in the euro area, exemptions to the rules were made so as to permit bilateral financial assistance from other euro-area states, and support packages were adopted. In the face of intense pressure, the Eurosystem decided to expand its traditional toolkit by adding unconventional instruments, some of which stretched the limits of its mandate. While these measures prevented the crisis from coming to a head and took the weight off the countries receiving support, they also weakened the accountability of sovereigns and investors as well as the credibility of the no-bail-out rule. Pressure on politicians to push through more extensive institutional reform in the euro area eased off. The introduction of emergency measures, which were not envisaged when monetary union was launched, was chiefly driven by concerns that a sovereign default in the European monetary union might impair financial stability not only in

5 For more detailed information on this issue, see various articles in Deutsche Bundesbank, Monthly Report, January 2014.

the country affected but also right across the euro area. These dangers were underestimated when monetary union was set up.

Reforms implemented or initiated

Some reforms already implemented or initiated in the fields of financial market regulation, …

A raft of reforms have been put in place since the onset of the crisis to more effectively avert future crises or make them easier to manage. Measures were implemented in the fields of financial market regulation and banking supervision in an effort to eliminate the need for governments to use public money to rescue distressed banks, especially those which are potentially systemically important ("too-big-to-fail" problem). A major objective is to lessen the danger of a mutually reinforcing feedback loop between banks and public finances (sovereign-bank nexus). Measures taken to this end include a dedicated resolution regime for banks. This notably envisages bailing in shareholders and creditors to bear a portion of the losses of a resolved credit institution, thereby obviating or minimising the need for government support measures.[6] The resolution regime is complemented by rules aimed at improving banks' resilience. These chiefly comprise rules enhancing the quantity and quality of capital to be held by all banks but especially by systemically important institutions. Other reform components are designed to diminish systemic risk. For instance, macroprudential instruments such as a countercyclical capital buffer and variable capital requirements for retail and commercial real estate lending can be deployed in future to combat an accumulation of risk in the financial system.[7]

… banking supervision and bank resolution, …

In the fields of banking supervision and bank resolution the launch of the new banking union will spark major changes, not least with a view to protecting public finances from contagion from financial sector distress.[8] The Single Supervisory Mechanism (SSM) was put in place to harmonise prudential standards across all the participating member states. Amongst other things, it is hoped that this will counteract the temptation for national supervisors to give their domestic banking sector a competitive edge by regulating it lightly, whereas the resulting risks to stability could well spill over to other jurisdictions where they might have to be borne by governments. The provisions concerning bank recovery and resolution and the Single Resolution Mechanism (SRM) likewise seek to make injections of public money the exception rather than the rule in future. The envisaged liability cascade for bank resolutions is broadly similar to normal insolvency proceedings in that shareholders will be first in line to bear losses, followed by creditors. As a rule, these two groups will be fully liable for any capital shortfall remaining after the write-down and conversion of relevant capital instruments, although they are not to be worse off than under normal insolvency proceedings. If the ailing bank's shareholders and creditors cover at least 8% of the liabilities, the resolution fund can then, in isolated cases, contribute towards funding the resolution. The resolution fund's resources are divided into national compartments which will be progressively mutualised over a period of eight years. If these measures prove to be insufficient, public funds can be drawn upon as a last resort.[9] National public funds will need to be the primary source of funding until a common fiscal backstop (the design of which still needs to be agreed upon during the transitional period) is up and running. If the member state in question is unable to raise sufficient funding, it has the option of requesting assistance from the European Stability Mechanism (ESM) subject to certain conditionality. As a last

6 The key attributes of effective resolution regimes agreed at the global level were implemented in the European Union by way of the Bank Recovery and Resolution Directive (BRRD). For more information see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.
7 Additional buffers are in place for systemically important banks.
8 For more information see Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43-64.
9 For more information see Deutsche Bundesbank, The envisaged role of public funds in European bank resolution, Monthly Report, June 2014, pp 53-54.

resort, a facility has also been put in place to recapitalise banks directly using ESM funds, subject to strict conditionality, if the provision of further ESM assistance loans would pose a threat to the sustainability of sovereign debt.[10] Finally, the envisaged harmonisation of national deposit guarantee schemes is designed to strengthen the single market and improve depositor protection.

… budgetary surveillance, …

In the fiscal field, fiscal policymakers announced at the height of the crisis that the existing budgetary rules would be tightened as a *quid pro quo* for the granting of extensive financial support, and they adopted measures to avoid a repeat of the misguided developments that had occurred in the years preceding the crisis. Amendments to the Stability and Growth Pact (SGP) came into force at the end of 2011 which notably allowed sanctions to be imposed on euro-area countries which miss the medium-term goal of achieving a structurally close-to-balance government budget. Similarly, financial sanctions can now be imposed more quickly on member states which fail to carry out the prescribed measures to correct an excessive deficit. The 2011 legislation also introduced special majority voting requirements which make it more difficult for the Council to reject a sanction recommended by the European Commission. The Commission's role was strengthened because it was thought at that time that it would take a harder line than the Council. The amended SGP also specifies how government debt-to-GDP ratios in excess of the 60% ceiling are to be reduced, besides introducing measures that will enhance the quality of budgetary statistics. Furthermore, the 25 EU member states which adopted the Fiscal Compact have committed to enshrining in their respective national legislation uniform budgetary objectives that are largely on a par with the European requirement to achieve a structurally balanced budgetary position in the medium term.

… crisis resolution mechanism …

The European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM), which were initially set up as temporary fiscal assistance mechanisms, were superseded by the ESM. This permanent support fund can provide temporary liquidity assistance for illiquid, albeit not overindebted sovereigns in situations where it is thought that a failure to provide assistance would jeopardise financial stability in the euro area as a whole or in an individual member state. Countries requesting ESM liquidity assistance are generally required to sign up to adjustment programmes that are subject to economic and fiscal policy conditionality.[11]

… and macroeconomic surveillance

In the macroeconomic field new macroeconomic imbalance procedures (MIP) were introduced.[12] They are aimed at helping to avoid, identify and, where necessary, eliminate looming or existing macroeconomic imbalances in the member states if those imbalances might impair economic stability in the relevant member state, the euro area and the European Union (EU). Much like the SGP mechanism, financial sanctions can also be imposed under the MIP if a member state repeatedly fails to cooperate in correcting an excessive imbalance.

Many reforms heading in the right direction but more needs to be done

Many of the reforms mentioned above take on board the lessons learned from the crisis and may contribute to preventing and resolving future crises. These initiatives are likely to have fostered financial system stability, reduced the threat posed by the banking sector to national government finances and made investors more accountable for their investment decisions. The upshot of these measures, such as the introduction of fiscal support funds, the single bank resolution fund and a number of Eurosystem measures, has been to distinctly increase the

10 For more information see Deutsche Bundesbank, Implications of the banking union for financial stability, 2014 Financial Stability Review, pp 69-88.
11 The first assistance programme for Greece in spring 2010 was funded by bilateral loans granted by euro-area countries. For more information see Deutsche Bundesbank, Towards a European Stability Mechanism, Monthly Report, February 2011, pp 64-65.
12 For more information see Deutsche Bundesbank, Economic policy coordination in the European Union, 2012 Annual Report, pp 36-39.

degree of joint liability within the euro area. While European-level surveillance and coordination were stepped up at the same time, their design and implementation were and are unsatisfactory in some cases, and there is good reason to seriously doubt that the rules as they currently stand will be strictly applied.[13] In effect, member states' autonomy in economic and fiscal policy matters has been left largely intact. All in all, the reforms do not go far enough, and, with the exception of the banking union, the increase in mutualised liability has not been matched by the introduction of broader joint control mechanisms.[14] This would suggest that the euro area is inadequately protected against fresh financial turmoil and the attendant risk of monetary policy being swayed by fiscal policy.

Template for further reform

Two templates conceivable for a regulatory framework with reduced moral hazard: a decentralised approach …

Broadly speaking, two different models can serve as a template for a regulatory framework for monetary union that features reduced moral hazard. Both models should ensure that policymakers also bear responsibility for the consequences of their decisions (balancing liability and control). The first of these models follows a decentralised approach and is rooted in the Maastricht Treaty. Apart from the single monetary policy, it is premised on extensive national accountability of member states. While it is true that European rules can encroach on this autonomy (in fiscal matters, for example), the European level ultimately has no power to intervene directly in national affairs. The notion of leaving decision-making powers largely at the nation-state level is consistent with the no-bail-out rule (which lays down that a member state's debts cannot be assumed by other member states or the community) and the possibility of a member state defaulting.[15]

… and a fiscal union that mutualises risk and transfers budgetary sovereignty

The other template centres on the idea of economic and fiscal policy integration – in effect, fiscal or political union. This approach maintains a balance of liability and control by matching the increased mutualisation of risk with a surrender of (at least fiscal) sovereignty to a central European level.[16] Calls to move forward in this direction came from various quarters at the height of the crisis.[17] A cohesive fiscal or political union backed by a large political majority across all countries and sharing a common economic policy vision – a federation of states – would certainly be less vulnerable to crises overall than a currency union composed of autonomous member states if the latter does not appear capable of withstanding the insolvency of individual states. However, following the decision to set up a banking union, the politicians seem to have lost any interest in ramping up the pace of integration or embracing fundamental treaty change, apparently because they do not believe that such steps, and especially the extensive surrender of national sovereignty, will enjoy majority backing in the member states.

Spotlight on strengthening the decentralised model

As long as that remains the case, the focus of future reforms will need to be on improving the resilience of the existing framework, but there

13 See, for example, Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2014, pp 68-72; and Deutsche Bundesbank, The implementation of fiscal rules in the European monetary union, Monthly Report, December 2014, pp 8-10.
14 See, for example, German Institute for Economic Research, Zukunft der Währungsunion, DIW Wochenbericht 24/2014, pp 527 ff; Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011, pp 53-58; Deutsche Bundesbank, Banking union: a useful addition for Europe in the medium term, 2012 Financial Stability Review, pp 82-83; Deutsche Bundesbank, Implications of the banking union for financial stability, 2014 Financial Stability Review, pp 69-88.
15 For further background information on this article, see German Council of Economic Experts, Stabile Architektur für Europa – Handlungsbedarf im Inland, 2012/13 Annual Economic Report, pp 102 ff; and Gegen eine Rückwärtsgewandte Wirtschaftspolitik, 2013/14 Annual Economic Report, pp 156 ff.
16 See also A Sapir and G Wolff, Euro-area governance: What to reform and how to do it, Bruegel policy brief, 2015/01. Effective control of joint liability instruments would be impossible without first surrendering the relevant decision-making competence. See expert group on a debt redemption fund and eurobills, final report, 31 March 2014.
17 See H van Rompuy, J Barroso, J-C Juncker and M Draghi, Towards a genuine economic and monetary union, Report to the European Council, December 2012.

is no getting round the fact that rules can only ever fulfil their purpose if they are rigorously applied in practice. Bearing this in mind, the following sections outline approaches that seek to strengthen the existing regulatory framework based on national accountability. The guiding principles of this framework are enshrined in the European treaties and as such constitute the foundations of European monetary union. Specifically, these are the no-bail-out clause, extensive economic and financial autonomy of the member states, their citizens and investors, and the *de jure* and *de facto* independence of monetary policymakers in pursuing their primary objective of ensuring monetary stability. The sections below consider at length key steps towards better safeguarding financial stability (see pages 22 to 29) and ensuring sound public finances (see pages 29 to 34) before briefly discussing options for improving macroeconomic coordination and the role of monetary policy (see the summary on page 23).

Steps towards safeguarding financial stability

Safeguarding financial stability key to curbing threat of monetary policy coming under pressure

Sound public finances in the member states and a path of macroeconomic development that is devoid of serious and persistent imbalances are important prerequisites for safeguarding financial stability in the euro area. However, extensive safeguarding of financial stability requires that it remains robust even if individual member states fail to prevent the emergence of macroeconomic imbalances or to rein in ballooning sovereign debt that might leave that country teetering on the brink of default. This objective primarily targets the banking system, given its particular systemic importance for the stability of the financial system. But other potentially systemically important areas of the financial system, such as the shadow banking system, need to be addressed as well.[18] Regulators and supervisors play a pivotal role in the prevention of systemic crises in the financial sector. Yet if financial institutions nonetheless encounter stress, the onus is on monetary policymakers to step in with temporary liquidity assistance for banks that are illiquid but not overindebted. The task of the resolution authority and, at the end of the day, fiscal policymakers, by contrast, is to either recapitalise overindebted financial institutions by bailing in their shareholders and creditors, or to wind them up in an orderly fashion where a failure to do so would jeopardise the stability of the financial system. Part of the rationale for this is that this task involves large-scale decisions affecting the redistribution of funds and debts. If fiscal policymakers fail to fulfil this task, monetary policymakers may come under pressure to step into the breach.

Sovereign-bank contagion nexus must be effectively severed in both directions

Two objectives need to be achieved in order to stem the spillover of risk from the government to the banking sector and *vice versa*. First, financial stability needs to be maintained even in the unlikely yet conceivable worst-case scenario of a haircut being imposed on sovereign bonds. Shoring up financial stability in this way is crucial for upholding the principle of national responsibility and the no-bail-out clause. Second, the risk of contagion channelling in the other direction – from banks to sovereigns – likewise needs to be effectively curbed.

Reducing the risk of contagion from the banking sector to the government sector

Banks' loss-absorbing capacity is key to stopping spillover of risk from banking to government sector

The bulk of the measures rolled out so far to safeguard financial stability address the spillover of risk from banks to sovereigns. Although some progress has been made, further action still needs to be taken. To further reduce the risk of contagion, it needs to be ensured that systemically important banks, in particular,

18 The shadow banking system can in general be defined as credit intermediation involving entities and activities outside the regular banking system. See Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, Report, October 2011, p 1.

Summary of selected recommendations and measures

<table>
<tr><th>Financial stability</th><th>Fiscal policy</th><th>Economic policy</th></tr>
<tr>
<td>Strengthen banks' loss absorbency: capital requirements and/or leverage ratio
Consistently deploy and refine macro-prudential toolkit
Improve integration of equity and debt markets
– Uniform legal framework
– Diversified lending
Segregate monetary policy and banking supervision
Single Resolution Mechanism (SRM)
– Adequate bail-in-able capital
– Apply bail-in rules strictly, and stringently wind down non-viable banks
– Common fiscal backstop with national loss retention
Properly regulate financial system outside the banking sector (eg shadow banks), too</td>
<td>Set up independent budgetary surveillance institution
Fiscal regime
– Simpler and clearer rules, strictly applied
– Uniform and transparent surveillance
– Reduce discretionary leeway
– Step up automatic corrective measures
– Strengthen role of debt ratio
ESM
– Conditional liquidity assistance
– Interest rate mark-ups for assistance
– Stronger role in insolvency process
– Non-standard fiscal measures to avert or mitigate haircuts</td>
<td rowspan="2">Review imbalance procedure and adapt if necessary once sufficient experience has been gathered; implement strictly
Streamline and enhance transparency of European coordination mechanisms
Take account of cross-border effects, but no fine-tuning of economic policy by central authority</td>
</tr>
<tr>
<td colspan="2">Deprivilege sovereign bonds
– Capital backing
– Large exposure limits
– Adapt liquidity rules
Revise sovereign bond contracts
– Collective action clauses with single-limb aggregation
– Automatic maturity extension if ESM assistance granted
Create framework for more orderly sovereign insolvency</td>
</tr>
<tr><th colspan="3">Monetary policy</th></tr>
<tr>
<td colspan="2">Keep focus on core objective of price stability
Define mandate narrowly so as to legitimise independence
Do not undermine unity of liability and control in other areas or distort market processes</td>
<td>Assume no responsibility for financial stability risks caused by sovereigns' and banks' solvency problems
Avoid engineering joint liability for sovereign solvency risks via central banks' balance sheets
Institutional segregation of monetary policy and banking supervision</td>
</tr>
</table>

Deutsche Bundesbank

have deep loss-absorbing capacity. This increases, for example, with higher capital, which absorbs losses and thus allows business operations to be continued. Some critics claim that stricter capital adequacy requirements drive up banks' funding costs and might, as a result, stunt macroeconomic growth.[19] As a rule, however, any higher funding costs are matched by macroeconomic benefits stemming from the potential improvement in financial stability. However, where higher funding costs result from the fact that tighter capital requirements eliminate or reduce implicit government guarantees, this is no reason not to impose stricter capital standards. At the end of the day, this merely removes an inappropriate subsidisation of banks' debt financing.

19 This line of argument is open to doubt, however. The Modigliani-Miller theorem, for instance, holds that, given perfect markets, an enterprise's funding costs are unrelated to its form of funding. A rising equity capital ratio lowers the uncertainty of payment flows for shareholders and creditors alike, thus reducing the risk premium for both forms of funding. This offsets the additional cost involved in holding a higher proportion of (more expensive) equity capital. While it is true that market frictions, an asymmetric distribution of information or taxes may well drive up the cost of equity, empirical research suggests that the additional costs are not substantial. See also European Central Bank (2011), Common equity capital, banks' riskiness and required return on equity, Financial Stability Review, pp 125-131.

Capital requirements should be critically reviewed

In order to increase banks' loss-absorbing capacity, the new capital requirements under Basel III should be critically reviewed.[20] Such a review should notably examine whether the risks that are not captured or are insufficiently captured in the risk models are adequately backed by capital (eg by the various capital buffers). It is not least in the light of such risks that the risk-weighted capital requirements were supplemented by the introduction of an instrument that is explicitly not risk-based, ie the leverage ratio. From 2018, it will be possible to convert this ratio from a monitoring metric to a binding measure. In this case, too, it should be reviewed whether the minimum requirement of 3% currently being tested by the Basel Committee is appropriate.

Macroprudential monitoring plays a supporting role, but is not a panacea

Macroprudential monitoring and policy play a part in making the financial system more resilient and also in adequately curbing cyclical developments of systemic risk. The instruments created for this at the European and national levels at least for the banking sector, such as the countercyclical capital buffer, the systemic risk buffer, and the option of higher risk weights for certain exposures, are essentially suitable for countering undesirable developments in a relatively focused way. The effectiveness of macroprudential policy will, however, hinge on how willing policymakers actually are to rigorously deploy the instruments and to tackle unwelcome developments, including in the face of political pressure if necessary, and on the extent to which any evasive actions can be thwarted. It would be wrong to place exaggerated expectations on macroprudential policy. It has only a limited ability to counter misguided developments originating from risky national economic or fiscal policy, as it cannot tackle the root causes. Tax legislation in many member states, for example, currently favours debt financing over equity financing. This tends *per se* to weaken firms' capital base, which means that bank loans can more quickly become nonperforming in the event of negative shocks. In turn, this weakens the stability of the financial system. While, in this regard, macroprudential policy can strengthen the resilience of the banking sector and damp the cyclical dynamics of the financial system, the tax policy bias remains in place. The existence of macroprudential instruments therefore cannot be used as an argument for laxer regulation in other areas or for less prudent economic policy. This constraint is further underscored by the fact that the macroprudential instruments that are currently available predominantly seek to contain undesirable developments that originate in the banking sector. The task of extending the macroprudential toolkit to other areas such as the insurance sector or the shadow banking system is still in the early stages.

Positive effects could also emanate from a capital markets union and …

The concept of a capital markets union is currently being debated as a way of advancing integration of the debt markets and, above all, the equity markets. Dismantling the barriers and restrictions related to this can play a role here. This could allow the impact of asymmetric shocks to be more widely spread and better cushioned within the EU via the financial markets. The desired stronger diversification between capital market-based and bank-based financing would have a similar effect.

… more diversified bank lending

In addition, more diversified bank lending in the euro area would disperse risk more widely and thus strengthen the banking sector with regard to problems confined to individual member states. Domestic banks, for example, would be less affected by the consequences of misguided fiscal policy developments in a country extending to the extreme risk of a haircut on government debt which, moreover, would normally be accompanied by a recession and a rising wave of credit defaults in that country. However, the prerequisite for this is that credit risk does not rise on account of diversification.

20 The requirements envisage a basic capital ratio of at least 8% of risk-weighted assets. Additionally, however, banks will need in future to hold various capital buffers on top of the minimum requirements in order to reduce the risk of the minimum capital requirements being undershot. Capital surcharges for systemically important financial institutions will also be introduced.

Independent and stringent banking supervision another central pillar

Comprehensively securing financial stability requires independent and stringent banking supervision. Conferring responsibility for banking supervision on a Single Supervisory Mechanism (SSM) was a first key step.[21] In order to avoid conflicts of interest with monetary policy, however, in the longer term banking supervision should not be based at the ECB but instead at an independent institution that has the final say in supervisory matters, or at the very least, the decision-making structures for monetary policy at the ECB should be clearly separated from those for banking supervision. Against this backdrop, plans should be made to amend European primary law.

Quicker market exit of insolvent banks and entry of new banks

A country's economic recovery can also be speeded up by making it easier for insolvent banks to exit the market and for new banks to enter the market. Uniform and accelerated insolvency proceedings throughout Europe for households and enterprises could reduce uncertainties by facilitating faster identification of banks' actual balance sheet position.

SRM needs adjusting to ensure efficient bank resolutions

Some adjustment is required to the Single Resolution Mechanism (SRM), which is designed to facilitate the orderly resolution also of systemically important financial institutions without recourse to government support measures. Given the extremely complex decision-making framework, there is considerable doubt as to whether bank resolutions can be carried out efficiently in the tight timeframe envisaged.[22] This points to a continuing need to amend primary European law with a view to creating the legal basis for a genuine European resolution authority with efficient autonomous decision-making powers.

Need for government support measures for banks should be minimised through rigorous implementation and …

There is still a considerable need for improvement to ensure that the risk of bank insolvencies is actually borne by the investors and to effectively reduce the probability and extent of future strains on public budgets from the financial sector. What is particularly problematic is that applying the bail-in tool to creditors involves great discretionary scope. On top of this, it is uncertain how far the political announcement that the banking sector will be called on to finance losses where necessary, possibly by way of *ex post* levies, will be followed up. In order to reliably ease the burden on public budgets and to ensure that investors increasingly bear risks themselves, there are a number of conceivable approaches besides the higher capital ratios already discussed. For instance, in the actual implementation of resolutions it is crucial that banks which are a gone concern really are rigorously resolved without using taxpayers' money. This will allow a track record to be established that negates the lingering expectation of an implicit government guarantee.

… sufficient bail-in-able debt

In addition, the bail-in of creditors could be made more credible *ex ante* by obligating banks to hold sufficient capital and debt that is reliably available for bail-in in a loss event.[23] This is the objective of the minimum requirements for loss-absorbing capacity – or total loss-absorbing capacity (TLAC) – which the Financial Stability Board (FSB) is aiming to introduce for global systemically important financial institutions; these requirements are intended to make sure that there are sufficient levels of liable capital and debt in a resolution event. For this to succeed, however, it must be ensured that the draft presented by the FSB in November 2014 is not watered down in the ongoing

21 For more information, see Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43-64.

22 For more information, see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.

23 The Expert Advisory Committee to the Federal Ministry of Finance has put forward a proposal on this. According to this proposal, a significant requirement of bail-in-able capital would be that it may not be held by banks either directly or indirectly (eg via credit default swaps (CDSs)), in order to avoid the risk of contagion across the banking system. Furthermore, a clear trigger for a liability event should be defined in bond contracts, and debt should then automatically be converted into equity (comparable to "coco bonds"). Finally, it would have to be ensured that other debt positions are not automatically exempted from bail-in owing to the existence of these bail-in bonds. See Expert Advisory Committee to the Federal Ministry of Finance, Stellungnahme zur aktuellen Entwicklung der Europäischen Bankenunion – Plädoyer für ein glaubwürdiges Bail-in, 01/2014.

consultation process.[24] Furthermore, regulatory requirements must restrict other banks from holding TLAC instruments in order to avoid contagion effects. The Bank Resolution and Recovery Directive (BRRD) also contains minimum requirements for liable equity and debt, in the form of minimum requirements for own funds and eligible liabilities (MREL).[25] For this element of liability to be credible *ex ante* in a resolution event, however, it would have to be assured that, as well as own funds, the liabilities covered by the minimum requirements, in particular, can actually be drawn on in the event of a resolution. Potential contagion channels in the financial system would have to be closed as far as possible. At the same time, the discretionary scope for decision-making in a resolution event would need to be more clearly limited.

Common fiscal backstop that minimises moral hazard

The additions to the safeguards that have already been implemented at the upstream stages discussed in this article are intended to rule out government support measures if possible. Nonetheless, a credible fiscal backstop may be required as the final step of the liability cascade to enable orderly resolutions also of systemically important financial institutions, if necessary, and to avoid excessive uncertainty in the markets. This would prevent central banks from being pressured to keep failed banks alive by providing extensive and sustained liquidity and thus avoid resolutions entailing considerable risk to financial stability. To align liability and control in the field of banking supervision, it would essentially be conceivable, following the transfer of banking supervision from the national to the European level, to likewise put in place a fiscal backstop at the European level. However, a prerequisite for this is that the legacy risks on banks' balance sheets that accrued under national responsibility are comprehensively rectified first. What is more, the backstop would have to be structured in a way that avoids moral hazard that would discourage sound public finances and a sustainable economic policy. The influence of national economic and fiscal policy on risks in the national banking system grows inversely to banks' degree of diversification across national borders. A risky economic and fiscal policy would tend to be fostered if the attendant risks were fully communitised, whereas temporary advantages arise chiefly at the national level. Depending on the perceived severity of these moral hazard problems and the assessment of the effectiveness of the corrective action through diversification, bail-in, the European budget and economic surveillance procedures and macroprudential policy, a more or less extensive degree of national loss retention for the costs of resolving a bank supervised at the European level would make sense.[26]

Shadow banking sector must not become a new source of systemic risk

A final requirement for comprehensively securing financial stability is that no systemic risk builds up in other areas of the financial market, for example in what is known as the shadow banking sector. Specifically, macroprudential instruments should be developed – in a similar way as for the banking sector – with respect to the improvement and further harmonisation of the framework conditions for decentralised structures in the financial system (eg for non-bank-based direct and indirect corporate financing), which is currently another objective of the capital markets union, in order to counteract any undesirable developments resulting therefrom.

Reducing the risk of contagion from the government sector to the banking sector

Equally as important as reforms relating to spillover risk from banks and the financial system to the government sector are reforms concerning

24 See Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution, Consultative Document, November 2014.
25 For more information, see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.
26 For more information, see Deutsche Bundesbank, The envisaged role of public funds in European bank resolution, Monthly Report, June 2014, pp 53-54.

Eliminating spillover risk from the government to the financial sector also in the event of sovereign insolvency

contagion risk in the opposite direction – ie from the government sector to banks and the financial system. These reforms should aim to make financial stability more independent of the development of public finances and highly likely to remain robust even in the scenario of a restructuring of government liabilities. This would also ease the pressure on monetary policy to take on responsibility for ensuring financial stability or sovereign debt sustainability. A core approach to tackling this issue likewise encompasses banking and financial market regulation. The objective of any changes must be to limit banks' sovereign exposure risk to such an extent that even strongly interconnected, systemically important banks can either absorb fiscal stress events up to and including a comparatively extensive haircut on government debt or else ensure that they can be resolved in an orderly manner if necessary. It is important in this context to take account of second-round effects that arise because a sovereign default is usually accompanied by a slump in economic activity and a growing number of non-performing loans to private debtors in the country concerned.

Approaches to limiting banks' sovereign exposure risk

Approaches to limiting the risk posed to the banking system by sovereign exposures include risk-appropriate capital backing for government bonds, a limit on the volume of sovereign exposures held by a bank (large exposure limits) and treatment of such assets under the liquidity regulation that is commensurate with their actual degree of liquidity. A great deal could be achieved here simply by ending, or at least substantially scaling back, the regulatory exemptions thus far afforded to sovereign debt from capital adequacy requirements and large exposure limits.[27] At present, capital essentially does not have to be held against banks' exposures to sovereigns in national currency, even though the sovereign debt crisis has clearly demonstrated that sovereign debt is by no means risk-free. Sovereign exposures have so far broadly been exempted from the existing large exposure limits, too. The large exposure rules are designed to prevent concentration risk in the banking system, with the aim being to stop a bank from running into difficulties itself when a debtor defaults.[28]

Changing contractual terms of government bonds also worth considering

The consequences for banks of a haircut on government debt could possibly be further reduced by changing the contractual terms of sovereign debt instruments. The aim would be to create a sufficient volume of national bonds with relatively good credit quality for banks even in times of stress, and, if possible, to transfer the default risk more from bank balance sheets to other areas of the financial market where any losses from a haircut will not lead to a systemic financial crisis. One option worth examining is the potential benefit of dividing individual national government bonds into first-loss and second-loss tranches as a complement to the amendment of banking regulations discussed above.[29]

Approaches to improving sovereign insolvency procedure can strengthen financial stability somewhat

Alongside banking regulation, a contribution to financial stability can also be made by approaches that, faced with the potential sovereign default of a euro-area state, envisage the timely initiation, rapid execution and predictable structuring of a relevant insolvency procedure. Without such mechanisms, there are incentives for both the debtor country and its creditors to postpone a sovereign debt haircut. The government of the debtor country fears a loss of votes and image as well as negative repercussions for the domestic financial system. Creditors of short-dated claims can currently press for the haircut to be delayed long enough

27 The Basel Committee has already begun reviewing the privileged treatment of sovereign exposures in the regulatory requirements.
28 For more information, see Deutsche Bundesbank, Reducing the privileged regulatory treatment of sovereign exposures, 2014 Annual Report, pp 23-40.
29 Mandatory risk diversification by bundling the bonds of all euro-area states into a single bond, as suggested by the Euro-nomics group, does not appear necessary for this. See Euro-nomics group, European safe bonds (ESBies), mimeo, 30 September 2011. Rather, the Euro-nomics group's proposal involves some joint liability elements, which run counter to the guiding principle of the regulatory framework of European monetary union. Appropriate risk diversification can be better achieved through appropriate banking regulation, as outlined above.

that their claims are satisfied in full.[30] This makes it more difficult to rapidly restore sovereign solvency, prolongs uncertainty in the financial markets about the pending steps and increases the economic costs of a sovereign debt overhang via the knock-on effects on the real economy.[31] Reform approaches to mitigating the negative impact of sovereign insolvencies on the stability of the financial system should therefore be aimed at the timely triggering of sovereign insolvency and at putting in place a reliable, efficient and transparent procedure for rapidly restoring sovereign solvency.[32] Overall, however, it must be ensured that contract fulfilment and legal principles are upheld and that countries are in no way enabled to extricate themselves too easily from contractual arrangements with regard to sovereign debt.

CACs introduced in 2013 could be stiffened

Since 1 January 2013, all government bonds issued by euro-area states with a maturity of more than one year have had to contain collective action clauses (CACs).[33] These aim to ensure efficient restructuring of outstanding liabilities if the need arises by making it easier to make changes to the key terms and conditions of a bond series that are binding for all creditors. To this end, the clause stipulates that the majority required to modify the terms and conditions for the individual bond series falls if a qualified majority across all bond series votes for a modification. This reduces any incentive for investors to hold out for full settlement of their claims at the cost of the entire group of creditors (holdout problem). However, this "two-limb" procedure cannot prevent a financially strong investor from blocking the restructuring of an individual bond series by acquiring a blocking minority. In the longer term, a solution to this could be a "single-limb" aggregated voting procedure, whereby a qualified majority across all government bonds issued is sufficient to trigger a binding debt restructuring for all bonds regardless of the voting results for individual bond series.[34]

Modified pari passu clause would mitigate holdout problem

In order to deter holdouts more effectively, the standardised bond contracts of euro-area states could additionally be critically reviewed with a view to restricting the *pari passu* clause.[35] In principle, this clause is designed to ensure the equal treatment of bondholders by issuers.[36] At the very least, however, existing ambiguities of interpretation should be eliminated so that

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30 Creditors of short-dated claims who have a blocking minority could, for instance, credibly signal that they do not consent to a potential debt restructuring.
31 The current debate about a haircut in Greece is taking place against a fundamentally different backdrop. Private creditors in Greece have already incurred a haircut, and the vast bulk of Greek debt now comprises assistance loans from public creditors. Although Greece's debt ratio is still exceedingly high, extensive debt relief was provided by the very low interest rate charged on the assistance loans (from an economic perspective, granting very low interest rates and forgoing redemption payments for a protracted period are very similar to partial debt forgiveness). The sustainability of Greek public finances is therefore significantly less strained than the debt ratio alone suggests thanks to this very limited interest burden. According to the European Commission's latest forecast, Greek interest expenditure in relation to gross domestic product in the current year, for instance, is below that of Ireland, Italy and Portugal, even though Greece's debt ratio is significantly higher.
32 See, for example, the Expert Advisory Committee to the Federal Ministry of Economics and Technology (2011), Überschuldung und Staatsinsolvenz in der Europäischen Union, Gutachten Nr. 01/11; Committee on International Economic Policy and Reform, Revisiting Sovereign Bankruptcy, Discussion Paper, October 2013; and C Fuest et al, Die Krise im Euroraum nachhaltig überwinden, Study by the Centre for European Economic Research (ZEW) for Vereinigung der Bayerischen Wirtschaft (vbw), April 2014.
33 See EFC Sub-Committee on EU Sovereign Debt Markets, Collective Action Clause Explanatory Note, 26 July 2011, and Model Collective Action Clause Supplemental Explanatory Note, 26 March 2012. The integration of CACs into the bond terms and conditions of regional and local government entities of member states is not mandatory, however.
34 See International Monetary Fund, Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring, IMF Policy Paper, 2 September 2014.
35 In the global context, the IMF has attempted to strengthen contract-based debt restructurings by tabling not only proposals for model clauses with the option of a single-limb majority requirement, but also proposals for redesigning the pari passu clause, and has recommended their use in future international bond issues. See International Monetary Fund, loc cit. The IMF proposals are based on the model clauses, revised shortly beforehand, issued by the International Capital Markets Association (ICMA). See ICMA, Standard Aggregated Collective Action Clauses ("CACs") for the Terms and Conditions of Sovereign Notes, August 2014, and ICMA, Standard Pari Passu Provision for the Terms and Conditions of Sovereign Notes, August 2014.
36 It has only limited significance for sovereign issues as the concept of rank presupposes the option of liquidating the issuer's assets (and the subsequent distribution of the insufficient proceeds to the creditors). The liquidation of an insolvent sovereign's assets is hard to reconcile with the modern concept of a sovereign state and the inalienability of its sovereign rights, however.

creditors who reject a debt restructuring (holdout creditors) cannot invoke the *pari passu* clause to build up potential pressure by threatening to block payments to the restructured bonds. This reduces the holdout incentive for creditors and hence reinforces the incentive for all creditors to agree to a restructuring. As a result, the risk of a disorderly sovereign default diminishes.[37]

Regulated insolvency procedure for euro-area states could further reduce adverse effects on financial stability

In addition, a framework and procedure could be developed in the longer term which would allow government bonds to be restructured in a more orderly and structured way than is currently the case.[38] This could curb uncertainty about the steps required to restore sovereign solvency and mitigate systemic contagion effects and negative repercussions for financial stability. Any liquidity restrictions for the debt instruments that are to be restructured, the impact on the domestic real economy and the level of the debt haircut required could potentially be limited further. Regardless of such a framework, however, it must be ensured that financial stability is safeguarded to the greatest extent possible also in the not inconceivable event of a disorderly sovereign insolvency.

ESM could be given prominent role in insolvency procedure

In connection with a potentially more orderly framework for sovereign insolvencies, the ESM could be given a greater role, and could contribute to balancing the interests of debtors and private creditors as well as to achieving speedier agreement on restructuring. Sovereign debtors may in any case apply for liquidity assistance from the ESM, subject to certain conditions, until they regain access to the capital market. The prospect of such liquidity assistance is likely to make it easier for the debtor country to agree to a restructuring. Creditors will probably submit to a haircut more readily if ESM assistance is credibly pegged to structural reforms and fiscal consolidation, thus giving them greater assurance that their remaining claims will then actually be settled.

Approaches to anchoring a stability-oriented fiscal policy

Increase incentives for sound fiscal policy

Under the existing regulatory framework of the European monetary union, responsibility for fiscal policy lies mainly with the member states. They decide on the specific design of fiscal policy and also on whether the national government debt is ultimately serviced. This wide-ranging autonomy in decision-making is essentially consistent with the no-bailout principle. A central aim of stability-focused reforms in the field of fiscal policy must be to increase the incentives to pursue sound public finances.

Improve budgetary surveillance and implementation of fiscal rules

Independent European fiscal authority could aid better implementation of rules

With regard to the fiscal rules, the main problem is not so much that they are fundamentally unsuitable, but more that they are seldom designed and implemented systematically. This is illustrated, for example, by the European Commission's recent decisions to make greater use of the flexibility of the rules in future to further relax the requirements and also to loosen the requirements for sovereigns that clearly did not comply with the European Council's recommendations. At present, the Commission has a crucial role in monitoring budget developments and interpreting the European fiscal rules. Despite its formal independence, however, it faces considerable political pressure and also pursues many different objectives simultaneously. A new European fiscal authority, which, similarly to the autonomous national fiscal councils, has

37 Holdout incentives could also be effectively curbed without modifying the pari passu clause if the payment streams of the parties taking part in a restructuring are immunised against the claims of creditors that have elected not to participate in the restructuring. See Committee on International Economic Policy and Reform, loc cit. Another change to the terms and conditions of government bonds is proposed below (see pp 30 and 31) with the automatic extension of the maturity when ESM assistance is granted.
38 See, for example, F Gianviti et al (2010), A European mechanism for sovereign debt crisis resolution: a proposal, Bruegel Blueprint Series, Volume 10.

a clear mandate obligating it to solely assess budgetary developments in terms of compliance with the fiscal rules should be better able to ensure objective monitoring as well as to conduct transparent and comprehensible analysis. The new body could take over the Commission's role in the procedure and would be less exposed to the risk of making inappropriate compromises at the expense of budgetary discipline.

Simple and transparent rules create reliability and promote effective budgetary surveillance

Regardless of this institutional issue, the fiscal rules can be made more effective by making them much simpler and clearer. This would allow both the general public as well as the political opposition in the respective countries to clearly identify any breaches of the rules. This aspect is a key condition for the rules to have stronger binding force, as such public accountability ensures that the rules have a disciplining effect on the political decision-makers. It would also be necessary to make all data publicly accessible, to largely eliminate the discretionary scope laid down in the existing rules for setting fiscal targets and assessing compliance with them, and to tightly restrict and clearly define exemptions from the rules. Since responsibility for ensuring sound public finances remains with the member states, it appears advisable to restrict any European-level requirements more than before to the anticipated consolidation requirement and the deadlines for its implementation. The fundamental aim of the envisaged overhaul of the rules should not be to try and take account of every conceivable specificity by structuring the rules even more granularly, but instead to emphasise clear upper limits and thus strengthen the ability to implement the rules. Ultimately, the crucial assessment gauge should not be the (supposed) efforts of a member state, but rather the outcome. In this context, there must be a degree of acceptance that the rules cannot completely cover every single eventuality and that not all unexpected developments will be excused. What must be borne in mind is that the fiscal rules constitute agreed upper limits and that member states actually have extensive room for manoeuvre as long as the rules are complied with.[39]

Automatic correction mechanisms worth considering

Safeguarding sustainability by means of simple and transparent fiscal rules could be further reinforced by setting the scope of consolidation in the event of missed targets in such a way that not only is the deficit corrected, but the increased debt incurred in the meantime on account of the deviation is also reversed. The binding force of the European budgetary rules could also be decisively enhanced if member states, in advance of any breaches, define concrete measures that will then enter into force more or less automatically and can be replaced, at most, by fully specified, offsetting measures.[40]

Promote incentives for financial markets to press for sound fiscal policy

Disciplining effect of financial markets key incentive for sustainable fiscal policy

The actual or potential imposition of interest rate premiums on countries pursuing unsound public finances remains an important incentive for sustainable national fiscal policies in the euro area. This requires that creditors really are exposed to the full risk of any investment in government debt instruments and that they assess this risk appropriately.[41] Corresponding interest rate signals will then encourage governments to adopt a sustainable fiscal policy.

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39 For more information, see Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2014, pp 68-72.

40 Sustainably safeguarding stable public finances could also be achieved by introducing direct (tiered) rights of intervention at the European level in cases of severe and persistent breaches of the fiscal rules. These could also take the form of surcharges on common taxation instruments or deductions from certain spending categories, which are to be stipulated by the member states in advance and the amount of which will vary depending on the size of the breach. However, such rights of intervention imply a distinct reduction in national fiscal sovereignty (and hence an approach that is not discussed further in this article) and is highly unlikely to find a consensus at this point in time.

41 The prerequisites for adequately assessing the risks of an investment in government debt instruments include reliable statistics, the timely provision of relevant information, and transparent processes and methodology in the context of budgetary surveillance.

However, if financial market participants expect fiscal or monetary rescue measures in the event of a crisis, this diminishes the perceived default risk of a misguided national fiscal policy, and market participants will, at best, require only small country-specific risk premiums. This weakens the disciplining effect of the financial markets from the outset.

Restoration of no-bail-out principle and compliance with the prohibition on monetary financing

Against this background, it is important that the principle of individual responsibility on the part of investors and member states is firmly re-established in future. There must be no prospect that the no-bail-out principle or the prohibition of monetary financing by central banks may ultimately be ignored. A key prerequisite for this, however, is that risks to financial stability posed by a threatening sovereign insolvency are adequately contained by the aforementioned reforms (see pages 22 to 29), as the fear of a financial market collapse is ultimately what led to these principles being relaxed during the financial crisis.[42]

Orderly sovereign insolvency procedure for euro-area countries improves credibility of the no-bail-out principle and strengthens investor liability

The collective action clauses introduced for euro-area countries in 2013 can not only contribute to greater financial stability, as explained, but are also a first important signal that investors will face a sovereign debt haircut if a country becomes overindebted. This signal could be underscored by proposals, already mentioned in the context of strengthening financial stability, to reform the contractual terms of government bonds and introduce a more orderly insolvency regime for euro-area states. This could also bolster the credibility of a debt haircut as it would mitigate the implications for the financial system and the losses for the real economy, thus making the haircut easier to push through politically. At the same time, it must be ensured that the insolvency of a debtor state is not seen as an easy option. The imposition of conditions on economic and fiscal policy by a coordinating body, such as the ESM, could prove useful in this regard, as explained below.

Automatic extension of government bond maturity if ESM assistance granted

Inserting a clause into government bond contracts that automatically extends the bond's maturity if ESM assistance is granted could also be a useful addition. This would be an effective means of preventing private creditors from receiving full repayment of short-dated bonds at the expense of providers of public assistance. Moreover, private investors would be aware that they would be involved in any subsequent haircut. Their risk would rise accordingly, which would probably help to strengthen the disciplining effect of financial markets on fiscal policy.[43]

Eliminating preferential treatment of government bonds in banking regulation would promote risk-based interest rates

The aforementioned amendments to banking regulation – risk-based backing also of government bonds, adjustments in categorising assets under liquidity rules and inclusion of public-sector bonds in large exposure rules – should additionally help to reinforce the disciplining effect of financial markets on fiscal policy. Eliminating the existing preferential capital treatment of government debt instruments would curb banks' demand for sovereign debt instruments, particularly from countries with poorer creditworthiness.[44] Overall, the measures should increase risk spreads for government bonds that have a higher probability of default and therefore make it less attractive for these countries to expand their borrowing. This would increase their incentive to pursue stability-oriented fiscal and economic policies as a declining debt ratio would hold out the prom-

42 Even if monetary policy generally has a certain role to play in safeguarding financial stability, it is limited by the prohibition of monetary financing, which places sovereign solvency protection beyond the scope of its mandate. Moreover, in a conflict of interests, the objective of maintaining price stability takes precedence over seeking to contribute to financial stability. For more information see Deutsche Bundesbank, The importance of macroprudential policy for monetary policy, Monthly Report, March 2015, pp. 39-71.

43 For more information see Deutsche Bundesbank, Proposal for an effective private sector involvement for bond issues from mid-2013 onwards, Monthly Report, August 2011, pp. 68-71 and Bank of England, Sovereign default and state-contingent debt, Financial Stability Paper 27, November 2013.

44 See European Systemic Risk Board, ESRB report on regulatory treatment of sovereign exposures, March 2015.

ise of securing more favourable financing terms.

Flaws in financial market constraints on governments' propensity to borrow

In the past, the ability of financial markets to effectively constrain the borrowing propensity of fiscal policymakers was limited by two key flaws. First, investors were very tardy in reacting to a deterioration in a country's fiscal sustainability and then tended to react very abruptly.[45] The resulting rising interest burden, especially for sovereigns with substantial short-term borrowing, often made it harder for fiscal policymakers to take timely countermeasures. This being so, it would be better for states to fund their routine financing needs through longer-term debt as this would give them more time to react in the event of abrupt market reassessments. Second, in some cases fiscal policymakers were themselves slow to react to the interest rate signals. The aforementioned proposals should help to mitigate these problems. Even so, there will still very likely be limitations to the disciplining effect of financial markets – as of fiscal rules – in the future. It therefore seems prudent to pursue both avenues in order to achieve sound government finances in the long term.

Need for a crisis resolution mechanism free from moral hazard

Crisis resolution mechanism should aim for the swift restoration of solvency

Despite reforms to the fiscal policy framework and supplementary measures to improve financial stability, the possibility of member states encountering solvency difficulties in future, along with the emergence of attendant systemic risks, cannot be ruled out. A credible crisis resolution mechanism is required for this contingency. Ideally, it should neither create moral hazard for national fiscal policymakers nor undermine the no-bail-out principle, and hence the disciplining effect of financial markets on fiscal policy. It should prevent systemic contagion effects in the financial sector and related spillover effects on the real economy. The fundamental objective should be the swift restoration of confidence in a country's solvency.

For illiquid countries: reform and consolidation programme and, if need be, supplementary liquidity assistance from public institutions

The appropriate course of action depends on whether the state in question is merely illiquid, with a fundamentally manageable debt situation, or overindebted.[46] In the first scenario, it may be possible to secure the state's capital market access and solvency simply by agreeing a sustainable reform and consolidation programme. However, even if a country is merely illiquid, such a programme typically needs to be implemented before capital market confidence in the country's long-term ability and willingness to pay can be restored. It is therefore likely that temporary assistance from the ESM or other public institutions, or a debt moratorium, will additionally be required. Central banks are prohibited from making a financial contribution to the crisis resolution mechanism because of the prohibition on monetary financing.

For overindebted countries: one-off wealth levy worth considering as crisis resolution instrument

If a country is overindebted, the first thing that must be done is to map out a sustainable debt reduction path. This is also a prerequisite for receiving liquidity assistance from the ESM. If debt sustainability is gravely endangered and unlikely to be achieved through conventional consolidation measures and reforms, extraordinary fiscal measures should also be considered in order to avert a sovereign debt haircut if possible. Particularly in cases in which the overindebted country is also home to considerable private wealth, a one-off redistribution of assets within that country might well be considered, for exemple, before any attempts are made to restructure its outstanding debt. This could, say, take the form of a one-off levy on

45 See European Central Bank, The determinants of euro area sovereign bond yield spreads during the crises, ECB Monthly Bulletin, May 2014, pp. 67-83.
46 In practice, it is very difficult to differentiate between illiquidity and overindebtedness. Thus far, all euro-area countries that have received help from an assistance programme have been assumed to be illiquid but solvent. While the majority of these countries have since successfully ended their programmes and have been able to return to the capital market, a haircut was carried out on private holdings of Greek government bonds barely two years after the start of the Greek programme.

residents' net assets. Such a move could make a noticeable contribution to ensuring the sustainability of a country's debt situation. In principle, this would hold the electorate accountable for its voting behaviour and sensitise it to the significance of such votes. This should increase incentives to strive for a fiscal policy that is fundamentally stability-oriented. If a country is increasingly unable or unwilling to repay its debts, the possibility of a one-off wealth levy being required as part of either an adjustment programme or a debt restructuring can prevent the debtor state (and thus its electorate) from looking for a quick fix to its debt burden at the expense of the country's creditors.[47]

Regulated procedure preferable for sovereign haircut event

If an overindebted country does carry out a debt haircut, a regulated procedure within the framework of a properly structured sovereign insolvency regime – potentially with the ESM as the coordinating body – as described above would be preferable to an unregulated approach. If the ESM defines fiscal and economic policy conditionality under this framework and makes the provision of liquidity assistance dependent on compliance with it, this could also potentially make it easier for private creditors to agree to a required debt haircut. In addition, the conditionality would counteract any incentives the debtor state may have to seek a quick-fix solution at the creditors' expense and would therefore also discourage unsound fiscal policy in the first place.

Beneficial automatic maturity extension of euro-area government bonds when ESM assistance is granted

As proposed above, the inclusion of a standard clause in euro-area government bond contracts stipulating automatic maturity extension in the event that ESM assistance is granted is particularly beneficial in this context. It not only improves the disciplining effect of financial markets on fiscal policy, but also significantly reduces the volume of public assistance required, as financial investors would remain liable for their investment decision if ESM assistance were to be granted.[48] Thus they can still be called upon if a subsequent debt restructuring becomes necessary.

ESM assistance loans must be free of moral hazard

ESM assistance loans to bridge temporary liquidity difficulties should be strictly tied to compliance with the reform and consolidation programme agreed with the given country. Even a change in government in the state receiving the assistance or in the creditor countries must not be allowed to fundamentally call these agreements into question. Reliable conditionality is an essential prerequisite for tackling the root causes of solvency problems and for the country in question to regain trust and access to the capital markets through its own efforts. It is also of key importance for gaining the confidence of the assistance-providing countries, which in effect provide *ex ante* loans without a repayment guarantee. Perceptible interest rate mark-ups on the refinancing costs of assistance loans should likewise provide governments with incentives to swiftly consolidate their public finances in order to lower the risk spreads as soon as possible and return to the capital markets. In addition, in order to protect taxpayers in creditor member states, public funds should generally be excluded from any subsequent restructuring, as is currently agreed in the case of ESM assistance loans.

Overall package improves sustainability of public finances and limits systemic risks of a sovereign haircut

Overall, the proposed measures for a more rigorous implementation of the European budgetary rules, the strengthening of the role of financial markets as a counterweight to fiscal policymakers' propensity to borrow and an improved crisis resolution mechanism may help to achieve greater sustainability in public finances. In conjunction with the aforementioned supplementary reforms to strengthen the financial system's loss-absorbency and to improve the resolvability of systemically important banks, these measures would contain the systemic risk arising from a not inconceivable sovereign debt

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47 For more information see Deutsche Bundesbank, A one-off capital levy: a suitable instrument for solving national solvency crises within the current EMU framework?, Monthly Report, January 2014, pp. 49-51, and G Kempkes and N Stähler, A one-off wealth levy? Assessing the pros, the cons and the importance of credibility, Fiscal Studies, forthcoming.
48 For the duration of the maturity extension period, funds would only be required to finance the deficits and no longer to redeem maturing government bonds.

haircut and underpin the credibility of the no-bail-out principle.

Prevent or correct misguided macroeconomic developments

National sovereignty not infringed even by the excessive imbalance procedure

The introduction of the procedure for monitoring and correcting macroeconomic imbalances has provided monetary union with an important crisis-prevention tool that was previously lacking. Its objective is to counteract cross-border risks and economic policy developments that cause negative spillover effects on other member states and, in particular, on the functioning of monetary union. The reform was carried out within the existing legal and institutional framework, which means it does not encroach on the legally enshrined national sovereignty in the area of economic policy. The implementation of the economic policy recommendations of the European level therefore depends on the willingness and ability of member states to take these into consideration within the framework of their national economic policies. An advantage in this context is that, in the course of monitoring, macroeconomic imbalances can be identified by means of transparent analysis as this reveals problems to voters and capital market players, who can then put pressure on policymakers to take remedial action.

Still too early for robust evaluation of procedure

At the end of November 2014, the European Commission published a communication on the review of the EU's new economic governance regulations.[49] The gist of the communication, which seems reasonable, is that it is too early to draw meaningful conclusions regarding the impact of the procedure because of the short period in which it has been in force. This is underscored by the fact that, in a number of EU countries, macroeconomic imbalances were already in the process of being corrected by the time the excessive imbalance procedure was implemented in 2011, so that the procedure can only be put to the test in future periods in which imbalances first arise.

Inadequate use of the procedure by the Commission and overreliance on member states' reform promises

It must be said, however, that the European Commission's evident reluctance to fully utilise the steps available under the procedure merits a critical assessment. Thus the number of countries in which it has identified an excessive imbalance has risen from zero in 2012 to five in 2015. Yet the European Commission has not initiated excessive imbalance procedure in a single case to date, and this year, too, it has not yet issued any proposals to initiate such a procedure. Furthermore, when assessing the extent of imbalances, the Commission places too much importance on member states' reform promises, whereas experience shows that they are then only partially implemented or not implemented at all.[50]

Acceptance at national level an unresolved problem

A general problem, which ultimately also applies to the excessive imbalance procedure, is the often low acceptance in the individual member states of economic policy recommendations formulated at EU level, which are often seen as encroachments on national sovereignty. As part of its review, the Commission therefore calls for incentives for better implementation of the reform recommendations by the member states, though it fails to spell out what form these incentives should take. It should also be noted that the European level's diagnostic capability is not necessarily superior to that of the member states. This would suggest that the subsidiarity principle should apply as extensively as possible in order to prevent attempts by the Commission at macroeconomic fine-tuning. That being said, a purely national view that neglects the negative consequences for other member states and monetary union as a whole can be equally problematic. For example, a smaller country might opt to pursue a risky structural policy – such as growing a large financial sector – if it sees po-

49 See European Commission, Economic Governance Review, November 2014.
50 See European Central Bank, Economic Bulletin, 2/2015, pp. 53 ff.

tential advantages at the national level, while offloading a large portion of the negative risks onto the Community, for example via the banking union.

Financial incentives to reform unconvincing

The proposal made in the debate on the potential deepening of economic and monetary union to use extensive financial payments to overcome national resistance to Brussels' reform recommendations seems unconvincing.[51] Among other things, this would create incentives to put up fierce initial resistance to reforms and then subsequently demand large amounts of financial compensation in return for implementation. It would be rather difficult to justify a situation in which funds are granted when unsound developments arise and are corrected but not when unsound developments are avoided in the first place.

Stronger integration of national parliaments potentially helpful

Experience has shown that a comprehensive reform process in an affected member state can only really get off the ground and be successful if a large proportion of national policymakers and voters are convinced of the need for the recommended adjustments and are also prepared to see them through. A stronger integration of national parliaments could therefore be helpful. However, future amendments to the coordination mechanism should avoid making procedures altogether too complicated.

The role of monetary policy

Focus on price stability in compliance with market principles

The primary objective of the European System of Central Banks is to ensure price stability, and this is why it was granted independence, particularly from national governments. An essential counterpart to this independence is a monetary policy approach that is focused as narrowly as possible on the ESCB's price stability mandate and kept at arm's length from fiscal activities. Moreover, monetary policymakers must pursue this objective in compliance with market principles. The European treaties, which also govern the Eurosystem, are rooted in the principle that free competition is a prerequisite for the efficient allocation of resources. This makes it essential that monetary policymakers do not contribute to an imbalance between liability and control in other policy areas.

Monetary policy must not be misused to neutralise market forces

In other words, monetary policymakers must ensure in the course of their activities that responsibility for liquidity management ultimately remains with the commercial banks and that banks' funding costs are determined by market forces.[52] Banks which cannot raise funds on the money and capital markets, or which can do so only at prohibitive expense, must not be kept on life-support indefinitely by the central bank. Otherwise this could lead to a misallocation of resources.

Institutional segregation of monetary policy and banking supervision needed in the long term

Banking supervision should not be based at the ECB but instead at an independent institution that has the final say on supervisory matters, or at the very least, the decision-making structures for monetary policy and banking supervision at the ECB should be clearly segregated so as to avoid conflicts of interest between the two policy areas. Against this backdrop, the aim should be to amend European primary law in the long term to achieve an institutional separation of monetary policy and banking supervision at the European level.[53]

Monetary policy must not undermine the regulatory framework for fiscal policy

Just like the abovementioned comments on private responsibility for risks in the financial system, where monetary policy interacts with fiscal policy, the risks taken by fiscal policymakers are the responsibility of national governments and must be shouldered by the member states themselves. This means that, in this respect, too, monetary policy must not be allowed to

51 On this proposal see European Commission, A blueprint for a deep and genuine economic and monetary union: Launching a European debate, Communication from the Commission, November 2012.
52 For more information see Deutsche Bundesbank, Implications of the Eurosystem's monetary operations during the financial crisis, Monthly Report, April 2014, pp. 37-59.
53 For more information see Deutsche Bundesbank, Launch of the banking union: the Single Supervisory Mechanism in Europe, Monthly Report, October 2014, pp 43-64.

undermine the disciplining impact of the market. Measures aimed, for example, at reducing the financing costs of individual member states affected by rising risk spreads should be viewed critically in this context. Equally, monetary policymakers must not use the central bank's balance sheet to communitise sovereign debts via the back door.

Monetary policy and macroprudential policy

As both monetary policy and macroprudential policy target the financial sector, interactions between these two policy areas are inevitable. At the current juncture, however, there is only limited experience and scant knowledge in respect of macroprudential instruments as to their mode of operation, calibration and interaction both among themselves and with monetary policy. Nevertheless, the recent past has shown that the monetary policy stance can influence, in particular, the risk-taking propensity of financial market participants. Monetary policymakers should therefore also duly consider the implications of their decisions for the stability of the financial system as a whole. However, they can only do so within the scope of their mandate. Ultimately, this suggests that monetary policy should be applied symmetrically over the financial cycle and that policymakers should also weigh up medium and long-term risks to price stability. Such a symmetric monetary policy could help prevent financial market participants assuming too much risk.[54]

Conclusions

Establishing a coherent economic policy framework …

The crisis has pinpointed the need to reform the regulatory framework of monetary union. Many reforms and changes have since been implemented, often as short-term reactions to stress events. One of the fundamental questions raised is whether a fiscal or political union could be a viable objective. Given the evident lack of political support for such a scheme in the member states, it would seem that this path, along with comprehensive changes to EU primary law, is no longer on the agenda. As long as this remains the case, the existing regulatory framework must be made as crisis-proof as possible in the medium to long term.

… requires corrections and additional measures in various areas

The current constellation of growing joint liability, euro-area-wide risks to financial stability from potential unsound developments in individual member states, and extensive national autonomy in economic and fiscal policy is contradictory and unstable. This makes monetary union susceptible to new crises, and there is a risk of monetary policymakers being pressured into subjugating the objective of price stability to other general concerns such as securing financial stability or sovereign solvency, which are actually the responsibility of other political actors. If the current basic principles governing economic policy in the euro area, such as extensive national autonomy in economic and fiscal policy, continue to prevail, corrections and additional measures will therefore be required in various areas.

Strengthen financial stability through better loss-absorbency and improved resolvability of banks and ending the privileged status of government bonds in banking regulation

In terms of financial stability, further measures to strengthen banks' loss-absorbency and to improve the resolvability of financial institutions could promote a situation in which state funding for distressed banks is only required in extreme cases in order to avert a systemic crisis. It is equally crucial to curtail negative spillover effects of unsound public finances on financial stability. For this to happen, it is essential that a sovereign debt haircut can be carried out in future without raising fears of a systemic financial crisis. Only then will the no-bail-out principle applicable to other states, the Community, and monetary policymakers be credible and only then will financial markets more adequately assess the risk of a state being unable or unwilling to repay its debts. In this regard, considerable progress could be made if the existing favourable treatment of government debt securities in banking regulation were to be pared back in the medium term and abolished in the long term. Banks' exposures to sovereigns

54 For more information see Deutsche Bundesbank, The importance of macroprudential policy for monetary policy, Monthly Report, March 2015, pp. 39-71.

would then also require risk-appropriate capital backing and be subject to rules on large exposure limits.

Improve fiscal rules, strengthen disciplining role of financial markets and overhaul crisis resolution mechanism

In the area of fiscal policy, budgetary surveillance could be transferred to an independent institution mandated exclusively to safeguard sound public finances. In addition, the European fiscal framework, particularly the Stability and Growth Pact, should be tightened and, above all, actually implemented. If the Community level is not to be granted rights of intervention into the budgetary sovereignty of member states, then the disciplining effect of financial markets on fiscal policy will play an important role, irrespective of the fiscal rules. Lastly, the current crisis resolution mechanisms should be improved. For example, government bond contracts could be adjusted (single-limb collective action clauses, *pari passu* clause, automatic maturity extension upon the granting of ESM assistance), and a framework could be established to make sovereign insolvency procedures as orderly as possible. The ESM could be given an important role in this context.

Too early to reliably assess the need for further action on macroeconomic imbalances

In terms of macroeconomic developments, the introduction of the procedure for monitoring and correcting macroeconomic imbalances already represents a significant step forward. It is not yet possible to say with any certainty whether further reforms will be required, although so far the European Commission has adopted a fairly lax approach to implementation. Possible options to improve the acceptability of the Commission's recommendations by the member states include stronger integration of national parliaments and a streamlined and focused design of the rather complex European coordination frameworks.

Proposed reforms would take the pressure off monetary policymakers and contribute to a stability-oriented monetary union

All in all, the proposed reforms in the areas of financial stability and fiscal policy, in particular, would mitigate the risk of monetary policymakers being pressured into carrying out tasks outside or at the very limits of their mandate. In the upshot, this could make an important contribution to securing a stability-oriented monetary union.