The group of 14 French and German economists behind the recent CEPR *Policy Insight* argue that the Euro Summit statement represents a constructive first step and crosses red lines that were considered taboos only a few months ago.
The outcome of the Euro Summit of 29 June regarding the reforms of the euro area’s architecture disappointed observers who had hoped it would provide decisions along the lines of the Meseberg declaration by German Chancellor Angela Merkel and French President Emmanuel Macron. Yet the statement is a constructive first step and has substantial symbolic value as it crosses red lines that were considered taboos only a few months ago. It is important to use this momentum to finalise the promised reforms as well as to break further taboos in order to move towards a stable monetary union.

Despite the summit statement’s brevity, there are several positive elements. Europe’s political leaders seem to have understood that fixing the euro area’s banking system remains a high priority – most of the statement is devoted to this. The firm commitment to a backstop from the European Stability Mechanism (ESM) for bank crisis resolution is an important stabilising element. Given the strong opposition in Germany, the explicit reference to a European Deposit Insurance Scheme (EDIS) after a sufficient reduction of legacy risks in banks, made for the first time ever at the Leaders’ level, breaks an important taboo and is a step in the right direction of both risk reduction and risk sharing.

It is also encouraging to see a willingness to improve future crisis management and resolution by strengthening the euro area’s rescue mechanism, the ESM. Referring to a prior letter by the Eurogroup president, political leaders have signalled openness to more flexible forms of ESM lending to countries not yet in full blown crisis as well as to enhanced collective action clauses to allow for orderly sovereign debt restructuring and the bailing in of private creditors, without automaticity.

Far from being misguided or irrelevant, the summit’s commitments are thus important steps towards effective euro area reform. However, they still fall short of a comprehensive package. Three key pieces are still missing.
First, euro area leaders must finish the job started in 2012 of breaking the vicious circle between banks and national governments. This requires breaking another important taboo, namely by regulating the risk of excessive concentration of banks on a single sovereign. This could be achieved by limiting how much domestic sovereign debt banks can hold, for example through sovereign concentration charges, as well as by exploring the creation of a safe asset for the euro area backed by diversified pools of sovereign bonds.

Second, neither the statement nor the letter by the Eurogroup president discusses how to improve the functioning of the fiscal framework. The current fiscal rules have proven to be overly complex, hard to enforce, and procyclical. Many observers, including our group, have therefore proposed moving towards simple public expenditure rules guided by a long-term debt reduction target.

Third, the statement is silent on the issue of macroeconomic stabilisation. An important reason why some countries experienced crises that were far more severe than necessary was the lack of fiscal stabilisation during the euro area

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crisis. The Eurogroup raises the possibility of introducing an unemployment insurance scheme that might fulfil such a stabilisation function – irrespective of whether or not it is labelled a ‘euro area budget’. Such a scheme could play an important role in helping countries avoid a deep recession and crisis. It could be set up without creating a ‘transfer union’, thus addressing concerns of Germany and other northern European countries. The objective in the next few months should be to better explain the economic benefits of such a stabilisation mechanism.

In addition, the items put on the agenda during the summit must be fleshed out and implemented swiftly, avoiding overly long transition phases. The current efforts to reduce non-performing loans and to avoid their future build-up should be sustained to enable the fiscal backstop and a well-designed EDIS to enter into force. To stabilise the euro area and avoid self-fulfilling crises, it is necessary to create lending instruments available at the ESM that are sufficiently flexible and credible. There is still a huge stigma attached to tapping ESM help. Crisis resolution is effective only if countries are willing to accept the support.

Overall, the Euro Summit declaration could be the start of a constructive process, no small achievement given the meeting’s difficult political circumstances. Transforming this into actual policy success requires breaking more taboos and crossing further red lines. If there is a strong positive message from the Euro Summit, it is that this may indeed be possible.

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