Reconciling risk sharing with market discipline: A constructive approach to euro area reform

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“Our future is Europe –
we do not have another one.”

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Reconciling risk sharing with market discipline: A constructive approach to euro area reform

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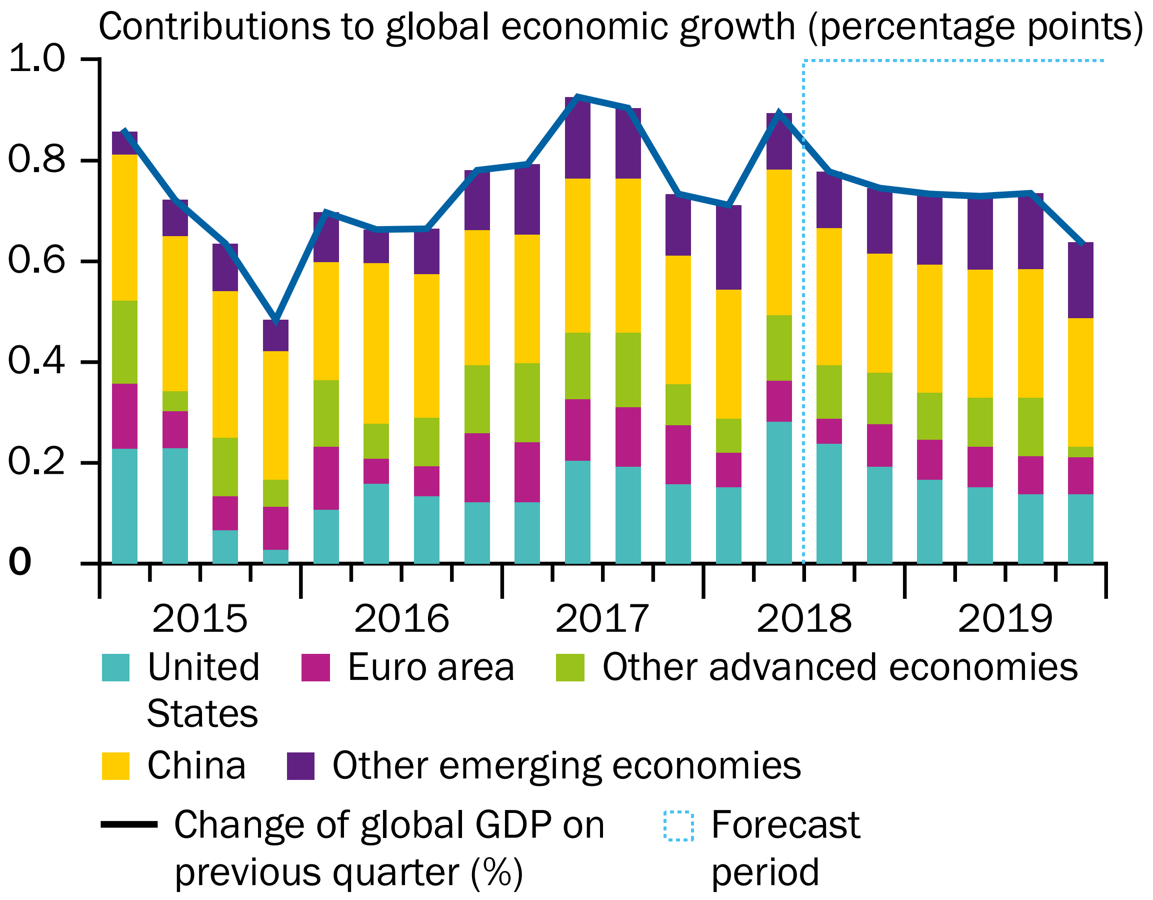
Overview

1. Diagnosis: Euro area remains fragile
2. Risk sharing and market discipline are complements
3. How to reform the euro area
4. Conclusion

1. Diagnosis: Euro area remains fragile

Slowing expansion of the global economy



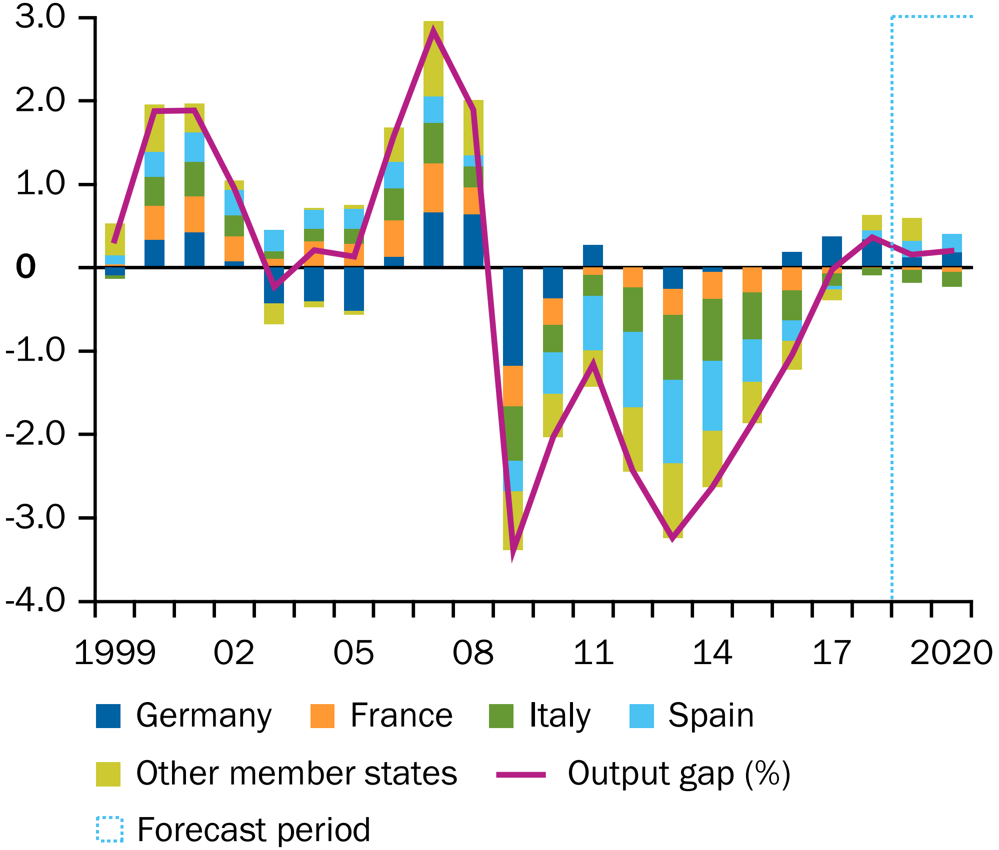
Sources: IMF, own calculations

- Overall less dynamic development, especially in China

Uneasy waters for the euro area

Contributions to the output gap

Percentage points



Sources: European Commission, own calculations

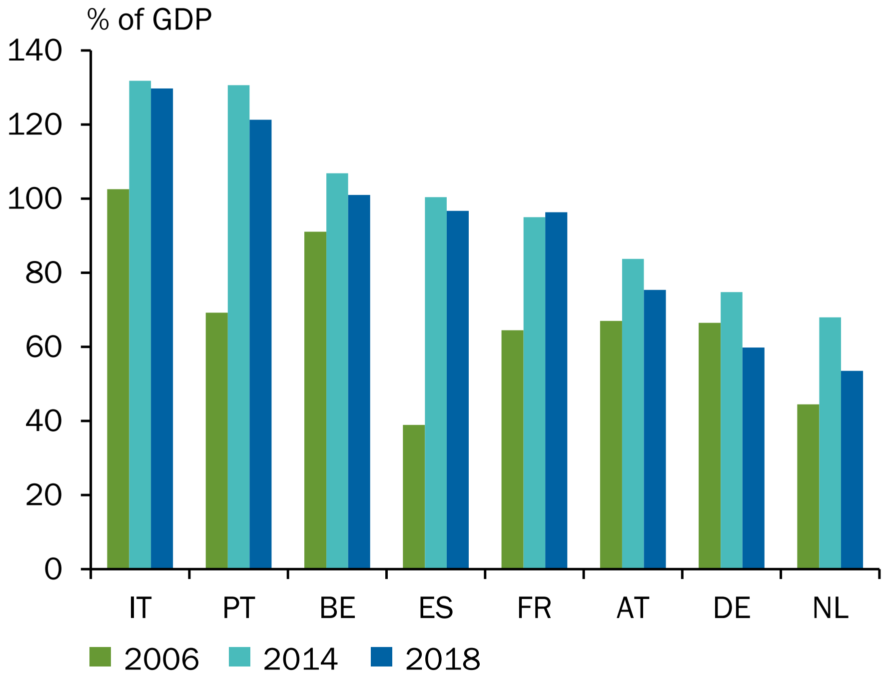
- Slower expansion in the euro area after a long boom
- High risks:
  - Trade conflict
  - Brexit
  - Resurgence of the euro area crisis

Significant progress since the euro area crisis…

- New / improved institutions:
  - European Banking Union (Single Supervisory Mechanism SSM, Single Resolution Mechanism SRM)
  - European Stability Mechanism (ESM) for crisis management
  - Reformed Stability and Growth Pact
  - …
- New regulation:
  - Basel III
  - Macroprudential regulation
  - …

… but high public debt levels in many member states

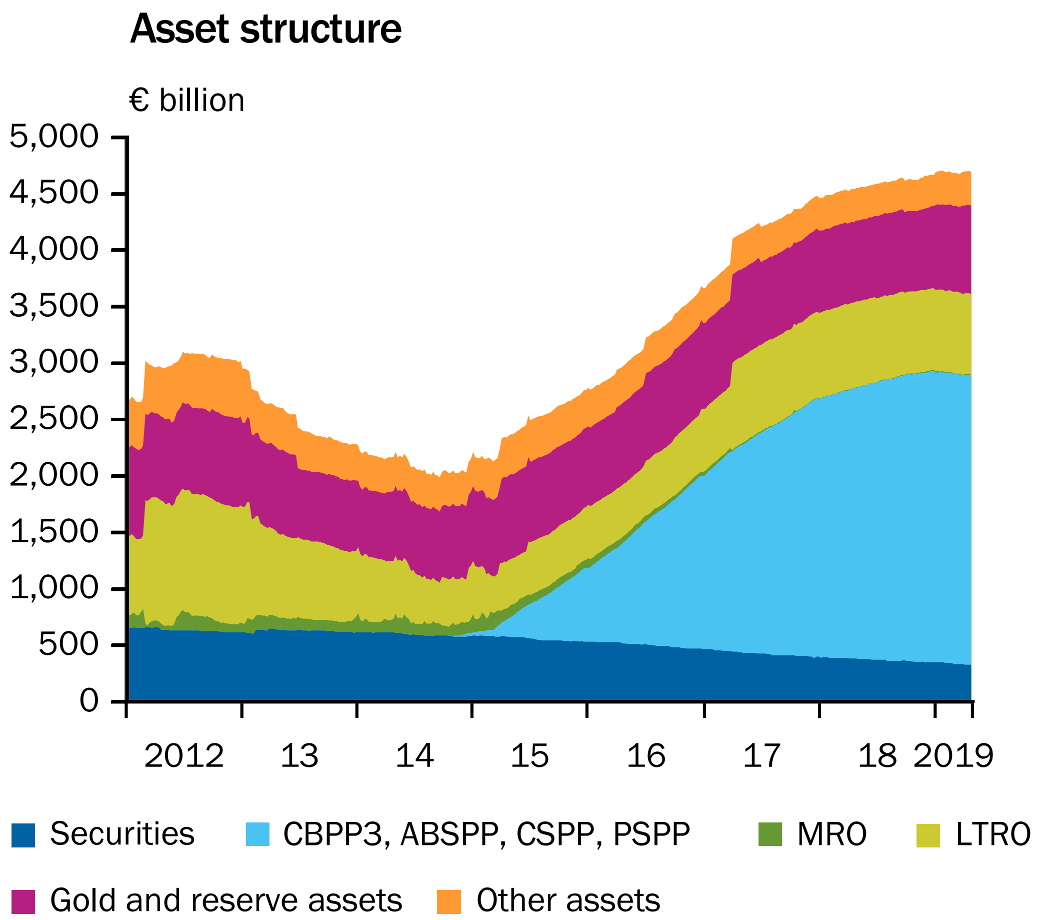
Gross government debt



Sources: IMF, own calculations

- Sharp increase in public debt during the global financial crisis
- Good times have not been sufficiently used for consolidation
  - Fiscal framework procyclical, ineffective and politically divisive
- Little fiscal space in the next crisis or recession in many member states

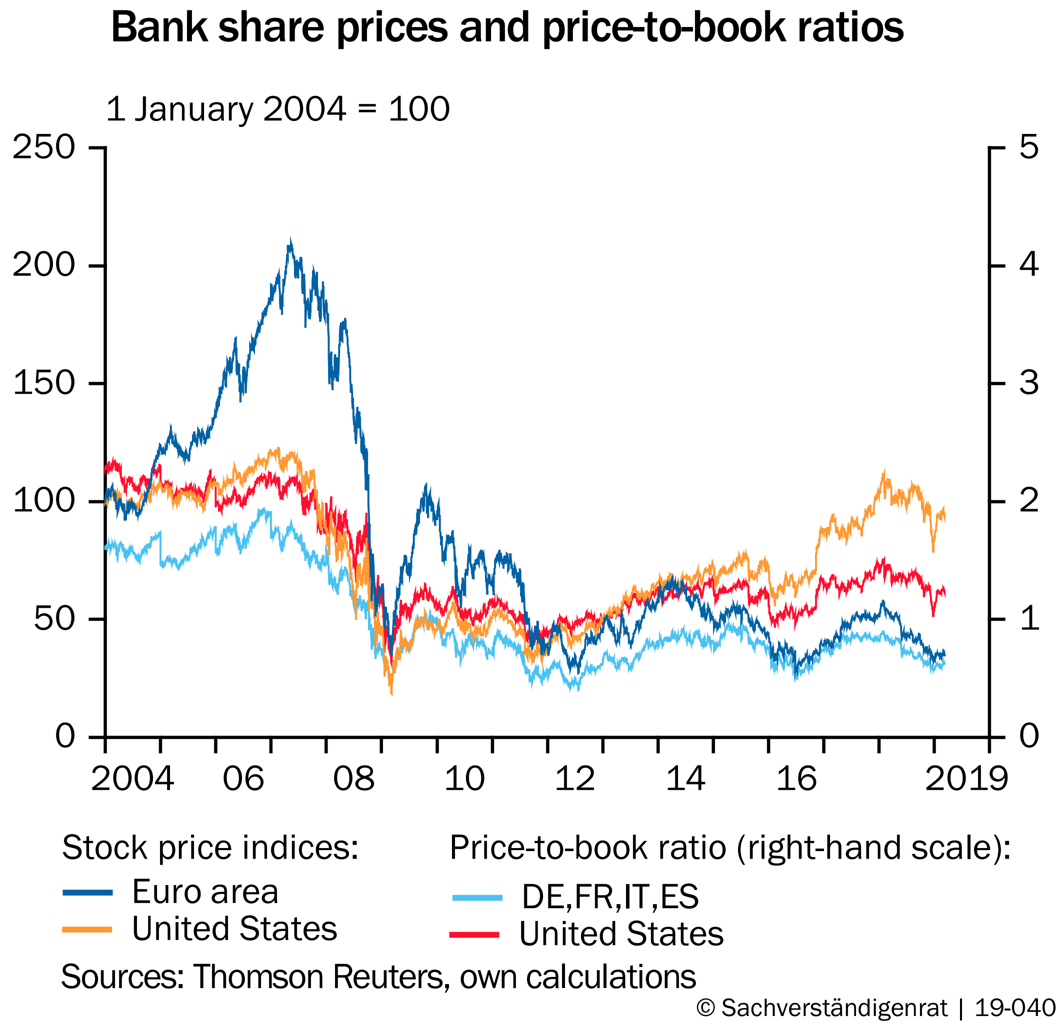
… limited monetary space in another crisis or recession



Sources: ECB, own calculations

- Macroeconomic situation would have allowed for an earlier normalization of monetary policy
- Slowing growth makes exit from loose monetary policy unlikely
- But: Euro area will not be able to rely on the ECB to the same extent as in the last crisis

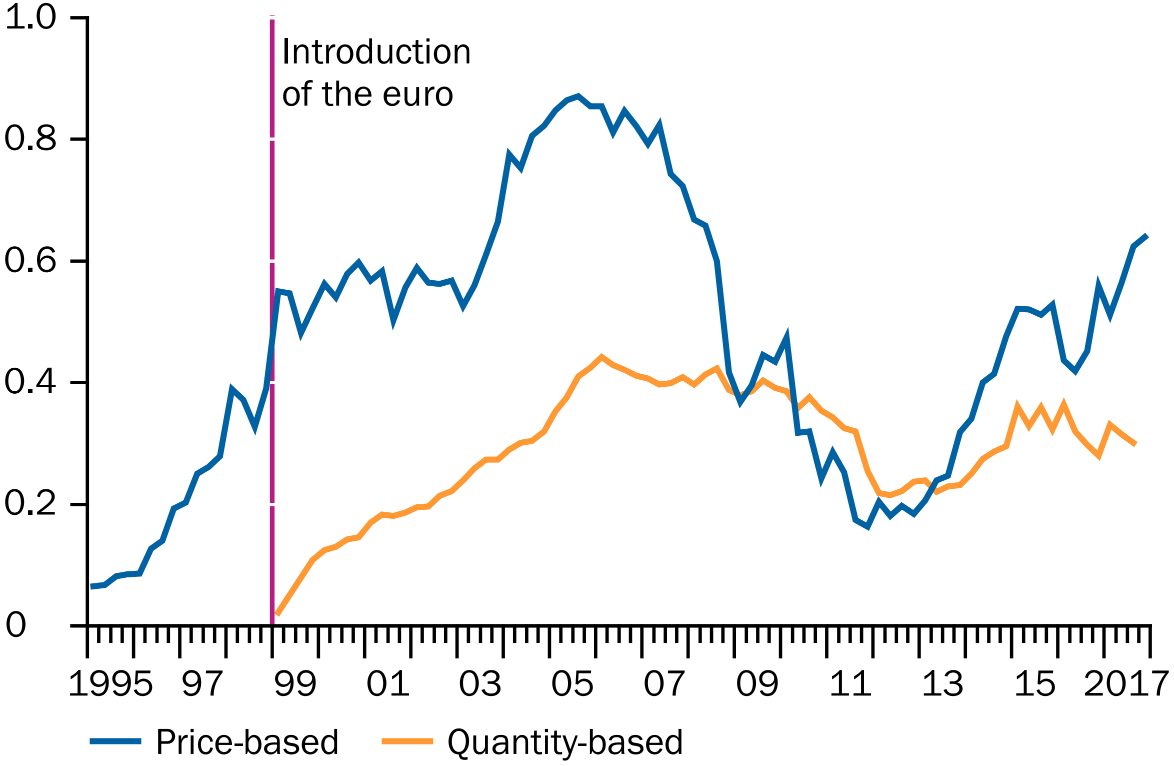
… European banking sector remains weak



- Capital ratios higher but not high enough
- NPLs lower but not low enough
- High risk taking in low interest rate environment
- High exposures to domestic sovereigns
- Structurally low profitability

Little risk sharing in the euro area

Euro area financial integration indicators

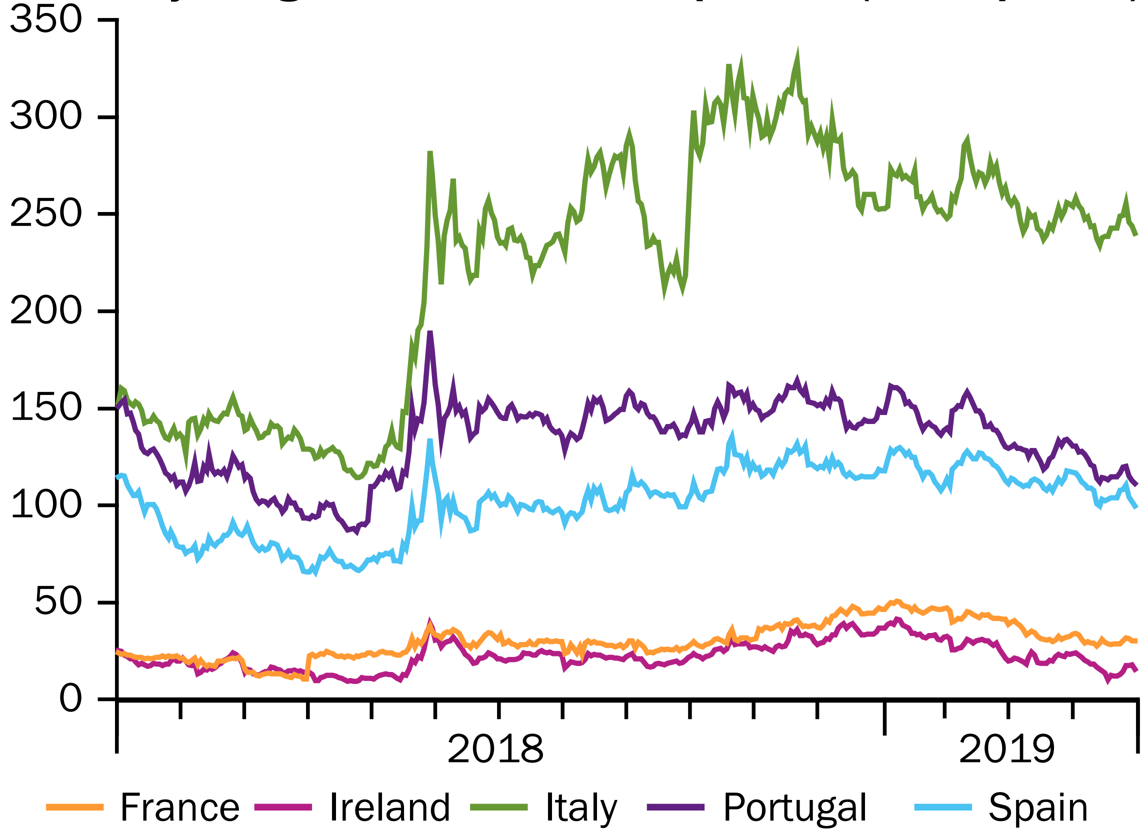


Source: ECB

- Sharp drop in financial integration after the financial crisis
- Segmentation of European banking and capital markets
- (Too) little risk sharing in the euro area

Wake-up call from Italy

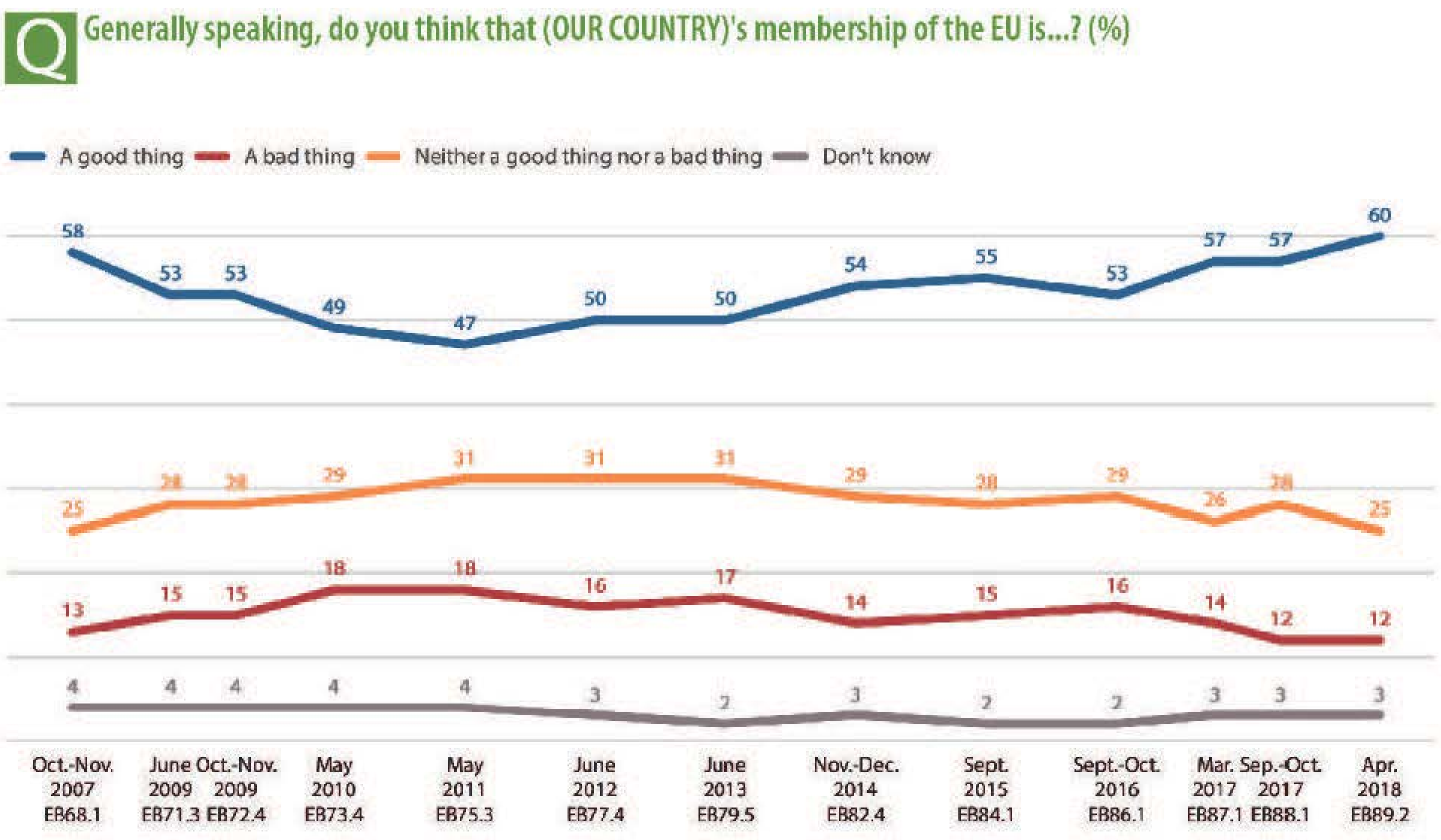
10-year government bond spreads (basis points)



Sources: Thomson Reuters, own calculations

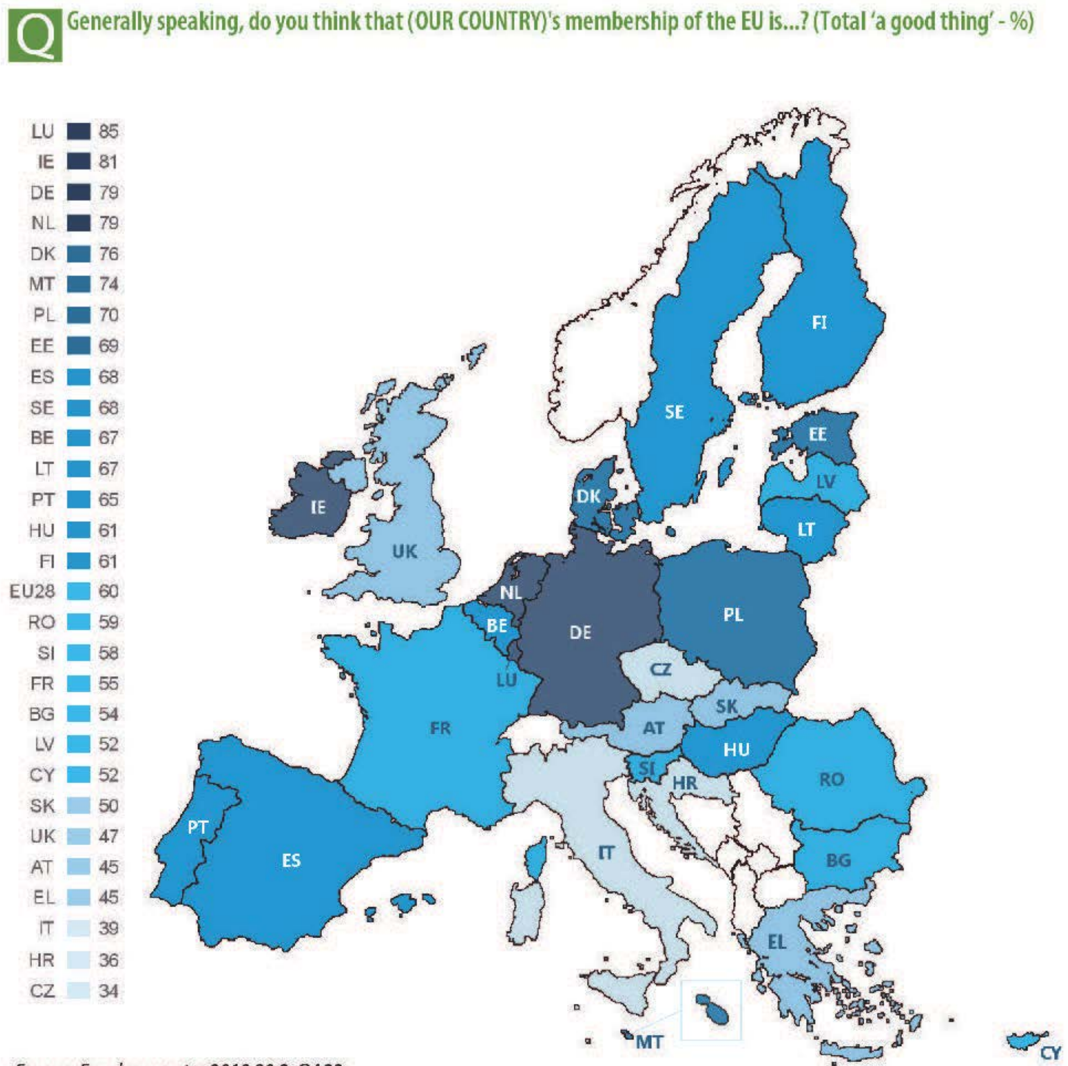
- Sharp rise in Italian government bond spreads in May 2018
  - Evidence of market discipline
  - But also redenomination risk
- Transmission to other countries and to Italian and other European banks
- Euro area is still unstable

Rising popularity of EU membership…



Source: Eurobarometer 2018 89.2, QA23

… but large heterogeneity across countries



Source: Eurobarometer 2018 89.2, QA23

- Political polarization and anti-European movements in some countries
- Crisis management has increased political tensions in Europe
  - Discontent of both debtor and creditor countries

Status quo remains unstable

- Recovery has relied strongly on the ECB
- But: Limited fiscal and monetary space to deal with the next recession or a new crisis

- Different "philosophies" have created a deadlock, which prevents further reforms
- This poses a threat to the stability of the euro area

2. Risk sharing and market discipline are complements

Different philosophies...

- “German” view:
  - Unity of liability and control
  - More market discipline, incentive compatibility
  - Fiscal discipline, enforceable rules
  - No transfer union

- “French” view:
  - Insurance against asymmetric shocks
  - Avoid procyclicality
  - Need for “safe assets”

… imply different solutions

- “German” view:
  - Orderly restructuring of sovereign debt
  - Credible fiscal rules with sanctions
  - Removing privileges for sovereign exposures

- “French” view:
  - Fiscal capacity
  - European deposit insurance
  - “Safe assets”

Central hypothesis of the report:
Risk sharing and market discipline are complements

- Not a political compromise but an economically consistent approach:

  - Risk sharing without discipline induces moral hazard and is not sustainable in the long run
  - Disciplining devices based on administrative or political procedures alone are hard to enforce
  - Market discipline without risk sharing is destabilizing and therefore not credible

➔ Risk sharing <u>and</u> market discipline are necessary

3. How to reform the euro area

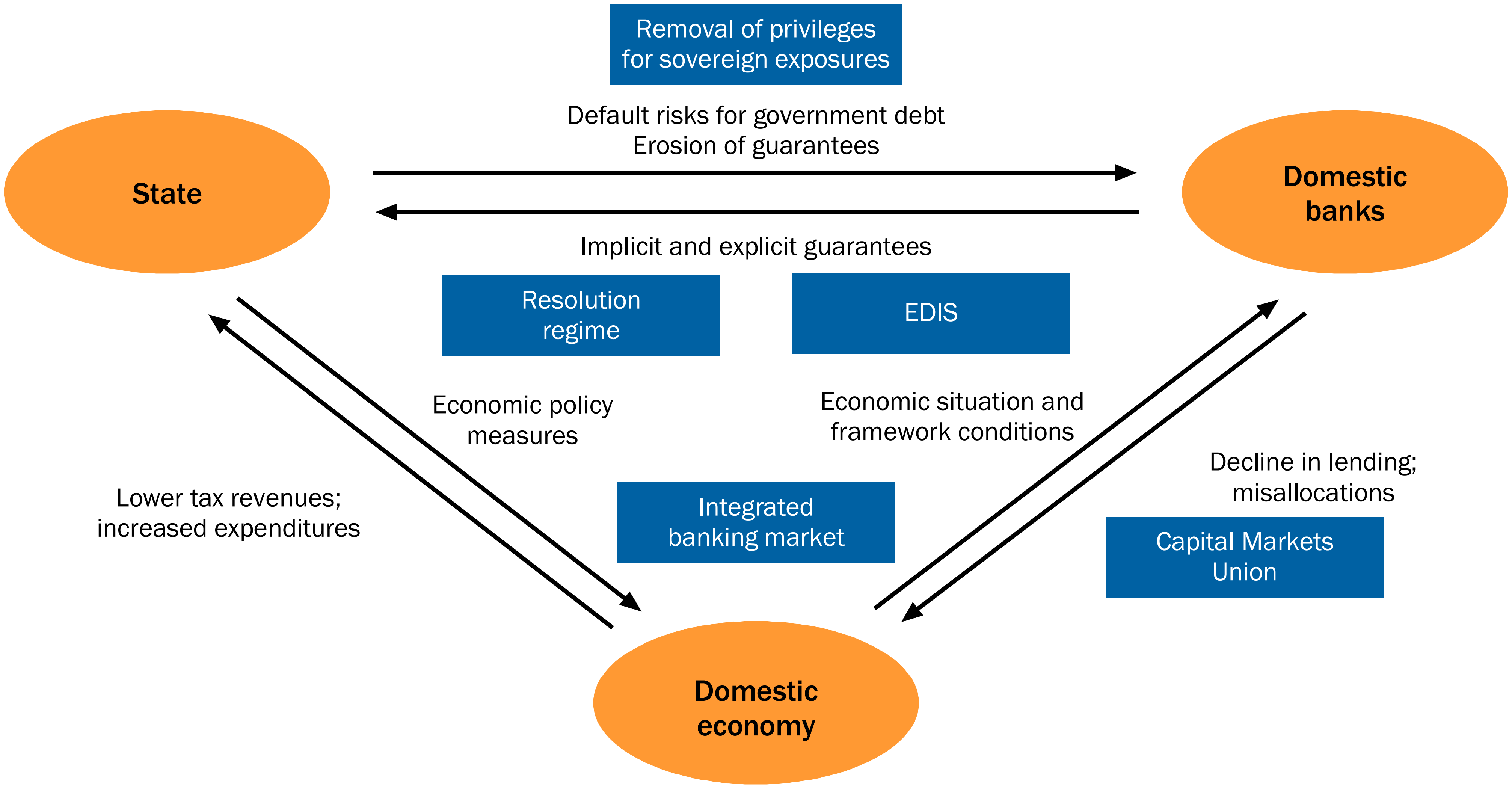
Essential elements of euro area reform

1. Strengthen the financial architecture:
   - Break the sovereign-bank nexus
   - Create a European banking and capital market

2. Raise the credibility of the fiscal framework
   - Expenditure rule: less procyclicality, better enforcement
   - Credible restructuring of sovereign debt as a last resort

3. More stabilization through European unemployment reinsurance
   - Incentive-compatible design
   - No permanent transfers

Breaking the sovereign-bank nexus is the core of financial reforms



Source: own illustration based on Shambaugh (2012) and Schnabel and Véron (2018)

Financial sector reforms

1. Credible resolution regime, including a common fiscal backstop and a special liquidity facility for banks in resolution
2. Well-designed European Deposit Insurance Scheme (EDIS)
3. Ending regulatory privileges for sovereign exposures
4. Integrated European banking market: Phase out options & national discretion, remove obstacles to pan-European mergers, no formation of national banking champions
5. Well-developed European capital market: Foster resilient capital flows through Capital Markets Union, remove debt bias, expand the competences of the European Securities and Markets Authority (ESMA)
6. Is there a need for a European safe asset?

Reforms of the fiscal framework

1. Fiscal expenditure rule

- Current rules are hard to enforce and procyclical (too little bite in good times, too harsh in bad times)
- Expenditures must not grow faster than nominal GDP (potential growth + expected inflation), lower as long as debt/GDP > 60%
  - Cleaned for interest rates and cyclical components (esp. unemployment insurance and discretionary tax changes)
- Enforcement: Excessive expenditures must be financed through junior debt ("accountability bonds")

Reforms of the fiscal framework

2. Rules for orderly sovereign debt restructuring

- Goal: Make the no-bailout rule credible
- No automatic restructuring of the stock to avoid self-fulfilling effects
- But: No ESM loans to insolvent countries without debt restructuring
- Mitigate holdout problems through comprehensive Collective Action Clauses
- Lower the costs of debt restructuring by reducing bank holdings of domestic sovereign debt

Need for fiscal stabilization

- National fiscal space can be insufficient in spite of responsible behavior
- Insurance cannot be achieved by financial integration alone
- ESM program not a substitute for macroeconomic stabilization

- Fiscal capacity can act as an automatic stabilizer
- Appropriate design can prevent long-term transfers and incentive problems
  - Reinsurance, ex-ante conditionality, experience ratings

- Even if incentive problems remain, these have to be weighed against the benefits from stabilization
- Remember: More stabilization may actually make market discipline more credible

Stabilization instruments

1. European unemployment reinsurance against large shocks
   - Trigger: large increase in unemployment rate
   - One-time transfer (not repayable)
   - Financed through national contributions with “experience rating“, no borrowing
   - Ex-ante conditionality: Access only when rules are complied with (fiscal rules, European semester)

2. Liquidity line at the ESM
   - Access to short-term liquidity at low rates without having to apply for a regular ESM program
   - Ex-ante conditionality

How to overcome political resistance

- Convince politicians and the population that…
  - … the euro area is unstable in its current form
  - … a strong euro area fosters economic growth and strengthens the role of Europe in the world
  - … doing nothing or waiting for the next crisis are very bad options
- Need of building reform packages for economic and political reasons
  - All sides will have to cross red lines
  - Red lines must not be used as an excuse not to do anything
- Firm commitment on all sides
  - Define preconditions and consequences
- Take into account political developments when designing economic programs

4. Conclusion

How to proceed?

- In spite of reforms the euro area is unstable
- Situation in Italy should not be used as an excuse to delay reforms but it rather shows their urgency

- From the “German” (“French”) perspective it would be unwise to reject any further risk sharing (market discipline)
- Instead the euro area should agree on an incentive-compatible design of risk-sharing mechanisms

- Reforms are likely to come too late to deal with current issues but may help to stabilize expectations regarding the future of the euro area

“Our future is Europe – we do not have another one.”

Thank you very much for your attention!

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