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

Isabel Schnabel
University of Bonn and German Council of Economic Experts

46th Economics Conference of OENB & SUERF
European Economic and Monetary Union: The first and the next 20 years
Vienna, 3 May 2019
“Our future is Europe – we do not have another one.”
Reconciling risk sharing with market discipline: A constructive approach to euro area reform

Agnès Bénassy-Quéré, Paris School of Economics and University of Paris 1; Markus Brunnermeier, Princeton University; Henrik Enderlein, Hertie School of Governance and Jacques Delors Institute Berlin; Emmanuel Farhi, Harvard University; Marcel Fratzscher, DIW and Humboldt University Berlin; Clemens Fuest, Ifo Institute and University of Munich; Pierre-Olivier Gourinchas, University of California at Berkeley; Philippe Martin, Sciences Po, Paris and Conseil d'Analyse Économique; Jean Pisani-Ferry, Bruegel, EUI, Hertie School of Governance and Sciences Po; Hélène Rey, London Business School; Isabel Schnabel, University of Bonn and German Council of Economic Experts; Nicolas Véron, Bruegel and Peterson Institute for International Economics; Beatrice Weder di Mauro, INSEAD and University of Mainz; and Jeromin Zettelmeyer, Peterson Institute for International Economics
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
Overall less dynamic development, especially in China
Uneasy waters for the euro area

- Slower expansion in the euro area after a long boom

- High risks:
  - Trade conflict
  - Brexit
  - Resurgence of the euro area crisis

Sources: European Commission, own calculations

© Sachverständigenrat | 19-138
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

- 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

Sources: IMF, 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

... limited monetary space in another crisis or recession
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

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

Source: ECB © Sachverständigenrat | 18-305
Wake-up call from Italy

- 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

Sources: Thomson Reuters, own calculations
Rising popularity of EU membership...
Political polarization and anti-European movements in some countries

- Crisis management has increased political tensions in Europe
  - Discontent of both debtor and creditor countries

... but large heterogeneity across 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 and 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!

Follow me on Twitter: @Isabel_Schnabel