The road to financial union

Daniela Gabor, UWE Bristol

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University of the West of England
BRISTOL

Financial union

- Structural changes in architecture of financial markets (financial markets integration)
- Supervisory infrastructure

Completing the FU: a brief history

- The Lamfalussy (repo) *market* approach: a market-based European financial system more efficient
- The (incomplete) *federalization* approach
- The CMU *market* approach: risk sharing via STS securitisation

The Lamfalussy approach

- Lamfalussy (2000): "We've seen an accelerated move to a market-centric system from the bank-centric system that has tended to prevail in Europe"...

- ...."I have no doubt that a market-centric system is more efficient, but there's a question whether it is stable." The key to stability - for the pricing of corporate as well as public debt - is *a liquid and transparent government debt market*.

The Lamfalussy approach

- Lamfalussy (2000): ‘the key to stability - for the pricing of corporate as well as public debt - is *a liquid and transparent government debt market’*.

- A *global* solution after LTCM/Russian crisis: ‘core asset markets whose ample liquidity would benefit the whole financial system need to be identified and promoted…. government securities provide a principal, but not the only, example of such a core asset class’ (CGFS 1999)

The Lamfalussy approach

1. Integrate national repo markets (Giovannini report 1999, Financial Collateral Directive 2002, T2S): demand for collateral = financial integration
2. Stability = interchangeable safe assets without pooling fiscal sovereignty. ECB catalyst through collateral framework:

‘the way market participants perceive the different national characteristics of securities accepted as collateral in repo transactions constitutes one aspect of the fragmentation of the euro area repo market. For instance, given the different credit ratings of euro area governments, there might be differences in the terms of repo transactions (i.e. repo rate, haircut) with government securities as collateral, depending on the country. The same applies to the differences in the liquidity of government securities. Market integration would benefit from the extension of a euro GC approach, enabling participants to put securities with similar, although not the same, characteristics in the same basket. Eurosystem collateralised operations are an example of this approach.

ECB (2002)

The Lamfalussy approach by 2008: stylized facts about financial integration

- …on balance sheet of cross-border European banks turning to capital market activities (Liikanen Report 2012)
- … funded in repo markets against (own and foreign) sovereign collateral (ICMA 2008, Hordhal and King 2008, Bolton and Jeanne 2010)
- ..levering up via sovereign collateral: sovereign-bank loop = market driven, policy supported.

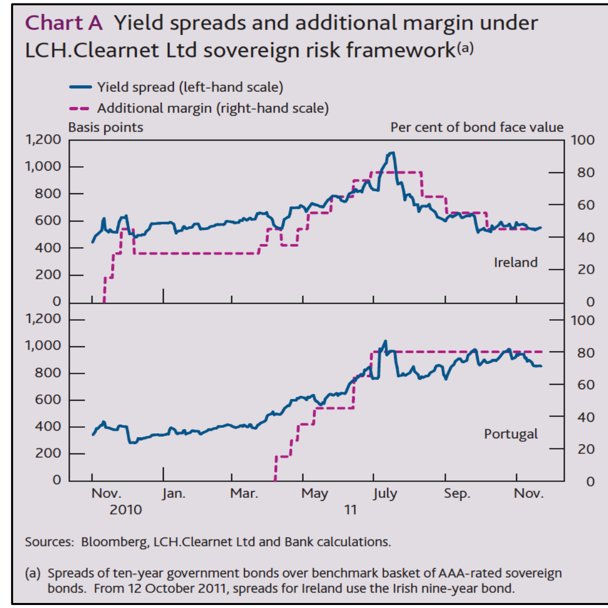
The weakness of the Lamfalussy approach

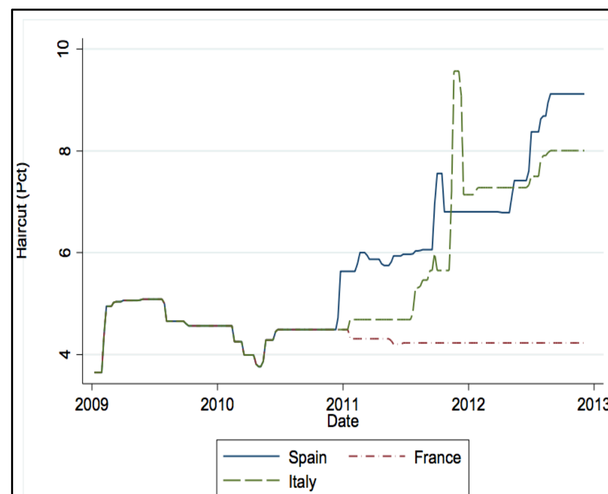
- after Lehman: (CCP) haircut/margin spirals + fragmentation of euro GC baskets = crises of sovereign collateral

- illusive repo liquidity for periphery sovereigns

  'asset liquidity may no longer depend on the characteristics of the asset itself, but rather on whether vulnerable counterparts have substantial positions that need liquidating' (Praet and Herzberg 2008)

- repo = from high-liquidity, low risk instrument to pro-cyclical shadow market (FSB 2012)





The federalization approach

- ECB/national central banks as backbone to financial union.

- Incomplete Banking Union: EDIS vs sovereign-bank loop.

CMU: the new market approach

STS securitisation – extending Lamfalussy (ECB/ BoE market catalysts, tapping into demand for safe assets, banks as market-makers) with better safeguards.

– can STS supply enough safe assets if sovereigns don't?

Bank of England

28 In normal times the Bank supports market liquidity by providing liquidity insurance to individual institutions, but in exceptional circumstances, the Bank stands ready to act as a market maker of last resort. Any such intervention would aim to improve the liquidity of one or more markets whose illiquidity posed a threat to financial stability or was judged to be important to the transmission mechanism of monetary policy. The importance of a market in financing such activity is likely to relate to its size, substitutability and interconnectedness with other markets.

CMU: the new market approach

- STS securitisation – extending Lamfalussy (ECB/BoE market catalysts, tapping into demand for safe assets, banks as market-makers) with better safeguards

- But risk sharing without sovereign debt markets (or supervisory infrastructure)

Principles for CMU

- Since market-based finance is collateral-intensive, markets that circulate collateral need adequate regulation (beyond SFTR/FSB)

- Back to Lamfalussy principles: institutional framework to ensure that ***all*** euro sovereigns supply safe assets
  - market discipline not enough, it leads to multiple equilibria in sovereign debt markets and little room for countercyclical fiscal policies (Cœuré, 2016)
  - borrowing costs for private issuers will not converge otherwise

- Financial union requires fiscal risk-sharing