MANAGING FINANCIAL CRISES: WHERE DO WE STAND

How can we achieve more risk sharing in the euro area?

Laurence Boone, November 5th 2018, Brussels

BETTER POLICIES FOR BETTER LIVES

Outline

We agree on long term objectives but dissent when it comes to transition especially for:

- **Limiting banks' exposure to sovereign debt**
- **How to deal with NPL**
- **Need for public risk sharing**

WHERE WE AGREE

Agreement on long term targets

1. We agree on the diagnosis: not enough risk sharing, financial markets quickly fragmented along national lines after 2008.

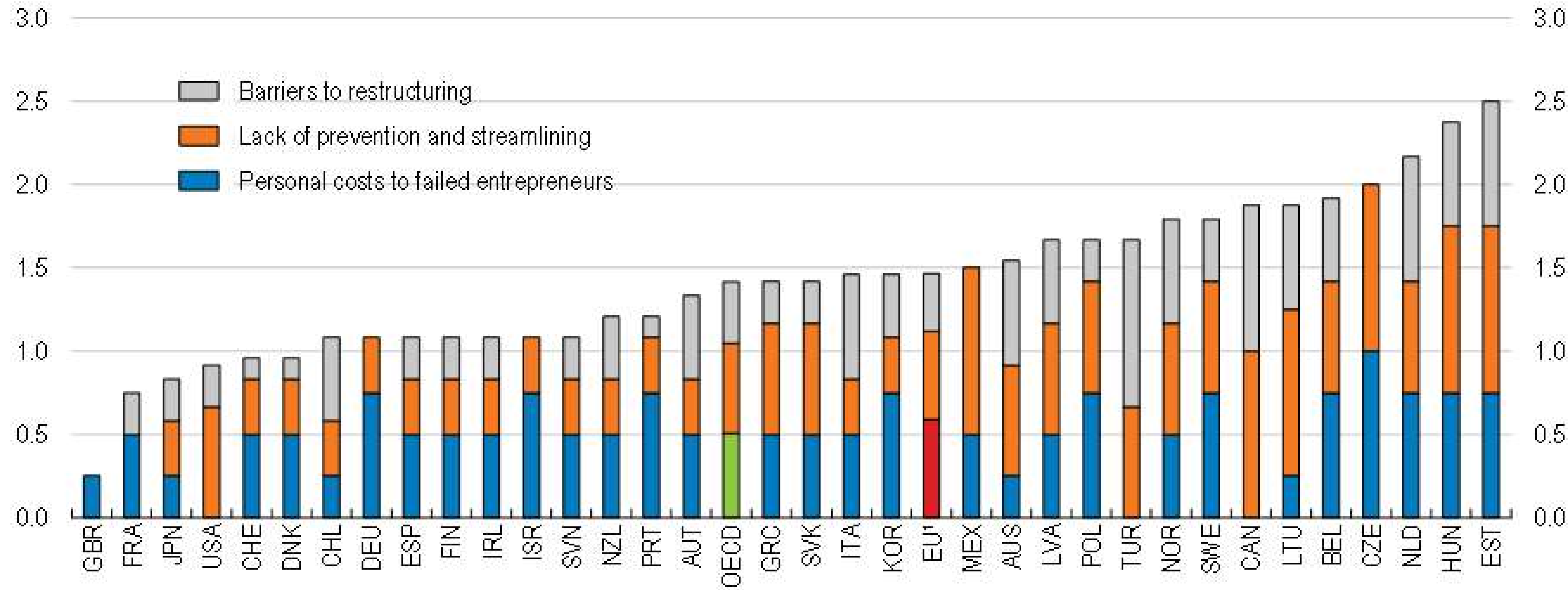
2. We agree on the next steps: completing the Banking union with a fiscal backstop to the resolution fund and a common deposit insurance.

3. We agree on the long-term aim of reducing home bias in financial intermediation through capital markets union.

4. I will also highlight the role of insolvency regimes and the efficiency of justice.

Insolvency regimes vary considerably across countries

Design of insolvency regimes across countries, 2016



1. Simple average across the 22 countries for which data are available.

Source: OECD calculations based on the OECD questionnaire on insolvency regimes; Adalet McGowan, M., D. Andrews and V. Millot (2017), “Insolvency Regimes, Zombie Firms and Capital Reallocation”, OECD Economics Department Working Papers, No. 1399, OECD Publishing, Paris; Adalet McGowan, M., D. Andrews and V. Millot (2017), “Insolvency Regimes, Technology Diffusion and Productivity Growth: Evidence from Firms in OECD Countries”, OECD Economics Department Working Papers, No. 1425, OECD Publishing, Paris.

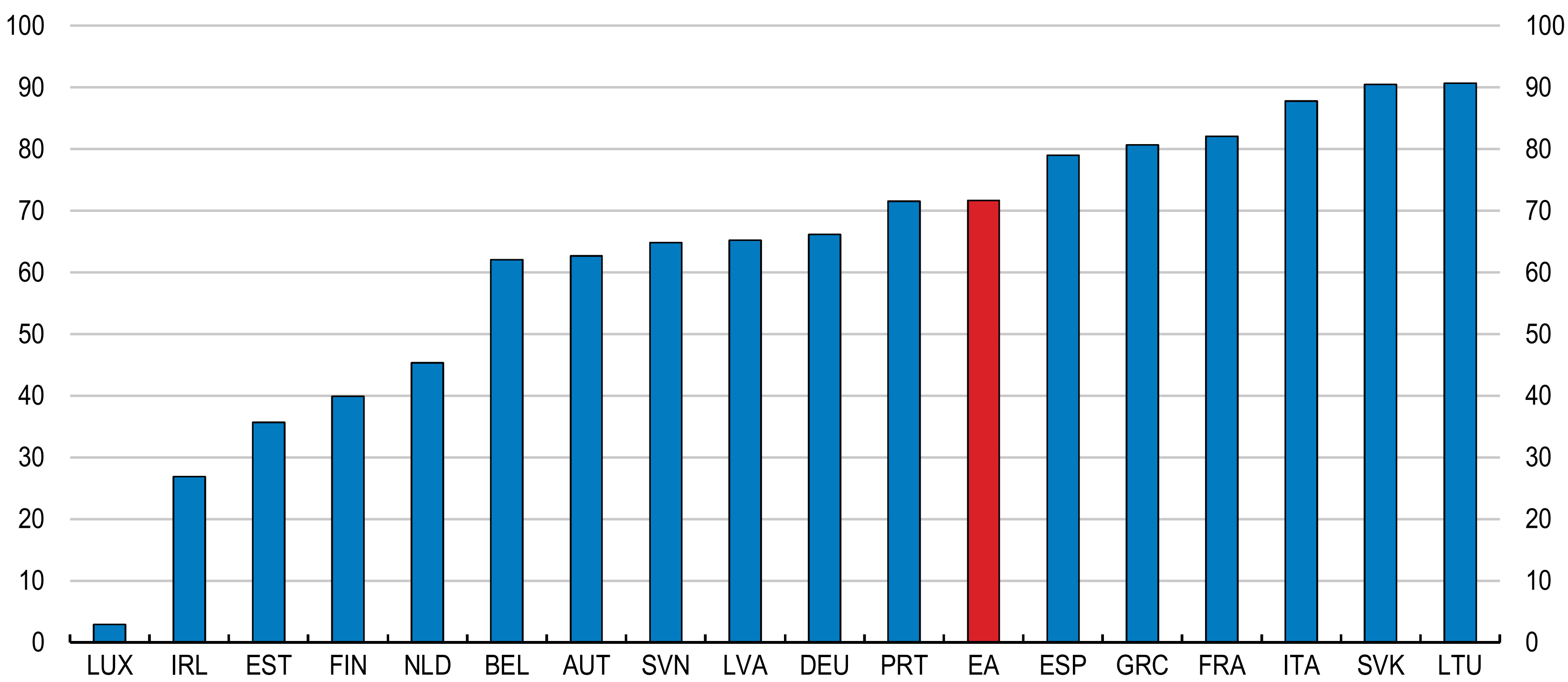
ISSUES FOR DEBATE

Reducing risk before any risk sharing?

- **Can risk can be shared only once it has been significantly reduced?**
- **On the banks' side, this is leading to proposals for concentration charges and more bail-inable debt.**
- **On the governments' side, this is leading to proposals for more market-driven discipline, such as junior debt.**
- **But could a too rapid move in that direction, without putting in parallel risk-sharing instruments, backfire?**

Can we impose concentration charges?

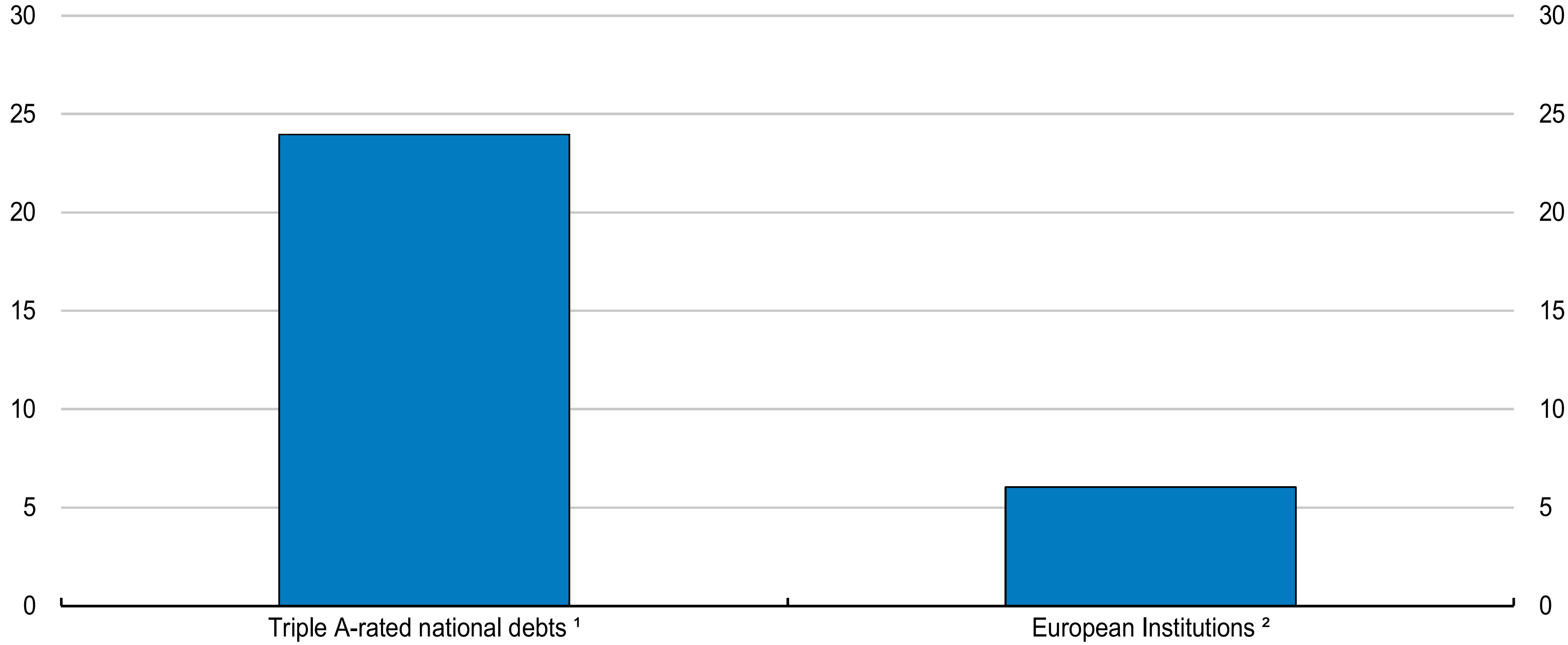
Share of domestic sovereign bonds in banks portfolios, March 2018 (%)



Source: OECD calculations based on ECB (2018), "Balance Sheet Items statistics", *Statistical Data Warehouse*, European Central Bank.

The supply of European safe assets is limited

Debt securities issued by governments and European institutions
As a percentage of euro area GDP, 2016

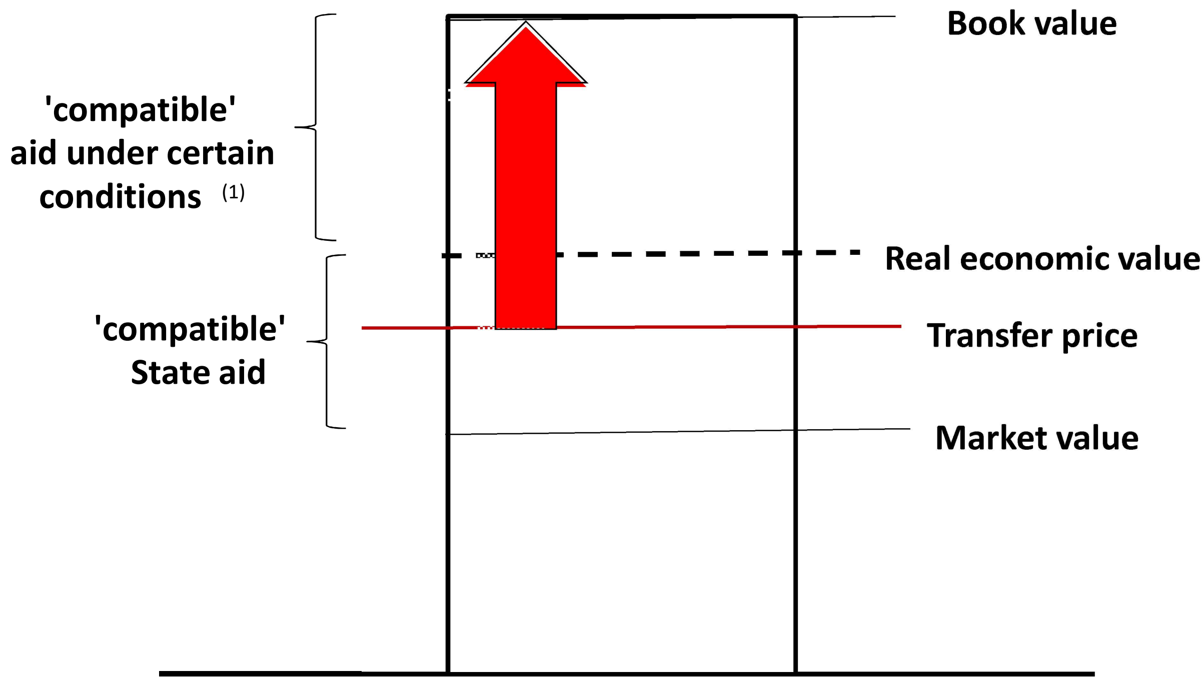


1. Sovereign debt securities issued by the governments of Germany, Luxembourg and the Netherlands.
2. Triple A-rated securities issued by the EU institutions and authorities (EIB, ESM, EFSM, BOP Facility and the Macro-Financial Assistance Programs.

Source: Brunnermeier, M. et al. (2017). ESBies: Safety in the tranches. Economic Policy, 32(90), 175-219; OECD calculations based on public information released by European Institutions.

More bail-inable debt could backfire

Valuation of impaired assets and state aid rules



(1) These conditions include claw-back clauses, in-depth restructuring and/or liquidation.

Source: Cas and Peresa, 2016

Do we need public risk sharing?

Banking union and capital markets union will take time to complete
And they may not be enough to face large shocks.

- **Private risk-sharing stopped during the global financial crisis**
- **Simple private consumption smoothing may not be sufficient from the aggregate perspective (Farhi and Werning, 2017)**
- **National fiscal policy could be constrained by high public debt.**

➢ **More fiscal risk-sharing would improve the mix of monetary and national fiscal policy, prevent pro-cyclical tightening and help mitigate spillovers.**

A COMMON FISCAL CAPACITY

Strengthening resilience through a common fiscal capacity

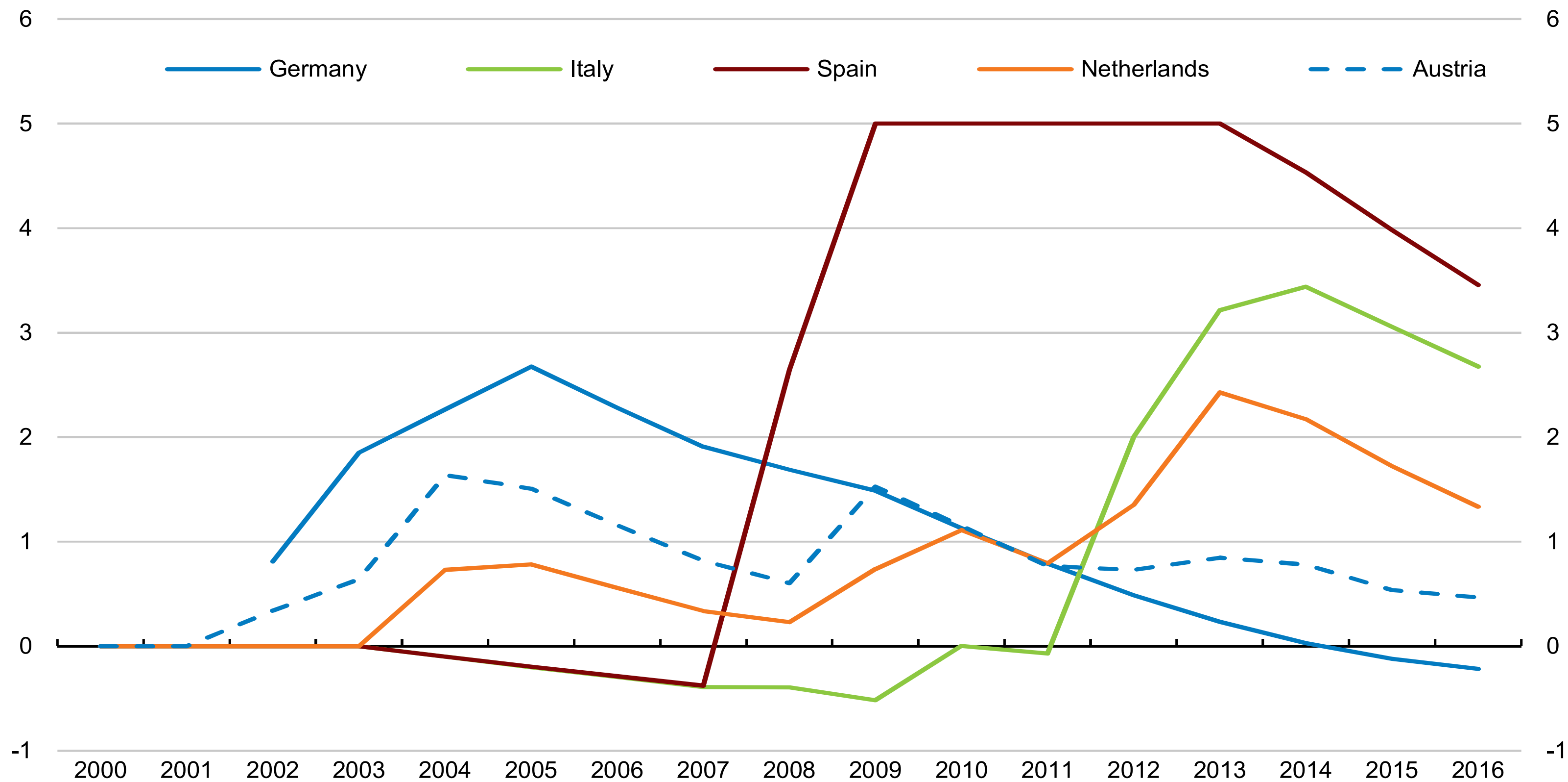
1. **Set up a fiscal stabilisation capacity in the form of an unemployment-triggered scheme that can borrow in financial markets.**

   - **Automatic trigger: support is provided when unemployment is increasing and above long-term average.**
   - **Support is proportioned to the size of the shock: 1% of GDP for 1 p.p. increase in the unemployment rate.**
   - **Cap on cumulative transfers: support stops at 5% of GDP in cumulative terms.**
   - **Regular annual contribution (0.1% of GDP when funds' balance is below -0.5% of euro area GDP) and experience rating (additional 0.05% of GDP for each time the fund was activated for past 10 years)**

2. **Make access to the common fiscal stabilisation capacity conditional on past compliance with fiscal rules.**

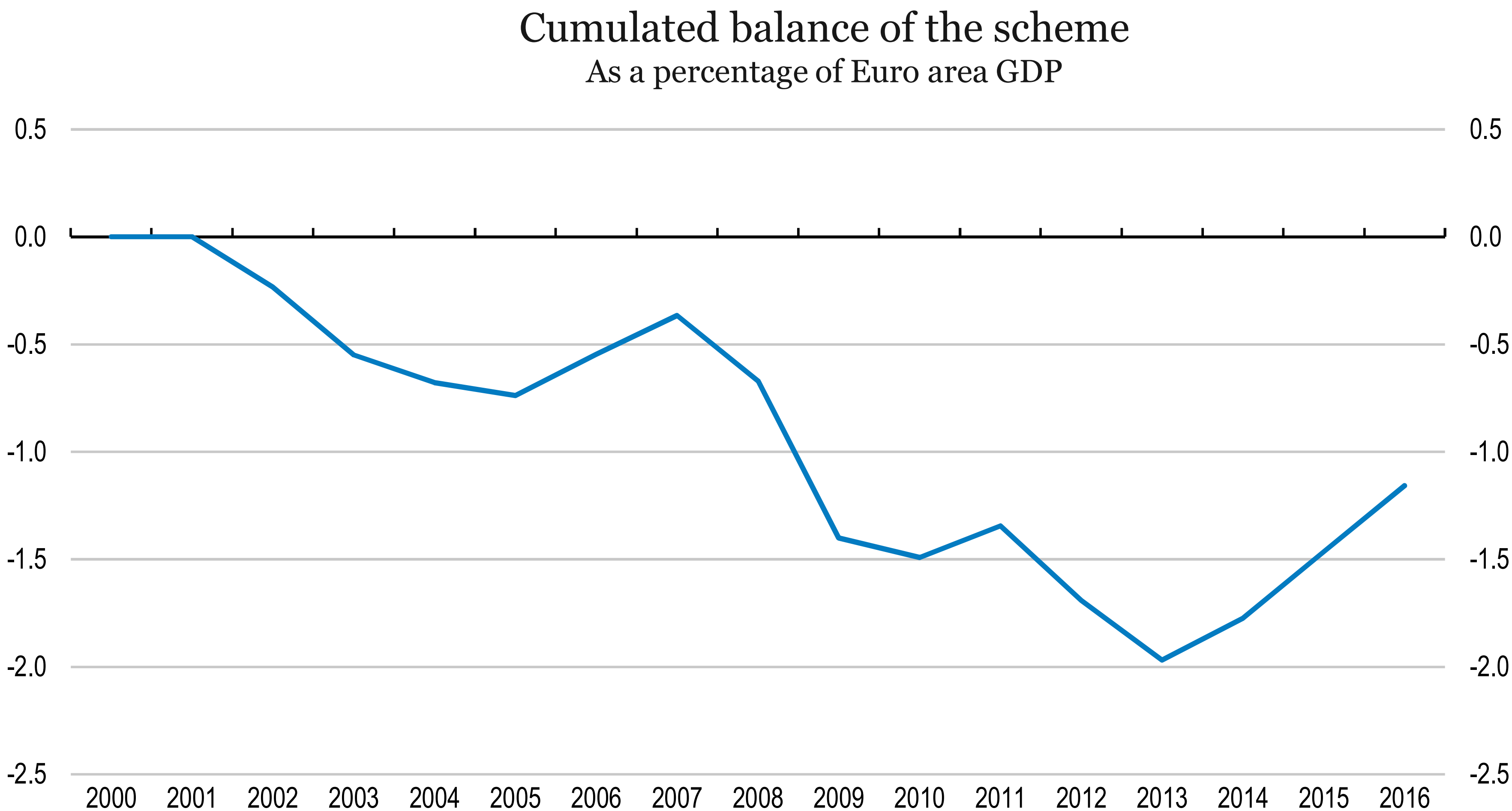
Most countries would benefit over time

Cumulative net balances towards the scheme (% of GDP)



Source: Claveres and Stráský (2018).

The scheme is set to return progressively to equilibrium



Source: Claveres and Stráský (2018), based on data from the *OECD Economic Outlook: Statistics and Projections* (database).

THANK YOU!