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NBB/ECB/Solvay/TSE conference

Managing financial crises: where do we stand?

Euro area governance – A new consensus? two challenges, and an open flank

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Outline

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1. A new consensus?
2. Two challenges
   - Fiscal risk sharing is unnecessary
   - Market discipline could be counterproductive
3. An open flank

A new consensus?

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1. Euro area requires both more risk sharing and more (market) discipline
2. There is no tension between the two. Risk sharing facilitates market discipline by making the no-bailout clause credible.
3. More risk sharing means completing banking union (EDIS, fiscal backstop), capital markets union, safe asset, easier access to ESM liquidity, but also a fiscal risk sharing mechanism (on top of reform of fiscal rules).
4. Market discipline in addition requires reducing sovereign exposures of banks to their own sovereign, to make sovereign debt restructuring feasible as a last resort.

Bénassy-Quéré et al (2018). Other proposals in this philosophy: Gros and Mayer (2010), Allard et al (2013), Berger et al (2018). Inching in the same direction: European Commission “reflection paper” (2017).

Some quotes reflecting this consensus

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"Market discipline can only be established if default is possible because its cost can be contained." – Gros and Mayer, 2010

"Far from diluting market discipline, insurance with strict ex ante rules could be an improvement over the current situation, where the credibility of the no bailout clause has been undermined by ad hoc responses to systemic stress" – Allard et al, 2013 (IMF team based in the European Department).

"Risk-sharing and stabilisation instruments are necessary for effective discipline." – Bénassy-Quéré et al, 2018

"The weak credibility of the no bailout rule stems from a time-consistency problem that fiscal risk sharing may ameliorate" – Berger, Dell'Ariccia and Obstfeld, 2018.

Disclaimer: these authors do not all agree on *which* risk sharing mechanisms that are needed, but all argued that more risk sharing is needed

How new is this really?

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- The list of actual reforms – EDIS, capital markets union, fiscal risk sharing mechanism, safe asset, gradual reform of regulation of sovereign exposures,– looks a lot like 4 Presidents, 5 Presidents, and European Commission have been advocating for a long time.

- Two differences:

    1. Credibility of no-bailout-clause, by making debt restructuring feasible, is one aim of the reforms.

    2. Extra careful in designing risk sharing arrangements in a way that does not give rise to new moral hazard
        - risk based insurance premia, reinsurance mechanisms

- For these reasons, a chance that "new consensus" may overcome the north/south divisions that have blocked the Presidents' reports/EC proposals. Or so we thought.

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Is fiscal risk sharing really necessary?

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Completing banking union and adopting an expenditure rule may be all you need for euro area to achieve U.S. levels of consumption smoothing.

Reason: (potential) automatic stabilizers are much larger in euro area countries than U.S. states.

- Percent of output shocks smoothed according to Alcidi et al. (2017):
  - Ø 1998-2007: U.S. 83%, Periphery (incl. Italy): 39%, Core: 58%
  - Ø 2008-2009: U.S. 86%, Periphery (incl. Italy): 47%, Core: 98%
  - Ø 2010-2013: U.S. 77%, Periphery (incl. Italy): 3%, Core: 40%
- Percent of output shocks smoothed according to Milano (2017):
  - Ø 1999-2006: U.S. 70%, Periphery (excl. Italy): 23%, Core: 59%
  - Ø 2007-2014: U.S. 60%, Periphery (excl. Italy): 23%, Core: 74%

Policy implication: ensure that fiscal space and "rules space" exists for automatic stabilizers to work, promote financial integration and CMU.

Is fiscal risk sharing really necessary? Reply

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Good points. But Yes, it is necessary

1. Banking union and reform of fiscal rules are essential, but may not guarantee success. Need “belt and suspenders” approach.
2. Even if we could achieve same degree of consumptions smoothing in EA as in the U.S. w/o fiscal risk sharing, it would be a less efficient way to achieve it (does not exploit welfare gains of diversification).
3. So, it comes down to whether any “agency costs” of risk sharing arrangements offsets the efficiency gains. They do not, because fiscal risk sharing makes no-bailout more credible. In fact, it may be the economic (and political) quid pro quo for insisting on no-bailout clause.
   - If we want to use debt restructuring to deal with deep solvency crises (≈ large permanent shocks), need to make such crises as unlikely as possible.
   - These crises are precisely when transfers work better than self-insurance (Farhi and Werning 2017).

Is debt restructuring option really necessary?

The "Risk sharing plus market discipline" consensus, if it gets its way, could make things worse for high debt countries, for two reasons.

1. Limiting capacity of banking system to buy bonds of sovereign removes a key source of borrowing in a crisis.
2. The explicit aim of "risk sharing plus market discipline" is to make debt restructurings more likely. Hence, borrowing costs will go up, hitting high-debt countries disproportionately.

For these reasons, implementing the prescriptions of the "new consensus" may well trigger a crisis. Even if it does not, it will make it harder for high-debt countries to reduce their debts, and it will make them more susceptible to self-fulfilling runs.

Is debt restructuring option really necessary? Reply

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Good points. But Yes, it is necessary.

1. If we want to break the sovereign-bank doomloop, national banking systems can no longer be lenders or last resort of their sovereigns. This place must be filled by official institutions (ESM/ECB)
2. The aim of "risk sharing plus market discipline" is *not* to make debt restructurings more likely. It is only to make debt restructurings more likely *in a case of deeply insolvency*. But the chances of becoming insolvent decline due to risk sharing.

Lack of debt restructuring option sets EA up for another Greek-style disaster:

- Botched official rescue attempt with far too much austerity
- After attempt has failed, choice of either bailing out (= official debt relief) or euro exit

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Three pathways to exit

1. Lack of debt restructuring option. Could lead to either exit of crisis country (if no-bailout-clause is enforced) or of (one or several) creditor countries (if no-bailout-clause keeps getting violated).
2. Protracted stagnation inside the euro triggers "voluntary exit".
3. Governments do not want to exit, but neither do they want to play by the rules – including the rules of the safety net (ESM conditionality).

"Risk sharing plus market discipline" offers a solution for 1. It does not offer a solution for 2 or 3.

- 2 may not be soluble – but it is hard to see why being in the euro would create worse *long run* growth conditions than being outside.
- But 3 *could* be solved, by maintaining ECB support for the banking system even in the absence of financial support for governments.

Closing the open flank

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- Euro members can never "run out of reserves". Krugman-style speculative attacks are impossible.
- But: they are forced to exit if ECB stops supplying banks with liquidity.
- Greece 2015: supplying banks with liquidity (keeping ELA going) requires minimum cooperation from government. Must want a program.
- What if governments to not cooperate?

"Risk sharing plus market discipline" would offers a solution if it is extended by a mechanism through which euro area authorities (SSM, SRB or ESM) could take emergency control of the banking system.

1. Let non-cooperative governments default (rest of EU is protected by safe asset, precautionary ESM liquidity, ECB).
2. Seize control of banking system and continue ELA indefinitely, until government changes course.

Backup slides

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Strengthen market discipline by lowering disruptions associated with debt restructuring

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"Market discipline can only be established if default is possible because its cost can be contained." (Gros and Mayer, 2010).

Hence, need to find reforms that:

1. Lower domestic costs of debt restructuring *when this is needed*
2. Lower spillover risks/contagion within euro area

Reforms to reduce disruptions of debt restructuring

1. To minimize reputational spillovers/negative signaling, give role to ESM in deciding whether a debt restructuring is necessary.
2. Encourage banks to diversify sovereign exposures. Over longer term, create euro area level safe asset immune to sovereign default.
3. Create a European deposit insurance (EDIS)
4. Precautionary access to ESM liquidity for pre-qualified countries
5. Expand risk sharing, via more integrated capital markets, but also via a fiscal risk sharing mechanism.

Potential objection: but won't these ideas – a common safe asset, expanded access to ESM liquidity, EDIS, fiscal risk sharing – undermine the very market discipline that we are trying to create?

Answer: not if these mechanisms are properly designed.

Example 1: European deposit insurance

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- A single European entity. Unconditional equal protection of all insured deposits, regardless of country. *For the depositor*, equivalent to a fully mutualized entity
- *Within* this entity, a waterfall structure. Mutual compartment tapped once national compartments are empty
- Risk-based insurance premiums. Based on structural indicators such as the effectiveness of insolvency and foreclosure processes

Example 2: Reinsurance fund for large shocks

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- Prequalification: requires meeting minimum standards of policy making (respect of fiscal rule, country-specific recommendations)
- Trigger: large increase in unemployment (e.g. 2 percentage points) or collapse in employment
- Payout: one-off transfer, e.g. 0.25% of GDP for each percent increase of unemployment above trigger level. Not repayable.
- Conditions related to use of funds (e.g. unemployment benefits, or public investment).
- National contributions depend on volatility of "trigger variable"; experience rated. Order of magnitude: 0.1% of GDP per year of participating countries.
- Incentives preserved through (1) prequalification, (2) reinsurance character, and (3) experience-rated contributions.

Example 3: Safe asset

Create – or incentivize creation – of a euro area debt instrument backed by national bonds. Two examples:

- "ESBies": senior tranche of sovereign bond backed securities. Issued by private intermediaries buying sovereign bonds at market prices.
- "E-bonds" issued by a senior public financial intermediary who puchases debt at face value and charges borrowers its funding costs

SBBS

Assets	Liabilities
Government bonds (100)	ESBies (70) EJBies (30)

E-bonds

Assets	Liabilities
Senior government loans (100)	Safe asset (100)

Both ideas avoid mutualization, but very different safety properties, redistributive impact, and impact on borrowing costs

Replace the SGP by an expenditure rule managed mostly at the national level

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1. National fiscal councils, supervised by euro area watchdog:
   - define medium term (e.g. 5 year) debt reduction target based on distance from 60% D/Y, but also broader analysis of fiscal solvency
   - prepare medium-term nominal growth projection based on potential output growth and inflation target.
   - On this basis, "back out" expenditure growth ceiling (simplest case: expenditure growth ≤ expected nominal growth rate)
2. Expenditure calculated net of non-discretionary changes in unemployment benefits and changes in tax rates/administration.
3. Expenditure in excess of ceiling must be financed using subordinated bonds, which suffer automatic maturity extension in case of ESM program. Present sanctioning system is abolished.