Euro Area Governance
Politics is crucial

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Managing Financial Crisis: Where do we stand?
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Introduction

- The euro area suffered badly from the crisis

- Two reasons:
  - EMU 1.0 allowed huge imbalances before the crisis
  - The governance of EMU 1.0 was not fit to manage the crisis

- Despite important progress, EMU 2.0 still has fragilities
  - Major imbalances remain
  - Current ESM, BU, OMT are insufficient

- Various proposals to improve the EA's economic governance

- But political governance and politics (EA and national) are crucial

What was wrong with EMU 1.0?

- Impact of EMU on financial integration underestimated & consequences for financial stability ignored:
  EMU 1.0 badly prepared to address financial crises

- Nature of EMU sovereign debt ignored:
  EMU 1.0 badly prepared to address sovereign debt crises

The Maastricht EA crisis management framework

Function	Banks			Sovereign debt		
(institution)	EMU 1.0	EMU 2.0	EMU 3.0	EMU 1.0	EMU 2.0	EMU 3.0
Surveillance	Supervision			SGP		
(institution)	(national)			(EC)		
Crisis management	LOLR			-		
(institution)	(national ELA)			-		
Crisis resolution	Resolution, DI			-		
(institution)	(national)			-		

Today's EA crisis management framework

Function	Banks			Sovereign debt		
(institution)	EMU 1.0	EMU 2.0	EMU 3.0	EMU 1.0	EMU 2.0	EMU 3.0
Surveillance	Supervision	Supervision		SGP	2-P, 6-P, TSCG	
(institution)	(national)	(SB-ECB)		(EC)	(EC)	
Crisis management	LOLR	LOLR		-	EA loan, OMT	
(institution)	(national ELA)	(national ELA)		-	(ESM, ECB)	
Crisis resolution	Resolution, DI	Resolution, DI		-	-	
(institution)	(national)	(SRB, national)		-	-	

How should EMU address financial crises?

- § EMU needs
  - » A common mechanism for supervision, resolution and deposit insurance guarantee for banks
  - » To rely less on bank finance

- § EMU 2.0 provides a partial answer

- § EMU 3.0 needs to
  - » Complete the BU
  - » Give the ECB greater responsibility for LOLR
  - » Reduce bank dependence: Capital Markets Union

How should EMU address sovereign debt crises?

- EMU needs
  - To lower national sovereign debt
  - To reduce the exposure of banks to national sovereign debt

- EMU 2.0 provides a partial answer

- EMU 3.0 needs to
  - Have better fiscal rules and better enforcement
  - Increase the ability of ESM and ECB ‘s OMT to deal with crises

The crux of the matter: dealing with risk

- The Franco-German 7+7 contribution (Benassy-Quéré et al., 2018) to the debate puts the emphasis on
  - Risk sharing
  - Risk reduction (through market discipline on governments)

- The Italian and Spanish contributions (Bini-Smaghi, 2018; Almunia et al., 2018) instead (or also) emphasize
  - Risk of redenomination

- Both are right
  - The objective should be to (nearly) eliminate the redenomination risk
  - The instrument to achieve this is to combine risk sharing [at the EA level] and risk reduction [at the EU/EA level (CMU) and at the national level (lower sovereign debt and cap exposure by banks)]

Redenomination risk (RR): causes and cures

- Two possible origins:
  - Domestic: fiscal and political risk
  - Foreign: contagion from other EA countries

- The cures:
  - Domestic origin: domestic mesaures
  - Foreign origin: EA measures

- An illustration: Belgium and Italy during the crisis

BE vs IT: 10-year yields on government bonds (%)

Takeaways from the comparison between BE and IT

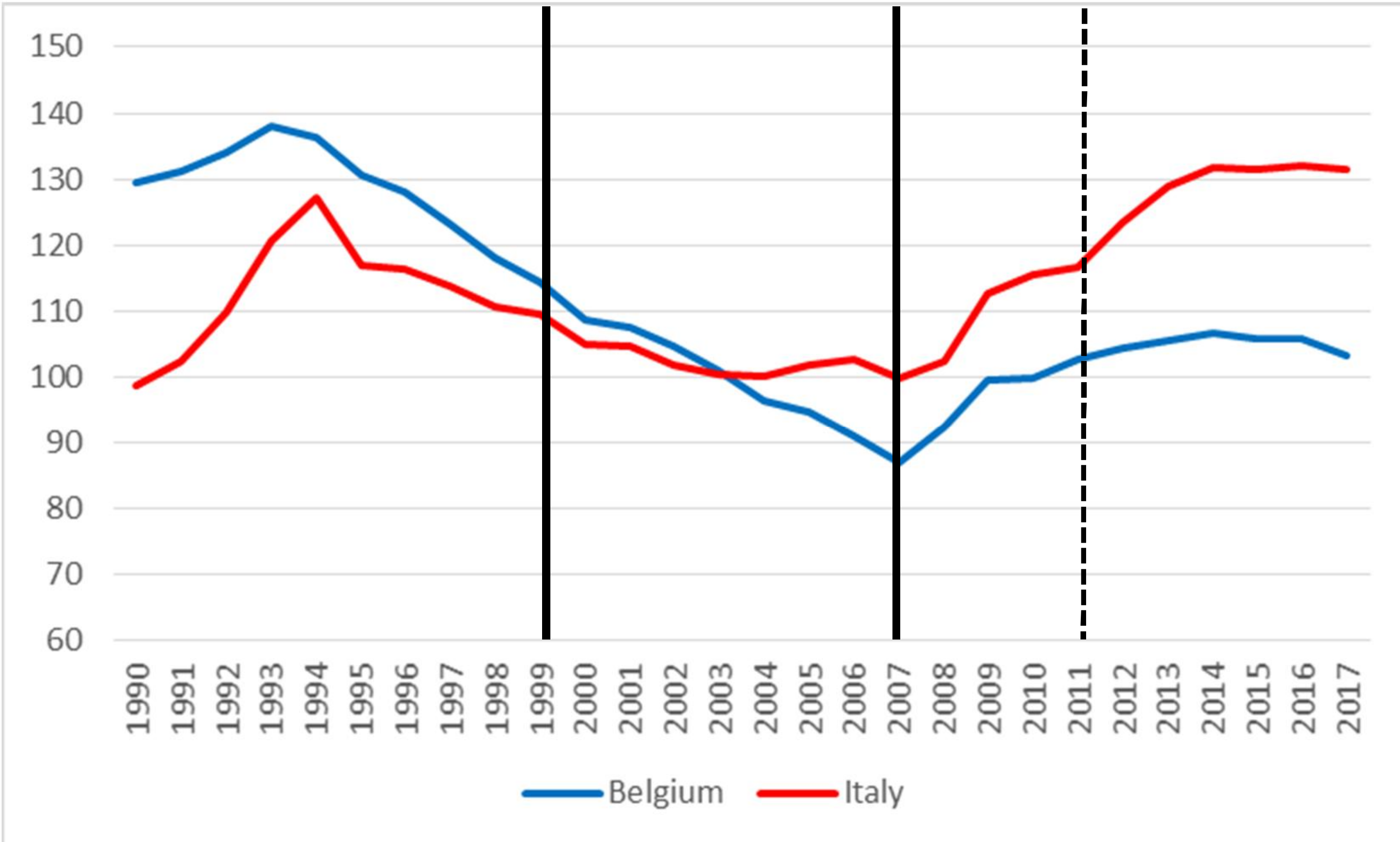
- Before May 10: yields lower in IT than in BE

- May10-July11: Contagion from EL with similar effects in BE and IT (yield correlation = 0.97)

- July 11-July 12: Markets clearly differentiate between BE and IT (yield correlation = 0.51). Two reasons:
  - Different public debt and NPL records: domestic political ownership; EA surveillance framework
  - Different political situation and policies

- Since July 2012: The ECB has been able to lower yields in both countries, but they are now always higher in IT than in BE
  - ECB alone can mitigate but not eliminate redenomination risk: politics

BE vs IT: Debt-to-GDP ratio (%)



BE vs IT: NPLs as % of gross loans

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
BE	1.2	1.6	3.1	2.8	3.3	3.1	4.2	4.2	3.8	3.4	2.9
IT	5.8	6.3	9.4	10.0	11.7	13.7	16.5	18.0	18.1	17.1	14.4

The ECB & ESM: at the center of crisis management

- Three main problems with EMU 2.0
  - BU is incomplete and ESM direct bank recapitalisation not operational
  - ESM’s logic for banks & sovereigns is ‘ultima ratio’, not precautionary
  - No instrument to deal orderly with sovereign insolvency

- From EMU 2.0 with the ESM to EMU 3.0 with the EMF
  - Logic
    - One institution dealing with fiscal needs of banking and sovereign crises
    - One institution (ECB) dealing with liquidity needs of both types of crises
  - Governance
    - Replace unanimity by (super-) majority
    - Replace prior approval by national parliaments by something else
    - Governance per se does not matter. What does is that it delivers precautionary measures to prevent contagion

Possible future EA crisis management framework

Function	Banks			Sovereign debt		
(institution)	EMU 1.0	EMU 2.0	EMU 3.0	EMU 1.0	EMU 2.0	EMU 3.0
Surveillance	Supervision	Supervision	Supervision	SGP	2-P, 6-P, TSCG	Fiscal rules
(institution)	(national)	(SB-ECB)	(SSM-ECB)	(EC)	(EC)	(EC)
Crisis management	LOLR	LOLR	LOLR	-	EA loan, OMT	EA loan, OMT
(institution)	(national ELA)	(national ELA)	(ECB ELA)	-	(ESM, ECB)	(EMF, ECB)
Crisis resolution	Resolution, DI	Resolution, DI	Resolution, DI	-	-	SDRM
(institution)	(national)	(SRB, national)	(SRDIB/EMF)	-	-	(EMF)

Better economic governance & political governance

- Giving the ECB and the ESM/EMF a greater role in crisis management (risk sharing) is highly political

- It requires therefore greater trust
  - Between countries
  - Towards the ESM/EMF

- ESM/EMF must become an instrument of a EA fiscal authority with EA (and national) accountability

- Ideally this fiscal authority should
  - Comprise the EA Finance Ministers + some EU/EA representatives
  - (Also play a role in the EA fiscal stance)

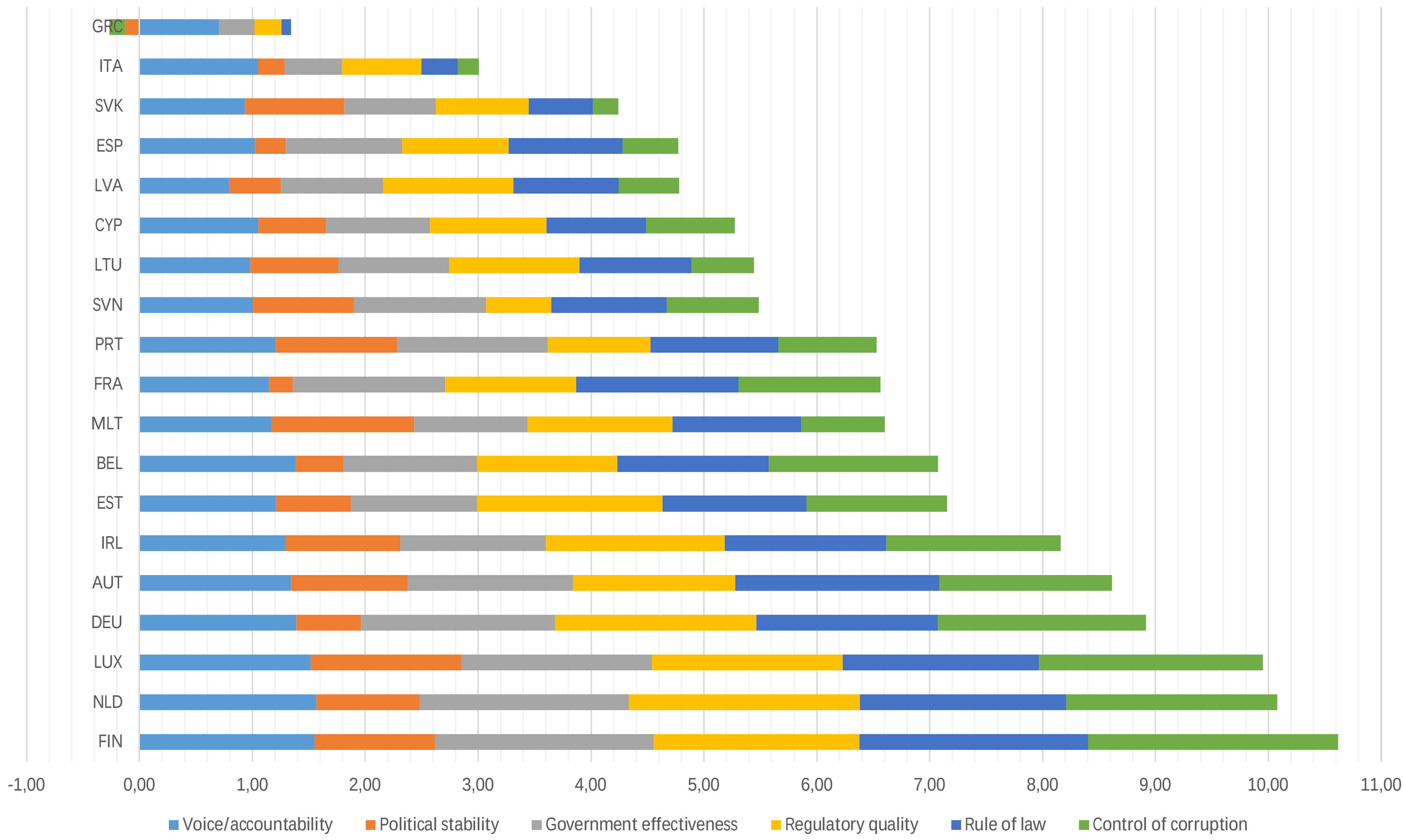
Trust between countries

- Greater risk sharing and risk reduction to eliminate the risk of redenomination require greater trust between countries

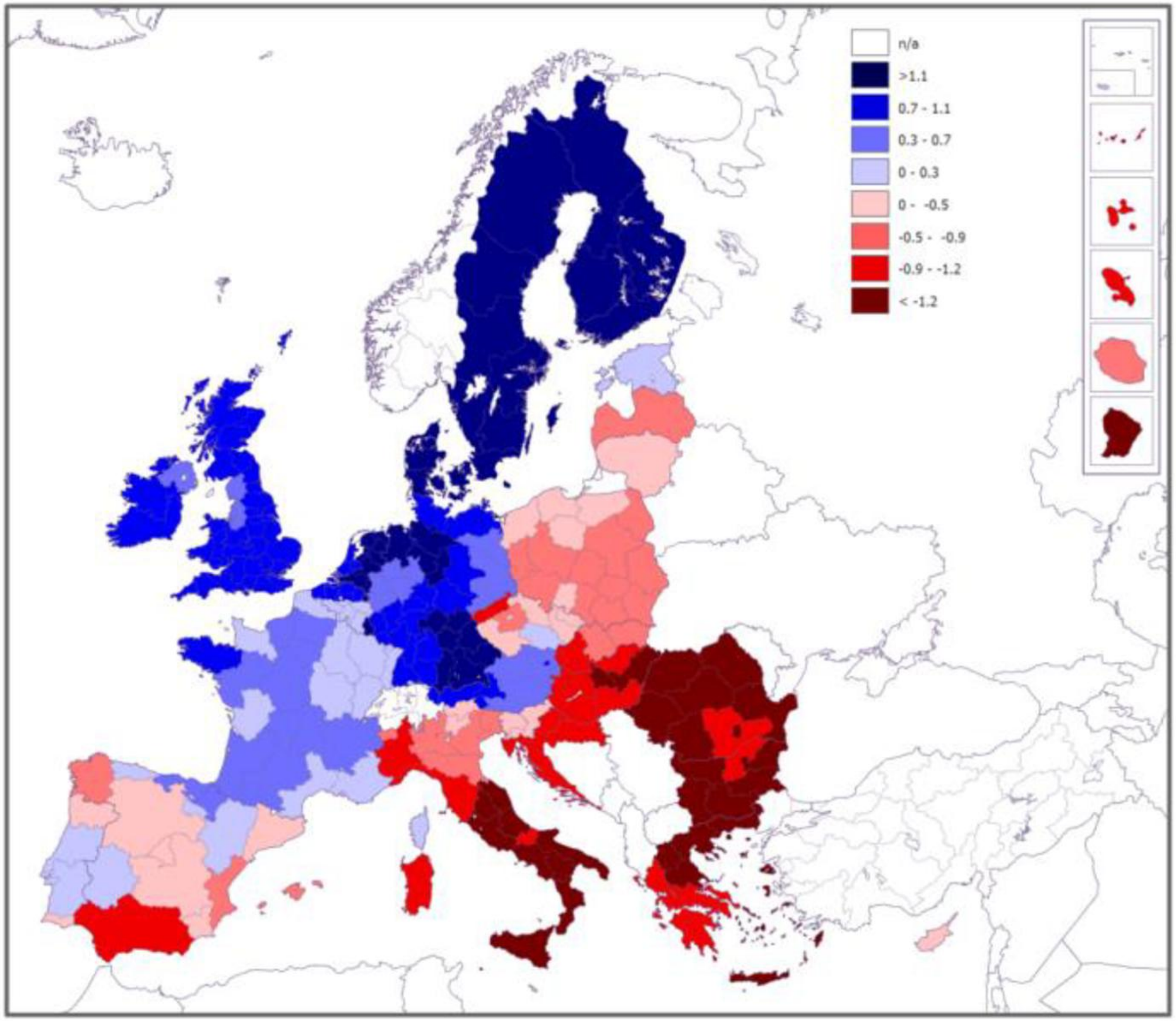
- Greater trust requires less heterogeneity, more convergence

- The quality of governance varies a lot across EA countries

World Bank governance indicators (EA countries, 2017)



Quality of government (EU regions, 2017)



Source: Charron and Lapuente (2018). Quality of government in EU regions. Gothenborg University.

Country heterogeneity and risk sharing: a proposal

- There are two potential options:
  - Wait for greater convergence before accepting greater risk sharing among all EA countries
  - Move ahead with greater risk sharing among all EA countries despite high heterogeneity

- A third option: move ahead with greater risk sharing but only among countries with sufficiently low risk. Two advantages:
  - It would incentivize countries to reduce risk
  - It would eliminate RR due to contagion as countries with low levels of risk should qualify for precautionary ESM loans and OMT. The other countries (those with higher levels of risk)
    - Should be helped to converge: to reduce risk and improve governance
    - Should have access to the ESM, but not to its precautionary window

Conclusion

- EMU 1.0 was inadequate to deal with financial and sovereign crises

- EMU 2.0 is a great improvement but is still insufficient to manage crises

- EMU 3.0 needs to go further and eliminate as much as possible the redenomination risk
  - This requires accepting further risk sharing and risk reduction
  - Further risk sharing is politically difficult given the heterogeneity but it is crucial to eliminate RR
  - Risk reduction is also politically difficult but crucial
  - The system must provide incentives for convergence
  - In the meantime it can significantly reduce the contagion risk