# Is the Eurozone ready for the next crisis?

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# Outline

1. Why was the last financial crisis so bad?

2. What has been fixed, what is now worse, what remains to do?

3. Concluding remarks

# Why was the last crisis so bad?

1. Initial conditions and preventive arm
   - Unsustainable current account deficits and real exchange rates
   - Large public debts

2. Amplifying mechanisms
   - Bank-sovereign doom loop
   - Redenomination risk and political reactions

3. Not enough private risk sharing / market discipline?
   - No ESDRM => not enough debt restructuring

# Why was the last crisis so bad?

4. No fiscal tools for managing a sudden stop
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# 1. Initial conditions and prevention

- Large legacy debts are THE main stumbling block preventing EZ reforms and main source of fragility
  - They ought to be reduced urgently. How?

- Mkt Discipline alone is too late and too sudden

- Institutional constraints matter
  - 2017 Deficit: EZ: <1% US: 5% Japan: 4.3% UK: 2%
  - D/Y: EZ 87% (↓ by 4 pp in 4Y) US: 108%

- But Fiscal Compact should be strengthened (EFB 2018)
  - Commission was too lenient in past few years
  - Rules too complex
  - Sanctions and enforcement

# How to strengthen the Fiscal Compact

- Assessment delegated to non-political body (independent arm of Commission?)
- Focus on medium term goal of debt reduction
- Operational target: primary net expenditure growth (EFB)
- Exploit market discipline for enforcement: excess debt must be junior
  - More costly, with larger haircuts at ECB and higher capital charges for banks
- Countries in violation to be excluded from risk sharing mechanisms

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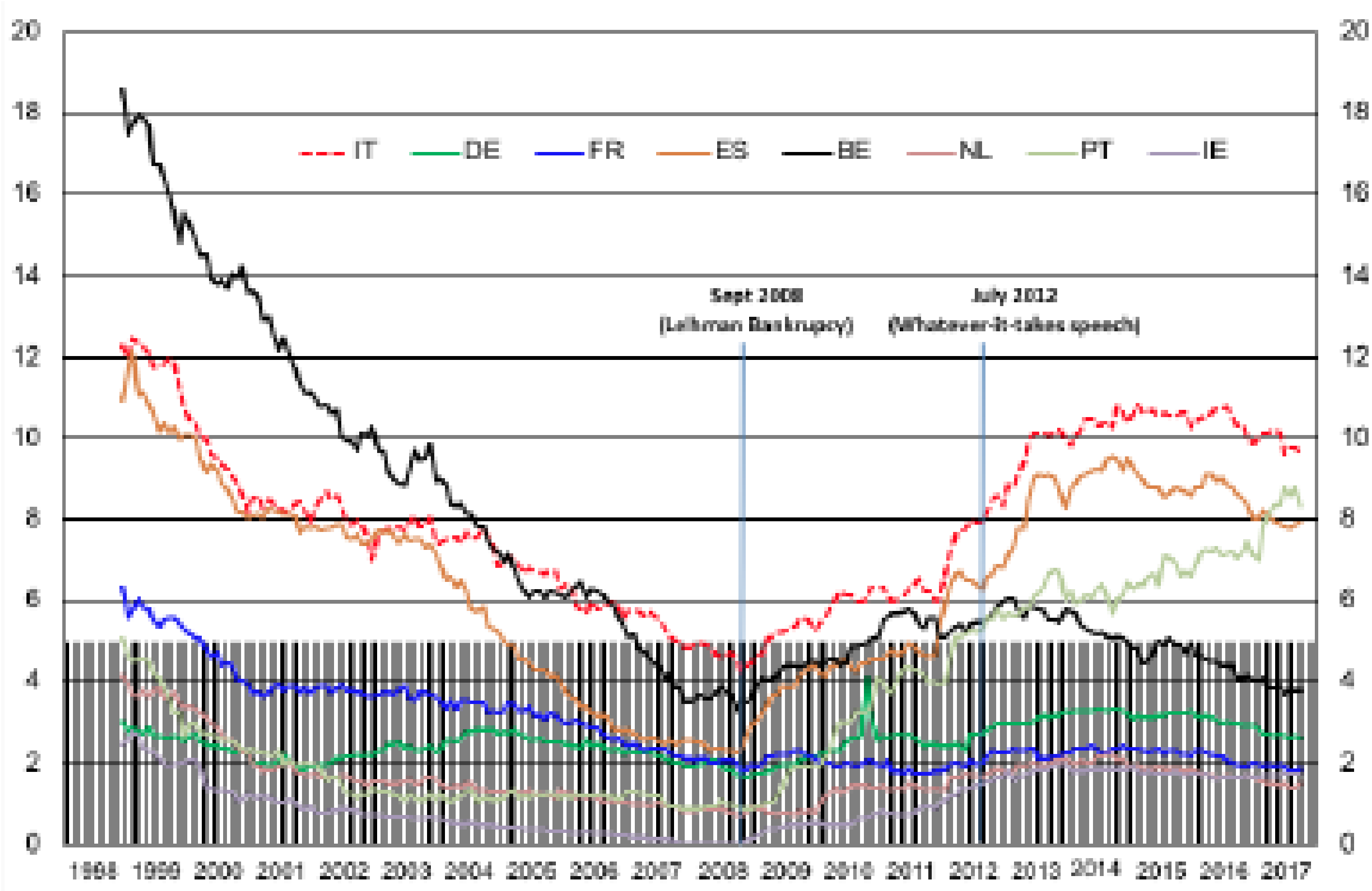
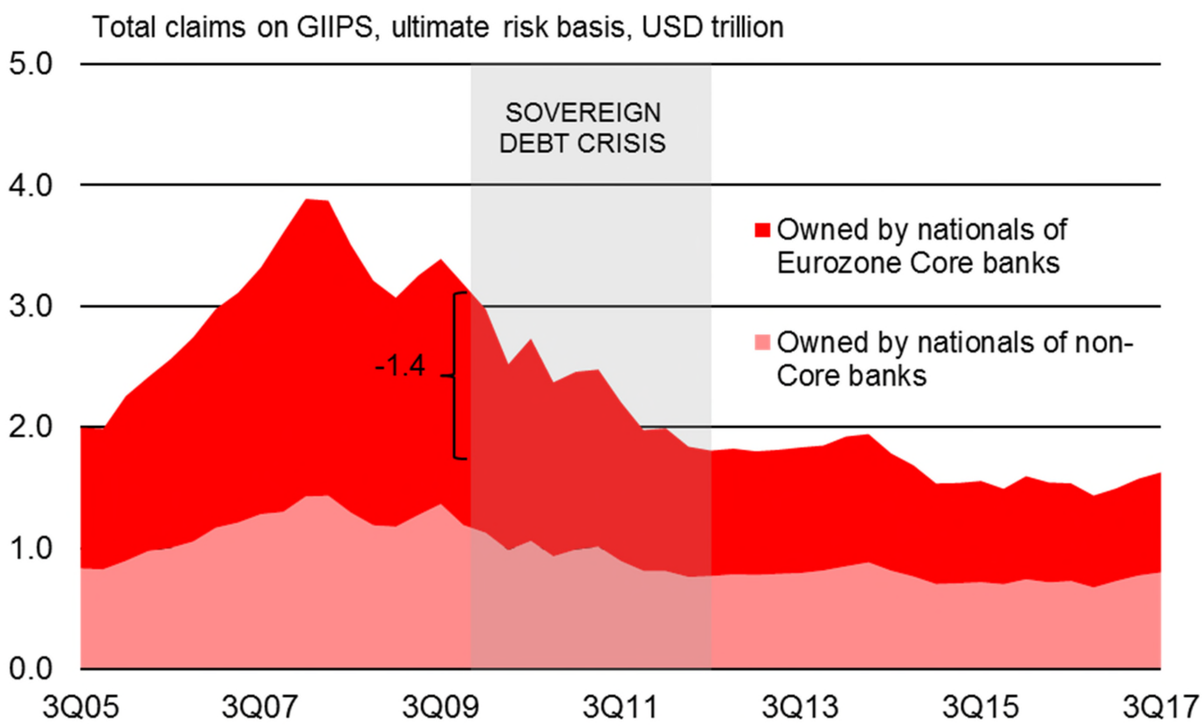
# Bank holdings of domestic sovereign bonds




Source: Lanotte and Tommasino 2018

# Eurozone debt crisis: Core banks removed liquidity from periphery

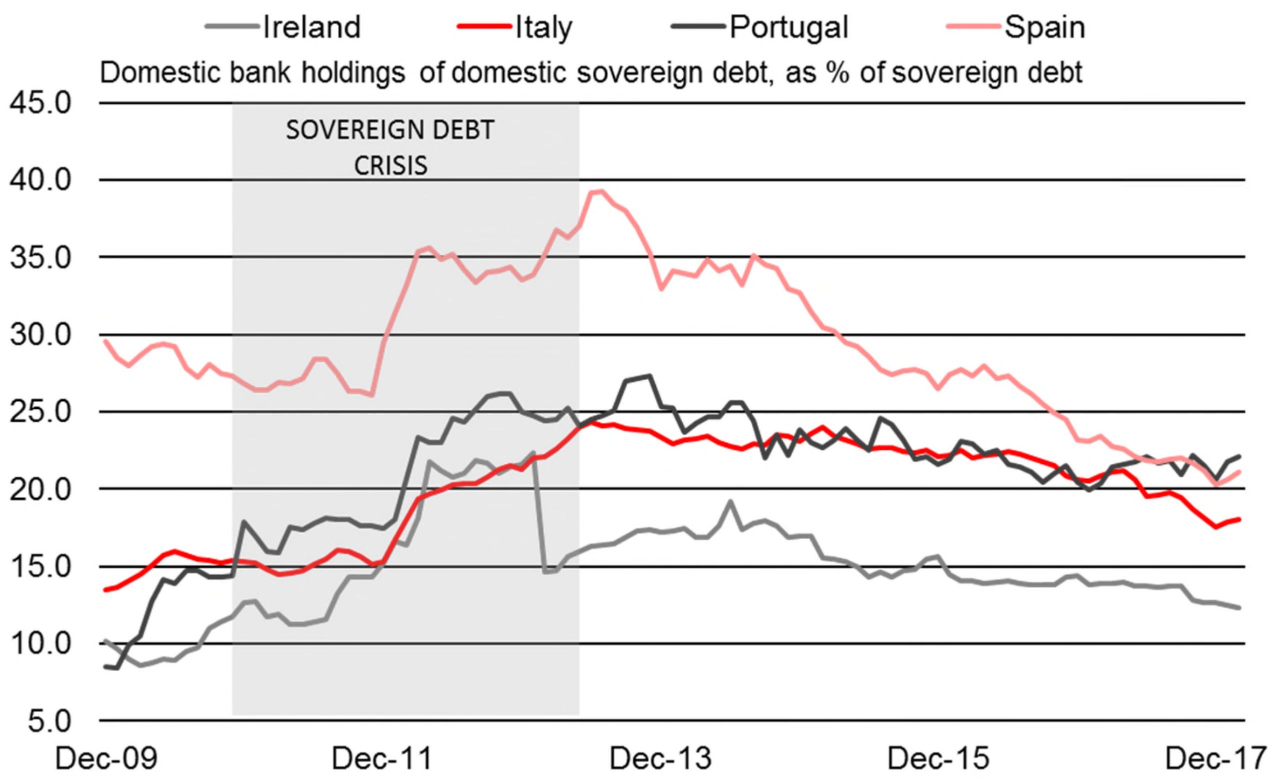



Note: BIS Consolidated international banking statistics, Table B4: Consolidated claims of reporting banks on individual countries: foreign claims by nationality of reporting banks, ultimate risk basis. Eurozone core is Germany, France, Austria, Belgium and Netherlands. GIIPS is Greece, Ireland, Italy, Portugal and Spain.



Source: BIS, UniCredit Research

# Peripheral banks buying sovereign bonds was a shock absorber




Note: Debt here consists of marketable debt only.



Source: ECB, UniCredit Research

# 2. Amplification mechanisms are very hard to brake

- If D/Y high, “doom loop” cannot be avoided, even if banks held a diversified portfolio
  - Redenomination risk remains unless much more political integration;
  - Wealth tax and capital flight
  - Recession and NPL;
  - Sovereign is ceiling for corporate ratings (Almeida et al.)

# Sovereign concentration charges?

- Benefit of portfolio diversification could be small, cost can be high

- Mixed evidence that more diversified banks did better during the crisis, once control for nationality
  - Botondi et al. (*JEEA*): During 2011 growth of bank credit to private sector determined by *Nationality* of bank, *NOT* by portfolio composition

- Sovereign risk assessed differently by domestic bank vs intnl mkts
  - Domestic bank would not survive D default or Redenomination
  - Limited liability => Sovereign risk is discounted by domestic banks

=> Increased home bias during sudden stop reduces fire sales
  - Implicit debt monetization providing liquidity to the sovereign

- Counter-cyclical concentration charges (relaxed during a crisis)?

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# 3. What purpose for European SDRM?

1. More orderly Debt Restructuring (DR)

2. Reduce time inconsistency of DR

   - in equilibrium DR comes too late, even if D unsustainable

   - this weakens mkt discipline, enhances moral hazard

=> *Make DR more likely* (conditional on high legacy D)

But......D sustainability is endogenous (D runs)

- DR more likely => D runs also more likely

# “Orderly” Debt Restructuring?

- When D/Y  > 130% this is a joke
  - Lessons from debt restructuring of developing countries with mainly external debts not relevant for Eurozone
- D is issued under national law
  - CAC *reduced* the cost of borrowing !
  - Ex-Post, an international court would protect creditors, not debtors
- If serious about reducing cost of DR, remove CAC & increase ambiguity for D issued under national law
- More costly sovereign default is bad ex-post but good ex-ante

# A Seniority Structure on Public Debt?

- Analogy with SIFI: issue equity-like instruments to achieve D reduction during crisis
  - Need external enforcement or intnl coordination

- New debt should be junior, if in excess of pre-established path   More expensive at the margin

- "Purple bonds" (consistent with pre-established path) and protected from ESM restructuring (Bini Smaghi 2018)

- Implicit juniority by indexation to *level of nominal GDP*
  - Stabilizing during crisis
  - Avoid explicit default (risk of contagion, political legitimacy)

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# 4. What role for ESM?

- ESM can only lend if D is sustainable, and this should not be changed

- But assessment of D Sustainability is difficult
  - Liquidity crisis more likely if weak fundamentals

- More proactive and rigid role for ESM in assessing D sustainability very risky

- Politically unacceptable with current ESM governance
  - ESM represents interests of creditor countries
  - What if used to extract concessions on other policy issues?

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# 5. The ECB

Monetary policy tools to manage a sudden stop

- OMT: why conditional on ESM program?
  - Independence of ECB and clear mandate should be enough

The inflation targeting framework

- Risk of being at $i$ = 0 at next recession is high
  - Remove asymmetry in inflation goal and / or raise it ?
  - Price level targeting ?

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# 6. A Eurozone fiscal capacity?

Goals?

- Aggregate demand management if $i$ = 0 or to cope with large asymmetric shocks

Tools:

1. Issue EZ debt – game changer but not politically feasible

2. Rainy day funds
   - Cost: asset accumulation (rather than D reduction)
   - Smaller benefit (small size), but still some benefit

     Less risk of pro-cyclical fiscal policy

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# 7. What kind of Risk Sharing?

- What risks?  Large vs small shocks

- Complete the Banking Union
  - EDIS, with higher charges on high D/Y countries but no additional constraints on portfolio composition of banks
  - SRF funded by ESM

- European Unemployment Insurance
  - Disbursements: Reinsurance vs direct payments to individuals (political / symbolic benefit for EZ image)

# Summary

- Key problem left unresolved: economic divergence and high legacy debts
- Strengthen external constraints on fiscal policy to achieve faster reduction of legacy debts
- Avoid EZ reforms that create global instability
  - Proactive role of ESM;
  - Forced diversification of bank portfolios
- Get started with limited EZ fiscal capacity
- Complete Banking Union (fiscal backstop for SRF, EDIS)