NBB/ECB/Solvay/TSE conference

Managing financial crises: where do we stand?

Slides for the intervention by Vítor Constâncio as discussant on Session 2

Euro Area Governance: is it fit to address the next crisis?

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The European Monetary Union and economic and financial crises

The more difficult problem of a monetary union among different countries, that emerges in any significant crisis, is the fragility of national sovereign debt markets. This results from the uncertainty about the CB using open market operations to stabilise markets and from the fact that investors can move from a country member debt to another member market without incurring additional exchange rate risk. This opens the possibility of pure liquidity squeezes, sudden-stops, speculative attacks and contagion that create redenomination risk or without the euphemism, the threat of countries leaving. **Any significant crisis may trigger these problems**. **The difficulty in addressing them lies in creating mechanisms that defend against this type of situations without allowing free-riding by country members.** Dealing with this last problem, requires a fiscal rule, financial assistance with conditionality and, ultimately, the possibility of debt restructuring. These three conditions already exist in the EA and have all been used. There is a debate whether they need changes. What has a more uncertain existence is the first part, regarding the mechanisms to defend the fragile national debt markets. Ultimately, the solution lies in a Fiscal Union and/or Eurobonds with mutualisation of debts, both requiring completing Monetary Union with a higher degree of Political Union. While that is not possible, the alternative is, as Eichengreen puts it, to have a “normal central bank” that, while ensuring price stability, acts as liquidity provider to credit institutions and markets via open market operations that the Treaty foresees. The ECB made progress in that direction during the crisis. From now on, the ECB will have no excuse to not fulfil its mandate in addressing the impairment of the single monetary policy transmission by intervening in the sovereign bond market when markets go well beyond what fundamentals would justify. Nonetheless, it would help if more legal clarity would be provided by all member countries so that these ECB competences would not be challenged.

WHAT TYPE OF NEXT CRISIS?

1. **A world economy downturn (or even a recession) within the next 24 months, coming from the US and EM.** Policy measures required:
   1. Monetary policy: yield curve control with purchases focus on medium term yields, going beyond the self-imposed limit of 33%, if necessary.
   2. Expansionary fiscal policy with European coordinated fiscal stance and **Euro Area Fiscal Capacity** (Stabilisation Fund with borrowing capacity)
   3. Build up confidence in the banking sector by **completing Banking Union** (EDIS and backstops for EDIS and the SRF) and continue to press for banks de-risking.
   4. Avoid destabilising markets with risky initiatives on **debt restructuring/ESM enhancement, and high concentration capital charges on banks´ holdings of domestic sovereign debt.**
   5. Create a **European Safe Asset** to allow diversification of banks´ portfolios and to promote **Capital Markets Union**.
   6. Start discussions to revamp the **Stability Pact** based on the type of expenditure rule in the CAE Note n.47, with some adjustments and correcting its proposed approval procedures to avoid further delegitimization of national political authorities.
   7. **Expand the set of macroprudential instruments** in the CRD/CRR, e.g. to include borrower-based measures, and streamline approval procedures.
2. **Italian crisis with further yield increases, further budget deterioration and redenomination risk**
   1. Prepare the use of OMT if all its conditions are met.

Banks-Sovereign Nexus and the European safe asset

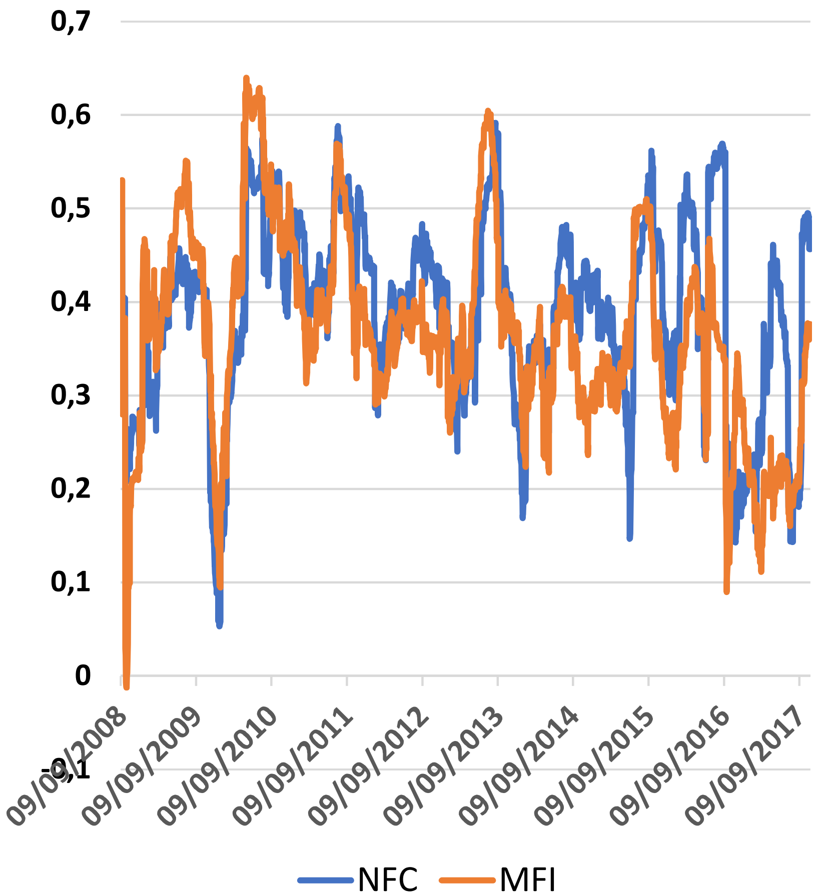
I. **There are good reasons for some home bias that exists in all countries** in the World Hedging against exchange rate, redenomination risk of other countries, geographical composition of the balance-sheet assets and liabilities .
   1. Asset cross-border trade costs
   2. Information frictions.

II. **The macro channel**: Diversifying the banks´ portfolios does not prevent a major impact of a sovereign credit collapse on the banks. Since 2008, the CDS premia of Banks and NFCs correlations with their Sovereign CDS, has been quite similar, despite the fact that NFC do not hold significant amounts of Sovereign debt.

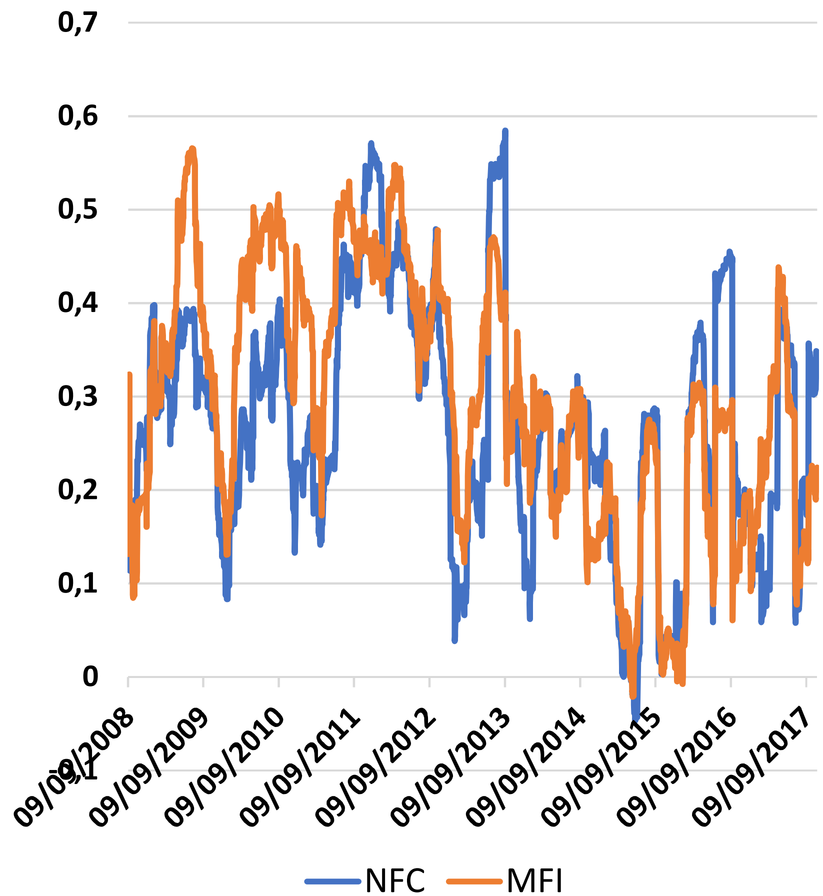
III. In a robust monetary union, **home bias should be much smaller**, but should be reduced without destabilising debt markets. **Applying quantitative limits or high concentration capital charges would be destabilising now**:
   - **a) Immediate surge in rollover risk**. Countries with high rollover requirements (some with annual hundreds of billions) cannot quickly change their investor´s composition. They have naturally to rely heavily on existent debt owners renewing their holdings.
   - b) Induced diversification to other sovereign bonds is very likely to **increase the balance sheet risk of most banks in the Euro Area**.
   - c) Induced diversification to other sovereign bonds **does not improve the tail risks either for single countries or for the EU banking system**.

Banks-Sovereign Nexus and Macro channel

Average 60 days rolling correlations of NFC´s CDS and MFI´s CDS with Sovereign CDS in Periphery Countries



Average 60 days rolling correlations of NFC´s CDS and MFI´s CDS with Sovereign CDS in Core Countries



Sources: 5y senior CDS spreads from Datastream for June 2008 to October 2017. Periphery countries : IT,ES,IE,PT,GR and Core countries: DE,Fr,NL,AT,BE.

Banks-Sovereign Nexus and the European safe asset

“ Using a sample of 106 European banks included in the EBA stress testing dataset over the period June 2013 to December 2015, **we find that a diversification requirement such as the ones proposed can actually increase the risk of the resultant portfolios, while having little effect on the tail-risk or contagion risk.** Given that the reduction of risk is a major reason for a costly diversification requirement, results suggest caution before their adoption…. **Using simple rebalancing rules, we find that the likely portfolios that result from such higher diversification requirements will generally increase the risk of most banks in the Euro area.”**

Analysing the tail risk of portfolios, the authors conclude that: “the rebalanced and current portfolios show similar levels of tail risk, both for single countries and for the EU banking system, which means that rebalancing portfolios to increase diversification may be inefficient, even when correlation between sovereigns defaults is higher, as during a crisis.”

Giuzio, M., B. Craig, and S. Paterlini (2016), “Effects of diversification and capital buffers on the EU sovereign- bank networks”, mimeo

Banks-Sovereign Nexus and the European safe asset

"…our numerical simulations indicate that there is a fundamental tension between lowering concentration and lowering credit risk in the absence of an area-wide low-risk asset. … None of the reforms unambiguously achieve both, as Table 11 indicates. In some cases, regulatory reform can have perverse effects."

Table 11: Summary of simulation results

	Change in concentration relative to mid-2017	Change in credit risk relative to mid-2017
Price-based tools for credit risk	?	↓
Price-based tools for concentration	↓	?
Quantity-based tools for credit risk	↓	?
Quantity-based tools for concentration	↓	?
Area-wide low-risk asset	↓↓	↓↓

Source: S. Alogoskoufis and Sam Langfield (2018) "Regulating the doom loop" ESRB WP n. 74, May 2018

A European safe asset is now a crucial reform. Also for the neglected project of **Capital Markets Union.** There are reasonable solutions: either a tranched security with small first loss guarantee for the junior tranche or E-Bonds with seniority without OR with a small capitalisation. (Leandro,& Zettelmeyer CEPR PI n. 93, June 2018)

Debt restructuring

Debt restructuring is already a possibility under Euro Area rules (ESM Treaty) and there is even a precedent. No other measures are necessary.

To make restructuring more likely now, there are proposals to give more powers regarding the DSA to the ESM, or to define thresholds or imposing automatisms. All three are destabilizing. First, giving more powers in the matter to the intergovernmental ESM (that is not an European Institution, recognized in the Treaty) undermines the legitimacy of European bodies and gives new arguments to national populism. Second, there are the reasons indicated in the CEPR PI n. 91 : " When introducing such a policy, it is essential to ensure that it does not give rise to the expectation that some of the present debts of high-debt countries will inevitably be restructured, triggering financial instability in debt markets." However, as the text recognizes, there is no simple solution to this transition problem and what is proposed, e.g. delayed or gradual implementation, is not convincing.

Debt restructuring

Two CEPR publications dated from 2015 and 2016, proposed to precede the introduction of the SDRM with an operation of legacy debt reduction. The 2015 text recognised that introducing immediately the SDRM: "would be dangerous, as the transition path would be highly destabilising. Imagine, for example, announcing the implementation of the debt restructuring mechanism … in an environment where several countries are already highly indebted. **The result could be a run on their debt. The way to deal with the transition path problem is a *quid pro quo. We propose a coordinated, one-off solution to decrease the legacy debt in exchange for a permanent change in institutions".***

The debt reduction would be funded by capitalised revenues from seigniorage or assigned taxes.

There were other debt relief proposals but meanwhile all have disappeared from the discussion. In any case, it does not seem possible now to see member countries doing a Faustian pact including a SDRM and debt relief.

Revamped Stability Pact

1. Revise the Stability Pact, applying **a pure expenditure rule as compliance criterium**. The calculation of the expenditure path would be based on:
    a) A medium term debt reduction target based on distance from 60% debt ratio, but also on "a broader analysis of fiscal sustainability… and a economic analysis of the economic situation and the relevant path of debt reduction"
    b) A medium term nominal growth projection based on potential output growth and inflation target.
    c) A medium term expenditure growth ceiling based on a) and b) and a target expenditure for the coming year. This would be the only target subject to compliance. A compliance exception for severe recessions needs to be added.
    d) Expenditure is calculated net of non-discretionary changes in unemployment benefits, costs of significant natural catastrophes, financial assistance to the financial sector and additional revenues resulting from changes in tax rates/administration.
2. Governments present their budget proposals according to the present procedural rules and with a Report by independent National Fiscal Councils, without further delegitimizing national political authorities.
3. Expenditure in excess of ceiling must be financed using subordinated bonds

Conclusion

1. In the short-term, there are no political conditions, especially while the Italian standoff lasts, for an agreement on **meaningful reforms**, either about more risk-sharing or risk-reduction. EDIS, the Fiscal Capacity or the ESM enhancing powers, will not happen soon.

2**. If the next crisis is an economic downturn (or even a recession)** , monetary policy and appropriate fiscal policy coordinated stimulus will have to deal with it. Fiscal and external balances are now healthier and banks´ capital position much more robust.

3 **A worsening of the Italian crisis will be more difficult to overcome**. In a very uncertain situation, where both sides have much at stake, there are some fixed points:

a) Financial markets will dictate the outcome. Italy cannot win against the markets.
b) Ultimately, the EU has no legal means to impose compliance on Italy (a net contributor to the EU budget)
c) The EU will help only if there is an agreement on compliance and/or an OMT programme, if all conditions are met for its activation.

I exclude the scenario of Italy wanting to leave for many reasons, including the majority view of Italians: The June Eurobarometer gives 61% in favour of the euro area; an October HuffPost poll shows 68% in favour of remaining in a hypothetical referendum; a recent Demos poll indicates that 58% want the Government to compromise with the EU.

The euro area will withstand and overcome the next crisis.

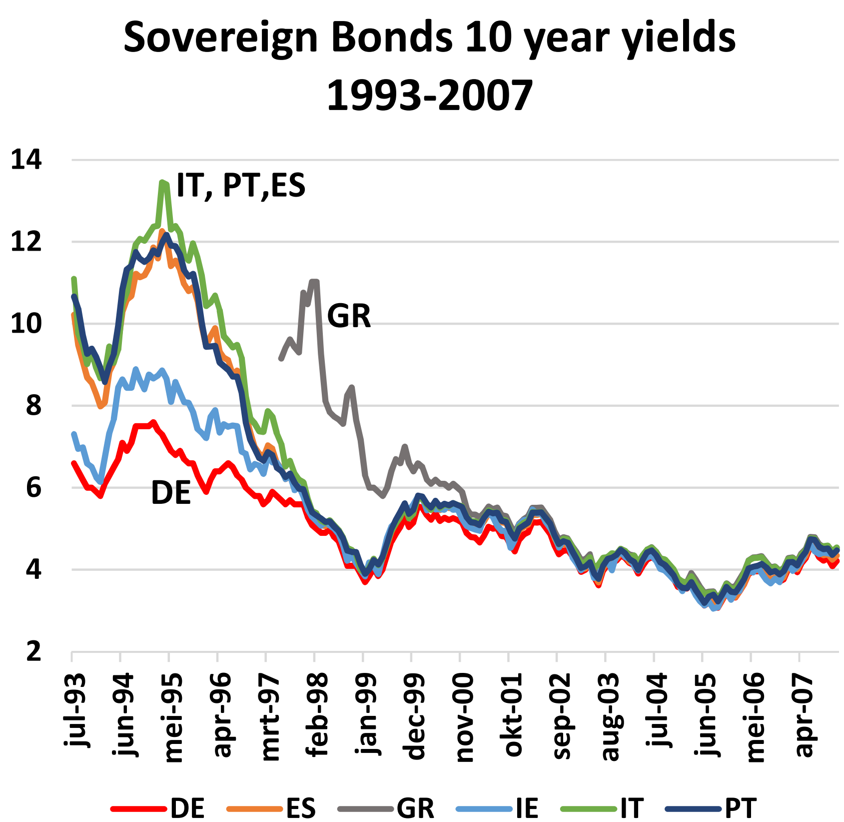
BACKGROUND SLIDES

Table 1. The fiscal narrative: Deficits, Public and Private Debt Ratios

	Budget deficits in % of GDP (2006-2007)	Public Sector Debt Ratio (% of GDP)			Private Sector Debt Ratio (Variation in %)
		1999	2007	Δ 99-07 In %	Δ 99-07 In %
Euro Area	-1.1	71.7	66.4	-7.4%	26.8%
Greece	-6.3	94.9	107.2	13.0%	217.5%
Italy	-2.55	113.0	103.3	-8.6%	71.2%
Spain	2.05	62.4	36.3	-41.8%	75.2%
Portugal	-3.65	51.4	68.4	33.0%	48.9%
Ireland	1.55	47.0	25.0	-46.8%	101.0%

Source: Constâncio, Vitor (2014) "The European crisis and the role of the financial system " in *Journal of Macroeconomics* 39 (2014)

Tthe financial shock of the step decline of interest rates during the nineties



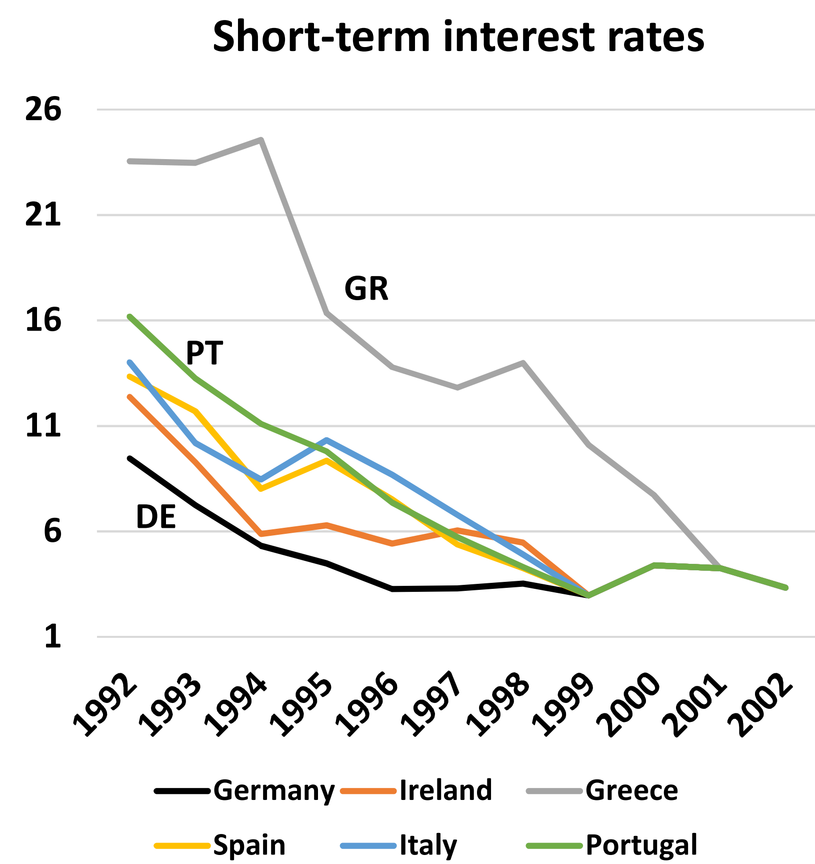
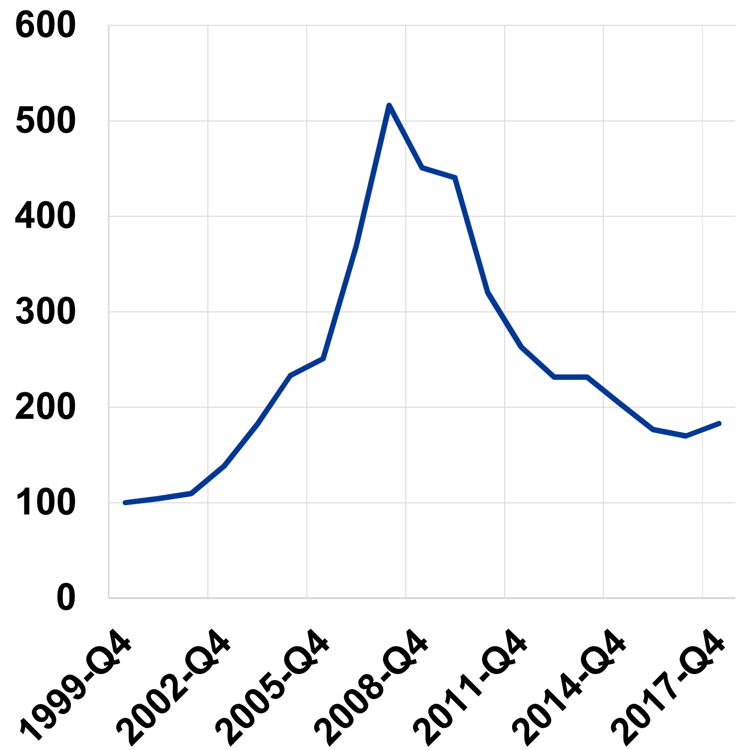
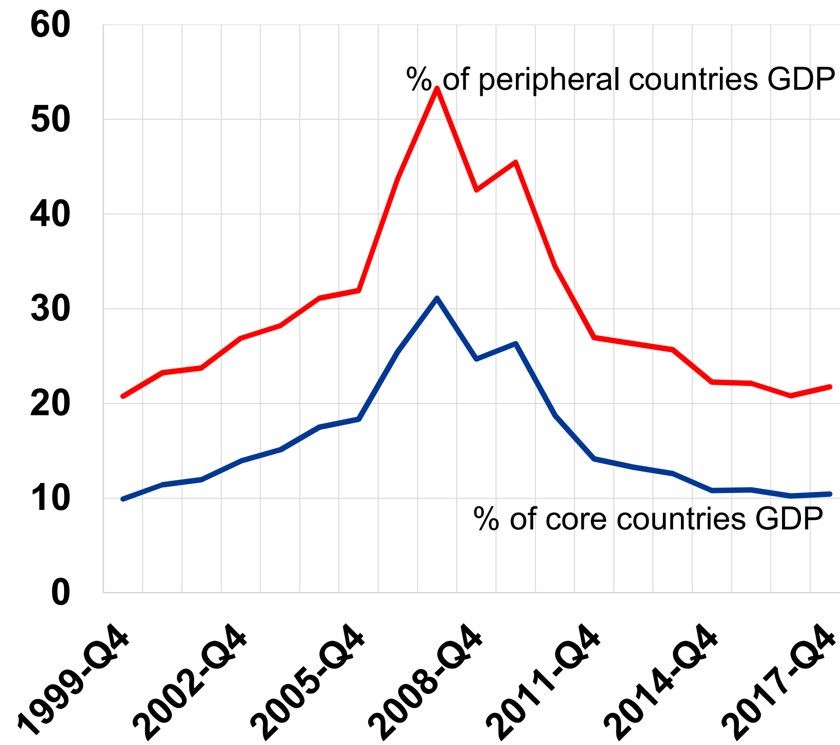


Figure 1- Credit flows to peripheral banks

Cumulative growth of exposures in core countries´ banks to peripheral countries´ banks Index 1999=100



Exposures of banks in core countries to borrowers in peripheral countries in % of respective GDP



Source: BIS database

Figure 2- Cumulative growth of Bank credit to the non-financial private sector (1991=100)