



Risk Sharing in the Euro Area

Mahmood Pradhan

Deputy Director and Euro Area Mission Chief

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What do we mean by risk sharing?



- Risk sharing entails spreading the costs of negative shocks
- This means sharing the costs of shocks with other countries
- This can occur through multiple channels:
 - Cross-border fiscal transfers
 - Capital Markets (incl. direct investment)
 - Labor income (e.g., remittances)
 - Credit markets (e.g., cross-border bank lending)

Why is risk sharing important for EA?

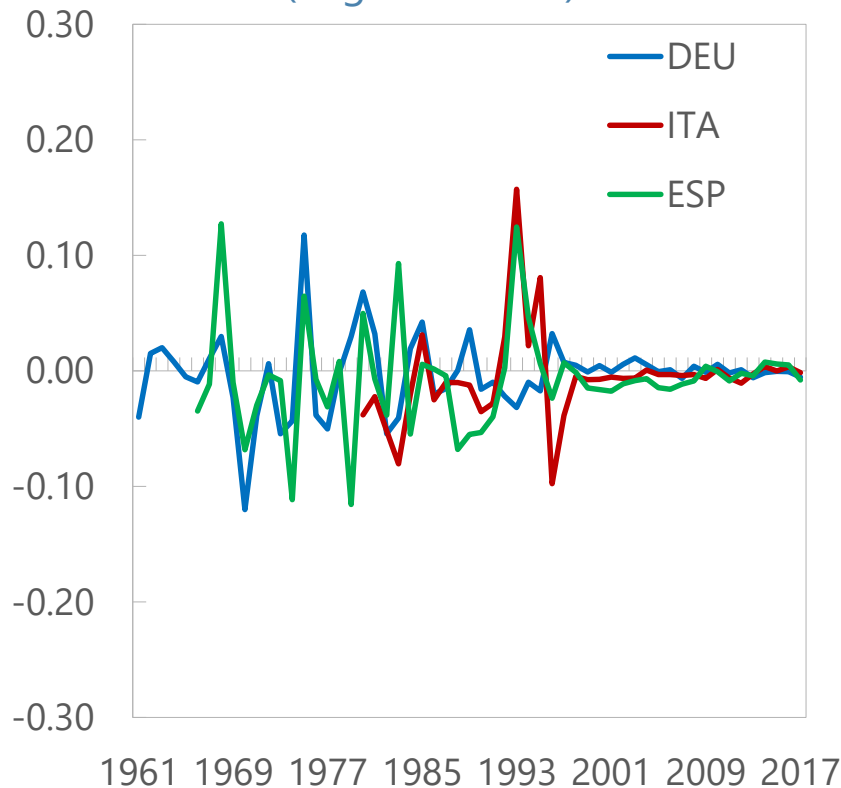


- Euro adoption → Loss of independent monetary policy and exchange rate as shock absorber
 - Monetary policy may be too tight from a country perspective even if appropriate for EA
 - Real exchange rate can adjust through inflation differentials, but this is slow and limited

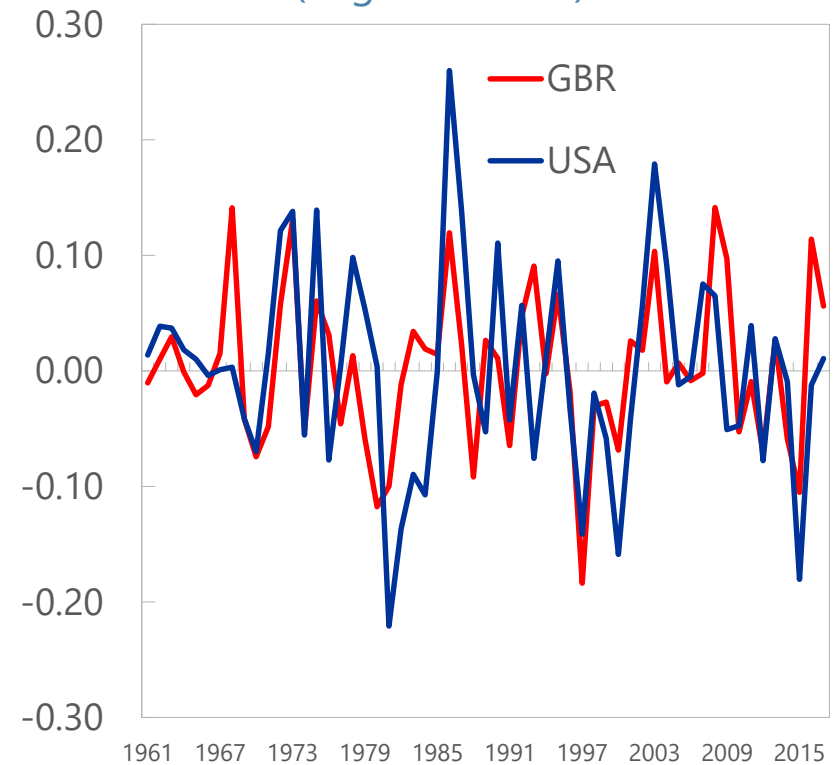
Limited RER adjustment relative to other EA countries since euro adoption



France. Bilateral Real Exchange Rate Fluctuations
(Log difference)



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(Log difference)



Source: IMF World Economic Outlook and IMF staff calculations.

How do we measure cross-border risk sharing?

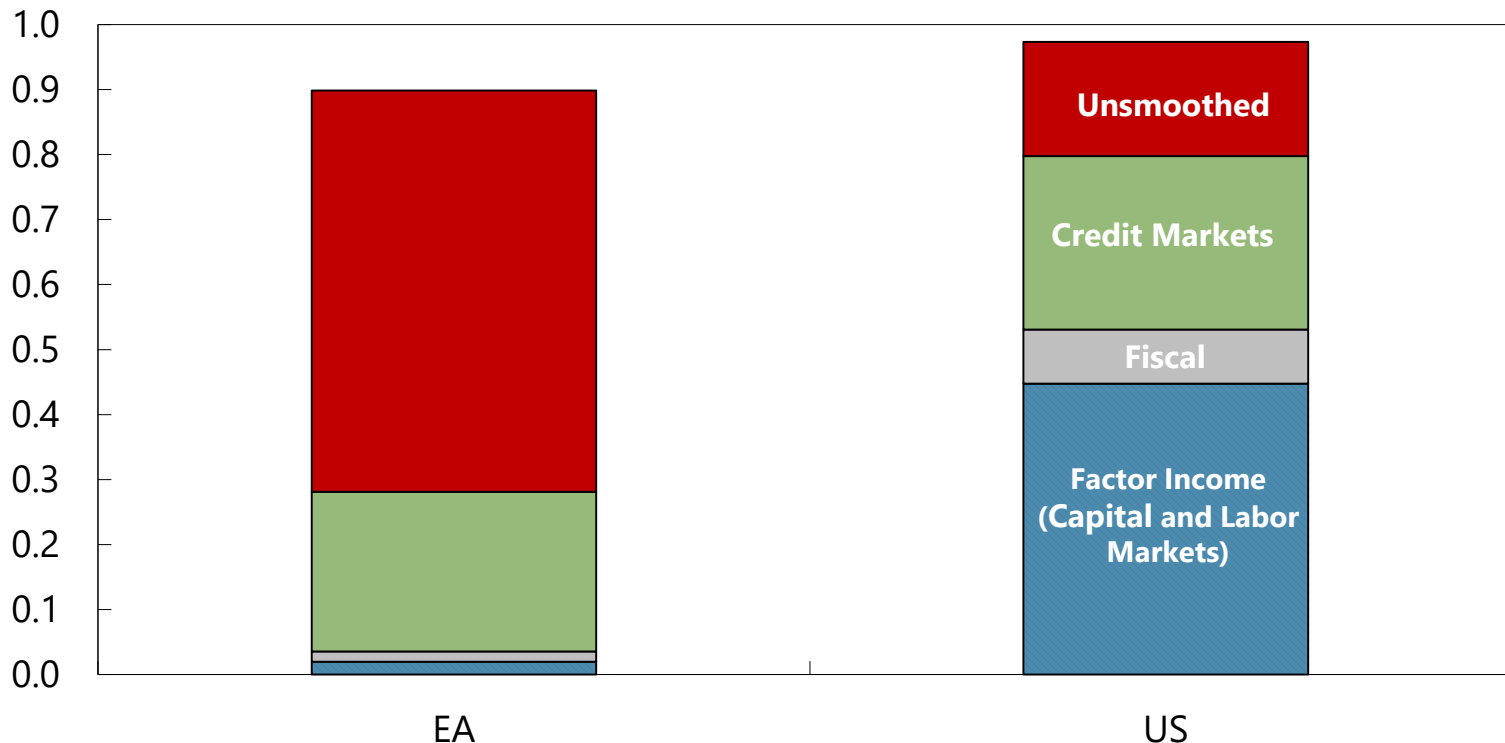


- Asdrubali, Sorensen and Yosha (1996)
- Decompose asymmetric shocks using national accounts data to identify share smoothed by:
 - Cross-border factor income (capital markets and labor)
 - Cross-border fiscal transfers
 - Credit markets
 - Unsmoothed

Less cross-border risk sharing in Euro Area compared to US



Smoothing of Asymmetric Shocks in Euro Area and US (Share of shocks smoothed by channel)



Source: "Cross-border risk sharing" (Nikolov, 2016).

Note: Euro Area sample includes BEL, DEU, ESP, FIN, FRA, IRL, ITA, NLD, and PRT.

Euro area data covers 2000Q4-2015Q4. US data covers 1963-2013.

Need for public sector risk sharing

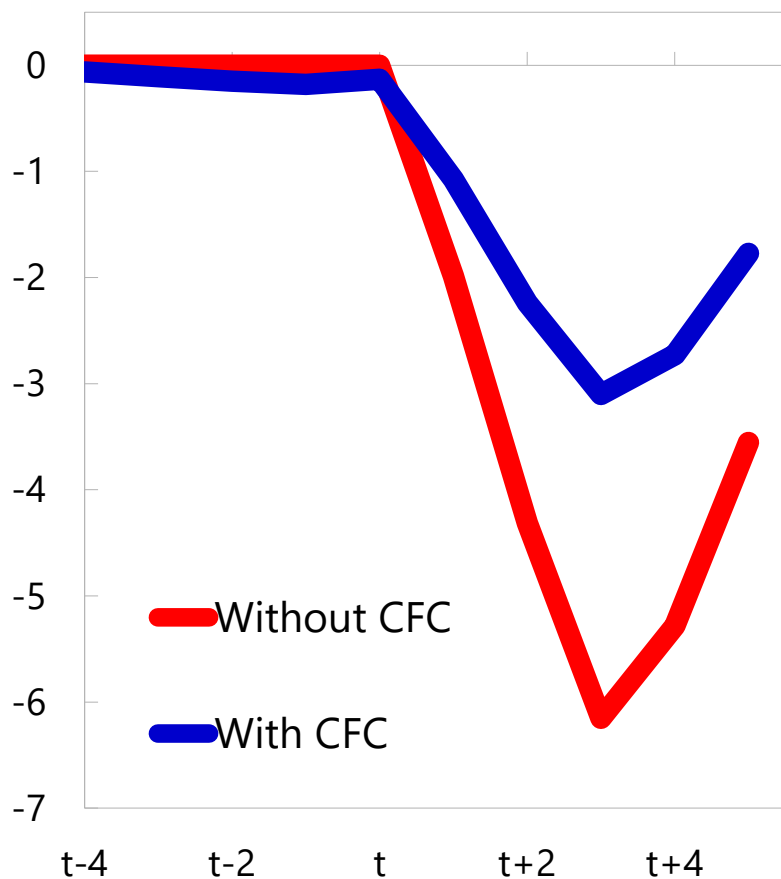


- Greater burden on fiscal policy for stabilization of asymmetric shocks
- More fiscal risk sharing would
 - Improve monetary-fiscal policy mix
 - Help prevent procyclical fiscal tightening
 - Mitigate negative spillovers
- IMF staff proposal for a [Euro Area Central Fiscal Capacity](#) (CFC)

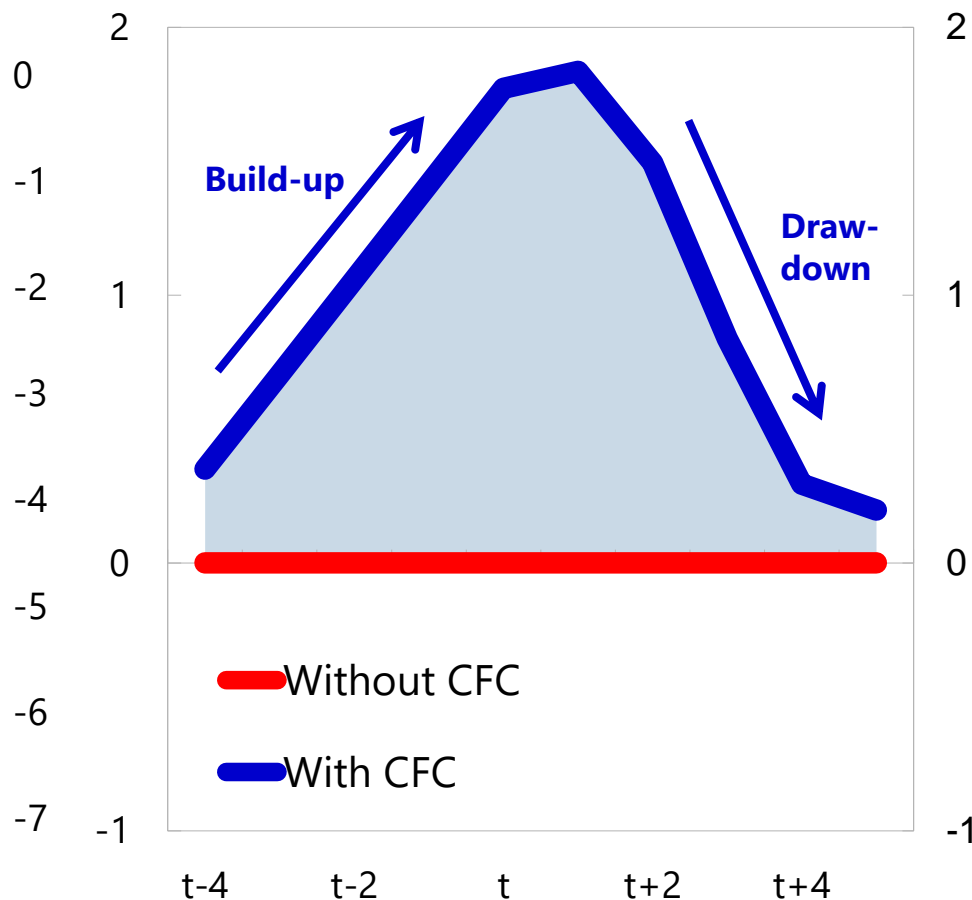
CFC could provide substantially more public sector risk sharing



Impact of Large Shock on Output Gap (Percent of GDP)



Size of Fund (Percent of GDP)

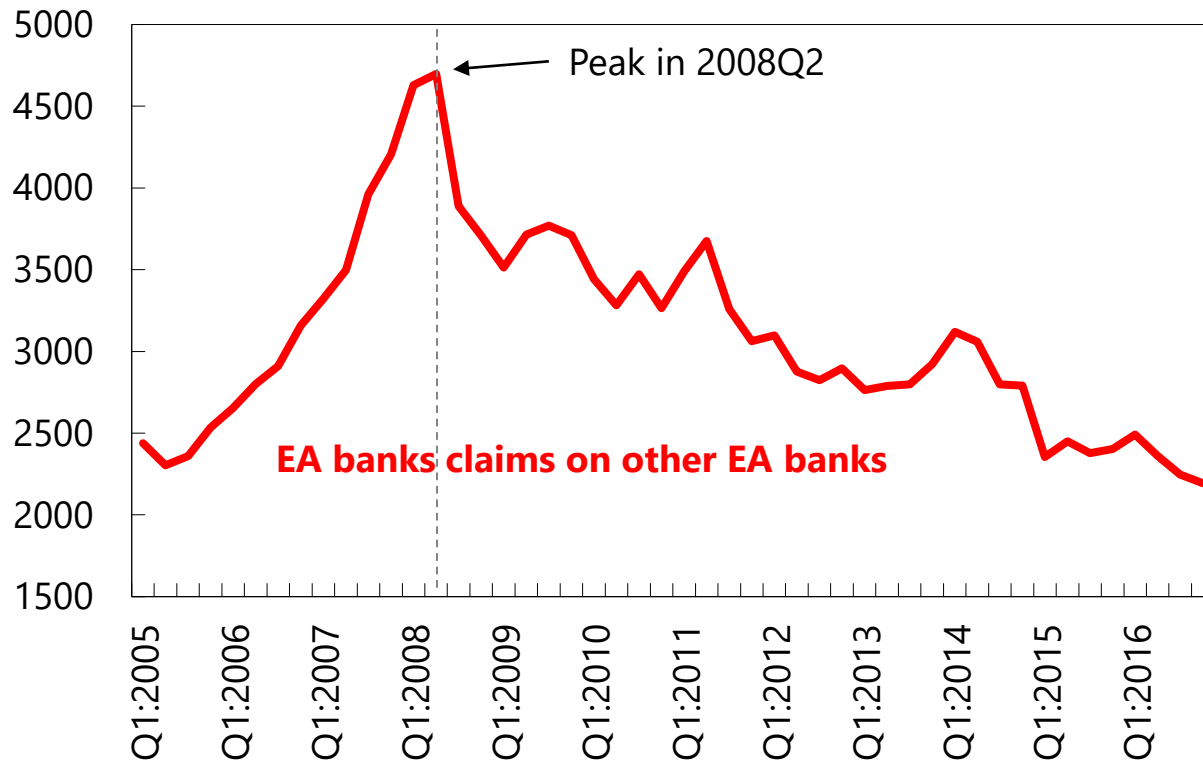


Source: IMF Staff calculations.

Private sector risk sharing through credit markets reversed since the crisis



Interbank Cross-border Claims
(Billions of USD)

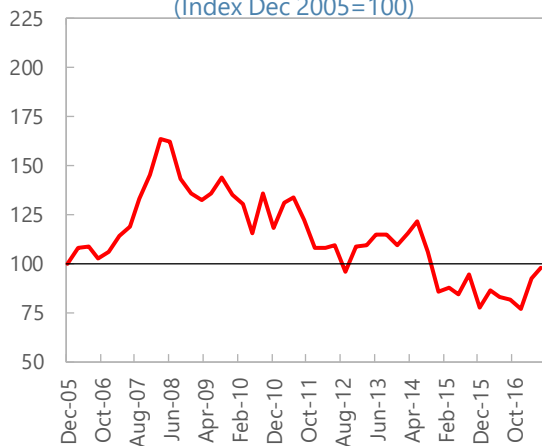


Source: BIS, Locational Banking Statistics; IMF staff calculations.

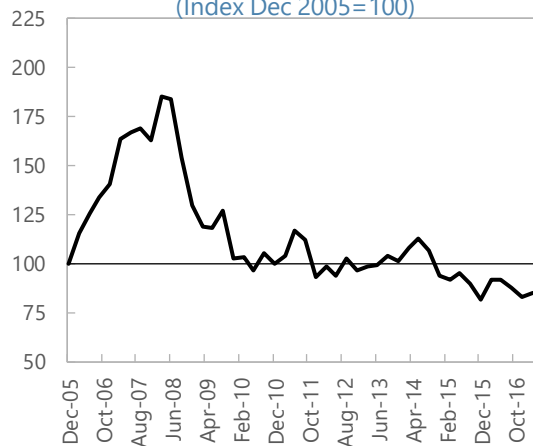
Not just a problem for crisis hit countries



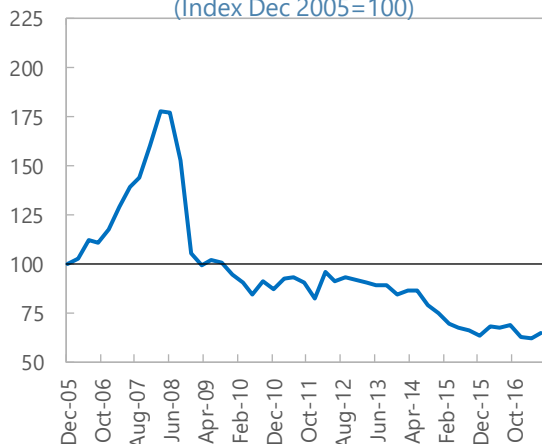
EA5 Claims on Germany
(Index Dec 2005=100)



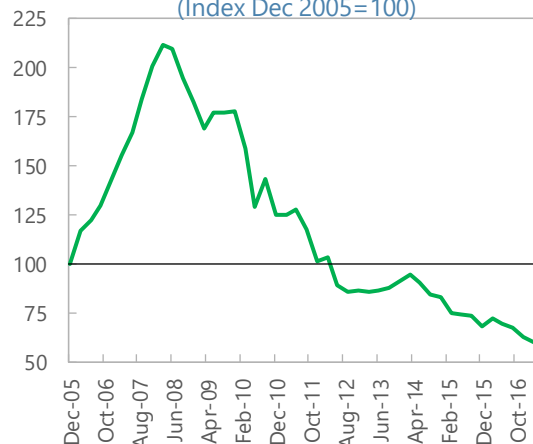
EA5 Claims on France
(Index Dec 2005=100)



EA5 Claims on Netherlands
(Index Dec 2005=100)



EA5 Claims on Spain
(Index Dec 2005=100)



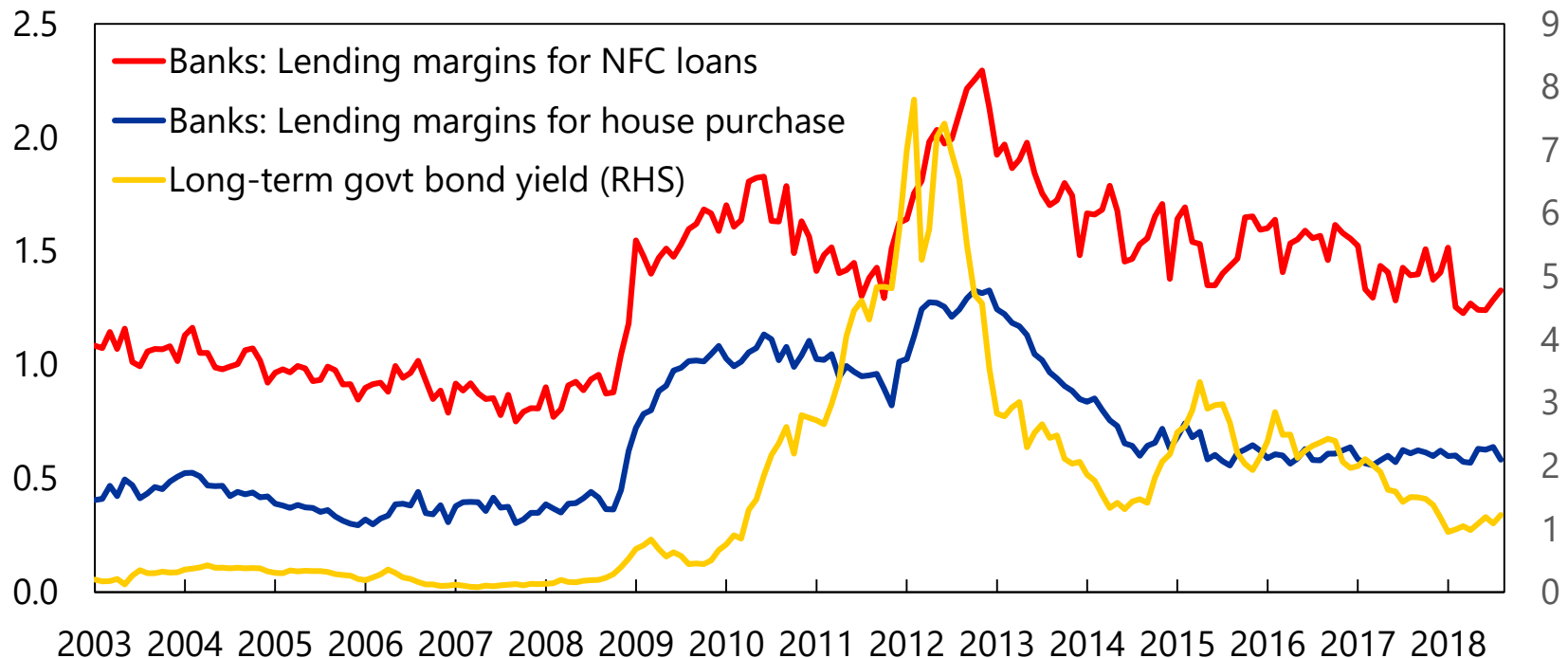
Sources: BIS Consolidated Banking Statistics and IMF staff calculations

Note: EA5 are the other five euro area countries, besides the recipient country, in the group DEU, FRA, ESP, NLD, AUS, and BEL

Significantly higher dispersions in bank lending margins since the crisis



Dispersion of Bank Lending Margins across the Euro Area
(in standard deviations)



Sources: ECB and IMF staff calculations.

Completing the Banking Union

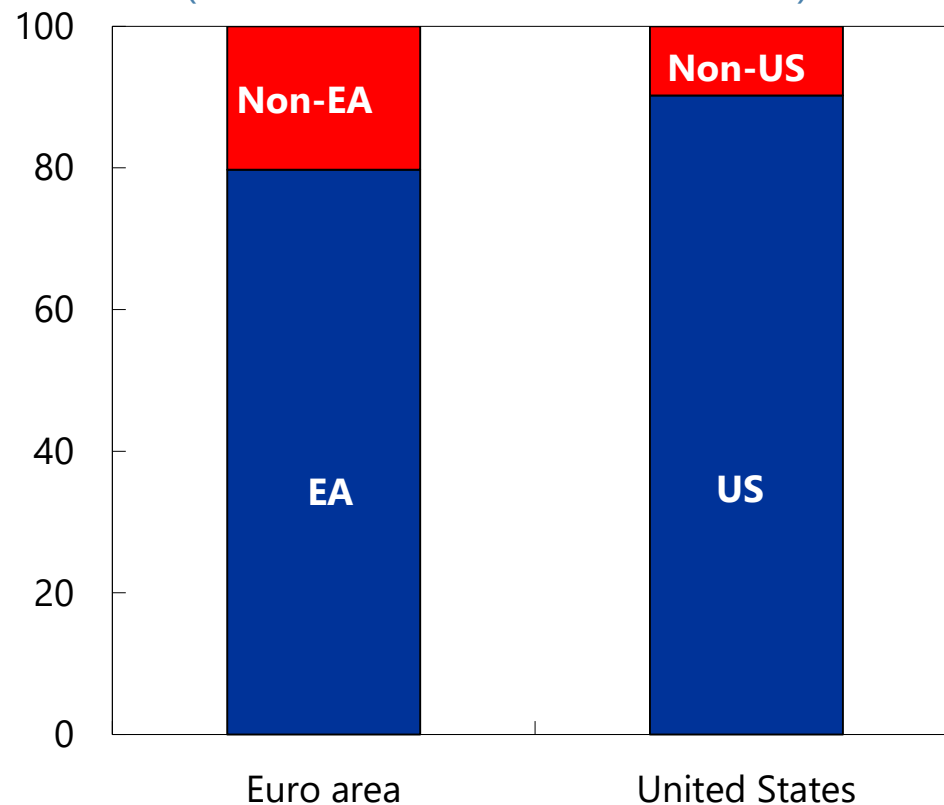


- Single Resolution Fund backstop would help
- Most critical is a common European Deposit Insurance Scheme (EDIS)
 - Essential to reduce incentives to ring fence
 - Would facilitate cross-border consolidation in banking sector, improving efficiency
- Also needed for truly borderless banking union
 - Close gaps in SSM powers
 - Fix shortcomings of BRRD

EA residents mostly invest in euro area (similar to US)



Financial Assets held by Residents
(Percent of residents' total assets)



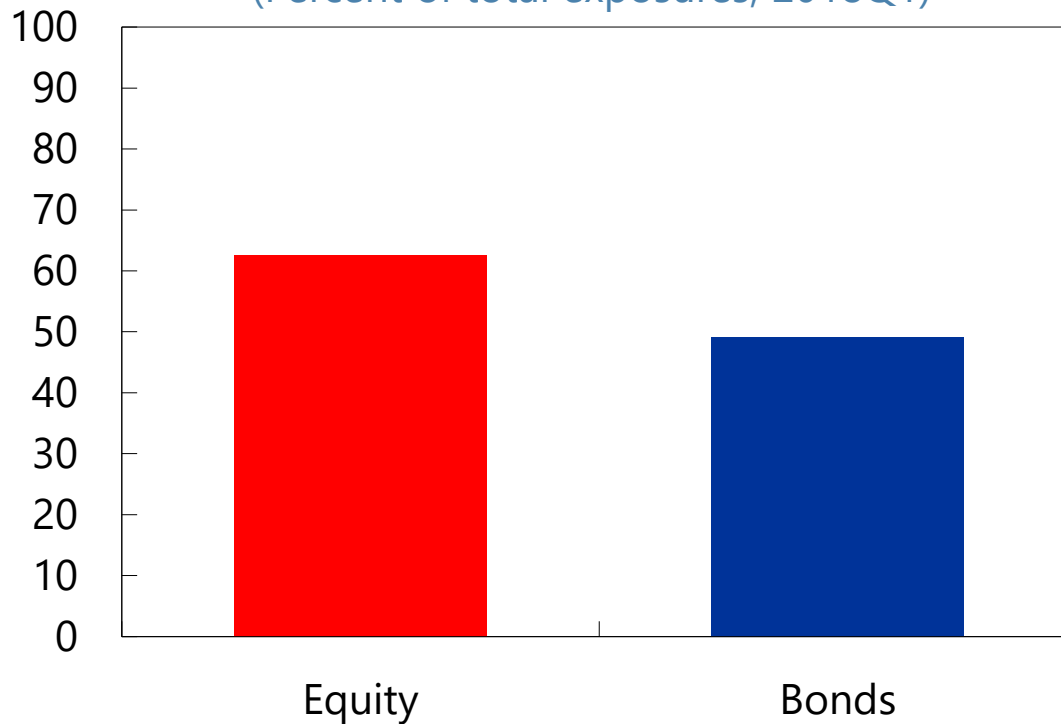
Sources: U.S. Fed Flow of Funds; and ECB Whom-to-whom.

But there is pervasive home bias within the EA, even for sophisticated investors



Euro Area Insurers' Assets: Exposure to Domestic Markets

(Percent of total exposures, 2018Q1)



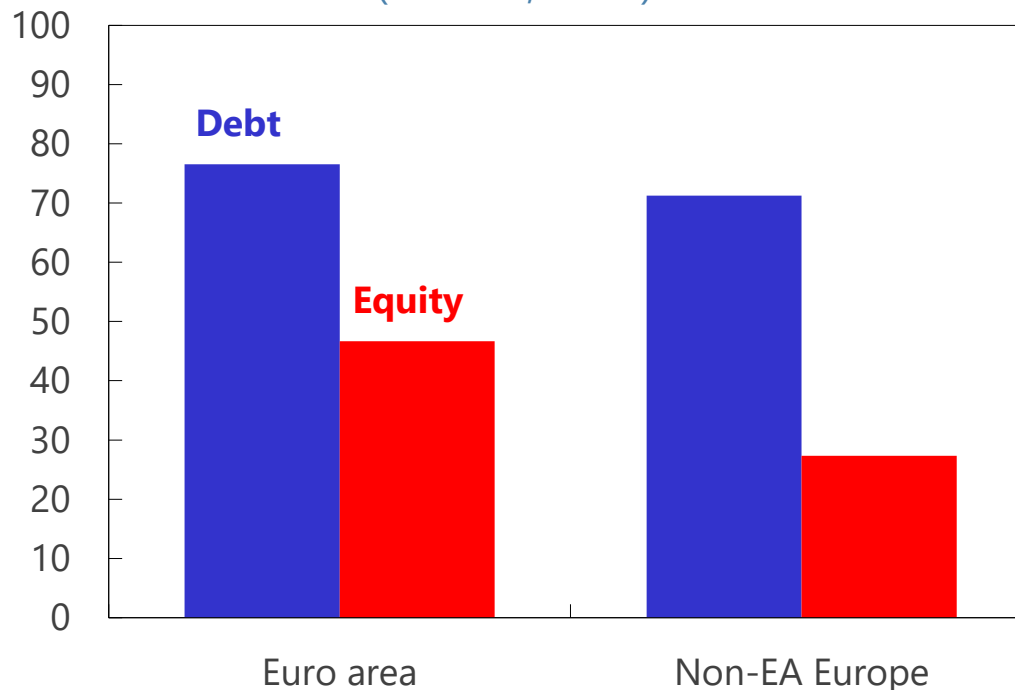
Source: EIOPA and IMF staff calculations.

Note: Weighted average of total EA exposures.

EA pension funds exhibit home bias too, more than non-EA European funds



Pension Funds' Assets: Home Bias in Selected European Countries
(Percent, 2017)



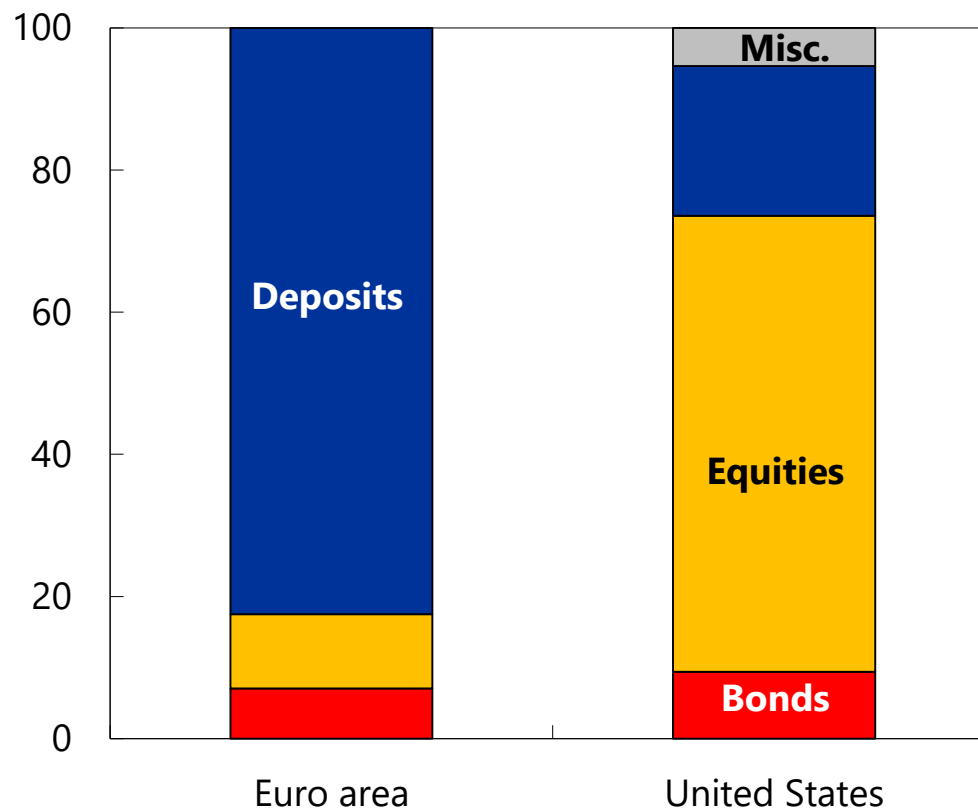
Sources: Eurostat, Mercer (2018), European Asset Allocation Survey, and IMF staff calculations.

Note: Euro area is simple average of BEL, IRL, NLD, ITA, DEU, ESP, PRT, and FRA. Non-EA Europe is simple average of DNK, NOR, GBR, and CHE.

Household balance sheets in EA are overly skewed toward deposits



Household Financial Assets by Type
(Percent of total assets)



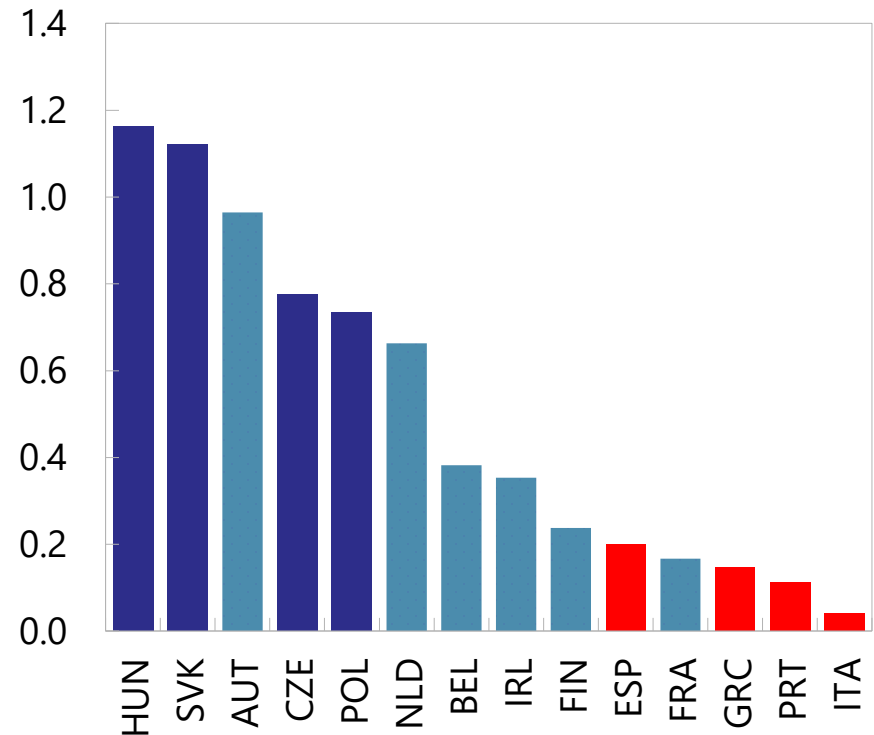
Sources: U.S. Fed Flow of Funds; and ECB Whom-to-whom.

Too little cross-border FDI between north and south



- FDI from north went east, not south
- Some countries need better factor allocation & higher productivity

Average FDI Flows from Germany, 1995-2012
(in percent of recipient country GDP)



Capital Markets Union



- Limited cross-border investment by households and firms → fewer cross-border sources of income that can help smooth asymmetric shocks
- Even insurers and pension funds too concentrated domestically, not as instrumental in funding firms cross-border as they should be
- Most critical element is greater cross-border equity investment, both in terms of households' portfolios and firms' FDI and M&A activity

Capital Markets Union: EU Plan



- Progress on many fronts, but much more to do
- Supervision and regulatory improvements made more urgent by Brexit
- Much of it technical → but may be politically easier
- Long-run CMU requires deeper reforms related to national insolvency rules, taxation, etc.
 - This may be more challenging

Conclusion



- EA needs greater public and private risk sharing
- Completing Banking and Capital Markets Unions would help facilitate more risk sharing through financial markets
- But this will take time
- Risk sharing is not a panacea for deep-rooted structural problems that give rise to substantial competitiveness gaps