

# **The euro crisis: Is banking union enough?**

Jean Pisani-Ferry(\*)

Banque de France - Sciences Po Seminars Series

January 2013

# The issue

- Two views on euro crisis:
  - Main problem was lack of enforcement of Maastricht framework
  - Main problem was design flaws in the Maastricht framework
- Evolving official stance:
  - Until summer 2012 first view prevailed (apart from recognition of need for crisis management and resolution instruments)
  - June 2012: Launch of discussions on banking union, launch of reflection on 'genuine EMU'
  - October 2012: Endorsement of 'completing EMU' goal, agreement to explore 'fiscal capacity'
  - December 2012: Agreement on first step of banking union, outline of the rest, but no endorsement of fiscal union concept
- So will EMU#2 consist in Maastricht + banking union?
- If so, enough?

# Outline

1. The crisis in retrospect: A North-South framework
2. What went wrong: known unknowns
3. A closer look at financial integration
4. What went wrong: unknown unknowns
5. EMU's systemic flaws
6. What banking union solves
7. What remains

# **The crisis in retrospect: A North-South framework**

Country-level approach: trees hide the forest

Therefore groupings (see appendix) to build simple North-South framework

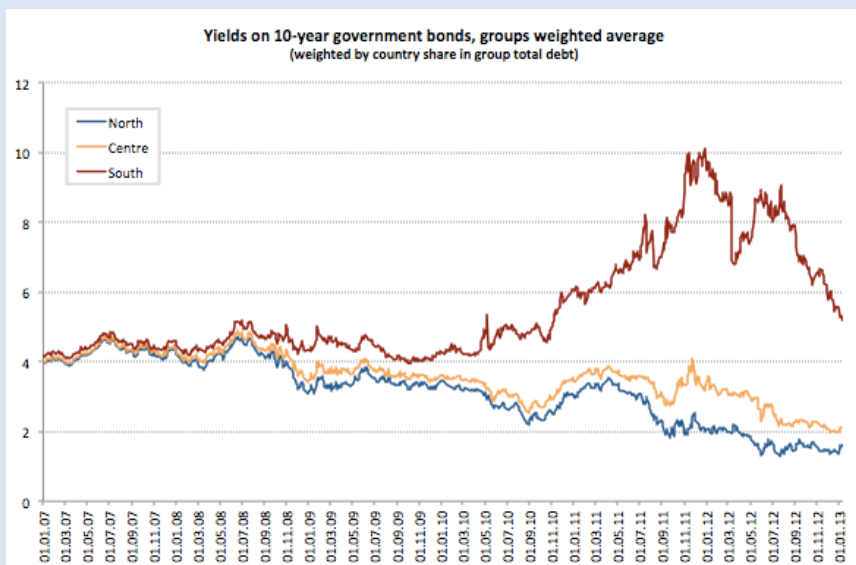
- North: Austria, Finland, Germany and the Netherlands
- Centre: Belgium and France
- South: Greece, Ireland, Italy, Portugal and Spain
- (Excluded: Luxembourg; Estonia, Cyprus, Malta, Slovakia, Slovenia)

GDP (average 1999-2011): North=41%; Centre=25%; South=34%

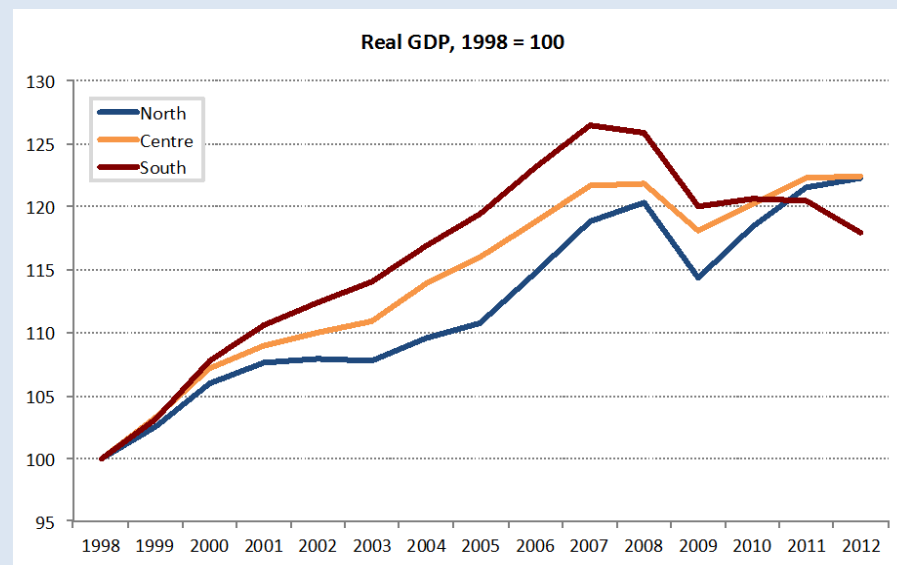
Population (average 1999-2011): North=36%; Centre=23%; South=41%

# Different fates

## Government bond yields

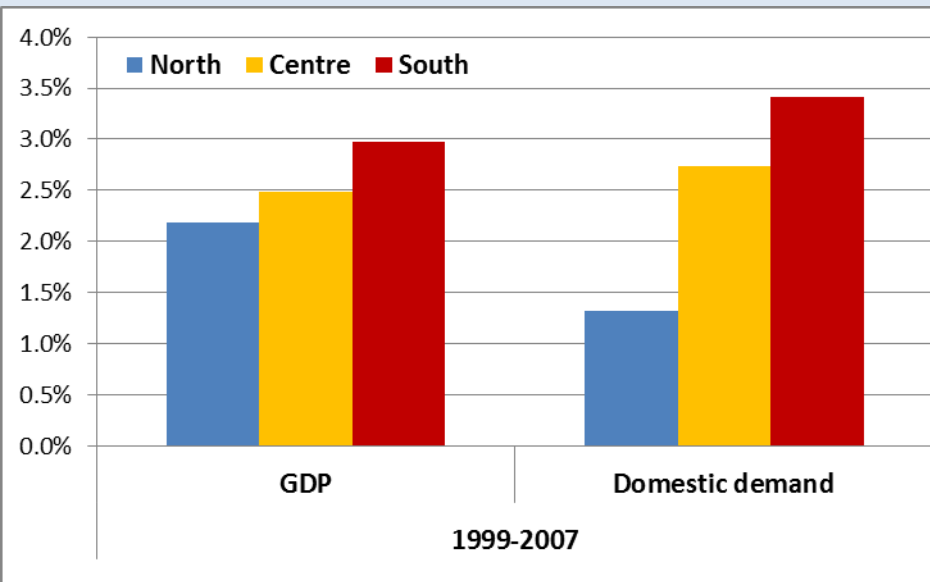


## GDP

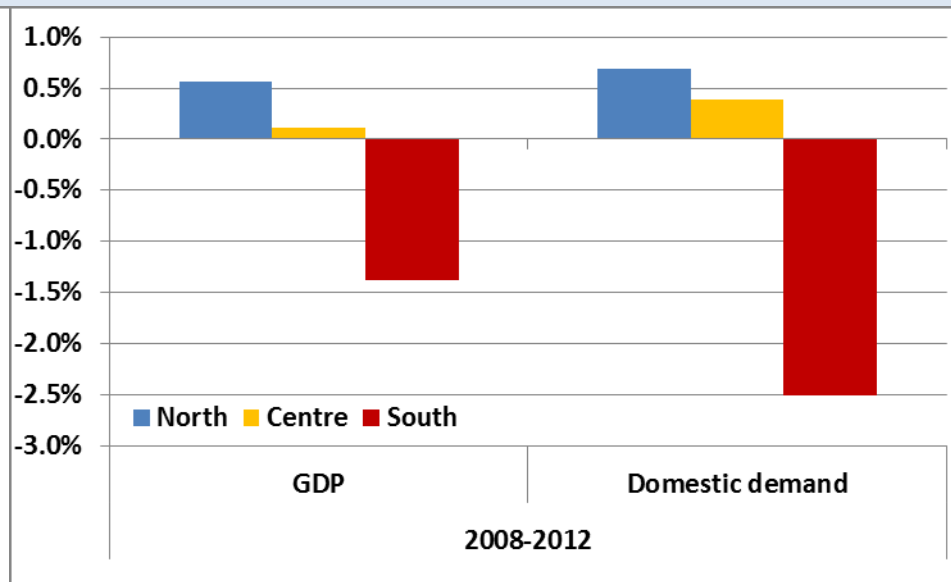


# Demand and growth

Pre-crisis

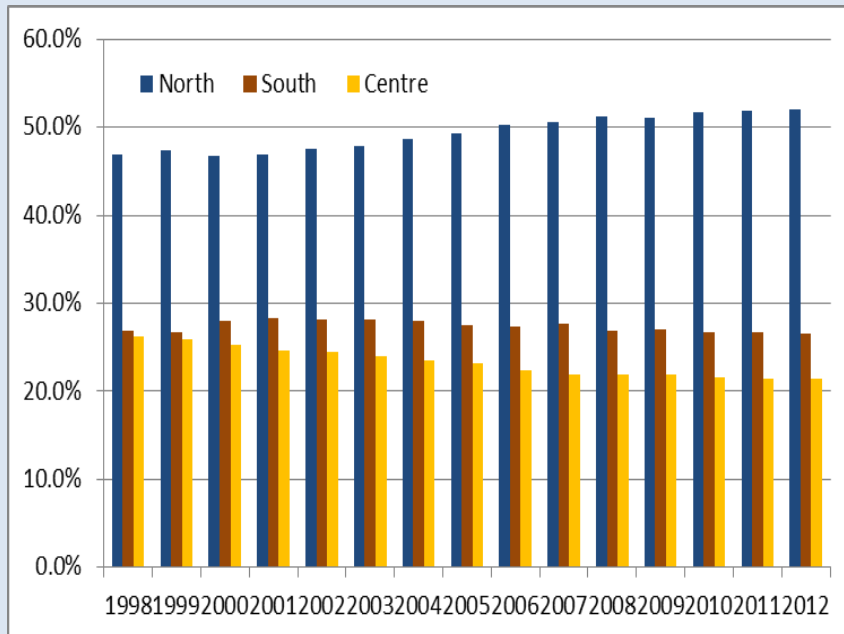


Post-crisis

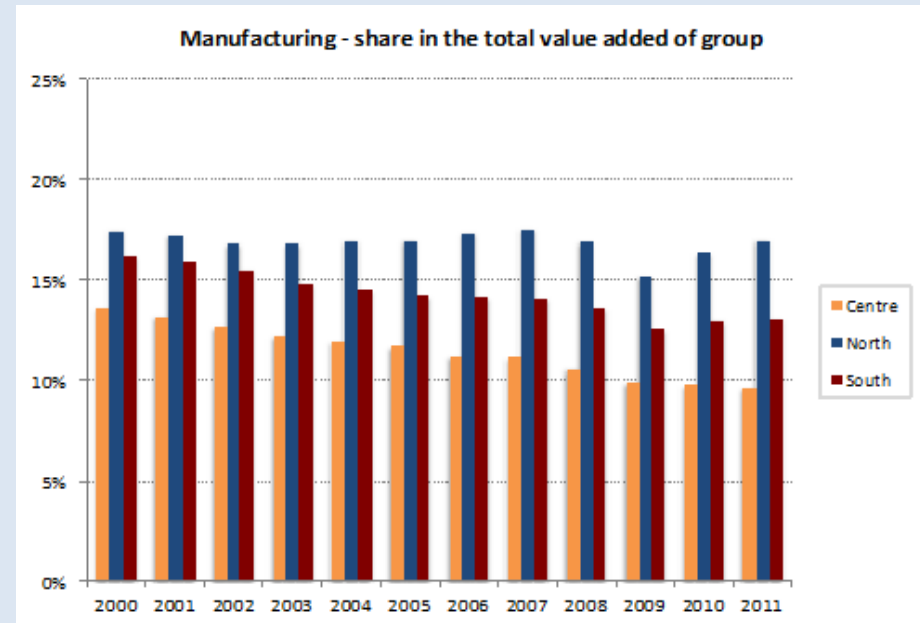


# Structural consequences

Share of each group in total exports

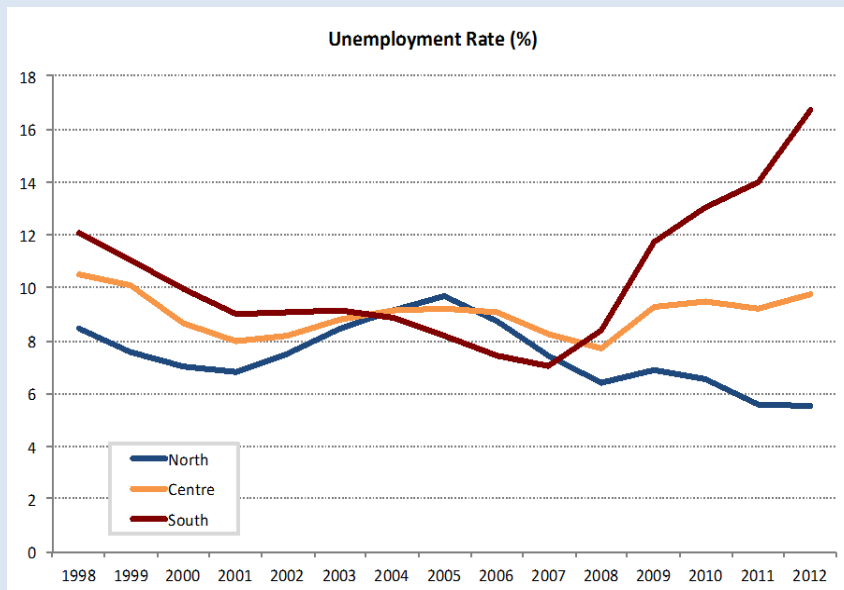


Share of manufacturing value added in group GDP

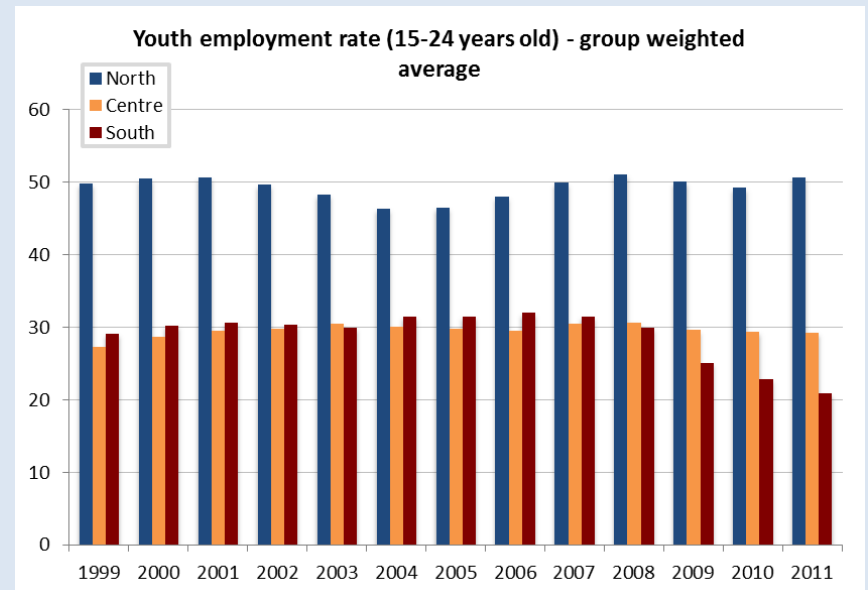


# Labour market consequences

## Aggregate unemployment



## Youth employment rate





# What went wrong: Known unknowns

*“There are known knowns; there are things we know that we know.*

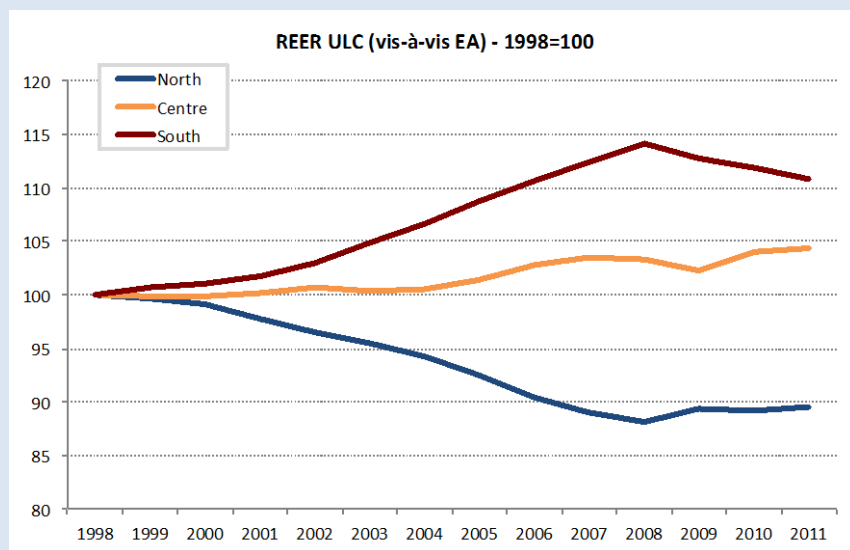
*There are known unknowns; that is to say there are things that, we now know we don't know.*

*But there are also unknown unknowns – there are things we do not know, we don't know”*

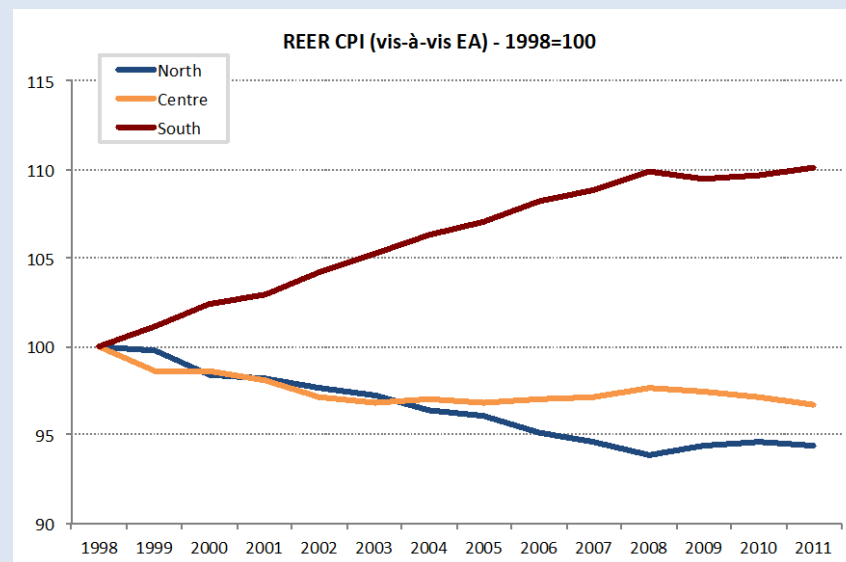
Donald Rumsfeld, February 2002

# The (familiar) story: Pre-crisis divergence in competitiveness

REER (ULC)

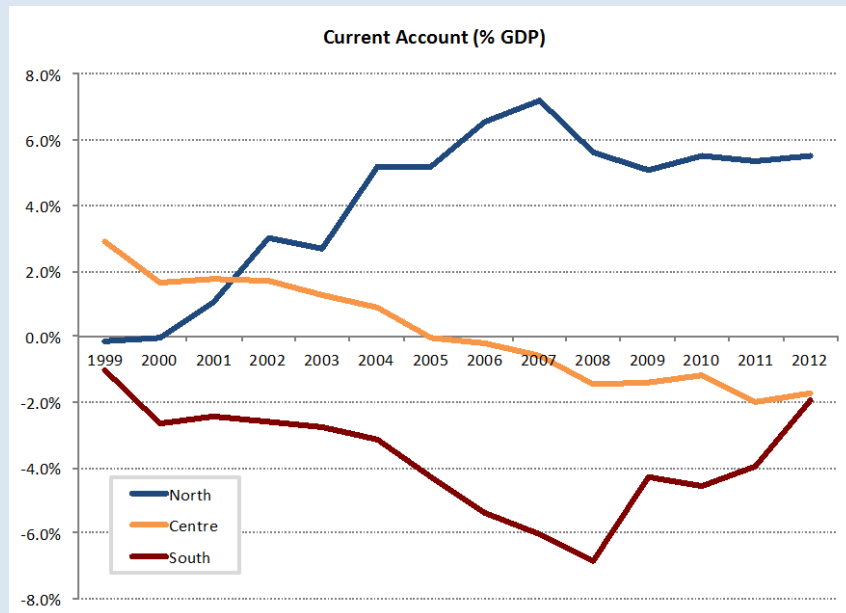


REER (CPI)

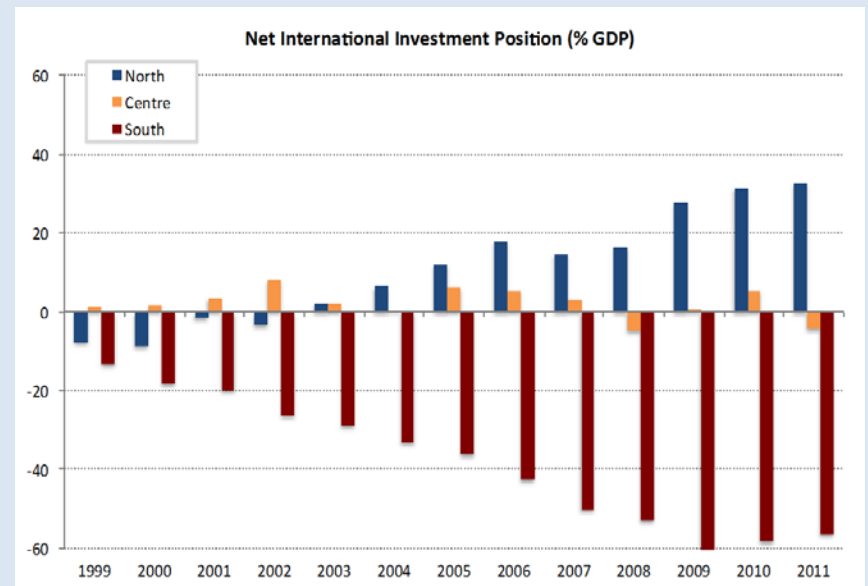


# Current accounts and NFAs

## Current-accounts



## Net Foreign Assets



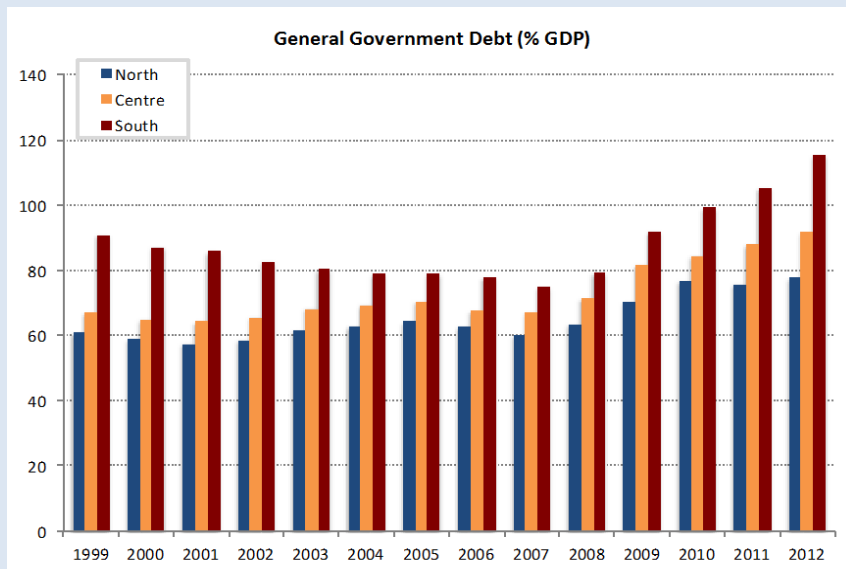
# The consequences: REER misalignments

Source	Method	Date	Misalignment
Coudert, Couharde and Mignon (2012) <ul style="list-style-type: none"> <li>• Greece</li> <li>• Portugal</li> <li>• Spain</li> <li>• Italy</li> <li>• France</li> <li>• Germany</li> </ul>	BEER	2010	+ 20 % + 14 % + 10 % + 7 % 0 % - 1 %
Carton and Hervé (2012) <ul style="list-style-type: none"> <li>• Greece</li> <li>• Portugal</li> <li>• Spain</li> <li>• Italy</li> <li>• France</li> <li>• Germany</li> </ul>	FEER	2010	+43 % + 25 % + 10% + 8 % + 8 % - 10 %

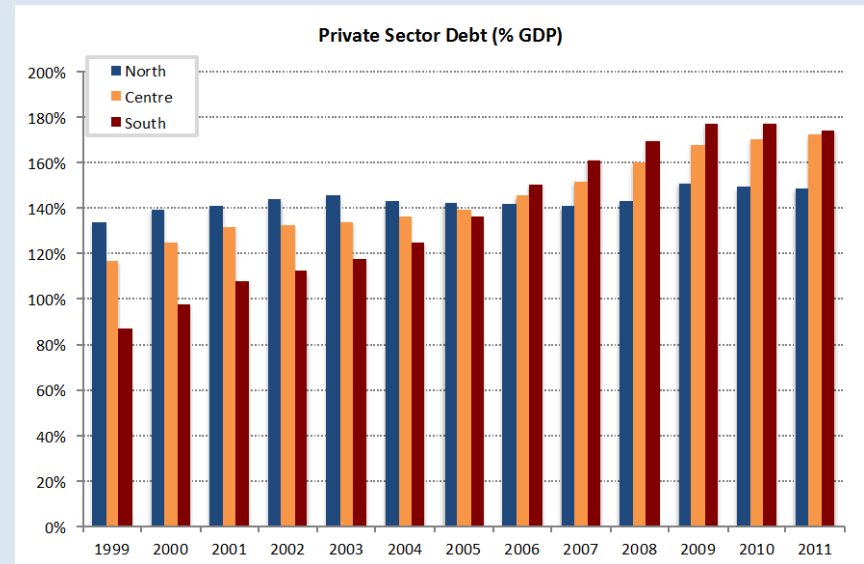
# What is behind?

Not primarily a public finance story – rather a private debt story

## Public debt



## Private debt



# Summing up

A large part of the current problems were correctly anticipated by research

What did policymakers do to address these risks?

A bit:

- SGP
- Surveillance framework

But not much...

- Nominal rather than real entry criteria
- No real efforts to foster single market integration
- Isolated efforts to ensure wage/price flexibility
- Only a few governments gave thoughts to ways of controlling divergence
- Weak implementation of surveillance provisions
- No crisis management mechanisms

It is being corrected

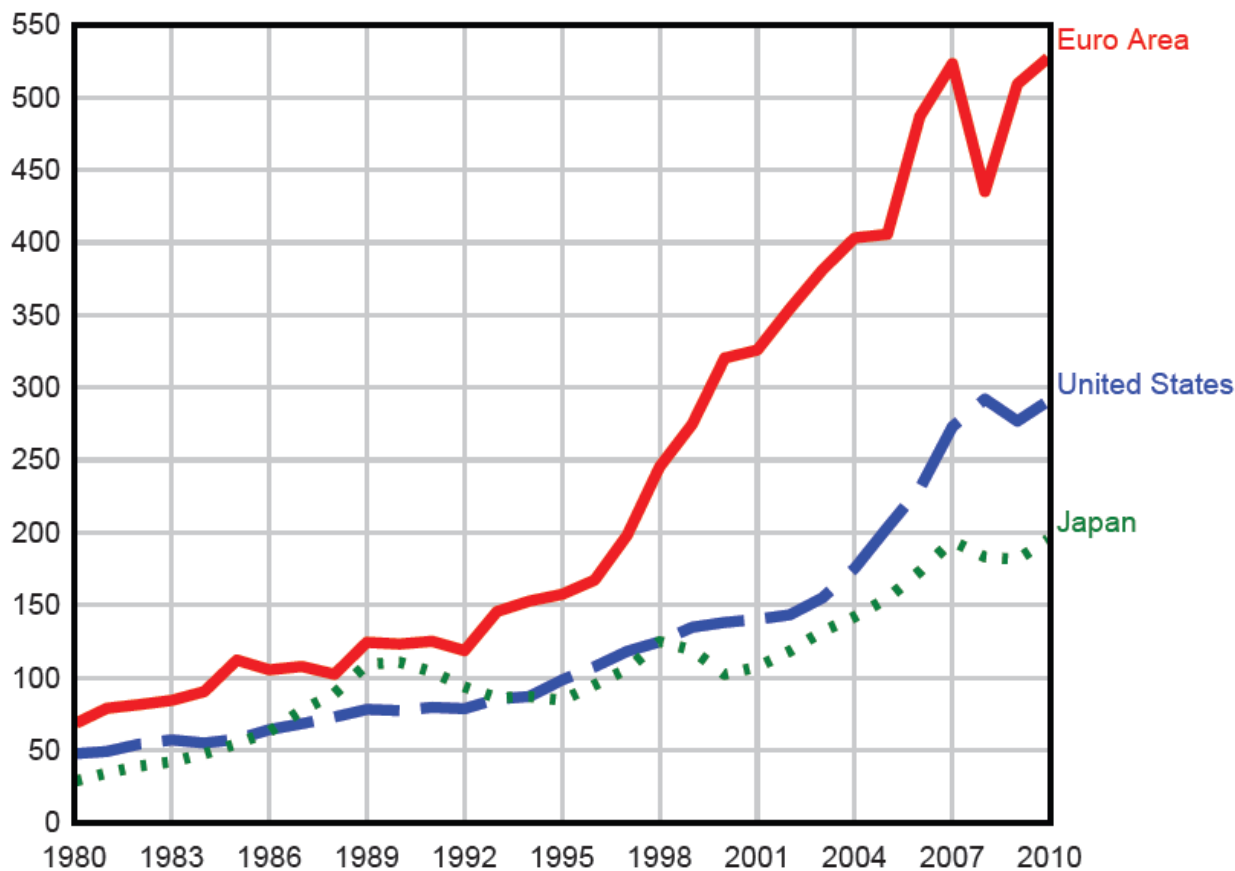
- Macroprudential approach
- Six-pack, Excessive imbalances procedure
- Fiscal treaty

# Why were warnings ignored?

- Predominance of (high) politics
  - Euro choice
  - Entry highly politicised choice
- Implementation problems
  - Hard to define undisputable entry criteria based on OCA
- Adjustment and integration fatigue
  - No appetite for further reforms
  - No appetite for surveillance
  - No appetite for further transfer of competence
  - Not even for single market enforcement
- 'Europe is different' mindset
  - Including at the IMF
- Hence, complacent reading of the literature
  - Endogenous price flexibility assumed
  - Endogenous OCAs taken for likely
  - Solvency crises not considered a real risk
- In the end, incoherence between euro and other dimensions of integration

# A closer look at financial integration

Ratio of external financial assets and liabilities (including intra-EA) to GDP

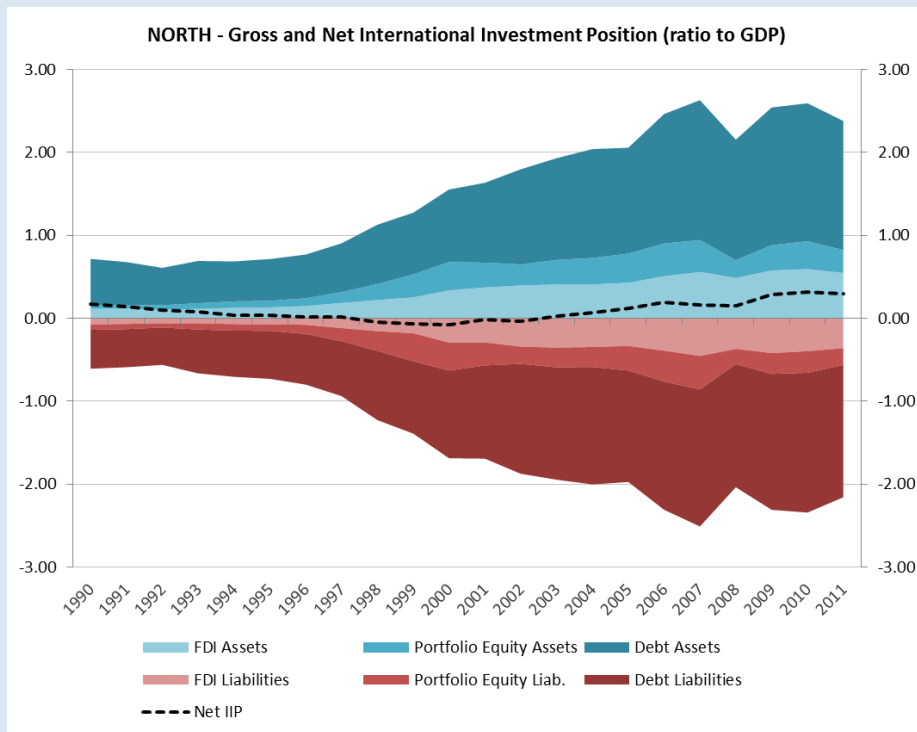


Source: Lane (2012), based on Lane-Milesi-Ferretti database

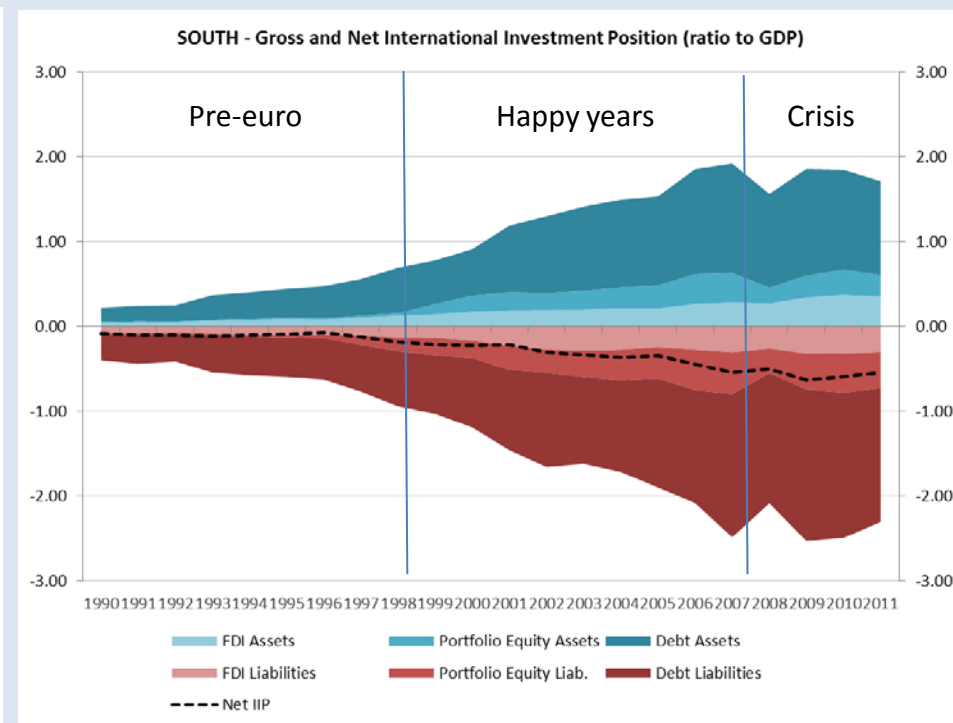


# Gross capital stocks: The euro effect

## North

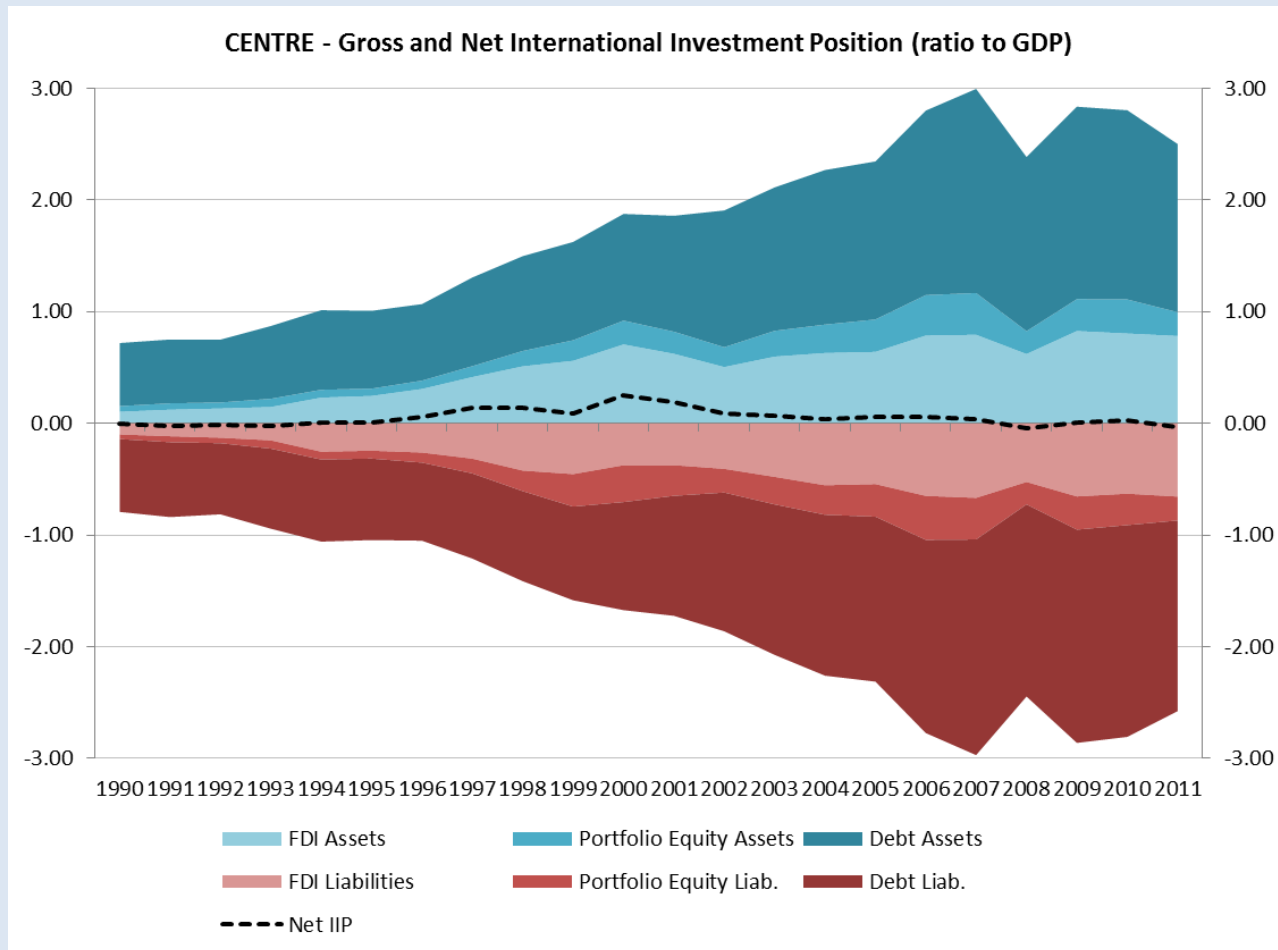


## South



Source: Bruegel, BOP data

# Gross capital stocks(cont'd): Centre as pivot?



# Net positions by instrument

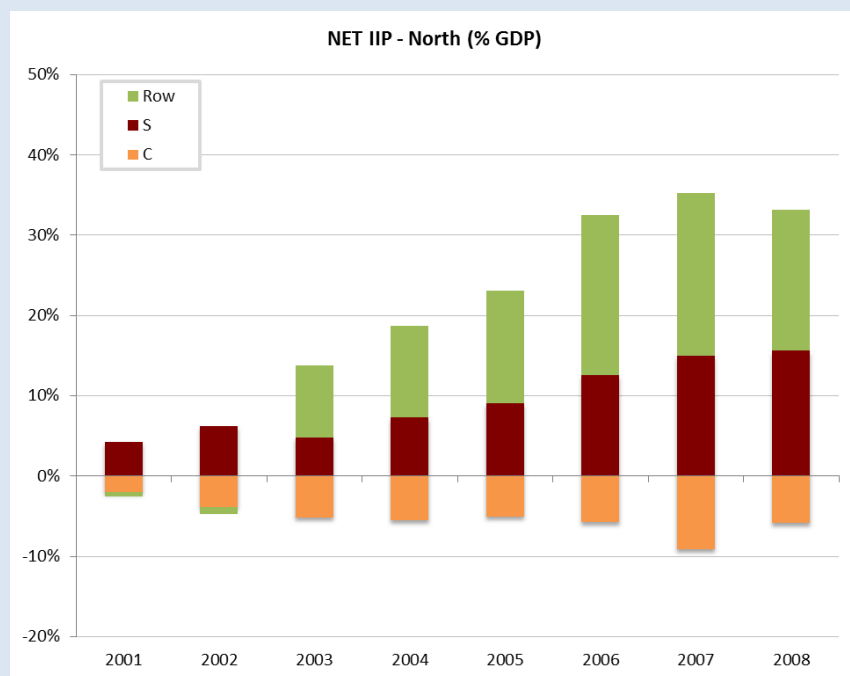
No major pivot role for any of the three regions

USD Tr.	2007			2011		
	North	Centre	South	North	Centre	South
Assets + liabilities	24.9	19.2	19.7	27.0	20.1	19.0
Assets – liabilities	0.7	0.1	- 2.4	1.5	- 0.1	-2.4
FDI, net	0.5	0.4	- 0.1	0.9	0.4	0.2
Portfolio equity, net	- 0.1	0.0	- 0.7	0.4	- 0.0	- 0.8
Portfolio debt, net	- 0.9	0.5	- 1.0	- 1.5	- 0.5	- 0.7
Other Investment, net	1.1	- 0.8	- 0.6	1.3	- 0.1	- 1.3

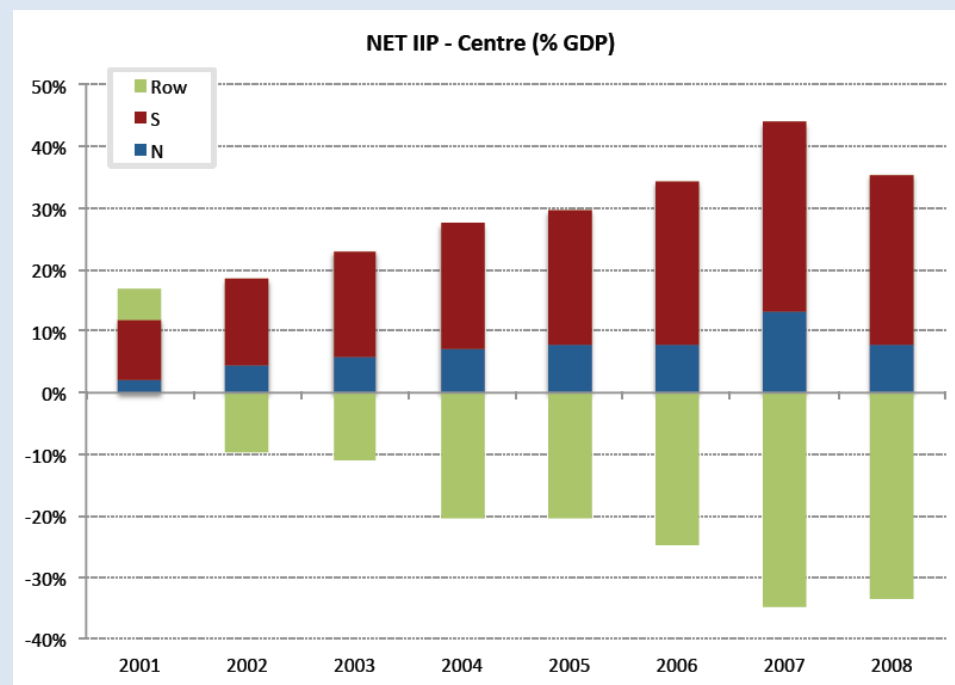
Source: Bruegel, BOP data

# Net bilateral positions: recycling by the Centre

## North-South: Savings flows



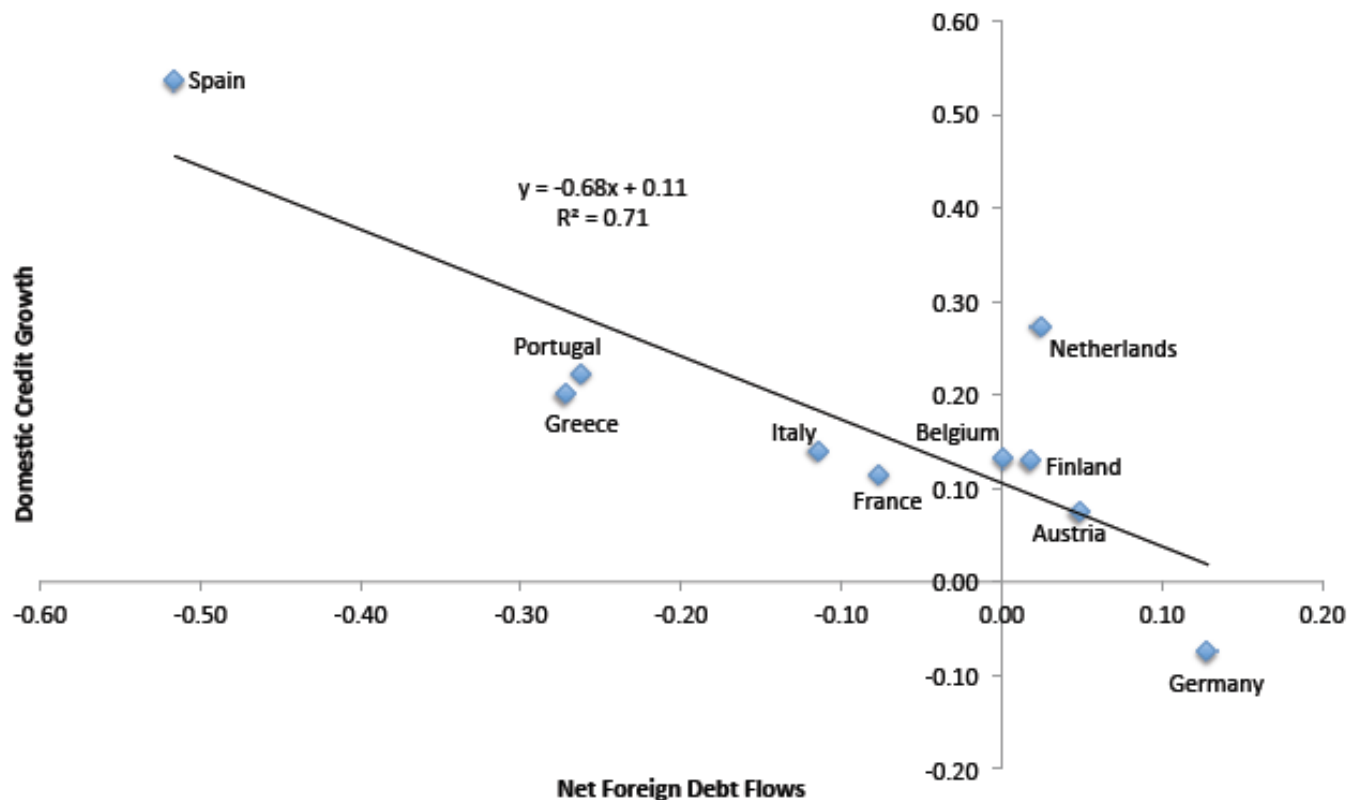
## Centre-South: Recycling



Source: Bruegel calculations with IMF data

# Foreign debt and domestic credit highly correlated

Net foreign debt flows and domestic credit growth, 2003-2008



# Summing up

- Major 'success' of financial integration on the basis of light framework (single market for EU, no specific EA framework)
- Major gross and net capital flow into South from North (out of savings) and Centre (out of intermediation)
- Smoking gun: Push role of bank lending (à la Bruno-Shin)

# What went wrong: unknown unknowns

Two main surprises

- Intensity of sovereign-banks correlation ('doom loop')
- Capital flows reversal and financial fragmentation

*“The traditional concept of a deficit or a surplus in a member nation’s balance-of-payments becomes blurred.. With a common currency, no individual country can be exposed to speculative attacks”*

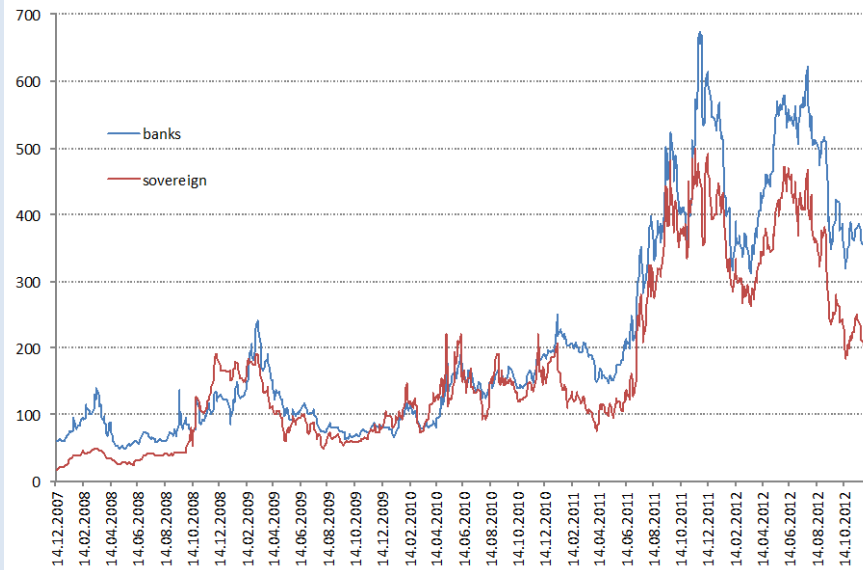
*(Ingram, 1973)*

*“A major effect of EMU is that balance of payments constraints will disappear in the way they are experienced in international relations. Private markets will finance all viable borrowers, and savings and investment balances will no longer be constraints at the national level.”*

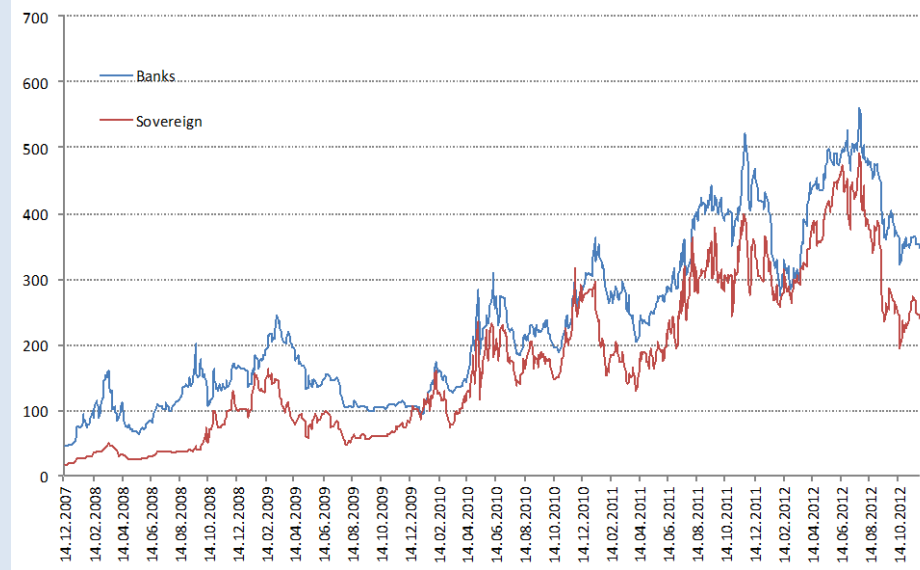
*(One Market, One Money report 1990)*

# Bank-sovereign interdependence

ITALY- 5year CDS premia on sovereign and banks



SPAIN- 5year CDS premia on sovereign and banks

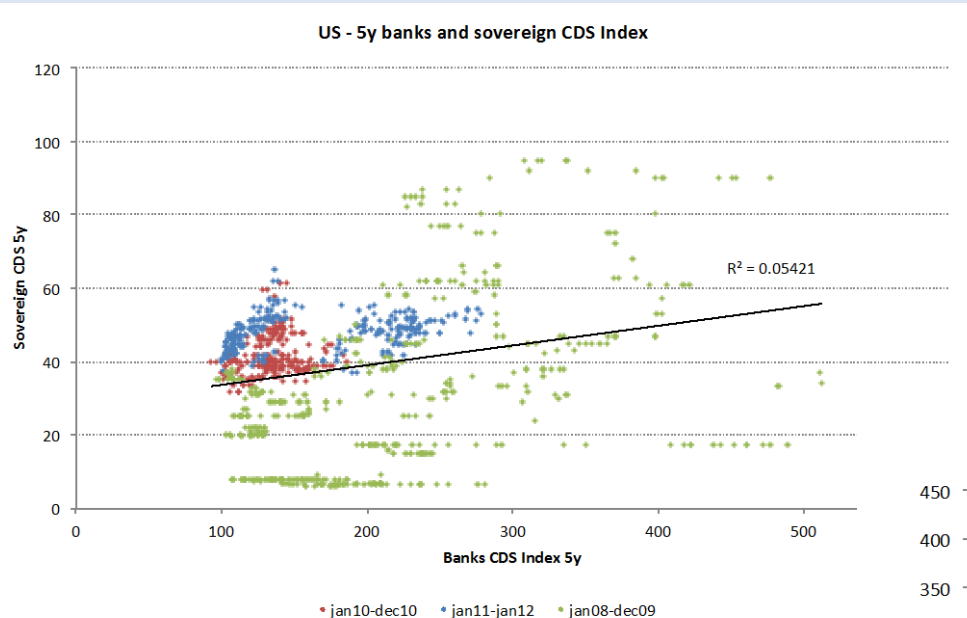




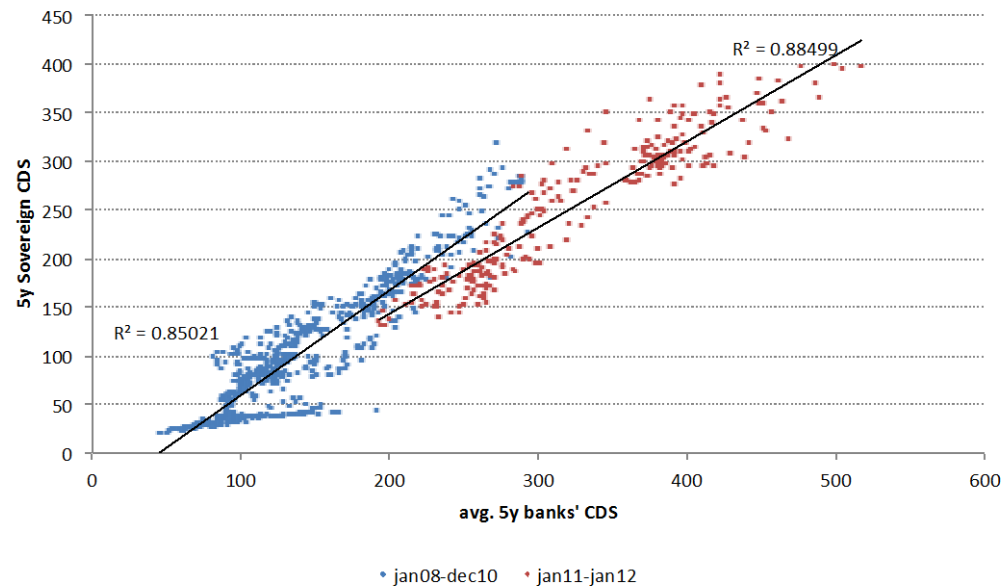
# Correlation of sovereign and bank CDSs

## Sovereign CDSs and bank CDSs, 1/2008 to 1/2012

US



SPAIN

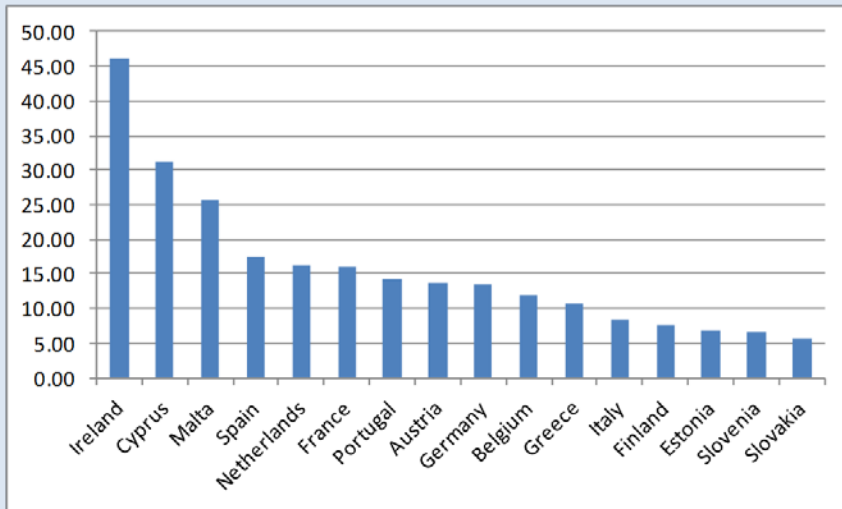


# Why?

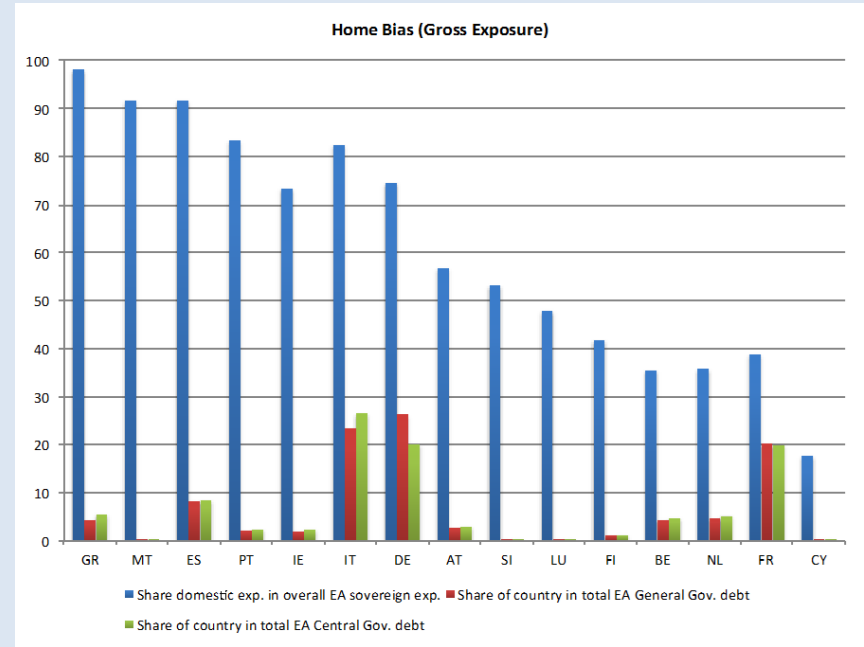
Sovereign exposure to banks is considerable...

..banks exhibit strong home bias in holding of govt bonds

Total bank assets to government tax receipts ratio, 2010

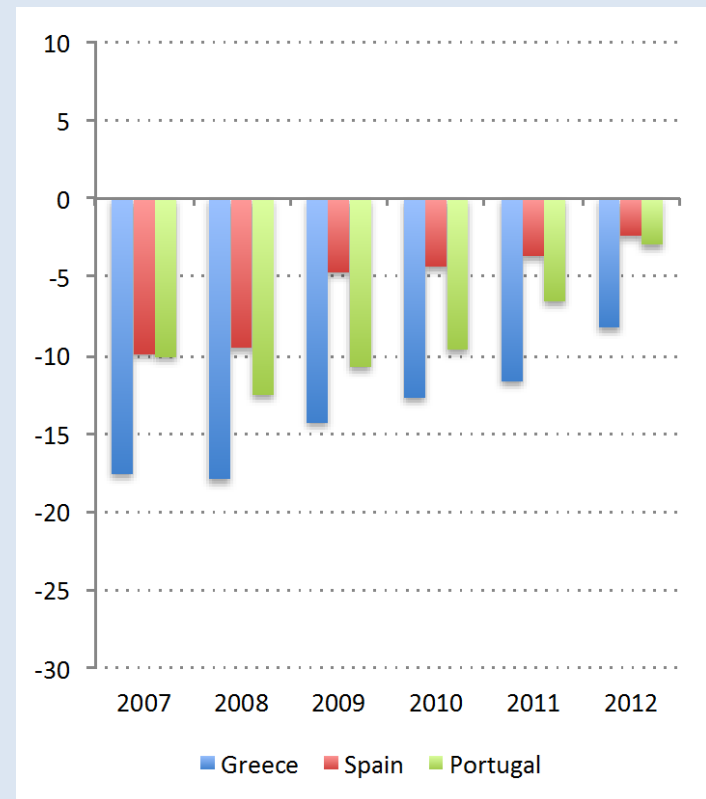
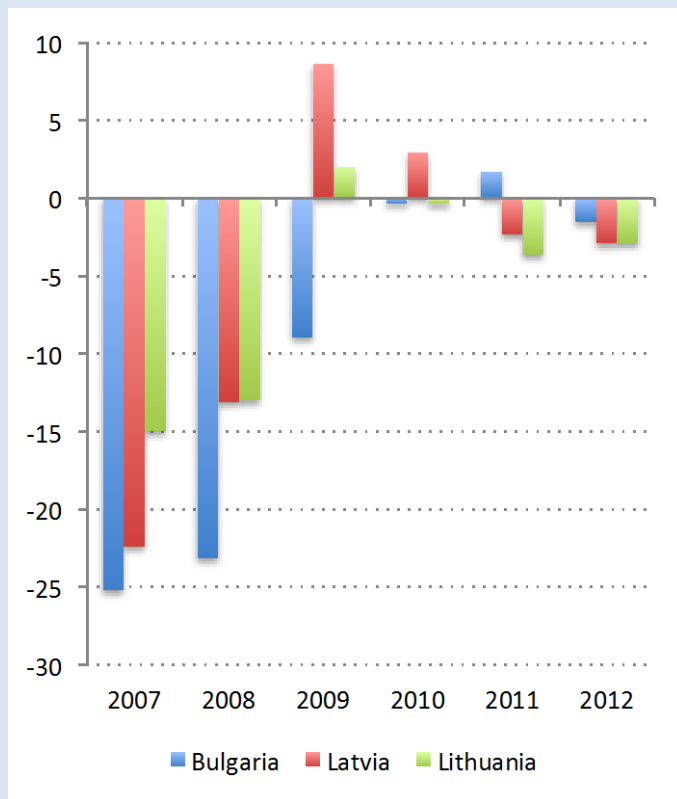


Share of own sovereign's bonds in EA government bonds held by banks, 2010



# Evidence of sudden stops in spite of apparently smooth BOP adjustment

Current-account balances as a percentage of GDP, 2007-2012

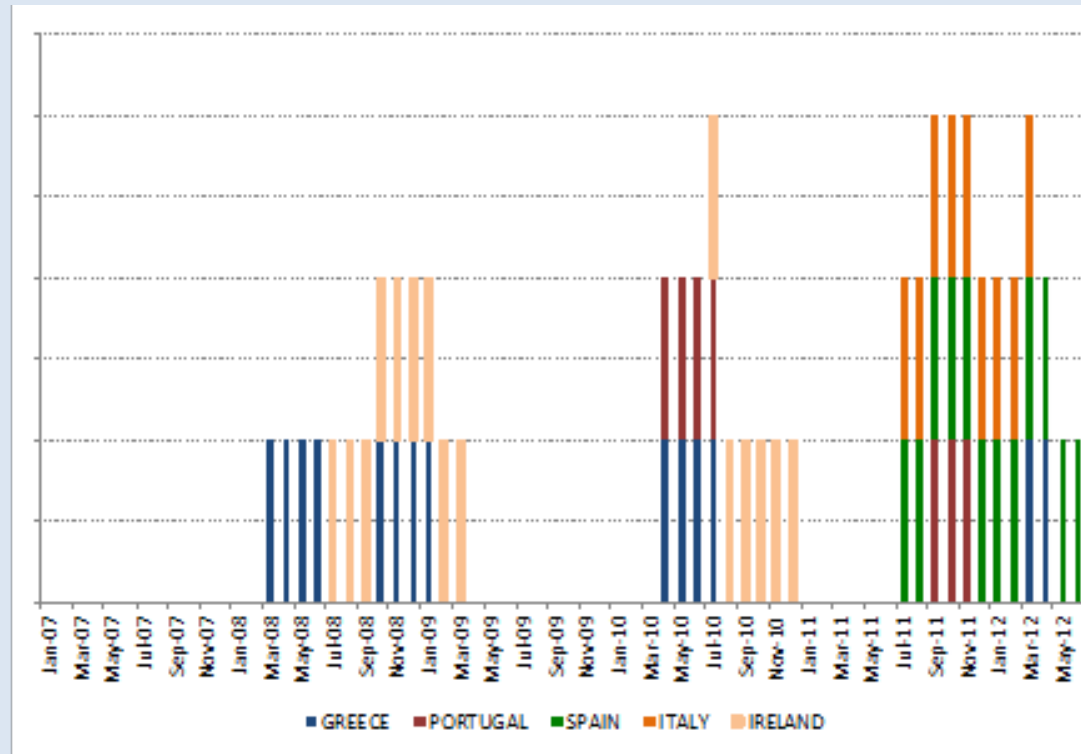


# Episodes of sudden stops

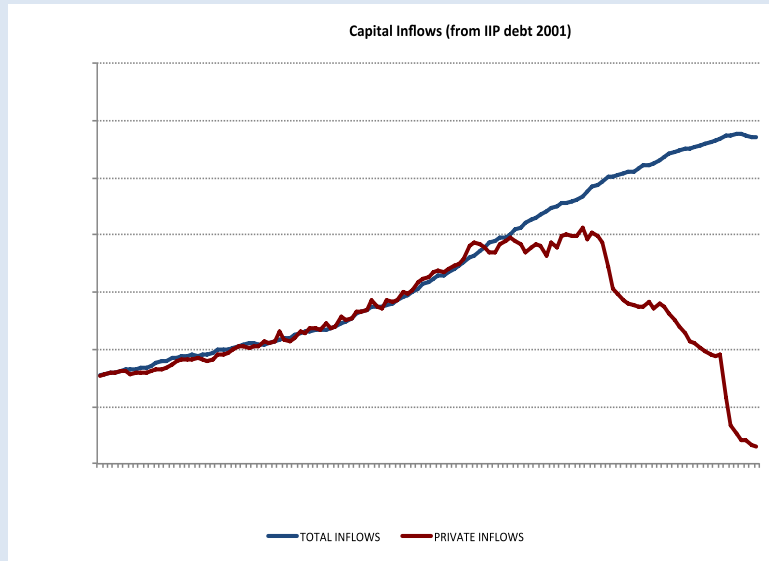
## Three periods and evidence of contagion effects:

- Global financial crisis (Greece; Ireland)
- Greek Programme (Greece; Ireland; Portugal)
- Summer-Autumn 2011 (Portugal; Italy; Spain)

**Public capital flows have substituted private flows**

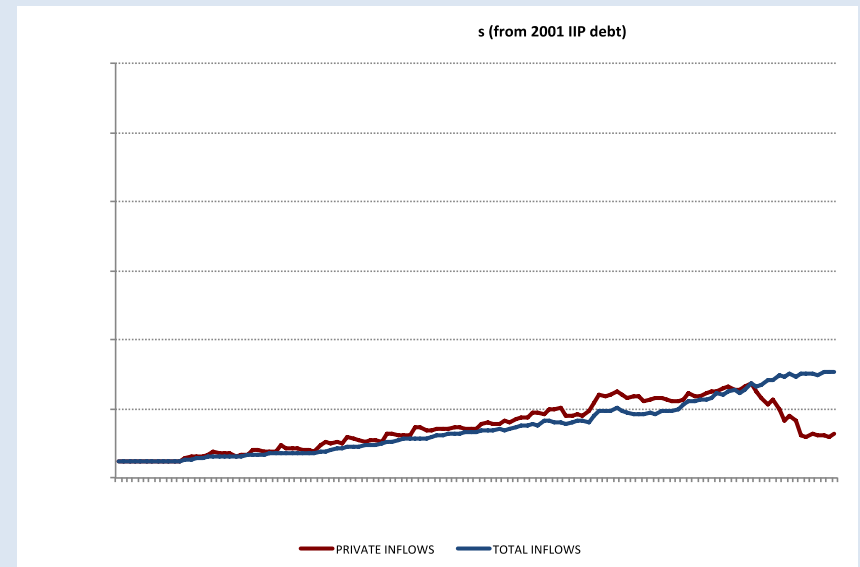
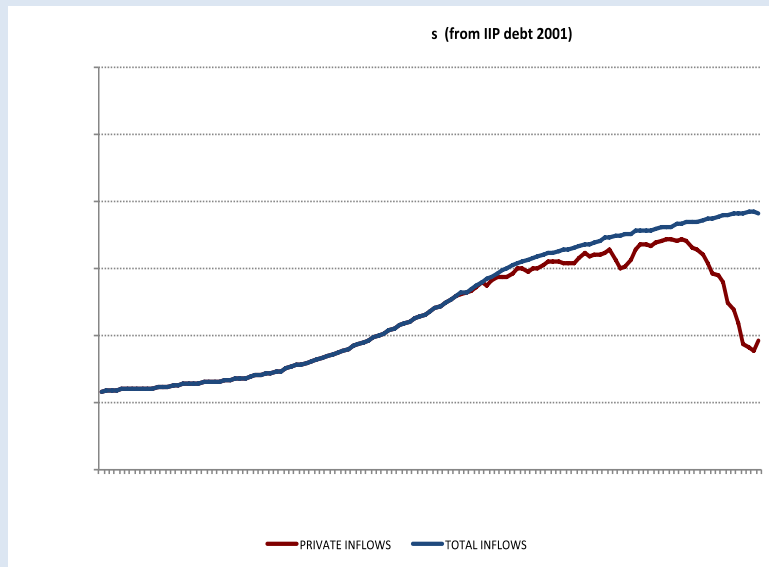
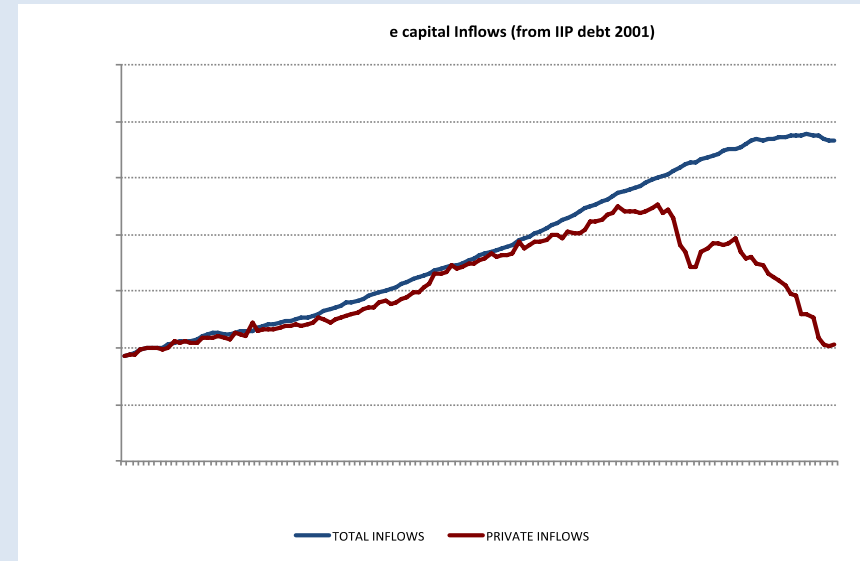


# Sudden stops: cumulative capital inflows by country



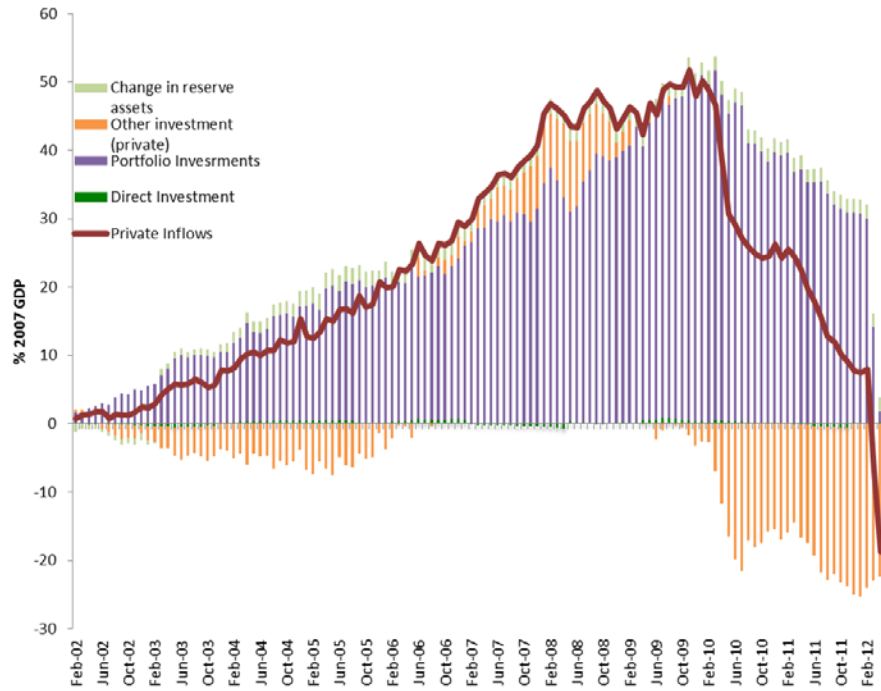
Total

Private



# A closer look - Greece

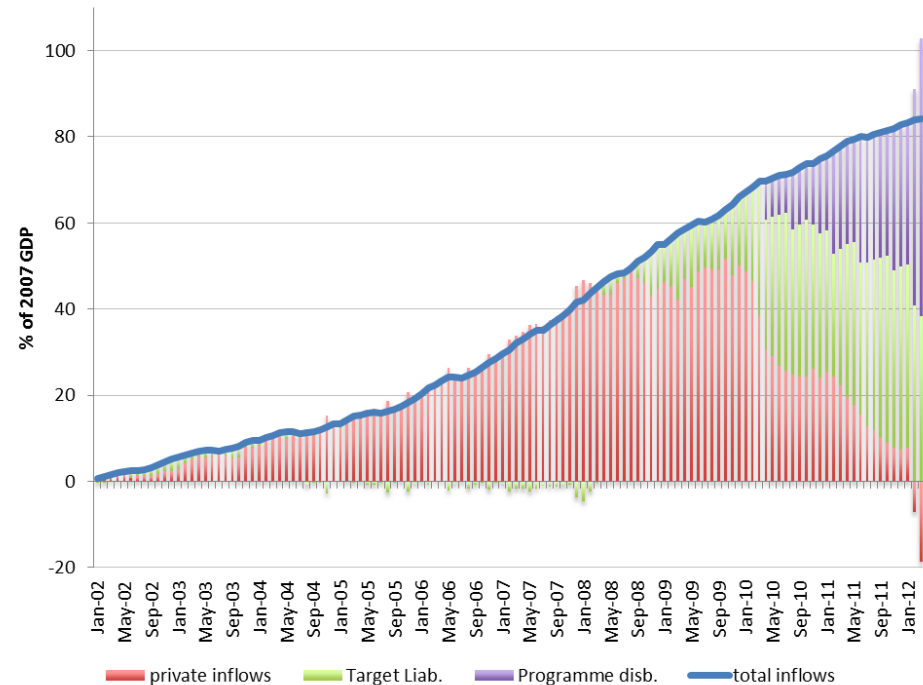
GREECE - Composition of Private Capital Inflows



Composition of private capital flows

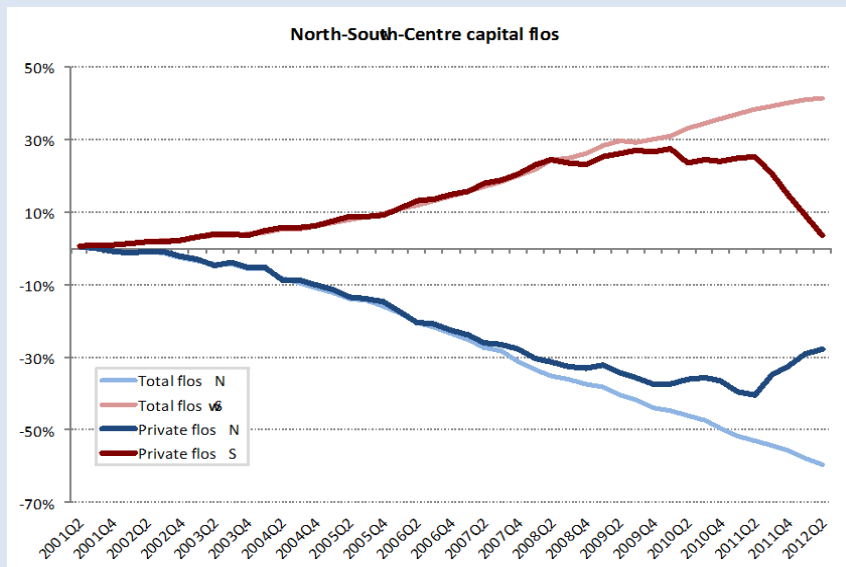
Composition of public capital flows

GREECE - Components of cumulative capital inflows

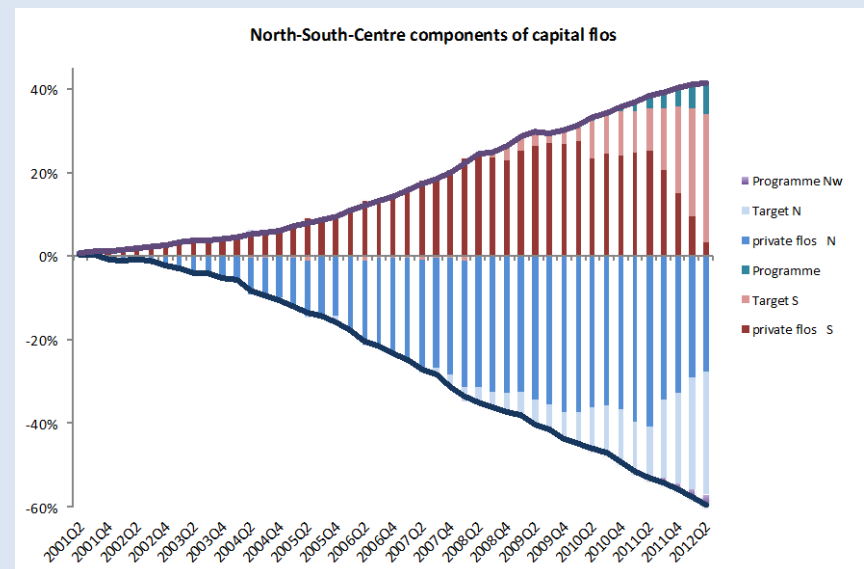


# The aggregate picture: North-South capital flows

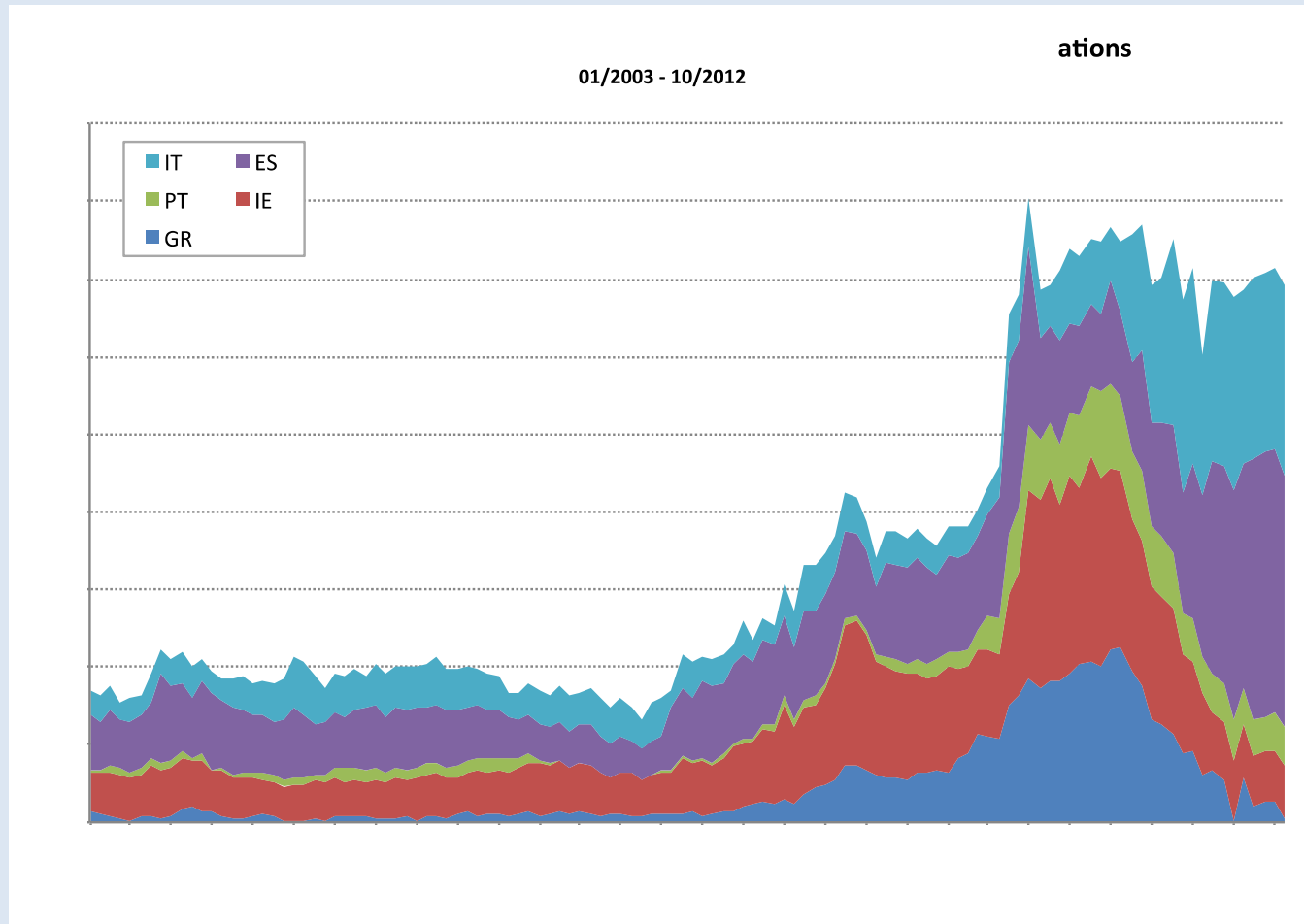
Private and public flows



Details: private flows, TARGET2 flows and programme flows



# The role of ECB liquidity provision

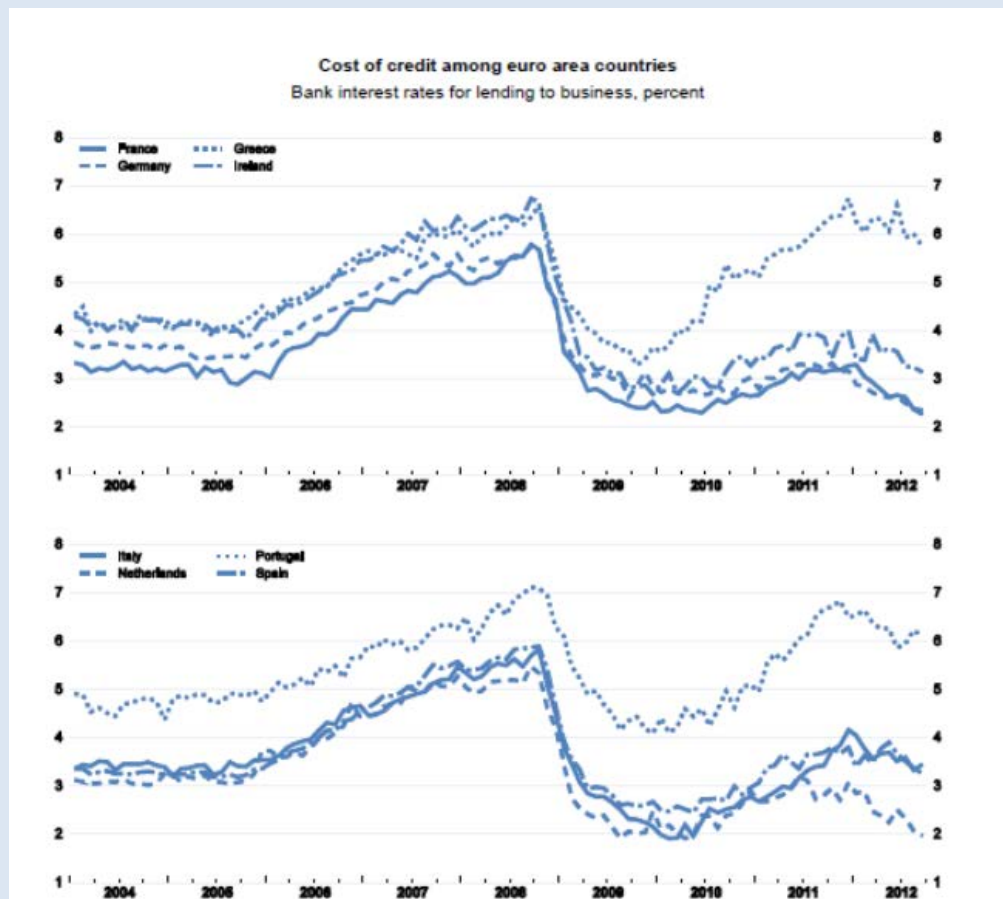


Source: Bruegel Dataset of Eurosystem lending operations



# Evidence of financial fragmentation

## Cost of credit to nonfinancial business



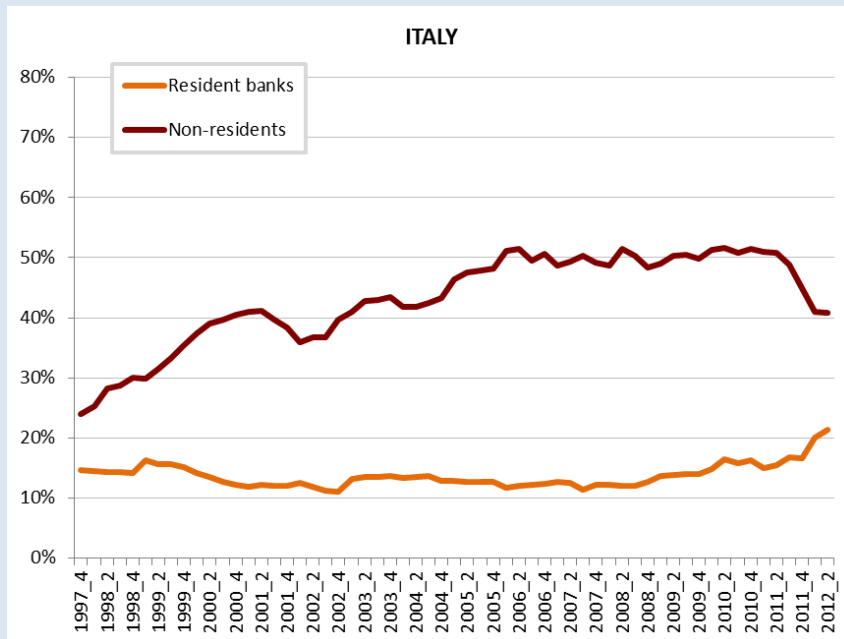
Note: Cost of credit is defined as interest rates on new loans to non-financial corporations (all maturities), with the exception of Greece where it refers to new loans with maturity of up to one year. Last observation is September 2012.

Source: European Central Bank.

# Debt renationalisation and the strengthening of the sovereign-bank loop

## Shares of public debt held by non-residents and by domestic banks

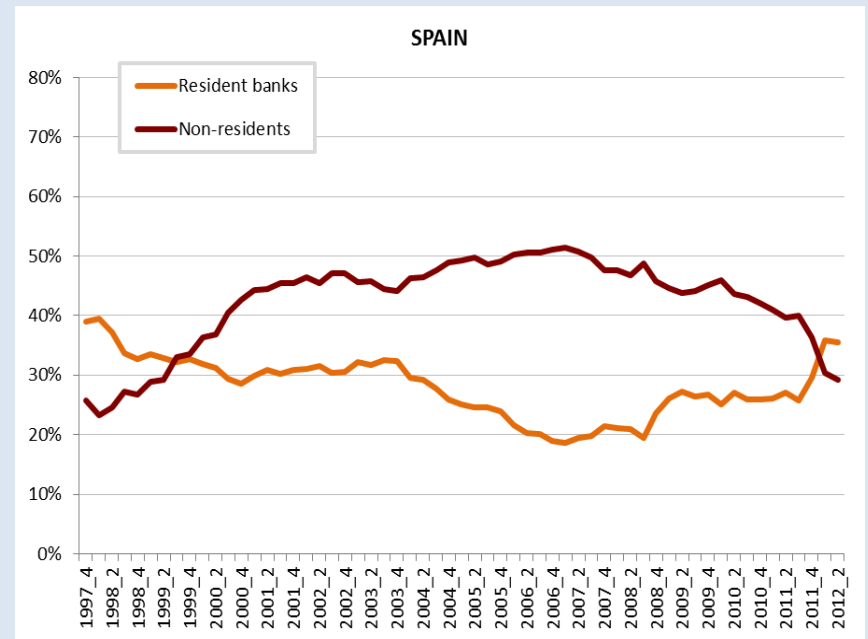
### Italy



Bonds held by domestic banks:

- €168bn in June 2007
- **€364bn** in June 2012

### Spain



Bonds held by domestic banks:

- €71bn in June 2007
- **€235bn** in June 2012

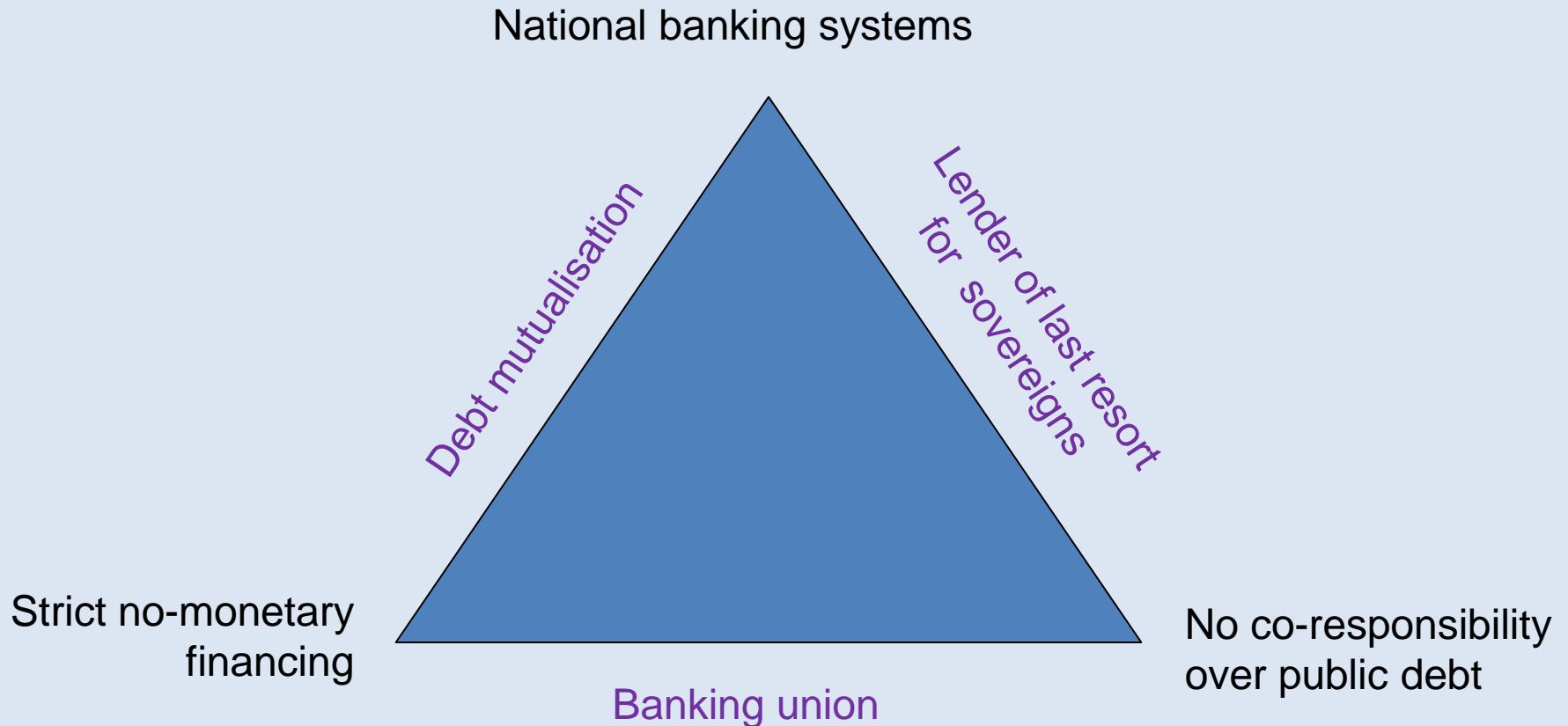
# Summing up

- Sudden financial arrest of intra-EMU financial flows
- Major financial disintegration starting summer 2011, only very partially reversed in spite of OMT, BU announcement
- Capital outflows have led to renationalisation of sovereign holdings, strengthening of bank-sovereign loop

# EMU's systemic flaws

- Oblivion of finance
- Bare-bones EMU:
  - Single market (for all EU)
  - Independent central bank
  - Fiscal discipline provisions
- No financial dimension whatsoever
- Naive view of finance as stabilising force

# Behind the doom loop: The other trilemma



# Behind financial fragmentation: still-separate financial system

- Equally solvent banks do not have same access to funding
- Equally solvent NF agents borrow on different terms
- Why?
  - Ambiguous role of supervisors. Several (e.g. BAFIN) are forcing banks to limit cross-border exposure
  - Still-national banks concentrate risks from national credit boom, whereas risks are pooled inside a country
  - State responsibility for bailing out banks a factor of aggregation of individual agents' budget constraints

# Immediate response: The OMT

## Outright Monetary Transactions:

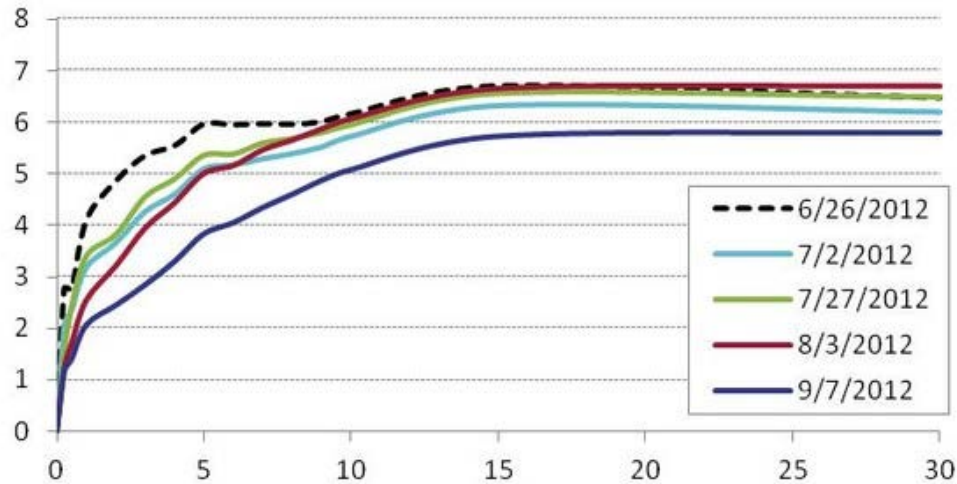
- Defined purpose (ward off fragmentation, divergence of credit conditions for non-financial agents)
- Defined scope (lower part of the yield curve)
- Defined conditions (ESM programme)

## So better than SMP. Yet issues remain:

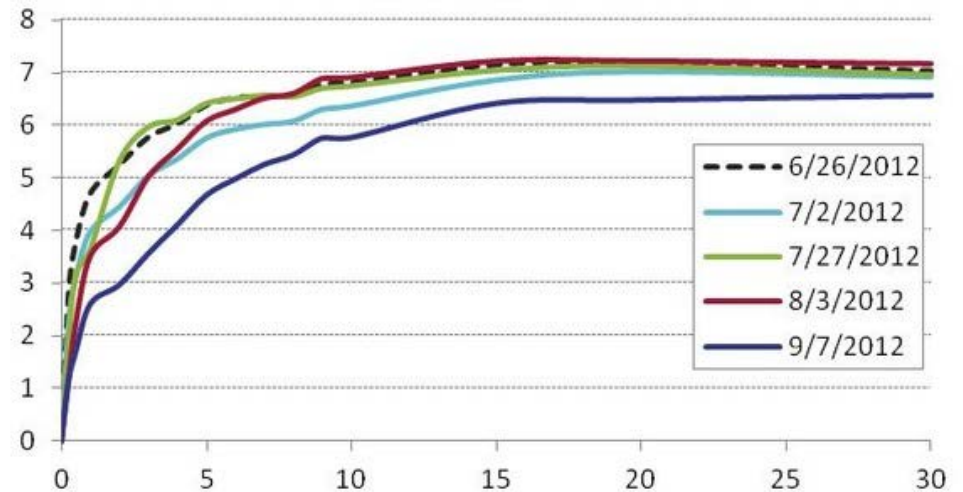
- Operationalisation (target spreads for rate of credit to private agents?)
- Contract with governments
- Response to implementation slippages
- Political sustainability

# How effective was OMT announcement?

YIELD CURVES-Italy

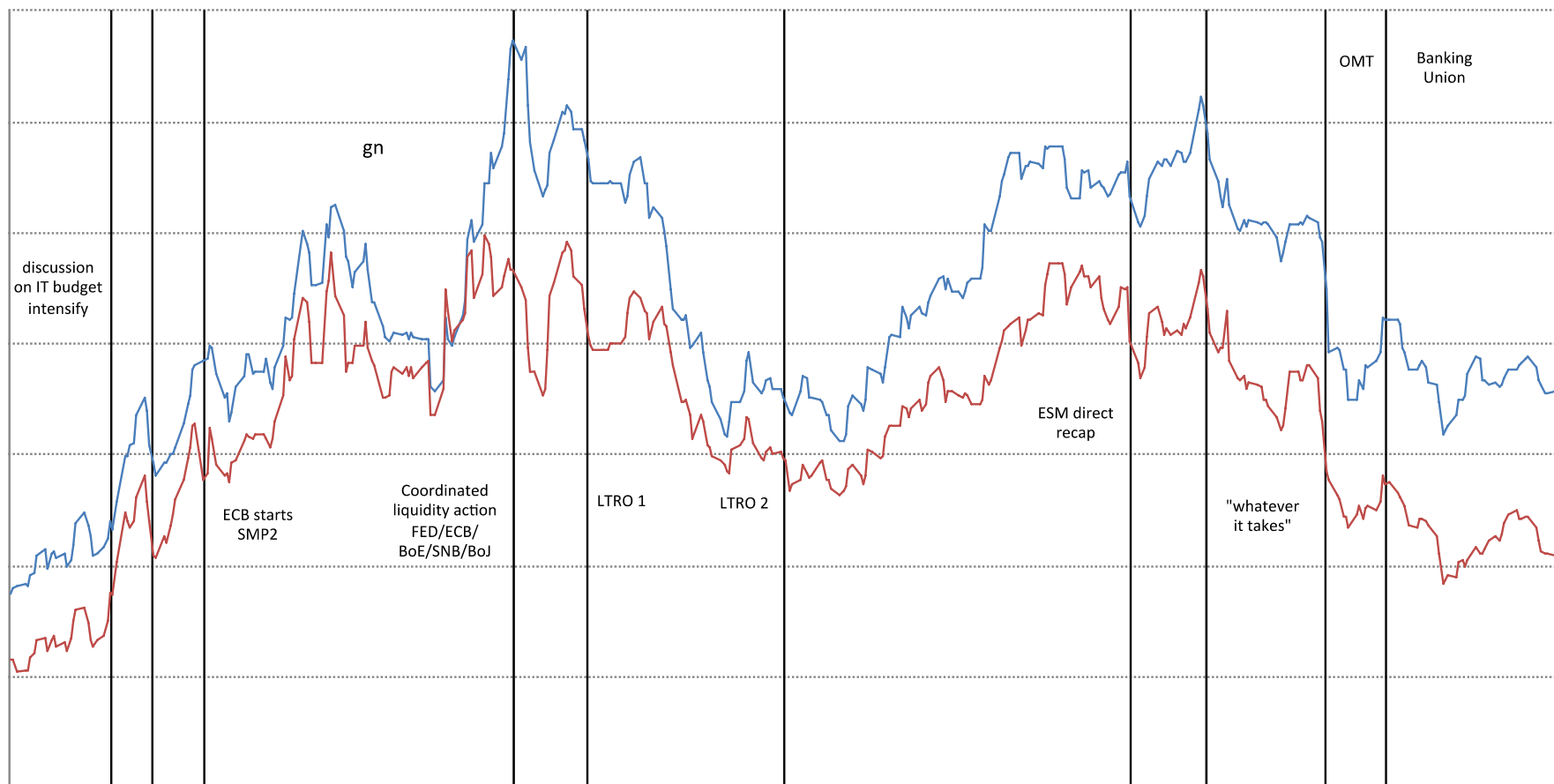


YIELD CURVES-Spain





# How effective the OMT announcement?



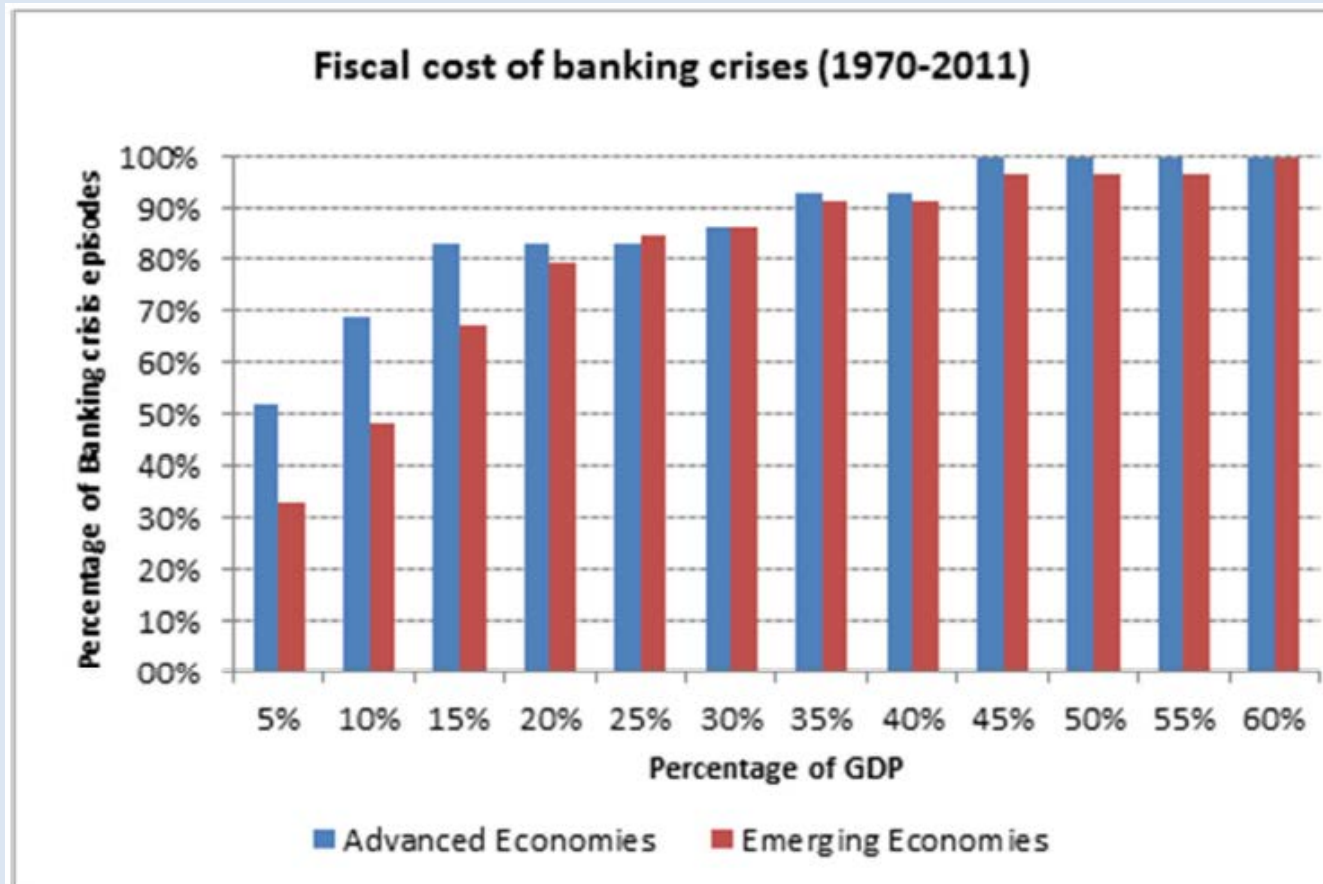
# What banking union can solve (back to the trilemma)

- LLR role for the ECB
  - Legality
  - Governance
- Debt mutualisation
  - Legality
  - Implications for fiscal regime
- Banking union
  - Intrusive resolution
  - Fiscal union through backdoor

# Banking union

- Supervision
  - Long-term impact on cross-border integration
- Resolution
  - Should diminish potential fiscal burden, however in the long term
- Fiscal backstop
  - Major effect on bank-sovereign loop

# Banking crises are (sometimes very) costly



Source: Bruegel calculations with the Laeven and Valencia (2012) database.

# Key issues for negotiation

- Resolution regime
  - Leaders' conclusions now speak of « single resolution mechanism »
- Legacy costs
- Ultimate fiscal responsibility
  - Ambiguity as leaders' conclusions speak of « backstop arrangements »
  - « Skin in the game » necessary for incentive compatibility
  - But catastrophic risk should be mutualised
- Ex-ante burdensharing

# What remains

## Revisit the Maastricht assignment?

- Maastricht assignment:
  - Stabilisation role of national budgets (within limits)
  - Private agents' unconstrained access to financial market

*“Loss of the monetary policy and exchange rate instrument at the national level will place new demands on budgetary policy at the national level for stabilization and adjustment purposes in the case of country-specific disturbances [...] National budgets will [...] retain their capacity to respond to national and regional shocks...”*

*(One Market, One Money report, 1990)*

- What went wrong
  - Shocks an order of magnitude bigger than expected
  - States may be cut off from access to credit market faster than expected
  - Bank-sovereign loop
  - Impairment of credit channel for private agents too (sudden stops)

# The response so far: Maastricht+

- ECB liquidity to banks
  - Indispensable, major stabilisation effect
  - But short-term fix, and strengthens bank-sovereign loop
- Conditional assistance through the ESM
  - Indispensable, but intervened after state had lost market access
  - Uncertainty about treatment of insolvency
- Strengthening of fiscal framework (euro-area and national levels)
  - Indispensable, but will deliver only in the medium term
  - Experience suggests stabilisation can be impaired even if initial debt level is low
- Banking union
  - Indispensable, but will only help restore credit channel
  - Banks still vulnerable through asset side

## The case for doing more

- Economic
- Political economy

# The return of the ghosts: A stabilisation mechanism...

- “A conjunctural convergence facility to extend grant finance to economically weak member states in particularly difficult economic situations”  
(MacDougall report, 1977)
- « A common instrument dedicated to macroeconomic stabilisation could provide an insurance system whereby risks of economic shocks are pooled across member states »  
(Commission communication, 11/2012)
- « An insurance-type mechanism between euro-area countries to buffer large country-specific economic shocks »  
(Van Rompuy report, 12/2012)



## ..a budget..

- “A high-powered budget model for the Community which would aim at the specific needs of economic, monetary and political union”  
(MacDougall report, 1977)
- « An autonomous euro-area budget providing for a fiscal capacity for the EMU to support member states in the absorption of shocks »  
(Commission communication, 11/2012)

## ... unemployment insurance

- “A Community Unemployment Fund under which part of the contributions of individuals in work would be shown as being paid to the Community and part of the receipts of individuals out of work as coming from the Community.” (MacDougall report, 1977)
- « Une capacité budgétaire propre à la zone euro, distincte du budget des 27 et financée sur des ressources autonomes, et qui aurait une véritable fonction contra-cyclique.. un socle d’indemnisation chômage en zone euro, par exemple » (Moscovici Speech, 11/2012)

# Alternative schemes

- (i) A small, high-power euro-area budget
  - Ex: support for unemployment expenditures financed with a federal corporate tax
- (ii) A support scheme based on deviations from potential output
  - Triggers federal contributions or transfers
  - Example: scheme to stabilise 25% of output gap above 2% of GDP
- (iii) GDP-indexing of government bonds (debt as equity)
  - Amount of the principal to be repaid depends on output growth
  - If growth disappoints, value of debt reduced
- (iv) Quotas for the issuance of mutually guaranteed debt
  - Recourse to limited federal borrowing during financial market volatility

# The schemes compared

	Euro-area budget	Automatic transfer scheme	Debt as equity	Guaranteed bonds quota
Principle	Automatic stabilization role of federal budget	Transfers based on deviation of output gap from EA average	Part of debt issued in the form of GDP- indexed bonds	Right to issue jointly guaranteed bonds (several tranches with increased withdrawal of sovereignty)
Origin of stabilisation	Income transfer from partners	Income transfer from partners	Wealth transfer from (non-resident) bondholders	Borrowing capacity, mutualisation of default risk
Advantages	-True budget	-Maximises stabilization power for any given level of contributions - Symmetric	-Recognises risky character of government debt	-Builds on Maastricht logic that stabilization is done nationally -Continuum with assistance
Drawbacks	-Difficulty to agree on euro-area public goods. -High elasticity implies that budget balance prone to volatility -Large variations across countries -Incentive effects	-Relies on technical potential output assumptions. -Real-time estimates uncertainty -Distributional effects?	-Untested instrument - Increases cost of borrowing for sovereigns -Macro stabilisation comes from non- resident holdings only	-Requires controversial Eurobonds -High initial debt level may impair stabilisation -Limited stabilisation impact

# Conclusions

- Very hard to mimick a federal budget
- All schemes have shortcomings
- But deserves a discussion
- Maastricht + banking union a significant improvement, yet with still evident weaknesses

# Appendix 1:

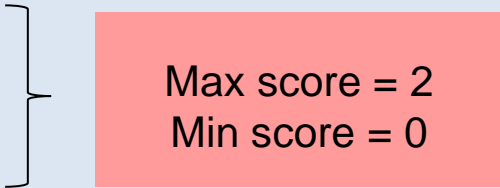
## North-South categorisation

Simple North-South framework for collecting evidence (see Appendix)

- How to define regions?
  - Start from indicators of Excessive Imbalances Procedure
    - CA balance in % of GDP (3-years backward moving average)
    - Net International Investment Position in % of GDP
    - Government Debt in % of GDP
    - Private Sector Debt in % of GDP<sup>a</sup>
    - REER vis-à-vis EA-12, CPI-adjusted (EUROSTAT)
    - Nominal ULC (AMECO)
  - Use indicators to define categories
- (a) Definition of the Macro-Imbalance Procedure: sum of loans and securities other than shares from non-financial corporations' and households/NPISHs' financial liabilities; non-consolidated accounts

# Implementation

## Strategy:

- For each variable x year, use 33% and 67% percentiles across countries
  - Assign a score to each country:
    - 0 if less or equal to 33% percentile
    - 1 if between 33% and 67% percentile incl.
    - 2 if above 67% percentile
- 
- Max score = 2  
Min score = 0
- For each year average score over the 6 indicators used and classify as:
    - South if average score less or equal than 0.67
    - Centre if average score between 0.67 and 1.33
    - North if average score above 1.33

*Merler & Pisani-Ferry (forthcoming)*

# North-South: categorisation

Polarisation has increased over time

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Austria	C	C	C	C	C	N	N	N	N	N	N	N	N	N	N
Belgium	N	N	N	N	N	N	N	N	C	C	C	C	C	C	N
Finland	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N
France	N	N	N	N	N	N	N	N	N	N	N	N	N	N	C
Germany	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N
Greece	S	S	S	S	S	S	S	S	S	S	S	S	S	S	S
Ireland	C	C	C	C	S	S	S	S	S	S	S	S	S	S	S
Italy	C	C	S	C	C	C	S	S	S	S	S	S	S	S	S
Netherlands	C	C	C	C	C	C	N	N	N	N	N	N	N	N	N
Portugal	S	S	S	S	S	S	S	S	S	S	S	S	S	S	S
Spain	C	C	C	S	S	C	C	S	S	S	S	S	S	S	S

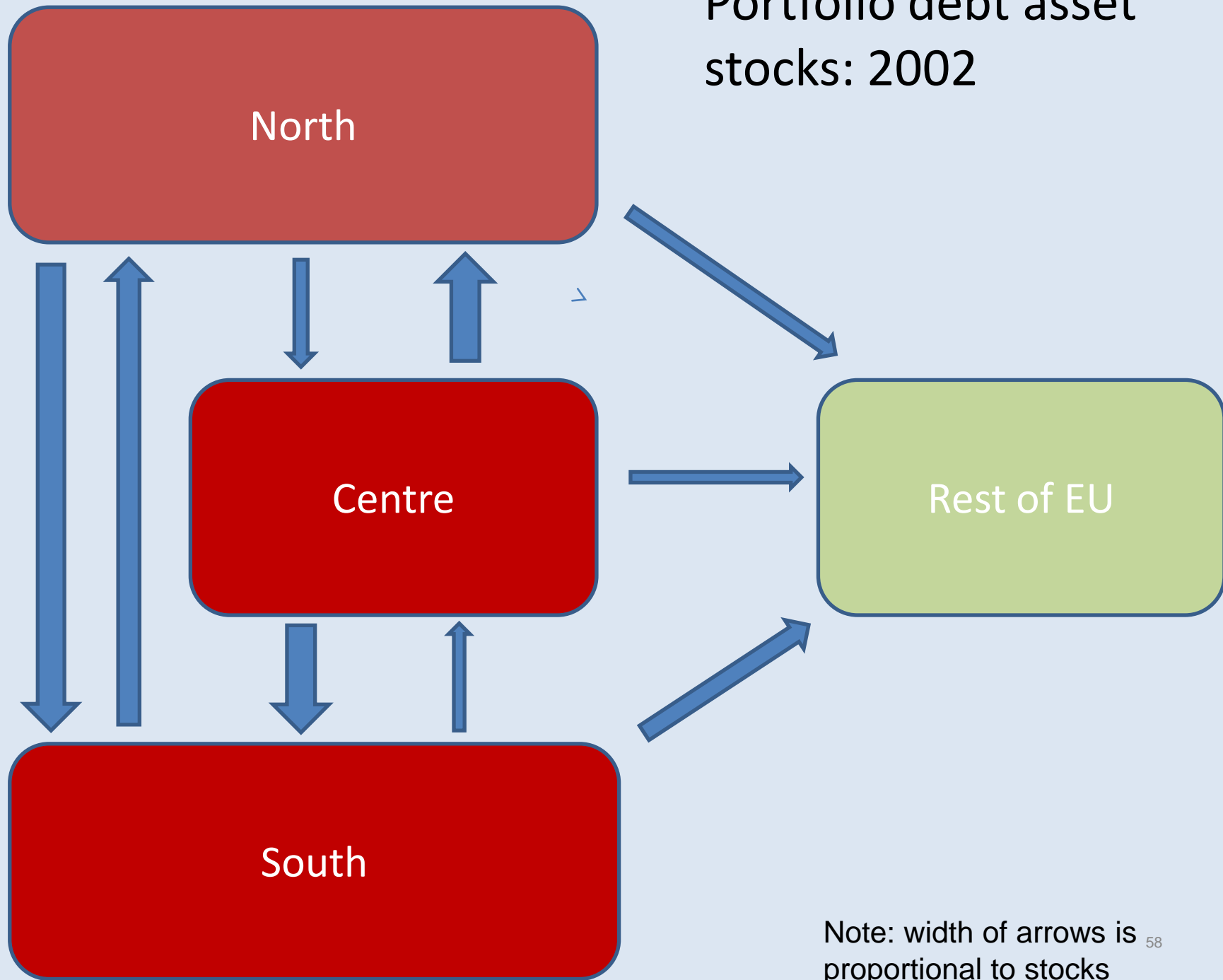
Start from the average position of 2010-2011, as the analysis is meant to be forward looking:

- North: AT; DE; FIN; NL
- Centre: BE; FR (France N/C position sensitive to percentiles chosen, with 25%/75% definitely Centre)
- South: ES; GR; IE; IT; PT

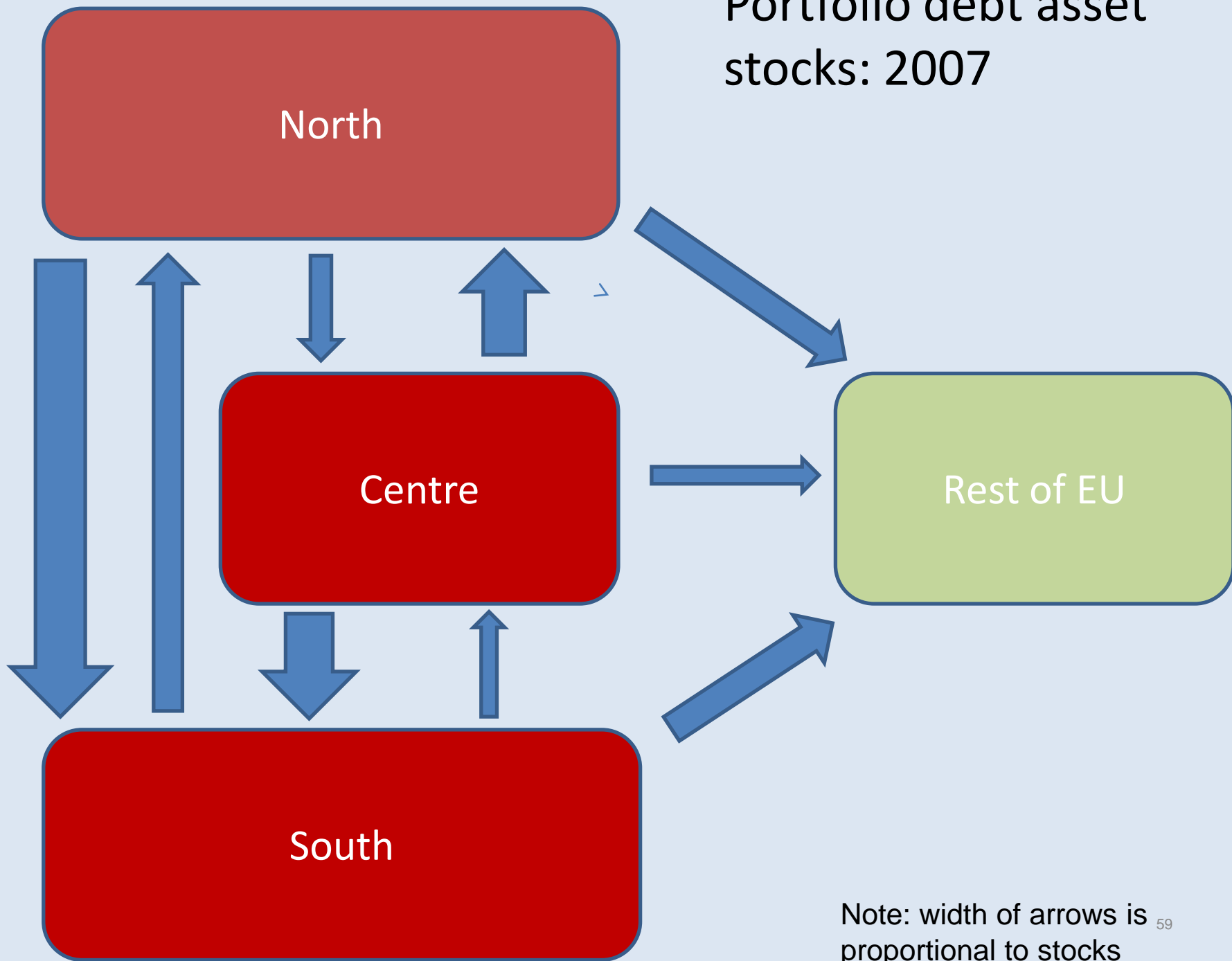


Additional slides

# Portfolio debt asset stocks: 2002



# Portfolio debt asset stocks: 2007



# Portfolio debt asset stocks: 2011

