

RECONCILING RISK SHARING WITH MARKET DISCIPLINE

- COMMENT ON THE CEPR POLICY INSIGHT N.91 -

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Introduction

The policy paper published by 14 French and German economists in the CEPR Policy Insights series (CPI91) presents a series of proposals to improve the Eurozone financial architecture, with a view to make it less vulnerable to crises and to deliver long term prosperity. CPI91 recognizes that a stronger institutional framework is required for the Eurozone, both for crisis mitigation and crisis prevention. Although reforms need time to be fully implemented, a comprehensive proposal should urgently be agreed, without conditioning measures aimed at risk sharing on progress achieved on risk reduction, or vice versa.

The CPI91 makes an important contribution to the discussion, and strongly promotes the need for change, but is subject to a few but important shortcomings. This note aims at pointing out some of these shortcomings and tries to make alternative, although partially complementary proposals, with a view to ensure a greater consistency of the overall reform package.

The first shortcoming of CPI91 is that it is based on a partial assessment of the crisis, its main causes and the effectiveness of the policy response.¹ It largely views the crisis as one mainly caused by a lack of budgetary discipline, which was certainly the case in Greece, but

¹ R. Baldwin and F. Giavazzi, *"The Eurozone crisis: a Consensus View of the Causes and a Few Possible Solutions"*, VOXeu eBook, CEPR Press 2015.

not in the other countries, such as Ireland, Portugal or Spain. The private sector origin of the crisis, in particular that related to excessive credit growth and housing bubble, is not appropriately considered, although it is a feature common to market economies. This is the kind of crisis that the Eurozone may not be adequately prepared to tackle, going forward. Furthermore, CPI91 underestimates the contagion effects which took place during the crisis, in particular as a consequence of the debt restructuring in Greece. Much emphasis is given to the doom-loop between sovereign and bank risks, but other sources of financial market instability are not considered, in particular those deriving from the incompleteness of Eurozone financial and monetary framework. Last, but not least, the so-called redenomination risk, reflecting market's fear that countries could exit the Eurozone, and that the euro might possibly break-up, is totally neglected.

The second shortcoming of CPI91 is where it attempts to reinvent the wheel, in particular with respect to fiscal discipline, which makes the proposal politically difficult to implement and would require a very long negotiation phase. This is in contradiction with the need for an urgent reform package. The SGP certainly has a number of deficiencies. However, it has been implemented and adapted over time, learning from experience. The view that the SGP has become too complex and that simpler rules are now needed to govern fiscal policy in the Eurozone appears somewhat naive. The Global financial crisis has shown that discretion may at times be required, because each crisis differs from the others. The implementation of a new fiscal rule, similar to the expenditure ceiling proposed in CPI91, would run against problems of interpretation and implementation not that different from those experienced with the SGP, for instance concerning the estimate of potential growth.

The third shortcoming of CPI91 concerns the proposed changes to the institutional system, which assume that Fiscal policy can be implemented and assessed through mechanisms that are largely independent of the prevailing political system, in the member states and in the Eurozone as a whole. The limitations of the current system cannot be overcome just by shifting responsibilities within technocratic structures, national or European. When it comes to fiscal policy, which cannot be governed only through simple rules, political responsibilities cannot be evaded. They need to be exercised within the appropriate body, in particular the Eurogroup, albeit in a more efficient and transparent way.

I will elaborate on the above shortcomings in considering some of the detailed proposals contained in CPI91. This note does not aim to be comprehensive nor to address all issues, but rather to stimulate the discussion on some important pillars of the required reform.

Financial Sector Architecture

CPI91 focuses on the bank-sovereign doom-loop. Indeed, this has been a key factor in exacerbating the crisis. However, this is only one part of the problem. In other words, limiting, or eliminating the loop by severely constraining bank's holdings of Government bonds would not be sufficient to avoid other perverse loops from occurring nor to make the Eurozone more resilient. It may actually make things worse if the proposed measures are taken in isolation, rather than being part of a comprehensive approach.

The problem is that the Eurozone does not have a fully integrated financial market, that can distribute risk efficiently. There is a very strong home bias, which tends to exacerbate the impact of asymmetric shocks, or the potentially differential effect of symmetric shocks. In fact, financial market integration has receded in recent years, which weakens the Eurozone's ability to absorb shocks in the future.

Banks' holdings of their own countries' Government bonds contribute to increase the home bias. However, even if banks did not hold, or had limited holdings of such bonds, they would nevertheless suffer disproportionately from a shock affecting their country, for instance a local housing bubble. Local banks would suffer the most, and would contract and restructure their balance sheets, thus provoking a credit crunch which would exacerbate the effects of the shock.² The doom-loop therefore exists even if banks did not hold Government bonds. Furthermore, given the lack of a federal budget in the Eurozone, banks' ratings, credit risk and access to financial markets are closely linked to the rating of the respective sovereign. This applies not only to banks but to all companies. As shown during the crisis, the financing problems of the sovereign affect all issuers located in the country, and this is what causes the doom-loop.

² M. Bofondi, L. Carpinelli and E. Sette, "Credit Supply During a Sovereign Debt Crisis", Journal of the European Economic Association, August 2017.

How can this be mitigated? There are two lines of action, concerning the steady state and the transition phase.

The first is to accelerate the realization of a fully integrated financial market in the Eurozone, and to reverse the recent trend towards fragmentation. This is an issue on which the CPI91 is quite shy. In fact, the Commission initiatives on implementing a Capital Market Union fall short of what is really needed. A much more ambitious CMU plan is required, starting with the progressive integration of national regulators into a single one, the ESMA. The process should be similar to the one which led to the creation of the ECB for monetary union and the SSM for banking union.

In any case, a true CMU cannot be created unless Banking Union is fully implemented. Without the creation of a pan-European banking system, no CMU can develop. This is the lesson from the US experience.³ In this respect, it is interesting to note that there is a broad consensus that only one of the three legs of the Banking Union would still be missing, i.e. a European Deposit Insurance Scheme. This is not the case. The other two legs are also incomplete.

First, concerning the SSM, its actions are still impaired by European and national legislation which allows for national authorities to apply discretion and exceptions. Since the crisis, European banks have become more national and the system more fragmented, thus more prone to fuel the doom-loop, i.e. the opposite of what is needed. Bank capital and liquidity can still not be moved freely within the Eurozone.

The CPI91 partly recognizes these problems, but more concrete proposals need to be put forward.

Just to mention a few examples of the incompleteness of the first leg of the Banking Union, according to the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRDIV), banking groups need to comply with capital and liquidity requirements both on a consolidated basis and at the level of each subsidiary, even within the Eurozone. Some countries, notably Germany, still require banks to set limits for intra-group exposures, even if these banks are supervised on a consolidated basis by the SSM. In Germany, pressure has also been exerted on banking groups to set voluntary commitments to limit exposures to

³ L. Bini Smaghi and M. Marcussen, "The role and structure of banks in the future Capital Market Union", presented at the conference Capital Market Union and Beyond, London 25-26 January 2018.

other group entities, allegedly to mitigate contagion risk. As a consequence, capital and liquidity tends to remain “trapped” at the national level, which prevents an efficient allocation within the Eurozone. These regulatory and discretionary obstacles should be removed, and the remaining national discretions and exceptions progressively phased out.

Furthermore, intra-Eurozone activities should be considered as domestic exposures for the purpose of computing the indicators for the G-SIIs score (cross-border activity indicator and cross-jurisdictional indicator respectively). The requirement to fully preposition internal MREL at the level of the solo subsidiary should be reconsidered within the SSM.

In sum, the regulatory framework, and the way in which the SSM and national regulators are currently implementing it, needs to be reviewed with a view to promote financial integration in the Eurozone, which is a key objective of the Banking Union, together with financial stability. While substantial progress has been achieved on the later since the start of the SSM, there is a clear failure with respect to the former.⁴

Coming to the issue of macro-prudential regulation, powers are currently largely in the hands of national authorities, which have less incentives to implement them in a preventive way. This is quite inefficient. The ECB should be endowed with macro-prudential instruments, in particular to prevent credit bubbles, which have represented a major cause of the crisis. The SSM’s powers to induce banks to clean and restructure their balance sheets, especially in good times and with respect to the absorption of NPLs and reduction in Government bonds’ holdings, should also be strengthened.

The second leg of the Banking Union, in particular the resolution fund (SRF) and the rules for addressing failing banks, is also incomplete. The fact that the fund focusses mainly on large banks, letting the task to address the others to the national authorities is one of the main factors behind the potential doom-loop. Banks cannot be regulated (directly or indirectly) at European level, while being resolved at the national level through different procedures, for instance with respect to the application of state aid rules. This asymmetry is not sustainable, as shown by recent experience. The rules for preventive bank recapitalization need to be made more flexible and adapted to the specific Eurozone situation.

⁴ ECB, “*Financial Integration in Europe*”, May 2017.

Concerning the third leg of BU, the European Deposit Insurance Scheme, its implementation is a necessary requirement for the development of a truly integrated financial system, and the development of pan-European banks. EDIS is key to mitigate risk, in particular of contagion across the Eurozone.⁵ The Commission proposal is too gradual and not encompassing enough to be fully credible.⁶

To sum up, any proposal for reform of the financial architecture needs to be clearer and more ambitious, especially on the measures required to accelerate the implementation of both the BU and the CMU. These are key to mitigate any doom-loop between the various risks.

The CPI91 devotes more attention to the transition phase, and to risk reduction, in particular the risks deriving from NPLs and banks' holdings of Government bonds. As mentioned above, it should be up to the SSM to design rules and procedures for banks to adapt their balance sheets in a way that ensures financial stability while at the same time not hampering economic growth and avoiding pro-cyclicality.

Concerning NPLs, it is the responsibility of the SSM to establish the appropriate speed of adjustment, in particular to make sure that banks have cleaned their balance sheet well ahead of the next economic slowdown. If there are legal constraints to the SSM's powers in this area, as it appeared following the publication of its December Addendum,⁷ they should be clarified and eventually removed.

Concerning banks' holdings of Government bonds, CPI91 refers to some proposals which have been recently put forward, in particular with a view to avoid distortionary effects.⁸ However, any framework designed with a view to contain the doom-loop between sovereign and bank risk should be consistent with a series of objectives. First, it needs to be compatible with the overall global regulatory framework, in particular the new liquidity requirements, set especially for larger banks, with a view to avoid penalizing the latter vis a vis their foreign competitors. In this respect, it should be noted that the Basel Committee has decided not to deal with this issue. This does not prevent the European regulators from addressing the problem, but this should be done having in mind the broader regulatory

⁵ L. Bini Smaghi, "European banking union needs its final leg", Financial times, 21.10.2017.

⁶ S. Micossi, "A Blueprint for Completing the Banking Union", CEPS Policy Insight (27/11/2017).

⁷ https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum.

⁸ N. Véron, "Sovereign concentration charges: A new regime for banks", European parliament, November 2017.

environment (for instance the global liquidity requirements) and avoiding putting the European financial system at a competitive disadvantage. Second, any constraint needs to be consistent with the ECB's monetary policy framework. In general, while banks' main task is not to finance the public debt, limits to banks' holdings of government bonds should not create undue problems for the ability of the central bank to implement its monetary policy. Typically, the central bank injects liquidity against collateral and at times of crises, or economic slowdown. In this context, Government bonds represent the main type of collateral available for banks to access operations such as the LTRO. This may require that any limits to banks' holdings of Government bonds be adjustable by the central bank, and part of the broader macro-prudential instruments, which – as mentioned above – should be made available to the ECB.

In sum, the task of setting limits to Banks's holdings of Government bonds and of fostering diversification should largely be in the hands of the SSM, which is ultimately responsible for the stability of the Eurozone financial system. This is particularly the case given that any reduction in such holdings is likely to imply during the transition a restructuring of the banking system and a change in banks' business model, which needs to be appropriately monitored and supervised.

Fiscal architecture

The CPI91 states that it is time to drop the SGP because it has not prevented the accumulation of debt, while it has hampered stabilization policy and overburdened monetary policy.

This assessment is contradictory and inappropriate.

Looking at the current state of public finances in the Eurozone, it fares relatively well compared to that of other advanced economies, in particular the US, Japan or the UK. In 2017 the Eurozone budget deficit was lower, both on average and for its members, than in the other countries. The overall Eurozone primary balance was in surplus, while it recorded a deficit in the three others. The overall Eurozone public debt was falling (in percentage of GDP), while rising in the US, UK and Japan. Compared to 2008, the debt was higher by about 20 percentage points on average in the Eurozone, against 35 points higher in the US, 40 in

the UK and 50 in Japan. In some Eurozone countries, notably Spain, Portugal and Cyprus (and of course Greece), the debt increased more than 30 percentage points of GDP, but it has stabilized and started to come down recently. It is close to 130 per cent in Italy and Portugal.

The highest accumulation of debt has taken place where the recession has been deepest and the contra-cyclical response strongest, so the SGP cannot be accused of having at the same time caused high debt and prevented stabilization policy. It cannot be accused either of having overburdened monetary policy, at least not more than in other parts of the world. In fact, the adoption of the Fiscal compact has created the room for the ECB to announce the “whatever it takes” and to later adopt QE.

The SGP has evolved and become more complex, indeed. However, the problem is that the world is complex, and so are crises. It is an academic illusion to think that fiscal policy can be run through simple rules, especially at times of crises, where the depth of the recession needs to be carefully assessed to avoid pro-cyclicality, or outsourced to Fiscal councils, national or European.⁹

It’s true that fines have never been imposed, but it is also true that countries have over time largely abided by the rules. The SGP has represented an important reference in the domestic budgetary process and has influenced the internal politics of fiscal policy.

The current fiscal framework has the advantage that it builds on the experience of over 20 years. It is more complex because less “stupid” (to use R. Prodi’s qualification in the early 2000s) than the first version. This does not mean that it cannot be improved further, nor simplified. But changing the framework completely would mean having to learn again from mistakes, possibly more serious ones than those made in the past.

The rule proposed in CPI91 may look simpler than it is bound to be in practice. First, a potential rate of growth has to be set for each country, which is not that different from the concept of potential output needed for the calculation of the structural deficit in the current fiscal framework. Second, a classification of expenditures need to be agreed, netting those cyclically sensitive. Third, exceptional circumstances have to be defined, to make the escape clauses operational. Finally, ensuring the independence of the national fiscal council is

⁹ R. Beetsma and X. Debrun, “Independent Fiscal Councils: Watchdogs or Lapdogs”, VoxEU eBook, January 2018.

easier said than done, as we have seen from recent experience. This is not to suggest that these problems could not be overcome, but it would require time, which is not consistent with the stated urgency.

To sum up, the proposal to move from the current fiscal framework, based on deficits and debts, to one based on public expenditures is not fully convincing, neither from a technical nor a political viewpoint. It would in any case require the start of a long negotiation, requiring most likely a change in the Treaty, which would ultimately result in delaying the comprehensive reform for a very long time.

The CPI91 proposal also aims at strengthening market discipline over the member states public finances. The key feature consists in the issuance of junior bonds, that are automatically subject to restructuring in case of access to the ESM.¹⁰ There are several problems with this proposal.

First, experience has shown that markets do not discipline governments in good times, while being overly reactive in bad times. There is no reason to think that this would be any different with the CPI91 proposal. Without the pressure from EU institutions, and in a benign low interest environment, countries would be induced to borrow too easily to finance excessive expenditures. Second, the CPI91 note assumes that there is no risk of self-fulfilling expectations in financial markets that may accelerate the resort to the ESM, and thus to debt restructuring. Experience after the Deauville agreement in 2010 and after the Greek restructuring in 2011 has shown that the fear of debt restructuring tends to destabilize markets and to accelerate crises. This would occur also with the junior bonds proposed in CPI91. Third, the paper assumes that the restructuring of the junior debt would be without consequences for the ability to issue senior debt. Again, experience suggests the opposite. The expectation of junior bonds' debt restructuring, or the effective restructuring, may trigger an even greater stress in the public debt market that would further deepen the crisis, requiring in the end an even bigger financial package from the ESM.

The above observations do not imply that the issuance of junior bonds does not contain some favorable elements. Even if it may not fully succeed in disciplining ex ante the respective countries, it nevertheless attributes more clearly the responsibility for deciding

¹⁰ A variant of this could be to issue bonds indexed to nominal GDP, rather than junior bonds.

any deviation from the agreed rules. In fact, the proposal for issuing junior bonds does not need to be linked to the clause of automatic debt restructuring in case of access to the ESM. The maturity extension (which would affect the junior bonds first) should take place when the debt sustainability is declared to be compromised or uncertain, rather than automatically, as is the case for the IMF exceptional access policy (mentioned in the CPI91).

The proposal to issue junior debt can also be adapted to the current framework. Accordingly, countries would issue junior bonds to finance deficits, or part of the debt in excess of what is consistent with the implementation of the fiscal compact.

For instance, if the prevailing rule (within the Fiscal compact) required that a country reduces its debt-to-GDP ratio from 100 to 98 in a given year, but the country still issued 100, the extra 2 would be issued through junior bonds, i.e. the first to be restructured in case of crisis, while the other 98 would be considered senior, and in case of crisis supported by the ESM. This would create an incentive for countries with high debt-to-GDP ratios to reduce their debt within a given time horizon. If they did not, the excess of debt over 60% would become junior over a given time period, and thus first in line in case of restructuring. To take another example, if a country was required to reduce its debt from 100 to 60 per cent of GDP over a given time horizon, say 20 years, but maintained its debt level unchanged at 100, at the end of the period its debt would be composed for 60 per cent by senior instruments and 40 per cent by junior instruments.

This mechanism could be implemented right away, while the CPI91 proposal, which is conditional on countries having first reached the 60% debt level, would enter into force in the very long term.

Concerning contagion, in particular from the debt restructuring of the junior tranche to the senior, it can be avoided to the extent that the senior part, issued according to the prevailing rule, can be considered substantially “safer” than the junior part. This would require that the senior part would benefit from the ESM backing in case of crisis.

The modified senior-junior proposal would also reduce the need to create a safe asset, in the sense considered in the CPI91. The ESBies proposal is not without problem, in particular with regards to complexity, market segmentation and potentially fueling destabilizing effects at times of crisis. If, as mentioned above, the debt issued consistently with the rules

of the Fiscal compact is considered senior, and that in excess is junior, over a few years the amount of safe assets, that have priority in the service of the debt, will represent 60% of the overall EZ GDP, which may be a sufficient amount for an appropriate functioning of the Eurozone financial market.

Institutional architecture

The CPI91 paper rightly regrets the confusion of roles which has been created in the EU Commission, in particular between the watchdog, or prosecutor, and the judge. The question should be who's fault it is and how to remedy it. Governments accuse the Commission of mission creep and of acting both as prosecutor and judge. But the role of the Commission is to monitor and make proposals. It is up to the Council, or the Eurogroup, to take the ultimate decisions. In fact, member states have not had in the past the political courage to vote against the Commission (with the notable exception of 2003) and have often hidden behind the Commission to avoid taking a stance. And when the Commission took a stance that they did not like, they criticized the Commission rather than voting against its proposal.

For instance, the German Government has often complained against the Commission's leniency towards France's budgetary policy, but never explicitly voted against the Commission proposals. In fact, with the 2013 reform the Council has made it even more difficult for it to vote against the Commission by accepting the reverse majority voting in the excessive deficit procedure. This lack of courage and transparency by the Eurogroup cannot be addressed just by creating an independent fiscal board or watchdog. As I mentioned above, fiscal policy cannot be decided by simple rules nor by bureaucrats and cannot be totally de-linked from political considerations. The problem is to make the decisions and the procedures explicit and transparent. This will not happen by creating two separate branches within the Commission, as proposed in CPI91.

One way to address the issue would be to increase the accountability of the Commission, by making its policy recommendation subject to the vote not only of the Council but also of the European Parliament. Any vote against the Commission should be de-dramatized. It's part of a proper functioning of a democratic system that the legislative branch may at times vote

against the executive. This could mean, as in normal democracies, that the proposal by the Commission would have to be changed, or, in extreme cases, that the Commission would have to resign, and a new Commission would have to be nominated. The Eurozone will not escape from the need to improve its democratic accountability, which would not happen if fiscal policy is delegated to technocratic structures.

Concerning crisis management, the CPI91 is silent on the issue of efficiency and democratic accountability of the ESM. Concerning the voting system of the ESM, while it is understandable that its overall resources are decided through special majority rules, like the IMF, specific decisions to grant support to a country cannot be subject to unanimity, nor voting rules that provide a veto power to one or a few countries. Decisions have to be speedy, to avoid aggravating crises.

This principle also applies to the Eurogroup, which takes decisions largely by consensus. The crisis has shown that institutions which are bound to act by simple majority are the most effective, and the most credible.

What's missing from CPI91

It's difficult for any proposal to be all-encompassing and to tackle all the problems that the EZ may face in the future. However, the CPI91 does not address the key factor which has transformed a normal crisis into a deep and existential one, i.e. the redenomination risk, in other words the risk of exit from the euro.¹¹ Comparing the Eurozone performance to that of the countries close to it (such as the UK, Sweden, Switzerland), it is clear that 2011-12 crisis has taken a dramatic turn because of the expectation of a Eurozone break-up, which pushed financial markets to raise dramatically the credit risk of certain Eurozone members. The repercussions were felt not only by peripheral countries but also by the core, as shown by the economic slowdown and contraction of private investment in Germany, the Netherlands and France in 2012-13.

The ECB's "whatever it takes", and subsequent Outright Monetary Transaction, immediately impacted financial markets, showing that the redenomination risk was a major factor in the Eurozone crisis. The redenomination risk increases the burden of adjustment for the

¹¹ P. De Grauwe, "The Governance of a Fragile Eurozone", CEPS Working Document n. 346, May 2011.

Eurozone countries implementing policy adjustments. If markets expect that a country may exit the Eurozone, the sovereign risk will rise even higher and capital flows will stop suddenly. As the adjustment costs rise, the populist campaign against the euro become more vocal and citizens start doubting about the advantages of staying in the Eurozone. It is not by chance that the polls show that the popularity of the euro is strongly correlated with economic conditions.¹² In economic downturns and at times of crises the popularity of the euro falls, as the common currency becomes the easy scapegoat of populists, and the temptation to exit the monetary union increases.

The problem is that the OMT has never been really tested and is strongly dependent on the credibility of the ECB and of its leadership. Furthermore, it is often forgotten that the OMT is conditional on countries having requested an ESM program. The Eurozone and IMF experience show that there is a stigma attached to the ESM assistance, which is considered as some form of “surrender” of national sovereignty, and thus tends to be delayed until the crisis is well advanced.

To sum up, the most dangerous doom-loop is not so much due to the correlation between bank and sovereign risk but rather between redenomination and sovereign risk. This doom-loop can be contained by strengthening the resilience of the Eurozone, in particular by improving economic convergence and by adopting better shock absorbers. However, it is likely to remain a major problem unless the institutional framework is adjusted. The Greek crisis has shown that even though the adoption of the euro is considered to be “irrevocable” in the Treaty, in practice it would be difficult to deny a sovereign state the right to exit the Eurozone if this was the result of a democratic decision. In fact, several populist parties have proposed to hold referendum on the euro membership. The uncertainty and lack of information which characterizes referendum makes the risk of exit significant, especially at times of crises, which in turn exacerbates the adjustment cost. How can this risk be reduced?

The Treaty does not provide for an exit clause from the euro, similar to Art.50 for the EU membership. The reason is that any reference to a euro exit would fuel the doom loop. In addition, the exit from the monetary union has spill-over effects on the other members, and thus needs to be discouraged. This has created the room for some populist movements to

¹² C. Dustmann et al., “*Europe’s Trust Deficit*”, CEPR Press 2017.

defend the idea that it is possible to exit the monetary union without exiting the EU, in other words to leave the euro and adopt a new national currency while remaining full member of the European Union.

One way to reduce the doom loop is to make it clear, possibly by amending the Treaty, that the adoption of the euro is irrevocable and that any unilateral exit from the euro would automatically trigger art.50 of the EU Treaty, leading the country to exit the European Union. Such a change would strengthen the credibility of the Eurozone and reduce the scope for populist parties' campaign against the single currency.

To conclude, CPI91 is a welcome contribution to the debate on how to complete the institutional architecture of the Eurozone. It contains however a series of shortcomings that make the proposal either difficult to implement or subject to undesired effects. This note makes some suggestions on how to overcome these shortcomings, while sharing the sense of urgency. We cannot afford to wait for the next crisis to repair the Eurozone's roof.