Europe and the euro: Proposal for a workable way forward

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Europe and the euro: A Workable Way Forward

I. Some principles and an over-arching framework: Maastricht 2.0
II. Gaps to be filled and measures to be avoided

Extra: Concrete proposals on missing links

13/14 Against a backward-looking economic policy
14/15 More confidence in market processes
15/16 Focus on future viability
16/17 Time for reforms
17/18 Towards a forward-looking economic policy

I. Some principles and a Maastricht 2.0
Things to keep in mind

- European Union is the key post-WWII peace project. Do not destroy it with an „integrate or out“ vision of USE.
- EU needs right mix of centralized vs national decision-making to stay viable for Member States and their citizens.
- The common currency and monetary policy is a (mostly) common experiment.
- Need to achieve stability with substantial Member State sovereignty over fiscal and economic policies.
- Principle: Keep control and liability on the same level.

Maastricht 2.0

To Do: Focus on sustainability

Structural reforms for improving competitiveness and efficiency are national responsibility, need to continue reform process. Deficits have been reduced but public debt is still high; need to continue consolidation; make use of interest savings. Fiscal policy focused on national priorities, not euro area fiscal stance. Reduce complexity of fiscal rules, joint fiscal capacity not needed. Expand ESM with role in surveillance and orderly sovereign debt restructuring mechanism. Completing banking & capital market union, risk-reduction prior to further risk sharing, caution regarding SBBS.

Principles for a stable European Union

- Need to strike appropriate balance between Member States responsibility and centralized decision making
- Maintain principles of subsidiarity and the unity of liability and control
  - Avoids moral hazard
  - Improves acceptance of the European integration process
Construtive further development of EU

- Strengthen European responsibilities in selected areas
  - international trade, digital common market, procurement in defense, migration and political asylum, climate protection, anti-terrorism policies
- But:
  - No general constraints on foreign direct investment
  - Posted workers directive constrains common market in services
  - Need new priorities for EU budget
- One-time extension of negotiations with UK to avoid disorderly Brexit, which would be harmful for all and destructive to Europe

II. Institutions and policies oriented towards sustainability of the euro area

Convergence in euro area: Reforms as national responsibility

Real effective exchange vs euro area based on unit labor costs

- Germany
- Spain
- Italy
- France
- Portugal

Public debt still high, consolidation needs to continue

- Germany, Spain, Italy, France
- Ireland, Greece, Cyprus, Portugal
Reduce complexity of fiscal rules

Current framework
- European Commission supervised by the European Fiscal Board (EFB)

Possible simplification
- Independent EFB

<table>
<thead>
<tr>
<th>Preventive</th>
<th>Responsive</th>
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<tbody>
<tr>
<td>Structural primary balance &gt; MTU</td>
<td>Budget balance &gt; -3%</td>
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<tr>
<td>Improvement of structural primary balance &gt; 0.5%</td>
<td>Debt-to-GDP ratio &lt;= 60%</td>
</tr>
<tr>
<td>Improvement of net real public expenditures / growth of potential GDP</td>
<td>Reduction of B/B-to-GDP ratio &lt;= 1/200%</td>
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</tbody>
</table>

Joint fiscal capacity or other transfer mechanisms not needed
- Structural and cyclical effects not easy to separate, potential for moral hazard
- National fiscal policy achieves stabilization via intertemporal adjustment, if needed with help of ESM
- More risk-sharing via capital markets by strengthening capital market union

Priority for sustainable fiscal policy on national level

National fiscal policy needs to adjust to member state situation, not be constrained by a prescription for euro area fiscal stance

Risk reduction prior to more risk sharing
1. Swift reduction of non-performing loans
   - Stronger supervisory targets
   - Not publicly-financed bad banks
2. Bank resolution
   - Raise hurdle for exceptions to creditor participation
   - Address differences in national insolvency law
3. State-Bank-Nexus
   - End regulatory privilege for sovereign debt
   - Large-exposure limits

Completion of banking and capital market union

Non-performing loans

- Risk reduction prior to more risk sharing
  1. Swift reduction of non-performing loans
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     - Not publicly-financed bad banks
  2. Bank resolution
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     - End regulatory privilege for sovereign debt
     - Large-exposure limits

Strengthen ESM, caution regarding SBBS

ESM is a key element of euro architecture
- Add rules for orderly restructuring of sovereign debt in crisis case
- Add mandate for monitoring fiscal policy of member states
- Medium term: Possible fiscal backstop for SRF in systemic crisis

Sovereign-bond-backed securitites
- Strict conditions avoiding implicit liability risks
- Emission by private actors, abolish regulatory privilege of sovereign debt
- First abolish regulatory bias against securitisation of sovereign bonds
EXTRA: Concrete proposals on missing links for the euro area

Member states issue debt in „foreign” currency
- Mechanism increases effective capacity of ESM
- Avoids use of monetary financing
- Investors bear risk, no complete bailout
- States have responsibility for sustainability, market discipline
Orderly procedure starting with ESM Programme request
- Debt sustainability analysis
- If not sustainable, maturity extension
- Prior to market entry, in case of overindebtedness, nominal debt reduction vis-a-vis private creditors.

Orderly procedure

Sovereign debt restructuring mechanism

Orderly procedure starting with ESM Programme request
- Debt sustainability analysis
- If not sustainable, maturity extension
- Prior to market entry, in case of overindebtedness, nominal debt reduction vis-a-vis private creditors.

Programme request

ESM programme with strict conditionality

First stage: Maturity extension
- Eligible debt $ > 60 % to 90 % of GDP or
- Eligible debt funding requirement $ > 15 % to 20 % of GDP or
- More than 2 or 3 violations of fiscal rules in last 5 years

Second stage: Further restructuring, if necessary
- Based on debt sustainability analysis by ESM
- Completed before programme end

Share of debt stock with CPC's
Abolishing privilege of sovereign debt in banking regulation

Risk-adequate capital requirements
- Increases loss absorption capacity, reduces bias in pricing
- Basle risk weights, grandfathering possible

Risk-based large exposure limits
- Central element, reduces cluster risk.

Large exposure limits and risk weights for sovereign debt

<table>
<thead>
<tr>
<th>Standard &amp; Poor's credit ratings ¹</th>
<th>Member states ²</th>
<th>Basel risk weight for sovereigns</th>
<th>Large exposure limit ³</th>
<th>Basel risk weight for corporations</th>
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<td>-/−/GR</td>
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</tbody>
</table>

¹ - As of 1 July 2015. 2 - DE-Germany, LU-Luxembourg, AT-Austria, FI-Finland, NL-Netherlands, BE-Belgium, FR-France, EE-Estonia, IE-Ireland, SK-Slovakia, LT-Lithuania, LV-Latvia, SI-Slovenia, MT-Malta, ES-España, IT-Italy, PT-Portugal, CY-Cyprus und GR-Greece. 3 - Own calculation.

Sources: Basel Committee on Banking Supervision, Standard & Poor’s

Sovereign exposures of banks (EBA stress test 2014)

Effects of large exposure limits