Fiscal Risk Sharing and Governance for the Euro Area: More Important than Ever

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Enhancing euro area resilience

- Currency union: makes it more difficult to defend against country-level shocks and sovereign liquidity runs; opens the door to cross-country externalities; and reinforces links between sovereigns and banking system
- Successful currency areas provide fiscal risk sharing
- Absence of political union and presence of integrated financial markets enhance need for fiscal rules
- Market discipline needs (at the very least, a minimum degree of) banking and fiscal union
- With both in place, sovereign/bank loop can be managed

Fiscal risk sharing

Recap: The classic currency area problem

- Idiosyncratic national shocks…
- …but “one-size-fits all” monetary policy and realistic price/wage rigidities
- Labor mobility across members limited and rarely costless
- Need for fiscal instruments to counter local (and especially at ELB, global) shocks
- But aside from usual limitations on effectiveness and speed, the currency-union setting throws up additional complexities

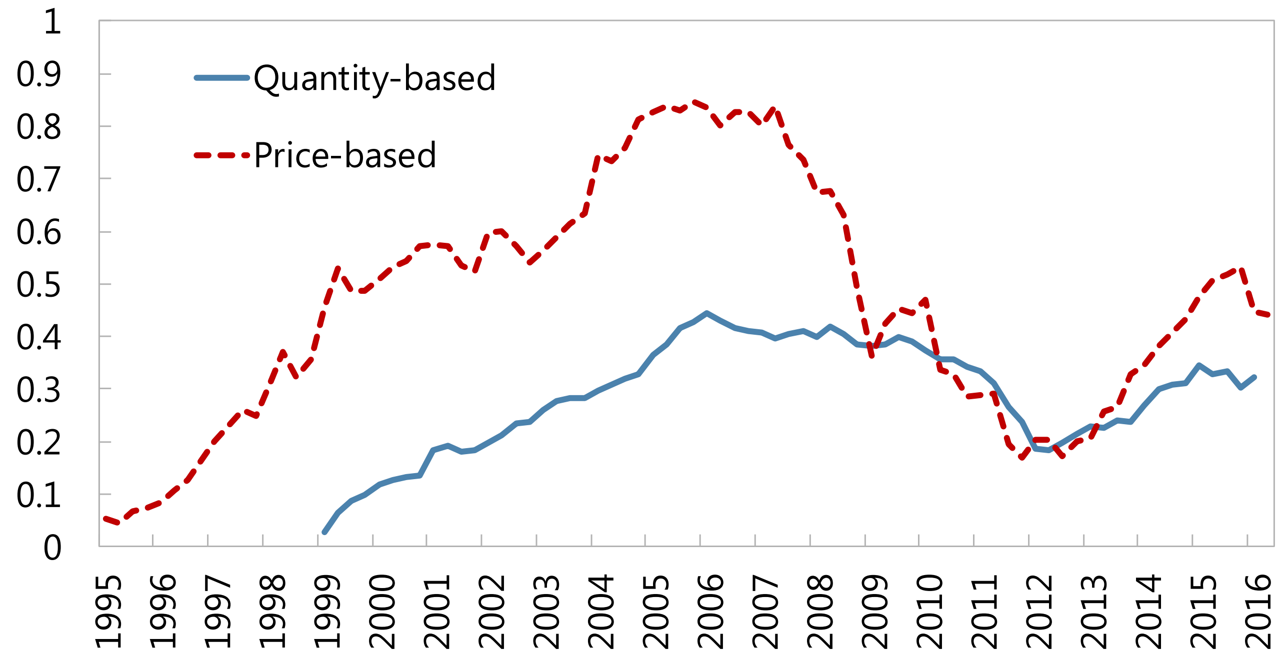
Efficiency requires ex ante risk sharing

- Even with complete markets, households ignore macro externality and under-insure (Farhi and Werning 2012), suggesting a basic need for government intervention
- While incomplete, capital and credit markets contribute significant inter-regional risk sharing in most currency areas
- Given their incomplete financial integration, euro area financial markets provide relatively little risk sharing
- Moreover, euro area cross-border financing recedes under stress (e.g., Furceri and Zdziencka 2013; ECB 2016)

Asset-market fragmentation under stress

Indicators of Financial Integration in Euro Area

(Index; 1=full integration, 0=full fragmentation)



Source: ECB Report on "Financial Integration in Europe, 2016"

Note: The composite indicators measure the average degree of financial integration across the Euro area, and are constructed by aggregating various sub-indicators across money, bond, equity, and banking markets.

Financial integration a two-edged sword?

- Combination of macro externality and incomplete securities markets implies need for EMU-level policies
- Some of these relate to greater integration of banking and capital markets, with development of latter also a goal
- Scheme of inter-government transfers contingent on outcomes would raise welfare (credit less helpful)
- But with greater financial integration comes the need for greater joint fiscal resources as stability backstop

Fiscal risk sharing helps (Kenen 1969)

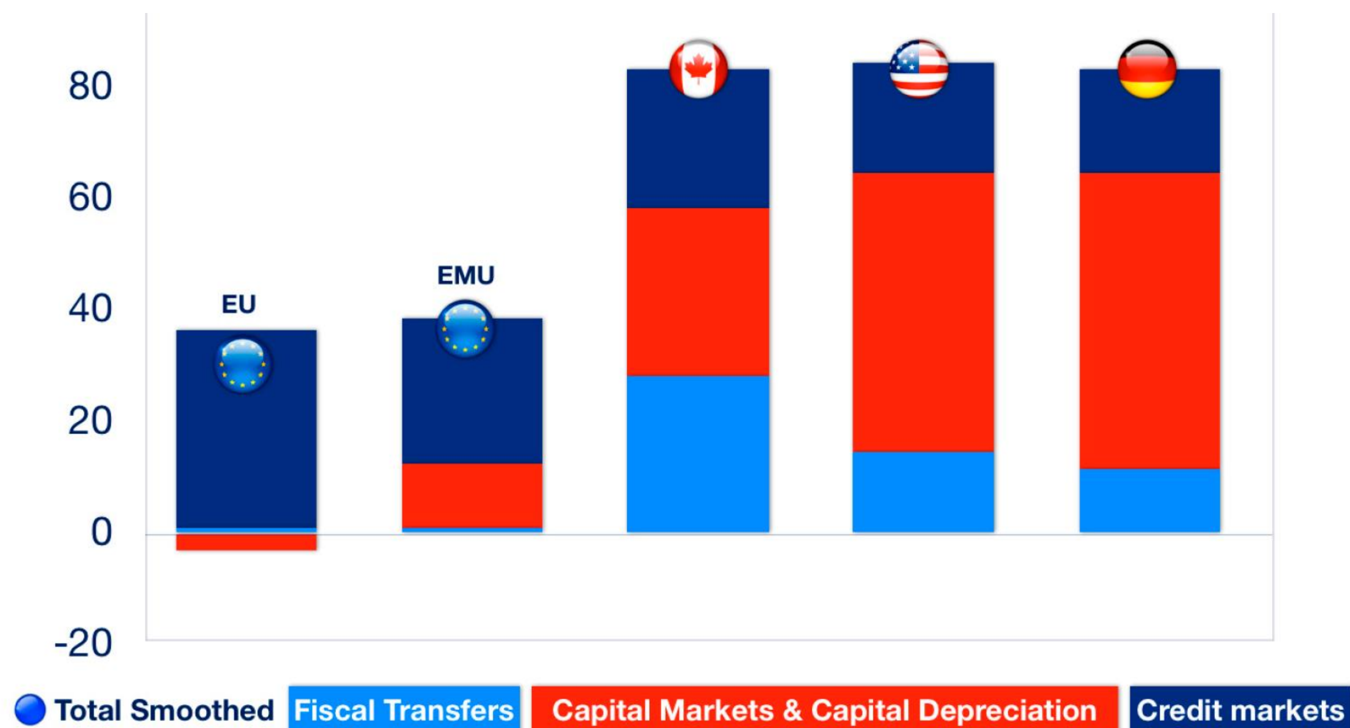
- Present in various combinations in other currency areas
- Ex ante & ex post
  - Crisis emergency funds/help
  - Sharing/redistribution of tax revenue
  - Common budget with joint provision of public goods
- Micro & macro
  - Area-wide social insurance in addition to common budget
- Financial market backstops
  - E.g., common deposit insurance, bank resolution funds

Euro area risk sharing mechanisms exist…

- EU budget (≈1 percent of GDP)
- ESM (crisis triggered; liquidity at subsidized rates)
- SRF (still incomplete)
- EIB; EFSI
- ECB discretionary purchases
- TARGET2

…but, overall, they are falling short

The smoothing of regional income shocks
(*Percent of shock overall*)



Source: Allard and others (2013)

Capital-market integration clearly important

- This important avenue for market-based risk sharing is underdeveloped in Europe
- Unlike in typical national currency unions
- Requires overcoming remaining national obstacles (e.g., capital markets union plan by Commission) and better common frameworks – e.g., for securitization (ECB 2016)

Governance and discipline

Why not fiscal discretion?

- Spillovers **+** domestic policy focus **=** externalities
- Policies impact others, directly and through common monetary stance
- Sovereign debt purchases may undermine joint central bank's inflation credibility (Chari and Kehoe 1998, 2008)
- Sovereign default could ramify through payments and banking system, leading to ease monetary policy, or to direct bail-out (Eichengreen and Wyplosz 1998)
- Domestic residents could take losses on foreign debts

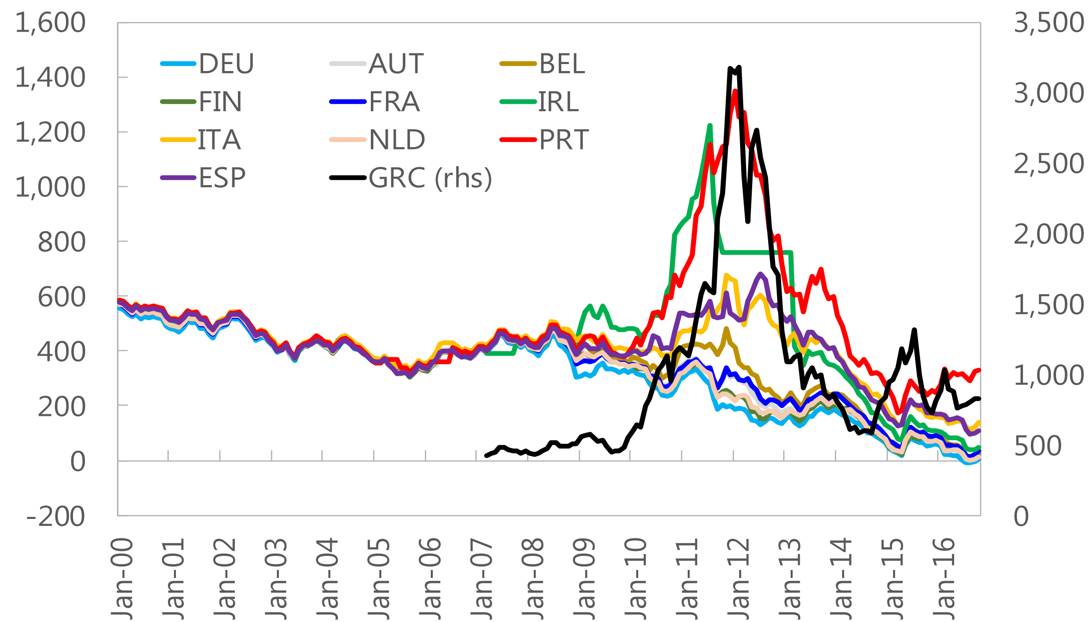
Suggest compelling case for fiscal rules

- Not all federations have them, or sometimes they are self-imposed—but other currency areas are political unions
- Countries with high degree of sub-national risk sharing also tend to impose relatively tighter rules
- Euro area framework does not lack rules,…
- …but compliance remains a concern (e.g., Andrle and others 2015; Eyraud and others 2016)
- Rules can discourage reforms (Beetsma and Debrun 2004)

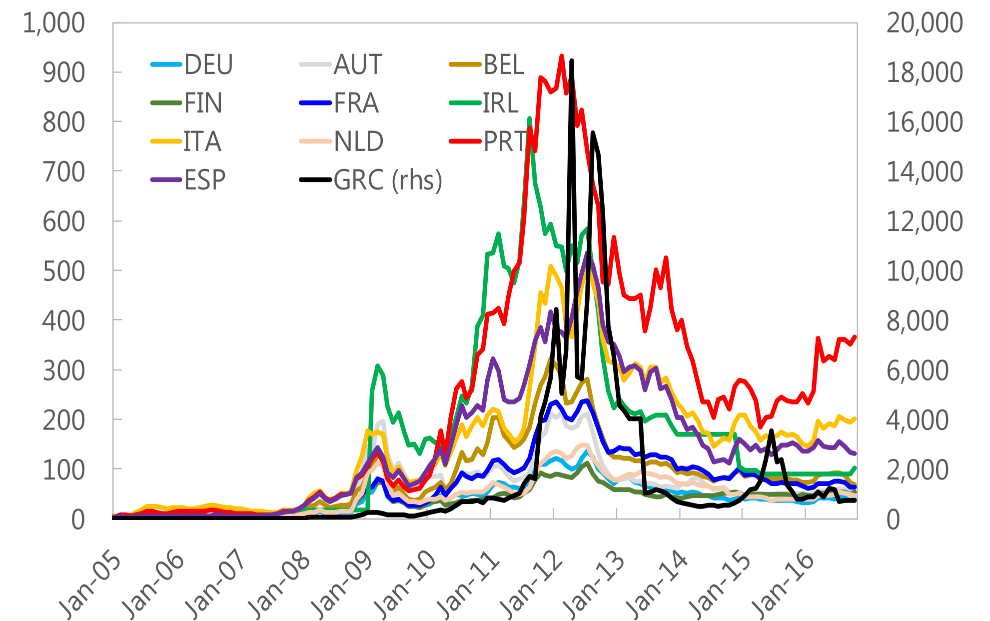
Is there a role for market discipline?

- Redundant, if rules were effective and eliminated default risk
- Pre-crisis, little differentiation of sovereign credit risks
- More post crisis, despite ECB operations
- Since 2013, CACs mandatory for bonds > 1 year
- No systematic sovereign bankruptcy framework…
- …but, in principle, default could mean adjustment at creditors’ expense, not partner governments’
- GDP-linked bonds another option, but we’re not there yet

Spreads more differentiated recently…

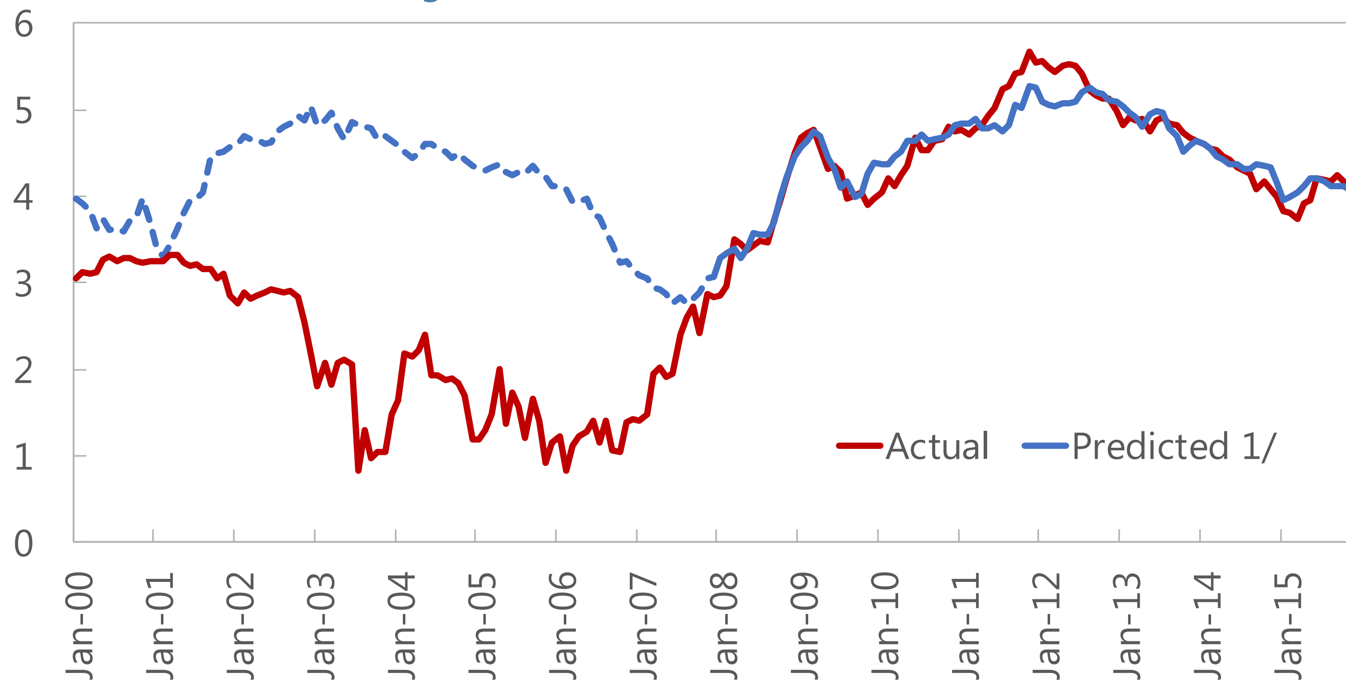


Sources: Bloomberg and Fund staff calculations.



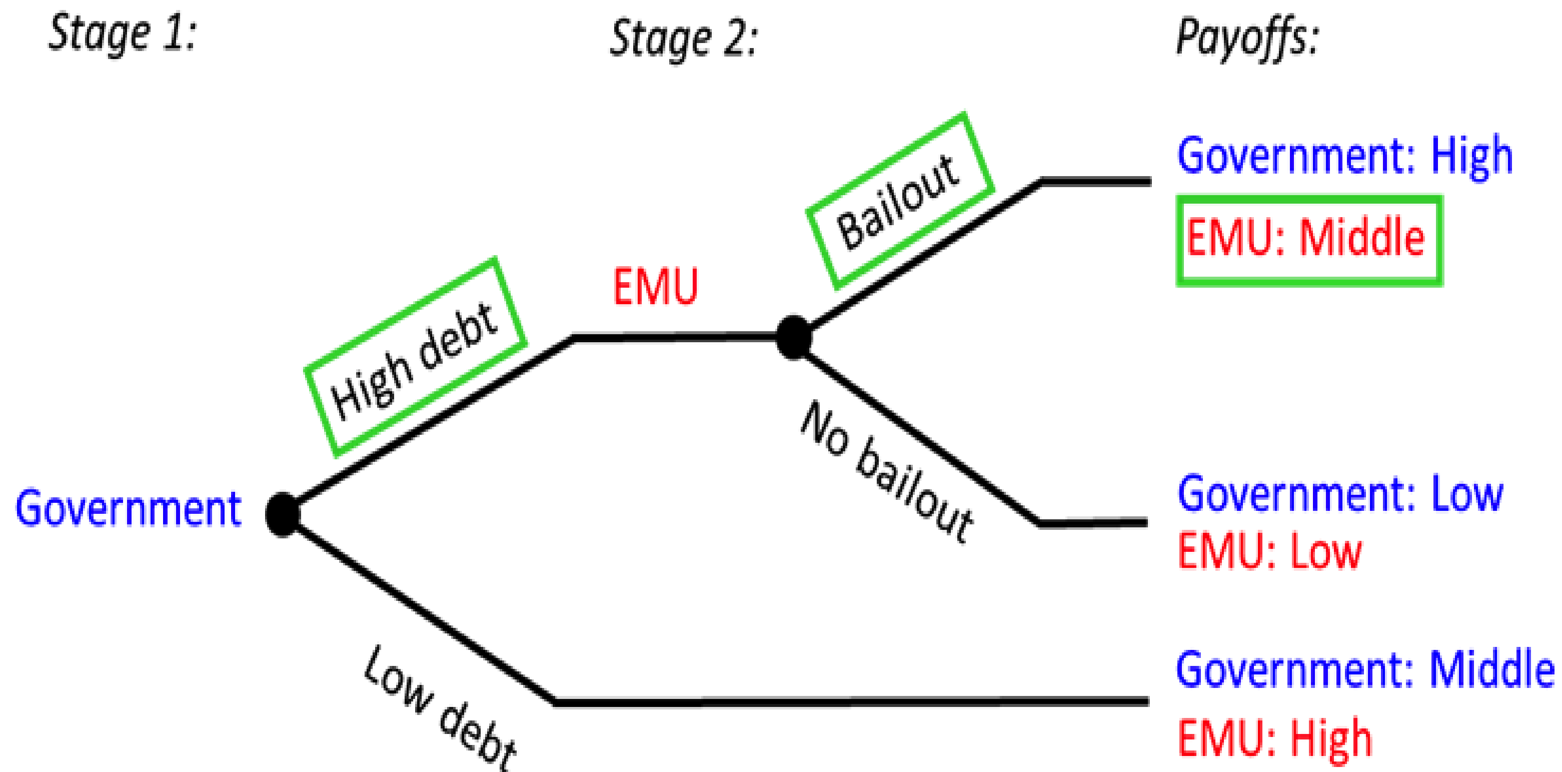
Sources: Bloomberg and Fund staff calculations.

…but fundamentals played muted role pre-crisis



Sources: Fund staff estimates. 1/ Predicted from a panel regression of 2008-15 bond spreads on country fundamentals (e.g., debt, fiscal balance, growth, inflation), including Europe-wide variables (policy rate, high bond yield index) and country fixed effects. Dashed line shows out-of-sample predictions for 2000-07 period.

Due to contagion and spillovers, sovereign default w/o risk sharing not credible



Tradeoff: Mitigating moral hazard vs. stability

- Allowing (credible) sovereign default fosters discipline and private sector involvement in restructuring…
- …but with stability costs, like few “safe assets” (Coeuré 2016)
- Multiple debt-market equilibria once default possible
- In other currency areas, central bank can mitigate
- In EMU, if sovereign debt is defaultable, zero risk weighs subsidize borrowing, understate bank balance sheet risk
- But realistic weights could raise banking system procyclicality

Sovereign-banking nexus

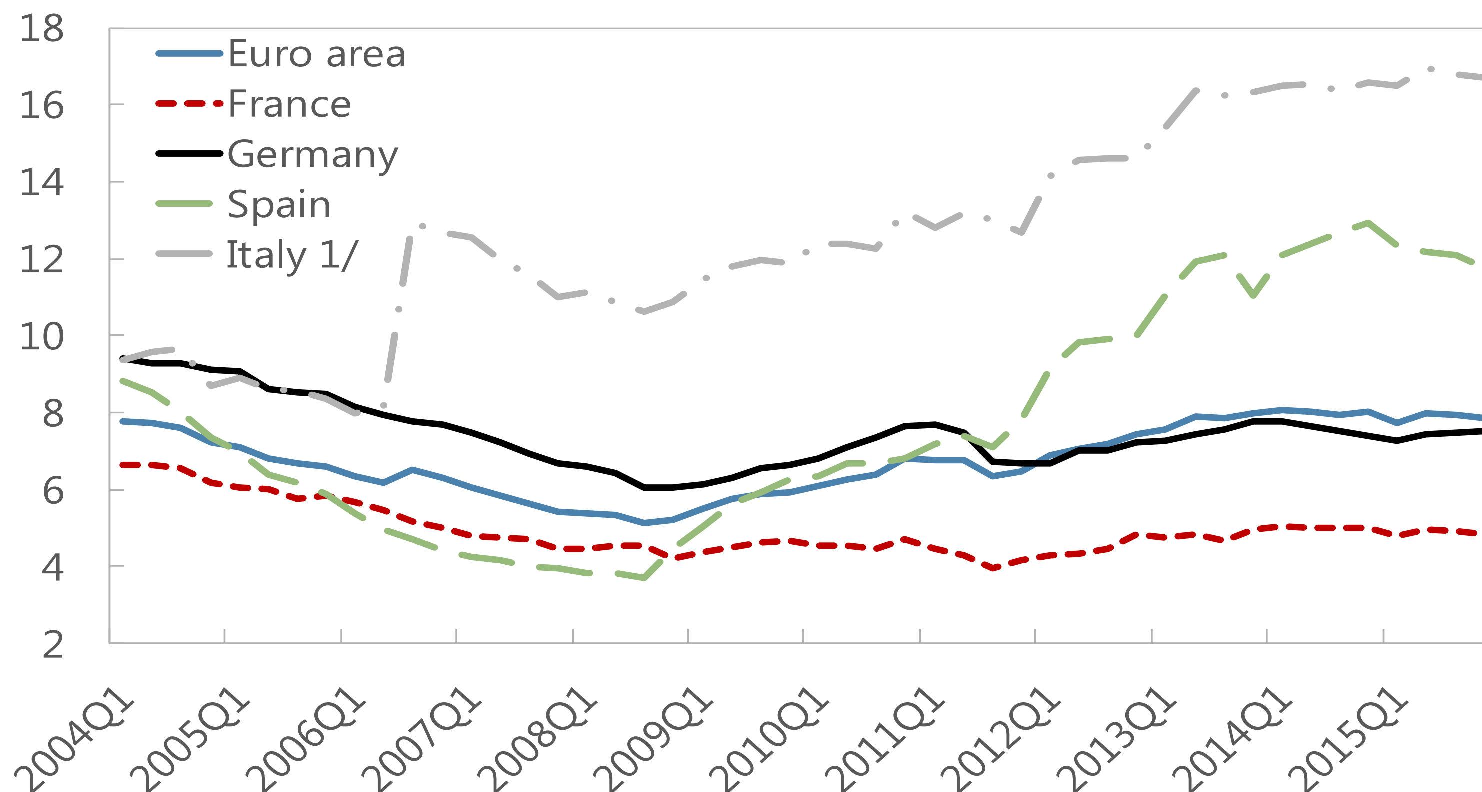
Beyond the classic debate: Banking issues

- No longer can we discuss fiscal union apart from banking union
- At time of Maastricht, plausible that governments could have backstopped banking systems
- Now, we have learned that financial sectors are large enough to threaten government solvency…
- …while sovereign weakness can undermine bank stability
- Crisis highlighted the “doom loop” (e.g., Acharya and others 2014; Brunnermeier and others 2016)

Large ramifications

- Intra-EMU spillovers can be strong
- Mutually reinforcing problems in one member’s debt market and banking system can infect external banks/sovereigns
- Need for **fiscal rules** (to limit financial externality/free riding from weak sovereigns) and **fiscal risk sharing** (for area-wide backstop) *is even stronger*
- Prudential limits on banks’ holdings of other sovereigns’ debts could help – but, in isolation, are counter to spirit of single market and could reinforce doom loop

Bank sovereign debt holdings less diversified



Sources: Arslanalp and Tsuda (2014, updated), ECB, and Fund staff calculations.
1/ The kink in Italy's series is due to inclusion of a large public financial institution in 2006.

Link between banking and fiscal union

- Managing doom loop requires banking union with joint fiscal backstop and fiscal risk sharing for non-banking shocks
- Conversely, financial-sector shocks are now a potent source of asymmetric shocks, making fiscal union more necessary
- Local gaps in supervision/resolution quite analogous to undisciplined fiscal policies, creating contingent liabilities
- Fiscal instabilities, leading to banking instabilities, or the converse, can undermine EMU's credibility

Progress toward banking union

- Substantial but still incomplete
  - SSM – but divided responsibilities
  - SRM – SRF too small
  - Common deposit insurance – absent
- BRRD attempts to contain moral hazard at country level via bail-in, while reducing fiscal impact and spillovers
- However, as for market discipline of sovereigns, there is a tradeoff between moral hazard mitigation, and ex ante and ex post financial stability

Financial stability lessons from history

- In many different settings, foreswearing bailout has proved non-credible; e.g., Carlos Díaz-Alejandro (1985):

  > It may be that private financial agents, domestic and foreign, lenders, borrowers and intermediaries, whether or not related to generals, know that the domestic political and judicial systems are not compatible with laissez-faire commitments which a misguided Minister of Finance or Central Bank President may occasionally utter in a moment of dogmatic exaltation. When a crisis hits, agents will reason, bankruptcy courts will break down; when almost everyone (who counts) is bankrupt, nobody is!

- "Collective moral hazard" (Farhi and Tirole 2012) a threat; need ex ante defenses, as well as design for ex post resilience

Path(s) to fiscal union

Lack of progress is leaving EMU vulnerable

- Political difficulty does not absolve from economic necessity
- Improvements can/should come along multiple dimensions, following example of existing currency areas
- Envisaged **fiscal backstop to the banking union** remains urgent step towards cutting bank/sovereign loop
- Requires common deposit insurance, joint resolution fund
- However, fully addressing EMU vulnerabilities will require additional efforts to improve fiscal risk sharing and discipline

Ways to share fiscal risk

- Central **fiscal facility** providing public goods—with common revenue source and some limited access to debt financing—for additional fiscal risk sharing at macroeconomic level; scalable, political will permitting
- Longer term, elements of **area-wide social insurance** schemes add provide risk sharing at microeconomic level
- Helpful ongoing discussion of options
    - E.g., IMF Country Report 16/220; Demertzis and Wolf 2016; Dolls and others 2016; Juncker and others 2015; Allard and others 2013

Discipline and banking regulation

- As progress is made in this direction, no-bailout clause will gain credibility and markets help incentivize fiscal discipline
- This will allow proceeding with adjustment of regulatory framework for sovereign bond holdings—that is, ending the practice of zero risk weights
- Can open the door for the introduction of “ESBIEs” to ensure adequate supply of safe assets
- Fiscal backstop makes bank resolution plans more credible, enhancing discipline

Reform deficits and legacy issues

- Significant unaddressed structural reform needs across EMU. Suggests that linking reforms to fiscal risk sharing is sensible, both from an economic point of view (it will add to resilience) and politically.
- Similarly, resolving legacy debt and balance sheet issues will help functioning of banking union and additional national efforts are needed (one-off support could facilitate such efforts)

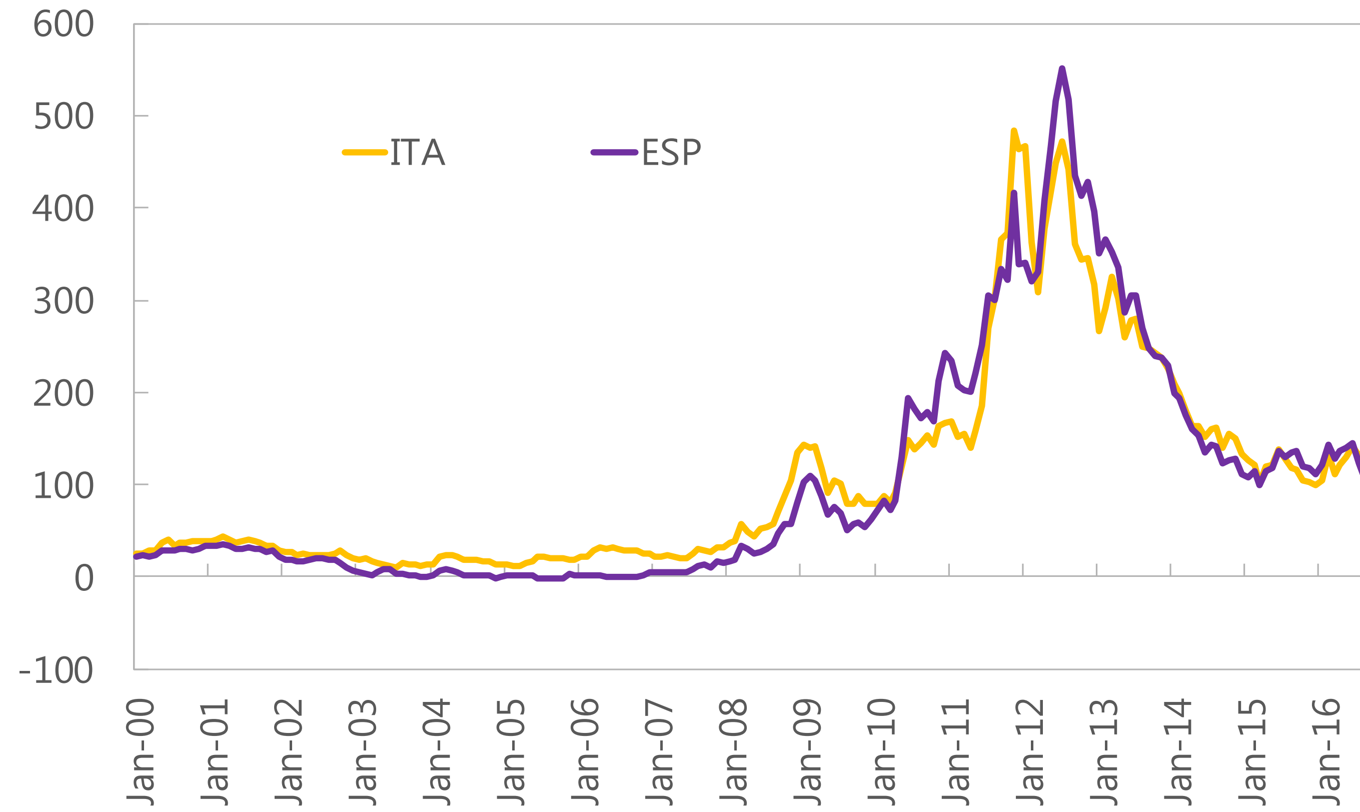
Thank you

EXTRA SLIDE

Sovereign spread differentiation?

Sovereign Bond Spreads in Spain and Italy

(Basis points)



Sources: Bloomberg and Fund staff calculations.