ASSET Round table
Risk-reduction versus risk-sharing in the Euro Area

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Outline

- Risk reduction versus risk sharing: A meaningful distinction?
- Towards the December Euro Area summit and beyond
- How to break the impasse – a balanced package: content and sequencing
## Two competing models for EMU

<table>
<thead>
<tr>
<th>&quot;Back-to-Maastricht&quot;</th>
<th>Fast forward to federalist EMU</th>
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<tbody>
<tr>
<td>Stronger enforcement of EU fiscal rules to rein debt and deficits</td>
<td>Distribution of fiscal efforts to achieve an appropriate aggregate fiscal stance</td>
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<td>Mechanism of imbalances procedures (MIP) focused on competitiveness of lagging countries</td>
<td>Symmetric adjustment to help weak countries and reduce Euro area current account surplus</td>
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<td>Banking Union does not need common deposit insurance</td>
<td>Full Banking Union to ensure financial stability and private risk sharing</td>
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<td>End to the risk-free status for sovereign debt and establish sovereign debt restructuring mechanism</td>
<td>Fiscal capacity for public risk sharing and eventually sovereign debt mutualisation</td>
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<td>More market discipline</td>
<td>Euro area Treasury</td>
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In their « pure » form, both are economically and/or politically unfeasible
The false distinction between risk reduction and risk sharing: the economic case

A strict distinction is analytically doubtful for two reasons:

1. Developing risk-sharing mechanisms across Member States may actually help reduce risks:
   - A central fiscal stabilization capacity could help countries avoid a financial assistance programme
   - EDIS and the SRF backstop will enhance private risk-sharing, reducing the risk of a need for public intervention

2. Without proper sequencing and preconditions, reforms to reduce risk, especially for the banking sector and sovereigns, may lead to more risks:
   - Reviewing RTSE or introducing a sovereign debt restructuring mechanism could backfire and create self-fulfilling crises
The false distinction between risk reduction and risk sharing: the political economy case

A strict distinction is even more problematic:

1. A simplistic dichotomy opposition crystallises the division between creditors and debtors which threatens the sense of common purpose that is critical to reach a true compromise.

2. Those who only put emphasis on the risk sharing neglect that the political capital to implement such measures is limited. Only by taking measures to actually reduce risk can the political capital for risk-sharing be extended, as for example is being done in the case of non-performing loans in the EU.
Deliverables of the EA summit in December

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<th>Deliverables</th>
<th>Key issues</th>
<th>Degree of consensus</th>
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<tr>
<td><strong>Single Resolution Fund (SRF) backstop</strong></td>
<td>Decision-making process</td>
<td>++</td>
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<td><strong>ESM reform</strong></td>
<td>ESM toolkit and division of labour with COM</td>
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<tr>
<td><strong>EDIS</strong></td>
<td>Consensus on need; strong disagreement on preconditions (sovereign exposures)</td>
<td>-</td>
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<tr>
<td><strong>Central fiscal capacity</strong></td>
<td>Insufficient consensus on both need and design</td>
<td>- -</td>
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How to break the impasse beyond the December summit: we need a balanced package

Red lines must be crossed, in a prudent way:

1. **Complete the Banking Union** to mitigate the bank-sovereign doom loop and support the emergence of pan-European banks by:
   - Agreeing Single Resolution Fund (SRF) backstop through ESM reform
   - Agreeing a common deposit insurance (EDIS) over two phases
   - Continued strong delivery of legacy asset risk reduction and
   - Considering already now both (i) changes to regulatory treatment of sovereign exposures (RTSE); (ii) the introduction of a EA safe asset

2. Agree on a central fiscal stabilization capacity to boost public risk sharing together with...

3. **Accelerated progress in Capital Markets Union (CMU)** to increase private risk sharing via diversified financing and sources of income
How to break the impasse beyond the December summit: sequencing of reforms

Strategic choice: Agree upfront on a two-phase roadmap for EDIS, RTSE, EA safe asset and fiscal capacity

1. Short-term deliverables:
   - Agree SRF backstop with potential advanced timeline and risk reduction targets, together with balanced ESM reform
   - Accelerate progress in Capital Markets Union
   - EDIS - Liquidity phase

2. Medium-term deliverables:
   - Agree central fiscal capacity, starting small, together with simplification of the fiscal rules
   - Discussion on EDIS - mutualisation, RTSE changes and on the introduction of a EA safe asset must take place in parallel.
     - EDIS – Mutualisation : conditional introduction
     - RTSE: better concentration charges than risk weights
     - Safe asset: could be done without mutualization or securitization, potentially by ESM (e.g option 3, Green Paper on the feasibility of introducing Stability Bonds, COM(2011) 818 final)
Conclusions

• Risk-sharing and risk reduction measures are complements, not substitutes, both from economic and political point of view

• Need to overcome this distinction which hardens political dividing lines - we should focus on a common narrative and genuine compromise

• We have made progress but the time has arrived to prudently cross some red lines and work on a comprehensive package

• Implementation of the more difficult reforms (RTSE, SA, EDIS, fiscal capacity) may stretch well into the next decade but the composition of the package and its sequencing must be agreed quickly