DRIFTS OR CONNECTIVITY: THE STRATEGY FOR EUROPE ?

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I will focus on

1. Economic issues

2. Eurozone

There is a broad consensus that:

1. The Economic and Monetary Union is not complete

2. Repair/Finish building the roof while the sun shines

3. Otherwise the EMU may not be able to resist the next crisis

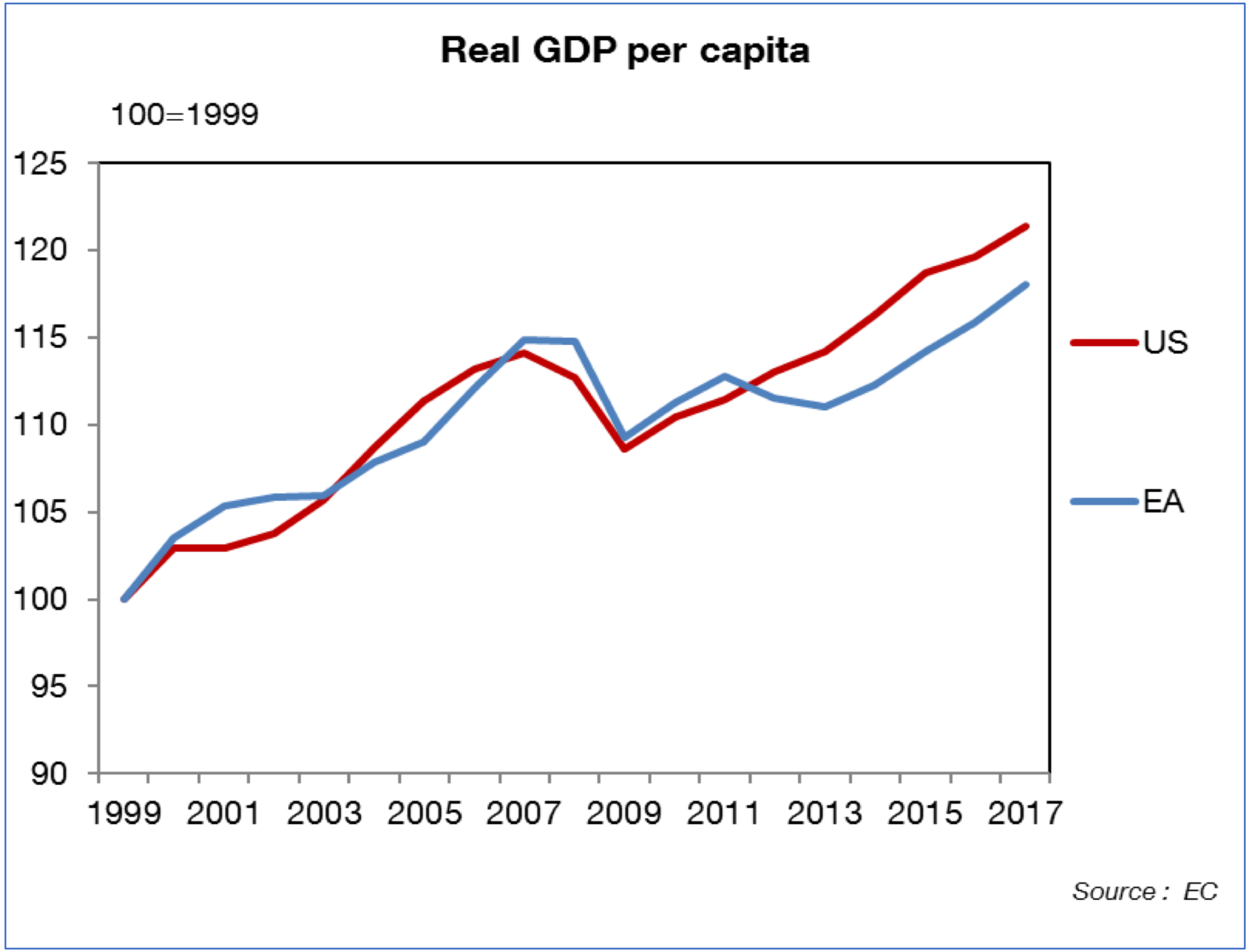
Differences recipes depend on

1. Differences of views on the causes of the crises

2. Differences of views on economic analysis

3. Differences of views on what is politically feasible

The Eurozone crisis: which crisis?



The Eurozone crisis (2011-12)

Source : Datastream

What triggered the crisis?

Not the economy!

GDP growth pc	2011		2012	
	Fall 2010	*Spring 2011*	*Fall 2010*	*Spring 2011*
Eurozone	**1.3**	**1.4**	**1.6**	**1.5**
US	**1.3**	**1.7**	**1.6**	**1.8**
Japan	**1.4**	**0.6**	**1.8**	**1.7**

European Commission forecasts

What triggered the crisis?

Not excessive fiscal deficits!

Deficit/GDP	2011		2012	
	Fall 2010	*Spring 2011*	*Fall 2010*	*Spring 2011*
Eurozone	**-5.1**	**-4.4**		
Italy	***-4.3***	***-4.3***	***-3.6***	***-3.5***
Spain	***-6.9***	***-6.2***	***-6.3***	***-5.6***
Belgium	***-5.1***	***-3.9***	***-5.3***	***-4.0***
France	***-6.0***	***-5.8***	***-4.7***	***-4.9***
US	**-8.1**	**-10.8**	**-6.6**	**-7.5**
Japan	**-8.9**	**-10.0**	**-8.1**	**-8.4**

IMF Fiscal Monitor

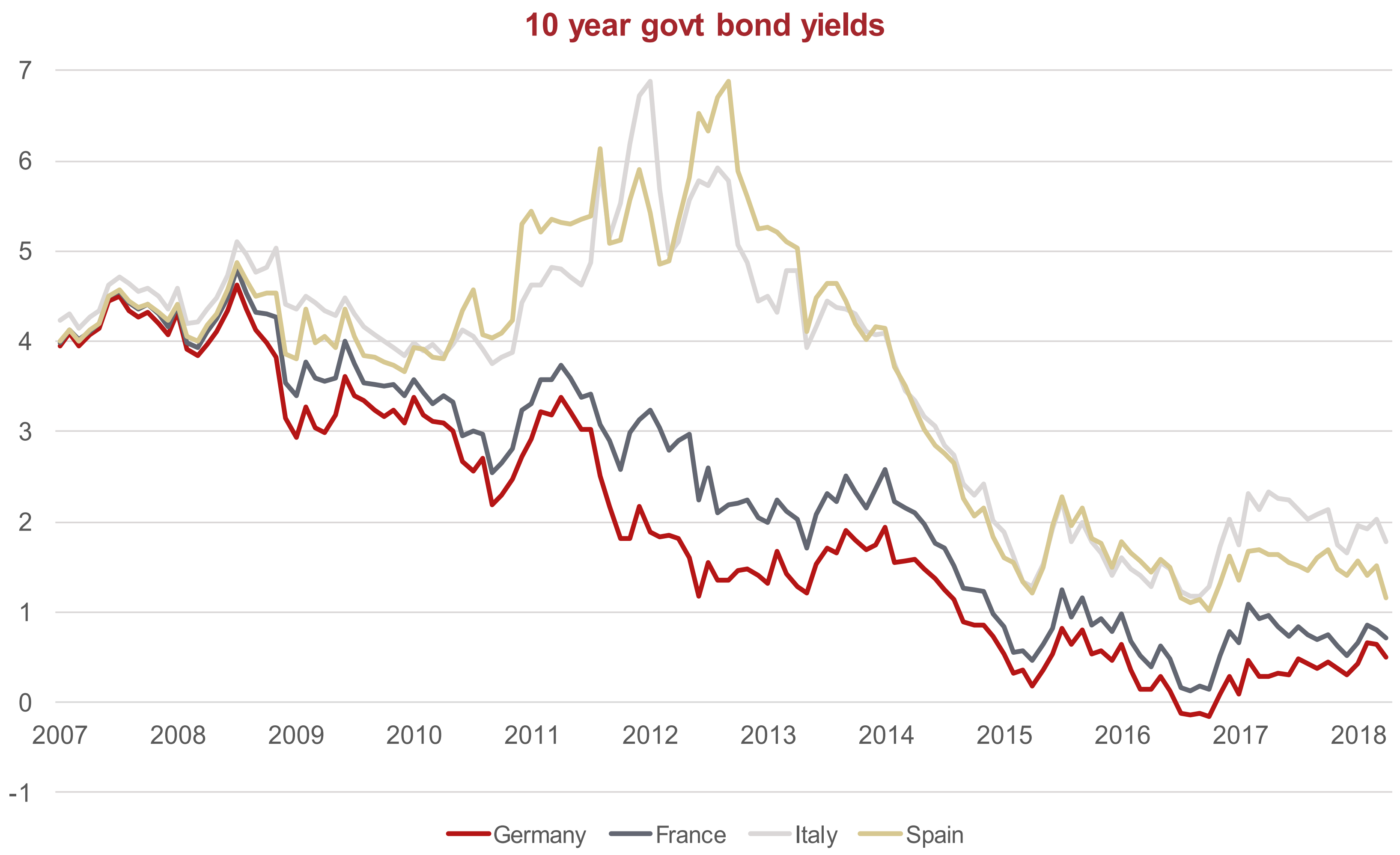
What triggered the crisis?

Not excessive public debt!

Debt/GDP	2011		2012	
	Fall 2010	*Spring 2011*	*Fall 2010*	*Spring 2011*
Eurozone	**119.7**	**119.7**		
Italy	***119.7***	***119.7***	***119.7***	***119.3***
Spain	***70.2***	***63.9***	***75.1***	***67.1***
Belgium	***103.1***	***97.3***	***105.0***	***97.4***
France	***84.2***	***85.0***	***87.6***	***86.9***
US	**99.3**	**99.5**	**102.9**	**102.9**
Japan	**234.1**	**229.1**	**238.6**	**233.4**

IMF Fiscal Monitor

Contagion (2011-12)



Source : Datastream

Why contagion?

That’s how financial markets work!

When an asset is subject to a major price change, for instance through restructuring or depreciation, financial market participants ask “what’s next?”, “who’s the next?”, to exploit opportunities of divergence trades (short-long positions) which can be easily leveraged.

Examples:

- **in September 1992, after the Lira exited the ERM, the Pound Sterling got under pressure and subsequently the French Franc**
- **in September 2008, after the Lehmann collapse, panic affected other financial institutions (banks and insurance companies, mutual funds….)**
- **in May 2010, after the Greek adjustment package, the Irish and Portuguese bond markets also got under pressure**

How did contagion work?

After the Greek debt restructuring, markets started asking a series of questions, such as:

1. **Which other Eurozone country's debt might be subject to restructuring?**
2. **What would happen if these countries restructure their debt? Which other assets would be subject to restructuring?**
3. **Can the European Stability Mechanism support the countries that restructure their debt?**
4. **Would the restructuring of the debt be easier outside or inside the Eurozone**

To sum up

The 2011-12 crisis was triggered by financial contagion from the Greek debt restructuring which

- → **turned into an economic crisis mainly due to the weak bank position in some countries, that led to a credit crunch**
- → **threatened fiscal positions because of:**
  - **- Impact of lower growth on budget deficits**
  - **- Impact of (potential) bail-outs of banks**
- → **led to a doom-loop between sovereign and bank risk**
- → **Induced further fiscal tightening to restore budgetary soundness**

The Doom-Loop

Financial shock ← Fiscal adjustment

↓ ↑

Credit crunch → Economic recession

↓

€ Exit?

How to break contagion?

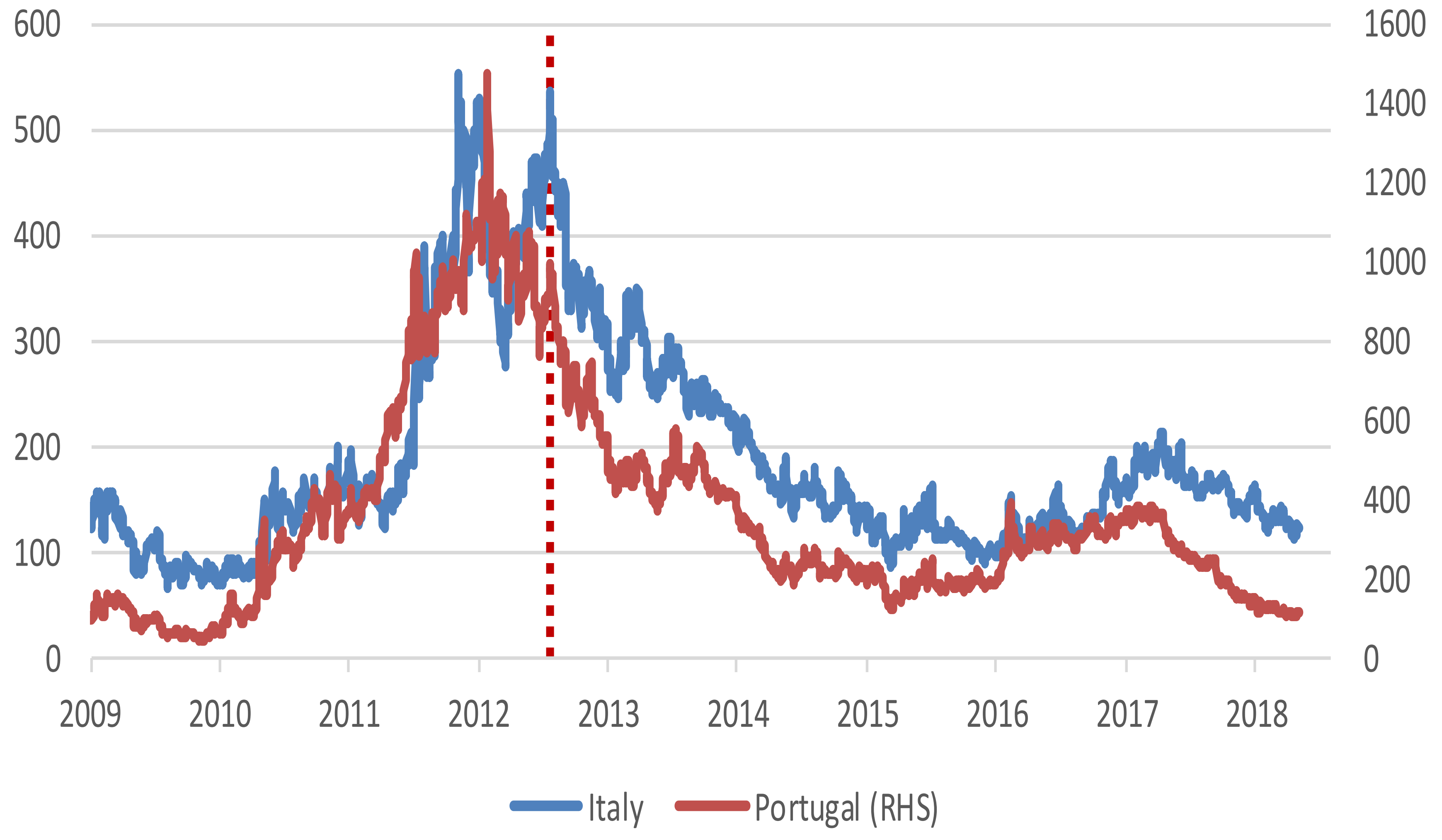
1. The ECB adopted the OMT ("*whatever it takes*").

2. A Banking Union has been started

3. The Fiscal compact has been adopted

4. The ESM has been created

The effectiveness of the "Whatever it takes"



Is this sufficient?

Are these actions sufficient to avoid future crises and contagion?

1. **The OMT is untested, and conditional**
2. **The Banking Union is not yet complete**
3. **The Capital Market Union project is a long term project**
4. **The Fiscal compact cannot deal with major shocks**
5. **The ESM is rigid**
6. **Fiscal policy mistakes cannot be excluded**
7. **The euro exit cannot be excluded**

Areas for improvement

1. Monetary policy
2. The Banking Union
3. The Capital Market Union
4. Fiscal policy
5. ESM
6. Euro exit

2. Banking Union

Complete Banking Union:

1. Full harmonization of rules, reduction/elimination of national exceptions, strengthen the role of the SSM (including macro-prudential policies)
2. Strengthen SRF (backstop, liquidity,…)
3. Implementation of EDIS over a clear time horizon

3. Capital Market Union

Why?

- **Key shock absorber**
- **Reduces concentration of risk in the banking system**
- **Enables the development of more efficient and pan-European banking**

Requirements

- **More ambitious agenda**
- **Greater powers to ESMA**

4. Fiscal policy

Objectives:

1. Improve Fiscal discipline
2. Create appropriate room for Fiscal stabilizers
3. Strengthen a common Fiscal backstop
4. Create a safe asset

Creating a safe asset for the Eurozone

Many proposals have been put forward, but some are technically complex, others politically unfeasible, like the Eurobond.

Would Eurobonds be a problem if they represented at most 60% of GDP?

How can we ensure that debt does not rise above 60%, in all countries, given that Fiscal policy is the responsibility of the member States?

Blue and Red Bonds proposal (Depla and von Weizacker, 2010)

A Proposal for Purple Bonds

Purple bonds represent every year the amount consistent with the debt reduction specified by the Fiscal compact when debt is in excess of of GDP, i.e. decrease by 1/20 the excess over 60% of GDP.

PB would have the backing of ESM.

Zero risk weight/no limits in banks' balance sheets.

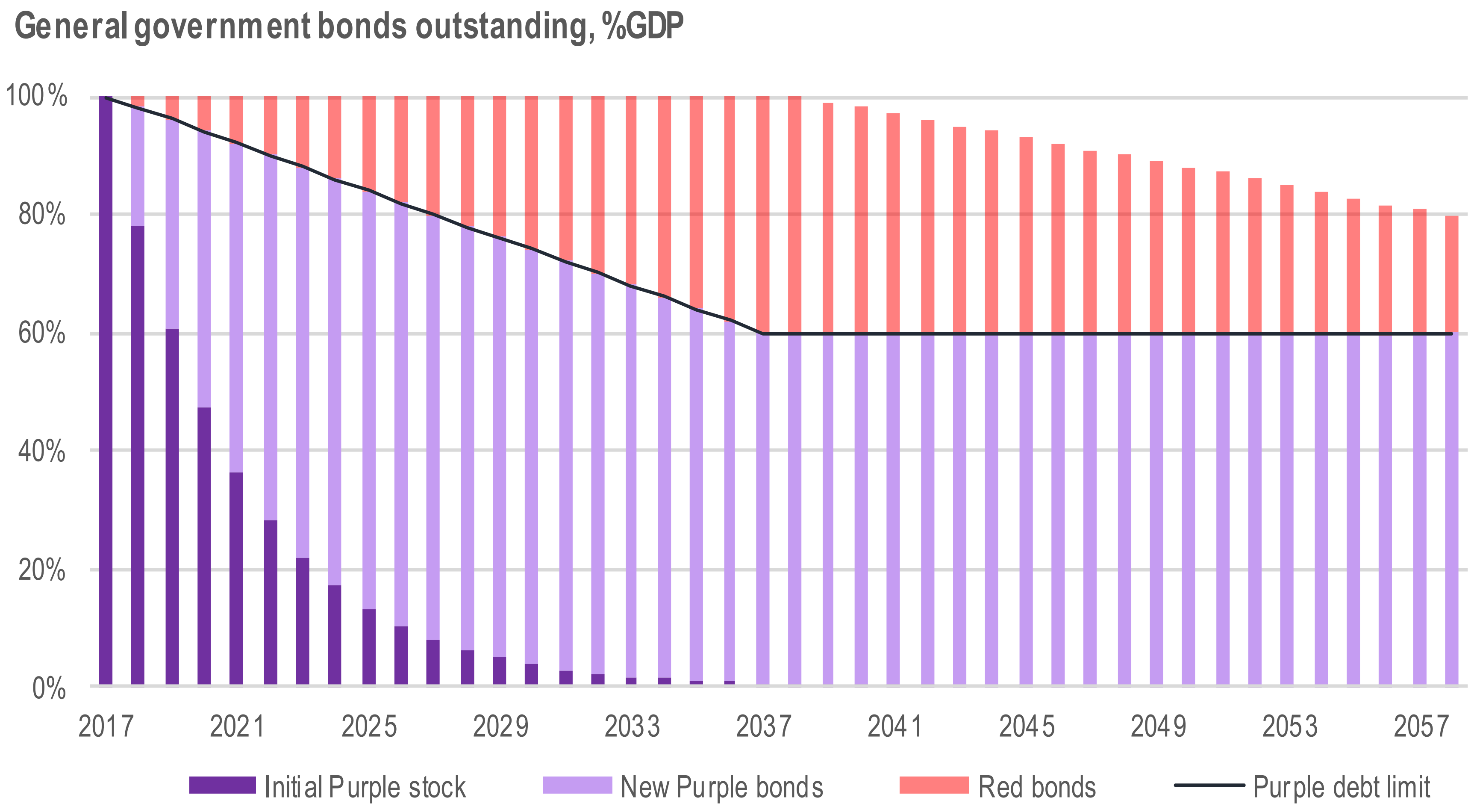
No haircut in monetary policy operations.

Red bonds, issued by each country for the debt in excess with the limit imposed by the Fiscal compact, under the responsibility of the member state.

Junior in debt restructuring.

Subject to supervisory limits in banks' holdings.

An Example


General government bonds outstanding, %GDP
100%
80%
60%
40%
20%
0%
2017
2021
2025
2029
2033
2037
2041
2045
2049
2053
2057
Initial Purple stock
New Purple bonds
Red bonds
Purple debt limit

From Purple to Euro Bonds ?

At T+20

Purple bonds could become Blue bonds.

BB are joint and several guarantee. They are issues for a maximum of 60% of GDP.

Zero risk weight/no limits in banks’ balance sheets.

No haircut in monetary policy operations.

Red bonds, issued by each country for the debt in excess with 60%, under the responsibility of the member state.

Junior in debt restructuring.

Subject to supervisory limits in banks’ holdings.

Advantages

Combine:

- **Fiscal discipline of the Fiscal Compact (less incentive to politicise excessive deficit procedure)**
- **Market discipline, implemented gradually through RB**
- **Gradual discipline on banks' holdings of Sovereign risk**
- **Gradual creation of a wide market for safe assets in Europe**
- **Greater risk awareness of excess debt**

5. ESM

How can it be more efficient?

- **Democratic accountability (qualified majority for resource increase, simple majority for program)**
- **Backstop for the SRF (in practice would never be used)**
- **Separate Surveillance from EU Commission?**
- **Involvement of the IMF?**

6. Redenomination risk

- **Difficult to avoid contagion**
- **Difficult to prevent politically**
- **Dangerous to provoke (Schauble's mistake with Greece in 2015)**

- **How can it be discouraged?**
- **Clarification of the Exit conditions (learning from Brexit)**
  - **What happens to the Target2 debtor positions?**
  - **What happens to EU membership?**

Conclusions

Complete the roof while the sun is shining

Strengthen ALL aspects of the architecture within a defined time-table

Resort to deadlines, two-speed strategy

Clarify redenomination risk, Exit conditions