Financial Stability: the neglected stepchild of Maastricht

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Main points

New political opening to ‘complete’ EMU.

But how?

Two competing visions ‘Maastricht’ versus US model.

Key role of financial stability for both.

Main points on past

1. Financial stability Maastricht's stepchild.
2. Concentration on inflation, not financial stability.
3. Increase in financial integration not anticipated (although already started).
4. Nature of intra-area financial integration (debt) 'crisis prone'.
5. Two sources of risk: sovereign debt and real estate boom/bust.

Main points on way forward:
how to deal with the two sources of risk

1. Banking Union needed to break sovereign/bank loop at national level.
2. But also need to reduce likelihood of shocks:

Sovereign: Belts plus suspenders: Fiscal Compact plus ESM.

Real estate boom/busts: Macro-prudential policies.

An aside:
Is Europe’s integration process too slow?

- Compare with the US:
- Interstate Commerce Act after 100 years (despite clause in Constitution).
- Central Bank (Federal Reserve) after 120 years, fully operational 20 years later. (Initial attempts failed twice during 19th century, several states became insolvent, free banking = different currencies).

=> Full banking union after 140 years in US.

No agreement on what ‘full’, or ‘completing’ EMU means: US model or Maastricht 2.0?

Different visions point into different directions:

- **US model** (today) = Not only same currency but also unified economic policy, large federal ‘fiscal capacity’, fully integrated financial markets, etc.

=> Implies ‘European Finance Minister’, fiscal capacity for euro area, more transfers, common unemployment insurance, etc.

- **Maastricht model** = Single currency, but national responsibility for economic and fiscal policy (‘no bailout’).

=> Insolvency rules for sovereigns, stricter enforcement of Fiscal Compact or linking ESM eligibility to observation of Maastricht rules.

What is common to US model and Maastricht?

Maastricht forgot about financial markets, two consequences:

1. ‘No bailout’ cannot be credible if insolvency by one country imposes high cost on others via financial markets. => need Banking Union to stabilize financial markets?
2. Lesson from US: integrated banking and capital markets facilitate risk sharing and shock absorption: stabilize against regional idiosyncratic shocks, but magnify common shocks => need common fiscal backstop for BU.

Overall consequence: Banking Union now part of ‘Maastricht’, but US more advanced (has Capital Markets Union). US Model has also elements of Maastricht (no bail out of States).

Maastricht vision:

Background ‘narrative’: experience of 1970s and 1980s.

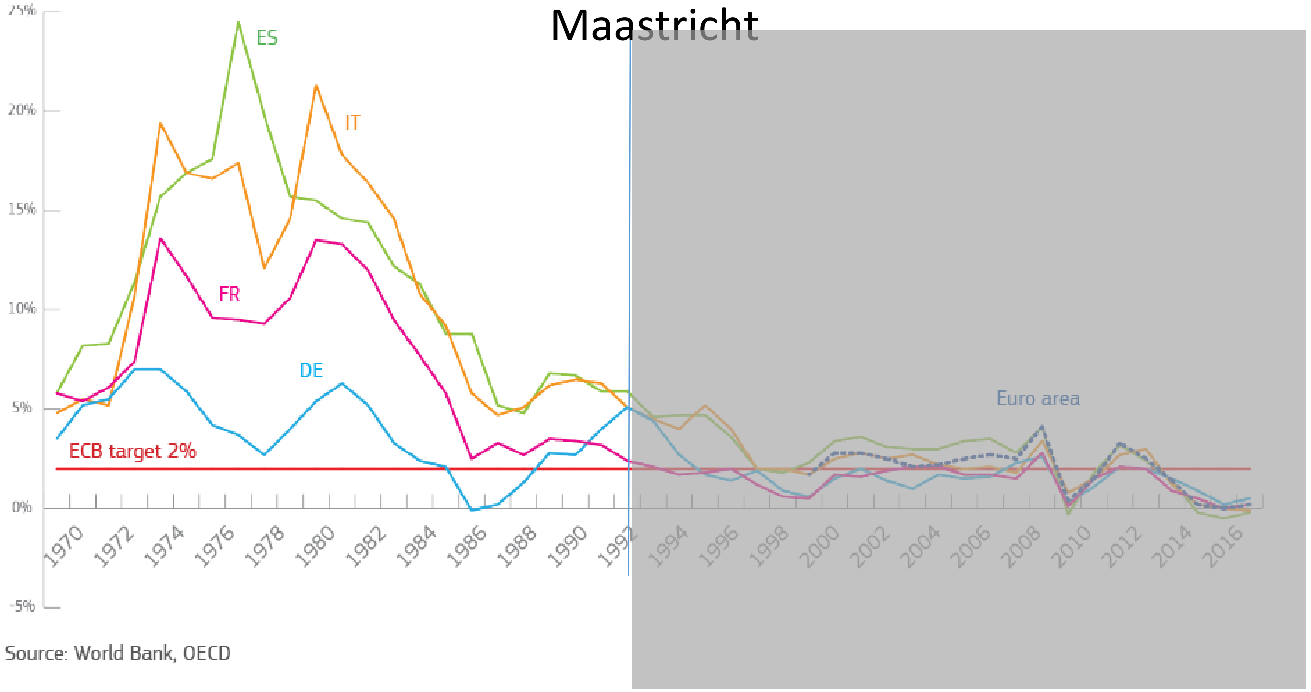
Inflation = financial instability, (financial crisis without inflation not part of ‘living experience’).

⇒Inflation ‘root of all evil’

⇒Price stability = financial stability.

The euro has brought stable prices

Consumer Price Index, % change on previous year



Source: World Bank, OECD

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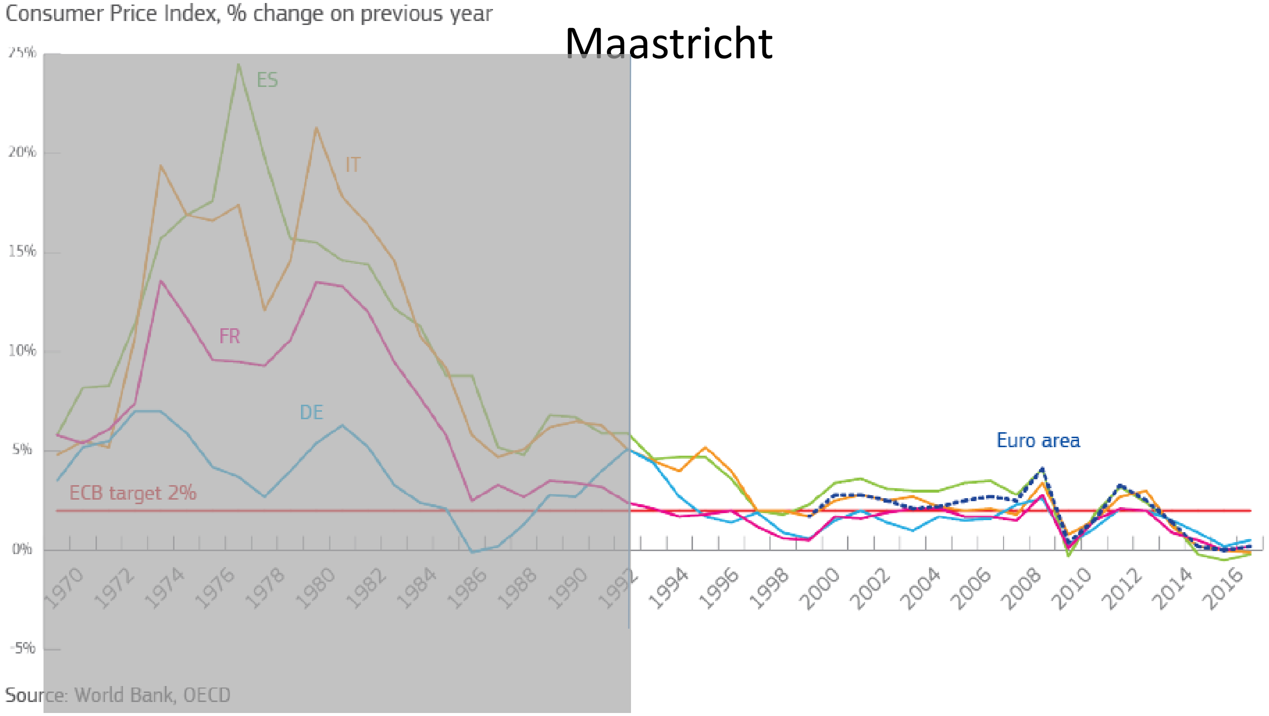

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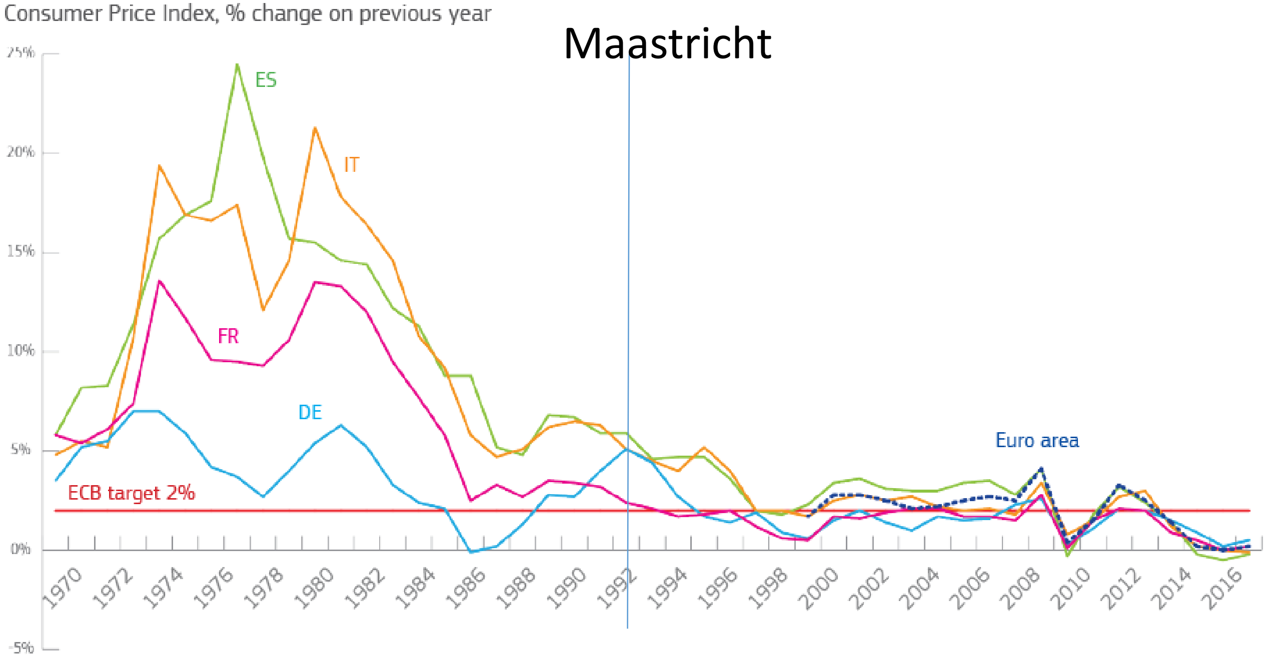

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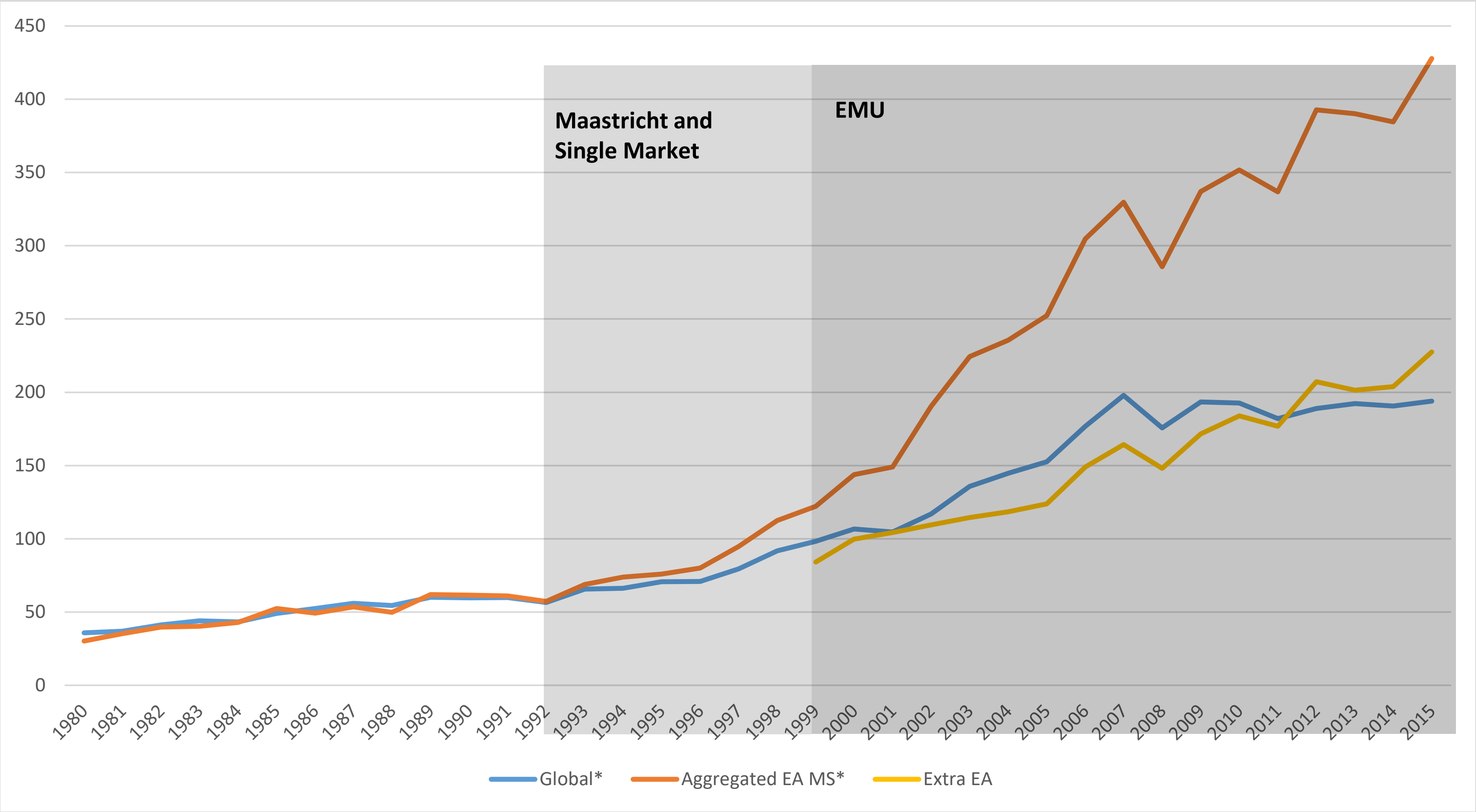
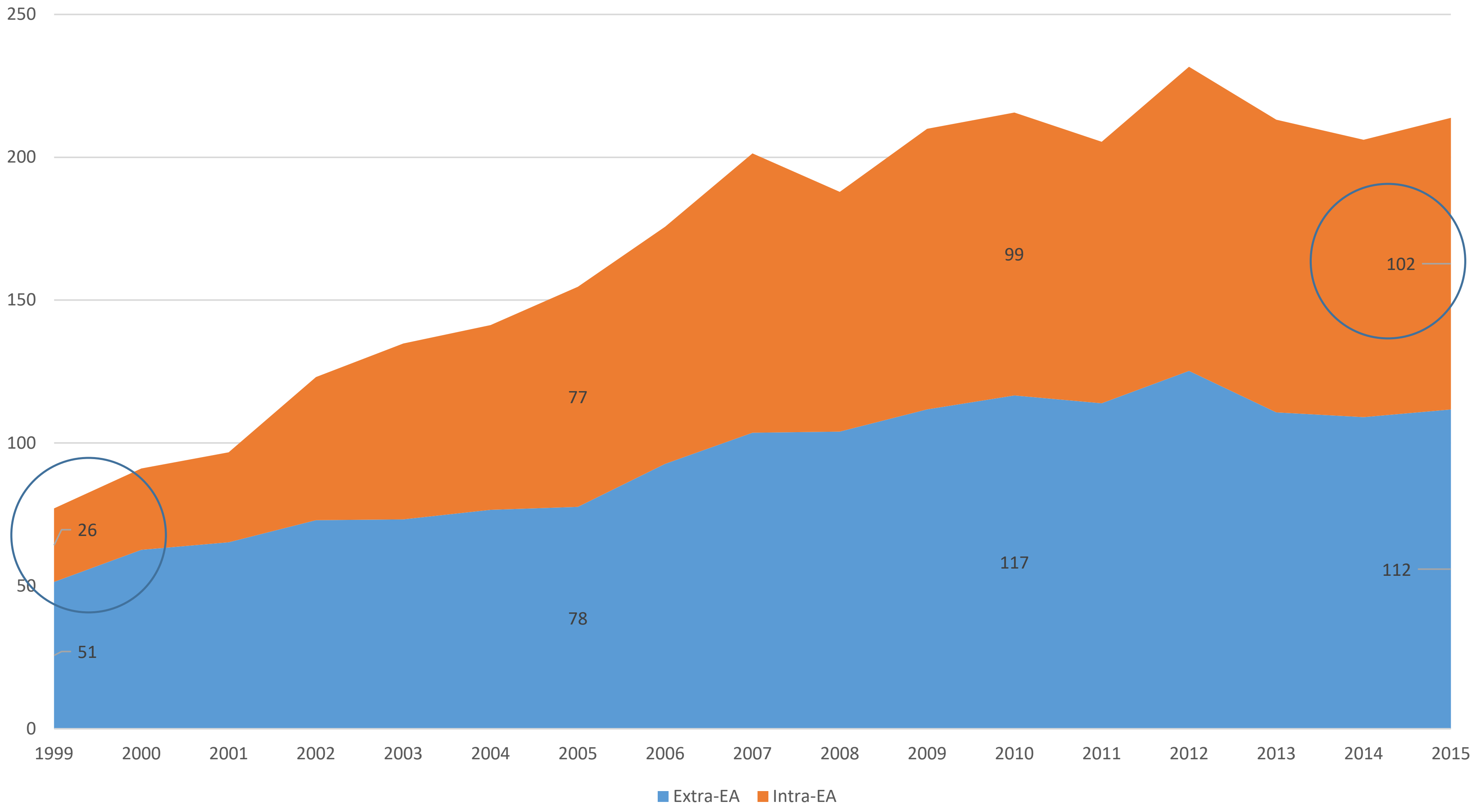
Financial integration: the nemesis of ‘naïve’ Maastricht

- Original Maastricht vision did not factor in key role of spill-overs as financial integration was much less strong.
- (Key logical omission: one of the purpose of EMU was to foster financial integration, which should imply more spill-overs.)

Financial integration in Europe (IIP assets as % of GDP)



Crisis prone integration: cross border debt (stocks as % of GDP)



What to do now?
Go for US model or Maastricht + financial stability ('+' = ESM + BU)?

'Maastricht +'   only realistic option.

- Corresponds to political reality that legitimacy for economic and fiscal policy remains at national level. In many cases would need to change national constitutions to transfer direct competences on fiscal/economic issues to the EU level.
- Moreover, difficult to imagine that 'Brussels' could somehow 'know best' details of economic and fiscal policies for 20 diverse Member States.

Maastricht + financial stability (= ESM + BU)

- For banks: Complete Banking Union.
- For sovereigns: ESM (in theory only for liquidity crisis).

How to make ‘Maastricht +’ sustainable?

Need to address both bank/sovereign feed-back loop at national level and reduce shocks. Aim: be able to avoid large shocks (‘large’ = leading to loss of market access).

1) Feed-back loops:

a) Sovereign => banks = holdings of sovereign debt.

b) Bank => sovereign = completion of Banking Union (Deposit insurance)

2) Reduce shocks:

a) Fiscal Compact (little teeth)

b) Macro-prudential

How to make ‘Maastricht +’ sustainable? 1 a)

Feed back Sovereign => banks:

Key problem is technical and political, banks hold 2-3 times capital sovereign debt. Possible because risk weight = 0.

Considering sovereign debt on bank balance sheets riskless not compatible with ‘Maastricht +’ (‘no bailout’ => sovereign debt is risky).

Problem is <u>concentration</u> (on own sovereign), not holdings of debt per se (banks intermediaries).

Solution known (application of concentration limits), but highly contentious.

How to make ‘Maastricht +’ sustainable? 1 b)

Feed back Banks => Sovereign

Weak banks require public support when system is at stake. For individual bank failures BRRD should reduce need for back up (de Groen and Gros (2016). But not enough for systemic crisis.

Need to complete Banking Union.

Single Resolution fund distributes some risks. Still needed: (back-up for) Deposit Insurance.

If aim is to provide insurance against large shocks: only need re-insurance of (national) deposit insurance (Gros 2012).

How to make ‘Maastricht +’ sustainable? 2 a)

Make shocks from Sovereign less likely:

Fiscal Compact should lead to (public) debt ratios < 60 % of GDP.

Problem is lack of enforcement (+ time inconsistency at national level).

European Finance Minister incompatible with national sovereignty.

Only solution: strengthen incentives: Violation of Fiscal Compact means exclusion from ESM (and thus OMT).

Credible only with strong banking union.

How to make ‘Maastricht +’ sustainable? 2 b)

Make shocks from banks less likely: Macro prudential policies.

Key remaining source of risks: (national) real estate boom/bust cyles.

Wrong lesson learnt from past?

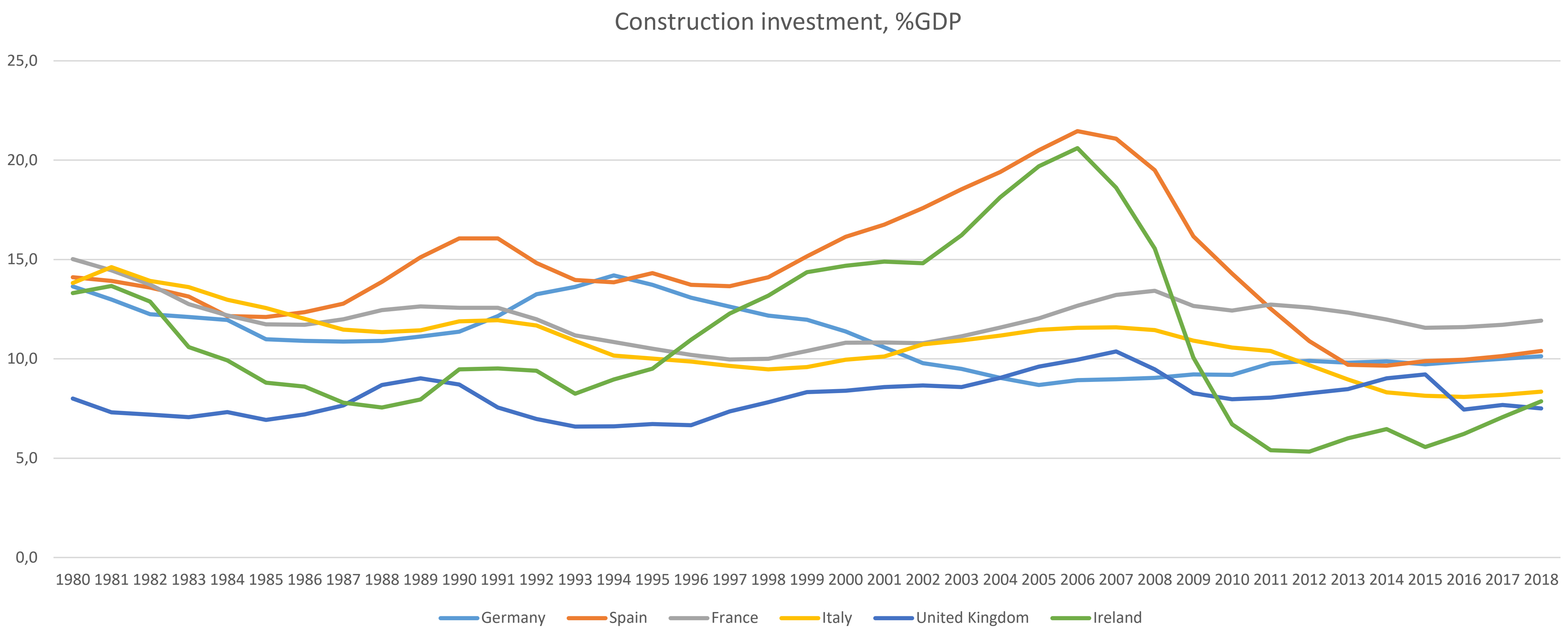
Rising house prices => increasing credit => losses when prices collapse?

In reality construction activity more important than house prices.

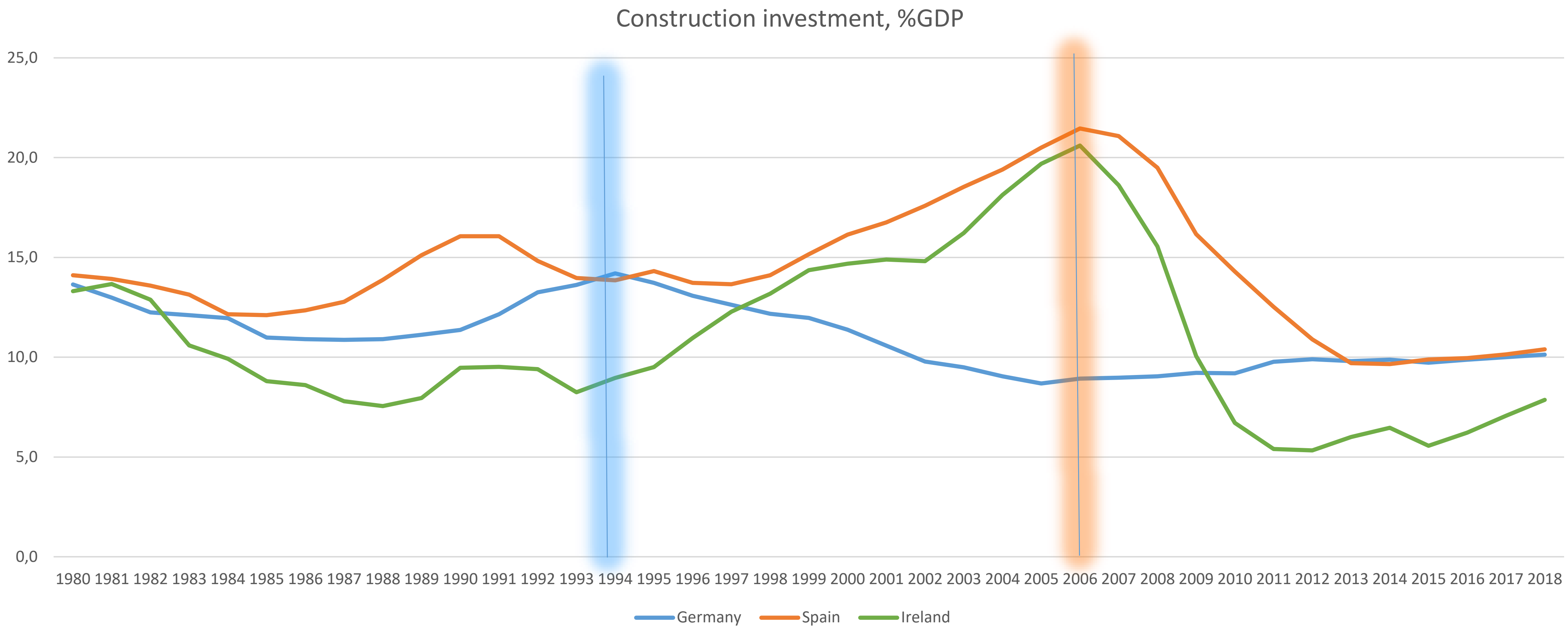
Rising prices: housing not net wealth!

Selling houses among home owner: buyer needs credit, seller can repay existing one (need very heterogeneous agents).

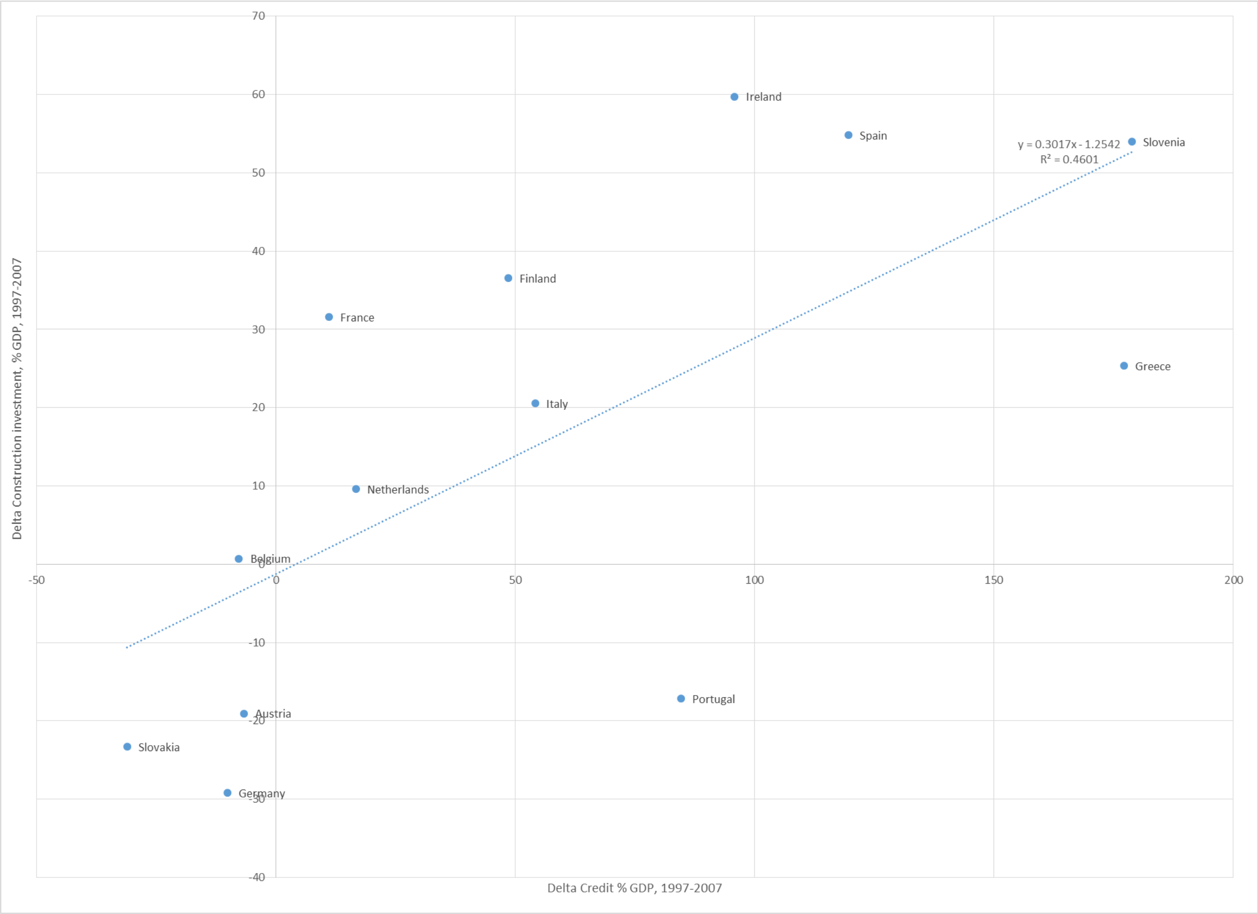
Construction important and variable



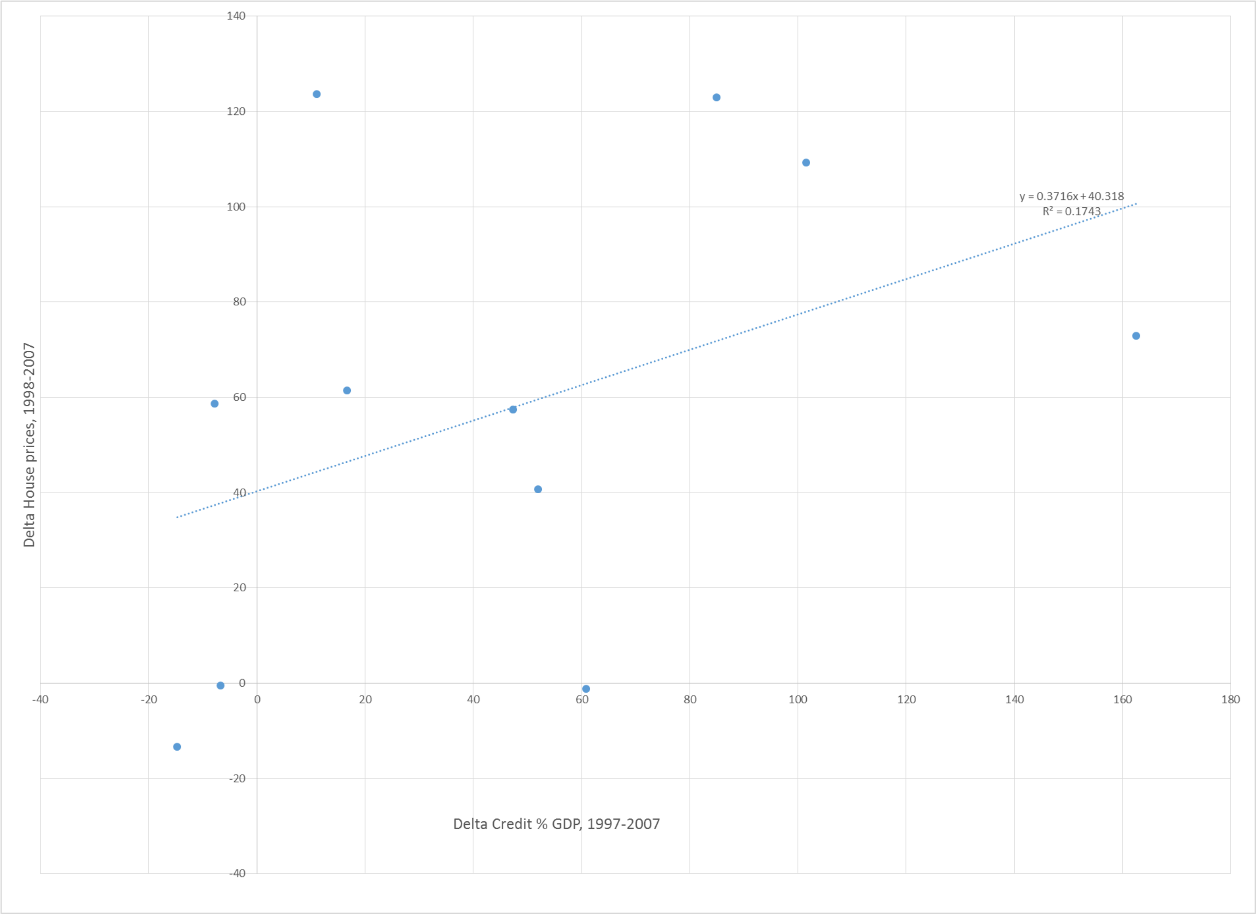
German unification: key asymmetry



Credit more correlated with construction than house prices



Little link between house prices and credit



Real estate booms/busts will arise again

- Macro prudential should focus on construction
- And ….
- Take different ownership structures and consumer protection rules into account (Germany).
- Can overturn relationship.

The way forward : lessons from the past, the political deal

- Maastricht was Franco-German deal:
- The problem of the day was capital market liberalization combined with exchange rate stability. With stable exchange rate Bundesbank becomes leader (France mere follower).
- **Maastricht = The Deal:** Bundesbank becomes ECB and France gets a seat at the ‘table’, or so its leaders thinks. (But French representative must be independent and escapes French political control.)
- Italy insists on joining because its credibility problem even bigger than France’s and EMU promises ‘painless‘ way to achieve credibility and price stability.

The way forward II: What lessons from ‘today’?

- The problem of the day is ‘excessive’ credibility to maintain price stability.
- Financial instability associated with deflation and high public and private debts (opposite of 1980s).
- => price stability not sufficient to guarantee financial stability, deflation potential threat to financial stability with debt overhang.
- => Fiscal Compact with focus on debt.
- + Pressure on banks to deal with NPLs.

The way forward III: lessons from which past?

- Should today's reform of EMU also be backwards looking? How far backwards, 1980s or 2000s?
- Likely future environment: Debt overhang will linger, but deflation threat probably not long-term.
- + Euro held responsible for domestic problems (Italy, Greece).
- Main threat to price stability comes from lingering high debts, now mainly public.
- Financial instability 'compressed' by central bank action or really reduced?
- Financial markets remain big, but not immediately a source of shocks themselves. Macro prudential more important than before.