

# **EMU Architecture: Where do we stand?**

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Building site.. And then ?





1. Known unknowns and unknown unknowns
2. Assessing the policy response
3. Conclusions



## 1. Known unknowns and unknown unknowns of EMU

*“There are known knowns; there are things we know that we know*

*There are known unknowns; that is to say there are things that, we now know we don't know.*

*But there are also unknown unknowns – there are things we do not know, we don't know”*

Donald Rumsfeld, February 2002

## Known unknowns

- EMU not an OCA (and may not develop into one)
- Walters critique
- Fiscal risks, lack of incentives to discipline
- North/South asymmetry
- Possibility of crises

Some evidence based on North/South framework ([Appendix 1](#))

- Major divergence
  - No self-correction
  - Partially but not primarily fiscal
- 
- Why warnings were overlooked
    - High politics
    - Implementation
    - Complacency

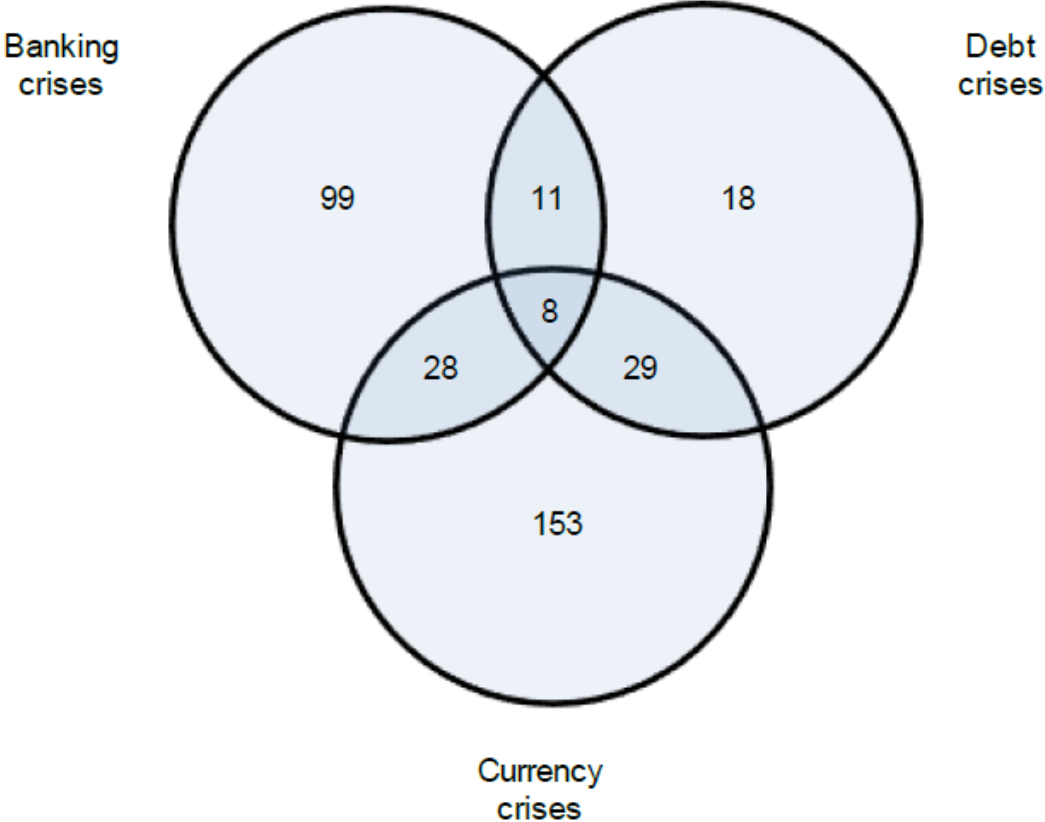
## Unknown unknowns

- BOP crises / Doom loop
- Financial fragility



# Debt crises, banking crises and BOP crises

Correlation between crises was known (Laeven-Valencia 2012)





- What has been new
  - High degree of correlation between sovereign and banks spreads
  - Balance-of-payment crises
- Evidence on sudden stops ([Appendix 2](#))
- Why?
  - Mobility
  - Banks



- Need for repair
- Need for reforms

Incompleteness of bare-bones EMU

What is needed?

## 2. Assessing the policy response

### Three steps

- Building of crisis management and resolution system
  - EFSF
  - ESM
- Reform of crisis prevention regime
  - Six-pack
  - TSCG
  - Two-pack
- Initiatives to address systemic flaws
  - Banking union
  - ECB role
  - Eurobonds?

### Next steps?

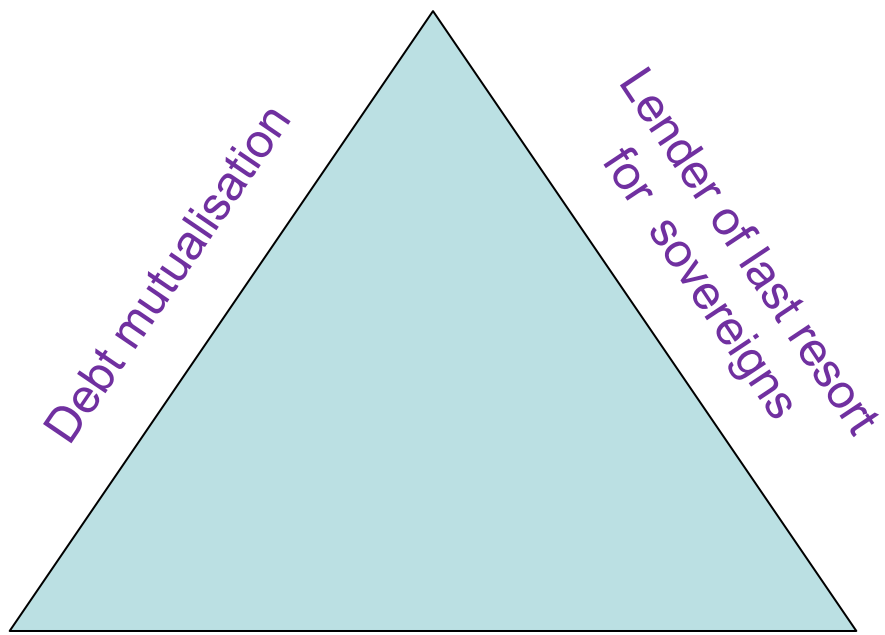
- Fiscal capacity
- Institutions
- Economic union

# Impossible trinity



## The other impossible trinity

Bank-sovereign interdependence



Strict no-monetary financing

No co-responsibility over public debt

Banking union

- How far should it go?
  - Supervision
  - Resolution
  - Deposit insurance ?
  - Fiscal backstop
- Evidence: [Appendix 3](#)
- Is it achievable?

## Is banking union sufficient ?

- Works on the liability side of bank balance sheet

### Asset-side (Eurobonds)?

- Which safe asset for the euro area
- Incentives
- Safe debt level



### **Van Rompuy report (12 October)**

- *In the longer term, there is a need to explore the option [of] developing gradually a fiscal capacity for the EMU.*
- *One of the functions of such a new fiscal capacity could be to facilitate adjustments to country-specific shocks by providing for some degree of absorption at the central level.*
- *Asymmetric shock absorption at the central level would represent a form of limited fiscal solidarity exercised over economic cycles.*
- *A key aspect of a future fiscal capacity, which would need to be examined carefully, would be its possible ability to borrow.*

### **Questions**

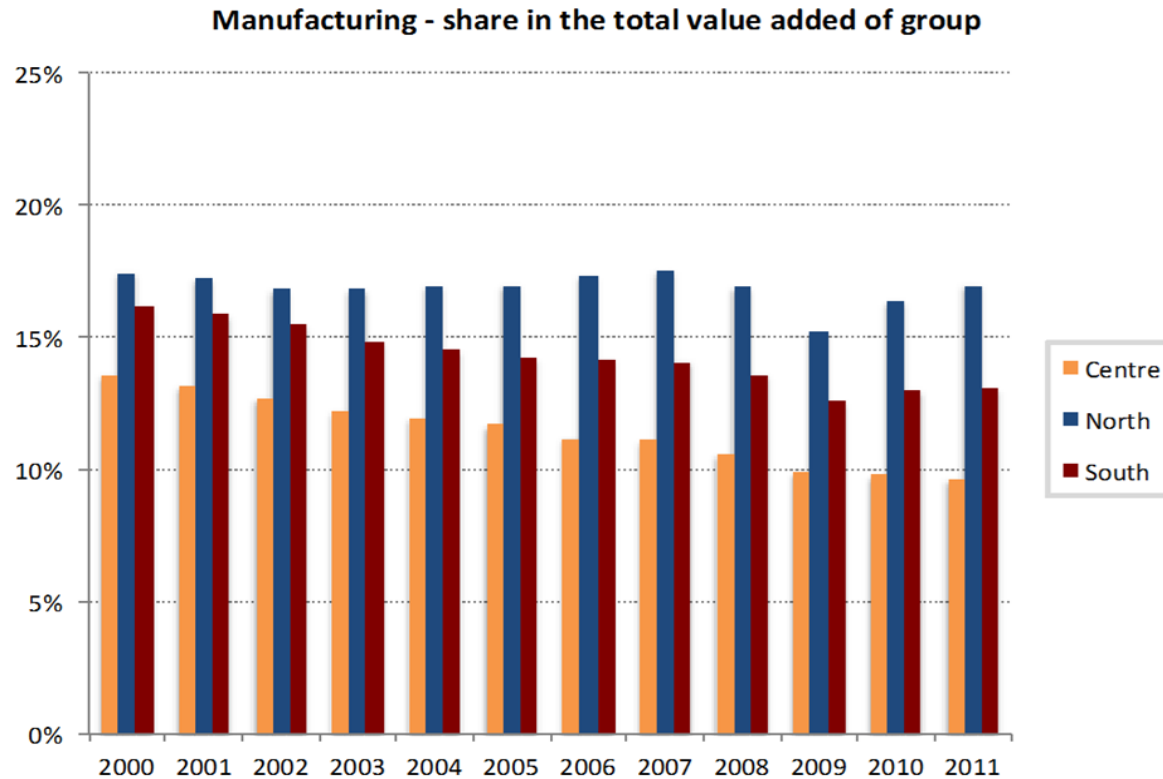
- Stabilisation: by national budgets or central budget?
- Euro-area public goods



# Institutions

- Two competing models
  - Federation
  - Mutual insurance

	Mutual insurance	Federalism
<b>Executive</b>	ECFIN Commissioner / Eurogroup president	European treasury
<b>Parliament</b>	Euro-area finance committee based on national parliamentary finance committees	Euro-area parliament
<b>Financial resources</b>	Mutualisation	Fiscal autonomy
<b>Debt mutualisation</b>	Eventually	No
<b>Common budget</b>	No	Yes
<b>Common debt</b>	No	Yes



The remedy: move jobs to people or people to jobs?





### Jobs to people

- First-best policies (macro stability and structural reforms): enough?
- Second-best policies?
- How sustainable economically?

### People to jobs

- Institutions to foster mobility
- Partial redistribution of agglomeration rents
- How sustainable economically?

### 3. Conclusions

- Limitations of EMU 1.0 evident
- Banking union a major initiative
- But significant uncertainty about future model
  - Economic principles
  - Institutions

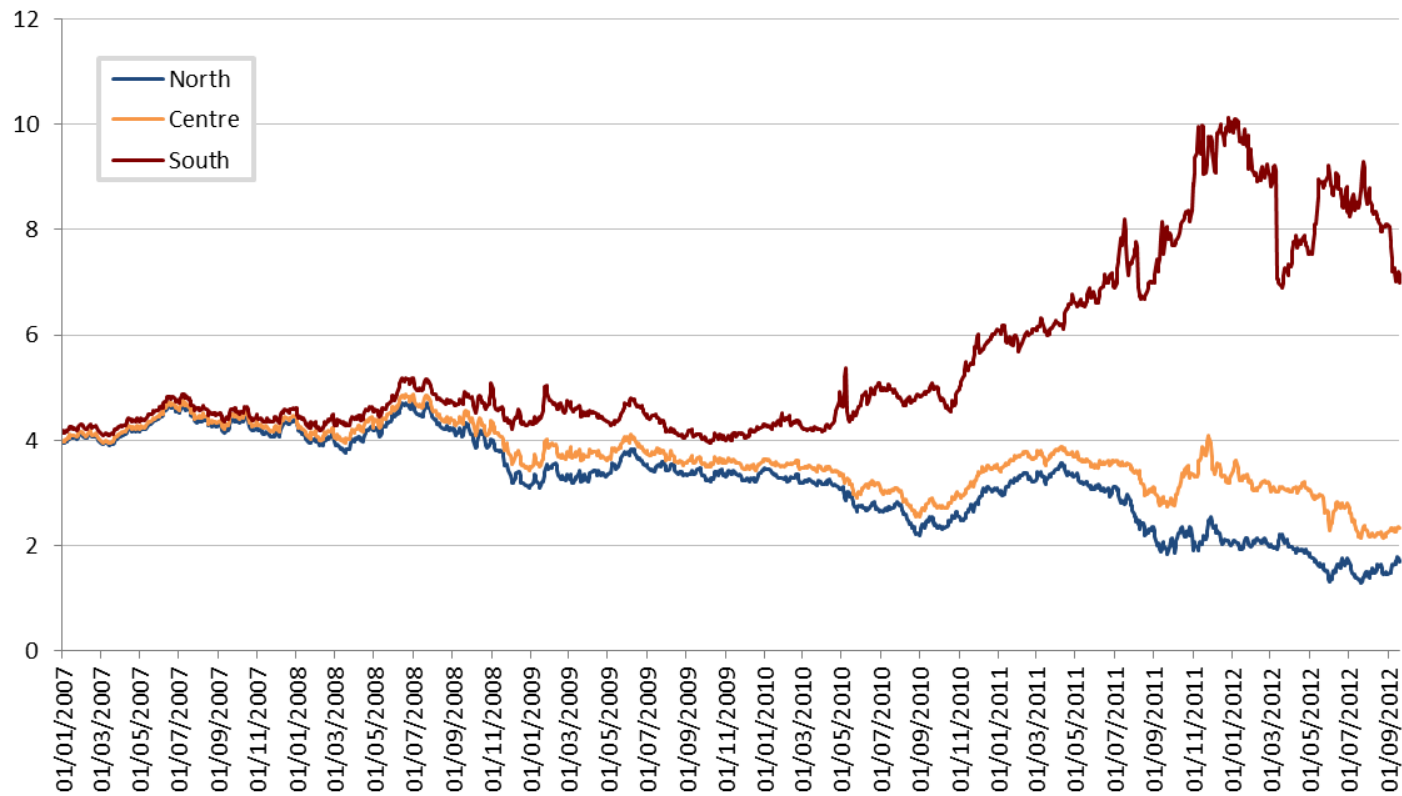


## **Appendix 1: A simple framework for analysis**

# Different fates



Yields on 10-year government bonds, groups weighted average  
(weighted by country share in group total debt)



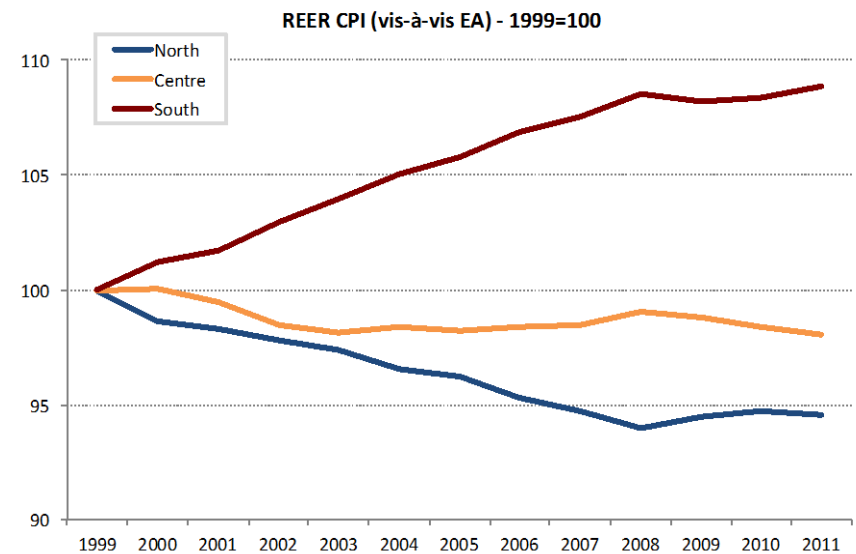
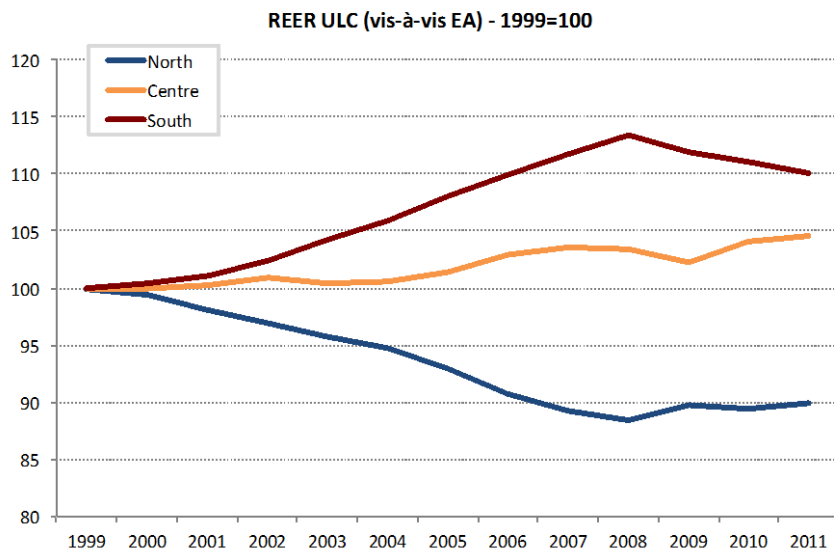
Source: Datastream

# The (familiar) story: pre-crisis divergence in competitiveness



## REER (ULC)

## REER (CPI)

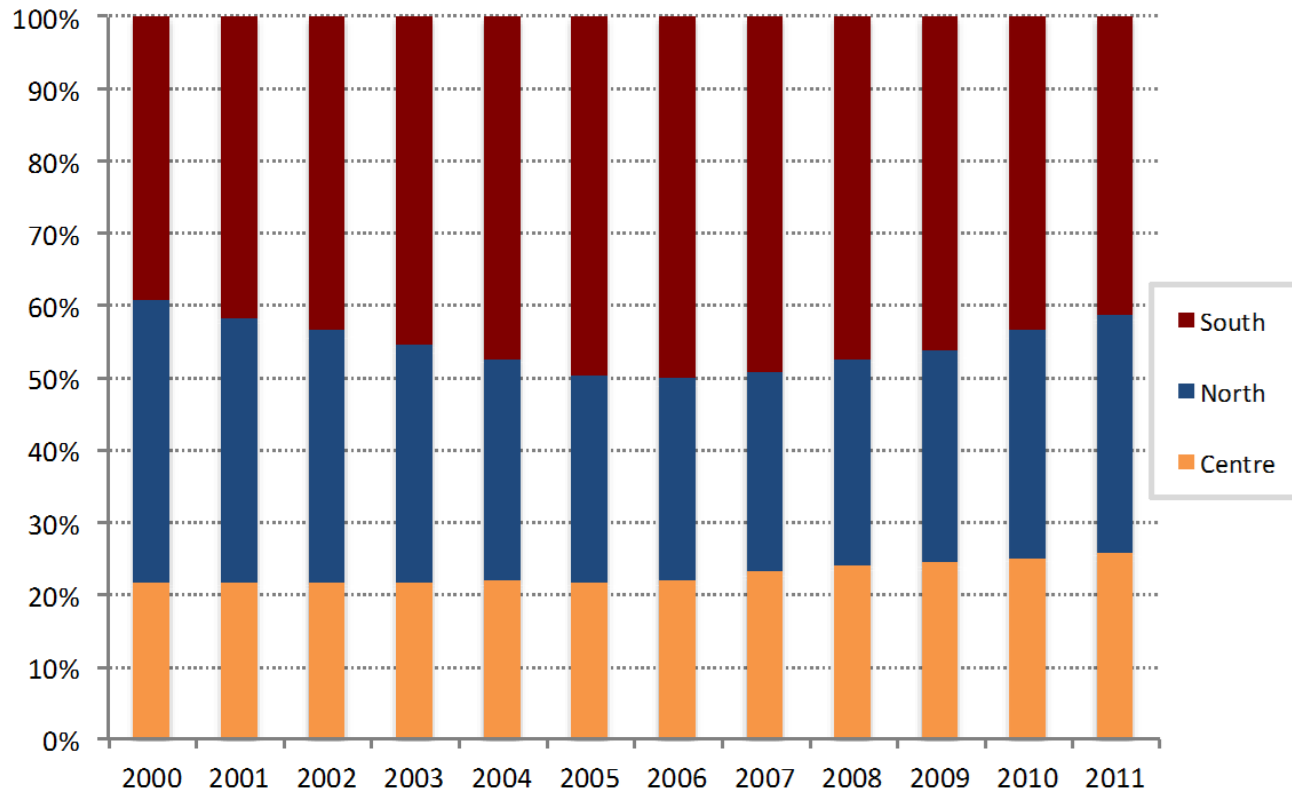


Source: Eurostat

# That bloated construction sector

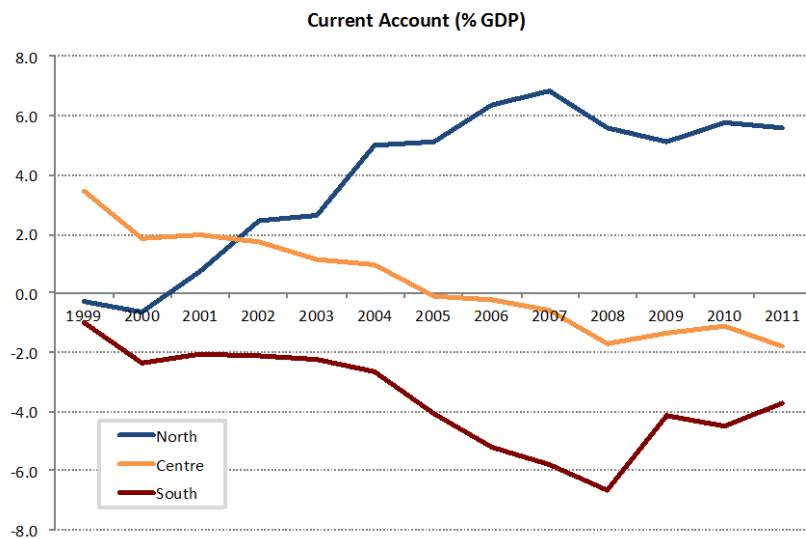


Construction - group share of total EA value added

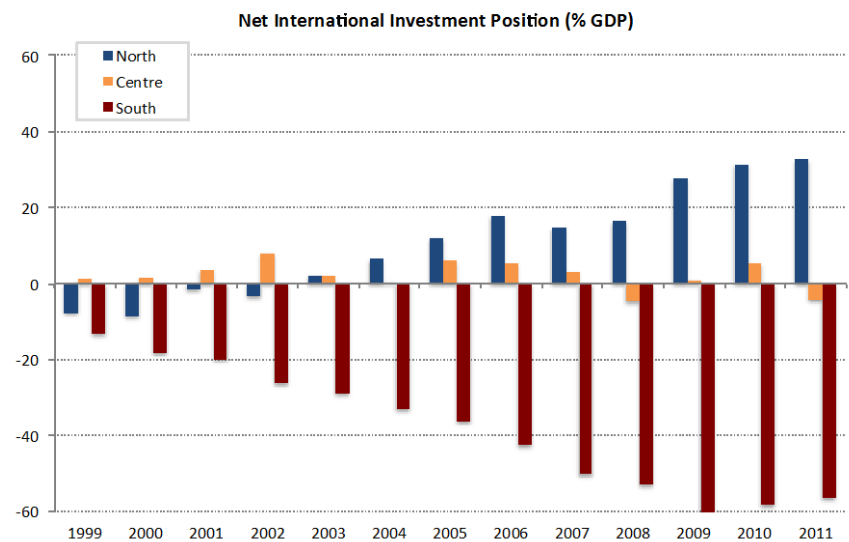


Source: Eurostat

## Current-account divergence



## NFA divergence



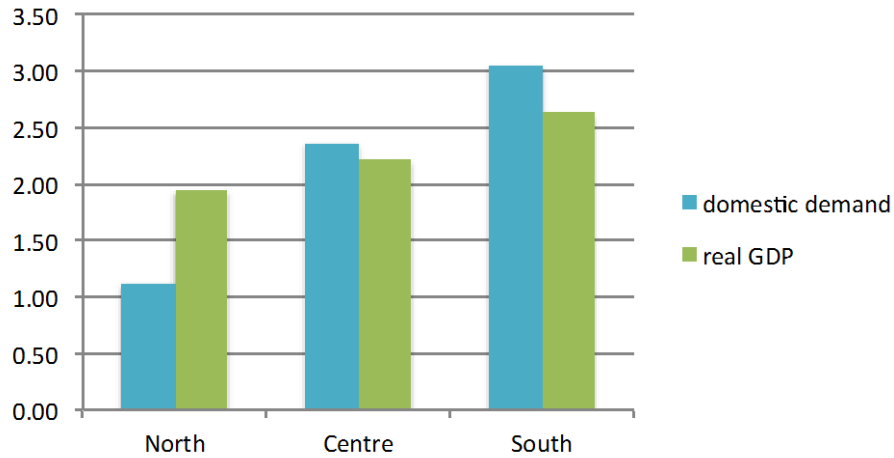
Source: Eurostat

# Demand and growth



## Pre-crisis

1999-2007



## Post-crisis

2008-2011

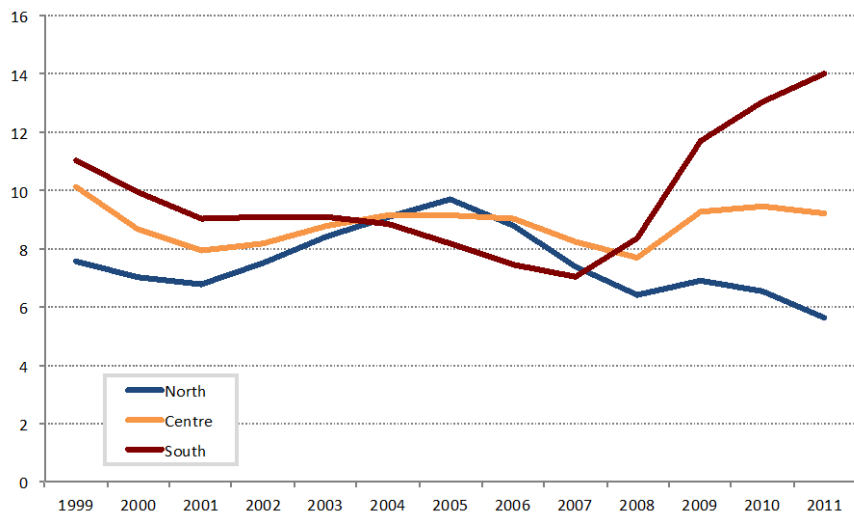






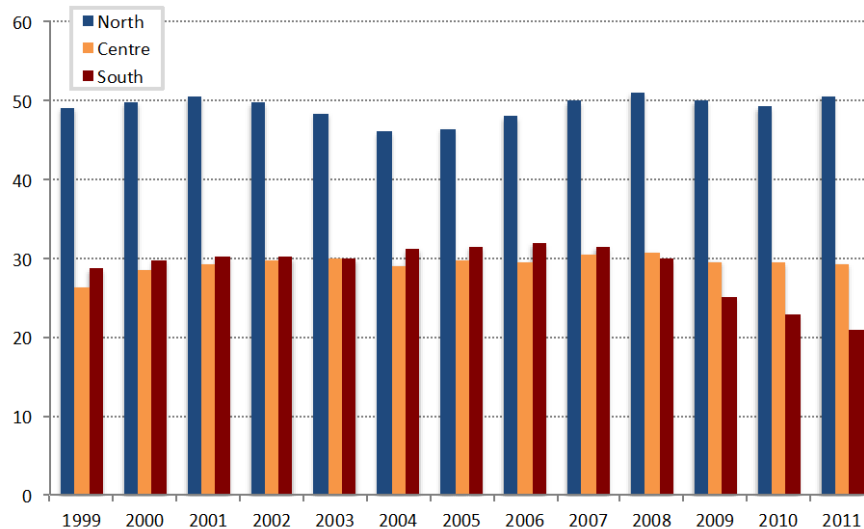
## Aggregate unemployment

Unemployment Rate (%)



## Youth employment

Youth employment rate (15-24 years old) - group weighted average

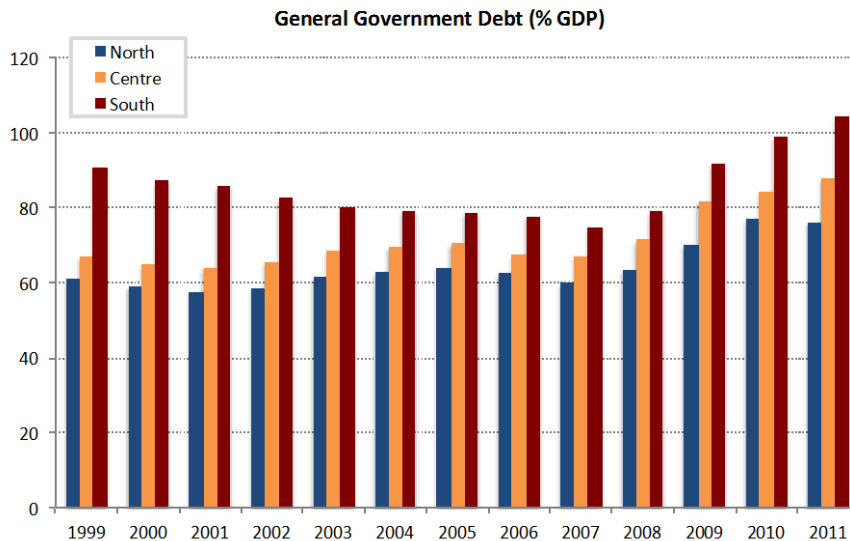


Source: Eurostat

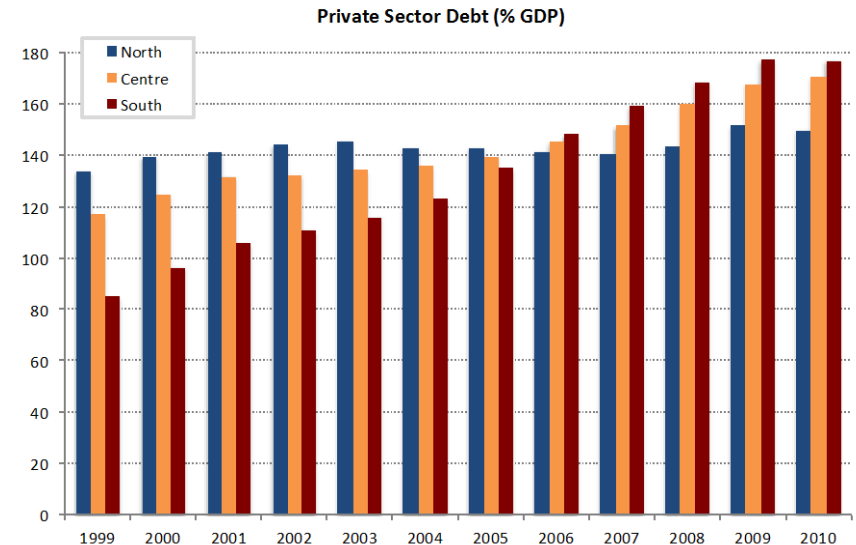
# Where did this divergence come from?

Debt – but not primarily public debt, rather private debt

## Public debt



## Private debt



Private debt is defined as sum of loans and securities other than shares, from non-financial corporations' and households/NPISHs' financial liabilities; non-consolidated accounts. Source: Eurostat





### How to define them? Start from indicators of Excessive Imbalances Procedure

- CA balance in % of GDP (3-years backward moving average)
- Net International Investment Position in % of GDP
- Government Debt in % of GDP
- Private Sector Debt in % of GDP<sup>a</sup>
- REER vis-à-vis EA-12, CPI-adjusted (EUROSTAT)
- Nominal ULC (AMECO)

### Use indicators to define categories

- (a) Definition of the Macro-Imbalance Procedure: sum of loans and securities other than shares from non-financial corporations' and households/NPISHs' financial liabilities; non-consolidated accounts



### Strategy:

- For each variable x year, use 33% and 67% percentiles across countries
  - Assign a score to each country:
    - 0 if less or equal to 33% percentile
    - 1 if between 33% and 67% percentile incl.
    - 2 if above 67% percentile
- } Max score = 2  
Min score = 0
- For each year average score over the 6 indicators used and classify as:
    - South if average score less or equal than 0.67
    - Centre if average score between 0.67 and 1.33
    - North if average score above 1.33

# North-South: results

## Polarisation has increased over time

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Austria	C	C	C	C	C	N	N	N	N	N	N	N	N	N	N
Belgium	N	N	N	N	N	N	N	N	C	C	C	C	C	C	N
Finland	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N
France	N	N	N	N	N	N	N	N	N	N	N	N	N	N	C
Germany	N	N	N	N	N	N	N	N	N	N	N	N	N	N	N
Greece	S	S	S	S	S	S	S	S	S	S	S	S	S	S	S
Ireland	C	C	C	C	S	S	S	S	S	S	S	S	S	S	S
Italy	C	C	S	C	C	C	S	S	S	S	S	S	S	S	S
Netherlands	C	C	C	C	C	C	N	N	N	N	N	N	N	N	N
Portugal	S	S	S	S	S	S	S	S	S	S	S	S	S	S	S
Spain	C	C	C	S	S	C	C	S	S	S	S	S	S	S	S

Start from the average position of 2010-2011, as the analysis is meant to be forward looking:

- North: AT; DE; FIN; NL
- Centre: BE; FR (France N/C position sensitive to percentiles chosen, with 25%/75% definitely Centre)
- South: ES; GR; IE; IT; PT



## **Appendix 2: Evidence on sudden stops**

Problem: official flows (Target + programmes) substituted private flows.  
Need to focus on private flows only, apply sudden stop test à la Calvo

Calvo (2004) test for sudden stop:

- At least one observation with year-on-year change in capital flows fall 2 standard deviations below average
- It start with the first observation of year-on-year change in capital flows falling 1 standard deviation below the average
- It ends when the change in year-on-year capital flows returns above average minus 1 standard deviation
- Addition: only episodes lasting at least 3 month

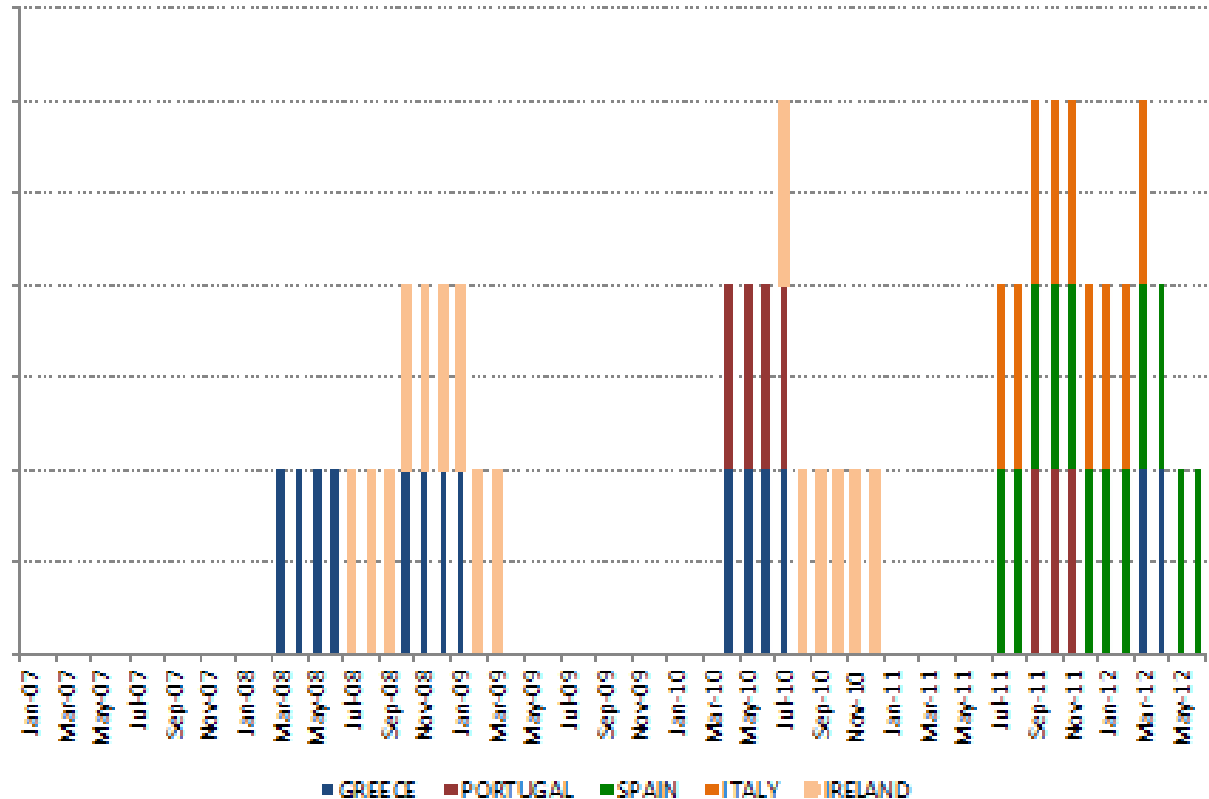


# Evidence of Sudden Stops

Three periods and evidence of contagion effects:

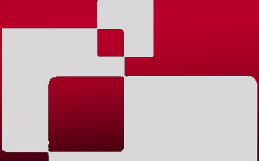
- Global financial crisis (Greece; Ireland)
- Greek Programme (Greece; Ireland; Portugal)
- Summer-Autumn 2011 (Portugal; Italy; Spain)

Public capital flows have substituted private flows

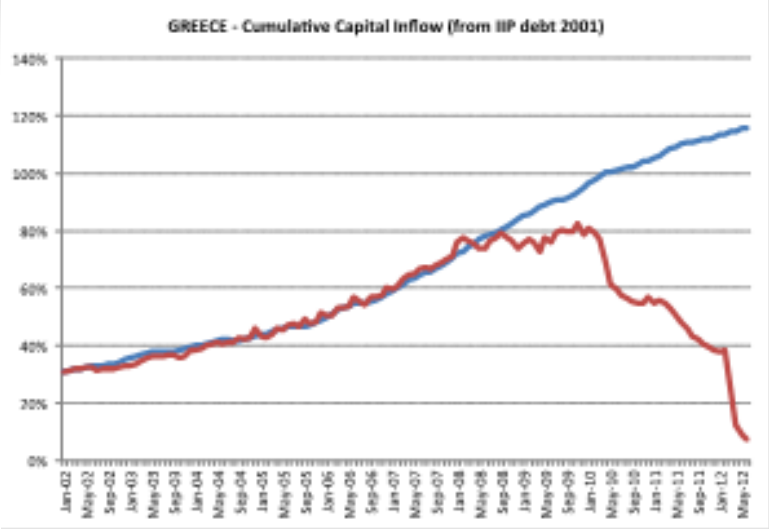


Source:  
Merler & Pisani-Ferry (2012)  
"Sudden Stops in the Euro area"



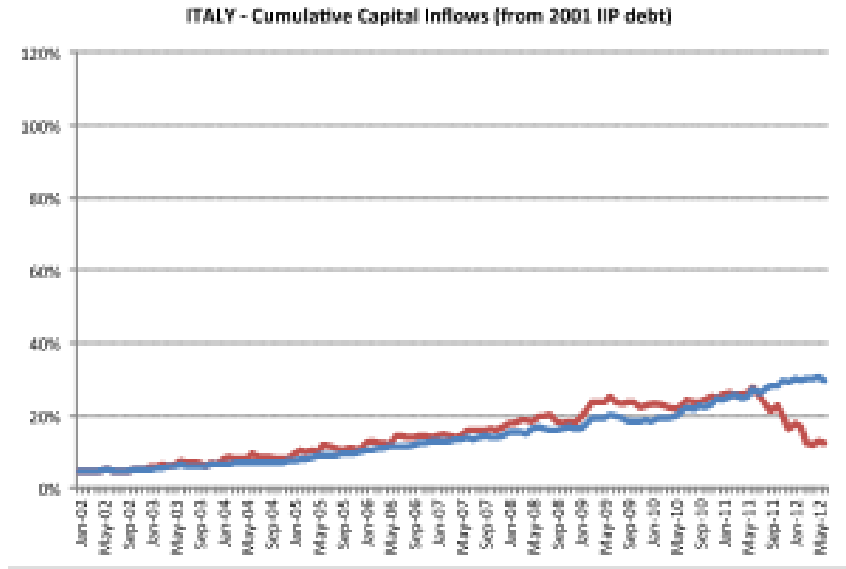
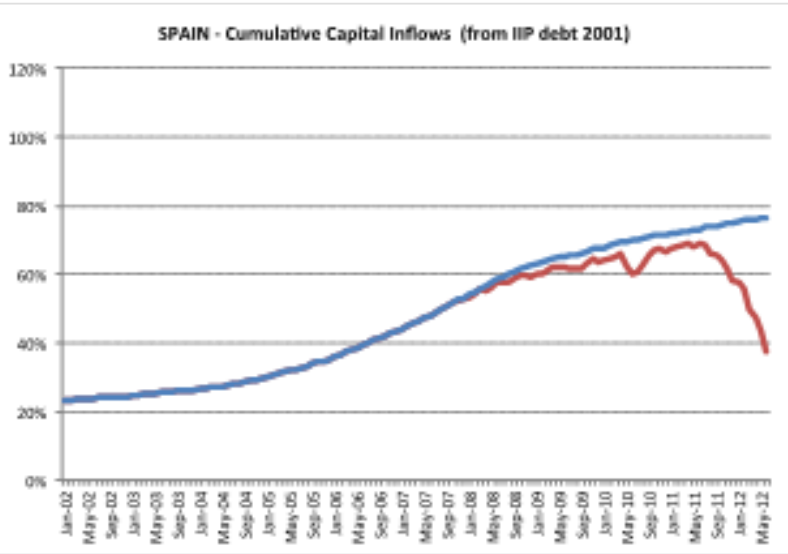
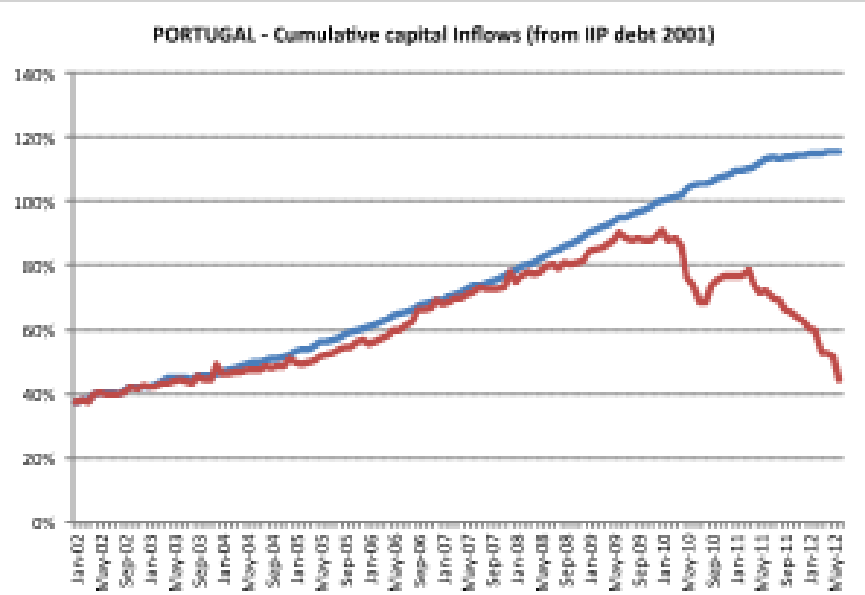


# Sudden stops: cumulative capital inflows by country



Total

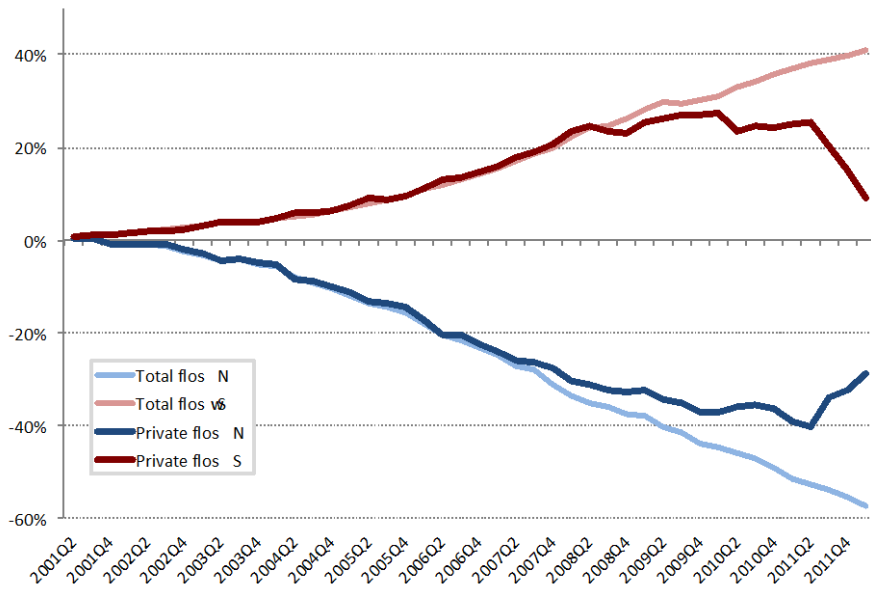
Private



# Capital flows

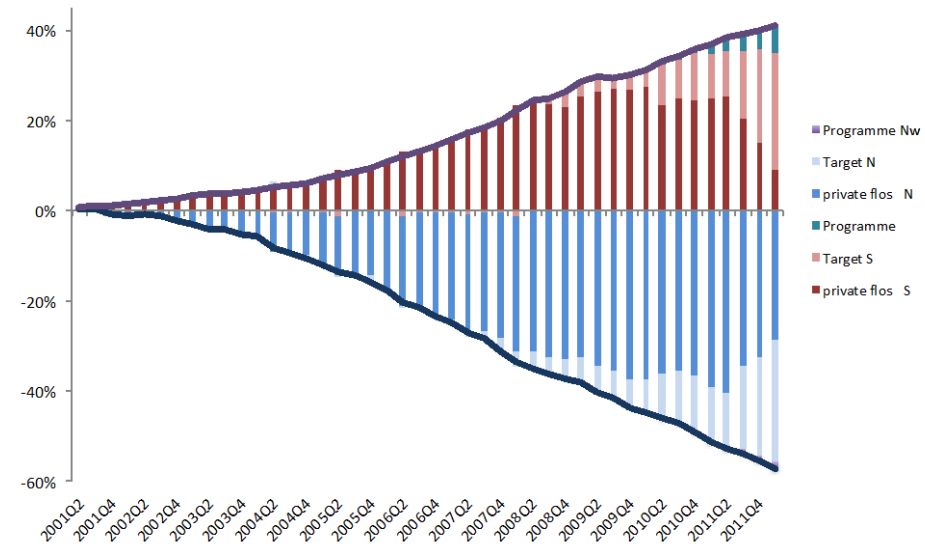
## Private and public flows

North-South-Centre capital flos



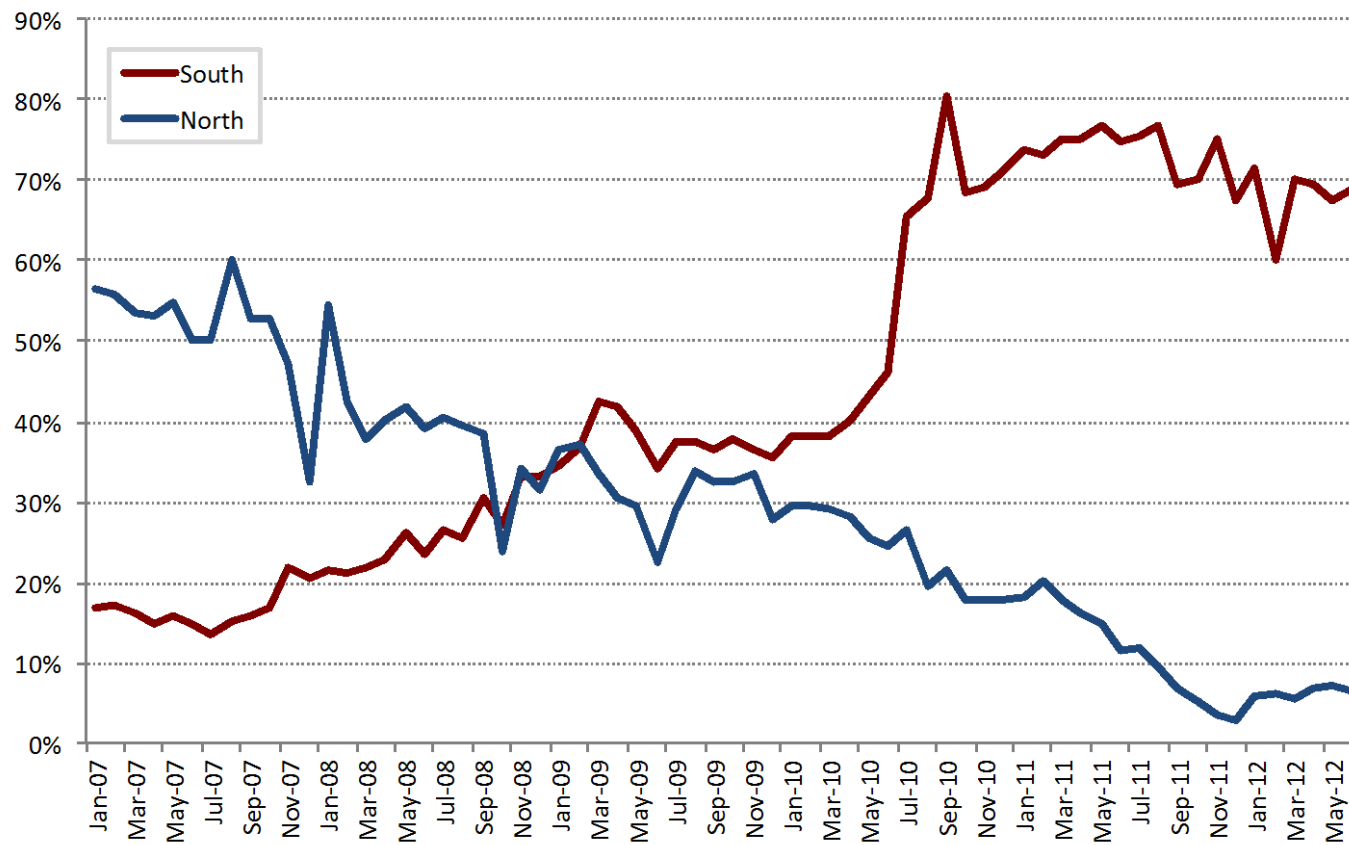
## Details: private flows, TARGET2 flows and programme flows

North-South-Centre components of capital flos



# Reliance on ECB liquidity

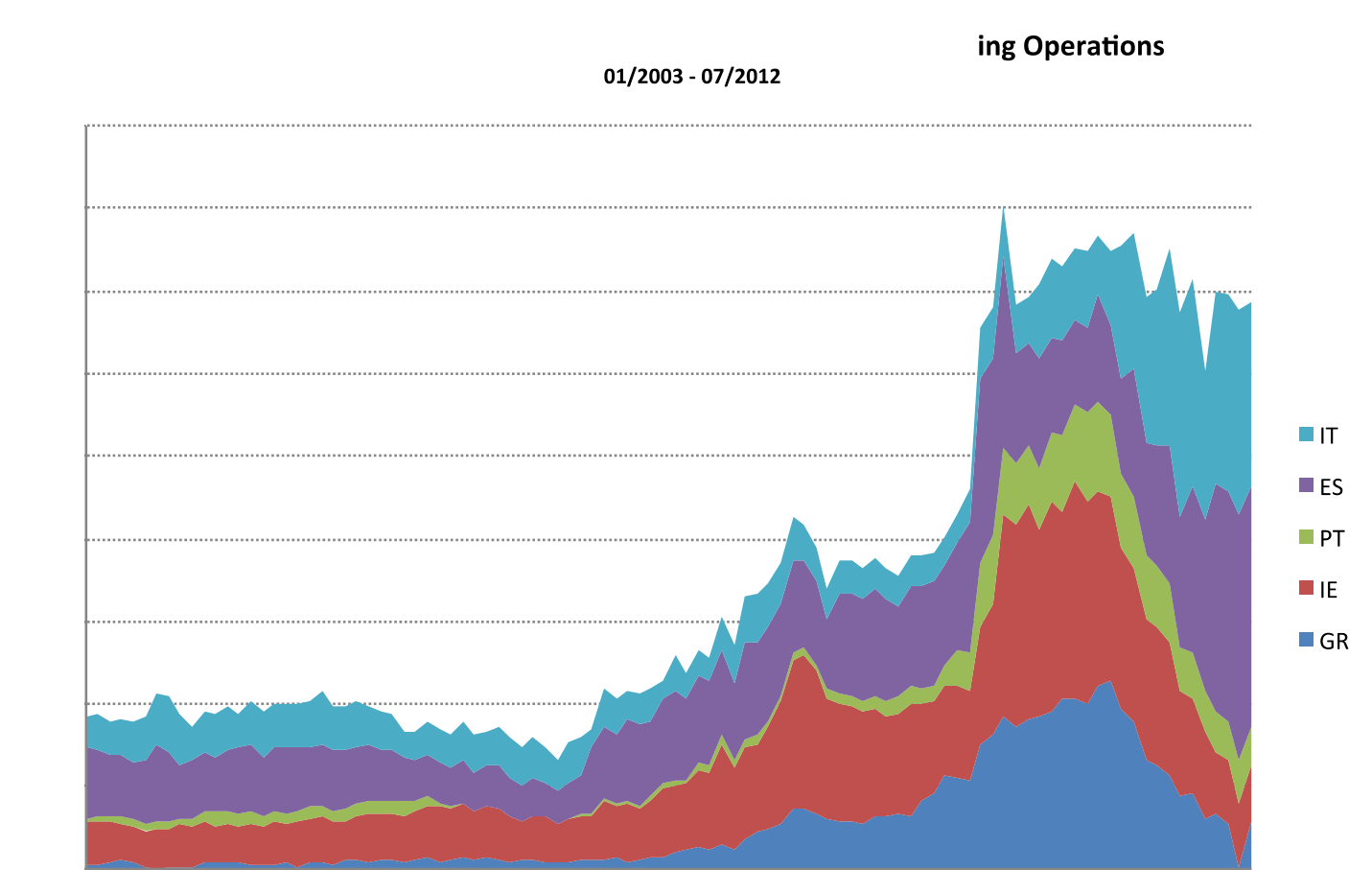
## Use of Eurosystem liquidity - North and South's shares



Source: National authorities

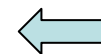


# Reliance on ECB liquidity



Source: National authorities

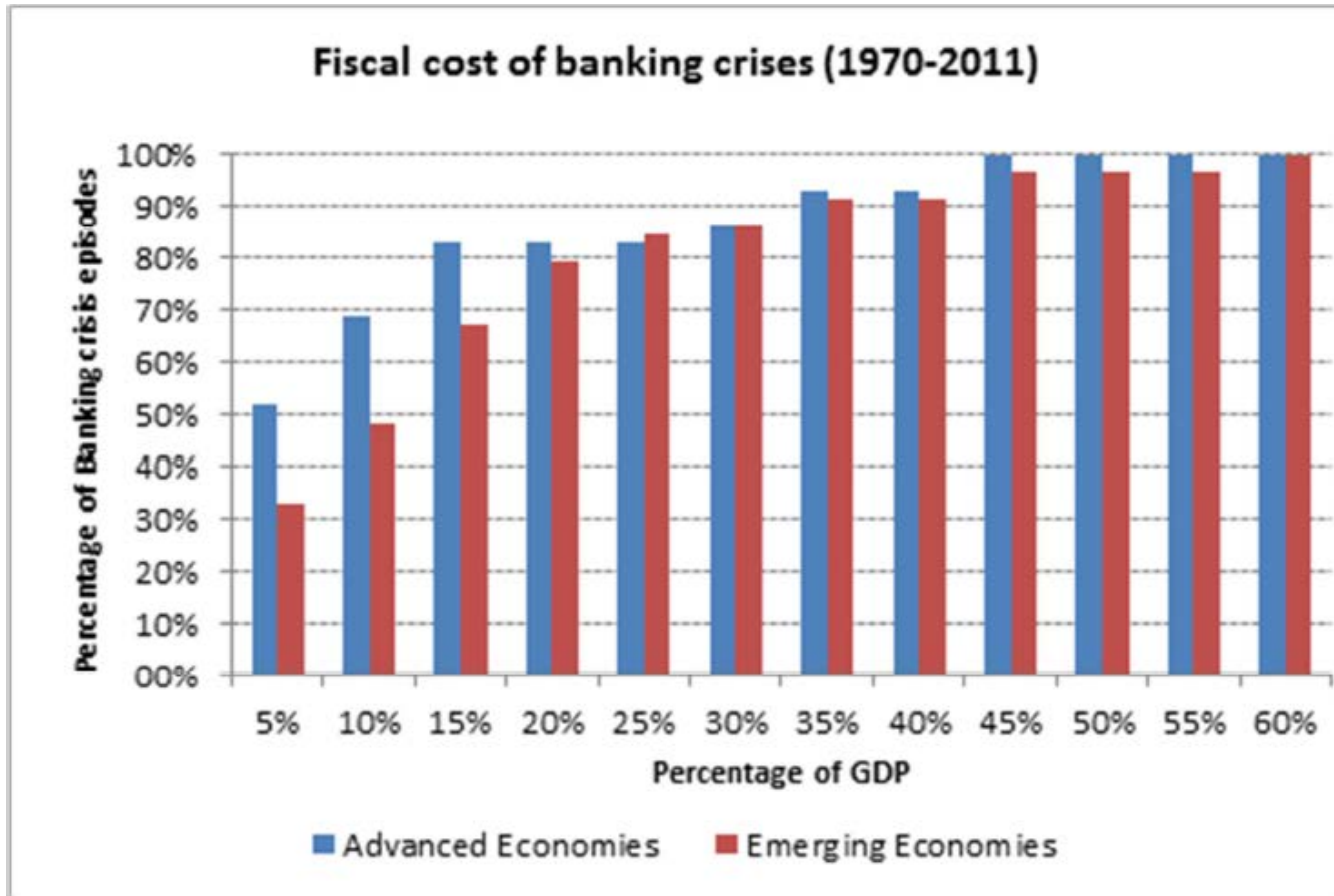
- Sudden financial arrest of intra-EMU financial flows
- Major financial disintegration in the making
- Ambiguous role of public authorities
  - Supervisors (e.g. BAFIN) are telling banks to limit cross-border exposure
  - But 100 per cent substitution through Eurosystem, programmes
  - Does not foster CA adjustment
  - Aggravates bank-sovereign loop





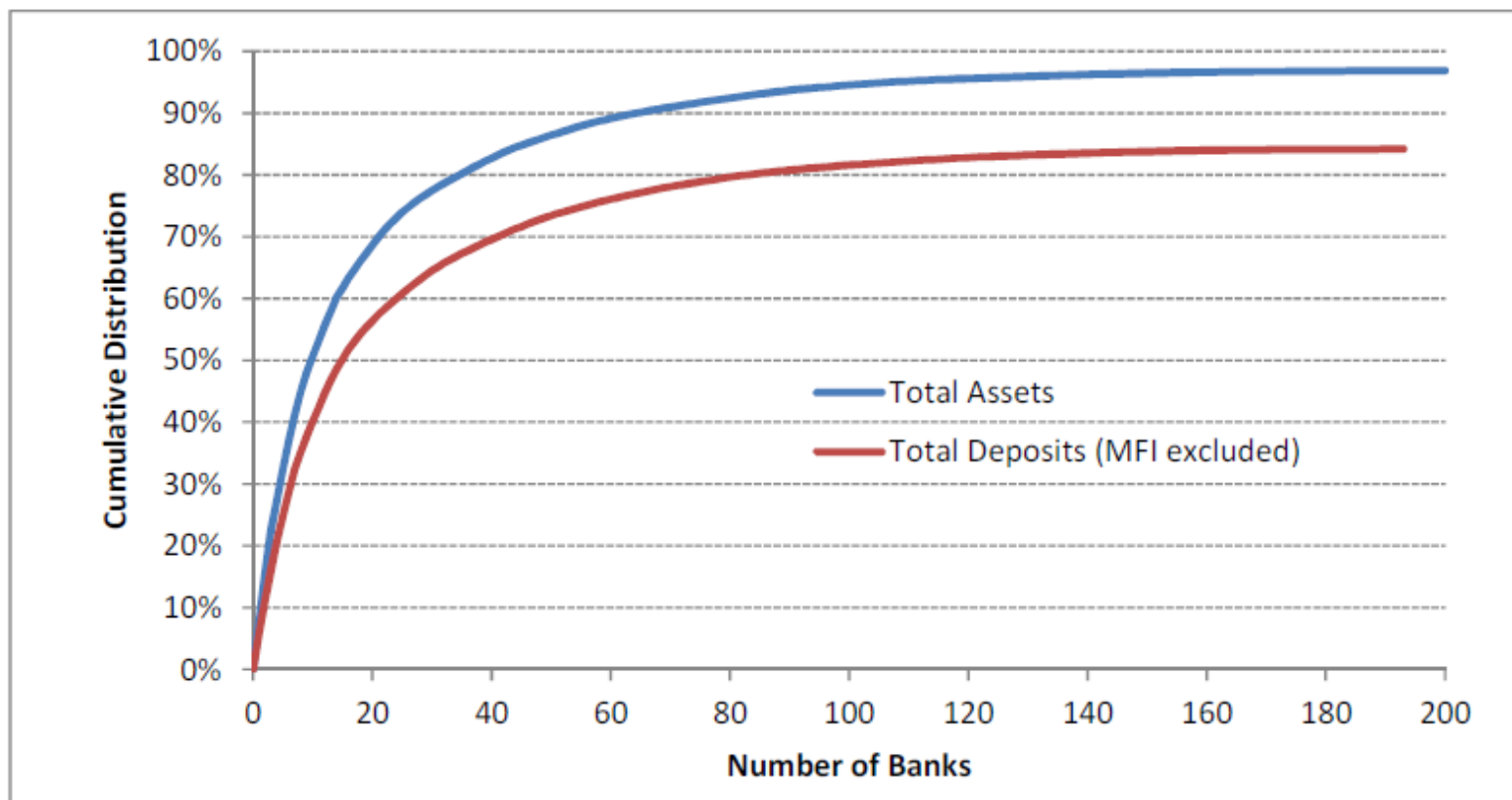
## **Appendix 3: Banking union**

# Cost of banking crises



# Supervision: how many banks?

Figure 2: Distribution by Asset and Deposit Size of the Euro-Area Banking Sector

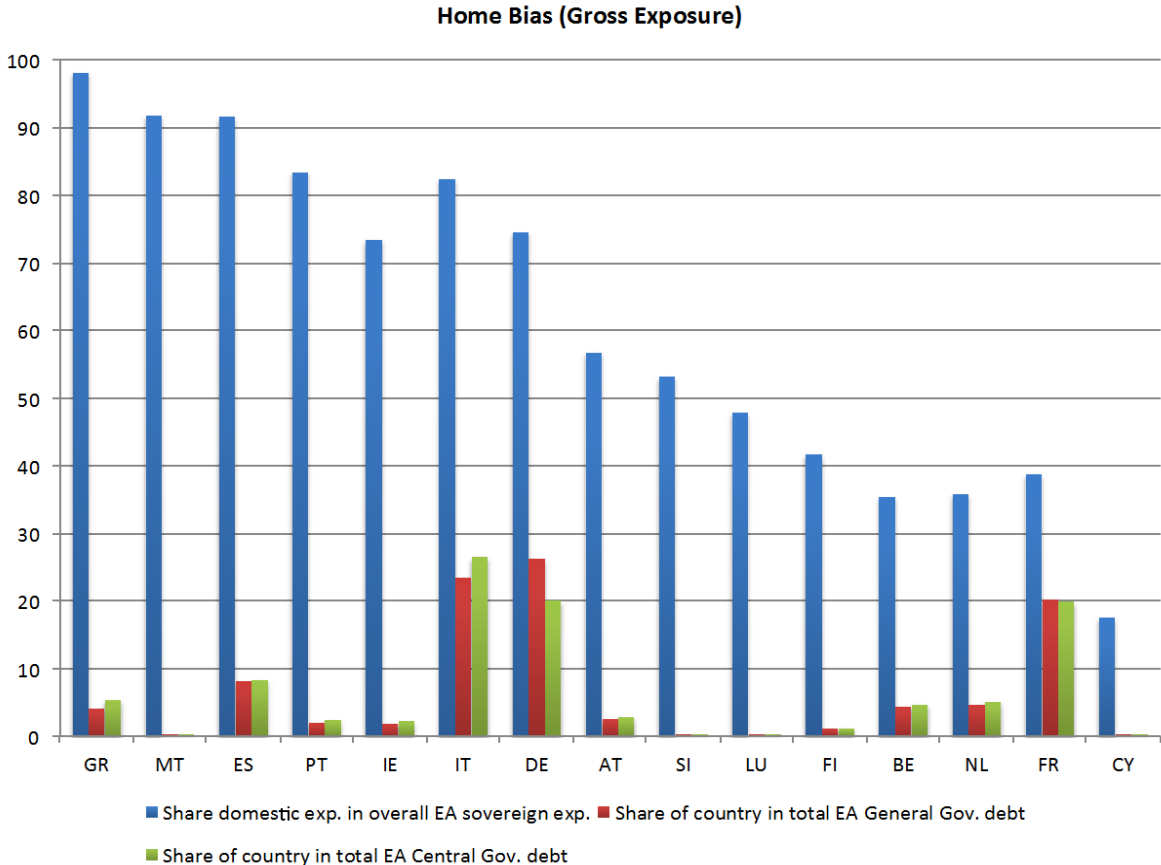






# Banks exhibit strong home bias in holding of govt bonds

## Share of own sovereign's bonds in EA government bonds held by banks, 2010

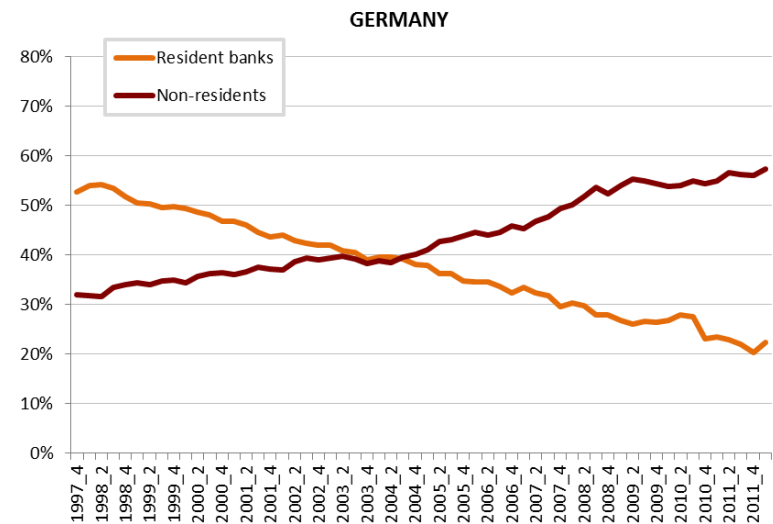
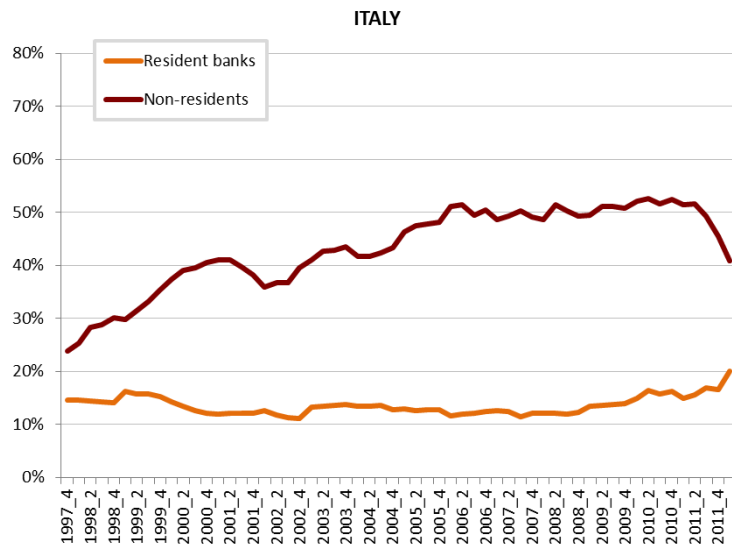
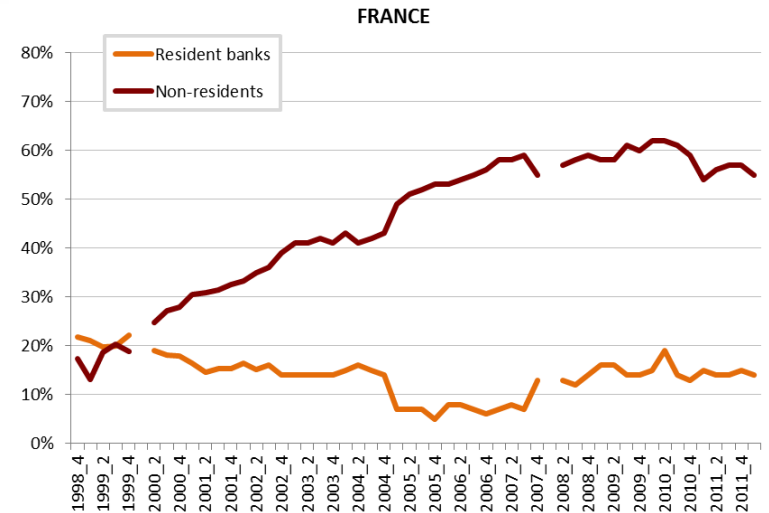
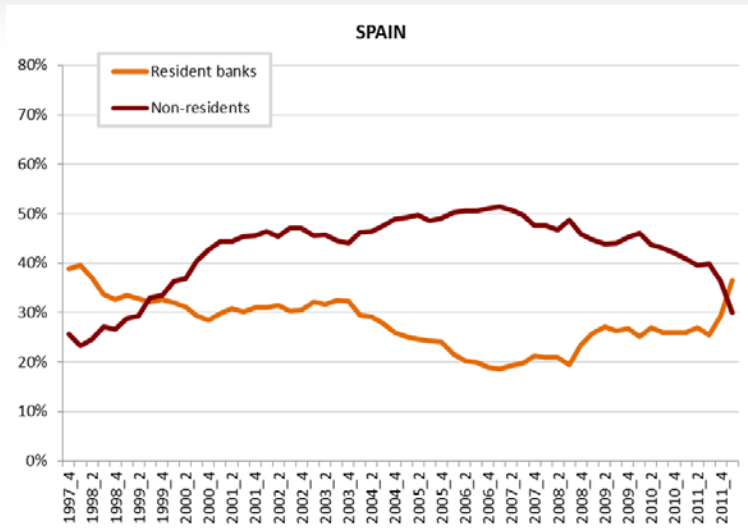


Source: EBA, EUROSTAT, Bruegel calculations

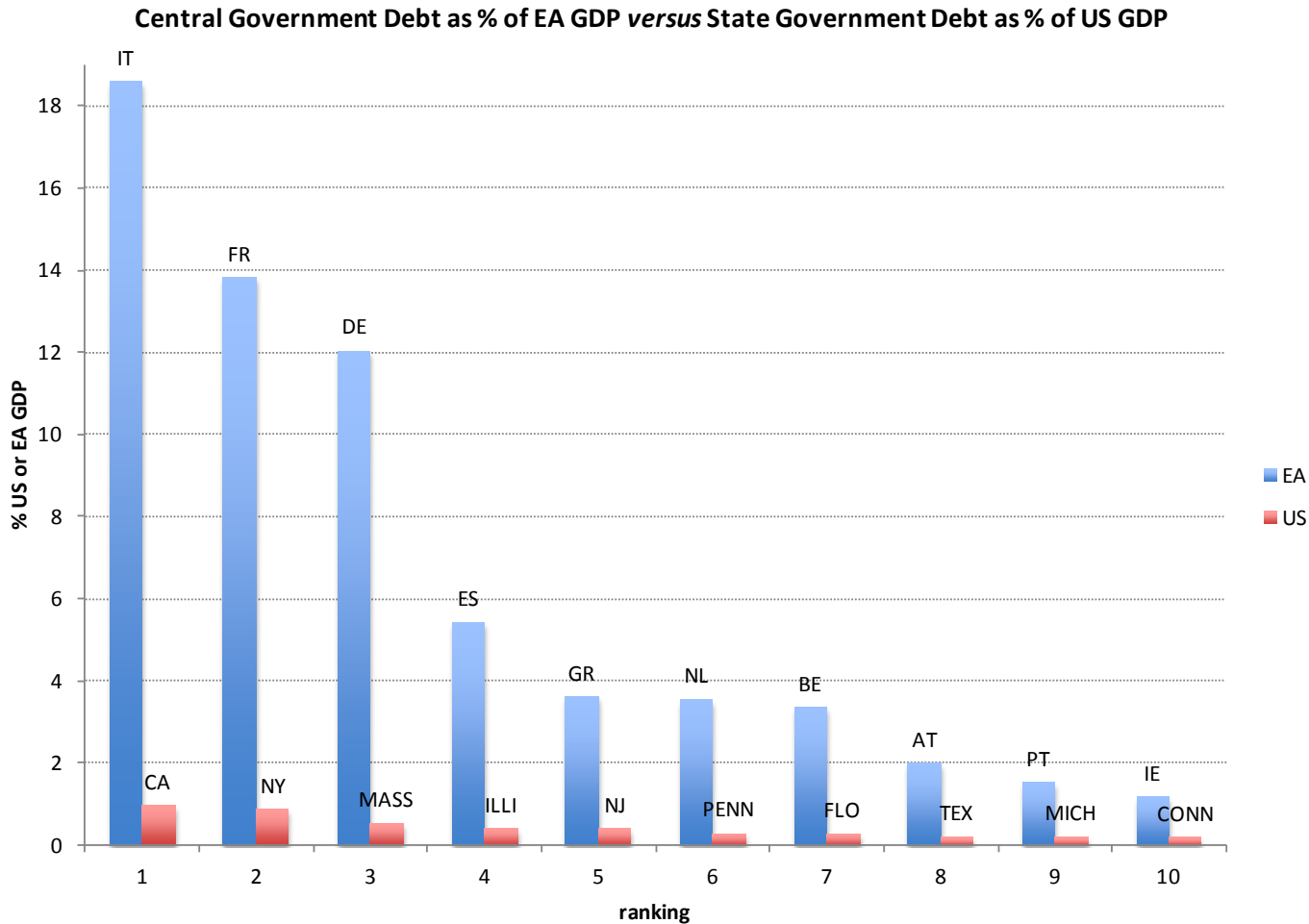
# Furthermore banks home bias increased as non-residents withdrew



## Shares of domestic banks and non-residents in holding of govt bonds, 1998-2011



Qualitatively the same as in the US..  
but not quantitatively



Source: Eurostat, US Census, Bruegel calculations

