BBVA | RESEARCH

Europe: Maastricht 2.0 and options for fiscal union

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Maastricht 1.0

Eurozone is NOT an Optimal Currency Area

Maastricht Treaty workarounds

No common fiscal policy
No bailout clause

Deficit (3%) and debt (60%) criteria to avoid excessive public debt

Markets should discriminate across debtors

Asymmetric shocks

Allow cyclical deficits (but below 3%)

Mobility of goods and capital, but not so much of labour

Rigidities in prices and wages

Countries to apply structural reforms and reduce rigidities (given the incentives of having a fixed FX rate)

Problems during the 1998-2007, hidden by growth ("known unknowns")

1) Deficit and debt **rules not fully respected**

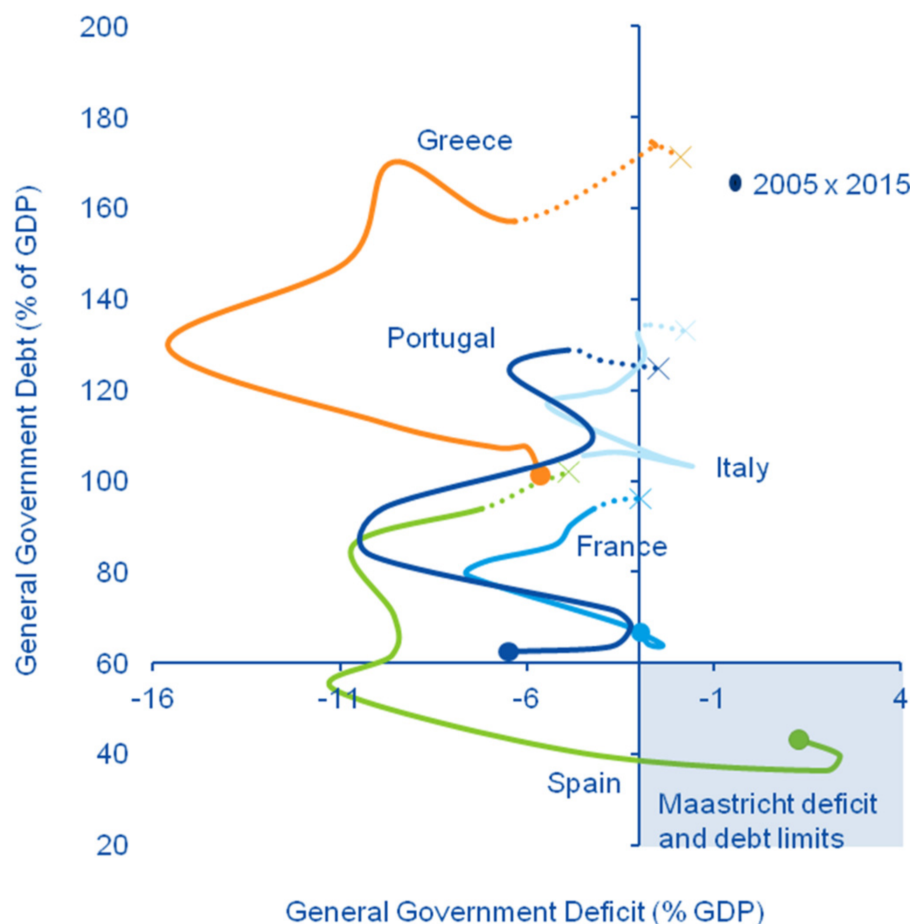
2) **Private and external debts built up**

3) **Few structural reforms**, with divergences in unit labour costs

4) **Markets did not believe the no-bailout clause**

Failure #1: Deficit and debt rules not fully respected

Government debt and deficit 2005-2015
Source: IMF



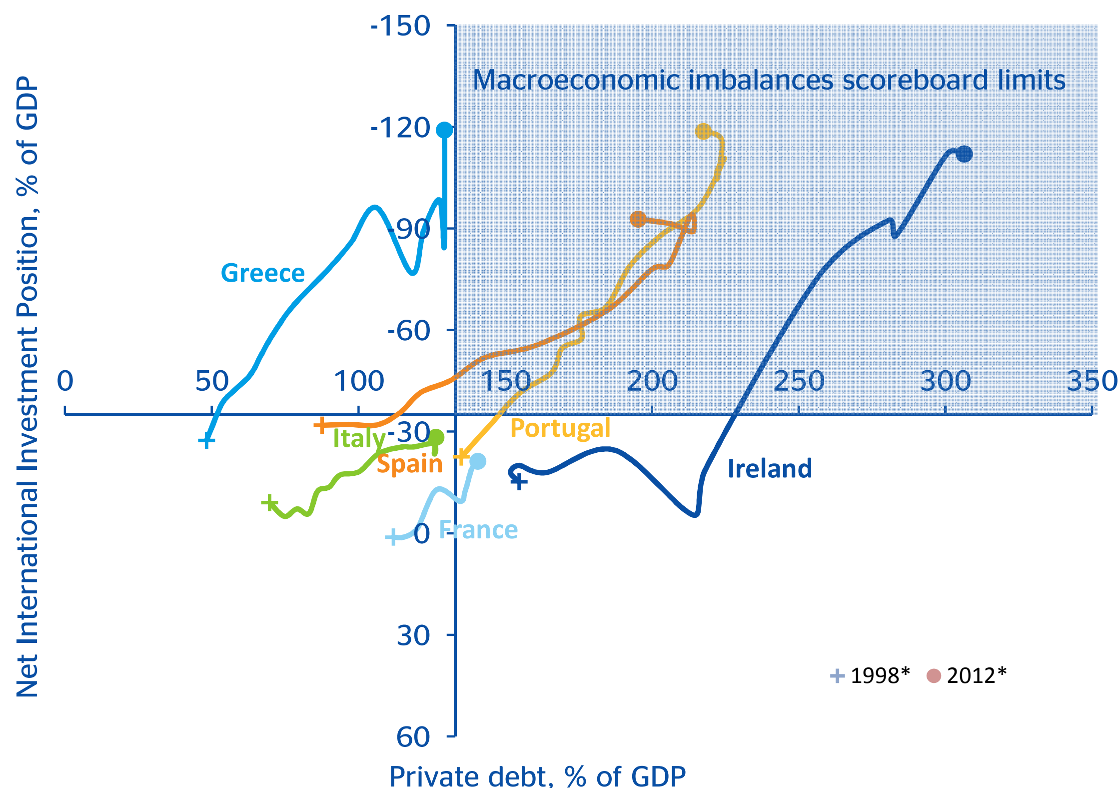
Deficit rules were breached, also by France and Germany

Deficits in general below the 3% threshold, thanks to good economic environment

But debt levels were not reduced below 60% in some countries despite the space to do it

Failure #2: Private and external debts built up

Private and external debt in the periphery
Source: Haver Analytics, Eurostat and BBVA Research



Initial interest rate shock created bubbles fuelled by private debt

External deficits not considered a risk at the time

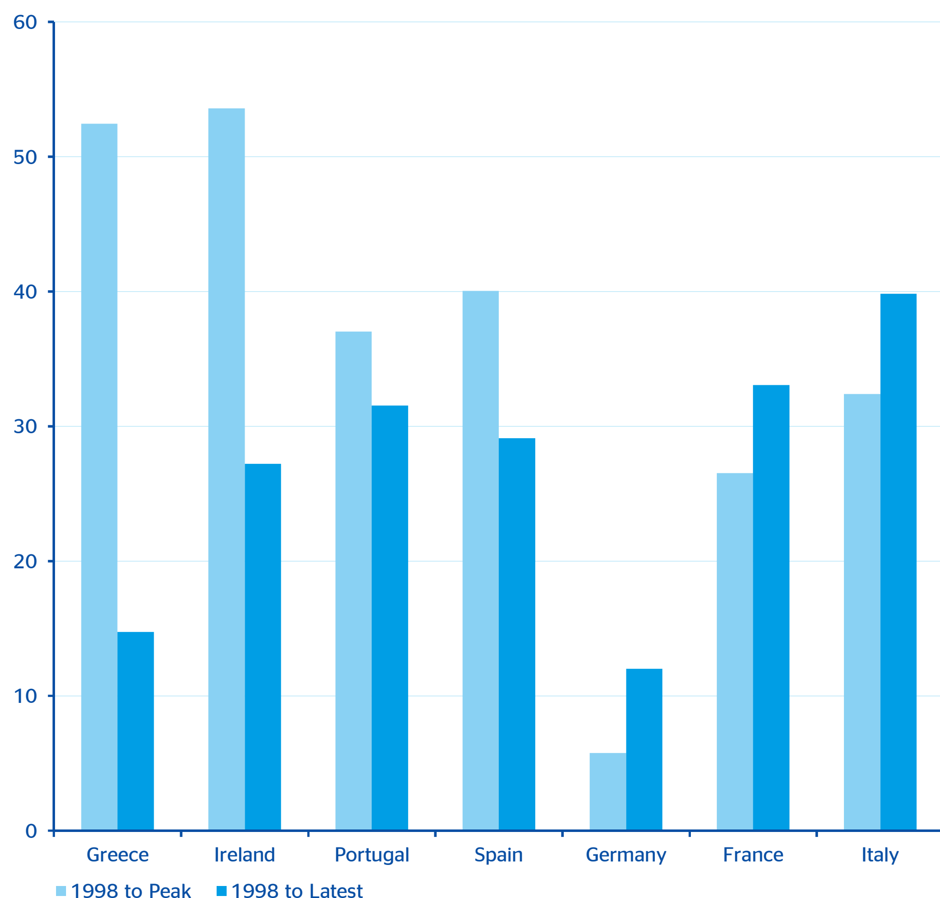
Maastricht had forgotten to control both external and private debt

Official limits by the EC:
1) Net foreign debt: 35% of GDP
2) Private debt: 133% of GDP

Failure #3: Few structural reforms, no closure of structural current accounts

Percentage change in unit labour costs since 1998

Source: Haver Analytics, Eurostat and BBVA Research



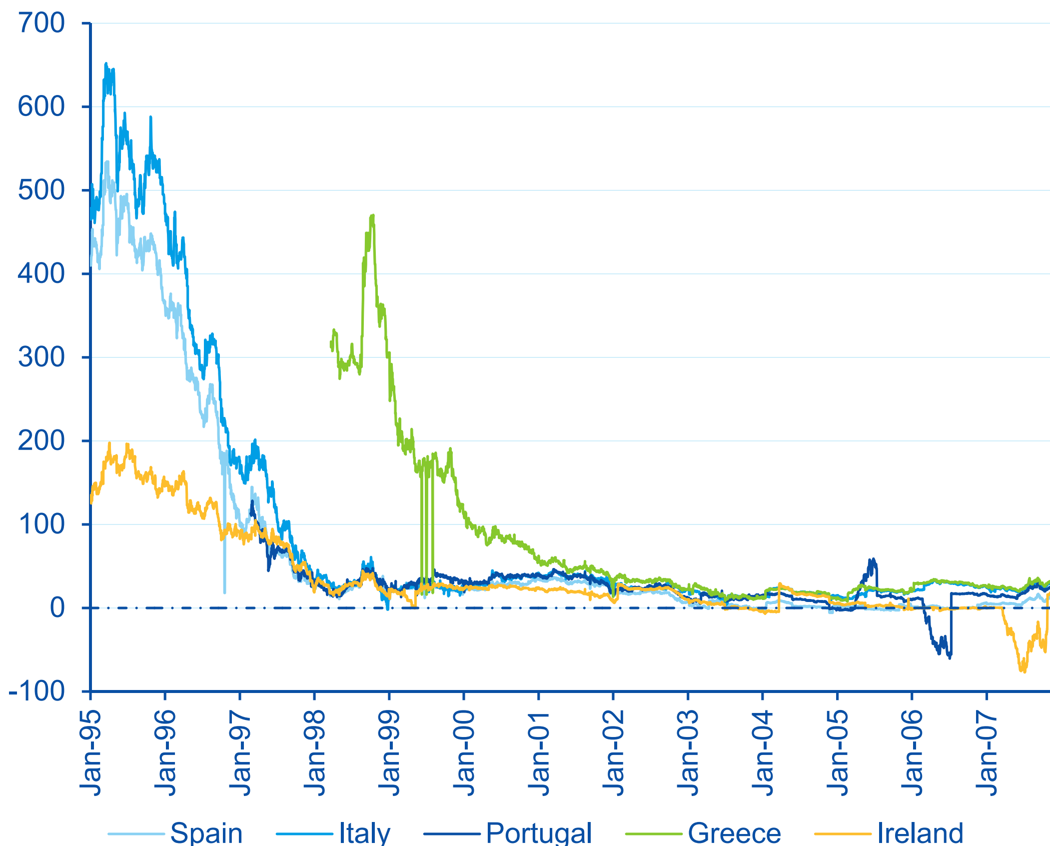
* Peaks are Q1-2010 for Greece, Q4-2008 for Ireland and Q1-2009 for Portugal and Spain. For France, Germany and Italy peak refers to 2010 since unit labour costs peak in the last available period.

Some reforms in some countries after the convergence period (Germany, Spain) but not generalised

Wage rigidities overall persisted with a perceived low cost

Failure #4: Markets did not believe no-bailout clause: no differentiation

10-year government spreads vs Germany 1995-2007
Source: Bloomberg and BBVA Research



No-bailout clause was key to force governments to keep house in order in the absence of a fiscal union

But markets did not differentiate across countries

1) They believed that ultimately "Europe" would bailout problem countries.
2) They were distracted by high growth
3) They did not really think it through

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New problems after the 2009-2013 crisis (“unknown unknowns”)

1) **Structural fiscal positions** turned out to be **much worse than expected**

2) High private and public debt hit bank’s balance sheets: **bank-sovereign loop**

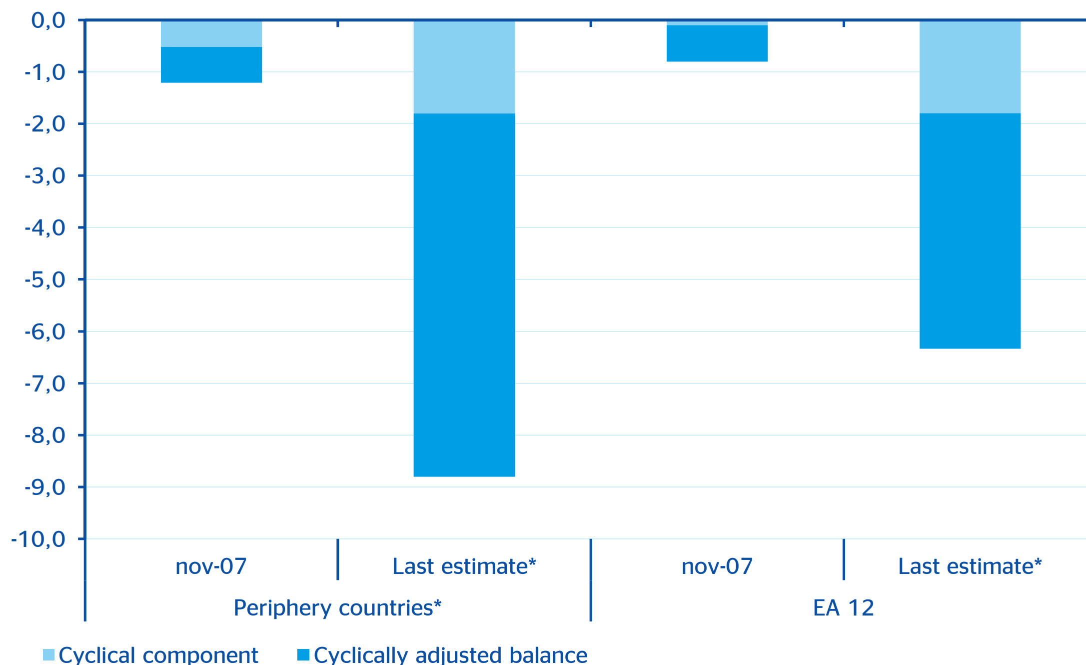
3) **Fragmentation** and **renationalization of flows,** in particular in interbank market

4) **Euro redenomination risk** shows up

5) **Market sentiment reversed**, possibly implying overreaction

1) Deterioration of fiscal positions

Estimate of the 2009 public deficit before (2007) and after the crisis (2014)
Source: AMECO



* Periphery countries includes Portugal, Italy, Ireland, Greece and Spain. Last estimate date is May-2014

Fiscal revenues that seemed permanent were of a temporary nature

In some cases, official debt levels also rose due to hidden past debt

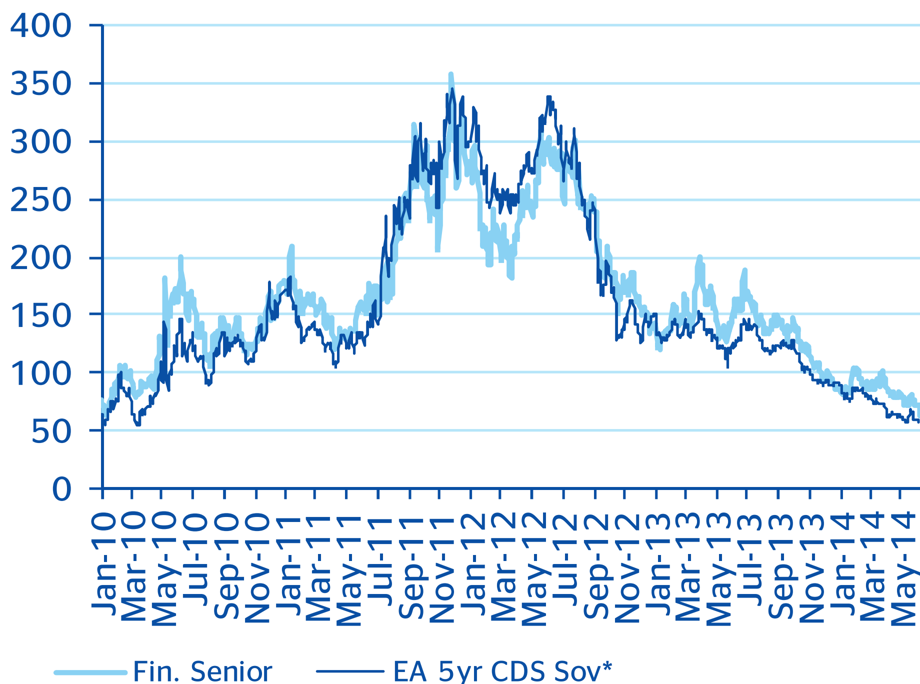
Problem: The structural fiscal deficit turned out to be much higher than what was believed before the crisis

2) Bank-sovereign loop

High correlation between bank and sovereign spreads

Bank and sovereign spreads in the eurozone (bp)

Source: Bloomberg and BBVA Research

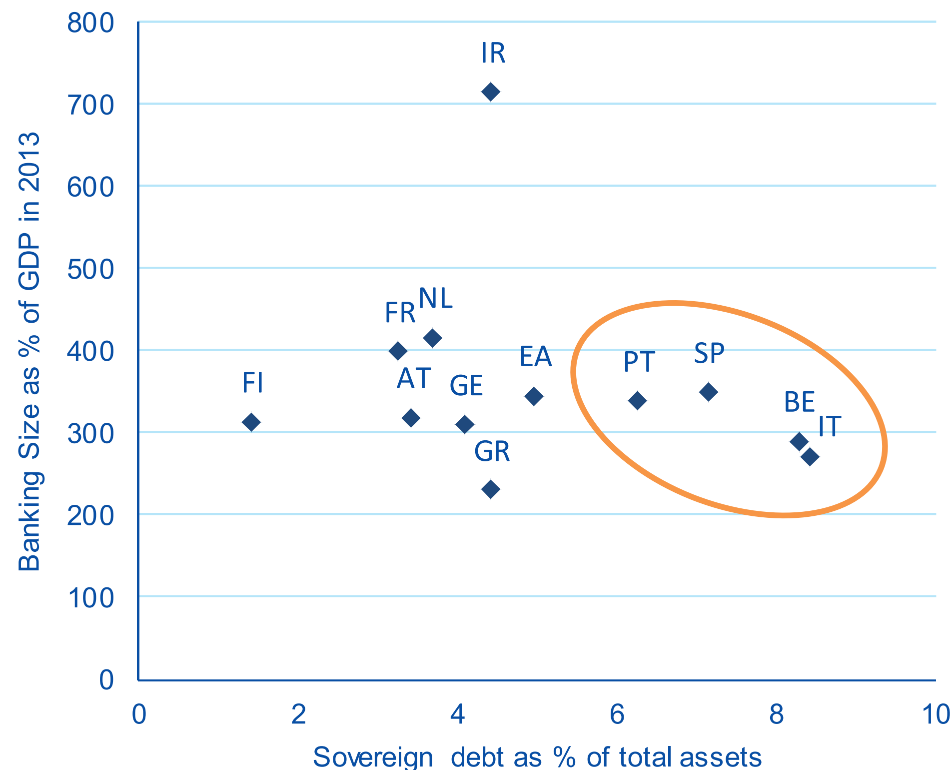


* EA: Weighted average (% debt of total EA debt), Greece is not

Unclear EU rules for bank rescues imply that what counts is the strength of the sovereign

Banking size and sovereign debt portfolio, 2012

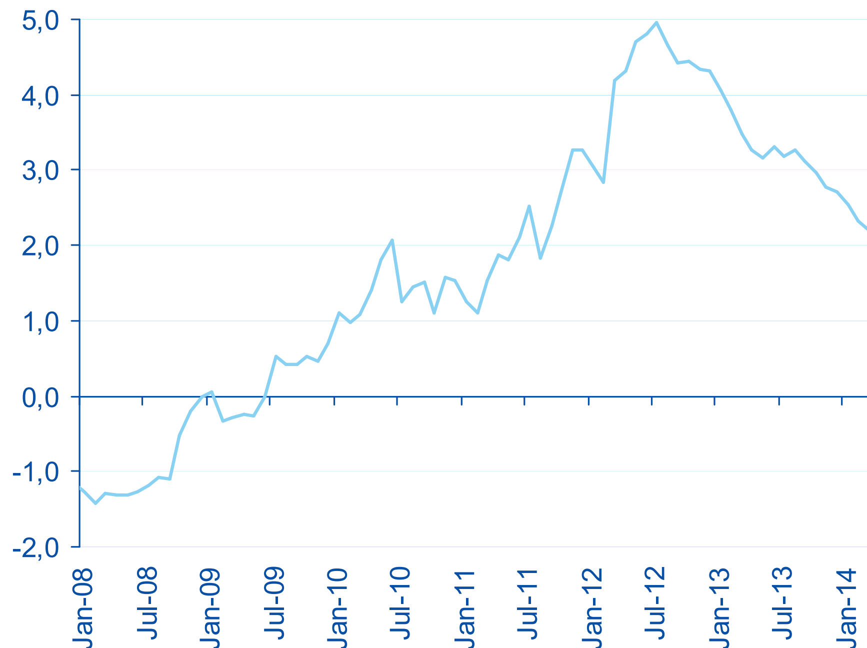
Source: BBVA Research



Problem: Doubts of sovereigns translated into a problem for banks and the negative feedback loop settled in

3) Fragmentation and renationalization of risk

Composite measure of EZ financial fragmentation*
Source: Bloomberg and BBVA Research



* First principal component of (i) the cross country dispersion (specifically, coefficient of variation) of bank lending rates to corporates and households (average) (ii) the Target 2 balances of surplus (iii) gross liquidity provision by Eurosystem as a share of bank assets and (iv) the interquartile range of Euro area countries' two-year government bond yields

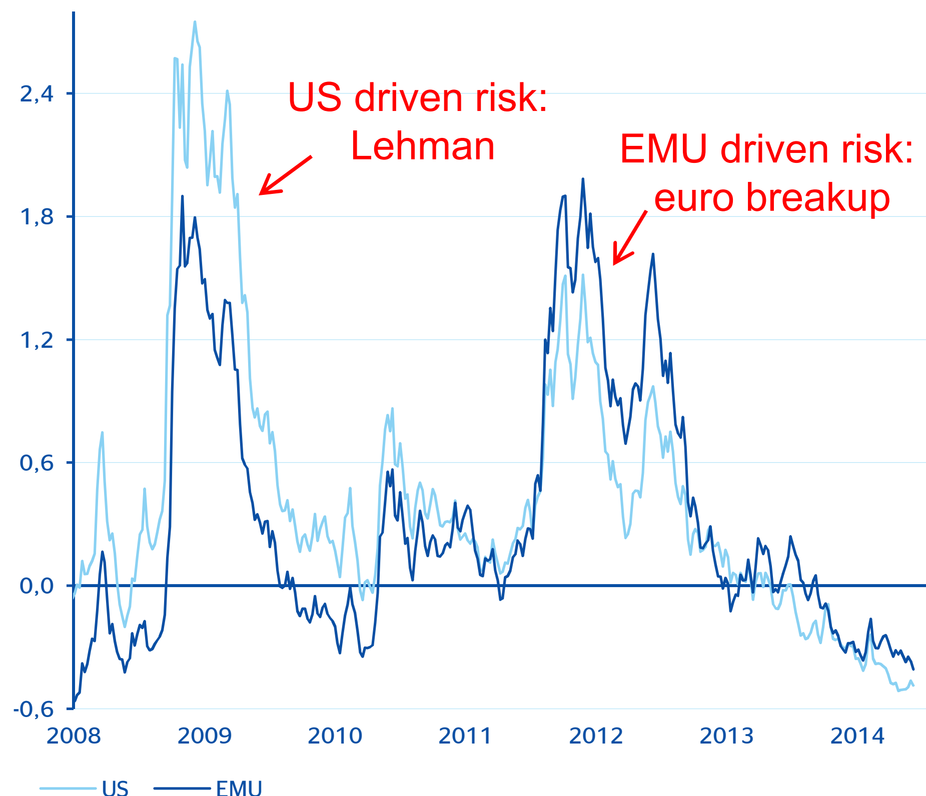
Cross-country interbank flows much reduced

Renationalization of risk

Problem: For equal risk there were differences in interest costs faced by firms based on location, against the logic of a monetary union

4) Euro redenomination risk

Index of financial tensions: US and EZ
Source: Bloomberg and BBVA Research



Bank-sovereign loops and recession-debt loops created the impression that the euro might not be sustainable

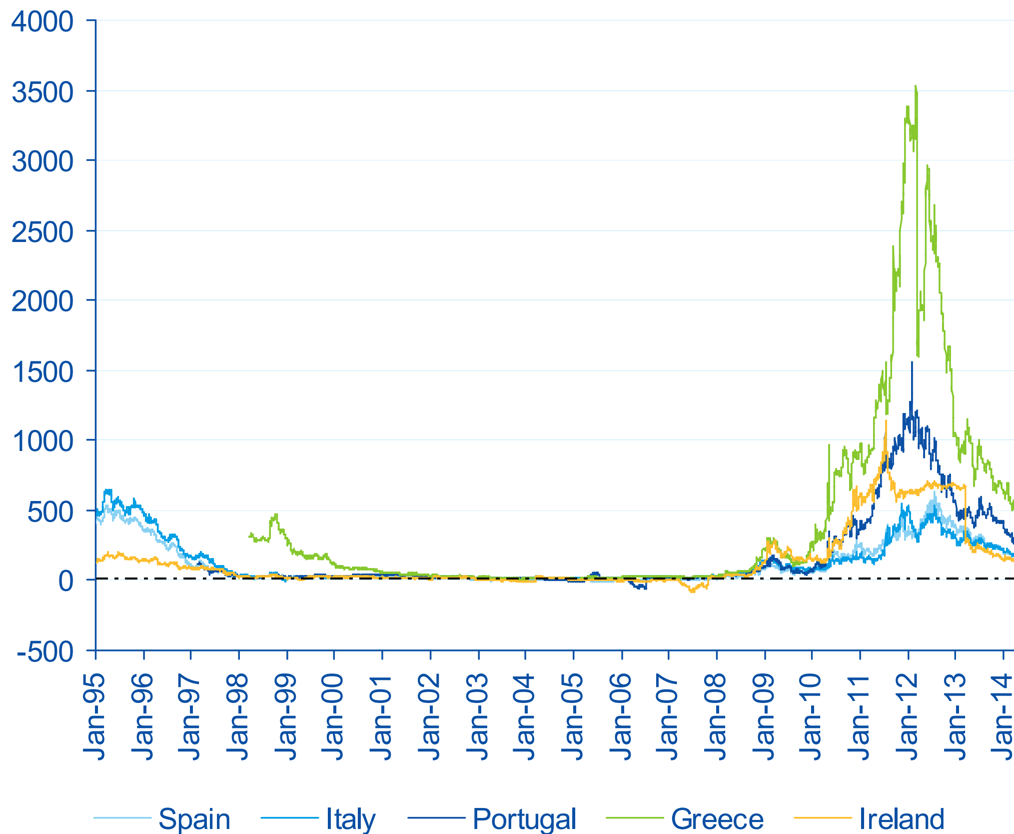
Initial decision not to bail out Greece at Deuville reinforced that sentiment

Contagion to the rest of the periphery, including systemic countries such as Italy and Spain

Problem: Sovereigns and private agents were paying a spread not only corresponding to their own fundamentals, but also to the perceived risk of an euro breakup, which by itself would lead to multiple defaults

5) Market sentiment reversed, perhaps too much

10-year government spreads vs Germany
Source: Bloomberg and BBVA Research



Spreads rose with the Greek crisis, and shot up when the possibility of PSI was apparent

The second recession reinforced the sentiment that public debts might not be sustainable

But spreads rose above equilibrium levels for some countries

Problem: The issues mentioned above plus the reaction of rating agencies and the interconnectedness of European economies derived in contagion, suddenly raising borrowing costs

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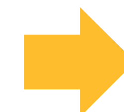
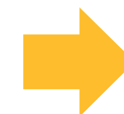
Reaction to the crisis: patchy and "late-night", with ad-hoc measures for each new problem

Potential imbalance or risk	New measures implemented during the crisis	
Public imbalances	Fiscal compact and six-pack and two-pack	
Private debt	Six-pack and macro-prudential measures	
External imbalances	Six-pack, structural reforms, troika programs	
Bank-Sovg loop	Banking union	
Fragmentation, renationalization	EFSF, ESM, LTROs, Banking Union	
Euro redenomination	OMT, Banking union	

Maastricht 2.0: The new setup seems workable

Main features	Evaluation
Banking union (with SSM and SRM) as the main instrument	Largest cesion of sovereignty since creation of euro
	No treaty change was required
	Mutualization is mostly private (banking sector); tax-payers' burden minimized
No-bailout clause	Seems contradictory. But PSI still possible. Bailouts only as last option, subject to conditionality
ESM for bailouts	
Implicit ECB backstop	Implicit role as sovereign lender if there is redenomination risk.
	Approval of OMT by European Court of Justice still pending
Fiscal compact and new monitoring architecture	Reinforced and expanded, but doubts that sanctions work

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Is the new setup sustainable? Two paths for action

1) Institutional instability:

Messy setup

- **All the new measures and institutions** are outside the Treaty
- The **exit of a country** is still possible, but the rules unclear
- The legal **status of OMT** needs to be clarified
- **Ambiguity on bailouts** (no bailout + ESM rescues)
- Complex relationship between **Eurozone and EU**

→ Treaty change?

2) Economic instability:

Monetary union is incomplete

- Is the **sanctions regime** strong enough to avoid future imbalances?
- **Legacy problem**: Are public debts too high?
- Is a **public backstop** necessary to complete **banking union**?
- Do we need an **asymmetric shock absorber** for future crises?

→ Fiscal union?

What features of fiscal union?

1) Common budget (meaning also revenues!)

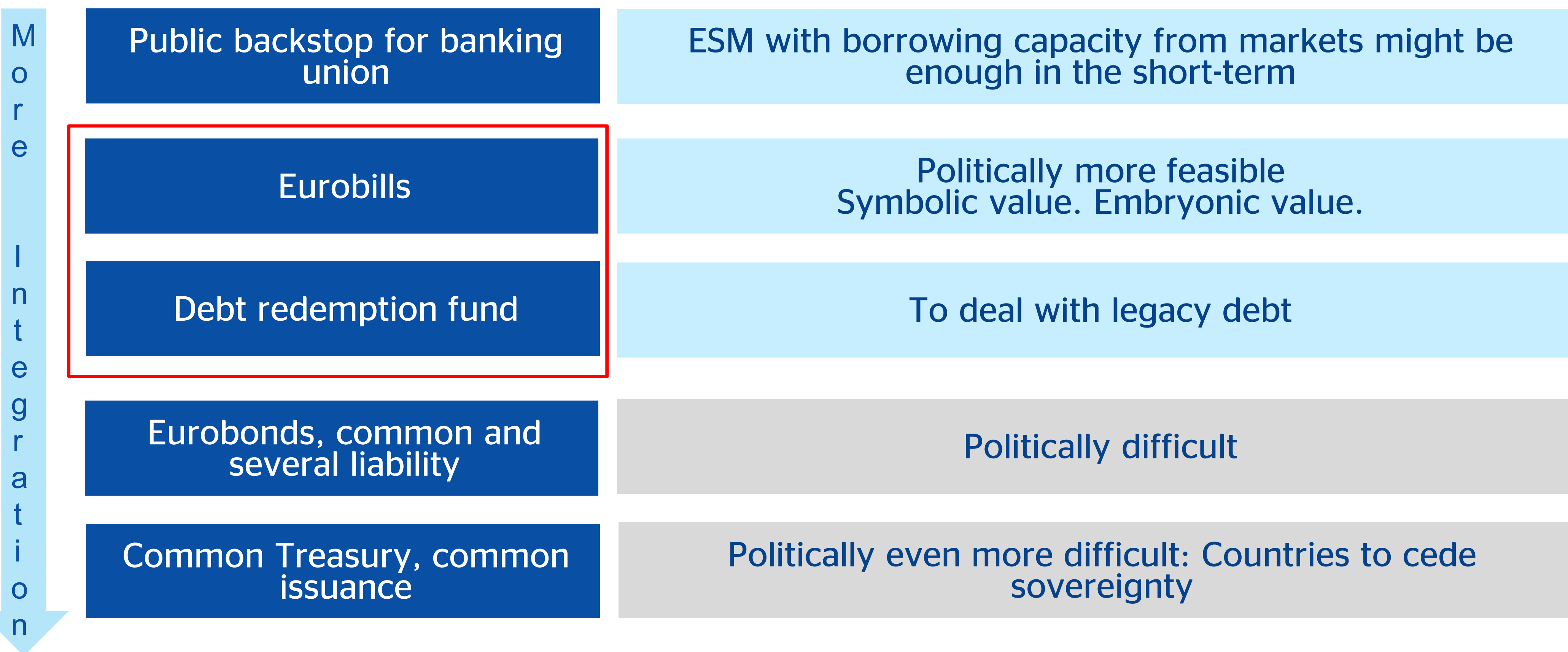
Equalization system	Politically difficult; it already exists at small scale (EU funds)
Small common budget to counter asymmetric shocks	For normal crises, current deficit rule is flexible enough. For systemic crises, it is useless.

2) Common independent fiscal authority

Common independent fiscal authority at EU level	It would help to avoid problems of hidden debt (Greece), unify methodologies for structural deficits, build institutional fiscal trust among members, etc.

What features of fiscal union?

3) Risk sharing, common instrument for monetary transmission



Eurobills: main features

Short-term bills with joint and several liability to finance European or national budgets

A safe a liquid asset

Limits the extent of mutualization in first years, but can grow up as confidence returns

Fiscal discipline:

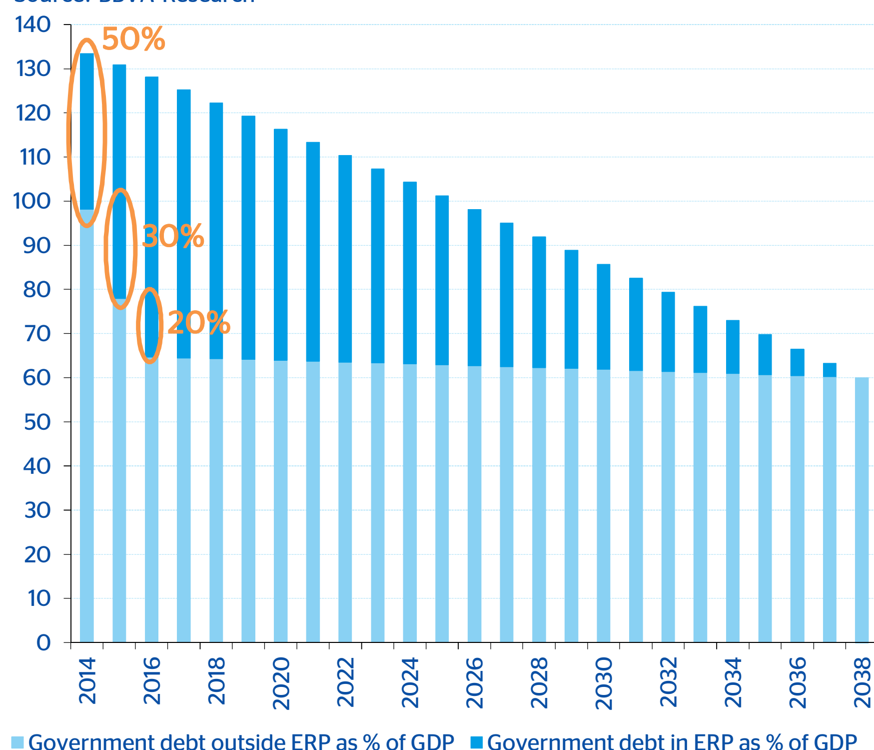
- Exclusion rules: It can be linked to fulfillment of deficit and debt rules
- Extra cost can be linked to fulfillment of fiscal targets

Can be implemented without Treaty change if are introduced as temporary, through combination of art 312 and intergovernmental agreement

Strong symbolic value

Only short-term term bonds, small quantities at the beginning

Debt Redemption Fund. How would it work? The case of Italy



Debt above 60% of GDP is transferred in three years into a European fund that would issue bonds…

… to cover refinancing requirements of participating countries

Countries enter into repayment obligations to repay its transferred debts within 25 yrs

Annual payment would bear the (lower) interest costs arising for the bonds issued by the fund and would also repay the debt

Debt redemption fund: main features

Temporary mutualization, not a permanent fiscal union

Introduces a mechanism to reduce high initial debt (legacy problem)

Complements the monitoring setup: strict rules, coordination and multilateral surveillance, avoiding moral hazard

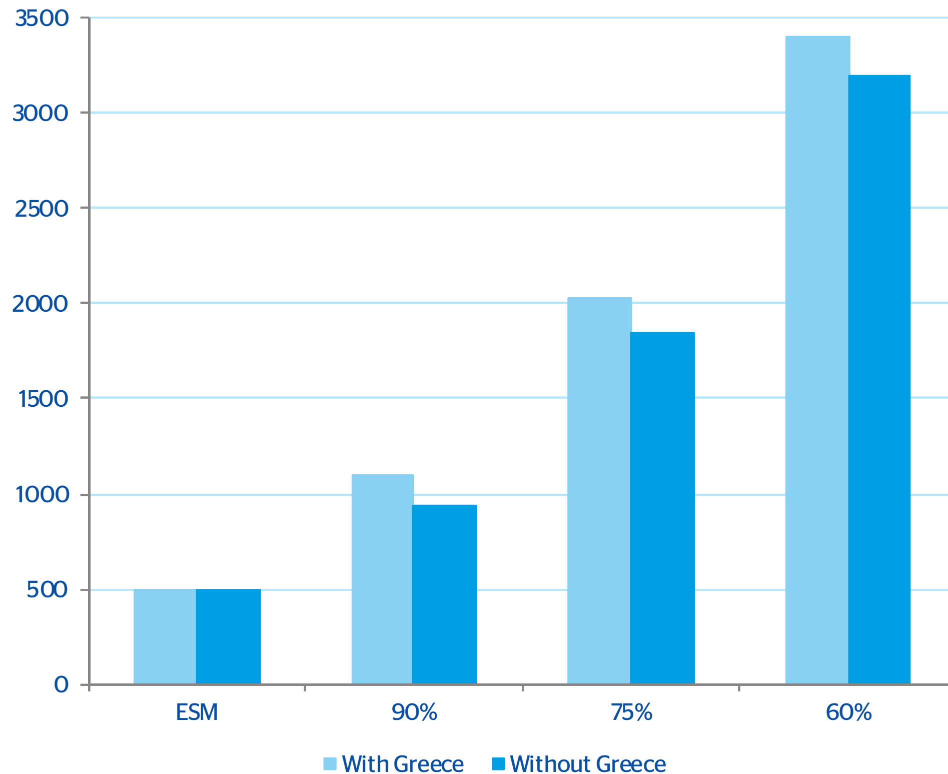
If countries respond to the fund's debt with joint a several liability, it requires a Treaty change

Lower interest payments for the country for the transferred debt

There is an European asset that can be used for monetary policy operations

Requires a compromise of high primary surpluses for many years (debt reduction), lacking flexibility

The fund size to reduce debt up to 90% is twice the current size of the ESM (500bn)



We consider all countries (also Ireland and Portugal) with debt above certain thresholds

Depending on the maturity structure and redemption payments, only a part of the fund should be guaranteed

Conclusions

1. The reaction to the crisis has created a **messy institutional framework** that should be reorganized, probably through a **Treaty change**, during the next 5 years.

2. **The new setup (banking union, reinforced imbalances monitoring, ESM) is probably sufficient to make the EZ resilient** in the absence of very large shocks

3. But **progress towards more integration,** especially fiscal integration, is desirable

4. Politically feasible options for moves towards a fiscal union include **Eurobills and/or a debt redemption fund**

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ICCBE, June 2013

Annex 1: Banking Union

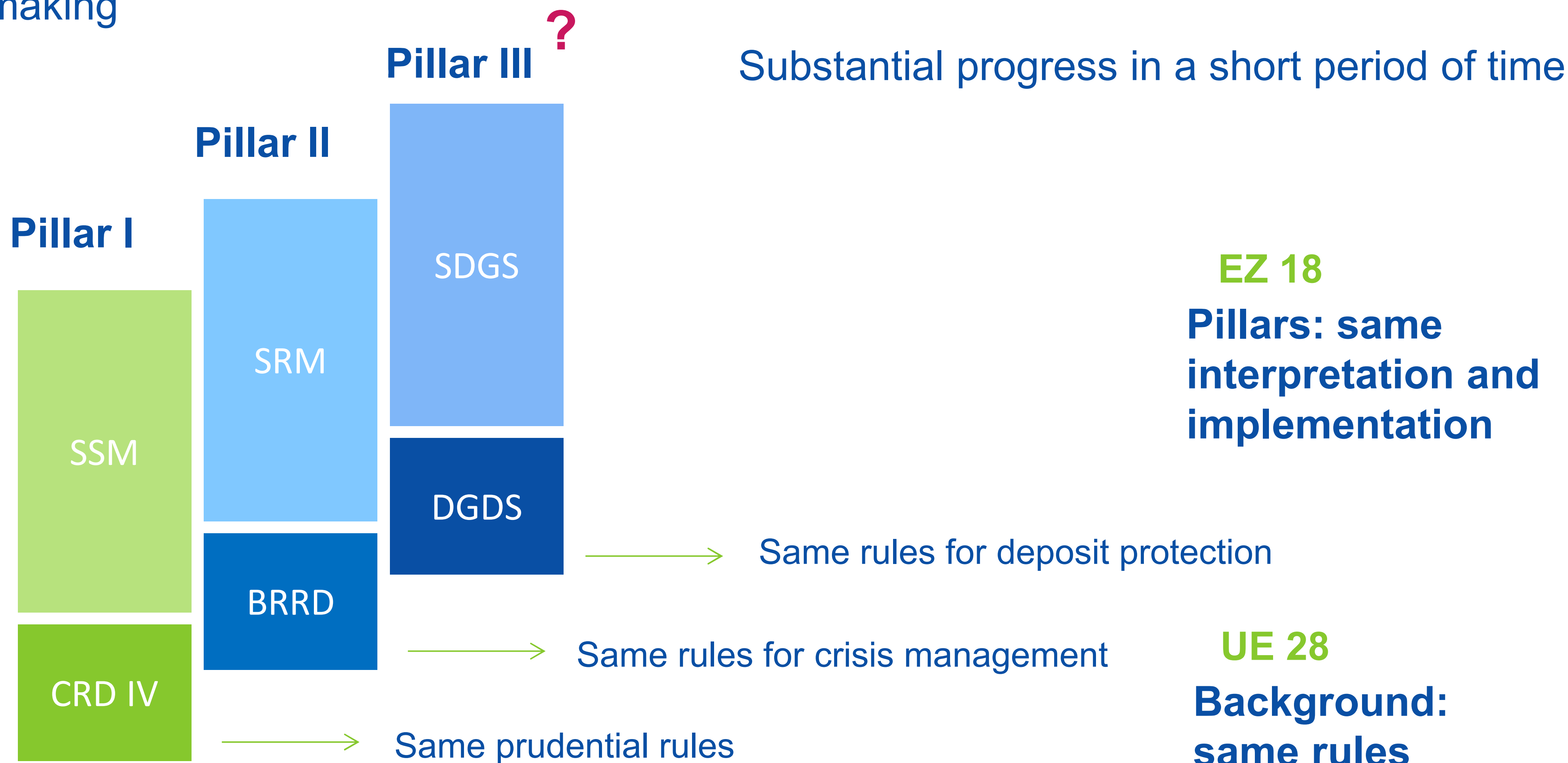
To what extent has the BU process made progress?

It will take time to break the vicious circle between banks and the sovereign, but we have already started……

It has contained the fragmentation process (building the required bridge to defend the euro)…	… but it has to be completed with a single deposit guarantee fund and a explicit fiscal backstop and move towards deeper economic, fiscal and political union
This project is not designed to solve and pay for the problems of the past, rather those of the future…	…but a definitive solution to the legacy problems has to be applied to restore confidence
The SSM is a game changer for banking supervisory culture and practice in Europe…	… but will have to set up a constructive relationship with third countries (home-host). The same challenge than other institutions, as in the U.S.
Under the SRM ailing banks will need to be resolved over a weekend with recourse to private funds	…but the uncertainty on the common public backstop must be dispelled (it will take time!)

The Eurozone needs to go beyond harmonization, it needs integration

Homogeneous criteria for supervision and resolution, with centralized decision making



The new framework for banking supervision in the Eurozone

From 04/11, the ECB will become legally responsible for nearly 6.000 banks

What for?

Unified interpretation and implementation of the new prudential rules (CRDIV pack)

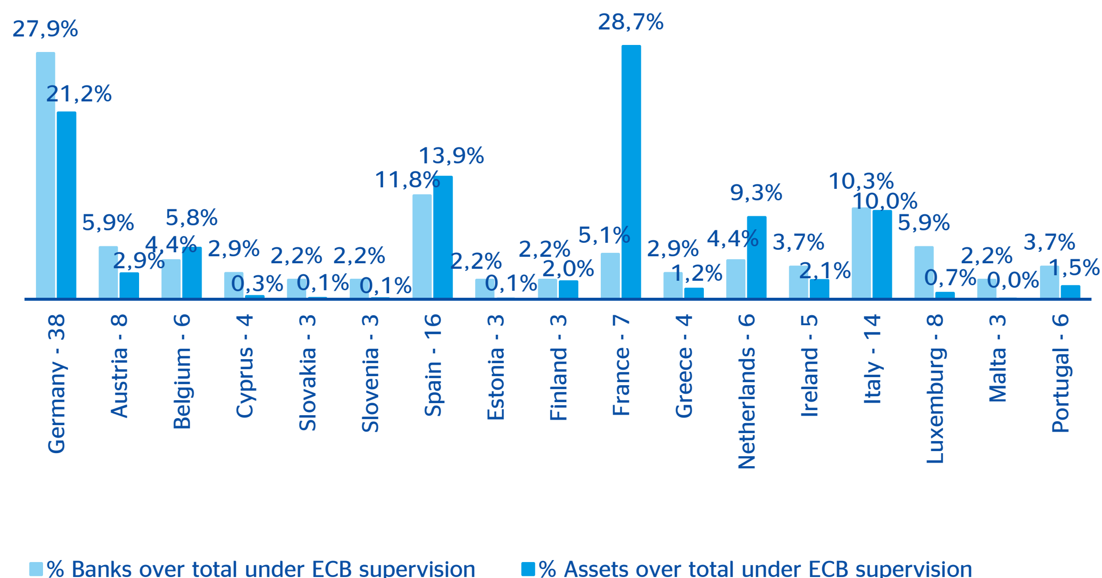
Put an end to national ring-fencing and forbearance practices

Increase confidence in the supervision of the European financial sector

Which entities?

ECB direct supervisory scope, by country

Source: BBVA Research and ECB



Why the ECB? Reputation, independence, knowledge, legal reasons

Single supervision: challenges ahead

Stages to complete, before being fully operational on November 4, 2014

1. **Single effective supervision:** develop a single book for supervision, establish the *Joint Supervisory Teams*
2. **Resources/appropriate tools:** budget (supervision fee) + recruitment (complete the hiring of about 1,000 skilled employees)
3. **Orderly transfer** of functions and knowledge from national authorities to the ECB
4. Ensure the necessary mechanisms for **adequate separation between prudential and monetary functions** within the ECB

A resolution equal for all banks in the Eurozone

From 01/2015, the Board will be responsible for nearly 6,000 banks

What for?

Provide the single supervision with a credible counterpart at the same level

Preserve the level playing-field by ensuring a uniform implementation of the EU bank resolution rules (BRRD)

Enhance cross-border resolution processes in the EU

Which entities?

- Directly supervised by the ECB
- Transeuropeans
- Requiring the use of the SRF

Direct resolution

- Indirectly supervised by the ECB
- No trans-europeans
- Not requiring the use of the SRF

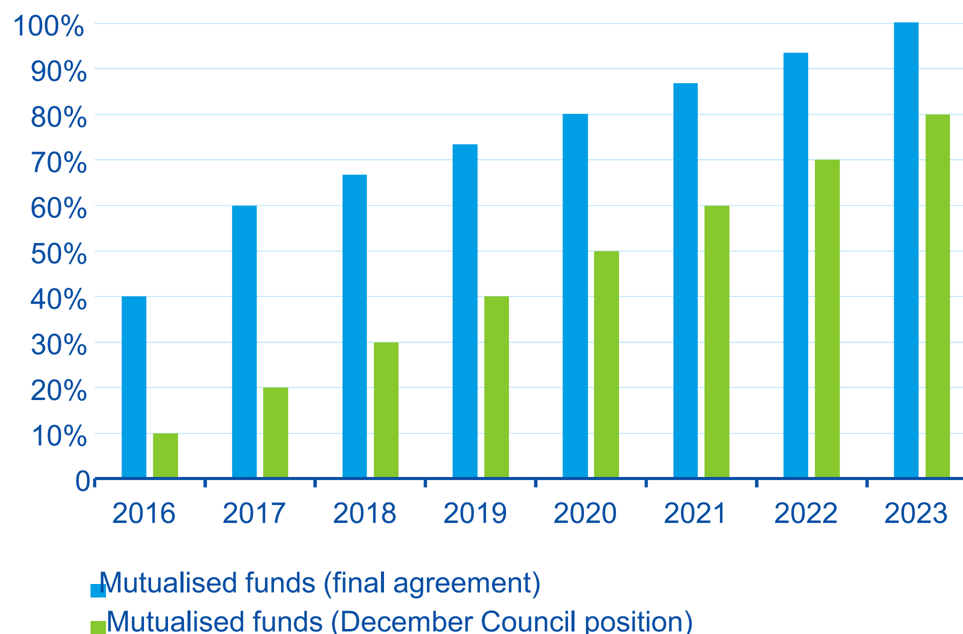
Indirect resolution

New framework to finance banking resolution

The IGA defines the use, transferences and mutualisation of funds

Use of the Fund (2016-2023)

1. Affected compartments
2. Mutualised funds of all compartments of the Fund
3. Remaining funds of affected compartments
4. Ex-post contributions
   Loans between compartments
5. Borrowing capacity of the SRF



A single private fund from 2016, to reach €55 Bn in 8 years

Single resolution: challenges ahead

The agenda for the coming months is very ambitious

1. It is necessary to **complete the legislative process** to establish the Single Resolution Authority as soon as possible. Recruitment of 200-300 FET of staff.

2. **Set the Board** and management provisions necessary for the first step. Establish **fees to cover SRM administrative costs** and collect them before 2015

3. Develop and adopt, before 2015, **the methodology for contributions** to the national fund (2015) and the Single Resolution Fund (2016)

4. Throughout 2015, complete the construction of the SRM (**public backstop for the single Fund**) and prepare to take on **resolution functions** in January 2016

Annex 2: European elections

Election results: anti-system parties up, but mainstream keeps majority

Europe	2014		2009	
Party	Votes %	Seats (Total 751)	Votes %	Seats (Total 766)
EPP (Centre-right)	28,4	213	35,8	274
S&D (Centre-left)	25,3	190	25,6	196
ADLE (Liberals)	8,5	64	10,8	83
	7,1	53	7,4	57
CRE (conservatives)	6,1	46	7,4	57
GUE/NGL (Left)	5,6	42	4,6	35
EFD (Nacionalist right)	5,1	38	4,1	31
Not attached members	5,5	41	4,3	33
Others	8,5	64		
PPE+S&D+ADLE	**62,2**	**467**	**72,2**	**553**

Ger=65
Ita=47
Fra=40
Spa=33

Ger=77
Ita=63
Fra=49
Spa=46

Anti-establishment parties are very heterogeneous.
Victories in France, UK and Greece

The three mainstream parties keep 62% of votes and seats: EPP and SD get 54%

Among mainstream parties, Germany and Italy gain influence

Implications for European agenda

The weakening of the mainstream implies more difficulties to approve decisions and and to influence Commission and Council's politics

France loses influence against Germany and Italy

Italy and France will likely press for more EU-wide investment, for helping youth unemployment and perhaps for a slower fiscal consolidation. Germany could agree on the first two.

Elections make it easier to focus more on consolidating what already XXX. In 4 years time, there will be a serious debate on the road map: more weight to the European Parliament or a union based more on national criteria (attention to measures such as Schengen)

Transnational commercial agreements such as TTIP will be more difficult for the strong opposition of emerging parties.

The UK is becoming even more eurosceptic.

Implications for individual countries

Country	Implication
France	Far-right (25%) beats centre-right (21%) and centre-left (14%)
Italy	Huge victory of the centre-left (41%) defeating Grillo (21%). Government strengthened to implement structural reforms and ask Europe for less contractive policies
Germany	Emergence of anti-euro party (8%). The difference between CDU and SDP is maintained
Spain	Government party wins elections despite the crisis, but both mainstream parties get less than 50%. Emergence of new anti-establishment party on the left
Greece	Anti-establishment Syriza wins, but not with enough strenght to call early national elections
Portugal	Opposition socialist party beats government coalition, but with less margin than expected

Annex 3: Proposals for Eurobonds

Proposals for Eurobonds

Proposal	Description
Eurobills (Hellwig and Phillipon, 2011)	Short-term securities, joint and several guarantee, issued by a eurozone debt management office, conditionality on fiscal discipline required, cap at 10% of GDP
Red-Blue bonds (Delpla, V. Weizsäcker, 2010)	Joint and several liability of debt up to 60% of GDP. Blue debt is senior; managed by independent stability council.
Stability bonds (EU Commission, 2011)	Commission proposal including three modalities: 1) Full eurobonds, 2) Blue-red bonds up to 60% of GDP; 3) EFSF bonds (no several and joint liability)
Debt redemption fund (German Council of Economic Experts, 2011)	Debt exceeding 60% of GDP is tranferred to a debt redemption fund (EDR), for which countries and jointly and severally liable. In 25 years banks repay the debt, earmarking part of revenues
European Safe Bond (ESBies, 2011)	Pool of secondary market bonds by a new debt agency (EDA) up to 60% of GDP. EDA to issue two types of bonds, safe and junior. No joint and several liability.