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Both rules and risk-sharing are essential in the EU(EA)

My brief comments focus on: a/ what kind of financial integration is desirable, b/ risk-sharing and risk-reduction, and c/ a series of policy instruments that relate on economic stability and which should be judged conjointly. As a matter of fact, the huge handicap of the EA reforms is that these are still done in a piece meal fashion, not done in a holistic and consistent way timewise.

1. What sort of financial integration in the EU (the role of CMU (BU))

A basic question: can a Capital Markets Union/Banking Union overcome market fragmentation and economic divergence in the absence of arrangements that would enable accommodation of asymmetric shocks, foster economic convergence, and deal with systemic risks?

- for BU and CMU would, arguably, enhance connectivity and systemic risks; consequently, proper regulation and supervision and proper risk reduction and risk-sharing arrangements are badly needed;
- two key issues should be considered in this context: the LoLR issue in capital markets and business conduct
- In my view, pro-cyclical capital markets are hardly avoidable…and macroprudential tools are needed for for CMs too

Could "shadow capital markets" become a problem (as shadow-banking): a/ unregulated business; b/ systemic risks; c/ fintech

Some argue that a complete BU/CMU would dispense with the need of public risk-sharing; it is wrong in my view

- Moreover, is it sufficient for a robust EA that risk-sharing applies to finance only?
- And would private risk-sharing be sufficient to cope with systemic risks?
- A collective deposit insurance scheme (EDIS) could not involve private money only; some fiscal risk-sharing may be needed. ..

Fiscal integration is the biggest hurdle to overcome in the EA since it calls for it involves institutional integration and a significant EA budget; it leads to a huge political conundrum. .. in the spirit of Dani Rodrik's trilemma (there can be no integration in cohabitation with an

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autonomous economic policy and democratic accountability at national level; something must be given up).

Unless financial integration is accompanied by policy arrangements and mechanisms that combat growing divergence between member states, extremism, populism, Euroscepticism would continue to rise.

The progress of the euro area (EA), of the BU, demands a reconciliation between rules (and discipline), on one hand, and risk sharing (private and public) on the other;. But an adequate calibration between rules and risk-sharing, between private and public risk-sharing, is an open question.

Only private risk-sharing schemes (CMU) would not make the EA more robust. Financial markets are too fickle and produce systemic risks recurrently; unless it will get adequate risk-sharing schemes, the EA will continue to be very rigid (like the gold standard regime) and prone to experience tensions and crises recur

2. Risk reduction and risk sharing

The non-standard operations of the ECB (including sui generis LoLR operations) have rescued the EA. Although the correction of external imbalances (deficits) should not be underestimated, it is sensible to think that the current sovereign bond spreads of the "periphery" over German Bunds do not illustrate member states' economic performances accurately; (the Italian crisis –the redenomination risk)

Some Member States highlight the need to reduce NPL stocks (a legacy problem) as a risk reduction measure, prior to implementing a risk-sharing scheme --a collective deposit insurance scheme, which is the key missing link in the BU architecture, though a considerably higher resources for the SRF is also needed.

But, the flow of non-performing loans hinges, essentially, on economic performance, and not on a particular level of NPLs, which can be brought down through various means. **In the absence of mechanisms and instruments that foster economic convergence in the EA, NPL stocks at national level would tend to diverge widely again**. Can MPPs play a role in reducing NPLs?

One can imagine a diversification of banks' loan portfolios that would diminish the threats posed to their balance-sheets by activities in weaker economies.

But a complete decoupling of banks from weaker member states' economies is not realistic and not welcome, and contagion effects can still be significant. A decoupling would cause further fragmentation in the Union/EA –where finance is largely bank-based. Moreover, there are small- and medium-sized banks whose activity remains quasi-local/national….the issue of SME, which rely on internal financing….(dual systems operate already)

A concern is that reforms would lead to a "transfer union", which would call into question the political legitimacy of such arrangements.

But systematic transfers should be distinguished from transfers that help cushion asymmetric shocks. This distinction fits the logic of social insurance systems (every income-earner contributes to a pool of resources that should be used when some contributors are in need of justified assistance, not sine die).

If banking groups diversify their government bond portfolios while considerable competitiveness gaps persist among member states, and if sovereign bond ratings were no longer "risk-free", a strong preference for holding safer bonds would ensue.

Banks would discriminate among countries, thus harming economic activity in some member states… peripheral economies would become even more fragile once non-zero risk bonds come into being. The non-existence of proper risk-sharing schemes would only strengthen such perilous dynamics.

It is worth mentioning, in this context, the bailing-in scheme (creditors' and shareholders' involvement in loss sharing, or haircuts) in contrast to the bailing-out scheme, with the latter being prohibited by the Treaties). Bailing in is meant to protect tax-payers from costly resolution operations. But bailing in can trigger contagion effects unless it is done with utmost care. And it is not clear that implacable rules are to be applied in this respect. The ECB was forced by a grim reality to take on a de facto LoLR function from 2010 onwards; and one should not rule out bailouts under exceptional circumstances, when contagion effects may become very threatening.

Unless EA reforms are undertaken in a holistic manner, bailing–in schemes will not fly…(Angeloni's piece in FT recently on bank resolution –Deutsche and Carigi…))

3. European "safe assets" and financial integration

The need to reduce the bank-sovereign doom loop as much as possible lies at the root of attempts to come up with a European safe asset. For years now, Eurobonds have been mentioned as risk-pooling assets that would make the EA more robust. However, mutualisation of risks is rejected by creditor nations, which do not accept the idea of a "transfer union".

The idea of a synthetic financial asset (sovereign bond-backed securities – SBBS) came up; this synthetic bond is derived from the pooling and slicing of sovereign bonds into three tranches: a senior one (deemed to be equivalent in strength to the German Bunds), a mezzanine (medium-risk) tranche, and a junior (seen as highly risky) tranche, with the latter bearing the brunt of losses in case of default (Sovereign bond-backed securities: a feasibility study, ESRB, Frankfurt am Main, January 2018). This financial asset is intended to be attractive for banks and other financial institutions and to replace much of the current sovereign bond holdings.

But SBBS present a problematic feature: the supply of senior tranches depends fundamentally on the demand for junior tranches, and this demand is likely to fall dramatically during periods of market stress, when some member states' market access may be severely impaired. In those instances, demand will swiftly shift towards top-rated sovereign bonds, towards other safe assets. This is a weak trait of this synthetic asset. In times of crisis, the demand for solid financial assets (such as the German Bunds) would go through the roof, while the demand for periphery bonds would plummet, which would translate into a collapse in the demand for junior tranches as well.

One can envisage a variation of the composition of SBBSs as a function of member states' market access, but this would make the whole scheme extremely cumbersome to implement. The fact is that, unless market access is secured for all member states, the supply of SBBSs turns too unreliable to make them a workable asset. Moreover, were SBBSs to come into being, their volume would be too small to make much of a difference in financial institutions' balance-sheets, for the foreseeable future at least.

4. *Policy instruments in the EA to be seen jointly*:

- liquidity assistance available during times of market stress;
- schemes to cushion asymmetric shocks, such as an unemployment benefit scheme;
- a EA budget is needed; in the guise of investment programs is not adequate and, in addition, it cannibalizes the EU budget
- EDIS is a must (it asks for risk-sharing) + a much stronger SRF (it is peanuts now)
- sovereign debt restructuring should not be triggered automatically (automaticity as a condition for ESM support programmes), for it may cause panic in the markets, more fragmentation;
- rules for adjusting imbalances should not be pro-cyclical (a revision of the Fiscal rules rules makes sense: simplification, avoid pro-cyclicality, an overall policy stance is badly needed (is policy coordination enough?); it is blocked politically (ECOFIN); the structural budget deficit as an unobservable variable…
- a euro area-wide macroeconomic policy that should reflect in the fiscal policy stance over the business cycle; policy coordination does make sense (MS that have fiscal space…; the argument that spill-over effects are small is not convincing; in addition there is a danger of economic downturn against the backdrop of currency and trade wars)
- the macroeconomic imbalance procedure (MIP) should operate symmetrically, for both large external deficits and surpluses countries;
- investment programmes that foster economic convergence are needed;
- no de-reregulation of finance
- fintech to be regulated; crypto-currencies (private digital currencies are a big threat -LIBRA); giving up cash completely would also pose significant risks…