Challenges to Euro-Zone Stability

Marco Pagano

University of Naples Federico II, CSEF and EIEF

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Challenges to EZ stability

- External challenges
  - global growth slowdown
  - high uncertainty: trade war tensions, Brexit
- Internal challenges
  - political tensions from resurgent nationalism
  - North-South divergence in growth performances
  - monetary policy dug itself into a hole, while…
  - … no EZ-wide countercyclical fiscal policy in sight
  - (dangerously) unfinished banking union (BU)
  - ailing banks: overcapacity, fintech & negative rates
  - capital market union (CMU) going nowhere

External challenges

- **Global growth slowdown and trade tensions**
  - particularly serious for countries with a strong export orientation
  - especially jointly with the absence of counter-cyclical EZ-wide fiscal policy: EZ states willing to do it cannot, and those that can are unwilling
- **Brexit**
  - aside from trade effects, a serious blow to CMU plans: the EZ loses its main security marketplace
- **But there is a (political) silver lining…**
  - external challenges are the EZ's best hope to unite and "get its act together": shift sovereignism from the nation-state to the EZ level!

Internal challenges

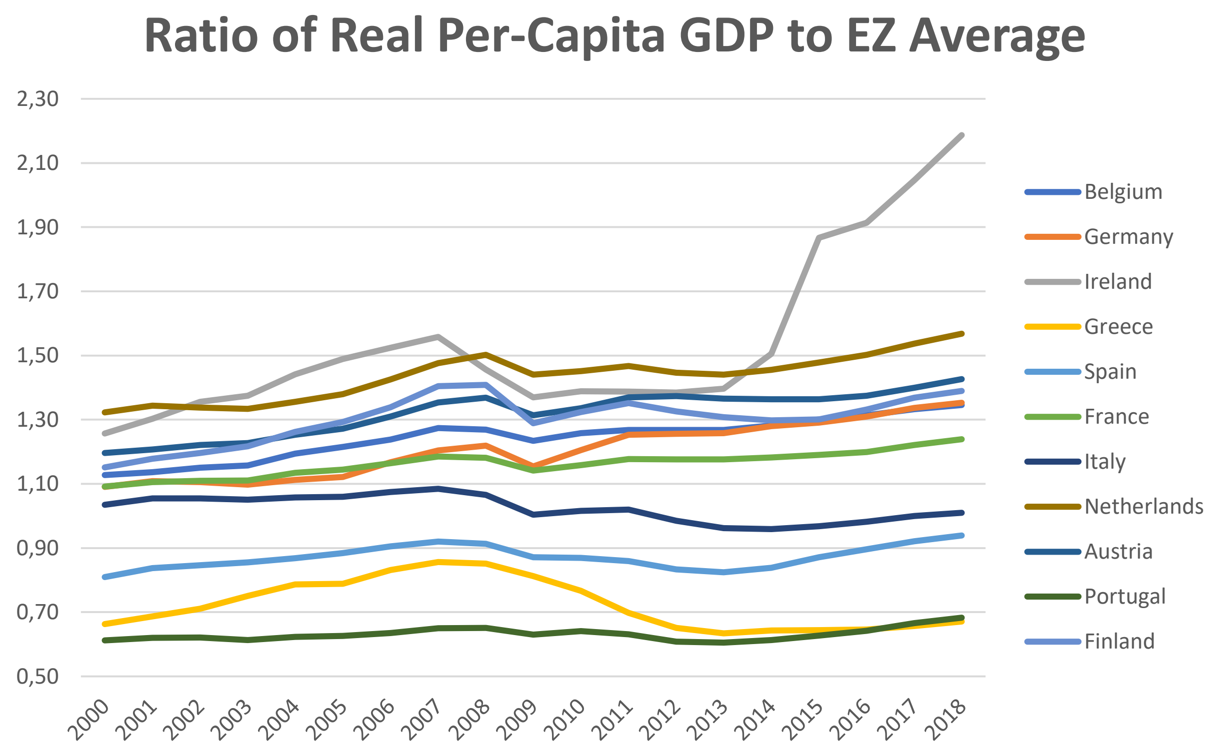
- These are the **most serious ones**
- **Common cause: lack of political vision and courage by member state governments**
  - EZ is "not delivering the goods": moving only on the verge of collapse
- **Combined effect:**
  - **not sudden collapse, but gradual decline**, loss of popular support and death by exhaustion
- **Nationalist parties have sensed this**, and this is part of the reason for their success…

Internal challenge no. 1

- Resurgent nationalism:
  - **reason** for weakness of EZ institutions, or **effect** of this weakness?
  - Why withdrawal from the single currency is no longer on the platform of nationalistic parties in Europe? Because the euro is something on which the EZ delivered, and people like it
  - “Ultimately, all good politicians know that the longer they appear to be doing nothing, the more they risk being replaced by rivals who look like they want to do something – anything” (Martin Sandbu, FT, 13/11/19)

Internal challenge no. 2

Divergent North-South growth, especially after the crisis → persistent difference in fiscal vulnerability across countries



Unavoidable in an (institutionally) **"diverse monetary union" (Perotti & Soons, 2019)?**

Internal challenge no. 3

- **Monetary policy dug itself into a hole:**
  - **asset purchase program** close to limit of what it can achieve in terms of expansionary stimulus
  - in fact, **negative rates** on reserves penalize banks that rely more on deposits (Farzad & Heider, 2018) → on the whole they may depress lending
  - they are also playing a destabilizing role in the insurance and pension fund industry
  - yet, **very hard to normalize rates** without triggering instability: large wealth losses for intermediaries, shutdown of zombie firms, etc.

→ **call for fiscal policy to step in, but …**

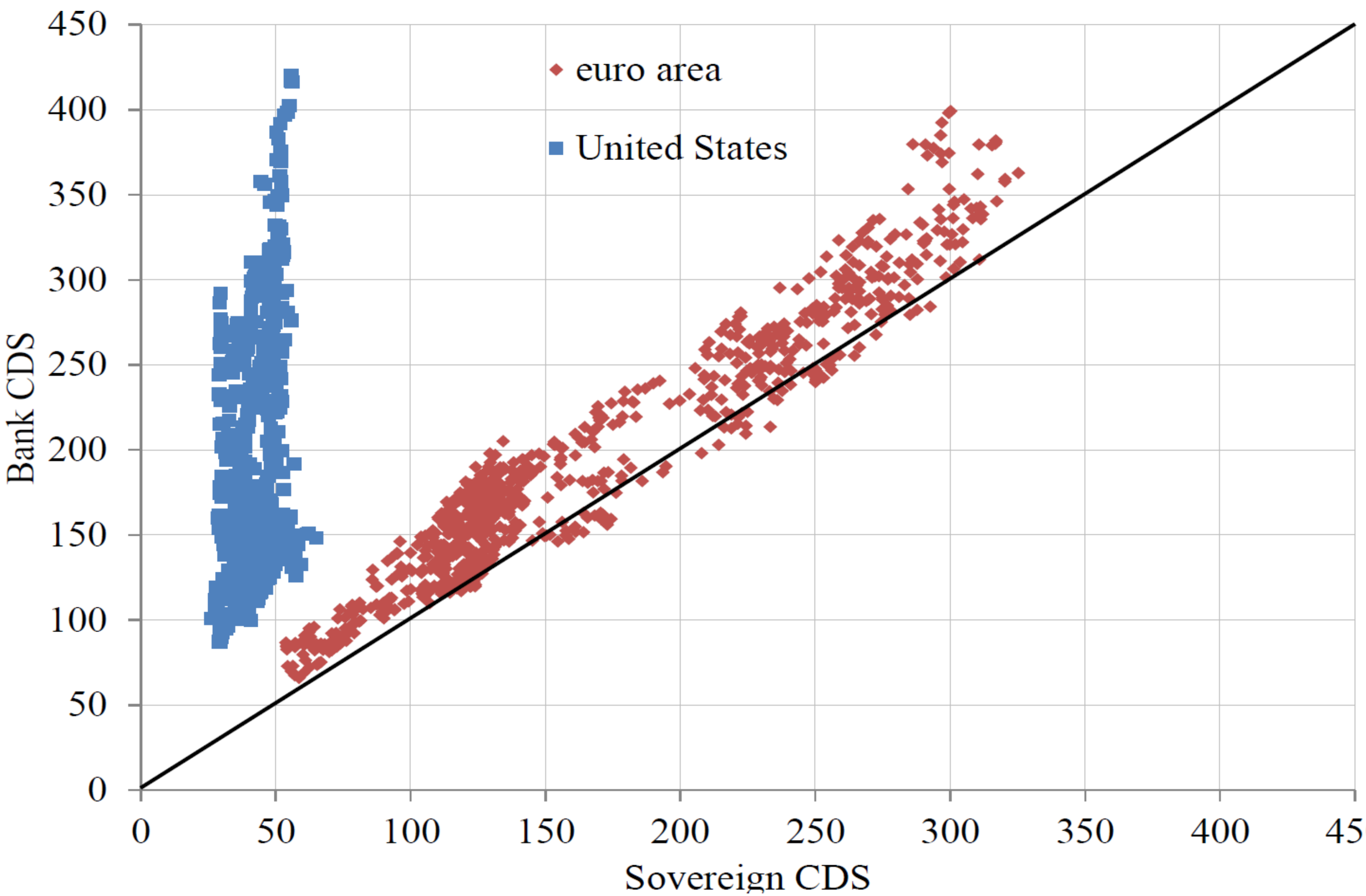
Internal challenge no. 4

- **Lack of EZ-wide countercyclical fiscal policy:**
  - On 7 November, the European Commission published its Autumn Forecasts and they do not show any significant fiscal expansion
  - The Commission is better positioned than any other institution to assess the policy stance of European countries: its staff looks at all Draft Budgetary Plans by all EU/EZ countries, and discuss them with governments
  - Note despite such privileged information on fiscal policies, since 2017 fiscal policy has turned out to be much tighter than what the Commission had projected

Internal challenge no. 5

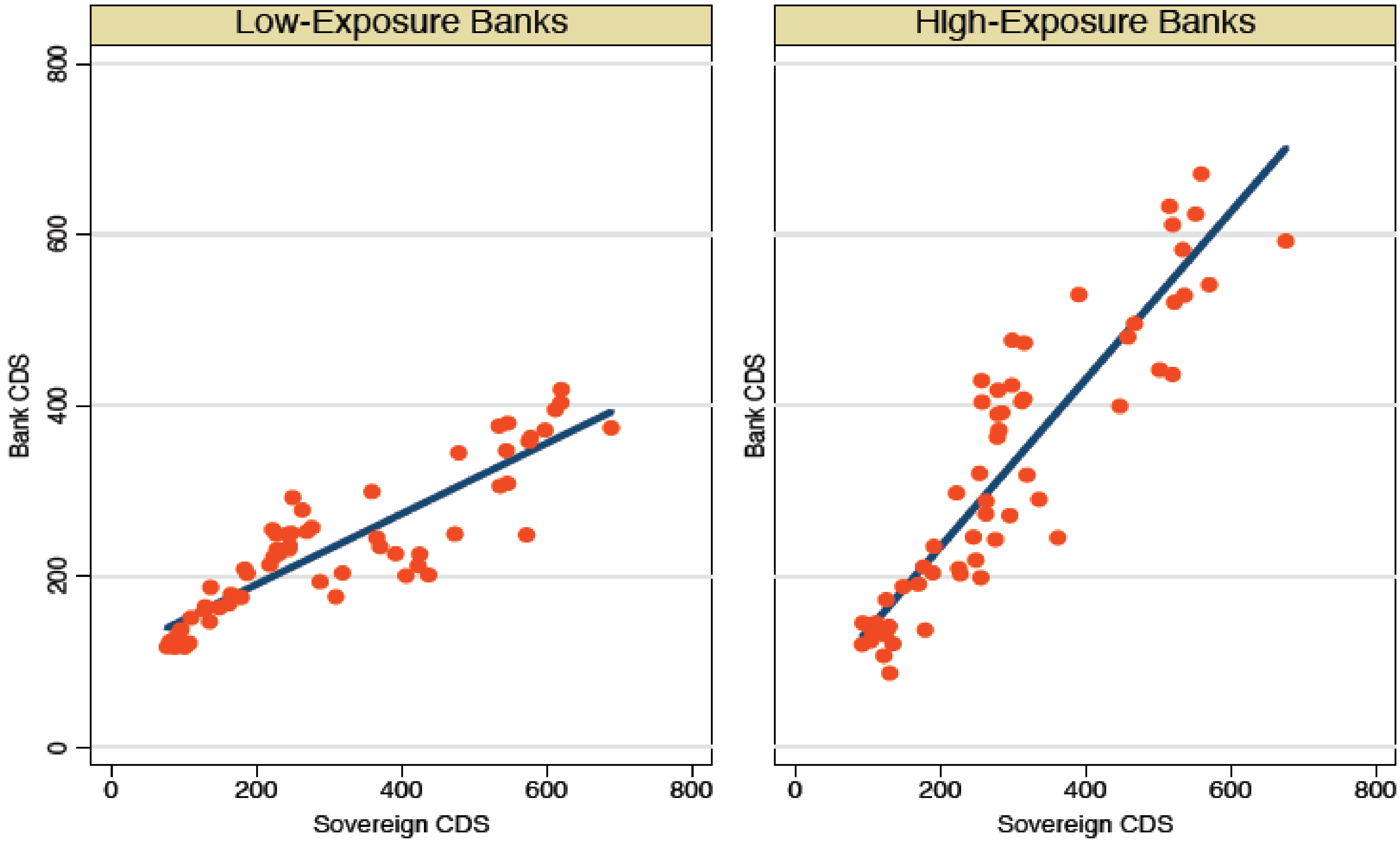
- **Unfinished business on the BU front:**
  - No EZ-wide deposit insurance
  - No reform of prudential regulation of banks' sovereign exposures
  - No EZ-wide safe assets for banks to hold
- Combination of missing pieces leaves the **EZ exposed to amplification of sovereign stress shocks**, as in 2011-12:
  - particularly dangerous in light of political instability, persistent fiscal vulnerability and still high domestic sovereign exposures of banks in Southern EZ countries, especially Italy

Sovereign and bank CDS premia: euro area vs. US



Pagano: Challenges to euro-area stability

Sovereign and bank CDS premia in stressed countries



Still a problem

European banks

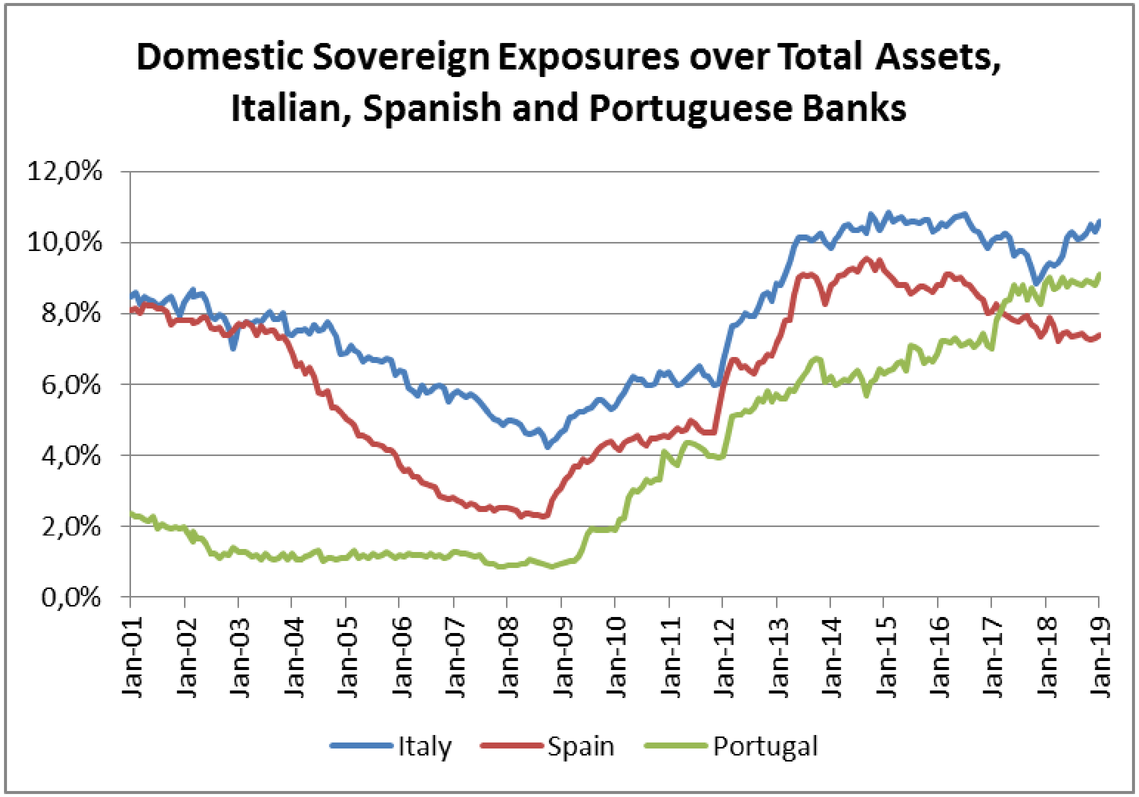
Eurozone banks buy sovereign bonds, reviving 'doom loop' fear

Banks' purchases of domestic debt revive as ECB launches fresh injection of cheap lending

Kate Allen in London MARCH 8, 2019

Banks across the eurozone have begun to stock up on their own governments' bonds for the first time since the bloc's debt crisis half a decade ago — even as the European Central Bank launches a fresh round of stimulus to prod them into lending.

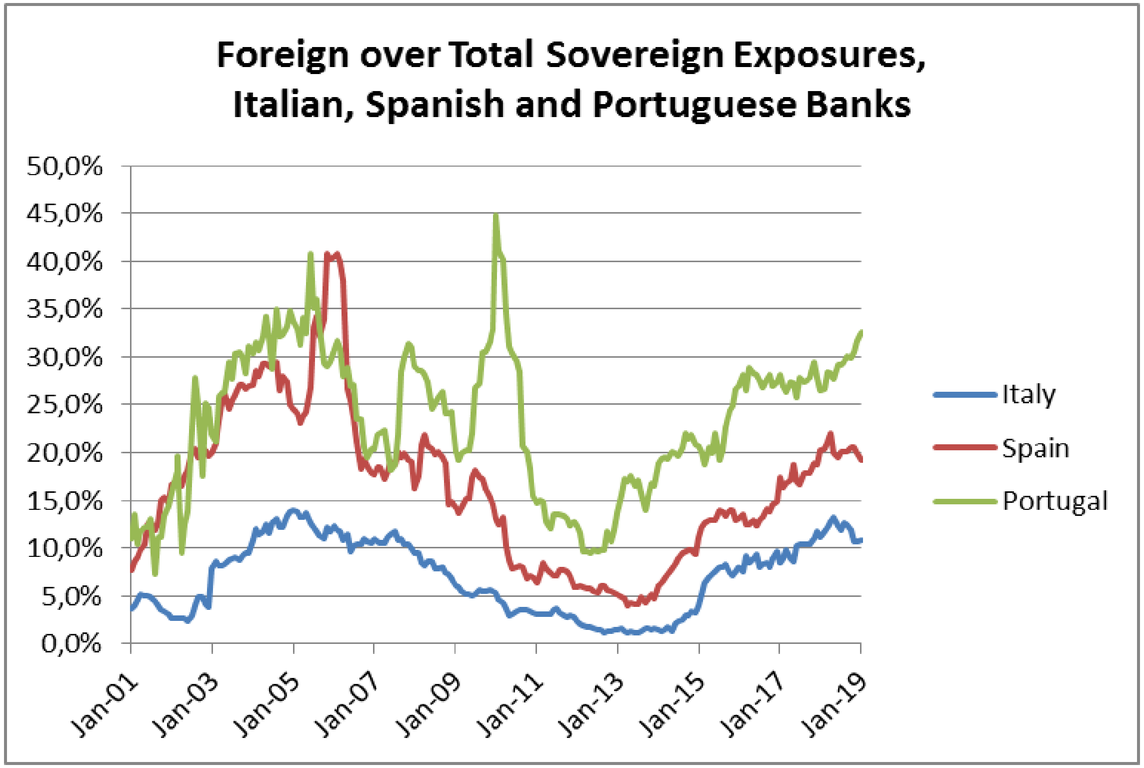
Sovereign exposures as % of TA: Italy, Spain &Portugal



Source: ECB.

- **Italian banks**: domestic exposures peak in early 2015, drop until Dec. 2017, then bounce back in 2018
- **Spanish banks**: domestic exposures peak in June 2013, then decline continuously
- **Portuguese banks**: domestic exposures rise from 5.7% in Sep. 2014 to 9.1% in Jan. 2019

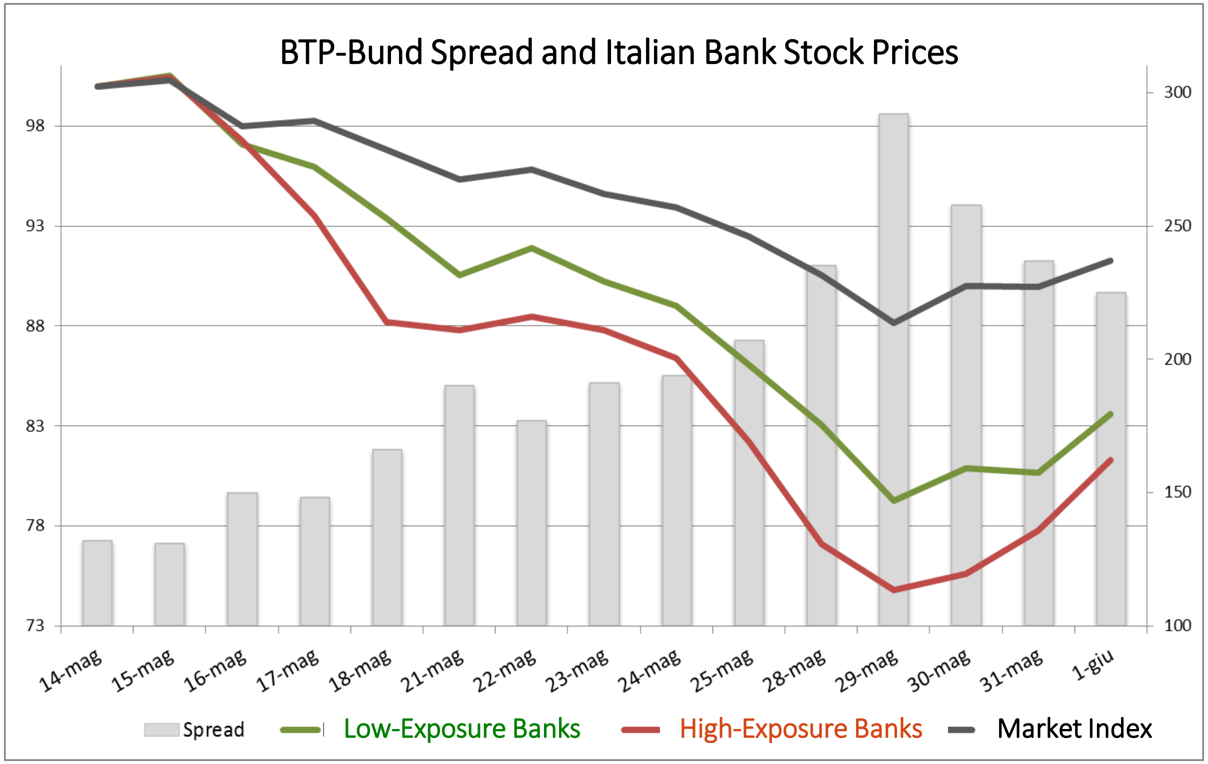
Sovereign bond diversification: Italy, Spain & Portugal



Source: ECB. Foreign exposures are non-domestic euro-area public debt holdings.

- Italian banks’ sovereign portfolios always less diversified than Portuguese and Spanish banks’ ones
- Diversification on the rise since 2014, but less so in Italian banks
- Also Italian banks diversify mostly into Spain and Portugal, Spanish banks into Italy and Portugal, Portuguese ones into Italy and Spain!

No surprise that doom loop is alive and well in Italy



Source: Pagano and Simonelli (Sole 24 Ore, 9 June 2018). Data: EBA, MTS & Thomson-Reuters.

Italian Finance Minister Tria (24 October 2018):
"Clearly these levels [of the BTP-Bund spread] pose a problem for the banking system and particularly for weaker banks"

Internal challenge no. 6

- **Weak – and weakening – banks: caught in the crossfire of four adverse factors**
  - structural overcapacity in EZ banking sector: insufficient exit of less efficient banks due to explicit or implicit public support
  - negative interest rates (combining with other regulation) "taxing" banks on reserves
  - entry of fintech and large data companies taking bites of remaining profitable segments (with a comparative advantage): Google just announced entry
  - crushing weight of prudential regulation: overdone?
- Though better capitalized, banks may not be much more resilient than a decade ago…

Combined challenged require bold reform

- Daunting combination of internal challenges
- **Need for bold reform to redesign major aspects of the EZ functioning:** "grand deal" likely to succeed where piecemeal one would fail (something in it for everyone)
- **For instance, we largely know what is to be done to complete the Banking Union, but shall we rise to the challenge?**
- Or shall we remain entangled by reciprocal vetoes? **Are we waiting for another crisis to get into action?**

Thank you!