

**A European Banking and Fiscal
Union?
Implications for the global economy**

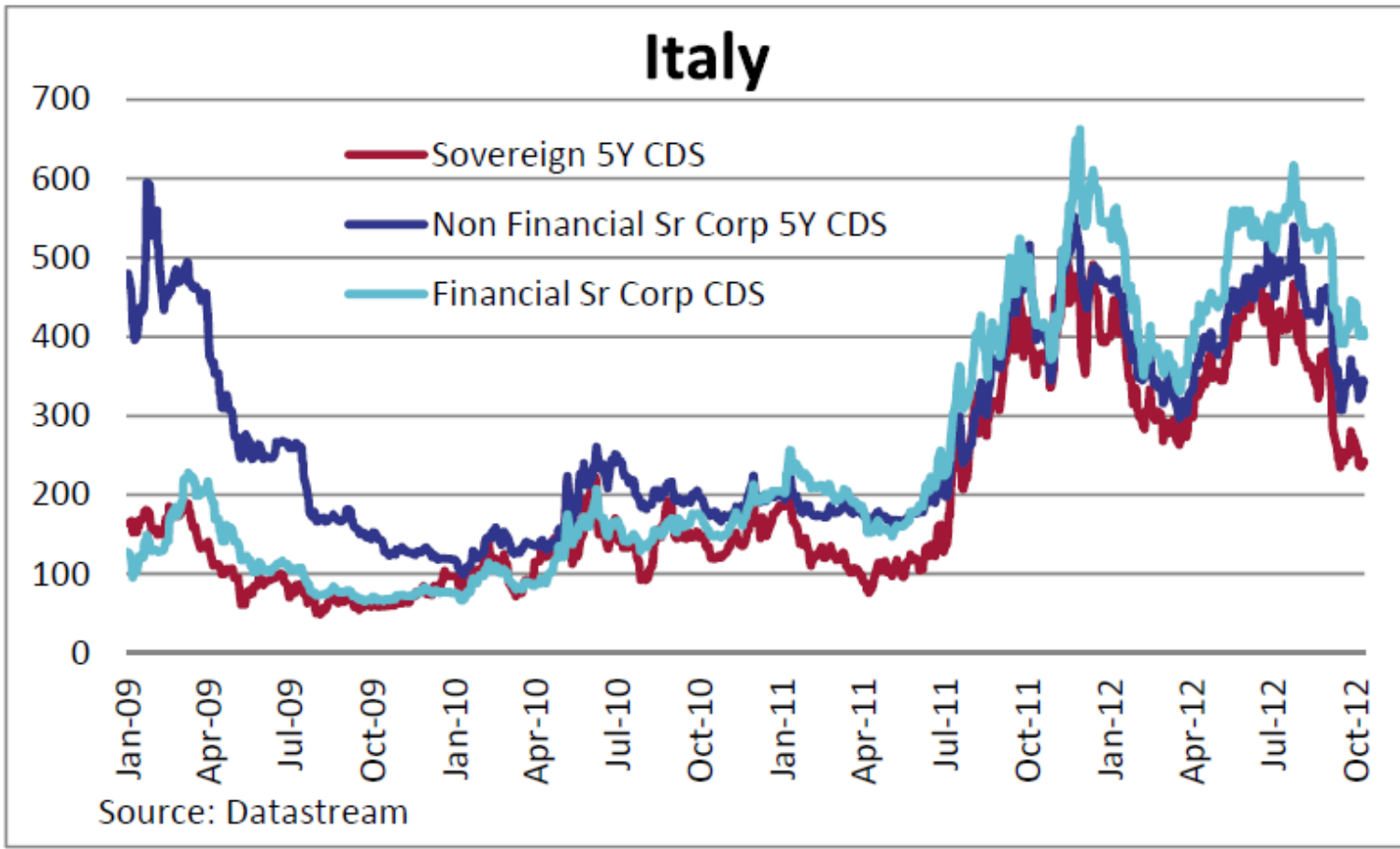
**Guntram B. Wolff
Bruegel**

Motivation



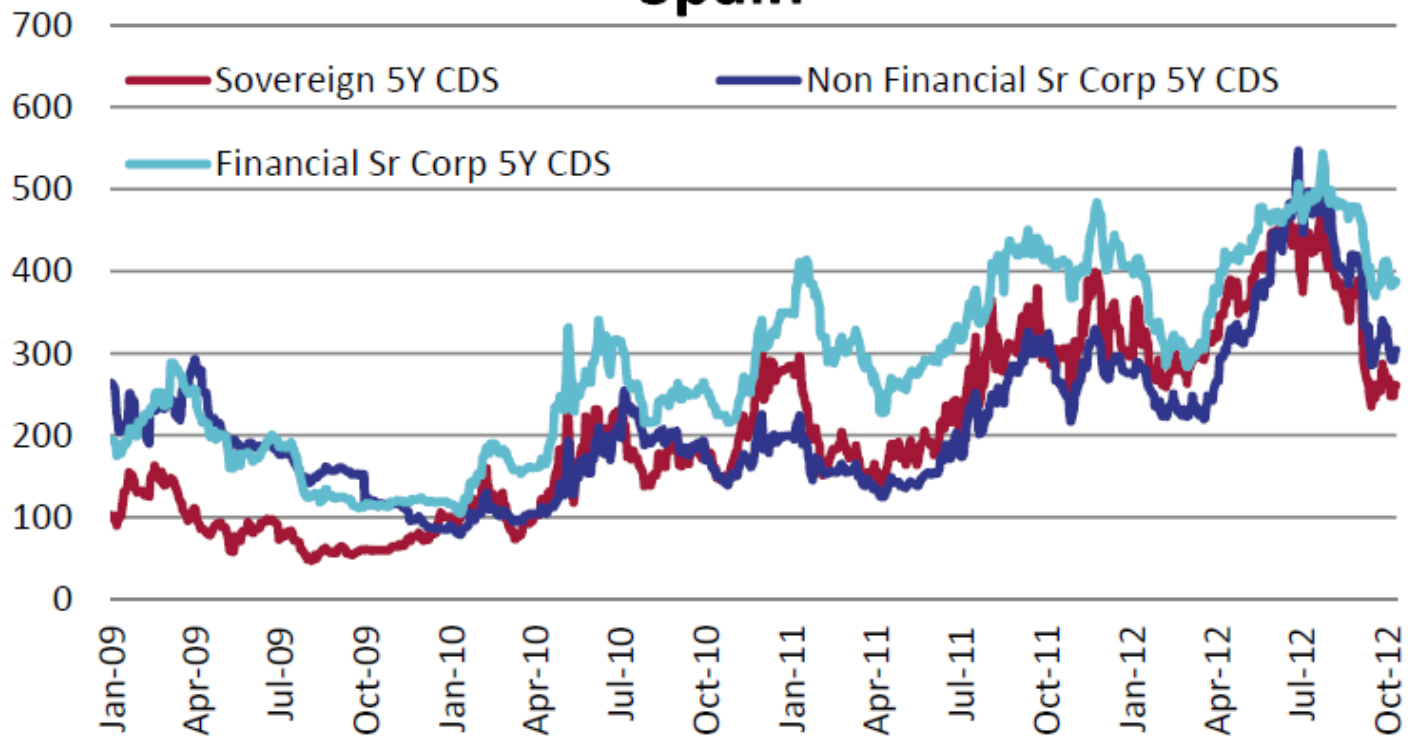
- Problems in the banking system are at the core of the euroarea crisis
 - Serious fragmentation of the financial system in the euro area....
 - ... leading to increased exposure in the ECB
 - ... and prohibitive credit conditions for non-financial firms
- doom-loop affecting entire economies
- preventing real-economic adjustment as it constitutes serious competitive disadvantage
- June summit conclusion
- “ We affirm that it is imperative to break the vicious circle between banks and sovereigns“

What have we achieved to date? What are the next steps? What are implications for Asia and beyond?





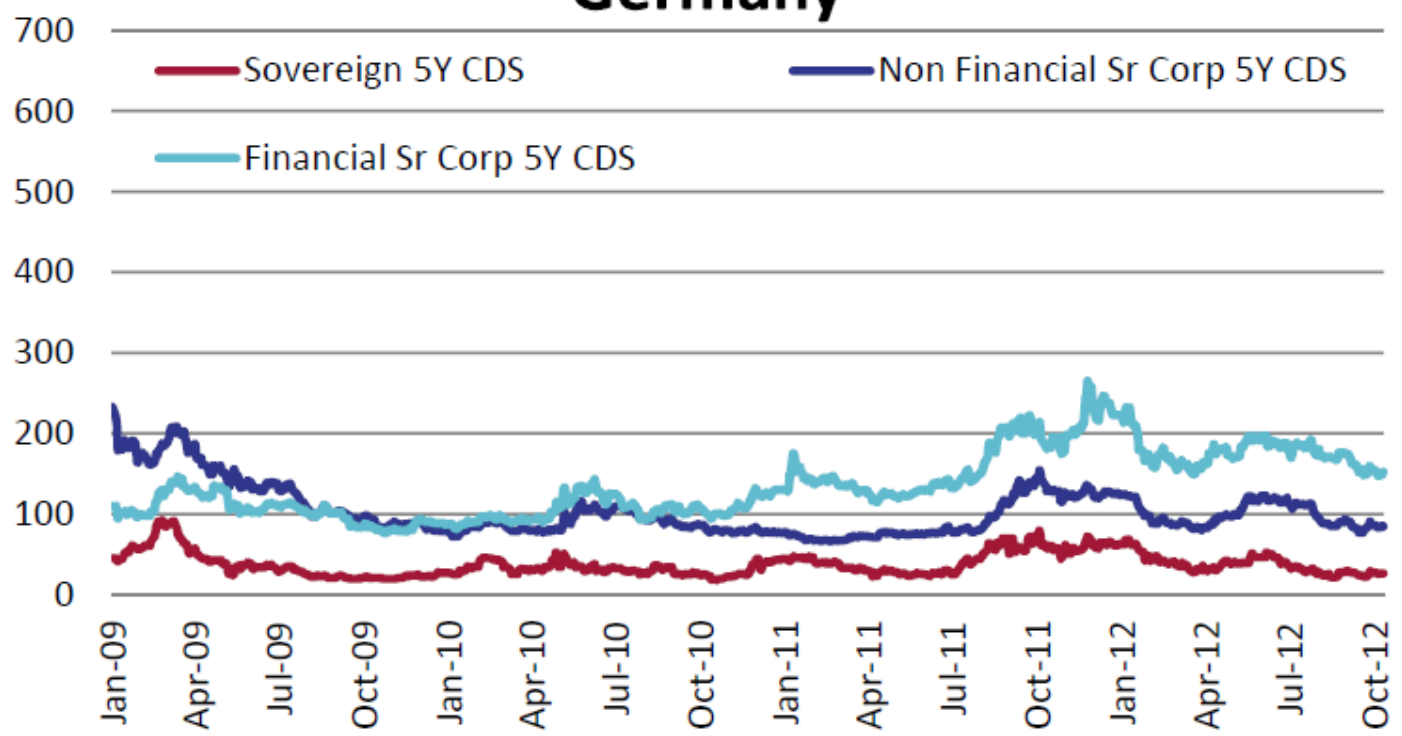
Spain



Source: Datastream



Germany



Source: Datastream

Decoupling still not achieved

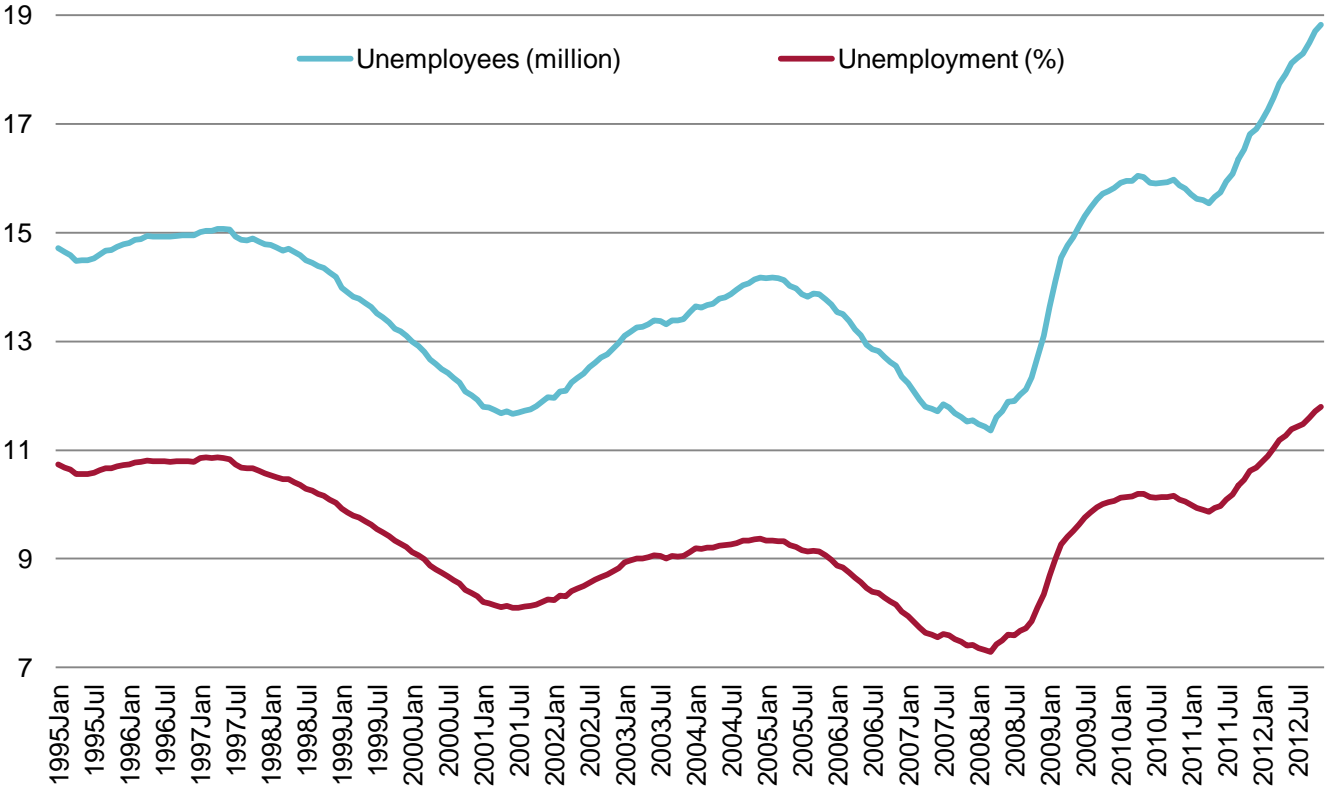


- While risk measures have come down, the correlation remains high
 - Risks have come down thanks to the removal of catastrophic risk scenarios with ECB's OMT programme
 - Big question: is debt & price adjustment trajectory sustainable and if not what would the ECB do?
 - How should Europe deal with the high debt levels while avoiding major social tensions in the South?
- Issue of further fiscal integration remains on the table



What risks for EA?

Unemployment in the EA17

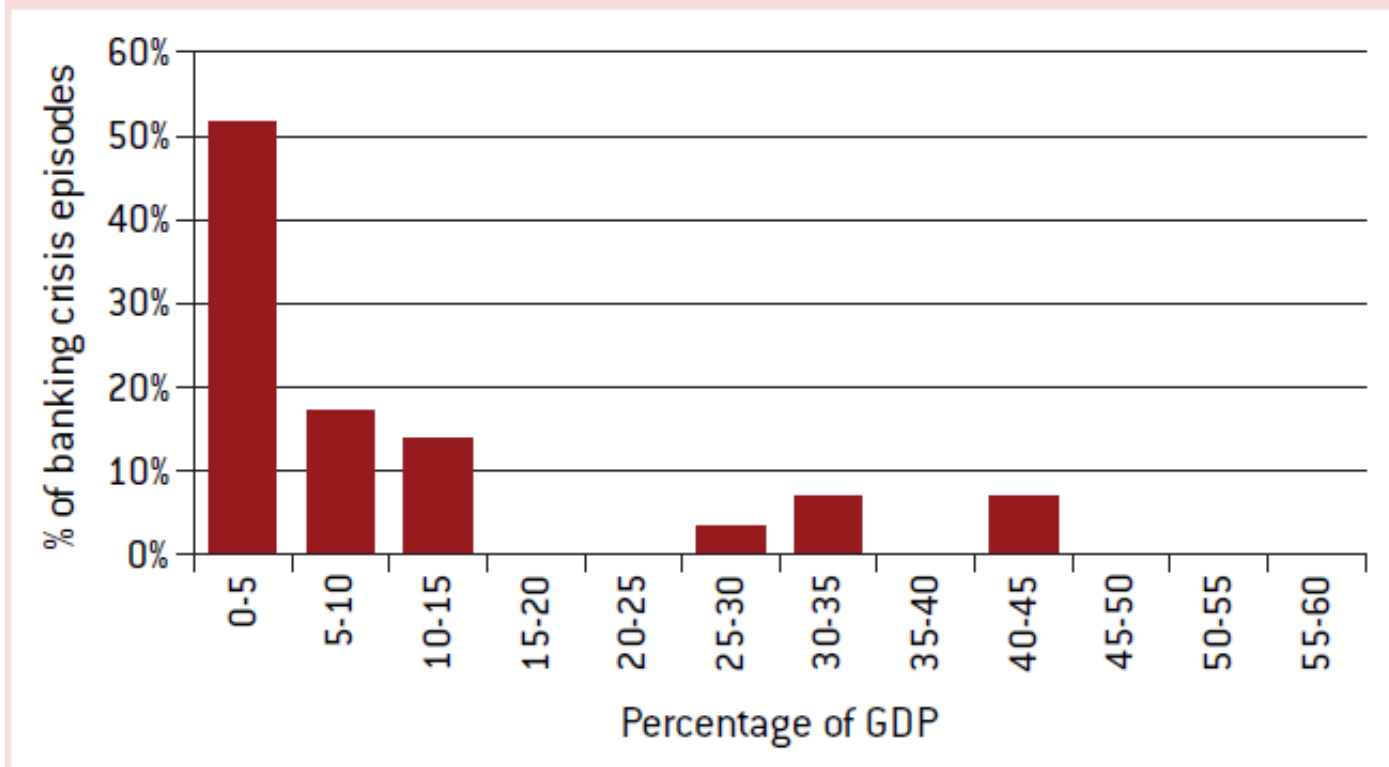


Next steps: Complete banking union

- Agreement on common supervision is a strong one
 - ECB will have far reaching competences and responsibility for overall system
- Agreement that a single resolution mechanism needs to be defined
 - Much more difficult, both technically and politically
- Fiscal backstop
 - Creditor bail-in important to minimize tax payer costs
 - This is central part of bank resolution. Ideally creation of something similar to US FDIC, but what can be done in current treaty framework?
 - Big issue is long-term design and dealing with the current legacy issues.
 - Most likely option appears to be the ESM but numerous obstacles, e.g. ESM treaty implementation in Germany does not allow for direct bank recapitalisation.



Figure 1: Fiscal cost of banking crises, 1970-2011, advanced economies



Source: Bruegel using the Laeven and Valencia (2012) database

- What if current debt level is not not sustainable because of the combination of high external debt & remaining price adjustment needs...
- OMT is not a solution
- Default is not a solution as contagion effects are large

Proposals:

- a euro area budget to provide support to countries in need
- Partial debt mutualisation mechanisms

Big question:

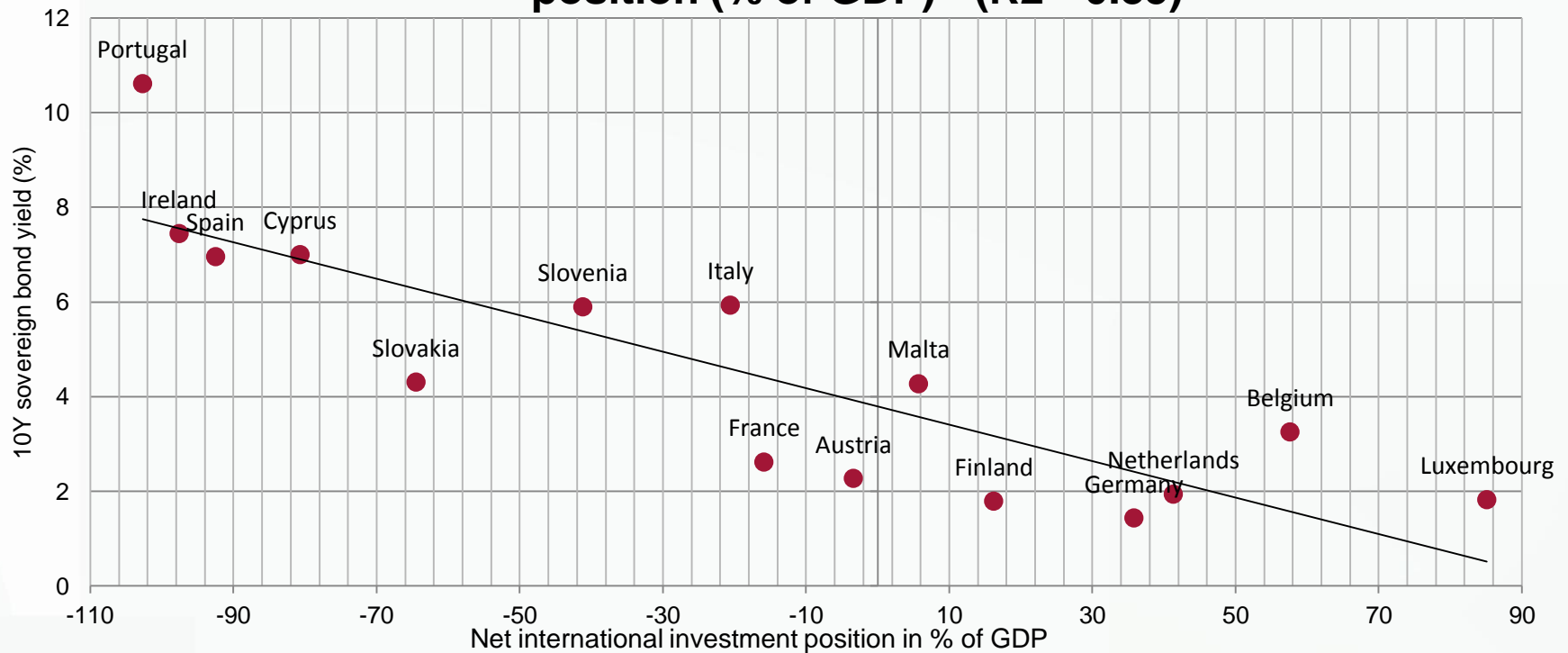
- What institutional basis is required? Certainly current fiscal surveillance is insufficient.
- What kind of debt issuance agency?
- Should the ESM become the euro area treasury?

- Missing stabilization tool in the euro area, currently, South of Europe has restrictive fiscal and monetary policies
- Old insight from fiscal federalism: stabilization can only be effectively done at federal level (e.g. Oates 1968)
- Other stabilization channels in Europe ineffective (Asdrubali et al 1996)
 - In the US, capital markets smooth 40 % and credit markets 25 % of regional shocks
 - The share of federal stabilization typically 10-20 %
- Impossible to shift sizeable amounts of spending to federal level
- But possible to agree on high-powered fiscal transfer system that is ex-ante neutral
- 2% of EA GDP as fiscal capacity would likely suffice
- Unfortunately, European Council of December delayed process

Why is a EA budget needed?

Problems with the credit channel

Sovereign bonds 10Y yields Vs. Net international investment position (% of GDP) - (R2=-0.85)



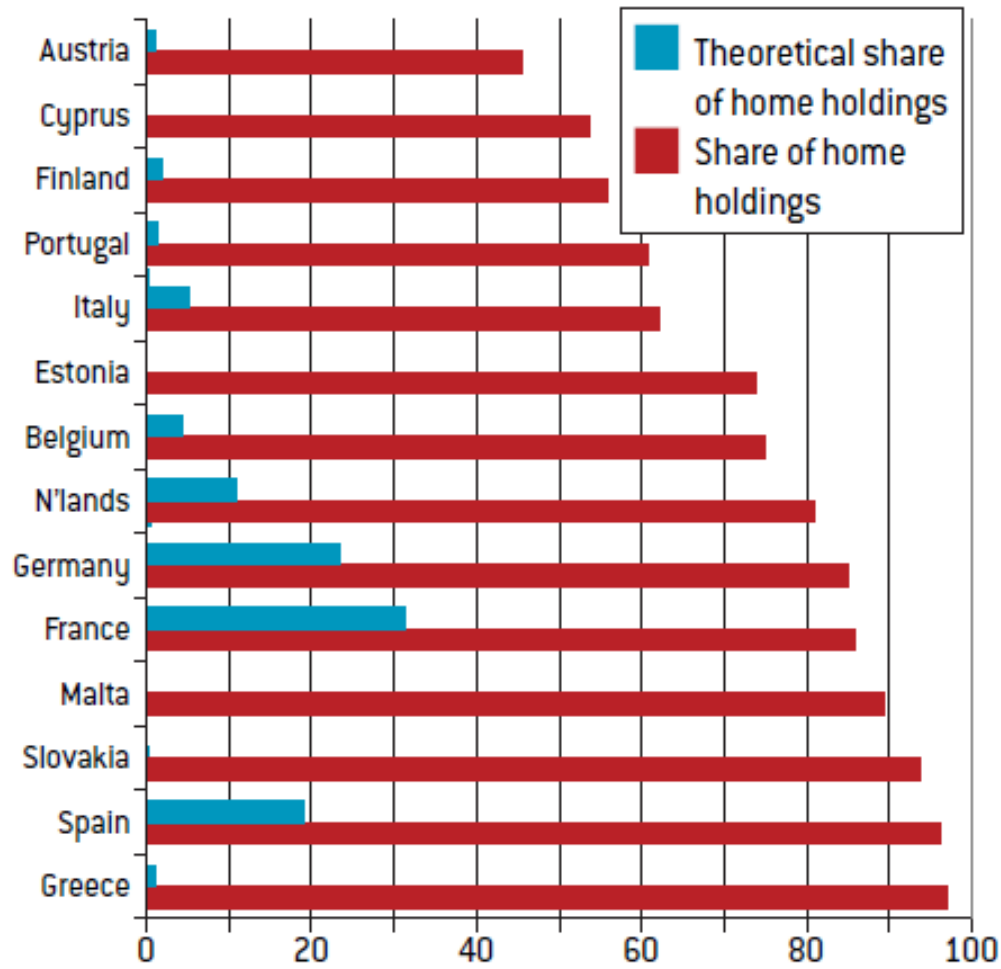
Sources: Datastream and Eurostat

Note: yields at the 15 of June 2012, Greece is excluded

Why is a EA budget needed?

Problems with the capital channel

Capital markets continue to exhibit a high degree of home bias



Source: Bruegel based on World Bank data on stock market capitalization and IMF CPS data on cross-border holdings following the methodology of Balta and Delgado (2009).

Note: Theoretical share of home holdings is equal to the share of domestic market capitalization of total OECD stock market capitalization.

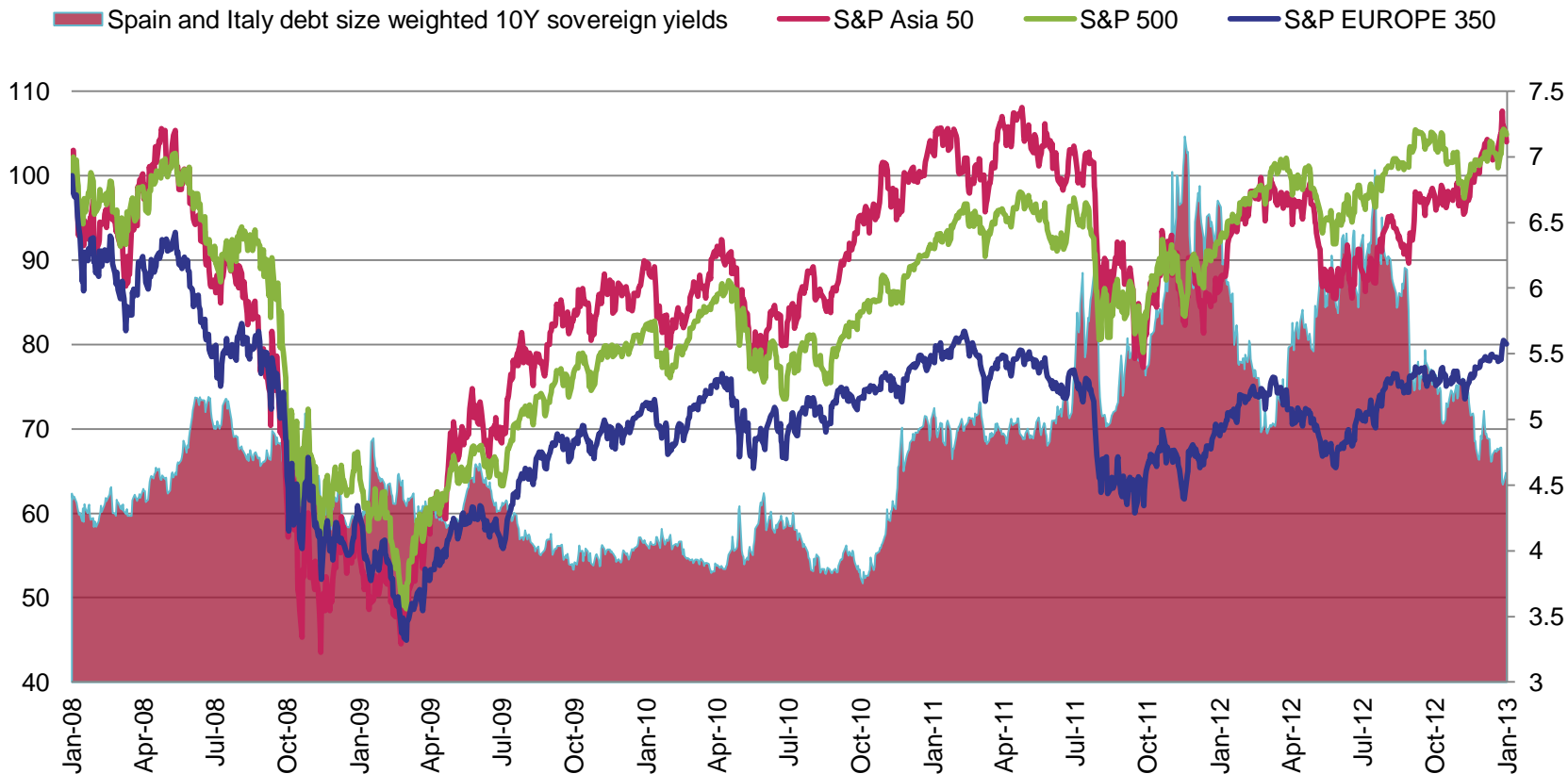


- Financial contagion
 - Stock markets
 - Eurobond solution? → implications for global reserve currency
- Trade patterns

Some decoupling in levels but high correlation



Stock market indices (Jan2008=100)

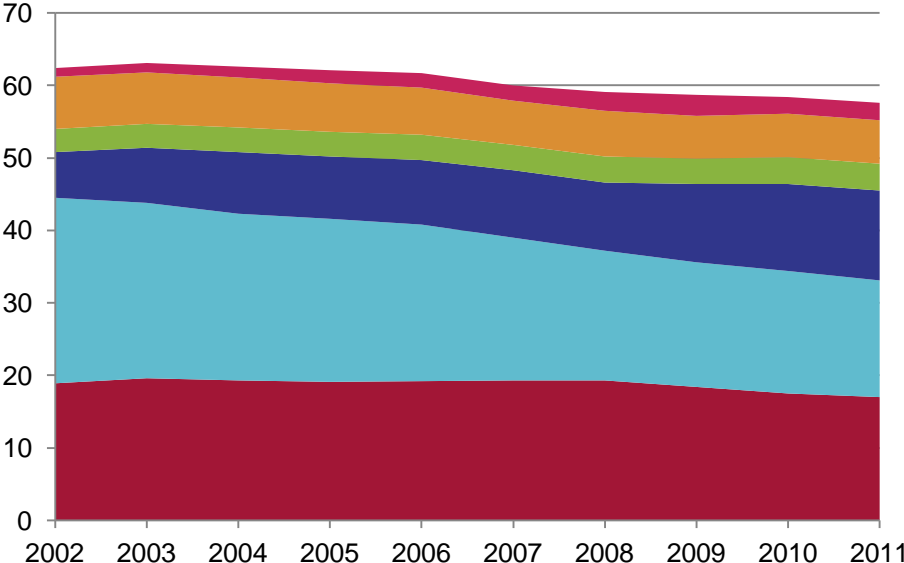


Sources: Datastream and Bruegel's calculations

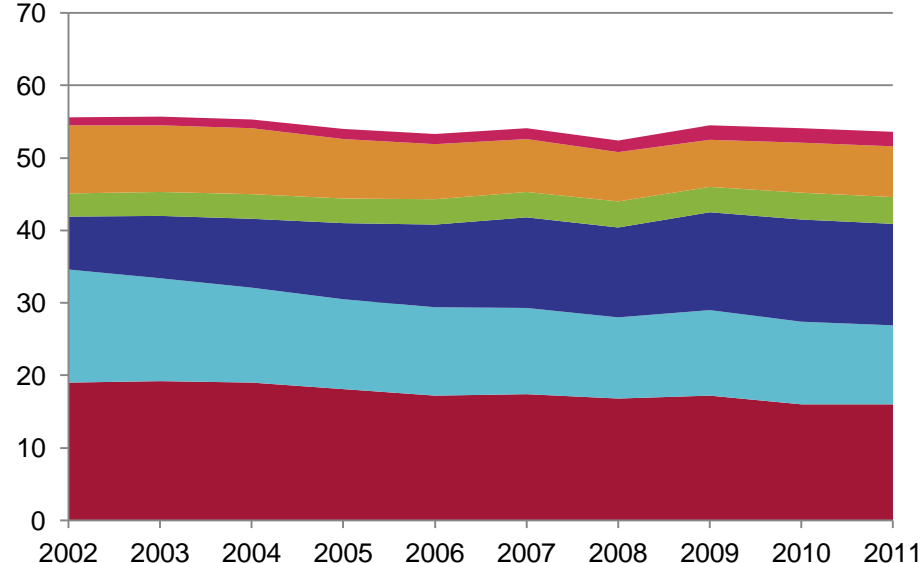


Europe has kept its share in global trade

Share of national imports in world imports (%)



Share of national exports in world imports (%)

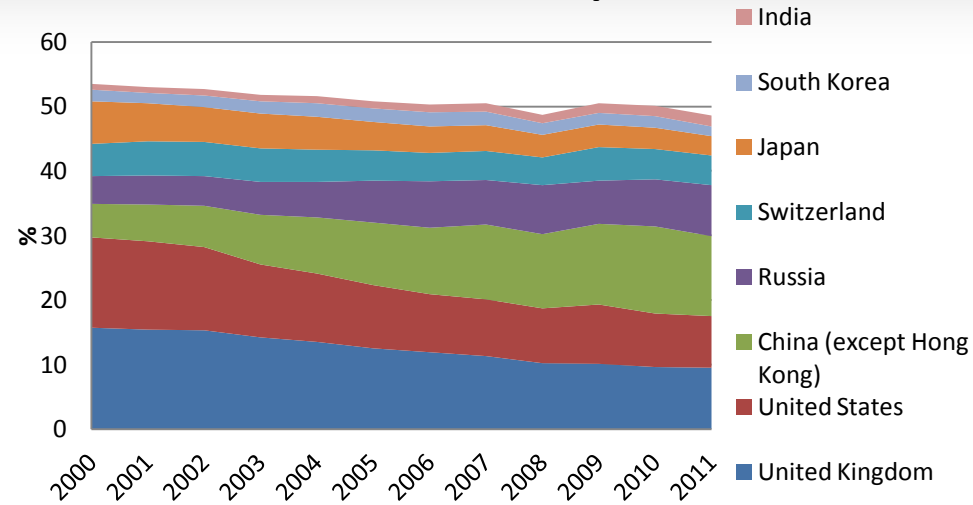


- India
- South Korea
- United States
- Japan
- China (except Hong Kong)
- European Union 27

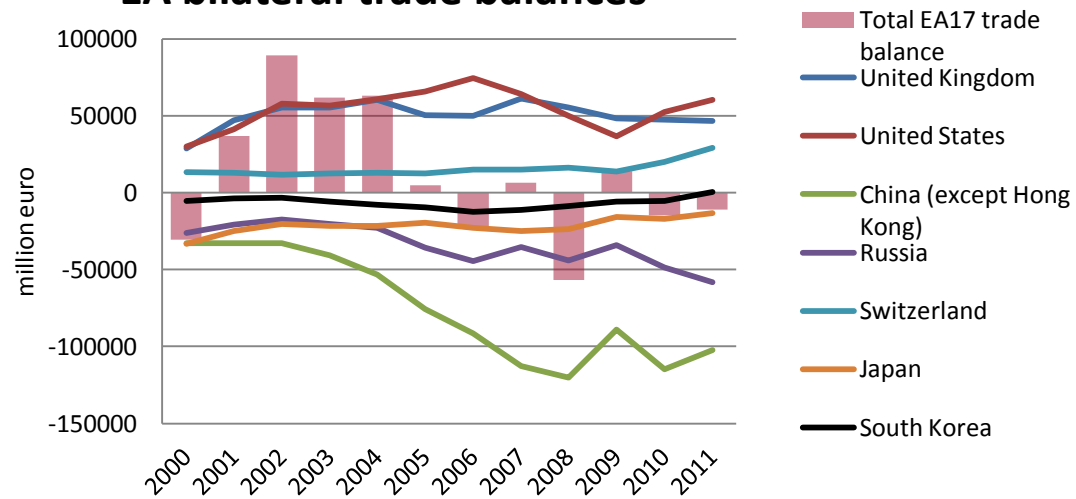
Source: Eurostat



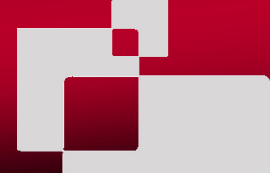
Share of EA Imports



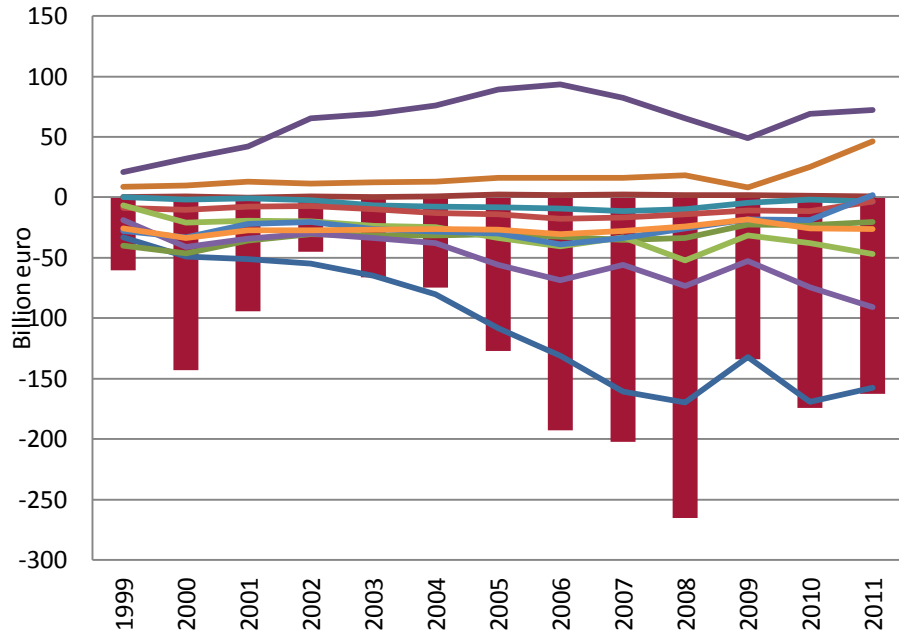
EA bilateral trade balances



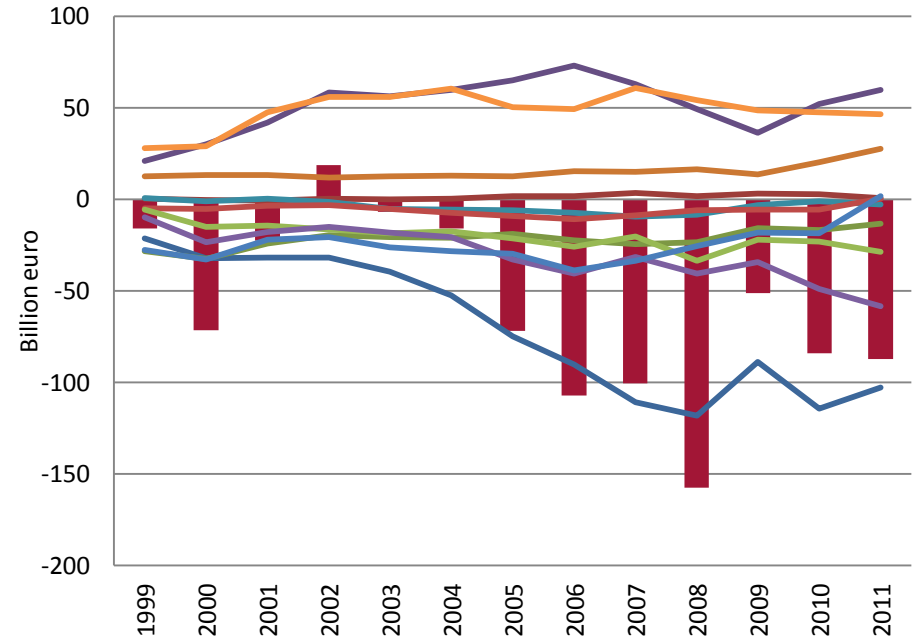
Trade balances with its main partners



EU27



Eurozone (evolving composition)



■ EU27_EXTRA

— INDIA

— UNITED STATES

— SWITZERLAND

— NORWAY

— Dynamic Asian economies (DAEs)

— CHINA

— JAPAN

— BRAZIL

— SOUTH KOREA

— RUSSIA

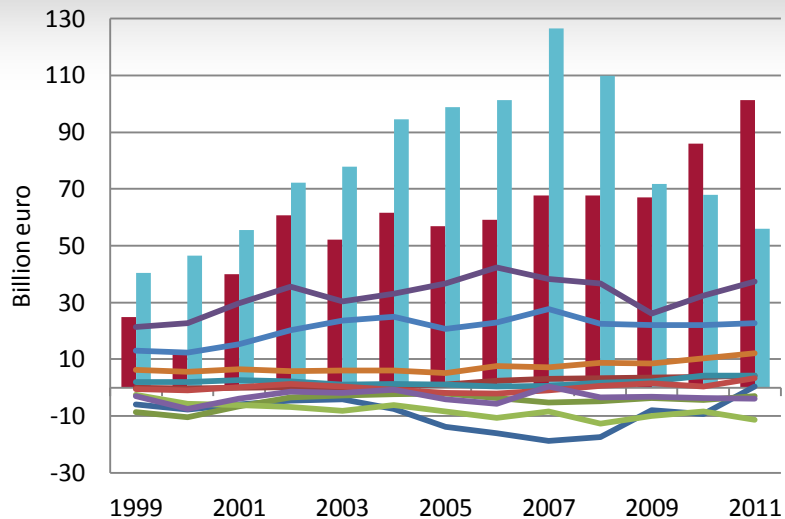
— Association of Southeast Asian Nations

Source: Eurostat

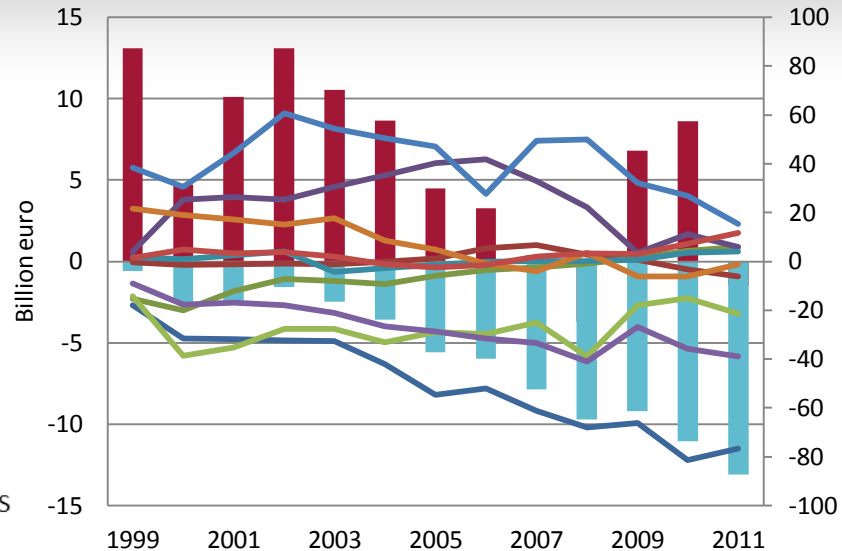


Trade balances with its main partners

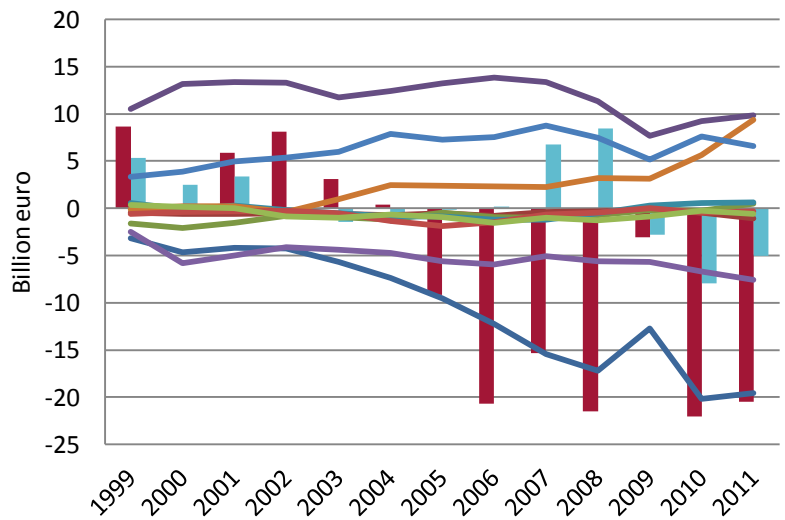
Germany



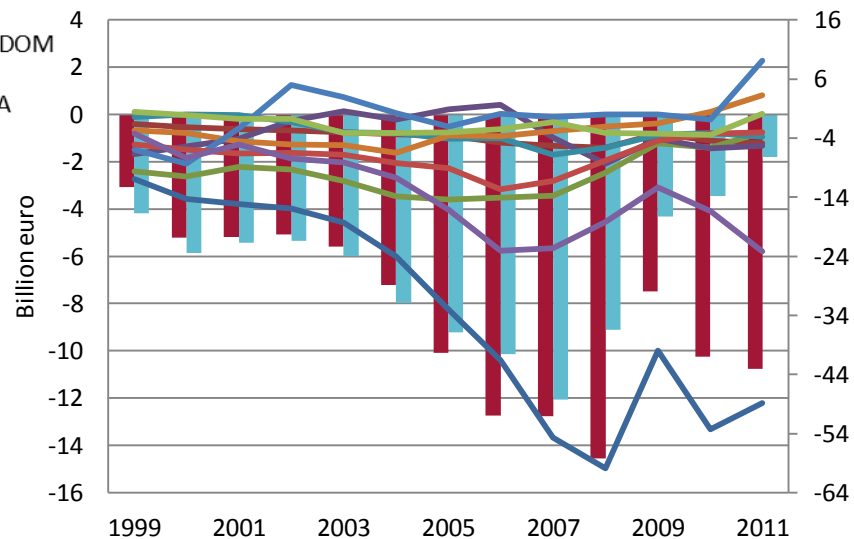
France



Italy



Spain



- EU27_EXTRA
- EU27_INTRA
- CHINA
- INDIA
- JAPAN
- UNITED STATES
- BRAZIL
- SWITZERLAND
- UNITED KINGDOM
- SOUTH KOREA
- NORWAY
- RUSSIA

Conclusions

- Banking Union is central to end crisis, first step is supervision on which work is well advanced. Ultimately, agreement on resolution and fiscal burden sharing needed
- Banking Union is also a political project and cannot be separated from political integration, including with more parliamentary control
- Ultimately, Europe will have to advance more on the fiscal integration, for stabilization as well as for public debt overhang
- Resolution (or not) of European crisis has implications on global financial markets as well as on global and European trade patterns
- Major risks in Europe are social tensions and political difficulties in South as well as North