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The EMU at 20: from divergence to resilience

Welcome address. Third Annual Research Conference of the Banco de España

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Ladies and gentlemen,

Let me start by welcoming you to the Banco de España for the Third Annual Research Conference. We began organising this conference three years ago, with the aim of bringing together leading scholars and policymakers to discuss frontier research on relevant topics. This year, the chosen topic is "The EMU at 20: current status and the way forward", which I think ranks highly in the current policy debate. It would be hard to imagine a more eminent group of researchers to discuss this topic. I would like to thank all of you for your attendance here today.

2019 marks the 20th anniversary of the creation of the euro. We reach this milestone in the context of a global macroeconomic deterioration, while still facing the legacy of the crisis, in terms of high unemployment rates and persistent levels of indebtedness. Part of this worsening of economic conditions is linked to trade tensions, against a background in which the multilateral financial and trade system in place since the end of the Second World War is being put into question. At the same time we are confronted with global trends, such as digitalisation and climate change, which pose significant challenges, of a different nature, for the European economy.

But I am optimistic about our common future. Economic and Monetary Union (EMU) remains the world's foremost economic integration project of recent times. And after 20 years, there can be no question that the euro is perceived by the public as a success. In the latest Eurobarometer surveys, euro area citizens have declared the highest level of support for the euro yet recorded.

Europe has proved itself to be innovative and decisive, although sometimes the necessary steps have only been taken under the pressure of extreme circumstances, such as the ones we experienced during the last sovereign debt crisis. That said, some bold advances have been made towards the completion of EMU over the past decade. Let me highlight two of these.

First, the two main pillars of the Banking Union that are now in place and operational: the Single Supervisory Mechanism and the Single Resolution Mechanism. Second, the creation of the European Stability Mechanism, which played a significant role in the solution of the crisis, and the ongoing reform of which is expected to strengthen this institution's capacity not only to combat but also to prevent crises. It is further envisaged that it will act as a common backstop for the Single Resolution Fund (SRF), filling a fundamental gap in the euro area's institutional architecture.

Despite these, and other, significant achievements, it is fair to acknowledge that the framework still lacks some fundamental pieces. In particular, as regards its ability to withstand a severe crisis. Let me flag some institutional elements that, in my view, rank highest among those needed.

First, completing the banking union comes at the top of the list, in particular, by overcoming the current deadlock on the third main pillar of the Banking Union, the **European Deposit Insurance Scheme (EDIS)**. The commitment to deploy such a scheme would have a strong impact on citizens' trust and would contribute to increased risk-sharing in the euro area, insofar as it is designed as a fully-fledged mutualised EDIS.

In addition, it would help align financial responsibility with the pan-European decision-making that already exists in the areas of banking supervision and resolution. The current misalignment makes EMU governance more prone to institutional and political frailty. It also remains crucial to eliminate certain regulatory barriers and practices that are hindering the emergence of a truly European banking market.

The second priority is linked to the need for well-developed and integrated capital markets within EMU, which requires further deepening of the **Capital Markets Union**. This is essential to enhance the capacity of the euro area to cushion macro-financial shocks. In particular, the development of a truly cross-border financial sector would allow economic agents to smooth asymmetric, national shocks through a strengthened credit channel.

Moreover, an enhanced Capital Markets Union would improve the channelling of the abundant aggregate savings – which currently exceed investment in the area by 3% of GDP – to satisfy investment needs in the areas of infrastructure, energy and innovation.

Third, there is also an urgent need to improve the functioning of the current fiscal policy framework, so that it delivers an aggregate stance that is consistent with national constraints and the needs of the euro area as a whole. On the one hand, the current fiscal policy coordination device, the Stability and Growth Pact, has not stood the test of time very well. Our **fiscal rules** have proven to be hard to enforce in a timely manner, not least because of their complexity, and have also been unable to avoid procyclical fiscal policies at the national level. On the other hand, and more importantly, the past decade has shown us that lacking a centralised fiscal tool to target an appropriate **euro area macroeconomic policy stance** is a serious limitation for the functioning of our monetary area.

I strongly believe that a central fiscal capacity at euro area level could contribute, in particular, not only to tackling asymmetric, country specific shocks, but also to macroeconomic stabilisation. In this respect, monetary policy would not become overburdened, as it might be in the current economic juncture.

Finally, let me advocate the need to explore the introduction of a **common safe asset** for the euro area. In my view, a well-designed safe asset would contribute significantly to addressing some of the root causes of the euro area's institutional weaknesses. In particular, it could increase the effectiveness of monetary policy, improve financial integration and complete the Banking and Capital Markets Union, by breaking the bank-sovereign doom loop and facilitating diversification. Let me expand on these aspects.

The normal operation of markets and financial intermediaries requires the availability of a broad spectrum of assets with sufficient liquidity and bounded counterparty risk, including so-called "safe assets". This is even more the case in turbulent times, as investors tend to react to increases in uncertainty by turning to assets with a lower level of perceived risk. As Holmstrom and Tirole[1] put it, a safe asset is an instrument that allows wealth to be transferred from one point in time to another without any nominal loss. If you allow me the metaphor, the supply of a broad enough set of assets is the infrastructure in an electricity grid. A large enough infrastructure is needed to ensure the grid's smooth functioning, in

[1] Holmstrom, B. and J. Tirole, "Private and Public Supply of Liquidity", *Journal of Political Economy*, Vol. 106, No 1 (February 1998), pp. 1-40 (40 pages).

particular, to allow it to withstand episodes of high demand. If not, the system is prone to disruptions and even blackouts.

There is a wide consensus regarding the existence of a secular **shortage of safe assets** at global level. To put it simply, there is not much highly-rated paper available once holdings in monetary policy portfolios are discounted. This phenomenon has become more acute since the outbreak of the European sovereign debt crisis, given that some euro-denominated sovereigns have seen their ratings downgraded, in part due to the persistence of an incomplete EMU.

As such, the total amount of European safe assets, defined as government bonds with a high credit rating (AA or higher) or privately-issued AAA products, is around $3 trillion, half of its peak in 2009.[2] By comparison, privately-held safe debt in the United States totals more than $14 trillion. Thus, the scarcity of safe assets is particularly acute in the case of euro-denominated safe assets, which limits the diversification options of investors in the euro area's common currency, in particular, those of international reserve managers with a mandate to invest safely.

The latter has two important consequences for the euro area. First, it precludes a more prominent **international role for the euro**, as investors need to take into account multiple sovereign risks and insolvency frameworks. Second, the demand for safe assets is entirely concentrated in a group of sovereigns. As a consequence, we face a form of **"exorbitant divergence"** in the euro area, as only some government bonds enjoy a high convenience yield stemming from their status as safe assets.[3] A common safe asset would provide a single benchmark for every country in the euro area, allowing banks and companies to diversify their portfolios without triggering capital flights in the event of a crisis, and mitigating the "exorbitant divergence".

The introduction of a safe asset would also help to alleviate an unwarranted national bank - national sovereign nexus. I am referring here to the large domestic sovereign debt holdings of national commercial banks and the lack of incentives for them to act differently under the current legal framework. Solving this problem would certainly make a broad agreement on EDIS more likely and vice versa. To create adequate incentives for commercial banks to move away from domestic sovereigns, some proposals support the introduction of risk weights or concentration charges on banks' holdings of domestic sovereign debt. In my view, this is an issue that has many facets and requires thorough analysis. The literature has shown that, if implemented in isolation, such measures could have significant side effects. In particular, while pure diversification reduces exposure to the domestic sovereign, it could increase aggregate risk, as banks' portfolios become more overlapped and interconnected.[4, 5] In addition, risk weights may have unwarranted distributional effects, by giving the bonds of specific sovereigns a regulatory advantage.[6]

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2 Aggarwal, R., J. Bai and L. Laeven (2016), *The Role of the Government Bond Lending Market in Collateral Transformation*.
3 Estimated by the ECB as 110 basis points, as compared to 160 bp in the US. See: ECB (2019), *The International role of the euro.*
4 Craig, B. R., M. Giuzio and S. Paterlini (2019), *The Effect of Possible EU Diversification Requirements on the Risk of Banks' Sovereign Bond Portfolios*.
5 Acemoglu, Daron, Asuman Ozdaglar and Alireza Tahbaz-Salehi (2015), "Systemic Risk and Stability in Financial Networks", *American Economic Review*, 105 (2): pp. 564-608.
6 Alogoskoufis and Langfield (2018), "Regulating the doom loop", *ESBR Working Paper*, No 74.

One of the best ways of increasing the degree of diversification of banks' holdings of sovereign debt, without relying on complex regulations with possible unintended effects, is through the creation of a pan-European safe asset.

But as I will now argue, the relevance of a euro-denominated safe asset for strengthening our monetary union is not just linked to breaking the doom loop between sovereigns and banks, increasing diversification and strengthening the international role of the euro. It is also of paramount importance for the Capital Markets Union project.

EU regulation has done a significant job in harmonising investment and savings products across the European Union. Nevertheless, the completion of the Capital Markets Union is hardly possible without a common benchmark for investors and firms at the euro area level. Under the current framework, even highly diversified multinationals are linked to the sovereign of the host country. For example, the credit default swaps (CDS) of the most important Spanish non-financial multinationals (firms with revenues from all over the world) show a more than 90% correlation with the CDS of the Spanish government. Again, the benchmark for any firm is not a pan-European benchmark (or the Bund), but the national one. A single, risk-free asset would likely become a common benchmark, allowing the prices of equities and bonds across the euro area to reflect fundamental risk more clearly. Naturally, a European safe asset would facilitate the development and integration of capital and financial markets in the euro area, as **flight-to-quality movements would no longer imply flight-to-core-countries movements**.

The existence of a common euro-based safe asset would be particularly important in times of stress, as **it could mitigate the possibility of monetary policy transmission being hampered in a context of fragmented bond markets**. The effectiveness of monetary policy should be independent of the existence of country risk in the euro area. Similarly, a sufficient supply of safe assets would also facilitate the transmission of non-conventional monetary policy, by expanding the assets available in the event of a large asset purchase programme. It would allow monetary policy to expand the ECB's balance sheet without squeezing liquidity in national sovereign markets.

More generally, the literature has shown that a shortage of safe assets leads to a lower economic growth environment when monetary policy is constrained by the effective lower bound on interest rates. This is so because the scarcity of safe assets pushes the natural rate downwards. If central banks are constrained in their ability to lower nominal rates, a disequilibrium emerges in asset markets, giving rise to a **"safety trap"**. In this case, households, faced with deflationary pressures and (relatively) high real rates, have an incentive to save and postpone consumption, and firms, faced with low demand and high risk premia, to postpone investment. The result is a recession or a period of sluggish growth, which, in turn, reduces the wealth of savers and their demand for safe assets.[7]

Do we have alternative ways of escaping this trap? We require, following my earlier metaphor, an update to our electricity grid. On first thoughts, **two ways to expand the set of safe euro-denominated assets** spring to mind. On the one hand, euro area countries with a sovereign bond that is not considered sufficiently safe should focus on reducing their idiosyncratic sovereign risk, in particular by implementing credible medium-term fiscal

[7] Caballero, Farhi and Gourinchas (2017), "The safe asset shortage conundrum", *Journal of Economic Perspectives*, 31(3).

plans, in order to jump on the safety bandwagon. On the other hand, increases in the amount of current safe instruments could mitigate the safety trap.

However, this strategy may not be enough to ensure a sufficiently stable and ample supply of safe assets. First, its success depends on the capacity of the less safe countries to become safe. The sovereign debt crisis has shown that it is not sufficient to start from a low level of debt and a budget surplus, as was the case of Spain in 2007. Second, countries with fiscal space might face restrictions on the amount of debt they can issue. As a consequence, one cannot guarantee that, faced with another negative shock, risk perceptions will not differ nor fragmentation increase. In addition, this strategy will not suffice to disentangle the financing of the economy from the status of its sovereign. For that, we need a pan-euro area safe asset.

I have set out a number of reasons why a euro-based safe asset is desirable. Several operational proposals have been suggested in the literature.[8] Most of them, such as the one for sovereign bond backed securities (SBBS),[9] which have been subject to a thorough analysis by the European Systemic Risk Board, entail the creation of a synthetic bond backed by national sovereign bonds. This proposal emphasises that, through diversification, it will be possible to provide a senior tranche with lower risk than German debt. An alternative option is E-bonds,[10] which would be single tranche bonds issued by the ESM or any euro area body with the capacity to issue bonds, backed by loans to all euro area sovereigns. I think we need further reflection on the properties of these proposals and the constraints and incentives involved.

Let me point out three conditions that any of the proposals must fulfil in order to improve the current framework.

First, they should have the potential to generate a sufficient amount of safe assets at the European level. They cannot simply involve a swap of one form of safety for another, as that would not solve the shortage of safe assets.

Second, they should preserve liquidity in the markets for national sovereign securities. This would allow the market to price idiosyncratic risks correctly and help treasuries to meet own funding needs.

Third, and connected with the previous condition, they should preserve the incentives to pursue sound fiscal policies. Ultimately, sound public finances are indispensable for the provision of a truly safe asset.

Lastly, the sizable current account surplus and the strong overall fiscal position of the European Union, compared to those of other advanced economies, can be seen as a call for greater investment. Among the main areas of necessity, we should prepare our economies and citizens for challenges related to climate change, ageing and digitalisation. More importantly, the EU lags behind the US in terms of productivity growth. These challenges are widespread and common to all our economies, and therefore a common and

[8] Leandro and Zettelmeyer (2018), "The search for a Euro Area safe asset", *Peterson Institute for International Economics Working Paper*, 18-3.
[9] Brunnermeier et al. (2017), *ESBies: Safety in the tranches*, and ESRB (2018).
[10] Zettelmeyer and Leandro (2019), "Beyond ESBies: safety without tranching", in *Risk sharing plus market discipline. A new paradigm for Euro Area reform*.

safe source of financing would be tailor-made for them. It could also provide some stabilisation for the economy, as investment provides a safety net in times of economic distress.

In short, **some sort of European investment agency**, whether in the form of a new or an existing euro area body, with the capacity to issue bonds, might be able to target an optimal fiscal policy stance, while providing the economy with more safe assets, thus facilitating monetary policy transmission, increasing the international role of the euro and completing the Banking and Capital Markets Union.

Twenty years ago, the euro was seen, in Christian Noyer's words, as a catalyst for integration. This view is now as valid as it was then. In order to achieve price stability, the single currency generates the need to pursue sound economic policies. But it is clear now that monetary integration does not immediately lead to financial integration. This is an ongoing process, and the governance framework to guarantee the success of the European project is still developing. We must endeavour to achieve completion of the Capital Markets Union and the Banking Union. This will also require progress towards the Fiscal Union. A European safe asset lies at the heart of all of these initiatives. But, more often than not, the heart is the most difficult place to reach.

I am sure that these two days will bring advanced research and a constructive exchange of views to bear on this and other important areas of the euro area architecture.

Thank you for your attention.