Europe and the euro: Proposal for a workable way forward

German Council of Economic Experts

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13/14 Against a backward-looking economic policy
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17/18 Towards a forward-looking economic policy

Europe and the euro: A Workable Way Forward

I. Some principles and an over-arching framework: Maastricht 2.0
II. Gaps to be filled and measures to be avoided

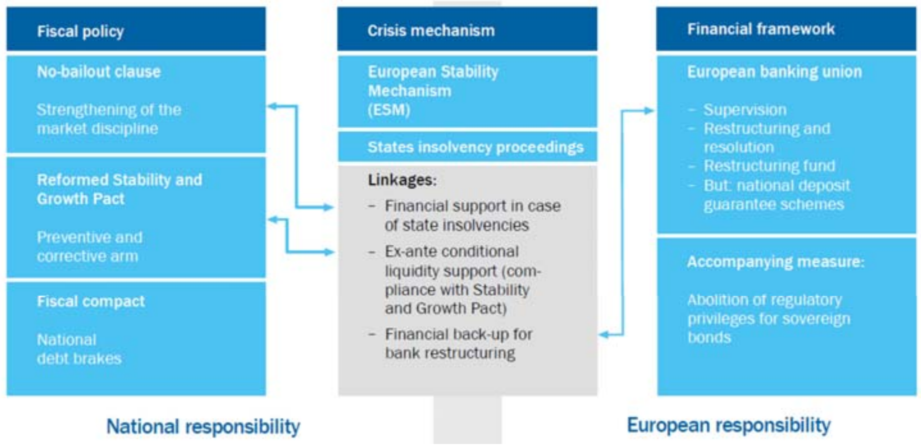
Extra: Concrete proposals on missing links

I. Some principles and a Maastricht 2.0

Things to keep in mind

- European Union is the key post-WWII peace project. Do not destroy it with an „integrate or out“ vision of USE.
- EU needs right mix of centralized vs national decision-making to stay viable for Member States and their citizens.
- The common currency and monetary policy is a (mostly) common experiment.
- Need to achieve stability with substantial Member State sovereignty over fiscal and economic policies.
- Principle: Keep control and liability on the same level.

Maastricht 2.0



To Do: Focus on sustainability

Structural reforms for improving competitiveness and efficiency are national responsibility, need to continue reform process.

Deficits have been reduced but public debt is still high; need to continue consolidation; make use of interest savings.

Fiscal policy focused on national priorities, not euro area fiscal stance.

Reduce complexity of fiscal rules, joint fiscal capacity not needed.

Expand ESM with role in surveillance and orderly sovereign debt restructuring mechanism.

Completing banking & capital market union, risk-reduction prior to further risk sharing, caution regarding SBBS.

Principles for a stable European Union

- Need to strike appropriate balance between Member States responsibility and centralized decision making
- Maintain principles of subsidiarity and the unity of liability and control
  - Avoids moral hazard
  - Improves acceptance of the European integration process

Construtive further development of EU

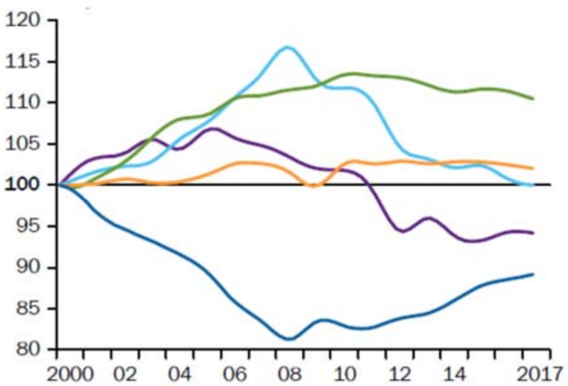
- Strengthen European responsibilities in selected areas
  - international trade, digital common market, procurement in defense, migration and political asylum, climate protection, anti-terrorism policies
- But:
  - No general constraints on foreign direct investment
  - Posted workers directive constrains common market in services
  - Need new priorities for EU budget

- One-time extension of negotations with UK to avoid disorderly Brexit, which would be harmful for all and destructive to Europe

SACHVERSTÄNDIGENRAT zur Begutachtung der gesamtwirtschaftlichen Entwicklung

II. Institutions and policies oriented towards sustainability of the euro area

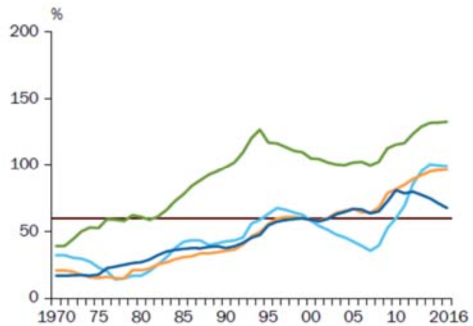
Convergence in euro area: Reforms as national responsibility



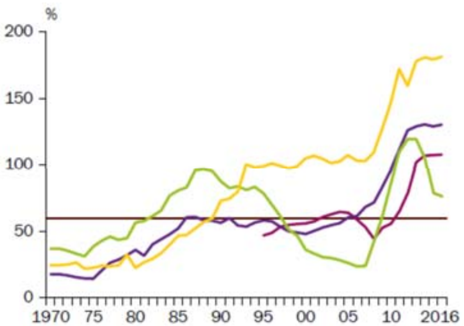
Real effective exchange vs euro area based on unit labor costs

Germany
Spain
Italy
France
Portugal

Public debt still high, consolidation needs to continue

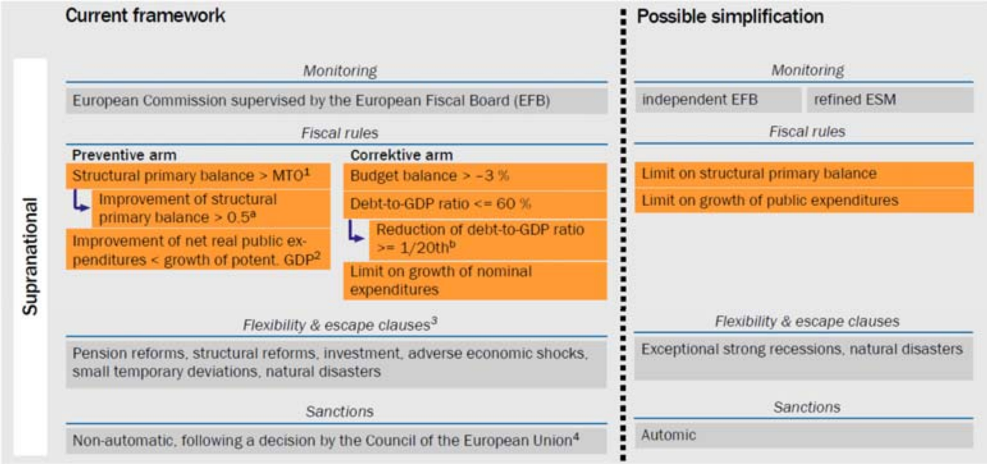


Germany, Spain, Italy, France



Ireland, Greece, Cyprus, Portugal

Reduce complexity of fiscal rules



Priority for sustainable fiscal policy on national level

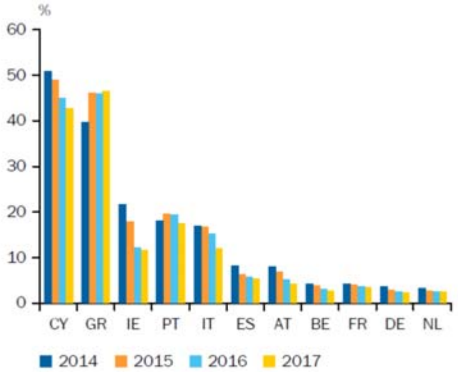
National fiscal policy needs to adjust to member state situation, not be constrained by a prescription for euro area fiscal stance

Joint fiscal capacity or other transfer mechanisms not needed

- Structural and cyclical effects not easy to separate, potential for moral hazard
- National fiscal policy achieves stabilization via intertemporal adjustment, if needed with help of ESM
- More risk-sharing via capital markets by strengthening capital market union

Completion of banking and capital market union

Non-performing loans



Risk reduction prior to more risk sharing

1. Swift reduction of non-performing loans
   - Stronger supervisory targets
   - Not publicly-financed bad banks
2. Bank resolution
   - Raise hurdle for exceptions to creditor participation
   - Address differences in national insolvency law
3. State-Bank-Nexus
   - End regulatory privilege for sovereign debt
   - Large-exposure limits

Strengthen ESM, caution regarding SBBS

ESM is a key element of euro architecture

- Add rules for orderly restructuring of sovereign debt in crisis case
- Add mandate for monitoring fiscal policy of member states
- Medium term: Possible fiscal backstop for SRF in systemic crisis

Sovereign-bond-backed secturities

- Strict conditions avoiding implicit liability risks
- Emission by private actors, abolish regulatory privilege of sovereign debt
- First abolish regulatory bias against securitisation of sovereign bonds

EXTRA: Concrete proposals on missing links for the euro area

Sovereign debt restructuring mechansim

Member states issue debt in „foreign“ currency
- Mechansim increases effective capacity of ESM
- Avoids use of monetary financing
- Investors bear risk, no complete bailout
- States have responsibility for sustainability, market discipline

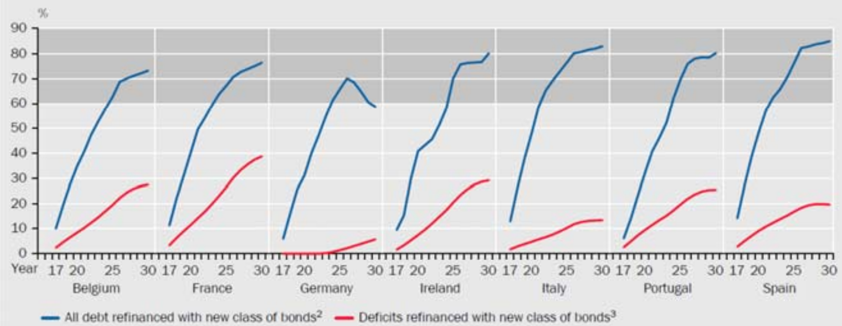
Orderly procedure starting with ESM Programme request
- Debt sustainability analysis
- If not sustainable, maturity extension
- Prior to market entry, in case of overindebtedness, nominal debt reduction vis-a-vis private creditors.

Orderly procedure

1 – Newly issued debt including Creditor Participation Clauses. 2 – Range of possible threshold levels.

Share of debt stock with CPC's

Penetration of debt stock with bonds including Creditor Participate Clauses (CPCs) issued from 2017[1]



1 – Assumes bonds are issued with new clauses starting in 2017 based on maturity profile of bonds as of end-2014, with (i) maturity of newly issued bonds similar to 2014 and (ii) nominal debt following European Commission (2015b) and extrapolated after 2017. 2 – Assumes that share of other debt relative to GDP remains constant. 3 – Deficits until 2026 based on European Commission (2015b), and convergence towards 0.5 % of GDP at an annual rate of 0.5 percentage points afterwards. Bonds with CPCs falling due are rolled into similar bonds.

Abolishing privilege of sovereign debt in banking regulation

Risk-adequate capital requirements
- Increases loss absorption capacity, reduces bias in pricing
- Basle risk weights, grandfathering possible

Risk-based large exposure limits
- Central element, reduces cluster risk.

Large exposure limits and risk weights for sovereign debt

Risk-adjusted large exposure limits and risk weights for sovereign exposures

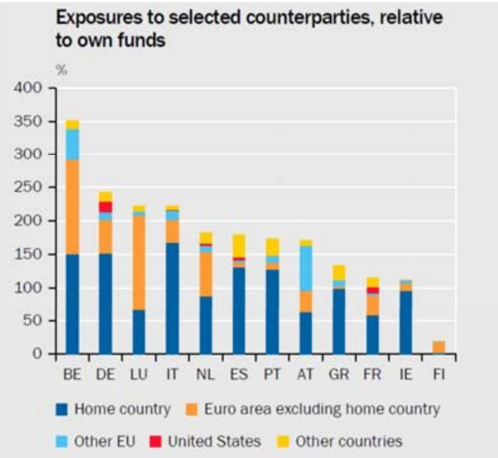
Standard & Poor's credit ratings[1]	Member states[2]	Basel risk weight for sovereigns (%)	Large exposure limit[3] (%)	Basel risk weight for corporations (%)
AAA	DE, LU	0	100	20
AA+/AA/AA–	AT, FI, NL/BE, FR/EE			
A+/A/A–	IE/SK/LT, LV, SI	20	90	50
BBB+/BBB/BBB–	MT/ES/IT	50	75	100
BB+/BB/BB–	–/PT/–	100	50	
B+/B/B–	CY/–/–			150
CCC+/CCC/CCC–	–/–/GR	150	25	

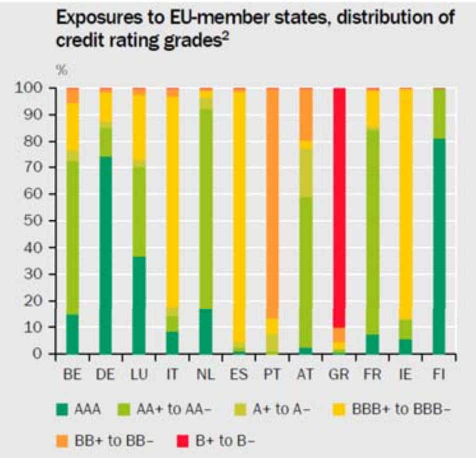
1 – As of 1 July 2015. 2 – DE-Germany, LU-Luxembourg, AT-Austria, FI-Finland, NL-Netherlands, BE-Belgium, FR-France, EE-Estonia, IE-Ireland, SK-Slovakia, LT-Lithuania, LV-Latvia, SI-Slovenia, MT-Malta, ES-Spain, IT-Italy, PT-Portugal, CY-Cyprus und GR-Greece. 3 – Own calculation.

Sources: Basel Committee on Banking Supervision, Standard & Poor's

SVR-15-429

Sovereign exposures of banks (EBA stress test 2014)





Effects of large exposure limits