Could uncertainty derail the European recovery ?

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Among the sources of uncertainty

EU specific

- Germany’s political situation and delay
- Lack of time and political concentration, also due to geopolitical tensions
- Franco-German leadership: is there sufficient agreement, outside and inside the couple?
- Political and economic problems coming from Italy (but most of them are de facto European)

Global

- Contrast between “good” economic situation and geopolitical tensions (see over)
- Global economic “conflicts”: Trump tariffs and protectionism (see a coming slide)

When the [global] economy is fine and politics is not

- <u>Cyclical illusion </u>? When long term trends (consistent with inappropriate political behaviour) are neglected while settling for short term good news. Weaker economics forecasts for the coming years
- <u>Economic complacency distracts from the efforts to correct wrong policies and improve institutions</u>: are [divided] EU and global [lack of] cooperation waiting for the next Great economic Crisis?
- How much the Fault Lines, the unbridged, somehow <u>hidden fractures that "caused" the Great Recession </u>are still with us? (see over)

Some "Fault Lines" that increase uncertainty

- Income and wealth distribution and the "losers" from globalization
- The credibility of the élites and the distance between "people" and supranational decisions
- Productivity paradoxes, Secular Stagnation (?) and its various causes
- Excessive global leverage: also to keep "losers" alive and hide structural weaknesses and fractures
- Financial innovations and the new complexities of risk-taking (asymmetric probability distributions, black swans and all or nothing risk appetites)
- Monetary policies and exchange rates in a world with thick and deeply interconnected financial sectors
- Monetary and fiscal short-term stabilization vs structural reforms (demand vs supply policies) : political conflicts and trade-offs; short termism

Protectionism

- Trump tariffs, EU threatened retaliation, Trump's threat to put tariffs and/or quotas on cars, China's reaction, etc. : trade wars?
- Non tariff trade obstacles and distortions (dumping of various types) have been always in place and growing: too much neglected ?
- Is the WTO inadequate ?
- Trade policy cooperation shouldn't be meant as ideological liberalism: well studied temporary compensations for excessive differences in cost of producing and/or adapting productive structures to the new comparative advantages
- The role of G20
- EU trade policy centralization: is it in danger? Germany's special interests and the various resurgent nationalisms

EU dossiers on the table to beat uncertainty: *European public goods*

- defense, security, migrations, infrastructures, even a potential future social pillar, …
- Stress the concept, explain; ban net-credit net-debit calculations
- Connections with EU’s multiannual budget (HLCOR, 2016) and tax [base] harmonization
- Gradual steps but with long-term ambitions
- Italian support
- Partial inversion of Monnet’s functional hierarchy (economic integration driving political unity)?

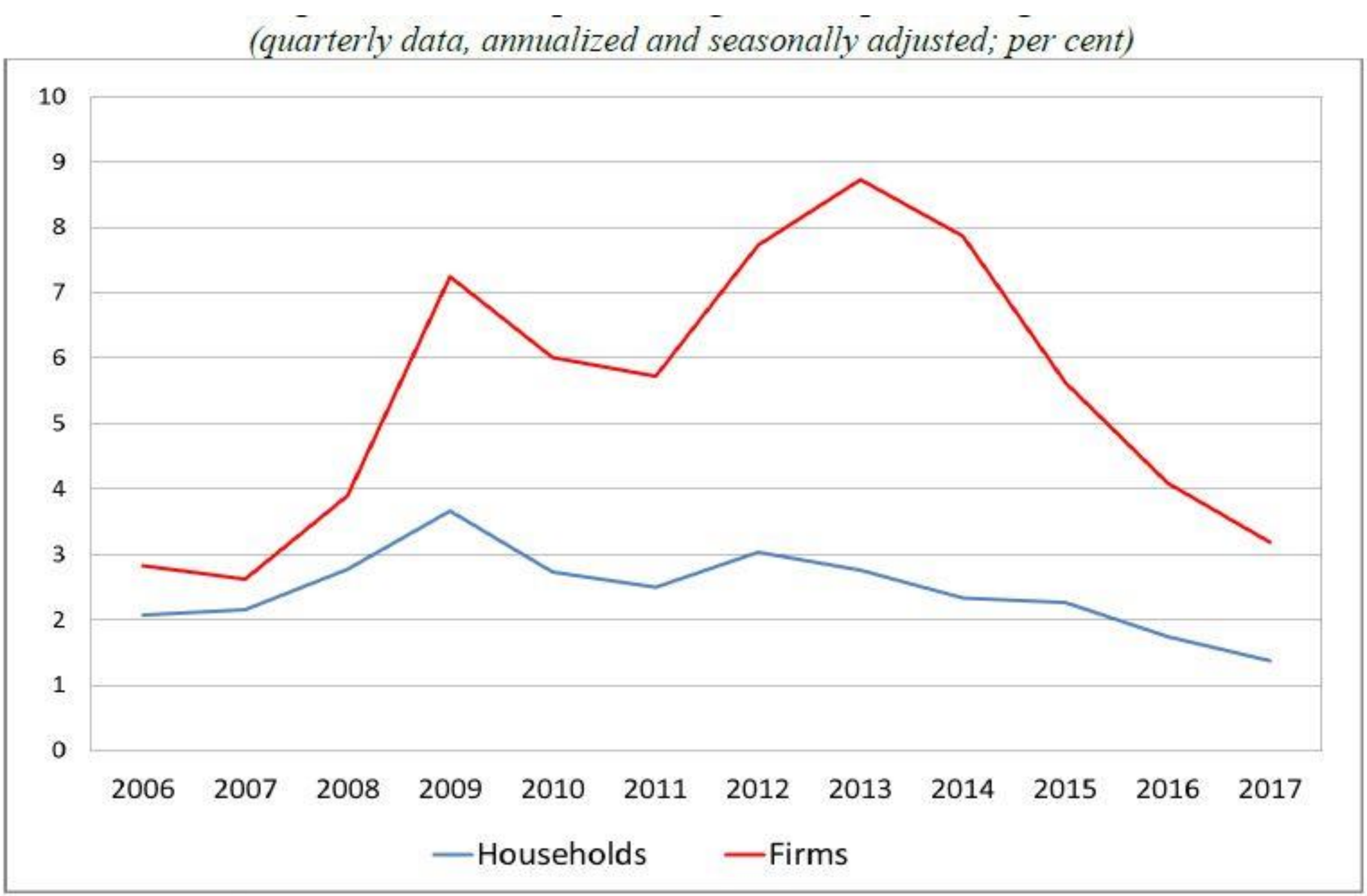
Selecting important economic-financial dossiers

- European Banking Union (publicize! More important than fiscal union): deposit insurance
  - **NPLs**
  - Sovereign-bank interdependence ("**doom loop**")
- **ESM-EMF**
  - Governance (no longer intergovernmental?)
  - Tasks (includes sovereign risk sharing, generation of risk free assets, fiscal surveillance, backing of Resolution and Deposit Insurance funds ?)
- Role of **market discipline and orderly resolution** for both sovereigns (automatic procedure?) and banks (bail-in, bail-out)

NPLs

- No sustainable solution without deep <u>restructuring</u> of the banking system
- We can manage stocks and flows but they will come back without intervening on <u>bank management quality, business models and governance</u>. We can deal with the balance sheet but the final solution is in the **income account**. Also: subtract the excess of the resources employed in an obsolete sector like banking
- Important changes needed in bank-firm relationships, decreasing the maximum **firms' leverage to access bank credit** and (legally and managerially) facilitating the **withdrawal of misallocated credit lines**
- EU can help but national defensive attitudes (by bankers, politicians and authorities) must stop
- In Italy: recent **progress with FLOWS** of NPLs, banks CHANGES of business models and firms' financial structure FLOWS (<u>*see the following figures*</u>). However, the STOCK/STARTING situations were very bad and we are just watching **marginal improvements**

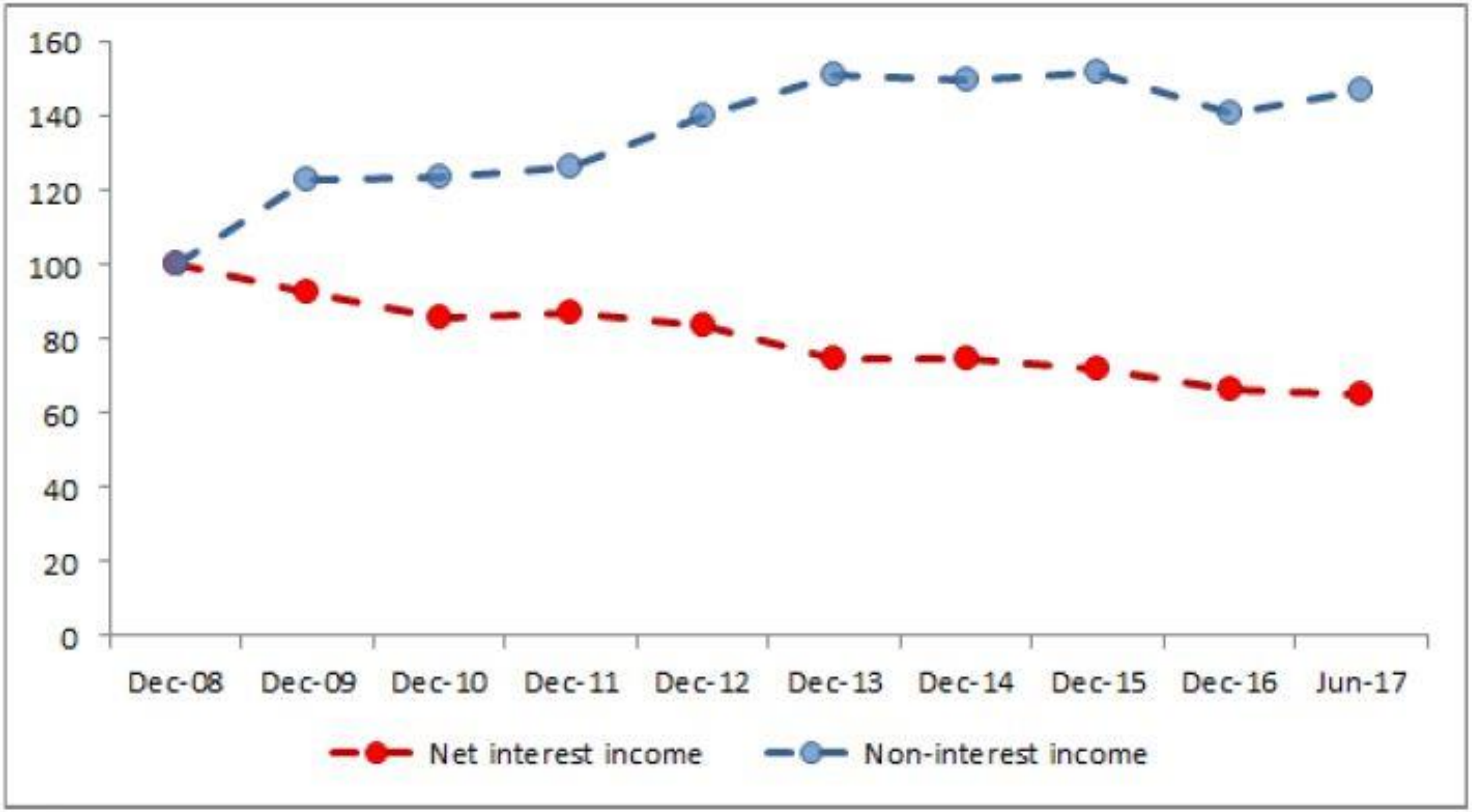
Italy : ratio of new-non performing loans to performing loans



Source: Bank of Italy, Central credit register.

From: F.Panetta, http://www.bancaditalia.it/pubblicazioni/interventi-direttorio/int-dir-2018/panetta-20180219.pdf

Italian banks: gross income: dynamic of interest and non-interest income

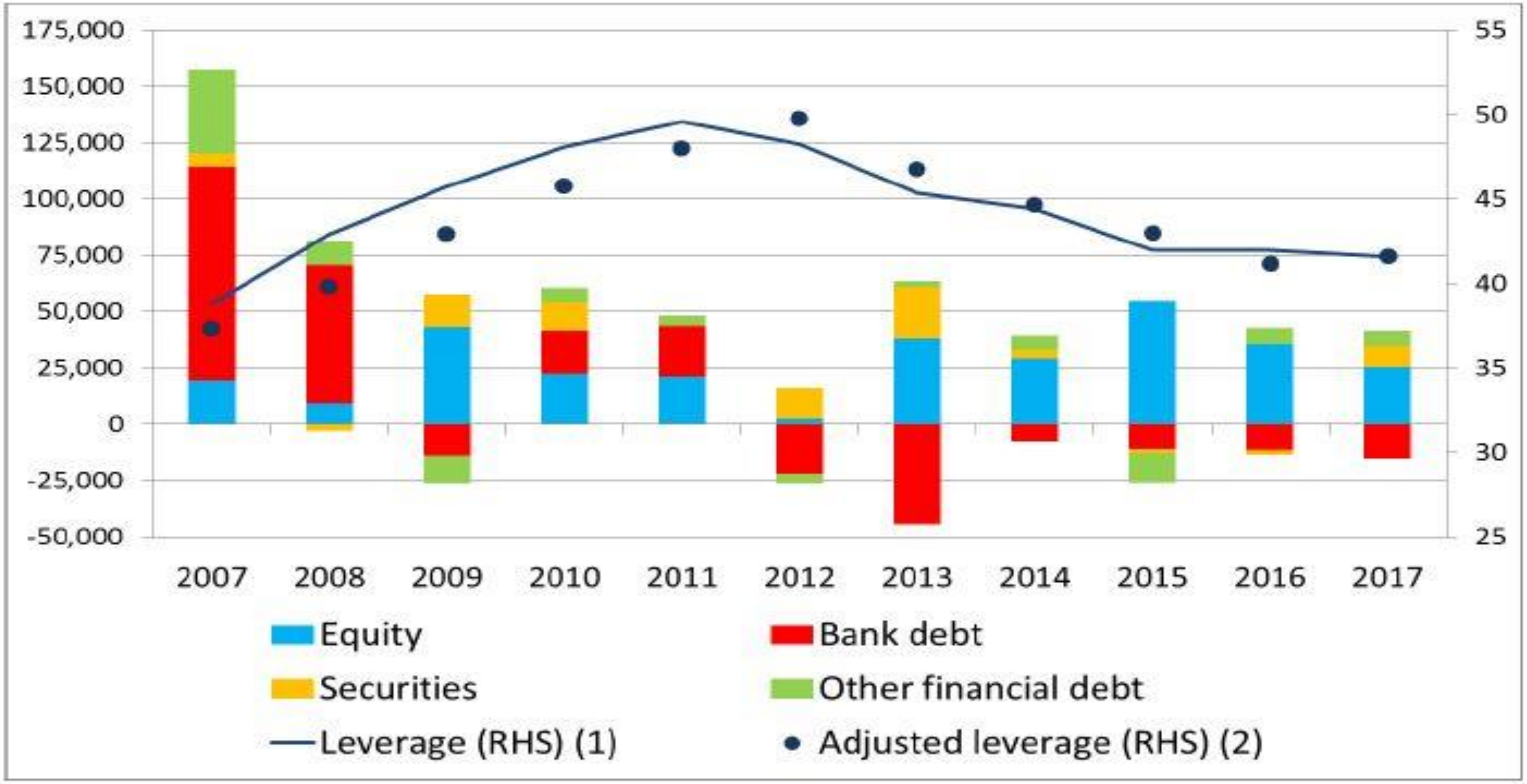


Source: Bank of Italy.

From: F.Panetta, http://www.bancaditalia.it/pubblicazioni/interventi-direttorio/int-dir-2018/panetta-20180219.pdf

Sources of funding and leverage of Italian firms

(annual flows in billions of euro and per cent)



Source: Bank of Italy and Cerved.

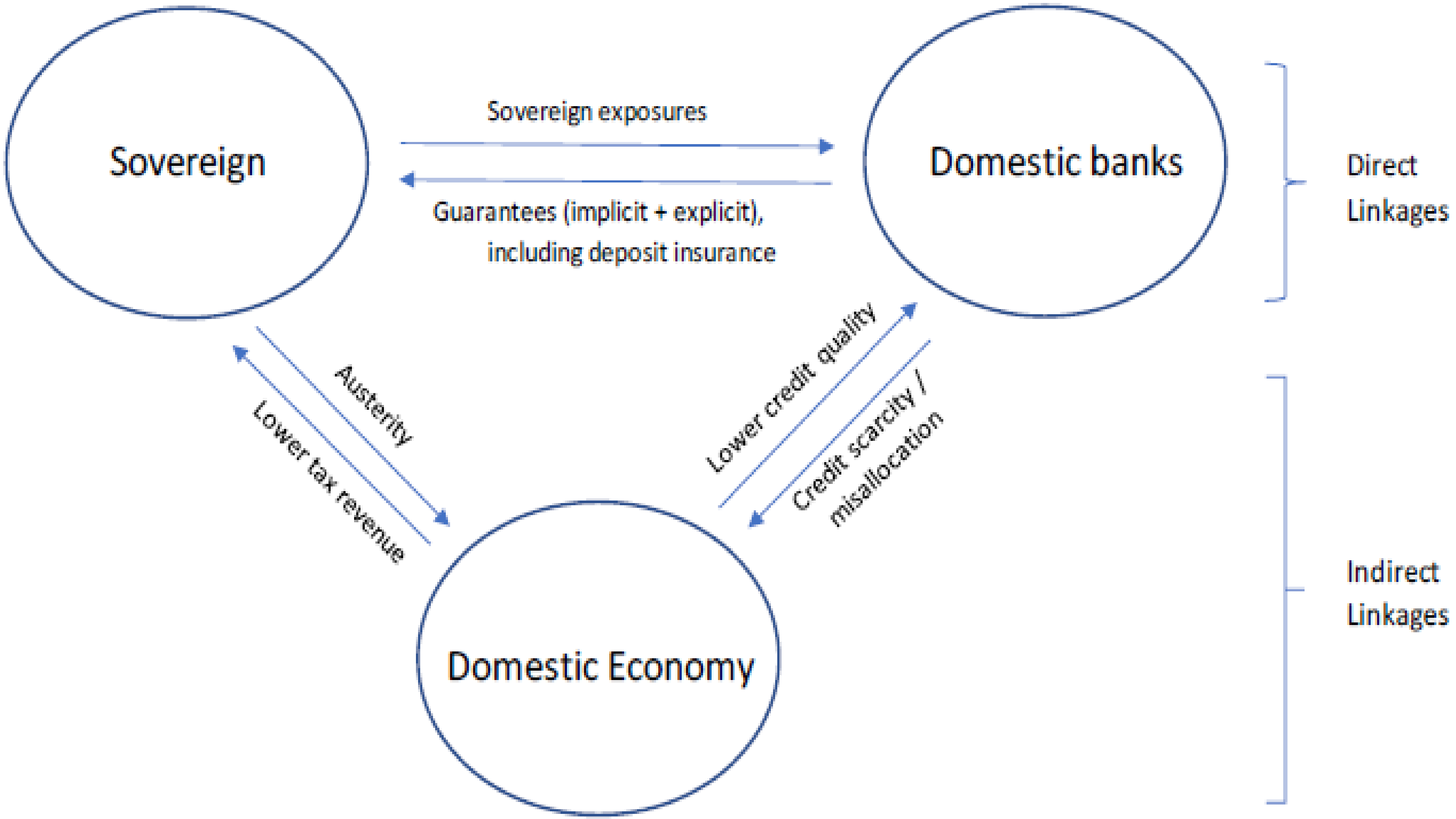
(1) Leverage is calculated as the ratio of financial debt to the sum of financial debt and net equity at market prices. (2) Adjusted leverage is calculated by removing the effects of changes in the market value of net equity. A value above (below) the solid line indicates, for a given year, a decrease (increase) in the market value of equity.

From: F.Panetta, http://www.bancaditalia.it/pubblicazioni/interventi-direttorio/int-dir-2018/panetta-20180219.pdf

Sovereign-bank interdependence and the "doom loop"

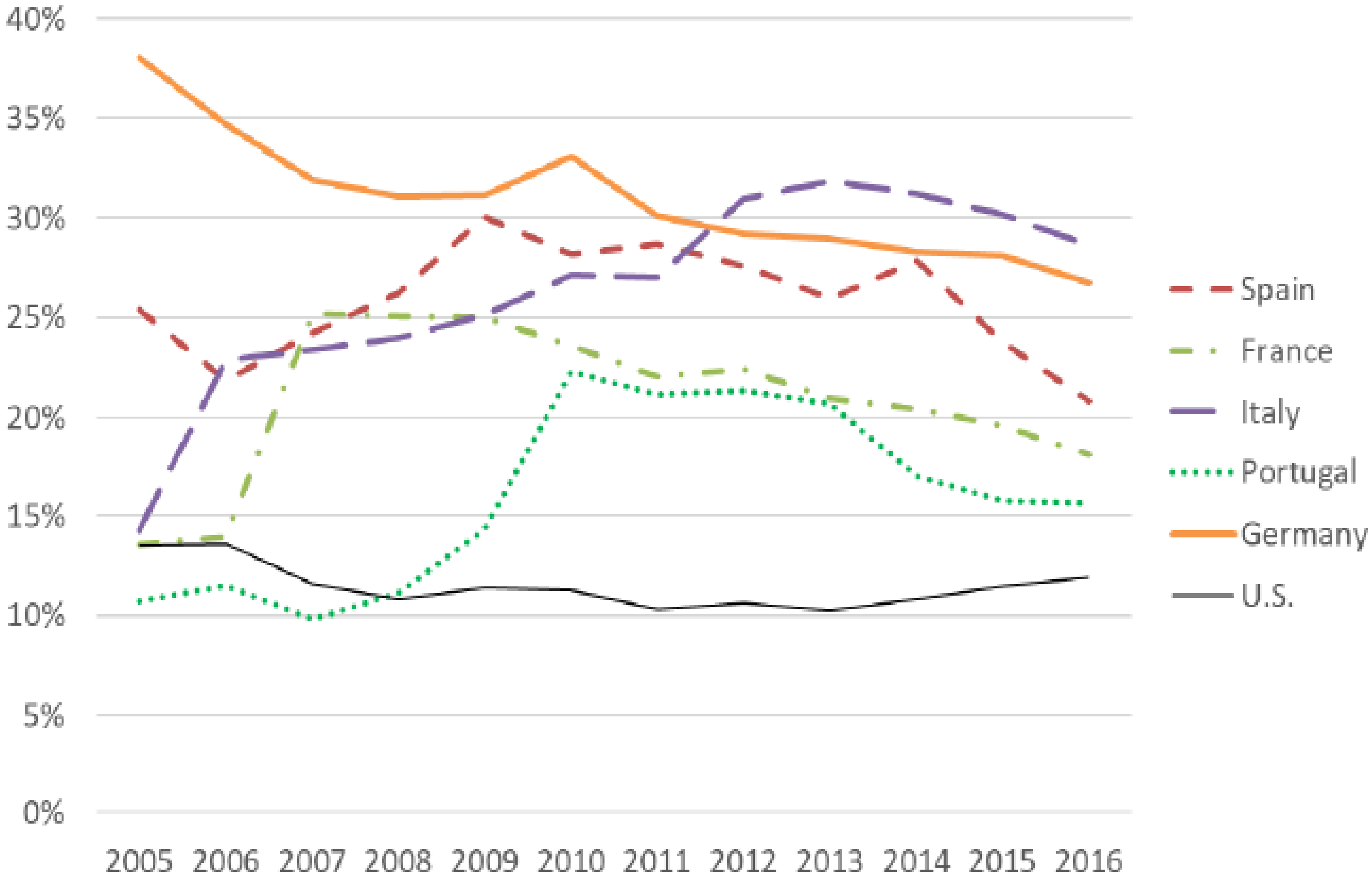
- The EU Parliament and Nicolas Véron proposal (gradually **eliminate the concentration risks** with no change of Basel ratios)
  - with positive side effects on capital markets union (& market based risk sharing) and the transmission of monetary policy
- Is the doom-loop issue **overstressed?** As a sovereign default always involves banks. No:
  - From sovereigns to banks: the case of spread-type <u>speculative shocks</u>
  - From banks to sovereigns: liquidity interbank shocks, bail-outs and bail-ins, mark-to-market accounting of banks holdings of sovereigns
  - Implicit <u>support of public debt</u> (with or without moral suasion) and potential crowding out of credit to the private sector

Sovereign-bank interdependence and the "doom loop"



From: N.Véron, http://www.europarl.europa.eu/RegData/etudes/STUD/2017/602111/IPOL_STU(2017)602111_EN.pdf

Ownership Share of Domestic Banks in Sovereign Debt Outstanding



Source: ECB, US Federal Reserve Board, US Treasury. Updated and adapted from Figure 1 in Lenarcic, Mevis and Siklos (2016), adding US agency securities, non-marketable public debt and some components of marketable public debt in the definition of US sovereign debt.

From: N.Véron, http://www.europarl.europa.eu/RegData/etudes/STUD/2017/602111/IPOL_STU(2017)602111_EN.pdf

Sovereign Exposures of Euro Area Banks, end-June 2016

	Number of banks in sample	Coverage of country's SIs (by assets)	Unweighted average domestic sovereign exposure ratio	Weighted average domestic sovereign exposure ratio	Median Home Bias
Cyprus	2	58%	47%	30%	92%
Germany	15	92%	222%	159%	85%
Spain	3	67%	129%	102%	78%
Ireland	3	89%	91%	79%	75%
Slovenia	2	80%	147%	144%	74%
Italy	6	78%	199%	171%	73%
Greece	4	100%	60%	60%	72%
France	6	93%	99%	114%	70%
Portugal	4	85%	153%	155%	66%
Belgium	4	65%	217%	209%	62%
Austria	6	95%	90%	78%	58%
Malta	2	65%	122%	178%	41%
Netherlands	4	95%	52%	46%	35%
Finland	1	25%	21%	21%	27%
Luxembourg	1	23%	49%	49%	13%
Total	**63**	**83%**	**142%**	**119%**	**75%**

Source: author's calculations based on *Annex B*, on the same sample of banks minus outliers BNG and SFIL. Countries are ranked by decreasing median home bias of banks headquartered on their territory. The domestic sovereign exposure ratio is the ratio of domestic sovereign exposure over Tier-1 capital. The weighted average is weighted by Tier-1 capital, i.e. calculated as the ratio of aggregate domestic exposures over aggregate Tier-1 capital for all the country's banks in the sample. The home bias is defined as the ratio of domestic sovereign exposure to aggregate sovereign exposures to euro-area countries. Banks are assigned to countries on the basis of their country of headquarters, which explains the absence from the table of Estonia, Latvia, Lithuania, and Slovakia, where none of the sample's banks is headquartered.

From: N.Véron, http://www.europarl.europa.eu/RegData/etudes/STUD/2017/602111/IPOL_STU(2017)602111_EN.pdf

ESM-EMF: governance

- The important point is the independence of management with stability objectives, accountable to the board of directors, with the possibility to intervene *sua sponte*, even with no conditionality
- Resuscitate part of the spirit of the OMTs
- Compatible also with substantial intergovernmental board of directors
- Smoothing markets function as an ex post pillar after ex ante surveillance (Commission for countries, EC for banks) and market discipline. And … before default !

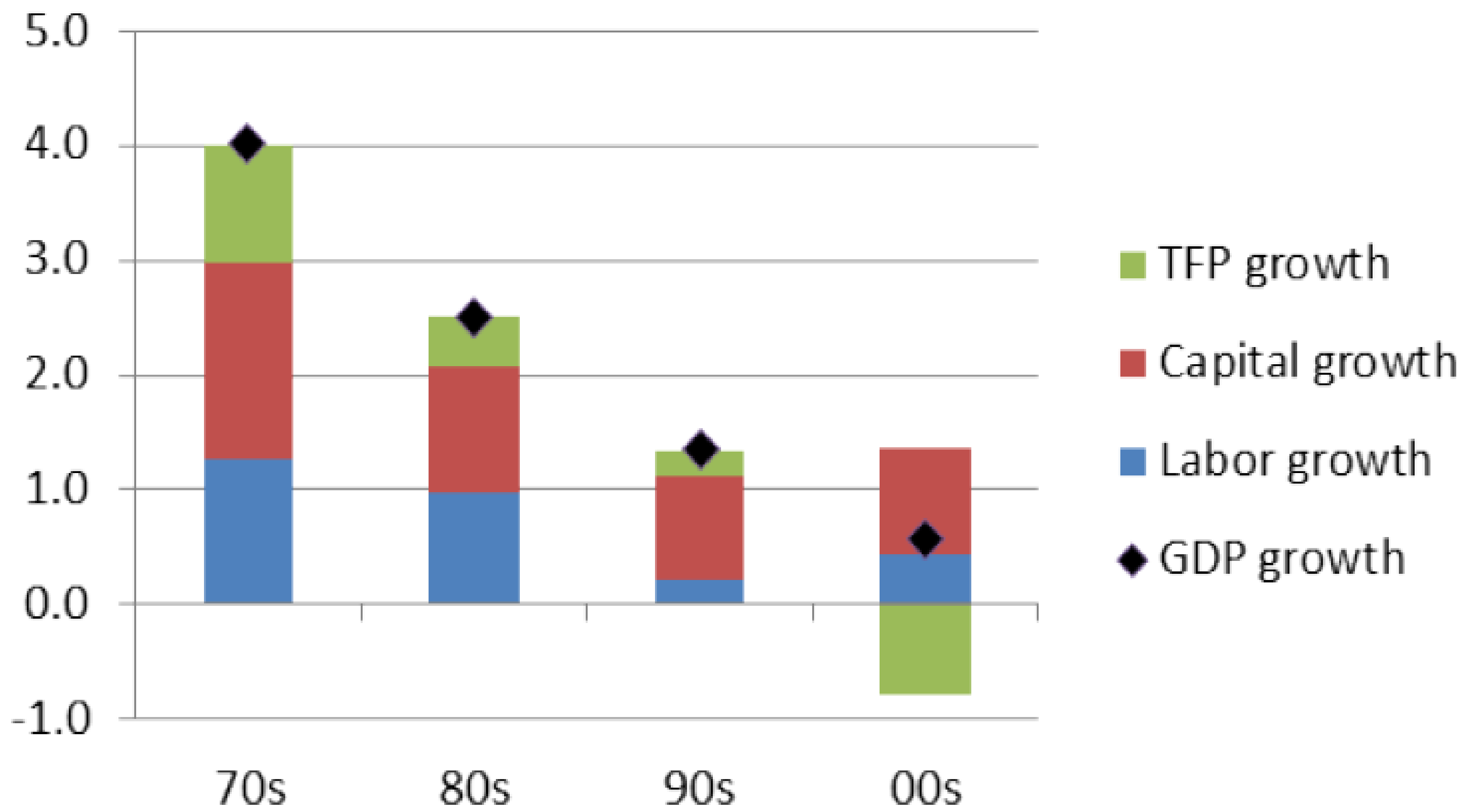
Defaults

- Stop the <u>hypocrisy</u> that banks and EU-sovereign defaults are “impossible” or inevitably disastrous
  - market spreads aren’t always market failures
  - Greece, Cyprus have happened: with private (?) solutions
- Once defaults are admitted, <u>orderly publicly regulated procedures</u> are needed
- **No automaticity** as defaults and complex deals also needing tactics and discretion (as well as the implicit consensus of the defaulting government)
- The importance of <u>partial (“small”) sovereign defaults</u>: where the defaulting government compares the cost of adjusting with that of defaulting

Structural Reforms to remedy Misallocations of Labour and Capital

- Structural reforms are the only sustainable solution for the growth problems of the euro zone: a widely shared view
- Crucial for Italy where productivity has been low since the mid ‘90s
- A less stressed point: there is a serious **misallocation problem** for labour and capital markets
- Continuous **globalization and technological shocks** require smooth and **quick reallocations**
- Reforms (in many sectors) to facilitate the reallocation task of factor markets
- Allocative risk need **risk sharing and coordinated structural reforms**
- Impressive figures on Italy’s misallocations (see figures)

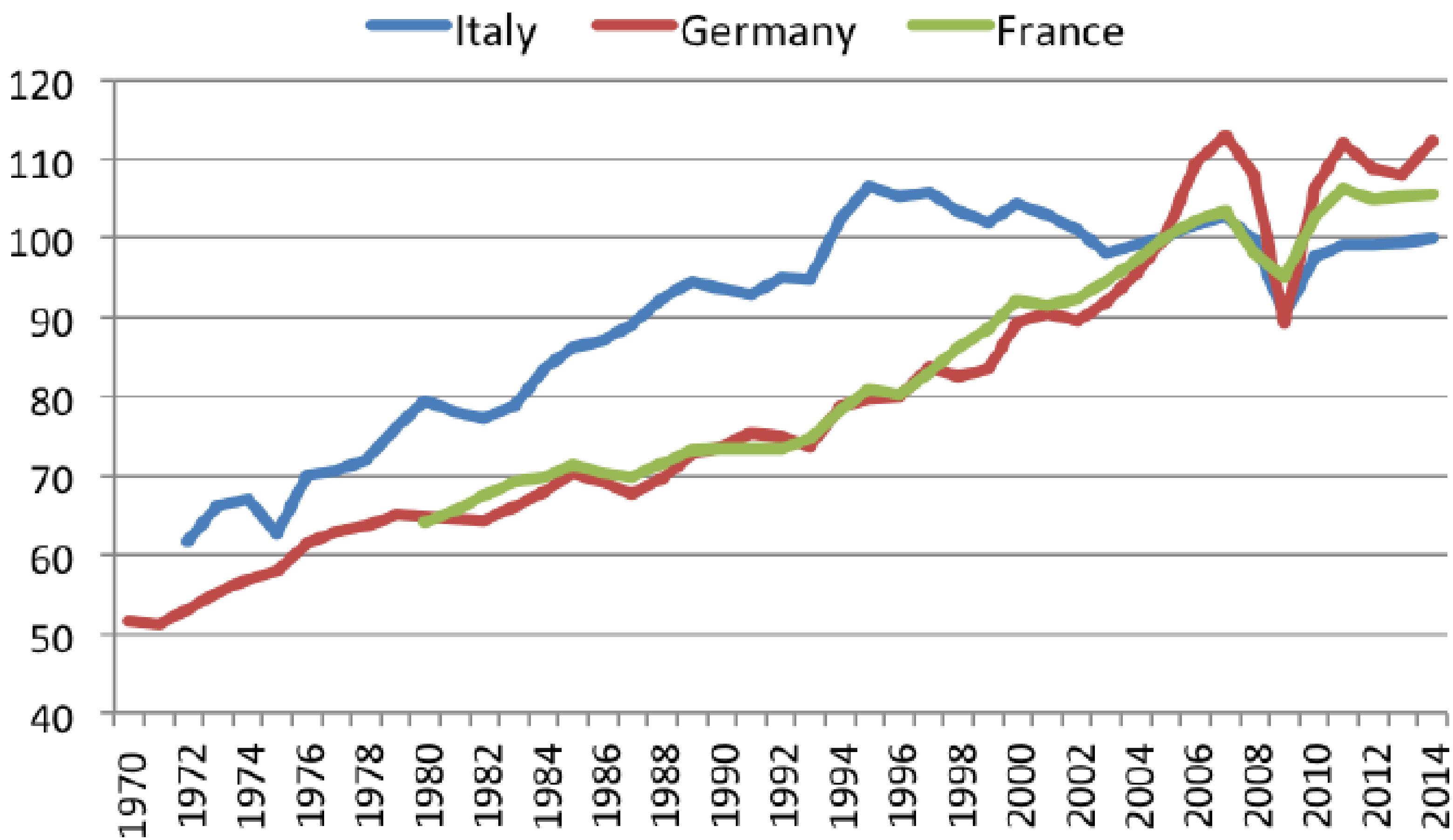
Italy: contribution to value added growth



Data: EU-Klems

From: G.M.Ottaviano et al., http://cep.lse.ac.uk/pubs/download/dp1520.pdf

TFP in manufacturing for Italy, Germany and France (2005=100)

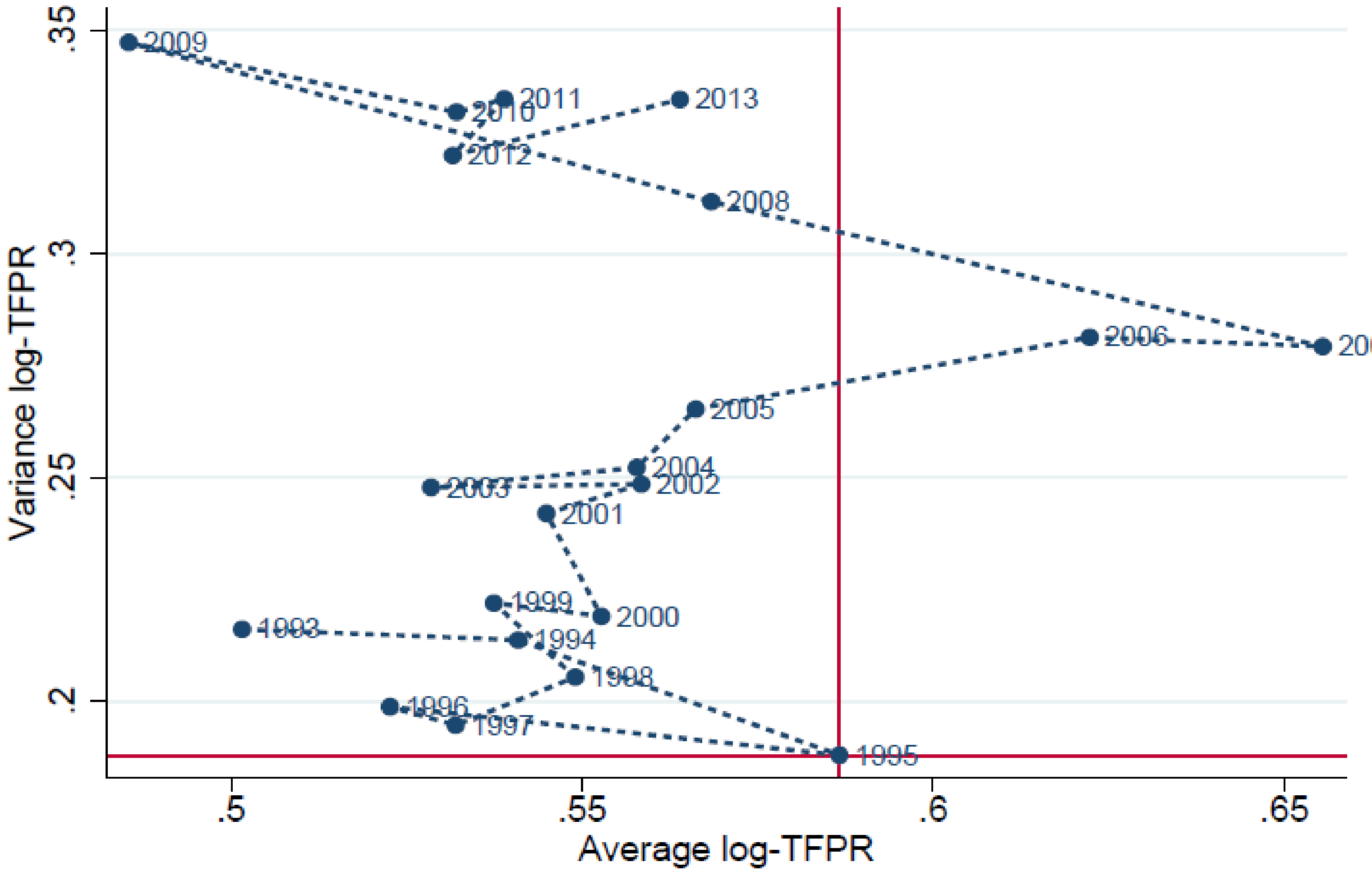


Source: Hassan and Ottaviano (2013)

From: G.M.Ottaviano et al., http://cep.lse.ac.uk/pubs/download/dp1520.pdf

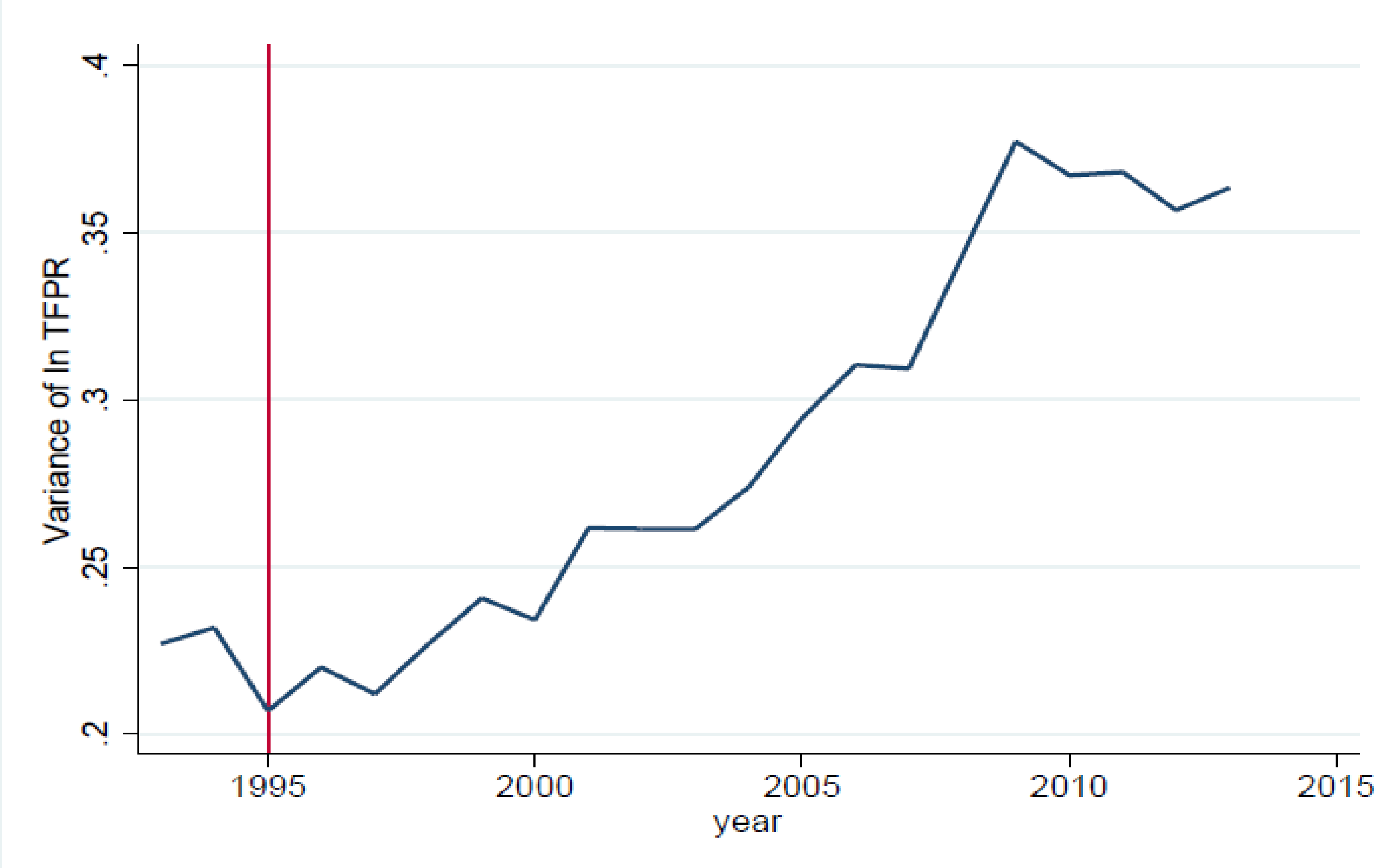
Italian manufacturing firms: a rising misallocation index

Misallocation measured with the variance of individual firms' Revenue TFP



From: G.M.Ottaviano et al., http://cep.lse.ac.uk/pubs/download/dp1520.pdf

Italy: evolution of aggregate misallocation



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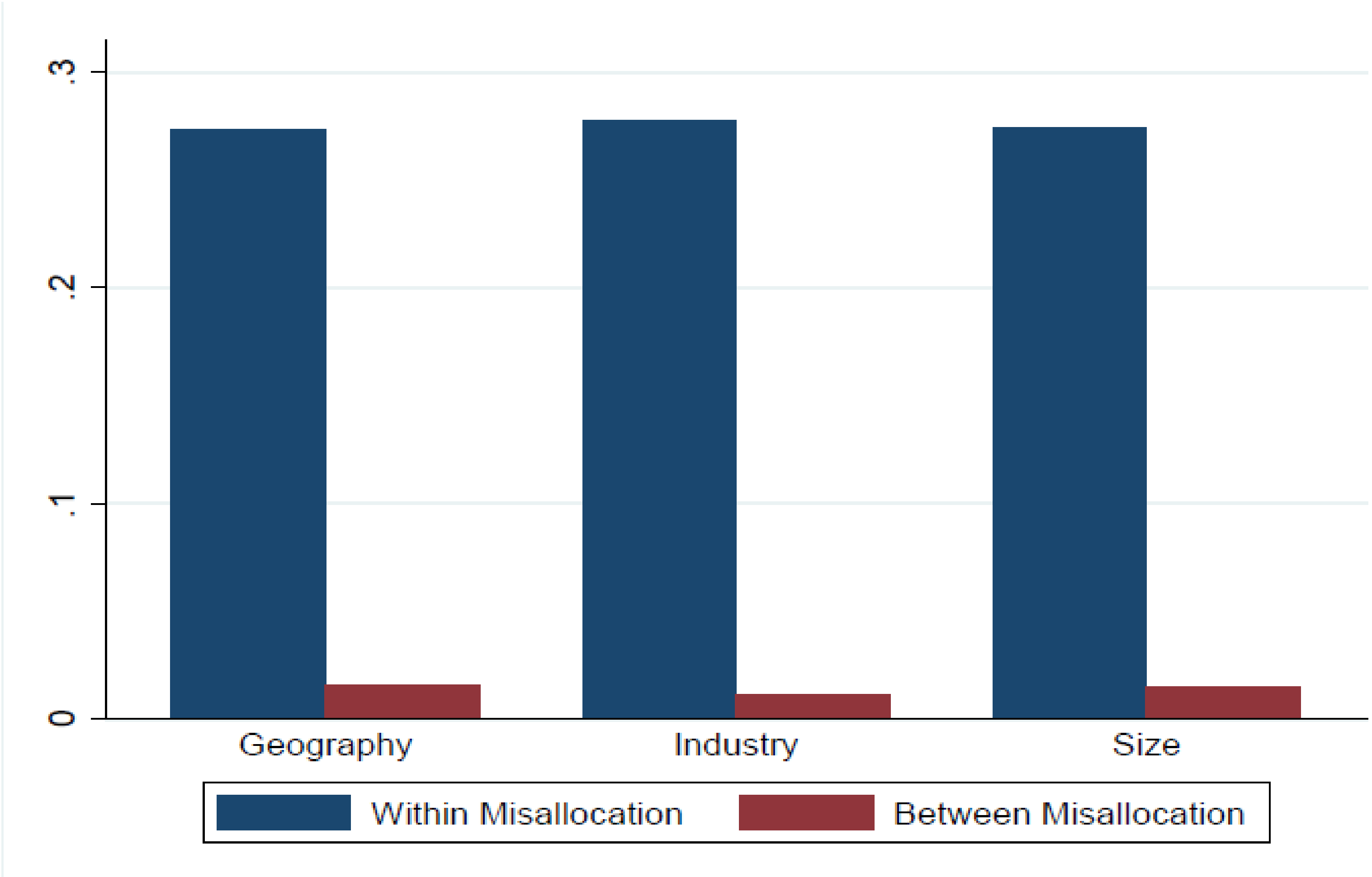
From: G.M.Ottaviano et al., http://cep.lse.ac.uk/pubs/download/dp1520.pdf

Misallocation, within vs. between categories (average 1993-2013)



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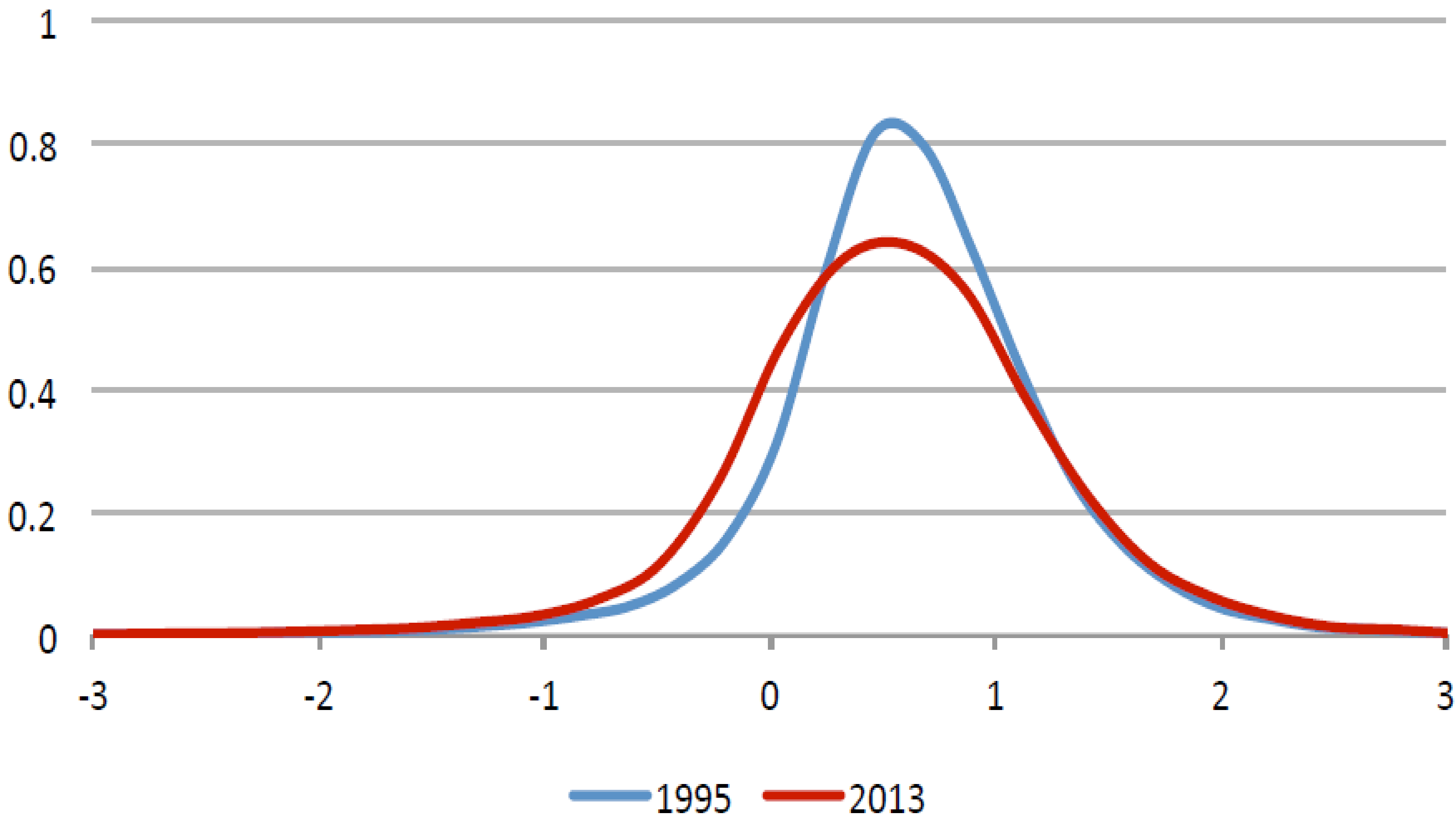
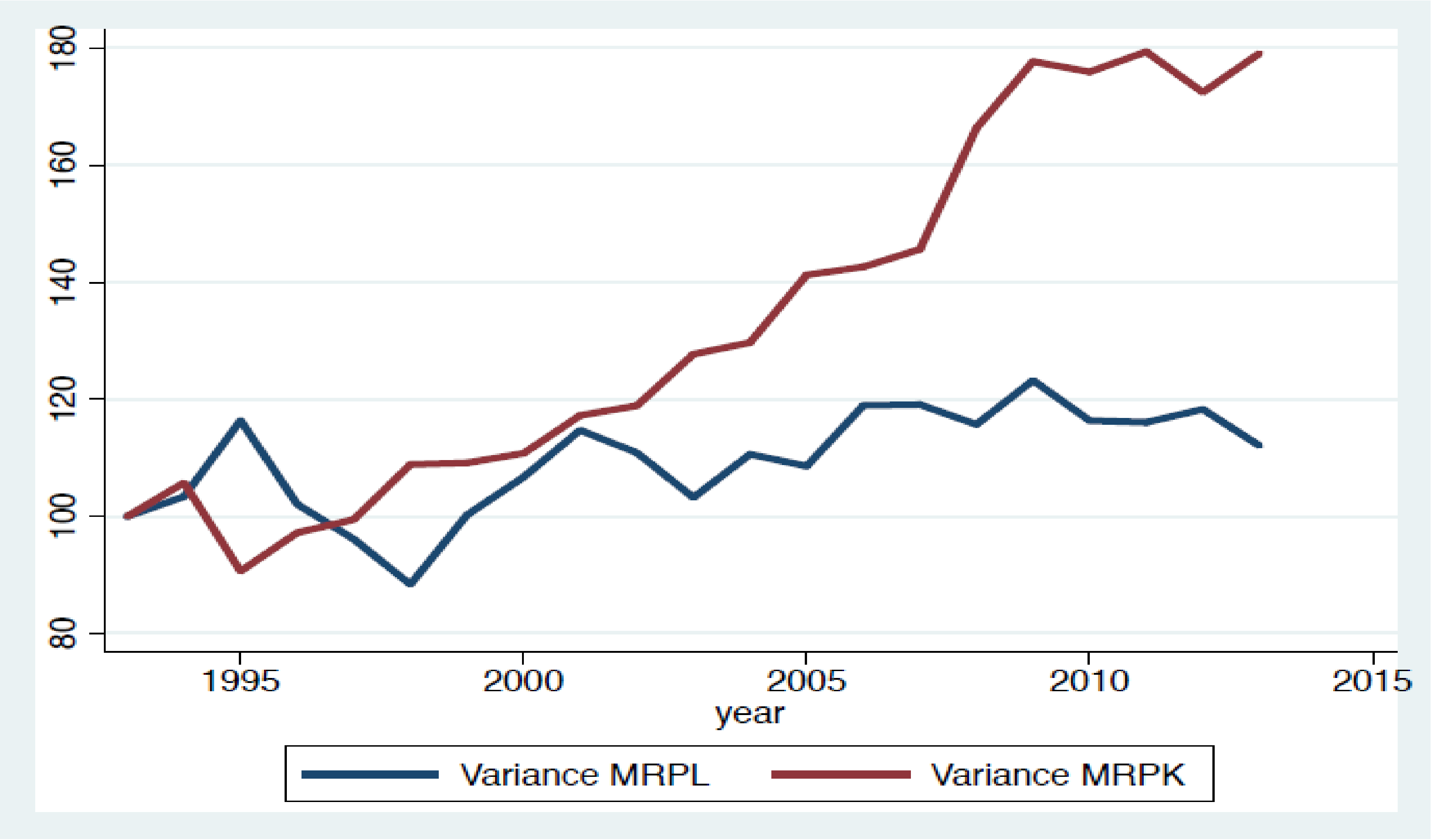
Italian manufacturing industry: distribution of individual firms' TFPR



From: G.M.Ottaviano et al., http://cep.lse.ac.uk/pubs/download/dp1520.pdf

Italian manufacturers: is the capital market a stronger source of misallocation than the labour market? Or: <u>the crucial importance of EBU and CMU</u>



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