

European banking union in its final leg

Category: Euro Area,European Union,Uncategorized

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After years of crisis, we are now experiencing an economic expansion in Europe. But further crises are certain to come, sooner or later, and improvements in the euro area's resilience to economic shocks will require further policy changes. Notably, it is important to allow that the cost of significant economic shocks is shared as widely and fairly as possible, both within private and public sectors, what we call for simplicity public and private risk-sharing. In this post, based on the 2018 Economic Survey of the Euro Area, we focus on potential for private risk sharing through the banking sector. The lack of risk sharing in this sector was a major cause of the euro area crisis during the great financial recession since governments became overly exposed to difficulties faced by their banking sectors. Better risk sharing would reduce the risk that a banking crisis triggers government insolvency, reinforcing the solidity of the euro area.

For better or for worse, banks remain at the core of the

financial system in Europe. Diversification towards other sources of financing and better access to finance for small and medium enterprises are important goals, which in the longer-term will be substantially facilitated by completion of the capital markets union project. In parallel, the efforts to improve the functioning of the European banking system, including the conditions for creation of Pan-European banks, must continue.

The euro area banks are now much better capitalised than before the financial crisis and benefit from stronger and unified supervisory standards. Even so, additional reforms to complete the banking union are necessary. The Single Resolution Mechanism that restructures failed banks while preventing wider repercussions in the financial system needs an effective backstop to ensure its credibility. The backstop should be fiscally-neutral over the medium term, meaning that any pay out should be recouped from future banks' contributions. As the next step, euro area countries should put in place a pre-funded common European deposit insurance scheme. Such a tool would increase financial stability benefits for all participating countries by spreading the risks across a large and more diverse pool of financial institutions and reducing the likelihood that individual pay outs will overwhelm the system. It would also further improve monetary policy transmission in the euro area by making different forms of money more homogenous across euro area countries.

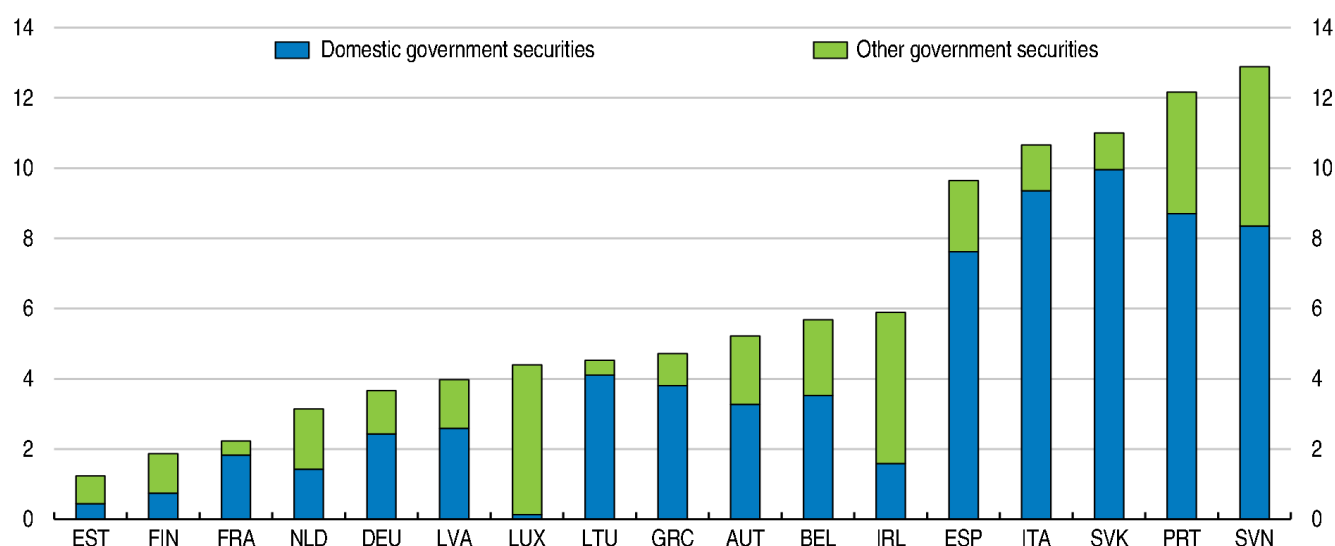
To limit the risk of some banks subsidising others, the insured banks should pay to the European deposit insurance scheme a variable insurance premium that would require riskier banks – based, among other things, on the level of loss-absorbing capacity, stability and variety of funding sources, business model and management quality – to pay higher contributions. In addition, the risk premia should also be sensitive to the amount of systemic risk in the national

banking system.

Risk reduction in the banking sector will eventually have to go beyond the reduction of still-elevated non-performing loans in some countries and prevention of the build-up of new non-performing loans. The recent gyrations in some European sovereign debt markets have shown that the potentially harmful links between banks and their own states that amplified the euro area crisis are still present. Large exposures of banks to the sovereign debt of their home country, linking the health of the banking sector to the health of public finances, continue to exist in many euro area countries and need to be addressed (Figure 1).

Figure 1. General governments securities¹ held by banks are mainly domestic

As a percentage of total MFIs assets, March 2018



1. Domestic government securities denote own-government securities other than shares held by monetary and financial institutions (excluding central banks). Other government securities refer to other Euro area government securities held by MFIs.

Source: ECB (2018), *Statistical Data Warehouse*, European Central Bank.

StatLink  <http://dx.doi.org/10.1787/888933741770>

The reduction in banks' holdings of government bonds would make banks' financing costs dependent on their own riskiness, rather than geographical location, potentially reinforcing cross-border activity and banks' ability to exploit the economies of scale. Such change, which would need to be gradual, including long phase-in periods and involving only the newly issued debt, could be achieved by introducing an

additional capital requirement increasing with concentrated sovereign bond holdings of banks (BCBS, 2017; Véron, 2017). Banks with higher holdings of sovereign debt would be required to hold additional capital as protection against associated risks. In order to give banks an alternative safe asset to invest in, potential changes should be considered in parallel with the introduction of a European safe asset. Although some existing proposals suggest the creation of synthetic safe assets, such instrument may be too sensitive to cyclical variation in investors' demand. Other ways of creating a European safe asset without risk mutualisation thus may be needed.

The Banking Union needs to be completed and the time to act is now. The three missing legs the Banking Union should stand on are the fiscal backstop to the Single Resolution Fund, the European deposit insurance scheme and the reduction of the harmful links between banks and their own states.

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Structural reforms in a difficult time

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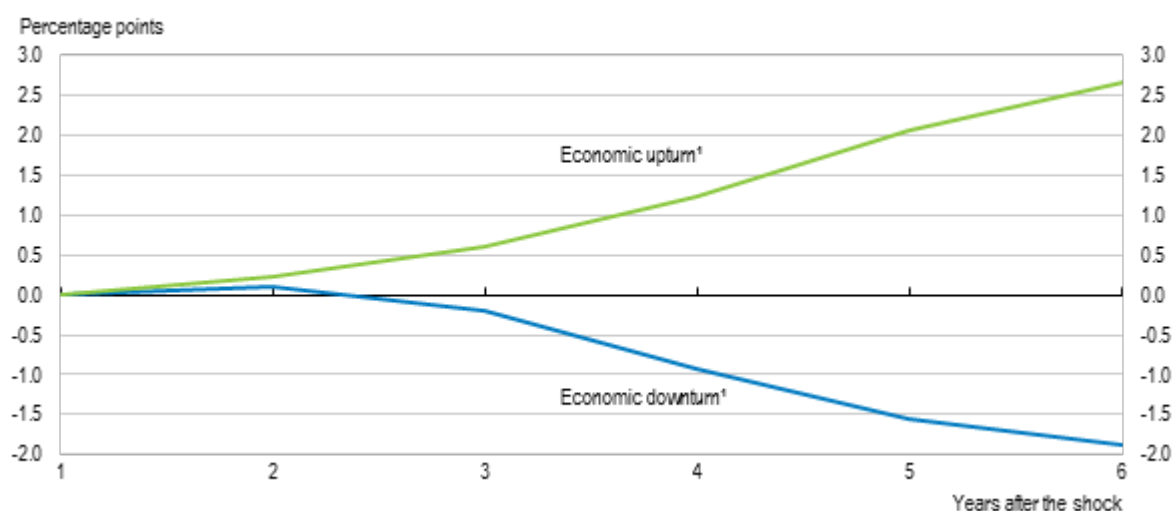
The pace of structural reforms is slowing just when the world economy needs decisive policy actions to strengthen fundamentals and restore healthy growth (the 2016 *Going for Growth* report). Policy makers may be concerned that introducing structural reforms in the current context involve trade-offs between the mid- to long-run gains in employment and productivity and short-run losses.

In our recent paper (Caldera Sánchez, de Serres and Yashiro, 2016), we note that when the economy is near its potential, and confidence among consumers and investors is high, gains from growth-enhancing reforms have been found to exceed potential losses even in the short run, as demand increases on the anticipation of the future benefits. However, the short-term impact of reforms may be less favourable when they are introduced in difficult macroeconomic conditions, as several factors may prevent a pick-up in demand. In some circumstances, specific reforms may even entail short-term reductions in demand.

There are several conflicting channels through which reforms affect the real economy. The strength of the channel can change under different macroeconomic conditions. Take reforms of unemployment benefits that aim to improve work incentives by strengthening the conditionality of income support in the case of a lay-off on intensive job-search efforts. By facilitating the return to work, such reforms raise employment, household income and thus consumption. However,

uncertainty regarding disposable income also increases, potentially discouraging consumption. In good times, employment gains can be quick, so that output increases within 2-3 years after reforms. But during recessions when the unemployed are less likely to find jobs the gains in employment can even turn negative (See figure).

The gains in employment of an unemployment benefit reform can turn negative during a downturn



Note: The lower (upper) line corresponds to the impact of the reduction in the initial unemployment benefit replacement rate during economic downturn (upturn), where the economic cycle is measured through the level of the pre-reform unemployment gap (i.e. the difference between the structural unemployment rate and the unemployment rate). The economic downturn (upturn) corresponds to the case where unemployment gap is set to the minimum (maximum) value within the sample.

Source: Bouis et al. (2012).

Other reforms that seek to restore competitiveness through lower relative costs and prices can also depress demand if conducted during downturns. This is because in bad times labour and goods demand respond little to the lower wages and product prices resulting from reforms, while workers or firms see their income and profit eroded in the short term. Ideally,

governments can deploy expansionary fiscal policies or monetary policies to support demand. But, in some cases, macro policies may also be constrained, as has been the case for several countries in the past few years. Strong external demand can help to bring forward the benefits of reforms as well. For instance, our review of case studies suggests that Canada's labour market reforms around the mid-1990s benefited from strong demand from the United States. This supported the gains in employment following the reforms.

Even under limited supports from fiscal and monetary policies or external demand, a smart packaging or sequencing of reforms can alleviate the negative short-run impacts on demand: (1) reforms of labour and product markets can be conducted in tandem, so that the lower prices from stronger competition limit the impact of labour market reforms on real wages; (2) addressing dysfunctions in the financial sector as early as possible can improve access to credit and allow households and firms to capitalise on the future benefits of reforms and expand consumption and investment today; (3) reducing policy uncertainty through well-communicated, credible reform strategies can prevent the deterioration of confidence among business and consumers.

Many reforms can boost demand by themselves even during difficult macroeconomic conditions. For instance, measures aimed at raising investment in knowledge-based capital, including through infrastructure spending, as well as tax structure reforms can bring short benefits. Also, reducing regulatory barriers to entry in services sectors with large pent-up demand and relatively low entry costs (like professional services or taxis) can boost business expansion and employment relatively quickly. Similarly, reducing barriers to geographic or jobs mobility can increase the speed of employment gains in difficult times. Strengthening active labour market policies and to alleviate skill shortages and mismatch can unleash business activities that were previously

constrained by skills bottlenecks. Reforms that contribute to the long-term sustainability of public finance and to the cost-effectiveness of healthcare or pension systems can reduce uncertainties on household's future income, thereby boosting consumption today.

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