A political perspective on EMU reform

PIIE event on

The Future of the European Economy
After the French Election

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The basic argument

- For political as well as economic reasons, EMU will survive only if it relies less on rules and instead on a combination of market discipline, delegation to common institutions and (simpler) rules.
- There are two – intellectually and practically – hard parts to this:
    1. Creating common fiscal institutions that do not, in expectation, redistribute in favor or specific countries
    2. Making market discipline credible, particularly at a time when "too much" discipline can create a crisis.
- Both problems can be solved. In this presentation, focus on problem 2: how to make market discipline work.

Starting point: everyone hates "Brussels"

- EMU in theory: fiscal rules will prevent debt crises and underpin ECB indendence
- EMU in practice: fiscal rules create a political problem.
    1. Deficit countries blame rules for protracted austerity and resent micromangement from "Brussels".
    2. Surplus countries resent the fact that "Brussels" invariably ends up striking some compromise („The Commission has lost its role as the guardian of the treaties")
- Result: "Brussels" is resented and scapegoated from all sides. This compromises not just the Euro but the European project.
- Solution in principle: less "Brussels discipline", more market discipline.

The complication

1. More market discipline on sovereign is not credible if it creates large collateral damage on the economy
2. Reducing collateral damage requires reducing sovereign exposures of banks
3. But this is hard at a time when bank and sovereign balance sheets are weak.
   - Example: placing a capital charge on sovereign holdings of banks would both raise financing costs of sovereigns and force banks to deleverage and/or raise additional capital.

Hence, the solution must involve changes in regulatory treatment of sovereign bonds *together with* the introduction of a “safe asset” that is free from capital charges.

One way of creating a safe asset

- Extend role of ESM - or create sister institution, also with preferred creditor status (PCS) – to buy national debt at face value up to threshold, financed by bond issuance
- Because of PCS, ESM bonds would be much less risky than most national bonds – provided stock is small enough relative to national bonds
- Residual risk could be dealt with through a one-time capital injection. Member state guarantees would **not** be needed.

Note: Not the only way. Alternative: Brunnermeier et al (2011, 2017) idea of creating a "European safe bond" through a combination of pooling and tranching.

What volume of safe assets would be required?

Government debt in the Euro area, selected issuers
(end-2016 stocks, in percent of issuer GDP)

Issuer	General government debt		Bonds holding in banks of …	
	total	bonds	Euro area	Issuing country
Austria	84.6	67.2	18.9	9.6
Belgium	105.9	80.0	18.8	10.1
Finland	63.6	46.3	8.1	1.4
France	96.0	73.7	10.4	0.0
Germany	68.3	47.3	9.0	7.2
Ireland	75.4	45.8	9.5	6.7
Italy	132.6	105.6	28.9	22.2
Netherlands	62.3	46.5	9.1	5.8
Portugal	130.4	63.8	20.6	11.8
Spain	99.4	75.2	24.1	17.5

Source: European Central Bank

Answer: up to 30 percent of GDP

Replacing sovereign bonds in bank balance sheets: how it might work

- After ESM (or new intermediary) begin bond buying/issuing operations, Euro area bank holdings of *newly issued* sovereign debt would become subject to a capital charge. The capital charge does not apply to (1) sovereign debt issued previously; (2) bonds issued by the ESM.
- In each year, volume of ESM bond buying/issuing operations are calibrated to replace maturing sovereign bonds on bank balance sheets
- As stock of senior ESM debt rises, *marginal* cost of national debt issuance not bought by ESM (junior debt) would rise for lower-rated borrowers. However, *total* (average) cost of debt issuance would not rise (and may fall over time).

Impact on marginal cost of debt
(back-of-the envelope calculation)

Parity between returns of safe bond and risky bond:

$$(1 + i^*) = p(1 - l_0) + (1 - p)(1 + i_0^r)$$

where p is default probability, l_0 is loss-given-default before.

PCS of intermediary means that $l_0$would rise to $l_1 = C * l_0$, where C is a factor reflecting the fact that loss-given-default must be shared among fewer bondholders (e.g. $C = \frac{120}{90} = \frac{4}{3}$)

This implies:

$$\Delta i^r = i_1^r - i_0^r = \frac{p}{1-p}(l_1 - l_0) = \frac{p}{1-p}(C - 1)\ l_0$$

Example: $i^* = 0.42\%$, $i^r = 2.25\%$, $l_0 = 0.5$ implies $p = 3.5\%$

$\Delta i^r = \frac{p}{1-p}(C - 1)\ l_0 = 0.036 * \frac{1}{3} * \frac{1}{2} = 0.036 * \frac{1}{6} = 0.006$ **(60 basis points)**

Total interest cost of risky country cannot rise, however

- Sum of debt servicing costs across **all** countries cannot go up, since sovereign risks have not changed
  - ❖ investor buying entire portfolio – senior ESM bonds and junior country bonds – would receive equal or slightly lower (due to ESM capitalization) interest payment than investor buying entire porfolio before change.
- Interest cost of **low risk** countries identical or slightly higher (if funding costs of ESM slightly higher than funding costs of low risk country notwithstanding capitalization)
- Hence, interest cost of **high risk country** must be equal or slightly lower than before change
- Any beneficial liquidity effects (via large pool of ESM debt) would strengthen this conclusion.

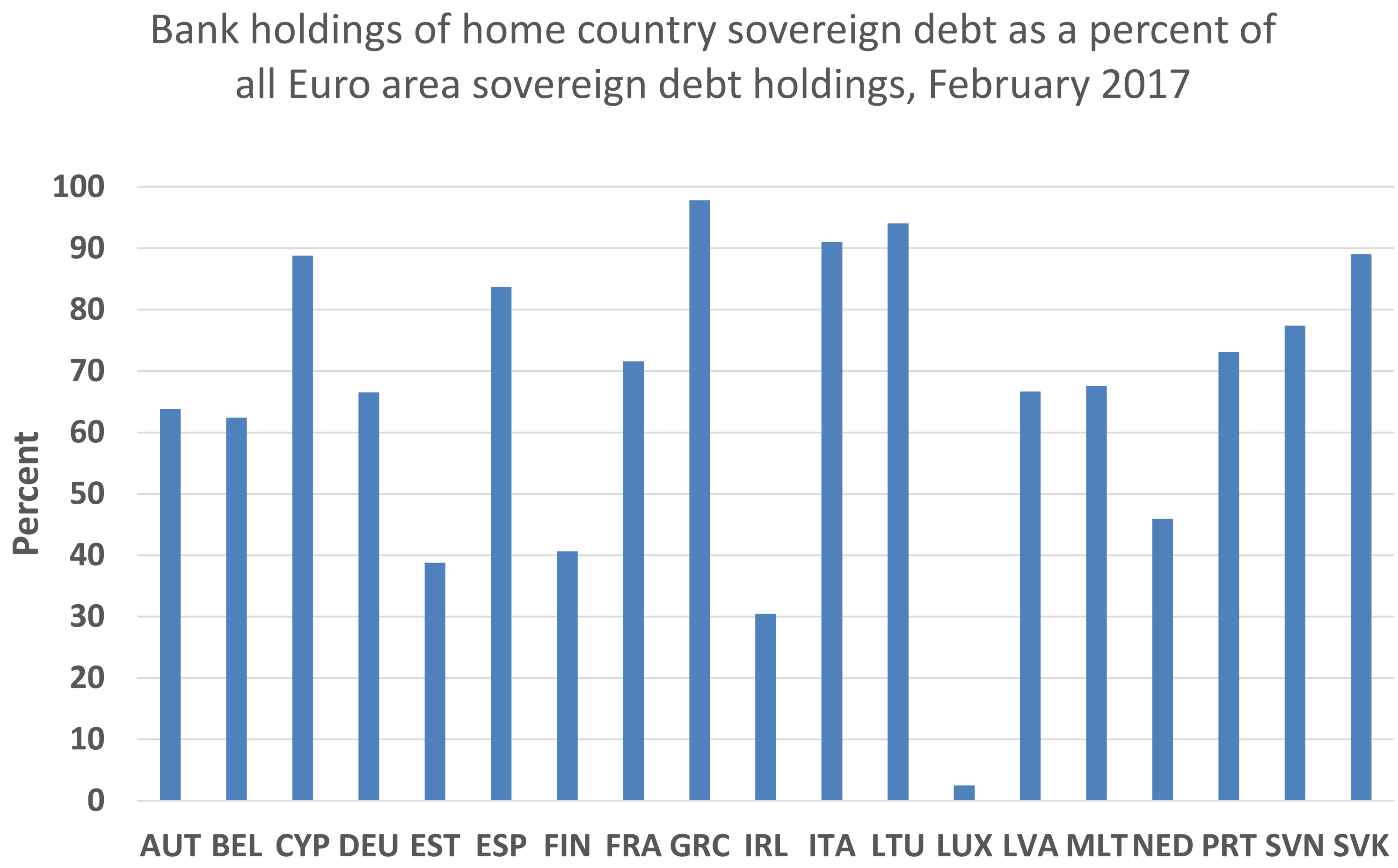
Possible complementary reforms of fiscal framework

1. Legal changes to better address holdout problem
   - Change in ESM treaty that shields sovereign assets from attachment by holdout-creditors
   - "one-limb" collective action clauses
2. Change in ESM treaty that requires ESM to seek "reprofiling" of country debts as a condition for an ESM-supported program when debt sustainability is not without doubt
3. Scrap SGP, or simplified SGP that gives countries more flexibility to conduct expansionary fiscal policy in a recession.
4. A small Euro area budget for *aggregate* fiscal stabilization.

1 and 2 would be market discipline enhancing *on top of* increase in marginal debt costs in high-debt countries due to junior status.

Thank you

Concentration of sovereign exposure of banks



Source: ECB and author's calculations