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REFLECTION PAPER ON THE DEEPENING OF THE ECONOMIC AND MONETARY UNION

Discussion

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22 June 2017

An excellent paper

- Coherent and well argued
  - No dumbing down this time
- Courageous
  - Not afraid to raise potential red flags for both sides
- Constructive
  - Balanced, may contain the ingredients for a grand bargain
- Appropriate mix of specificity and sketchiness
  - Specificity on ideas, aims, and sequencing
  - Open on institutional design

EMU reform: why is it so hard?

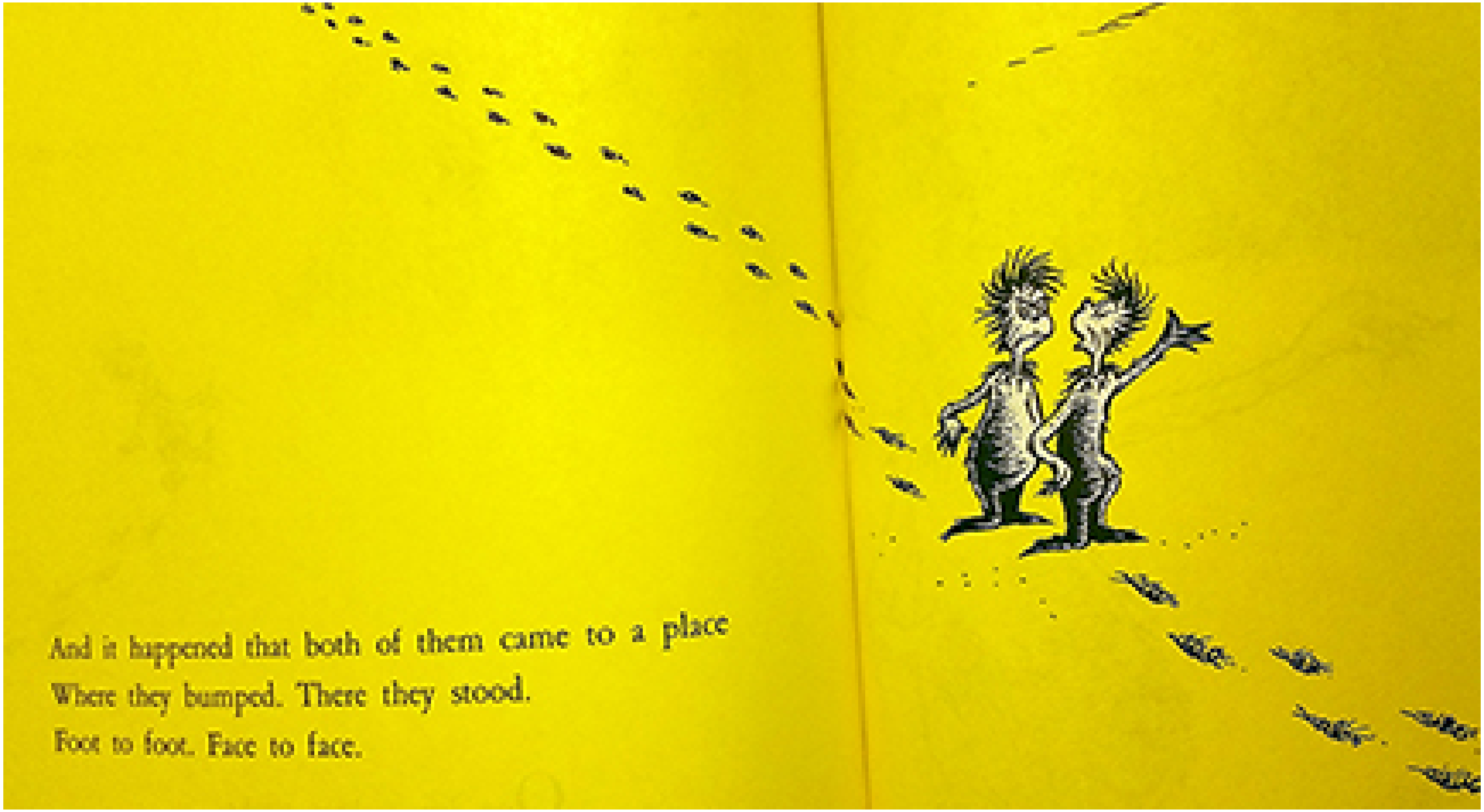
$$\max_{\substack{institutional\\design}} \{joint\ welfare\}$$

subject to

i. No redistribution ex ante (the “Northern” red line)
ii. No short term increase in crisis risk (the “Southern” red line)
iii. “democratic accountability” (everyone’s favorite condition)
iv. Robustness of i. and ii. to deviations from optimal plan/path (aka: “minimize risk of unintended consequences”)

- i, ii, and iii are often in conflict
  - E.g. market discipline good for i. but bad for ii.
- iv. is extremely difficult to achieve.

“South” vs. “North”: Dr Seuss.



“South” vs. “North”: EMU reform

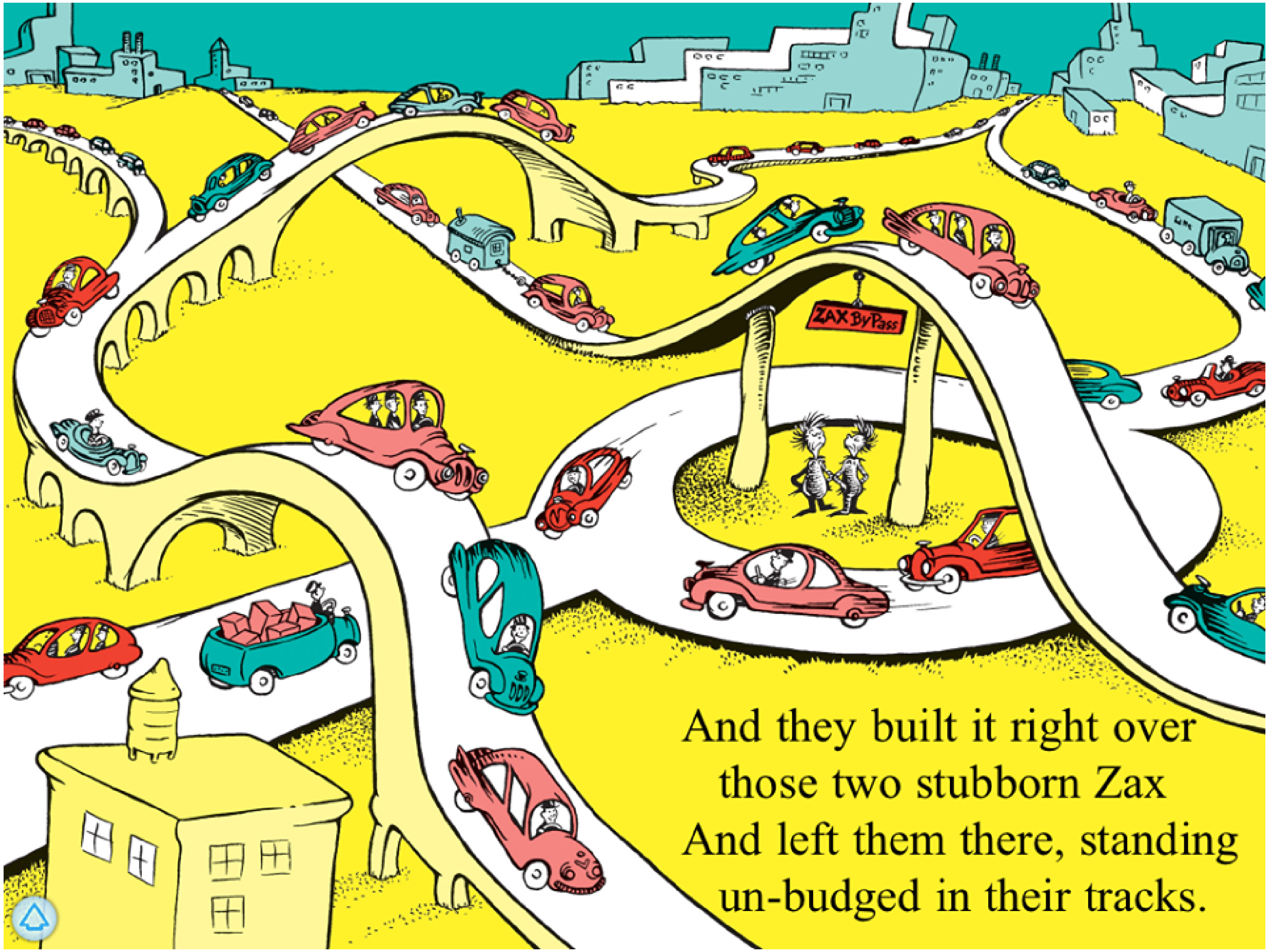
What the South wants

1. Less interference in national policy. More flexible rules.
2. Extra risk sharing and stabilization options. EDIS.
3. A capital markets union (maybe).

What the North wants

1. More interference in national policy (of the South). Less flexible rules.
2. No extra risk sharing and stabilization options that could give rise to redistribution. No EDIS.
3. A capital markets union (maybe).

“South” vs. “North”: Dr. Seuss’ solution



“South” vs. “North”: DG EcFin’s solution

1. Greater incentives for good national policies
   - EU funding
   - Market discipline

2. Financial sector “risk reduction”
   - November 2016 proposals to amend banking regulation (CRD, CRR and BRRD)

3. Long list of ideas/institutions for more risk sharing and stabilization. EDIS.
   - But: stabilization mechanisms should rule out “permanent transfers”

4. Careful sequencing.

What about this solution is really new?
(particularly with respect to 5-Presidents-Report)

1. More emphasis on improving incentives facing national policies, including via market discipline
    - *stronger incentives for national policies*: 1 mention in 5PR (in a box); 4 in reflection paper.
    - *market discipline*: 0 mention in 5PR; 3 mentions in reflection paper.
2. Euro-area level safe asset as a key innovation for Euro financial stability; link to regulatory treatment of sovereign exposures.
    - No details yet – this is understandable.

These are important and courageous steps forward. 1. may upset South. 2. may upset North. But both are necessary.

Quibble No. 1

(mostly on behalf of the North – and political cohesion)

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- Principle of no-permanent-transfers applied only to stabilization mechanisms, and not developed beyond what was already in 5PR. But this principle should apply much more universally.
- No risk-sharing or stabilization institution should give rise to expected transfers. All should pass a no-gaming condition:

  $E\{T_{i,j} | a_j\} = 0 \;\forall\; i,j$ (where a_j denotes policy actions of country j)

- Reason why North does not like EDIS: it may well result in expected transfers.
  - True because of legacy debt
  - But could also be true in steady state, because of continued national control of large policy areas that determine riskiness of banks (housing policies, tax policies, corporate insolvency frameworks …)
- Will need to be reflected in timing and design of EDIS.

Quibble No. 2

(mostly on behalf of the South – and political cohesion)

- Simplification/reform of fiscal rules again on the back burner! Mentioned only in 1 sentence, at the very end.
- But it is a first order issue!
  - Procyclicality
  - measurement error
  - Constant source of friction
- Why the procrastination?
  - It's a hugely controversial reform project.
  - But maybe also: the Commission may not mind the discretionary power in now enjoys under the SGP. But that is a mistake.
- For the sake of the European Project, we must find seek ways to generate discipline that do not rely mainly on the Commission in the role of the bad cop. This is a general point, beyond SGP reform.

Thank you

Backup slides

More market discipline: the complication

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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.

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.

- Preferred creditor status 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 on impact, 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.