Public Debt Markets: Key Challenges in a Context of Deepening the EMU - speech by Matjaž Sušec

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I would like to thank the organisers for inviting me to talk about this important topic.

It is always good to be back in Lisbon.

On the broad topic of EMU reforms, I would like to focus on what is still seen as a controversial issue but one that could significantly shape Europe's debt markets in the future: a European safe asset. The introduction of a safe asset would interact with other policy initiatives, like a possible central fiscal capacity and Capital Markets Union, which we are discussing here today.

Before entering into reforms that are still ahead of us, allow me to recall the progress that has already been achieved in deepening the EMU since the crisis. The institutional architecture of EMU has been significantly strengthened by the creation of banking union and the establishment of the two rescue funds: the EFSF and ESM. A sovereign lender of last resort did not exist in Europe before the crisis.

Enhancing the ESM is now part of a broader package of deepening EMU, which also involves the completion of banking union and a new budgetary instrument.

The ESM's enhanced roles are the following:

- The common backstop to the Single Resolution Fund, which the ESM will provide in the form of a credit line.
- A stronger role for the ESM in future economic adjustment programmes: in the future, the ESM and European Commission will together design and monitor stability support in case of a request. To be prepared, the ESM will follow and assess the macroeconomic and financial situation including the sustainability of public debt of its Members.
- ESM's precautionary instruments were reviewed and will be more effective and transparent in the future.
- The ESM, upon request, can facilitate dialogues between euro area countries and private investors in case of a debt restructuring.

This is the result of good cooperation among Member States and Institutions. We have achieved this together. In the meetings that I attended in 2015 and 2016, in Brussels, the common backstop also seemed very far, almost impossible to achieve. Now, we have a solid agreement.

I would say that, for the time being, there is no political agreement on the creation of a European safe asset among euro area Members, but creating a safe asset in the future could follow a similar path of the policy initiatives I just mentioned.

Current state of play

After all the progress, what are the challenges we still face? First, European financial markets are still fragmented and interest rates on sovereign debt by-and-large serve as an anchor for the price of credit to households and corporates.

In case of renewed market distress, sovereign borrowing rates in some Member States could rise more than in others, because of flight to quality, an issue that has not been yet addressed. These developments would then spill over to the private sector.

Second, banks still hold important quantities of sovereign debt issued by the state in which they are located. This direct link between sovereign and bank risk could make things worse in the case of a new crisis.

A safe asset would increase financial stability

Creating a euro area safe asset would address these challenges. A safe asset would increase the pool of highly rated assets, which is now limited to a few sovereign and supranational issuers. As such, it could increasingly provide a common benchmark that could be used to price debt across borders.

Replacing some of the sovereign bonds held by banks with safe asset investments would help banks to diversify away from sovereign risk.

The safe asset could also mitigate the flight to safety dynamics and facilitate monetary policy transmission.

Together these elements would increase financial stability and support private sector risk sharing via cross-border loans and investments. Households and businesses across the euro area would no longer be penalised by their geographical location in terms of financing costs.

… and help strengthen the euro

Overall, the creation of a euro area wide safe asset could also strengthen the international role of the euro.

First, it would expand the supply of euro denominated safe assets and facilitate the euro’s use as a reserve currency.

Second, as mentioned, a euro area safe asset would contribute to a greater stability of the euro area, along with other reforms that are part of EMU deepening, the completion of banking union and strengthening the Capital Markets Union. Greater stability would in turn make the euro more attractive for international investors and strengthen its role in the international monetary system.

How to progress on safe asset design?

We have seen a number of proposals recently. Each of these proposals has its strengths and weaknesses.

I’d like to stress that to create a euro area safe asset we do not need to reinvent the wheel, we can build on the experience of supranational highly rated issuers.

For investors to accept a safe asset, the two essential elements are safety and sufficient market liquidity.

Keep in mind that the ESM, as well as the EIB for example, already issue debt, which has a very high credit standing and is therefore safe. For the ESM this would not be possible without the capital backing of the nineteen euro area Members. This enables the ESM to pass on its low funding cost, which enables significant savings in the budgets of beneficiary Members.

One of the recently discussed proposals - E-bonds - would benefit from a capital cushion. The proposal foresees a publicly owned intermediary with a preferred creditor status issuing safe assets and lending to euro area Members. This proposal has a number of similarities with the current ESM structure.

Any option for a common euro area safe asset will have some implications for the functioning of the national bond markets. So, we should start small and build up the proposals in a way that is acceptable for the debt management offices.

Work on safe assets is a joint project!

We need a high degree of trust among Member States to gather support for this project. The strong commitment to respect fiscal rules is a prerequisite to pursue further proposals for safe assets.

One of the questions you may also ask is whether coordination among debt management offices is inevitable. Already today, debt management offices plan their activity in a way that targets investor needs, avoiding periods of market saturation. Furthermore, the EU Sovereign Debt Markets subcommittee regularly discusses topics of common importance to debt managers.

On this basis, I would very much encourage that debt management offices are part of the preparatory work. We should maintain the well-established inclusive model, where Member States, their debt managers and institutions together explore how to build a safe asset.

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