Ensuring Debt Sustainability in the Euro Area – the Role of a Safe Asset

Speaking notes for round table discussion –
"Ensuring debt sustainability in the euro area - anything else needed?",
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1. "Doom Loop" between banks and sovereigns – the feedback from sovereign debt troubles to the real economy and back, via the banking system – continues to be a threat to the stability of euro area.
    - Addressing doom loop requires a European Deposit Insurance System, but this is not enough
    - Need to ensure that sovereign debt stress does not automatically lead to stress in the domestic banking system
    - This requires reducing direct exposure of banks to their sovereigns

2. Regulation of sovereign exposures is not enough to *safely* reduce direct exposure of banks. Two problems.
    - Spyros Alogoskoufis and Sam Langfield (2018):[2]
        i. Risk based measures will not necessarily achieve lower concentration.
        ii. Concentration based measures will not necessarily lower risk. May increase contagion by spreading risk.
    - The process of reducing sovereign exposures poses new threats, particularly for high-debt sovereigns whose banking systems currently hold significant volumes of bonds. Shedding these bonds could lead to disruptions in the sovereign debt market.

3. Introducing a euro area safe asset in conjunction with a gradual change in the regulatory treatment of sovereign exposures could solve both problems.
    - New regulation would be designed to create incentives for banks to largely replace holdings of domestic sovereign debt by the new safe asset.
    - New safe asset could be based, or backed, by sovereign debt, creating a source of demand for sovereign debt that compensates for lower direct demand from banks.

4. How does one create such a safe asset?
    - One option: "ESBies"/Sovereign Bond Backed Securities. But reactions from both markets and national governments so far is not encouraging. Like to GMOs. Safe and reliable with proper regulation?
    - An alternative option: single-tranche bonds issued by the ESM, backed by loans to all euro area sovereigns, who would be charged the average funding costs of the ESM ("E-bonds"). Would require change in the ESM treaty.

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[1] These speaking notes are partly based on Alvaro Leandro and Jeromin Zettelmeyer "The Search for a Euro Area Safe Asset" (2018) Peterson Institute for International Economics Working Paper No. 18-3 and Jeromin Zettelmeyer and Alvaro Leandro (2018), "Europe's Search for a Safe Asset", Policy Brief 18-20, Peterson Institute for International Economics, October.

[2] Spyros Alogoskoufis and Sam Langfield (2018), "Regulating the Doom Loop," ESRB Working Paper No. 74, May 2018.

5. Main characteristics of E-bonds
    - Like ESBies, "safety" would be created through a combination of diversification and seniority. But seniority is not created through tranching, but rather through the PCS of the ESM. No financial engineering.
    - Because all sovereigns are charged same interest rate, there would be redistribution benefiting riskier borrowers. But can show this effect would be very small, because ESM loans would be protected by large cushions of subordinated market debt. In one variant (Leandro and Zettelmeyer, 2018a,b), all sovereigns would be allowed to borrow from ESM up to a fixed proportion of their debt (about 25%) or their GDP (about 50%), whichever is smaller.
    - Disciplining effect: once countries are at their ESM borrowing limit, marginal cost of borrowing in the market would be higher compared to the status quo and would rise faster for higher debt countries. But can show that the average cost of debt would be about the same (slightly lower for riskier borrowers, slightly higher for low-risk borrowers, because of redistributive effect).
    - Many details – including whether legal seniority would need reinforcing – need to be worked out. But idea deserves a thorough exploration, similar to ESRB review of ESBies.