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A COMMENT:
WHY CONDITIONAL LIQUIDITY PROVISION MATTERS

Reconciling risk sharing with market discipline

Astrid-Sep

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Introduction

- The 14 Franco-German economists' paper (PI91) aims to show that:
  "market discipline and risk sharing could be viewed as complementary pillars of the euro area … rather than as substitutes" (p. 2).
- Hence, fair combination between risk sharing (RS) and market discipline (MD) with respect to crucial features of EMU governance:
  - financial architecture;
  - fiscal architecture;
  - institutional architecture.

Outline

- My comments will address four points.
- First three points relate to the PI91's proposed balance between RS and MD in:
  (1) Financial architecture;
  (2) Fiscal architecture;
  (3) Institutional architecture.
  These three points = opportunity to enter into some details → specific controversial points.
- Point (4) = attempt to weaken the constraints ← by the combination RS-MD.
  Reference to conditional liquidity provision (see also Stefano Micossi's comment: SM).

1. Financial architecture

- PI91: MD in financial sector ←→ risk reduction:
  (a) Reduction in the amount of NPLs;
  (b) Reduction in the large exposures;
  (c) Reduction in the national idiosyncratic regimes relating to resolution mechanisms;
  (d) Weakening in the use of State aid (i.e. in the enforceability of the Treaty's provision).
- Risk sharing:
  (i) Public back stop (ESM) in resolution processes;
  (ii) Introduction of EDIS;
  (iii) Introduction of ESBies.

1. Financial architecture

- Point (a): ‘Reduction in the amount of NPLs’ + Point (c): ‘Reduction in the national idiosyncratic regimes in BU’s second pillar’ = agreement iff ‘full’ EDIS.
- PI91 designs an EDIS where “losses should first be borne by the relevant ‘national compartment’ of EDIS, while common funds … can be tapped only in large systemic crises which overburden one or several national compartment(s)” (p. 8).
  This design mimics that proposed by the EC (2017), but just as a transition regime.
- PI91’s EDIS is reduced to:
  - a private backstop to be complemented by a partial public backstop (ESM’s financing).
  Hence: why build such a complex architecture?

1. Financial architecture

- Point (b) ‘Reduction in large exposures’ = conditional agreement.
- This reduction requires the introduction of a ‘safe asset’ for – at least – three reasons:
  - efficient working of financial markets;
  - buffer to banks’ potential losses;
  - stabilization of public debt in ‘peripheral’ MSs.
- ESBies = CDOs where:
  - junior tranches: no ‘safe asset’;
  - senior tranches: ‘safe asset’ if no strong correlation between the underlying assets.

  Otherwise, lack of demand for junior tranches would affect riskiness of senior tranches.
- Hence, point (b): not only concentration risk but also positive risk for public bonds of peripheral MSs.

1. Financial architecture

- Point (d) ‘Weakening in the use of State aid’ = non-understandable.
- Treaty’s provision = based on a general efficiency principle: ‘high’ risk of systemic instability more distortionary than state aid.
  Hence: case-by-case basis (see p. 6, fn. 4) ←→ incompatible with Treaty’s provision.
  Impossible to introduce Treaty’s changes by re-interpreting a EC’s communication or directive.
- General conclusion: PI91 maintains that it could be convenient “offering only catastrophic risk (re) insurance, so that the ‘first loss’ is always borne by the [country] insured” (p. 4).

2. Fiscal architecture

- This point = sketchy comments (reference to SM).
- PI91 → MD is largely based on:
  (a) ‘discipline-improving’ proposals ← simpler fiscal rules;
  (b) ‘stabilization-improving’ proposals ← an ex-ante threat of “early debt restructuring”.
- (a) leads to:
  (i) rules based on “nominal public expenditures growth ceilings consistent with a public debt reduction target”;
  (ii) compulsory issue of junior bonds in case of a MS’s excessive spending.
- (i) Valuable suggestion. However, it re-introduces ‘potential output growth’, now set by National Fiscal Councils (Bini Smaghi 2018).

2. Fiscal architecture

- Hence: main changes = MTOs nationally stated. Point (b): ‘Early debt restructuring’ is implicitly justified by the national flexibility on MTO.
- This point is one of the main reasons justifying our disagreement toward PI91 (see SM). This disagreement not ← by refusal of excessive MD; it is ← by worry of keeping macroeconomic instability under control. Assessment of the “redenomination risk”.
- General conclusion: PI91 maintains that the ‘Deauville’ solution does not work just because of the “high legacy debt” (p. 4). Hence, PI91 can state that (re)insurance is required to handle “transition problems” (p. 5).

3. Institutional architecture

- PI91: necessary to introduce more independent fiscal watchdog, shifting this role from the EC to either the ESM or the European Fiscal Council (p. 19).
- In our Comment (SM&MM, 2018), we explained the reasons of our agreement (SGP’s lack of credibility; ESM as crisis lender) as well as partial disagreement. However, we did not enter into analytical details.
  - PI91: “no clear separation between the watchdog (prosecutor) and the political decision-taker (judge): the Commission and the Eurogroup share those roles” (p. 18).

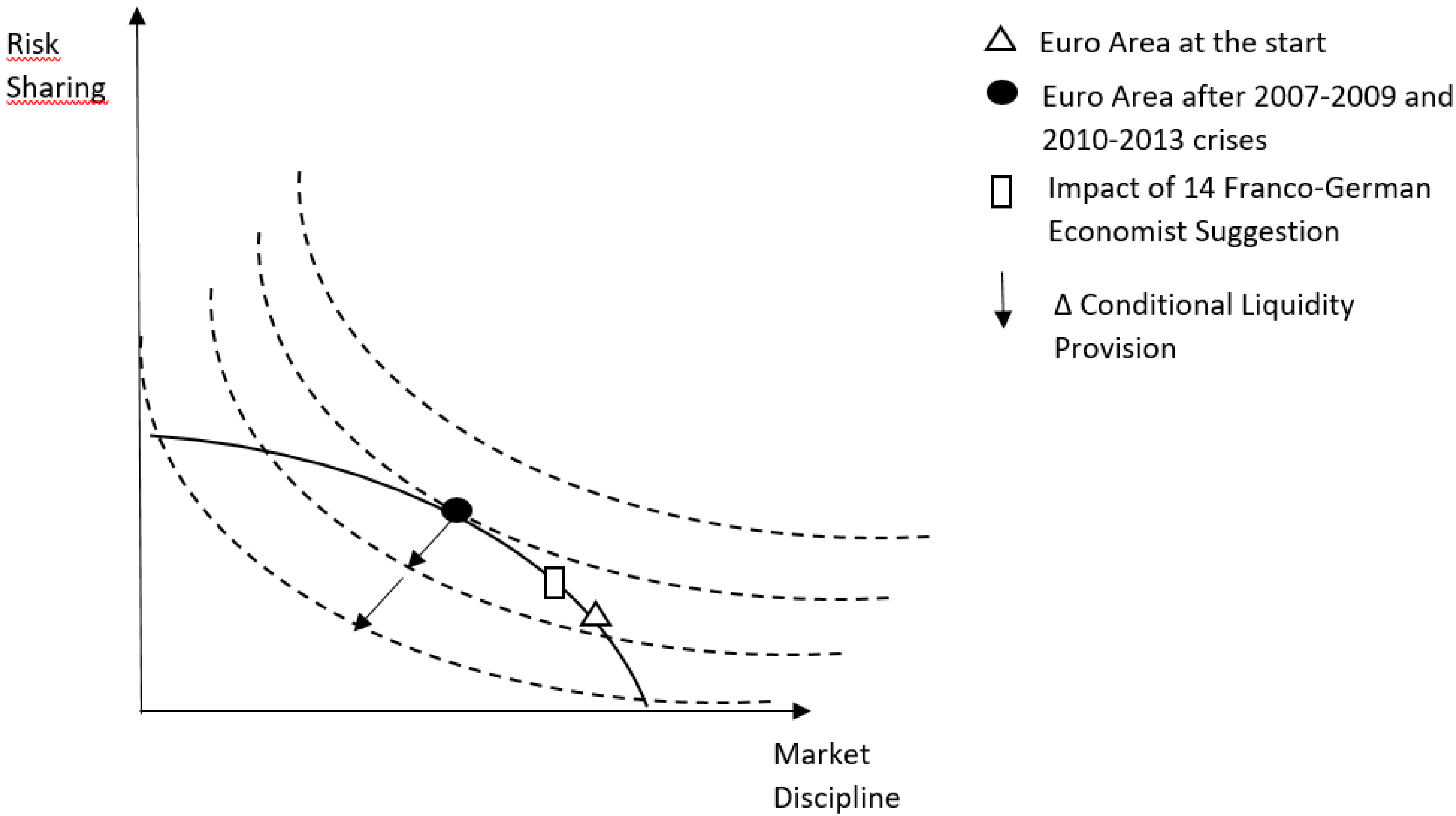
3. Institutional architecture

- PI91’s solution:
  - ESM/European Fiscal Board as prosecutor;
  - Eurogroup president (a Commissioner) as judge.
- This institutional model leads to ‘jumping out of the frying pan into the fire’:
  - the conflict 🡐 by the overlapping of prosecutor/judge is replaced with a far deeper conflict 🡐 by a double non-separation: judicial/legislative power; legislative/executive power.
- Possible reply:
  the couple prosecutor/judge is just an analogy. Hence, it cannot be an analytical basis for a change in the institutional setting.

4. Overcoming the couple RS-MD

- The previous analysis justifies SM’s figure.
  I re-interpret this figure by means of Fig. 1.
- Assumptions:
  - all curves in the Cartesian plan ➔ same ‘redenomination risk’ as a proxy of euro-area (in)stability;
  - changes in RS and/or MD are, directly as well as indirectly, costly;
  - all the points of each curve ➔ same total direct cost.
- The RS-MD curve is concave to stress that it is not efficient to stay in the neighborhood of the MD ‘corner’ solution (increasing slope in a.v.).

Fig. 1: RS - MD curve



4. Overcoming the couple RS-MD

- In SM&MM’s reading: PI91 ➔ a right-shift along the RS-MD curve relative to the after-crises point. Hence, analogously to Schauble’s Non-paper, this shift leads to an efficiency-loss.
- This new possible inefficient equilibrium could suggest proposals implying new left-shifts along the RS-MD curve (weakening MD).
  However, SM&MM’s proposal is different:
  - RS-MD curve is not an efficient frontier → Pareto-improvements if the RS-MD curve shifts downwards since, by assumption, lower direct costs and same ‘redomination risk’.

4. Overcoming the couple RS-MD

- This statement various theoretical justifications (for instance: basics of CAPM).
- Here, it is sufficient to stress that conditional liquidity provision ➔
  - downwards shifts in RS-MD curve;
  - convexity in RS-MD curve in the sense that the neighborhood of the MD 'corner' solution does not ➔ large decreases in RS.
- PI91 ➔ new liquidity line offered by ESM;
  Our comment: too severe constraints for its implementation.
- Possible positive example: EC's (2017) transition period for EDIS.