LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY
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Debate on Euro Area Governance

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COMMENTS ON CERP PI NO. 91

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PREMISE n.1: the euro area suffers from a special disease entailing a continuing threat of financial instability – and that is the fact that the provision of liquidity to the sovereign bond and banking markets is not under the control of national central banks, but of the ECB Governing Council – which decides by consensus in a large body where many a member may be opposed to the provision of the required liquidity – and in addition there is no ultimate fiscal backup behind the provision of liquidity in front of a large systemic crisis hitting the sovereign bond and banking market.

ILLUSTRATE TABLE 1

Two extreme policy views, one stressing the need to provide liquidity to maintain market confidence, the other placing emphasis on the need to maintain sound policies and enforce effective market discipline on euro area members

As you move from left to right, the risk premium on highly indebted countries goes up, and typically not by smooth increments but by discontinuous jumps – possibly up to the point where the country loses market access – it goes up because of fears that liquidity might not be available to meet an idiosyncratic shock

And, rising risk premia entail a return of **market fragmentation**, with three consequences

(i) An increased the home bias of domestic investors – including banks
(ii) A reduced role of private capital markets in sharing the risk of idiosyncratic shocks – entailing an increased risk of public bail-out in case of a shock hitting the country
(iii) Little recycling of external surpluses coming to the countries involved – with the implication that the deflationary bias of the eurozone is magnified, since countries with high risk premia have no other choice that to deflate domestic demand and reduce domestic wakes to maintain a sustainable external equilibrium

PREMISE N. 2: there is a 'conservative' German position that never quite accepted that tensions in the euro area may be the result of inadequate liquidity provisions – and always held that sufficient budgetary and market discipline would suffice to prevent the build-up of distress in the euro area. A non-paper commonly attributed to Wolfgang Schäuble summarized the main ingredients of such discipline in four areas (Table 2):

1. sovereign debts: establish a system of ex-ante debt restructuring before granting financial assistance to a member state under distress; automatic restructuring (debt maturity extension) in case of request of ESM assistance
2. shift all powers for crisis lending to distressed sovereigns to the ESM and exclude any Commission involvement; Commission seen as 'political' and unable to enforce discipline
3. significant risk reduction necessary; oppose cross-border deposit insurance scheme (hence also no backup for deposit insurance schemes)
4. increase ownership of structural reforms under CSRs, with support from EU budget; no macro-stabilisation function necessary

The main feature of this scheme is that each country is left on its own and help from common institutions is subject to harsh preventive action – and uncertain, thus eliciting investors' runs.

Let's now turn to **CEPR PI no. 91** and the reasons why we read in its recommendations an unwelcome similarity with Schäuble.

1. It pays little **attention to the liquidity problem**, and hardly mentions the redenomination risk (only once, to mention that they would like to

eliminate it) – although it envisaged a new liquidity line from the ESM for countries in compliance with the common policy rules

2. It proposes a distinct **tightening of the screws** on national policy making – with some compensatory measures that we regard as insufficient – which in our view altogether entails a weakening of euro area defences against idiosyncratic financial shocks, and hence a heightened sensitivity by market investors to any sign of distress – that is a risk of higher instability. More precisely:

3. On **debt restructuring**, the fundamental aim is to strengthen and make more credible the no-bail out rule by making "insolvent" countries restructure their debt before they are granted financial assistance, and by mitigating the financial and economic impact of debt restructuring. A noteworthy aspect here is that measures to reduce the financial impact of restructuring are described as risk-sharing measures (?).

4. The ESM Statute already requires assessing debt sustainability when considering ESM assistance; but in PI 91 we have a system where any access to the ESM entails automatic extension of maturity of the special junior bonds, and in addition a **preventive** assessment of debt sustainability – with a "data driven methodology" (objective?) developed by the ESM itself ; "transition" problem of **potential instability** – due to fears that existing sovereigns of some countries will inevitably have to be restructured – and that otherwise there would be a tendency to 'extend and pretend'. The key question here is whether starting the process of preventive assessment may push the interested country over the brink of insolvency, even if its problem was originally one of liquidity

   a. Small digression on debt seniority structure and the implications for financial stability

5. The **ESM** would not be allowed to provide financial assistance to a country hit by an idiosyncratic shock that has lost market access without a prior decision on debt sustainability, as has been described; the new governance proposed for the ESM in crisis lending would weaken the role of the Commission (by eliminating its present power of proposal) and, under an IMF-type quota system in voting, would give creditors greater weight in decision-making.

6. On Banking Union, three main recommendations:

   a. On one hand the screws of state aid to banks and the application of the bail-in instrument would be tightened;

precautionary recapitalizations subject to full asset quality review; (p. 6) there is a key question here as to whether the proposed changes in governance would reduce the room for taking into account systemic financial stability exceptions in the application of the state aid discipline and the BRRD

b. Concentration charges would discourage bank holdings of 'own' sovereign debt – a proposal with which we concur – but we are concerned about the state goal that "the specific role of national banking systems as default absorbers of domestic sovereign debt" would be "structurally" eliminated – in the view of the authors of CEPR PI no. 91 the impact of this measure would be allegedly compensated by the introduction of EDIS "and the corresponding sharp reduction of redenomination risk"

c. However, EDIS would be introduced with two features: (i) that national compartments would remain and assure the absorption of "first losses" also in the long term; and (ii) deposit insurance fees would be set also based on country risk;

It seems to us that these two features are bound to maintain financial fragmentation and an adverse risk-premium on the banks of highly-indebted countries (even without any specific risk charges on national sovereign holdings). They are also likely to reduce the depth and liquidity of the national sovereign market.

7. The tightening of the screws on national policies, as has been described, would be allegedly offset by:

a. New ESM credit line for countries "with good policies" but under conditions (ex-ante and ex-post) that would perhaps make any such demand for financial support unlikely; is it like the present ESM precautionary credit lines (?)

b. A rainy-day fund for countercyclical stabilisation of large employment shocks – providing a one-time transfer; not very relevant in case of financial shock – numbers not very large at all events

c. EDIS as has been described, with a mutualised compartment for large idiosyncratic shocks and an ESM backup (credit line, sine any use would have to be repaid)

d. A new safe asset – ESBies – to help banks get rid of sovereigns in balance sheets – perhaps unlikely to fly without public support

The fundamental question here is whether this would be sufficient to ensure for the system's overall stability – in an environment in which the

ECB QE policies would come to an end and the room of manoeuvre of the ECB to act as lender of last resort for a sovereign debt market under attack may be now weakened, also in view of its large holdings of sovereigns

Or, in other words, there is a real question here of assessing the effects **on liquidity** of the **overall balance** of the measure that are proposed

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