ADEMU
Final Conference

In the aftermath of the euro crisis: lessons and dealing with the debt overhang (comments on Giancarlo Corsetti)

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(with some elements based from the 7+7 Franco-German Report published as CEPR policy insight 91)

My comments on the chapter

- 2 questions
  1. Is the monetary backstop in EMU the OMT or QE?
  2. How to deal with unsustainable public finances in EMU?
- 2 proposals
  1. Make the no-bailout rule credible (from 7+7)
  2. Build a broader safety net (from 7+7)

Is the OMT the monetary backstop in EMU?

1. Background
   - OCA theory incomplete because EMU is incomplete
   - Impossibility to make Deauville work → negative spiral
   - Need for „monetary backstop of government debt“ (sic)
2. Corsetti argues OMT is the backstop – but what about QE (totally absent from the chapter)?

OMT	QE
- Asymmetric - Spread-focused - Justification: monetary transmission - Conditional upon ESM	- Symmetric - Rate-focused - Justification: EA cycle - Unconditional

3. This is more than a semantic question
   - Conditionality, free-riding, question of sovereign debt sustainability

How to deal with unsustainable public finances?

1. No-bailout clause absent from the chapter, so is sovereign debt restructuring
   – So does the chapter address its own title („Lessons and dealing with the debt overhang“)?
2. This is indicative of the broader EMU discussion. There are three ways to look at the issue
   – View 1: No bailout is de facto dead (thanks to ESM + OMT)
   – View 2: No bailout is alive, restructurings should even be automatic as soon as a country loses market access
   – View 3: Don‘t talk about it
3. The broader question is: should markets or politics address debt overhang?

The approach from our recent Report:

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Reconciling risk sharing with market discipline: A constructive approach to euro area reform

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Approach: Make the no-bail-out rule credible

No-bail-out rule (which is still in the Treaty): no official lending to countries with unsustainable debts unless accompanied by sovereign debt restructuring.

Requires:

1. Reducing financial and economic disruptions associated with debt restructuring. Requires reduction of concentrated sovereign exposures, better stabilization tools
2. A legal device to protect sovereigns against holdout creditors (CACs)
3. A more IMF-like ESM that is able to develop its own lending policies and stick to them

Dealing with the "transition problem":

- Phase-in new polices. To apply only to new stock of debt, and only after new stock exceeds e.g. 60-90% of GDP (Corsetti argues against this)
- Announce in good times (now)
- Announce in combination with risk-sharing reforms

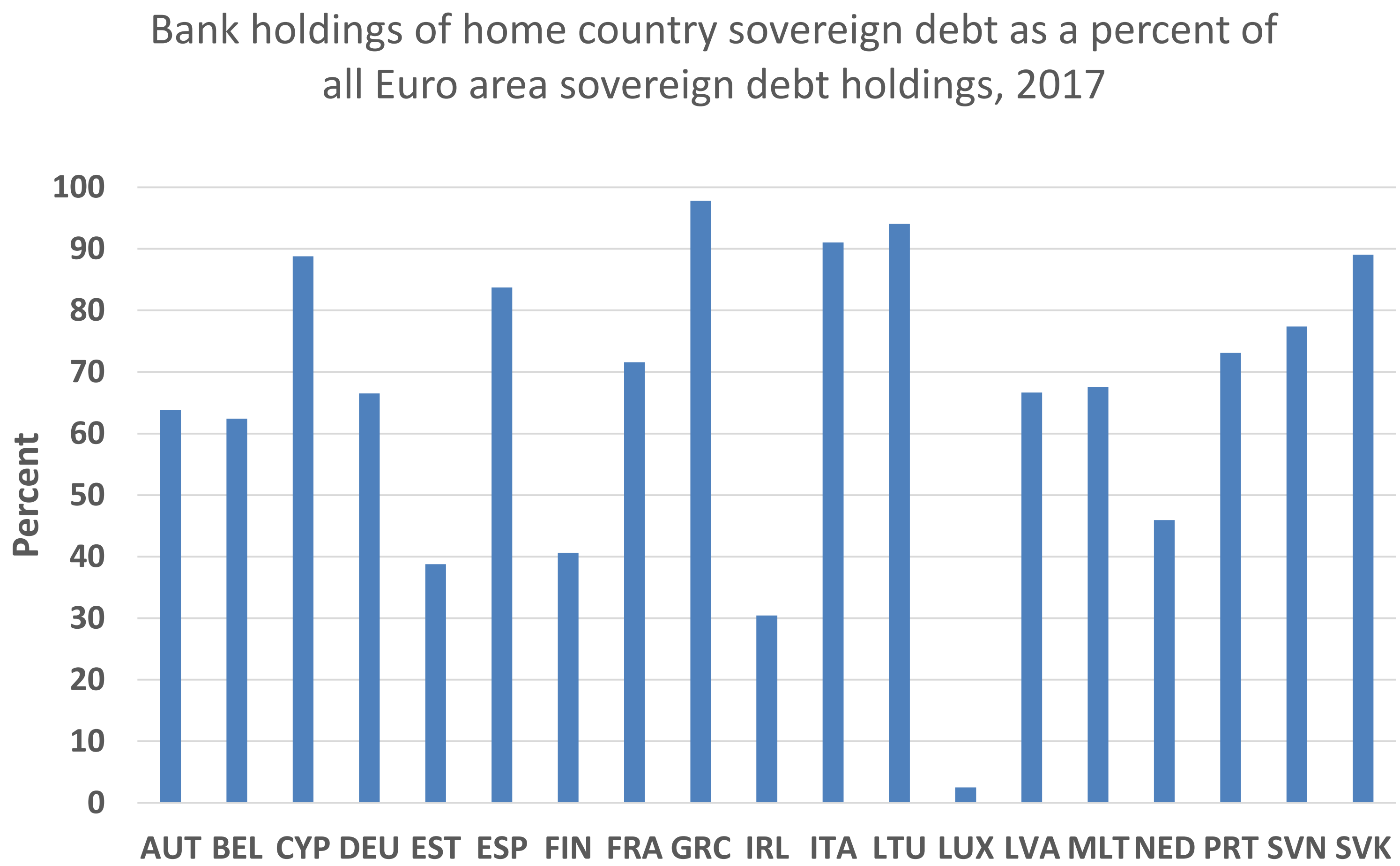
Proposal 1: use junior bonds

- Abolish current apparatus involving “escalation”/sanctions
- Expenditures in excess of ceiling must be financed by the issuance of ”junior bonds” that are:
    1. Legally subordinated
    2. Subject to automatic maturity extension in case of ESM program
    3. Subject to capital charge and a low maximum exposure limit.
- Advantages compared to current system.
    1. No discretion (except in catastrophic circumstances). Therefore, more credible, less politically costly.
    2. Not just a deterrence instrument. Economically meaningful even ex post (protection of existing creditors).
    3. Extent of “market sanction” will depend on reasons for rule violation and overall credibility of government fiscal and economic policies

Proposal 2: build a credible safety-net that doesn’t rely on a direct monetary backstop

1. Introduce “sovereign concentration charges“ that incentivize banks to invest in diversified bond portfolios
2. Offer banks a “safe asset“ (not subject to concentration charges), e.g. ESBies (senior tranches of a sovereign bond backed security).
3. Reform financial architecture to encourage euro area financial integration (European deposit (re-)insurance, capital markets union, more cross-country consistency in resolution).
4. Introduce a fiscal capacity to protect countries from large economic disruptions (e.g. unemployment reinsurance funded by experience-rated national contributions).

Concentration of sovereign exposure of banks



Source: ECB

Conclusions

1. If the objective is to „deal with debt overhang“ it is unavoidable to discuss the rare events of sovereign debt restructurings.
2. If Deauville triggered a situation that unanchored market expectations, the the discussion should be how to anchor market expectations in a Deauville-like context.
3. Too much emphasis on the monetary backstop is dangerous. The OMT is hard to use as a real backstop. QE is strictly limited to very specific situations. Also, the legitimacy of the ECB is at stake.