
DOMESTICATING THE EURO

THE SAFE ASSET DEBATE



WHO NEEDS SAFE ASSETS?

IT'S NOT JUST BANKS !

Banks

Governments

ECB

Capital Markets

Counter-cyclical
balance sheet
instrument

Safeguard
government
funding

Effective
monetary policy
transmission

Support deep &
liquid capital
markets

Reduce the
sovereign-bank
doom-loop

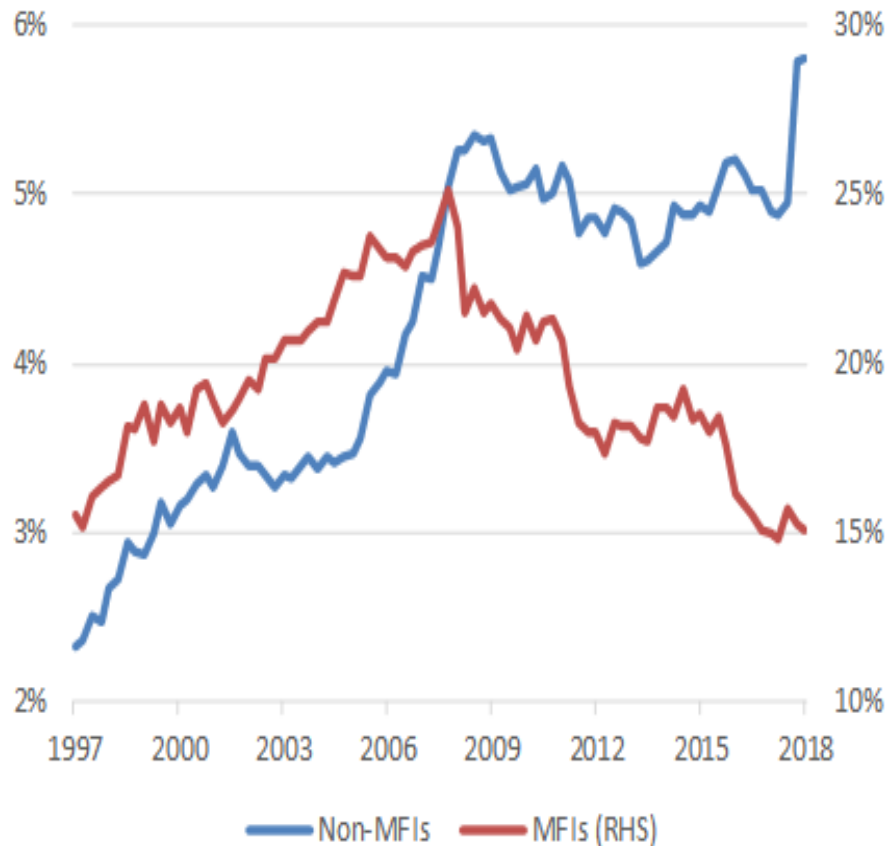
Support
fiscal policy

Unlimited QE
(if needed)

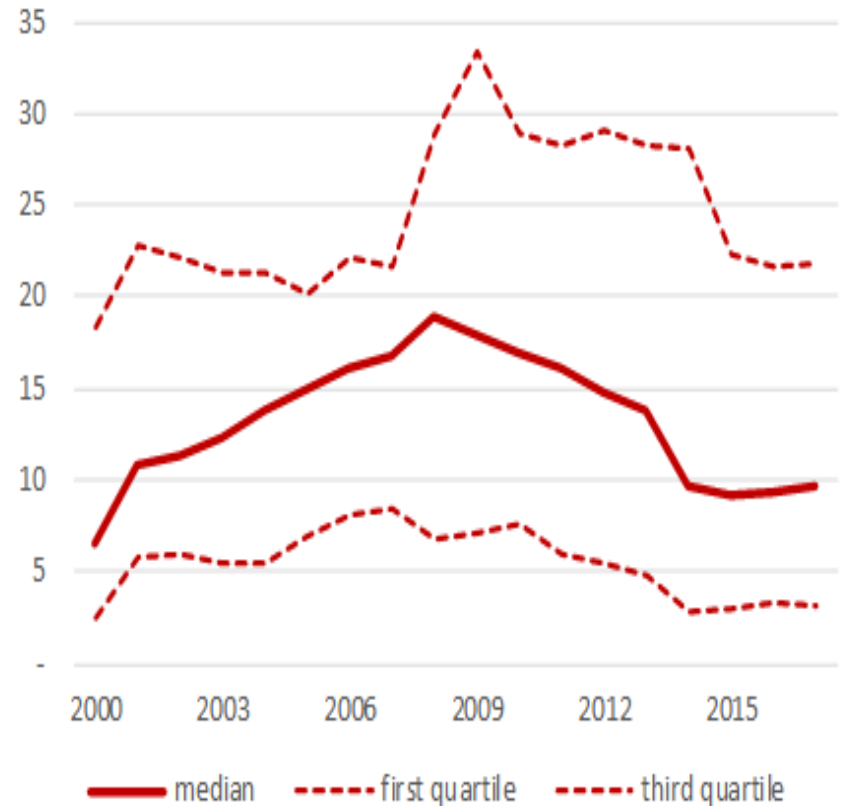
Support the
international
role of the euro

THE DOOM-LOOP IS NOT JUST ABOUT GOVERNMENT BOND PORTFOLIOS

Loans, Outstanding amounts by residency of the counterparty
To other euro area countries, % share

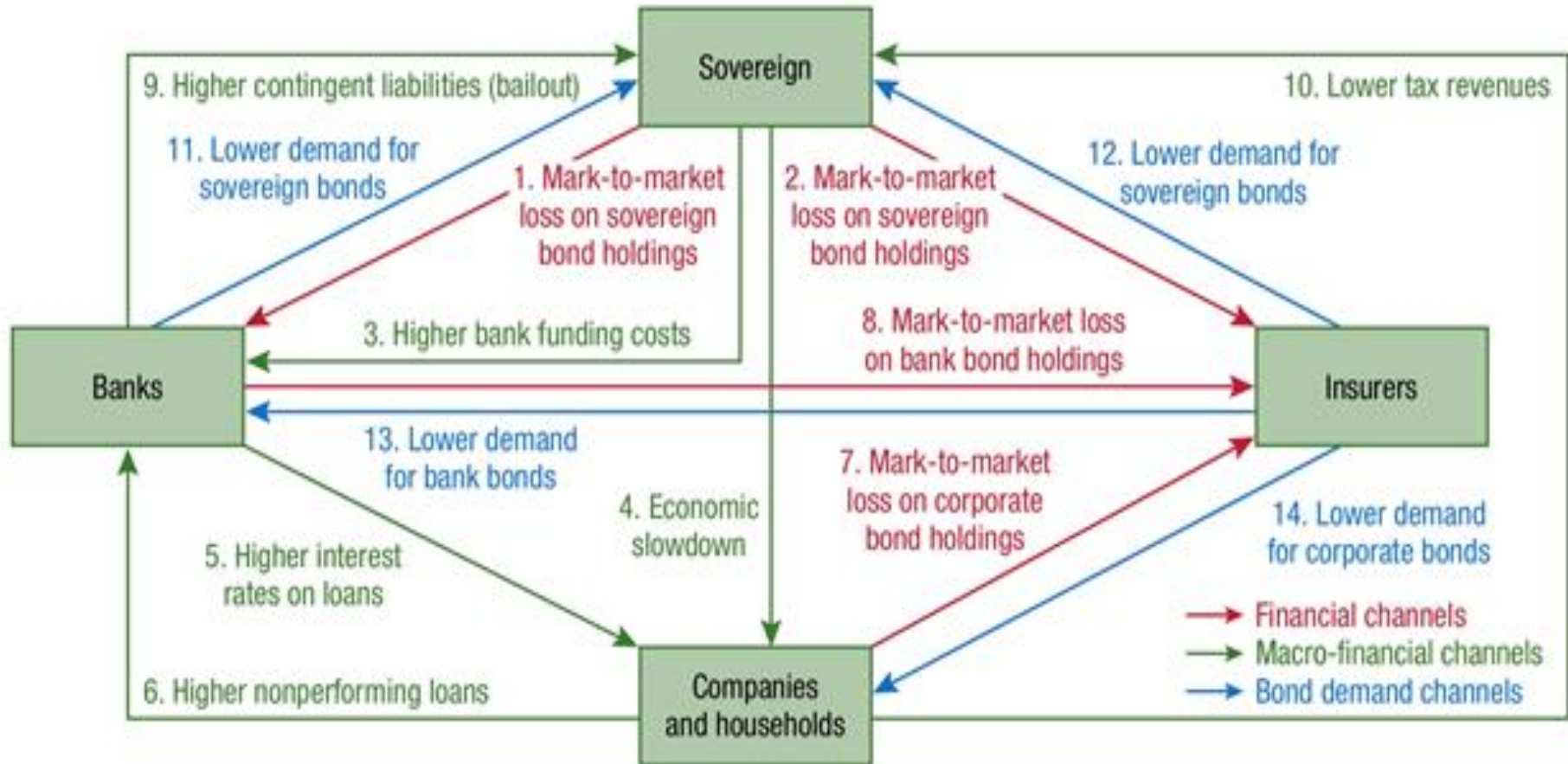


Dispersion of the total assets of foreign branches & subsidiaries
of euro area banks across euro area countries, % Total assets



Source: ECB

THE MANY DIMENSIONS OF THE DOOM-LOOP



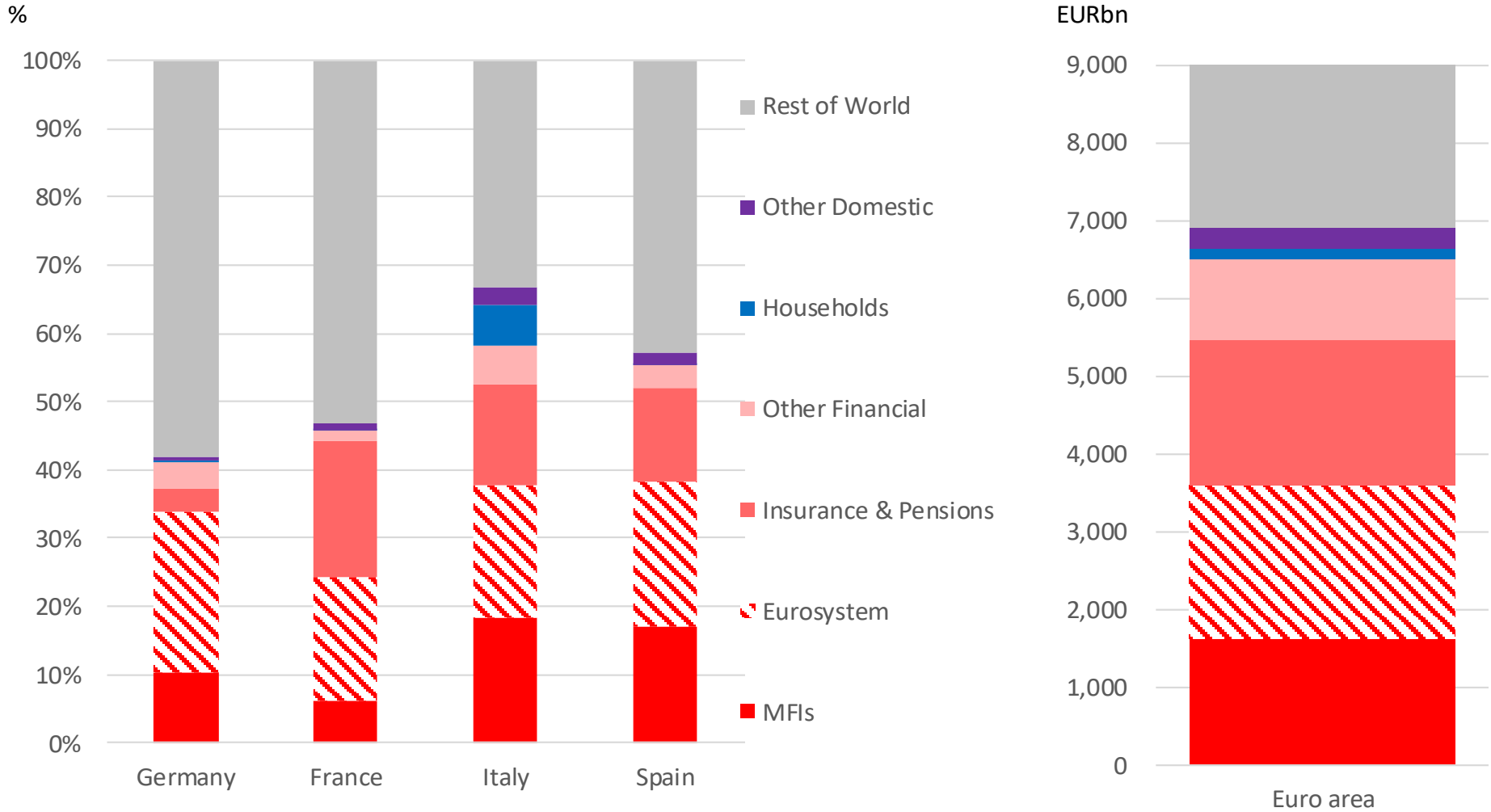
Source: IMF staff.

Source; GFSR, IMF April 2019

HOW LARGE DOES A SAFE ASSET POOL NEED TO BE?

€1,500BN IS PROBABLY NOT ENOUGH !

Outstanding Government Securities by Ownership, 3Q18

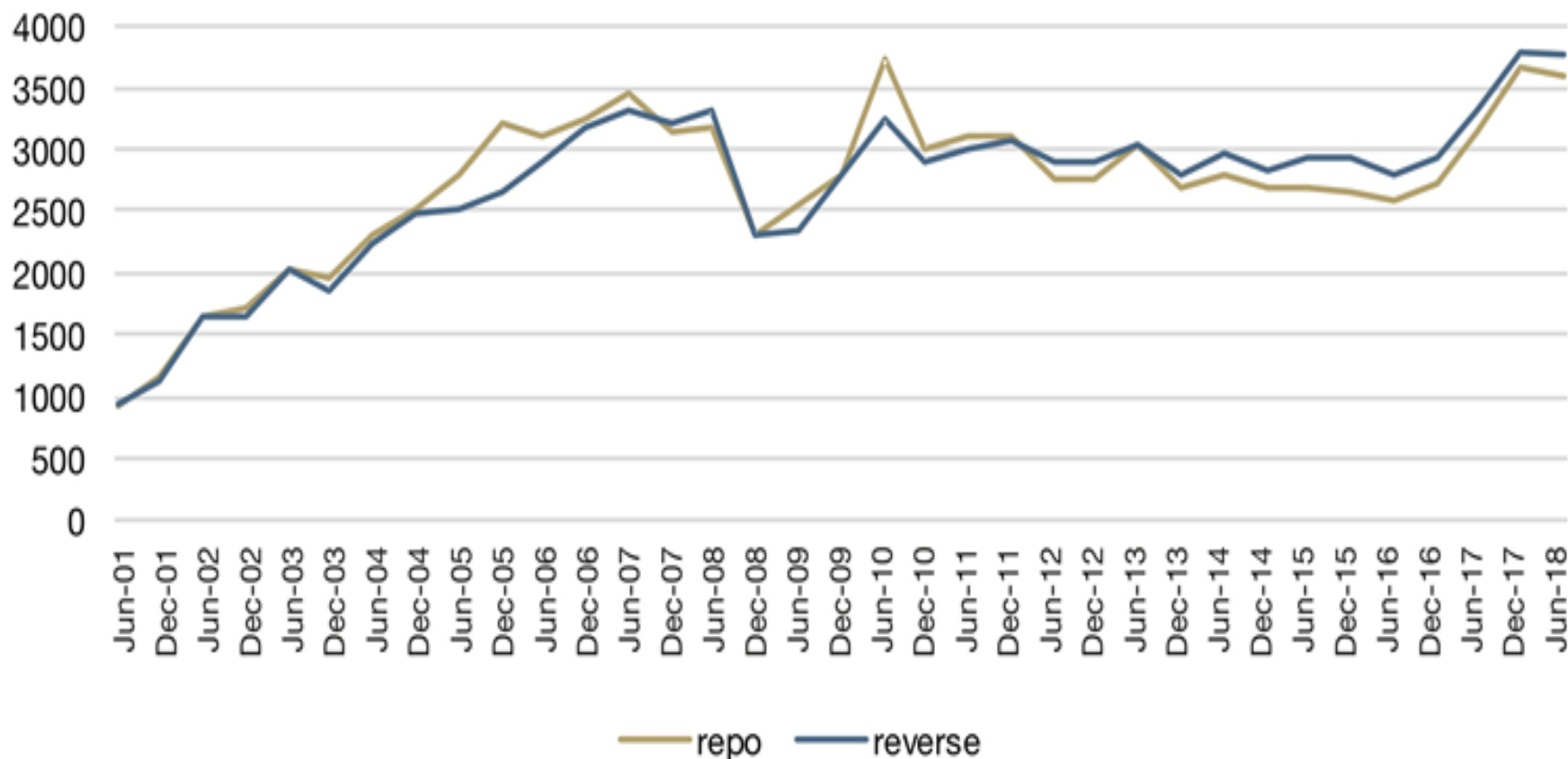


Source: ECB, Datastream, SG Economic and Sector Studies

HOW LARGE DOES A SAFE ASSET POOL NEED TO BE?

A €7.35BN EU REPO MARKET, GOVIES MAKE UP 85% OF COLLATERAL

Total repo versus reverse repo business



Source: ICMA, European Repo Market Survey

WHAT'S IN A GOVERNMENT BOND YIELD?

THERE IS NO "MAGIC" WAND TO REMOVE RISK ...

Real risk free
short-term rate
expectations



Inflation
expectations



Safe asset
term premia

Counter-cyclical components



Liquidity
risk



Restructuring
risk



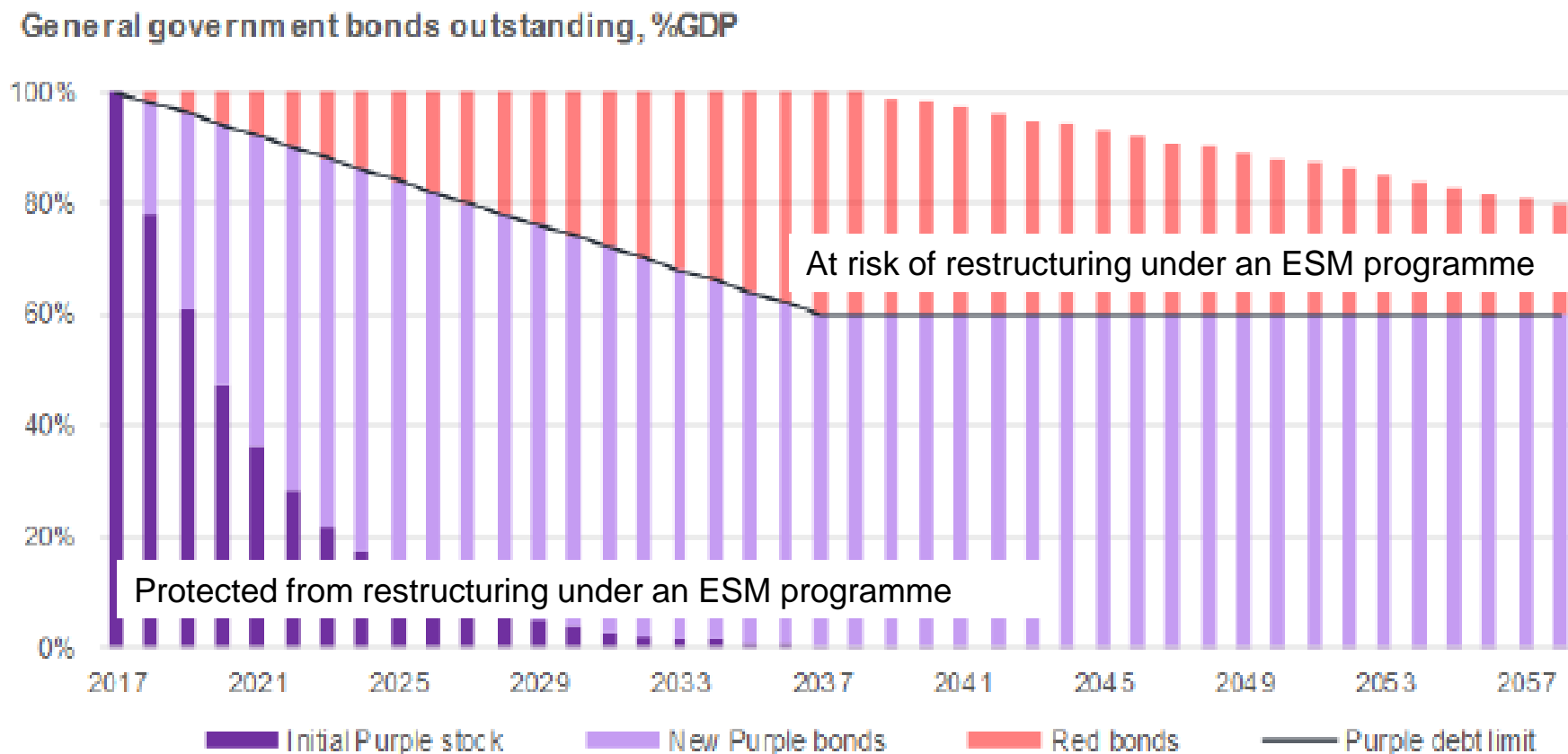
Redenomination
risk

Pro-cyclical components

... BUT RISKS CAN BE SHARED AND RE-ORGANISED

	Blue & Red bond proposal	Purple & Red bond proposal	E-bonds	National tranching, then pooling	SBBS
Safe asset	Pool up to 60% of national debt under joint and several liability	At t=0, guarantee existing debt against restructuring under an ESM programme; lower the guarantee to 60% of GDP over 20yrs.	Loans to national governments by a preferred creditor status institution, which then issues E-bonds.	A senior tranche of pooled national senior debt tranches up to a predefined level.	National debt is pooled and then split into a "safe" senior tranche ...
Risky asset	National junior bonds to finance any excess financing needs	National junior bonds to finance any excess financing needs	National government debt in market circulation	National junior bonds to finance any excess financing needs	... and a "risky" junior tranche.
Public risk sharing	Yes	Yes	Unsure	No	No
Pooling	Yes	No	Yes	Yes	Yes

A PROPOSAL FOR PURPLE BONDS PURPLE AND RED DEBT ... AN ILLUSTRATION



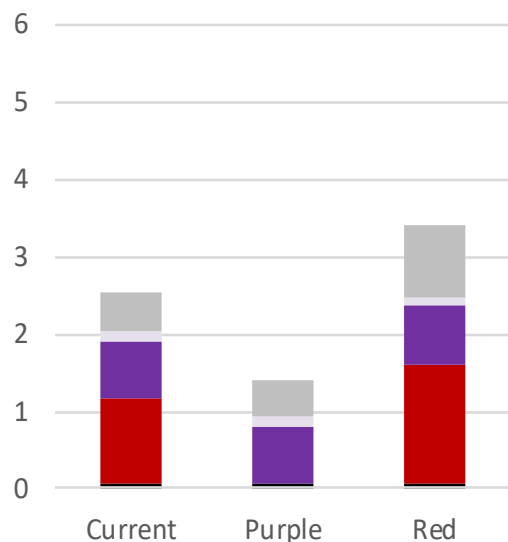
Source: Own calculations

PURPLE BONDS

A HYPOTHETICAL PRICING EXAMPLE

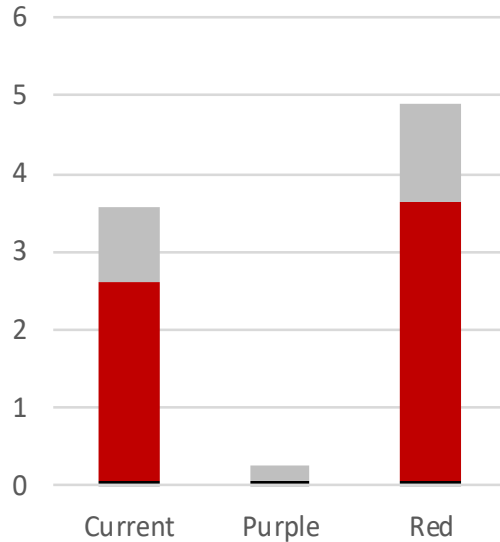
10Y Government Bond

Present day



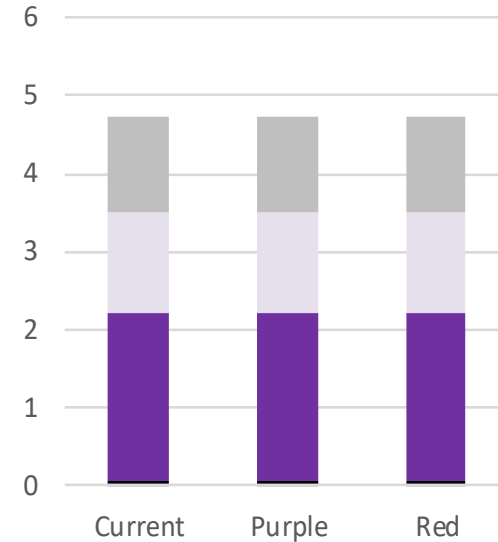
- Market friction
- €-exit & redenomination (P=4%)
- €-exit & restructuring (P=14%)
- ESM & restructuring (P=20%)
- Bund yield

Negative economic shock



- Market friction
- €-exit & redenomination (P=0%)
- €-exit & restructuring (P=0%)
- ESM & restructuring (P=40%)
- Bund yield

Euro exit fears



- Market friction
- €-exit & redenomination (P=35%)
- €-exit & restructuring (P=35%)
- ESM & restructuring (P=0%)
- Bund yield

WHO WILL GET A SAFE ASSET ?

BANKS AND GOVERNMENTS

	Debt tranching		Debt structuring	
	National tranching	Purple bonds	E-bonds	SBBS
BANKS				
Counter-cyclical balance sheet instrument	Not initially	Yes on restructuring risks, no on redenomination risks	Yes	Yes
Breaking the sovereign banks doom-loop	Not initially	Partially	Partially	Partially
GOVERNMENT				
Safeguarding government funding	Not initially	Supports ESM credibility	Question on ESM capacity	No
Supports fiscal policy	Not initially	Partially	No	No

WHO WILL GET A SAFE-ASSET ?

ECB AND CMU

	Debt tranching		Debt structuring	
	National tranching	Purple bonds	E-bonds	SBBS
MONETARY POLICY				
Effective transmission of monetary policy	Not initially	Partially	Partially	Limited
Unlimited QE (if needed)	Not initially	Partially	No	No
CAPITAL MARKETS UNION				
Supports deep and liquid capital markets	Not initially	Limited	Yes	No
Supports international role of the euro	Not initially	Limited	Yes	No

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