



EUROPEAN CENTRAL BANK

EUROSYSTEM

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# Safe assets in a monetary union

Remarks from a monetary policy  
perspective

CEPR Research and Policy Network  
on European Economic Architecture

16 April 2019

***The views expressed in this presentation are those of the presenter and do not necessarily reflect those of the ECB or the Eurosystem***



# **Monetary policy of the ECB and euro area safe assets**

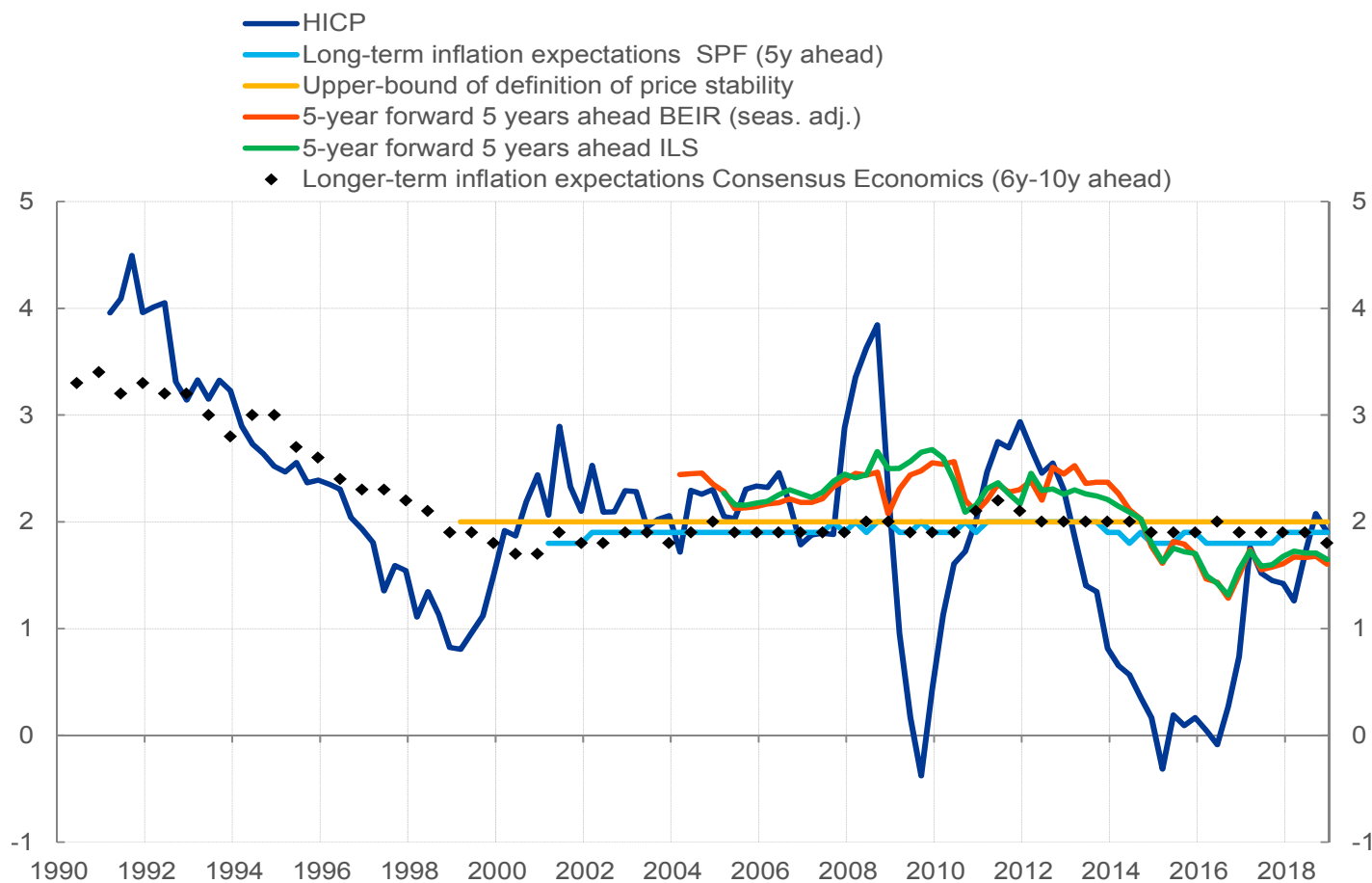
## **General remarks**

## Safe assets: overview

- Safe assets: rich set of concepts
  - private vs public issuers
  - private vs public assets
- This richness is recognised by the ECB's broad operational framework for monetary policy (counterparties, collateral)
- **Focus of this presentation:**
  - Bond-like sovereign EA safe assets in the context of EMU deepening

# The ECB has successfully delivered on its primary mandate

## HICP inflation and inflation expectations (percentages per annum)



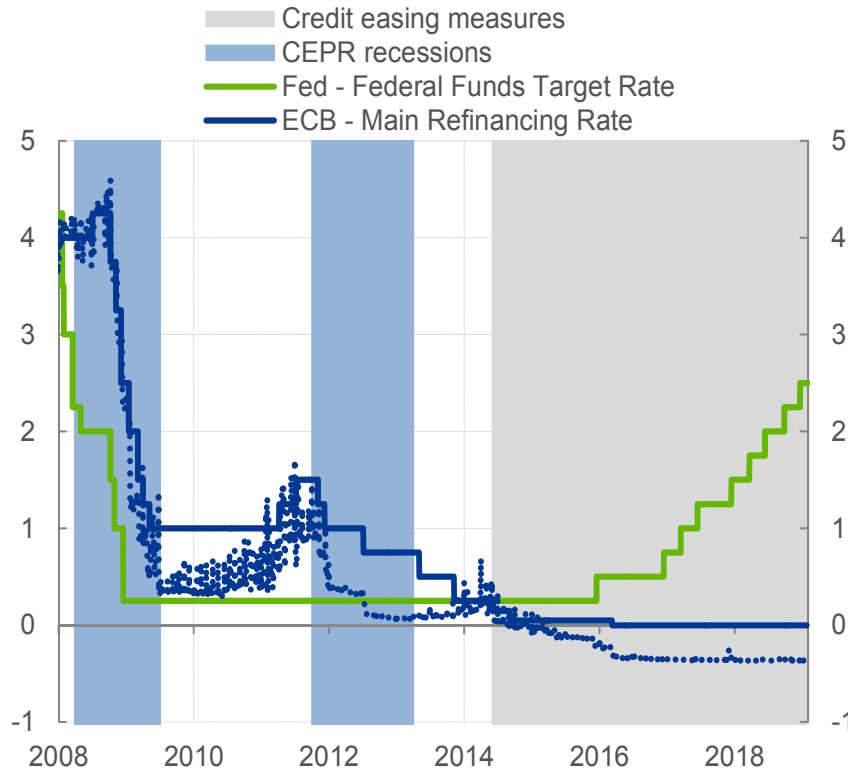
Sources: ECB, Eurostat and Consensus Economics Forecast.

Note: Longer-term inflation expectations from Consensus Economics Forecasts refer to a horizon of six to ten years, while those from the Survey of Professional Forecasters refer to five years ahead. Consensus inflation expectations are constructed as a weighted average of the five largest euro area countries which together account for more than 80% of euro area GDP. Quarterly Values.

Last observations: 2018Q4.

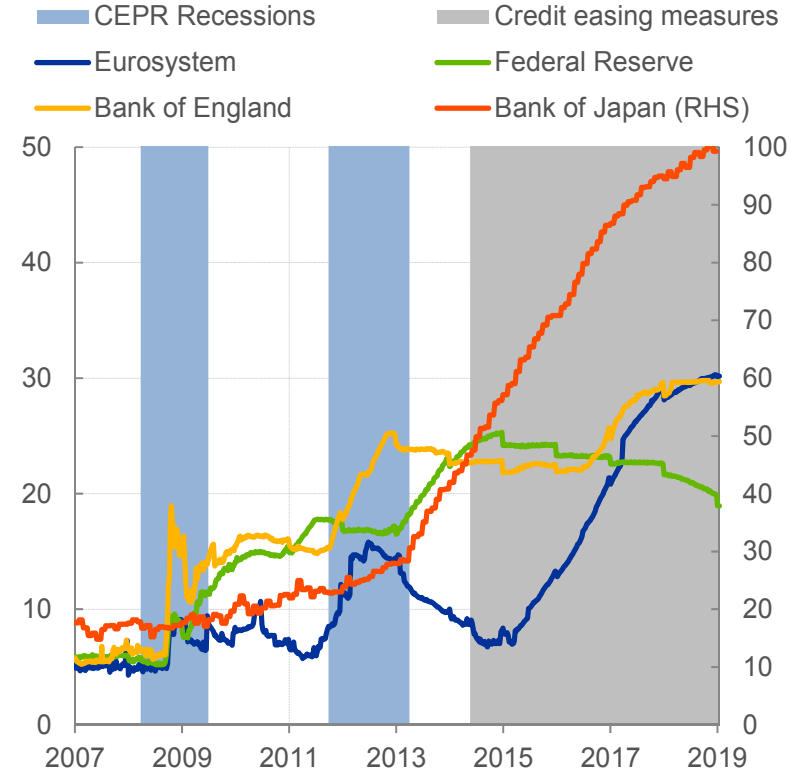
# ECB uses like other central banks standard and (EA-specific) non-standard policies

## ECB and FED key interest rates and EONIA (percent)



Source: ECB, Federal Reserve.  
 Notes: Main Refinancing Rate (ECB), Federal Funds Target Rate (Fed), EONIA (ECB).  
 Latest observation: 24 January 2019.

## Central bank balance sheets (MP instruments as percentage of GDP)



Source: ECB, Federal Reserve, Bank of England, Bank of Japan, Eurostat, BIS. Notes: MP instruments only comprise assets related to monetary policy. The BOE balance sheet is approximated after the 24 September 2014 since the institution only discloses 90% of its consolidated balance sheet after this date.  
 Latest observation: 18 January 2019 (Eurosystem, BoE, Fed) and end of December 2018 (BoJ).

## But: incompleteness of EA architecture poses formidable challenges

- BU still incomplete and CMU to be developed
    - goals: **risk reduction** and improved mix of **private and public risk sharing**, better **financial integration**
    - challenges: **bank-sovereign nexus ? cross-country safe haven flows ? lack of a common safe asset (pricing, hedging, collateral) ?**
  - Double need to reform fiscal landscape
    - Find credible, simple mechanism to enforce **sustainable national fiscal policies**
    - Develop **EA-dimension of fiscal policy** (reinforced by ZLB needs)
  - Need to preserve attractiveness of EA membership for all MS, with diverse legacies
    - challenges: recognise legacy issues, allow for smooth transition dynamics
    - negotiate attractive new steady state
- **safe asset agenda to be seen as key element of a much broader reform agenda**
- clear benefits from balanced reforms via complementarities across dossiers

## Moreover: progress with EMU deepening is of key relevance for monetary policy

Short-term concerns:

### Effectiveness of monetary policy?

- In general: low inflation environment remains a challenge: ZLB-constraint plus weak EA policy mix
- In particular: absence of shared EA safe asset prevents first-best design of QE

Medium-term concerns:

### Overburdening of monetary policy?

- Treaty assignments in line with monetary dominance
- Challenge: bank-sovereign nexus to be mitigated. Otherwise risks of fiscal and/or financial dominance

Upshot: **Monetary policy has a key interest in success of balanced reforms**



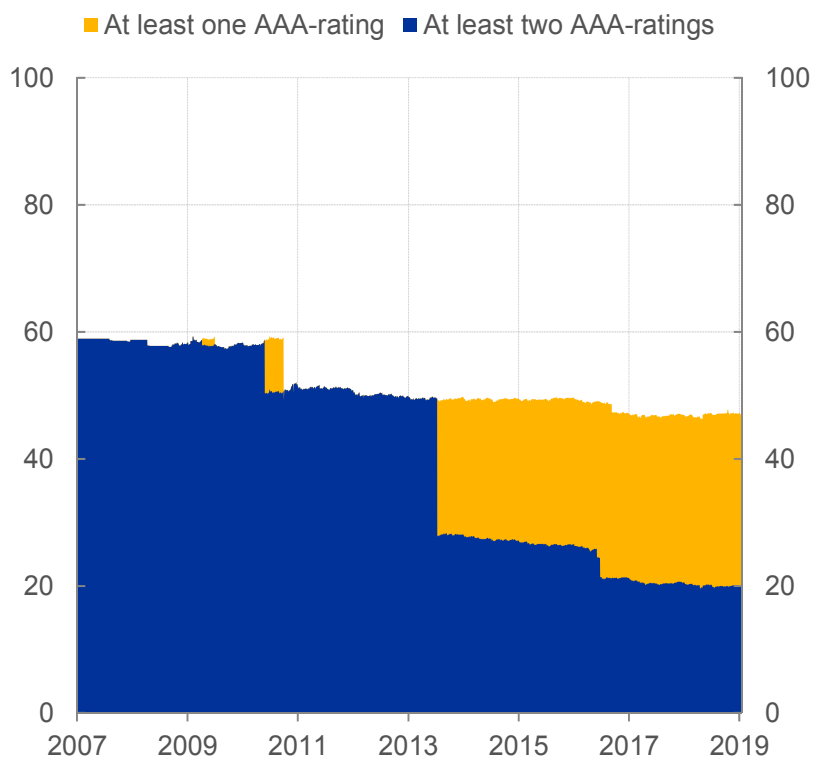
# **Safe assets and transmission of monetary policy**

## **Selected evidence**



# Supply of safe assets has declined and is low relative to size of economy...

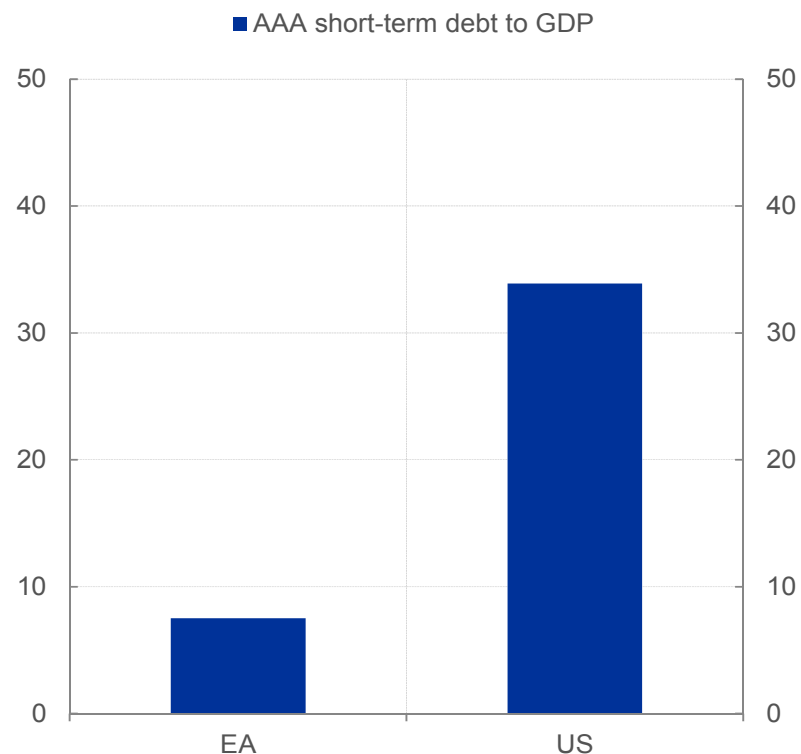
**Share of euro area sovereign bonds with AAA-rating**  
(percent)



Source: ECB.

Notes: Ratings based on Moody's, Fitch, Standard & Poor's and DBRS.  
Last observation: 17 January 2019.

**Share of short-term government debt with AAA-rating relative to GDP**  
(percent)

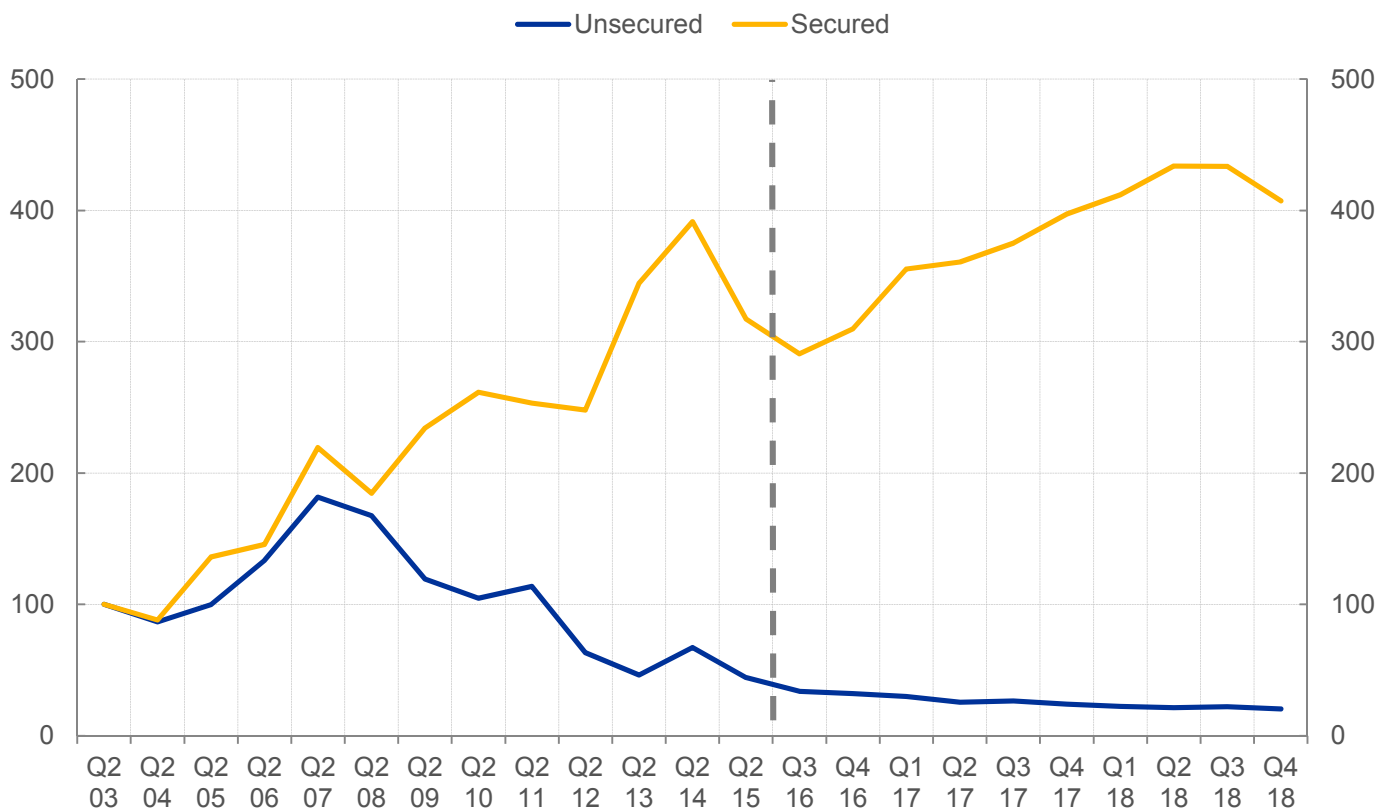


Source: ECB calculations.

Notes: Ratings based on Moody's, Fitch, Standard & Poor's and DBRS. AAA-rating based on at least one of its ratings being AAA. Short-term debt refers to securities with a residual maturity of up to and including 2 years.  
Last observation: 17 January 2019 for government debt, end 2017 for GDP.

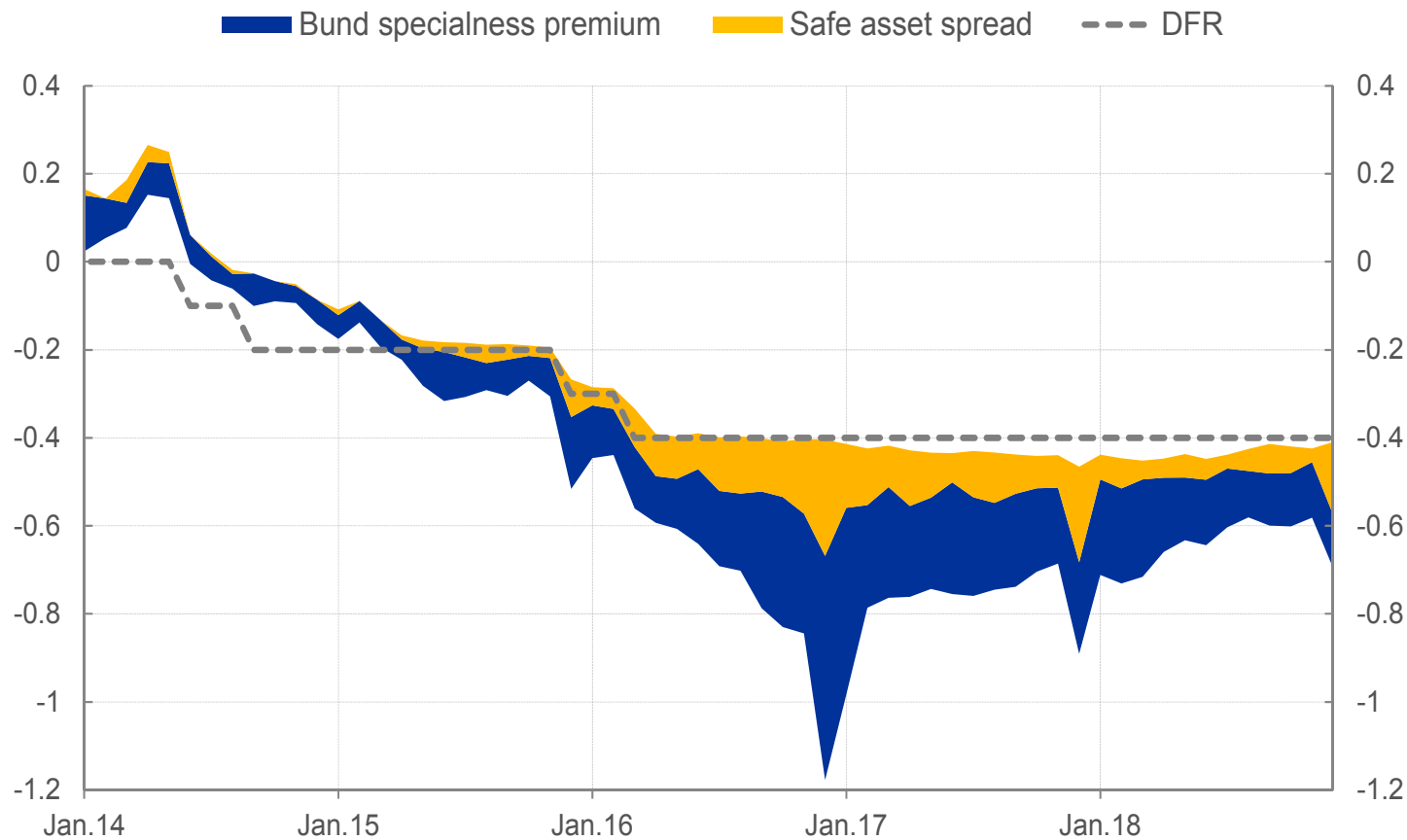
...while demand for safe assets has increased

### Turnover in selected money market segments (index: total volume in 2003Q2 = 100)



Sources: ECB Euro Money Market Survey (until 2015Q2) and money market statistical reporting (MMSR, as of 2016Q3).  
Last observation: 2018Q4.

## Safe asset spread and Bund specialness premium (percentages per annum, monthly weighted average)



Sources: BrokerTec, MTS, and ECB calculations.

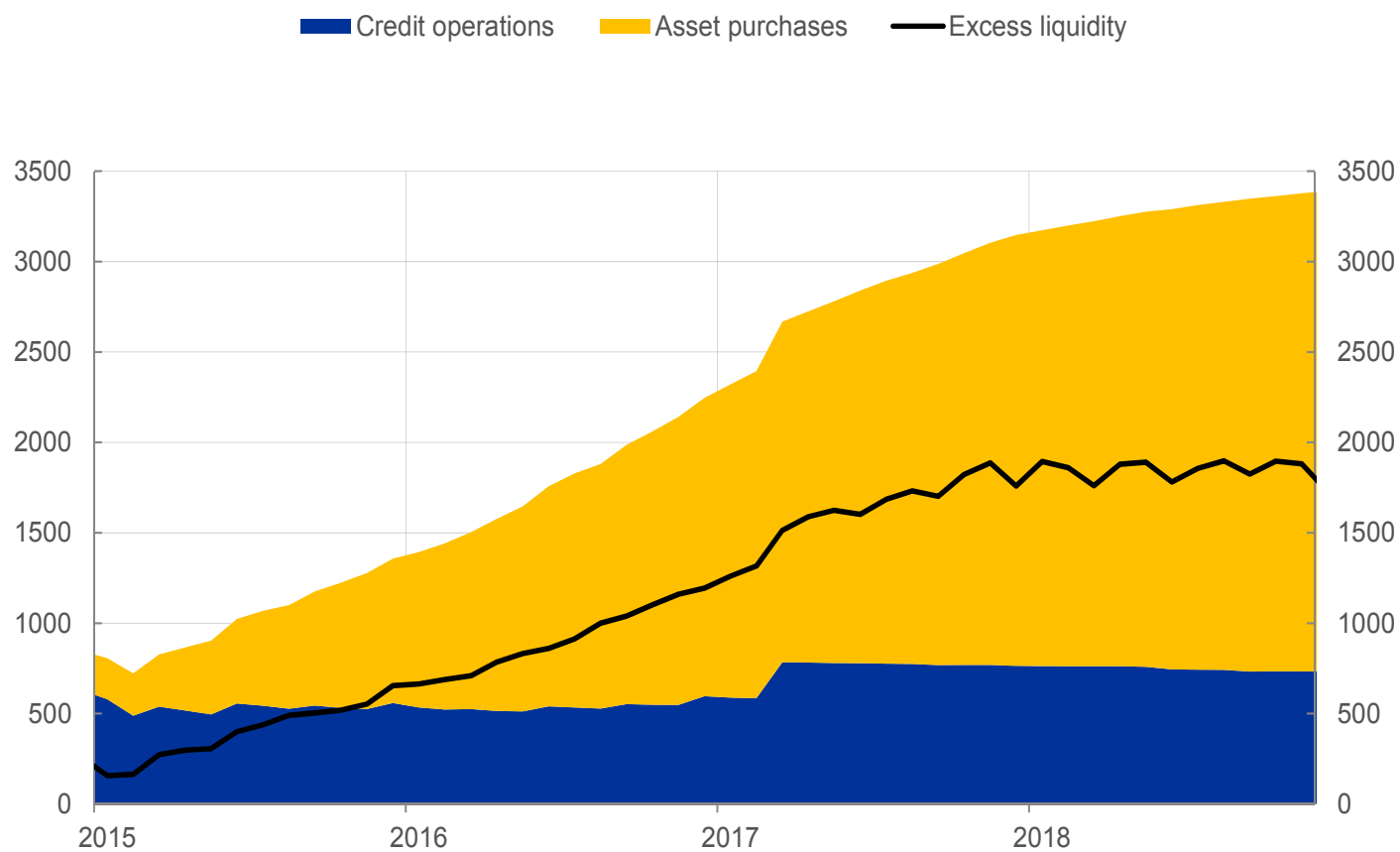
Notes: The series are monthly volume-weighted averages.

The Bund specialness premium is defined as the spread between the GC German and the Special German repo rates, while the safe asset spread is the spread between the GC pooling ECB and the GC German repo rates.

Latest observation: December 2018.

# APP creates one type of safe assets, central bank reserves

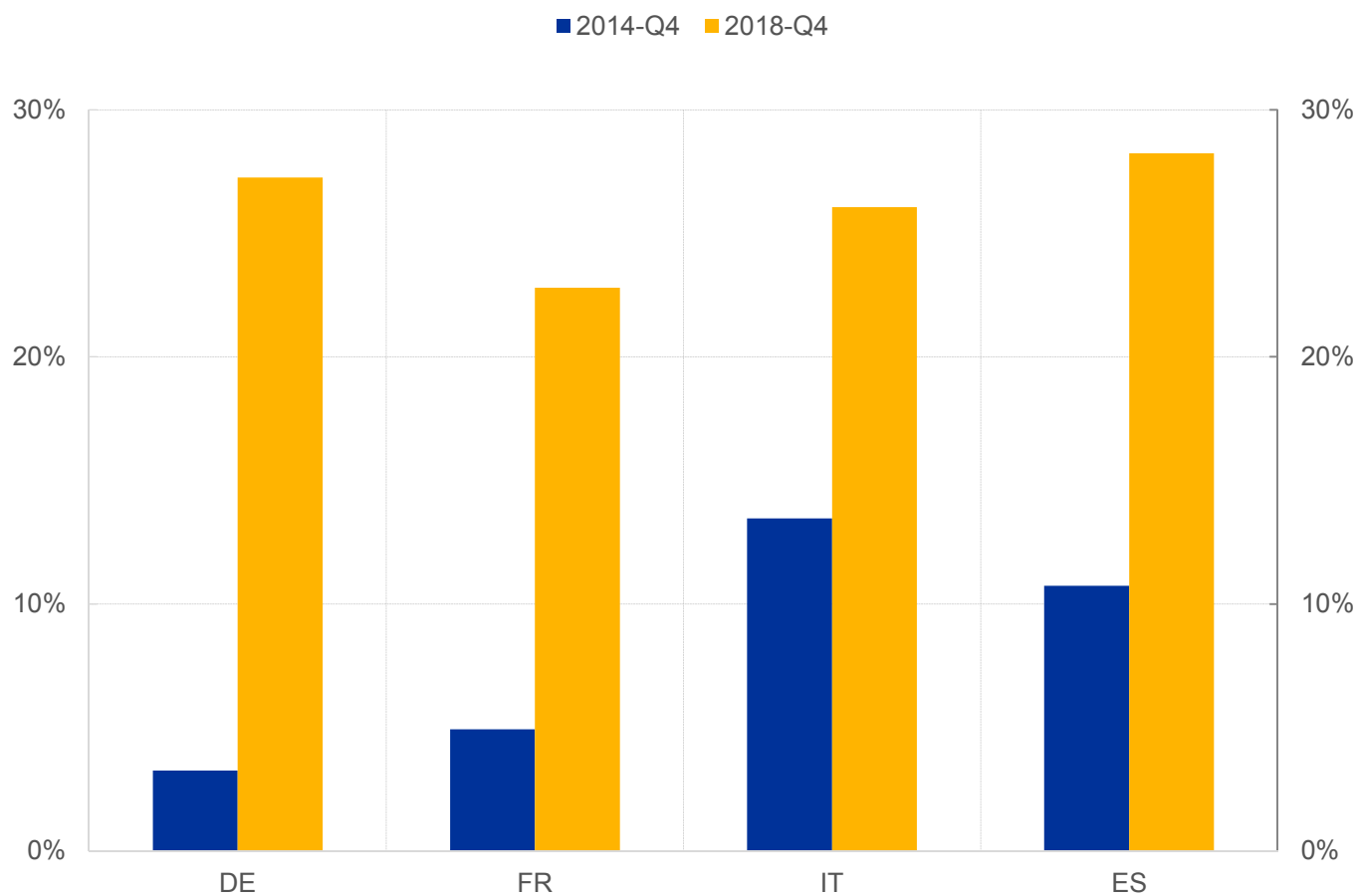
## Selected Eurosystem balance sheet items and excess liquidity (EUR bn)



Source: ECB.  
Last observation: December 2018.

and withdraws another type of safe asset, government bonds, from the market...

### General government bonds held by the Eurosystem as a share of outstanding amounts (percent)



Source: ECB.



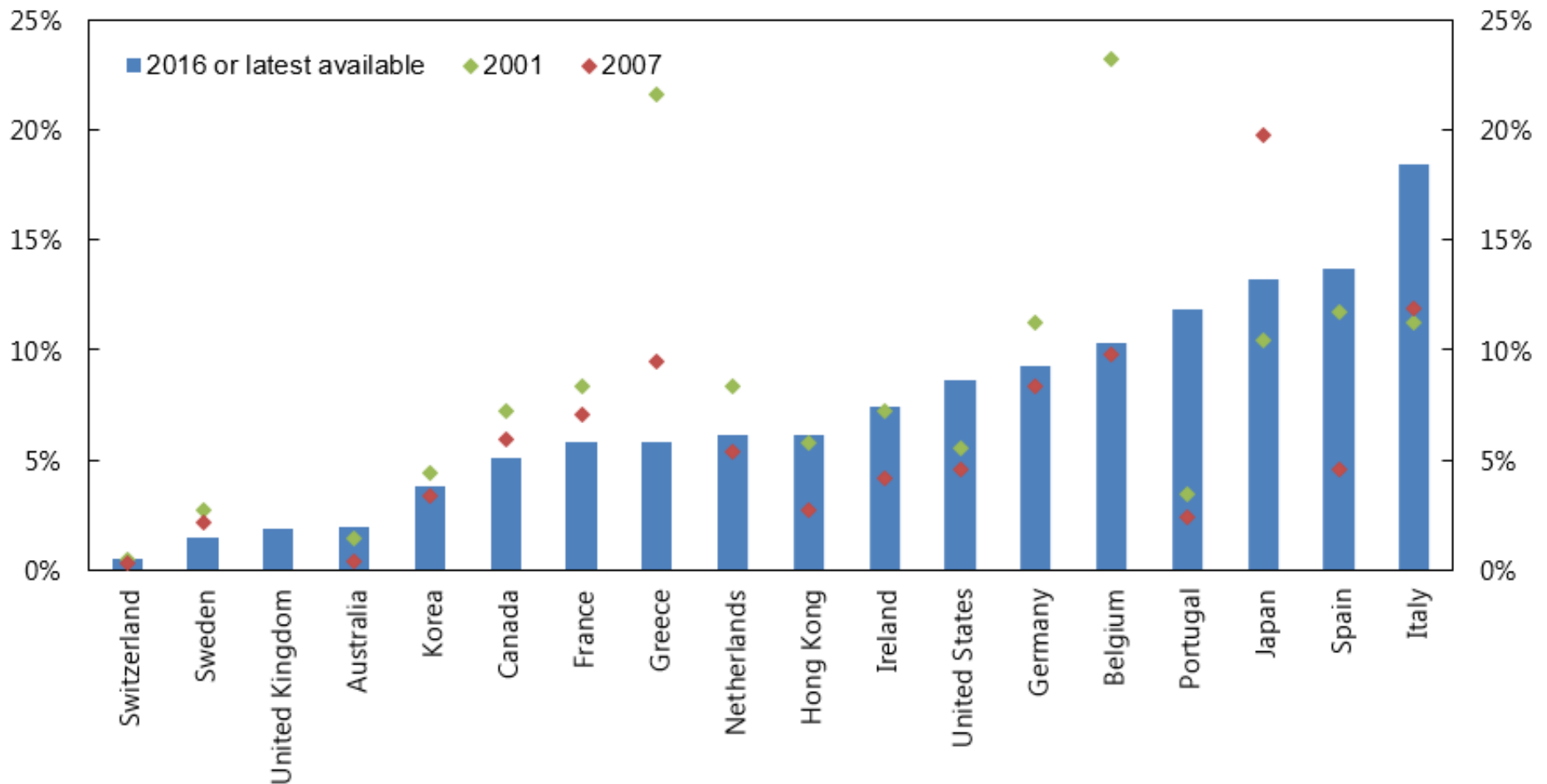
## Ways forward ?

## How to create safe assets in EMU?

- Provision of a safe asset is a decision of the fiscal authority, with backing through the central bank
- EA has 19 fiscal authorities, issuing national debt with different risk and liquidity properties
- **Challenge:** Creation of a safe asset in a Monetary Union without a Fiscal Union is a complicated matter
  - Traditional proposals (“Eurobonds”): common issuance, mutualised
  - Recent proposals: low-risk assets to be created from (existing) national debt, without mutualisation
  - Scope for combinations (see: blue-red-bond logic): ensure safeness through link to fiscal framework and differentiated CB support?

## Broader context: Bank-sovereign nexus

### Bank claims on domestic gov't debt in advanced economies (% of assets)



Source: *Basel Committee on Banking Supervision, Discussion paper, The regulatory treatment of sovereign exposures , December 2017*



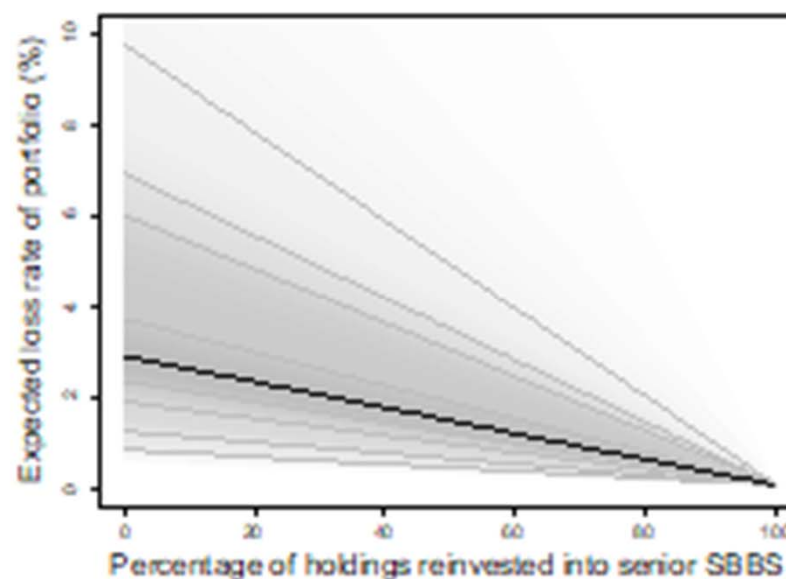
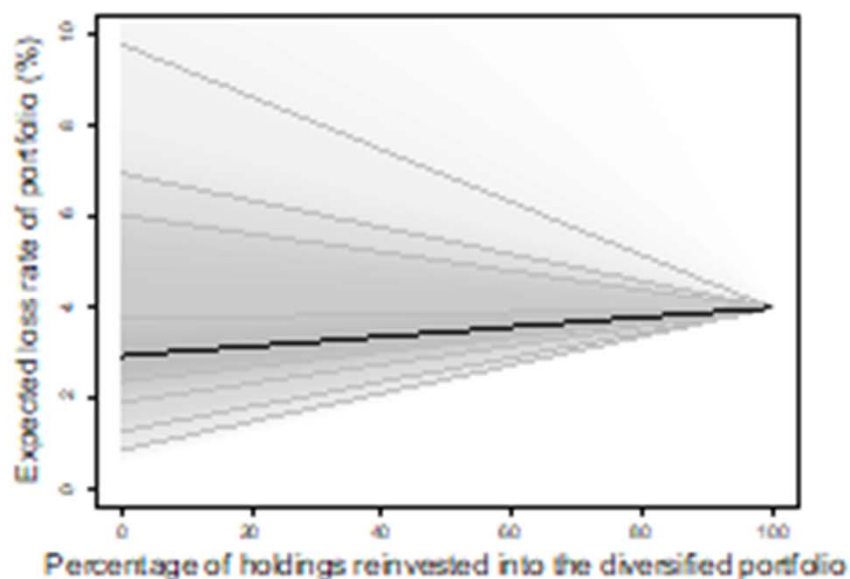
## Bank-sovereign nexus

**Challenge: de-risk banks smoothly over time** (flows vs legacy assets)

- Bank portfolios of sovereign debt need **less concentration risk** and **less credit risk** to avoid i) **contagion** and ii) **fragmentation**.

(see: Alogoskoufis and Langfield, 2018)

→ **Safe asset agenda offers a (non-trivial) complement**. Various Alternatives (combining **fiscal aspects, financial engineering, and regulation**)



Estimated expected loss rates of banks' sovereign bond portfolios. LHS: Banks reinvest a given percentage of their portfolios into a diversified portfolio of EA central gov't debt (ECB capital key). RHS: Banks reinvest into senior SBBS.

# Safe asset agenda and bank-sovereign nexus: some options

## Option 1: SBBS (diversification and tranching embedded)

- Demanding on financial engineering, lighter on regulation
- Fiscally neutral; private issuance possible (demand-led); creates **shared safe asset**

**Politics:** frozen (excluded from Meseberg); but: COM regulation proposal; (draft) EP report favours compromise between ESRB and COM

## Option 2: National debt with seniority structure

- Lighter on financial engineering, stronger on regulation
- Excess borrowing can be disciplined via link to fiscal rules; **national safe asset**

**Politics:** Not very actively discussed; various proposals (accountability-purple-blue-red-bonds); GDP-linked bonds; design of seniority: defaultability; state contingency?

## Option 3: E-bonds (issued by public issuer against portfolio of senior loans to sovereigns)

- Avoids securitization, but fiscally non-neutral (national debt becomes junior to e-bonds)
- Political economy of issuer; regulation consistent with seniority ?; creates **shared safe asset**

**Politics:** Discussion has started (see: *COM Workshop January 2019*)

## Option 4: Reliance on regulation only ?

- Strong on regulation (eg GCEA 2018: *concentration charges based on credit risk*); **no direct contribution to safe asset**

**Politics:** No consensus on merits of (significant) RTSE-reform

**Status quo:** Dislike of financial engineering; insufficient ambition to reform fiscal framework, waiting for fiscal consolidation in critical countries

**Politics:** not attractive (lack of credibility, political fatigue)

**Monetary Policy:** remains vulnerable if impasse<sup>18</sup> persists; QE design 2<sup>nd</sup> best



**EA sovereign safe assets  
and  
aspects of monetary policy normalisation**

## Monetary policy dimension

- **Eurosystem balance sheet** is a **mirror image of the other balance sheets**  
→ link to debate on safe assets and private vs public risk sharing
- Existing sovereign safe asset proposals are mostly motivated through fiscal aspects
- They hardly mention monetary policy and the current balance sheet constellation

### *Questions (to be picked up by needed research):*

How to assess the proposals in view of the current balance sheet constellation?

- Transition issues ?
- Steady state issues ?

### Pre-crisis constellation

- Monetary policy: price stability objective achievable with standard instrument (i.e. via variation of short-term interest rate)
- Balance sheet constellation
  - CB with lean balance sheet and w/o outright portfolio of sovereign debt

### Current constellation

- Monetary policy: near ZLB, price stability objective achievable with large CB outright portfolio of longer-term sovereign debt (i.e. via reduction of term premia and via signalling effects)
- Balance sheet constellation
  - CB portfolio of longer-term sovereign debt funded by short-term CB reserves
    - de facto “shortening” of government debt maturity in private portfolios
    - reduces government funding costs

## Balance sheet dimension induced by non-standard MP

### Open market operations

- credit, long
- Outright (including PSPP), long

### Standing facilities

- marginal lending

### Non-monetary policy assets

### Banknotes

- stable

### Standing facilities

- large excess reserves

### Capital and reserves

- retained income, incl. from outright asset holdings, net of reserve remuneration

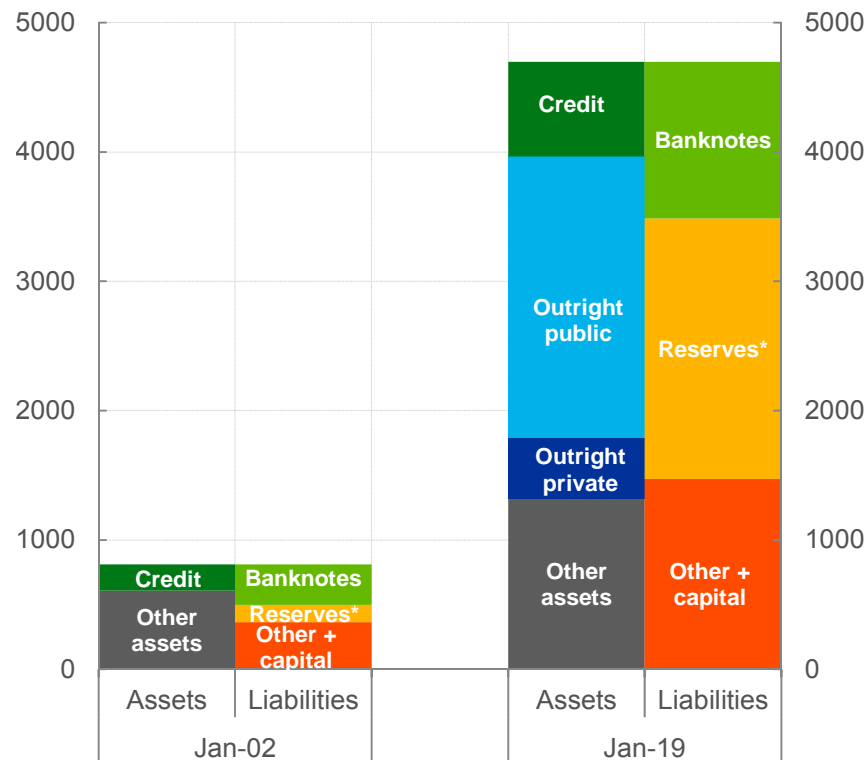
Source: ECB.

Notes: Adapted from Reis (2018), who is considering the Federal Reserve.

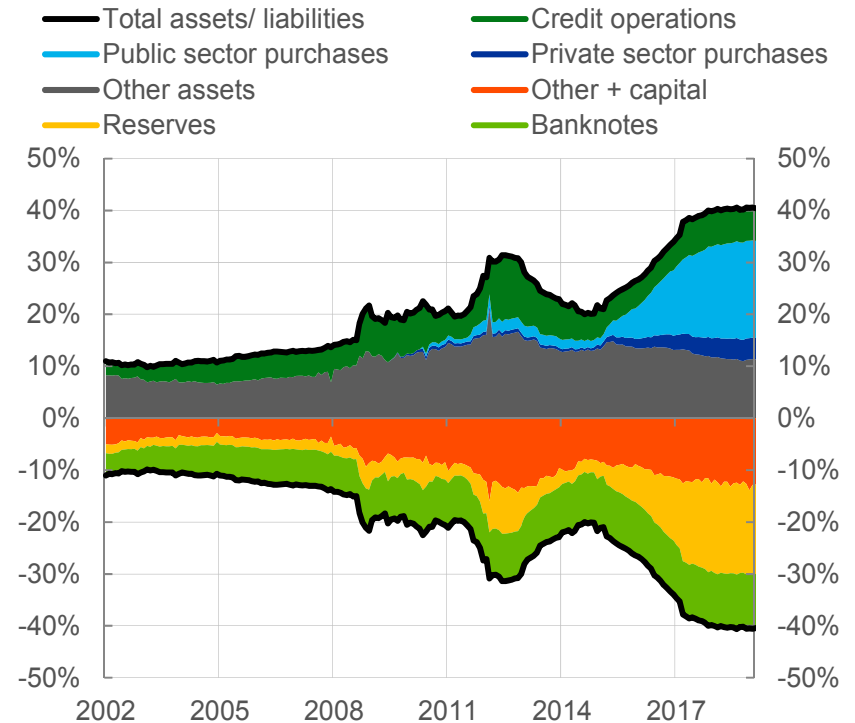
# Consolidated Eurosystem balance sheet

Over time, Eurosystem has become a key force in EA sovereign debt markets

**Eurosystem balance sheet**  
(€ bn)



**Eurosystem balance sheet**  
(% of GDP)



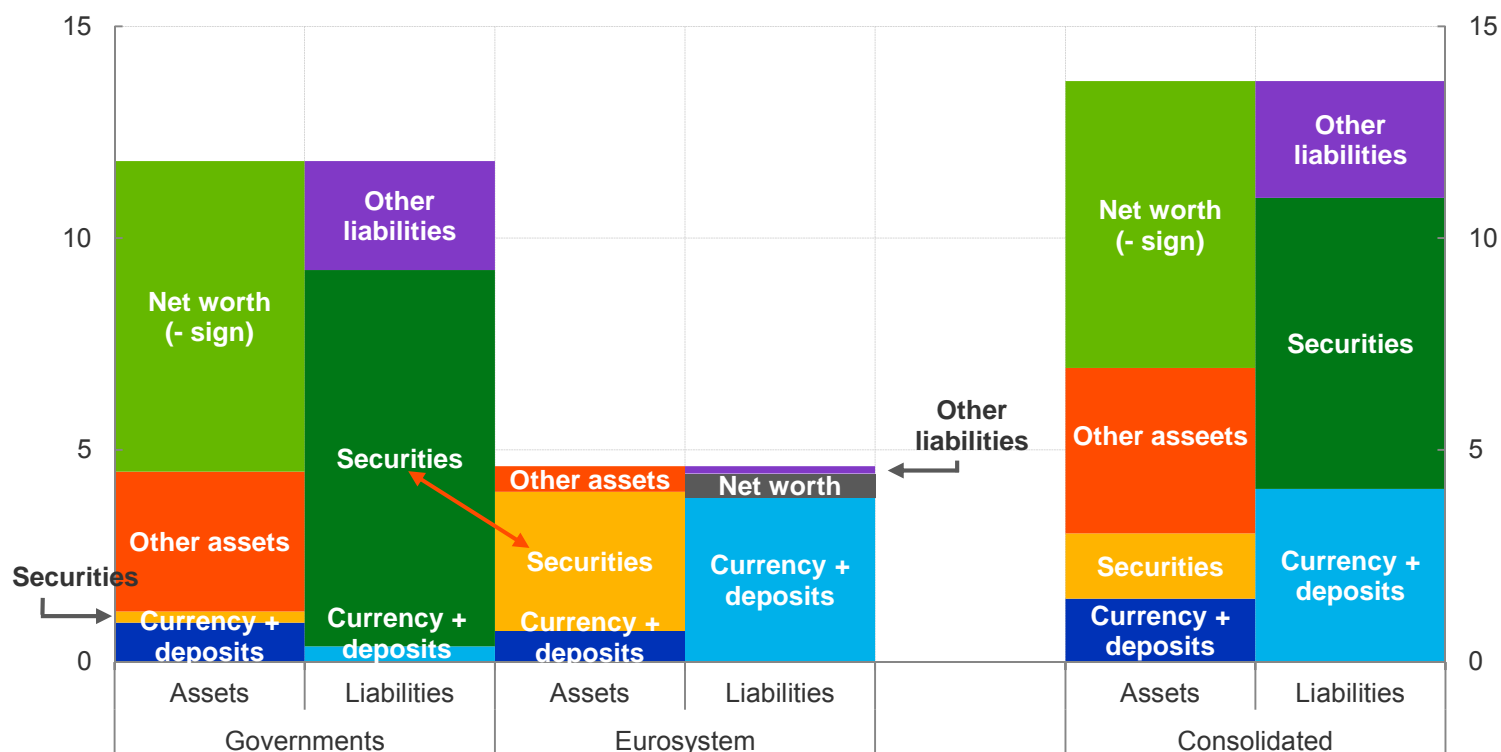
Source: ECB.

Notes: On the asset side, credit comprises credit operations under asset positions A5.1 (MROs) and A5.2 (LTROs, TLTROs) of the ECB's Financial Statement. Assets outright refers to the monetary policy portfolios under asset position A7.1. Other assets are the residual assets, including the marginal lending facility and fine-tuning operations, gold, foreign reserves, non-monetary policy portfolios, and other assets. Banknotes are liability position L1. Reserves are defined as the sum of current account and deposit facility. Other liabilities are the residual liabilities, including government deposits, loss-absorbing capacity, and other liabilities. RHS: Assets and liability categories are defined as on the LHS and are divided by nominal GDP.

Last observation: January 2019.

# Monetary union dimension of Eurosystem balance sheet

## Consolidated vs. unconsolidated public sector balance sheet (€ trn)



Source: Eurostat, ECB.

Notes: The consolidation for currency and deposits concerns euro area general government deposits in Eurosystem facilities. The consolidation for euro area securities concerns PSPP holdings of general government debt and supranational debt, SMP holdings of general government debt, investment portfolios of the Eurosystem, and general government debt in foreign currency held in the foreign reserve portfolios by the Eurosystem.

Last observation: 2018Q3.



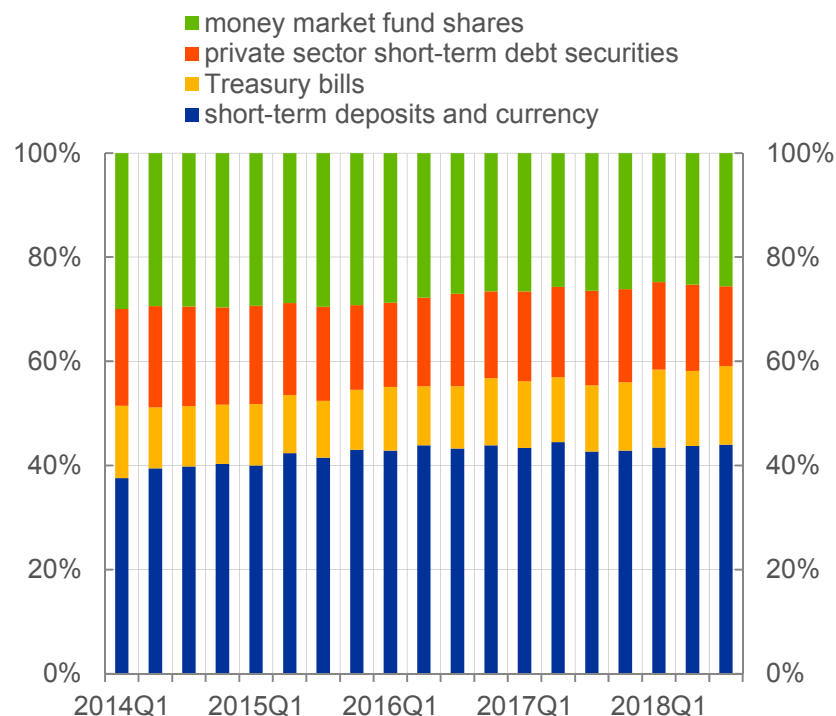
## Remark 1: Flexibility

Eurosystem balance sheet offers a good amount of flexibility for normalisation and beyond

- No need to return to pre-crisis operational framework
- *Jeremy Stein*: CBs should maintain large balance sheet and keep providing liquid, short-term liabilities in order to reduce private incentives to engage in excessive amounts of maturity transformation
- Evidence for EA: The euro area financial system is bank-centered and regulation is more effective in preventing excess private maturity transformation, lessening the need for a large balance sheet

# Supply of US short-term debt is diversified while banks dominate issuance in euro area

**Distribution of “money-like” claim holdings by non-financial sectors in the US**  
(percent)

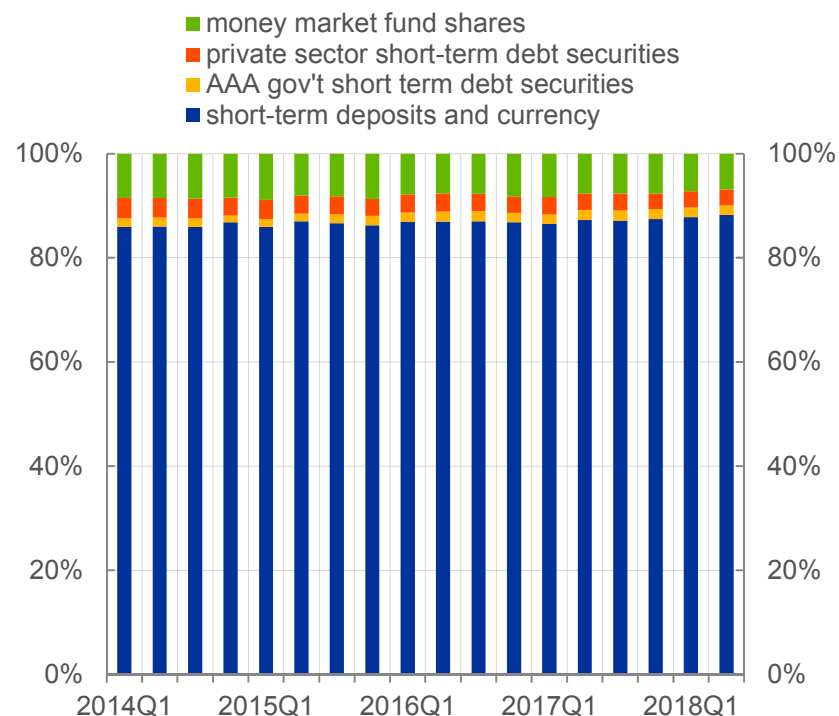


Source: Federal Reserve, ECB calculations.

Notes: Holdings of short-term assets by US non-financial sectors (households, NFCs, US general government) and the rest of the world based on the Fed Financial Accounts data and following Greenwood et al. (2016). Short-term deposits refer to checkable deposits and currency, other private sector short-term claims refer to the sum of repurchase agreements, commercial paper and private foreign deposits, and Treasury bills are approximated by multiplying the holdings of total Treasury securities with the share of T-bills in outstanding marketable Treasuries.

Latest observation: 2018Q3.

**Distribution of “money-like” claim holdings by non-financial sectors in the euro area**  
(percent)



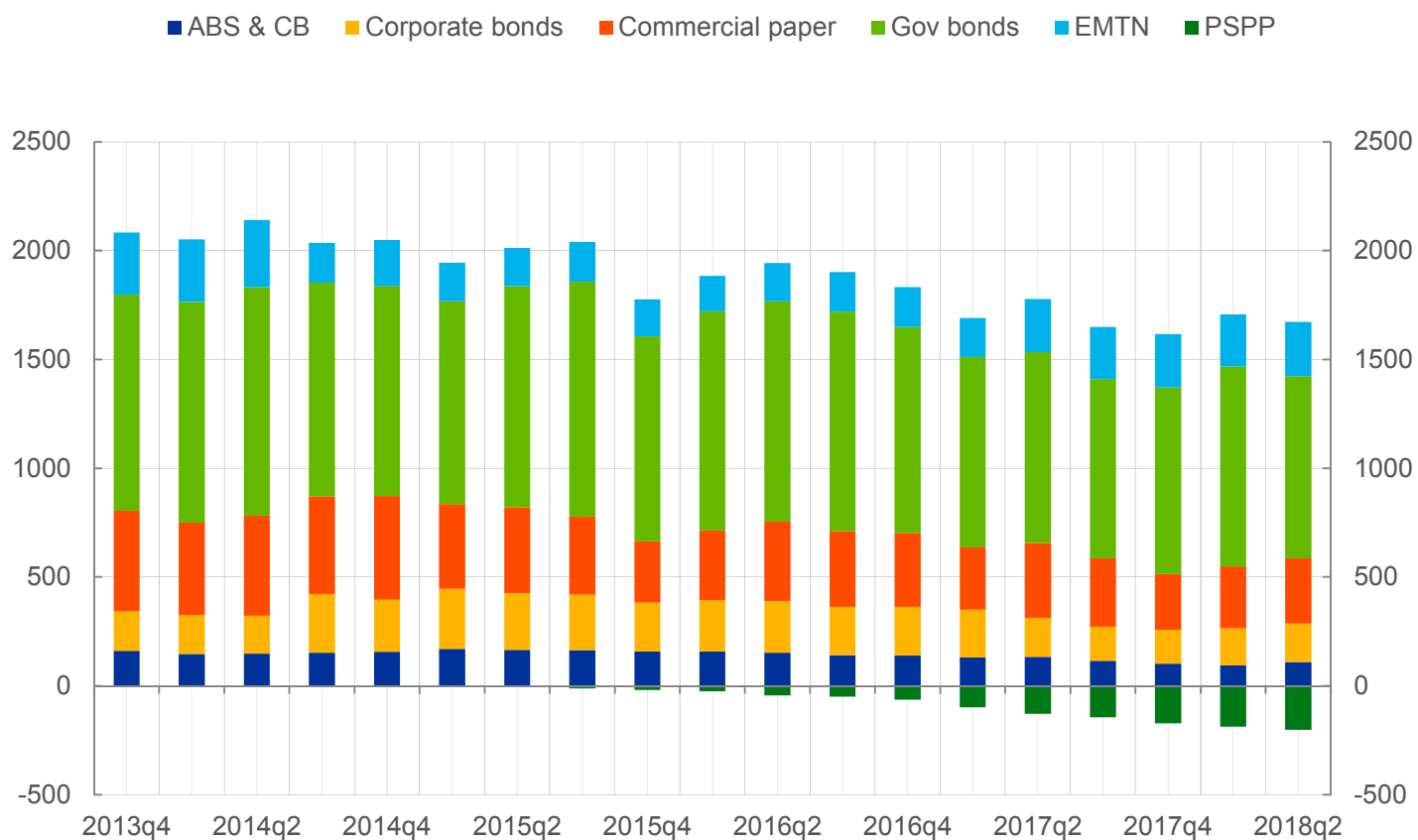
Source: ECB, ECB calculations.

Notes: Holdings of households, NFCs, general government and the rest of the world. Short term deposits comprise overnight deposits and repos for households and NFCs, (estimated) overnight deposits for general government and deposits with a maturity of up to 1 year for the rest of the world. Private sector short-term debt securities are issued by NFCs, MFIs, ICPF and OFIs and have an original maturity of up to 1 year. AAA gov't short term debt securities refer to debt securities issued by AT, DE, FI, FR, LU and NL with an original maturity of up to 1 year.

Latest observation: 2018Q2.

# Outstanding nominal amounts of safe assets by asset type and PSPP holdings

## Outstanding nominal amounts of safe assets by asset type and PSPP holdings



Source: ECB, Securities Holdings Statistics.

Notes: The chart shows safe assets, defined as euro denominated debt securities with residual maturity of less than 2 years and a first best rating better than AA.

Last observation: 2018Q2.

### Remark 2: Separation of monetary and fiscal policies to be maintained

- Typically short-term liabilities of the CB not to be seen as substitute for longer-term safe assets provided by government sector
- One element of MP normalisation: return to a smaller CB balance sheet ?
  - CB portfolio of sovereign bonds to be reduced over time in case there is no clear monetary policy justification
  - **Challenges:**
    - Reduced CB demand for sovereign bonds, ceteris paribus, to be replaced by increase in private sector demand for these bonds
    - Sovereign debt of EA Member States carries country-specific risk
  - **Questions:**
    - Can monetary policy normalisation be facilitated, in parallel, by creation of appropriately designed, shared sovereign safe asset?
    - Scope for synchronisation of disinvestment of CB portfolio and parallel phasing-in of sovereign safe assets ?
      - *Context: facilitate re-absorption of sovereign risk in private portfolios*
      - *Needed: comparison of the various proposals along these lines*

### Remark 3: Need to align objectives and instruments

- Safe asset agenda needs to remain anchored in broad agenda of EMU deepening
- Fiscal landscape: instruments needed for two objectives
  - **Need to facilitate better conduct of national fiscal policies**
    - *Context: proposals w/o mutualisation*
  - **EA-dimension of fiscal policy to be developed**
    - Urgency from monetary policy perspective reinforced by ZLB environment
    - *Context: area-wide fiscal capacity, budgetary instrument, going forward: borrowing capacity*

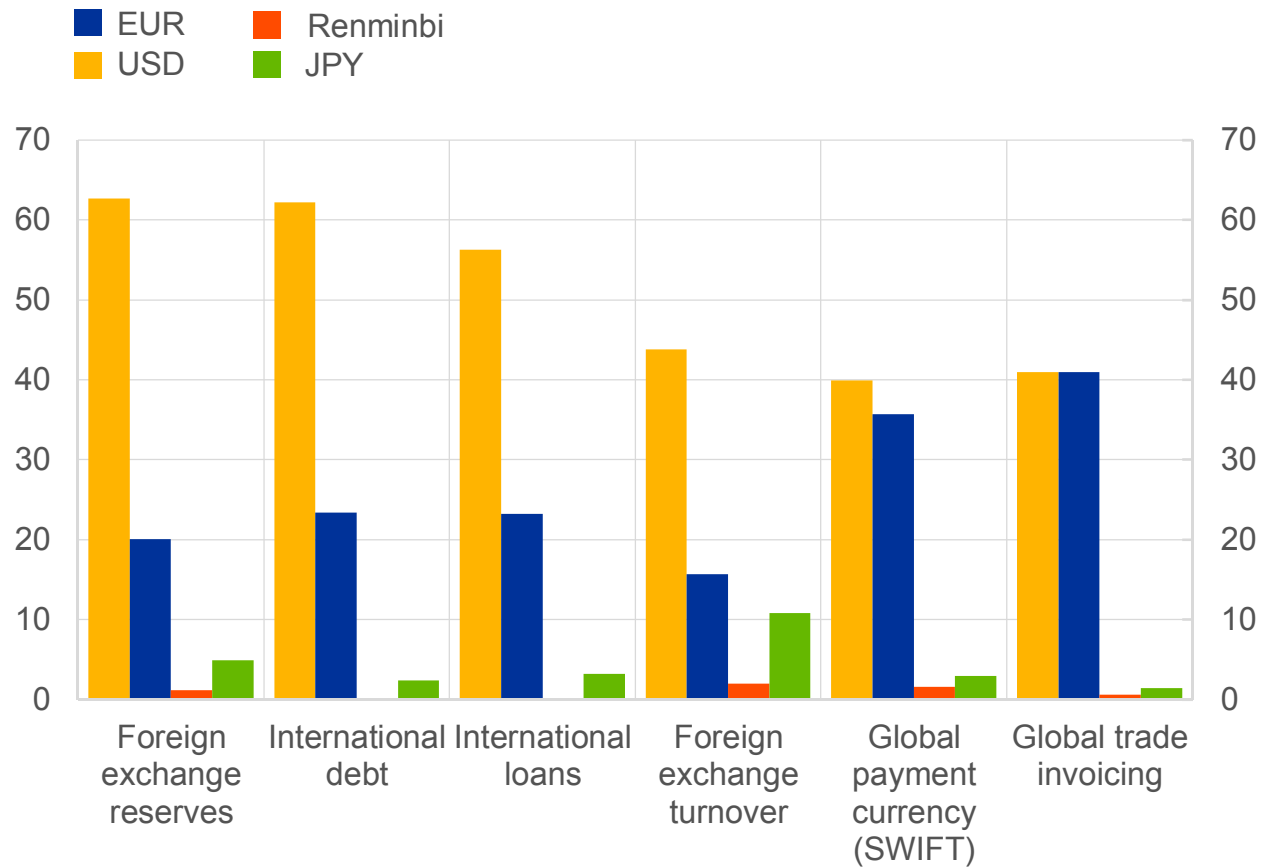


# Annex

## International role of the euro

# The euro is the world's second global currency

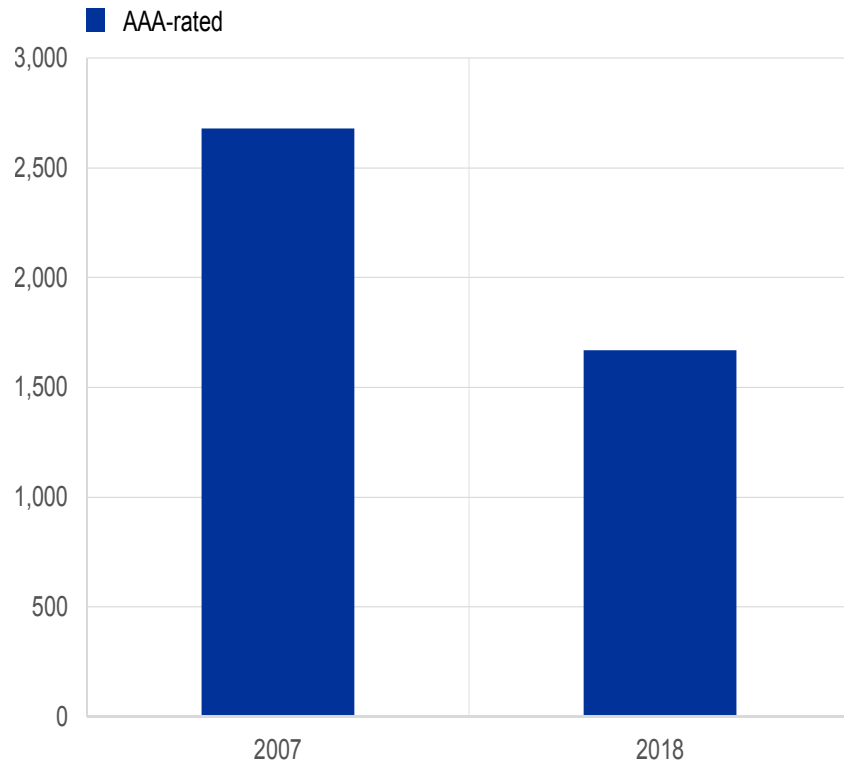
## Snapshot of the international monetary system (percentages)



Source: BIS, IMF, SWIFT, Gopinath (2016) and ECB calculations.  
Notes: Data as at the fourth quarter of 2017 or latest available.

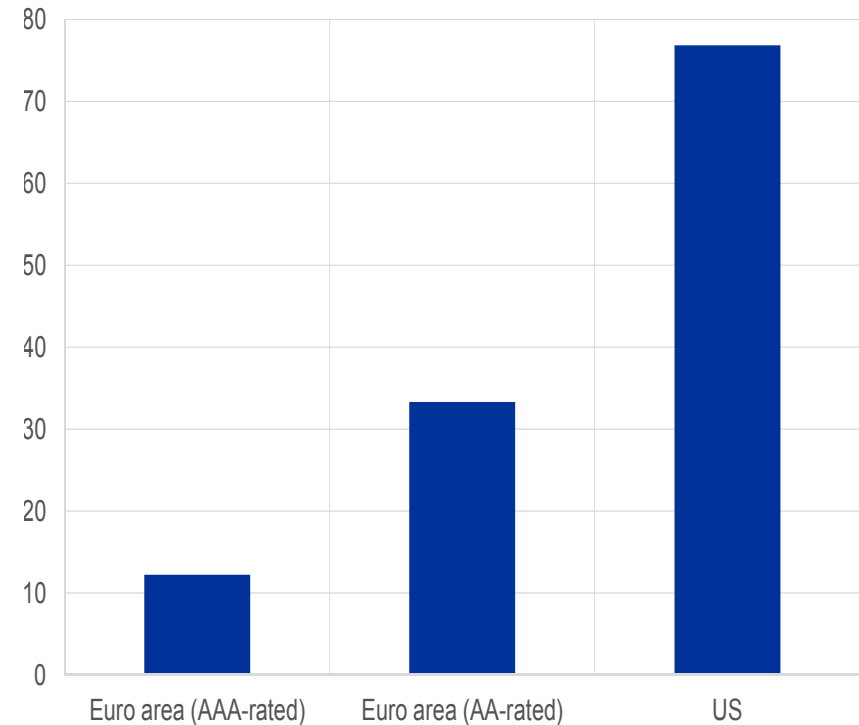
# The supply of euro area safe assets has declined and is small relative to the US

**Outstanding amount of AAA-rated debt securities issued by euro area central governments**  
(EUR billions)



Source: OECD Government Statistics and ECB staff calculations.  
Notes: Outstanding amounts at market value. The blue bars in the chart report debt securities issued that are rated AAA/Aaa both by Standard and Poor's and Moody's (local currency long-term debt rating). Totals for 2007 includes Austria, Finland, France, Germany, Ireland, Luxembourg, the Netherlands and Spain. Totals for 2018 include Germany, Luxembourg and the Netherlands.

**Debt securities issued by central governments**  
(2018; as percent of GDP)



Source: OECD Government Statistics, IMF WEO and ECB staff calculations.  
Notes: Outstanding amounts at market value for the euro area; publicly held Treasury securities outstanding for the US.





# Annex

## The European Distribution of Debt Instruments (EDDI) Initiative

- European Distribution of Debt Instruments - EDDI
- The Eurosystem is exploring the possibility to establish an issuance and distribution service to be offered to the euro debt issuers

## Why to consider an EDDI initiative?

- Today, there is a structural gap in the current issuance and initial distribution channel of debt securities in the EU:
  - ✘ Unlike the situation in other currency areas, issuers and investors in the Euro area have to resort to either national or international channels to issue and distribute debt instruments
  - ✘ These solutions are neither neutral, nor harmonised and they do not offer a pan European reach
  - ✘ The status quo does not support innovation neither the much needed standardisation/harmonisation; at the same time, it hampers financial integration

- Reflection on pan-European issuance and distribution channel in the most efficient manner would be in line with the endeavour to deepen the single capital market in the EU
- This could have a positive impact on the establishment of a domestic yield curve for the euro money market. Should market participants propose solutions in this area, the ECB will certainly take them into consideration in its own investigation



# Annex

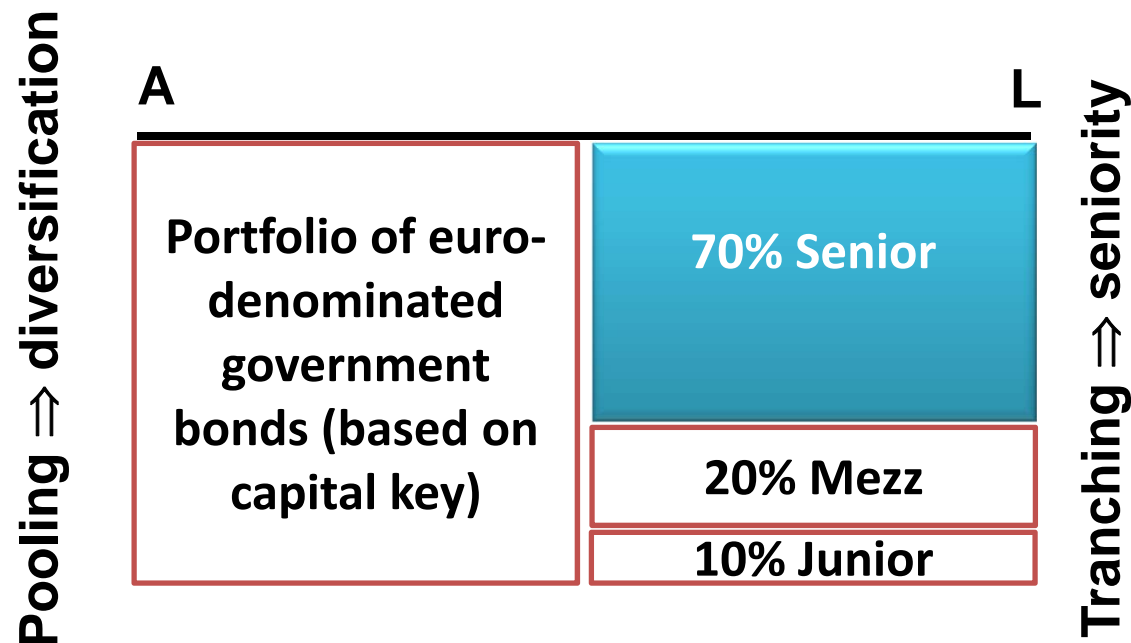
## Politics of SBBS

June 2016: ESRB HLTF established “to further investigate the empirical and practical considerations” related to sovereign bond-backed securities (SBBS)

January 2018: publication of HLTF report (2 volumes)

**Objectives of SBBS**: unlike Eurobonds, repackage national debt issued by MS

- i) mitigate bank sovereign nexus: **diversification plus tranching**
- ii) reduce cross-border safe haven flows via **common low-risk security**
- iii) improve financial integration by **tradeable low-risk security**



May 2018: Regulation proposal from European Commission

**Common features** of **ESRB-SBBS** and **COM-SBBS**

- Remove unfavourable treatment of SBBS resulting from securitisation
- Diversification embedded via financial engineering
- Pass-through vehicle: no mutualisation; SBBS issuer has no seniority

**Differences** between **ESRB-SBBS** and **COM-SBBS**

- COM favours private issuance; COM favours less uniform tranching points
- COM treats senior and non-senior tranches prudentially alike (while ESRB proposes that the treatment of non-senior tranches should sui generis reflect their greater riskiness; overall context: complex *RTSE debate*)

June 2018: SBBS become **not part of Meseberg / agenda of Euro summit**

October 2018: **(draft) EP report** revisits **ESRB** and **COM**, open for a **compromise** (private issuance; regulation in the spirit of ESRB)