Risk sharing and market discipline: Finding the right mix

Guido Tabellini 16 July 2018

A key question in the debate on the reform of the euro area concerns the right mix between risk sharing and market discipline. This column, part of the VoxEU debate on the topic, argues that proposals to enhance market discipline in the euro area are counter-productive, because they increase the vulnerabilities of countries with high legacy debts.

This column is a lead commentary in the VoxEU Debate "Euro Area Reform"

The debate on the reform of the euro area concerns a key question: what is the right mix between risk sharing and market discipline? The answer depends on how large the stock of outstanding debt is. Market discipline works very imperfectly – it is completely absent in some circumstances, and then all of a sudden confidence can collapse and countries fall victims of sudden stops, without any change in their fundamentals. The risk that this happens is strongly correlated with the stock of outstanding debt. Even with sound fundamentals, the larger the outstanding debt, the higher the risk that market discipline degenerates into a debt run. This risk weighs on high public debt countries even in the absence of debt runs, raising the cost of capital for the whole economy, reducing growth, and making self-fulfilling debt runs more likely.

The CEPR Policy Insight by 14 French and German economists (Bénassy-Quéré et al. 2018) reflects the nationality of its authors, i.e. two countries that belong to the core of the euro area and are not exposed to a considerable risk of a sudden stop on their sovereign debt. The compromise that they have found, however, is not suitable for a country where the risk of a debt run is much higher. In this column, I explain why.

Before doing that, however, I emphasise an obvious but important point. A confidence crisis that hits a country in the euro area is likely to spread to other countries as well. The resilience of the euro area is not much higher than that of its weakest member. For this reason, reforms that increase the vulnerabilities of the weaker countries may be counter-productive for all.

The doom loop

An important amplification mechanism at the heart of debt runs is the 'doom loop' between a sovereign and its banks. Can this vicious circle be broken by imposing that banks reduce their exposure to the domestic sovereign? The answer is no, for two reasons.

The first reason is well known. Any bank is unlikely to survive the default of its sovereign, irrespective of how much domestic debt it holds. A debt default is a dramatic event accompanied by extreme economic and political disruptions. A defaulting country could choose to exit the euro area. No bank would survive this event, because its non-deposit liabilities cannot be re-denominated since they are subject to international law. Even if euro exit does not occur, the fear that this could ' (or the fear of capital levies on private wealth) will lead to capital flights and banking panics. sion will unavoidably occur, and many bank debtors will be insolvent. In such tances, the doom loop cannot be avoided simply by holding a diversified portfolio of bonds.

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One could argue that portfolio diversification can help to insulate banks from financial volatility due to sovereign risk in circumstances less extreme than in the event of a default. This may be true in principle, but the question is how large this benefit is in practice. The evidence during the financial crisis suggests that it is very small. According to Constancio (2018), “[f]or European countries, CDS [credit-default swap] premia of non-financial firms and banks are impacted in a similar way when the sovereign credit rating severely deteriorates. During the crisis, CDS premia do not even show that banks with higher ratios of domestic public debt did significantly worse than others with lower ratios”.Similarly, using a rich data set for Italian banks and firms during the financial crisis, Bofondi et al. (2018) show that credit growth from banks operating in Italy to non-financial corporations is explained by the nationality of the bank (whether it is a foreign subsidiary or not), and not by the composition of its bond portfolio.

Second, asking banks to reduce their exposure to their sovereign can be counter-productive. As shown by Lanotte and Tommasino (2018), periphery banks increased their purchases of domestic government bonds during the crisis, when no one else was willing to buy them and when foreign investors were large sellers. It is not difficult to explain why this happens. Any bank discounts the risk of a default of its sovereign compared to the assessment of financial markets. The reason is limited liability, not irrationality, inside information, or moral suasion (although the latter could also play a role). Since a bank is unlikely to survive the default of its sovereign, limited liability imposes a lower bound to the losses incurred in the event of a default, while the upside risk is fully internalised. This is not true for an international investor, who would survive a foreign default and who fully internalises both losses and gains. Thus, during a financial crisis, foreign investors rush to the doors, while domestic banks act as shock absorbers and are residual buyers of sovereign debt.

Gros (2017) objects that banks can hardly be a stabilising force, since their cost of financing is typically higher than that of their sovereign. But banks can get cheap liquidity from the ECB. The *carry trade* financed through the long-term refinancing operation (LTRO) during the crisis amounted to an implicit debt monetisation. This restored confidence in the public debt market and allowed periphery banks to make large profits. The euro area does not have a lender of last resort to cope with a sovereign sudden stop. Domestic banks can play such a role, and we should not close or discourage the use of this safety valve.

Debt restructuring and the ESM

The Policy Insight and ongoing debates repeatedly make the following argument: there is a time-inconsistency in the assessments of debt sustainability as a precondition for ESM lending. Because debt restructuring is so costly, there is an incentive to procrastinate over a judgement of unsustainability and to keep lending to an unsustainable sovereign. This creates moral hazard and weakens market discipline. To avoid this inconsistency, the criteria for assessing debt sustainability should be clarified and made more rigorous, and the ESM should take a more proactive role in its assessment.

Note first of all a logical implication of this argument: debt restructuring should become more likely. Otherwise, the alleged time-inconsistency would not be addressed and any reform would be irrelevant. But this is an obvious problem for countries with high legacy debts. An increased likelihood of a debt restructuring also implies that the cost of servicing the existing debt increases and that debt runs are more likely. For this reason, earlier discussions of this kind were also accompanied by (unrealistic) proposals of how to reduce legacy debts (eg. Buccheit et al. 2013). In the current debate, instead, the issue of high legacy debts is either totally forgotten, or – as in Bénassy-Quéré et al. (2018) – there is a vague and inconclusive discussion of gradual implementation.

The idea that the ESM should play a more proactive role in the assessment of debt sustainability (and perhaps also monitor all member states to clarify who can or cannot access a credit line with the ESM) also raises a political problem. With all due respect to its employees, the ESM is an intergovernmental institution that inevitably represents the interests of the stronger members states who are more likely to act as creditors. Assessments of debt sustainability are a powerful weapon that can move financial markets. What if this weapon is used to extract political concessions in other controversial policy areas? The mere suspicion that this could happen would have devastating consequences for mutual trust in the EU. The same problem applies to the design of conditionality clauses. More generally, the issue of the governance of the ESM is inextricably linked with its function. Any proposal to reinforce the role of the ESM should go hand in hand with proposals to transform it from an inter-governmental body into a full-blown European institution that operates under majority rule and is accountable to the European (rather than national) Parliament.

…ere (Tabellini 2017) I criticised the idea that Europe needs a Sovereign Debt Restructuring …ism, and I will not repeat my arguments here except to emphasise two important points. …ost euro area sovereign debt is issued under national law. This facilitates debt restructuring

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relative to debt issued under international law, even in the absence of a commonly agreed restructuring procedure. In fact, the introduction of collective clauses has lowered the yield on government debt, the opposite of what it was meant to achieve.

Second, a seniority structure on public debt is desirable, but it should be achieved through explicit verifiable contingencies (such as with indexation clauses to nominal GDP), rather than by making junior debt more easily defaultable. Sovereign default is very different from a corporate bankruptcy. Ultimately it amounts to a political decision to break a sovereign promise. As such it has devastating consequences on the legitimacy and functioning of democratic institutions. Moreover, a default on junior debt could also trigger a debt run and have contagion effects on more senior debt in circulation. This is why the proposals in Bénassy-Quéré et al. (2018) to force countries to issue junior (more easily defaultable) debt if in violation of institutional debt brakes, or to create a seniority structure through tranching, are dangerous and could have unpredictable consequences.

Concluding remarks

The euro area has two main fragilities.

- First, because it does not have a lender of last resort that can support the sovereign, it is exposed to risks of financial crisis induced by sudden stops.
- Second, it does not have a fiscal stabilisation tool to help monetary policy when interest rates are at the zero lower bound.

The risk-sharing mechanisms financed by rainy day funds and the ex-ante ESM lending facility suggested in the Bénassy-Quéré et al. (2018) are too modest to address these fragilities. On the contrary, the proposals to enhance market discipline may destabilise the entire euro area, because they increase the vulnerabilities of countries with high legacy debts. More ambitious reforms are probably not politically feasible now. What should be done, then?

- First, we should not make the system even more fragile, by removing shock absorbers or increasing the risk of debt runs. The CEPR Policy Insight is not careful enough in this respect.
- Second, a fast reduction of legacy debts should be a priority for all. The asymmetries between countries induced by such debts are the main obstacle to reforms, and high debts are one of the main sources of instability. To achieve a faster debt reduction, institutional constraints on national fiscal policy can be strengthened. It is not true that external constraints have been ineffective. Fiscal policy in the euro area has been more disciplined than elsewhere, and progress in reducing public debts has taken place in several countries. Bénassy-Quéré et al. (2018) contains some useful ideas on how to make such institutional constraints less pro-cyclical and more effective.
- Third, there is no reason not to complete the banking union, with the ESM acting as a fiscal backstop for the Single Resolution Fund and initiating a system of European deposit re-insurance.

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