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THE SINGLE SAFE ASSET: A PROGRESSIVE VIEW FOR A 'FIRST BEST EMU'

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In a Nutshell…

The Single Safe Asset is an important if underappreciated element of the on-going debates on the EMU architecture. This Brief first describes the 'Northern' and 'technocratic' view of safe assets and then proposes three pillars of a progressive standpoint to frame the debate:

(1) Single and national safe assets;
(2) Public not private single safe asset;
(3) ECB, not ESM/EMF, backstop for EMU safe assets.

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1. Introduction

The Single Safe Asset is an important if underappreciated element of the on-going debates on the EMU architecture. It has been discussed in the recent paper published by 14 French and German economists (Bénassy-Quéré et al. 2018), in the ECB's and ESRB's public interventions, and in the European Commission's May 2018 proposals on sovereign bond-backed securities (SBBSies), drawing on the White Paper on the future of the Euro. These address the following question: does the provision of the public good of financial stabilization require a single safe asset issued supranationally? By contrasting with the 'Northern' and 'technocratic' view of safe assets, this brief proposes three pillars of a progressive standpoint to frame the debate:

1. *Single and national safe assets.*
2. *Public not private single safe asset.*
3. *ECB not ESM/EMF backstop for EMU safe assets.*

2. The 'Northern' and 'technocratic' view of EMU safe assets

The 'Northern' view on safe assets in EMU can be resumed as follows (see Table 1). The supply of safe assets in the form of national government bonds has been disrupted by the sovereign-bank loop. Strict market discipline and the on-going strengthening of fiscal rules would be sufficient to ensure a steady supply of safe assets provided EMU countries agree on mechanisms to limit banks holdings of (own) government bonds, either by non-zero risk weights in prudential regulation or quantitative exposure limits. The plans of the new Italian government are further proof of the urgent need for discipline. This would also ensure the completion of the Banking Union.

In contrast, the technocratic view stresses that the sum is greater than its parts in EMU macrofinance. A collection of national safe assets does not make a single safe asset because national safe assets are ill suited to credibly store value for integrated capital markets populated by banks, asset managers and institutional investors (market-based finance). While market-based finance prefers to store value in government bonds rather than bank deposits, relying on market discipline to preserve the safety of government bonds assumes perfect markets (Cœuré 2016). Yet markets everywhere tend to underprice risk in good times, and overprice it in bad times, with the added complication that EMU government bonds are vulnerable to 'break-up'/redenomination bets. These bets may further entrench the position of Northern countries as *de facto* issuers of safe assets for EMU, and erode the safe asset status of 'Southern' EMU government bonds (van Riet 2017). EMU lives with the permanent threat of a sudden contraction in the supply of safe assets that has been, and would again be, in Cœuré's words, 'extremely disruptive for the financial system'.

Table 1 – Summary of contrasting views on EMU Safe Assets

Themes	Northern view	Technocratic view	Progressive view
Single vs. national safe assets	national safe assets (government bonds)	single safe asset for integrated capital markets	single + national safe assets
Pathways to safety	break bank-sovereign loop	*ECB bills *market solution: synthetic safe assets by securitisation of sovereign bonds (SBBS)	* past market-based solutions failed * Eurobonds (full risk-sharing) vs. ECB bills (partial risk-sharing)
Institutional set-up (to preserve safety)	market discipline	market discipline ESM/EMF for national government bonds	ECB responsibility for EMU safe assets under financial stability mandate
Obstacles & challenges	ill-suited to integrated capital markets/market-based finance	collective opposition of Debt Management Offices (liquidity/financial stability)	political resistance to risk-sharing

Source: Daniela Gabor (2018), The Single Safe Asset: a progressive view for a 'First Best EMU', FEPS Policy Brief, May 2018.

The 'technocratic view' envisages two solutions. One is for the ECB to directly create safe assets by issuing central bank bills (see Cœuré 2016). The advantage of ECB bills is that central bank liabilities are truly safe, since these are backed by its money-creating power. The obstacles arise from political (risk-sharing) and mandate constraints. The second solution is synthetic bonds: working with markets in order to create a single safe asset out of existing EMU public debt. A carefully designed process of securitising government bonds – the ESRB/European Commission's Sovereign-Bond Backed Securities proposals - would achieve such an aim. The SBBSies may circumvent objections to risk sharing because of its market-based approach but face other political and stability dilemmas. There is little political support for SBBSies among the debt management offices/Treasuries of EMU countries. These raise concerns about the potential negative impact on the liquidity of national government bond markets and the financial stability implications. For the proponents of SBBSies, the safety of national government bonds should be treated separately from the single safe asset and could ultimately be resolved through the on-going negotiations on ESM/EMF conditional backstops.

From a progressive standpoint, the ESM/EMF conditional backstop may erode the counter-cyclical room for manoeuvre that lies at the heart of the state's social contract with its citizens. If imperfect markets can erode the safe asset status of public debt, is it reasonable to assume that safety can be designed a-priori into synthetic assets built from public debt? Economic theory suggests otherwise. Synthetic bonds may threaten the safety of the underlying assets, through contagion from one sovereign bond in the synthetic pool to others. To effectively avoid contagion, backstops should provide a time-critical response to tensions in any one government bond market in the synthetic pool. Lengthy conditionality negotiations may lead to the contamination of the underlying pool of EMU sovereigns. This is risk-sharing through the backdoor, without the benefits of overt risk-sharing: room for countercyclical fiscal policies.

3. Towards a progressive approach

A progressive approach to the EMU safe asset conundrum should explore in further detail the following proposals:

1. Single and national safe assets

Rather than a question of either/or, the single and national safe assets need to co-exist, at least until there is political agreement on fiscal union. A truly single safe asset that would support a sustainable capital markets union should be designed by seeking to restrict the potential negative effects on national government bonds (in terms of secondary market liquidity or contagion), and in close cooperation with the debt management offices of the EMU states.

2. Public not private single safe asset

In deciding the exact shape of the single safe asset, it is important to acknowledge that market-based approaches have in the past proven detrimental to the EMU's safe asset supply. Since the inception of the Euro, the ECB worked with market participants to create a synthetic private safe asset through repo markets, seeking to 'leverage' the existing supply of public debt in a manner similar to the SBBS approach (Gabor and Vestergaard 2018). In the absence of ECB support, the repo single asset proved unsafe in crisis, and its unravelling contributed to the sovereign debt crisis. While Eurobonds or ECB backstops for private assets may be politically difficult or undesirable, the path of least resistance may be accommodating the issuance of ECB bills in the mandate of the central bank.

3. ECB not ESM/EMF backstops for EMU safe assets

The lesson of the banking and sovereign debt crisis is that any new initiatives on creating a sustainable supply of safe assets for EMU should carefully consider the institutional mechanisms through which safety would be preserved in the crisis. This was not the case for the synthetic repo asset. The ECB's extraordinary liquidity operations expanded the range of acceptable collateral, but simultaneously abandoned the single approach that treated all EMU sovereign debt as equal collateral in the ECB's own repo loans.

The resilience of the capital markets union, and the fiscal space of EMU sovereigns, is at stake. The first best solution for achieving these twin aims is for the ECB to assume responsibility for the supply of EMU safe assets, single and national, since this is a monetary issue that falls within the scope of its mandate. The ECB would draw on the experience of the Bank of England and the US Federal Reserve, who have assumed explicit responsibility as market-makers of last resort for a range of safe assets, including own government bonds. A second best solution is to clearly specify the mechanisms of coordination between the ECB and the ESM/EMF. The treatment of public and private debt in the ECB's collateral framework has immediate signalling effects for safe asset status, and thus inevitably interacts with conditional backstops from the ESM/EMF.

References

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