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Domesticating the Euro

When the collapse of Lehman Brothers in September 2008 sent shockwaves through global financial markets, the euro behaved like a safe haven currency, reflecting the credibility of the price stability target and the strength of the ECB as an institution. However, in the absence of a lender of last resort to the sovereign and a banking union, cracks soon appeared, triggering a costly crisis that saw the euro area periphery behave like an emerging market.

In a bid to address these issues, the euro area set up several new institutions and tools. At the top of that list, the European Stability Mechanism (ESM) established conditional funding support for Member States that have lost or are in danger of losing market access. The creation of the Banking Union delivered a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). Governance was also enhanced with the European Semester, encouraging Member States to coordinate economic policies, ensure sound public finances, drive structural reform and boost investment. Finally, the European Central Bank (ECB) introduced several new tools including Outright Monetary Transactions (OMT) as a potential support to sovereign bond markets of Member States under an ESM programme.¹

Impressive as this progress has been, the sovereign-bank doom loop has yet to be fully severed. This reality has triggered a flurry of new proposals that set out various ideas as to 'how' a sufficient supply of 'safe' euro assets can be created and replace national government bonds on bank balance sheets. While this design discussion is both valuable and necessary, we believe it is worth taking a step back to summarise the 'why'. The following discussion

¹ As was the case for the other major central banks in the wake of the crisis, the ECB introduced several non-standard monetary policy measures in response to the crisis, including the Securities Market Programme (SMP), Longer-Term Refinancing Operations (LTRO), Covered Bond Purchase Programme (CBPP), Targeted LTROs, Asset-Backed Securities Purchase Programme (ABSPP) and Public Sector Purchase Programme (PSPP).

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sets out eight interlinked reasons why a single safe asset for the euro area is a 'need to have' rather than 'a nice to have', and next benchmarks the main proposals for a safe asset on the table today to see how well they fair. We find the litmus test is whether governments gain access to a safe source of funding in a 'domestic' currency. Of the list of solutions considered, both Purple bonds and E-bonds can meet this criterion. E-bonds provide a single safe asset from the on-set, while Purple bonds limit potentially destabilising risks in transition. The two proposals can be combined to secure both advantages.²

A safe euro asset is not just for banks

Creating a safe asset is about more than just breaking the sovereign-bank doom loop, and considerations must be given to government funding and monetary policy. Furthermore, if the euro area is to deliver on its ambitions for a Capital Markets Union and a stronger international role for the euro, these aspects must also be considered. We identify a total of eight reasons why the euro area needs a safe asset (see Figure 1).

A counter-cyclical asset for bank balance sheets

From the vantage point of a bank, a safe asset must preserve value, remain liquid in all market conditions, provide safe collateral and qualify for regulatory requirements. Highly-rated government debt generally exhibits counter-cyclical pricing patterns, remains liquid even in crisis (in part, due to potential central bank support), enjoys low risk weightings and qualifies for regulatory requirements. There are two main channels through which government debt holdings impact bank balance sheets and funding condition: asset and collateral.

- **Asset:** As is true for any asset held by a bank, losses on government debt holdings weaken the balance sheet, thereby making funding more expensive and harder to obtain. In extreme cases, bank runs can result.
- **Collateral:** Safe assets, and government debt in particular, play an important role as collateral to secure wholesale funding and central bank liquidity.

² L. Bini Smaghi, M. Marcussen: Strengthening the euro area architecture, a proposal for Purple bonds, SUERF Policy Note Issue No. 35, May 2018; M. Monti: A New Strategy for the Single Market, Report to the European Commission, 9 May 2010.

Figure 1
Eight reasons why the euro area needs a safe asset

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 ¹ (if needed)	Support the international role of the euro

¹ Quantitative Easing.

Source: Authors' own illustration.

The regulatory treatment of sovereign exposure is generally quite favourable. The Basel III framework includes the national discretion to apply a risk weighting of zero percent to national sovereign exposures funded and denominated in national currency. This practice means that it is attractive for national banks to hold these exposures as shown by Table 1 below.

Euro area banks today hold just over 1.5 trillion euro in the regions' government securities. A safe asset should be able to ensure that this demand is met. However, there are just under 1.6 trillion euro of outstanding German government debt securities, considered today the safest asset in the euro area. In fact, safe assets are desired not only by banks, but also by pension funds, insurance companies,

corporate treasuries and individual savers. And already, the numbers hint that the euro area today faces a shortage of safe asset supply.

Moreover, the European Repo Market Survey set the total value of repos outstanding on the survey date at 7.351 billion euro, excluding transactions with central banks, as part of monetary policy operations. The share of government bonds within the pool of EU-originated fixed income collateral stand at 85.2%. This survey is EU wide and the euro accounts for 65.3% of the cash currency. Again, these numbers hint at a shortage of safe asset supply.³

Status quo concern: A significant loss of investor confidence on periphery government debt markets would spill over quickly to the national banks in question.

Breaking the sovereign-bank doom loop

Breaking the sovereign-bank doom loop requires more than just a safe asset for banks. The Basel Committee on the Global Financial System identifies four channels through which sovereign credit impacts bank funding conditions.⁴ The first two, assets and collateral, have already been discussed above. In addition, there are:

³ ICMA: European Repo Market Survey – Conducted June 2018, Published October 2018.

⁴ BCBS: The regulatory treatment of sovereign exposures, Basel Committee on Banking Supervision, Discussion Paper, December 2017.

Table 1
Euro area general government debt securities and ECB and bank holdings

Selected Member States, latest available data point

	National		Bank holdings			ECB holdings		Outstanding		Maastricht Debt
	€bn	% GDP	Other euro area €bn	Total €bn	Total % Assets	€bn	% GDP	€bn	% GDP	% GDP
Germany	170	4.9	91	261	3.4	338	9.7	1583	46	57
France	138	5.7	28	166	1.9	357	14.9	1977	82	99
Italy	378	21.1	45	423	11.5	378	21.1	1960	109	131
Spain	194	15.6	48	242	9.1	226	18.2	1027	83	96
Netherlands	26	3.4	39	65	2.8	85	10.8	325	41	50
Belgium	34	7.5	24	58	5.8	65	14.1	401	87	100
Austria	26	6.5	15	41	4.8	42	10.6	257	65	71
Finland	4	1.5	5	9	1.4	26	10.8	109	46	58
Ireland	17	5.3	40	57	5.2	24	7.5	134	42	61
Greece	12	6.2	4	16	5.5	-15	-8.2	67	36	175
Portugal	34	16.8	16	50	12.9	15	7.1	164	80	119

Note: The outstanding amount is given for general government securities. Total Maastricht Debt is shown for reference.

Sources: ECB; Thomson Reuters; and author's calculations.