

Better Eurosystem Performance: What Roles for Financial Engineering, Monetary Policy and Politics?

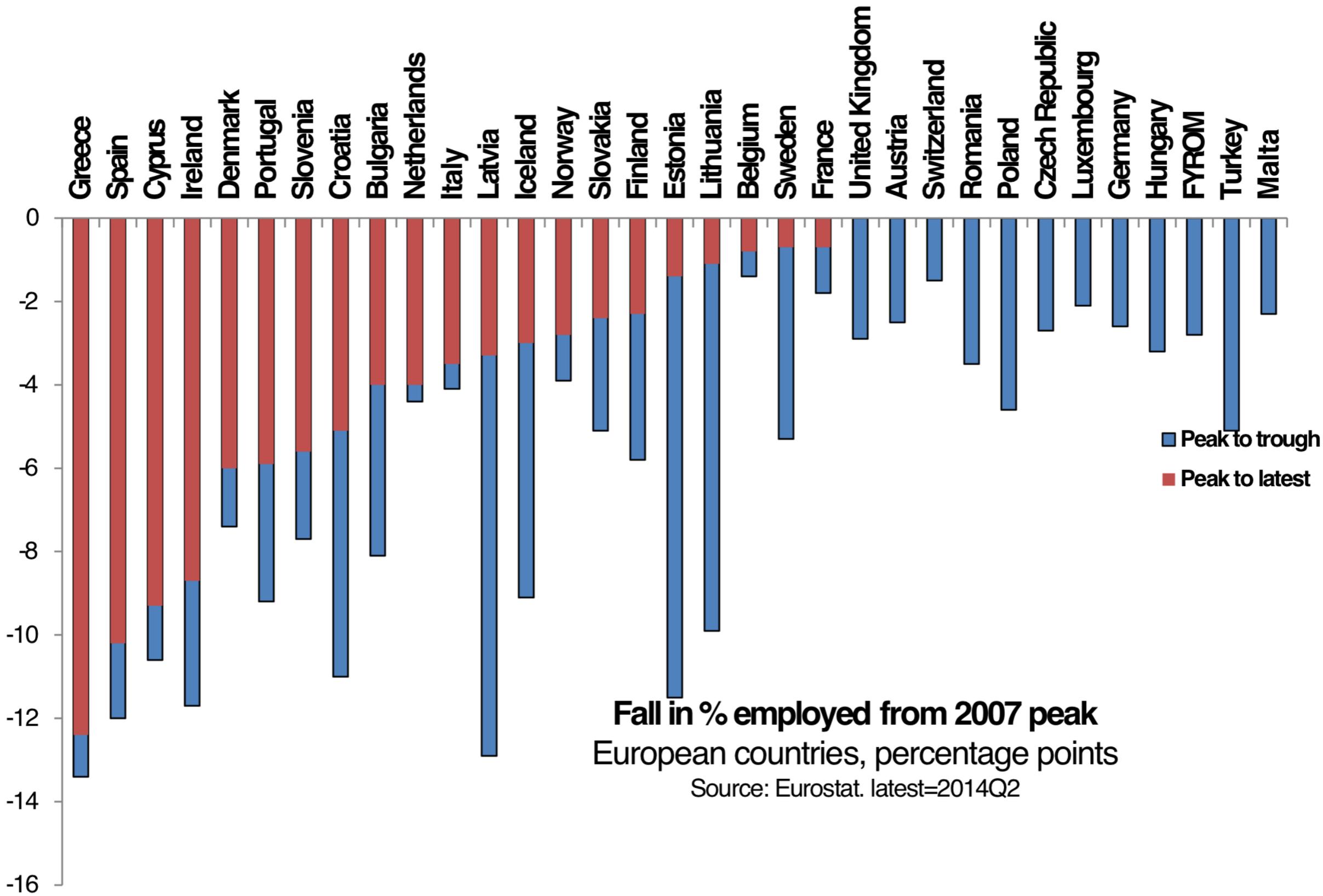
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Over the past six years a variety of financial engineering and monetary policy "fixes" have been proposed to address the debt and financial asset consequences of the sequence of adverse developments which have beset the euro area:

- The global financial crisis (financial engineering itself largely implicated in this);
- The euro area sovereign debt crisis; and
- The protracted period of below-target inflation that is in prospect.



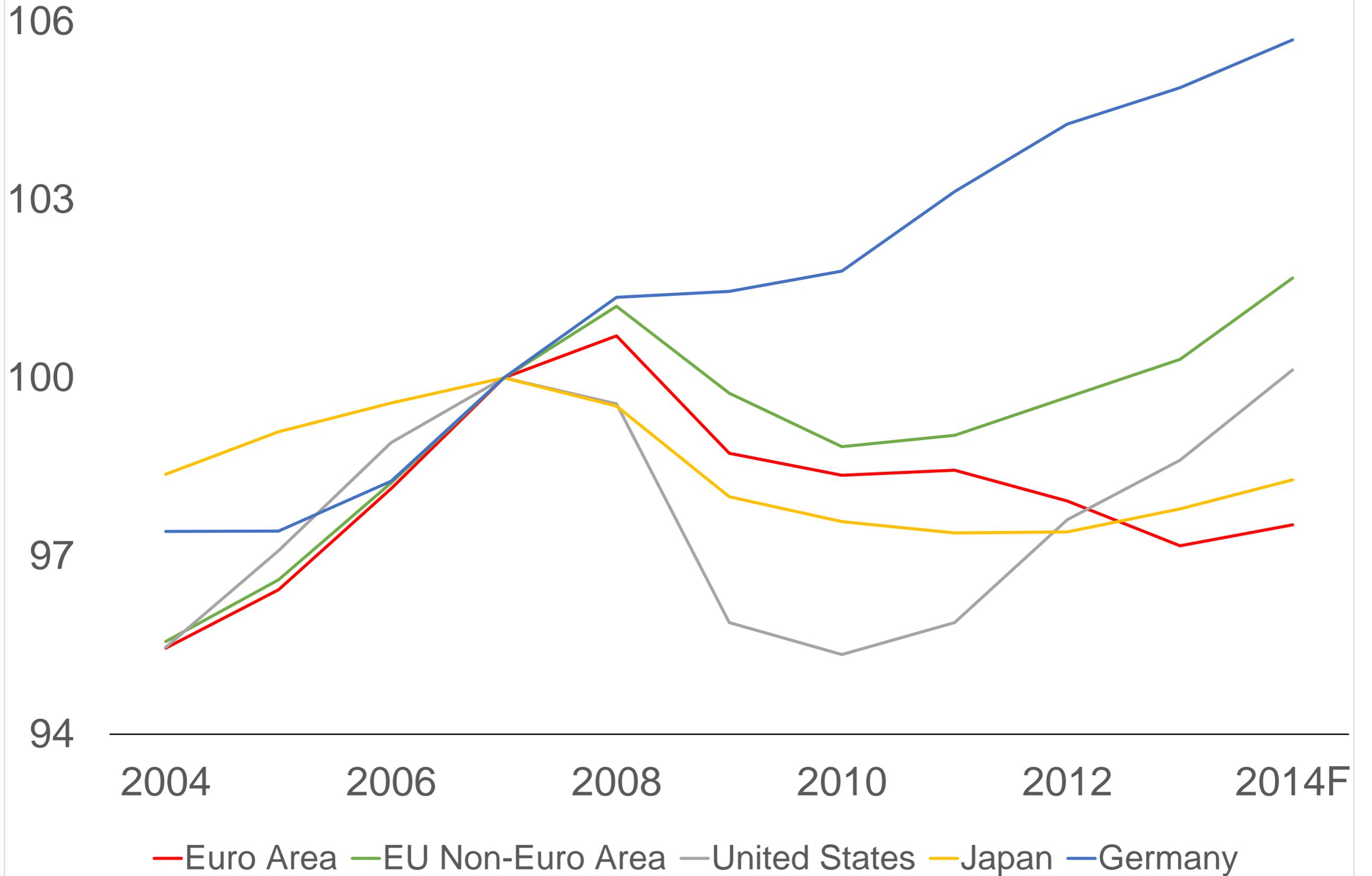
Scale of the debt issues for euro area has become large because:

(a) official indebtedness has become very high especially after crisis (and debt ratios slow to fall given low nominal GDP trend (real growth and inflation both below trend/target

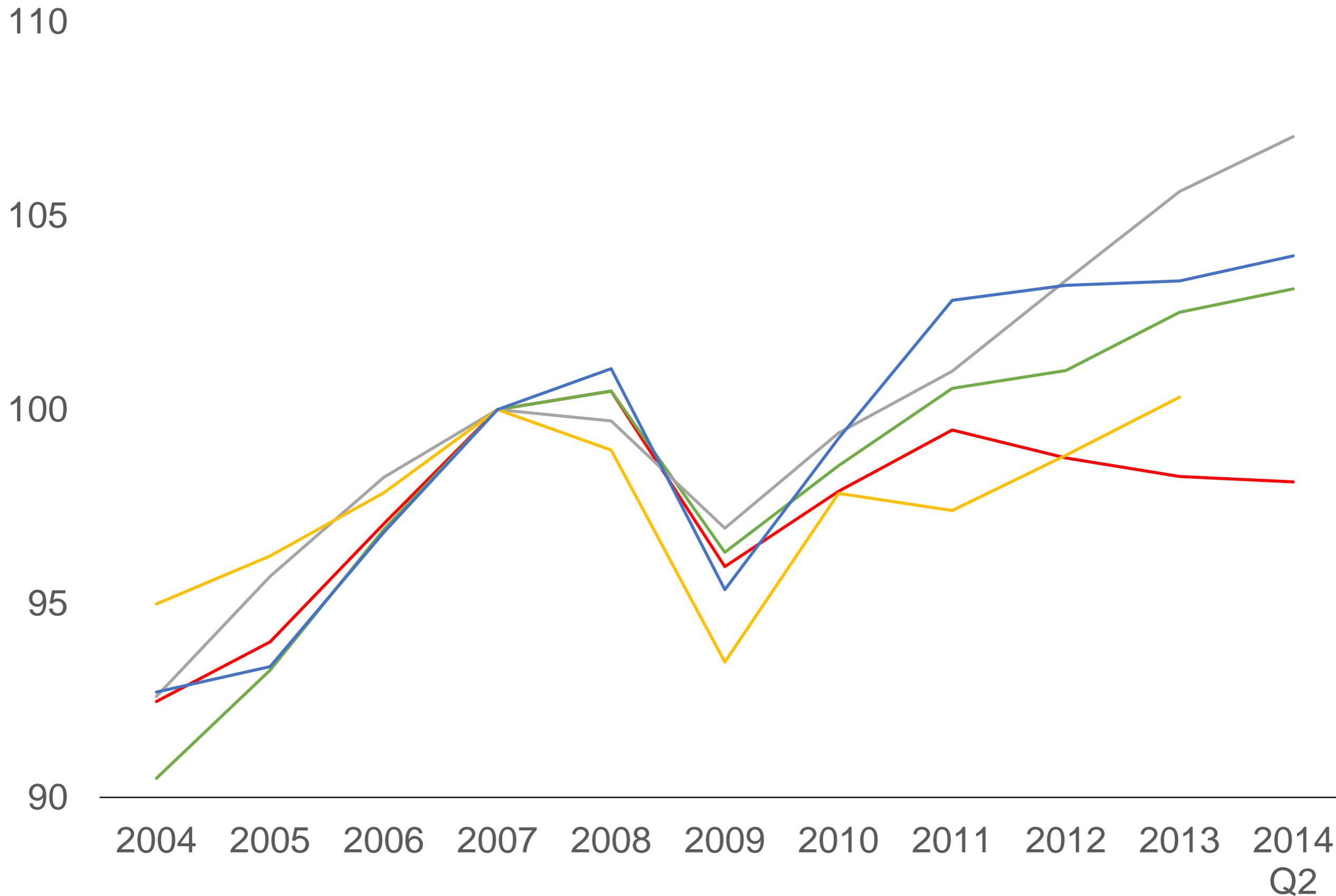
(b) defaults of Lehmann, Iceland and Greece resulted in reassessment of tail risks in market.

Consequences of debt overhang more clearly perceived in some countries

Total Employment Levels (2007=100)



Real GDP (2007=100)



— Euro Area — EU Non-Euro Area — United States — Japan — Germany

Some of these innovations have been implemented

- Leveraged official loans to stressed sovereigns.
- Negative nominal interest rates.
- Outright purchase of high yield assets (stressed sovereigns in the SMP, covered bonds, ABS).
- Long term secured lending to banks up to 4 years.
- Collective action clauses on new Sovereign debt.

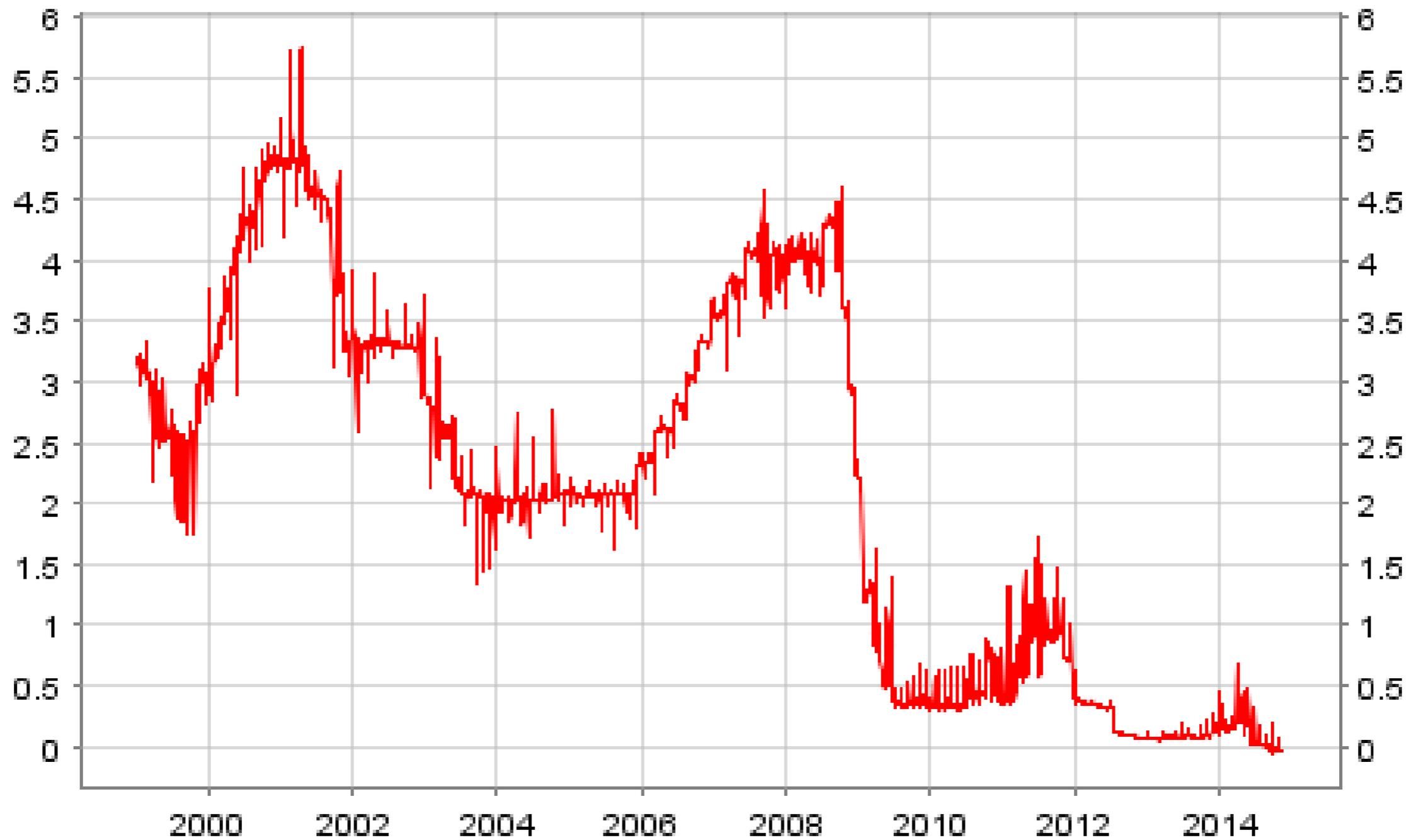
Others are projects, or not (fully) applied

- Eurobonds in various flavours.
- A banking license for a multinational fund.
- GDP-linked bonds.
- Official (multinational) tail risk insurance.
- Bailable bank bonds.
- Multinational direct capital injection in stressed banks.
- Central Bank purchases of a targeted quantity of sovereign debt.
- President Juncker's very recent CDO proposal

1. Monetary Policy

- ECB interest rate policy and forward guidance have kept long interest rates in core countries at record low levels especially since mid 2014.
- Lowers servicing costs on floating rate or new debt.
- Inflation has dipped below target for the past couple of years: action to bring it back

Eonia rate 1999- present



Euro area inflation rate 1999-2014



The ECB's balance sheet

Size matters, but composition also.

- Neutrality propositions.
- Term and credit risk
 - US took out term in QE
 - Some private credit risk absorption in CovBond and ABS programmes.
 - Sovereign credit risk in OMT through policy conditionality (not a problem faced by US, UK, Japan)
- Spillover effects: how strong? (Toothpaste). Segmentation of markets

Monetary policy initiatives in other countries

- US, UK, Japan have also driven interest rates to zero.
- In those countries also Central Bank has acquired large blocks of Government securities: debt servicing costs are thus monetised for the present. (Inflation has remained subdued, but non-inflationary scale and duration of such a strategy is inherently limited.)

2. Financial Engineering

Seeks to bundle and unbundle risks (e.g. credit and maturity/term) order to enable transfer of risks to those best placed to absorb them

(But has got a bad name because it sometimes transferred risks from those who understand them to those who do not)

Conjecture

A better transfer of risks in the euro area would have resulted in sizable overall gains of wealth

Caveat

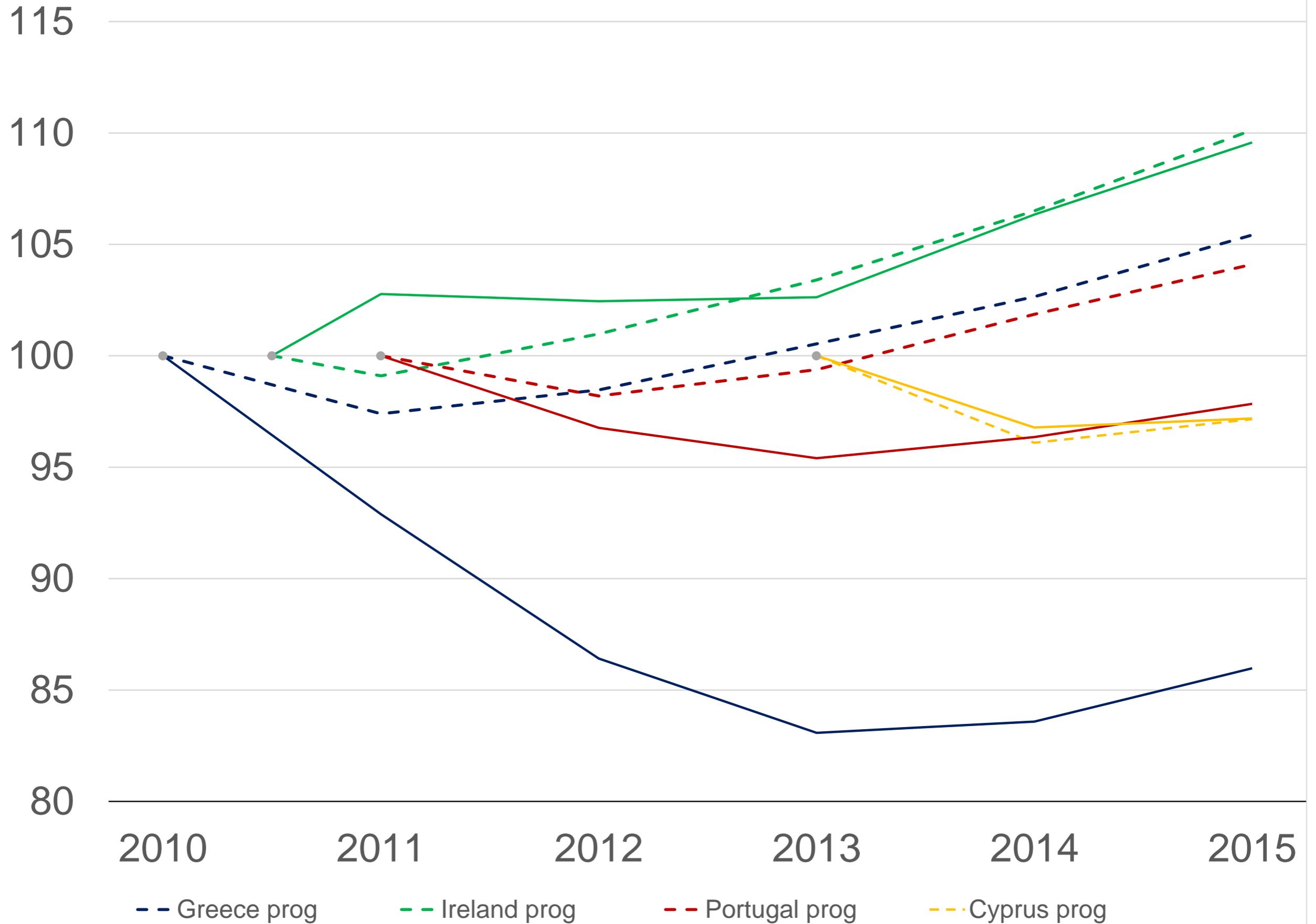
An attempt to transfer debts and losses often masquerades as a fairly-priced transfer of risks

Risk-sharing plans

Examples:

- Direct capital injection into banks (e.g. By ESM)
 - Upside potential for funds provider (as shown by experience)
 - Relief of over-indebted sovereign reduces other risks
- GDP-linked loans
 - Would help with lender over-optimism
 - Also reduce debt overhang

Programme GDP projections vs latest



Debt mutualization plans

Including:

- Debt Reduction Fund and Pact (DRF/P) (German Economic Experts);
- Eurobills (Philippon, etc);
- ESBIES (Euronomics group)
- PADRE plan (Paris-Wyplosz)

Significant contrasts -- one of them mutualises all debt less than 60% GDP (ESBIES); another all that is more than 60% GDP (DRF/P)

Do they involve wealth transfer *ex ante*; *ex post*?

- The envisaged benefits of these schemes, while they can be said to be Pareto-improving, the envisaged benefits of these schemes are skewed towards certain countries. This is a political barrier to action.
- The more grandiose the plan, the more likely its adverse side-effects would dominate.
- Moral hazard issues - both real and imagined - are central to the political debate.
- The Treaty's proscription of actions that would turn the EA into a "transfer union" stand in the way of several of the most far-reaching proposals.

So why has there not been more use of financial engineering?

- Contract credibility issues (sovereign and mkt)
- Insufficiently flexible institutional and legal structures (including Treaty prohibitions)
- Trust issues