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Speakers: Frederik Ducrozet, Pictet Wealth Management, Switzerland, Nicola Giammarioli, European Stability Mechanism, Luxembourg. Michala Marcussen, Société Générale, France.
Chair: Filippo Taddei, Associate Professor of the Practice of International Economics, Director of the Bologna Institute for Policy Research, Academic Director, Master of Arts in Global Risk

Financial Risk and Public Debt Management in the Euro Zone

The Johns Hopkins SAIS Global Risk Conference

The 2018 Global Risk Conference commenced with a panel discussion on financial risk and public debt management. This topic proved particularly timely given the recent downgrade of Italian debt and rapidly approaching culmination of the European Central Bank's (ECB) quantitative easing program. Approaching the topic from different perspectives, the speakers each addressed the question of how to make public debt sustainable, noting lessons learned from the 2008 financial crisis, ongoing risks, and proposals for further improvement.

Nicola Giammarioli, Head of Strategy and Institutional Relations at the European Stability Mechanism (ESM), began his discussion by reviewing the decade long European Sovereign Debt Crisis and how it was addressed. Following the 2008 Financial Crisis, many countries in the Euro Zone were running unsustainable budget deficits and were hit by a banking crisis against the backdrop of low competitiveness. These two factors reinforced each other (sovereign-bank doom loop). The crisis was addressed domestically with budget consolidation and structural reforms, and collectively with growing policy coordination and a strengthened banking system in the euro area. Unconventional monetary policy also plaid a key role. One of the most important responses was the creation of the European Financial Stability Facility (EFSF), a temporary rescue fund, and subsequently the ESM, the permanent institution in charge of providing financial assistance to euro area members in needs in order to preserve financial stability. The lending operations of these funds created firewalls against the crisis by providing cheap loans at low interest rates, offering relief to struggling countries with great success. All programs have concluded with Ireland, Portugal, Spain, and Cyprus serving as success stories; Greece just completed its third program in August, so it is too early to come to a definitive assessment. However, Greece can also become a success stories, provided the country remains committed to the agreed reforms. Overall, the former programme countries rank highest in the EU in terms of reforms and have seen fiscal deficits and macroeconomic imbalances decreasing as well as their competitiveness improving.

Thanks to this strategy against the crisis the euro area is today much more robust than it was at the outset of the crisis. However, challenges remain. Politically, populism threatens the status quo while immigration and security serve as ongoing political risks. The uncertainty of Brexit looms while l potential growth remains low. The next crisis will test the effectiveness of these firewalls and reforms, but Giammarioli believes the EU needs to do more. He proposes further integration of the financial sector with the completion of the banking union as well as the capital market union. Also Giammarioli believes that the currently discussed expansion of ESM beyond its current mandate and possibly further macroeconomic stabilization instruments will prove important to managing sovereign and financial crisis in the euro area.

Frederik Ducrozet, a Senior Economist at Pictet Wealth management provided an investor perspective to the same topic. By focusing on what has changed, Ducrozet highlighted the next steps of debt management with the underlying assertion that the euro will survive, whatever it takes. But with the recent episode of market pressure on Italian sovereign debt, currently at 130% of its GDP, the question becomes - what will it take? Ducrozet argues the successful action of the ECB and ESM, in buying of public debt, on the back of structural reforms and changing financial structures produced great success stories and set a precedent for future action. Though Italy may not benefit in the short term, there is a strong case for further improvements in the management of sovereign debt, including regulatory changes and the creation of a safe asset for the euro area over the medium term. Furthermore, Ducrozet believes unconventional monetary policy measures will remain part of the ECB's 'normal' toolkit. Though these changes are immensely important, more needs to be done to ensure the Euro Zone is secure.

Ducrozet argues the Euro Zone needs and deserves a safe asset. A safe asset, or a large pool of liquid securities that store value even in times of crisis, would encourage investors and risk adverse countries to buy sovereign debt while helping diversify banks' bond holdings. While Ducrozet did not advocate for a particular asset, he highlighted the various technical solutions, like e-bonds or ESBies, on the table and noted that decisions depend on politics and difficult choices including seniority. A safe asset would be an important first step in breaking the doom loop, however this is just a part of the challenge. The incompleteness of the Euro Zone needs to be addressed. Moving forward, a compromise needs to be reached in which both Germany and Italy benefit, and solidarity and responsibility are balanced.

Michala Marcussen, the Group Chief Economist at Société Générale, one of the largest banks in the Euro area, added to the discussion by providing concrete suggestions for a safe asset. Firstly, Marcussen argues that debt sustainability is attainable: if nominal GDP growth is above the nominal interest rate and the deficit is primarily balanced, then debt is sustainable. Unlike Japan, the Euro area has challenges to both growth and the interest rate meaning when financial crises arise, interest rates increase, behaving contrary to the desired counter cyclical fashion. Another shortfall is that unlike the US, the Euro area not enjoy full banking, fiscal, and capital markets unions. This resulted in a slower recovery, taking Europe 10 years to return to pre-crisis GDP levels after the Great Recession, whereas it took the US, with its integrated markets and institutions, 5 years. The need for further integration of the EU and the Euro area is well recognized; the primary challenge is to agree on the political roadmap and ambitions.

Like the other panelists, Marcussen argues a counter cyclical safe asset can help drive interest rates down on average over the cycle and allow banks to enjoy a genuine safe-asset in times of economic downturns and/or financial crisis. Marcussen presented a concrete policy proposal with "Purple Bond". The idea is to offer a transition to the original Blue and Red bond proposal. A Blue bond is a genuine euro bonds amounting to up to 60% of GDP whilst the Red bond is a national junior bond. The Purple bond, as a transition to a genuine eurobond, would initially cover the entire national debt stock and gradually decline to 60% of GDP over 20 years as foreseen by the Fiscal Compact; any debt needs in excess hereof would be raised through national junior Red bonds. Purple Bonds would remain national and would only enjoy protection from restructuring under an ESM program. Purple bonds would thus offer a safe, liquid, and counter-cyclical instrument, without adversely impacting the existing bonds and thus opening to possible bond holder suits.

Though presenting different perspectives and proposals to manage public debt, the panelists each conveyed a sense of urgency in managing financial risk before the next crisis. Though most argue the Euro Zone is not fully prepared, each also highlighted positive changes and effective tools. Though challenges remain, each expressed optimism for the future of the Euro Zone and the continued management of financial risk and public debt.