Making the Eurozone work: a risk-sharing reform of the European Stability Mechanism

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- Total assets **700 EUR bns**, residual lending capacity **370 EUR bns**
- Some concerns with the current implementation of the ESM:
  - Will it be large enough to weather another European debt crisis?
  - Liquidity issues (only 10% of subscribed capital is paid)
  - Is the governance system really democratic?

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- First order problematic, rich paper, ambitious proposals
- **I would like to see:**
  1. More discussion of the financing mechanism
  2. More discussion of the moral hazard issue (credibility of the sanctions?)
  3. More details on your numerical simulations

Financing mechanism - 1/2

Two-stage process:

1. Member states set aside provisions to make their debt safer

- Member states progressively replace their uninsured debt by insured debt
- In exchange for the guarantee, country i has to pay (per unit of debt)

$$\text{Insurance premium}_i = min\left(CDS_i - \overline{CDS}, 0\right)$$

- First stage completed when $CDS_i \rightarrow \overline{CDS}$ for all i
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2. Additional capital requirements to cover the remaining risk of default

- Applying the current Basel II-III Standardized Approach, 145 EUR bns
- Warning: your writing sometimes imply that the ESM is subject to prudential supervision

Financing mechanism - 2/2

Insurance premia financed by issuing debt

- Not possible: CDS rates will increase, convergence will not occur
- In your paper, convergence is assumed to take place in 10 years
- Should be financed from the fiscal budget: for Italy, 0.5% of GDP for 10 years
- Is it possible? Is a 10-year convergence period realistic?

Moral hazard problem

Being insured against default might induce member states to borrow excessively

- Proposed solution against moral hazard problem: maximum level of debt that would be insured by the ESM
- *"Any excess debt [would be] junior vis-a-vis insured debt."*
  - More details on the type of bonds guaranteed by the ESM (CAC/CPC,...)
- *"Non-compliant countries [would be subject to] the loss of the ESM guarantee and of the premiums paid up to that time (hence, premiums would be withheld by the ESM)"*
  - But then CDS will not converge in the first place
  - Assume sudden increase in debt due to unexpected shock. ESM guarantee may be withheld at the worst moment
  - Can this be credibly enforced?

Numerical simulations

Would like to see much more detail on the numerical simulations

- Not sure what the baseline scenario is (GDP projections)?
- Debt-to-GDP ratios decrease but you assume a balanced primary deficit. How would debt-to-GDP ratios evolve under more traditional assumptions?
- How would your results change with different $\overline{CDS}$, different capital requirements?

Other comments - 1/2

You do an exercise in part 9.1 in which you estimate the change in total loss for a portfolio of European sovereign bonds

- Total loss = Sum of Expected Loss (using probabilities of default) + Unexpected Loss (Gordy formula) for each member country
- *"Our approach is very similar to the one applied to financial institutions, following Brownlees and Engle (2017)"*
- Not really: Brownlees and Engle compute capital shortfalls conditional on an aggregate downturn (systemic event), different from summing losses resulting from individual defaults

Other comments - 2/2

You suggest to introduce a "golden rule to finance investment plans"

- *If, for example, in a given year the ESM receives new contributions for 10 billion euro from Italy, on the same year it issues 10 billion euro of supranational bonds to fund investments in Italy itself.*
- Is the ESM really the best tool to provide financing for investment plans? What are the economic synergies between the two activites?

Good luck with the paper!