**Problem 1: Diabolic loop**

Trigger: Banking crisis (Ireland, Spain)  
Fiscal crisis (Portugal, ...)

- Sovereign debt risk
- Tax revenue
- Growth in real economy
- Bailout probability

- Banks
  - Sovereign debt
  - Bank debt risk
  - Equity risk

- Loans to firms
Problem 2: Flight to safety capital flows

- 2008: all sovereigns were considered safe almost perfect substitutes = “European Safe Asset”

- 2010+: German Bund remains as safe asset

  flight to safety across borders

- Value of German debt ↑, Italian/Spanish debt ↓
  - German CDS spread rises, but yield on bund drops (flight to quality)
Problem 2: Flight to safety capital flows

- 2008: all sovereigns were considered safe almost perfect substitutes = “European Safe Asset”
- 2010-: German Bund remains as safe asset

flight to safety across borders

- Value of German debt ↑, Italian/Spanish debt ↓
  - German CDS spread rises, but yield on bund drops (flight to quality)
Stock (Legacy) Problems vs. Flow Problems

“Flow Problem”
- Competitiveness
- Fiscal discipline in the future – (fiscal compact, six pack, ...)

“Stock (Legacy) Problem” – resolve debt overhang
- Transfers to overcome debt overhang problem
- Who will absorb losses?
  - Eurobonds: “sneaky way” of transfers, but undermines LR fiscal discipline

*Chicken game (leads to delay and uncertainty)!*
Chicken game 1: Who absorbs losses?

Losses

Temporary (Liquidity)

Permanent

Bank
- Share holder
- junior bond holders (Recap banks, PSI, ..)

Fiscal
- taxpayer

Inflation
“Financial Repression”
- saver

(LTRO, ..)

Debtor/ Creditor country

Conflict!

Debtor country

Conflict!

Creditor country

Chicken game 1

Game 2: new fiscal order

Delay + uncertainty: strangles growth and leads to further losses!
**Debt mutualization, MH, Politics**

**Strategy 1: „Alexander Hamilton Strategy“**

- **Deal:** Transfers in exchange for **loss of fiscal autonomy**
  - Why transfers? Debtor country's tax payers pay bailout
  - GCEE redemption fund: Incentives to reduce public debt
**Debt mutualization, MH, Politics**

**Strategy 1: „Alexander Hamilton Strategy“**
- **Deal:** Transfers in exchange for loss of fiscal autonomy
  - Why transfers? Debtor country’s tax payers pay bailout
  - GCEE redemption fund: Incentives to reduce public debt

**Strategy 1+2: AH + Fait accompli/TINA Strategie**
- Eurobonds: deep fiscal union
- If not accompanied by strict fiscal union ➔ bigger crisis
- Eurobills: simply an „entry point“ for Eurobond (in the next crisis)
**Strategy 1: „Alexander Hamilton Strategy“**
- Deal: Transfers in exchange for loss of fiscal autonomy
  - Why transfers? Debtor country’s tax payers pay bailout
  - GCEE redemption fund: Incentives to reduce public debt

**Strategy 1+2: AH + Fait accompli/TINA Strategie**
- Eurobonds: deep fiscal union
- If not accompanied by strict fiscal union, bigger crisis
  - Eurobills: simply an „entry point“ for Eurobond (in the next crisis)

**Strategy 3: ESBies – Limit economic distortions**
- Break Diabolic loop between sovereign and banking risk
- Redirect flight to safety capital flows
- Flexibility to increase depth fiscal union
Flight to safety: in times of crisis

Today: asymmetric shifts across borders
  - Value of German debt decreases
    - German CDS spread rises, but yield on bund drops (flight to quality)
  - Value of Italian/Spanish/Greek... sovereign debt declines

With ESBies: Negative co-movement across tranches
  - Value of ESBies expands – due to flight to quality
  - Value of Junior bond shrinks – due to increased risk
  - Asset side is more stable

Sovereign debt (<60% of GDP)

ESBies

Eu Junior bond

Flight to safety asset is endogenous (coordination problem)
Wish list for bond structure

- Preserve full market discipline (+ political discipline)
- Create “European safe harbor asset”
  - Size
    - Small: large movements in price (see e.g. Switzerland)
    - Large: benefits
- Redirect flight to safety capital flows
- Break Diabolic loop b/w sovereign and banking risk
- Flexibility to increase depth fiscal union
- Introduce it soon
- Risk - Reversibility
# Comparing different proposals

<table>
<thead>
<tr>
<th></th>
<th>ESBies</th>
<th>Eurobond</th>
<th>Blue-red</th>
<th>Eurobills</th>
<th>Redemption fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market discipline</td>
<td>perfect</td>
<td>Switched off</td>
<td>Limited</td>
<td>Limited exit credible?</td>
<td>limited</td>
</tr>
<tr>
<td>Safe asset</td>
<td>large</td>
<td></td>
<td></td>
<td>small</td>
<td>not in the long-run</td>
</tr>
<tr>
<td>Flight to safety</td>
<td>redirected</td>
<td></td>
<td>redirect</td>
<td>swings in yield curve</td>
<td>not in the long-run</td>
</tr>
<tr>
<td>Diabolic loop</td>
<td>broken</td>
<td>no</td>
<td>broken</td>
<td>only partially</td>
<td>?</td>
</tr>
<tr>
<td>Speed</td>
<td>next month</td>
<td></td>
<td></td>
<td>years</td>
<td></td>
</tr>
<tr>
<td>Risk</td>
<td>reversible</td>
<td>difficult to undo (even after failure)</td>
<td>enforced</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexibility</td>
<td>scale up with fiscal union</td>
<td>deep fiscal union needed</td>
<td>entry into Eurobond</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hidden transfers</td>
<td>none (temporary if needed)</td>
<td>large</td>
<td>(large)</td>
<td>largest</td>
<td></td>
</tr>
</tbody>
</table>
In sum ...

- Create a “European safe harbor asset”
  - “flight to safety” - requires coordination
- Isolate banks from sovereign risk (diabolic loop)
  - LTRO goes in opposite direction
  - “doubling down strategy”
- ESBies are flexible and reversible
  - allow gradual introduction of fiscal union
  - No fait accompli/TINA strategy
- Greece vs. Spain/Ireland/...
  - Fiscal compact
  - Bank regulation
    - European FDIC, bank restructuring,
Extra slides
1. Sovereign debt yield (10 years)

Source: Eurostat
1. Persistent Inflation Divergence

12-Mo. Moving Average HCPI for Eurozone (1999=100)

Par Yield

Jan 96  Jan 00  Jan 04  Jan 08

Source: IMF
1. Accumulated Net Capital Inflows

Why in 2003? (Landesbanken)

Source: Eurostat
1. Accumulated GDP Growth

Source: OECD
1. Accumulated GDP Growth

Source: OECD
1. Diagnose: b) Flight to safety

German foreign claims

Source: BIS