

Implicit Blue Bond Expectations and Collective Action Insecurity - Explicit partial bond insurance (Purple Bonds) Could Have Mitigated Both Le Spread's Historic Compression and Current Blowout

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France's fiscal behavior has been reckless for decades – running primary fiscal deficits now since 2001, and continuing to do so under an accelerating debt to GDP burden approaching 120% by the end of this year.

But it was the German finance ministry that, while serially complaining about French complacency in meetings here in Berlin I attended over the years, rejected creating an institutionalized financial mechanism that would have established both effective regulatory and market supervision.

In Basel bank regulation terms think about establishing Pillar 2 (regulatory supervision) and Pillar 3 (market supervision), to enforce Pillar 1 (hard fiscal policy criteria).

Let's start with market supervision:

I had been pushing for the Greece government debt haircut in 2010, against the resistance of many European banks led by BNP Paribas which held 5 bln EUR in Greek bonds at the time. I remember a shouting match with BNP in one of my Brussels working groups.

As the Greek haircut was realized, I had proposed in 2011 a permanent explicit risk-sharing arrangement between the Eurozone members and the private sector that the EU Commission later baptized 'purple' bonds, a partial bond insurance scheme. Here the abstract of my paper for CEPS at the time (full paper attached):

'Blue' or Eurobonds guaranteed via joint and several liability by the eurozone member states have been proposed by Bruegel, the Brussels-based think tank, as a key tool to stabilise and structure the eurozone sovereign bond markets. However, as current events show, a second key feature of the proposal – their limitation in volume to 60% of GDP – will be untenable in times of financial crisis. It carries the risk of exploding marginal costs of funds to those sovereigns facing rapidly rising debt levels and forcing them to issue 'red' bonds on their own standing. Rapidly rising fund costs would quickly drive them out of the bond market and into the blue bond-issuing Eurozone Stability Mechanism (ESM). Therefore, under the current proposal, in practice all sovereign bonds issued in the eurozone, regardless of ex-ante GDP limits, would have to be assumed to be blue bonds – an outcome that is fraught with moral hazard.

Partial insurance of sovereign bonds by the ESM that avoids such ex-ante volume limitations is a more efficient alternative. Sovereign bonds would embed a predetermined percentage of junior debt that would be spun off as a marketable bond on the ESM application day, while the remaining senior debt would be amortised as scheduled. Such 'junior' bonds could be subject to a restructuring or haircut under an emergency fiscal adjustment programme devised by the ESM. The insured portion, the 'senior' bond, would stabilise investor balance sheets by setting a floor under sovereign bond prices – both ex-ante and ex-post. Additional debt to be issued by the sovereign during a financial crisis would remain partially insured and thus carry substantially lower marginal costs of capital than

‘red’ bonds. This would enhance the options for the borrower to adopt fiscal measures early and reduce the likelihood of tapping the ESM for primary market funds.

Viewed from a political economy perspective, partial sovereign bond insurance is nothing more than a formalisation of what has already been agreed upon. This is the declared policy action of both banks and governments in the current crisis: private sector first-loss participation while avoiding a catastrophic (‘Lehman’) loss event.

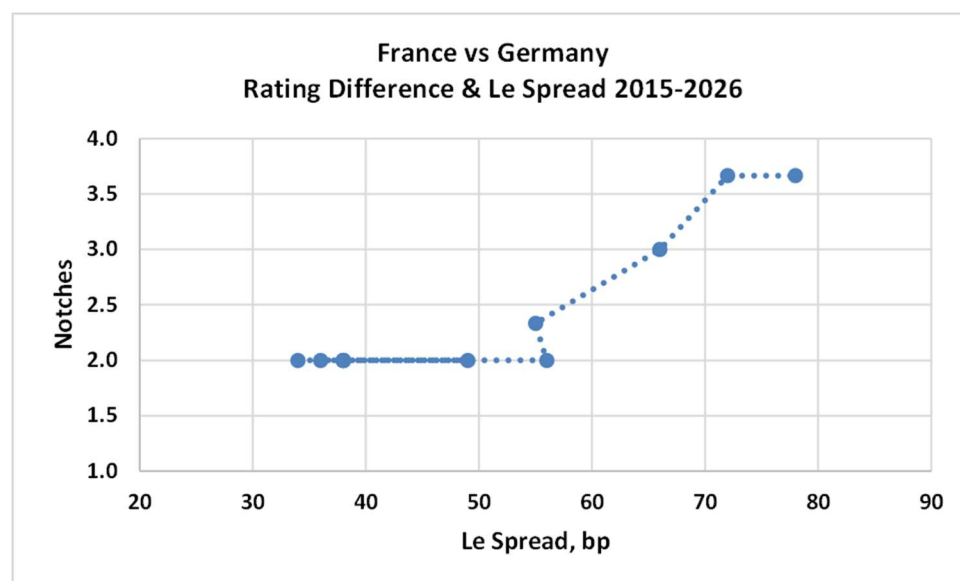
So what happened instead?

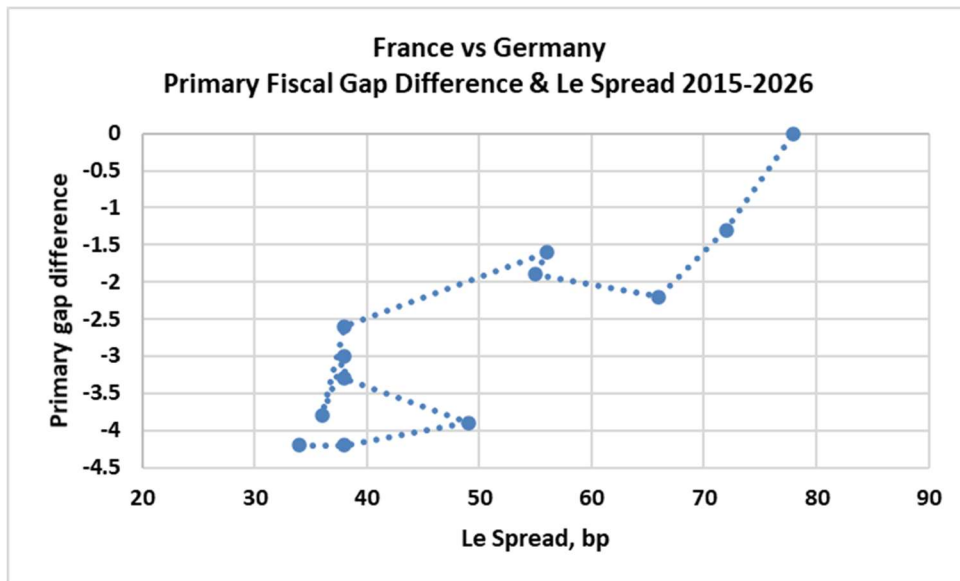
Exactly as predicted, despite her fiscal profligacy, French government bonds were treated for years since the 2010/12 sovereign crisis as quasi perfect substitutes for German government bonds.

Investors, many banks and institutions forced to hold government bonds by their prudential regulations, and of course the rating agencies as well, focused on the implicit German liability behind them and assumed them to be de-facto blue bonds.

The Greek haircut? An accident, no doubt, caused by lapses in investor vigilance and control over the political system.

When you bought France, you did not get AAA with a spread, as achieved in the alchemy of the 2000s that pooled BBB mortgage tranches. But with a AA rating until as late as 2023 what could possibly go wrong.





Now to Pillar 2 – regulatory supervision:

Conspicuously as the above figures show the widening of Le Spread is related to rating action, but not to the relative deficit situation between Germany and France. Obviously, something went very wrong with ratings while the primary deficit gap were huge.

There are other factors driving risk amnesia than faulty ratings, obviously. Zero risk-weight for banks holding government bonds regardless of the scale of debt, no Pillar 1 market risk penalties for the same banks making intermediation profits with government bonds for which they don't have to hold capital to begin with, and obviously said ECB purchases – an institution tightly controlled by France, added to the mispricing.

But it is clear in an institutional setup without an explicitly tasked bond insurer that bears the costs of at least partial bond insurance, there is no financial incentive, and no suitably powerful lever, e.g., in terms of provisions of prompt corrective action clauses embedded in insurance contracts, that would serve to rectify the situation.

So, the problem festered on for more than a decade. I am sorry, but DG ECFIN as your de-facto second opinion rating agency is no substitute for a formal bond insurer with clear contractual, and possibly even public law-based, prompt corrective action abilities.

So now after one and a half decades of mispricing of Le Spread meet La Solution – collective action clauses, which were introduced as a substitute for an explicit insurance solution after the Greek crisis.

Collective action in case of a French sovereign default, or more likely a failed auction forcing the Trésor to seek the help of the permanent ESM, can mean anything for investors: a haircut, an extension, an interest rate reduction, or an exit from the Eurozone and repayment in New French Francs.

Collective action means maximum legal ambiguity and uncertainty of outcomes for investors. As opposed to a partial insurance promise that puts a floor under bond prices, it can mean rock-bottom

bond prices and sky-high yields, which would force the ECB to come in with purchases in force again – this time asymmetrically.

The result of a central bank going all in can be observed BTW in the UK, where the BoE holds far more government bonds than the ECB without being able to enforce a change in fiscal behavior. Long story short, markets are not convinced.

Bottom line: the absence of an explicit partial insurance regime has made sure that a phase of exuberance of inadequate compression of Le Spread was followed by today's phase of panicked widening spreads. The alternative would have been defined investor risk-sharing as proposed, which confines Le Spread to a band, with higher lows and lower highs than what we have seen.

The maximum uncertainty approach that has been adopted makes ham-fisted government intervention esp. through the central banks more likely, and puts central banks into a monetary policy straight jacket. Uncertainty begets politization, and in the end will embolden investor lobbyism and imply far more expensive fiscal rescue operations than necessary.

So when will Berlin, or Paris for that matter which certainly disliked hard supervision as much as Berlin disliked a partial insurance regime, start accepting some form of joint responsibility for the debt situation enshrined in an enforceable bond insurance contracts for their investors?

Because one thing is sure: a fiscal crisis needs to be matched by a fiscal solution and cannot be solved through the printing press without crashing credibility with investors and population. And it is not so that this is a French issue alone, see Germany's ballooning deficits.

Inertia of the fiscal policy apparatuses caused by window dressing over untenable promises of absence of collective fiscal responsibility have made sure that no suitable solution for enforcing fiscal discipline exists so far in the Eurozone. In the light of the current crisis of Le Spread, which is likely only the harbinger of a far greater one to come, taking suitable financial policy action is becoming an imperative.