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THE GERMAN GOVERNMENT'S STRATEGY FOR THE EURO AREA IN VIEW OF ITALY'S INSTABILITY

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In a period of three months, ever since "Plan B" for exiting the euro was unveiled by economists close to the current government, the Italian spread has doubled. In recent weeks the government's leading representatives have been speculating that Italy may run into financial turbulence. Should it happen, it will be essential for Italy to have cooperative relations with partner countries with which it shares vital decisions in the institutions that safeguard the euro area's financial stability.

Among these partners, for reasons related to size and political culture, is the German government, which plays a significant role. It is therefore important to understand the attitude of the executive branch led by Angela Merkel with respect to the integration of the euro area and in particular, the uncertainties coming from Italy. As a response to the interpellation of German parliamentarians from the Die Linke Party, a federal government document offers a very explicit picture of Berlin's fears concerning Italy. The document, dated July 24, 2018, reiterates the German government's readiness to predispose a mechanism for restructuring sovereign debt so that the costs of an accident in the refinancing of other countries' public debt are not borne by German taxpayers. But the interpellation also enters into the details of the proposals that are being superficially discussed in Italy, proposals that have caused alarm in Berlin and presumably also in other euro-area countries. These are proposals, advanced by economists close to the League and the Five Star Movement Parties, that regard the introduction of mini-Bot, that is, government bonds with very short maturity capable of monetizing government debt and being adopted as payment methods to substitute the euro, methods that are unconnected to the monetary mass controlled by the ECB and may de facto represent a parallel currency. The proposal to transform the Monte dei Paschi Bank into a state investment bank with European guarantees has also raised concern.

With these developments in Italy's political economy debate, the German government has shown greater caution than in the past with respect to the process of euro-area integration, including the much desired completion of a banking union. Presumably, it is waiting for Italy's political and financial position to be clarified.

The first and most controversial argument raised in the debate between the government and parliament in Berlin concerns the necessity for a member state to have an insolvency regime. According to the German government, after the meeting in Meeseberg (June 19, 2018) between Chancellor Angela Merkel and French President Emmanuel Macron, Berlin can count on Paris's support for the rapid introduction of a collective action clause to be included in the issuances of members states that impose a single-limb position on creditors in the event of debt restructuring. This proposal should cause preoccupation in Rome because it is a reminder of the crisis' widening after similar clauses were proposed by Merkel and Sarkozy in Deauville in 2010.

Instead, Berlin believes that the European Stability Mechanism (ESM) can assume an intermediary role even with private creditors and is not worried about the objections of those who say that, in the absence of the ECB's guarantee, the clauses would lead to an increased risk for indebted countries. "Even though the possibility cannot be excluded," Berlin believes that the risk of default would depend on the credibility of the issuer and therefore on his "budgetary policy, which is mainly responsible for the risk premium."

The German government does not quantify the probability of a new debt crisis in the euro area. It believes the following are sufficient: the surveillance structure prepared after 2010, which assumed greater control of budgetary policy; some measures to coordinate economic policies designed to increase the competitiveness of the single countries and to reduce macroeconomic imbalances; the stabilization of financial markets through the banking union; and a stable assistance mechanism by reinforcing the ESM.

However, Berlin opposes the reinforcement of the supervision of macroeconomic imbalances, an issue that often has Germany accused of accumulating surpluses exporting much more than it imports. In particular, the German government does not believe the sanction mechanism in the macro-imbalances procedure should be strengthened. The explanation is that the current-account surplus in the German balance of payments is the result of the efficiency of German production and of the free working of supply and demand, and nothing else. When criticized by the EU Commission and the International Monetary Fund, Berlin responds that for the euro area the only thing that is important is the surplus in the aggregate balance of payments of the euro area (3.5% of euro-area GDP) and not the national one (8% of German GDP), and that economic-financial policies, whether national or European, are not capable of directly influencing Germany's balance of payments. Only a higher economic growth in Germany could help rebalance the trade current accounts with the other countries. This is why the German government is favoring further structural reforms. At the same time, however, Berlin believes it has already encouraged domestic public investments, reduced the tax burdens of local communities and introduced a minimum wage. Other policies are designed to strengthen private investments and household consumption so as to support internal demand, as can actually be seen in the latest data.

The European governance initiatives that interest the Merkel government are instead those that aim to reduce risks rather than share them. Special attention is given to bank portfolios dangerously accumulating government bonds, a problem that is still highly conspicuous in Italy. According to the German government, "the financial crisis has demonstrated that government bonds are not without risks and therefore these risks should be considered from the viewpoint of bank regulation." In accordance with the roadmap designed by ECOFIN in 2016, sovereign risk weighting in banks is considered a precondition for the beginning of the European negotiation on a European common insurance for bank deposits.

The government admits that in recent years progress has been made in the reduction of problematic loans, or non-performing loans, given by banks in the euro area. However, it believes that their level is still too high and that it is necessary to proceed with the reduction plan approved by the European Council on July 11, 2018. Even if Berlin understands the importance of strengthening and finalizing the banking union, it says that it is still too early to start speaking about a common deposit insurance. Besides the measures advanced in ECOFIN's "banking package", Berlin first wants to see progress in the minimal harmonization of the insolvency law across the euro area, in the reduction of non-performing loans and in the commitment to avoid their future increase, as well as the creation of a regulatory framework of the government bonds in bank portfolios. "Before speaking about deposit insurance, all these aspects must be resolved."

Given the impossibility of reaching an agreement on sovereign risk weighting, both on the European level (unless concentration indexes that do not apply to the exposure of national securities are adopted) and the G20 level, Berlin seems to be endlessly postponing the introduction of the common deposit insurance, even though it considers it essential for avoiding vicious circles in banking crises and public debt.

Although it is generally accepted that the ESM can act as a backer of the bank resolution fund, the German government wants this to happen only after the comprehensive reform of the ESM has been agreed on. However, this reform is still far from being introduced, since for now only the institution's future tasks are being discussed and no decision has been made about whether to establish the future ESM within EU's legal framework or leave it outside the treaties. According to Berlin, institutional issues should be systematically subordinated to the choice of content and thus, following the same principle, the German government refrains from assuming a position on the necessity of a European Finance Minister, which in 2017 was part of the proposals on euro-area integration advanced by both France and the European Commission. Similarly, Berlin is opposed to a greater parliamentary role, whether European or national, in the control of euro-area institutions. The absence of these controls contrasts with Berlin's assent to the institution of funds and a euro-area budget that would stabilize the economies of the member states and support structural reforms.

A serious concern that the government shares with the Bundesbank and the Financial Stability Committee regards the consequences of a substantial and unexpected increase in interest rates. In such a case the profits of about 1,500 small and medium German banks would be severely affected in the short term.

The German government also reacted negatively to requests to exempt some items on the public expenditure list, including public investments, from the expense limits scripted in the Stability Pact in the event of the application of the "golden rule", which is often mentioned in Italy. The fact that the German government and parliament's attention is concentrated on Italy can be seen by the specific interpellations that go into the details of the public declarations made by exponents of the Italian majority, starting with the proposal to transform - using public money - Montepaschi into an investment bank with European guarantees. The German government says that it cannot respond to this question because it does not have information about a concrete plan that regards Montepaschi, and concerning the proposal to introduce mini-Bots, it revealingly says that in case the proposal is concretized, it will be necessary to verify its compatibility with the European treaties.