LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

POLICY BRIEF – JANUARY 28, 2016

# EURO-ZONE, ITALY'S RESPONSIBILITY

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## 1. The ECB's help will not last forever

We are all tempted to say that the worst is behind us once and for all. However, eight years after the crisis started, the stability of the euro-area is still at risk. Despite several attempts to improve the practices and institutions of common governance, European countries sharing the single currency continue to follow divergent trends. The current system does not seem capable of facilitating economic growth and spreading it around the euro-area. We are actually neither sure if available policy tools can significantly reduce risks of instability that have shaken the foundation of the euro-area, nor certain if these tools will allow governments and citizens in different countries to join forces and share appropriate countermeasures.

Monetary policy seems to be the only policy instrument in use, but it may only very gradually bring inflation to normal levels and support economic activity. However, since the use of non-conventional monetary policy also entails risk, we already need to take into account the eventuality that the ECB's quantitative easing will end. Global, geopolitical, or financial factors will affect the duration of the Central Bank's program. However, the March 2017 deadline has been explicitly mentioned by ECB officials, meaning the European economy is already only a year out from facing the end of the bond-buying program that has given it breathing room and stabilized the market for sovereign bonds.

## 2. From centralized coordination to a decentralized mechanism

The attempt to respond to the crisis by centralizing coordination of economic policies of euro-area countries has gradually lost credibility. Impressive and intricate systems of governance have been set up through the Six-Pack, Two-Pack, and European Semester, but the application of their rules has proved problematic, asymmetric, and inconsistent between countries, which, among other things, has undermined the sense of community that would have otherwise facilitated adoption of and respect for shared rules. In fact, the results of the new governance are not satisfactory: indebted countries have seen their debt-to-GDP ratio deteriorate further; structural reforms have been reluctantly adopted in countries like France and Italy; other countries that, like Germany, accumulate surplus savings have not agreed to discuss the rebalancing of their large current account surpluses; in the context of low economic growth, weaker countries have been forced to recover their competitiveness solely through domestic deflation. Loss of credibility and effectiveness have contributed to the erosion of confidence in European governance.

Until 2012, the crisis' management and accompanying institutional changes were based on a hierarchy among countries, whereby countries with a savings surplus could dictate stringent conditions to countries in need. Such conditions have also been reflected in the operation of the European Stability Mechanism (ESM) and financial assistance programs. Subsequently, when the European Central Bank took over the task of stabilizing the crisis, with the intention of re-starting transmission channels of monetary policy and defending the integrity of the single currency, the grip of political conditionality imposed on the weakest countries through control of financial assistance eased. The drive for reform and fiscal consolidation, activated by the financial emergency, receded throughout the area.

In simple terms, with the survival of the euro-area in jeopardy, the ECB had to assume a pivotal financial role that previously had been controversially assumed by Germany. For better or worse, the hierarchy among countries that allowed those with stronger economies to dictate rules and impose technical supervision has withered. Political coordination among the economies of the euro-area, despite being enacted solely through Berlin's centralized role, has become less effective.

Germany's role as Europe's financial and political pivot is now further evolving. The Syrian migrant crisis has cost Berlin its traditional political allies in Eastern Europe. Moreover, countries most-affected by the economic crisis have voted in political leaders who denounce austerity policies. The European Commission is unable to centralize coordination because it is seen by the weak countries as the executor of asymmetric policies favoring Germany, while the latter views Brussels as an accomplice in the watering down of fiscal discipline. With the centralization of policy coordination founded on German leadership losing influence and effectiveness, Berlin has shifted the burden of adjustment back to individual countries, subject to joint but less intrusive supervision—a model we define as "decentralized coordination."

The erosion of confidence in the centralized model of coordination reliant on German leadership also occurred for domestic political reasons. Peripheral countries have grown impatient in the face of ineffective economic policy recipes imposed by outsiders. This sentiment is reflected in the various anti-European movements protesting the centralization of responsibilities at the European level. In Germany, the endless challenge of migration, diminished fiscal discipline in the euro-area, and the attenuation of its influence over other countries and European institutions has fostered a growing sense that it is "losing control" over both national and European challenges. This sentiment is affecting domestic politics leading up to the forthcoming 2017 elections in France and Germany.

## 3. The risks to Italy

In this context of less stringent rules and economic coordination, Italy chose to boost demand by raising government deficit, invoking flexibility clauses equivalent to one percent of gross domestic product. After the disappointing results of austerity policies, the aim was to stimulate growth and thus reduce the debt-to-GDP ratio. In doing so, it decided to primarily channel resources into restoring at least part of the confidence destroyed by years of recession, distributing money to families instead of bringing down the cost of labor or easing conditions for economic activities. This move has thus far produced modest effects on private consumption, while investment shows no sign of taking off.

Therefore, the possibility exists that the debt-to-GDP ratio will not fall in any significant way. It may even go up again if the global economy grows less than was forecasted in the Budget Law for 2016, which is likely.

The level of Italian debt is one of the most critical elements for the stability of the euro-area. The debt-to-GDP ratio is indeed key to the new system of governance of the euro-area economy. Until last year, Italy has benefited from a transitional period that made annual commitments to debt reduction less cogent. But this year, the leeway ends, and the possibility that the Commission might open infringement procedures against Italy for breach of compliance of its medium-term objectives should not be excluded.

## 4. The negative effects of the new "decentralized coordination"

An increase in debt through generous spending policies is the first reason for the reluctance among other countries to forms of risk-sharing. The slowdown of structural reforms and lack of confidence in Italy's ability to reduce its debt-to-GDP ratio hampers the centralization of economic policies and initiatives to share risk. France and Spain have lower public debts than Italy, but their fiscal deficits are comparatively out of line. Their unique interpretation of fiscal rules, all with sound economic or political reasons, make these three countries prime examples of the persistence of different sensitivities in the euro-area with respect to fiscal stability. This inevitably leads to different levels of willingness when it comes to risk-sharing, which has fiscal consequences.

In fact, a different pattern of coordination has emerged out of Germany that favors "decentralized coordination" of economic policies over centralization of responsibilities. Instead of risk-sharing, the crux of this new paradigm is the confinement and reduction of risk originating from high debt countries. Specifically, countries with high debt are asked to assume the responsibility of reducing risk from idiosyncratic shocks by strengthening the separation between sovereign and banking risk. This aim is pursued primarily through new rules that assign an explicit risk coefficient to sovereign bonds of euro-area countries, forcing banks to no longer treat them as practically risk-free securities. New proposals have been discussed that would set limits on the amount of a country's sovereign bonds each bank can hold.

In particular, the Bundesbank has requested not to proceed with planned measures to share banking risk until the process of decoupling sovereign and banking risk has been completed. The European Deposit Insurance Scheme (EDIS) has been postponed because, from the German point of view, sharing risk for banks loaded with government bonds is equivalent to sharing risk for public debt. Following the same logic, but applying it instead to private creditors, EDIS would only be available after the harmonization of regulations governing bankruptcy laws. In the absence of shared rules, a country might choose to allow their banks and businesses to fail, offloading at least a part of the burden on deposit insurance financed by foreign taxpayers.

Once sovereign bonds are taken off the balance sheets of banks, it would be possible to, in the event of a crisis, restructure the public debt of a country without devastating its banking system and, theoretically, private economic activity. With the decentralization of sovereign risk, automatic mechanisms to restructure debt, through the extension of public bonds maturities, would actually be available and enforceable each time a country loses access to financial markets for the financing of public debt, forcing it to turn to the European Stability Mechanism (ESM) for assistance.

For countries with high debt and a considerable amount of problematic bank loans, the situation is worrying. If the workings of the Single Resolution Mechanism (SRM) remains national for another 10 years, the links between banking and sovereign risk could be intensified, rather than weakened. Even more troubling is the threat of automatic restructuring of public debt of countries facing financial difficulties. This threat could be self-fulfilling, as was the case in the more dramatic moments of the recent crisis.

## 5. A high-risk gamble on Italy's GDP

In this context, it is crucial to immediately proceed with the completion of the European Single Resolution Mechanism or, with just less urgency, the creation of the European Deposit Insurance Scheme. While the restructuring and unification of the Italian banking system seems to have started, it is not enough: the amount of high risk credit on the balance sheets of banks requires timely stabilizing measures. In this regard, despite the strictness of new European regulations, there is still room for forms of securitizations that will not compromise the equilibrium of Italian bank balances. It should be highlighted that these balances are overloaded with sovereign bonds that are destined to devalue as soon as inflation returns to normal levels and nominal interest rates increase. It is therefore advantageous for our banks to use the current ample availability of liquidity, furnished by the ECB, to speed up the reduction of their exposure and diversify their holdings.

Speeding up the completion of the SRM and EDIS requires a reconstructed foundation of trust. In this regard, the major European actors need to understand whether Italy's economic recovery will also improve its debt-to-GDP ratio. The economic reforms implemented by Italy in the past few years had not been bold enough to guarantee the necessary economic growth and to make sure that budget deficits actually stimulated the economy. The Italian government in particular has stalled in its attempts to curb inefficient public spending and tax breaks. While we are still waiting for a detailed report on judiciary reform, the Antitrust legislation seems to have been watered down and delayed.

While the process of aggregation and restructuring in the banking sector is observable, it is insufficient for ensuring the sector's stability. A similar structural process aimed at the development of larger industrial players is both slow and truncated. Instead of helping, the use of subsidies and occupational support schemes is hindering the restructuring of the manufacturing sector. The intensive plan for reforms aimed at boosting productivity through micro-economic interventions has yet to be realized.

Faced with the risk of disappointing results from investment and the slew of recently launched reforms, it is vital to keep an eye on debt. On this front, there has not been a strong signal that reforms aimed at fiscal consolidation have resumed, as it would be possible, for example, by making safeguard clauses trigger automatic spending cuts instead than tax increases. Underestimating the risk of an increase in the debt-to-GDP ratio could be very risky, and precautionary measures seem appropriate. For example, privatization measures that would reduce nominal debt increases should be immediately identified. Extraordinary intervention projects to reduce the size of the national budget should be considered.

## 6. National obligations and European negotiations

The euro-area needs more cohesiveness between its member states, lest its survival, not only economic, will remain at risk. But there can be neither cohesion nor risk-sharing unless each country starts, at this very moment, to reduce their own reasons for instability.

For Italy, it is most important to make progress in the mutualization of risks. In particular, with respect to the banking union, we need to strive for a more rapid implementation of the Single Resolution Mechanism and to make European governments respect the commitments they had already made to the European Deposit Insurance Scheme. In addition, we need to move forward with the definition of a coordinated fiscal policy, where restrictions necessary in certain countries are compensated by expansive policies in others. European institutions need to return to the task of implementing growth-oriented policies of common interest and anticyclical policies for the euro-area, while reinforcing existing tools. In particular, it is necessary to improve the European initiative to promote investment, defining areas for intervention that can be jointly financed, starting with measures to bolster the area's security and guard its borders. Additionally, investment in infrastructure and public utilities should go hand-in-hand with the opening of national markets to competition, in the spirit of the single market. These measures are indispensable for creating a less fragile and more cohesive economic area.

However, it would be impossible to create a consensus for sharing economic and financial risk if each country does not simultaneously work toward reducing their own sources of instability. The completion of the Banking Union through the realization of the SRM and EDIS requires significant progress in weakening links between sovereign and banking risk. For Italy, this comes with difficult choices that have the potential to be beneficial in the medium term. After all, in the eyes of many other members of the monetary union, one of the most significant risks is the high level of public debt that refuses to go down. Therefore, Italy's fiscal policy cannot ignore debt reduction. The systematic application of the flexibility clause with little regard to the relationship between debt and GDP could become an obstacle to reinforcing risk-sharing processes.

In conclusion, Italy needs to work toward returning to centralized coordination despite various failed initiatives. Our economy needs the processes of creating common institutions and mutualization to move forward, in a way that keeps systematic risk, which recent experience has shown we are particularly vulnerable to, under control. Already, a high level of mistrust between member states risks the area taking steps backward, in the direction of decentralization of risk and responsibility and abandonment of coordination on the part of European institutions. Italy could benefit from negotiating on two fronts: national responsibility on one hand and increased European cohesion on the other. Its coherence with both sides of the negotiation will allow it to play a central role on the European stage, uniting countries that share similar needs and strengthening Europe by promoting cohesion and risk reduction.