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On selling sovereigns held by the ECB to the ESM:
institutional and economic policy implications

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Abstract

This paper follows up on a CEPS Policy Insight of October 2020, in which Stefano Micossi argued that the increase in sovereign indebtedness under way in the euro area should be managed through collective policy actions. A repetition of austerity policies of the early 2010s is not consistent with maintaining adequate growth and sovereign debt sustainability in the post-pandemic environment. Likewise, a debt restructuring process with deep haircuts during this period will just upset the fragile state of the markets and create a run on the debt of the most vulnerable member states, forcing the ECB to buy even more debt.

Common policies are thus required to keep the sovereigns acquired by the ECB with its Asset Purchase Programme (APP) and Pandemic Emergency Purchase Programme (PEPP) programmes out of financial markets for an indefinite period. The European Stability Mechanism (ESM) can offer the appropriate instrument by purchasing the ECB-held sovereign debt and issuing own liabilities to fund the purchases. The programme could develop gradually over several years to ensure the smooth rollover of expiring securities. As the purchases would be funded by the ESM's own liabilities backed by the sovereign holdings, ESM debt would become the long- sought-after European safe asset.

We argue that this ESM action could be conducted without an ESM Treaty change. It would be premised on the legal framework of the revised Article 14 (precautionary financial assistance). The ESM could then gradually evolve into a debt management agency for the euro area. The transfer of much of ECB sovereign holdings to the ESM would restore monetary policy independence and ease any frictions in this field, thereby allowing EU policymakers' focus to shift to the completion of the European Banking Union.

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Contents

1. Introduction 1
2. A new ESM facility to purchase sovereigns from the ECB 3
2.1 Overview 3
2.2 The rationale of the scheme 4
2.3 The mechanics of the scheme 6
2.4 Two operating options 7
3. ESM Treaty underpinnings of the proposed ESM facility 8
3.1 General criteria 8
3.2 Article 14 of the revised ESM Treaty 9
4. The economic and financial impact of the ESM sovereign debt facility 12
5. Conclusion 14
References 17

List of Figures and Tables

Figure 1. The options of ESM intervention 12

Table 1. Government and non-financial private sector debts (% of GDP) 2
Table 2. Breakdown of debt securities under the APP and PEPP programmes 4

List of Abbreviations

APP	Asset Purchase Programme
BIS	Bank for International Settlements
CAC	Collective Action Clause
CJEU	Court of Justice of the European Union
ECB	European Central Bank
ECCL	Enhanced Conditions Credit Line
ESCB	European System of Central Banks
ESM	European Stability Mechanism
LoI	Letter of Intent
MoU	Memorandum of Understanding
NCBS	National Central Banks
PCCL	precautionary conditioned credit line
PCS	Pandemic Crisis Support
PEPP	Pandemic Emergency Purchase Programme
PCCL	Precautionary Conditioned Credit Line
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union

1. Introduction

The Covid-19 crisis stands out as a *common* shock affecting all eurozone countries. While the timing and the size of the shock may differ slightly from country to country, there is little doubt that all eurozone economies have experienced a deep recession because of an unwieldy *mix of supply and demand shocks*. On the supply side, the restrictive measures taken by governments to contain the spread of the virus have stopped or decreased production in certain sectors (notably in travel and tourism, restaurants and accommodation, cultural and communication events, etc). Restrictions on movement and firms' operations have simultaneously induced a precipitous drop in aggregate demand. These shocks have led to a massive increase in private and public debt.

Very high levels of public and private indebtedness may lead to classic debt overhang scenarios, with a critical impact on public spending – notwithstanding financial injections from the EU Recovery Fund. Alternatively, finding a feasible way to manage the debt mountain that is compatible with the EU Treaty could stabilise market expectations about levels of inflation and medium and long-term economic growth, creating a favourable environment for private sector investment. It could also help to move the eurozone beyond the present environment of lax monetary policies and widespread ECB interventions in the sovereign debt markets, which at some stage after the pandemic are likely to court political controversy.

This paper follows up on an earlier CEPS Policy Insight (Micossi, 2020),[2] which stresses that the Covid-19 pandemic will leave governments and private agents in the euro area with much higher levels of indebtedness in an environment of slow economic recovery and poor productivity. In this scenario, the traditional cure of budgetary restraint to repay sovereign debt would not be compatible with debt sustainability and would likely compromise the ability to mend the economic and social scars inflicted by the pandemic. Therefore, the increase in sovereign indebtedness under way in the euro area cannot be left to member states to manage by themselves; it raises common policy action problems that must be addressed by a collective response.

To recall, the average sovereign debt ratio to GDP of the euro area has risen by about 16%, to 102%, with seven countries close to or above 120% (160% for Italy, above 200% for Greece; cf. Table 1). With nominal growth of around 3% (assuming inflation will go back to 2% soon), in order to bring their debt ratios down to 60% in 20 years, as required under the (suspended) Stability and Growth Pact, these countries would be required to run sizeable primary surpluses (of 2-3-4% of GDP?) – which would significantly constrain domestic demand and weaken debt sustainability. While the Commission is preparing a review of the SGP to increase its flexibility, the outright elimination of debt brakes is not likely.

Moreover, after the financial crisis triggered by the collapse of Lehman Brothers, in many countries private investment never recovered to pre-crisis levels, with a large increase in net savings in 'core' countries, while in high-debt countries (such as Greece, Italy, Spain, and

[2] S. Micossi (2020), "Sovereign debt management in the euro area as a common action problem", CEPS Policy Insight No 2020/27, CEPS, Brussels, October 11.

Portugal) public investment was also severely cut to meet budgetary constraints. High debt may contribute to low investment by feeding expectations of future tax increases and fears of financial instability. Of course, member states with the highest levels of debt are the most vulnerable due to currency re-denomination risks that in the past led to an exodus of deposits from Greek, Cypriot, and Italian banks.

After the ESM Treaty reform recently endorsed by the European Council, sovereign debt restructuring may have to be undertaken preventatively before granting financial assistance to member states when debt sustainability appears imperilled. However, this recipe is not to be recommended in practice as it could wreak havoc in the economies of highly indebted countries by swelling the cost of debt refinancing out of proportion and undermining euro area financial stability. These risks were clearly demonstrated by the Greek experience (Micossi, 2020, Corsetti et al., 2015). Indeed, a literal interpretation of Article 3 of the Treaty establishing the ESM restricts the granting of ESM financial assistance to when a country is already on the brink financially, and the whole euro area financial stability is under threat. This interpretation makes access to the ESM destabilising in itself by raising the spectre of widespread creditor haircuts and loss of market access. Namely, such an interpretation would de facto deprive the euro area of its main crisis management tool.

Table 1. Government and non-financial private sector debts (% of GDP)

	General government debt (*)			Households (**)		Non-financial corporations (**)	
	2019	2020	2021	2019	2020	2019	2020
Euro area	**85.9**	**101.7**	**102.3**	**56.8**	**61.6**	**78.5**	**86.8**
Belgium	98.1	117.7	117.8	61.8	68.1	118.7	126.5
France	98.1	115.9	117.8	61.7	68.3	91.6	107.4
Germany	59.6	71.2	70.1	54.4	57.9	50.9	55.3
Greece	180.5	207.1	200.7	56.0	60.9	54.4	65.0
Ireland	57.4	63.1	66.0	37.5	37.4	165.0	152.8
Italy	134.7	159.6	159.5	41.2	45.5	65.3	73.6
Netherlands	48.7	60.0	63.5	101.4	106.3	133.7	140.4
Spain	95.5	120.3	122.0	56.9	63.9	72.5	85.8

Sources: our estimates based on ECB, Eurostat and Ameco (**), 2020 refers to 2020Q3.

If neither the debt brake nor debt restructuring offer a viable exit from excessive debt accumulation, it is reasonable to wonder whether common policies at euro area level could help. A common solution is required in view of the important spillover effects that may arise from the accumulation of high levels of sovereign debt within the monetary union. The need to ensure sufficient growth for debt sustainability is one such external effect, requiring a collective uplift of the dismal pre-Covid growth rates in the euro area.

A more significant spillover effect is a direct consequence of the present configuration of the currency union because national fiscal policies remain independent. Since individual member states may not intervene in sovereign debt markets without the consent of all other member states, financial shocks hitting one country may escalate into a systemic crisis. Investors may come to fear that permission to intervene may be refused, raising the risk of default of that member of the euro area and of others as contagion spreads. This externality of the common currency does not disappear with low or even negative interest rates.

Since high sovereign debt ratios are the root cause of this potential source of instability, common policies may contribute to the solution by keeping substantial amounts of sovereign debt out of capital markets and thus mitigating investors' fears of insolvency. They could also tame banking system risks by helping banks reduce their national sovereign portfolios and partially substitute them with other 'safe' assets.

Our proposal, drawing on that of Micossi (2020), is to set up a new credit facility to enable the ESM to gradually acquire the sovereigns held by national central banks (NCBs) – acting jointly with the ECB as the European System of Central Banks (ESCB) – and to renew them indefinitely, or at least for as long as is needed to avoid any destabilising effects that their redemption may bring to national public debt markets. Under our design, the ESM would evolve into a euro area debt management agency which, in the process, may also utilise the policy conditionality of Article 14 of the revised ESM Treaty, turning it into an invaluable pan-European economic governance tool.

The following sections will describe the rationale of the new ESM facility (section 2); examine its legal and institutional feasibility (section 3); and discuss the economic and financial impact of the facility (section 4). The main conclusions are in section 5.

2. A new ESM facility to purchase sovereigns from the ECB

2.1 Overview

Under our proposal, the ESM would be empowered to purchase from the ESCB – henceforth referred to for simplicity as the ECB – the sovereigns acquired by the latter for its monetary policy operations and pay them with financial resources raised by placing its own liabilities on the financial markets. One important aspect is that there is no need for these ESM liabilities to claim legal seniority to national sovereign debts; they can earn their reputation in the market.

To recall, total purchases of sovereigns under the two programmes, APP and PEPP, reached a total amount of over €3 trillion at the beginning of 2021 (Table 2), or about 30% of total outstanding sovereign debt in the euro area (and more or less the same percentage of the area's GDP). Purchases of other securities by the ECB raise the total amount of securities held by the ECB to about euro €4 trillion, just about 35% of euro area GDP. Ongoing programmes may well add another €1.5 trillion before they are discontinued, since purchases will continue as long as inflation does not 'sustainably' converge to the 2% target – which is not in sight for this year and probably for most of the next year either.

The sovereigns held by the ECB have an average maturity of about seven years, with some maturities stretching over ten years and more; if they were not renewed, liquidity conditions would tighten undesirably as member states placed equivalent securities on financial markets. In order to avoid this effect, the ECB has already stated that expiring securities will be renewed as long as is justified by monetary policy considerations – a motivation so far accepted by the European Court of Justice.[3]

Table 2. Breakdown of debt securities under the APP and PEPP programmes
cumulative net purchases (bln€)

	Public Sector Purchase Programme (APP) (2015- Jan 2021)	Public Sector Securities under the PEPP (Mar.2020- Jan.2021)
Belgium	87.0	26.1
France	493.1	133.6
Germany	580.0	188.7
Greece	-	18.9
Ireland	37.9	12.1
Italy	415.0	136.3
Netherlands	119.0	42.0
Spain	295.0	89.8
Total	**2,476.8**	**768.1**

Source: ECB.

2.2 The rationale of the scheme

To the extent that, as has been argued, high sovereign debts contribute to lowering growth and keeping investors on edge as a continuing potential source of financial instability, the possibility of holding those sovereigns out of capital markets for a period longer than justified by pure monetary policy considerations must be considered as a means to make the euro area more resilient financially. Clearly, no agreement is likely on this, at least beyond Covid-19 debt, without sufficient convergence of national fiscal policies and, eventually, euro area members moving to a closer fiscal union. Credible reform of the SGP is a necessary step in this direction. Reform of the SGP lies outside the scope of this paper and will not be further discussed here.

Meanwhile, as long as economic and financial conditions in the eurozone remain as fragile as they are today, the announcement by the ECB of a decision to start reducing its sovereign portfolio may well engender deep financial instability and push some high-debt countries

[3] The CJEU held in Case C-493/17 *Weiss*: "[the] ECB has made the valid point that the efficacy of such a programme through the mechanisms described in paragraph 77 of this judgment depends on a large volume of government bonds being purchased and held. That means not only that the volume of purchases must be sufficient, but also that it may prove necessary — in order to achieve the objective pursued by Decision 2015/774 — to hold the bonds purchased on a lasting basis and to reinvest the sums realized when those bonds are repaid on maturity." Id. para. 90.

against the wall. Suffice to recall in this connection that when President Lagarde stated in her fist press conference as Chair of the ECB that “we are not here to close spreads”, the risk premium on Italian sovereigns jumped instantly above 300 basis points.

This destabilising effect may also be achieved even years after the pandemic has become a memory and need not involve the ECB selling its sovereign holdings. By simply letting them expire at maturity the cost of debt refinancing will be shifted to the sovereign and will be totally dependent on the circumstantial conditions of the market at that time. But arguing that the refinancing of Covid-19 debt should be subject to market discipline while its formation had nothing to do with the actual fiscal behaviour of the country but was due to an entirely exogenous macroeconomic shock, defies any economic logic. It would simply penalise eurozone governments for taking measures to support the health and well-being of their citizens and support the minimum function of their economy and their citizens’ livelihoods during the pandemic. No austerity-supporting economist and big G-20 country in the world has so far come anywhere close to suggesting that Covid-19 debt should be exposed to the rigours of market discipline. It would therefore be paradoxical if the eurozone decided to do just that, albeit a few years hence.

These considerations point to a need to manage outstanding sovereign debts in the euro area for reasons of financial stability rather than monetary policy, and not just in the short term. The goal of financial stability also covers the orderly rollover of outstanding sovereign debts, even after the end of ultra-loose monetary policy. In practice, purchases by the ESM would offer an extra hedge against the liquidity risk of a financial shock hitting one or more sovereign markets in the euro area. This task could not be permanently entrusted to the ECB without crossing the line that separates monetary policy from fiscal policy, as established by the European Court of Justice in its decisions in *Gauweiller and others* and *Weiss and others*.[4] The ESM, which is an institution set up by euro-area governments as a crisis management tool, and which has enough capital to cover any losses from such operations, looks like the natural choice.

The capital of the ESM amounts to €704.8 billion – an amount more than sufficient, as it were, to guarantee €3-4 trillion of security issues with a total leverage ratio (total assets = equal total liabilities minus capital divided by capital) no higher than six. In fact, the BIS, the main EU investment institution, operates with a lower leverage ratio but that seems much too conservative a benchmark, given that the ESM would shoulder the default risk of the sovereigns held in its portfolio. Under present arrangements this risk stays with the national central banks of the issuing country; it is only natural to postulate that it would remain there even after the sovereigns are purchased by the ESM or, later, when they are renewed at expiration with existing sovereigns purchased in the secondary market or newly issued sovereigns.[5]

This is a critical observation in three important aspects. First, the cost of repayment is not moving to the ESM and thus there is no risk of breaching Article 125(1). Second, any losses will materialise on maturity assuming the sovereign defaults, which is a very unlikely scenario. Thus,

[4] *Weiss and others*, C-493/17, 11 December 2018; *Gauweiler and Others*, C-62/14, 16 June 2015.

[5] Also, these purchases would not affect other features of the sovereign securities such as the CAC (Collective Action) clauses that following the ESM Treaty have been present in new sovereign issues in the euro area since 2013.

ESM holdings need not be marked to market, which would make the ESM show losses as soon as interest rates went up. Third, ESM investors would be concerned only if the yield on ESM own liabilities backed by the sovereign holdings significantly exceeded the yield on ESM assets. But, again, such a scenario is unlikely since the ESM can borrow at very low interest rates and the ESM liabilities issued under the scheme will at all times attract very low interest rates for one additional reason: they would play the role of a eurozone 'safe' asset and would thus be in very high demand.

Therefore, not only is there no reason for the ESM to mark to market its sovereign holdings, but the possibility that the ESM will pay a much higher interest rate for own liabilities issued under the scheme than it would have earned from the sovereign holdings is quite slim. Either way, any losses accruing that way will be minimal and can easily be covered by ESM capital, which is a pre-committed facility intended to absorb losses, if ever such a need arises. Given the CJEU's decision in the Pringle case there should be no doubt that ESM capital stands there to absorb any losses from ESM operations sanctioned by its Treaty and such loss absorption, if any, does not amount to "debt mutualisation".

2.3 The mechanics of the scheme

Under the proposed scheme, the purchase of sovereigns by the ESM from the ECB would develop according to a programme stretched over a decade – say with moderate monthly purchases in the order of €25 to €30 billion – and eventually cover a large share of the ECB holdings in order to achieve the desired impact on investors' expectations and create a substantial market for ESM liabilities for monetary policy operations. An adequate basis would thus be established for the development of a large, deep, and liquid market for a European safe security, which would underpin a truly integrated capital markets union and the international role of the euro as a reserve currency and investment instrument (Micossi, 2021).

The purchases could accelerate should the ECB need to sell, at some future time, parts of its sovereign holdings for monetary policy purposes. In this case, the ESM could absorb the higher ECB sales and replace them with its own liabilities. Thus, the restrictive monetary effect would work through the market for ESM liabilities, whose interest rate may rise, rather than through the national sovereign debt markets, essentially creating a common EMU debt instrument. The ECB, in turn, would be less constrained by concerns about the orderly rollover of sovereign debts in certain countries, and would thus regain its monetary autonomy.

Purchases by the ESM should continue as long as necessary to bring the average sovereign debt left with private investors in the euro area down to below 75% of GDP – a debt ratio that could be set (by amending the Treaty Protocol on excessive deficit procedures) as the new benchmark for the debt ratio to GDP in the excessive deficit procedure. At the same time, the question of how to deal with large sovereign debts in excess of the 75% benchmark remains unresolved and should be handled as part of the SGP reform.

In order to manage this task, the ESM would set up a revolving facility, under the new Article 14 of the revised ESM Treaty, allowing it to buy and sell its members' sovereigns for financial

stability purposes.[6] Subsequently, the total amount of sovereign bond purchases by the ECB would stabilise once unconventional monetary policies end, without creating any unnecessary shocks in euro-sovereign debt markets or any substantial spike in debt refinancing costs.[7]

2.4 Two operating options

Two options can be employed to further our proposal. The first would allow the new ESM facility to purchase from the ECB – in practice from the National Central Banks within the ESCB – existing securities that the ECB acquired from the secondary markets under its emergency purchase programmes (APP and PEPP). In this case, ESM purchases would not entail any differential effects favouring specific (high debt) countries. While the exercise of this option could morph into an instrument of financial assistance by the ESM to individual member states, it would be rather problematic to attach to this instrument the macroeconomic conditionality under Article 12 of the ESM Treaty. Instead, as we argue, the granting of this assistance should mirror general eligibility criteria sufficient to ensure the protection of euro area financial stability, as defined above, in the same way as the Pandemic Crisis Support (PCS) has defined general eligibility criteria to support member states "whose economic conditions are still sound",[8] or the way in which the ECB defines eligible securities for its asset purchase programmes for the purpose of preserving the goal of price stability and the monetary policy transmission mechanism.[9]

As a new instrument of precautionary financial assistance to member states would still fall under the ESM Treaty general purposes, this could be established according to the procedures of Articles 6 (i) and 19 of the ESM Treaty as was done for the PCS credit line.

The second option would entail the ESM specifically targeting the sovereigns issued by a member state in difficulty with its open market purchases, as permitted under Articles 17 and 18 of the ESM Treaty. In this case we would be back into the domain of conditional financial assistance to individual member states requiring an adjustment programme under Article 16 of the ESM Treaty.

The establishment of such a facility at the ESM is inconceivable as long as public finances in some countries appear unsustainable or are feared to be so. Therefore, a precondition for the acceptance of our scheme is that the reform of the SGP leads to a more credible set-up for budgetary discipline of euro area member states, possibly entailing (as a minimum) a balanced budget constraint over the cycle that targets incremental debt reduction. Debt sustainability

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[6] The latter is an indispensable condition for the activation of financial assistance under the ESM Treaty. Also, the CJEU in the *Pringle* case held that Article 125/TFEU does not in principle prevent member states from granting any form of financial assistance to another member state, but that "the activation of financial assistance by means of a stability mechanism such as the ESM is not compatible with Article 125 TFEU unless it is indispensable for the safeguarding of the financial stability of the euro area as a whole . . ." Case C-370/12, Pringle, para. 136.

[7] The Scheme represents so many advantages for the ESCB members that we are of the opinion that they will feel adequately incentivised to sell their holdings to the ESM.

[8] As described in the ESM PCS Template and supporting decisions by the Eurogroup on April 9, 2020 and European Council endorsement on 23 April 2020.

[9] Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17) *OJ* L 91, 25.3.2020, p. 1-4.

analysis should in any event be a precondition to using the ESM sovereign purchase scheme under our proposal.

3. ESM Treaty underpinnings of the proposed ESM facility

3.1 General criteria

As mentioned above, with respect to debt purchased under the proposed scheme and held by the ESM to maturity, the member state remains responsible for its obligations and at no point does the ESM act as guarantor of those obligations. These two conditions make the scheme fully compatible with the general principles for ESM financial assistance developed by the CJEU in the Pringle case. As held there, Article 125 TFEU does not prohibit the granting of financial assistance by one or more member states to a member state that remains responsible for its commitments to its creditors provided that the conditions attached to this assistance are such as to prompt that member state to implement a sound budgetary policy.[10]

The ESM has the constitutional capacity to buy the bonds either from the ECB in the secondary market (Art. 18, henceforth Option 1) or have them issued to it directly by the member states and buy them in the primary market (Art. 17, Option 2).[11] This is something that the ECB cannot do under Decision (EU) 2015/774, which was reaffirmed by the CJEU jurisprudence[12] in order not to breach the prohibition of Article 123(1) TFEU (monetary financing). Therefore, in the context of Covid-19 debt, Option 1 may only be used for ESM purchases up to the level of debt originally held by the ECB and subsequently transferred to the ESM. Any further purchases under Option 1 (debt purchases on the open market) or under Option 2 (purchases directly from the member state at issuance) will be regarded as ESM financial assistance under Article 16. In this case it will attract the additional requirement of macroeconomic conditionality to fully comply with the (original and the revised) ESM Treaty and the *Pringle* judgment.[13]

In any event, the sovereigns purchased by the ESM would need to have a maturity, even if a very long one, and renewal should remain the subject of a discretionary decision taken by the

[10] *Pringle*, C-370/12, EU:C:2012:756, Paragraphs 137, 143.

[11] Under Article 1 of the ESM internal Guideline on Precautionary Financial Assistance, member states can only draw funds under precautionary instruments via primary market purchases, not through the secondary market. However, this condition may be changed by the ESM governing bodies to restore to full operability Article 18 of the ESM Treaty.

[12] CJEU in *Weiss and others*, Case C-493/17, para. 102 notes: "According to the wording of Article 123(1) TFEU, that provision prohibits the ECB and the central banks of the Member States from … purchasing directly from them their debt instruments". Also, the ESCB "cannot validly purchase bonds on the secondary markets under conditions which would, in practice, mean that its intervention has an effect equivalent to that of a direct purchase of bonds from the public authorities and bodies of the Member States" id. para. 106. Also *Gauweiler and Others*, C-62/14, EU:C:2015:400, paragraphs 95, 97.

[13] "Under Article 3, Article 12(1) and the first subparagraph of Article 13(3) of the ESM Treaty, the financial assistance provided to a Member State that is an ESM Member is subject to strict conditionality, appropriate to the financial assistance instrument chosen, which can take the form of a macro-economic adjustment programme; the conditionality prescribed nonetheless . . . is intended to ensure that the activities of the ESM are compatible with, inter alia, Article 125 TFEU and the coordinating measures adopted by the Union." *Pringle*, C-370/12, Paragraph 111.

ESM[14] based, among other things, on continuous respect of eligibility conditions described in the next section. This would ensure respect of the ESM Treaty requirement that the ESM would under no circumstances assume the debts of the member states.

3.2 Article 14 of the revised ESM Treaty

Revised Article 14 and the new Annex III of the revised ESM Treaty concretise the conditions for the granting of "Precautionary Financial Assistance" by the ESM. Under Article 14(1), the Board of Governors may decide to grant precautionary financial assistance to an ESM member "with sound economic fundamentals which could be affected by an adverse shock beyond their control" provided that the government debt of the member state seeking assistance is sustainable. The Board of Governors may decide to grant precautionary financial assistance either in the form of a precautionary conditioned credit line (PCCL) or in the form of an enhanced-conditions credit line (ECCL) in accordance with Article 12(1), subject to the fulfilment of eligibility criteria to be applied for each type of such assistance as provided for in Annex III.[15] Article 14 does not provide a cap as regards the type of assistance that can be granted under Article 14, unlike the PCS.

The eligibility criteria for granting PCCL are both qualitative and quantitative.[16] The quantitative criteria refer to the following conditions, which must have been met for the two years preceding the request of a PCCL: a) the general government deficit should not exceed 3% of GDP; b) the general government structural budget balance should stand at or above the country-specific minimum benchmark; and c) the debt/GDP ratio should be below 60%, or there should have been a reduction in the differential with respect to 60% over the previous two years at an average rate of 1/20th per year.

The qualitative criteria require that the requesting country should have access to international capital markets on reasonable terms and have a sustainable external position. It should also not be experiencing excessive imbalances or severe financial sector vulnerabilities that put its financial stability at risk.

[14] As regards the renewal at maturity of bonds held by the ESM under the proposed scheme, we acknowledge that if these renewals were to happen today, they would attract an adjustment programme. But as maturities under the proposed scheme could stretch to as long as 50 or 70 years, we assume that the proposed scheme will have been fully implemented by then, and triggering a macroeconomic conditionality will not be required, even if the bonds themselves were to be rolled over. At any rate "in the long run we are all dead". And to give its proper context to this famous Keynes' quote in his work *A Tract on Monetary Reform* (Macmillan, Dec 1923), JM Keynes, taking sides in the debate about the restoration of the pre-First World War gold standard, said: "Advocates of the ancient standard do not observe how remote it now is from the spirit and the requirements of the age ... [T]his *long run* is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."

[15] Annex III of the revised ESM Treaty offers a list of eligibility criteria for ESM precautionary financial assistance. These were determined having regard to: a) the Euro Summit Statement of 14 December 2018 which endorsed the term sheet on the reform of the ESM, and b) the joint position on future cooperation between the European Commission and the ESM, as annexed to the term sheet on the reform of the ESM, as well as to the roles and competences of institutions as foreseen in the European Union legal framework.

[16] Annex III, para. 2, revised ESM Treaty.

Where the criteria for granting PCCL are met there will be no need for the requesting country to sign a Memorandum of Understanding (MoU). Instead, the country will specify its policy intentions in a Letter of Intent (LoI), committing to continuous compliance with the eligibility criteria. Continuous respect of the eligibility criteria will be assessed at least every six months. The ESM member has the right to request funds at any time during the availability period, according to the terms agreed.

It is, however, unlikely that under the current macroeconomic conditions many ESM members can meet the eligibility criteria for granting access to the PCCL. Conversely, member states seeking to take advantage of Option 1 (purchase of their sovereign debt by the ESM in the secondary market) can be granted precautionary assistance if they satisfy the eligibility criteria for the ECCL facility. The latter is explicitly designed for ESM members that do not comply with some of the eligibility criteria required to access the PCCL but whose general economic and financial situation remains sound and where government debt is sustainable.[17] In this case the requesting country has to sign an MoU detailing policy conditionality, aimed at addressing weaknesses and requiring continuous respect of the eligibility criteria that were considered met when the credit line was granted.

In this regard, Article 12 of the ESM Treaty makes a clear distinction between "a macroeconomic adjustment programme" and "continuous respect of pre-established eligibility conditions". Given the clear inclusion of the term "macroeconomic conditionality" in the text of the original ESM Treaty and its reiteration in the revised ESM Treaty, it can be plausibly assumed that the drafters of the revised Treaty did not refer to a budgetary adjustment programme when they used the term "policy conditionality". If this is what they had in mind they would have said so. Therefore, unless in the event of a future referral the CJEU holds otherwise, the term "policy conditionality" must be taken to mean a broader set of policies than those covered by the "macroeconomic conditionality". The member state must at all times adhere to the "policy conditionality" in order to be deemed compliant with the Article 14 eligibility criteria. Naturally, restoration of broad compliance with the full eligibility criteria of Article 14 would be within some agreed timeline but the requisite policies would not necessarily refer to a pre-agreed economic adjustment programme, as would have been the case with an Article 16 ESM loan.

The policy conditionality could thus refer to a number of reforms to modernise the economy and the institutions of the member state concerned. For example, it could refer to the restructuring of the civil justice system or the decision-making processes of the member state's public sector, or to the retooling of the economy, to fostering green economy projects and the percentage of public expenditure that would be directed to them. These are only a fraction of the economic and institutional reforms a member state might agree to in order to restore full compliance with the Article 14 and Annex III criteria.

Accordingly, assuming that the ESM instrument proposed here under Option 1 follows the specifications of the revised Article 14, and such assistance is granted either as a PCCL or, more likely, as an ECCL facility, then that instrument could become a driver to promote governance

[17] Ibid. para 3.

standards in the member state in question (and across the euro area), bolstering its competitiveness and thus its budgetary position. Conversely, if it were held that the proposed Option 1 is assistance that exceeds the purpose of Article 14 ESM, questions would have to be raised as to the purpose and value of ESM precautionary assistance, which is the euro area's new crisis backstop to prevent an economic and market disturbance suffered by member states due to "an adverse shock beyond their control", as of course the Covid-19 pandemic is.

Having established the content and the limits of policy conditionality for access to the new facility, a last step needs to be considered. Under what conditions the new ESM facility would allow the purchase from the ECB bonds issued by all of the euro area member states at the same time (under Option 1), and indeed in the proportionate amount of such acquisitions as set in the ECB purchase programmes (the ECB capital keys). The preliminary condition is of course a policy decision by the Eurogroup and the European Council that such a facility is justified for preserving the financial stability of the euro area and combating financial fragmentation. These political decisions would in practice establish that all member states and the euro area as a whole would benefit from the facility as, despite having sound economic fundamentals, they could all be affected "by an adverse shock beyond their control" (Article 14.1). Accordingly, it is expected that they would all accept that the ESM will buy their sovereign debt from the NCBs and hold them to a long maturity – which would clearly be in their interest in view of the resulting increased stability and resilience of the euro area.[18] For one thing, the stigma sometimes attached to ESM assistance in this case could be overcome by the fact that assistance is granted simultaneously to all member states, on the basis of a similar set of eligibility criteria. For the same reason, any playing field concerns will be much more contained and will not become a matter of bitter intra-union political disputes, unlike the post-2010 country financial assistance and adjustment programmes. In any case, by approving the proposed common policy entailing the proportional purchase by the ESM of sovereigns held by the ESCB, the member states would have to undertake a commitment to let their sovereigns be part of the scheme.

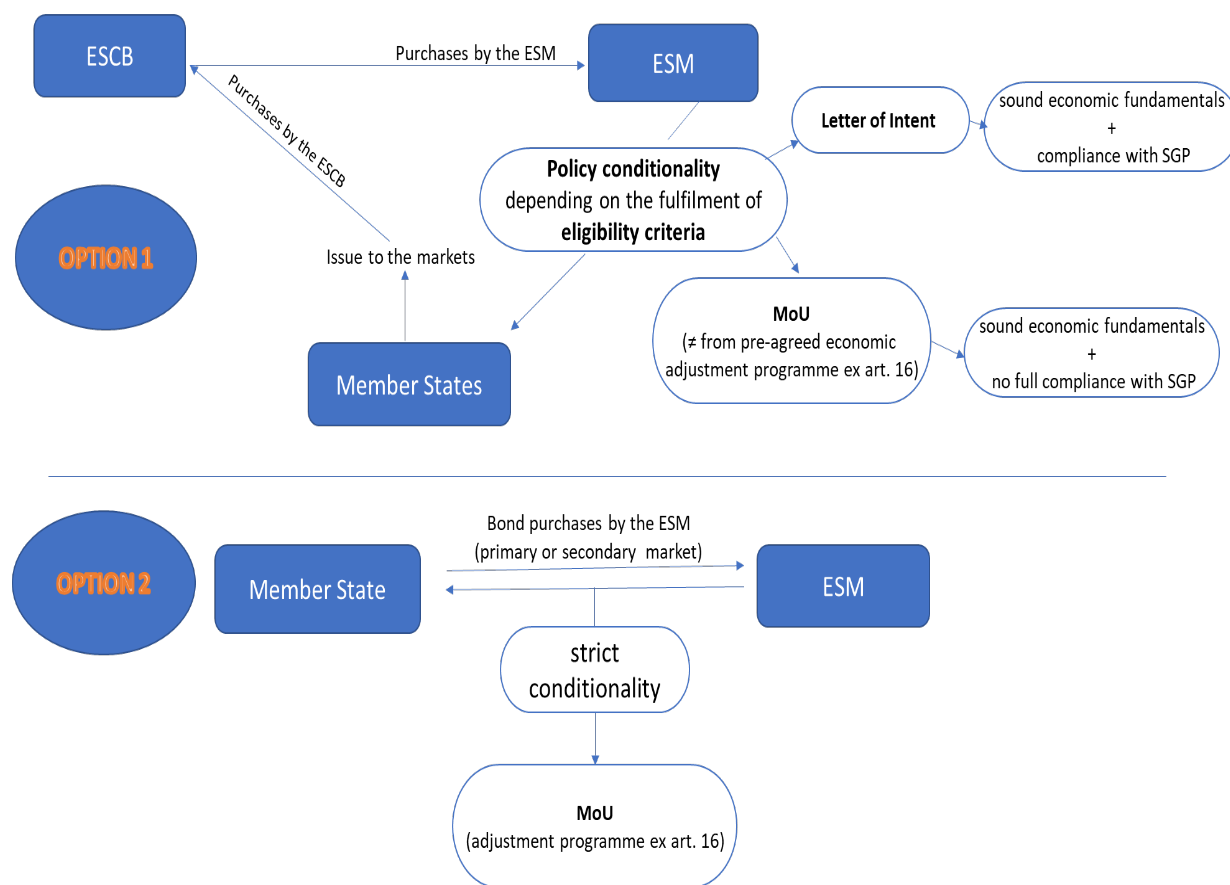
Under the ESM Treaty, these purchases would configure an act of financial assistance to each member state involved and would therefore require an assessment by the ESM that the policy conditionality for precautionary credit lines under Article 14, as has been discussed, are continuously met under appropriate surveillance procedures. In most cases this conditionality would boil down to respecting the policies indicated in the country-specific recommendations under the European semester. When this is the case, the requirement of a LoI with the ESM could perhaps be waived. However, in those cases in which eligibility conditions are not met and assistance would be granted under an ECCL, then an MoU would have to be signed between the member state concerned and the ESM, containing policy requirements in line with the eligibility conditions listed in Annex III – notably including that debt sustainability and the external position were not at risk.

In the figure below we summarise the different conditionality options open to member states as a result of the ESM purchasing national sovereigns from the ECB – from the light option of a

[18] For example, those member states that would be required to sign an MoU in order to become eligible for the programme are also those that would benefit most in terms of liquidity and borrowing costs.

simple LoI, to the need for an MoU with policy commitments to meet specific eligibility conditions, to a full adjustment programme when the financial stability or debt sustainability of a member state appeared at risk.

Figure 1. The options of ESM intervention



4. The economic and financial impact of the ESM sovereign debt facility

Excessive sovereign debt lowers growth rates by raising interest rates in the more indebted countries and engendering financial fragmentation. The key factor behind financial market fragmentation is the threat of sovereign debt restructuring and, ultimately, of the exit of a member country from the euro. With financial fragmentation, the risks of similar financial instruments and financial intermediaries in different euro-area members are priced differently by market investors, limiting cross-border interbank and capital flows, which in turn act as a major limitation on the ability of financial markets to cushion cross-border financial shocks.

The problem is aggravated by the incomplete architecture of the monetary union, which still lacks a cross-border deposit insurance scheme, a robust crisis resolution mechanism for banks, and a full public backstop in case of a systemic bank crisis, while banks continue to hold substantial amounts of national sovereign bonds. Consequently, the nexus between sovereign and financial sector stability, the so-called ‘doom loop’, has not been vanquished but may still reappear following, for example, a rating downgrade of a highly indebted sovereign to below investment grade.

The first question to ask is whether the proposed new facility at the ESM would help overcome or at least mitigate these effects. The straight answer is that it would, by reassuring investors that the orderly rollover of sovereign debts in financial markets – which have been raised to new heights by the Covid pandemic – would not be endangered by the potential winding-up of sovereign holdings accumulated by the ECB.

Investors' fears of future tax increases or dangerous bouts of financial instability could well be allayed through purchases of sovereigns by the ECB under open market operations, which lower interest rates by increasing liquidity and by facilitating the orderly rollover of sovereign debts. The announcement by the ECB that those bonds will be renewed at maturity reassures investors that liquidity conditions will not be tightened prematurely. However, the time of loose monetary policy is bound to come to an end at some point, forcing the ECB to start disposing of those sovereigns. Indeed, while today there is no conflict between the monetary policy inflation target and that of ensuring the smooth financing of large sovereign deficits, such a conflict may at some stage emerge, should changing economic and financial conditions require the ECB to tighten monetary policy and possibly require the ECB to sell some of its sovereigns. As mentioned earlier, even the gradual winding-up of ECB holdings can impact market expectations and destabilise sovereign bond markets.[19]

An earmarked portion of the ESM capital could cover any shortfalls in the ESM profit and loss accounts due to the interest rate differential between the cost of own-issued securities placed and the revenues on its sovereign holdings. As has already been noted, the possibility of ESM losses is remote but cannot be entirely ruled out in the present environment of negative interest rates on the bonds of some member states, even on long maturities. However, over time this anomaly is likely to disappear, and the overall sovereign portfolio of the ESM is likely to produce a total return higher that the rate paid on its liabilities – thanks to the ESM's high credit rating and the likely success of the suggested safe asset.

The figures in the consolidated accounts of the ESCB for 2020 demonstrate how remote is the possibility of the ESM incurring any substantial losses due to interest rate differentials. These figures show a tiny profit (of about €1.2 million) on its sovereign holdings for monetary operations of €2.9 trillion. With the cost of ESM issues at present around zero, the ESM would not show a loss because of its sovereign purchases.

A related issue concerns the sovereign purchase price paid by the ESM, as this could later result in capital losses. To the extent that the ESM is expected to hold these securities to maturity, it would be logical for it to pay the nominal price rather than the market price. Therefore, as mentioned in the previous section, there would be no need to mark to market its sovereign portfolio. The clear alternative would be for the ESM to purchase its sovereign securities at market price, in order to avoid generating gains or losses for the ECB, and then accepting the risk of capital losses. The good news on this score is that, typically in the euro area, when some sovereigns lose value others gain value, so that on balance any net losses would not be very

[19] This is not simply a theoretical possibility: many analysts are starting to see the risk of a return of inflation, should the sudden recovery of demand as the pandemic subsides meet with capacity constraints on the supply side. This possibility becomes more likely following approval by the US Congress of the enormous stimulus package (US$1.9 trillion) proposed by the new administration.

large – provided the ESM maintains balanced shares of all maturities within its sovereign portfolio.

The supply of a new safe asset fully guaranteed by the ESM capital and its holdings in member state bonds would pave the way to increase diversification of the sovereign portfolios of euro-area banks. The process could be encouraged by appropriate regulatory incentives and disincentives (Véron, 2017; Micossi and Peirce, 2020). Banks need a risk-free asset, available in large quantities, to underpin their liquidity-management operations, their market-making activities, the pricing of securities, and their investment and wealth-management policies (Basel Committee on Banking Supervision, 2017). They are not likely to abandon their home bias for a financial instrument issued by another sovereign – even by, say, Germany – as long as the prospect of the dissolution of the euro, however remote, or euro-exit and currency redenomination remains. Issuance of ESM liabilities backed by a wide range of euro area sovereign bonds would likely overcome this problem.

Interest rate spreads and financial fragmentation would probably be much reduced, although the problem will not disappear without the completion of the banking union. However, by bringing to the market a large supply of new high-quality assets, the scheme is likely to relieve the downward pressure on interest rates in the bond markets of safe (low debt) euro area countries, opening the way to interest rate increases even with present ECB policies remaining in place. Moreover, these ESM securities would price countercyclically, as they would become the haven for investors fleeing instability (Bini Smaghi and Marcussen, 2018).

5. Conclusion

Micossi (2020) argued that the increase in sovereign indebtedness under way in the euro area cannot be left for member states to manage by themselves but raises common policy action problems that must be addressed by a collective response. This paper develops and expands the proposal in that paper to discuss the mechanics, and the legal and institutional set-up of a new facility at the ESM to purchase sovereign debt from the ECB.

The Covid-19 pandemic will leave governments and private agents in the euro area with much higher levels of indebtedness in an environment of slow economic recovery in the medium term and after the initial bounce back. This would be the case for as long as relatively poor productivity rates, due to pre-existing structural weaknesses that were exacerbated during the Covid-19 pandemic, are not raised. Arguably, the traditional cure of budgetary restraint to repay sovereign debts would not be compatible with debt sustainability and would likely compromise the ability to heal the economic and social scars left by the pandemic. Preventative debt restructuring is also not recommended in practice as it could wreak havoc in the economies of highly indebted countries, increasing the cost of debt refinancing and undermining euro area financial stability, as clearly demonstrated by the Greek experience.

A common solution at euro area level is required, in view of the threat of important spillover effects that may come from the accumulation of high levels of sovereign debt within the monetary union. The need to ensure sufficient growth to safeguard debt sustainability is one such common action that requires a collective uplift of dismal pre-Covid growth rates. A more

important spillover effect is a direct consequence of the currency union, which operates under independent national fiscal policies.

Given that individual member states may not intervene in sovereign debt markets without the consent of all other member states, financial shocks hitting one country may degenerate into a systemic crisis. ESM financial assistance with Article 16 loans is only granted when a country is already on the brink financially, and the whole euro area's financial stability is under threat.

Since high sovereign debt ratios are the root cause of this potential source of instability, common policies may contribute to the solution by keeping substantial amounts of sovereign debt out of capital markets, thus mitigating investors' fears relating to denomination risk even if outright default is unlikely. They could also tame banking sector risks by helping banks reduce their national sovereign portfolios and partially substitute them with alternative safe liabilities.

The possibility of keeping those sovereigns out of capital markets for a period longer than justified by pure monetary policy concerns must be considered as a means to make the euro area more resilient financially. By contrast, as long as economic and financial conditions in the euro area remain as fragile as they are today, the announcement by the ECB of a decision to start reducing its sovereign portfolio may well engender deep financial instability and push highly indebted countries against the wall.

We suggest entrusting this task to the ESM. In this respect, we propose the establishment of a new credit facility within the letter and the spirit of Article 14 to enable the ESM to gradually acquire the sovereign bonds held by the ESCB and to keep them indefinitely, or at least for as long as is needed to avoid any destabilising effects of winding up the ESCB holdings. Our proposal is distinctly different from proposals suggesting the write-off of part of the ESCB holdings. To begin with, it respects all the limitations placed by the TFEU Treaty (Articles 123, 125) as set out in the relevant CJEU jurisprudence. Secondly, it prevents any political turbulence that may follow suggestions to disregard the TFEU limitations and reform the TFEU in the middle of a gigantic economic and health crisis.

Under the proposed plan, the ESM would raise money from the financial markets by issuing its own liabilities, which would be backed by its plentiful capital, member states' guarantees, and its sovereign holdings. The default risk on the sovereigns acquired from the ECB would remain with national central banks. Therefore, ESM liabilities would compete with other safe assets in the euro area and the international monetary system as a high-quality outlet for international investors. Moreover, this way the ESM would gradually evolve into a euro area sovereign debt management agency.

The key step forward is to decide whether under the proposed new facility the ESM could purchase the sovereign securities of all euro area member states at the same time, in the proportions set in the ECB purchase programmes (the ECB capital keys). This facility would free the ECB of the encumbrance of the sovereigns acquired under its APP and PEPP programmes and the associated concerns about the orderly rollover of sovereign debts in certain countries. As a result, it would help it to regain its monetary autonomy.

The preliminary condition is of course a policy decision made by the Eurogroup and the European Council that such a facility is justified to preserve the financial stability of the euro area and to combat financial fragmentation, goals that go well beyond the monetary policy target for inflation. These political decisions would in practice establish that all member states and the euro area as a whole would benefit from the facility as, despite having sound economic fundamentals, they could all be affected "by an adverse shock beyond their control" (Article 14.1) and would accept that the ESM will buy their sovereigns from the ECB over a prolonged period, spanning a decade or more, and hold them to a long maturity.

Under the current ESM Treaty sovereign debt purchases would constitute financial assistance to the debtor country and require appropriate conditionality. We have argued that this assistance should be managed under the precautionary credit lines of Article 14, which normally would not require a macroeconomic adjustment programme but only "continuous respect" of certain eligibility conditions. Compliance would be assessed by an adequate surveillance procedure. The eligibility conditions would in most cases coincide with those required for access to the PCCL and would boil down to the country-specific recommendations, to be assessed under the European semester procedures.

Where eligibility conditions are not met and assistance is granted under the ECCL facility an MoU would have to be signed between the member state concerned and the ESM, containing policy requirements in line with the eligibility conditions listed in Annex III – notably confirming that member state debt sustainability and their external position are not at risk. These requirements would still fall well short of a macroeconomic adjustment programme but could include reforms designed to improve the country's governance institutions and market functioning.

This approach is cumbersome and over time the ESM's role should be reviewed, elevating it to the position of a true debt management agency for the eurozone and thus going beyond the present design of a mere provider of financial assistance to member states. For this transition to be achieved at some future date, the success of the proposed facility would be instrumental. Only then would a treaty reform to empower the ESM to run the debt management facility as a separate policy become feasible.

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