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Abstract

The completion of EMU, and banking union as its critical component, requires that certain taboos in the policy debate are brought out in the open. First, the Commission must stop pretending that Italian public debt is sustainable under current policies and shift from politically motivated forbearance to serious implementation of the SGP and notably its debt rule. Second, it is necessary to acknowledge that crisis management by the ESM is crippled as long as its financial assistance can only be granted after the country in need is close to losing market access and, in addition, this threatens the financial stability of the entire euro area. The already-existing alternative to assist a country that is not respecting the SGP is to utilise the enhanced conditional credit line (ECCL) introduced by the ESM reform, approved by the European Council and awaiting national ratifications, in order to agree on a full-fledged adjustment programme before any euro area member (Italy) comes to the brink again – without any preventive conditions on the sustainability of public debt. And, third, the completion of the banking union requires a reduction of banks' home sovereign portfolios, that can be incentivised by the introduction of mild concentration charges. However, the system will not work without simultaneously offering the banks and financial investors in general a true European safe asset, fully guaranteed by its member states. Our proposal is that such a safe asset could be offered by the ESM, which would purchase in exchange the sovereigns held by the ESCB as a result of the quantitative easing asset purchase programme. The risk of losses on these sovereigns would continue to lie with the national central banks, thus avoiding the transfer of new risks to the ESM.

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1. Introduction

Negotiations on the governance of EMU have come to a standstill on a wide front encompassing the Stability and Growth Pact (SGP), the European Stability Mechanism (ESM) Treaty and banking union. It is high time to recognise that this gridlock cannot be resolved within the negotiating framework developed by the Eurogroup, which is flawed in its two basic premises: that financial stability of the euro area can be achieved without any arrangements for sovereign risk sharing; and that crisis management in the euro area requires the establishment of a mechanism of preventive sovereign debt restructuring. Recent events add a new urgency to the matter, as once again the euro area is confronted with rising financial fragmentation owing to a lack of coordination in the economic and financial response to the health crisis.

It is claimed that both premises stem directly from the no-bailout principle of the EU Treaty (Article 125 TFEU). However, the Greek debt crisis showed that the survival of the Economic and Monetary Union (EMU) may well make a bailout inevitable following systematic and prolonged violation of common fiscal rules. More broadly, the 2008-09 financial crisis and the subsequent euro area debt crisis showed that a common monetary policy in diverse countries may lead to the accumulation of unsustainable financial imbalances in the private sector which, following a financial shock, may then endanger the sustainability of sovereign finances (Micossi, 2015; Sandbu, 2015). The reasonable response by the European Council was to strengthen fiscal rules and to launch banking union in order to sever the link between sovereign debt and banking crises.

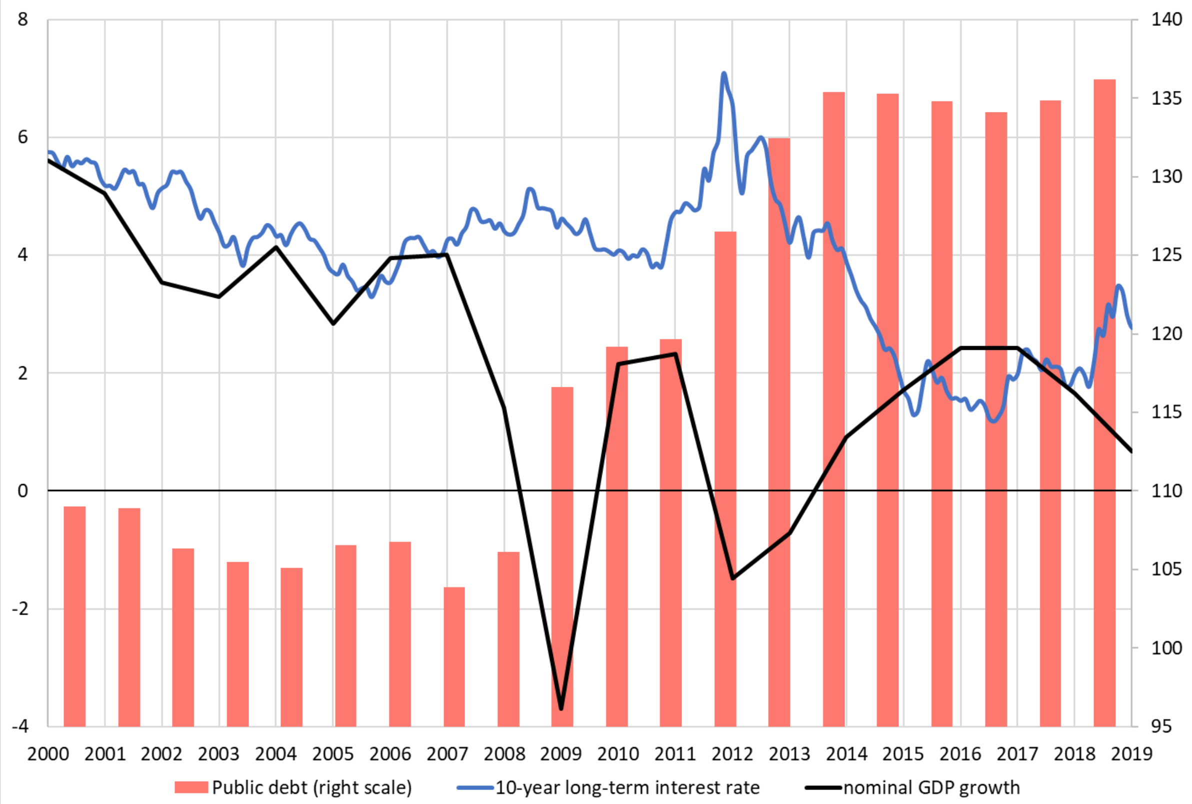
However, despite important progress on both fronts, the introduction of credible rules preventing unsustainable sovereign indebtedness has not been achieved; banking union remains incomplete, without its cross-border deposit insurance pillar supported by a credible fiscal backstop; and the main crisis management tool of the euro area, the ESM, has undergone a questionable reform entailing a stronger role of the creditor member states in granting financial assistance and problematic new clauses on preventive debt restructuring. As a result, financial fragmentation has not been eliminated and EMU remains exposed to idiosyncratic financial shocks, which may well require further violations of the no-bailout principle if the euro is to survive, the alternative being to let it unravel.

This note argues that it is high time to change approach and, rather than building ever further layers of opaque rules to accommodate incompatible negotiating red lines, to directly tackle the main stumbling blocks impeding a well-functioning EMU, thus reassuring financial investors that the euro will not be brought to the brink again. These stumbling blocks are the colossal Italian sovereign debt, the threat of sovereign debt restructuring when ESM financial assistance is sought, and the excessive sovereign exposure of some national banking systems. With these obstacles out of the way, a revised economic policy governance and the completion of banking union would no longer be the unattainable goals they unfortunately appear to be at the moment. Financial fragmentation would have been conquered.

2. Italy's sovereign debt is the main threat to EMU

Italy's sovereign debt reached almost 136% of GDP at the end of 2019, after rising by 30 percentage points between 2007 and 2014 and then hovering around that level ever since (Chart 1). This dramatic increase is by and large explained by the fall in GDP engendered by the twin financial crises of 2008-09 and 2011-12 – the largest fall in peace-time experienced by Italy since the country's unification in 1861 (Bastasin et al., 2019).

Chart 1. Italy - Public debt (% of GDP), nominal GDP growth (%) and 10-year long-term interest rate (%, monthly data)



Source: European Commission and ECB

Furthermore, since 2018, a positive gap has emerged between the average interest rate on sovereign debt and the nominal growth rate of GDP. Thus, while the current low level of interest rates mitigates the 'snowball effect' stemming from this positive gap, under current trends Italy's public debt is technically unsustainable.

On this, Bastasin et al. (2019) have argued that the long term sustainability of Italy's public debt is fundamentally endangered on the one hand by the growing rigidity of public expenditure, largely made up by pensions, salaries and interest payments on the debt; and, on the other hand, by the resulting implicit promise of future punitive taxation on business and private wealth that they see as a main reason for the collapse of private investment. Public investment also fell, bearing the brunt of the effect of expenditure reducing policies. The resulting stagnation of productivity has been aggravated by the halt, and even reversal, of economic reforms since 2016 (European Commission, 2019a and 2020) and by the distribution of generous public transfers by the last three governments (altogether some 2 percentage points of GDP) that destroy the incentive to work and endanger the sustainability of the pension system. The single currency brings important benefits in terms of lower interest rates and market integration, but it rules out any relief of the debt burden through higher inflation.

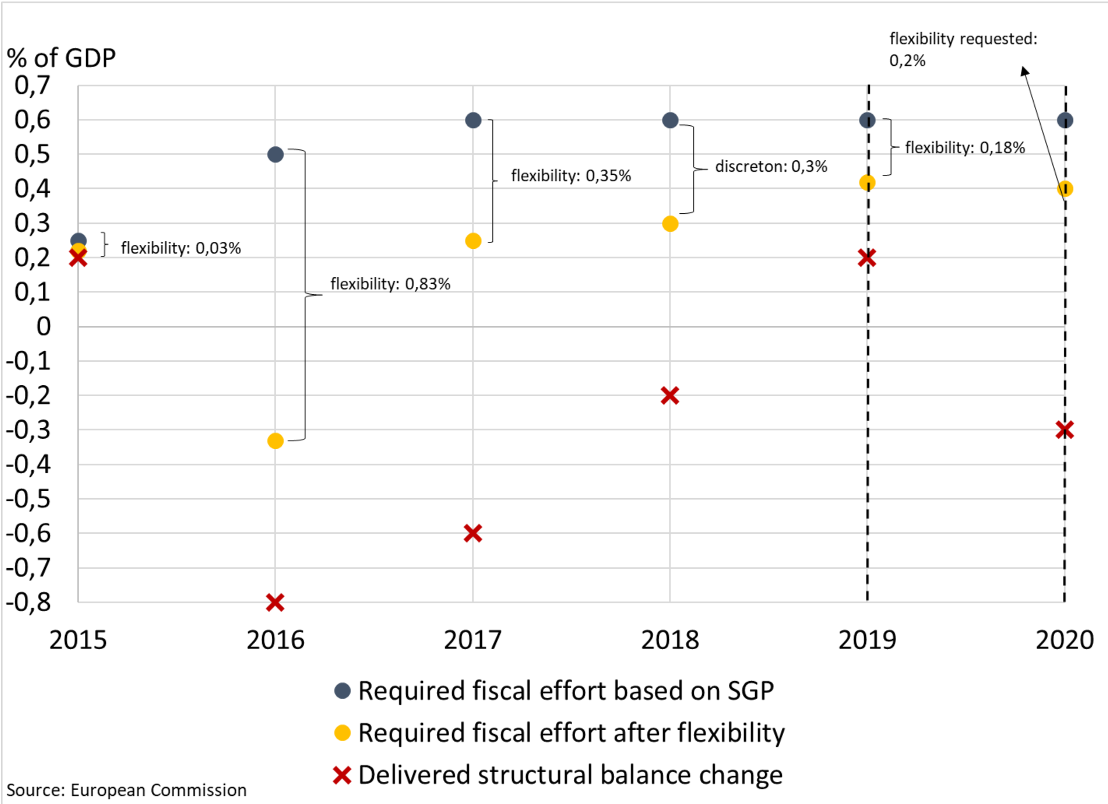
Chart 1 calls the attention to another important feature of Italy's predicament: clearly, the high variability of the interest rate on sovereign debt has not been driven by the evolution of the debt ratio but rather by external events and domestic political factors. Thus, the rise in interest rates in 2011-12 reflected contagion effects of the Greek debt crisis, which were only brought under control after the adoption of draconian public deficit reduction measures by the Monti government (at the end of 2011) and decisions by the European Council and the ECB (in the course of 2012) that dispelled investors' fears on the possible breakdown of EMU. Later on, large upwards jumps in interest rates were generated by the advent in the summer of 2018 of the anti-European 'yellow-green' government and the subsequent confrontation with the European Commission regarding respect of European budgetary rules. They were reversed when a new government, installed in the summer of 2019, adopted a budget law still not in line with European rules but looked on kindly by the European Commission largely on account of political considerations.

Thus, Italy's financial stability stands on a fragile platform of Commission forbearance, which so far has managed to sustain investors' confidence but is meeting growing opposition among euro area partners. And indeed, the adequacy of Commission policies on Italy under the SGP is open to question. What has happened is well summarised in Chart 2 that depicts budgetary goals under the SGP, the higher deficits tolerated under the various flexibility clauses (as under the 2015 Commission Communication), and actual outcomes (indicated by a bold X in the chart). As may be seen, since 2016 Italy has systematically failed to respect the deficit and the MTO requirements despite substantial flexibility allowances (cumulatively, €36 billion or over 2% of 2019 GDP); a further overrun in the order of 0.7% of GDP is already factored in for 2020, now likely to be aggravated by the coronavirus health crisis.

In its August 2019 Report, the European Fiscal Board noted that, following the approval of the Two-Pack reforms,[2] policy surveillance has concentrated on annual budgetary balances, shifting the nature of fiscal surveillance from a multilateral to a bilateral dimension and de facto giving the Commission solo responsibility for the opinions on draft budgetary plans submitted by the member states in October. In the case of Italy, which experienced dismal growth and increasing political turmoil over the period, this opened the way to a growing laxity in policy assessments by the Commission, motivated by the desire to appease a public opinion turning increasingly anti-European. The systematic divergence of national policies from the country-specific recommendations was by and large condoned by ever broader use of political discretion. With the benefit of hindsight, this was especially unfortunate in view of Italy's dismal growth performance, which is by no means of a cyclical nature but rather reflects deep structural factors depressing potential growth (cf. European Commission, 2020; IMF 2019; Ichino et al., 2019).

[2] Since the Two-Pack reform in 2013, under Regulation 473/2013 euro area members are required every autumn to submit their draft budgetary plans (DBP) for the ensuing year to the Commission and the Eurogroup. The Commission may issue a negative opinion when it identifies "particularly serious non-compliance with the budgetary policy obligations laid down in the SGP" in the DBP; in this case the country has to submit a revised DBP.

Chart 2. Italy, required and delivered changes of the structural balance (%)



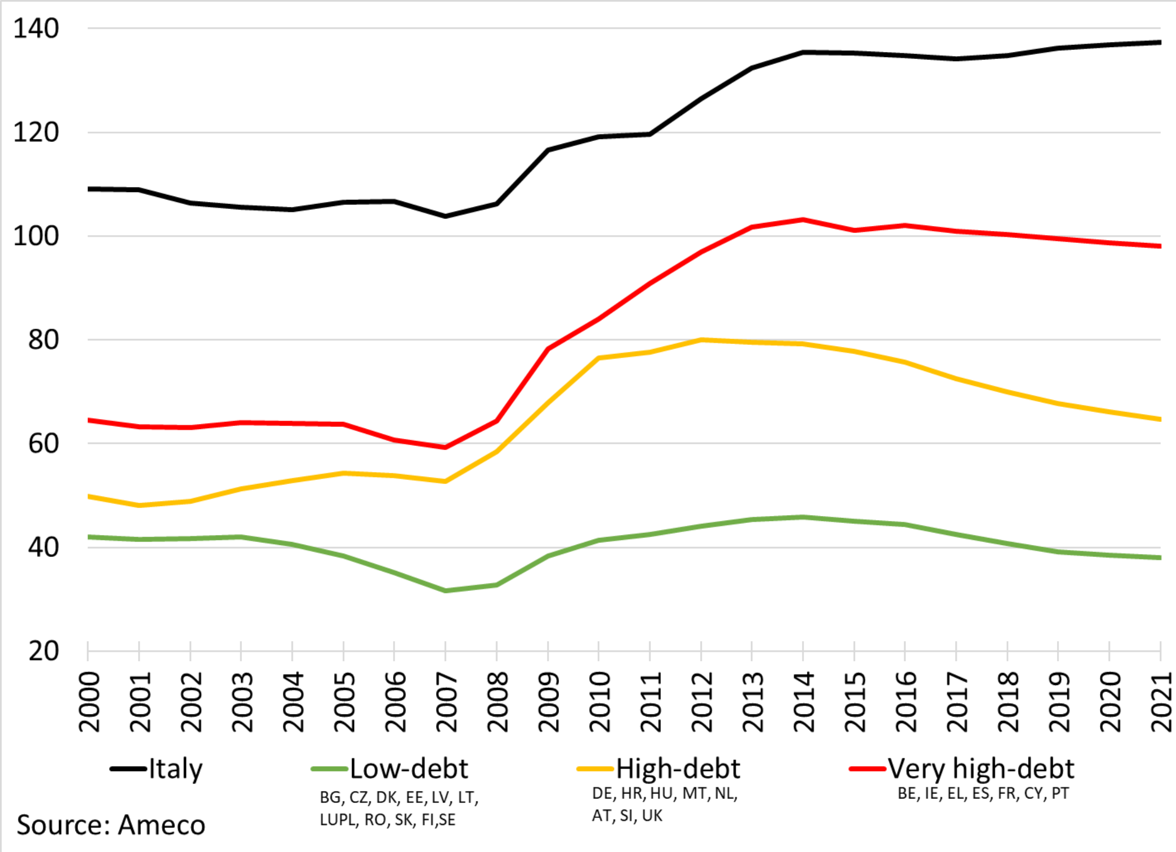
Data for 2019-20 prior to corona-virus emergency.

One implication of the emphasis on annual outcomes in surveillance by the Commission is that past overruns are not corrected; this is reflected in the cumulative deviation from the debt rule of the high-debt countries within the euro area. Chart 3 shows that in this regard Italy has become the extreme outlier in the euro area (together with Greece, which however is a special case that we will discuss in the next section), with reference both to the value of its debt-to-GDP ratio and to the fact that this ratio shows no tendency to decline. Both the Commission opinion on Italy's draft budgetary plan for 2020 and its earlier report on the respect of the debt rule (European Commission, 2019a and 2019b) stress in their conclusions that Italy is non-compliant with the medium-term objective (MTO) and the country-specific recommendations. The recent Italy Country Report (European Commission, 2020) concludes that Italy's economic imbalances are not expected to unwind in the near term while its debt-to-GDP ratio will continue to worsen in 2020 and 2021. Sooner or later investors are going to take notice.

Thus, also in view of the sheer size of its public debt, Italy currently stands as the single most serious threat to the financial stability of the euro area. If its high debt is not addressed with credible corrective measures, no progress can be expected in the negotiations on the completion of EMU and banking union.

One-shot debt reduction operations are not on the cards: following the mass privatisations of the 1990s, the sale of remaining public assets would do little to diminish the mountain of sovereign debt, and a fragmented political system is unlikely to bite the bullet and levy a large wealth tax on the substantial real and financial assets held by its citizens, which (according to Banca d'Italia's annual survey of household wealth) are equivalent to some eight times disposable income. The option of debt restructuring is also inconceivable on account of the massive disruption that it would entail for the economy, society and possibly even the survival of democracy in a country with weak political institutions and rampant populist parties (we will return to the issue of debt restructuring in the next section).

Chart 3. Debt ratio by groups of member states (% of GDP)



There is really no alternative, therefore, to the tough medicine of building a substantial primary surplus in the public sector – raising it from the present level of just above 1% to at least 3.5%, and more if the current low interest rates were to rise – and undertaking unpopular economic reforms. A credible commitment to debt reduction would bring the immediate benefits of lower interest rates, and private investment would likely come back, thus compensating the initial negative impact on demand of reduced net government deficits. The positive confidence effect on economic activity would be compounded by economic reform policies promising to lift potential growth.

In order to reap its full benefits, Italy's commitment to debt reduction and economic reform should be enshrined in a multi-year programme, approved by parliament and subsequently incorporated into an agreement with the European institutions, which would be capable of anchoring investors' expectations to a new stable path of domestic policies. As has been suggested by Marcello Messori (2019), a useful tool to this end may be offered by the new Enhanced Conditional Credit Line (ECCL) provided for in the reformed ESM Treaty (yet to be ratified by national Parliaments). We will return to this aspect in the next section.

3. Crisis management and debt restructuring

Crisis management in the euro area is built on various pillars that include the ECB monetary policy and market interventions, the reinforced SGP (after the Six-Pack and the Two-Pack reforms) and the linked surveillance procedure over member states' economic policies, and the ESM. The latter is the cornerstone: it provides financial assistance to member states that are at risk of losing market access, subject to strict conditionality, when this is indispensable for safeguarding the financial stability of the euro area (Article 3 of its founding Treaty). Moreover, the possibility of activating the ECB Outright Monetary Transactions (OMT) for the debt securities of a member state under attack is also predicated on the conclusion of a financing agreement or precautionary credit line with the ESM entailing appropriate policy conditionality.

These mechanisms do not offer a solid dam against speculative attacks: they may only be activated when a country under attack is coming to the brink of precipice, when this attack poses a threat to the stability of the entire euro area, and, in any case, after concluding an accord with the ESM entailing strict conditionality – which, of course, would require time and hard decisions to be negotiated. The very announcement that a country is seeking ESM assistance could trigger turmoil in financial markets. The September 2012 market stabilising operation by the ECB would likely not be repeatable without actual sovereign debt purchases under the OMT – which would also require agreement on an ESM financial assistance programme.

Against this background, the ESM Treaty reform – already approved by the Council but not yet sent for ratification before national parliaments owing to last minute Italian reservations – has given new powers to the ESM in assessing the conditions for granting financial assistance. First, the ESM, and thus indirectly the euro area member states who control its governing bodies, will now have own powers to "follow and assess the macroeconomic and financial situation of its Members including the sustainability of their public debt" (new Article 3). Up until now, the Commission was solely responsible for this assessment.

Moreover, in Article 13.1 it is now established that the assessment as to whether public debt is sustainable "and whether stability support can be repaid" will be undertaken jointly by: (i) the managing director of the ESM; (b) and the European Commission in liaison with the ECB. Based on these assessments, the final proposal to the Board of Governors of the ESM on whether to grant financial assistance, and under what conditions, will be made by the managing director of the ESM. This assessment "shall be conducted in a transparent and predictable manner while allowing for sufficient margins of judgement". In this context, the expression "transparent and predictable" evokes a notion of preventive debt restructuring, before granting financial assistance, based on objective quantitative indicators – as demanded by some member states; while the reference to "sufficient margins of judgement" indicates that, when financial assistance is sought, debt restructuring will not be the automatic result of quantitative indicators. Further ambiguity is added by Recital 12A, which specifies that in case of disagreement, the Commission will make the overall assessment on debt sustainability while the ESM will assess the ability of the member state concerned to repay the ESM. It is also envisaged (Recital 12) that "upon request by an ESM member and where appropriate, the ESM may facilitate the dialogue between the ESM member and its private investors on a voluntary, informal, nonbinding, temporary, and confidential basis".[3]

Thus, we end up with one thing and its opposite: an ambiguous result of convoluted bureaucratic compromises that is bound to create great uncertainty on the actual application of ESM conditionality in a specific programme of financial assistance.

The new emphasis on preventive debt restructuring derives from a famous 'non-paper' by Wolfgang Schäuble (2017), which was his legacy statement on the occasion of his departure from the Eurogroup; it was taken up by seven French and seven German economists in their influential CEPR Policy Insight paper (Bénassy-Quéré et al., 2018), and again resurfaced in the Franco-German Meseberg Declaration on Europe of June 2018. The argument runs as follows: there is a time inconsistency in the assessment of debt sustainability, because debt restructuring is overly expensive and hence there is tendency to delay the judgement of unsustainability and to keep on lending to a country that will not be able to repay its debts. This creates moral hazard and weakens market discipline.

The solution advocated by the French and German economists – within the context of a comprehensive proposal covering the financial system, new fiscal rules, a reformed ESM and the introduction of a EU safe asset – was predicated on the premise that there was a need to restore the credibility of the no-bailout rule (Article 125 TFEU), which was to be achieved by excluding insolvent countries from ESM financial assistance unless they first restructured their sovereign debt. In their view, this would strengthen the incentives for responsible fiscal policies and would prevent economically destructive 'gambles for redemption' that ultimately always prove fruitless.

Accordingly, they proposed legal arrangements to facilitate debt restructuring through the introduction of 'single limb' (single vote) aggregation of creditors in the restructuring negotiations to overcome the 'hold-out' problem – a proposal that is now incorporated in the ESM reform (Recital 11). More importantly, they proposed that the ESM develop its own debt sustainability analysis, using transparent and consistent criteria across countries "that would need to be assessed based on a data-driven method that can be reproduced and checked by the public". One option they mention is to envisage an automatic maturity extension of privately held debts for the duration of an ESM programme; another possibility is to have countries under a programme issue debt subject to automatic restructuring whenever the country concerned violated the expenditure limits agreed under the programme.

Two main objections have been raised to this approach. The first is at the same time analytical and empirical: as argued by Guido Tabellini (2017), as there is no evidence that countries' debt policies are motivated by moral hazard, resorting to debt restructuring to strengthen market discipline over fiscal policies appears misguided.

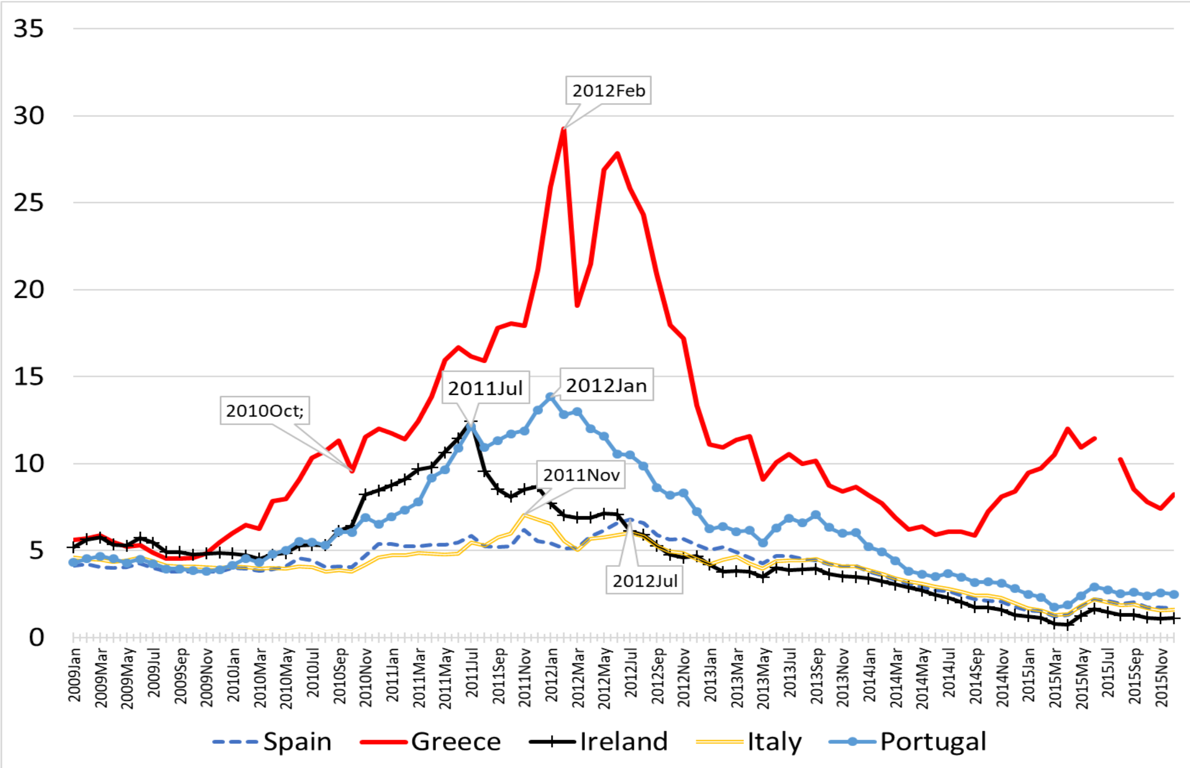
The second objection is even more compelling. Debt sustainability is not a stable condition that can be reliably measured with objective quantitative indicators, but rather evolves unpredictably with market sentiment (Messori and Micossi, 2018; Micossi, 2017). In a multiple equilibrium world, an unpredicted shock to confidence may tilt the balance from a stable to an unstable debt path; the announcement that a debt sustainability

[3] In the old treaty, the existence of the conditions for granting ESM assistance was to be assessed by the European Commission. The Commission would also determine whether the public debt of the country seeking assistance is sustainable, "whenever appropriate and possible" in collaboration with the IMF. No role was envisaged here for the member states.

analysis may qualify the stable configuration of the economy as (potentially) unsustainable may well become the shock shifting the economy to the unstable path.[4]

The behaviour of interest rate spreads between high-debt countries' sovereigns in the euro area and the German bund provides a clear illustration of the problem (Chart 4). Already in 2010 the news of a possible insolvency *cum* Grexit pushed the Greek interest rate close to 30%; it came down to below 20% on the announcement of an agreement with private creditors (concluded in March 2012), but shot up again following the difficult negotiations on a new rescue package.

Chart 4. 10-years long-term interest rate (%, monthly data 2009-2015)



Source: ECB.

Pretty soon investors started to look for other targets and rapidly pushed Ireland and then Portugal against the wall, forcing them to seek financial assistance from the EFSF (the EU facility preceding the ESM). In both cases, the governments decided to fully guarantee the banks' liabilities, in order to avoid worse damage to the economy, leading to a large increase in government debt. Contagion was heightened by the Merkel-Sarkozy announcement in Deauville that private creditors would have to participate in debt restructuring: Mody (2014) estimated that this announcement alone cost the Greek government an increase of 150 basis points in the

[4] These arguments are also reflected in IMF lending policies, notably its exceptional access lending. In its 2002 framework, this policy allowed exceptionally large financing when four criteria were met, among which one was that there is a high probability that the country's debt is sustainable. When this criterion was not met, debt restructuring would have to precede IMF lending. The Greek crisis convinced the IMF to adapt the policy with explicit allowance for the possibility that debt might be sustainable but not with high probability. This 'systemic exception' was introduced precisely out of serious concerns that upfront debt restructuring could lead to serious contagion effects in Europe and beyond. The systemic exception was later removed, but the policy still allows the IMF to lend when the debt is not sustainable with high probability as long as the member also receives financing from other sources, private and public. As to debt restructuring, the policy would also include the softer option of 'debt reprofiling', that is a (short) extension of maturities during the programme, with normally no reduction in principal or coupon.

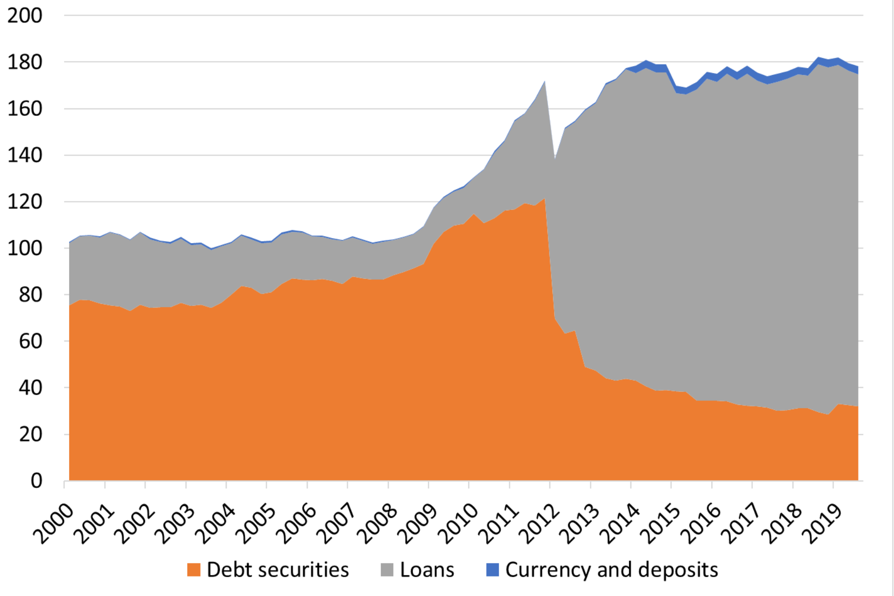
spread with the Bund. The subsequent decision in 2011 to restructure Greek private exposure detonated the start of contagion involving Spain, Italy and even France. In November, a rampant speculative attack obliged Italy to dismiss the Berlusconi government and call in former European Commissioner Mario Monti to enact a shock budgetary stabilisation package, pushing the economy into a deep recession. In July 2012, Spain negotiated a €100 billion financial assistance program from the EFSF for the recapitalisation of financial institutions, agreeing on a memorandum of understanding entailing mild macro-economic conditionality. Eventually, it took the ECB's new OMT programme, which was launched in September 2012 and promised unlimited purchases of sovereigns under speculative attack, to halt the run of investors on indebted countries in the euro area.

A careful empirical analysis of the factors driving the pricing of interest rate spreads for Greece by Gibson et al. (2014) concluded the following: prior to 2008-09, financial markets paid little attention to deteriorating economic fundamentals, and accordingly utterly failed to incorporate credit risk in the price of Greek sovereigns. Subsequently, following the revelation of the true state of government accounts (in 2010), sovereign downgrades by rating agencies and political uncertainty pushed up Greek sovereign spreads well above the levels justified by economic fundamentals. The study also found evidence of a separate effect of credit downgrades generating a perverse loop of rising spreads, falling economic activity, worsening debt sustainability, and again rating downgrades. We already observed in Chart 1 that the behaviour of Italy's spread seems unrelated to the government debt ratio but moves wildly in response to political shocks.

This evidence confirms what was already well known, that financial markets are not capable of ensuring fiscal or economic discipline but react rather erratically to short-term shocks. More important, debt sustainability may be affected by market sentiment in an unpredictable manner, making an objective and 'data driven' measure of debt sustainability quite difficult to achieve.

As to the effectiveness of debt restructuring in reducing the debt burden and restoring debt sustainability, Chart 5 shows that massive private debt restructuring in Greece in March 2012 led to an increase in overall government exposure, owing to the need to fill the gap created by vanishing private finance.

Chart 5. Greek government debt (%, of GDP)



Source: Eurostat

As Greece had already lost market access, an increasing role in providing liquidity to the Greek financial system was then taken up by the ECB, through its emergency liquidity assistance – which thus evolved from an emergency credit line for individual banks in difficulty to an emergency macro-financing channel (Micossi, 2015; European Commission, 2017b). The result is that Greek sovereign debt is now even less sustainable than it had been prior to private debt restructuring; the fact the most of it is owed to public institutions has pushed all talk of further debt restructuring into an indefinite future. Jeromin Zettelmeyer has argued that the bad outcome of the 2012 Greek debt restructuring is due to the delay in decisions (PIIE, 2020), but his interpretation strains credibility. From what we have seen, the sure effect of preventive debt restructuring is that of cutting the country out of all external financing and raising the cost of external finance to unsustainable heights, thus compelling the government to become the residual provider of finance to the economy. The only way to restore sovereign debt sustainability is debt relief (and the ESM is best placed to provide it with sufficiently long-term financing at concessionary terms).

This discussion points to an inevitable conclusion. While debt restructuring cannot be ruled out eventually as a component of actions to restore market access of a country unable to service its public debt, the notion that preventive debt restructuring when granting ESM financial assistance should simply be removed from the table is utterly destabilising. Debt sustainability, on the other hand can only be taken fully into account in adjustment programmes, as required by the ESM Treaty, to the extent that it is approached with tools that do not elicit an investor run – such as privatisations, domestic wealth taxes, or with a primary surplus maintained for a sufficiently long time to restore investors' confidence in the country, together with incisive reforms to strengthen potential output.

Building an effective crisis management system requires a further step – as has been described – to correct for the fact that financial assistance from the ESM only becomes accessible in conditions of extreme turbulence, i.e. when the concerned country is close to losing market access and the financial stability of the euro area is under threat. This set-up reflects the reluctance of potential creditors to intervene, but may encourage speculative attacks following the news that a country may be approaching the ESM for assistance. A confidence crisis that hits a country in the euro area is likely to spread to other member countries. As noted by Tabellini (2018), the resilience of the euro area is not much higher than that of its weakest member; therefore, reforms that increase the vulnerability of the weakest countries may well prove counterproductive for the financial stability of the entire euro area (Messori and Micossi, 2018).

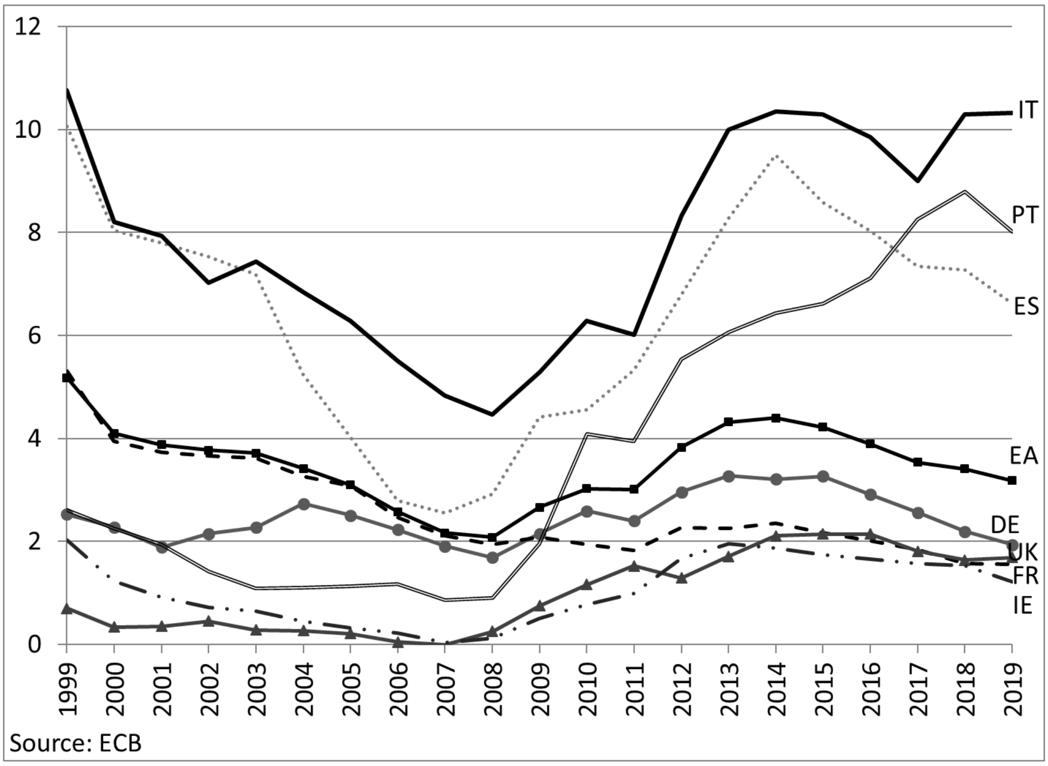
Fortunately, a way out of this conundrum is provided in the reformed ESM Treaty by the ECCL, its new precautionary credit line, which is accessible by a country that is not compliant with SGP rules but has a strong adjustment programme guaranteeing debt sustainability. The precautionary nature of this credit line excludes the detrimental announcement effect of the standard request of financial assistance; any actual resort to ESM financing could very well be avoided, as the country's market access would not be imperilled. The possibility to address mounting domestic financial imbalances without the risk of financial turmoil should offer sufficient inducement for member states to turn to this facility in good time – as shown by the successful financing operation negotiated by Spain in 2012 to restore the capital and viability of its banking system. Provided, of course, that national politicians are lucid enough to recognise the advantage of corrective policy action before the country arrives at the brink.

4. Tackling banks' sovereign exposures

The third issue blocking progress in the completion of banking and monetary union is banks sovereign exposure, which threatens the stability of EMU due to the potential resurgence of the 'doom loop' between the sovereign debt crisis and the banking crisis observed in 2010-12. The other main legacy risk of the twin financial crises in the euro area in 2008-09 and 2010-12 was the excessive accumulation of non-performing loans (NPL), but by and large this has been reduced to manageable proportions (especially in the banks under direct ECB supervision) thanks to strong supervisory policies as well substantial capital strengthening by the banking system over the past decade (EBA, 2019).

On the other hand, the sovereign exposure of some banking systems versus their sovereign remains exceedingly high, notably in Italy, Portugal and Spain (Chart 6). Relative to CET1 capital, this exposure was estimated to amount on average to about 140% (120% if the exposures are weighted with the banks' share in CET1 capital). Banks in Belgium, Italy, and Germany have exposure ratios over CET1 capital at or above 200%. A notable feature in this exposure that is directly relevant for the sovereign-bank nexus is its strong home bias: some three-quarters are represented by debt of their national sovereign (Véron, 2017).[5]

Chart 6. Sovereign debts held by domestic banks
(% of total assets, 1999-2019)



The sovereign-bank nexus is a straightforward matter. Distress in sovereign markets spills over into the banking system directly through their holdings of sovereign paper and indirectly through the state of the

[5] These data date back some years but probably still offer a reliable representation of the current situation.

economy; conversely, severe distress in the banking system may ultimately require government interventions that worsen debt sustainability (Basel Committee on Banking Supervision, 2017; Schnabel and Véron, 2018). The nexus could be substantially weakened, if not eliminated, by full cross-border deposit insurance; however, this would require that member states collectively share the risk of sovereign distress in one country leading to a severe banking crisis, thus de facto mutualising sovereign debt sustainability risks.

The immediate consequence is that the European scheme for cross-border deposit insurance (EDIS) proposed by the European Commission does not fly and EMU remains incomplete and gravely exposed to idiosyncratic financial shocks. Negotiations on this have endlessly turned around attempts at building cross-border deposit insurance without risk sharing – which core countries assimilate to a promise of bail out – by limiting joint support to a national banking system under stress to temporary credit lines to be repaid by the same banks when the crisis subsides. And indeed, in a different context, a credit line is the only last-resort backup by the ESM to the Single Resolution Fund that could be agreed upon in the Eurogroup for the reformed ESM Treaty.

However, deposit insurance without risk sharing will not eliminate financial fragmentation – at least not until all financial stability risks have been eliminated in high-debt members in the euro area. 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 acts as a major limitation on capital markets union. The threat of debt restructuring and, ultimately, of exit from the euro, is but another factor raising financial fragmentation, as investors seek the higher returns on low-grade sovereign debt but stand ready to flee at the slightest political shock.

Be that as it may, there is little doubt that banks' sovereign exposure in high-debt members of the euro area remains a main stumbling block to an agreement on EDIS. In recent years the Basel Committee on Banking Supervision discussed various possible changes to the regulatory treatment of sovereigns in banks' balance sheets – which at present are normally exempted both from risk-weighted capital requirements and from the large exposure limits.

The main options under consideration were the introduction of risk weights for most sovereign exposures in the banking and trading books and/or the introduction of concentration charges to discourage sovereign concentration risk. Other ideas that have been discussed include sovereign risk monitoring and stress-testing under Pillar 2 guidance, and enhanced disclosure of sovereign risk exposure under the Pillar 3 framework (Basel Committee on Banking Supervision, 2017). Proposals entailing capital penalties linked to sovereign risk rating were met by strong objections, mainly for two reasons: because the calculation of the risk weights for sovereigns is fraught with unsurmountable difficulties due the fickleness of market sentiment on sovereign debts; and because the application of risk weights linked to sovereign debt ratings would inevitably prove pro-cyclical, raising capital charges on banks and pushing them to unload their sovereigns precisely when these come under pressure in the market. The possible creation of a competitive disadvantage for EU banks internationally was also seen as an important drawback (Basel Committee on Banking Supervision, 2017; Véron, 2017).

Concentration charges, on the other hand, do not suffer from these drawbacks since they would be independent of debt ratings; for this reason, they have found widespread support among academia and policy analysts. At present, large exposures are limited to 25% of CET1 capital but the limit does not apply to sovereign exposures. The exemption would be removed for exposure ratios, relative to CET1 capital, higher than a given threshold (that could be well higher than 25%); after passing the threshold, the bank would be confronted with (mildly) rising capital charges linked to rising volumes in excess of the threshold. The identification of the threshold and the calibration of the concentration charges above that threshold would need to take account of the multifaceted role that sovereigns play in the balance sheet and operations of the banks. If appropriately calibrated and flexibly implemented, concentration charges may help reduce banking risks without weakening financial stability – against the background of strong debt reduction policies in high-debt euro area countries, as we have previously described.

Recent empirical research by Lamas and Mencia (2019) on Spanish banks' behaviour in periods of sovereign stress confirmed that the increase in sovereign portfolios was not motivated by moral hazard or opportunistic risk-shifting strategies, but rather by broad macro-economic factors, notably including financial fragmentation. They associate this behaviour to the pursuit of a hedge against the risk of an EMU break-up and the redenomination of the banks' liabilities in the national currency (cf. also Tabellini 2018). This calls once again the attention to the fact, not sufficiently appreciated in the policy debate, that financial fragmentation hampers the contribution of private cross-border credit and capital flows to risk sharing, ultimately raising the probability that a severe financial shock may require a bailout by euro area partners with official resources (Micossi, 2017).

The introduction of regulatory disincentives for banks' sovereign holdings will not work unless banks and market investors are provided with adequately large quantities of a new European risk-free or 'safe' asset to accommodate the diversification of sovereign portfolios (Visco, 2019; ESRB, 2018; Bénassy-Quéré, 2018). 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 – so long as euro-exit and currency redenomination remain possible.

Brunnermeier et al. (2017) made an influential proposal for developing sovereign bond-backed securities (SBBS) with varying seniority tranches, with the most senior tranche (European Safe Bonds, or ESBies) being as safe as the German bund. Being based on private contracts, their SBBS would not entail any risk sharing. A High-Level Task Force on Safe Assets, established by the ESRB, was set up to assess the feasibility and impact on financial stability of creating a market for SBBS. They concluded (ESRB, 2018) that the development of a demand-led market for SBBS might be feasible 'under certain conditions', but could not agree either on its desirability (for the feared impact on sovereign debt markets) or its viability without regulatory support (including the introduction of concentration charges to penalise banks' holdings of national sovereigns, the usability of ESBies as collateral in ECB operations, and complex enabling product legislation). The Commission followed up in May 2018 with a proposal for a Regulation on SBBS (European Commission, 2018), which Parliament and Council failed to approve before the end of the past legislature. Further possibilities in the same line of thought are discussed by Leandro and Zettelmeyer (2019).[6] All these proposals aim to create safety

[6] The first one is an 'e-bond' scheme where a public institution, e.g. the ESM, would lend to euro area members up to a limit set as a share of GDP, and then issue (single-tranche) securities backed by a portfolio of these loans. The loans would be senior to member states' sovereign debt issuances. The second proposal envisages that the euro area members would issue tranched sovereign bonds (with a limit on senior issuances set by reference to GDP and/or the debt stock); regulated private intermediaries would purchase a portfolio of the senior tranches and issue a single-tranche security backed by those tranced of national sovereigns. A different strand of proposals turns around the notion of a Redemption Fund to amortise outstanding sovereign debts (see Cioffi et al., 2019 for a

by combining diversification of the underlying sovereign risk with seniority; this last feature is most problematic due to its likely adverse impact on sovereign markets' spreads and liquidity.

More importantly, the very idea of building a safe asset without risk-sharing by euro area members seems an artefact founded on a wrong premise: that monetary union can survive indefinitely without some element of fiscal union, i.e., as a minimum, some joint sharing of sovereign risks. The reason is well-known, and yet consistently overlooked by many participants in the policy debate: the single currency generates a special externality due to the lack of a lender of last resort in national sovereign markets, which in turn entails the risk of default and currency redenomination (Micossi, 2017). Some sovereign risk sharing in EMU is therefore unavoidable to conquer financial fragmentation; it must of course be predicated on sufficient convergence of national fiscal policies.

Thus, the inevitable conclusion is that a European safe asset must be issued by an EU public entity – arguably, the ESM – and must enjoy a public guarantee against sovereign default. As argued by Bini Smaghi and Marcussen (2018), only such a 'genuine' Eurobond would bring sufficient benefits to the euro area – including the credible promise that the euro will never again be called into question, which is key to conquer financial fragmentation.

The simple scheme that we would like to propose is that the ESM would purchase the sovereigns held by the European System of Central Banks (ESCB) as a result of the asset purchase programme (APP) undertaken to enact its quantitative easing policies. The sovereigns would be purchased according to the proportions established in the APP, thus avoiding any undesirable differential impact on national sovereign markets. More importantly, the sovereigns purchased from the ESCB should continue to enjoy the present guarantee against potential losses offered by national central banks, so that no sovereign risk would be transferred to the ESM.

As a counterpart, the ESM would offer its own securities; its issues could be organised in suitable maturities reflecting the composition of its underlying sovereign portfolio. Like other outstanding ESM liabilities, these securities would be guaranteed by its sizeable (callable) capital; in addition, they would enjoy the guarantee of its member states already in place for ESM liabilities, in proportions determined by the member states shares in the ESM capital. This double guarantee, together with the guarantee maintained by national central banks on their sovereign paper, should be more than enough to ensure the Triple A rating for ESM securities without any special seniority privilege; a major drawback of the various proposals for a safe asset previously examined would thus be eliminated.

While of course these purchases by the ESM would develop gradually over time, they would eventually make available a total amount of over €2 trillion that would offer plenty of space for the diversification of banks' sovereign portfolios, as well for large investments by international investors. An adequate basis would thus be established for the development of a large, deep and liquid market for a European safe security, that would become the basis for a truly integrated capital market union and underpin the international role of the euro as a reserve currency and investment instrument.

review of the literature and a proposal); its main drawback is that, while it could facilitate the reduction of sovereign debt, its contribution to the creation of a safe European asset would only be temporary, i.e. for the time required for member states to reimburse their exposure to the Fund. Finally, Bini Smaghi and Marcussen (2018) have developed a 'purple bond' proposal as an alternative way to protect the seniority of the existing sovereign debt stock by means of a no-restructuring clause to be inserted in the ESM Treaty.

This scheme has several other attractive properties that are worth recalling. First, it would over time free the ESCB from the encumbrance of sovereigns in their balance sheets, thus creating suitable conditions for unwinding the large increase in their balance sheets after quantitative easing policies come to an end. As ESM purchases proceeded, the liquidity created by the asset purchase programme would be reabsorbed, but the ECB would receive cash from the ESM. It could then decide to purchase other sovereigns, to maintain an unchanged policy stance, or let its balance sheet shrink if it deemed that the existing degree of monetary stimulus was unwarranted. The time for such a decision will of course be postponed well after the current coronavirus crisis ends.

Second, 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. Moreover, these ESM securities would price counter-cyclically, as they would become the safe haven for investors fleeing instability (Bini Smaghi and Marcussen, 2018); and they could become the principal instrument of monetary policy operations, as the ECB could purchase and sell it freely without effects on national budgetary policies.

Interest rate spreads and financial fragmentation would in all likelihood be much reduced. However, the problem will not disappear without the completion of the banking union. For this, the ideas flagged by the European Commission (2017a) offer a well-structured way forward – by necessity eventually entailing the mutualisation of banking risks but in an environment in which sovereign risks would be tamed.

5. Conclusions

We have argued that the completion of EMU, and banking union as its critical component, requires that certain taboos in the policy debate are brought out in the open and broken. First, the Commission must stop pretending that the Italian debt is sustainable with current policies and shift from politically motivated forbearance to serious implementation of the SGP and notably its debt rule.

Second, it must be acknowledged that crisis management by the ESM is crippled as long as its financial assistance can only be granted after the country in need comes to the brink, which threatens the financial stability of the entire euro area. Moreover, the notion that financial assistance will be conditioned on a preventive assessment of the sustainability of the country's public debt heightens the destabilising potential of announcing that a country is seeking financial assistance from the ESM. The already-existing alternative is to utilise the enhanced conditional credit line (ECCL) introduced by the ESM reform in order to agree a full-fledged adjustment programme, also ensuring debt sustainability.

And, third, the completion of the banking union requires a reduction of banks' home sovereign portfolios, that can be incentivised through the introduction of mild concentration charges. However, the system will not work without simultaneously offering the banks and financial investors a genuine European safe asset, fully guaranteed by its member states.

Our proposal is that such a safe asset could be offered by the ESM, which would purchase in exchange the sovereigns held by the ESCB as a result of the quantitative easing asset purchase programme. The risk of losses on these sovereigns would continue to lie with the national central banks, thus avoiding the transfer of risks to the ESM. The ESM liabilities would also be guaranteed by its sizeable capital as well as by the guarantee of its member countries, according to their capital keys in the ESM, as already happens for ESM issues.

The safe asset would bring along some important benefits, including reduced capital inflows and higher interest rates in safe-haven euro area countries (Germany, The Netherlands, etc.). Moreover, it would price counter-cyclically, as it would become the safe haven for investors fleeing instability. It could become the principal instrument of monetary policy operations, as the ECB could purchase and sell it freely without any effect on national budgetary policies. And it would offer the basis for an expanded role of the euro in international capital marketsUnlocking the gridlock in EMU negotiations is taking on a fresh urgency as the euro area is once again coming under stress with rising financial fragmentation, as markets are spooked by lack of a common response to the daunting challenge posed by the coronavirus; once again, difficult decisions may have to be taken in unsettled financial conditions, due to our collective inability to advance in fair weather.

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