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CURING AND PREVENTING EUROAREA'S SOVEREIGN DEBT CRISES: SOME ISSUES AND A RECIPE

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1. Introduction

The sovereign debt crisis that has now been troubling the euro area for nearly three years originated as part of the scenario of the global financial turbulence that started in the summer of 2007, but it is characterised by specific causes and peculiar problems. The efforts to diagnose its causes, as well as to cure it and to prevent future difficulties of the same kind and severity, require careful consideration of the features of the institutions of the European Union, of the organisation of the financial sector of the euro area and of the economic policies of the member countries.

In order to offer a contribution to these efforts, the paper discusses a group of issues, organising the arguments by crossing two criteria: using as a scheme a "recipe" for cures and prevention of euro sovereign crises, with seven ingredients; and devoting special consideration to the Italian case.

Italy's role in the sovereign debt crisis has been crucial and special: its analysis can be instructive, for several reasons. The main reason is that the Italian sovereign problem is by far the most "systemic", compared with those that trouble the other peripheral euro countries. It is systemic because the illiquidity or the insolvency of the very large stock of Italian public debt are an enormous danger for all the euro area (an even for major countries outside Europe). But its systemic nature derives also from the opposite causality: Italy's debt is a wide sail, ready to suffer any serious turbulence affecting the global capital market, as soon as risk aversion increases, even if the country's fiscal behaviour is well disciplined and in spite of the fact that Italy has a proportionally smaller public deficit than other European problem countries and a considerable amount of private saving and wealth.

Italy's case study is interesting also because the country's fiscal discipline is deeply interconnected, more than elsewhere, with structural problems of productivity and competitiveness. As a consequence, the only way to seriously alleviate the sovereign debt problem in the short term is to increase the credibility of national policymakers as well as of European institutions that assist the country over the medium-long run with structural issues. The role of credibility (and therefore the potential disasters springing from multiple equilibria), which only in part depends on the short term strength and speed of macroeconomic

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adjustments, is such that Italy has relied a lot on the benefits coming from a sudden change of government, bringing to power a rather peculiar cabinet of non elected "technicians", as they are called.

The following sections are devoted to the seven ingredients of the recipe: two of them refer to adjustment policies and are dealt in section 2; section 3 discusses three ingredients for appropriate financing of disequilibria; section 4 is about two ingredients consisting in orderly default procedures for sovereigns and banks. The paper argues that all the ingredients are necessary and complement each-other. The case of Italy is used as the main example in the reasoning. Section 5 concludes with a comment on the irreversibility of the euro, as stated at the beginning of August by the President of the ECB.

2. Adjustment

2.1 The ingredients

The first ingredient, for the cure and the prevention of sovereign debt crises, is the presence of adequate domestic rules and incentives to adjust fiscal disequilibria. In building a framework for stability it is impossible to disregard the domestic stimulus to adjustment efforts, rooted in the political and institutional mechanisms of each country, as well as in the public opinion and in the economic culture of the population. External discipline and international rules cannot be effective and reach sustainable results if they are not perceived as coherent with national interests. When left alone, external discipline tends to prefer short-term non structural measures to reassure foreign creditors; moreover it can endanger other aspects of the international relations of a country and threaten the democratic legitimacy of its economic governance.

On the other hand, the separate consideration of individual national interests cannot result in stability and growth of a highly interdependent world. International interdependencies are particularly strong inside the euro area. Massive external economies and diseconomies are not accounted for when domestic decisions are taken by private or public agents; their impact tends to come back in a second round, after it has affected other countries, and then bounces again abroad, and so on. Therefore interdependencies do not allow to consider the global or regional interest as the sum of individual national interests, to be pursued in isolation or "exchanging favours" between countries with a "zero sum game" approach. In an interdependent word the concept of national interest must be reinterpreted, otherwise it becomes meaningless and even impossible to compute.

Fiscal adjustments to improve stability and growth must take into account the inadequate internalization of economic interdependencies. They must therefore rely on international coordination and, in the case of the highly integrated Eu and the euro area, they must also be guided by a substantial dose of supranational centralisation of economic policy decisions, which is therefore the second ingredient for curing and preventing sovereign debt crises.

Supranational decisions and constraints have an additional function, besides taking care of interdependencies: they often favour the achievement of national interest, *strictu sensu*, as they avoid distortions as well as the capture of deliberations by special interests and time inconsistencies in the national political decision process. European competition policy, for instance, is also a defence of consumers at the national level from domestic monopolies which would be more powerful without a supranational enshrining of anti-trust rules. As far as public finance disequilibria and their adjustments are concerned, a crucial role of supranational (supposedly virtuous) coordination is the defence of the interest of (national!) "future generations" that are under-represented in the national decision process.

Finally, the second ingredient is required as a complement to the fourth one, solidarity, that will be discussed later. Without supranational control, solidarity is a source of moral hazard and international support for national adjustment processes, as well as member states' mutual insurance against shocks, disequilibria and instability, is unacceptable for European citizens.

External discipline is often considered an unwarranted interference with national decisions, lacking democratic accountability, even if this criticism should not concern the initiatives of European authorities which receive their legitimacy from the member countries that they coordinate and discipline. Italy has a long history of external macroeconomic discipline, dating back to the fixed exchange rates of Bretton Woods and then to the international help received during the '70s, the struggles to comply with the EMS rules in the '80s, the management of the serious exchange rate crisis of 1992-95, the admission to the euro area followed by the first years of implementation of the Stability and Growth Pact. All in all, the experience can be judged positive: both the governments and the electorate have a long tradition of acceptance of the fact that external pressures are needed to remedy the weaknesses of the internal incentives to sound policymaking.

However, in 2011 the reactions to "Europe's" requests of policy measures were unusually controversial and bitter. Even Mario Monti, three months before his internationally highly appreciated appointment as premier of the country, wrote a newspaper article[2] highlighting the limits of the quality and of the effectiveness of policies dictated by a "foreign Podestà" like in the "seigniories" of the Middle Ages[3]. One of the main causes of the problem was the institutional disorder that characterised the enactment of European macroeconomic discipline in the hardships of the sovereign debt crisis. The action of the Commission was weak and ineffective, its relationship with the agonising Berlusconi's government was vain and its legitimate voice was badly mixed up with the pronouncements of the self-appointed and hardly convincing leadership of Sarkozy and Merkel. In such a confusing situation the stepping in of the Ecb as an additional unauthorised "foreign podestà" was badly received when a confidential, unusual and anomalous letter was made public by a newspaper[4]: signed by the president of the Ecb and by the governor of the Bank of Italy, the letter was setting detailed conditions for the central bank support to Italy's sovereign securities.

After becoming prime minister Mario Monti rushed to stress that the adjustments and the reforms were not imposed from abroad as they coincided with national interest and that the recommendations of the Commission and of the Council were coming from institutions with

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[2] Corriere della Sera, 7 agosto, 2011.

[3] Domenico Manegoldo di Tettuccio, from Brescia (a foreigner for Genoans) was the first "podestà" called in Genoa, in 1190, to settle internal fights, which he did in a rather bloody fashion. In the following two centuries Genoa had 78 foreign "podestà", before the establishment of Simon Boccanegra as a "doge perpetuo"; see: F.Bruni, *L'Italia nella crisi finanziaria e la denazionalizzazione della politica economica,* in (Bonvicini and Colombo eds.): "La politica estera dell'Italia", edizione 2012, Il Mulino, Bologna 2012, 27-52

[4] The letter, dated 5 August, should have remained confidential; it was "searched and obtained in indirect ways" by the Corriere della Sera and published, the 29 September, both in its original English version and in an Italian translation (www.corriere.it/economia/11_settembre_29/sensini_documento_bce_e68f29d6-ea58-11e0-ae06-4da866778017.shtml)

powers delegated by member countries, including Italy. Moreover Monti exploited the strong adjustment measures that his government immediately adopted to gain new influence in the European coordination process. But also along 2012, the Italian case keeps looking as a instructive example of the difficulty of stirring the indispensible mixture of the first and the second ingredients of the recipe for stability: domestic incentives and international pressures to adjust and reform unsustainably unbalanced macroeconomies.

For an easier mixture, obviously, the quality and the right speed of the adjustment plans matter a lot. Again, a discussion of Italy's plans can be instructive.

2.2 The optimal speed and quality of the adjustment: the Italian case

During the spring of 2011 the Italian fiscal adjustment was shaped with the Economic and Financial Document, following the procedures of the new version of the Stability and Growth Pact and jointly with the presentation of the National Reform Programme. As shown in **Table 1,** a balance budget was planned for 2014 with restrictive measures to be enacted in 2013-4. The Commission and the Council expressed their opinion in July. They did not object to the 2014 target for balancing the budget; their recommendation concentrated on the fact that corrective measures were insufficiently defined: "back up the targets for 2013-4 ... with concrete measures by October 2011"[5]. This official opinion has to be kept in mind in discussing the sudden acceleration of the adjustment plan that followed the speculative attacks on Italy's sovereign debt in August. Until July, while the quality of the adjustment appeared weak, the quantity and the timing were widely considered sufficient.

The later part of the summer exacerbated two problems: the contagion effects from the Greek crisis and the lack of credibility of the Italian government. The latter was also accused by domestic critics of unhealthy cunning in having postponed the restrictive measures until after the 2013 elections. The Ecb resumed its interventions under the Securities Market Programme and robust purchases of Italian treasury bonds were accompanied by a letter signed by Trichet and the Governor of the Bank of Italy containing a detailed list of measures to be considered "essential"[6], including the requirement to bring the balancing of the budget forward to 2013. The adjustment plan had to be precipitously corrected, also to take into account the worsening Gdp forecasts. With successive, controversial announcements, decision were taken to quicken the adjustment and balance the budget in 2013. They were summarised (see the figures in **Table 1**) in an official revision of the Economic and Financial Document dated September 22.

But the new plan turned out to be insufficient to calm the markets, due to the worsening of the turbulence in the euro area and an extremely confused political situation in Italy, also preventing a constructive discussion with the Commission, as the country's premier was at odds with his finance minister. The sovereign spread with the bunds skyrocketed and from 20 September to 7 October all the three major rating agencies downgraded the Italian sovereign risk. The consequent higher prospective cost of the Italian debt caused a further worsening of Italy's fiscal scenario; the adjustment path of the deficit/Gdp ratio was also endangered by a new deterioration of global Gdp forecasts. The political crisis precipitated and a new

[5] Council recommendation of July 12 2011, "Official Journal of the European Union", 21.7.2011, p.6-7.

[6] The letter (see footnote 4 above) was dated August 5 and was confidential but was later published by the daily "Corriere della Sera", causing several criticisms for the unconventional interference of the central bank.

government of "independent technicians", chaired by Mario Monti, was appointed in November with the support of a large bipolar majority in the Parliament.

After three weeks a government's decree adopted a package of severe fiscal measures. As far as the aggregate size and the timing of the adjustment are concerned, the package stuck to the previous government's commitment with the Eu. In particular, the balanced budget was set for 2013. The decision to pursue basically the previous deficit/Gdp targets (see **Table 1**) in spite of significantly worse Gdp forecasts was highly pro-cyclical. The reason behind the decision was probably the belief that a revision of the targets would have made more difficult the rebuilding of Italy's credibility on the markets. To enhance credibility, the quality of the measures was changed, making them much more concrete – for instance: with significant immediate tax increases and no accounting for the highly probable proceeds from the reduction of tax evasion – and implicitly worsening the previous government's forecasts of the deficit as well as the estimated impact of the measures adopted during the summer. This revisions can perhaps be inferred from the fact that the new adjustment plan implied a higher than usual elasticity of the estimated deficits with respect to forecasted Gdp: Monti's December plan shows an 0.74 average elasticity, while 0.44 was the average value in the September plan of the previous government; while Monti's self-correction, in April 2012, goes back to more traditional elasticities, averaging 0.54[7]. The prudence of the December plan was also shown by the forecasted marginal interest cost of debt refinancing which was assumed to stay as high as when the new government was appointed[8]. The short term provisions of the plan consisted mainly in increases of various taxes but the most radical, politically costly but credibility-enhancing measure was a deep reform of the pension system with substantial structural decrease in public transfers in the medium to long term.

[7] The Table below derives from **Table 1** the difference between the estimated unadjusted deficits, as a percentage of Gdp, and the target percentage deficits of the previous adjustment.

September 2011	2012	2013	2014	average
(i) Forecasted unadjusted deficit minus previous target	0.6	0.7	0.8	
(ii) % cumulated reduction of the Gdp forecasted *level*	1.1	1.7	2.1	
(iii) "elasticity" = (i)/(ii)	0.54	0.41	0.38	**0.44**
December 2011				
(i) Forecasted unadjusted deficit minus previous target	0.9	1.2	1.3	
(ii) % cumulated reduction of the Gdp forecasted *level*	1.1	1.7	1.9	
(iii) "elasticity" = (i)/(ii)	0.82	0.71	0.68	**0.74**
April 2012				
(i) Forecasted unadjusted deficit minus previous target	0.5	0.5	0.4	
(ii) % cumulated reduction of the Gdp forecasted *level*	1.0	0.8	0.8	
(iii) "elasticity" = (i)/(ii)	0.50	0.63	0.50	**0.54**

Dividing this difference by the percentage revision of the forecasted *level* of Gdp (by chance the percentage revisions of each year's Gdp forecasts have been rather similar in the September and in the December adjustment plans) one obtains the relevant "elasticity" of each year adopted in the successive plans.

[8] However the higher marginal rates used had small proportional impacts on the deficit forecasts, due to the maturity structure of the public debt.

During the first part of 2012 some improvement of the attitude of the markets towards Italian sovereign debt went together with a new (the third in less than a year!) significant worsening of the Gdp forecasts, especially for the current year. In preparing the new Stability Programme of Italy, issued according to the rules of the European Semester as part of the spring 2012 Economic and Financial Document, the Monti government did not react to the worse Gdp forecasts with further pro-cyclical deficit cuts. In fact in the revised figures the targeted deficit/Gdp ratios looked somewhat less ambitious that in the December plan.

But precisely during the spring of 2012 the world-wide issue of pro-cyclicality of fiscal adjustments was creating new panic on the markets. This fact had a negative impact also on Italy's sovereign risk measures. The issue was complicated by a rather impressionistic international discussion of the Treaty labelled "Fiscal Compact", widely perceived to be more rigid and pro-cyclical than its proposed text really was. The controversial contrasting of growth with fiscal rigor became mistakenly overwhelming.

In the case of Italy the issue was further confused by a misunderstanding of the relationship between the stock and the flow adjustment requirements of the debt to Gdp ratio. The "six-pack" rule requires the country to decrease the ratio each year by at least 1/20 of the difference between its excessive value and the Maastricht's 60% limit. This reduction was often presented as an element of additional fiscal restriction, going beyond the balanced budget constraint. This reading of the rule is obviously mistaken: balancing the budget allows any *nominal* Gdp growth to result in a decrease of the debt/Gdp ratio. As Italy's debt/Gdp ratio is currently a little higher than 120%, with zero deficit a yearly nominal growth (including its inflation component) of around 2.5% would be sufficient to comply with the 1/20 rule. A different issue is the difficulty of keeping the deficit at zero: in particular when, for a constant primary surplus, real interest rates increase or, for a constant real interest rate, the primary surplus decreases reflecting the bad cycle. But the official forecasts and the sensitivity analysis, as presented in Italy's Stability Programme in April 2012 (see **Figure 1**), are favourable: based on the current medium term adjustment and on long term forecasting techniques agreed at the Eu level, the debt/Gdp ratio will converge to 60% in less than 20 years even if the real interest rates were to double or the primary surplus shrink by 1/3 of its value in the baseline scenario.

Abstracting now from the specific case of Italy, what is a reasonable "theory" of the optimal speed of adjustment of excessive sovereign deficits and debts?

Once the path of adjustment of the public budget is designed in a cyclically adjusted way, avoiding the vicious circle between fiscal restriction and the slow-down of Gdp, the optimal speed along the path is mainly determined by the technically and socially feasible speed of the structural reforms and the reorganisations of the public administrations that must substantiate the adjustment. No other criterion can decide the right rhythm of a sustainable and efficiency-enhancing re-equilibrium of the public sector financial balance.

However, the optimal speed is somewhat higher than this benchmark speed based on the structural reform process. The reason is that when the plan of reforms and adjustment

Table 1 **ITALY'S FISCAL ADJUSTMENT PLANS**

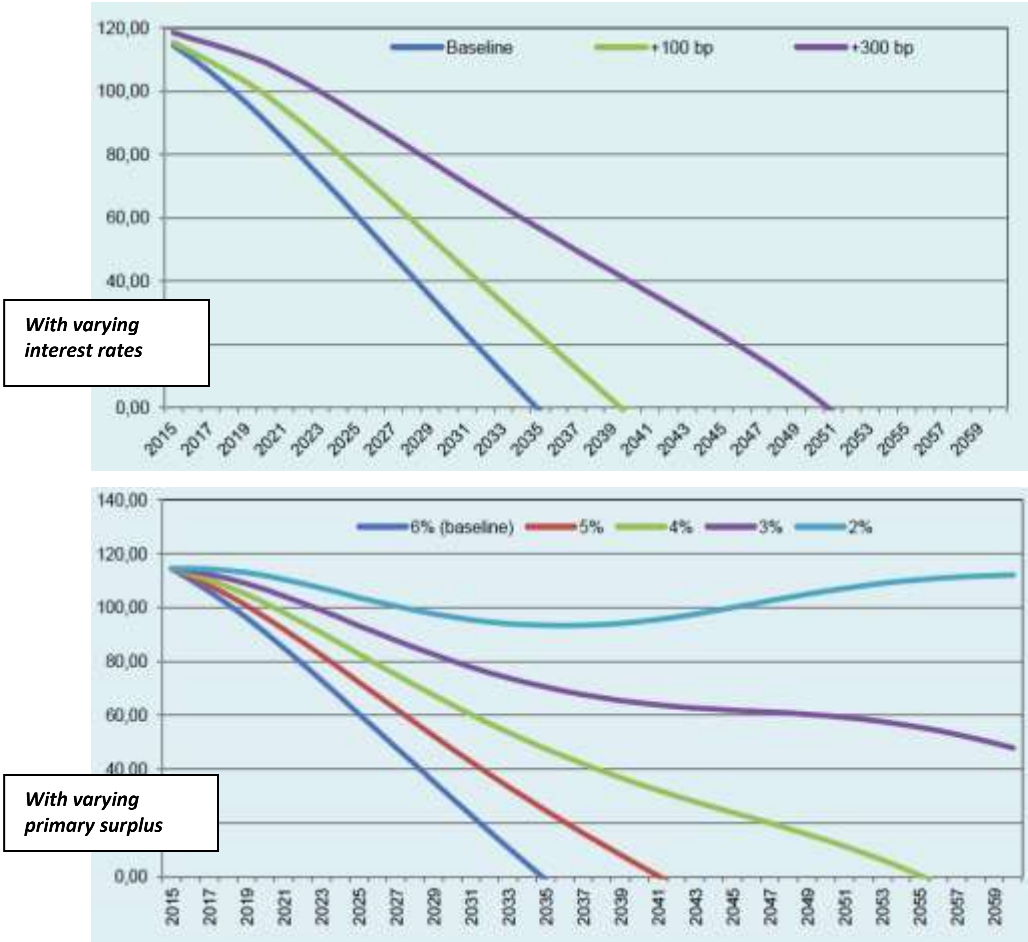
Adjustment plan	**2011**	**2012**	**2013**	**2014**
Spring 2011				
Gdp forecast	***1.1***	***1.3***	***1.5***	***1.6***
Unadjusted deficit	- 3.9	- 2.7	- 2.7	- 2.5
Planned adjustment	0	0	+ 1.2	+ 2.3
Target deficit	- 3.9	- 2.7	- 1.5	- 0.2
September 2011				
Gdp forecast	***0.7***	***0.6***	***0.9***	***1.2***
Unadjusted deficit	- 4.1	- 3.3	- 2.2	- 1.0
Planned adjustment	+ 0.2	+ 1.7	+ 2.1	+ 1.2
Target deficit	- 3.9	- 1.6	- 0.1	+ 0.2
December 2011				
Gdp forecast	***0.6***	***- 0.4***	***0.3***	***1.0***
Unadjusted deficit	- 3.9	- 2.5	- 1.3	- 1.1
Planned adjustment	0	+ 1.3	+ 1.3	+ 1.3
Target deficit	- 3.9	- 1.2	0	+ 0.3
April 2012				
Gdp forecast	***0.4***	***- 1.2***	***0.5***	***1.0***
Unadjusted deficit	- 3.9	- 1.7	- 0.5	- 0.1
Planned adjustment	0	0	0	0
Target deficit	- 3.9	- 1.7	- 0.5	- 0.1

All the figures are expressed as percentages of Gdp. Deficits have a minus sign, surpluses and restrictive adjustments a plus. Unadjusted deficit are calculated as if previously planned adjustments were enacted.

Author's calculations based on Italian governmental documents.

Figure 1

ITALY'S PUBLIC DEBT/GDP RATIO : FORECAST AND SENSITIVITY ANALYSIS



Source: Italy's Stability Programme, April 2012 measures starts, it cannot be fully specified and credible for the markets that must keep providing the financing of the deficit during the adjustment period. Therefore, in order to optimise the sovereign risk premium of the adjusting country, the initial fiscal restrictions, temporarily devoid of detailed connections with the reform path, must proceed somewhat faster than structural reforms, particularly so during a first phase of the path. To obtain this provisional extra speed it is intuitively easier and less distorting to resort more to temporary extra taxes (net of transfers) than to extra expenditure cuts, as public expenditure is more rigid and sticky and as the optimal path of expenditure cuts is more tightly connected that tax changes to the structural reform plan. The earlier portion of the time profile of fiscal adjustments has therefore good reasons to be biased towards tax increases, even when the optimal mix of the overall long-term adjustment is highly biased towards lowering public expenditure[9].

Opposite conclusions can be drawn from the literature on non Keynesian effects that render fiscal restraints expansionary and from macro models where sustainable fiscal consolidations are easier to obtain by limiting tax increases in favour of immediate substantial reductions of public expenditures. Purely macro and aggregate theories of fiscal policy can look unconvincing: the effects of changing taxes and public expenditures should take into account the microeconomics of the public sector and their structural impact on the whole economic system. Recent research has also de-emphasised the super-role of expectations on which the non-Keynesian effects are based and has shown[10] that fiscal multipliers are positive and much larger during recessions than in the upward phase of the cycle: during recessions fiscal consolidations must therefore be very gradual; moreover, in a depressed economy with financially constrained agents and where monetary expansions are unable to compensate fiscal restrictions, fiscal restrictions should initially rely more on tax increases than on expenditure cuts.

The role of tax increases in the first phase of a fiscal consolidation is crucial as well as controversial in the case of Italy, with the Monti government immediate tax rising decisions only gradually followed by a rational “spending review” and a gradual plan of expenditure-reducing reforms. The debate is still difficult and fierce and the Italian sovereign risk premium, besides being influenced by euro-systemic factors and contagions, is determined by the credibility of the speed and of the mix of adjustment measures as they are decided and implemented.

Early in July of this year the Council[11] has adopted the Commission recommendation to extend the deadline for the correction of the excessive deficit in Spain by one year, due to a further deepening of the economic crisis. An extension was already been granted in December 2009 due to the “steeper than expected decline in economic activity”. An extension has also been asked by Greece and might be considered for some of the other numerous countries subjected to the excessive deficit procedure. The general picture resembles to one where a basic mistake was made by European authorities in prescribing an exaggerated speed of adjustment of budgetary

[9] Accelerations of privatization plans can also be designed, sometimes, to use the anticipated proceeds for a faster lowering of the public debt; but this turns out to be sub-optimal if the deterioration of the general quality of the accelerated privatization program (taking into account also its impact on the competitiveness of the economy, on private sector productivity and on the incentives to proceed with structural reforms to reduce the deficit) turns out to be larger than the sustainable benefits for the sovereign risk premium.

[10] See N.Batini, G.Callegari and G.Melina, *Successful austerity in the Unites States, Europe and Japan,* IMF working paper WP/12/190, July 2012, and the literature review and bibliography that goes with the authors’ econometric analysis.

[11] www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/131676.pdf.

disequilibria during the global financial crisis[12]. Myopic speeds of fiscal consolidations can be as damaging as myopic debt-financed unsustainable expansions. Probably, it would have been better to pay more attention to the quality of the adjustment measures and to their effective implementation than to print on useless papers excessively severe numbers also worsening the credibility of the whole exercise in the mind of the markets.

But slower adjustments require financing.

3. Financing and solidarity

3.1 The ingredients

In order to allow adjustment plans to be of good quality and to proceed at a sustainable and correct speed, macroeconomic unbalances must be temporarily financed in such a way as to "buy" the time required for real reforms. To precipitate myopically the measures of adjustment can aggravate sovereign risks and worsen the real distortions that cause them: therefore finance is required to allow the right gradualism which, as argued above, coincides with the quickest possible rhythm of the phasing-in of the structural reforms that make the adjustment concrete and sustainable.

Two types of financing are required by the public finances of a country overburdened by debt. They constitute <u>the third and fourth ingredients</u> of the recipe proposed in this paper:

- collateralized <u>short-term financing by the central bank</u>, and
- <u>medium-long term financing jointly provided</u>, through various technical channels, <u>by the governments</u> of member countries, conditioned by the adoption of economic policies and measures agreed with the Commission.

Short-term support from the central bank is crucial: (i) to counter problems of illiquidity, when insolvency issues are still far away, looking to the systemic illiquidity risk well beyond the individual problem-country, in a macro-prudential perspective which implies, by symmetry, an early restriction of liquidity in the starting period of a credit boom; (ii) to kill destabilising short-term speculation and dominate market panics, without suffocating the price-pressures originated by the longer-term views that the market holds when considering the fundamentals of the debtor country; (iii) to insure the orderly functioning of the payments system and the smooth and homogeneous transmission of monetary policy during the crisis; (iv) to bridge the gap between the time when an unsustainable serious unbalance is unveiled and the time when the governments' medium-long term financing is available. Good collateral must be provided to the central bank against this short-term support, the cost of which should be in line with the central bank judgment of the quality of that collateral as well as with the key interest rate that characterises the current stance of monetary policy.

All in all, these functions and characteristics of the central bank's action in a sovereign crisis are not far from those of the classical Bagehot-type "lending of last resort" (Lolr), even if the Ecb would offer its support directly on the secondary market for sovereign securities besides channelling its help via its natural counterpart, the banking system. On the contrary, the expression Lolr is seriously misunderstood when it is used to mean, more or less explicitly, that the central bank must appear to the markets as the residual final debtor behind sovereign debts. There is nothing "normal", as some say, in a country where the central bank is perceived as the

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[12] This message is implicit in the previously cited IMF working paper by Batini et al..

LoIr is this latter sense: on the contrary, such a perception is incompatible with the monetary constitution and culture of the Eu, is an indicator of more or less absolute fiscal dominance, with no true monetary anchor and no central bank independence. To the extent that this is the situation in the Us and that their sovereign securities enjoy the alleged never-ending support of the Fed, the Eu would lose its institutional identity if it were to imitate this kind of American “normality”.

As to the long term financing by governments, intermediated by a suitable common “fund”, the orthodox model is the IMF conditional credit. But special schemes, tailored to the European needs, can be set up, as the bilateral intergovernmental lines of credit that have been arranged for Greece, the European Financial Stability Facility, the European Stability Mechanism and various types of so called “eurobonds”[13] that have been proposed or imagined since the beginning of the crisis.

In order to understand the conceptual problem behind long term governmental “mutual” financing, the nature of the credit risk which is associated with it must be made explicit. In principle this credit risk can be minimised with at least three techniques: by monitoring the implementation of the economic policies that make up the conditionality attached to the financing plan; by obtaining good guarantees as collateral; by “seniority”, that is by making official public lenders highly privileged with respect to private creditors. But it is precisely this potential lack of risk that weakens the effectiveness of the fourth ingredient of the stability recipe and requires a fifth ingredient, which cannot but consist in an adequate degree of “solidarity”. Without solidarity, long-term financing looks simply as an extended remedy to a long lasting liquidity problem; to the extent that there is a true solvency problem, solidarity is required: creditor countries must be explicitly ready to lose part of what they lend. The logic of the principle of solidarity is rooted in international interdependencies and in the fact that financial and economic stability is a collective international good, particularly so in a single currency area.

The precise form with which solidarity is associated to a system of mutual medium-long term sovereign credit support, as well as the dose of the ingredient of solidarity in the recipe, can be very different. After all, even a small bilateral loan of the German government to the Greek government, guaranteed by Greek sovereign securities, contains the principle of solidarity, to the extent that German taxpayers’ funds are at risk: the German acrobatic distinction between a forbidden (by the Treaty and/or by the German constitution) “solidaristic” bail-out from a self-interested support “to save the common currency”, looks more apparent than real. On the other hand, macroeconomic solidarity cannot be soundly and legitimately based on “generosity”: it can only be justified by public interests and international interdependencies.

It is crucial to acknowledge that it is impossible to guarantee the financial stability of the euro area without approving of the principle of solidarity, i.e. without being available to lose, that is to transfer unilaterally, at least a well defined and limited part of a member country’s resources to another country of the euro area which is in trouble in refinancing and repaying its international debts. This impossibility derives from two factors. First, the only way to prevent national governments to have a degree of autonomy sufficient to allow the wrongdoing required to put themselves in serious financial trouble would imply an unrealistically high degree of political unification and centralisation of Europe: moreover this unified Europe, by definition, would imply

[13] The issue of “eurobonds” can be arranged in different ways; some of them appear equivalent to conditional credit extended by a common fund “owned” by European governments.

a maximum degree of intra-European solidarity. Second, the other ingredients cannot be available in the quantity and quality required to do away with solidarity.

But also the relationship of solidarity with the other ingredients is one of complementariness. The most important example is its relationship with the second ingredient: centrally dictated adjustment and fiscal discipline is a complement of solidarity because it avoids solidarity resulting in moral hazard. But the reverse is also true: without solidarity, which involves every country in other countries' health, central discipline would have one less reason to be imposed.

While solidarity can be available in a continuum, so to speak, of different forms and doses, there is an important "discontinuity" when it takes the strong shape of a "joint and several" guarantee, such that all the guarantors are jointly obliged with all the others and the guaranteed can levy the execution of the guarantee on any guarantor. In the case of European sovereign debts the "joint and several" clause means that all the countries are jointly responsible for the repayment of the sovereign debts of every one of them, at least in certain specified circumstances. A simple and limited type of this strong solidarity is for a country to pay in its share of the capital of a fund that will then lend to countries in difficulty. The amount of solidarity embedded in each euro paid into the fund is obviously larger the less is the seniority recognised to the credits of the fund with respect to private credits. A substantial increase in solidarity[14] is associated, for example, with the political understanding recently reached by the Eurogroup[15] to transfer to the future ESM "without gaining seniority status" the financial assistance to be provided to Spanish financial institutions by the ESFS.

3.2 ESM and the Italian debt problem

The ESM project has been evolving along 2011-12, with several successive changes to the proposed text of the Treaty. The discussions around the project have turned a lot on the question of its size: will the fund be sufficiently large to substantially improve the view of the markets and to provide the amount of money required to stop the potential default (with or without the abandonment of the euro) of more than one member country of the euro area?

Italy is clearly interested in this issue. First, indirectly: if the ESM can calm the crisis in Greece, Portugal and Spain, Italy will suffer a smaller contagion and benefit more from the difficult policies with which has been able to cure its unbalances. But in case its unbalances turn out to be insufficiently adjusted, Italy's interest in the capacity of the ESM is more direct: is the fund adequate to help a sovereign debtor as large as Italy?

Other issues besides the size are worth discussing when considering the ESM. For instance, the role of "private sector involvement" (PSI) in the ESM-guided crisis management procedures, which seemed much more clear in the very first version of the project (the "Term Sheet" that appeared as an Annex to the conclusions of the European Council of 24/25 March 2011) than in later formulations of the Treaty[16]. But there is a fundamental weakness of the ESM concept which cannot receive a better illustration than the one provided by the case of Italy. This feature of the mechanism is the inadequacy of its powers and autonomy to combat systemic risk. This is a consequence of the bilateral nature of the ESM interventions that are directed to individual countries and subject to "strict conditionality", which prevents the possibility to act quite

[14] Not only the elimination of an obstacle to private financing flows.

[15] www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131648.pdf

[16] On PSI and ESM see section 4.2 below.

independently from a specific request of a problem country, to calm a systemic shock that can hit the European sovereign market in very different ways, as a consequence of events taking place in countries that do not coincide with those that suffer most from the shock or even in countries outside the euro area.

Consider the case of Italy and suppose that its government is able to fix in a credible way its public deficit and its medium-term growth potential. In spite of the adoption of the best possible mix of policies, Italy's public debt to Gdp ratio will remain very high for many years. As the country's sovereign securities are spread in the international financial market, every time a substantial decrease in risk aversion takes place at the global level, Italian securities suffer and are potential victims of speculative attacks. This is not a short-term problem due to destabilising market manipulation by destabilising unprincipled speculators: it is a medium-long-term "rational" weakness than cannot be attributed to the inadequacy of the country's adjustment policies. Suppose a large French bank becomes seriously illiquid or insolvent: the shock hits, at least, the whole euro area and Italy's public debt cannot but be seriously involved in the problem, without any responsibility of Italy's economic policies. The same would happen following, say, a financial disaster in the US or a sudden very hard landing of Chinese growth. This type of problem is the heart of the "systemic" profile of financial turbulences that is probably the most important "discovery" of macroeconomics and finance brought by the consideration of the post 2007 crisis. Being overexposed to systemic risks in the euro area adds a number of basis points to the sovereign risk premium of the country that should be dealt with under the joint responsibility of all the member countries. All of them, in various ways, will also benefit from the reduction of the risk premium.

But the ESM cannot effectively deal with this problem. According to the "concept" of the mechanism, the Italian government should take the initiative to ask the support of the fund and "sign" some special covenants to comply with the basic idea of "strict conditionality". This procedure, a part from the "stigma" problem that would unfairly burden Italy with serious prejudice for its access to private financing[17], doesn't make any sense: the ESM should be able to react immediately to the systemic turbulences, with autonomously decided timely interventions on the sovereign (as well as non-sovereign) securities of Italy and of any other country affected by the systemic shock. A different matter is the type of intervention, which is allowed by the ESM concept, required by the country where the problem is rooted and where the policies are out of order.

To be able to act effectively, autonomously, on its own initiative, against systemic problems, the ESM should have a much less intergovernmental nature, an independence and a managerial governance similar to those of the Ecb. The latter will in fact be involved in the management of the systemic crisis if the ESM cannot proceed: but the involvement of the central bank can easily be driven beyond the short-term and beyond the limits of its mission and of its accountability. The ESM was invented to dispense the ECB from performing functions that should be funded by governments, based on the consciousness of their interdependencies that generate systemic risks and require solidarity. But the ESM was conceived under the obsession of the idea that "strict conditionality" is needed to make sure that problems are solved by correcting the behaviour of the "bad guy". There are always bad guys around but systemic turbulences call for more that shooting

[17] Dangerous delays in the management of the European sovereign crisis were repeatedly caused by the stigma problem, combined with the fear to "be governed from foreigners", inducing Greece, Ireland, Portugal and Spain to postpone as much as possible the official request of international support.

at them. No strict conditionality can be enforced on a complex set of financial inter-linkages that propagate the shocks until very far from where the misbehaving policymakers are located.

The inability of the ESM to effectively cope with systemic crises in the sovereign securities markets is a serious minus for the whole euro area (and also outside of it) but it is a particularly important problem for the management of the medium-long term adjustment of Italy's macroeconomic unbalances. On the other hand, Italy's problem is particularly useful to understand this limit of the ESM. The possibility to autonomously decide interventions to limit the systemic risk premium paid by "virtuous" sovereigns (i.e. sovereigns that are not originating the risk), with no other conditionality except the requirement to remain virtuous, is, in a way, a special type of "fourth ingredient", that is of medium-term financing to allow the correct pace and to favour the best possible quality of a country's adjustment.

Italy has been active during the summits of June and July 2012 in pressuring the Eurogroup to allow the ESM to "automatically" purchase sovereign's securities of those member countries that pay an excessive sovereign premium but comply with the various recommendations and commitments defined with the Commission and the Council under the European Semester, the Stability and Growth Pact and the Macroeconomic Imbalances Procedure. No automatism has been obtained, even if a "flexible and efficient use of existing EFSF/ESM instruments" in support of those complying member countries has been promised[18]. "Flexibility" could mean that the request of the country and the conditionality attached to its support will only require a quick signature of a light-type of MoU. But this concession could turn out to be insufficient to prevent the "spread" of Italy's government bonds to substantially exceed the risk premium caused by Italian fundamentals, reflecting systemic problems associated, firs of all, with the potential contagion of Greek and Spanish issues.

The excessive spread could then complicate the adjustment of Italy's public deficit and debt and slow down the country's growth rate by influencing the cost of credit to the private sector. Italy's difficulties in adjusting would then backfire, hitting the whole euro area by increasing the systemic risk all over the place. When systemic risks are not managed with systemic interventions they tend to grow and further invade the system. Other countries could soon discover the seriousness of this problem, including France, which could see its spread over German bunds jumping up, with markets becoming less forgetful of the impact of systemic risks on French sovereign securities, precisely when Paris were to recognise with more transparency how serious are the needs of reform and adjustment of the country, i.e. precisely when a truly virtuous process were to start to fulfil those needs. A country's isolated action of "putting its house in order" is an insufficient remedy for systemic risk and, paradoxically, its announcement of more rigorous domestic policies can even wake up the markets in evaluating that country's exposure to the riskiness of the system as a whole.

Looking at the time profile of Italy's (and Spain's) sovereign spread over German bunds (see **Figure 2**) , the idea that the risk premium contains a large systemic component does look reasonable. After a substantial decrease following the appointment of the new government and its first impressive decisions, prolonged and helped by ECB's LTROs, the spread increases again. Only part of this inversion can be attributed to the obstacles encountered by Monti in enacting its domestic adjustment and reform plans. The correlation with the Spanish spread shows the relevance of contagion and of systemic effects, which become impressive in the second part of July (non reported in the Figure below), when Italy's spread increases just after the diplomatic success of

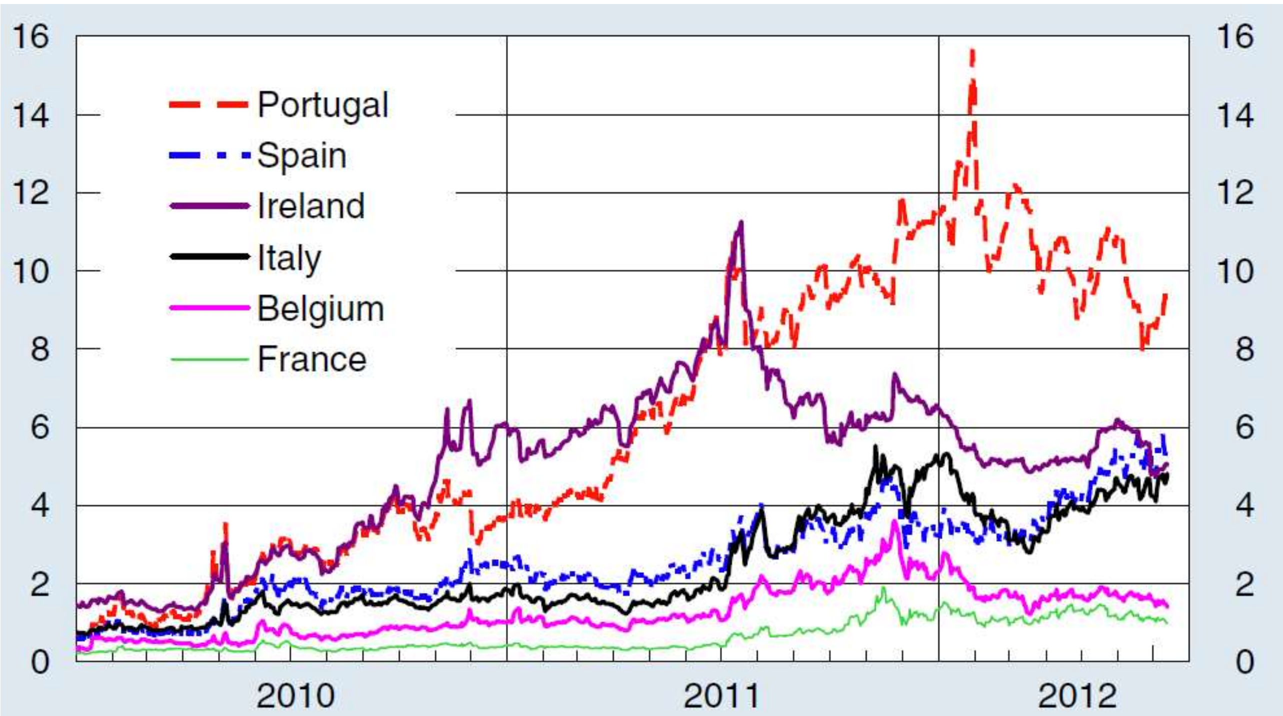
[18] As reaffirmed, for instance, in the Eurogroup statement of 9 July.

the premier in the G20 and Euro summits, the approval by the Parliament of the "fiscal compact" and the promising start of a long-waited and carefully prepared "spending review" which consolidates the solid and unrivalled primary surplus of Italy's multiannual budget.

The contagion from Spain is evident, but also Spain is obviously victim of the inability of Europe to adequately deal with the systemic risk problem: the jump in its spread on the 20th of July is contemporaneous to the approval by the Parliament of a very hard budget cut as well as, by the Eurogroup, of a 100 billion support programme for Spanish banks. Markets were clearly disapproving the fact that the support would not reach the banks directly but would increase the government's debt. Europe looked too slow to decide to take on its own shoulders the burden of adjusting debts and disequilibria that are also the result, as in the case of Spain, of the imprudence of British, French and German bankers, creditors and investors, the lack of European financial supervision, the contagion of the Greek mess, the very controversial and, therefore, badly defined responsibility of the ECB for financial stability, the insufficient size and autonomy of the ESFS and of the coming ESM, and other EU's faults as well. Insisting on an individual-member-state approach to systemic problems, with a punitive attitude providing help only with much trumpeted "strict conditionality", is a non-solution and a stimulus to international contagion.

FIGURE 2

Sovereign 10y spreads over German Bunds



Source: Bank of Italy

4. Crisis management

4.1 The ingredients

The lasts are not the least : the two final ingredients are crucial for the success of the recipe. They are interconnected because they deal with the two deeply interconnected problems that characterise the troubled scenario of the euro area: the sovereign crisis and the banking crisis. It is well known that sovereigns suffer also because they back the difficulties of overleveraged and imprudently invested banks and that, in turn, banks suffer also because they back sovereigns, having large amounts of governments' debentures in their portfolios. The interconnection greatly complicates the crisis management: it is important to be able to manoeuvre on the two fronts much more independently.

Moreover, on both fronts there is a taboo: "defaults" cannot be even mentioned, as they would produce unmanageable panic and self-fulfilling disasters. Governments and banks are financially sacred entities, apparently, that cannot go bankrupt. In reality, while the default of a country is conceptually different from the default of a private enterprise, the world has a lot of experience with sovereign defaults, even if only in cases of less developed countries with debts denominated in foreign currencies. They usually take the shape of "debt restructurings" and are sometimes kindly renamed "private sector involvements" (PSI); they have often been managed in effective ways by international finance, limiting contagions and the "stigma" effect that usually burdens for some time the defaulting country. As for the banks, the euphemism "resolution" is widely used to indicate special procedures that, taking into account the special nature of the banking firm, try to avoid interrupting the socially most delicate part of their activity. Italy's legislation and practice on bank crisis management and bank resolution are considered among the best[19].

Let us discuss first the issue of sovereign defaults in the euro area and then look at bank resolutions. In both cases there is an essential ingredient of our recipe: the availability of a precise and effective procedure for dealing with solvency crises. Our <u>sixth ingredient is therefore a clear set of appropriate rules for euro-sovereign defaults</u>; <u>the seventh is a good European regulation for banks' resolutions</u>. The idea that these things never happen, or can be dealt with as exceptional cases with improvised and ad hoc measures, seriously endangers the quality of crisis management. Hypocrisy and opaqueness cannot nourish a useful and "constructive ambiguity": the latter can characterise certain aspects of the *specific decisions* of the crisis manager, to limit moral hazard and market panics, but ambiguities must not be such as to conceal the basic rules, *the procedures* and the allocation of *responsibilities* in the process of managing the crisis. On the two fronts the European ambiguity is excessive and non constructive.

The next section deals with sovereigns and the following with banks. In the case of banks though, the ingredient consisting in an effective European resolution procedure is tightly linked to the much more complex and vast requirement that has been named "<u>banking union</u>", currently under discussion and preparation by the European authorities. In a sense, the banking union is an integral part of our seventh ingredient.

4.2 Sovereign orderly default procedure

The problem of sovereign defaults in the euro area has two peculiar aspects. First, member countries are "advanced", instead of "less developed" as was the case in the many defaults

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[19] G.Boccuzzi, *Verso un nuovo assetto della gestione delle crisi bancarie. Il dibattito internazionale e il modello italiano*, "Quaderni di ricerca giuridica", Banca d'Italia, n. 71, ottobre 2011.

happened in the last decades: the possibility of their insolvency has never been contemplated. Second, their debts are mainly denominated in euro, which, from a certain point of view, is their national currency: as such one could presume that money can be provided without limits to reimburse public debts or, at least, that its potential availability could in part reassure their creditors. But the euro is supranational, created by a common and independent central bank with the mandate to preserve price stability as well as to contribute to certain aspects of financial stability that are relevant for monetary policy and for the soundness of the payments system. The ECB, to be sure, has the statutory prohibition to lend to governments. Therefore, sovereign debts do contain a true risk of default, in case expenditure cuts, tax collections and other forms of refinancing, turn out to be insufficient for their reimbursement.

During the first ten years of life of the euro, markets have overlooked this risk; they then started to take it into account with increasing attention, to the point of making it a major element of portfolio choices and speculations. The mere availability of a national printing press, even in presence of de facto and/or de jure central bank independence, is probably the main explanation of the fact that the cost of the UK debt is lower than that of some less indebted countries belonging to the euro area. Moreover, sovereign defaults in the euro area have been increasingly perceived as a catastrophe, because their risk cannot easily be distinguished from the risk of the end of the European monetary union: analysts now tend to read euro sovereign risk premia as premia for exchange rate risk. Defaulting and abandoning the euro are often considered as inevitably joined disasters. Models of multiple equilibria explain how the expectation of sovereign defaults can be self-fulfilling[20]. The role of expectations in these models provides the basis for a type of contagion that could progressively transform the default of a single sovereign in a complete break-up of the euro zone.

However, one is not far from truth when saying that the riskless nature of the sovereign debt of an EU country has been considered an implicit “dogma”, and that sovereign defaults have been excluded as a matter of principle, at least until the crises of Greece, Ireland and Portugal have forced the markets and the authorities to bring the dogma into question, even if in a confused, disordered and somewhat hypocrite way. The main consequence of the dogma is that no public, official, orderly sovereign default procedure must be provided in the euro area: the existence of such a procedure would indeed sound as a contradiction of the dogma and may even encourage defaults. Sometimes the arguments in favour of the dogma have something in common with those that were used in the 90s to combat, unfortunately with success, the IMF proposal of a Sovereign Debt Restructuring Mechanism[21].

The necessity of a “private sector involvement” (PSI) in the euro area has been semi-officially mentioned for the first time, with an unexpected violation of the dogma, in an informal meeting (a promenade along the Deauville seafront) of Sarkozy and Merkel on the 26th of May 2011; according to some, that mention of the idea triggered the speculative process that aggravated the sovereign debt crisis in July and August, involving Italy in the front line. Later, an effort was done to reassure the markets stating that the PSI was intended as an extreme measure to be considered only in the absolutely exceptional case of Greece.

[20] Paul De Grauwe, *The Governance of a Fragile Eurozone,* CEPS Working Document, No.346, May 2011, www.ceps.be/book/governance-fragile-eurozone.

[21] See: Anne O. Krueger, *A new approach to sovereign debt restructuring,* IMF, April 2002 (www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf) and the debate that followed the proposed project.

But during the following summer, markets caused the skyrocketing of Italy's default risk premium. The Italian case is particularly interesting in the discussion of the reaction of Europe to the possibility of sovereign defaults. The possibility of an Italian default had been for some time kept behind the main stage of the crisis, as a tremendous but improbable danger. The size and the wealth of the country, together with its very high debt to Gdp ratio, render the dogma of the impossibility of a sovereign default more natural and, at the same time, more indispensible to avoid the panic and the massive contagion due to the very wide international diffusion of Italian treasuries. However, as the refinancing of Italy's public debt started to become increasingly difficult, it was precisely the Italian case that, paradoxically, obliged European authorities to tackle the dogma in a more explicit way, trying to take general decisions on the potential role of sovereign debt restructuring and PSI in the rules to manage a financial crisis.

As a matter of fact, since 2009 markets have shown disbelief in the dogma, as they have been asking interest rates on government securities that contain very substantial risk premia. These interest rates have exerted a significant "market discipline" on governments' budgets. The disciplinary action of financial market tends to be discontinuous, myopic and often destabilising. But market discipline still provided a valuable contribution to increase and speed-up fiscal discipline in the euro area where the disequilibria in public finance are often associated with fragile and unstable political situations. The codification of the "dogma", that is of the principle that euro sovereigns cannot default, would kill myopic and destabilising speculation but would also block any disciplining stimulus coming from government bond markets. An increased moral hazard would result both for governments and for the investors that imprudently buy their debentures. This moral hazard is a first reason to eliminate the dogma.

What is needed is a filter for the disarranged and short-sighted action of the markets; the filter should try to preserve that action's medium-term disciplinary pressure while avoiding the unjustified transformation of illiquidity in insolvency and moderating short-sighted speculative attacks that have no rational basis in the fundamentals of the situation of a country's public finances. Such filtering is a difficult and perhaps overambitious task, but there it has to be tried, using the ingredients of the recipe for financial stability that have been illustrated above in discussing the financing of gradual adjustment paths. Also in this case, the ingredients prove to be complements: the existence of the possibility of default needs the assistance of the stabilising action of some short and medium term financial help for the debtors; and conditional, negotiated financial help makes sense only to the extent that a default is possible.

The second reason to avoid the sanctification of the dogma is that, anyway, markets do not find it convincing. Proclaiming that sovereign defaults are excluded by principle, appears foolish to financial operators and causes a loss of credibility for the authorities that affirm the dogma. It means stating that the level of interest rates on government bonds reflect a risk that does not exist, thus insultingly contradicting a strongly held opinion of the markets. It also means thinking that the other ingredients of the recipe suffice to guarantee the solvency of governments; it means relying, in particular, on three among them: the central control of the adjustment process (the second ingredient), solidarity (the fifth) providing bailouts, and the (unlimited) financing of the central bank (the third). In fact the confused and controversial debate on the possibility of sovereign defaults has been (and still is) revolving around the role of these three ingredients and their capacity to banish the idea of sovereign default. The Italian case is in the centre of this debate.

Let us first consider the centralisation of fiscal discipline. To the extent that a certain degree of national autonomy will always exist in a "federal" EU, the second ingredient, the strongest possible central discipline, will never be sufficient to completely avoid that the countries, by misbehaving, end up in unsustainable debt positions. Moreover, the central discipline is weaker without the threat of default. The threat of default is credible only if an official orderly default procedure exists. The second and the sixth ingredients are complements, so that the contributions of the former to financial stability decreases if the latter is absent.

Consider now solidarity. It is already very difficult to institutionalise a limited amount of solidarity to be used in special situations for guaranteeing financial stability: it is unthinkable to ask for an amount of solidarity sufficient to completely bailout a not-very-little member country that cannot be denied a dose of autonomy sufficient to self-inflict unsustainable debts. Fiscal solidarity can help to limit the size of the default and make it manageable without unbearable social costs, panic and contagion: it is a complement to an orderly default procedure; but solidarity is a non credible substitute for default. Again, Italy is the crucial example. Even if one can think that the country is too big to be allowed a more or less well regulated default, it is undisputable that Italy is far too big to bailout if unable to refinance its enormous debt.

This leave us with the apparently most powerful ingredient to avoid sovereign defaults: the so called “bazooka” of the ECB, sufficiently powerful to destroy any danger of sovereign default. Some think the ECB should be considered the “debtor of last resort” for government securities. On logical and technical grounds this is the only possible way to completely exclude sovereign risk and therefore to avoid setting up an orderly default procedure for sovereigns.

Obviously, being a debtor of last resort destroys the independence of the ECB and it is against the Treaty. And it is somewhat paradoxical that it is precisely from the ECB that came the strongest opposition to consider the possibility of sovereign defaults and to provide orderly procedure to allow them happening with a minimum of systemic effects. Trichet would become literally furious when the idea was mentioned. The opinion of the bank was that the disciplined adjustment enacted by governments, both autonomously and as a consequence of centrally imposed measures, together with ECB’s action in providing some short-term liquidity as well as with a longer term mutual financial support funded by national governments, should suffice to remedy disequilibria and avoid defaults. Mentioning default procedures, as happened in Deauville, only worsens the situation and creates panics and contagion.

For what has been argued above, this reasoning is unconvincing: the only way to exclude defaults is to oblige the ECB to guarantee the repayment of public debts; with its insistence in opposing the plans for orderly procedures of sovereign defaults and with its wishfully excessive reliance on too precipitous centrally imposed national adjustments and on the financial solidarity of member governments, the ECB ended up favouring the insistence on her role as debtor of the last resort, precisely the role that she cannot have and, very rightly, does not want to play. But playing that role would be the only way to completely avoid the possibility of a default.

The quality of crisis management has suffered from the necessity to be pragmatic in finding urgent remedies to emergencies and, in the same time, set up rational and rigorous mechanisms to preserve financial stability in the longer run. In the first half of 2011, when it became evident that even Italy could deeply suffer from the contagion of the Greek problem, a pragmatic idea was ventilated, in the international arena as well as among several academics: Europe should officially distinguish countries with unsustainable debts from countries that, in spite of their difficulties in refinancing, could not be considered at risk of default. Italy is was the second group: the ECB should therefore purchase on the secondary market the sovereign securities of this group of countries, without hesitations and limits, even pegging a maximum level of their interest rates. Only when this support would be available in a credible and effective way, the issue of default could be considered for Greece. But even then, it should consists in a voluntary, privately arranged default, and it should be made clear that it would have been an absolute exception, that nobody could dare to consider a precedent for other future defaults in the euro area; the ECB firewall would avoid contagion for Italy and other large countries of the second group.

This pragmatic recipe, composed by a private default procedure to be considered "exceptional", plus an improvised ECB firewall, cannot look but as a confusing and counterproductive idea. It denies the necessity of providing an official, public, supranational, orderly procedure for timely debt restructurings, to be arranged when the dimension of insolvencies is still manageable and the country in difficulty can be re-launched by imposing bearable doses and rhythms of adjustment and structural reforms and by offering adequate international medium-term financing. But, in the contradictory European crisis management of 2011, the denial of official defaults procedures came precisely when the door was opened for starting a messy, "privately" arranged Greek default. The contradictory nature of this type of pragmatism also resulted from the fact that the role of "debtor of last resort" of the ECB was denied precisely when the bank was pushes to play that role, even if in a special and temporary fashion.

Pragmatism cannot appear as confusion of principles; "constructive ambiguity" cannot keep consisting in a disorganised mix of unfeasible rhythms of adjustments, unchecked market discipline based on uncontrolled spreads on sovereign securities, threads of unregulated defaults and extreme uncertainty on the type of help that can be provided by the ECB and by intergovernmental funds. Such an ambiguity is not constructive. Using the stick and the carrot in an effective way with countries in need of adjustments and reforms, requires more prudence and clearer rules: probably even the evolution of the Greek crisis would have been more favourable if Europe, and Germany in particular, had been more consistent following a set of sustainable and credible rules for crisis management. Such a set must include also, as a measure of last resort, a procedure to deal in an official and realistic way with the situation of a country that does not succeed in correcting an unsustainable debt and must therefore default.

The "private" default of Greece took place but, as could be expected, was more a source of further uncertainty and confusion than a serious contribution to improve the situation and to offer the right form of European help and assistance to the country. In the meantime, the adoption of a public, official and appropriate debt restructuring procedure, remained a cause of controversy, with the opposition of the ECB, but frequently mentioned as a possibility by the German government, denied sometimes by everybody but, unexpectedly, included in the draft of the document approved by the European Council as early as in March 2011, to set up the European Stability Mechanism[22], initially thought to start in 2013 and then tentatively (but unsuccessfully) anticipated to be set up in the summer of 2012. According this original project, the ESM should have among its tasks the coordination of sovereign debt restructurings to be decided using a "collective action clause" to be compulsorily attached to all new issues of sovereign securities in the euro area.

That the controversy (and the confusion) on this issue is still alive and present can be understood from the fact that, in the last version of the ESM Treaty, the role of "private sector involvement" is

[22] See Annex II (p.21) of the *Conclusions* of the European Council of 24/25 March, 2011, Brussels, 20 April 2011, EUCO 10/1/11, REV1, CO EUR 6, CONCL 3, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf. See in particular the section devoted to "private sector involvement" starting on p.29, where the procedure that the ESM should follow to orderly orchestrate the default is somewhat detailed.

mentioned in a much more hidden form[23], nourishing the suspect that an effort has been done, in a non transparent way, to downplay and render more opaque and less binding the official responsibility of the new institution in managing neat and official procedures for sovereign defaults. An effort in this direction, though aimed at avoiding panic and contribute to stability, could backfire on the authorities that suggested it, when a neat crisis management scheme were needed to reassure the markets that unsustainable debts will be dealt with in a realistic fashion.

4.3 Euro-rules for bank resolution and the "banking union"

Given the special role of banks in the economic system and the peculiar, unavoidable fragility of their balance sheets, the need to have good rules to resolve failing banks has been always felt, everywhere. In particular, adequate rules are required for international banks as the action of different national authorities must be coordinated and the burden of a potential bailout has to be shared among different countries. The issue was obviously felt as more important and urgent after the explosion of international financial crisis and the Lehman event. The G20 and the Financial Stability Board (FSB) have been working on the issue with a special focus on the problem of the Systemic International Financial Institutions (SIFIs) and to the proposal of requesting that large banks prepare "living wills" to facilitate their resolution in case of insolvency. When banks are large, the idea of optimising the rules for their resolution is, in a sense, opposite to the idea, which has also been considered by the FSB, of using stricter regulations and supervisions to render nearly impossible the failure of banks that are judged to be "too big to fail".

In the EU, the problem of having homogeneous rules for bank resolution has been for long dominated by the specific issue of international banks: how to share the burden of their bailouts, how to regulate the roles of host versus home authorities, how to coordinate their respective national supervisors and governments [24]. In the background, the main effort was to accelerate the harmonisation of supervision with the Lamfalussy process, since 2001, and, starting from 2011, the creation of the three European Supervisory Authorities (ESAs). But it was soon evident that the powers of the ESAs were insufficient and that the backbone of supervision was still in the hands of national authorities.

Most importantly, the sovereign debt crisis, by increasing the danger of banking crises, produced a situation where the issue of supranational supervision coincides with the need to have European authorities and rules for managing bank resolutions, as you cannot place at the supranational level the responsibility of managing bank crises while leaving the powers of supervision at the national level. In the EU summits and documents of the summer 2012, the idea was labelled "banking union". Besides a single supervisor and a jointly managed and jointly funded resolution fund (probably managed through the ESM), the project contemplates a European deposit insurance to reimburse deposits, up to a certain amount, of a liquidated bank. The detailed design of the project of the "banking union" was planned to take place with the maximum urgency, to be fairly advanced before autumn 2012 and possibly finalised before the end of the year.

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[23] T/ESM 2012/en, www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf. In fact the wording "private sector involvement" appears in point (12), p. 6 on the introduction following the "whereas", but is never mentioned again in the proposed text of the articles of the Treaty.

[24] See, for instance the discussion around the famous saying "he who pays the piper calls the tune", starting from the paper by C.A.E. Goodhart and D. Shoenmaker, *Should the functions of monetary policy and banking supervision be separated?*, "Oxford Economic Papers", 47, 1995; see also the abundant literature that followed, including, for instance, C.A.E. Goodhart and D. Shoenmaker, *Fiscal burden sharing in cross border banking crises,* "International Journal of Central Banking", 5(1), 2009.

This paper is not the right place to discuss in any detail a project that is in process of being defined and the relevance of which goes well beyond the issue of crisis management. It is clear though that a good European bank resolution process, together with all the other elements that can construct a European "banking union", cannot but be an indispensible ingredient of the recipe presented in the paper. This is fairly obvious but it is made even more clear by the symmetrical facts that many European banks are full of sovereign securities and that several European government debts have been, or could be increased in unsustainable ways by the costs of bailing out failing banks.

The aim of the rest of this section is only to contribute a few sparse and diverse observations on the topic of banking union.

First, the usefulness of the banking union for financial stability is not limited to international banking. European financial problems originate also from the inadequateness of regulation, supervision and crisis management in certain member countries. Competition in stability policies does not work: is a cause of laxity, inefficiency and protectionisms. The idea of minimum harmonization has also failed in the history of European financial regulation. Creating homogeneity and centralizing powers is also an opportunity to reduce distortions along national frontiers and improve the quality of the governance of financial systems' stability, extending best practices and reducing the risks of capture. In several member countries the crisis has shown the weaknesses of many small and medium size narrowly national banks that will benefit from supranational financial stability policies no less than larger international intermediaries. In fact these smaller and regional banks, especially in Germany, seem to be defending the protection they receive by national inefficient and permissive supervision by lobbying against their participation into the coming banking union.

Second, Italy is among the member countries that will benefit more from the banking union. The reason is twofold. Supervision, regulation and crisis management are of quality in Italy and Italian banks suffer most from the systemic weaknesses of the European banking system as a whole. Moreover, a large part of the problems of banks in Italy, more than elsewhere, is connected to the amount of Italian treasuries that they hold, also as a consequence of more or less explicit political pressures. By disentangling country and bank risk, the banking union reform would help them a lot. To the extent that the uncoupling of the two risks will reanimate the international circulation of interbank liquidity in the euro area, the cost of bank credit for solid firms in Italy could decrease as soon as it is disconnected from the risk premium on sovereigns.

Third, the banking union project, based on a long history of efforts to unify European prudential rules and authorities, was greatly accelerated after the spring of 2012 to remedy the dramatic situation that was labeled "sudden stops", whereby the circulation of interbank liquidity across the national frontiers of the euro area was blocked by country risks and by their implicit transformation into exchange risks, as operators started to seriously fear the breaking of the single currency. The sudden stops caused very large imbalances in the Target 2 which rendered more plausible the idea that the existence of the euro was at risk. **Figure 3**, taken from an updating of the path-breaking paper on sudden stops[25], shows that Italy is among the countries the suffers more from the national segmentation of the market for liquidity. While it is often said that a monetary union is not sustainable without a sufficient amount of fiscal and economic integration, the major obstacle to for the euro area to become a true optimum currency area was probably the

[25] S.Merler and J.Pisani-Ferry, *Capital flight in the euro area: from bad to worse*, Bruegel, 12th July 2012, updating evidence reported in the same authors' *Sudden stops in the euro area*, Bruegel Policy Contribution, 2012/06, February 2012.

lack of a banking union and the lack of intellectual emphasis – as opposed to the overabundant rhetoric on the "original sin" of "creating a currency without the backing of a government" – on the need to unify the banking system as money is mainly made by banks and vice versa.

Figure 3a

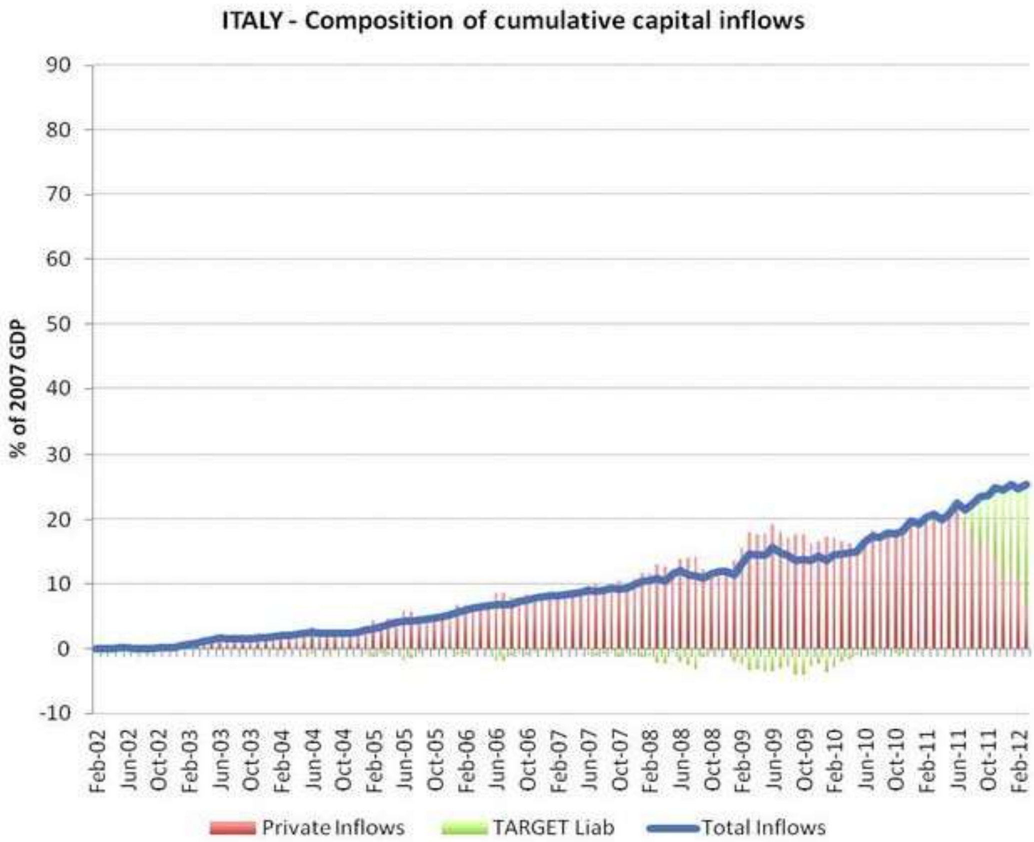
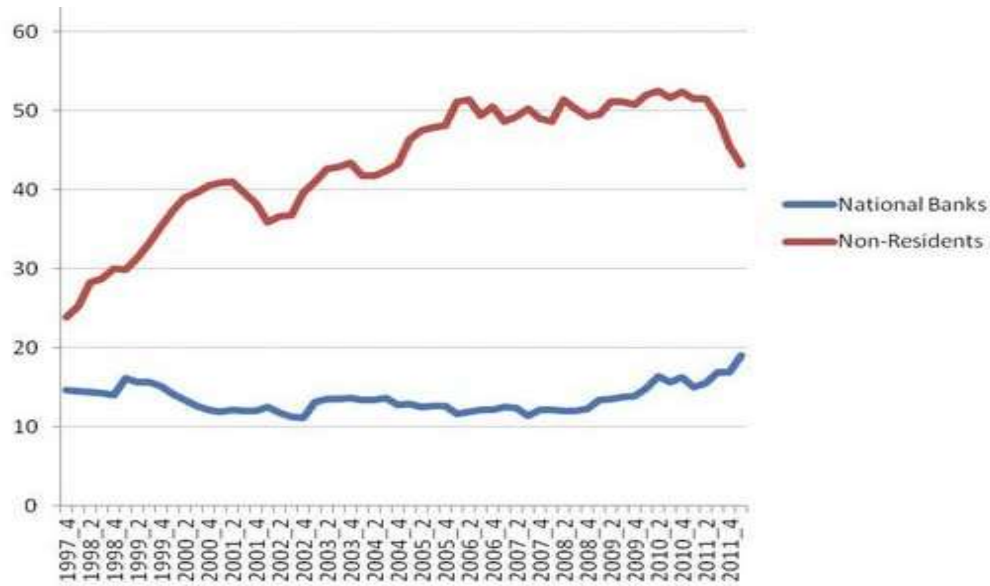


Figure 3b

Share of domestic banks and non-residents in total holdings of government securities



Source: Merler and Pisani-Ferry: see footnote.

Forth, the rules for crisis management in the banking union must be rigorous, seriously punish imprudent shareholders and managers and do not provide easy bailouts nor generate moral hazard for bankers and for their creditors. In this respect, the recent proposal of the Commission for a Directive on recovery and resolution of credit institutions is an important building block for the future rules of the banking union[26]. The planned action to help the recapitalization and the restructuring of Spanish banks, which will probably start before the finalization of the banking union, must function as an important exercise to establish the reputation of the crisis management style that, after the start of the banking union, will characterize the European mechanism for resolving and restructuring problem banks, acting directly, without passing through national governments as it will happen now with Spain. Losses on shareholders and unsecured creditors of Spanish banks must be imposed; during the last decade the European Shadow Financial Regulatory Committee has issued several statements where sound and rigorous principles of crisis management have been suggested: the most recent one is on the Spanish case[27].

Prompt corrective action, intervening rather early when objective indicators (such a leverage and risk-weighted capital ratios, that have to be substantially increased) show the deterioration of a bank’s liquidity and/or solvency, must be among the main tools of the preventive arm of European supervision. Uninsured depositors and bondholders must be more or less automatically involved, together with shareholders, in bank resolutions and restructurings, making appropriate use of contingent liabilities and compulsory subordinated debt instruments. The cost of deposit insurance must be charged to the banks in proportion to their riskiness. Instead of the elusive “Tobin tax”, special taxes on certain speculative and risky banking transactions and operations, as well as on the size of the bank, could help funding the deposit insurance, together with fines of banks that do not comply with certain rules.

Fifth, the political importance of the banking union must be stressed. The euro has been accuse to represent the “EU of the bankers” and to have an insufficient background of political unity. But the sacrifice of national autonomy and powers that is needed for building the banking union is formidable, sacrificing some of the most delicate jalousies of national politicians and bureaucrats. This fact has to be emphasized to explain the importance of banking union to the general public and avoid that the measure is considered an unpopular technocratic trick that does not go to the heart of the process of construction of a “political” EU. On the other hand, one must be conscious that going ahead with the project of European banking union is particularly difficult today as it means running “against the wind” of ring-fencing national financial systems, an attitude that is currently prevailing to create the illusion of defending each country’s credit institutions and markets from the turbulences of the crisis.

Sixth, it is easy to argue in many ways that the sub-ingredients of banking union – single supervision, supranational rules and powers of resolution, single deposit insurance – are deeply linked and complementary to the rest of the recipe presented in this paper. In particular, they require a sufficient amount of solidarity among member countries to accept the joint responsibility and the joint risk of managing together, from a supranational level of power and responsibility, their entire banking system. But, after all, this joint management of the banking system can be considered the most immediate and inevitable consequence of the

[26] EU Commission, *Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms*, Brussels, COM(2012) 280/3.

[27] ESFRC, *Escalating Crisis in the Eurozone: Time for Urgent Action,* Statement No.35, Tillburg, 27 June 2012.

adoption of a single currency, a single monetary policy, a single central bank, a single payments system.

5. A concluding comment on the irreversibility of the euro.

During the first part of the sovereign crisis of the euro area it was somewhat easy to counter the superficial comments that were saying that the "euro" was in crisis. The problem could be presented as one of excessive debts of the public sector of some countries in the euro area, in certain cases originated as private debts – and, as such, connected to insufficient saving and weak competitiveness – that were later bailed out by governments.

But in the summer of 2012, a larger consensus and better grounded explanations became nearly suddenly available for the idea that an "exchange risk premium" was among the determinants of the very large spreads between sovereign yields. In other words: the relative cost of Spain's debt, for instance, was also due to the risk that Spain could exit the euro area and depreciate its currency or that a group of countries centered on Germany could abandon the ("southern") euro and appreciate. Sudden stops in interbank international money and credit flows, by building up growing opposite Target2 unbalances of national central banks, seemed to confirm that the risk of breaking up of the euro area was a serious one. The idea was nourished by frequent comments from some academics, journalists and politicians, often presented as obvious sentences ("non converging countries cannot share the same currency", "Greece cannot but exit the euro area and needs depreciation to recover a minimum of competitiveness", "Germany cannot keep paying for keeping peripheral countries in the common currency area", etc.) just waiting to be confirmed by facts.

Explaining spreads with exchange risk was also of help in limiting the accusations that financial markets were unjustifiably irrational and that purely self-fulfilling, ungrounded and myopic speculation was distorting the relative costs of sovereign indebtednesses. Markets were pricing a true risk: the failure of the euro adventure, for lack of fiscal and political integration.

Also the otherwise too vague idea of "systemic risk" was acquiring concreteness as it was interpreted as the risk of the break-up of the euro. Italy's cost of public debt, for instance, could be considered higher than the level warranted by the country's own weaknesses; but the reason was not a general unspecified risk that Italy could default on his debt as a consequence of external shocks and mismanaged international interactions: the reason was that, in an insufficiently integrated Europe, the common currency could not survive and Italy was a natural candidate to be in the group of depreciating countries.

The "theory" of spreads based on exchange rate risk was sanctified by Mario Draghi, on the 2nd of August 2012, in his introductory speech to the press conference following the meeting of the ECB Governing Council, when he said[28]: "the Governing Council extensively discussed the policy options to address the severe malfunctioning in the price formation process in the bond markets of euro area countries. Exceptionally high risk premia are observed in government bond prices in several countries and financial fragmentation hinders the effective working of monetary policy. Risk premia that are related to *fears of the reversibility of the euro*[29] are unacceptable, and they need to be addressed in a fundamental manner. *The euro is*

[28] http://www.ecb.int/press/pressconf/2012/html/is120802.en.html.

[29] Emphasis in italics not in the original.

irreversible[30].". He then added that the ECB will stand ready to "undertake outright open market operations of a size adequate to reach this objective". But, in order to intervene to reduce the impact of the risk premia on the spreads "necessary conditions are the adherence of governments to their commitments and the fulfillment by the EFSF/ESM of their role". Draghi explained further the logic of conditionality in the Q&A part of the conference: "we want to repair monetary policy transmission channels and we clearly see a risk, and I mean the *convertibility premium*[31] in some interest rates. But the Governing Council knows that monetary policy would not be enough to achieve these objectives unless there is also action by the governments. If there are substantial and continuing disequilibria and imbalances in current accounts, in fiscal deficits, in prices and in competitiveness, monetary policy cannot fill this vacuum of lack of action. That is why conditionality is essential. But the counterparty in this conditionality is going to be the EFSF. Action by the governments at the euro area level is just as essential for repairing monetary policy transmission channels as is appropriate action on our side. That is the reason for having this conditionality".

Fighting exchange rate risk premia is therefore part of the mandate of the ECB but, according to the Governing Council, the required action would be inappropriate and ineffective without the parallel adjustment policies of the member countries and the conditional intergovernmental support of the ESM. The measures by Frankfurt are therefore "strictly conditional" on individual countries' behaviors – which could be considered in contradiction with the fact that the problem is due to the defective functioning of the euro "system" as a whole – and postponed until – among other things – the sentence of the German court on the ESM Treaty. But, quite apart from the controversial issue of conditionality, the substance of Draghi's message is that the systemic nature of part of the exchange risk component of spreads requires systemic action, also from the central bank. This systemic nature also derives, for any member of the euro area, from the potential unmanageable contagion of a unilateral and voluntary abandonment of the euro that any other member country could decide, also in absence of external shocks, purely on the basis of its own problems and national preferences.

It is difficult to separate the exchange risk premium from other sources of risk of default. The abandonment of the euro (as well as of the EU) by a country implies, with very high probability, some substantial default on its sovereign debts. What is insufficiently emphasized though, is that the opposite is not necessarily true: substantial defaults can take place also with the defaulting country keeping the euro, as already happened to Greece, and as could happen more easily if the sixth ingredient of the recipe of this paper were used setting up official, supranational, public, orderly and timely default procedures for sovereigns. Therefore, Draghi's solemn sentence, "the euro is irreversible", does not mean that undisciplined countries must be bailed out. It just means that reverting to national currencies is no solution for the euro area tensions and disequilibria.

But is the euro truly irreversible? The irreversibility of the common currency looks as a necessary condition for sustainable financial stability in the euro area[32], but it obviously could

[30] Italics are ours.

[31] Italics are ours.

[32] It also reinforces the action of the second ingredient of the recipe of this paper: external discipline acts in a more persuasive way if the alternative of exiting the euro can be completely excluded. Recent German disciplining voices

turn out to be wishful thinking. Our recipe probably needs an 8th ingredient consisting in what can make Draghi's sentence a solid and uncontroversial reality. This paper would go beyond its modest aim if it tried to seriously pursue this line of reasoning. Political and institutional conditions can be imagined that would obtain the result of a nearly irreversible euro. But it is worth stressing that "cultural" conditions are also needed. The fear of the breaking-up of the euro rests on the idea that there can be incentives to break it, as nominal exchange rates can be manoeuvred to correct macro imbalances, and that their flexibility is an effective economic policy instrument so that the creation of the euro implied the cost of giving up the exchange rate instrument, a cost to be hopefully compensated by larger benefits.

This cost-versus-benefit idea is contained in any standard macro textbook and is a basic tenet of the prevalent optimum currency area theory. But the idea today is probably wrong. In a (financially as well as commercially) highly integrated area, composed by a large majority of relatively small and very open economies, and in a globalised world where interest rates, prices and expectations are less and less sticky, as they increasingly react to expected monetary policies, flexible exchange rates are ineffective policy instruments, unable to influence the terms of trade, as well as the supply of competitive tradable goods, for more than a very short time, while they provide powerful incentives to speculation, thus nourishing all sorts of continuous monetary disorder. Moreover, the autonomy of monetary policy, which class lectures often associate with exchange rate flexibility, becomes closer to an illusion, resulting in weaker monetary discipline, self-neutralising competitive depreciation strategies and dangerous inflationary pressures. Modern macroeconomic theory is increasingly far from possessing a robust theory that proves the existence of reliable real effects of monetary policy. The fact that price stability is the statutory target of the ECB – together with its implications for financial stability – is also due to the weaknesses that, already two decades ago, characterised more activist monetary theories. These weaknesses are now even more evident. The euro is irreversible also because it has been introduced on the basis of a monetary strategy centred on stability and highly sceptical about the possibility of conveniently manoeuvring real variables using the monetary veil as an instrument.

The stability of the euro area requires these basic ideas to be reappraised and seriously adhered to by its members states, opinion leaders and leading academics. If we seriously think that Greece, by leaving the euro area, would be able to substantially increase its competitiveness and to restart growth-cum-stability, if we believe that Athens would succeed in keeping together a floating exchange rate with an open economy, as well as with a resurging export sector, with sufficient savings protected from the robberies of financial repression, with reasonably stable goods and asset prices, then "Grexit" should happen as soon as possible, benefitting both Greece and the rest of the EU; but, then, the whole idea of the euro area and its strategy pursuing macroeconomic stability should be set aside all over the place. In order to consider the euro truly irreversible we must be convinced that, also for Greece, reverting to the national mint would have only costs, without any appreciable and truly achievable benefit.

It is often stressed that a single currency requires – besides price and wage flexibility and international mobility of goods, services, and factors of production – convergence,

directed to Greece seem rather confusing and ineffective when accompanied by the opinion that, to begin with, Greece should not belong to the euro area.

international fiscal transfers, centralization of budgetary and other economic policies. The usual discourse goes on stating that, perhaps on the basis of an implicit theory of "endogenous optimal currency area", the euro area made the unsustainable mistake to try and function for a long time with an insufficient dose of convergence and centralization. This is in part true and any effort to accelerate economic and political integration will certainly benefit the monetary union. But throwing away the exchange rate instrument and adopting monetary policies lacking the whims of fine tuning and the frivolous ambitions to "stimulate" the growth rate of inefficient economies, is a persuasive idea[33] in itself and can benefit European countries also in absence of the much needed acceleration in economic and financial integration. The irreversibility of the euro – together with financial stability of the euro area – cannot but be grounded also in this persuasion.

[33] After all, the project of European monetary unification, even if grounded in the general idea of the Union since its postwar beginnings, acquired concreteness after the frustrating experience of floating rates nourishing the macro-monetary mess and the financial protectionisms of the 70s.