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Policy Brief 8/2022

February 23, 2022

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Abstract

Following the proposal by Avgouleas and Micossi (2021) and Micossi (2021), several authors (Amato and Saraceno 2022, Baglioni and Bordignon 2022, Cottarelli and Galli 2021, D'Amico et al. 2022) have engaged in the debate on how to manage the sovereign debt portfolio accumulated by the European System of Central Banks (ESCB) as a result of their purchase programmes undertaken since 2015 to fight deflation in the eurozone and provide emergency support to the economy in response to the Covid-19 pandemic. These proposals share the common goal of addressing an important and urgent public policy problem but differ in their specific institutional solutions. This paper provides an assessment of their consistency with present European legal and institutional arrangements in order to assess their practical relevance. The conclusion is that a new mechanism is needed to free the ESCB of the encumbrance of the sovereigns acquired following their assets purchase programmes. The ESM could perform that task while respecting all relevant European law.

[1] I am grateful to Gianluigi Tosato for carefully checking all my legal arguments, without of course taking any responsibility for my views, and to Lorenzo Bini Smaghi, Michala Markussen and Cinzia Alcidi for useful suggestions.

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1. Introduction

Following the proposal by Avgouleas and Micossi (2021) and Micossi (2021), a number of authors (Amato and Saraceno 2022, Baglioni and Bordignon 2022, Cottarelli and Galli 2021, D'Amico et al. 2022) have engaged in the debate on how to manage the sovereign debt portfolio accumulated by the European System of Central Banks (ESCB) as a result of their purchase programmes undertaken to raise inflation in the eurozone (the PSPP programme, since 2015) and to provide emergency support to the economy in response to the Covid-19 pandemic (the PEPP programme, since 2020). These proposals share the common goal of addressing a public policy problem that cannot be pushed under the rug but differ in their specific institutional solutions. An assessment of their consistency with present European institutional arrangements may be useful to assess their practical relevance and bring forward the discussion on eurozone governance.

2. On the orderly rollover of the ESCB's sovereign portfolio as monetary policy tightens

The sovereigns held by the ECB (in fact, by the ESCB, as national sovereigns are purchased and held by each national central bank, which therefore carries all attendant risks) represent a potential problem to the extent that at some stage they may have to fall back onto their private markets, thus potentially unsettling monetary conditions and financial stability. More specifically, these securities were purchased as part of monetary policy measures to raise inflation and improve the transmission of monetary policy. This had been done in an environment where interest rates had fallen to their 'lower bound' and therefore traditional interest rate policies were no longer effective. Once the inflation goal is achieved, the fundamental requisite allowing the ECB to hold those sovereigns legally under the TFEU[2] may disappear, forcing the central bank to dispose of them, potentially causing unwanted effects on some sovereign markets and, perhaps, on overall monetary conditions.

For this reason, Micossi and Avgouleas (2021) had proposed that the ESCB sell (a large share of) its sovereigns to the European Stability Mechanism (ESM). Similarly, Amato and Saraceno (2022) and D'Amico et al. (2022) have proposed the creation of a 'European Debt Agency' to remove part or all of the outstanding sovereign debts from capital markets and substitute them with a 'safe asset'. This would then become the tool of choice for open market operations by the ECB.

The ECB has of course been kept informed of these proposals but, unlike all other EU institutions potentially concerned, has refused to engage in any open discussion on the matter. However, in their recent 'Combined monetary policy decisions and statement' of 16 December, they have seemingly outlined a way out of the policy dilemma that has been described by announcing their intention to reinvest the principal from maturing securities both under PEPP ('for at least until the end of 2024') and APP ('for an extended period of time past the date when it starts raising the key ECB interest rates'). Their solution, therefore, is to take upon themselves the task of ensuring the orderly rollover of the sovereigns held by the ESCB under the blanket cover of their monetary policy mandate, and to do it for a period long enough to remove any immediate relevance of the matter.

[2] The Treaty on the Functioning of the European Union (in the consolidated version approved in Lisbon in 2007).

This approach, unfortunately, papers over the problem rather than solving it, both on operational and on legal grounds. Operationally, the rapid rise of inflation currently under way is already bringing forward the conflict between the ECB's twin policy goals of draining excess liquidity from the system while ensuring the orderly rollover of their sovereign portfolio. It suffices to point to the sharp rise in the adverse spreads on Italian and Greek sovereigns – relative to the German bund – that has followed almost instantly the changed forward guidance on future interest rate and asset purchase policies (at the time of writing, in mid-February 2022). At some stage, in a not-so-distant future (perhaps, already next year), the announcements will have to be followed by monetary policy actions which will inevitably entail asset sales, or at least a decision by the ECB not to renew expiring securities.

An effective measure in avoiding any adverse impact of monetary tightening on the sovereign markets of high-debt countries would be to restrict asset sales by the ECB to the sovereign securities of low-debt countries. Such a decision, however, would likely be seen as an *economic policy* decision, thus exceeding the monetary policy competences of the ECB.

Baglioni and Bordignon (2022) have argued that, in the current conditions of excess liquidity (Keynes would have spoken of a 'liquidity trap'), the ECB actually has two independent instruments, namely the interest rate on their deposit facility – which is the floor of the entire interest rate structure – and their asset portfolio to manage excess liquidity. In their view, in the current circumstances the ECB could raise the rate on the deposit facility (currently at -0,5 %) without any need to restrain the monetary base with open market sales. In a similar vein, Cottarelli and Galli (2022) have considered that the ECB could restrict liquidity by imposing an increase in reserve requirements, so as to freeze the increase in liquidity generated by their asset purchases, and then be allowed to roll over the PEPP bonds in perpetuity.

These solutions seem unconvincing to me beyond a very short short-term. Indeed, it won't take long for banks to react to an improved ECB deposit rate by raising their demand for reserves, with repercussions on all lending and borrowing markets – including sovereign debt markets. The ECB could also raise their bank refinancing rate to tighten lending conditions; again, the impact on securities markets would not be long to emerge. Similar effects would follow an increase in reserve requirements. More broadly, the announcement of tighter monetary conditions would likely raise the demand for liquidity fairly rapidly throughout financial markets, due to private agents' responses. Tighter liquidity conditions would also likely result in significant losses by national central banks on their sovereign portfolios, impacting their capital.

In sum, the escamotage of the December 16 decision by the ECB Governing Council will not suffice to resolve the problem even solely on operational grounds. I will examine the legal arguments leading to the same conclusion in the following section.

3. Monetary policy vs. financial stability

What is sometimes insufficiently recognised is that the new Article 136 TFEU and the ensuing decision to establish the ESM have formalised the existence of a new function within the TFEU, which is the preservation of financial stability – and this function, which is distinct and separate from monetary policy, has been entrusted to the ESM.

Under amended Article 136 TFEU, 'The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality'. Accordingly, Article 3 of the ESM Treaty describes the purpose of the ESM 'to mobilise funding and provide stability support under strict conditionality to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and its Member States'.

With its Pringle judgement (Case C-370/12), the Court of Justice of the European Union (CJEU) has clarified that the new comma in Article 136 TFEU has not created a new competence since the Member States were already able to act to safeguard the financial stability of the euro area. According to the Court, that function is 'clearly distinct' from the objective of maintaining price stability, which is the primary objective of monetary policy.

Following the establishment of the ESM, the power to intervene in sovereign markets to preserve financial stability and manage financial crises belongs primarily the ESM and not to the ECB. The exception was represented by the Outright Monetary Transactions (OMT) programme announced by the ECB on 6 September 2012, which entailed selective sovereign purchases. The decision creating OMT, however, was undertaken to counter 'severe distortions in government bond markets which originate, in particular, from unfounded fears on the part of investors of the reversibility of the euro', translating into 'severe … malfunctioning in the price formation process in the government bond markets, which undermines the functioning of the monetary policy transmission mechanism'. On this, with its Gauweiler judgement (Case c-62/14), the CJEU confirmed that selective intervention by the ESCB could only be justified by the need to preserve the 'singleness' of monetary policy, to safeguard an appropriate transmission of monetary policy and to contribute to its primary objective of price stability (against inflation as well as deflation). They also stated that the difference between the objectives of the ESM and those of the ESCB is 'decisive', to the effect that ESM interventions intended to safeguard the stability of the euro area does not fall within monetary policy.

Thus, the task of preserving financial stability and providing financial assistance to the Member States cannot be seen or treated as a natural extention of monetary policy – as the ECB Governing Council has arguably tried to do with its 16 December decision. Specifically, it appears that any intervention to shield a Member State from the adverse impact of monetary policy measures on its sovereign debt market would go beyond the monetary policy mandate and trespass into an 'economic policy' measure. And indeed, in their decision to launch the public sector asset market purchase programme (Decision 2015/774 of 4 March 2015), the Governing Council introduced specific thresholds for the purchases of eligible securities to permit the formation of a market price for eligible securities and 'avoid obstructing orderly debt restructurings' (Whereas n. 5).

Accordingly, when stating in their 16 December decision, that they would be ready to reinvest the maturing principal on their sovereign holdings (acquired under the PEPP) 'for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation', the Governing Council are setting a clear limit to what they can do to ensure the orderly rollover of its sovereign portfolio. They may, in this regard, be underestimating the pressing nature of the policy conflict that may soon emerge, as the stance of monetary policy is adapted sooner than expected to the acceleration of inflation under way.

For this reason, the issue of freeing the ESCB from the encumbrance of national sovereigns requires urgent attention – also in view of the time required to reach agreement on a solution within the Council. By transferring those securities to the ESM, as suggested by Micossi (2021), and rolling them over in an orderly way without any interference with monetary policy goals, the potential policy conflict between monetary policy and the separate goal of financial stability would be eliminated, and full separation would be established between the monetary policy and 'economic policy' sides of the issue.

A brief comment is in order on the notion of financial instability. Martin et al (2021) have made a distinction between (idiosyncratic) financial shocks generated by a self-fulfilling confidence crisis, which in their view should be tackled by the ECB, and a solvency crisis driven by economic fundamentals (identified with stochastic sustainability models). It may not be as easy to disentangle the two shocks in practice, as was clearly shown by the experience of the early years of the last decade.

The issue is rooted in the special externality arising from the common currency, as the latter may not be used to counter an idiosyncratic shock without the consensus of the ECB Governing Council – a consensus that may not be forthcoming without full agreement on appropriate policies to restore debt sustainability in a country that is losing investors' confidence. This was indeed the ground for the OMT programme decided by the ECB in September 2012, which however achieved its goals in highly unsettled market conditions without any interventions being necessary. The success of that announcement is probably explained by the fact that the instability was itself the consequence of publicly voiced disagreement within the Council of the European Union and the ECB Governing Council on the need to intervene.

However, according to the ECB decision, actual interventions would have required a fully-fledged adjustment programme, which in turn would have entailed long and acrimonious negotiations likely to generate further instability, before an agreement could be reached. The Greek experience in the summer of 2015 is a telling example.

This type of instability is generated when doubts arise over the ECB's willingness to provide financial support to a specific Member State, and for which only the ECB has adequate means. It is also, however, a reflection of a still unbalanced relationship between monetary and fiscal tasks within the eurozone, where an inordinate burden is still placed on the shoulders of the central bank.

4. Abiding by Article 125 TFEU

Article 125 TFEU states the twin prohibition for the Union and for Member States to 'be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project'. This is the famous 'no-bailout' clause that represents a keystone of the Maastricht Treaty and the ensuing construction of the single currency – and therefore certainly not one aspect of the institutional set up that may be changed to accommodate expedient proposals to facilitate sovereign debt management by the Member States.

In this regard, suffice to note that some kind of similar explicit or implicit clause is present in most federal states, usually as result of financial crises involving lower government bodies seeking help from the federal government. The key issue here is that, without appropriate constraints, decentralised governments in a federal state have perverse incentives (moral hazard) to overspend and borrow unsustainably in capital markets under the umbrella of a presupposed guaranty by the federal government.

While the European Union is not (yet) a federal state, the common currency has created strong links between the financial conditions of its Member States and the overall stability of the euro. The preparatory works leading to the Maastricht Treaty make it clear that the purpose of Article 125 is to ensure that the Member States follow sound budgetary policies. The Stability and Growth Pact (SGP) was set up (and subsequently strengthened by various provisions, following the eurozone debt crisis of 2010-12) precisely to ensure that independent fiscal and economic policies do not threaten the stability of the common currency. *Ad hoc* financial assistance to a Member State may be granted by the ESM 'in difficulties or seriously threatened by with severe difficulties' under economic policy conditions that guarantee the return to balanced domestic financial policies and the repayment of the loan, and therefore ensuring that Article 125 will be respected.

This long premise is to understand why any proposal to overhaul sovereign debt management within the EU and, specifically, the euro area must meet the constraint set by Article 125 or risk practical irrelevance. On this score, it appears that Micossi (2021) and Amato and Saraceno (2022) do pass the test, while D'Amico et al. (2022) do not.

It is useful to recall that all three proposals would exploit a supposedly vast untapped demand for a European asset guaranteed in the end by the Commission's ability to enforce sound fiscal policies by its Member States and ensure that sovereign debts are always repaid.

Micossi (2021) has proposed that the ESM buys from the ESCB a large share of national sovereign debts in their portfolio (not necessarily only their pandemic-related debt) and roll them over perpetually at market conditions. After the initial purchases from the ESCB, which the ESM would undertake gradually over a number of years following a political mandate by the European Council, the ESM would be free to manage those sovereigns, including the possibility of not reinvesting the proceedings of maturing obligations. The scheme could entail a temporary support to one Member State in case of default on its liabilities to the ESM; however, he Pringle judgement has made it clear that the Member State would remain fully liable for those contributions, therefore respecting Article 125 TFEU. As a practical matter, experience shows that the ESM/EFSF did not suffer any losses following the restructuring of the Greek debt, where the losses were eventually charged on the country itself. Therefore, it would be safe to assume that actual losses on its sovereign portfolio would not be likely. All in all, this scheme appears attractive in that it respects both European law under the Lisbon Treaty and the ESM Treaty, and therefore could be implemented by the Council, acting by unanimity, without any need to negotiate new treaty changes with the Member States.

Amato and Saraceno (2022)'s proposal ultimately entails complete substitution of national debts by common debt issued by a new institution – a 'European Debt Agency', or EDA – which would become the only lender to national governments (the public sector at large) and would charge to each borrower a risk-based interest rate. The principal would not be repaid[3]. The combination between insurance against losses and different risk-based interest costs for the borrower (that should include differential charges for the insurance against losses) seems to exclude all mutualisation of debt obligations, and therefore respects Article 125. However, the creation of the EDA would require either a new separate treaty among eurozone Member States or an amendment of the Lisbon Treaty.

D'Amico et al. (2022), on the other hand, have seemingly made an explicit choice to ignore institutional constraints and concentrate the attention on the analytical features of their European Debt Agency. These include: (a) the creation of a large fiscal entity issuing euro-denominated Union debt; (b) tapping a hopefully large demand for such euro-bonds; (c) the ESCB gradual shift, in its portfolio holdings, away from national sovereigns, thus also addressing the question of the ESCB's 'fiscal encumbrance' that has been discussed above.

Under the scheme, the Member States' sovereign debts incurred due to the pandemics would be purchased by the EDA at market prices, and then cancelled. Those debts would also no longer appear in national accounts. The Member States, however, would remain liable to the EDA for an annual contribution calculated so as to repay the agency of its expenses in managing the common debt share of each country and keep the 'mutualised' debt constant as a share of national GDP.[4] In a similar spirit, Micossi (2021) has proposed that the pandemic debts be excluded from the debt/GDP ratio relevant for the SGP, while however maintaining those liabilities in national accounts for all other purposes.

The point is that by purchasing those debts and mutualising them as EDA debts, D'Amico et al. (2022) seem in blatant violation of Article 125 TFUE. This conclusion would not change even by arguing that the present discounted value of all future government contributions *de facto* balances the debt cancellation: first, because the repayment of principal would not be included in that calculation and, second, because those future payments would not be formally written into the government budget (and, at all events, future governments could renege on that commitment). In practice, this constraint cannot be overcome, under the proposal, unless one envisages a transition to a fully-fledged fiscal union among eurozone (or Union) Member States – which today is not feasible.

5. Conclusions

The short conclusion of this paper is that the eurozone needs a new mechanism to free the ESCB of the encumbrance of the sovereigns acquired following the pandemics and, more broadly, to cope with the risk of deflation. Such a mechanism – that would entail foregoing repayment on those securities by rolling them over indefinitely at market conditions within some existing or newly established European institution – cannot be provided by the ESCB itself, since this would eventually be inconsistent with its mandate.

[3] The paper offers a nice argument on why sovereigns needn't be ever repaid, given the infinite time horizon applicable to the states' existence. This notion was originally behind the UK government consols in the late 17th Century.
[4] Analytically, this model is close to Leandro and Zettelmeyer (2019)'s euro area leveraged wealth fund. A puzzling technical question arises here regarding the formula for the determination of national contributions, which is derived from the stability conditions for the pandemic debt/GDP ratio in each Member State (the authors want to make sure that the ratio is stabilised) – but may not in most cases entail a positive service payment since the expression (r-g) has been typically negative in historical experience (the important exception being Italy in certain years).

The ESM could perform that task while respecting all relevant European law, and notably article 125 TFEU. The nice feature of the proposal by Micossi (2021) is that it is already fully consistent with European law as well as the ESM Treaty, and therefore could be implemented by a decision (with unanimity) of the Council of the Union. Whether or not to move in this direction is of course a political decision, belonging to the Euro Summit and the European Council.

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