

Sovereign debt management in the euro area as a common action problem

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Abstract

This Policy Brief discusses the question of sovereign debt management in the euro area following the large increase in those debts due to the pandemic crisis and reaches two main conclusions. The first is that sovereign debt externalities remain important in the euro area even in the new environment of permanently lowered interest rates. The second is that these externalities justify common euro area policies to deal with excessive sovereign debt accumulation and the attendant risks to the euro area's financial stability. Our proposal is that a substantial part of the sovereigns purchased by the European System of Central Banks (ESBC) – in the order of 20% of euro area GDP – could gradually be transferred to the European Stability Mechanism (ESM), without any transfer of default risks, which would continue to fall on national central banks. By rolling over these securities, rather than seeking reimbursement from the issuers, the ESM would make them equivalent to irredeemable bonds. These purchases would be funded by the ESM by issuing its own securities in capital markets. In addition to the national central bank de facto guarantees, these liabilities would be guaranteed by the ESM large (callable) capital and by the existing member states' guarantee, and therefore the ESM Triple A standing would not be endangered. A European 'safe' asset would thus be created without the drawbacks of various other proposed schemes. By bringing a large supply of new high-quality assets to the market, the scheme is likely to relieve the downward pressure on interest rates in the bond markets of low sovereign-debt euro area countries. Financial fragmentation would likely be much reduced, though it is not likely to disappear as long as the European Monetary Union (EMU) architecture remains incomplete.

¹ This Policy Brief is being published simultaneously as a CEPS Policy Insight.

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1. Introduction

Fiscal balances and sovereign debts of EU member states – especially in the euro area – are projected to deteriorate dramatically in 2020, and then recede marginally in 2021 (Table 1). The increase in the average debt ratio following the Covid-19 crisis is estimated at 16 percentage points in both the European Union and the euro area; in the latter case this brings it over 100%. It will climb by about 20 percentage points in France and about 30 points in Spain and Italy. Seven countries in the euro area are expected to show debt-to-GDP ratios well above 100%; Greece would climb to 205%, Italy to 162%, Portugal to 137%, France and Spain to about 120%, and Belgium to 118%. Things may turn out even worse if the expected second wave of the pandemic forces extended lockdowns in the economy again.

Some countries also display a large increase in private sector indebtedness. In Belgium, between 2007 and 2019, the debt of non-financial corporations rose by 36% to 124% of GDP, and in France by 20 percentage points to 89%. A 20 percentage-point increase was also recorded in the Netherlands, even though the burden of sovereign debt is low (just above 60%). Belgium and France also experienced a large increase in household indebtedness (in both cases about 14 percentage points of GDP). Conversely, Spain recorded a large decrease in private indebtedness, and in Italy private debt stayed at relatively low levels. The rise in private debt is relevant, of course, as it may foreshadow a future increase in sovereign debt to the extent that the public sector is forced to take it upon itself to contain damage to the economy from insolvencies.

Table 1. Government, non-financial private sector debts and interests on general government (%of GDP)

	General government debt (*)			Households (**)	Non-financial corporations (**)	Interests on general government debt (*)		
	2019	2020	2021			2019	2019	2019
EU27	79,2	95,3	94,6	56,5	77,5	1,3	1,5	1,4
EA	84,0	101,1	100,0	56,2	79,3	1,4	1,5	1,4
Belgium	98,7	117,7	117,1	61,6	123,6	1,7	1,6	1,4
Germany	59,5	73,3	72,2	54,1	51,6	0,6	0,6	0,5
Greece	180,9	205,2	200,5	53,0	54,4	2,9	3,0	3,0
Spain	95,5	123,0	121,3	56,5	72,8	2,1	2,4	2,4
France	98,1	118,7	118,6	60,0	88,9	1,4	1,3	1,1
Italy	134,8	161,8	158,3	40,8	65,5	3,2	3,5	3,4
Netherlands	48,4	59,3	61,1	99,9	133,7	0,6	0,5	0,8
Portugal	117,7	137,2	130,0	62,5	85,6	2,9	3,0	2,7
UK	85,4	108,0	111,5	82,4	70,6	1,4	1,0	1,1

Source: (*) IMFWEQ October; (**) Eurostat, only for EU27, EA, France latest data available 2018.

Against this background, the question arises as to whether high sovereign debt can be left to euro area member states to manage by themselves – with a repetition of the policies that followed the financial crisis at the

beginning of the decade – or whether a different approach should be taken instead. This paper argues that this is indeed the case; that the fresh increase in sovereign debt requires a common response in order to avoid a persistent compression of economic growth which could make sovereign debt unsustainable in many countries. The case for a common action is strengthened by the external effects generated in the euro area by the combination of the common currency with independent fiscal policies. This limits each country's ability to react to an investor run on its sovereign debt and raises the potential for the repercussions of one country's financial instability to affect the other members of the monetary union.

In his influential presidential address to the American Economic Association, Blanchard (2019) has argued that, in the new environment of low interest rates expected to last for an indefinite future, policy trade-offs between debt stabilisation and output stabilisation with fiscal policy have shifted fundamentally in favour of the latter goal. He has shown that, under very broad conditions, when interest rates on sovereign debt are lower than nominal GDP growth rates, then debt-to-GDP ratio will converge to a stable value, and therefore does not pose a threat to debt sustainability. Based on this analysis, Blanchard et al. (2020) have proposed substantial modifications of euro area fiscal rules that keep debt stabilisation on the back burner.

However, owing to the insufficient consideration of debt policy externalities within the euro area, their results may have been overstated. In a multiple-equilibrium world, these externalities include the possibility of a financial shock shifting the economy of a member state to a 'bad' equilibrium. This could involve an investor run on its sovereigns and, as a consequence, fresh threats to the survival of the euro by spreading contagion to other euro area members.

For this reason, this paper argues that common policies to improve debt sustainability are still required at euro area level. Our proposal is to exploit the financial clout of the euro area to keep substantial portions of national sovereigns out of the market, lengthen their maturity and lower their cost for riskier borrowers. In practice, the idea is to gradually bring sovereigns held by the ECB into the belly of the ESM (while leaving the attendant risk of default with national central banks, as is already the case, so that there would be no transfer of risk) and to leave them there indefinitely. The ESM would pay the ECB the market price for these sovereigns, with funds raised in international markets; its liabilities would offer traders and investors the safe asset needed to open the way to the euro becoming an international currency.³

2. Sovereign debt and economic growth

The health crisis underway worldwide will have a dramatic impact on economic activity. Table 2 summarises its impact on the European Union, based on the latest Commission forecasts (July 2020). GDP is expected to fall by over 8% in the EU-27 and close to 9% in the euro area, and then to rebound partially in 2021. By the end of that year GDP levels are expected to have lost several percentage points relative to the pre-crisis situation; enormous dislocations will strike the weakest components of our population and inequality will sharply increase.

³ On the long road to travel before getting there, see Micossi (2020b)

Table 2: GDP growth and harmonised index of consumer price (% change)

	GDP growth			HICP		
	2019	2020	2021	2019	2020	2021
EU27	1,5	-8,3	5,8	1,4	0,6	1,3
EA	1,3	-8,7	6,1	1,2	0,3	1,1
Belgium	1,4	-8,8	6,5	1,2	0,3	1,4
Germany	0,6	-6,3	5,3	1,4	0,4	1,5
Greece	1,9	-9,0	6,0	0,5	-0,5	0,5
Spain	2,0	-10,9	7,1	0,8	-0,1	0,9
France	1,5	-10,6	7,6	1,3	0,3	0,7
Italy	0,3	-11,2	6,1	0,6	0,0	0,8
Netherlands	1,7	-6,8	4,6	2,7	0,8	1,2
Portugal	2,2	-9,8	6,0	0,3	0,0	1,2
UK	1,5	-9,7	6,0	1,8	0,9	1,3

Source: European Commission.

In most countries, public policies have managed so far to limit the damage to personal incomes and corporate activity but have not yet addressed the problem of restoring sustained growth and social inclusion to acceptable levels.

An important contribution to address these questions will come from the vast resources made available by the European Council through the ESM (€240 billion or about 2% of the euro area GDP), the new fund SURE (€100 billion for support to labour-market adjustment) and, most importantly, the initiative Next Generation EU, which will mobilise fresh resources of up to €750 billion through the EU budget. The availability of these last funds will be made conditional on the implementation of economic reforms and those investments likely to raise productivity growth and strengthen societal cohesion ('resilience'). However, the positive effects on growth and productivity are likely to spread out over the medium term, thus implying that their direct contribution to debt sustainability may be weak in 2021-22 – unless the new policy course elicits a strong rise in investor confidence and private investments.

High sovereign debt, however, is likely to adversely affect economic growth. As may be recalled, an influential paper by Reinhart and Rogoff (2010) concluded that, while the link between growth and debt seems weak for 'normal' debt levels, "median growth rates for countries with public debt ratios over 90 per cent are one percent lower than otherwise; average (mean) growth rates are several percent lower". Their results, which were obtained from a data sample spanning 44 countries and 200 years, appear remarkably similar for advanced and emerging economies.⁴

⁴ The authors also document a strong negative effect of growth of external debt. However, this is less relevant for the EU where countries have had relatively strong external positions.

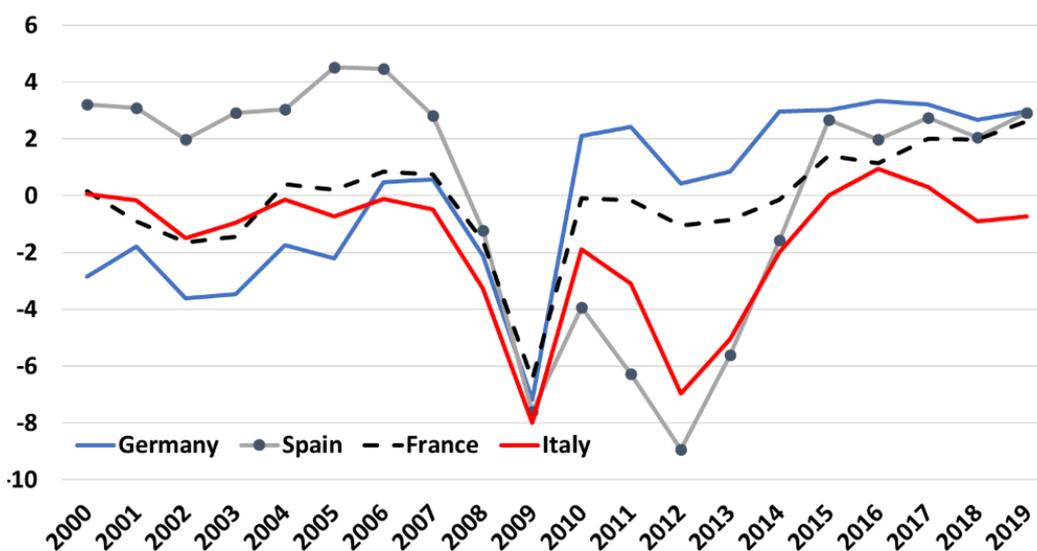
Their explanation for this finding is pretty straightforward: they see it as the (non-linear) response of market interest rates to rising debt levels, as countries pass certain ‘tolerance’ limits, leading in turn to investor runs, painful fiscal adjustments and occasionally even default. Fear of punitive taxation and uncertainty about the cost of funding may also represent a powerful disincentive for private investment (Corsetti et al. 2015).

These tolerance levels are not a constant but vary with circumstances. The ECB ultra-loose monetary policy measures have helped lower long-term interest rates, narrowing interest rate spreads within the euro area, but have not impeded large oscillations of these spreads for countries experiencing political instability. For instance, Micossi and Peirce (2020) show that while Italy’s spread seems weakly related to the government debt ratio, it moves wildly in response to political shocks. In addition, inflation is expected to remain well below its 2% target for the coming years, while employment and growth may remain weak. Therefore, after the rebound in GDP in 2021, nominal GDP growth in the euro area may result in being closer to 2% than 3% for some years into the future, with lower growth in high-debt countries, even in the mild scenarios without a second wave of the pandemic.

In Chart 1 we have represented the difference between nominal GDP growth and the 10-year nominal interest rate for the four largest countries in the euro area. When this difference is positive, sovereign debt may be deemed sustainable, regardless of the debt ratio (Blanchard 2019). As may be seen, the difference in 2019 was positive for France, Germany and Spain, roughly around 3%, but was negative for Italy, indicating that the debt ratio is on a naturally rising path.

Germany, whose debt ratio was already approaching 60% before the health crisis, would not be hard-pressed to rapidly improve its public sector deficit (and indeed the ‘debt-brake’ policy has been suspended, albeit not cancelled). But countries with debt ratios above 100% may well be forced to positive primary surpluses in order to prevent bouts of financial instability, further depressing growth. In the case of Italy, the likelihood of the adverse scenario is higher, since interest rates now already exceed the growth rate, and the debt ratio is expected to climb above 160%.

Chart 1. Difference between nominal GDP and 10-year interest rate (%)



Source: ECB

3. Sovereign debt restructuring

Before turning to discuss policy trade-offs and feasible policies, I need first to discuss what is not a feasible solution, namely debt restructuring country by country. And indeed the ESM Treaty reform – already approved by the Council but not yet sent for ratification before national parliaments because of last minute Italian reservations – has given new powers to the ESM (whose governing council is made up of the ministers of finance of the euro area member states). The ESM can now assess the conditions for granting financial assistance to: “follow and assess the macroeconomic and financial situation of its Members including the sustainability of their public debt” (new Article 3). Up until now, the Commission was solely responsible for this assessment.⁵

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

Thus, to restore the credibility of the no-bailout rule (Article 125 TFEU), insolvent countries should be excluded from ESM financial assistance until they first restructure their sovereign debt. This would strengthen the incentives for responsible fiscal policies and would prevent economically destructive ‘gamble for redemption’ that always prove fruitless. Accordingly, the ESM should develop its own debt sustainability analysis, using transparent and consistent criteria across countries “that would need to be assessed based on a data-driven method that can be reproduced and checked by the public” (Bénassy-Quéré et al. 2018).

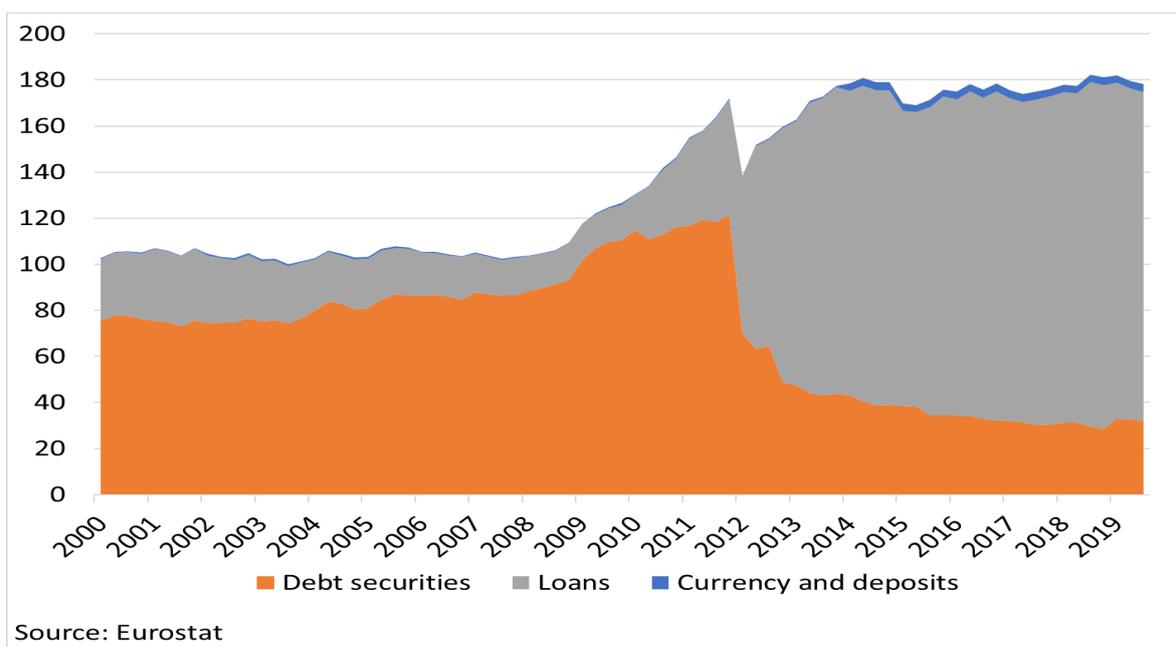
This approach is highly questionable, both analytically and empirically. Indeed, there is scanty evidence that countries’ debt policies are motivated by moral hazard (Tabellini 2017; on this more later). At all events, the experience with debt restructuring in reducing the debt burden and restoring debt sustainability within the euro area was far from encouraging. Chart 2 shows that massive private debt restructuring in Greece in March 2012 led to an increase in overall government exposure, owing to the need to fill the gap opened up by vanishing private finance. As Greece had already lost market access, an increasing role in providing liquidity to the Greek financial system was then taken up by the ECB through its emergency liquidity assistance. This

⁵ Under Article 13.1 the assessment as to whether public debt is sustainable “and whether stability support can be repaid” will be undertaken jointly by: i) the managing director of the ESM; and ii) the European Commission in liaison with the ECB. The final proposal to the Board of Governors of the ESM on whether to grant financial assistance, and under what conditions, will be made by the managing director of the ESM. This assessment “shall be conducted in a transparent and predictable manner while allowing for sufficient margins of judgement”. In this context, the expression “transparent and predictable” evokes a notion of preventive debt restructuring, before granting financial assistance, based on objective quantitative indicators – as demanded by some member states, while the reference to “sufficient margins of judgement” indicates that, when financial assistance is sought, debt restructuring will not be the automatic result of quantitative indicators. Further ambiguity is added by Recital 12A, which specifies that in the case of disagreement, the Commission will make the overall assessment on debt sustainability while the ESM will assess the ability of the member state concerned to repay the ESM. It is also envisaged (Recital 12) that “upon request by an ESM member and where appropriate, the ESM may facilitate the dialogue between the ESM member and its private investors on a voluntary, informal, nonbinding, temporary, and confidential basis”.

then evolved from an emergency credit line for individual banks in difficulty to an emergency macro-financing channel (Micossi, 2015; European Commission, 2017b). Moreover, private debt restructuring was followed in 2017 by a first round of official debt restructuring by the ESM on its financial assistance loans (the ‘short-term measures’), which reduced Greece’s (present value) debt-to-GDP ratio by an estimated 25 percentage points, and yearly gross financing needs by six percentage points. A further round of debt relief – the ‘medium-term measures’ – is expected to slash an additional 30 percentage points off Greece’s debt-to-GDP ratio, and a further eight percentage points from the country’s gross financing needs.

Zettelmeyer has argued that the bad outcome of the 2012 Greek debt restructuring is due to the delay in decisions (PIIE, 2020), but his interpretation is difficult to reconcile with the events that have been described (cf. Corsetti et al. 2015), which indicate that debt restructuring has cut the country out of all private external financing, thus compelling the government and the ECB to become the residual providers of finance to the economy.

Chart 2. Greek government debt (% of GDP)



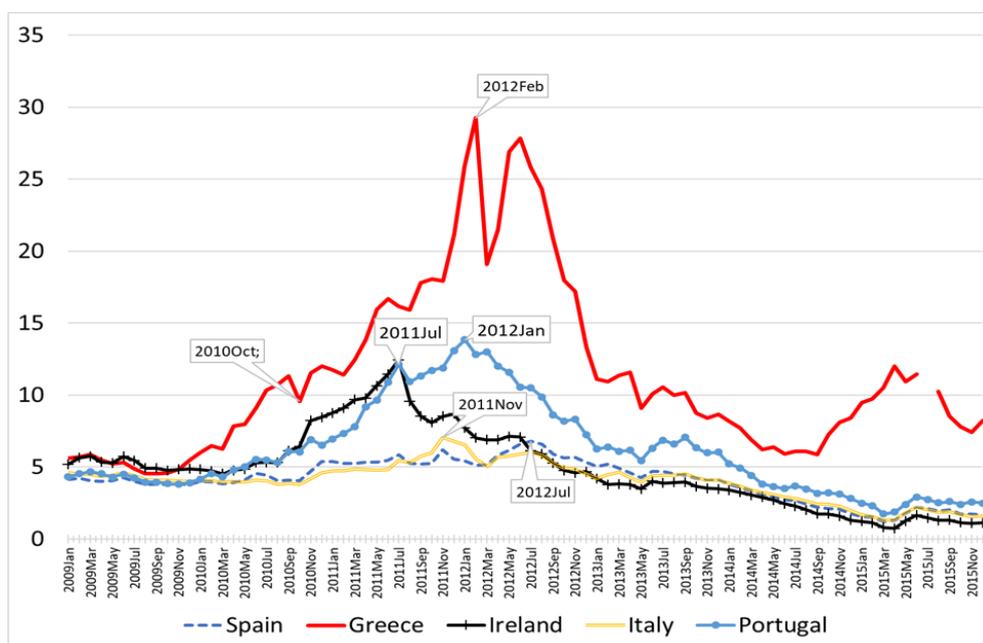
There is an even more compelling objection to preventive sovereign-debt restructuring. Debt sustainability is not a stable condition that can be reliably measured with objective quantitative indicators, but one that rather evolves unpredictably with market sentiment (Corsetti et al. 2015; Messori and Micossi 2018; Micossi and Peirce 2020). In a multiple-equilibrium world, an unpredicted shock to confidence may tilt the balance from a stable to an unstable debt path; the announcement that a debt sustainability analysis may qualify a currently stable configuration of the economy as potentially unsustainable may well become the shock that shifts the economy

to the unstable path; and, within the euro area's highly integrated capital markets, the shock may easily spread from one country's capital market to other capital markets.⁶

The behaviour of interest-rate spreads between high-debt countries' sovereigns in the euro area and the German bund provides a clear illustration of the problem (Chart 3). By 2010, the news of a possible insolvency *cum* Grexit had already pushed the Greek interest rate close to 30%; it came down to below 20% on the news of an agreement with private creditors (effectively concluded in March 2012) but shot up again following the difficult negotiations on a new rescue package.

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

Chart 3. 10-year long-term interest rate (% , monthly data 2009-2015)



Source: ECB

⁶ These considerations were also reflected in IMF lending policies, notably its exceptional access lending. In its 2002 framework, this policy allowed exceptionally large financing when four criteria were met, one of which was that there is a high probability that the country's debt is sustainable. When this criterion was not met, debt restructuring would have to precede IMF lending. The Greek crisis convinced the IMF to adapt the policy with explicit allowance for the possibility that debt might be sustainable but not with high probability. This 'systemic exception' was introduced precisely out of serious concerns that upfront debt restructuring could lead to serious contagion effects in Europe and beyond (Corsetti et al. 2015). The systemic exception was later removed, but the policy still allows the IMF to lend when the debt is not sustainable with high probability if the member also receives financing from other sources, private and public. As for debt restructuring, the modified policy also included the softer option of 'debt re-profiling', that is a (short) extension of maturities during the programme, with normally no reduction in principal or coupon.

Soon after the Greek crisis in 2010, investors started to look for other targets for short bets. They pushed Ireland and then Portugal against the wall, forcing them to seek financial assistance from the EFSF (the EU facility for financial assistance that preceded the ESM). In both cases, the governments decided to fully guarantee the banks' liabilities to avoid worse damage to the economy, leading to a large increase in government debt. Contagion was further fuelled by the Merkel-Sarkozy announcement in Deauville in October 2010 that private creditors would have to participate in debt restructuring. Mody (2014), while grossly underestimating the second round effects on other countries, reckoned that this announcement alone cost the Greek government an increase of 150 basis points in the spread with the Bund.

Confirmation in the summer of 2011 that private debt would indeed be restructured triggered the start of contagion to Spain, Italy and even France. In November, a speculative attack led Italy to dismiss the Berlusconi government and call in former European Commissioner Mario Monti to enact a shock budgetary stabilisation package, pushing the economy into a deep recession. In July 2012, Spain negotiated a €100 billion financial assistance programme from the ESM for the recapitalisation of financial institutions, agreeing on a memorandum of understanding that entailed mild macro-economic conditionality. Eventually, it took the ECB's new Outright Monetary Transactions (OMT) programme, which was launched in September 2012, and promised unlimited purchases of sovereigns under speculative attack, to halt the run of investors on indebted countries.

This discussion points to an inevitable conclusion. While debt restructuring cannot be ruled out as a component of actions to eventually restore market access to a country unable to service its public debt, the notion of preventive debt restructuring when granting ESM financial assistance should simply be removed from the table as utterly destabilising.

Moreover, an effective crisis-management system in the euro area quite clearly requires a modification of the conditions for access to ESM financial assistance, notably the fact that such assistance only becomes available when the concerned country is close to losing market access and the financial stability of the euro area is under threat. This set-up is bound to encourage speculative attacks following news that a country is approaching the ESM for assistance. A confidence crisis that hits a country in the euro area is likely to spread to other member countries. In general, as noted by Tabellini (2018), the resilience of the euro area is not much higher than that of its weakest member; therefore, reforms that increase the vulnerability of the weakest countries may well prove counterproductive for the financial stability of the entire euro area.

4. Macro-policy externalities in the euro area

Common European macro-policies are justified by the existence of external effects of national policies. Blanchard (2019) has argued that the new 'normal' of low interest rates for an indefinite future changes the trade-off between the goals of debt stabilisation and countercyclical fiscal policies, mitigating the importance of the former and creating greater need for the latter.

Blanchard et al. (2020) have applied this result to the euro area and have concluded that debt stabilisation should be given much less weight in common policies, as low interest rates have reduced the risk of default and hence created the potential financial overspill from high debt countries onto low debt countries. However, the single monetary policy within the euro area is in general less effective in countering demand and output

shocks in individual member states; the problem is aggravated when interest rates are at the lower bound and cannot be set at their ‘natural’ level to ensure full employment. At the same time, fiscal policy is more effective in raising output countercyclically, since the effects on output of discretionary increases in the fiscal balance are not offset by interest rate increases by the central bank, thereby raising the demand externalities of failing to act in a coordinated manner in the presence of large output falls. Blanchard et al. (2019) therefore see a need to reform the EU fiscal framework by allowing more room for demand-stabilisation policies and the acceptance of higher sovereign debts.

Their contention on demand externalities within the euro area are strengthened by the lack of fiscal space in some member states (European Fiscal Board 2020, Corsetti 2018) and, more broadly, by the competitive pressure maintained by Germany on its partners because of their low wages and depreciated real exchange rate for export goods (Micossi 2020a).

Before discussing the question of debt externalities in the euro area, two observations are in order regarding the recent application of common economic policies. The first one is that – as documented by the European Fiscal Board Report (2019) – in the past decade, the European Commission has de facto abandoned the debt-stabilisation rule, concentrating its attention instead on the realisation of the medium-term objective (MTO). As a result, past MTO overruns did not lead to demands for compensation in the ensuing years (cf. Micossi and Peirce 2020 for the Italian experience). This has led in turn to mounting criticism of the Commission by some member states, which motivated the European Council, in their ESM reform awaiting ratification by national parliaments, to shift some competences on the application of the Stability and Growth Pact (SGP) to the Ecofin (the Council of the ministers of finance) and the Board of Governors of the ESM.⁷

The second observation is that on 23 March 2020 the Ecofin, following a Commission recommendation, suspended the application of the SGP by applying the general safeguard clause of the EU budgetary framework. At present, therefore, neither the 3% deficit limit nor the 60% debt limit apply, together with Article 126 TFEU excessive-deficit procedure.

Thus, for now, the substance of the proposals by Blanchard et al. (2020) has become official policy of the European Council (which is the body ultimately in charge of the enforcement of common policies).⁸ However, it is also broadly understood within the Council that the SGP will be reinstated at some stage, and most member states of the euro area are already discussing when and how to start reducing national debts after the large increases underway. Therefore, the question of the proper post-crisis design of the SGP must be confronted.

We now turn to the question of debt dynamics and debt externalities within the EU. In the most general formulation, the sovereign debt-to-GDP ratio evolves over time according to the following equation:

⁷ First, the ESM, and thus indirectly the euro area member states that control its governing bodies, will now have its own powers to “follow and assess the macroeconomic and financial situation of its Members including the sustainability of their public debt” (new Article 3). Up until now, the Commission was solely responsible for this assessment while, as already seen, it is now established that this assessment will be undertaken jointly with the managing director of the ESM, who will also be in charge of making the final proposal to the ESM Board of Governors on whether to grant financial assistance, and under what conditions.

⁸ The current economic crisis generated by the pandemic was as yet unknown at the time of their writing, so the proposals by Blanchard (2019) and Blanchard et al. (2020) were mainly justified by permanently lowered interest rates possibly pointing to secular stagnation scenarios.

$$d_t = d_{t-1}(1 + r) / (1 + g) + x_t + u_t \quad (1)$$

where d is the debt-to-GDP ratio, r and g are the relevant rate of interest (average debt cost)⁹ and GDP growth (both rates consistently taken in nominal or real terms and, for simplicity, assumed to be constant over the relevant time horizon), x is the public sector yearly net indebtedness divided by GDP (a net surplus has a negative sign), and u is a random financial shock potentially affecting sovereign debt with unknown distribution.

Building on Blanchard (2019), Blanchard et al. (2020) show that when $(1 + r)/(1 + g) < 1$, then ‘debt rollover’ is feasible and there is no need to achieve a primary surplus to ensure debt sustainability. This conclusion holds even if the country runs a public sector deficit forever that is larger, as a ratio to GDP, than the ratio $(1+r)/(1+g)$. However, a numerical example in their Appendix shows that when the debt ratio is high, its steady state value increases substantially when the deficit goes up. For example, with an initial debt ratio of 100%, an increase of the deficit from 2% to 3% of GDP raises the steady state debt ratio to 150%. Hence, while with $r < g$ debt sustainability is ‘technically’ consistent with much higher deficits, investors’ reaction to such large increases of the debt ratio remains an open question.

The authors do recognise the possibility that a change in the shock factor u may at some stage induce a change in sign of $r - g$, compromising debt sustainability, but they play down the importance of this possible outcome by referring to the historical experience of the US and the euro area, showing that interest rates on the debt were generally lower than the growth rate, and debt sustainability was guaranteed even in the presence of significant public-sector deficits.

This is where it seems to us that certain specific features of the euro area have not been given sufficient attention. The first feature that must be considered was described in the De Grauwe (2011) seminal paper: the fact is that the common currency is not available to individual euro area member states to stabilise their sovereign debt market without the consensus of (a majority of) the governing board of the ECB. The problem is at present kept ‘under the carpet’ by the ECB decision to flood the system with liquidity to counter the economic impact of the pandemic, but is bound to resurface at some stage once economic output returns to pre-crisis levels, and in view of the large increase in sovereign debts underway.

Its continuing relevance is apparent in the presence even now of a risk premium on sovereigns of highly indebted countries, which should be included in equation (1). The risk premium applies over the ‘safe’ return represented by the rate on the German bund. Accordingly, in equation (1) the interest rate in country i must be rewritten as:

$$r_i = r_G + s_i \quad (2)$$

where s is the risk premium on the euro area country i ’s sovereign debt over the German bund. As previously recalled, the risk premium s is highly volatile and may easily turn sustainable sovereign debt into unsustainable sovereign debt. Even today, with massive ECB sovereign purchases, the value is 143 basis points for Greece, close to 130 for Italy and above 70 for Portugal and Spain.

⁹ Blanchard (2019) also adjusts this cost by considering the tax paid on interest by debt holders.

The spread spills over onto the required return of all asset classes in each country, indicating persistent market fragmentation. With financial fragmentation, the risks of similar financial instruments and financial intermediaries in different euro area members are priced differently by market investors, limiting cross-border interbank and capital flows. The threat of debt restructuring and, ultimately, of exit from the euro, is the fundamental factor behind financial fragmentation, as investors seek the higher returns on low-grade sovereign debt but stand ready to flee at the slightest rustling of leaves.

More importantly, the spread has appeared highly responsive to political shocks – whenever vocal disagreements within the European Council, or the ECB governing board, raised doubts among investors about the continuation of ECB support for highly indebted countries. Indeed, as it may be recalled, during the euro area debt crisis in the early 2010s, German official statements played an important role in maintaining pressure for austerity on high-debt countries through financial market spreads (Carmassi and Micossi 2010). When ECB President Lagarde said last March, in her first press conference, that “we are not here to close spreads”, the spread on Italian sovereign paper climbed immediately to above 300 basis points; it rose again to over 180 basis points in June and July, as investors doubted that an agreement would be forthcoming in the European Council on the new European Recovery Fund.

The problem is aggravated by the incomplete architecture of the monetary union, which still lacks cross-border deposit insurance, a credible crisis resolution mechanism for banks, and a full public backstop for both in case of a systemic bank crisis, while banks continue to hold substantial amounts of national sovereigns. Consequently, the ‘doom loop’ between bank crisis and sovereign crisis has not been vanquished and may still reappear following, for example, a rating downgrade of a highly indebted sovereign below investment grade – the u factor in equation (1). This remains as a potential source of strong financial shocks hitting large debtors, and the entire monetary union as an inevitable consequence.

As has been argued, both these possible shocks – on the sovereign spread and on the banking system of a member state – reflect externalities generated by the single currency. They would simply not arise if each member state had full access to central bank money to stabilise its sovereign and banking markets. Furthermore, the potential for instability linked to present institutional arrangements will continue to remain high as long as member states run independent fiscal policies whose effects and risks affect their partners in the euro area. Low interest rates in the anchor country, Germany, will not change this reality.

This source of potential instability in the euro area must be addressed by appropriate common policies. The natural question to ask, then, is whether and to what extent common policies may contribute to reducing the debt sustainability risks that have been described.

5. Common policies to mitigate sovereign debt risks in the euro area

The analysis above has left us with some important conclusions that point to the need to adapt common policies in order to reduce high-debt risks. First, there is little doubt that the present crisis will leave the euro area with a much-augmented sovereign debt that will likely rise above the Reinhart and Rogoff ‘comfort zone’ in several member states, entailing a depressing effect on the economy. This trend effect on confidence and investment may be compounded by bouts of financial instability even in the new environment of low interest rates, because of the lack of a lender of last resort in national sovereign markets, which in turn entails the risk

of default of some sovereign debtors and possibly associated currency redenomination. Both the trend and the short-term effects are directly related to the level of the debt ratio. Common policies may play a role here both in (de facto) reducing debt ratios and in sharing sovereign debt risks, thus helping to conquer financial fragmentation.

Clearly, no agreement is likely on this without sufficient convergence of national fiscal policies and, eventually, euro area members moving to a closer fiscal union. Credible reforms of the SGP are a necessary step in this direction. The proposals tabled last year by the European Fiscal Board (2019) offer a useful starting point; they contemplate the demise of the complex existing apparatus and a shift to a simple debt ratio target, implemented through a nominal expenditure limit. This proposal has broad support by academia but is not yet shared in the Ecofin and the European Council. At all events, reform of the SGP lies outside the scope of this paper and will not be further discussed here.

A related issue is banks' sovereign exposure, which threatens the stability of the EMU because of the potential resurgence of the 'doom loop' between the sovereign debt crisis and the banking crisis observed in 2010-12 (Veron 2017). Recent empirical research by Lamas and Mencia (2019) on Spanish banks' behaviour in periods of sovereign stress confirmed that the increase in sovereign portfolios was not motivated by moral hazard or opportunistic risk-shifting strategies, but rather by the pursuit of a hedge against the risk of an EMU break-up and the redenomination of banks' liabilities in the national currency (as also argued by Tabellini 2017). This brings us back to the question of how to overcome financial fragmentation.

Our contention is that a way forward would be offered by engineering large transfers of sovereigns from the ECB to the ESM, de facto keeping a substantial part of the debt out of the market for an indefinite future. The euro area would utilise the credit standing of its institutions to lower sustainability risks and debt service.

More specifically, the ESM would purchase the sovereigns held by the European System of Central Banks (ESCB) as a result of the asset purchase programmes (APP) undertaken to enact its quantitative easing policies. The sovereigns could be purchased according to the proportions established in the APP, thus avoiding any differential impact on national sovereign markets, or they could be skewed in favour of the sovereigns of riskier debtors, making the risk-reduction effect for the euro area stronger. The default risk of sovereigns purchased from the ESCB would remain with national central banks, as it is today, and would not be transferred to the ESM. At maturity, the sovereigns held by the ESM would be renewed into new securities with very long maturity, de facto turning them into irredeemables.

The purchases would be funded by the ESM selling its own securities in financial markets, in appropriate maturities, to meet market demand. Like all outstanding ESM liabilities, these securities would be guaranteed by its sizeable (callable) capital; in addition, they would enjoy the guarantee of its member states already in place for ESM liabilities, in proportions determined by the member states' shares in the ESM capital. This double guarantee, together with the de facto guarantee maintained by national central banks on their sovereign paper, should be more than enough to ensure the Triple A rating for ESM securities without any special seniority privilege; a major drawback of the various proposals for a safe asset that were formulated in

the past would thus be eliminated.¹⁰ Issuance of the new securities would need to be coordinated with the substantial issues expected to fund Next Generation EU.

The EU budget would have to cover any shortfalls in the ESM profit and loss accounts due to the interest rate differential between the cost of its securities placed in the market and the revenues on its sovereign holdings, with appropriate arrangements to allocate the burden only among euro area members. The 2019 consolidated accounts of the ESCB show in this regard a tiny profit (about €1.4 million) on its sovereign holdings for monetary operations of €2.2 trillion. With the cost of ESM issues at present around zero, the ESM would not show a loss because of its sovereign purchases. However, the return on sovereign holdings could well turn negative as sovereign spreads continue to go down for high-debt countries, and interest rates remain negative in Germany, France and the Netherlands. The ESM could also be asked to provide a reduction in debt-service obligations, as it is already doing with Greek sovereigns; the attendant costs of this subsidy should also be borne by the EU budget.

While ESM sovereign purchases would develop gradually over time, they would eventually make available a total amount of several trillion euro of ESM securities to private and institutional investors as well as to world central banks. Ideally, the substitution process would continue as long as necessary to bring the average sovereign debt left with private investors in the euro area down to about 80% of GDP – a debt ratio which could be set (by amending the Treaty Protocol on excessive deficit procedures) as the new benchmark for the debt ratio to GDP in the SGP. An adequate basis would thus be established for the development of a large, deep and liquid market for a European safe security, which would become the basis for a truly integrated capital market union and underpin the international role of the euro as a reserve currency and investment instrument.

The supply of a new ‘safe’ asset fully guaranteed by European institutions and the member states would pave the way for increasing diversification of the banks’ sovereign portfolios. The process could be encouraged by appropriate regulatory incentives and disincentives (Véron, 2017; Micossi and Peirce, 2020). Banks need a risk-free asset, available in large quantities, to underpin their liquidity-management operations, their market-making activities, the pricing of securities, and their investment and wealth-management policies (Basel Committee on Banking Supervision, 2017). They are not likely to abandon their home bias for a financial instrument issued by another sovereign – even by, say, Germany – so long as euro-exit and currency redenomination remain possible. The ESM liabilities would likely overcome this problem.

This scheme has several other attractive properties that are worth recalling. First, it would, over time, free the ESCB from the encumbrance of sovereigns in their balance sheets, thus creating suitable conditions for unwinding the large increase in their balance sheets after quantitative easing policies come to an end. As ESM

¹⁰ Brunnermeier et al. (2017) made an influential proposal for developing sovereign bond-backed securities (SBBS) with varying seniority tranches, with the most senior tranche (European Safe Bonds, or ESBies) being as safe as the German bund. Being based on private contracts, their SBBS would not entail any risk sharing. A High-Level Task Force on Safe Assets, established by the ESRB, was set up to assess the feasibility and impact on financial stability of creating a market for SBBS. They concluded (ESRB, 2018) that the development of a demand-led market for SBBS might be feasible ‘under certain conditions’, but could not agree either on its desirability (for the feared impact on sovereign debt markets) or its viability without regulatory support (including the introduction of concentration charges to penalise banks’ holdings of national sovereigns, the usability of ESBies as collateral in ECB operations, and complex enabling product legislation). The Commission followed up in May 2018 with a proposal for a Regulation on SBBS (European Commission, 2018), which Parliament and Council failed to approve before the end of the last legislature. Further possibilities along the same line of thought are discussed by Leandro and Zettelmeyer (2019). All these proposals aim to create safety by combining diversification of the underlying sovereign risk with seniority; this last feature is the most problematic because of its likely adverse impact on sovereign markets’ spreads and liquidity.

purchases proceeded, the liquidity created by the asset purchase programme would be reabsorbed, but the ECB would receive cash from the ESM. It could then decide to purchase other sovereigns, in order to maintain an unchanged policy stance, or let its balance sheet shrink if it deemed that the existing degree of monetary stimulus was unwarranted (any such decision to reverse monetary accommodation would of course be postponed until well after the current coronavirus crisis ends). It would at all events be fully capable of countering any unwanted effects on the sovereign debt markets produced by the substitution of ESM liabilities for sovereign held directly by the ESCB.

Second, by bringing to the market a large supply of new high-quality assets, the scheme is likely to relieve the downward pressure on interest rates in the bond markets of ‘safe’ (low debt) euro area countries, opening the way to interest rate increases even with present ECB policies. Moreover, these ESM securities would price countercyclically, as they would become the safe haven for investors fleeing instability (Bini Smaghi and Marcussen, 2018); and they could become the principal instrument of monetary policy operations, as the ECB could purchase and sell them freely without effects on national budgetary policies.

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

6. Conclusions

This paper has reached two main conclusions. The first is that sovereign debt externalities remain important in the euro area even in the new environment of permanently lowered interest rates. These externalities are first and foremost a consequence of the lack of a lending of last resort facility for sovereign debt at the ECB that may be tapped without conditions, which raises the possibility of sudden financial shocks fuelling an investor run on euro area members’ sovereign debts. The problem is aggravated by the incompleteness of the EMU architecture, which still lacks cross-border deposit insurance, a functioning bank-crisis management mechanism, and a public backstop to meet a systemic bank crisis.

These externalities justify common euro area policies to deal with excessive debt accumulation following the pandemic and attendant risks to the euro area financial stability. Our suggestion is that a substantial part of the sovereigns purchased by the ECB – in the order of 20% of euro area GDP – could gradually be transferred to the ESM, without any transfer of default risks, which would continue to fall on national central banks.

The ESM would fund these purchases by issuing its own euro-denominated securities in capital markets. In addition to the national central bank de facto guarantees against the risk of default, these securities would be guaranteed by the ESM large (callable) capital and by the existing member states’ guarantee. Thus, the ESM Triple A standing would not be endangered. A European ‘safe’ asset would thus be created that would not suffer from the drawbacks of various other schemes that have been proposed.

This scheme has several other attractive properties that are worth recalling. First, it would over time free the ESCB from the encumbrance of sovereigns in their balance sheets, thus creating suitable conditions for unwinding the large increase in their balance sheets after quantitative easing policies come to an end. At the

same time, the ECB would remain fully capable of countering any unwanted effects on the sovereign debt markets produced by the substitution of ESM liabilities for sovereign previously directly held.

Second, by bringing to the market a large supply of new high-quality assets, the scheme is likely to relieve the downward pressure on interest rates in the bond markets of 'safe' (low debt) euro area countries, paving the way for interest rate increases, even with present ECB policies.

Interest rate spreads and financial fragmentation would likely be much reduced. They are not likely to disappear as long as the EMU remains incomplete.

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