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Key points

- The draft reform of the European Stability Mechanism (henceforth ESM) was not approved as scheduled at the Euro Summit in December 2019, nor in subsequent meetings, because the Italian Prime Minister was obliged to ask for a delay in the face of strong domestic opposition to the reform from populist parties. With the outbreak of the Covid19 epidemic in February the issue has fallen out of the European agenda, at least for the time being.
- The arguments used by the populists against the reform were deeply flawed.
- The proposed changes in the text of the EMS Treaty were relatively minor and did not contain any mechanism of automatic restructuring of the debt of countries asking for financial assistance from the ESM.
- However, the small changes in the text reflected the idea that Italy would soon be obliged to restructure its debt. The only possible answer by the Italian authorities was to design a plan for the gradual reduction of the debt to GDP ratio. This will still be the case, with greater difficulties, after the end of the epidemic.
- Restructuring the debt may be a painful necessity, but it is not a way to solve the problem of a heavily indebted country in which most of the debt is held by residents.

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1. Introduction

This paper analyses the pros and cons of a proposed ESM reform and reports on how the populist parties have managed, with considerable skill, to exploit the criticisms of the reform of the ESM Treaty made last November by several Italian economists – among whom was the present author - to force Italian Prime Minister Giuseppe Conte to ask for a postponement of the signing of the agreement by the Euro Summit – an informal body indicating the meetings of the Heads of Governments of the Eurozone.¹ At the Euro Summit of June 2019, an agreement had already been reached in principle between the Heads of Governments, which led them to instruct the Ministers of Finance to work on the details so as to finalise the agreement at the December Summit.² However, at the December Summit, which was held in Brussels on 13 December, the decision was postponed, which allowed the Italian Prime Minister to avoid a government crisis.

Currently (the beginning of April), it is difficult to guess what the outcome of this saga will be. For the time being, decisions have been frozen due to the outbreak of the Covid-19 epidemic.

The paper is organised as follows. The next paragraph discusses why and how the reform of the ESM has become a topic of strong political confrontation. In Appendix 1, there is a short account of the political situation in Italy for readers who are not acquainted with it. Paragraph 3 summarises the reasons for and against the reform. Paragraph 4 reports on the evolution of the intellectual climate that has prevailed in recent years among many economists and in many European countries regarding the possible benefits of debt restructuring. Paragraph 5 points out that debt restructuring can be a painful necessity, but it is not a way of solving the debt problem in a country such as Italy, where most of the debt is held by residents. Paragraph 6 concludes the paper. Appendix 2 explains how the new intellectual climate about debt restructuring has translated into small but meaningful changes in the draft text of the ESM reform.

2. The political controversy over the ESM reform

As explained in Appendix 1, Italy had the Conte I government for 15 months, from June 2018 to August 2019, and now has the Conte II government. The first government was based on a coalition of two populist parties,

¹ See also Teresa Arnold, Ugo Panizza and Mitu Gulati, ‘The Ridiculous Drama in Rome Over Proposals to Reform the ESM Treaty’ (2019) December 10, University of Oxford - Faculty of Law.

² The press release of the summit had the following sentence: “We take note of the broad agreement reached by the Eurogroup on the revision of the ESM Treaty. We expect the Eurogroup to continue its work so as to allow for an agreement on the full package in December 2019”.

the M5S (Movement 5 Stars) and the League party and was essentially a right-wing government with strong anti-European and anti-immigration positions. The current government is based on a coalition between the M5S and the Democratic Party. Although it is headed by the same Prime Minister, Giuseppe Conte, and still has the M5S in the coalition, this government leans towards the centre-left, is very much pro-European and has abandoned the anti-immigration campaign of the previous government. The League is the main opposition party and has more than a 30% consensus in the polls.

The consensus on the reform of the ESM at the Euro Summit of June 2019 was given by the Prime Minister of the Conte I government, when the League party was still in the government, along with the M5S. However, at the time, no one objected to the reform. The political controversy began much later, in November 2019, when the Conte II government was in office and Salvini had become the leader of a very harsh opposition. What kicked up the dust was, unfortunately, a hearing held on 6 November at the Budget Committee of the Chamber of Deputies, in which the present author was called to give an opinion as an independent expert.³ Essentially, in that hearing the following arguments were made:

- the ESM is a very useful tool, especially for countries with high public debts such as Italy, because it is a safety net with considerable financial means and tends to keep spreads low;
- it is a remarkable show of solidarity of the core European countries towards the others since it is very unlikely that Germany, which is the first contributor to the ESM, will ever resort to it. Even if there was a banking crisis, Germany, with its public debt now falling below 60% of GDP, would have no difficulty in coping with it with its own means;
- the reform is suboptimal for a country such as Italy, not so much because of the words that are written explicitly in the new text (also for this reason, as will be shown in Appendix 2), but, above all, because the small changes proposed in the draft text of the Treaty reflect the European core countries' prevailing belief that Italy has no way out other than restructuring its public debt;
- since about 70% of the Italian debt is held by residents, a restructuring according to the Greek model would have very negative consequences on domestic demand (it would essentially be in a one-off tax in the order of 50% of GDP) and on the stability of the financial system;
- the only possible response from Italian authorities, it was argued, is to put in place policies to gradually improve the primary surplus and put the debt-to-GDP ratio on a downward trajectory.

³ See, on 6 November 2019, the following link at the Chamber of Deputies' site: https://www.camera.it/leg18/1347?shadow_organo_parlamentare=2805&id_tipografico=05

In that hearing, the present author used strong words against the idea, which was supported with vigour and authority by Nobel Prize winner Josef Stiglitz, that restructuring must be done “early”, that is, as soon as the problem arises, and must be “deep” to definitively solve the problem.⁴ Stiglitz's idea is that, otherwise, the international community's aid is used to repay the creditors of the state and is of little help in alleviating the suffering of the people. According to this theory, Greece should have restructured in 2010, which would have had high costs for French and German banks that were heavily exposed to the Greek state. According to this same theory, Italy should have already restructured its debt, as Josef Stiglitz said publicly at a conference at Luiss University in Rome in 2014.⁵ These sort of arguments were met with the objection that an early restructuring, i.e. one that occurs when government bonds have not yet collapsed to virtually zero value, is a decision that no government can take because it would be a “cold-blooded pistol shot in the heads of innocent savers, a kind of bail-in applied to millions of people who have trusted the government by buying its securities. It would be a far worse event than those that Italy has experienced in recent years due to the failures of some banks”.

According to the present author, these considerations were aimed at convincing politicians to take the problem of public debt seriously in a situation where (and this is the key point) the problem seemed to have disappeared from public discourse and, above all, from the policies put in place by the different Italian governments long before the outbreak of the epidemic. The idea that Italy should work to make its public debt and, with it, its welfare system, sustainable seemed to have almost disappeared in Italian politics. This circumstance legitimised the belief of the other countries that Italy would end up defaulting. This helps to explain why the core countries blocked those Eurozone reforms that included some form of risk-sharing, such as the European deposit insurance. It also helps to explain why the reform of the ESM Treaty envisaged a strengthening of the precautionary credit lines; these could be seen as a sort of Chinese wall to insulate other countries from a crisis in Italy.

Despite the present author and other economists' good intentions, the political reaction espoused the opposite view. The President of the Budget Committee, a staunch euro-sceptical member of the League, asked the House to urgently call a hearing with the Minister of Finance because, in his view, this was a case of high treason. The Prime Minister, who at that moment felt the hostility of the League, the main opposition party,

⁴ Martin Guzman, Joseph Stiglitz, *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (2016) Columbia University Press. doi:10.7312/guzm17926

⁵ See at this link, minute 55: <<https://www.youtube.com/watch?v=czGnyXjWm4A>>. Stiglitz proposes a deep and rapid restructuring of Italian debt so as to avoid the problems that occurred in Greece.

had given his consent to a reform that was a "pistol shot in the heads of innocent savers". The issue became very problematic for the Conte government because the M5S soon proved sensitive to the League's accusations against Europe and the reform of the ESM. And here it is crucial to understand the populist and anti-establishment soul of the M5S. For this political party, as well as for many populist parties in Europe, the EU is a symbol of the establishment. And the Eurozone reforms made during the sovereign debt crisis, between 2010 and 2013, are the worst imaginable evil, an enemy to be fought independently of its specific content. These reforms – in particular the ESM, Fiscal Compact and balanced budget – are the sons of the German ordo-liberal ideology that is considered the root of the hated austerity imposed on European countries and that, in Italy, has been perceived as the cause of a formidable increase in poverty and all the indicators of social unease.

The hard and uncompromising opposition to European austerity has been one of the key factors in the success of the M5S, as well as of many populist movements in Europe. This is the common trait – perhaps the only one – between the M5S and the League. That's why the M5S, while defending Prime Minister Conte, could not be surpassed by the League in this match of demagogues.

On 30 November, Luigi Di Maio, then the political head of the M5S and Foreign Minister of Italy, made a rather convoluted statement (after all, in June 2019 he was the major shareholder in the government) in which he said that Italy "could not sign the ESM Treaty in the dark". At this point, Prime Minister Conte was forced to change his strategy and on 2 December, summoned to Parliament as if there was a national emergency, he declared that he would ask the European partners to postpone the negotiations with the aim of reaching what he called a "package accord", i.e. an agreement on a wider set of issues, including the banking union, and not just on the reform of the ESM.

The result of these events was that the Euro Summit which took place in Brussels on 13 December ended in the manner that Conte had asked for, namely with a postponement and an invitation to the finance ministers to find the necessary consensus on a package of measures, including the ESM and the Banking Union.⁶ After December, and before the epidemics, there was no progress in the negotiations.

⁶ "We task the Eurogroup to continue to work on the ESM package of reforms, pending national procedures, and to continue work on all elements of the further strengthening of the banking union, on a consensual basis".

3. The economics of the ESM reform

This paragraph discusses the economic substance of the ESM reform and its pros and cons for a country such as Italy, which has a serious financial fragility problem.

For this purpose, it is useful to start with the position of the Italian Minister of Finance, Roberto Gualtieri, who believes that the reform changes virtually nothing as regards the most contentious issue, which is the restructuring of the public debts of countries seeking assistance from the ESM. In particular, the Minister pointed out that the reform does not introduce any automaticity that obliges a country seeking help to restructure its debt. An automatic mechanism had been demanded by some countries in the North and was in the auspices of the Bundesbank governor, Jens Weidmann, as well as of many French and German economists.⁷ As shown analytically in Appendix 2, from a literal point of view, Gualtieri's position is correct. Indeed, in the new text, as in the previous one, it is written that "In exceptional cases, an adequate and proportionate form of private sector involvement, in accordance with IMF practice, shall be accompanied in cases where stability support is provided by conditionality in the form of a macro-economic adjustment program". It is also written that the involvement of the private sector – a periphrasis for debt restructuring – will only take place if, following a specific analysis, the debt is judged to be unsustainable. From a certain point of view, this phrase, which was not in the old text, can be considered a truism since if a debt is not sustainable – whatever reasonably predictable policies are implemented – it is hard to see what else can be done if not to restructure it. It should also be added that this sentence is new, but that similar phrases were present in the previous text: in paragraph 1 point (a) of Article 13, a country seeking support from the ESM was expected to be subject to an assessment of the sustainability of its debt.

Therefore, Minister Gualtieri is right: it is true that, from the point of view of what worried Italian politicians, the Italian negotiators had done a good job and that it is difficult to find, in the letter of the new treaty, a worsening compared to the previous version.

The problem lies upstream: the small changes in the text, which are reported in the Appendix, reflected the evolution of the belief held by many European countries that Italy had no other way out than through a restructuring process. The problem, as argued in paragraph 5 of this paper, is that restructuring is not a solution to the Italian problems and could actually make things worse. Thus, a different text would have been

⁷Jens Weidmann, *Prospects for Europe and the euro area*, Speech held at the Centre for European Policy, Freiburg im Breisgau, 20 September 2018.

preferable, one which, instead of reiterating more forcefully the truism that an unsustainable debt must be restructured, would have said, for example, the following two things:

1. That the analysis of sustainability is very complex and involves elements of judgment on future policies that cannot be entrusted to a standardized procedure.
2. That in any case, before asking a country to restructure its debt, an analysis of the cost-benefit of the restructuring process should be carried out. In particular, when debt is held mainly by residents, one should consider that restructuring could entail a worsening of a country's overall condition, rather than freeing it from the burden of the debt.⁸

On 15 November, the Governor of the Bank of Italy, Ignazio Visco, had expressed very strong doubts about the reform of the ESM Treaty.⁹ These are Visco's words: "The small and uncertain benefits of a debt restructuring mechanism must be assessed in the face of the enormous risk that would be taken by introducing it: the mere announcement of such a measure could trigger a perverse spiral of insolvency expectations, likely to be self-fulfilling. We should all bear in mind the terrible consequences that followed the announcement of Private Sector Involvement in the resolution of the Greek crisis after the Deauville meeting at the end of 2010".

Visco's concern was therefore linked to the well-known conflict between possible ex-post benefits of mechanisms facilitating debt restructuring (here the reference would seem to be mainly to the introduction of

⁸ A reasonable solution is the initial version of the Treaty signed on 11 July 2011, which never entered into force: Art. 12 (2) had a procedure that was much more cautious for PSI. This procedure required the full involvement of national authorities: "An adequate and proportionate form of private-sector involvement shall be sought *on a case-by-case* basis where financial assistance is received by an ESM Member, in line with IMF practice. The nature and the extent of this involvement shall depend on the outcome of a debt sustainability analysis and shall take due account of the *risk of contagion* and potential spill-over effects on other Member States of the European Union and third countries. If, on the basis of this analysis, it is concluded that a macro-economic adjustment programme can realistically restore public debt to a sustainable path, the beneficiary ESM Member shall take initiatives *aimed at encouraging the main private investors to maintain their exposure*. Where it is concluded that a macro economic adjustment programme cannot realistically restore the public debt to a sustainable path, *the beneficiary ESM Member* shall be required to engage in active negotiations in good faith with its non-official creditors to secure their direct involvement in restoring debt sustainability. In the latter case, the granting of financial assistance will be contingent on the ESM Member having a credible plan for restoring debt sustainability and demonstrating sufficient commitment to ensure adequate and proportionate private-sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decisions on disbursements". (*our italics*)

⁹ See this link: <<https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2019/visco-audizione-4122019.pdf>>

the CAC single limb foreseen by the reform) and ex-ante costs related to the concerns of the markets for possible restructuring.¹⁰ Several other Italian economists expressed reservations about the reform.¹¹

The following paragraph reports on the evolution of the thinking of several economists and governments on debt restructuring in general and on the case of Italy in particular. In Appendix 2 explains how traces of this thinking can be found in the letter of the new version of the Treaty. In paragraph 5, it is argued that debt restructuring is not a solution to the problem of the debt for a country such as Italy and should, therefore, be the subject of a careful cost-benefit analysis.

4. New developments on the issue of sovereign debt restructuring

The idea that a rule should be established to impose restructuring on a country that requires access to ESM funds has been repeatedly expressed by leading members of the German establishment and other Northern European countries.¹²

This proposal is grounded in the view that the formal rules (Stability and Growth Pact and Fiscal Compact) have not worked and therefore some countries have continued accumulating debts whose sustainability over time has become increasingly dubious. Thus the idea of making market discipline work better and the need to make sense of the no-bail-out clause in the Maastricht Treaty. Aid is given, but conditioning it to the restructuring of the debt does not give rise to the moral hazard effect which, according to some, is the underlying reason why politicians in some countries did not make the necessary budgetary adjustments. The consequence, then, is that before getting involved in operations that involve risk sharing (for example, the joint deposit insurance or a stabilization budget for the Eurozone), deviant countries need to be led to reducing their risks.

¹⁰ Immediately after this declaration, the Bank of Italy corrected its position and made it clear that Visco was not against the reform. This position of non-opposition was then officially confirmed by Visco himself at a hearing held at the House Budget Committee on 4 December.

¹¹ See in particular Marcello Messeri, 'The flexibility game is not worth the new ESM' at the link: <https://sep.luiss.it/research/working-papers/2019/10/25/m-messori-flexibility-game-not-worth-new-esm>. See also Maria Cannata: 'New debt crisis clauses: vicious circle risk', (2018) Lavoce.info, 8 July.

¹² Not only Jens Weidmann. See, for example, the opinion of the Council of the German Wise Men in the following link: <https://www.reuters.com/article/us-eurozone-greece-germany-bankruptcy/german-advisers-say-euro-zone-exit-should-not-be-taboo-idUSKCN0020PS20150728?feedType=RSS&feedName=businessNews>

An essential step in this strategy is to shift the axis of economic power in economic matters from the European Commission, considered to be too politicized, to an intergovernmental and theoretically more technical body such as the ESM.

In the face of this idea, which originates in the Northern countries, there is the French view, also supported by Italy, that the two processes - risk reduction and risk sharing - must proceed together. In the Franco-German declaration made in June 2018 on the sidelines of the Mesemberg Summit¹³, mediation was found between these positions and the general principles were established, paving the way for the amendments that were later proposed to the ESM Treaty.¹⁴

Here are the main points of the Franco-German declaration, with brief comments:

- conditionality remains the founding principle of the ESM and of all its instruments of intervention;
- any decision to provide assistance to a member country must be subject to a DSA (debt sustainability analysis). Implicitly, it is understood that in the event of a failure the debt must be restructured;
- in all newly issued securities, "single limb" CACs (Collective Action Clauses) will have to be introduced.¹⁵ These are contractual clauses that allow all public debt securities to be aggregated and restructured with a single vote of the creditors, which greatly facilitates the restructuring of public debts;¹⁶
- the ESM's task should be to facilitate dialogue between the Member States and investors (when restructuring takes place);
- the ESM must play a more important role in designing and monitoring the adjustment programs of the countries to which loans are paid out;

¹³ *'Renewing Europe's promises of security and prosperity'*, a joint Franco-German declaration adopted during the Franco-German Council of Ministers, 19 June 2018 in Mesemberg, Germany.

¹⁴ Many of these ideas are inspired by a paper written by 14 French and German economists: A Bénassy-Quéré, M Brunnermeier, H Enderlein, E Farhi, M Fratzscher, C Fuest, PO Gourinchas, P Martin, J Pisani-Ferry, H Rey, I Schnabel, N Veron, B Weder di Mauro e J Zettelmeyer, 'Reconciling risk sharing with market discipline: A constructive approach to euro area reform', (2018) CEPR Policy Insight, No. 91, London, 2018, pp. 1-23. For a critique of this position see: Marcello Messori and Stefano Micossi, 'Counterproductive proposals on euro area reform by French and German economists', (2018) CEPS Policy Insights, n. 4, Brussels, pp. 1-10; also, in SEP Policy Brief, February 13, Rome, 2018.

¹⁵ As a rule, the debt contract refers to a specific bond defined by the place of issue, duration and other negotiating terms and clauses. Therefore, the stock of debt consists of a multiplicity of contracts. Under the current clauses, which have been in place throughout the Eurozone since 2013, restructuring needs a qualified majority creditor for each contract. The introduction of the single-limb drastically simplifies the procedure: the restructuring of the whole stock of debt can happen with a single vote that aggregates all holders of public securities, regardless of the specific contract signed.

¹⁶ This is what the ESM's Managing Director, Klaus Regling, said in a speech on 30 September 2009 in Helsinki.

- the ESM must have the capacity to assess the overall situation of the Member States, thus contributing to the prevention of crises. It is added – but frankly, it seems more like a style clause – that all this must be done in full respect of the role of the Commission.
- precautionary loans from the ESM to countries that have balance sheets in order, but are at risk of losing market access due to liquidity problems, must be strengthened. This is a positive innovation, but in the current circumstances it could be seen as a safety net to avoid the contagion from the country that is forced to restructure its debt.

To better understand the intellectual climate in which these guidelines have matured, it must be said that the idea of an architecture that involves a restructuring of sovereign debts in crisis situations comes not only from the "ordo-liberal" establishment of Northern Europe but is indeed a widespread idea among economists who have no confidence in the virtues of the market. The most authoritative reference, as already mentioned, is probably Joseph Stiglitz. The idea is that national authorities tend to delay debt restructuring as long as possible because the political cost of this operation is very high. But at some point, restructuring becomes inevitable and then it has heavier social and economic costs. Hence Stiglitz believes that restructuring must be "early and deep", meaning that it must take place as soon as the problem arises and must be profound in such a way as to be decisive. As far as Italy is concerned, as already mentioned, Stiglitz has long recommended it to restructure its debt.

Thus, the idea of establishing a rule that defines how debt should be restructured when a country turns to the international community for help comes not only from rigorists of Northern Europe but also from the opposite side of the political/intellectual spectrum.

5. Restructuring may be a painful necessity, but it is not a way to solve the problem of debt¹⁷

It will now be argued why restructuring may be a painful necessity, but it is not a way to solve the problem of debt. This is the view of most Italian economists, but here, of course, personal opinions are expressed which cannot claim to be representative of the economics profession in Italy.

Before presenting the analytical arguments, it should be said that:

¹⁷ This paragraph draws on Giampaolo Galli, 'Collective Action Clauses and Sovereign Debt Restructuring Frameworks: Why and When is Restructuring Appropriate' in Allan Franklin, Elena Carletti, Mitu Gulati M. and Jeromin Zettelmeyer (eds), *European Financial Infrastructure in the Face of New Challenges*, 2019, European University Institute, Florence, Italy.

- a. Defaults and restructuring can happen. They are a fact of life, whether or not they are a rational choice. One cannot conceive a federation of states in which some states provide an unlimited guarantee to other states.
- b. Market discipline usually works better than formal budgetary rules. However, much too often we see markets reacting too slowly and too abruptly, a point that was made in the Delors Report, and that is the logical underpinning of the system of fiscal rules that have been adopted in the EU. This means that governments live under the illusion that they can pile up mountains of debt and keep refinancing it at low rates. And the realization that such a strategy will not work perpetually does not arrive in the minds of the government officials and politicians until it is too late.¹⁸
- c. Sovereign restructuring may be unavoidable and perhaps appropriate under some circumstances, which are mainly the following: i) a country asks for external assistance, which means foreign taxpayers' money; ii) the restructuring is part of a package agreed with official creditors aimed at fiscal rectitude and is by no means a substitute for fiscal rectitude, and iii) the restructuring is not too large in a sense that will be made clear below.

With that said, the ultimate goal of what the European Union is doing must be clear: it is trying to convince Italy to implement a credible plan to improve its budget, according to current rules. The goal cannot be the restructuring of the debt: restructuring in the absence of a credible fiscal plan would be a tremendous problem for Italy and would cause harm to the rest of the Eurozone as well.

Therefore, the key point is that restructuring is a way to “solve the problem of the debt”, that it is an alternative to fiscal rectitude.¹⁹ Restructuring can at best be a complement to fiscal rectitude unless it is a necessity. In this latter case, one is not talking about rational choices, but, at best, about disaster management. Here is why:

- a. the key thing to have in mind is that restructuring the Italian debt is a different story from the various emerging market countries dealt with by the IMF in recent decades and also from Greece. The reason is that in these cases, most of the debt was held by foreign banks or by a small number of wealthy nationals who held domestic bonds through illegal foreign deposits. In these cases, restructuring imposed a burden on foreign institutions and a few wealthy nationals. In the case of Italy, it would impose a

¹⁸ See Marco Committeri and Pietro Tommasino, ‘Managing Sovereign Debts’ *Banca d'Italia Occasional Papers*, July 2018, at the link: <https://www.bancaditalia.it/pubblicazioni/qef/2018-0451/OEF_451_18.pdf?language_id=1>.

¹⁹ See Sofia Bernardini, Carlo Cottarelli, Giampaolo Galli, and Carlo Valdes, ‘Reducing Public Debt: The Experience of Advanced Economies over the Last 70 Years’ (June 16, 2019). Available at SSRN: <<https://ssrn.com/abstract=3405018>>

substantial burden on domestic residents who hold the debt either directly or through (mutual or pension) funds. Residents hold about 70% of the debt in Italy today, while they held roughly 30% in Greece in 2012. This is an essential difference from a social and political point of view.

- b. There are also different economic consequences, because, when the debt is large and widely held by the population, a restructuring of the debt will be detrimental to domestic demand through three main channels: (i) wealth effects on consumption, because restructuring is a very large tax on wealth; (ii) reputational effects that may prevent private companies to access markets for quite some time given that corporate ratings are linked to sovereign ratings and both would be at junk level; and (iii) a credit crunch, since bank capital would be eroded by the loss on government bonds. The importance of this argument depends on how large the restructuring is and this leads to a critical analytical argument.
- c. A small restructuring will cause the markets to expect a bigger one, and capital flight will be huge (unless accompanied by a significant shift in budgetary policy to make the debt sustainable in the context of an agreement with the official creditors).
- d. In turn, this means that the restructuring makes sense only if it is large, in the sense that it is a definitive and credible solution to the problem of the debt. This implies that a debt of 130% of GDP must be cut down to something like 80 or 90 percent. This move is bound to cause a major recession through the three channels mentioned above. In addition, the restructuring would have to be accompanied by a very tight budgetary policy both to minimize the need to tap the markets the next day and to regain credibility. These actions would aggravate the fall in domestic demand. ESM and IMF resources can smooth the transition and allow a country to continue running a small deficit for some time, but at the end of the transition, after 3 or 4 years, the country must be able to regain access to the markets, which in any case requires that the budget be brought to an equilibrium (which essentially means a balanced budget). In the end, fiscal rectitude is necessary, whether or not there is a restructuring, but it is more difficult to exercise it if there is restructuring because the latter damages domestic demand and does not do much to reduce the primary surplus, which is needed to put the debt on a downward path.²⁰
- e. To these considerations one should add that a large part of the debt (as in the case of Greece) is held by domestic banks, which, following a restructuring process, would need to be recapitalized, otherwise one would not only have a credit crunch but a full-fledged banking crisis. This means that the state would have to ask for official loans, implying that there would be little or no relief on this part of the debt.

²⁰ If $(r-g)$ is around zero, the level of the debt ratio is irrelevant for debt dynamics. If it is +1%, then having an initial debt ratio of, say, 90% instead of 130% makes a difference of 0.4% of GDP in the level of the primary surplus that is needed to keep the debt constant. With a $r-g=2\%$, the difference would be 0.8%, still less than one per cent of GDP.

6. Conclusions

Given these considerations, the following conclusions seem warranted:

- a. The ESM is a very useful tool, especially for countries with high public debts, such as Italy, because it is a safety net with considerable financial means and tends to keep spreads low;
- b. It is a remarkable show of solidarity of the core European countries towards the others since it is very unlikely that Germany, which is the largest contributor to the ESM, will ever resort to it.
- c. The proposed changes in the text of the EMS Treaty are relatively minor and do not contain any mechanism of automatic debt restructuring in countries asking for financial assistance from the ESM.
- d. However, the small changes in the text reflect the idea that Italy will soon be obliged to restructure its debt.
- e. Since about 70% of the Italian debt is held by residents, a restructuring process according to the Greek model would have very negative consequences on domestic demand (it would essentially be a one-off tax in the order of 50% of GDP) and on the stability of the financial system.
- f. A small debt restructuring is likely to engender a fiscal crisis because agents will come to expect a more extensive restructuring. A large restructuring, on the other hand, bringing the debt down from, say, 130% to 80%, will cause serious damage to domestic demand, thus making it more difficult to put the debt ratio on a sustainable path. Such negative effects could last for several years because of the loss of reputation in the markets.
- g. At the end of the story, the budget must be balanced, and the level of the debt makes a relatively small difference in the primary surplus that is needed. Hence, the path to fiscal rectitude is far less painful without restructuring because restructuring reduces the debt, but causes significant damage to domestic demand. It is obvious, although worth repeating, that if the government never undertakes fiscal responsibility, then default and restructuring become a necessity, and – it should be added – a dramatic one.
- h. It is doubtful that there can be such a thing as an orderly restructuring when a debt is large and is held by millions of domestic savers. Major financial disruptions are to be expected, as well as social and political tensions of great magnitude. The experience of Argentina in 2000-2001 probably gives a sense of how bad things can get. Or the Weimar Republic, when the government's default on the real debt annihilated Germany's middle class.²¹

²¹ Alberto Alesina 'The end of large public debts', in Francesco Giavazzi and Luigi Spaventa (eds.), *High public debt: The Italian experience*, Cambridge University Press, 1988.

- i. It is also unclear that there can be such a thing as an early restructuring. In the sense that no government will ever decide to restructure the debt unless it is already close to a state of default and bond prices have already collapsed; only then can the government offer a slightly better deal to bondholders. As mentioned above, an early restructuring is a cold-blooded pistol shot in the heads of innocent savers. It is much worse than bank fraud, for which there are penal responsibilities in all countries. Besides, in Italy, as in most countries, an early restructuring would likely be held in local courts as unconstitutional, because the Italian judicial system is based on the rule of law and it protects property rights and, especially, savings; expropriation is possible for reasons of public interest, but only with due indemnification.²²
- j. Whatever the EU will do with the ESM rules, it is crucial not to repeat the mistake that was done in 2010 in Deauville. When markets learned about PSI, contagion effects were significant and markets were destabilized in several Eurozone countries.²³

For these reasons,

- these issues must be handled with great care;
- a different wording of the ESM Treaty would have been desirable, stressing, in particular, the need for a thorough cost-benefit analysis of any restructuring proposal;
- Italian authorities and politicians should stop complaining to Germany or Europe about budgetary rules or the ESM. The only thing that makes sense for them is to start being serious about reducing the ratio of public debt to national income.

²² A preemptive restructuring, i.e. one that occurs before technical default on some payments, is very different from an early restructuring and may instead be useful in making the restructuring less disorderly and costly. See Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises*. MIT Press, 2006.

²³ Lorenzo Bini Smaghi, 'Reconciling risk sharing with market discipline - Comment on the CEPR policy Insight n.91' (2018) *LUISS School of European Political Economy, Policy Brief*.

Appendix 1: Italy's political background, Conte I and Conte II governments

This appendix provides an essential background on the political situation in Italy. It is necessary to understand why the issue of the ESM reform has been and still is a source of so much tension. The reader who is familiar with the Italian political situation can skip this Appendix.

In June 2019, when Eurozone governments gave the green light to the reform, Italy had the so-called “yellow-green” government, a coalition between the two populist parties that had come, respectively, first and third in the general elections held at the end of the previous legislature in March 2018: the M5S (5 Star Movement), a party founded by comedian Beppe Grillo, which was characterized by being against everything that appeared to be an expression of the establishment, and the League, a party led by a real politician, Matteo Salvini, which was born to claim autonomy for Northern Italy and had turned into a nationalistic right-wing movement characterized by hostility towards immigration and by international relations with Orban, Le Pen and Farage within Europe and with Putin outside Europe. In the general election of 4 March 2018, the M5S received 32.7% of the popular vote and the League polled 17.4%. Together, with great difficulty, they formed a government which on paper had a fairly solid majority in Parliament (because of the share of seats allocated by the first-past-the-post method), although it was immediately clear that the two parties were going to clash on many issues. The M5S, while refusing to declare itself either right-wing or left-wing, has a rebellious soul, with pauperism and anti-imperialistic tones in international affairs and dirigisme in economic issues, which somewhat resembles the student movements of the past decades. From this point of view, it was doomed to clash with the League whose social base is formed to a large extent by that myriad of small entrepreneurs, strongly pro-market, who have been the success story of the richest areas of Northern Italy. To form a government they needed a Prime Minister who would somehow appear as a mediator and, after having written the government program, they chose Giuseppe Conte, a law professor who had never been in politics and who was unknown to public opinion and politicians themselves. That government lasted for 15 months, from 1 June 2018 to 5 September 2019, when Matteo Salvini, who was polling above 30% in the surveys, withdrew from the government, thinking that the President of the Republic, Sergio Mattarella, would have called early elections. However, this did not happen and, after another rather complex story, a “yellow-red” government was formed, composed of the M5S and the Democratic Party, which in the 2018 elections had taken 18.7% of the popular vote, as well as of smaller parties. There are two paradoxical aspects of this improbable alliance: the Democratic Party is the party that, between alternate vicissitudes, had supported, until the very last day, the Monti government in 2011-12 and had then been in government for the entire 2013-2018 legislature;

therefore, the Democratic Party represented the symbol of that political and financial establishment that the M5S was born to fight. The other paradox is that, at the request of the M5S, lawyer Giuseppe Conte remained Prime Minister. Therefore, Italy had the Conte I government, which was centre-right, strongly Eurosceptic and hostile to immigration, and today it has the Conte II government, leaning to the centre-left with a soul that is contrary to that of the previous government, especially on issues of immigration and relations with Europe. During this passage, the M5S lost its soul and, above all, the votes; in the polls it fell below 20% and in the local elections it almost disappeared. The League party remains very strong, with more than 30% in the surveys.

Appendix 2: The changes in the draft proposal of the new ESM Treaty

This Appendix illustrates analytically the points of the draft reform of the Treaty, which reflect the evolution of the economic thinking mentioned in paragraph 5.

- a. **Point 5B of the preamble and art. 3 paragraph 1.** This is where the ESM is given all the powers that the Commission has today regarding crisis prevention and management, both for countries with financial assistance and for others. The difference in the tasks of the two institutions is defined by a crucial phrase of the preamble that reads: "The ESM performs its analysis and assessment from the perspective of a lender". Of course, this is the point of view of those who have the knife on the side of the handle. Above all, this is a rather serious problem in the system of European institutions, whose perspective can only be that of the well-being of the entire European community and not just of a part of it.
- b. **Point 10 of the preamble.** The existing Treaty gives the Commission and the ECB the function of carrying out the tasks of the Treaty itself. What is new is that these institutions can no longer act without an ESM decision.
- c. **Point 11 of the preamble and art. 12 paragraph 4.** Single limb CACs are introduced on all sovereign bonds issued from 2022. In theory, these clauses are more efficient than those implemented in the Eurozone since 2013, but it is difficult to doubt that their introduction, even from 2022, is a negative

signal about Italy being given to the markets today²⁴. This reflects the belief that restructuring is almost inevitable in Italy.

- d. **Point 12 of the preamble.** The ESM is tasked with facilitating dialogue between investors and the Member State that restructures its debt. This is an important task given to the EMS and suggests that the idea of restructuring was not considered as a remote possibility.
- e. **Point 12 of the preamble and art. 13 paragraph 1.** It is stated that the ESM provides financial assistance only to countries whose debt is considered sustainable and whose ability to repay loans to the ESM itself is confirmed. The analyses are carried out jointly by the ESM and the Commission, but if a common position is not reached, the Commission has the final say on debt sustainability. However, it is the ESM that is responsible for assessing the country's ability to repay the loan. Here, too, it seems obvious that the knife is in the hands of the ESM.
- f. **Point 12B of the preamble.** Here is a concept that was already present in the previous formulation, but which in this context takes on a somewhat different meaning: it is the concept of PSI, or "Private Sector Involvement", a periphrasis for debt restructuring. This expression was used by Angela Merkel and Nicholas Sarkozy in the famous Deauville Walk on 18 October 2010 and had a tremendous effect on Eurozone financial markets. At the time, this phrase referred to Greece, a country whose debt was clearly unsustainable. Today it refers to Italy. Repeating this phrase today, in a different context from that of 2010, can have a negative effect on the markets.
- g. **Point 18 of the preamble and art. 13 paragraph c.** The ESM is responsible for establishing appropriate warning systems in order to ensure that they receive payments due to the defined deadlines. This is also a very important operational task which shifts the axis of economic power against the Commission.
- h. **Art. 7 paragraph 4.** The power of the ESM Managing Director, who acts in total independence in the performance of his duties, is strengthened: he only responds to the Board of the ESM. Note that the Managing Director is the ESM's only interface with the entire European Commission.
- i. **Art. 14.** This is where the instruments of precautionary loans are strengthened, and it is specified that these loans are provided to countries whose debt is sustainable, but which are hit by exogenous shocks beyond their control. The precautionary line of credit under condition (PCCL) is granted to countries with solid fundamentals in the face of a simple letter of intent; a strengthened precautionary credit line

²⁴ Single limb CACs are meant to minimise the problem of holdout creditors. For a discussion of the problem, see: Lee C Buchheit, Mitu Gulati, and Ignacio Tirado, 'The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings' (January 22, 2013). Available at SSRN: <<https://ssrn.com/abstract=2205704>>

(ECCL) is granted to countries that do not meet all the requirements with the signing of a detailed Memorandum of Understanding. An important innovation is that both lines of credit are granted only to countries that are not subject to excessive deficit procedures and that have been complying with the criteria of the Stability and Growth Pact for at least two years. These innovations undoubtedly strengthen countries that do not have problems with financial instability, but it could also be a line of defence against the risk of contagion from a country forced to restructure its debt.

Concluding this analysis of the text, it can be repeated that Minister Gualtieri is right: innovations are marginal and there is no automatic restructuring. The small changes introduced, however, reflect the evolution of the thinking of many European governments that may be a legitimate source of concern for a country such as Italy.