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TOWARDS A JOINT DEBT INSTRUMENT AND FISCAL CAPACITY

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THE EUROPEAN UNION is going through a very difficult phase, besieged by historic internal and external security challenges, unmanageable migratory follows, and deep-seated discontent among its citizens. With Brexit came the first tangible sign that the process of European integration is not irreversible. The area's financial conditions, at this moment, are relatively stable, but this stability could prove ephemeral, since severe tensions and divergences permeate the euro system.

On the one hand, divergences in the fundamental economic variables between Northern European member states (the "core") and those in the south (the "periphery") are not going away. Policies to limit deficits and public debt face mounting internal obstacles, in an environment of high unemployment and low economic growth. Extensive areas of fragility in the banking system remain. Political systems are weakened by the rise of populist parties, who dwell on public discontent and use it to fuel anti-European sentiments.

At the same time, discussions on strengthening the area's common economic policies are stalling. The credibility of the Stability and Growth Pact has crumbled, caught in a vise between opposing visions—respect for European rules is pitted against requests for budget flexibility to bolster political consensus. Negotiations on Banking Union at the ECOFIN Council are gridlocked due to an inability to agree on the issue of risk reduction. The European Commission is criticized in Berlin because it has not succeeded in enforcing the rules and in Rome because the rules are considered too rigid.

Also, the European Central Bank (ECB) has lost manoeuvring room, both because of doubts over the efficacy of its expansionary monetary policies, as well as the increasing hostility in the financial world against its bond-buying and negative rate policies. If Mario Draghi were forced to postpone or put on hold the announcement of further measures of quantitative

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easing (QE) policies, it could be the signal markets are waiting for to bet against the euro, causing the re-denomination risks on certain sovereign debts to reappear.

In these circumstances, new financial shocks cannot be excluded, and, were they to manifest, the profound disaccord between the authorities governing economic policies of member states risks resulting in an inadequate response and a failure to stabilize markets. This disaccord could provide an opening for destabilizing attacks not dissimilar to what occurred in 2011-12.

The second consideration centres on this point, i.e., the virtual breakdown in the coordination of macroeconomic policies and the apparent abandonment of the framework preconfigured in the *Five Presidents' Report.* This framework envisages a strengthening of economic and budgetary reform, along with the establishment of a European Minister of Finance endowed with the power to correct national deviations from agreed targets, as well as elements of Fiscal Union (a common 'fiscal capacity'), and a European deposit insurance scheme (EDIS). These latter elements imply a degree of macroeconomic and financial risk-sharing, providing the euro with a shield against the dangers of new financial shocks.

In Berlin today, this framework seems to have been abandoned, or at least relegated to second place. One sees, instead, the favouring of proposals to reinforce budgetary discipline through market mechanisms, leaving economic and budgetary policy decisions at the national level, along with new provisions whereby countries in financial difficulty seeking assistance from the European Stability Mechanism (ESM) must first accept an automatic "haircut" on its sovereign debt, imposing losses on holders of its sovereign bonds. Thus, in the name of increasing stability in the Euro system, highly indebted countries would have to announce that investors in their sovereign debt would be subject to automatic losses.

In equilibrium, a system that included such clauses would, of course, be seen as improving incentives and entailing greater market discipline. However, during the transition to the new regime, one cannot play down the destabilizing effects that could result from investor flight.

Remember, in this regard, that the true detonator of contagion in the sovereign debt crisis of the Eurozone, which impacted countries from Greece to Portugal, including Spain, Italy, and even France, was the announcement in Deauville by both the leaders of Germany and France of the decision to impose substantial losses on private investors holding Greek public debt in their portfolios. Investors took this, and they were not wrong, as an announcement that sovereign debt of euro area countries could no longer be considered risk free. Also, remember that the acute instability in the markets following this event became the leverage Germany used to impose austerity policies on its partners, which brought about a new phase of deep recession, following that of 2009, disproportionately embroiling the indebted peripheral countries of the Euro area.

Meanwhile, we must not overlook the possibility that the ECB's ability to intervene to stabilize financial markets in turmoil might have become more constrained—the promise of doing "whatever it takes" would probably not suffice this time, forcing the central bank to use real money to sustain sovereign bonds under attack. As we all know too well, under the Outright Monetary Transactions (OMT) programme, the money needed to support sovereign debt cannot be spent without preliminary agreement on a stabilization programme with the European Stability Mechanism (ESM)—an agreement that requires unanimity among member states, and therefore the consent of Germany, which could be rather difficult to obtain.

Are we really sure that we want to go down this path again? Is there a full understanding that the euro may not survive a new passage of this type?

A final consideration concerns the design of the ultimate structure of the monetary union—assuming that, sooner or later, a sufficient level of economic convergence is achieved, public debts are credibly brought under control, and the Banking Union is completed with a European deposit insurance scheme and adequate fiscal backstop mechanisms against systemic cross-border banking crises.

It seems inevitable that this final structure will involve resuming enforcement of Article 125 of the Treaty (the no-bail-out clause), which has, in fact, been suspended in recent years. The history of federations indicate, in fact, that this is a fundamental condition of financial stability. The consequences of this prerequisite for a stable monetary union should be fully understood. The history of federations show that, when the debt of sub-federal governing units are no longer risk free, the direct consequence of the no-bail-out clause, a risk-free bond, issued at the federal level, also needs to exist.

This is necessary in order to provide the financial system with an instrument of liquidity, which is a basic requirement for that system to function. For example, a fractional-reserve banking system (whereby a bank holds reserves equivalent only to a fraction of its deposit liabilities, and provides credit to the economy with the rest) cannot function without a perfectly liquid instrument, negotiated on a wide market, in which banks and investors can place their liquidity buffers.

The existence of a common debt instrument naturally calls for a common fiscal capacity, with various possible means of intervention. This could be used for the ECB's liquidity interventions, for anti-cyclical interventions by the federation's treasury, or even used to finance European infrastructural projects for the internal market—projects that naturally guarantee higher returns than the issue cost on the market. The management of the bond issuance could be entrusted to the ESM, which already constitutes a potential nucleus for a joint fiscal capacity.

The existence of a joint debt instrument and fiscal capacity naturally presupposes a Minister of Finance for the federation, with adequate powers for managing common policies under the mandate of the Governing Board of the ESM (de facto, the Eurogroup Ministers of Finance). This would return us to the framework preconfigured in the *Five Presidents' Report*.