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The flexibility game is not worth the new ESM

Marcello Messori

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THE FLEXIBILITY GAME IS NOT WORTH THE NEW ESM

Marcello Messori*

Abstract

The reform of the Treaty Establishing the European Stability Mechanism (ESM) broadens the functions of this mechanism so as to transform its current role of financial manager of sovereign debt crises into an institution for the prevention, control and management of such crises. There is thus the risk that the ESM will also have the power to decide whether a euro area Member State that is forced to apply for a European aid program should restructure its government debt in advance. In this eventuality, euro area countries with a high public debt - such as Italy - would be exposed to heavy and distortionary instability. It is therefore appropriate to prevent the ESM from assuming this restructuring power or, at least, to minimize the risk of Italy having to resort to a European aid program. The repeated use of flexibility in the management of public balance sheets is not going in that desired direction and must therefore be replaced by other strategies.

JEL Classification

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Keywords

Crisis management, crisis prevention, restructuring of public debts.

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1. Introduction

After the 2007-2009 international crisis the still short history of the euro area has seen the profound evolution of economic regulation and governance alternate with phases of stalemate. During the phases of evolution, the European institutions produced more binding centralized rules concerning national budgetary policies, the adjustment of macroeconomic imbalances between Member States, and the working of the banking and financial sectors in order to create space for the introduction of risk management and risk reallocation mechanisms. During the stalemate, institutional innovations lost their vigor, fostering the illusory belief that the economic stability of the euro area could be guaranteed through market 'discipline' alone. For example, the adoption of the first tools of centralized regulation in the banking and financial markets and the proposals for the revision of the ***Stability and Growth Pact*** (SGP) were accompanied by the implementation of European aid programs through the creation of new, even if – as a first step – temporary, mechanisms for managing the sovereign debt crises (2010). In the subsequent phase (2011), it was instead necessary to wait until the end of the year for the European Central Bank (ECB) to outdo the other – impotent - European institutions and to put an end to the regulation and market 'failures' and to the 'doom-loop' between the sovereign debt crises in the 'periphery' of the euro area and the crisis of the European banking sector.

This paper does not intend to analyze the alternation between the phases of institutional renewal and the phases of stalemate in the European Union (EU) and the European Economic and Monetary Union (EMU).[1] In fact, it focuses on the ongoing phase that began with putting aside the 'package' of initiatives proposed by the European Commission in December 2017, that was supported on several occasions by French President Emmanuel Macron and echoed in words by various Franco-German bilateral documents without, however, becoming a priority objective in the official agenda.[2] One of the few elements of this 'package' that has not been deleted or weakened but that has, on the contrary, taken on increasing importance concerns the redefinition of the statute and the tasks of the European Stability Mechanism (ESM). Approved as a permanent mechanism in December 2010 and set up for becoming operative in March 2012 under an international treaty outside the EU regulatory framework, the ESM actually entered into force in October 2012.

In mid-2018, the Eurogroup and the Euro Summit initiated a process for extending the tasks and functions of the ESM that intends to revise the treaty establishing this mechanism. If the deadlines

[1] The problem has been addressed in various papers. Here the reference to Bastasin-Messori (2018) will suffice.

[2] Cf. European Commission (2017c); cf. also European Commission (2017a) and (2017b). Regarding Macron's speeches, it is enough to refer to the one at the Sorbonne (November 2017); and as for the Franco-German documents, the most interesting is: Meseberg declaration (2018).

are met, by the end of 2019 the ESM will not only manage – as has been the case so far – the financing of aid programs for the euro area Member States that have lost or are likely to lose access to financial markets in order to (re)finance their expiring public debts, but will also carry out strengthened functions of precautionary prevention, ex-ante control and crisis management in those same states.[3] This paper aims to demonstrate that there is thus a risk of introducing ex-ante – quasi-automatic – mechanisms for restructuring national government debts and increasing instability in the euro area.

In the following, I will describe the main novelties that have already been or are in the process of being approved regarding the tasks to be assigned to the ESM (cf. Section 2). The scope of these novelties is then assessed in terms of the delicate balance of weights between national responsibilities and European rules in terms of budgetary policies (cf. Section 3). It follows that, given the more general framework of European governance, the reform of the ESM is a crucial step to avoid the alternation of the abovementioned phases of progress and stalemate that have hampered the strengthening and credibility of the EMU (cf. Section 4). The main envisaged solution is, however, one of the worst possible for countries with a high public debt such as Italy (cf. Section 5). It is therefore in the Italian interest to pursue an alternative solution, one that can be based on the same reform of the ESM (see Section 6). The short ***Conclusions*** (see Section 7) sum up the paper's policy suggestions and emphasize the difficulties that need to be overcome for the implementation of these suggestions.

2. The new tasks of the ESM

The June 2018 meetings of the Eurogroup and the Euro Summit put aside the set of proposals, elaborated by various European actors in the second half of 2017, that were aimed at opening a new stage of progress in the economic governance of the euro area. These proposals were echoed in Macron's speeches, the European Commission's 'package' (2017c) and the Franco-German declarations (cf. footnote 2), as already mentioned. Despite these initiatives, the completion of the banking union, the creation of a common balance sheet in the euro area, the appointment of a European economy minister, and fiscal harmonization have stalled. Conversely, as highlighted by the letter sent on June 25, 2018 by Eurogroup President Mario Centeno to the then president of the European Council (and the Euro Summit) Donald Tusk, the finance ministers of the euro area agreed on the necessity to strengthen the ESM as a manager of crises that can threaten the

[3] In what follows, I neglect the fact that also the 2012 Treaty attributed to the ESM some precautionary prevention tools since it would have been very difficult for the ESM to actually utilize these tools. It is also assumed that the EU countries that are not part of the monetary union can adhere to the ESM Treaty on a voluntary basis. For the sake of simplicity, reference will still be made to the euro area only.

stability of the monetary union. The proposal was to equip the ESM with new tools of precautionary prevention and to strengthen its support for Member States that are in difficulty and/or require assistance but that - at the same time - comply with European rules or are ready to undertake the implementation of the necessary adjustments.

In that same letter, Centeno acknowledges that the June 2018 Eurogroup did not come to a shared interpretation of the ESM's new tasks. Some finance ministers from the most fragile Member States believed that these tasks mainly required the ESM both to carry out anti-cyclical and stabilization support measures even without implementing formal European aid programs and to activate of 'last resort' (backstop) interventions in banking resolution processes. Some ministers from the Northern European countries, instead, insisted on the ESM's new responsibilities in terms of prevention and ex-ante control with respect to the management of budgetary policies of countries with a high public debt, even by possibly imposing the preliminary restructuring of such a debt on the Member States applying for the activation of a European aid program.[4] Following a similar approach, these same ministers suggested reducing the role of the backstop offered by the ESM to an emergency credit line, even if in the form of a revolving fund.

In the same letter President Centeno introduces some key points which are very close to this second position. He says that, despite "the concern expressed by some members for the impact on the market", by the end of 2018 the Eurogroup intends to apply the so-called single-limb to the "Collective Action Clauses" (CACs) [5]; even if, with an ***excusatio non petita*** (unrequired justification), Mr. Centeno adds that this introduction does not foreshadow – in and of itself – recourse to the restructuring of the public debt and the related involvement of the private sector in case a Member State is forced to activate a European aid program. These considerations were strengthened by the ***Statement*** of the following Euro Summit, also in June 2018, which, besides recommending the approval of a weak form of backstop for the end of the year, shares the proposed reforms of the ESM and urges their implementation.

[4] See, in this regard, the subsequent document, entitled ***ESM Reform*** (November 2018), which was shared by the finance ministers of the following EU countries: Czech Republic, Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands, Sweden and Slovakia.

[5] The CACs imply that, even if the borrowers are sovereign countries, the restructuring (or renegotiation) of a debt contract cannot be unilateral but requires the support of a qualified majority of the lenders. As a rule, the debt contract refers to a specific obligation defined by the place of issue of the contract, its duration and other terms and negotiation clauses. Therefore, the stock of public bonds of any country is based on a multiplicity of debt contracts; and the restructuring of the entire stock requires the qualified majority provided for by each subset of (private) holders of government bonds of that country that belong to each of the specific contracts. The introduction of the single limb drastically simplifies the procedure: the restructuring of the debt stock of a country is based on a single vote that aggregates all the holders of public bonds of that country, regardless of the specific signed contract. Therefore, the approval of this restructuring requires a qualified majority of the aggregate of (private) holders of that country's public bonds.

After discussing the matter also at the Eurogroup meeting in early November 2018 (cf. the related ***Remarks*** by M. Centeno), in the meeting of December 3, 2018, the Eurogroup agreed on six points:[6] (i) the attribution to the ESM of a backstop function in the second pillar of the Banking Union, transformed, however, into a revolving credit line that is difficult to implement and that is subject to the prior reduction of other banking risks so as to postpone its likely operativity until 2024; (ii) the clear indication that the ESM will have to take responsibility for both precautionary prevention and ex-ante and ex-post control and for the management of the debt crises of the euro area Member States; (iii) a preliminary definition of the precautionary tools that would allocate the new ESM funds to countries with budgetary fundamentals that comply with European rules but that are affected by negative shocks beyond their control; (iv) the substantial removal of those instruments for fiscal stabilization and for economic convergence which were desired by the most vulnerable Member States; (v) the attribution to the ESM of a mediation function between lenders and borrowing Member States (even if voluntarily accepted by the contracting parties and with non-binding impacts for these same parties); (vi) the simplification of the procedures for the restructuring of the public debt by the application (by 2022) of the single limb to the CACs on newly issued government bonds.

The Euro Summit ***Statement*** of December 14, 2018 legitimized these six points and urged their formalization. It stressed that there was full agreement on the backstop and the reform of the ESM, such that the Eurogroup was invited to "prepare the necessary amendments to the ESM Treaty (with the inclusion of the common backstop [...]) by June 2019".

3. The revision of the ESM Treaty

The Euro Summit's request was largely met at the Eurogroup meeting on June 13, 2019. As stated also in the ***Statement*** of the following Euro Summit (June 21, 2019), the financial ministers of the euro area reached a broad agreement with regard to: the revision of the ESM Treaty, which includes the practically definitive specification of how the backstop should work for the second pillar of the Banking Union[7]; the attribution to the ESM of the new tasks of precautionary prevention and sovereign crisis management and the consequent redefinition of the relationship

[6] Cf. the ***Term sheet on the European Stability Mechanism reform***, 4 December 2018; and the ***Terms of reference of the common backstop to the Single Resolution Fund***, 4 December 2018.

[7] In the remaining part of the paper, this instrument will not be elaborated upon. Let us only note that, in accordance with the suggestion of Bénassy-Quéré ***et al.*** (2018), in the draft revised Treaty of the ESM it is suggested that the backstop be definitively transformed from a 'last resort' reinsurance instrument into additional financing with fiscal neutrality in the medium term. This solution, which had been proposed by the European Commission (2017b) as the first transitional phase, has serious limits in terms of permanent implementation and effectiveness (cf. Messori-Micossi 2018).

with the European Commission[8]; the specification of new precautionary instruments that could be used by the ESM. The whole set of these measures and their connection with the existing regulations will have to take final form by December 2019 so as to be adopted at the beginning of 2020. At the same meeting, the Eurogroup members also designed instruments for convergence and competitiveness within the euro area that were removed from the ESM functions and included in the new EU multiannual financial framework (cf. ***Term sheet on the budgetary instrument for convergence and competitiveness***, 14 June 2019).

From a legal point of view, unlike what the European Commission desired (2017c), the draft revision of the ESM Treaty does not aim to incorporate the latter institution into the European legislation but instead maintains its intergovernmental statute based on international law (cf. Gianniti 2019). From the governance point of view (cf. The Eurogroup 2019, Art. 4-7), it does not offer effective solutions to the previous and excessive centralization of powers in the hands of the managing director. Economically ***(ivi,*** Art. 3), it states that ESM interventions in support of a Member State are bound by the sustainability of its public debt and by a strict conditionality; moreover, these interventions can be implemented only if they are crucial for ensuring the stability of the euro area. Two of these possible actions are examined here: precautionary assistance and the ex-ante assessment of the debt of the Member States that require the activation of a European aid program.

With regard to the first subject (cf. ***ivi***, pp. 7-8, Articles 13-14, and Annex III), the ESM may provide precautionary assistance to euro area Member States which have sound economic and financial fundamentals, but which are affected by a negative shock beyond their control. In particular, to access the precautionary conditioned credit line (PCCL), a country with the mentioned general features must also have met in recent years the requirements of the new SGP (including the public debt rule) and must not have macroeconomic imbalances, financial vulnerabilities and difficulties in accessing capital markets that are so serious so as to produce negative systemic impacts. In such cases, the ESM offers its assistance on the basis of a 'letter of intent' requiring the country to curry on its compliance with European rules and, where appropriate, to follow a few broad guidelines. Conversely, if a Member State has the general features but does not meet all the requirements specified above, it shall not have access to the PCCL but may use the enhanced conditions credit line (ECCL) which makes ESM assistance conditional on the sharing of a detailed

[8] In this regard, wide reference was made to the previous document agreed between the two institutions: ***Future cooperation between the European Commission and the European Stability Mechanism*** (14 November 2018).

Memorandum of Understanding (MoU). In such cases, the country's commitments to the ESM become more penetrating and binding.

The new precautionary prevention functions do not remove the ESM's old tasks: provide financial support to euro area Member States which do not have economic fundamentals sound enough to access the PCCL or ECCL and which, being in difficulty, are forced to ask for European aid programs. In the draft revision of the ESM Treaty (see Eurogroup 2019, Art. 13, par. 2-8), this old task is enriched by ex-ante and ex post control functions and by more pervasive crisis management responsibilities. These functions require the ESM to make precise assessments of the economic and financial imbalances and of the sustainability of the public balance sheets of countries with high debt stocks and, therefore, with high risks of being involved in a European aid program ***(ivi,*** p. 7 and Art. 3, par. 1). In particular, as is repeatedly stressed in the draft revision of the Treaty, the ESM can finance an aid program or – all the more so – a precautionary support for a country only if this country has a public debt that is sustainable and does not compromise its solvency. To assess the sustainability and solvency ex-ante, the ESM should, however, have already carried out an assessment of the debt stocks of the high risk countries; and, in the "exceptional cases" in which it has judged some of these stocks unsustainable, it should enforce an "adequate and proportional" form of "private sector involvement" which is equivalent to public debt restructuring. In these cases, ex-ante debt restructuring becomes the precondition for accessing the European aid program (cf. ***ivi***, p. 7, point 12B; and Article 12).

Note that the novelty does not lie in the fact that sovereign debts can undergo restructuring. Already the 2012 Treaty gave the ESM, the European Commission and the ECB ample possibility for intervention in the event that a country under an aid program was unable to repay its debts and the related financial charges. In addition, the draft revision of the ESM Treaty is careful not to interfere in the new division of competences, which are being drawn up by the Commission and the ESM (cf. ***ivi***, pp. 4-5; see also n. 8); in fact, this draft provides for the co-decision of these two institutions (and, even, for the involvement of the ECB) with regard to the possible restructuring of a Member State's sovereign debt. However, the fact remains that, in substance although not to the letter, the draft revised Treaty is innovating with respect to the Treaty of 2012 as it moves the evaluation of the sustainability of the public debt of a country at risk to the phase preceding the activation of the European aid program. This passage from a possible ex post restructuring to an ex-ante one implies that the ESM obtains a prominent role in a crucial issue for the stability of the euro area.

4. The quasi-automatic restructuring of sovereign debts

The above thesis may seem forced. The draft revision of the ESM Treaty provides that, in the event of different assessments between the ESM and the Commission on the ex-ante sustainability of the public debt of a given Member State under an aid program, the final general word has to be carried out by the Commission itself, while the ESM can only assess the solvency risk of its possible credit position (cf. Eurogroup 2019, p. 5 point 5B and p. 7 point 12A; Art. 12, par. 5 and Art. 13, par. 5-8). However, it is clear that this clause provides the ESM with a veto power because the Commission cannot force the potential lender to grant financial support that is too likely to default. To avoid non-cooperative solutions that – in 'game theory' parlance – are called 'tit-for-tat' and that lead to inefficient results, the Commission and the ESM must therefore find a compromise on the valuation of the "extraordinary" unsustainability of the public debt of the countries at risk and on the consequent ex-ante debt restructuring procedure in the case where one of these countries is forced to apply for a European aid program. The informational advantage, which the draft revision of the Treaty attributes to the ESM, implies that the rational compromise consists in entrusting – to a large extent - the decisions to the ESM itself because the mechanism is the lender and the most informed 'principal'.[9]

Given its old and new tasks, the ESM has at least three reasons for acquiring timely information on Member States with a high public debt. First, the draft revision of the Treaty requires this actor to verify ex-ante and monitor almost continuously the sustainability of public debts in the euro area, eventually leaving to the Commission the greater burden in ex post controls of the aid programs' macroeconomic outcome (cf. Eurogroup 2019, p. 9 point 18; Art. 13 par. 6 and Art. 12 par. 1). In addition, the new ESM needs to be prepared for precautionary measures and needs a constantly updated framework on the compliance of national fiscal aggregates with European rules (cf. ***ivi***, Art. 14 par. 2 and 6-7). Finally, with its "perspective of a lender" (***ivi,*** p. 5 point B), the ESM has a strong incentive to collect and process the maximum amount of information available ex-ante.[10] This last point is the crucial one since it emphasizes that, as stated above, the Commission or other European institutions cannot replace the ESM as potential lender in the assessment of the potential borrowers' solvability. Moreover, the new ESM benefits from another task entrusted to it by the draft revision of the Treaty (cf. Eurogroup 2019, p. 7 point 12; and Art. 12

[9] The analytical reference is to the 'principal-agent' models with asymmetries of information (see for example: Bolton-Dewatripont 2005). One of the long-standing findings in literature is that, in the presence of multiple 'principals', the relatively better informed one is able to draw up the dominant contract with the 'agents' (see for example: Riley 1975).

[10] Schumpeter (1970) maintains that banks play the role of social accountants. Following this Schumpeterian vein, Stiglitz – Weiss (1988) maintains that the traditional task of banking activity consists in reducing information gaps with respect to borrowers in order to implement an adequate allocation of loans. When financing Member States, the ESM responds to incentives similar to those of a traditional bank.

par. 4): the role of mediation between private creditors and Member States in difficulty. Although it can only take place on an informal and voluntary basis and can only be confidential and advisory, such mediation is a valuable source of ex-ante information.

Given the roles played in the European Semester and in the application of the Six Pack and the Two Pack, the European Commission must also acquire a substantial amount of information in relation to the Member States. Thanks to its regular and systematic analysis of national cases, its access to a variety of databases and its econometric apparatus, the Commission has the most accurate ex-post information base to monitor the fiscal choices of the Member States and to draw up the macroeconomic adjustment to be implemented by countries involved in European aid programs. Furthermore, although it must share with the ESM the verification tasks previously carried out by the so-called troika (representatives of the Commission itself, the ECB and the IMF), the Commission enjoys advantages in monitoring and verifying the macroeconomic results achieved after the countries under aid program make the required adjustments. However, the Commission does not need to process data that are as precise as those processed by the ESM concerning the short term and an ex-ante perspective.

These considerations bring about, at least, four results: (a) the EMU will have, in a few months, a powerful tool for the possible ex-ante restructuring of the public debts of Member States that request an aid program and that find themselves in 'exceptional' cases of fiscal unsustainability; (b) starting in 2022, the activation of this restructuring procedure will be greatly simplified thanks to the application of the single limb in the CACs on new public debt bonds (see above, footnote 5); (c) the ESM will have predominant decision powers to assess the (un)sustainability and the related 'exceptional' ex-ante restructuring of the sovereign debt of the countries requesting the aid program; (d) the ESM will thus assume decisive responsibility not only as a manager of the actual crises in the euro area, but mainly as an ex-ante controller and monitor of potential crises or of crises that are in the making.

A fifth implication must be added to the previous four. Although less evident, this fifth implication is even more relevant than the others. The ESM aims to secure that its choices will be backed by the European Commission in exercising its co-decision power; moreover, it aims to be accredited as a reliable ex-ante crisis manager. Hence, the ESM will tend to minimize its discretionary choices and base its proposals for ex-ante restructuring of sovereign debt on transparent and invariant criteria. This trend is also endorsed by the draft revision of the Treaty (cf. ***ivi***, p. 7, point 12A; and Art. 13, par. 1b). Hence, the ESM will end up implementing rigid procedures and rules that will have two serious consequences: (a) such procedures and rules will not be able to grasp the complexity of the specific cases of effective unsustainability of public debts; (b) they will establish threshold values of (un)sustainability that will become common knowledge and that will thus transform themselves into attractors for speculative bets in the financial markets. Regardless of the ESM's will, point (b) will prompt speculative investors to focus in advance on the 'exceptional' condition of unsustainability in Member States with the highest public debts and to cause the effective non-compliance of these debts with the threshold values. If they have sufficient financial endowments to reproduce their downward bet for an adequate time, those speculators will be rewarded by the actual ex-ante restructuring of the public debt ('hair cut' of the private sector) of their target country. The speculators will thus obtain new financial ammunition and strong incentives to make additional downward bets on other Member States with high public debt.

This radically changes the balance between the centralized European fiscal rules and the national management of public budgets and balance sheets. The ex-ante restructuring acquires the form, even if undesired and even if limited to "exceptional cases", of a quasi-automatic restructuring of the sovereign debts in the euro area[11]; and this quasi-automatic restructuring triggers speculative spirals, uncertainty about the future and financial and economic instability that are all difficult to overcome.

5. Flexibility and 'market discipline'

The conclusions of the previous Section may lead to misunderstandings and therefore require some clarification. They do not support the argument that the euro area should expunge any mechanism for restructuring sovereign debt. On the contrary, I argue that, in the absence of appropriate ex post sanctions, a monetary union with fiscal policies that are decentralized at the national level would be exposed to a systematic violation of the relative centralized rules by the national policy makers. To use more analytical concepts, such a monetary union would be vulnerable to various forms of 'moral hazard' and could never achieve efficient equilibria (cf. Townsend 1979). In designing the ex post sanctions applicable to the EMU countries that have violated the common rules and that have not implemented the agreed adjustments, it is therefore effective to include – as an extreme case – the restructuring of sovereign debt. This credible ex post sanction protects against the 'moral hazard' without causing those problems that would follow an ex-ante restructuring and that have already been mentioned (cf. above, Section 4).

[11] The use of the term 'quasi-automatic' is justified by two elements: the result is not the effect of an automatic market mechanism but a speculative choice incentivized by market distortions (the threshold-signal); the winning speculative bets can be overturned in their outcomes by economic policy interventions (for example, by an unexpected monetary policy).

In recent literature dedicated to the possible restructuring of sovereign debt in the euro area, the thesis proposed herein is by no means the orthodox one. Many economists (especially Northern European ones) maintain that, to be credible and to provide an effective protection from the 'moral hazard', the threat of sovereign debt restructuring needs to act as the 'Damocles' sword' and hang over the heads of the countries with high public debt also – if not especially – ex-ante; only in this manner will these countries have an incentive to adjust their excessive public debt and to align themselves, in the shortest possible time, with European rules.[12] According to this orthodox view and differently from my previous analysis, maintaining that mechanisms for ex-ante restructuring generate instability and strengthen speculation is equivalent to confusing causes with effects: the responsibility for the possible occurrence of increased instability and speculation following the ex-ante restructuring of public debt would have to be imputed to the country that, having reproduced its imbalances, has not responded positively to the 'market discipline'. Consequently, the orthodox view states that the ex-ante restructuring of the public debts of the Member States that have a stock deemed unsustainable and that are forced to request a European aid program represents a balanced compromise: the negative externalities produced by a disorderly bankruptcy of a euro-area Member State are avoided,[13] but, at the same time, market 'signals' are strengthened since they lead to the punishment of the reprobate country and of the private holders of the country's debt bonds (bail-in).

According to the approach followed in the present paper, it could be reiterated that the abovementioned orthodox view contains serious analytical weaknesses and presents policy inconsistencies. In this key, it could be argued, for example, that fiscal policy makers in Member States with a debt deemed unsustainable will believe that the game is lost regardless of their late reactions. These fiscal policy makers will therefore have no incentive to implement adjustment measures that – even if their public debts are restructured – would be able to reduce the instability of the euro area in exchange for a further increase in the already heavy national social costs.

Rather than continue with this debate, which risks to become useless, it would be more interesting to reflect on the important implication that follows from the orthodox position: the main reference to market 'discipline' overcomes the opposition between risk reduction and risk sharing that has long impeded the European evolution, becoming one of the main causes of the succession of the phases of progress and of stalemate in the economic governance of the euro area, especially from the international financial crisis to the present. The use, although in "exceptional cases", of a

[12] See for example: Andritzky et al. (2019); Destais et al. (2019). The path pursued by these and other authors had also been explored by: Bénassy-Quéré et al. (2018). This Franco-German group of authors reiterated its position in: Bénassy-Quéré et al. (2019). A more articulated position on the problem is offered by: Erce (2019); Strauch (2019).

[13] This will be especially true, if the country involved is of considerable size.

quasi-automatic mechanism for ex-ante restructuring of sovereign debt in the euro area makes it possible to no longer assess the EMU's progress by the mere measure of compliance with fiscal rules by all Member States. The market 'discipline' reinforced by this mechanism will penalize and get back on track those Member States that are unable or unwilling to implement the agreed fiscal adjustments and to carry out the reforms necessary for a convergence process.

In this new framework, the EMU Member State that has the most to lose is Italy. Since the international financial crisis, Italy has been stuck in recession or low growth phases. The country has not systematically reduced its excessive debt-to-GDP ratio and has been unable to stably follow the adjustment curve of its structural deficit-to-GDP ratio, which would have allowed it to achieve its specific medium-term objective (MTO). Once the three-year period following the procedure for excessive public deficit ended, Italy approximated its compliance with European rules in the approved budget laws. However, it was able to bypass these rules in the actual balance sheets by fully exploiting the flexibility margins of the public deficits granted by the European Commission in mid-January 2015. The result was that the fiscal policies of the Italian governments compressed public investment, which had negative effects on private investment and growth rates, without keeping under proper control the dynamics of current public expenditures and – above all – their composition.

Today, Italy is the only country in the euro area where the GDP growth rate is lower than the average interest rate on public debt, despite the flattening down of the time structure of these rates. All this leads to a vicious spiral: increases in public debt fueled by the extreme utilization of flexibility and the related incidence of financial costs implies binding constraints in the national budgetary policies and lower the potential GDP; this leads to a further demand for flexibility, which increases public debt and the impact of related financial costs. These dynamics show that the sustainability of Italian public debt is hanging on a thin thread, as it depends on the ECB's monetary policy and can be compromised by any tension in the financial markets. If Italy remains a prisoner of the vicious spiral triggered by flexibility, it will be the Member State most exposed to an assessment of the unsustainability of its public debt by the ESM.

6. An alternative solution

The previous considerations imply that, even if they are assuming significant roles in the new euro-area frameworks, flexibility and market 'discipline' are a lethal mixture for Italy. To avoid this mixture, Italy would have to pursue an initiative which is easy to announce but quite hard to implement: a gradual but recurring and significant reduction of its public debt/GDP ratio, which, moreover, would have to be compatible with the relaunch of growth processes and of social development. The success of this initiative requires the cooperation with European institutions.

In this last respect, the draft of the revised ESM Treaty provides an opportunity which is an alternative to recourse to a European aid program and to the related risk of ***ex ante*** government debt restructuring, that is, the ESM's precautionary assistance. For the reasons examined in Sections 3 and 5, Italy is not compliant with the PCCL; however, it could apply for the ECCL. As stated above, this latter credit line is based on a detailed ***Memorandum of Understanding*** (MoU) between the ESM and the country involved. Hence, Italy's obtainment of ECCL assistance would require a partial and temporary transfer of its fiscal sovereignty to the ESM and other European institutions. However, it is also true that this partial transfer would open the possibility of European cooperation in the reduction of the Italian public debt.

The Italian government, backed by a vote of the national Parliament, would have to commit itself to implementing a multiannual program aimed at reallocating and reducing public spending and at reforming the national fiscal system in order to stimulate public and private investments and to strengthen education initiatives; at the same time, this program would have to implement a primary surplus in the Italian balance sheet with an average value not below 2.5% along the cycle. The Italian multiannual program would have to be discussed and refined with the European Commission and the ESM and would have to be approved by the Italian Parliament as well as by these two European institutions in order to become the crucial part of the MoU. Moreover, this same program would have to satisfy three main constraints: (i) to gradually reduce the yearly negative gap between the actual Italian growth rate and the average growth rate of the euro area; (ii) to this end, to gradually reduce the yearly negative gap between the actual Italian dynamics of labor productivity and the related average dynamics in the euro area;[14] (iii) to improve the effectiveness of social protection from the short-term impact of technical and organizational innovations.

It has been proved that, despite the very low current level of the term structure of interest rates on government debts, a yearly primary surplus of around 2.5% would be insufficient to put Italy on a path of reduction in its government debt/GDP ratio that would be able to fully meet the national MTO and to reduce this ratio below 100% in ten years. To these ends, given an expected average growth rate of the Italian GDP around 1% and an expected average Italian inflation rate around 2% per year, it would be necessary either to increase the yearly primary surplus to 4% or to keep

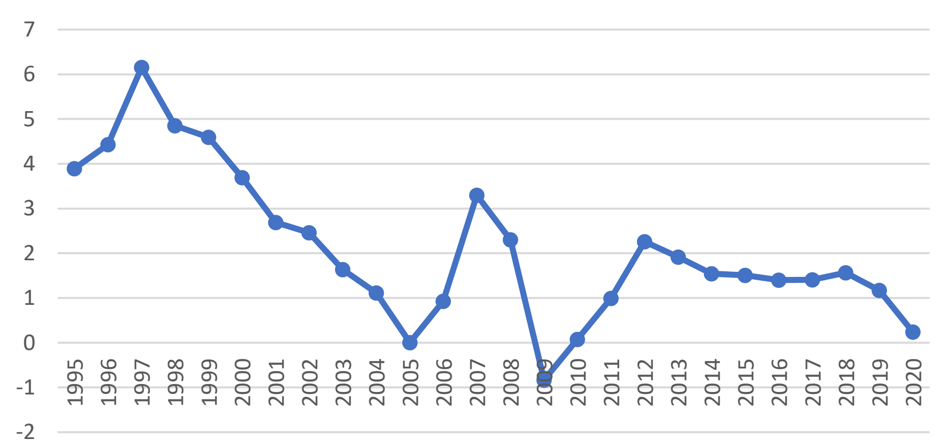
[14] The dynamics of labor productivity depends on several variables; and a large part of these variables are determined by factors (such as innovative investments) which are beyond the direct control of national and European policy makers since they mainly belong to the organization and managements of the various firms. However, policy makers could indirectly influence these variables by designing effective policy incentives.

the primary surplus at 2.5% and to decrease the public debt by 1.5 percentage points of GDP at least in the first phases of the ten-year adjustment process (cf. Visco 2017; cf. also Bastasin ***et al***. 2018). On the other hand, the pluriannual implementation of a 4.0% primary surplus has never occurred in recent periods with the exception of the 1995-2000 phase characterized by Italy's convergence to the parameters of the euro-area, which was under construction at that time (see Figure 1). Moreover, it would be possible to show that, in any case, this primary surplus would hardly be compatible with the three previous constraints (i)-(iii).

The Italian government could partially bypass the problem by having recourse to two measures. First, it could implement further yearly reductions of its public debt by 0.5 percentage points of GDP by carrying out privatizations and by exploiting recurrent decreases of the Italian spread in a persistent future scenario of low (or even negative) interest rates.[15] Secondly, the Italian government could contract a specific implementation of the ECCL precautionary program. The ECCL would have to fill the gap between the initial threshold of 4% and the sum of the actual primary surplus of 2.5% plus 0.5% with a yearly nominal amount of financing. Taking into account the decreasing Italian public debt on GDP ratio and the consequent reduction of the required minimum threshold in the primary surplus on GDP, in ten years the ESM's total amount of lending to Italy would be equal to around 150 billion euro at current non-discounted values.

Figure 1

Primary Surplus in Italy - 1995-2020



Source: AMECO.

[15] This scenario can be credibly assumed thanks to the decisions, taken by the ECB in its meeting of September 2019, and to the related forward guidance specified by the ECB's President. On the other hand, the nominal potential revenues of privatizations in Italy over the next ten years will largely amount to 90 billion euro at current non-discounted values.

In this respect, the crucial clauses of the MoU would have to be at least five: (a) after ten years, Italy would commit to gradually reimbursing the ECCL flows at a speed compatible with a systematic and stable reduction of its public debt/GDP ratio given a recurrent primary surplus of at least 2.5%; (b) the ESM credit line and the related Italian debt towards this mechanism would not enter in the calculation of the Italian structural public deficit and debt for ten years; (c) the same would apply to the residual debt stock during the additional reimbursement period (see clause (a)); (d) in the event Italy is not able to comply with a primary surplus not below 2.5% along the cycle, during either the first ten years of the ECCL assistance or the following years of reimbursement of the related debt towards ESM, the latter would be entitled to stop the agreement; (e) in the event Italy is compliant with a primary surplus not below 2,5% along the cycle during the same periods, the ESM would not have the possibility to stop the agreement unless it gives up its accrued amount of credit towards the borrower.

It is necessary to specify the implications of clause (d), which is introduced for keeping under control a possible ex-post opportunistic behavior on Italy's part, that is, for protecting the ESM from 'moral hazard' problems. If the ESM unilaterally stopped the agreement due to Italy's misbehavior towards the MoU, it would follow that the Italian balance sheet would have to immediately record the full amount of its hidden debt built up during the previous ECCL assistance. The related dramatic increase in the Italian public debt/GDP ratio would entitle the ESM to check the sustainability of the Italian balance sheet. The obvious and expected result would be the ESM finding the Italian government debt unsustainable; and, as a consequence, Italy would lose access to the financial markets. This situation inevitably leads to an "exceptional" case which requires the "involvement" – in an "adequate and proportional" form – of "the private sector". In other words, if the Italian government did not meet the adjustments and the other clauses included in the MoU, the ECCL assistance would lead to the ***ex post*** restructuring of the Italian public debt.

7. Conclusions

The above analysis explains why Italy is making a dangerous mistake by managing its enormous public debt through a recurrent search for flexibility with respect to its balance sheet and the related structural deficits. The combination of a public debt/GDP ratio above 135% (increasing further as a consequence of the recourse to flexibility) and a growth rate that is lower than the average interest rate on public debt has the double effect of increasing the risk that (i) Italy loses access to financial markets, and (ii) the Italian government debt becomes unsustainable. Obviously, the occurrence of point (i) would imply that Italy had to ask for the activation of a

European aid program. Given this activation and the draft of the revised ESM Treaty, the occurrence of point (ii) would lead the ESM itself to ask for an ex-ante quasi-automatic restructuring of the Italian public debt.

The alternative is that the Italian government starts a gradual but recurring and significant reduction of its public debt/GDP ratio in cooperation with various European institutions. In this perspective, the draft of the revised ESM Treaty offers an opportunity. This paper maintains, in fact, that a specific utilization of the ECCL precautionary program could offer to Italy a chance to start a virtuous process of economic adjustments. In a sense, Italy would have the opportunity to sign a "contractual arrangement" with the European institutions.[16]

As stated at the end of the previous Section, also the specific utilization of the ECCL could lead to a bad ending with an ex-post restructuring of the Italian public debt. However, this possible negative solution would be different from the case previously discussed, that is, the case of an ex-ante quasi-automatic public debt restructuring. In the hypothetical specific implementation of the ECCL precautionary program, the country involved has a new chance. The possible restructuring of its public debt would only be the consequence of its failure to meet the agreed commitments; and differently from the case of a quasi-automatic debt restructuring, it would not increase ex-ante the probability of this failure.

[16] This tool was proposed by the European institutions in mid-2013, but did not take off due to the crossed and incompatible constraints required, respectively, by the 'core' and 'peripheral' Member States of the euro area.

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