Ignazio Visco: The sovereign debt crisis and the process of European integration

Speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the 32nd Seminar "Federalism in Europe and in the World", Istituto di Studi Federalisti "Altiero Spinelli", Ventotene, 1 September 2013.

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The introduction of the euro was a fundamental step in European history, a political event that certified the progress made on the road to integration, a profound economic and social change. It was only a step, however, and not the end of the road, which is still a long and difficult one. Tommaso Padoa-Schioppa, who contributed so much to the achievement of monetary union, was well aware of this. In May 1998, on the eve of the introduction of the single currency, Padoa-Schioppa wrote in the *Corriere della Sera*, The European economic and monetary union's "capability for macroeconomic policy is, with the exception of the monetary field, embryonic and unbalanced […]. For the European Central Bank the real danger will not be too little independence but too much isolation […], having to operate almost in a vacuum, with no political power, budgetary policy, banking supervision, or financial market control function. […].It is thus right not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness." Since 2010 this incompleteness has fueled the sovereign debt crisis in the euro area.

In the absence of political union, the economic governance of the area was based on a fragile alliance between market forces and rules of conduct. Market forces were to ensure the economic convergence of the member countries and the definition and implementation of the necessary structural reforms at national level. Rules of conduct were expected to guarantee prudent budgetary policies. As early as the 1989 Delors Report, it was thought that, for the public finances, "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive."

Economic convergence was slow and difficult; in some cases the gaps actually widened. In many economies the delays and obstacles to adjusting to the large-scale global changes weakened competitiveness and the ability to grow. Mitigated by the improvement in funding conditions after the introduction of the euro, market pressures alone were not sufficient to drive the necessary reform efforts. Measured on the basis of unit labour costs in the whole economy, the loss of competitiveness recorded between 1999 and 2008 in the countries worst hit by the crisis went from about 9 percentage points in Greece and Portugal to 12 points in Italy, 19 points in Spain, and no less than 37 points in Ireland. Considering only manufacturing industry and competitiveness indicators based on producer prices, the competitiveness losses ranged from 7 percentage points in Italy to 22 points in Portugal (14 points in Spain, 16 points in Ireland and 18 points in Greece).

The rules for the public finances defined in the European sphere were not always respected. In 2007, almost a decade after the introduction of the single currency, only a few countries reported budgets close to balance in structural terms, i.e. not counting the effects of the economic cycle on revenue and expenditure. In some cases the public debt was still at an excessively high level in relation to GDP. For a long time the financial markets underestimated sovereign risks, thus confirming the doubts about their ability to provide timely incentives for the adoption of virtuous behaviour. Until the outbreak of the crisis the spreads between government bond yields within the euro area were close to zero.

In this framework, after the financial crisis in the United States and the very severe global recession in 2008–09, the full revelation of the unsustainability of the Greek public finances produced tensions which then spread to the economically weaker euro-area countries, characterized by excessive public or private debt, a foreign trade deficit, poor competitiveness, and low economic growth. Tensions grew with the bursting of the property

bubble and the consequent disruption of banking in Ireland. With the announcement of the involvement of private investors in restructuring Greek debt in the summer of 2011, the financial markets suddenly became aware of the implications of the ban on interventions to rescue member states under the Treaty on European Union. There followed a very serious crisis of confidence in the ability of the single currency to survive, with negative consequences for the real economies of individual countries and for the area as a whole.

The yield spreads between euro-area government securities suddenly increased in the second half of 2011; those between Italian and German 10-year government bonds, still below 200 basis points in the first half of that year, rose to 550 points in the following November. In the same period, in Italy and the other countries affected by the tensions, there was a sudden worsening in wholesale funding conditions for banks, whose creditworthiness was linked to that of their sovereign paper; placement of securities, especially uncovered bonds, dried up; the CD and commercial paper markets also thinned. The cost of fund-raising rose; in the money market there was a significant increase in the spreads between the very-short-term interest paid by Italian banks and the average.

Given the real risk of a severe tightening of the supply of credit to the economy, the Governing Council of the ECB cut its main refinancing rate by a total of 50 basis points in November and December 2011, introduced three-year refinancing operations (LTROs) providing unlimited liquidity at fixed rates, extended the range of assets eligible as collateral, and halved the compulsory reserve ratio. In the two LTROs conducted in December 2011 and February 2012 the Eurosystem supplied funds totaling around €1 trillion to banks in the euro area; taking account of the smaller volume of funds disbursed in other operations, the net increase in the flow of resources to the banking system exceeded €500 billion. The large injection of liquidity contributed to easing tensions in the money market. The excess liquidity is currently being reabsorbed: deposits held in the ECB's reserve accounts and deposit facility, excluding the compulsory reserve, now amount to €250 billion, down from €800 billion in March 2012.

Yield spreads between government bonds in the euro area are determined by two factors, one national and one European, linked respectively to the weaknesses of some countries' economies and public finances (sustainability risk), and to the incompleteness of European construction and the attendant fears of a break-up of the monetary union (redenomination risk). Europe's response to the sovereign debt crisis has consequently been two-pronged: on the one hand, individual countries have pledged to adopt prudent budgetary policies and structural reforms to support competiveness; on the other, a far-reaching reform of EU economic governance has been undertaken.

Not every country needed to consolidate its public accounts; in some cases in the international fora there was even talk of the possibility of expansionary interventions. Adjustment was indispensable in countries such as Italy that were experiencing difficulty in the financial markets and where the margin of confidence granted by investors and market operators was especially narrow. As I have remarked elsewhere, the volume of government securities to be placed every year to finance Italy's deficit and, above all, to roll over the maturing debt is in the order of €400 billion.

The recession has made budget corrections difficult, with their inevitably negative repercussions for economic activity in the short term. Nonetheless, prudent management of the public accounts has helped to avoid worse scenarios, to first limit and then lower interest rate differentials between euro-area government securities, and to prevent new liquidity crises. It has also proved difficult to implement structural reforms since, while helping to restore the growth potential of an economy, they can have short-term costs, especially in terms of employment.

Between the summers of 2011 and 2012 the Bank of Italy's assessment of the prospects for growth in Italy last year gradually deteriorated by over 3 percentage points; one point is attributable to the effect of public finance measures, while more than one and a half points

reflects the increase in the spread between Italian and German government securities and its effect on the supply of credit to the economy and on business and consumer confidence; the remainder is attributable to the darkening outlook for world economic growth.

The financial results of Italy's fiscal policy have been obscured by the recession. Notwithstanding an increase in the primary surplus – to 2.5 per cent of GDP, from 1.2 per cent in 2011 – government debt has risen by over 6 percentage points of GDP, to 127 per cent, reflecting above all the sharp deceleration in output. Almost two percentage points of the increase are attributable to the financial support that Italy has given to other EU countries.

The reform of European governance, which took shape in emergency conditions, along lines that were not always consistent and marked by uncertainty, overlap and heavy-handedness, along with the efforts made at national level, have nonetheless begun the process of rebuilding trust among member states. In the past, the Union's cohesion has been severely tested by repeated violations of budgetary rules – not only in relation to the most recent events, but also for those that led to the first reform of the Stability and Growth Pact in 2005 – and by the difficulty of making any in-depth assessment of national financial systems, which are subject to profoundly different regulations and supervisory practices. The strengthening of the budgetary rules, above all as regards prevention, and the extension of multilateral supervision to macroeconomic imbalances have accompanied the establishment of mechanisms for managing sovereign debt crises and paved the way for the launch of the banking union, renewing discussion on the budgetary union and plans for a political one.

The agreements reached in the last two years in the matter of public finances have reinforced the commitments entered into previously but they have not established more demanding targets. The new European governance has increased the automatism of coherence checks on policies and objectives and of potential sanctions; countries have been asked to recognize the European rules in their national legislation. Even the "debt rule", which calls on countries to reduce by 1/20th annually the amount by which their debt exceeds the threshold of 60 per cent of GDP, in fact renders operational a requirement already embodied in the Treaty of Maastricht. For Italy, compliance would not entail the adoption of a permanently restrictive budget policy stance, but it does imply the return to a stable growth path and it requires a faster pace of adjustment to the geopolitical, technological and demographic changes of the past thirty years.

The new macroeconomic imbalance surveillance procedure is an early warning mechanism based on a scoreboard of indicators and alert thresholds. The indicators are analyzed by the European Commission in an annual report identifying the countries to be subjected to in-depth review. In the case of particularly severe imbalances, the Commission draws up, for approval by the European Council, a set of specific recommendations calling for adjustment measures; failure to comply may lead to sanctions.

Until two years ago Europe had no tools with which to manage a sovereign crisis. The first measures to support Greece, and to a smaller extent Ireland, involved the use of bilateral loans. In May 2010 the European Financial Stability Facility (EFSF) was instituted – a temporary mechanism that was also adopted for Portugal and has remained in operation until this year; the bonds issued under the facility are guaranteed by the member states. In July 2011 the EFSF was flanked by the European Stability Mechanism (ESM), a permanent crisis management tool instituted by international treaty and endowed with capital of its own; ESM loans to Spain were used to bolster the country's banking system.

The total lending capacity of these two instruments, initially set at €250 billion, has been raised progressively to €700 billion. When the EFSF was launched the only method of intervention available was to grant loans under support plans for the countries in difficulty; this has gradually been extended and now includes, with appropriate conditionality, interventions on the primary and secondary markets for government securities, opening of precautionary credit lines, and funding of the recapitalization of financial institutions.

Between 2010 and 2012 the countries of Europe disbursed, either directly or through the EFSF or the ESM, some €280 billion in loans to their partners in difficulty. Italy contributed €43 billion, of which €27 billion for EFSF loans, €10 billion for bilateral loans and €6 billion to provide capital for the ESM. According to official estimates our contribution will rise to more than €55 billion this year and to almost €62 billion in 2014.

After the need to remedy the asymmetry of a single monetary policy and multiple national budget and structural policies had been recognized, a further gradual reinforcement of the Economic and Monetary Union was agreed and set in motion. The *Blueprint for a Deep and Genuine Economic and Monetary Union* published by the European Commission last November and the report *Towards a Genuine Economic and Monetary Union* presented in June 2012 and updated in December by the President of the European Council, working closely with the Presidents of the European Commission, the Eurogroup and the ECB, outline the stages of this process. They will lead to banking union, the introduction of autonomous fiscal capacity for the whole euro area, a common budget and, eventually, political union.

The time needed to implement Europe's complex strategy to counter the economic crisis will be long. The distortions that continue to affect the financial markets in the meantime could undermine the transmission of monetary policy and jeopardize the entire process. In July 2012 the yield differential between 10-year BTPs and the equivalent German Bunds was just over 500 basis points, compared with a value of about 200 basis points estimated to be consistent with Italian and German economic fundamentals.

Aware of these dangers, in the summer of 2012 the ECB Governing Council announced the introduction of a new method of intervention on the secondary market for government securities, Outright Monetary Transactions (OMTs). Countering an excessive increase in sovereign yields when it stems from redenomination risk and distorts monetary policy transmission is fully within the Eurosystem's mandate.

The OMTs are only activated in the presence of severe market strains and are confined to the securities of countries adhering to a macroeconomic adjustment or precautionary ESM programme. Their continued operation then depends on observing the conditions attached to the programme. There are no ex ante limitations on the duration or amount of the intervention.

This initiative has been made possible by the credibility of the Eurosystem and the progress made in the reform of European governance. Fears of euro reversibility are linked in the first place to those concerning the sustainability of public debts and the competitiveness of member countries. For this reason the activation of OMTs and their continuation are subject to specific undertakings regarding public finances and structural reforms as part of assistance programmes. The financing of the programmes with ESM resources is an incentive to further strengthen the governance of the Union, which is essential to achieve a permanent reduction in the European component of the differentials. Monetary policy can guarantee stability only if the euro-area's economic fundamentals and institutional architecture are consistent with it. Every country must do its part.

The announcement of OMTs produced immediate benefits: medium and long-term yields in the countries under pressure decreased and the fragmentation of markets along national borders was attenuated. Albeit with fluctuations linked to the remaining, pronounced uncertainty about the determination of all the member states to proceed with the strengthening of the Union, the yield spreads between euro-area government securities remained on a downward trend. That between ten-year BTPs and Bunds is about 250 basis points today.

On 19 July a group of economists of various nationalities and affiliations published a manifesto in support of outright monetary transactions (*A Call for support for the European Central Bank's OMT Programme*), arguing that "the success of the OMT announcement proves that the OMT is primarily a monetary policy instrument … It is the responsibility of a

central bank and a defining feature of a lender of last resort to assume liquidity risk, including through the purchase of financial assets when necessary (a step that has also been used by the Bundesbank itself in the past).”

There are different standpoints; it is understandable that some should question the compatibility of outright monetary transactions with the constitutions of some euro-area countries, but the doubts about the possibility of making effective use of ESM resources must be dispelled quickly in order to preserve the progress made, safeguard the rights and not thwart the efforts of those who have helped to develop the instruments of financial support. The OMT announcement prevented a financial collapse with potentially devastating consequences for the European economy: all the member countries benefited, not just those at the centre of the sovereign debt crisis.

More than anything else, however, a shared determination to advance towards a full European Union is essential. The ECB and the national central banks have shown that they are willing to accompany this advance, by continuing to “produce” the necessary confidence. But confidence is short-lived in the absence of real progress.

The handling at the beginning of this year of the Cyprus banking crisis, which was only resolved after difficulties of coordination between European and national authorities had emerged, further underscored the importance of the banking union project for interrupting the spiral between sovereign debt and the conditions of banks and credit. The creation of a single supervisor, in which the ECB and the national authorities play a pivotal role, is the first step; it must be completed by a common blueprint for the resolution of banking crises and a common form of deposit insurance.

Beyond banking union there must be the prospect of fiscal union and, ultimately, political union. In an interview he gave to *la Repubblica* on 6 October 2008, Padoa-Schioppa noted that “There is more bitterness than satisfaction in witnessing a prophecy come true. At the beginning of the euro I spoke of the dangers of a ‘currency without a State’. It is clear that we needed more of a European State, not less of a European currency: without the euro, Europe would now be living a catastrophe. One reason for the lack of credibility of national politics is that it keeps on giving people the illusion that national powers are capable of tackling issues (energy, climate, finance, security, migration, primary goods) which are not national, but continental and global.”

These words, spoken before the outbreak of the sovereign debt crisis, are highly relevant. It is necessary to further increase the coordination of economic and structural policies and the incentives for reforms, to shift from an intergovernmental form of management based on the peer review of national policies to the formulation of truly common policies. The scope of the project for a common euro-area budget must be defined as well as the timeframe for its implementation.

Economic and political reforms are not interdependent: confidence in the outlook for Economic and Monetary Union would benefit greatly from significant new steps towards political integration, including on a sectoral basis. In an essay written forty-five years ago (“Tecnologia ed economia nella controversia sul divario tra America ed Europa”) Nino Andreatta had already stressed the importance of a serious assessment of the “adverse consequences of a plurality of national government purchasing policies, which encourage an inefficient multiplication of research by individual countries and slow the growth in the size of markets.” The reflection on the desirability and necessity of going beyond the stage of comparison and cooperation and of our governments pooling institutions and policies that also have a major impact on our public finances – in fields such as defence, scientific research, infrastructure (and not just material infrastructure) and other fundamental sectors of government activity – has been under way for some time, the time is ripe for a process of concrete reform.