Ignazio Visco: The exit from the sovereign debt crisis: national policies, European reforms and monetary policy

Lectio magistralis by Mr Ignazio Visco, Governor of the Bank of Italy, at the Almo Collegio Borromeo, Pavia, 25 March 2014.

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The road to European integration is a long and arduous one; it is not linear: we often advance step by tiny step, but at times by vigorous leaps. The introduction of the euro was one such leap; it was a definite advance but it certainly did not complete the journey. The euro is a currency without a State; this is the lack it suffers from. The divergences, sometimes the diffidence, that still mark the relations between the member states weaken the Economic and Monetary Union in the eyes of the international community and in those of its citizens.

This incompleteness, together with the weaknesses of some member countries, has fueled the sovereign debt crisis of the euro area. If the weaknesses have engendered doubts about the sustainability of national public debts, the incompleteness has raised fears for the integrity of the union, allowed the risk of redenomination of the area's financial assets and liabilities in national currencies to gather strength, and reintroduced exchange rate risk within a monetary union, thus further weakening the position of the countries in difficulty.

Without political union, European economic governance has been founded upon budget rules and the ban on rescues between member countries; it has relied on the pressure of the single market for economic convergence. However, in many cases the budget rules have not been respected and the macroeconomic conditions have remained divergent, also structurally. The convergence of interest rates towards the low levels of the most "virtuous" countries allowed other countries to put off the necessary adjustments. For years the financial markets did not consider the possibility of an increase in sovereign risks. Before the crisis, the spreads between the yields on euro-area government securities had fallen to virtually nil.

The tensions in the euro area came to a head in an environment already fragile as a result of the global financial crisis and the consequent recession of 2008–09. Initially they involved Greece in view of the state of its public finances, Ireland owing to its real-estate bubble and consequent banking crisis, and Portugal as a result of its macroeconomic imbalances. In the summer of 2011 the announcement of the involvement of private-sector investors in the restructuring of the Greek public debt clearly revealed the implications of the ban on the financial rescue of a Member State imposed by the Maastricht Treaty and of the lack of a protocol for handling sovereign crises. The tensions became systemic; the countries that suffered the most were Spain, above all owing to its banking system's excessive exposure to the property market, and Italy, which was vulnerable because of its high public debt and the loss of competitiveness and growth capability in connection with the country's pronounced slowness to adjust to the major political, commercial, demographic and technological changes of the last twenty years.

The yield spreads between the euro-area's sovereign securities increased rapidly. For some countries, including Italy, they rose far above the level justified by the economic fundamentals. The spread between ten-year BTPs and German Bunds, still less than 200 basis points in the first half of 2011, reached 550 basis points at the end of that year. After narrowing in the early months of 2012, it returned above 500 basis points in July. We estimated then – and explained in technical analyses and public interventions – that less than half of this amount was due to the weaknesses of our economy; the rest reflected the fears of the single currency breaking up.

National policies and European reforms

To achieve a given number of objectives, economic policy must have at least an equal number of independent instruments at its disposal. And in fact the European strategy in response to the crisis did identify two instruments with which to pursue two objectives: national policies to remove the fragilities present in individual economies and a strengthening of the union to dispel the fears for the integrity of the single currency. In this case, however, since the fears of euro reversibility and those for member countries' debt sustainability fueled each other, the instruments were not independent. The reform of European governance thus necessarily hinged on the tightening of the budget rules and the introduction of new procedures for the control of other macroeconomic imbalances.

The considerable time needed to implement this strategy conflicted, however, with the persistent market uncertainties and the lack of an instrument, such as a common budget, that would make it possible to combat the recession that had followed the financial crisis, offsetting the adverse short-term effects of the necessary national budgetary adjustments with expansionary unitary policies. The succession of conventional and unconventional monetary policy measures helped to make market conditions easier and, as far as possible, to counter the fall in demand.

At the same time, in the worst-hit countries the aggravation of the social and economic consequences of the crisis made it harder to implement the necessary structural reforms, which, if they help to restore an economy's growth potential, carry undeniable short-term costs. The immediate visibility of the results of budgetary policies has been obscured. In Italy, despite the reduction in the budget deficit from 5.5 to 3 per cent of GDP, between 2009 and 2013 the ratio of the public debt to GDP rose by more than 16 percentage points to 132.6 per cent, reflecting above all the brusque slowdown of the economy. One contributory factor, counting for nearly 4 percentage points, was Italy's direct and indirect support to the financial adjustment of other euro-area countries.

The fragmentation of the financial markets produced by the inception of a vicious circle between the situation of sovereign borrowers and that of the corresponding banking systems interfered with the transmission of monetary policy, making the conditions of financing to the economy severely dishomogeneous among the euro-area countries and holding back the expansionary impulses in the economies that most needed them. The gap between the cost of new loans to firms in Italy and Germany widened progressively from virtually nil in the summer of 2011 to one percentage point at the end of that year. With the three-year refinancing operations decided in December 2011 the Governing Council of the ECB countered the consequences of the fragmentation and prevented a much worse contraction in credit than actually occurred.

In emergency conditions and with a good deal of uncertainty, national and European policies have nonetheless moved in the right direction overall. The state of the public finances of the countries most exposed to the crisis has improved, albeit at very high social costs in some countries. Reforms to support competiveness have been enacted and are being implemented. Above all, work has begun to rebuild trust among member states.

At the outset of the crisis Europe had no instruments for financial assistance to sovereign issuers: the first measures in favour of Greece, and to a lesser extent Ireland, took the form of bilateral loans. With the European Financial Stability Facility (EFSF), a temporary arrangement set up in May 2010, and the European Stability Mechanism (ESM), a permanent institution with its own capital endowment inaugurated in October 2012, Europe secured a lending capacity of almost €700 billion. Between 2010 and 2013 over €320 billion in loans was disbursed to the countries in difficulty. Including the amount paid in towards the capital stock of the ESM, Italy's contribution to this effort was in excess of €55 billion.

The need to address the asymmetry between the single monetary policy and the multiplicity of national fiscal and structural polices has been recognized. The plan published by the European Commission in November 2012 and the report of the President of the European

Council in June of the same year (updated the following December), plotted the stages of a further gradual strengthening of the Economic and Monetary Union. The first, Banking Union, is currently being implemented. Other, more difficult stages lie ahead: independent financial capacity for the euro area as a whole, a common budget and, in the future, political union.

In advancing resolutely along this road, one important challenge remains: namely, a marked attenuation of the diffidence found today between governments and between national communities. To this end, Europe cannot confine itself to identifying the weaknesses of some, objective though they may be, and requiring adjustments, albeit necessary, with reference above all to the short-term results. We must look responsibly to the longer-term prospects, while also taking account of the sustainability of the sacrifices and the distribution of the benefits.

Preparations for the Single Supervisory Mechanism (SSM), composed of the ECB and the national authorities, are proceeding apace. This constitutes a complex feat of institutional engineering, at least as demanding as that preceding the introduction of the single currency. Building on the accumulated technical expertise of the national authorities, the SSM must represent a supranational vision based on best practices in supervisory methods, analytical models and banking risk assessment. The transition to the single supervisor will enable easier comparison of the intermediaries and systems of the various countries, helping to combat the tendency to segmentation of financial markets along national lines. The comprehensive assessment of the euro area's leading banks, currently being carried out in preparation for the launch of the SSM, goes in the same direction.

The recent agreement of the European Council, Commission and Parliament on the Single Resolution Mechanism (SRM), due to be approved by the latter in plenary session in April, marks a further step towards Banking Union, with the harmonization of the responsibilities for crisis resolution, following that of supervision. With respect to the agreement previously reached by the European Council, this has simplified the decision-making process and shortened the time it will take for the mechanism to become fully operational.

The SRM will operate through a Single Bank Resolution Fund financed out of contributions from the participating banks and managed by a Board comprising permanent members, representatives of the national resolution authorities, the ECB and the European Commission, the latter with observer status. The Board, on the basis of the ECB's assessments concerning the existence of troubled banks, will determine whether bankruptcy can be avoided and whether there is a public interest justifying the activation of the resolution instruments. If so, it will draw up a crisis resolution plan subject to the approval of the Commission and, through a tacit consent procedure, of the Council. Disbursements of up to €5 billion will be decided at an executive session of the Board, comprising the permanent members and the resolution authorities of the countries in which the intermediary operates; other decisions will be adopted in plenary session, at which all the national resolution authorities participate.

The Fund will reach its full endowment of €55 billion in eight years. The banks' contributions will be paid into national compartments, which will be progressively mutualized starting with a share of 40 per cent in the first year and a further 20 per cent in the second. The Fund may also borrow on the market on the basis of decisions made in plenary session. All the operational aspects must now be rapidly finalized to permit accurate assessment of its financial capacity and to prevent uncertainty from amplifying the national component of risk premiums, thereby perpetuating financial market fragmentation and the vicious circle between the conditions of sovereign borrowers and banks.

Outright monetary transactions

As I observed, national policies and European reforms have introduced changes that will take a long time to implement; the distortions remaining in the financial markets in the meantime can jeopardize the whole process. During the crisis, the ECB's Governing Council made decisive use of the instruments at its disposal, cutting official interest rates repeatedly and introducing new refinancing operations with a long maturity and full allotment. In August 2012 it announced Outright Monetary Transactions (OMT), a new way of intervening in the secondary market for government securities.

The OMTs enabled the ECB to counter the effects of incorrect assessment of a sovereign borrower's risk – in particular for the component linked to fears of the monetary union breaking up – by purchasing securities on the secondary market with no limits of time or quantity, forgoing the status of privileged creditor. As a result of the interdependence between fears of euro reversibility and fears for the sustainability of individual countries' public debt, OMTs are conditional on precise public finance commitments and structural reforms within the framework of the ESM financial assistance programmes.

The announcement brought success; even without actual intervention on the markets, it was instrumental in the drastic reduction of the part of the sovereign risk premium connected with fears for the euro's survival: spreads have fallen to values closer to those consistent with the fundamentals, and markets are less fragmented. The yield spread between ten-year Italian and German government bonds has fallen back below 200 basis points. Bank of Italy estimates show that this improvement has been mainly due to the drastic reduction in the risk of the euro area breaking up. There have been signs of renewed interest in the Italian markets, including the government bond markets, reflected in a decline in the Bank of Italy's debtor position in TARGET2, which fell to €190 billion at the end of February, almost €100 billion less than the peak registered in August 2012.

These results would have been impossible without the start on resolving national imbalances and the reform of European governance. The single monetary policy cannot guarantee stability unless the economic fundamentals and the institutional architecture of the area are consistent with it. The risks are still present and tensions are ready to flare up again. In Italy the national component of the yield spread reflects high public debt and poor growth prospects; it needs to be reduced further: before the recession of 2008, for ten-year maturities this national component was less than 50 basis points.

The reform of European governance has resulted in surrenders of sovereignty, albeit limited, on the part of all member states, in the areas of both fiscal and structural policy. Unconventional monetary policy measures were taken in response to the crisis. There is a legitimate need to examine the conformity of the solutions adopted with national constitutional law.

Besides provoking a heated public debate, OMTs were scrutinized by the German Constitutional Court, which applied to the European Court of Justice for a judgment as to their legitimacy. The German Court argued that OMTs do not pursue a monetary policy goal in the strict sense, but since they have been used to safeguard the euro they have taken on a responsibility that properly lies with national governments; OMTs, it is held, overstep the ECB's mandate, violating the ban on the monetary financing of budget deficits; they could also lead to a redistribution of resources among the countries of the area, thus achieving the same effect as a transfer system that is not envisaged by the European treaties.

The aim of OMTs is to preserve monetary policy transmission in the euro area, which is jeopardized by distortions in the financial markets caused by the sovereign debt crisis. The goal is not to neutralize the spreads on the government bonds of specific euro-area member states in order to reduce their financial difficulties by interfering illegitimately with price formation in the market, but instead to reduce the components of spreads linked to factors independent of the financial sustainability of individual countries. Intervention does not aim to sustain the purchase of risky assets but to correct the misperception of that risk. The yield spreads between sovereign bonds observed at the moments of greatest tension were due only in part to market scepticism over the ability of individual member states to ensure the sustainability of their public finances and avoid a worsening of their credit risk. In large part, rather, they are explained by investors' fears of euro reversibility.

Lastly, the OMTs do not allow the ECB to buy government bonds whenever the monetary policy transmission mechanism is interrupted, but only when the interruption does not reflect a member state's sustainability conditions. OMTs are never supposed to be used to purchase the securities of a country with unsustainable public finances. As regards the argument concerning the risk of resources being redistributed as a result of OMTs, the risk that would be incurred by forgoing them would be far worse.

The way out of the crisis

Exit from the crisis in the euro area cannot be achieved by the isolated actions of individual economic policy authorities. In particular, monetary policy alone cannot guarantee the financial stability of the euro area if the problems underlying the sovereign debt crisis are not resolved at national as at European level.

The fragility of the public finances in some countries is the result of protracted fiscal imprudence and a culpable underestimation of the consequences of broad and persistent losses of competitiveness. Budgetary policy must ensure debt sustainability and full access to the market. The rules agreed at European level are the means, not the end.

The real budget constraint for our country is given by the need to guarantee the sustainability of the public debt and to maintain full access to the financial market. As I have pointed out on more than one occasion, our Treasury's annual resort to the markets is on the order of €400 billion. In a context still fraught with tension, it takes very little to undermine investor confidence. This is what happened between the summer of 2011 and the spring of 2012, when the share of Italian government bonds in foreign hands plummeted.

The agreements concluded in the last two years have put the earlier budget commitments into practice. The rule on public debt, which will apply to Italy for the first time in 2016, calls for an average annual reduction of about one twentieth of the excess over 60 per cent of GDP. In order to comply, it is not necessary to lower the nominal size of the debt. In "normal" conditions of close to 3 per cent nominal economic growth, all that is needed is structural budget balance. Contrary to what some commentators say, a correction of €40–50 billion a year will not be required, nor will it be necessary to maintain a restrictive budget policy permanently.

Although the debt rule does allow some room for flexibility, we must continue to aim for real growth in the economy, and hence the recovery of investment – which is at once a supply factor and a fundamental demand component. As to price developments, inflation is still below the level consistent with the ECB's definition of price stability, i.e. an annual price rise of below but close to 2 per cent in the medium term.

Actually, consumer price inflation in the euro area and Italy has fallen consistently more than expected in recent months and has kept below 1 per cent since October last year. According to recent estimates by the ECB, euro-area inflation will average 1.0 per cent this year, 1.3 per cent in 2015 and 1.5 per cent in 2016. Our forecasts paint a similar picture for consumer prices in Italy.

We are not in a situation of generalized price reduction, of deflation. But even a long period of excessively small price changes can have undesirable consequences: it hinders the correction of macroeconomic imbalances through the adjustment of relative prices; it can prompt consumers to postpone purchases, especially of durable goods; it can affect the cost of capital thus deterring capital formation; and it makes debt service more onerous. If such a situation lasts too long, it can cause inflation expectations to become dangerously detached from the monetary policy.

The risk of long-term inflation expectations no longer being anchored to price stability must be resolutely countered. This risk is limited for the time being, but there are signs that should not be underestimated. The downward trend in inflation expectations has sharpened in recent months, spreading even to more distant time horizons: the yields on inflation swaps indicate that the expected annual inflation rate is 1.2 per cent three years ahead and 1.6 per cent five years ahead. Professional forecasters surveyed by the ECB estimate a nearly 20 per cent probability that in two years' time inflation will be 0.9 per cent or lower.

The formation of expectations is a non-linear process; major changes can occur suddenly, almost without warning, making it more difficult to regain control. Against this background, the ECB's Governing Council has reaffirmed its intention to maintain an accommodative monetary policy stance for as long as necessary and has firmly reiterated that policy rates will remain at present or lower levels for an extended period. In line with its mandate, the Council will use all the tools needed to maintain price stability.

To accompany the reform efforts of individual countries, the ECB's monetary policy commitment in its area of responsibility must be matched by the commitments of the other institutional actors. The debate on the euro area's "fiscal capacity" launched by the Report of the President of the European Council and the Commission's Plan was abruptly broken off after the Commission presented its plans for major economic reforms and for financial support to structural reforms in March last year. The delays in implementing structural reforms in many countries are responsible for the build-up of the macroeconomic imbalances that have fuelled the current crisis. The Commission's proposals, expressly open to discussion in order to discover any scope for improvement, go in the right direction of identifying mechanisms to support the convergence needed to strengthen the Economic and Monetary Union.

Italy must succeed in taking full advantage of all the opportunities offered by the Union. In the past, for example, we were not able to benefit fully from the European Structural Funds. Introducing structural reforms that help us to regain competitiveness is an essential step towards the country's recovery. The measures that need to be taken have long since been identified. The process of European coordination could help to flesh out the details, but the ultimate responsibility for the reforms still lies with us.

It is important to continue resolutely along the path to a fuller Union. The adoption of single mechanisms for banking supervision and resolution is a crucial step. The benefits of strengthening European integration far outweigh the alleged advantages of weakening it. Choices must be made responsibly. We cannot fear only the risks of action and disregard those of inertia.