



BANCA D'ITALIA
EUROSISTEMA

The Economic and Monetary Union: Time to Break the Deadlock

Keynote address by Ignazio Visco
Governor of the Bank of Italy

OMFIF-Banca d'Italia seminar
"The future of the Euro area"

Rome, 15 November 2019

This seminar comes at a difficult juncture for Europe. The tide of the global financial crisis and the sovereign debt crisis has long fallen, but its poisonous legacy and geopolitical tensions are fuelling distrust, fears and even prejudices once thought long buried. The European construction is at a standstill while progress is badly needed in the key areas, where the Union is better at prohibiting things than at getting them done.

Although the single currency was a vital step on the path to European integration, the Economic and Monetary Union remains an unfinished construction. Europe's architects knew this, and wanted and anticipated greater progress in the future. Even before the introduction of the euro, the unusual status of a Stateless currency had been underlined, as had the institutional solitude of the European Central Bank (ECB) and the problems posed by the imperfect mobility of capital and labour.

The risks inherent in this situation materialised with unanticipated violence during the sovereign debt crisis. The inadequacy of the euro area's economic governance was laid bare. Hesitancy in defining the procedures to support countries in difficulty fuelled fears of a break-up of the euro. Spreads on government bond yields widened dramatically, in some cases by far beyond what would have been justified by the economic and financial conditions of the countries affected, making these conditions all the more difficult to overcome.

The proposals for reform drawn up after the peak of the crisis envisaged the gradual strengthening of integration, first in the financial area and then for public finances. Yet, seven years later, only partial progress has been made. The banking union is incomplete and not without flaws, the foundations for the capital union are still being laid, and fiscal union has been postponed to an unspecified future date.

Concerns about the public and private financial vulnerabilities accumulated during the crisis and mutual distrust keep progress on hold. While risk reduction and sharing should go hand in hand and mutually reinforce one another, uncertainty around how

to proceed, disagreement on the sequence and effects of interventions, and fears of negative spillovers produce a standstill in the reform process. As a consequence, the euro area's economic integration is being held back and the area itself continues to be exposed to financial risks.

This deadlock must be broken and the conditions must be created to allow for steps to be taken in the future that appear impossible today. Against this background, I would like to share some reflections with you, first, on how sovereign and banking risks are being dealt with in Europe, and second, on the state of play of fiscal and capital markets unions.

Sovereign and banking risks

The widespread concern over high public debts is justified. They are a source of systemic risk. Even if fundamentally solvent, highly indebted countries are more vulnerable to liquidity shocks and negative markets' assessment of national authorities' commitment to financial stability. In addition, in a currency area, a sovereign debt crisis can have strong repercussions for neighbouring countries, given the close economic and financial links.

A reform of the Treaty on the European Stability Mechanism (ESM) to reinforce its role in preventing and managing sovereign crises in euro-area member states is currently being finalised. It is part of an effort aimed at reducing uncertainty as to how and when a sovereign debt can be restructured. Clarifying the conditions and procedures for restructuring would certainly reduce the part of the cost of a sovereign default which can be attributed to uncertainty over the manner and timing of its solution.

But this is only a small part of the cost of sovereign insolvency. Moreover, this is a matter to be handled with care. The small and uncertain benefits of a debt restructuring mechanism must be weighed against the huge risk that the mere announcement of its introduction may trigger a perverse spiral of expectations of default, which may prove to be self-fulfilling. We should all keep in mind the dire consequences of the announcement of private sector involvement in the resolution of the Greek crisis after the Deauville meeting in late 2010.

The importance of rigorous budgetary policies at a national level cannot be overestimated. But reducing the debt-to-GDP ratio requires time and there is the risk that a crisis might interrupt the process, without this being the direct consequence of a policy decision. Europe should seek ways to support and protect the efforts that must be made by member states to reduce their debt. This is why some form of supranational insurance is needed, for example through the creation of a European debt redemption fund (ERF) financed by dedicated resources of the participating countries.

The mechanism can be designed in a way that prevents systematic transfers across countries while reducing the risk of financial instability for the area as a whole. The introduction of an ERF would strengthen national commitment to debt reduction (as the share of national debt transferred to the fund would be backed by a dedicated revenue stream) and reduce the systemic relevance of (residual) national debt. This would be

instrumental in enhancing the credibility of the no-bailout clause and the enforceability of European fiscal rules.

In the academic and political debate, the introduction of a sovereign debt restructuring mechanism is often linked to proposals to introduce prudential requirements limiting banks' sovereign exposures. Here, it is important to bear in mind that the sovereign-bank nexus does not operate exclusively through banks' direct exposures: a sovereign crisis would also affect banks through an increase in their cost of funding (particularly in the event of rating downgrades) and, above all, through its effects on the overall economy. A sharp rise in the perceived risk of one State's debt can quickly trigger a recessive spiral, kindling social tensions with unpredictable results. The blow to the banking system would be severe, irrespective of its capitalisation and direct exposure. Thus, if we really want to break the sovereign-bank nexus, we need to reduce the risk embedded in sovereign bonds, not just the amounts held by banks.

Moreover, simply shifting risky bonds from the balance sheet of banks to those of other sectors would not reduce the overall risk. Finally, since prudential requirements on sovereign exposures are not imposed in any other jurisdiction, if we were to introduce them in the European Union or in the euro area, we would need to provide financial markets with an alternative "risk-free asset", such as a Eurobond of some sort – and the debt redemption fund I mentioned before would be instrumental.

Reducing banks' sovereign exposures and the ratio of non-performing loans (NPLs) to total outstanding loans are often considered as preconditions for the completion of the banking union. Other important sources of risk have, however, not been sufficiently considered. Recent initiatives by the Single Supervisory Mechanism to determine the most appropriate treatment of illiquid and opaque assets on banks' balance sheets are meant to respond to these concerns.

Even worse, the vulnerability produced by an incomplete framework for the effective and orderly management of banking crises has also been, and still is, overlooked. On the one hand, consensus has grown around the idea to postpone the implementation of the ESM backstop to the Single Resolution Fund until 2024 unless further progress has been achieved in risk reduction measured solely in relation to NPL volumes (and in building up buffers of liabilities to be used in a crisis). On the other hand, a situation is accepted whereby a disorderly liquidation is the only possible outcome for the crises of small and medium-sized intermediaries which, like most European banks, are not subject to resolution (albeit – it must be noted – they are required to contribute to the Single Resolution Fund).

The recent suggestions from Germany on the completion of the banking union is a welcome development in that it shows willingness to keep the dialogue open. However, they fail to address some of the issues I just mentioned. Banking risks are once more exclusively identified with NPLs and sovereign exposures. Moreover, when considering a revision of the prudential treatment of the latter, there is no mention of the need to introduce a European safe asset, which is particularly at odds with the frequent references made to the US model, where the role of federal debt as a safe asset is paramount.

An adequate fiscal capacity and the implementation of the capital markets union

If sovereign and bank risks management is a source of concern, turning to the state of play of discussions about the fiscal union and the implementation of the capital markets union will provide little consolation. Monetary policy was the sole line of defence against the risk of euro area financial fragmentation during the sovereign debt crisis and against the risks of deflation that emerged in the years thereafter. The ECB's Governing Council demonstrated its readiness to use all of the instruments available and, if necessary, to introduce new ones to pursue the objective of price stability. It has been largely successful, but its actions could have been even more effective had they been accompanied by other economic policies.

Inflation in the euro area remains at levels that are still too low, and these low levels are pushing down short-term inflation expectations once again. The risk of a de-anchoring of medium- to long-term expectations has re-emerged. The Governing Council response has been timely, appropriate and proportionate. But once again we are seeing that to make the fullest possible use of the expansionary potential of monetary policy measures, other policies should move in the same direction.

Fiscal policies that support economic activity in the euro area can deliver a faster return to price stability. To ensure sustained higher growth, reforms are needed to remove any obstacles to development, foster innovation and help modernise the productive system. Acting in isolation, monetary policy can do nothing but continue along the path of "non-standard" measures. This increases the risk of adverse side effects, which, in turn, need to be kept under control using instruments of an increasingly administrative nature.

As the former President of the ECB recently recalled, "we need a euro area fiscal capacity of adequate size and design: large enough to stabilize the monetary union". This is no subversive statement. Economic theory as well as the concrete experience of other successful monetary unions, most notably the United States, suggest that the euro area would greatly benefit from the establishment of a supranational fiscal capacity. Indeed, a report on the appeal of a fiscal union – the MacDougall Report – was published as early as 1977 on behalf of the European Commission, and even the 1970 Werner Report makes reference to it. Later on, the technical papers accompanying the 1989 Delors Report discussed the topic in depth.

On 3 May 1998, when Europe was completing the last steps before the adoption of the single currency, Tommaso Padoa Schioppa wrote in a column in *Corriere della Sera*: "the Union has full competence for microeconomic policy [...], but its capability for macroeconomic policy is, with the exception of the monetary field, embryonic and unbalanced: it can avoid harm (excessive deficits) but it cannot do good (a proper fiscal policy). [...] It is thus right not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness".

Nevertheless, little progress has been made in the way of remedying the asymmetry of having a single monetary policy and yet multiple national budgets, perhaps out of fear of sharing the debts that could result from the operation of a fiscal union. Yet, as

I have observed, a common fiscal capacity can be structured in such a way as to avoid systematic cross-country transfers, thus reconciling the full exercise of macroeconomic stabilization with the balancing of public accounts in each country. Fiscal union would make it possible to implement policies consistent with the cyclical conditions in the various member states and in the euro area as a whole, promptly and with no doubts as to their legitimacy. The single currency needs to interact with a single fiscal policy.

It has been argued that national fiscal policies could absorb the effects of cyclical fluctuations in member states and that financial markets could provide an insurance analogous to the one that would be provided by a fiscal union. However, cross-country spillovers may reduce the effectiveness of national initiatives and, in the current situation, several national budgets have little room for manoeuvre due to high public debts. In addition, European financial markets are far from being perfectly integrated, which clearly limits their viability as shock absorbers.

In the United States, in Canada and in other federal countries, a significant share of individual states' income variability is offset by the federal fiscal system (estimates based on different methods average at 10-15 per cent for both the US and Canada). The difference between the euro area and fully-fledged federations in terms of shock- absorption capacity is even higher when we look at capital markets.

The smooth functioning of a currency area requires a single capital market that facilitates access to financing for businesses. In addition, an integrated market helps to absorb local macroeconomic shocks, increases the robustness of the economic system, and strengthens financial stability. It would also obviously aid the effective and speedy transmission of fiscal and monetary policy measures.

But it is a complex endeavour. It entails decisive action towards the harmonisation of company, securities, bankruptcy and tax laws, as well as of supervisory procedures. While such a harmonisation may begin with changes in relevant national legislation and focus on those areas which may produce broader effects, the ultimate goal must be one of achieving a single rulebook. Above all, a single capital market requires a common safe asset. Addressing this gap would support the banking and capital markets by creating a homogeneous product of a high quality and significant size that could become a benchmark for investors and improve financial integration.

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I do not think that I have to struggle to convince you of the lack of significant progress with the European construction. There has been a substantial transfer of sovereignty on economic and financial matters, especially in recent years. It is indeed illusory to believe that we can direct the course of the economy and finance, patently global phenomena, from within the narrow confines of individual European countries. The construction, however, is lopsided and incomplete; its very sustainability requires that the missing elements be incorporated soon.

Today, proceeding by means of compromise is becoming increasingly difficult. Distrust leads to disaccord, and in the exasperated pursuit of mutual reassurance and

short-term gains, the necessary steps are hard to take. The concrete achievement of monetary union, banking union, capital markets union, and even the prospect of a common fiscal policy, all call for a leap in quality. Europe must remain an anchor of stability in a world that appears ever more unstable and politically unpredictable.

The introduction of a safe asset in the euro area is a clear and immediate objective. It is a technical endeavour, but it is also the common denominator to the three unions (banking, capital markets, fiscal) that must flank monetary union. By partly replacing national government bonds, a European debt instrument could help to diversify the sovereign exposures of financial institutions. It could reduce the risk of flights to safety by investors in times of market tension and enable the financial market to play an effective role as shock absorber, thereby also enhancing the effectiveness of monetary policy. It could be an instrument for funding shared automatic stabilisers within a common fiscal capacity.

As I have said, it is possible to design mechanisms that enable a safe asset to be introduced with the necessary safeguards against the risk of opportunistic behaviour. But aside from the rules, the essential requirement for the viability of this solution lies in a renewed and convinced commitment by all to the European project and a willingness to pursue common solutions for common problems.

