La riforma dell'Eurozona e le proposte Franco-Tedesche

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EMU: political, institutional, monetary and economic issues.

An Italian perspective*

Prof. Rainer Masera

r.masera@unimarconi.it

*For a more comprehensive analysis of the arguments developed in this intervention I refer to a recent paper of mine which contains also the references to authors and to official documents mentioned here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3267211

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1. Introduction (and Conclusion!)

EMU was a political design: my contention is that the European political leaders of France, Germany and Italy were responsible not for design defects, but for a fundamental fault in execution: an original sin which continues to undermine the EMU.

The following arguments try to give content to this position.

Let me start (and as we shall see also end) with two references to a great Italian economist and very close friend of mine – who passed away too early in 2012: Professor Luigi Spaventa.

As an independent left-wing MP on December 12th 1978 he gave a remarkable and very important speech in Parliament on the Italian adhesion to the EMS – which also foreshadowed the later participation of the lira to the euro.

His spoke against the Andreotti Government decision to enter the exchange system on many mutually reinforcing – economic/political/power - grounds.

His speech was instrumental in convincing the Communist Party to withdraw its support to the Andreotti Government – but did not prevent the entry of the lira into the exchange system, and later the participation of Italy to Maastricht (Andreotti-Carli, 1989-91) and to the euro (Prodi-Ciampi, 1996-98).

I jump now to a later less well-known interview by Luigi to L'Espresso (30 Nov 2010): "*To go back to the lira: a folly*".

The argument had become that it was too late to return to the lira, mainly for the burden of the public debt, the speculation "against Italy", the drawbacks of a possible international default. He summed up the situation with the following phrase in latin: "*nec tecum nec sine te vivere possum*", Martial, Epigram XII, 46 (I can live neither with you, nor without you).

His thesis has become even more cogent now. After the ESM Treaty (2012), legal clauses have been introduced (Collective Action Clauses - CACs) which should prevent redenomination of Government securities with maturity above one year issued on or after 1th January 2013 (Art. 12, par. 3) (however, the effective enforceability of CACs has been put in doubt by leading international law firms).

All this strongly reduces the possibility of redenomination of public debt in national currencies (Lex monetae LM): the so-called B-Plans. LM is the law of the place of the currency. It is a legal principle recognized by most jurisdictions which stipulates that the currency of a debt expressed in foreign currency is determined by the law of the country in whose currency the obligation is expressed. In the EU legal framework, the Euro is the currency of the members countries of the Euroarea, which "irrevocably" replaced national currencies. These assumptions of irreversible commitments began to be questioned with the sovereign/bank doom loop and the Greek crisis in 2012, but the "whatever it takes" position taken by the President of the ECB in July 2012 temporarily calmed fears. In any event, as already indicated, the EU decided to introduce CAC clauses with a view to reducing redenomination risks. There is a snag: this by itself made – and makes – it difficult to regard as" highly unlikely" that parties would consider the possibility of redenominating contracts expressed in Euros.

These issues have been taken up in detail in the Meseberg Declaration of France and Germany (19 June 2018), with a view to facilitating the orderly restructuring of a sovereign EA debt through more stringent and more easily applicable clauses: "The single-limb aggregation of euro CaCs". These clauses should reduce the legal risk of "holdouts", i.e. creditors who avail themselves of all legal means to try and refuse to accept any losses. The ESM would act as facilitator in the controversies with the private sector. It would also be the examiner and the back stop in case of debt unsustainability and would work in close cooperation with the EC. Very wisely, it was agreed that automaticity of or mechanic approaches to debt restructuring should be avoided (Centeno, 2018). In December 2018 the Eurogroup indicated that ESM resources would be increased significantly by 2024, when the Mechanism should also become the common back stop to the Banking resolution fund. During this long interim period the ECB could intervene in support by activating the controversial OMT scheme introduced in August 2012. A country in difficulty would approach the ESM for an adjustment programme (macroeconomic adjustment or precautionary) which would imply strict conditionality. The ECB would consider in full discretion the use of OMT.

These arguments – together with the Pandora Box of settlement of T2 balances (see below) – reinforce the logical/political/policy need to consider the possibility of Eurozone exit clauses, beyond the Art. 50 TEU procedure (Fuest 2018). In my understanding, this was the position expressed by Professor Savona in his writings and more recently with reference to the possibility of a black swan event, which was however vehemently denounced as anti-European, notably by many "conventional" Italian economists!

2. The EMU suffers from inherent technical ill-execution and unfulfilled political promises/premises

The approach to EMU was based on the controversial assumption initially propounded by Jacques Rueff: "*L'Europe se fera par la monnaie, ou ne se fera pas*" (1949).

This was against the coronation theory, according to which the jump into the common currency would have required appropriate initial conditions of fundamental convergence and a swift move to political union, to avoid a currency without a State.

This was the German position – and for that matter also the Banca d'Italia position with Baffi and Masera,

- **François Mitterrand and Helmut Kohl, 1990:**

Our aim is that these fundamental reforms - economic and monetary union as well as political union - should enter into force on 1 January 1993.

(Letter by the German federal chancellor Helmut Kohl and French president François Mitterrand to the Irish Presidency of the EC . 19 April 1990. Source: Agence Europe, 20 April 1990)

- **Helmut Kohl, 1991:**

It cannot be repeated often enough: Political union is the indispensable counterpart to economic and monetary union. Recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union over time without political union is a fallacy.

(H. Kohl: Protocol of the Deutsche Bundestag, 6 November 1991)

The Delors Plan (1989) was based on the premise that the introduction of a common currency would have to be preceded by strong and effective economic and fiscal convergence. The Maastricht Treaty (1991) fully endorsed these points, and laid down the deficit and debt criteria for public finances. These limits were not at the time and were not meant in perspective to be overly restrictive. They were meant to prevent excessive government deficits and debt/income ratios in the new currency area.

The 60% debt limit was based on both the actual average ratios recorded in those years for perspective euro countries and on a forward application of the famous Domar (1944) model. The forward approach was grounded on what appeared to be reasonable assumptions of real growth, based on experience of the previous decade (3%), and on target inflation (2%).

Under these assumptions, with a constant deficit ratio of 3% - again a realistic assumption – the debt to GDP ratio converges to 60%, irrespective of the starting point (60=3/3+2).

In 1998, when the irrevocable conversion of national currencies into the euro took place, the situation had changed. The medium-term growth perspectives had come down and certain countries had not achieved convergence of fundamentals. The debt income ratio had diverged from 60% in many countries.

As to the convergence conditions, Ciampi was clearly overly optimistic on the Italian outlook. As Treasury Minister (1996-98) with Romano Prodi Prime Minister he had promised to Germany (Kohl) and France (Chirac) that in a few years, with the euro, the Italian debt to GDP ratio would come down to 60%!

The EMU suffers from fundamental faults in execution: it was and continues to be my position. What is much more relevant is that Delors himself indicated this: Jacques Delors underlined that the euro creation was marked by a "fault in execution" of his plan by the political leaders, who decided to turn a blind eye to the fundamental weaknesses and imbalances of some countries which entered the single currency (Delors, 2011). Similar concepts had been expressed by Issing (2008). This undermined the workings of the euro currency area.

3. The original sin – until now without redemption!

The currency without a State, the lack of convergence/structural reforms and the Fiscal Treaties imparted a deflationary bias to the EA, and eventually led to a wrong policy mix (too tight fiscal/too easy money).

The "*whatever it takes*" (July 2012) and later the (expanded) APP (*Asset Purchase Programme*) policies leading to negative interest rates are the progressive steps along the wrong policy mix.

Banking Union was a necessary advance. However, without EDIS, a strong backstop facility, and with a weak Resolution framework, it is an incomplete solution.

The leading/pervasive role of the ECB in the ESRB (Mr. Draghi is the Chairman of both institutions!) weakens de facto the independent role of the Board as Angel Guardian of macroprudential stability, notably in respect of the mix of monetary and fiscal policies, but also on the issue of the sustainability of Target balances.

An unsatisfactory application of the Basel 3 framework in the EA blunted monetary policy and hence required additional doses of monetary base expansion.

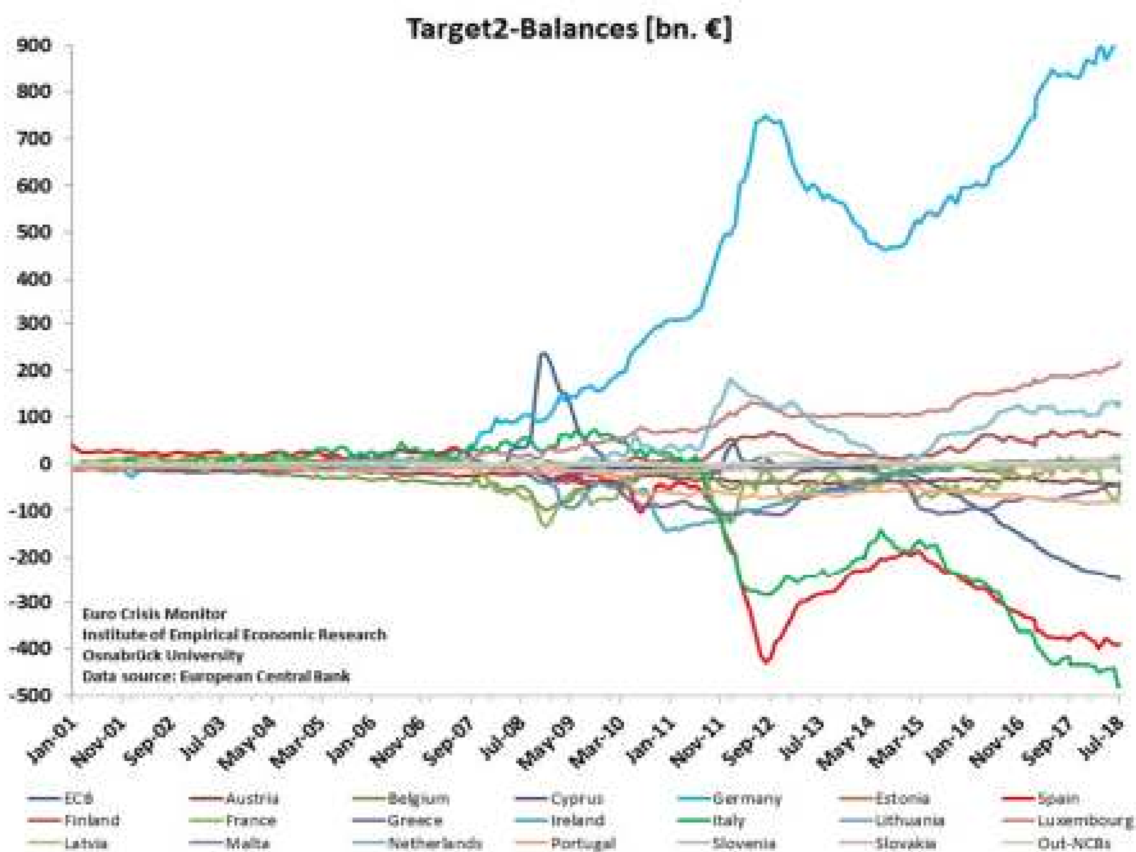
More technically, the Eurosystem/ECB nexus had and has flaws that have not been satisfactorily addressed so far.

Target2 balances are the forefront example. It was Hans Werner Sinn in 2011 who demonstrated to the ECB and the Bundesbank that TB2 was not merely a booking system: "*irrelevant balances with no direct relevance to ECB monetary policy*". They have to be interpreted within the context of money creation, international capital flows and current account deficits/surpluses in the EA.

Target2 balances (Chart 1) are official credit lines and therefore represents an exposure notably in the extreme case of a euro break up. In a nutshell, they are intra Eurosystem-ECB lines of credit which are automatically generated and unlimited in size, are not collateralized and with no redemption (repayment) date.

The Eurosystem/Target2 construction can be viewed as a system which lacks the critical economic feature of unified currency: i.e. that transfers of money take place automatically, without national central banks interfering (Friedman, 1968).

Chart 1 – Target2-Balances



Source: Euro Crisis Monitor

As indicated, the risks of TB2 are clearly intertwined with the state and prospect of the euro. The official position of the ECB had been traditionally that the euro was irrevocable and enshrined in the Treaties (Draghi 2012 – Morganti).

But later, Draghi (2017 - Valli and Zanni) opened a Pandora Box by indicating that "*If a country were to leave the Eurosystem, its national central bank's claims on or liabilities to the ECB would need to be settled in full*." This statement by the President of the ECB reopened the issue of the LM in two ways.

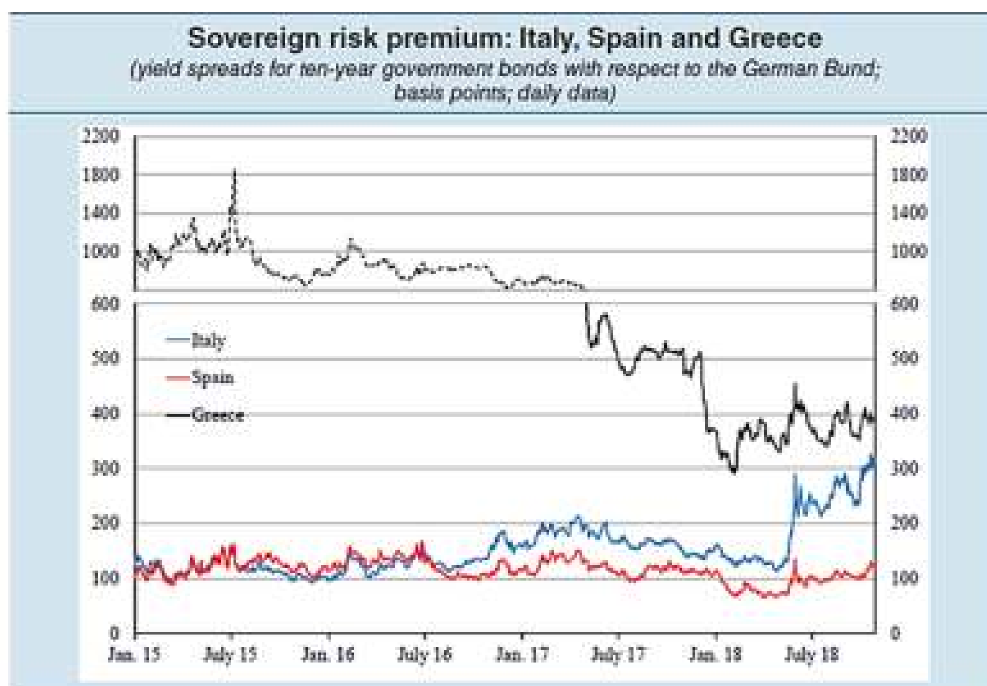
To start with, if a single member state exits the Euro and replaces it with a new (national currency), payment obligations could be redenominated according to the LM of the departing country (which would also leave the EU). It is precisely to cope with this type of risk that CAC procedures have been introduced.

If, however, there is a Euro break-up, the single currency itself would cease di exist, and it would be impossible to impose an obligation to pay in Euros. This Pandora scenario would make it impossible to refer to the Euro as the lawful currency.

Legal uncertainties surround this worst case, also in terms of the enforceability of CACs. This is partly due to the difficulty of matching the governing law of the contract clauses with the courts of the departing member states. Even more complicated, also from a legal perspective, is the treatment of Target balances in these circumstances.

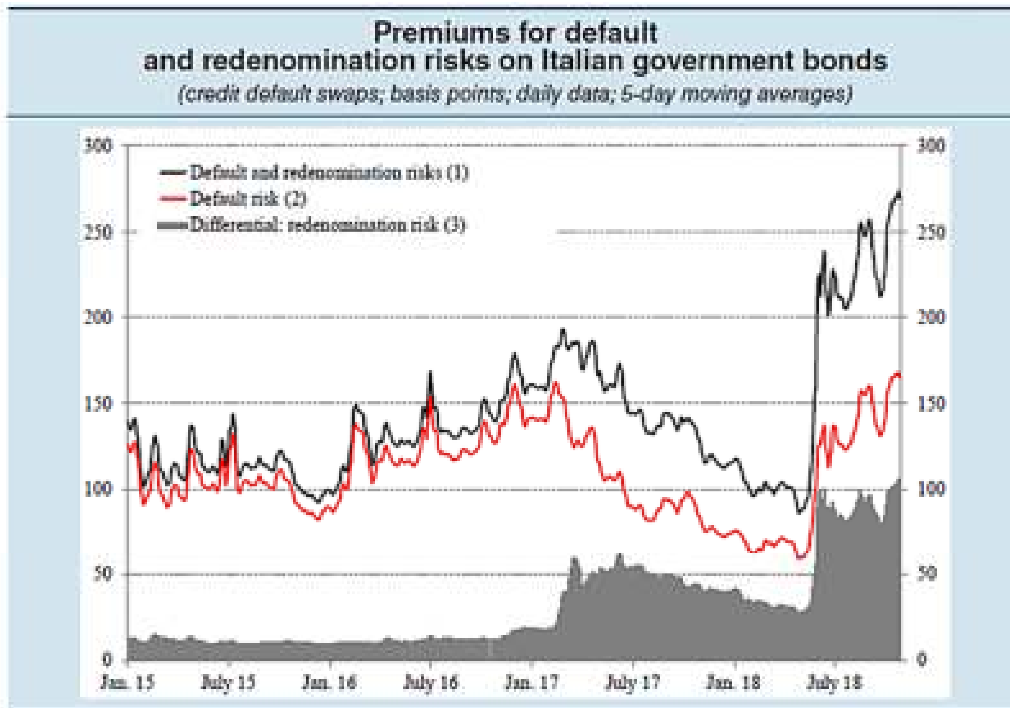
In any case, it has become impossible to consider the adverse scenarios described here as events characterised by a negligible probability. They have been admitted and examined by the official political, economic and monetary authorities of the Euroarea. It must be recalled that the whole G20 approach to financial regulation/supervision is based on the utilization of low-probability/extreme value theory models (capital risk weighted requirements stress tests, bail-in schemes). The current, more consistent and transparent official approach can be epitomized by the following charts recently presented by the Governor the Banca d'Italia (Visco, 2018) (Charts 2, 3 and 4) who duly recognised market derived low, but not negligible, probabilities for these adverse events.

Chart 2



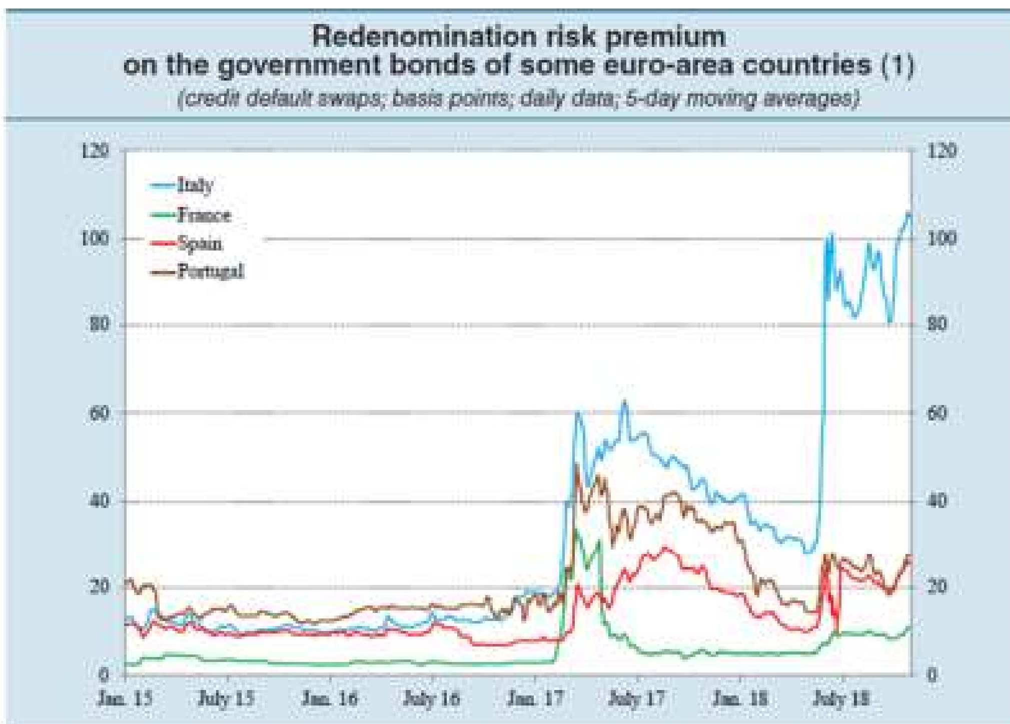
Source: Based on Bloomberg data.

Chart 3



Source: Based on Thomson Reuters data.
(1) Premium on the Italian sovereign CDS ISDA 2014 contract with 5-year maturity. – (2) Premium on the Italian sovereign CDS ISDA 2003 contract with 5-year maturity. – (3) Spread between the premiums on the CDS ISDA 2014 and the CDS ISDA 2003 contracts with 5-year maturities.

Chart 4



Source: Based on Thomson Reuters data.
(1) Spread between the sovereign debt premiums on the CDS ISDA 2014 and the CDS ISDA 2003 contracts with 5-year maturities.

To complicate things further, the EA is in the very uncomfortable position of not having a truly "safe asset" (which affects risk taking, portfolio and capital allocation). The traditional short-term Treasury bill is not

available (unless one takes the Bund as a reference point). The other key safe asset is the monetary base itself. But the ECB would be at risk in case of a euro break up. The time consuming and expensive efforts to create an artificial safe asset based on securitization and tranching of EA official debts are a mistake (Minenna, 2017).

4. The main issues which deserve immediate attention[1]

- The German and other countries' plans to discipline euroexits and reduce redenomination risk: feasible or counterproductive?
- The distortions of negative interest rates should not last longer, but also this exit is a source of significant risks.
- The EMF is an important French proposal, which is however not yet fully explained, in spite of Meseberg.
- The EDIS mechanism must be reassessed and implemented.
- The Resolution framework should be revised in depth (Masera, 2018).
- The safe asset issue must find a solution.
- The relaunch of (public) investments in the knowledge economy and society and for protection of the environment should have a favourable treatment in the EA fiscal rules.

A related question mark: is the ECB representative of a decentralised monetary union?

The evolving position of the ECB is portrayed in a further response by Mr. Draghi to two members of the European Parliament, Mr Joachim Starbatty and Ms Ulrike Trebesius: "*TARGET2 is integral to Monetary Union as it ensures that banks' reserves held at national central banks (NCBs) can flow freely across euro area Member States. By facilitating the cross-border flow of liquidity between banks, TARGET2 substantially reduces systemic risk and plays a key role in ensuring the smooth conduct of monetary policy, the correct functioning of financial markets, and ultimately banking and financial stability in the euro area. (…) Intra-system balances are an inherent feature of any decentralised monetary union. Limiting their size could restrict the free flow of money across borders and as a result undermine the smooth functioning of Monetary Union. For this reason, neither NCBs nor the ECB have put in place provisions to limit the size of TARGET2 balances, which are, however, constrained by the size and structure of the Eurosystem balance sheet*." (Draghi, 2018).

From an economist's perspective, the EU Treaty does not make reference to a decentralized monetary union in the conduct of monetary policy. The Consolidated version of the Treaty of the European Union - TFEU (Official Journal of the European Union, 2016, Art. 12 of the Protocol n. 4 on The Statute of The European System of Central Banks and of The European Central Bank), reads at follows: "*The Governing Council shall formulate the monetary policy of the Community (…). The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks.*". In this institutional framework, account being taken of the creation and operation of the SSM and the SRM, ELA should move from a decentralized implementation to a "single" mechanism managed by ECB.

Target2 should be reformed to make it sustainable. But the causal links (*who rules the roost?*) of the adjustment mechanism are not clear. Two alternative approaches: Philip Turner (2017), Paul De Grauwe et

[1] A lucid analysis and a clear elaboration of the steps required to overcome the standstill of the European construction is offered, from an official perspective, by Balassone and Visco (2018).

al. (2017) vs Salomon Fiedler et al. (2017): **should the burden of adjustment fall primarily on surplus or deficit countries?**

The stability and effectiveness of the Eurosystem rest on a correct answer to the above question and on appropriate economic policies.

The Italian issue

In Italy (Chart 2) the main problem – which is also a cause of the excessive public debt - is represented by the dismal long-term productivity performance. This real issue (low growth, low income trap) requires fundamentally real adjustments (improved country governance, structural supply side policies, tax adjustments, cuts in counterproductive bureaucratic layers of government and public employment, investments in human capital, R&D and good infrastructural investments broadly defined).

Chart 5 – Total Factor Productivity for Italy (1960-2014)

Source: University of Groningen and University of California, Davis, Total Factor Productivity at Constant National Prices for Italy [RTFPNAITA632NRUG], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/RTFPNAITA632NRUG, November 15, 2018.

5. Conclusion

As anticipated, I go back to square one, and to Luigi's Latin conclusions.

But, unless the key issues indicated here are properly – and rapidly – addressed, the system is vulnerable: EMU appears today an unsustainable equilibrium.