The new EU economic governance and market discipline

Ignazio Visco[1]

1. The Economic and Monetary Union has been a success in many respects. It has enhanced internal trade and delivered a credible monetary policy that has anchored inflation expectations and fostered a culture of price stability. The euro rapidly attained the status of a strong international currency. However, the functioning of EMU has been hampered by some very serious pitfalls in its institutional design. We now clearly see an asymmetry between the strength of the "monetary" pillar and the weakness of the institutional framework. The architects of EMU understood that fiscal discipline was necessary for the functioning of a monetary union in which the single monetary authority would be confronted by multiple national fiscal policy-makers. To achieve fiscal discipline they relied on a multilateral surveillance mechanism based on fiscal rules.

2. The European sovereign debt crisis has shown that the surveillance mechanism has not been effective. European rules were not sufficient to induce countries to adopt prudent fiscal policies in good times. The result was that many euro area countries faced the crisis with relatively high deficit ratios, still far from their medium term objectives; those objectives, equal to a balanced budget for most member states, would have allowed countries to let automatic stabilizers operate in unfavourable circumstances without exceeding the 3 per cent threshold. In several countries the debt-to-GDP ratio was above the 60 per cent ceiling, in some cases still by a large margin. Fiscal rules and procedures failed on more than one occasion. In 2003 a trade-off of short-term interests within the European Council stopped the rules from being applied to Germany and France. This reflected the lack of an independent enforcer. The sustained fiscal profligacy in Greece was not timely reflected in official fiscal data (the estimate for 2009 deficit, which in April of the same year was 5.1 per cent, was progressively revised upwards to 15 per cent). This case exemplifies problems of the statistical monitoring framework. There is a wide consensus that fiscal rules should be broader (encompassing debt dynamics) and more effective (via new voting procedures).

3. The crisis has also highlighted that low public debts and deficits do not guarantee fiscal sustainability. In a crisis, private liabilities can quickly turn into public debt. Before the crisis, the fiscal performance of Ireland was

[1] Deputy Director General, Member of the Governing Board, Banca d'Italia. Remarks to the Brussels Economic Forum 2011, "Rethinking economic policy in Europe – A new era of EU economic governance", Session II: EU economic governance framework in practice – Ensuring its Robustness.

considered extremely successful. From the launch of EMU, it almost halved its debt-to-GDP ratio, reducing it to 25 per cent in 2007. The recession more than doubled it. Furthermore, households and non-financial firms were highly indebted (their debt burden was about two and a half times GDP); the major Irish banks had balance sheet assets equal to five times GDP. The fall in real estate prices and the recession caused them big credit losses; the political decision to use public funds to bail out reckless financial institutions has pushed up the public debt by more than 20 percentage points of GDP so far, to a level of about 95 per cent of GDP in 2010, with further disbursements anticipated for this year following the results of the stress tests conducted on banks. Perhaps, the crisis would have been less severe if a framework to detect and tackle macroeconomic imbalances and systemic risks had been in place. This has prompted the introduction of a second pillar in EU economic governance: macroeconomic surveillance.

4. But there is a need for a third pillar: market discipline. I will not focus on the temporary arrangements devised to cope with the significant short-run challenges posed by the crisis. Rather, I would like to offer some remarks on the long-term institutional set-up that is currently taking shape in the European Union. During the early stages of the debate on the new European architecture, there was relatively little emphasis on the role that markets can play to induce fiscal discipline. The issue gained prominence in November 2010, when the main characteristics of the European Stability Mechanism (ESM), the permanent mechanism slated to replace the European Financial Stability Facility (EFSF) in June 2013, were spelled out.

5. Scepticism on the effectiveness of market-based fiscal discipline was already present in the early stages of the EMU project. The final report of the Delors Committee remarked in 1989 that: "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive". The European Commission expressed similar concerns a year later. And many years earlier, Luigi Einaudi, the great Italian economist and statesman, summed up the common view by saying "*i risparmiatori hanno cuore di coniglio, gambe di lepre…*" ("investors have the heart of a rabbit, the legs of a hare …"). I think it is fair to say that the mistrust in market discipline finds support in the EMU experience. In the period from 1999 to mid-2007 (just prior to the sub-prime crisis) markets almost did not differentiate among European sovereigns. Sovereign yield spreads relative to the German 10-year benchmark ranged from 5 basis points for Ireland to 50 basis points for Greece. The interest rate differentials for Greece, Ireland and Portugal were still below 50 basis points in the spring of 2008. After a period of increased financial market tension, during which, however, the spread on Greek and Irish bonds rarely exceeded 300 basis points, at the beginning of December 2009 10-year spreads were back below 200 basis points for all three countries. After that

they spiralled upwards, reaching 660, 380 and 330 basis points, respectively, between the end of April and the beginning of May 2010. There were several more acute bouts of tension on the euro area sovereign debt market in the second half of 2010 and the first few months of 2011. The pressure eased temporarily after the decision, last March, to increase the lending capacity of EFSF and to establish a permanent crisis resolution mechanism. But, also reflecting the perception that in the transition from the EFSF to the ESM the burden on private creditors may become extremely heavy, spreads have risen again to very high levels and now stand above 650 basis points for Portugal, 750 for Ireland and 1250 for Greece.

6. Formal statistical exercises also find a relatively weak correlation between spreads and fiscal fundamentals (i.e. the debt level, present and projected primary deficits) in the pre-crisis period. The correlation became stronger later, when it was already too late to avoid a major area-wide turmoil. The issue, then, is how markets can exercise a more prominent role, working properly – which means gradually – to complement rule-based fiscal surveillance. A deterioration of the cost and availability of funds to both private and sovereign issuers provides a strong incentive to correct irresponsible behaviour, tracking closely both the country's fiscal fundamentals and private sector's weaknesses (that may prompt the government to step in). Thus, the key question is when and under what conditions credit markets provide sufficient incentives to restrain irresponsible borrowing.

7. The recent experience suggests that investors will be more effective in disciplining euro area governments if certain institutional prerequisites are met. First, borrowers must adequately and promptly respond to market signals. Second, transparent and timely information concerning the actions and the budgetary position of sovereign lenders should be available to all agents (and a reform designed to improve the quality and reliability of fiscal statistics by strengthening Eurostat's powers has been recently adopted). Third, full bail-out of troubled governments should be credibly ruled out. A no-bail-out clause is already enshrined in the European treaties, but many investors were inclined to believe that the clause would not be applied in an emergency. This implied that, ex ante, investors did not demand sufficiently higher premia for holding government bonds with higher default risk. By contrast, if the threat of a default is credible, this will foster stricter market oversight and induce less fiscal profligacy ex ante. In equilibrium, default will be less, not more, likely.

8. But how can a no-bail-out clause be made credible? The answer, of course, is by making, ex post, the bail-out more costly than a bail-in for official lenders; that is, by reducing the spill-over of a sovereign default so that the economic and political costs of a default fall mainly on the defaulting country. It is paramount to weaken the link between sovereign risk and bank risk. This will

require a careful analysis of the many different channels through which a deterioration in fiscal conditions affects the cost and availability of bank funding. For example, regulators might want to carefully assess the (regulatory) incentives banks have to hold excessive amounts of risky sovereign bonds, and the collateral rules that are used by central banks and in wholesale markets could be reconsidered. The link between sovereign and bank credit ratings should also be carefully examined.

9. Rules and markets should not be seen as mutually exclusive, but as mechanisms that complement and reinforce each other. The challenge would be not only to limit the intermediary's exposure to a given sovereign borrower considered in isolation, but also to guarantee that intermediaries can survive even if debt restructuring in one country triggers restructuring in others. It should also be taken into account that a default can threaten financial stability through its impact on derivative markets (e.g. the market for credit default swaps). All this clearly requires regular stress testing of financial intermediaries and the availability of timely and objective assessments of sovereign risk. Such assessments should evaluate fiscal conditions and prospects, consider the level and trend of private sector indebtedness, and take a country's prospects of growth into account. Clearly, this is a formidable challenge, and we know too well that it has not been satisfactorily addressed by credit rating agencies. But we have to find ways for such institutions to develop proper standards and operate in a transparent relationship with national agencies such as independent national fiscal councils, supranational (in Europe, Community) institutions and international financial organisations.

10. Ex-ante procedures that facilitate an orderly default should be considered. The European Council's proposal to introduce collective-action clauses (CACs) would help to make debt restructuring more likely and quicker, credibly reinforcing the threat of a default. If approved, however, the innovation will apply only to new debt issues, potentially raising a problem of market segmentation and indirectly providing a senior status to current bonds. As Axel Weber and his Bundesbank colleagues have recently suggested, a clause that automatically extends debt maturity when a country gets the ESM assistance could also be included. This would put some of the burden of restructuring on short-term borrowers, who otherwise would benefit disproportionately from ESM intervention. It would make private sector involvement possible as soon as the crisis manifests itself, whereas CACs can only play a role in the later phases of a crisis, when ESM help has already proven ineffective.

11. The introduction of the ESM rightly envisages the involvement of the private sector in all cases where the sovereign borrower is deemed insolvent (short-term illiquidity problems are instead properly addressed with ad hoc and conditional financial help). Of course, the devil is in the details. There is no

foolproof way to distinguish short-term illiquidity from fundamental insolvency (the quest for a clear-cut answer probably started with Bagehot around 1870). So the ESM (like any other lender of last resort) is exposed to two kinds of risk: bailing out an insolvent borrower and allowing the bankruptcy of an illiquid one. Furthermore, unlike private borrowers, sovereigns usually can choose whether or not to honour their debts, so that the issue is not really insolvency in the strict sense (i.e. inability to repay) as unwillingness to repay owing to exceedingly high social or political costs, which are even less straightforward to judge and to measure. Still, this issue cannot be avoided. We need to think about what institution should be in charge of such evaluations, and acknowledge that it should comprehensively consider the evidence and assessments provided by credit rating agencies, national fiscal councils, international financial institutions and organizations. A tough assignment, indeed.

12. To conclude, I have to confess that, in a sense, I have cheated you. My Einaudi's quotation was actually incomplete. He not only said that "investors have the heart of a rabbit, the legs of a hare…"; he continued and said that they have "…*la memoria di un elefante*" ("the memory of an elephant"). This should be a reminder of the disruptive consequences of a default, which often permanently stains a government's reputation. Governments that default are excluded for potentially long periods from international capital markets, especially when markets consider the default opportunistic. They also face an increased cost of borrowing thereafter. Finally, and perhaps most importantly, default also signals an overall lack of reliability of the country. A proper design of the conditions for the ex-ante involvement of creditors in an orderly restructuring of the debt of a sovereign borrower and the definition of appropriate incentives for a more gradual, timely and responsible market assessment would significantly reduce the probability of sovereign default and the risk of extremely harmful financial stress associated with such an event.