THE EU FISCAL GOVERNANCE FRAMEWORK – HEADED FOR THE FUTURE”

Managing sovereign debts held by the Euro-system

Stefano Micossi

Rome, 11th October 2022

The need for common action

- With the end of asset purchase programmes and the ‘normalization’ of monetary policy, the problem arises of how to dispose of the Eurosystem’s sovereign holdings once their monetary policy justifications disappear
- In the short term: (already emerging) policy conflict between the need to restrict liquidity conditions throughout the eurozone and the adverse effects of monetary restriction on the sovereign markets of highly indebted countries within the eurozone
- In the medium term: the Eurosystem cannot continue to manage those sovereign holdings once the emergency circumstances that justified their purchase fade away, raising the issue of the mutual independence of monetary and ‘economic’ policies (ECJ Case Weiss and others C-493/17)

The way out of these policy and legal conflicts

- The ESM would establish a multi-year programme to purchase the sovereigns held by the Eurosystem, and roll them over indefinitely thereafter
- The programme would be sufficient to reverse much of the purchases under APP and PEPP and bringing the Eurosystem's holdings down to 'normal' operational need
- The sovereigns would be purchased in the same proportions that applied to the purchases (based on ECB capital keys) – but then the ESM would be free to manage those holdings in view of the financial stability requirements
- The sovereigns would be purchased at market price – the Eurosystem would intervene to compensate any unwanted liquidity effects

Can the ESM be entrusted of this task

- The ESM was established to preserve financial stability from shocks similar to those that destabilised individual member states and the entire eurozone in 2011-12 (see European Council Decision 199 of March 2011)
- The Court of Justice (Pringle Case C-370/12) has clarified that the decision to establish the ESM has formalized and assigned to the ESM the function of preserving financial stability in the eurozone, and that this function is 'distinct and separate' from the monetary policy task of preserving price stability
- The Treaty establishing the ESM (TESM) gives it the power to raise funds to assist euro member states, including the possibility to intervene in the secondary markets of sovereign debt instruments (Article 18 TESM) – with appropriate conditionality

ESM interventions under article 18 TESM

- At the time of the establishment of the ESM, Article 18 was conceived to allow open market purchases as later envisaged by the ECB with its OMT programme
- Albeit at that time financial instability was mainly seen as generated by divergent national policies, there is nothing in the TESM preventing it to intervene to purchase the sovereign debts of all eurozone members from the ECB if necessary to preserve financial stability
- In order to participate in the scheme, each country would have to meet ‘appropriate’ economic policy conditions verified by the ESM – e.g., as established for the precautionary credit lines – letter of intent for those complying with the Stability Pact, otherwise MOU (as in reformed TESM)
- Triggering Article 18 requires the Ecofin Council and the ECB to declare the existence of a risk to financial stability

Leverage and ESM risk management

- For the ESM financial assistance not to trespass into monetary policy, its financial assistance must be financed by its capital or by issuing its own euro liabilities (Pringle)
- Triple A rating for ESM liabilities is guaranteed by its capital and the quality of its assets. In this case the ESM would not borrow to lend but to acquire a portfolio of Member States' sovereigns, that is high quality assets; therefore, leverage over its capital could be well be higher than unity, since potential losses on in its sovereign portfolio would likely be a tiny share of its total portfolio
- Suffice to recall on this that the ESM/EFSF did not lose a penny on their loans for the restructuring of Greek sovereign debt
- Compliance with these conditions ensures that the securities issued by the ESM will be a 'safe asset' – no tranching, no gimmicks to assist their placement

Impact on interest rates and liquidity conditions

- The ECB would regain full freedom to manage liquidity, gradually making the liabilities issued by the ESM the instrument of its monetary operations
- The ESM could be given broad freedom to manage its sovereign holdings, including the possibility to intervene in support of specific bonds affected by systemic instability - thus a true common debt agency
- In order not to violate Article 125 TFEU (no bailout), all the member states must remain responsible for their debts – and the financial conditions of ESM operations must fully reflect market conditions (Pringle)
- The main incentive for member states to participate would be the greater financial resilience of the eurozone – an additional inducement for 'strong-currency' member states would be the likely decline in their interest rates following the emergence of a European safe assets

On the compatibility with EU law

- ✓Art. 127 TFEU (ECB exclusive competence in monetary policy): by purchasing sovereigns from the ECB, the ESM pursues non-monetary financial stability objectives, and at all events these purchases only entail a change in the portfolio composition of the ESCB
- ✓Art. 125 TFEU (*no bail out clause*): granting financial assistance to a MS is possible, provided MS remains solely responsible for its obligations and it implements sound policies. In our case, the debtor of the sovereign bonds remains the issuing MS; only the creditor changes (the ESM); compliance with the eligibility conditions of the new credit line guarantees the virtuous behaviour
- ✓Art. 123 TFEU (no monetary financing of MS by the ECB): this prohibition does not apply to the ESM; the scheme does not involve any monetary financing of sovereign debts → the ESM buys sovereign bonds from the ECB that the latter has purchased on the secondary market

On compatibility with the ESM Treaty

- In my proposal, the ESM intervenes to strengthen the financial stability of the euro area through the secondary market facility (Art. 18 TESM), which is fully within its mandate
- Activation of the facility should be preceded by an assessment of the eligibility conditions established in the TESM, and would then be followed by continuous assessment of eligibility conditions
- Therefore, there seem to be no grounds to claim incompatibility between the proposal under consideration and the TESM
- However, the decision to enact my proposal has a political dimension belonging inevitably to the European Council and the ESM Board of Governors

No treaty changes necessary

- The scheme presented here may be implemented without need to modify the TFEU or TESM
- The board of governors of the ESM (which coincide with the finance ministers of the Eurogroup) should only:
  a) set the path for sovereign bonds purchase – a one-shot operation would not be feasible
  b) establish the conditionality to apply to member states for participation in the scheme – in line with current provisions in the (reformed) TESM for precautionary credit lines
- The eurozone would at long last have a euro safe asset to offer banks to diversify their sovereign holdings, and to international investors as an international reserve asset

References

- Micossi S. (2021), *On the selling of sovereigns held by ESCB to the ESM. A revised proposal*, in CEPS Policy Insights n. 17, November

- Micossi S. (2022), *Managing sovereign debts held by the Eurosystem: operational and legal constraints,* www.voxeu.org, 1 April