Levy Economics Institute of Bard College

Policy Note

2019 / 1

A PROPOSAL TO CREATE A EUROPEAN SAFE ASSET

PAOLO SAVONA

The Problem

There is a consensus on the fact that the eurozone and the instruments of economic policy in the European Union more generally need to be reformed. Discussions have been ongoing for some time, based on reflection papers and proposals by the European Commission and contributions by some member states.

While progress has been made, what has been agreed to so far falls short of the goal of achieving an effective reform of economic governance mechanisms. Such reform must promote growth and jobs, increase economic security, and strengthen the international role of the euro. Satisfactory results have been achieved in particular on the banking union, the capital market union, and the reform of the European Stability Mechanism (ESM), including a backstop to the Single Resolution Fund, while a recent proposal for a eurozone budget has been restricted to a "convergence and competitiveness" function.

In the absence of some key elements, the current package of reforms will be ineffective at tackling the central imbalances that derive from the eurozone setup. The missing elements, which are clearly interconnected, are a common insurance scheme for bank deposits (the European Deposit Insurance Scheme [EDIS]), the possible regulation of banks' sovereign exposure, and the existence of a common safe asset.

PAOLO SAVONA is chairman of the Italian financial markets authority, CONSOB (Commissione Nazionale per le Società e la Borsa), and formerly Italy's Minister of European Affairs.

The quest for a European safe asset has been going on for a long time. There are many problems to be addressed at the technical (and political) level, among which are the implications for the financial system and monetary policy, the safety of the asset, the level of responsibility of member states, the size and liquidity of the market, the mechanism for distribution of benefits, and the possible identification of conditionality clauses. Given the complexity of these questions, it is not surprising that at least eight different approaches have been proposed.

However, the issues that have slowed progress on the creation of the safe asset seem to be differences in construction and an underlying lack of trust in how it would be used. There are fears that the instrument could be used by some member states to escape their responsibilities and ultimately result in mutualization of debt, that excessive conditionality could hamper the use of the safe asset, or that forms of debt restructuring might be imposed even when unnecessary. Finally, the relationship between sovereign debt and bank assets has been a controversial issue, with banks' sovereign exposure at times being sizeable. Some proposals could imply that banks would be legally prevented from buying national bonds, creating problems for their marketability.

Finding an agreement on the common issuance of a European safe asset could unlock the discussions on the EDIS and how to reduce banks' sovereign exposure. It is therefore essential to identify a possible compromise on the safe asset.

In addition to being instrumental to a more comprehensive package, common issuance of the safe asset would improve the policy options of all member states—in particular when they have high debt levels, as lower interest payments would free up resources while maintaining a balanced budget.

The Importance of Reducing Debt and Interest Expenditure

High levels of public debt put a severe constraint on member states' ability to spend on areas that have a significant positive impact on growth, such as investment in education. Uncertainty about the sustainability of public debt increases its costs and undermines confidence in member-state economies. This has an obvious impact on long-term growth prospects, which spills out to the rest of the euro area, creating economic and (sometimes) political instability, both domestically and at the euro area level.

The need for high-debt member states to maintain high primary budget balances, coupled with the rigidity of some important parts of the budget, reduces the space for spending to improve growth. The limited ability of some member states to change the structure of their budgets and to address the problems of low growth and high unemployment in a sustainable and long-term manner should be a strong reason for concern for everyone in Europe.

In 2017, euro area member states spent on average 2 percent of their GDP on interest payments on their debt. The highest spenders were Italy and Portugal (3.8 percent of GDP), followed by Greece (3.1 percent). A number of other member states (Spain, Cyprus, Belgium, and Slovenia) all remained between 2.5 percent and 3 percent of GDP. At the bottom of the rankings are Estonia (0.0 percent), Luxembourg (0.3 percent), Latvia (0.9 percent), and Finland, the Netherlands, and Germany (1 percent).

The same member states that spend the least on interest payments are those that spend the most on public investment, and vice versa: Estonia (5.4 percent), Latvia (4.4 percent), Finland (4.1 percent), and Luxembourg (4.1 percent) are on the opposite end of the spectrum as Portugal (1.8 percent), Spain (2 percent), and Italy (2 percent). Germany, with 2.2 percent of GDP spent on public investment, is an exception—in the sense that it spends less than it should, even as it has one of the lowest interest burdens (1 percent of GDP). Greece—spending 4.4 percent of GDP on investment and 3.1 percent on interest—is another special case (Eurostat).

Investment and interest are also on the opposite ends of the spectrum when it comes to flexibility of public spending. Interest belongs with other expenditures—such as pensions or healthcare—that are, or are deemed to be, "incompressible" (nondiscretionary). By contrast, when crunch time arrives and expenditures must be cut in order to respect external constraints (such as the Stability and Growth Pact), public investment can be postponed, sliced, or outright cancelled, with minimal political consequences but significant negative economic impact.

To reduce interest expenditure, it would be necessary to reduce the level of debt in terms of GDP, as well as the uncertainty about liquidity (which is priced by the market) and policies. But this is far easier said than done. To have a meaningful effect on a high level of debt, the conventional approach is to run (large) primary surpluses for a long period of time. However, to give an example, the assumption that Greece will be able to sustain, almost indefinitely, a primary surplus of 3.5 percent in order to bring down its debt (currently at 173 percent of GDP) has been repeatedly challenged by many—including the International Monetary Fund, which has called for some form of debt relief for Greece to avoid prolonged deflationary policies that would suppress growth. This debt relief argument has been accepted by the Eurogroup in the context of the ESM program: its reprofiling of the term structure of the Greek debt included reduction in interest rates and grace periods.

Italy has already been running an average 2.3 percent primary surplus since 1995, but the effects on debt dynamics and interest rate expenditure have been in large part offset by poor real growth rates—and also by undershooting the 2 percent reference value for inflation. With the exception of 2007, Italy's debt-to-GDP ratio has been more or less growing steadily since 2005 (when it was 101.9 percent) and reached 131.2 percent of GDP in 2017. It took four years of primary balances to reduce it by only 0.6 percentage points (it was 131.8 percent in 2014). Interest expenditure since the start of the Economic and Monetary Union (EMU) has been 4.8 percent of GDP on average—compared to 2.9 percent in the euro area as a whole—and only in 2016 did it drop below 4 percent. The expenditure differential between Italy and the euro area has remained more or less stable around its average of 1.9 percent since 2003 (Istat).

Italy's need to continue to run primary surpluses has produced important side effects, with a significant compression of investment once other sources of savings have been exhausted. Investment was on average 2.9 percent of GDP in 1996–2011, but dropped to 2.3 percent in 2012–17 and was at 2 percent in 2017. Looking at the functional classification of public expenditure, since the beginning of the euro, general public service has been almost halved (from 14.3 percent to 7.9 percent), with public salaries frozen for almost 10 years and a low or zero rate of personnel turnover. Education has also been hit (reduced from 4.5 percent to 3.9 percent), especially when it comes to investment. It should also be noted that teachers' salaries remain relatively low when compared with other eurozone countries. On the other hand, spending on social protection has grown from 17.6 percent to 21.1 percent, also because of the crisis, and health spending has grown from 5.3 percent to 7 percent (Istat).

The Italian case is an example of why reducing high debt-to-GDP ratios is a national problem that must be addressed in the construction of the EMU architecture. As long-running primary surpluses have been insufficient, complementary steps need to be explored to free up resources while maintaining the fiscal targets. This, of course, should be accompanied by careful review, monitoring, and management of public expenditure and taxation to improve the allocation of resources and their positive impact on growth and employment.

The scarcity of safe assets in Europe (since most eurozone countries have lost their AAA rating) and fragmentation of bond markets are crucial weaknesses, as they expose European countries to capital flight and hurt countries like Italy by nullifying their substantial fiscal efforts to reduce debt and increase employment. A solution of a European nature needs to include increasing the supply of safe assets provided by a common European issuer. Such a plan should fulfil a number of criteria in order to be satisfactory—politically and economically—to all member states.

Elements of a European Safe Asset

Common issuance of a European safe asset should be relatively straightforward to implement (possibly without creating new instruments). It should ensure that each member state remains fully responsible for its own debt; it should deliver significant stabilization of financial markets and hence contain spikes in interest rates; all member states should be able to benefit from it; and any conditionality should be limited to a portion of the benefits, defined in advance, and linked to the implementation of commonly agreed policies.

The main elements of the safe asset should be:

- The safe asset should be issued by a supranational entity, which then contracts bilateral loans with the euro area members; such loans would carry the same interest rates that the common issuer would pay on its own liabilities, and be equal for all. Over time, loans' maturities could be extended with maturity transformation. This setup would allow member states to decrease debt costs and spread the debt over a longer time period, reducing annual gross financing needs. It would also allow national governments to keep full responsibility for their liabilities.
- Common issuance of the safe asset could be made by the ESM. The ESM already has the mandate to support

euro area countries on a conditional basis in case of their inability to resort to financial markets. The ESM mandate could be extended to allow it to lend to its members in normal times as well, within very well-specified limits and under given conditions.

- ESM creditworthiness must be protected, and contagion risks must be eliminated. This requires that the ESM's claims be formally given a higher ranking compared to other liabilities of the member states. In other words, all other national debt, including debt securities placed in the market, should be subordinated to ESM loans. This would render any policy conditionality unnecessary, as subordination would ensure appropriate incentives for governments to pursue sound policies, and it would clarify and enhance market discipline of government policies.
- The decision to issue would be taken by the ESM board, supported by a Debt Management Officers (DMO) board on which representatives of the euro area DMOs sit, in order to take into account national specificities and needs in terms of public debt issuance.
- The loans provided by the ESM should have the same distribution key as the European Central Bank (ECB) capital key. According to simulations carried out by academics and internal work done by the European Commission, the volume of issuance could rise to 25–40 percent of euro area GDP over time, or up to €4 trillion, while preserving the safety of ESM emissions and ESM creditworthiness.
- The ESM emission would have a much lower cost than any of today's national bonds, because of the liquidity enjoyed by their sizeable issuance, because they would be global bonds, and because of the financial standing of the ESM (whose balance sheet would include a portfolio made up of the most secure part of each member's debt).
- Interest rates on the loans (which the ESM would make back-to-back to member states) should be the same for all, allowing an equal distribution of benefits. Some benefits could be released to member states based on conditions. ESM fees could be waived in case of compliance with pre-agreed conditions, or part of the interest rate differential could be granted only if spent on investment.
- Back-to-back loans by the ESM should allow for maturity conversions. For example, the safe asset could have a 5-year maturity while a loan could have a 15-year maturity, and both would have the same interest rate, as the ESM would be able to roll over the safe asset (also enjoying the backing of the ECB as lender of last resort).

These characteristics would bring important benefits:

- Stabilizing and reducing the cost of debt for member states would facilitate the mobilization of public and private resources, which could be used for investment, education, or research, while keeping a balanced budget.
- By linking additional benefits with reforms, the safe asset would provide important incentives to deliver improvements to the market structure while stimulating investment.
- The safe asset would enable the creation of a truly European bond, which would be a global benchmark and the main asset used by the European banks. This would allow banks to gradually reduce national exposures on their balance sheets without creating problems for member states, as their own debt securities in the market would be reduced over time given that a significant part of their rollover needs would be funded via the ESM.
- The introduction of the safe asset would therefore reduce the perceived risks for banks, which would hold a much smaller amount of national debt, thus allowing for progress on EDIS.

The Next Steps

The next step should be to promote the inclusion of provisions in the ESM Treaty allowing the ESM to carry out treasury services (therefore providing loans in normal times) to the benefit of its members, and to link it with the discussions on EDIS and banks' sovereign exposure. A high-level group on EDIS has been endorsed by the European Council and it is in that context that such discussions could take place. The group could discuss all these elements together in order to find an agreement for a package. That package could then be endorsed by the European Council in June and enshrined in the review of the ESM Treaty, and in changes to EU legislation if needed. The composition of the high-level group should adequately reflect the importance of the topic.

Notes

1. For a review and a comparison of the merits of the different proposals, see Zettelmeyer and Leandro (2018).

References

Eurostat. https://ec.europa.eu/eurostat. Last accessed December 2018.

Istat (Istituto Nazionale di Statistica). https://www.istat.it. Last accessed December 2018.

Zettelmeyer, J., and A. Leandro. 2018. "Europe's Search for a Safe Asset." Policy Brief 18-20. Washington, DC: Peterson Institute for International Economics.