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PIACENZA

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Abstract

The solution to the sovereign debt crisis and the restoration of confidence in the European project are critical for the long term stability and economic growth of the region, and for the stability of worldwide financial market. Defining debt sustainability is not an easy task. In the past, economic theory has suggested different proposals. European Union member countries decided to opt into a specific level of Public Debt to GDP ratio (60%) by signing the Maastricht Treaty and the Growth and Stability Pact.

Public debt sustainability during the core of the financial crisis (2008-2010) became under stress. The heritage of such period is very different in the Eurozone, leaving weaker countries more exposed and Italy, in particular, given its large public debt, with very reduced margin for manoeuvre.

What is now happening in Europe seem to be the response of a long path of uncertain developments and the return to a more focused planning on a long term financially stable union. In November 2014 the Single Supervisory mechanism (SSM) will be in place, allowing ECB to take over supervision responsibilities on the bulk of Eurozone banks (around 85% of the total assets as an aggregate). This step, followed by the developing of a Single Resolution Mechanism (SRM) in 2015 will allow Eurozone to have a fully fledged Central Bank.

Will all this be enough to stabilize the Eurozone and revamp the path of European Union in the long term? The answer will come only from future event, but, nevertheless, it is sure that financial stability in a large area as Eurozone will require again a renewed path to convergence for national economies and a globally stable and ordered situation of public accounts. This may imply the need of further significant structural reforms and, possibly, a political agreement on the long term shape of the Union.

Keywords: Convergence, Economic Growth, Globalization, Growth, US, EU.

JEL Classification: F620 Macroeconomic Impacts of Globalization

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The sovereign debt crisis in Europe: impacts on prices, stability, growth and perspectives for public debt sustainability

1. Sovereign Debt sustainability in Europe: what does not work?

Defining debt sustainability is not an easy task. In the past, economic theory has suggested different proposals. European Union member countries decided to opt into a specific level of Public Debt to GDP ratio (60%) by signing the Maastricht Treaty and the Growth and Stability Pact.

In reality there is a mix of factors to be considered, starting from the debt stock and the GDP growth level (as growth matters: also a relatively little debt may become unsustainable if the economy is in such a deep recession to forbid the state to have the needed resources to service its obligations), but also the structure of the debt itself (e.g. maturities – it is quite different the situation of a state with a sizeable debt whose maturities are spammed equally on twenty years, so that only 5% of it matures every year, and another with few debt, but all due within one year), the capability to make autonomous and accommodating monetary policies if needed (which is prevented to Eurozone members), the capability to implement fiscal policy corrections if needed (so to be able to raise taxes if credit is temporarily unavailable) and, last but not least, by the financial markets (internal and international) and their expectations (a negative judgement of the markets on a state may mean even a self-fulfilling prophecy: if there is no credit available, also a state with all theoretical sound fundamentals may not be in condition to service its obligations).

By definition, therefore, debt sustainability depends by a mix of circumstances and conditions, and may not be linked to specific ratios or rules. On top of this, we may remind what history has taught us, so that in specific moments, even very high debt are tolerable (e.g. the US after WWII reached a 200% Debt on GDP, and continued to support the reconstruction of Europe; but growth level was different and the US

experienced some years of double digit growth, which allowed to reduce the ratio in few years to much lower levels), whilst in moment of deep recession even relatively sound situations may be under severe stress.

General government gross debt - (includes IMF estimates)	2012	2013	2014	2015	2016	2017	2018	2019
Austria	74.1	74.2	79.1	78.2	77.5	76.1	74.8	73.7
Belgium	99.8	99.8	99.8	99.6	98.6	96.9	94.5	91.4
Cyprus	85.5	112.0	121.5	125.8	122.5	116.1	111.6	107.9
Estonia	9.8	11.3	10.9	10.3	9.6	8.9	8.2	7.6
Finland	53.6	57.0	60.2	62.1	62.0	61.9	62.1	62.1
France	90.2	93.9	95.8	96.1	95.3	93.6	90.8	87.7
Germany	81.0	78.1	74.6	70.8	67.0	63.8	61.2	58.7
Greece	157.2	173.8	174.7	171.3	162.5	153.7	146.1	137.8
Ireland	117.4	122.8	123.7	122.7	119.6	116.8	113.1	109.1
Italy	127.0	132.5	134.5	133.1	130.5	127.6	124.7	121.7
Latvia	36.4	32.1	32.7	29.3	31.3	30.5	28.4	27.3
Luxembourg	21.7	22.9	24.1	27.0	29.8	32.9	35.8	39.0
Malta	70.8	71.7	72.5	72.6	72.6	72.9	73.1	73.4
Netherlands	71.3	74.9	75.0	74.4	74.1	73.2	71.9	70.1
Portugal	124.1	128.8	126.7	124.8	122.6	119.1	116.6	113.8
Slovak Republic	52.4	54.9	58.6	59.8	60.4	60.8	61.1	61.4
Slovenia	54.3	73.0	74.9	77.9	80.0	81.5	82.4	83.0
Spain	85.9	93.9	98.8	102.0	103.7	104.3	103.9	102.4

Public debt sustainability is, in the end, the measure of the reputation of a state. In fact markets price the risk of public debt, and the lower is the price, the lower is the expectation of a possible loss (default, restructuring, etc). But, also, a low price incorporates factors such as the liquidity of a certain debt and the state capability to raise further debt; if a state, although heavily indebted, has no apparent difficulty in finding new loans, clearly the risk for its creditors is limited. The case of Japan in the last decade is significant: despite an over 200% Public debt to GDP ratio, the interest paid by Japan is currently still very low. The main reason is that its enormous debt is largely owned by nationals and is denominated in a national currency which is under the full control of its national central bank.

Why “internal” debt is perceived as less risky by the markets? Why a national central bank with full powers on monetary policy is so important?

The first question can be easily answered by suggesting that an internal debt does not need to be refinanced externally, and the internal market is less sensitive to, e.g., devaluation of the national currency. A foreign investor would not renew his credit if he fears a devaluation, which would mean incurring in a capital loss; a national does not see this risk (unless his target is to save money for investing abroad).

The second question is a bit more tricky. In theory a central bank is independent, and should never contribute in monetizing public debt. If it does so, its credibility will be destroyed. But, facing the dilemma of supporting the state at a risk of default or refusing doing so and let the state fail servicing its obligations, a central banker would have no choice, as the state default would be a catastrophic scenario also for banks and stability. In conclusion we may see that markets normally assume that it is practically impossible the default of a state on his national currency denominated obligations. Rather, the trouble lies in loans made in foreign currencies (which must be obtained through exports, other loans or foreign direct investments), and the likelihood of a public default on such obligations is not remote in case of significant crisis.

This last consideration may explain why Eurozone countries suffer so much of the incomplete architecture of Europe. In fact, EU is not a political subject, and has no central bank believed capable to support the public sector for its obligations. In reality it has the contrary: a central bank whose mission is to keep inflation and is anyhow forbidden to monetize debt. This last point may seem right, as it should never happen also in a normal “national” case, but it is not. In fact the “national” central bank is not supposed – nor normally does – to help paying public debt, but

the only fact that markets believe that it would never allow for a sovereign default allow national public debt to incorporate a presumption of “safe haven” asset.

EU’s ECB has not this power and is not perceived by markets as the one who will “save” single European countries from default. It cannot, not just for the constraints by its establishing treaty, but also because not being the EU a political body, allowing ECB to have such power would mean, de facto, forcing other Eurozone members to share the cost of the debt of one single member at risk of default. In conclusion, all European public debts are perceived by the markets as “foreign debts” for their issuing countries, and, by definition, the likelihood of a default is in the range of the possibilities.

This is the very reason for saying that current European sovereign debt crisis is not a matter of economics, but of politics. Should Europe decide to become a single federal state, by that moment the debt crisis would be over; the central bank would have all the powers to intervene in help of the ones in need, and this, by definition, would not be needed as the markets would believe that ECB can intervene. But this is not possible, and is not just a matter of saying that Europe will be a political union. It is a matter of controls and powers. In fact, the moral hazard for all members of the “political” EU would be high: single members, knowing that the central bank may at the end monetize their debt, will start spending with few controls, creating inflation and weakening the currency, but also the economies of other members.

This is the real dilemma: without political perspective behind, when we are speaking of public debt, the Euro remains a foreign currency for its members; but if it had been made a political agreement, this must be an agreement that strips the member states of the power to spend, by centralizing budget, controls and main fiscal policy. To date it seems unlikely that an agreement will be found in Europe. National governments do not want to lose the control on spending capability and budget, as

this would transform national states in regions; but without such a step, Europe and Euro will never be a complete currency system.

What is the logical next step we may have to see, but, if no agreement is found, the current architecture of Euro and Eurozone may lead to some determined scenarios.

2. The impact of the crisis on Eurozone debt sustainability

The current economic and financial crisis since 2008 has changed the landscape concerning the previous hypotheses on public debt sustainability. In fact, until 2008, the sole focus on the discipline for public budgets in Europe was on the level of debt relative to GDP and the level of deficit. The Maastricht Treaty's criteria set some strict principles such as Debt to GDP targets of 60% and deficit limit at 3% as examples of limits that would ensure sound public finances in the long term. But in this equation, one major item was missing: growth.

Unfortunately, in this projected virtuous public balance sheet as outlined in major European agreements were all considering growth as certain. So the idea of public budgets available for counter-cyclical spending was considered only a temporary diversion from theory, and the Maastricht targets remained the final long term objectives also when, after 2008, several countries had to significantly increase public spending to cope with the crisis.

But after 2008, the financial markets had substantially changed. State debt was not perceived by the markets as a completely risk-free asset. In light of this change, the previous unlimited capability of the states to leverage and spend to revamp the economy was impaired dramatically.

Now it is clear that markets impose a limit to public debt and that this limit is not the same for all states: it has a significant connection with the capability for growth.

Only the growth of GDP allows for reasonable stability in the debt/GDP level in the long term, and, thus, permits greatly needed countercyclical deficit spending.

The post-2008 crisis in Europe evidenced how important growth dynamics were in fiscal management. Where there was growth or potential to grow, the management of the crisis was easier. Also, where historical debt-management allowed for further leverage without harming for long term sustainability (as in France and Germany), the reaction to the crisis has been to leverage public balances, and in addition, to return to deleveraging as soon as feasible (e.g Germany). The case of previously highly indebted countries has been completely different, as not only there was no room for stimulating the economy through Keynesian politics, but for the sake of fiscal discipline, austerity measures have been taken, and enhanced the recession, creating a greater need for austerity in a feedback loop.

In recognition of the failure of the Stability Pact, 25 of the then 27 EU countries, including all Eurozone countries, agreed in March 2012, to a new "fiscal compact" that would force those countries with a debt to GDP ratio above 60% to limit themselves to a structural deficit maximum of 0.5% and to bring back the debt to GDP ratio to 60% within 20 years. Will this be the real way out to the crisis?

3. The financial crisis in Europe and its effects on national cases

Italian public bonds are the most traded and liquid of all sovereign debt in the Eurozone. Currently, around one-third of the total debt in circulation (over two trillion Euros) is held by non-Italian based investors.

The market for Italian sovereign bonds is primarily the MTS ("Mercato dei Titoli di Stato"), an electronic order-driven market for government bonds, quasi-government bonds, and corporate bonds operating in 30 countries, but bond trading is also

common in other contexts, such as over-the-counter transactions between major participants.

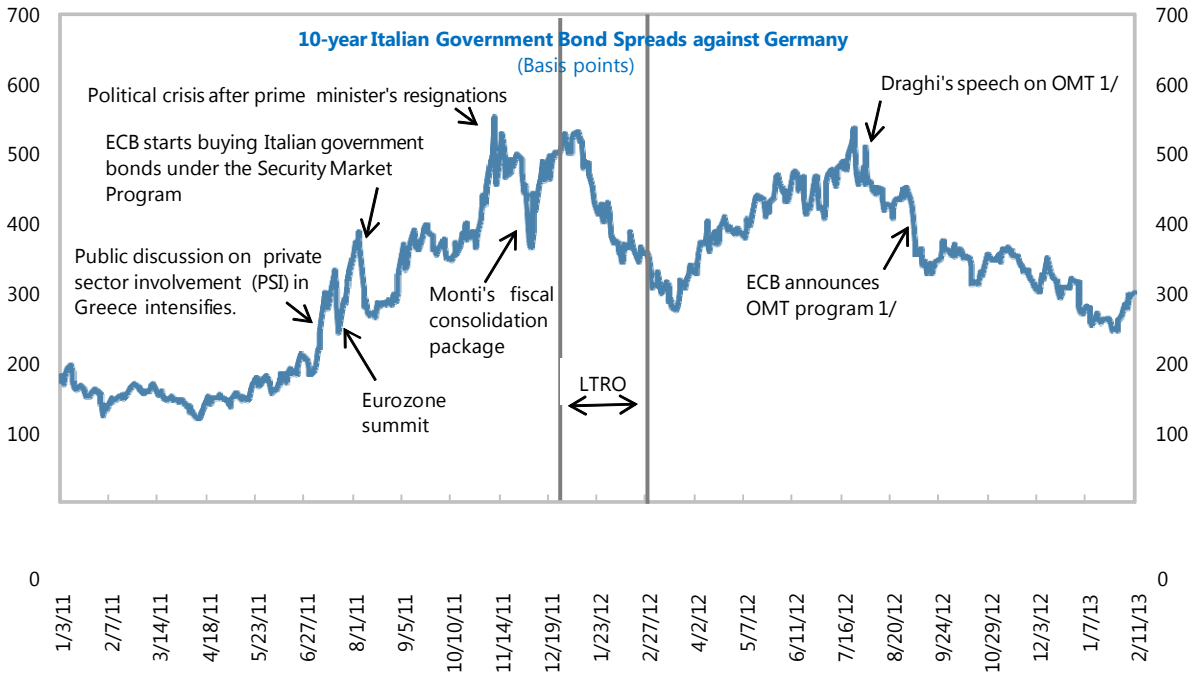
Theoretically, the high liquidity of Italian bonds, relative to bonds primarily traded over the counter, should give them greater price transparency and less volatility in the case of external events (announcements) which may normally cause short-term speculative behaviour. But the relative high liquidity of Italy's bond market may conceal different behaviours by market makers and operators. In fact trades – also by primary dealers – made simply for the purpose of setting a price for illiquid over-the-counter bonds (such as some corporate bonds) are maybe not always possible today.

To understand the dynamics of trading Italian sovereign bonds, it may be significant to see which foreign investors hold more Italian bonds. If foreign owners are mostly Italians shielded by a foreign bank (a practice historically used by domestic investors for several purposes), it would be logical to assume they are not trading their bonds, but holding them for long-term investment. If, however, a significant proportion of Italian bondholders are foreigners, they may actively trade bonds, thus enhancing the liquidity of the market.

But, as the Eurozone crisis exploded, tensions on the Italian sovereign bond market were also significant, and spreads versus the German bund became an object of political debate. Ordinarily, the liquidity of the market should be a shield to excessive price and spread movements due to speculation and announcement effects can be questioned. In fact, did the market react significantly to negative announcements? Does the current (and recent, 2011-2013) spread level represent a stable level?

Potentially, the Italian bond market may react to the arrival of new price information, such as news or developments in the fiscal situation of Italy. Some

examples may be found in specific cases, such as 11 July 2011, when Italian 10-year bonds surged 8.5% reacting to the news of a Eurogroup meeting of finance ministers, and 8 August 2011, where Italian 10-year bonds plunged by 13.7% reacting to both fears over Eurozone crisis contagion and the US sovereign debt downgrade.



Source: Bloomberg.
1/ Outright Monetary Transactions.

It may be also interesting to understand if the market equally represents the underlying economies, as proxied by differences in spreads and the impact of long term perspectives of events during the crisis, which may justify higher spreads due to more pessimistic outlooks on long-term finances.).

Changes in Italian sovereign spreads from 1998-2008 can be partially explained by the political economy of the European Union. Spreads converged in the run-up to the creation of the Euro, as all Eurozone currencies were seen as possessing equal default risk. However, in the aftermath of the fiscal crisis, spreads diverged based on investors' judgment as to the ultimate fiscal risk involved in each Eurozone sovereign bonds.

As Italy is one of the largest public debtor in Europe, a crisis there may present contagion effects for the rest of the Eurozone. But it is also clear, as a paradox, that this is the main reason to believe on the fact that a solution (political) will be found in the end. Analysing spreads and market reaction we may understand better how much speculative bid impacted and what lies behind them.

Inflation, average consumer prices - IMF staff estimates								
	2012	2013	2014	2015	2016	2017	2018	2019
Austria	2.6	2.1	1.8	1.7	1.7	1.7	1.7	1.7
Belgium	2.6	1.2	1.0	1.1	1.2	1.3	1.4	1.4
Cyprus	3.1	0.4	0.4	1.4	1.7	1.7	1.8	1.9
Estonia	4.2	3.5	3.2	2.8	2.5	2.4	2.3	2.2
Finland	3.2	2.2	1.7	1.5	1.7	1.9	2.0	2.0
France	2.2	1.0	1.0	1.2	1.3	1.4	1.5	1.6
Germany	2.1	1.6	1.4	1.4	1.6	1.7	1.7	1.7
Greece	1.5	-0.9	-0.4	0.3	1.1	1.2	1.3	1.6
Ireland	1.9	0.5	0.6	1.1	1.2	1.4	1.7	1.7
Italy	3.3	1.3	0.7	1.0	1.1	1.3	1.5	1.6
Latvia	2.3	0.0	1.5	2.5	2.3	2.3	2.3	2.3
Luxembourg	2.9	1.7	1.6	1.8	1.8	1.8	1.9	1.9
Malta	3.2	1.0	1.2	2.6	2.0	1.8	1.8	1.8
Netherlands	2.8	2.6	0.8	1.0	1.2	1.4	1.5	1.5
Portugal	2.8	0.4	0.7	1.2	1.5	1.5	1.5	1.5
Slovak Republic	3.7	1.5	0.7	1.6	1.8	2.0	2.1	2.2
Slovenia	2.6	1.6	1.2	1.6	2.1	1.9	2.0	2.0
Spain	2.4	1.5	0.3	0.8	0.9	1.0	1.0	1.1

During the July 2012-July 2013, Italy's government bond yield declined 0.87 percent. Historically, from 1991 until 2013, Italy Government Bond 10Y averaged 6.6 Percent reaching an all-time high of 15.3 Percent in October of 1992 and a record low of 3.2 Percent in September of 2005. Most commonly, a government bond is issued by a national government and is denominated in the country`s own currency. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds. The yield required by investors to loan funds to governments reflects inflation expectations and the likelihood that the debt will be repaid.

In particular, it may be significant to understand what happened between September 2008, the advent of the financial crisis and June 2009. Also, in November

2011 the spread between Italian and German 10-year debt increased by over 500 bps, and remained there for two months. Was there a specific reason for the spike in the spread or it was speculation?

It is important to see how much trading volumes changed in those periods versus other more 'calm' and which parties was trading (for example, if it was a generalized sell-off or if sales came from US or European countries). In particular it would be worthwhile to understand if when spreads widened, the underlying value of the bonds responded.

If the impact on yields was material, as the main Italian banking groups hold substantial amounts of public bonds, it would be worth examining if they intervened on the market to support the value of their holdings or took a different position (even a speculative) to hedge their losses, at the same time, implicitly enhancing the impact of the crisis.

The case of Cyprus has proven that once a country joins the Euro, there is no exit. Leaving the Euro would likely have plunged Cyprus into economic catastrophe. Before an alternative currency could be introduced (such as the old Cypriot pound), sellers, producers, service providers, landlords, creditors would demand being paid in 'hard currency', most likely the Euro, or some other major currency, such as the British pound or US Dollar. If the Cypriot government would try to impose the new currency by decree, it is likely that all contracts with foreign counterparts would have been cancelled (as standard commercial contracts in private sector rarely incorporate a change in currency). It is also likely that domestic contracts, as denominated in Euros, would be affected and potentially rendered void.

As a result, the issuing of a new national currency does not automatically convert the past stock of debt, public and private. It would rather mean the necessary default of borrowers, which will have their assets and revenues denominated in the

new currency (which would likely devalue dramatically), but their liabilities still in Euro. It is hard to see how this would not result in default for a substantial number of companies if the state ordered the conversion of debt. Consequentially, it is likely that private and commercial business will still be in preference made in Euro and, effectively, the country would still be "Euroised" – even if began reissuing its old currency.

4. Does it make any sense to still consider how to exit the Euro?

When Euro was created, the general understanding seemed to be that it was meant to be a first step towards a new European project, likely of a political federation of sovereign states, to be realized in a not too far future. This idea, that included the hope for a greater economic convergence of the EU members and of the achievement of a significant potential of growth, convinced the markets until the starting of the financial crisis.

The limits of Euro architecture have been made clear by the financial crisis. Some member states, under pressure, have even considered the idea to exit from the common currency. But to exit from Euro is practically impossible for a weak economy. Why? Not only for the treaties not contemplating the option, and not having a defined mechanism. And not only for the need to declare that an hypothetical changeover would be made at a certain future date (as there are technical needs for such a move), which will create huge uncertainty on the process and the value of the currency.

Indeed, also because if a country announces that it will reintroduce its national currency, and this latter is expected to devaluate versus the Euro, the only outcome of such a choice would be to compromise state and corporate balance sheet and budgets: liabilities (and public debt) would remain denominated in Euro, whilst

assets and earning would be in the new (old) devaluated currency. Practically speaking, the markets will perceive the exit of a member state as a declaration of incapability to remain in the Union, and the value of the new currency will be consequently likely priced at discount on the Euro. But this, as a self-fulfilling expectation, will lead to a spiral of depreciations, as the uncertainty will grow and will need to be factored in.

Very likely markets will panic in front of an uncertain assessment of the dimension of the depreciation of the new currency, likely triggering, early or later, the default of the state and, eventually, even of commercial and private operators. Should a state declare also its liabilities (and the ones of the private sector) to be converted, this would be perceived as an immediate default.

What can avoid all this? In principle, a possible way out would be to decide that instead of exiting the Euro by re-introducing a new (old) national currency which, being not any more on the markets, has an uncertain value, the new currency to be adopted is one already used and with a stable value which would likely not be affected by the economic area represented by the state willing to exit the Eurozone.

A possible solution would be a new currency pledged to gold or some real asset or commodity. But this is a solution which is completely unadequate to current financial system, as it implies a huge rigidity in money supply, and, on top of this, as to be credible it would need convertibility, cannot be adopted without risking a likely run to conversion from all currency owners. In theory it would work only if all the advanced economies would adopt the same solution, which would seem pue fantasy at the moment.

So, as it has to be a real and credible currency, there is only one currency which may respond to the needs of the description above: the US dollar.

If a Eurozone member decides to exit and agrees with the US the introduction of the US dollar at the place of the Euro (and it must be the actual dollar, not a pledge agreement: Argentina teaches us that the credibility on pledges on currencies is limited), markets will be immediately in condition to evaluate the expected trends and likely the change will not lead to a default (no risks of unlimited depreciations; likely the course of USD will remain stable). Also a conversion of liabilities from Euro to the dollar, which technically remains a default, may eventually be negotiated and become acceptable, as the two currencies are both reserve currencies and could be swapped.

Practically speaking, clearly the country who decides such a move will have to negotiate a deal with the US, including the entrance of its central Bank into the FED system, and, in the end, instead to seat at the EU table where it is a peer, will have most likely a subordinated position to the US. This poses the same problem that currently menaces the future of EU: without a political perspective giving up monetary sovereignty, in conditions of lack of economic competitiveness, equals to reduce all margins for a state to keep its peer status in the Union. So, if a country decides to adopt the dollar, likely it will have to ask the US to allow its citizens to hold a blue passport with an eagle and a star to be added to the US flag…

It seems an unlikely scenario. But, still, in some ways it deserves maybe to be explored further, as without a clear political perspective Eurozone will not survive in the long term.

But, wishing to make some pure hypothetical considerations, why the US would ever consider a proposal as such? Because this would allow the US to join the European Union and, in the long term, this new scenario will create the basis for far more than just a “Trade and Investment Partnership Agreement”. Clearly, it is not something that may be discussed in a day. Maybe steps such as a referendum or a democratic

agreement will be required. But, at least, in front of the failure to transform the European Union in a political body, the new “enhanced” US will allow for stability, security and economic growth.

Conclusions

Eurozone is slowly recovering from the financial shocks of 2011-13 and has undertaken a path of convergence which sees the Banking Union as a first and foremost step. Clearly this seems a path which, in theory, cannot avoid two specific consequences:

a) Eurozone members must in the long term represent a single economic space which is credible and consistent. To arrive there significant reforms and transfers of authority from national governments to European bodies must take place.
b) In the end, there is no alternative to imagine also a credible political architecture to govern the union, as the increased powers and authorities devolved to common bodies needs democratic accountability and legitimacy, and, ultimately, keeping the European states as separate has a cost in terms of interest rates. At the point we are in Europe the only sensitive idea is to head towards a real union.

Has this scenario a significant likelihood today? Apparently not. There is no clear consensus in practically any of the EU member states about a long term path to an eventual poltical union. This is priced by the markets in terms of spreads amongst stronger and weaker countries and assumes the possibility of sovereign defaults to occur (it is intuitive that in a case of a clear convergence path or a de facto political union there would be no spread. Eventually rates would be lower for everybody as a

huge uncertainty on the future would disappear and ECB would be in condition to act as a fully fledged central bank).

What is the possible way out? If the best scenario, the one just outlined which tends to the long term creation of the United States of Europe is not likely to be, the only sensitive way for reasoning is to think about how to smoothly at least partially revert the process, allowing the weaker countries a way for exit (which currently does not exist) which would prevent them from defaulting. It is not an easy process but the possible adoption of a scheme involving at least partially the US dollar (so returning to the very origins of the Bretton Woods scheme) may be a way. Eventually this may also benefit the remaining core EU countries and allow them to create a new aggregative path for a different Europe, maybe smaller but eventually stronger.

By suggesting all this we are not proposing solutions, but only suggesting some ideas for discussion to be eventually explored further, in a way that would allow Europe and the US to remain leaders in the way of development which has been created by our cultures and economies in the last centuries.