European Shadow Financial Regulatory Committee
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Fragilities in the Eurozone: Pre-emptive Action to Save the Euro

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After the banking crisis of 2007-2009 and the Eurozone crisis of 2010-2012 the European Union embarked on an ambitious course of recapitalizing banks, launching a banking union, unprecedented liquidity support through the ECB and emergency loans to several countries. Economic reforms and budgetary discipline were promoted. The banking union for the Eurozone includes European banking supervision and a European resolution mechanism for dealing with problem banks while the European deposit insurance remains controversial.

Notwithstanding all these important measures taken during the past decade, the Eurozone is still facing huge fragilities, which may threaten the survival of the Euro. Politicians and regulators may not be sufficiently aware of these risks but the situation can quickly become critical. In order to address these fragilities the European Shadow Financial Regulatory Committee (ESFRC) advocates in this statement that European policymakers urgently start working on the following pre-emptive measures:

1. The design of a longer-term financial policy action and structural economic reforms for Italy where the lack of economic growth and a high and even increasing government debt ratio puts the country at risk of facing a financial sustainability crisis, possibly leading to huge losses for banks and other investors in its government debt, a European banking crisis and the exit of Italy from the euro with unforeseeable consequences for the whole EU.

2. After agreement on a credible action plan for Italy, policymakers should move towards completing the banking union by introducing a European deposit insurance system and a form of risk sharing on the government debt issued by countries in the Eurozone.

3. The current approach taken on the revision of the ESM treaty should be reconsidered. With its focus on possible debt restructuring for countries receiving stability support, it has led to further political tensions between Italy and the European institutions, thereby making a new grand deal between Italy and the European institutions less likely.

4. Political as well as practical considerations require that the reforms with respect to Italy are not imposed from above but designed and implemented based on Italian initiatives, where the knowledge is the deepest and incentives for reforms are the strongest.

Why focus on Italy?

The debt crisis in Greece, in particular, demonstrated that non-sustainable government debt can threaten the Eurozone as a common currency area. Greece was small enough that a break-up of the Eurozone was averted but the threat of a larger Euro country failing to service its debt remains with potentially severe systemic consequences.

It is impossible to give even an approximate number for what level of government debt relative to GDP may be considered sustainable. The highest ratio of government debt to GDP in the euro areas is 1.76 for Greece followed by 1.33 for Italy, 1.17 for Portugal, 1.01 for Belgium, 0.99 for France and 0.96 for Spain. These numbers do not indicate a ranking of non-sustainability. The government budget surplus or deficit shows whether the level of debt is increasing or decreasing while GDP growth obviously reduces the ratio at a given level of debt.

Clearly, the expected future GDP growth rate is critical for the sustainability of a particular level of debt. The political pressures on government spending and tax policy, and on the government's ability to implement growth enhancing structural reforms are clearly fundamental factor for sustainability. Among the countries mentioned Belgium and France have implemented or are in the process of implementing reforms and their growth rates are positive. Spain and Portugal, similarly, have been able to recover and reduced their deficits sufficiently to avoid a near-term crisis.

Italy's GDP has been essentially stagnant for 20 years and the membership of the Eurozone prevented it from creating inflation to reduce the burden of debt. Italy must be able to generate economic growth in order to maintain or reduce the level of debt. Furthermore, a problem for Italy, as demonstrated by the experience of Greece, is that the country may find itself in a trap where attempts to increase economic growth are stymied by the burden of interest payments while the political situation prevents substantial structural economic reforms that would allow it to escape from the trap.

What makes the debt problem for Italy especially urgent from the perspective of the Eurozone is the size of the country and its debt. Italy can be considered "too big to fail" since a substantial haircut on its debt could threaten the solvency of Italian banks in particular, but also financial institutions elsewhere and, not least, Eurozone tax payers would have to accept large losses at the ECB with its large holdings of Italian government bonds. Italy with its 2,3 trillion Euro national debt may also be "too big to save" since the amounts that other countries would have to contribute would be so large that political resistance may prevent a rescue.

This fundamental dilemma for Italy in combination with an increasing debt burden and lack of economic growth implies that a pre-emptive strategy to deal with Italy's debt problem is required as suggested above.

Political risk should not be underestimated. Such risk may originate in an increase of populism or increased polarization of schools of thoughts on the EU level (New Hanseatic League vs. Southern European countries). Higher political risk may result in higher default risk and higher spreads in sovereign debt. The most dangerous situation is when high public debt correlates with political risk and unwillingness to take the necessary economic reforms, limiting support from other member states.

Why not rely on the European Stability Mechanism (ESM)?

A recent proposal for revision of the ESM Treaty of June 2019 expands the powers and the ability of the ESM to deal with euro area countries with non-sustainable government debt. The task of the ESM is to provide financial assistance, subject to strict conditionality to Eurozone countries. The proposal gives the ESM the task to "follow and assess the macroeconomic and financial situation of its Members including the sustainability of their public debt and carry out analysis of relevant information and data." The ESM will have a stronger voice in the design, negotiation and monitoring of conditionality in future financial assistance programmes.

Without going into the details of the proposal we note first that Italy has not agreed on it, partly on the grounds that conditionality would be imposed on Italy. More fundamentally, we may ask what happens in financial markets on the occasion when a country's debt level is declared non-sustainable. There would be an immediate and possibly large increase in the interest rate resulting in an immediate crisis that would make the need for rescue funds immediate and possibly much larger. In other words, if the country has not already implemented credible structural reforms and fiscal adjustment, it would be too late to avert a crisis at the time the debt burden is deemed non-sustainable.

A final point is that with its focus on possible debt restructuring for countries receiving stability support, the proposal for a revision of the ESM Treaty has led to further political tensions between Italy and the European institutions, thereby making a new grand deal between Italy and the European institutions less likely.

Involvement of Italy

That Italy is a serious problem for the stability of the euro has been clear for some time now. But it is time for the EU to recognize this in an official way and act accordingly.

To some extent the EU can suggest measures to improve Italian policymaking. In fact it had been doing this for years. However, it has no effective ways to enforce them except in case a financial crisis explodes and Italy is compelled to ask for financial support. But this would be too late and the crisis would in any case have serious costs for the whole euro area. The time has come to stop the game of chicken whereby European institutions criticize and Italians postpone. The political dynamics must change.

The idea of offering EU's financial support to a member country conditional on its implementing structural reforms has been suggested as a way out in several occasions. However, a reform plan that appears dictated from outside the problem country can be politically ineffective. We therefore suggest two innovative ideas. The reform plan should be prepared and presented by Italy. It can be immediately matched by some important financial help, for instance with well targeted EU financed investments. However, after this first exchange the Eurozone should come up with a deep reform plan to complete the banking union and to help the solution of the doom-loop problem also with the creation of a risk free asset.

Risk-sharing for the future

Once pre-emptive action has been taken to make Italian debt levels sustainable and the threat to the Euro averted, the EU can turn its attention to risk-sharing for the future to minmize the risk for future crises as a result of the “doom-loop” between sovereign debt and banking crises. The first step would be to implement a European deposit insurance system for the euro zone as suggested in the banking union.