Social Europe

New Brussels Reforms: Path To More Austerity For Italy

by Marcello Minenna on 14 June 2017

New reforms for the Eurozone are in sight, ready to be implemented in the short term by taking advantage of the stronger than expected European economic recovery. As was clearly hinted by the tenor of official declarations, after the electoral turmoil of recent months, Brussels intends to go on the counter-offensive against populist movements with a package of measures that have the potential to increase the monetary union's stability.

The roadmap is clearly outlined in the new "*reflection paper*" of the European Commission about the future of economic and monetary union (EMU), with a detailed timeline for each objective. Primary goal by 2019: to finally secure the fragile Eurozone banking system. In this perspective, the Commission envisages two key tools.

From one side, the Commission is strongly pushing for the adoption of European Safe Bonds (ESB), the securitized "Eurobonds" issued by a European institutional vehicle that would merge the underlying risks of government bonds like BTPs, BUNDs through standard securitization techniques. The project, sponsored by the *European Systemic Risk Board*, was launched officially at the March ECB meeting. The maximum volume of securitisable bonds has been projected to reach 60 percent of Eurozone GDP (over €6000 billion).

The intent is to provide the European banking system with a very liquid monetary instrument (the *senior* AAA tranche of ESBs) that should hopefully replace the prevailing role of government bonds as collateral in the interbank lending market. Banks would be recapitalized through a new asset (the ESB) that has by definition a very stable and secure value.

The EU institutional support is explained by the fact that ESBs are designed to avoid any real *risk-sharing* between Member States. Securitization does not mean a full mutualization of risks like in the original Eurobond project. On the contrary, the project seems to have been designed to discourage banks from holding “standard” government bonds, i.e. the debt securities that would not be conferred to the vehicle and securitized.

Moreover, according to the *reflection paper*, other measures are in the pipeline by 2019: standard government bonds, that are now accounted with a zero risk weight in the banks’ balance-sheets thanks to a regulatory exemption, would no longer be spared. This means that it would be necessary for EU banks to raise enough liquidity to hedge real sovereign risks. More practically, banks would be encouraged to sell the riskier portfolios of peripheral bonds and to substitute them with *senior* ESBs, that would still be expressly evaluated at zero risk.

Crowding Out The Periphery

The disappearance of the banks’ demand for standard government bonds will likely crowd out from the debt market those countries with a higher financial need to issue excess debt over the threshold of 60%, like Italy. The yields required on auction would probably spike to very high levels, forcing the government to pay significantly higher interest to refinance the debt.

The unpalatable alternative for troubled governments would be to give up completely their fiscal autonomy and implement at a forced pace the *austerity* requirements of the Fiscal Compact, due to be transposed into EU law by the end of 2017.

From a wider perspective, the proposed reforms and the punitive treatment that would then be reserved to standard bonds could be Mario Draghi’s “Trojan horse” to guarantee an effective *enforceability* of the *Fiscal Compact* debt brakes on reluctant peripheral governments. Currently the corrective measures envisaged by the *Stability and Growth Pact* are weak and limited to symbolic fees.

There are brighter spots: the Commission recognizes the need for *risk-sharing* tools at European level – a common deposit insurance scheme, a European Monetary Fund and even a Treasury Department with strong spending capacity to ensure the stabilization of economic cycles. This is a clear step forward with respect to the past narrative from the EU bureaucracy. However, the reported timeline here is 2025 (or beyond). In fact, in line with the position of the German government, the Commission insists on the need to first proceed to a radical risk reduction for the more exposed countries, thereby ensuring a ‘fair’ implementation of the *risk-sharing* principle.

This would imply that the Italian banks will not be able to rely on a European safety net without a drastic reduction of the level of *non-performing loans* (through fire sales at discount prices) and of the weight of government bonds within total assets. New, costly rounds of recapitalizations are looming during 2019 for Italian banks, without any guarantee of success.

The proposed reforms ultimately have the potential to reduce vulnerabilities in the Eurozone banking sector. But at what cost? The monetary union could become considerably more resilient without having to change the current framework that generates persistent imbalances in terms of trade flows and strong differentials in inflation, growth and employment.

Indeed, somewhat paradoxically, with a more stable financial system the weaker economies already under a regime of *austerity* would be forced to recover their competitiveness exclusively via the mechanism of internal devaluation, that is the reduction of prices and wages. This is already happening in Greece, where the average salary decreased of more than 25% in 6 years and the unemployment rate persists at over 23%. An unpalatable perspective for the Italian economy.