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A Revised European Stability Mechanism to Realize Risk Sharing on Public Debts at Market Conditions and Realign Economic Cycles in the Euro Area

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In this paper we propose an ambitious reform of the European Stability Mechanism (ESM) to remove two main distortions of the current Eurozone landscape: sovereign yield spreads and large discrepancies in terms of the economic performance. Unlike proposals originated in German or French–German environments which basically pursue risk segregation within peripheral countries, our proposal moves from the recognition that no economic and monetary union can function without sharing risks between the Member States. Hence the idea of turning the European Stability Mechanism into a supranational guarantor of the public debts of all Eurozone governments and reaching—at the end of the transition period—a unique Eurozone federal debt with a unique term structure of interest rates. In return for the savings on the interest expenditure that a similar reform would provide them, risky countries would be required to pay new cash contributions to the ESM capital in the form of marked-to-market insurance premiums. This makes the proposal consistent with market logic, matches Germany claims on preventing moral hazard conducts and makes overall more fair and financially sustainable the new ESM set-up. In addition, the improved capital endowment would allow the Stability Mechanism to keep its moderate leverage unchanged while issuing new liabilities to support high multiplier investments aimed at relaunching peripheral economies and support the re-alignment of the economic cycles of Eurozone members.

(*J.E.L.*: *E02, G01, H12, H63*).

1. Introduction

The financial crisis has forced European institutions to deploy extraordinary measures. The lion's share have been the ECB unconventional monetary policies which provided large liquidity to the Euro bloc; on the other hand, stricter fiscal rules were introduced. The Six Pack

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revision of the Stability and Growth Pact and the Fiscal Compact belong to this stream of anti-crisis provisions. Targeted regulations such as the Bank Recovery and Resolution Directive were adopted to strengthen the banking system and replace bail-out with bail-in provisions, whereas with regard to sovereign risk, the European Stability Mechanism was established in 2012 with the official purpose of creating a bail-out fund for Eurozone members.

Five years later, in 2018, Eurozone overhauling is still a priority in the agenda of the Euro-bureaucrats with the alleged aim of deepening integration within the European economic and monetary union and making it crisis-proof. Yet, apart from the different degree of severity, proposals placed on the table so far by the German establishment (German Council of Economic Experts, 2016, Schäuble, 2017), the European Commission and a pool of 14 French-German economists (Bénassy-Quéré et al., 2018), display little or nothing understanding of lingering Eurozone problems.

These proposals move from the shared view that the cause of Euro bloc fragility is fiscal profligacy of peripheral members, which in turn has led to excessive risk taking both on the public and the private sector. As a consequence, risk reduction via fiscal consolidation is perceived as the right solution. In this perspective, many proposals claim for a larger accountability to be put on the shoulders of rogue countries: more rigid fiscal oversight on the soundness of national accounts, other budgetary constraints (not really different from those prescribed by the Fiscal Compact) and a legal framework for the management of sovereign debt crises through automatic reprofiling and early restructuring provisions which should prescribe private sector involvement (as the one imposed to Greece on March 2012) as necessary condition to access ESM financial support and should be enforced as soon as the public debt of a country exceeds a given threshold.

Such proposals reflect the will of risk segregation by Germany and its neighbours. Nor this should surprise being fully consistent with similar made-in-Germany details which have featured all extraordinary measures enacted since the outbreak of the crisis (Minenna, 2016). Not only in terms of explicit rules on fiscally responsible conducts (which have led to a pro-cyclical dearth of investments within Eurozone periphery), but also in terms of other direct and indirect heavy conditions that were systematically adopted to protect German (and, at a lesser extent, French) interests and leadership amid the monetary union. The €1000 billion of LTROs injected by the ECB from December 2011 to February 2012 have reached almost nothing weak peripheral economies; rather they were mainly used to allow the deleveraging of sovereign and commercial exposures of French and German credit institutions towards the periphery. Although under different guises, the ECB's asset purchase programmes also obey the same logic: indeed, only a negligible part of the risks on purchased securities is shared, whereas the large part remains within the home country of the originator, in the balance sheet of its National Central Bank.

By preserving risk segregation, the proposals released over the last months are unable to effective achieve risk reduction and stabilisation of the Euro area. They disregard well predictable implications in terms of discrimination between core and peripheral countries, as in the case of automatic mechanisms for the management of sovereign debt crises which would re-ignite sovereign spreads as at the height of the crisis.

A perverse belief is inherent in these proposals; and it is that today sovereign spreads are low because artificial and undue interventions of the ECB. Instead, it would suffice having a look to those spreads in real terms (i.e. corrected for inflation differentials), to understand that not too much has changed over the last years as shown in Figure 1.

Further risk segregation, especially if introduced concurrently with the end of ECB purchases, would exacerbate yield spreads and jeopardize not only individual countries but also the survival of the monetary union.

A radical change of mind is therefore urgent within the Euro-bureaucracy and priority should be assigned to risk sharing and macro-economic stabilisation to be pursued with counter-cyclical measures (Herr *et al.*, 2017).

These arguments have pushed us to work on a proposal of reform for the European Stability Mechanism able to gradually deliver two main results: transition from multiple sovereign debts with different yield curves to a unique Eurozone federal debt with a unique cost of money, and targeted financial support to investments in more fragile countries of the Euro area.

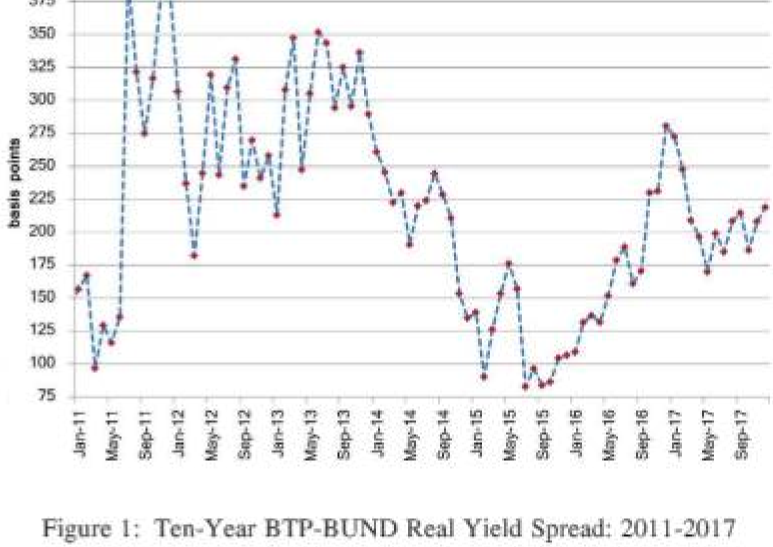

Figure 1: Ten-Year BTP-BUND Real Yield Spread: 2011-2017

2. Limits of the Current Architecture of the European Stability Mechanism

The European Stability Mechanism (ESM)—also known as Eurozone sovereign bailout fund—was established in September 2012 as permanent backstop facility for members of the Euro bloc. It took over the prior (temporary) European Financial Stability Facility (EFSF) after the Eurozone sovereign debt crisis, the Greek Private Sector Involvement, the concurrent Greek default of March 2012 and the proximity to default of Spanish banks.

German pressures in favour of risk segregation resulted in an extremely stringent set of rules which bounds the concrete intervention capability of the Stability Mechanism. Its financial assistance is reserved to countries which have signed the Fiscal Compact and is also conditioned upon:

1) A deep financial/economic distress of the beneficiary country;
2) The endorsement of the three larger ESM shareholders: Germany, France and Italy retain a veto right which each of them can use to block any financial aid;
3) The commitment of the country applying for financial help to implement a package of harsh domestic reforms, whose first aim is ensuring that any ESM loan will be timely re-paid. Such commitment is referred to as «*strict conditionality clause*» within the ESM establishing treaty (Euro Area Member States, 2012).

Points 2) and 3) are related each other. Indeed, the first three ESM shareholders can basically decide nature and features of the internal reforms to be realized by the beneficiary country because they can threaten their veto. And actually, it is exactly what happened with the last Greek debt crisis. Of the same opinion is a certain German literature which does not hesitate to claim that ESM intervention would be far from obvious to rescue a major Eurozone member hit by a large asymmetric shock.

The more one delves the details of ESM architecture the more it resembles to a German creature. The Stability Mechanism (as well as the Fiscal Compact) was established in the form of inter-governmental treaty to satisfy an explicit Germany's request and increase the power of the Bundestag within the Mechanism. Indeed, the Bundestag can always oppose to measures that could entail the involvement of its taxpayers. Such provisions are intended as extension of the no-bailout clause written in the EU treaties, once again to fulfill German indications.

Germany's influence can be detected also with regard to the peculiar composition of the ESM capital. The Stability Mechanism has a subscribed capital of €704.8 billion, but only €80.55 billion have been paid in so far. The remaining €624.25 billion are callable shares and the decision to call them for cash payment depends (once again) on a decision on which

Germany can veto. As a consequence, currently the Eurozone bailout fund faces a risk of liquidity squeeze because less than 12 per cent of the subscribed capital enjoys the most solid form of financial backing.

Not by chance the International Monetary Fund, institutionally appointed to intervene for the bailout of a Member State, requires its members to pay their subscription in full upon joining the Fund: at least 75 per cent is paid in the member's own currency, while up to 25 per cent must be paid in Special Drawing Rights or in foreign currencies acceptable to the IMF.

The inherent weakness associated with the current composition of the ESM subscribed capital also explains the large gap (more than €200 billion) between equity and maximum firepower (€500 billion) of the Eurozone bailout fund.

The strong German meddling on the Stability Mechanism arises from Germany being the largest contributor to the ESM capital: €21.7 billion of cash contribution plus €168.7 billion of callable shares.

Figure 2 reports the ESM capital key which is very similar to that of the European Central Bank.

Its 27 per cent share has earned to Germany the *de facto* control of the Mechanism, although also France and Italy have disbursed large amounts

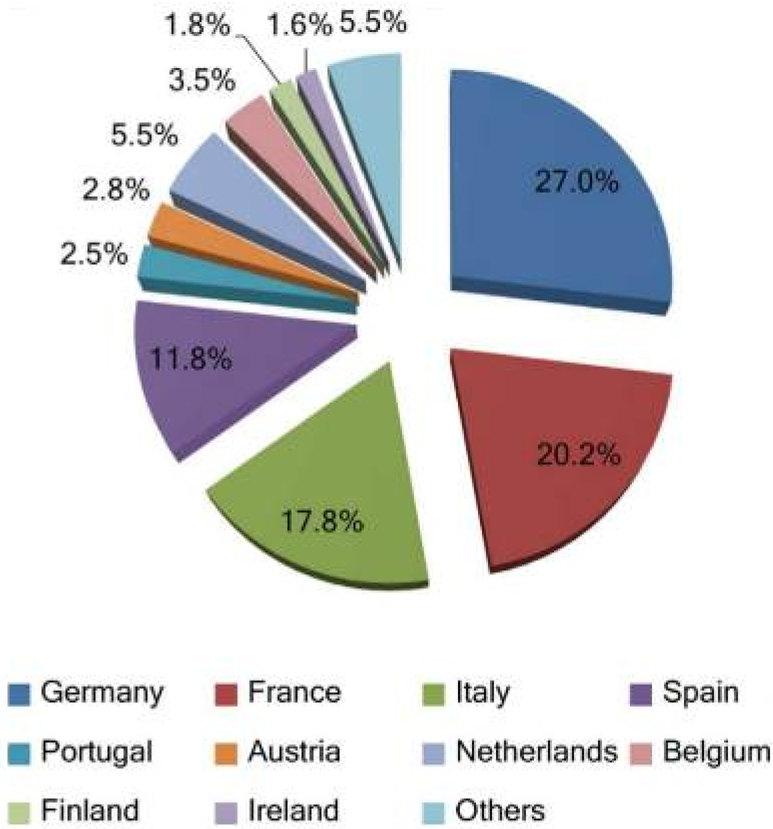

Figure 2: ESM Capital Key

(€16.3 and €14.3 billion, respectively) and run huge contingent liabilities from their callable shares.

Up today the Eurozone bailout fund has used its leverage capability to raise on the markets the funds needed to grant financial help according to a loan-based scheme. It has issued investment-grade securities and used the proceeds to loan money to Cyprus, Spanish banks and Greece, taking care of keeping a low leverage, about one with respect to the ESM cash capital. In all these cases the interventions of the Stability Mechanism occurred to deal with very critical situations regarding the public and/or private financial sector of the beneficiary country.

But this way of functioning is unable to adequately fulfill the mission of preserving Eurozone stability which, indeed, cannot rely exclusively on a "corrective arm" but needs also a "preventive arm". Also because the Eurozone federal budget is negligible (about 1 per cent of the Euro area GDP) and thus necessarily unable to support stabilisation and counter-cyclical interventions. It is an inherent weakness of the Eurozone which has to be overcome urgently. For this reason, in next sections, we present a proposal for a ESM reform which aims at fixing current limits and creating a framework favourable to the transition to a true federal budget and a unique Minister of Finance and Economic Development for the Euro area.

3. Public Debts Mutualisation at Market Conditions: A New Perspective for the ESM

A quick look at the Eurozone architecture reveals multiple factors of fragility: lack of fiscal integration, tiny federal budget, large current account unbalances.

Last but not least, the lack of a mutualized guarantee on public debts of the member countries: indeed, the abdication of monetary sovereignty by individual members was not replaced by a mandate for the ECB to act as lender of last resort for their government bonds. Consequently, sovereigns within the euro area issue debt in a "*foreign currency*" (De Grauwe, 2013), a condition which forces them to depend on fiscal discipline much more than countries which can rely on a monetary backstop in order to keep their funding costs under control.

The Global Financial Crisis (GFC) has unveiled that the above fragilities—albeit tolerable under normal/favourable economic scenarios—can become dangerous amplifiers in case of large adverse shocks. Neither the solutions deployed so far are really able to increase the resilience of the Eurozone or its stability since the policy of risk segregation systematically imposed by Germany made them substantially flawed (Minenna, 2016).

Germany has always opposed to proposals for debt mutualisation across Eurozone governments, claiming that it would have legitimated moral hazard by the periphery. According to Germany's standpoint, risk sharing on public debts would be equivalent to a free lunch for the Southern European countries.

Paying attention to the above arguments, we have developed a proposal for reform of the European Stability Mechanism that realizes a mutualisation of public debts compliant with market logics.

The Stability Mechanism should provide a supranational guarantee on the public debts of each member government and earn the market value of such guarantee in the form of additional cash contributions of member countries to the ESM capital.

Only countries whose sovereign risk exceeds the average of the Euro area would be charged for these further contributions. That means a concrete disbursement only by peripheral members. Conversely, core countries would be exempted from any additional contribution, being them left with the commitment deriving from the joint liability on the public debt which enjoys the ESM guarantee.

Admittedly, also such contingent liability has a market value, because Germany and other safe countries will suffer the temporary deterioration of their credit standing and the related increase of interest costs on debt. But it is not a debt transfer: risky countries would continue to pay notional and coupons on their government bonds, whereas Germany and other safe countries would run a *true* contingent liability compared to the *false* one (callable shares) prescribed by the current set-up and by-passable by exercising the veto right.

Table 1 provides an estimate[1] of the annual variation of the interest expenditure for the various countries, considering also the premium for the ESM guarantee required to risky countries.[2]

Savings on the interest payments increase over time for peripheral States. Initially, the cost of getting a larger and larger portion of their debt under the ESM umbrella prevails, but afterwards convergence across sovereign yield curves reduces the marginal insurance premium they have to pay.

Figure 3 offers the detail of annual costs and benefits of our reform proposal for the Italian case.

Let us spend some words on the dynamics driving the convergence across the term structures of interest rates of Eurozone members. These are market-driven dynamics associated to the sharp change of investors' expectations that would be activated by a credible commitment of risk

[1]Input data as of September 2017.

[2]The list of risky countries does not include Greece whose extremely distressed conditions require targeted measures to be adopted by the Eurozone institutions. The austerity receipt enacted so far has dramatically exacerbated the Hellenic situation and despite the country is expected exiting the ESM program over the next months, we doubt that things have really improved in recent years.

Table 1: Estimated Impact of the ESM Reform on the Interest Expenditure, net of the Premium Paid for the Guarantee on Debt Shared (EUR Billion)

Country	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Germany	1.8	3.2	4.2	5.0	5.7	6.3	6.9	7.4	7.9	8.3	56.8
France	1.0	1.7	2.1	2.3	2.3	2.1	1.9	1.5	1.0	0.4	16.3
Italy	0.5	−0.1	−1.6	−4.0	−7.2	−10.8	−14.7	−18.8	−23.1	−27.7	−107.4
Spain	−0.4	−1.1	−2.1	−3.5	−5.0	−6.7	−8.5	−10.4	−12.4	−14.5	−64.4
Portugal	0.0	−0.2	−0.5	−1.0	−1.5	−2.1	−2.7	−3.3	−4.0	−4.7	−20
Austria	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.2	0.2	0.1	2.7
Netherlands	0.3	0.5	0.7	0.8	1.0	1.1	1.2	1.3	1.3	1.4	9.6
Belgium	0.2	0.3	0.3	0.2	0.1	0.0	−0.1	−0.3	−0.4	−0.6	−0.2
Finland	0.1	0.2	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.5	3.9
Ireland	0.1	0.1	0.1	0.1	0.0	−0.1	−0.1	−0.2	−0.2	−0.3	−0.5

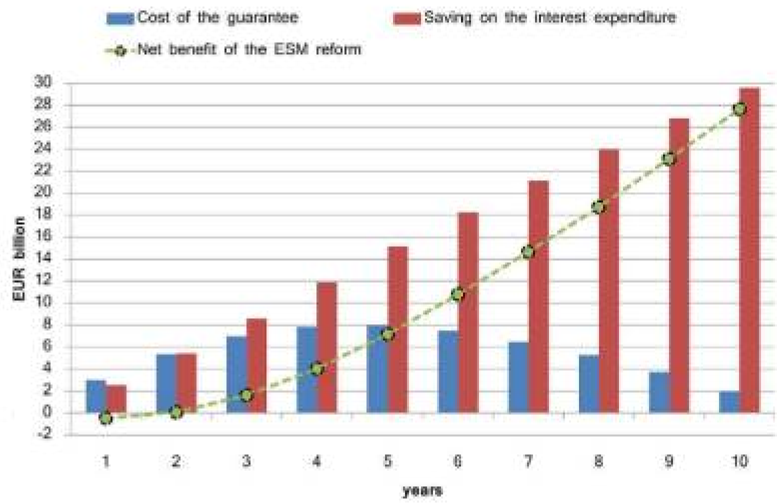

Figure 3: Costs and Benefits of the ESM Reform for Italy

pooling on public debts. Something very similar has already occurred at the inception of the single currency when hedge funds and other professional investors played global macro strategies known as convergence trades. Predicting that sovereign yields would have become equal across euro-candidates, they went long Italian and other peripheral government bonds (high yield & low price) and short German Bunds (low yield & high price) and made profits from yields convergence.

The eruption of the GFC and the risk segregation pursued under German pressures have dismantled markets' conviction on the euro area as a genuine common currency area and fueled divergence trades which have surreptitiously introduced different currencies for the different member States. Sovereign spreads are nothing else that shadow-currencies as they discriminate the effective cost of money required to any individual country. Consequently the sustainability of public debts began to be assessed solely on the basis of the state of health of the public accounts of the issuing State. Moreover, given the stringent rules of Maastricht, the Stability and Growth Pact and the Fiscal Compact, the positioning above certain thresholds of some fiscal indicators has in itself become a cause for alarm and for the expansion of the risk premium.

Figure 4 provides a graphical representation of this phenomenon by comparing the relationship between 10-year government yield and the debt-to-GDP ratio of the various Eurozone countries in 2006 (before the crisis) and in 2017.

Risk-sharing could be decisive in restoring the scenario seen prior the GFC when even highly indebted countries (such as Italy or Greece) had no problems of debt management and sustainability and have been hovering for years with debt-to-GDP ratios around 100 per cent. Of course, we cannot rule out that the update in investors' expectations might take some time, but

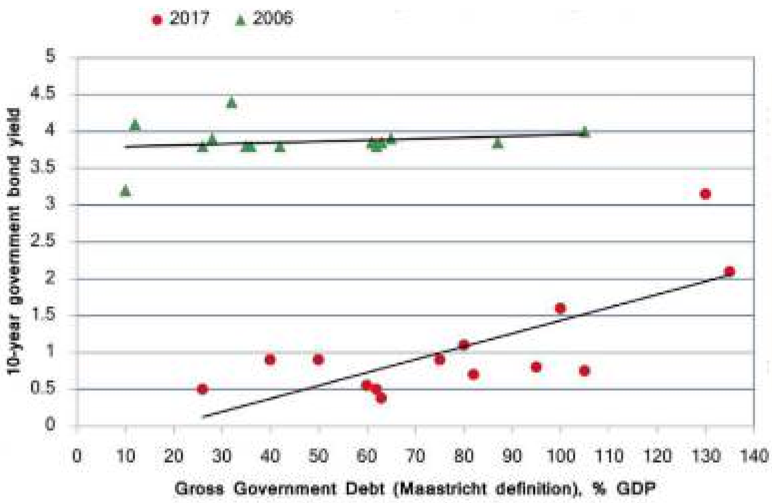

Figure 4: Long- Term Yields on Eurozone Sovereign Bonds and Debt-to-GDP Ratios: 2006 Versus 2017.

Note: only OECD EU-area member countries, excluding Greece.
Source: OECD

even in such a case, we are confident that any eventual deterioration of sovereign credit spreads would only affect outstanding bonds in terms of higher implied yields, with minor or none implication for issuers and also for bondholders (provided they hold their securities up to maturity).

From this standpoint, further changes of the Eurozone architecture could speed up the revision of the risk attitude of financial players. Starting from the commitment to remove the ban on monetary financing of public debts from the Statute of the European Central Bank as soon as the totality of national public debts will be assisted by the ESM guarantee. But also the pledge to establish, at the end of the convergence period, a unique Eurozone Finance Minister responsible for issuing and managing the entire federal public debt in strict cooperation with the monetary authority.

The improvement of markets' perception on the compactness of the Euro area would benefit also safe countries. Indeed, any reduction in the risk premia required to peripheral issuers would also translate into a lower amount of risk which core countries get exposed to on any euro of peripheral debt shared. Thus, the marginal annual increase in their interest expenditure would be decaying over time, as shown in Figure 5.

That said, it is clear that the proposed reform would have a re-distributive impact from the centre to the periphery of the Euro area: a higher annual interest bill for Germany (on average €5.6 billion) and France (€1.6 billion) and, on the other hand, considerable savings on the interest payments for countries like Italy (€11 billion) and Spain (€6.5 billion).

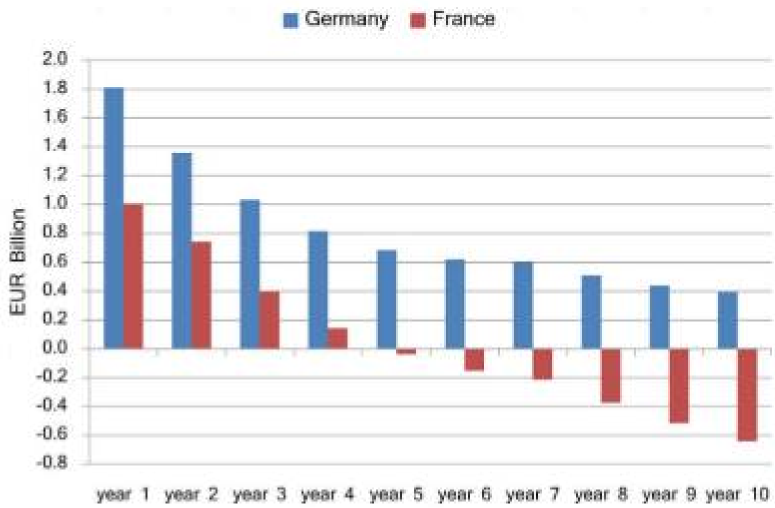

Figure 5: Second Order Effect of the ESM Reform on the Interest Expenditure of Germany and France

Hence, money would flow exactly in the opposite direction seen in the recent experience: from 2007 to 2016 Germany saved €240 billion on its interest bill thanks to risk segregation policies. Not to talk about the undue competitive advantage that its manufacturing system has got from very low funding costs.

In return for their larger financial involvement, Germany and France would get access to a concrete improvement in the stability of the single currency area which they belong to (Herr *et al.*, 2017). Indeed, the convergence of sovereign yields released by the proposed risk-sharing reform would make the Eurozone crisis-proof and favour its transition to a true federation of States.

Conversely, keeping the current ESM machinery unchanged, each member country risks being required to free its callable shares at a time of emergency and regardless of its liquidity situation. Even the country benefiting from the ESM aid programme must make its own contribution as happened to Spain at the time of the banking crisis.

From such standpoint, the adoption of the new ESM set-up would represent a net saving for all members: even for low risk countries—such as Germany—the cost under the reformed framework would be dramatically lower than the contingent liability it is running today because of its callable shares (Table 2).

We propose to replace quantity with quality: the revised architecture would reduce the total ESM capital but would also make the entire subscribed capital immediately available. We are talking about 200 billion euros at the end of a 10-year time frame, more than twice the current paid-in capital.

Moving to an insurance-based logic would also modify the capital key of the Stability Mechanism increasing the share held by risky countries as

Table 2: Estimated Savings From Moving to the New ESM Capital Structure With Risk Sharing (EUR Billion)

Country	Contingent liability from callable shares	Net cost (benefits) under the new ESM	Estimated saving from shifting to the new ESM
Germany	168.3	56.8	111.5
France	126.4	16.3	110.1
Italy	111.1	−107.4	218.5
Spain	73.8	−64.4	138.2
Portugal	15.6	−20	35.6
Austria	17.3	2.7	14.6
Netherlands	35.6	9.6	26.0
Belgium	21.6	−0.2	21.8
Finland	11.1	3.9	7.2
Ireland	9.9	−0.5	10.4

they would have to pay further contributions in exchange for the guarantee on their risk-shared debt.

In any case, we advise a much more democratic governance for the Stability Mechanism. Today, thanks to the veto right retained even in the emergency voting procedure, Germany (and, in theory, also France or Italy) can blackmail a member country which is applying for the ESM financial assistance or even prevent the Mechanism from rescuing that country.

The loss of the veto privilege would become less relevant for Germany under the new set-up. Indeed, the ultimate aim of the proposed reform is

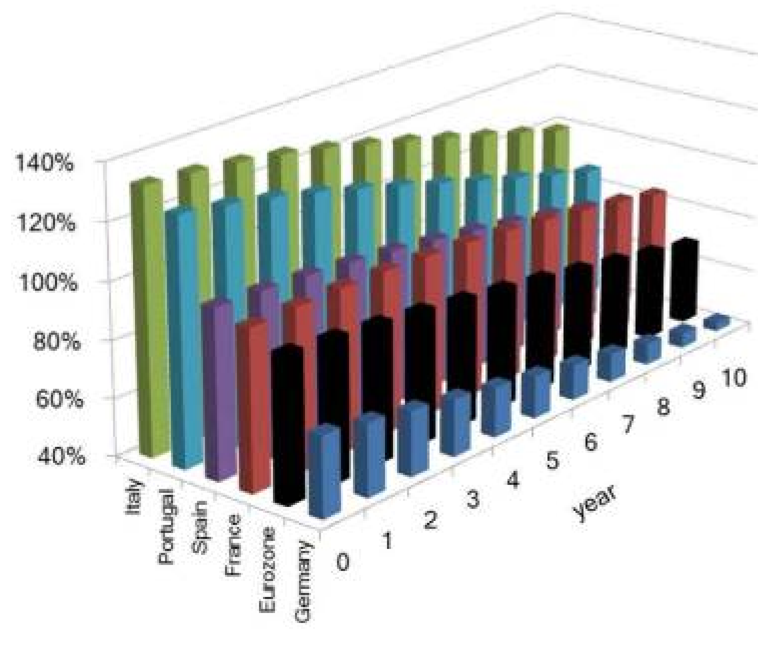

Figure 6: Estimated Path of the Debt-to-GDP Ratio Over the 10-Year Convergence Period

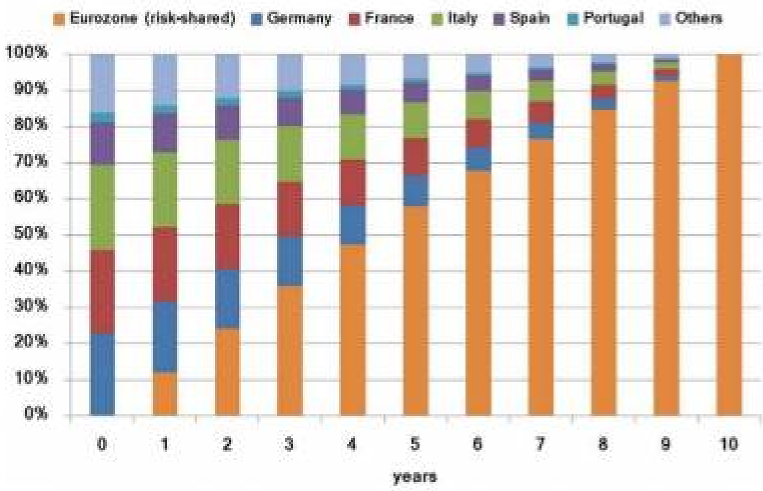

Figure 7: Estimated Evolution of Risk-Shared and Not Risk Shared Public Debt

strengthening the overall stability of the Euro area and, hence, reducing the probability that any member might need the financial support granted by the Mechanism.

According to our estimates, risk sharing would entail the progressive reduction of the debt-to-GDP ratio for any country with clear benefits on debt sustainability. At the aggregate Eurozone level, in 10 years the ratio would fall below 70 per cent, approaching the threshold enshrined in the Maastricht Treaty (Figure 6).

However, it should be remarked that, under risk sharing provisions, the debt-to-GDP ratios of the individual States would not make much sense since, at the end of the convergence period, there would be a single federal debt of the Euro area assisted by the joint liability of all member countries (Figure 7).

4. Using ESM Leverage to Revive Profitable Investments in the Eurozone

The advent of the GFC led to an investment shortfall in the Eurozone (European Central Bank, 2016). However, the data indicate that while in core countries, such as France and especially Germany, gross fixed capital formation has recovered quite rapidly after the collapse of 2009, in the periphery the large reduction in fiscal space available to governments has hindered the recovery of public investments and the credit crunch that of private investments (Buti and Mohl, 2014, Monokroussos and Thomakos, 2012).

The result—as shown in Figure 8—was a growing divergence of the investment propensity between the centre and the periphery, which went hand in hand with the divergence in economic growth (Pitlik and Schratzenstaller, 2011).

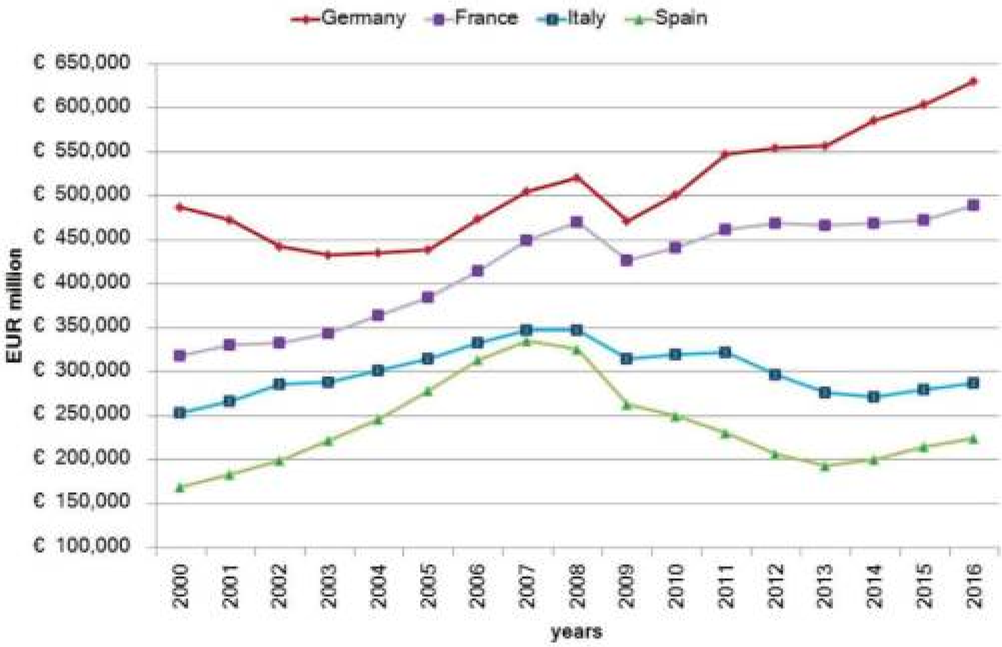

Figure 8: Gross Fixed Capital Formation in selected Eurozone countries: 2000-2016 (EUR million)

This divergence contradicts the principles of shared growth and development enshrined in the founding treaties of the Eurozone. Joining the single currency was based on the firm conviction that the elimination of the exchange rate risk would have strengthened the European economy as a whole, benefiting all Member States. But it did not: rigid budgetary rules, risk segregation, a monetary authority that pursues only an inflation target without any employment target have weakened peripheral countries, compromising the ability for sustained and durable growth (OECD, 2015; Szczepański, 2016).

In order to re-establish effective adherence to the principles enshrined in the European treaties, targeted interventions are needed to support the most fragile economies (Abiad *et al.*, 2015). Also on this field, the ESM reform can make a decisive contribution to removing the existing imbalances.

Let us see how. Currently, the Stability Mechanism uses its leverage capability to help countries that are on the verge of collapse. On the other hand, there is no preventive function aimed at strengthening the economic conditions of the peripheral countries with a counter-cyclical perspective.

Hence our proposal to amend the area of intervention for the European Stability Mechanism: funds raised on financial markets through the issuance of investment grade liabilities should be used to finance high-multiplier investments (Christiano *et al.*, 2009; European Commission, 2012; Bom and Ligthart, 2014) in the peripheral regions of the Eurozone (those with the highest expected ROI) (International Monetary Fund, 2014) without increasing ESM risk taking and maintaining a moderate leverage (Dixit and Pindyck, 1994; Auerbach and Gorodnichenko, 2010).

The idea is to limit the use of leverage to the amount of contributions paid annually to ESM's capital by risky countries as the cost for the guarantee on risk-shared debt. In this way the financial equilibrium of the Mechanism would be preserved.

Obviously a careful control of the entire process of selecting and implementing investment projects would be necessary. For this reason, our proposal provides that this process is governed by a supranational and independent body, with a neutral view based only on objective economic indicators of profitability. For example, an *ad hoc* department of the same Stability Mechanism could be appointed to oversee all activities related to investment management in agreement with the European Investment Bank.

5. Conclusions

The issue of Eurozone overhauling is a priority on the agenda of European institutions to increase antibodies against severe negative shocks and ensure stable and durable growth in line with the EU founding treaties and with the need for competitive strength required to successfully meet the challenges posed by globalisation.

The proposals developed in recent months by the Euro-bureaucracy and by some Franco–German economists suffer from a lack of understanding of the real causes of divergence between the centre and the periphery of the euro area. These proposals are inspired by the same wrong recipe adopted since the eruption of the GFC: the segregation of risks within the peripheral countries.

But this recipe risks only exacerbating the imbalances and increasing the risk of dissolution of the Eurozone.

On the other hand, in this paper, we propose a new ESM design fit to deliver two fundamental results for the success of the economic and monetary union:

1) A mutualisation of public debts to achieve the convergence of government yields towards a unique curve for all member States in a form even stronger than the one experienced in the first years of life of the Euro (until 2007–2008). In fact, a fully mutualized debt naturally implies a homogeneous credit risk evaluation, since national public debts would eventually disappear and merge within a Eurozone one;
2) The relaunch of investments in peripheral countries through targeted ESM financing in order to overcome the drop in gross fixed capital

formation caused by the failure of the banking channel of the monetary policy and the severe fiscal discipline enacted since 2011. In this way, more fragile countries would be supported in recovering from that competitiveness and productivity gap produced by risk segregation and their economic cycles would finally get re-aligned with those of core countries.

A such reformed Mechanism would be the embryo of a unique Finance Minister responsible for the entire Eurozone public debt and for a federal budget of adequate size to coordinate stabilisation and harmonisation of member economies.

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Non-technical Summary

The founding treaties of the Euro area provide for a sound balancing across the principles of subsidiarity and harmonic growth and development on the one hand and those of national accountability and no bailout on the other hand. However, measures adopted by the Euro-bureaucracy to counter the global financial crisis were inspired almost exclusively by the second stream of principles with unintended consequences for peripheral countries and for the compactness of the Eurozone as a whole. The unceasing pressures for risk reduction and risk segregation by Germany and other core countries have systematically driven the policy actions of Eurozone leadership. Strict fiscal consolidation is considered the only valid instrument to reach public debt sustainability by largely indebted members although its pro-cyclical implications are manifest.

Apart from a few exceptions, the ongoing process of Eurozone overhauling looks set to persist on this approach. Meanwhile, large imbalances divide periphery from the centre of the Euro area mainly because of the undue privileges produced by risk segregating policies. Such policies keep alive (especially in real terms) sovereign yield spreads across Eurozone members despite the ECB prolonged quantitative easing. As a result, countries joining the common currency area face different funding costs and, consequently, an unlevelled playing field. Indeed, higher interest rates entail a higher public debt burden and a more unfavorable economic landscape for both the public and the private sector.

In front of the above described scenario, Eurozone revision should address primarily two issues: restoring the uniqueness of the yield curve across sovereign States joining the monetary union and promoting the re-alignment of their economic performances with targeted support to investments in regions which still experience subdued growth.

To this aim, this work presents a proposal for a two-fold reform of the European Stability Mechanism (ESM), the Eurozone sovereign bailout fund. So far the Stability Mechanism has played a limited role in supporting Eurozone's more fragile members: it has being called to provide financial assistance only to deeply distressed countries that were close to sovereign defaults and/or to crises of the domestic banking sector. Moreover, ESM interventions are conditioned upon the implementation of a set of internal reforms by the applicant country. Contents and timelines of such reforms

are decided by the Euro-bureaucracy with a leading role of German representatives who are entitled to veto any ESM involvement.

The first layer of our proposed reform aims at turning the Stability Mechanism into a supranational guarantor of the public debts of all member countries. This could be achieved gradually by introducing risk-sharing provisions in the portion of governments debt to be refinanced each year: Govies featuring these provisions should enjoy the joint liability of all Eurozone members. A such reform would re-allocate more uniformly risk across the Euro area, making bonds issued by different governments perfect substitutes between each other. At the end of the transition period, the full stock of public debts would enclose risk sharing clauses with the consequent achievement of a unique Eurozone federal debt with a single term structure of interest rates. The proposed debt mutualisation scheme is also compliant with market discipline: indeed, each risky country would transfer to the ESM its excess-risk above the Eurozone average and pay the market price of this protection in the form of annual premiums disbursed to the capital of the Stability Mechanism. The market value of these premiums would compensate low-risk countries for the temporary worsening of their credit risk and would meet their requests for more responsible fiscal conducts by the periphery. On the other hand, the joint liability commitment would lead investors to bet on the convergence across sovereign yields, with the consequent reduction in the premium required to peripheral countries.

The second layer of our reform proposal envisages a concrete ESM support to revive investments in countries more affected by the crisis and by the austerity policies purported by the Euro-bureaucracy. The recapitalization through the premiums collected from risky countries would allow the Stability Mechanism to issue new liabilities without affecting its low-leverage and to use the proceeds to fund profitable investments within member States. In order to close productivity and competitiveness gaps with respect to core countries, these funds should be allocated in proportion to the premiums paid by peripheral countries in front of the ESM guarantee on their public debts.

A ESM with this new financial engineering would be the first step for the transition to a single Euro area finance minister and a federal budget of adequate size to implement stabilization and harmonization policies of the involved economies.