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A lesson for Italy from Germany's debt management

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The Italian Parliament is still debating whether to ratify reform of the European Stability Mechanism (ESM). These deliberations highlight questions about the institution's actual usefulness, particularly when public-debt crises hit large countries.

The ESM's interventions have so far been modest, but have nonetheless required difficult negotiations with European counterparties. For example, to get out of its 2015 crisis, Greece borrowed €62 billion from the ESM — equal to one-fifth of its then outstanding public debt — and in exchange it had to carry out an intensive series of internal reforms.

Let's now imagine the case of a larger indebted country, such as Italy. A fifth of the Italian debt is roughly €535 billion, more than all of the ESM's residual firepower (€417 billion). So the problem of a too-big-to-save country would inevitably arise. And all Eurozone countries face significant obstacles to accessing ESM financial aid. Germany, for example, could threaten a veto and freeze the assistance request or — as happened with Greece — impose a package of austerity-based reforms. The new ESM, moreover, would require a country to pass a debt-sustainability test before it activates its so-called "emergency credit line". If a country fails the test, it will need to restructure its debt before accessing ESM funds.

In other words: neither the old ESM nor the new ESM seem able to shield major countries in the bloc from crises. More ambitious reform is needed to transform the ESM into an institution that structurally improves public-debt management in the euro area.

This brings us to the two-stage ESM reform plan I developed several years ago with three other Italian economists. It has become more timely than ever.

In the first phase, the debt of the various Eurozone states would be progressively guaranteed by the ESM, and therefore jointly and severally by all Eurozone governments. In return, each country would have to pay the Stability Mechanism annual insurance premiums determined by market conditions. Paying these premiums gives officials a way to show they aren't asking for the benefits of risk-sharing without cost. It also provides a strong incentive for countries to manage their public finances soundly and prudently, because if they don't, their cost of insurance will be high. Both aspects should prove attractive to the euro zone's core countries.

Placed under the ESM's protective umbrella, the public debts of different countries would become, year after year, more and more similar in terms of riskiness. This would drive convergence between sovereign yield curves of the various countries, paving the way for a single safe asset of the euro area. The next phase would be the issuance of European federal debt, or Eurobonds, which would be used for two purposes: first to roll over maturing government bonds, and second to fund an ambitious investment plan to support the region's economy.

The above proposal meets and exceeds the recent requests of several economists who favour a European Sovereign Fund or a European Debt Agency. It involves immediate steps towards a systematic framework that could be put into place over the medium-to-long term.

In fact, ensuring resilience and prosperity in the Eurozone requires a shift away from the approach of the Maastricht treaty, and instead the spirit of solidarity that inspired Robert Schuman's declaration at the dawn of European integration. Just recently, we have seen important openings in this direction both during the pandemic (with loans to address unemployment risk and NextGenerationEU) and in joint purchases of natural gas by EU countries.

Italy should support this plan at the European level. It should also take immediate action in domestic sovereign-debt markets, by forming a debt-management agency to keep interest expenditure as low as possible.

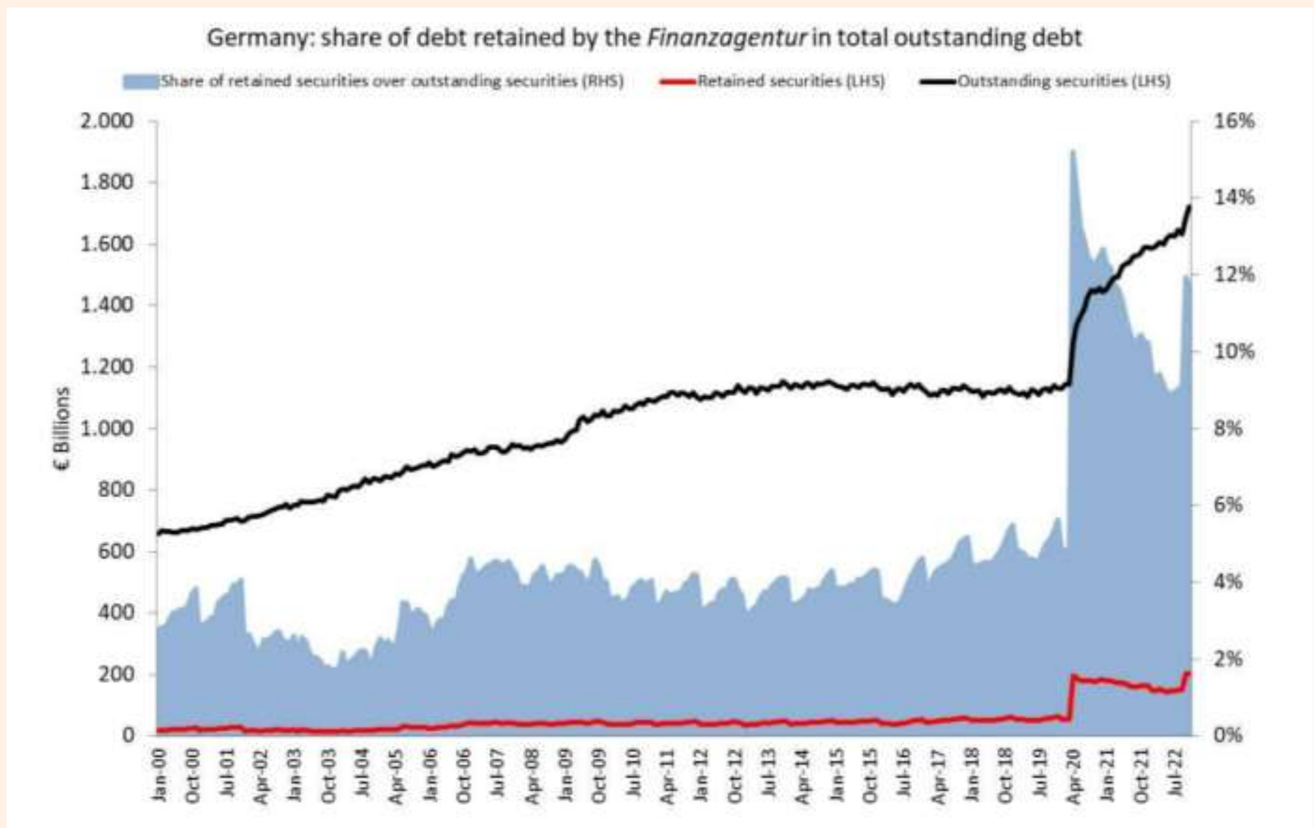
Germany has had an agency of this type since 2000: the Deutsche Finanzagentur, which operates on behalf of the Ministry of Finance, with the aim of guaranteeing the solvency of the federal government at all times. During Bund auctions, the

Finanzagentur retains a share of the securities offered, then appoints the Bundesbank to take them into custody for subsequent transactions on the secondary market. On average, this practice affects 20% of the issued amount.

But periodically its retention has been significantly higher, in practice easing the effect of auctions on Germany's cost of debt. This was necessary during the Eurozone debt crisis, the pandemic, and as recently as last October, when the agency retained 55.4 per cent of a 7-year issue that received a lukewarm reception at auction (a bid-to-offer ratio of just 0.47).

Retained securities are typically used to collateralise repo financing transactions, or for securities lending. That means the Finanzagentur has an additional margin of flexibility to cover any short-term financing needs, and to intervene to safeguard the smooth functioning of the repo market if needed. For example, last October, the day after the aforementioned 7-year auction, the Finanzagentur decided to tap 18 outstanding bonds for a total of €54 billion to use as repo collateral and, in the process, allowed the German government to raise additional cash without going back to auction.

It also was instrumental in dealing with unexpected cash requirements during the Covid-19 emergency. Between March and April 2020, the amount of bonds withheld by the agency rose by €140 billion. At the end of that period, the ratio of retained securities to Germany's total outstanding debt had climbed to 15.2 per cent from 4.8 per cent (see the blue shaded section of the chart below). This percentage decreased until the third quarter of 2022, though it has since started to climb again after the interventions last October.



Despite the many differences between the Italian and German public debt markets, the creation of an agency with similar prerogatives to the Finanzagentur would make an important contribution to the overall funding strategy of the Italian Treasury.

And in the current environment of rising interest rates and rapid downsizing of the Eurosystem's securities holdings, efficient debt management will require bold action from both Italian and European policymakers.

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