AIAF Position Paper:
the euro area sovereign debt crisis

Objective of this paper

The problems faced by the economy and the financial markets, as highlighted by AIAF in its March 2009 Position Paper[1] on the financial crisis, are still unresolved. Steps forward have been made in the field of supervision, in identifying a path for the strengthening of credit institutions, and in tackling certain conflicts of interest, which contributed significantly to the spreading of the crisis. However, the process leading up to a strengthening and stabilisation of the global financial system, an essential condition for, and functional to, healthy economic and employment growth, is still incomplete.

The sovereign debt crisis in the euro area stems from the financial crisis of 2008-2009, but has deeper roots in the contemporary growth model, with specific characteristics of an economic and institutional nature that make it unique and especially complex. Although it originated from the subprime mortgages crisis, the most recent crisis possesses a European specificity, as it found fertile ground in a monetary union, which is not at once a complete economic and political union. The road to the constitution of a political union in Europe suffered a setback in 2005, with the negative outcomes of the referendums held in France and Holland, a hitch subsequently remedied by the new Lisbon Treaty of 2007, approved by all the adhering states. However, there are still obvious shortcomings in the definition of a path towards fiscal unity.

The objective of this document is to propose viable solutions to overcome the sovereign debt crisis and strengthen the European economic-financial and institutional infrastructure. Italy's being subject to financial market pressures means that a nodal point has been reached in the crisis; a point at which the scenario becomes at the same time polarised and dichotomised. The two possible outcomes are: 1) a strengthening of the economic union; 2) the dissolution of the monetary union.

The resolution of the sovereign debt crisis in the euro area will neither be immediate nor simple, but requires a process capable of assuring the strengthening of the European institutions, and constant watch over the weaknesses of the economic-financial infrastructure of the Old Continent. A Road Map comprising immediate actions and longer-term interventions may represent an element of reassurance for the markets, and above all a form of protection of the economic and monetary union in the medium-long term.

[1] The Position Paper on the financial crisis is available on the AIAF website: www.aiaf.it

The AIAF Road Map to overcome the crisis

La solution of the crisis pans out along a Road Map calling for the following six initiatives, six in the short term (within the next 6-12 months) and six in the longer term (in the next 2-5 years):

In the short term (within the next 6/12 months):

1. The role of the ECB remains crucial

To ensure the euro area's resilience and to allow a correct transmission of monetary policy, the European Central Bank will have to keep purchasing government bonds.

One of the most acute phases of the sovereign debt crisis, and probably the one that resulted in a "seriousness leap" of the crisis, came in August 2011, when the financial markets began to doubt Italy's ability to sustain its public debt, amidst deteriorating economic conditions and high uncertainty on the European political authorities' ability to contain the spreading of the crisis. In this context, the role of the ECB has been crucial, especially with regards to the decision to reopen the Securities Market Programme and the purchase of government bonds on the market, albeit effectively conditioned to the implementation of corrective public finance measures by the Italian government. Furthermore, the putting in place of measures in support of the financial system, such as the introduction of full-allotment auctions also on longer maturities, or the covered bond[2] purchase programme, have provided essential support to the stability of the financial system.

Nonetheless, the ECB should take care to follow principles of fairness and homogeneity in its action, in order not to reap distortive effects on the rates curve or on the yields of the various government bonds. To this end, in respect of the independence of the European monetary institution, and also with the aim of guaranteeing correct transmission of monetary policy, forms of coordination with the national bodies responsible for the management of Sovereign debt should be established, with specific reference to interventions on the secondary market, and to issuance strategies on the primary market.

Going forward, the role of the ECB will have to remain central in the long process leading up to a strengthening of the European institutional infrastructure, both in terms of supporting the liquidity of the European monetary and financial institutions, and of the continuity of the Securities Market Programme, with the aim of preserving and guaranteeing monetary policy transmission channels. Extension of the powers of the European Financial Stability Facility to embrace the possibility of purchasing government bonds of European countries on the primary and secondary market, is unlikely to translate into operational flexibility comparable to that of the ECB, and has more the general objective of stabilising the system, rather than favouring an adequate transmission of monetary policy measures.

[2] A complete and detailed analysis of the ECB's non-conventional instruments is available online from: http://www.ecb.int/mopo/decisions/html/index.en.html

2. Strengthening of the EFSF / ESM

The European Financial Stability Facility needs to be extended, also resorting to additional "real" resources, to allow for more effective intervention capacity in support of sovereign states and, indirectly, of banks, maintaining the necessary conditionality. Introduction of the European Stability Mechanism must be brought forward.

The European Financial Stability Facility[3], which once fully operational will be replaced by the European Stability Mechanism, and which represents the main instrument in support of euro area countries in distress, needs to be further strengthened and afforded adequate operational flexibility. To this end, decision-making capacity should not be conditioned to the unanimous assent of the contributor countries, especially in situations in which speed of action is an essential factor in stabilising the markets.

Furthermore, the overall capacity of EFSF/ESM must be increased, also with additional "real" resources provided by governments, to signal the possibility of intervening also in support of countries with large public debts, or the support of which requires very substantial resources. This is because the use of leverage instruments to increase the EFSF/ESM's capacity should be limited, to prevent the multiplication effects that would occur in the event of a country's default.

Lastly, <u>indirect support offered by the EFSF/ESM to any banks in distress should not be bound to their liquidation, but rather based on an evaluation of solvency and of continuing of operations</u>, albeit potentially conditioned to the adoption of restructuring measures or to disposals.

3. Preventing an "involuntary" default of Greece

A disorderly default of Greece should be prevented, with specific reference to the opportunity of preventing the activation of CDS contracts. The voluntary swap solution is viable, on condition of its terms not being penalising to the point of making subscription to the swap insufficient.

Economic and financial conditions in Greece are serious and place the country in what is effectively already a default situation. Loss of access to the capital markets amplifies the crisis, as the country is forced to rely solely on international public support to service its debt. The need of further European financing for Greece in the next few years cannot be ruled out.

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[3] Information on the features and functioning of the EFSF are available online from: http://www.efsf.europa.eu/about/index.htm

However, the process of consolidating public finances, while incomplete and les effective than hoped, introduced important corrective actions, which with additional official support, the contribution of the private sector, and a further effort towards containing public spending without penalising growth, will be capable of brining the country's debt back under control. To this end, Private Sector Involvement (PSI) seems indispensable.

Nonetheless, it should be pointed out that if debt restructuring takes place on a non-voluntary, albeit "orderly" basis, by effectively modifying government bond conditions in a forced manner, the systemic effects could be devastating, and even worse than those observed following the default of Lehman Brothers. The activation of Credit Default Swaps would imply the need for a credit-fixing event for the definition of the contracts, but the opacity of the trading of such instruments prevents any ex-ante estimation of the potential chain effects the activation would trigger. The aggregate net notional value of CDSs referred to Greece is around 3.7 billion dollars (source: DTCC, 14 October 2011), but the indirect effects of an activation of the contracts are unknown.

A restructuring of Greek public debt based on a voluntary swap offer, on the other hand, would prevent activation of the CDS contracts, as clearly underlined by ISDA[4]. The rating agencies themselves, in the event of an offer made with no obligation of acceptance, have said they would consider assigning a "selective default" rating, only for the duration of the swap offer. However, in this case, even assuming public authorities exercise moral suasion on banks in possession of such securities, <u>the terms of the offer should not be penalising to the point of compromising adequate subscription. Therefore, in defining the terms of the offer, the need to involve the private sector, that would effectively reduce the cost faced by Greece to service its debt, should be set off against the need to guarantee sufficient participation of private investors in the swap offer</u>.

4. Strengthening the capital of banks

The capital of European banks must be strengthened through three channels, in order of priority: a) market or private sources; b) government intervention in the individual countries to which the banks belong; c) European Financial Stability Facility. However, the bank system's capacity to supply credit to the economy must be preserved; European government bonds should be valued at nominal value, as the hypothesis of a European public debt haircut must be implicitly excluded.

To overcome the sovereign debt crisis, a marked strengthening of banks in Europe is necessarily required, although specific conditions in individual countries vary. The link between sovereign debt and the capital of banks is a strong one, not only for the significant weight of European government bonds on bank assets. At the same time, the fragility of some sovereign states is often an expression of the need to support national banks in distress. The

[4] The ISDA release is available online from:
http://www2.isda.org/news/isda-statement-on-cds-credit-event-process

interconnection between banks and sovereign requires organic solutions, within a broader framework of public account consolidation and bank sector strengthening. It is also evident that, for some countries, the joint achievement of these goals is out of reach, and requires adequate support from other European countries.

In a logic of euro area solidarity and self-strengthening on the front of supporting the sovereign debt of member states, a system should be established of incentives addressed to banks owning government bonds in the euro area, for instance through their balance sheet valuation at nominal value. Observing the ECB purchase Italian government bonds, and some leading European banks contribute to heightening sovereign risk through the substantial disposal of government bonds in delicate market phases calls for closer supervision also on the trading activities of banks.

The primary source of recapitalisation for banks is still the private sector, be it in the form of a reduction of dividends or incentives, potential recourse to the market, or the opening up to large individual investors. Should this course of action not be possible, and conditions require it, government intervention would represent the subordinated yet inevitable solution for banks with an imperative need for capital to restore necessary confidence levels. If public finance conditions rule out government intervention, the EFSF, albeit on condition of the necessary actions being implemented to restore the banks involved to health, must represent the "last resort capital provider" for European banks.

The introduction of stricter capital requirements in Europe goes in the direction of a strengthening of banks, but must take into account market conditions and the conditions of the governments involved. The supply of credit to the economy must be safeguarded, adopting the most appropriate measures for a gradual transition towards new capital rules, which must not put at risk the growth of credit and of the economy. The strengthening of capital ratios must be achieved by means other than a reduction of assets, especially if these assets are functional to the supply of credit to the economy. While the authorities are well aware of all this, also in light of management incentives often directed to supporting stock quotations, it is not clear how to verify that capital strengthening will not translate into a credit crunch.

The plan to strengthen the capital of European banks, which are required to achieve a core Tier 1 ratio of 9% by 30 June 2012, taking into account the quotations of government bonds as at 30 September 2011, therefore risks being of damage to the economy. European government bonds should instead be accounted at nominal value, as the hypothesis of a haircut of European public debt must be implicitly excluded. Also, the accounting principles used for the capital strengthening plan[5] drawn up by the European Banking Authority (EBA) are focused to excess on government bonds, to the detriment of the more fragile countries, without considering the risks tied to possession of so-called "Level 3" assets.

[5] For further information on the plan aimed at strengthening the European banking sector, visit: http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-details-the-EU-measures-to-restore-confide.aspx

5. Strict market supervision

Strict market supervision should be exercised over the markets, with specific reference to the opportunity of extending the ban on naked short-selling and naked CDS trading as necessary, and of completing legislation aimed at implementing rules on preventive "counterpart identification" and on the "reasonable expectation" to have access to shares that are the object of naked short-selling. OTC market regulation must be accelerated.

Although there is no certain proof of the usefulness of the measures addressed to limiting naked short-selling, there is no doubt of the correctness and effectiveness, in principle, of the actions directed to preventing, for instance, the sale of government bonds aimed at repurchasing the same bonds at lower prices, in potentially unlimited amounts and in market contexts sometimes marred by a lack of liquidity and, therefore, by highly reactive prices.

Also, evidence of the diffusion of non-regulated markets, often lacking transparency, leads to the parcelling out of liquidity on financial instruments, resulting in the concentration of sales in the few, more liquid markets, in negative market phases. <u>In order to prevent the potentially catastrophic effects of shocks propagating in non-regulated markets within a context of overall opacity of transactions, and to safeguard the stability of the "transparent" financial system from the invasive growth of so-called "shadow banking", the regulatory reform process must be accelerated</u>.

However, this topic needs to analysed in much greater detail. This is why the AIAF is supporting an initiative called Market Eye, addressed to the realisation of a series of events for the promotion of a "permanent dialogue" among institutions, experts and operators, aimed at proposing the most appropriate solutions for an adequate regulation of the markets, to safeguard savings and promote their most efficient allocation to productive ends.

6. Corrective actions on public accounts

The countries most exposed to market turmoil must press on with corrective public finance actions, with a preference for the measures less likely to penalise economic growth in the short term.

The correction of public accounts, especially in the most exposed countries, such as Italy, is an essential condition in achieving medium-long term stability. However, fiscal policies should not renounce the level of flexibility that allows them to pursue counter-cyclical actions in negative economic trend phases. This need is amplified by the solely anti-inflationary function of the monetary policy pursued by the European Central Bank. To achieve the goal of consolidating public accounts, even if the starting conditions of the individual European countries differ significantly, the implementation of long-term structural reforms, such as those involving pension spending, the fight against tax evasion, liberalisations, and greater pubic administration efficiency, could promptly send off the convincing signal the markets are waiting for, i.e. that a structural consolidation process has started.

The nature of public finance in Western countries is such as to make recourse to the capital markets indispensable. For this reason, the confidence markets place in the solvency of a country remains crucial for the sustainability of that country's debt, all the more so for countries with fragile public finances. In addition to reducing dependence on the market, through public debt containment, <u>a structural surplus (of around 1%) should be targeted for the public current account balance, to be used to support economic growth in negative phases of the cycle, and subsequently built back up in sustained growth phases. This would allow overall public debt to only rise in extraordinary cases and for limited time periods</u>.

In the <u>longer term (within the next 2-5 years)</u>:

1. Strengthening of European governance and relaunching of growth

European governance and growth reforms (the so-called Six Pack, the Euro Plus Pact, and the Europe 2020 strategy) must be rapidly implemented and strengthened, to aid economic convergence and accentuate the binding nature of public finance objectives. A balanced and fair global growth model must be encouraged, through sound energy policies and avoiding potentially destabilising macroeconomic imbalances.

The package of measures designed to strengthen European governance represent an important step forward towards better economic and fiscal integration. The euro area crisis of the past two years is also the result of significant differences in the growth models adopted by individual countries, as well in their public accounts. An obvious competitive advantage of one euro area country over another, in a common currency regime which therefore rules out exchange rate adjustments, makes diverging public accounts trends very likely, mostly as a result of the different paces of economic growth and of different return on capital. The goal of economic convergence, as well as of a convergence of public accounts, is an essential balancing factor in the euro area.

Strictly from a fiscal point of view, the European Semester represents a step in the direction of closer supervision, including the adoption of semi-automatic penalty mechanisms. The introduction of reverse qualified majority voting systems (only a qualified majority can block penalties) mitigates the defects of the Stability and Growth Pact, which has been effectively infringed since the beginning of the last decade. The adoption of medium-term public finance objectives (MTO) and the obligation to present corresponding Stability or Convergence Plans (SCP) respond to the aim, by all means worthy of being upheld, of a preventive assessment of national budgetary actions.

Furthermore, the inclusion of debt reduction goals, as well as deficit containment objectives, promotes convergence, in addition to simply preventing a further divergence of public accounts among countries, although such goals should take into account the overall macroeconomic picture and the need to lay out medium-long term targets.

However, there is no shortage of reasons to doubt that punitive mechanisms will truly prove effective. While the voting system makes it hard to put together majorities capable of blocking the penalties, the experiences of the past decade prove that political solutions reached at the European Council level have often undermined the penalties proposed by the Commission. Also, penalties in the form of non-interest bearing deposits or fines may not be enough to encourage corrective programmes on public accounts, and could in fact further affect the public finances of member countries. A strengthening of the governance package geared to stepping up automatisms in applying penalties, and the introduction of non-financial penalties, such as limitations on voting rights on specific issues, would offer the advantage of building a more credible system to support convergence.

More in general, European governance should raise the bar more determinedly, with the likely advantage of aiding simplicity, going to the extent of prospecting institutional bodies designed to take over part of the fiscal sovereignty that is currently the exclusive competence of individual states. This would require specific amendments to Treaties.

In addition, a balanced and fair global growth model must be encouraged, through the implementation of sound energy policies, and avoiding potentially destabilising macroeconomic imbalances. It is a widespread and sharable opinion that persistent current account imbalances, with Western countries showing a trade deficit and Asian countries a surplus, have contributed significantly to keeping interest rates especially low over the past decade, fuelling private sector leverage. A preventive assessment of potential imbalances at the global level, possibly under the supervision of the G20, may contribute, if effectively put in place, to improved financial stability and healthier economic growth.

2. Inserting budget obligations in national constitutions

Budget obligations should be inserted in national constitutions, albeit without renouncing the counter-cyclical role of expansive fiscal policies. The achievement of small budget surpluses (around 1%) to resort to in periods of economic crisis represents a viable long-term solution, useful in containing debt levels.

The lack of effectiveness shown by the Stability and Growth Pact in its original version, and the doubts over the effective capacity of the new, strengthened version, to exercise necessary control over euro area public accounts, make appropriate the insertion into national constitutions of specific obligations on the stability of public accounts. This would facilitate the enforcement that the complex European governance procedure risks failing to attain. While called for within the framework of the recent European governance reform[6], insertion is left to the discretion of individual countries.

[6] The Six Pack mentioned above. Further information is available on line from: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/647&format=HTML&aged=0&language=EN&guiLanguage=en

However, the counter-cyclical role of national fiscal policies should not be forsaken, nor should the task of aiding economic convergence, preserving fairness in distribution, and maximising the potential growth of individual countries, also through the use of public resources. Tighter control over public accounts should not mean the loss of a crucial instrument for the political-economic life of a country. The very concept of giving up fiscal sovereignty, desirable in a context of greater economic integration, can only be limited and restricted to realms in which adequate convergence has already been achieved.

With these objectives, pursuit of a small budget surplus would make available resources necessary to implement counter-cyclical fiscal policies, while at the same time containing debt. The arising of situations of budget deficit, or of temporary increases in debt, should be exceptional events, corresponding to the need to put in place policies in support of the economy or of great relevance for the public interest.

3. Institutional integration and treaty amendments

European integration must be enhanced, through stronger centralisation of some public finance functions for euro area member states, leading up to establishment of a dedicated institution and to the necessary treaty amendments. The adoption of organic taxation methods at the European level, with a partial reduction of national taxes, represents a handing over of fiscal sovereignty from the periphery to the centre: a necessary condition for greater integration.

Ever since the start of the economic-financial convergence process undertaken by the early adopters of the single currency, the system used to assess such convergence, while largely based on specific economic indicators, has been also influenced by a markedly political approach, which is partly to blame for the current crisis. In particular, the decision to “waiver” the Stability and Growth Pact in years 2002-2003, in light of difficult public finance conditions also in countries such as France and Germany, effectively paved the way for excessively accommodative fiscal policies and the accumulation of public debt, especially in some countries such as la Greece. The main mistake in establishing the system to control the public accounts of European countries was to leave the assessment of the sustainability of euro area sovereign debts to political decisions, rather than to predefined rules.

The strengthening of European governance provided for by the so-called Six Pack is undoubtedly an important step forward towards stricter control, also of a preventive nature, over the public finances of European countries. However, the often merely consultative role of the European Commission in assessing budget policies, and the lack of clear enforcement mechanisms of any corrective measures, leave current governance still too weak to prevent lingering differences in the management of public accounts in the euro area.

<u>The strengthening of the European economic-financial system requires a higher level of budget policy centralisation, through a partial transfer of fiscal sovereignty from individual states to the central institutions. The establishment of a dedicated agency, or the strengthening of the</u>

powers afforded to the Commission and the Commissioner for Economic and Financial Affairs, must lead up to taxation autonomy on specific forms of taxation (such as that of financial transactions), also to the end of accumulating useful resources to support financial stability in Europe. Taxation should ultimately be differentiated by member state, in function of the extent of public account consolidation required. These reforms require amendments to the Lisbon Treaty[7], starting with Article 136, to allow a more pervasive role of European institutions on specific fiscal issues concerning euro area member states.

In its current form, the Lisbon Treaty does not include fiscal policy, not even among the matters of so-called shared competence between European institutions and member states. Any measures of a fiscal nature are provided for only in exceptional cases and backed by unanimous Council decisions.

More in general, on the fiscal front and with reference to specific areas of intervention, the principle of harmonisation needs to be transcended, to embrace a transfer of fiscal sovereignty from member states to the European institutions. One of the main themes to tackle in realising this project, in addition to strictly political aspects tied to the transfer of taxation powers, is the need to make a stronger distinction between European Union countries and euro area countries.

Lastly, although the Lisbon Treaty already includes most of the reforms prospected by the Rome Treaty of 2004, not subsequently ratified by all adhering sates, the resumption of the project of a European Constitution may represent the opportunity for a strengthening of all the Union's institutions, including the non-financial ones. The need to restart this process emerged on occasion of the recent proposal, later taken back, of a referendum in Greece on the European bailout package, that could have compromised the entire project based on a common currency and common institutions.

4. Issue of Eurobonds or Stability Bonds, evolution of the ECB's role

Enhanced fiscal centralisation, also as a necessary precondition, could allow the issue of bonds guaranteed pro-quota by Economic and Monetary Union member states. The issue of Eurobonds (o Stability Bonds) in the measure of around 60% of each country's GDP, for instance, albeit on condition of greater fiscal centralisation, is a solution that could produce immediate benefits for the public finances of the weaker countries. Amendments should also be made to the Statute of the ECB, affording it an active role as last-resort lender and in supporting economic growth, as well as in pursuing price stability.

Stronger fiscal centralisation, through conferment to the European institutions of a certain degree of autonomy in taxation, initially through a strengthening of the Commission's budget and of the role of the Commissioner for Economic and Financial Affairs, could be accompanied

[7] The Lisbon Treaty, in its consolidated version, is available online from: http://europa.eu/documentation/legislation/index_it.htm

by the issue of common debt, guaranteed by euro area member states in proportion to their GDP.

In order to contain moral hazard problems tied to member states, the issue of Eurobonds[8] should be limited to a total amount equal to 60% of the GDP of each member state. Issue policy should be managed by an agency established ad hoc, under the supervision of the Commissioner for Economic and Financial Affairs.

In addition to representing a sign of greater integration and of a shared fiscal policy, at least in part, the issue of Eurobonds would allow a reduction of the cost of debt faced by countries most exposed to financial market pressures, aiding correction of their public accounts. The trade-off for the benefits reaped by weaker countries on average, would be the higher cost of a part of the stronger countries' debt.

The transfer of resources from one member state to another is not a novelty. While to a limited degree, the European Union is already a Transfer Union. The most innovative aspect of the issue of Eurobonds, which probably represents a cultural leap, as well as a political-economic one, is the possibility of guarantees offered by the stronger countries being used to the benefit of weaker member states. On closer inspection, the latest reforms, such as the EFSF's power to purchase government bonds on the primary and secondary market, imply an indirect sharing of guarantees, as the member states act in substitution of the market as creditors of the country whose government bonds have been purchased.

The AIAF is convinced that the issue of Eurobonds upon completion of a virtuous process of public accounts correction, and progressive fiscal coordination at the European level, will overcome the recent negative views expressed by rating agencies on their credit merit.

Enhanced fiscal centralisation and the issue of common debt should be accompanied by a change in the role of the ECB. This is because conditions would be in place for the ECB to take on an active role as last-resort lender in support of economic growth, as well as in pursuing price stability. Greater fiscal centralisation would allow a drastic reduction of the moral hazard issues at play in a currency area in which fiscal policies are markedly decentralised. Therefore, the possibility would arise of the ECB taking on the role of last-resort lender, albeit with specific reference to "common" public debt. This would at least in part remove the dichotomy between currency (common) and public debts (national) that prevents the ECB from playing a role similar to that played by the Fed and the Bank of England in effectively countering the crisis.

The experience of the Fed in the United States also proves that the double mandate (economic growth and price stability) does not pose serious inflation risks, and will allow the central bank to maintain the necessary flexibility in an increasingly complex context in the years ahead. The Bundesbank model can be overcome, without compromising the credibility of the European monetary authority.

[8] The European Commission will present a Discussion Paper on so-called Stability Bonds by the end of the year.

5. Ensure equal, early application of Basel III standards

While spread over time, the criteria that will be adopted within the framework of the new bank regulation, have effectively been adopted early by many banking groups, and will probably be strengthened by the European bank recapitalisation plan. The strengthening of banks' capital and liquidity, as called for by Basel III, represents a essential trust-building factor in offering sound support to the economy, and to regain market confidence. However, this strengthening, as well as having to take place without damaging the supply of credit to the economy, must not be penalising for European banks.

The increase in sovereign and banking risk were two expressions of the same confidence crisis. On closer inspection, the financial history of the past four years has seen banks and sovereign states transfer resources and risks to each other, in a marriage that has finally revealed all its peril, due to its systemic implications against a background of low investors confidence[9]. Beyond the origins of the crisis and the regulatory shortcomings which undoubtedly fuelled its propagation, on of the aims of this paper is to highlight the need of a solid and reliable banking system to support investments, innovation, economic growth, and therefore the wealth of a country.

If the banking crisis precipitated by subprime mortgages turned into a sovereign debt crisis also as a result of public sector intervention in support of banks, the sovereign debt crisis has turned back into a banking crisis due to he exposure of banks to government bonds. If part of the solution of the sovereign debt crisis lies in the correction of public accounts, this banking crisis can only be solved by making the system more solid, by strengthening the capital of banks.

In the past two years, banks have generally opted for early adoption of most Basel III capital requirements, considering of no use such an extended time period over which to adopt the new measures. However, <u>at the present stage it is not clear whether in the United States the new regulations will be applied to all banks, or just to those with an international presence</u>. Therefore, uniform application of Basel parameters at the international level must be assured.

[9] On this topic, see: "Quantifying Spillovers from High-Spread Euro Area Sovereigns to the European Union Banking Sector"; Global Financial Stability Report; IMF; September 2011

6. Rating agencies and markets regulation

Although the financial markets have brought the ironic "benefit" of accelerating reforms that would otherwise have taken several years to draw up, recent experience has exposed a clear need for greater market regulation and transparency, highlighting to what extent the fragmentation of financial markets, often lacking transparency, may expose the system to significant risk. Furthermore, the establishment should be encouraged of rating agencies, also of a supranational nature, with a clear distinction between those which rate corporations and those which rate sovereign states. Greater competition should be guaranteed in the sector, with an adequate regulation, and strict independence from private interests and public authorities.

One of the key factors at the root of the deterioration of the sovereign debt crisis is evidence that states depend on the financial markets for the issue of public debt, and cannot do without them. The relationship between markets and sovereign states is based on trust, and specifically on the market's evaluation of the sovereign issuer's credit merit. This is why sovereign states need to reassure the markets on their ability to honour their commitments.

Beginning with the end of 2009, when Greece was revealed to have much worse public accounts than initially announced, the financial markets started to doubt the country's ability to meet its commitments. The market's reaction, exacerbated by a sluggish and often confused institutional response, both at the national and European levels, ultimately amplified the country's difficulties, to the point of totally denying it access to private capitals. A similar fate was soon shared by other fragile countries, such as Ireland and Portugal.

It is not our intention in this paper to examine the nature of market movements, to ascertain if and to what extent they were of a speculative nature, or determined by so-called "real money" investors. However, it is clear that the markets brought about the ironic "benefit" of unveiling serious shortcomings in European governance, as well as in the ability of the Old Continent's ability to react promptly with decisive and well-coordinated solutions.

Having said this, it should not be overlooked that on the public debt market quotations changes were often accompanied by a lack of liquidity and modest transaction volumes, and that sell positions were frequently financed on the repo market. What's more, the Credit Default Swaps market is playing an increasingly important role, and rising quotations on this market were often the first signal of a debt crisis in the more fragile countries. Many of these markets (CDSs, repos, alternative government bond trading platforms) are not regulated and lack transparency. Therefore, there is no doubt that part of the sovereign debt crisis was due to a lack of regulation and to evidence that the reaction time of regulators (and politics) is too long compared to the speed of global finance, or that in any case regulators failed to anticipate its distortive effects.

The topic, however, is an overly complex one to be taken on in passing in this paper, and deserves deeper investigation. To this end AIAF is supporting a research project on the markets which also addresses their regulation (the "Market Eye" project), with the aim of making a tangible contribution to the debate on this issue.

Lastly, in the sovereign debt crisis rating agencies have often had the role of amplifying market pressures. Rather than focusing on rating criteria, the transparency of which should in any case be increased, regulatory efforts should be addressed to the timing of the disclosure of views and ratings, and to encouraging the establishment of new agencies, also of a supranational nature. Greater competition would prove useful in preventing excessive concentration, in the hands of just a few agencies, of the rating of the credit merit of a country, and would probably moderate the presently pervasive effects which stem from a change in rating by a single agency. A key condition in making a correct assessment of credit merit is, as always, independence from private interests and from public authorities. To this end, the establishment of a supervisory body within the International Monetary Fund (and in Europe under the control of ESMA) could guarantee such independence.

Further measures which should be put in place are: limits on shareholdings in authorised rating agencies, timeline restraints in the awarding of ratings, non-collaboration clauses between shareholders of a same rating agency, and establishment of a global "register" of agencies authorised to carry out rating activities, and in particular the rating of sovereign debts[10].

[10] The European Commission is expected to present its proposals for a reform of the sector by mid-November.

The AIAF proposal's main innovative contents

For the love of greater clarity, the main features of AIAF's position are listed below.

In a nutshell, it is our conviction that the European authorities should:

- Offer a clearer representation of the path to follow for a strengthening of the European institutions, highlighting the appropriateness of achieving the issue of "common" public debt (Eurobonds or Stability Bonds);
- Take a clearer stance on dealing with the issue of potential institutional conflicts between euro area countries and the other European Union member states;
- Step up the EFSF/ESM's "real" resources to avoid the multiplication effect of potential default events, resulting from recourse to leverage;
- Provide for the insertion in national constitutions of a budget surplus obligation requirement (of around 1%), to be used in support of growth in unfavourable economic cycle phases;
- Increase automatisms in sanctioning failure to meet budget obligations, and in more in general overcome the approach based on "recommendation" and subsequent "sanctions", to embrace a deep review of the institutional structure, aimed at establishing a stronger European budget agency;
- Substantively amend the Lisbon Treaty, and take on the resulting ratification process;
- Recover and bring to completion the project of a European Constitution;
- Modify the ECB's mandate, adding economic growth as a general target in addition to price stability, and affording the central bank a role as last-resort lender;
- Value European government bonds at nominal value (excluding Greece) in calculating banks' capital requirements, and guarantee equal, early application of Basel III standards.

Conclusions

The sovereign debt crisis of the past two years, while rooted in a string of serious shortcomings in terms of regulation, the growth model adopted, and the economic-financial setup in general, has found fertile ground in the fragility of the European institutional setup.

The Greek crisis laid bare the extent to which the European approach to solving crises is to take a succession of small steps, rather than decisive action in support of the integrity of the economic and monetary Union. This approach is dictated by the will to preserve the political and fiscal sovereignty of individual states. However, it is now more clear than ever that a currency union cannot last without accomplished and durable economic and fiscal convergence. The current approach, based on “recommendations” and “sanctions” to euro area member states, albeit recently strengthened, does not seem sufficient to achieve such convergence. Therefore, a more radical change of the European institutional setup should be pursued, towards greater centralisation in the hands of the European institutions, and a significant stripping of sovereignty from euro area countries. This reform process should also regulate a dangerous risk tied to the conflict of interest between euro area countries and other European Union member states. Taxation autonomy on specific matters, the inclusion in national constitutions of a budget surplus obligation, the issue of “common” public debt (Eurobonds or Stability Bonds), and the establishment of a dedicated agency, or a significant extension of the powers of the Commissioner for Economic and Financial Affairs, are a few examples of reforms requiring amendments to the Lisbon Treaty, desirable also with a view to relaunching the project of a European Constitution. In this institutional picture, regulatory actions should be accelerated and intensified, accompanied by a strengthening of the Basel III financial system, taking care not to penalise the credit capacity addressed to the economy, and guaranteeing equal application at the international level.

However, as the implementation times of these reforms would undoubtedly be lengthy, the stability of the financial system must be guaranteed by the ECB maintaining an active role. The European countries should keep consolidating their public accounts and, more in general, continue pursuing economic convergence with the more virtuous countries, without excessively penalising short-term economic growth. The cost of debt faced by the more fragile countries, exposed to the pressures of the financial markets, should on the other hand be prevented by the EFSF/ESM from reaching unsustainable levels, on condition of the necessary reforms being implemented. The intervention capacity of the EFSF/ESM should therefore be increased with “real” resources made available by the euro member states. The financial markets must be supervised closely and consistently, extending the bans on short-selling and on transactions involving so-called “naked” Credit Default Swaps, using all the powers available to market authorities to avoid purely speculative transactions in contexts of scarce liquidity. Greece’s “involuntary” default should be prevented, given the resulting systemic effects it would have, in a market context (with regards to the CDS market especially) characterised by an extreme lack of transparency and regulations. The banking sector should be further strengthened in the short term as well, although the improvement of capital ratios should not be achieved to the detriment of lending capacity to the economy.

The case of Italy

The sovereign debt crisis escalated to new heights of seriousness when pressures started mounting on Italy, starting in July 2011. The fact that Italy represents a crucial node in the solution of the sovereign debt crisis is tied to the size of its public debt, which in case of loss of access to the capital markets would make impossible any attempt of a bailout using the means currently available.

Market scepticism on Italy's solvency is not "only political, but also tied to the fragility of the European institutional setup. It should be said that Italy's fundamentals differ dramatically from Greece's, and allow for further leeway towards a consolidation of public accounts.

However, a number of targets should be laid out urgently and resolutely:

1. **Restore, through adequate politics, stability, unity, and sense of responsibility**, essential in overcoming what is undoubtedly an emergency phase, and to put in place the necessary reforms to achieve a further adjustment of public accounts and stimulate economic growth.

2. **Relaunch economic growth**. This is an ambitious target that goes beyond the short term, given the need to implement structural reforms in the fields of liberalisation, the labour market, redundancy schemes, education, taxation, legality, and institutions in Italy.

3. **Public debt must be slashed**. Shock therapy is in order, and debt must be slashed by disposing of alienable national assets, and taxing the larger estates, which would have a much smaller impact on economic growth than further taxing income.

4. To ensure the resilience of the euro area and allow a correct transmission of monetary policy, **the European Central Bank will have to keep purchasing government bonds.** Such purchases, however, cannot replace the adoption of the necessary public finance measures required to restore public accounts to health and relaunch economic growth.

Crucial issues to tackle

More in general, regardless of the reasons that led to a loss of investor confidence in the solvency of Italian public debt, it is obvious that our country cannot do without the market, nor count "solely" on the European Central Bank to prevent cost of debt from reaching unsustainable levels, or a loss of access to the market. The weaknesses shown by Italy over the past two decades, i.e. **high public debt and weak growth**, are no longer accepted by the markets today, and must therefore be taken on as a matter of urgency.

Relaunching growth

This is probably the most ambitious target: Italy has been growing at a modest average pace for years, while deep reforms have been repeatedly announced and almost never realised.

The recipe is not a simple one, and touches on deep-rooted social and cultural aspects, as well as on purely economic considerations.

In general, the guidelines for achieving stronger economic growth in Italy are:

1. **liberalisation of services and professions;** this is a frequently declared goal, but never determinedly pursued, probably due to the major private interests at stake. With the exception of a few essential public services, such as the supply of water, liberalisation should apply to all local public services, for instance by introducing compulsory tenders for the awarding of their management. As regards the professions, minimum fees and the ban on advertising should be removed, in respect of the characteristics and dignity of the professional activity.

2. **Labour market and redundancy scheme reform;** "non-typical" contracts should be reviewed and unlimited work contracts should be encouraged with the offer of tax breaks; legislation on work contract termination should be reformed, seeking the widest possible consensus among social partners, and welfare should be redefined with regards to temporary unemployment benefit measures.

3. **Legislation on business incentives, promoting the dimensional and international growth of SMEs, should be reviewed**; legislation on business incentives should be reviewed, with the reintroduction of stimulus instruments such as law 488/92 or 215/92, albeit accompanied by strict control over their actual use for productive ends; company networks should be encouraged, as also venture capital initiatives, and the dimensional growth and internationalisation of SMEs, through the joint offer of tax breaks on partner investments, and on the issue of bonds to finance internationalisation projects.

4. **Fiscal reform, focused on reducing the tax burden on workers and businesses, cutting the cost of politics, and fighting tax evasion and corruption;** a fiscal reform should be aimed at cutting taxes on workers and businesses, while increasing the taxation of estates and some specific goods, such as luxury goods, safeguarding fairness in the distribution of the tax burden; the cost of politics should be slashed through the abolishment of provinces, and a reduction in the number and overall pay of members of

parliament; the fight against tax evasion and corruption should be stepped up, especially in relations between politics and the economy.

5. **Specific interventions should be addressed to Southern Italy, with the aim of strongly encouraging entrepreneurship;** stronger economic growth in Italy necessarily requires stronger growth in the southern regions of the country. Increased presence of the State on the territory, to guarantee the respect of legality, even at the cost of investing higher resources, must be accompanied by a system of tax and contribution incentives, to encourage the establishment and growth of businesses, especially in the more promising sectors, such as tourism, the agricultural and food product chain, renewable energy sources, and logistics.

6. **Infrastructural actions and investments in education and innovation**; the fiscal reform and cuts on unproductive and non-essential spending should free resources to finance selected infrastructures on the national territory, addressed to raising productivity and reducing production costs, especially in Southern Italy. Improved use of the Internet and incentives offered to internet companies are useful measures in this respect. More in general, investments in education and innovation are indispensable conditions to promote structural productivity growth in Italy.

Reduction of public debt

For decades, Italy has cohabited with a very high public debt. Attempts to reduce it, by the various governments which have led the country since its entry into the euro area, were often undermined by a stagnant or recessive economy, or by the lack of effective measures.

As of the summer of 2011, Italy's large public debt began to be viewed as no longer acceptable by investors, in a European context characterised by political-economic uncertainties and by higher risk aversion on the financial markets.

The very existence of a public debt in a Western country, unable to resort to self-financing or monetisation (nor would the latter be desirable, given its inflationary effects), makes access to the capital markets an essential condition to support financing. The role of the US or UK central banks as "last-resort lender" to their countries' governments, albeit of a temporary nature, is at present left unmatched in Europe, where the ECB cannot act along the same lines due to statutory reasons, and for reasons tied to the characteristics of the euro area and its Treaties. Structural, consistent intervention in aid of a country by the ECB would be in conflict with the Lisbon Treaty, as well as politically unacceptable today for the more virtuous countries.

Therefore, alternative measures are necessary, to be implemented within the national borders.

A reduction of Italian public debt can only be achieved by:

1. improving the primary balance, through further public spending cuts or increased taxation;
2. boosting economic growth, by adopting measures in support of the economy;
3. disposing of public assets;
4. introducing temporary fiscal actions on private estates.

The first course of action, i.e. spending cuts or taxation, while certainly desirable on some fronts, such as reducing the “cost of politics”, sees increasingly hard to implement in Italy, both for the recessive effects any further restrictive actions on public accounts would have, and for the political and social resistances that would have to be overcome in the present phase. However, as is widely known, there is ample margin for raising tax revenues through a widening of the taxable base, achievable by stepping up the fight against tax evasion, or cutting spending based on a strict spending review.

The second solution listed above, i.e. relaunching economic growth, should be pursued as soon as possible. However, even assuming prompt adoption of the most appropriate measures, the results would only be visible at a considerable time lag.

The third course of action, i.e. the disposal of public assets, would bring the advantage of reaping an almost immediate positive impact on debt reduction, although there is uncertainty over the sum that could be raised, given the unfavourable market phase. The current disposals programme (worth around five billion euros a year) seems in any case inadequate.

The fourth option, calling for a temporary taxation of private estates, would have the benefit of swiftly reducing debt, but its social and political acceptability is undoubtedly limited.

In our view, all four courses of action should be pursued. However, the latter two could have a stronger impact over a relatively short time period. On closer inspection, the measures included in the Stability Law embrace, to a greater or lesser degree, the first three options described above. Of the fourth, namely the property tax, there is still no trace.

The idea of a property tax

In the past few months, a number of hypothesis have been made with regards to a property tax[11]. It is our intention in this paper to make a few general considerations.

One of the reasons for the resistances opposed to a property tax is evidence that, in general, private estates are the result of savings set aside from income, therefore already taxed. As a result, a property tax would introduce a form of double taxation of income. However, a further consolidation of public accounts pursued by means of raising tax pressures on new income, or of public spending cuts, for instance with linear cuts, would be much more damaging for Italy’s

[11] See for instance: *“Imposta patrimoniale per chi ha di più”* by Pietro Modiano – *Corriere della sera*, 8 July 2011, which inspired the hypothesis outlined in this paper.

economic growth than a property tax. Indeed, the ratio of private consumption and the value of personal wealth in Italy has always been extremely low[12].

After years of accepting Italy's large public debt, the markets no longer seem prepared to wait for it to be cut through the traditional mechanisms of economic growth and primary balance. The only alternative Italy has is to transfer a part of private wealth to the state sector, also adopting mechanisms providing for a partial deduction of the property tax from declared income, in order to hit tax evaders. The property tax should also be accompanied by a drastic cut in the cost of politics, to improve its social acceptance. The turning point in our country's struggle against the crisis could therefore be reached by applying shock therapy, i.e. slashing debt by imposing a property tax on the wealthiest bracket of the population. The initially negative impact on economic growth would be much smaller than that of a further taxation of income.

We are well aware of the complexity of putting a property tax in place, especially considering all the issues tied to enterprises, funding, distinction between gross wealth and wealth net of debt, and the operational management of taxation. With this paper, AIAF intends solely to highlight the size of the revenues obtainable, and the implications in terms of the resources which could be used to reduce Italy's public debt and relaunch its economic growth.

The hypothesis described is based on Bank of Italy data on the wealth of Italian households[13], and on the "naïve" hypothesis of taxing the "richest" 10% of the population[14], which owns 45% of total wealth. The main home of residence is not included in calculating wealth. On this taxable base, corresponding to high-wealth-bracket households, the assumption is made of a property tax of **5 per mille** per year for **10 years**, or **20 years**. In the former case, overall tax revenue over the 10 years would amount to around **155 billion euros euro** (15.5 billion euros per year for 10 years). In the latter case, revenue would double to **310 billion euros** (15.5 billion euros per year for 20 years). Given the long timeline, to prevent capitals from being transferred abroad or stowed away in safe deposit boxes, taxation would have to be focused on current wealth (5% or 10%) and be spreads over 10 or 20 years. The size of the tax could obviously be adjusted considering a shorter period of time, but in this the annual collection would be more burdensome. For instance, assuming a scenario in which cost of debt is 8%, and 2012 is a recession year (-1% GDP growth), a property tax of 3.2% a year for two years would be required, on the entire population and on all components of wealth (except main houses of residence and government bonds) to bring the debt/GDP ratio down to 100%.

Introducing fiscal deductibility of a portion of the property tax would allow a stronger impact on taxpayers with large estates and low income, among which tax evasion should therefore prove to be highest. More in general, modulation of the size of the tax and of the specific

[12] On this topic see: *"Effetti ricchezza sui consumi: il caso italiano"; Temi di discussione n. 510*; Bank of Italy; or "Housing and equity wealth of Italian households", ECB Working Paper n. 857; or the ECB Monthly Bulletin of January 2009.
[13] Supplement to the Bank of Italy's Statistical Bulletin; *"La ricchezza delle famiglie italiane nel 2009"*.
[14] The wealthiest 10% of the population owns net a personal estate worth more than 530 thousand euros, based on 2008 data. Bank of Italy data; Sample survey on household wealth; February 2010.

taxable goods, allows for the pursuit of greater fiscal equality and a reduction in the concentration of wealth[15].

The resulting resources would be sufficient to drastically, albeit gradually, cut Italy's public debt, and to finance a reduction in the tax burden imposed on work income and businesses, and more in general to implement measures in support of economic growth. For instance, two-thirds of the resources could be used to cut debt, and one third to finance reforms. The prospected decline of public debt, ultimately to below 100% of GDP, would have a very favourable impact on the markets, and could **narrow the yield spread vs. German government bonds by up to two per cent[16].** The resulting drop in the cost of financing public debt would allow **savings of up to around 40 billion euros,** which in turn could be used to support growth and implement reforms, or even further reduce the public debt.

Conclusion

The sovereign debt crisis in Italy is at the same time an Italian and a European crisis. Italy is faced with the fragility of its economy, and is now forced, after decades, to take on its problems tied to modest growth and excessively large public debt. Europe is grappling with the weakness of a currency union that cannot survive without a more tangible fiscal and political union. While these are long-term and potentially insidious processes, the awareness that alternative scenarios could prove devastating for our country and for the Old Continent at large, should prompt us to pursue the targets laid out with determination, unity and sense of responsibility.

16, November 2011

[15] In relation to disposable income, average gross and net wealth in Italy is higher than in the United States, Germany, France, and the United Kingdom. Italian households own a net share of global wealth of 5.7%, larger than Italy's share of global GDP and of the world population (respectively around 3% and 1%).

[16] Estimate based on historical elasticity and on comparisons with other European countries.