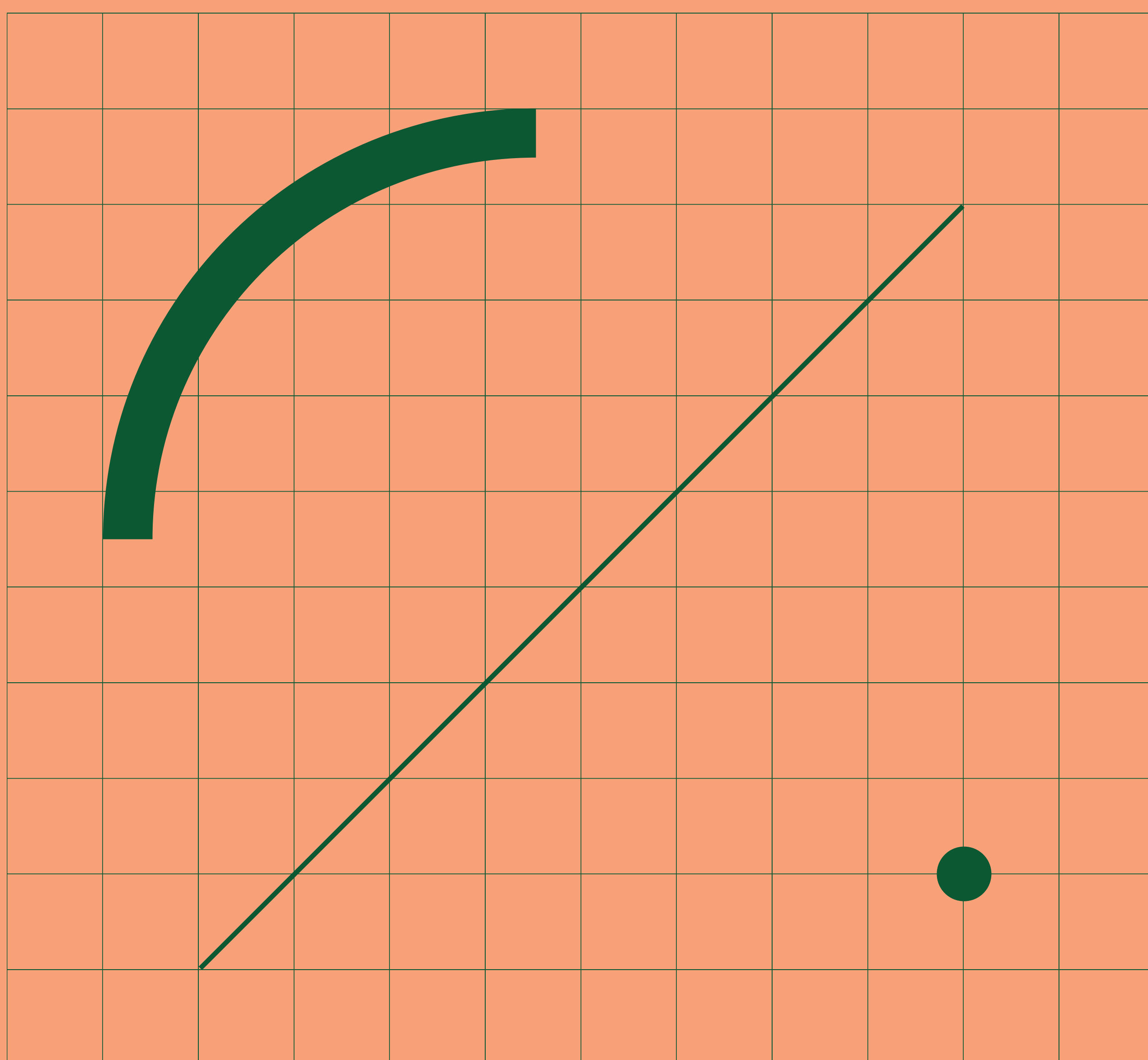
For a European Debt Agency

POLICY PAPER - FEBRURY 2022



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For a European Debt Agency

AUTHORS
MASSIMO AMATO
FRANCESCO SARACENO

45, RUE D'ULM 75005 PARIS
LEGRANDCONTINENT.EU
GEOPOLITIQUE.EU

GEG@ENS.FR

RECOMMENDED CITATION
MASSIMO AMATO, FRANCESCO SARACENO, FOR A EUROPEAN DEBT AGENCY, GROUPE D'ÉTUDES GÉOPOLITIQUES, POLICY PAPER,FEBRUARY 2022.

For a European Debt Agency

MASSIMO AMATO • ASSOCIATE PROFESSOR DEPARTMENT OF SOCIAL AND POLITICAL SCIENCES, UNIVERSITA' BOCCONI.
FRANCESCO SARACENO • DEPUTY DEPARTMENT DIRECTOR AT OFCE, SCIENCES PO

The debate over European economic governance reform is now getting to the heart of the matter and two closely related concerns are coming to light. The first is how to guarantee stable budgetary room for maneuver, particularly for the EMU countries who no longer have monetary policy as a tool. This can be accomplished either through the creation of a central fiscal capacity (such as a permanent version of the Next Generation EU program), by more favorable rules for investment, or both. What is certain is that the past decade has highlighted the need for budgetary policy to be permanently added back to the policymakers' toolbox. Of course, debt has reached record levels, but there was really no choice. Fiscal policy should continue to be active in order to be able to meet the challenges of the coming decades: from infrastructure to investments in healthcare, as well as the reform of social protections, and of course digitalization and the green transition.

Consequently, the second concern is knowing how to make a proactive fiscal policy remain viable with higher debt levels, even if and above all once monetary policy returns to normal and negative nominal rates end. What must be avoided at all costs, in order to guarantee the sustainability of debt when faced with future shocks, is that European states be obligated to implement fiscal consolidation policies, which would have catastrophic consequences for the social and environmental sustainability of our economies.

Now that the debate on rules is open, it is necessary to strike a compromise which to this point has been rather poorly managed: that of growth and stability, notwithstanding that this is clearly included in the very title of the Stability and Growth Pact, which has been suspended due to the pandemic. The matter of financing (and refinancing) member state debt must be addressed, with the goal being to relieve them of market pressure while guaranteeing fiscal discipline. New fiscal rules and appropriate forms of debt management should therefore be jointly established. This problem could also arise for the Commission, in the hope that the Next Generation EU program is followed by other similar programs, or even the creation of a permanent fiscal capacity.

Presidents Draghi and Macron seem to be very aware of this dual need. In their article published in Financial Times on December 23, 2021, they argue that the EU should define a set of shared macroeconomic principles and objectives and to translate these objectives into a fiscal framework to guarantee both growth and stability. Their argument is based on a "white paper" by – among others – F. Giavazzi and Ch.-H Weymuller (henceforth "Giavazzi et al.). Their first proposal is to introduce a so-called "golden" rule which would exempt investments from being calculated as part of the deficit. But the most innovative proposal in the "white paper" is the creation of "European Debt Management Agency" (EDMA) whose mission would be to absorb the debt accumulated to counter the Covid crisis. It is this second aspect of the proposal – its underlying principle and its subsequent execution – that we wish to examine here.

Shared management of eurozone member state debt would without a doubt give fiscal policy more room for maneuver. If it was accompanied by a revision of permanent rules to ensure responsible behavior, it could meet the stability and growth needs the presidents mentioned in their article. Additionally, and we will come back to this later, this shared debt management would help to normalize monetary policy.

And yet – one may object – the introduction of Eurobonds presumes a federal Europe, which would be rather bad news because federalism cannot be built in a few months, or even in a few years. Fortunately, this is not the case: yes, shared debt implies a certain degree of cooperation, but not necessarily federalism. While waiting for an entirely federal Europe (with a Treasury capable of issuing bonds guaranteed by a federal central bank), what could be put in place to guarantee stability and growth, or even, at the same time, investments and

the sustainability of their financing, is a strategy of structural cooperation concerning access to financial markets by eurozone states.

Of course, the shared management of debt by an agency is not without risks that must not be underestimated. The first, somewhat paradoxical, risk is that of creating greater instability: markets would consider debt not absorbed by the agency as "inferior" and therefore more difficult to place (called the "juniority effect"). The second, more political, risk is if the shared management was done through mutualizing a part of the debt (meaning each country would be responsible for all or part of the debt of each one of the others), which could encourage irresponsible behavior (the moral hazard). It is clear that the so-called "frugals", along with Germany, would have a hard time accepting the very principle of mutualization, which would mean that in case of trouble, the virtuous would pay for the less virtuous.

The proposal by Giavazzi et al. has already been criticized because it does not eliminate either of these two risks. In particular, it is not free from an unstated form of mutualization; the probability that the proposal will be discussed and, above all, approved during negotiations on European governance reforms therefore seems quite low. Additionally, as any fiscal transfer must be subject to a democratic control through a vote (no taxation without representation), mutualization would require, in order to be established as a principle, an institutional change in an overtly federal sense, which would not be easy to introduce without prior debate, which would necessarily take time.

Nevertheless, the two presidents and the economists that helped them deserve credit for bringing the issue of shared debt management to center stage. It is indeed possible to jointly manage European debt without introducing mutualization or creating instability. This is the point of the proposal developed by M. Amato and his coauthors since April 2021 and that we recently presented in a Policy Brief which was published in both Italy and France. Our proposal focuses on the creation of a European Debt Agency (EDA) which provides a collaborative but non-mutualizing solution, capable of managing in perspective the whole of euro area debt, past and future, and not just debt related to crises. Only an agency designed in this way can issue a true European safe asset and transform all the debt of the Eurozone into safe debt.

We will start by outlining the functioning of the debt agency as we propose it before coming back to its ability to combine economic efficiency and political feasibility.

The challenge of such an agency is minimizing the cost of debt financing for states while leaving their responsibility to their peers intact. The agency must therefore be able to put a protective screen in place between countries and markets which would be able to filter the so-called illiquidity risk linked to the volatility of market expectations and speculative attacks, all while leaving states responsible for insolvency risk which is itself linked to the long-term sustainability of their public debt.

This EDA would issue bonds on financial markets and would use the funds raised to finance member states with perpetual bonds, freeing them from the risk of refinancing and minimizing the cost of debt for each country. The agency would determine the loan's annual installments as part of a perpetual amortization schedule, which would evolve with the "fundamental" risk of each member state (meaning its risk of insolvency which depends on its economic foundation). This would eliminate any possibility of moral hazard. The loan's cost for the member state would be a function of the market cost of the EDA's portfolio, plus an incremental cost that would evolve to reflect its specific solvency: a sort of "bonus-malus" for public debt. It is important to point out here that each state would pay based on its ability to guarantee the sustainability of its public finances and respect common rules, whatever they may be; the creation of the EDA therefore could (and even should) happen at the same time as the reform of the European fiscal framework. The bonus-malus mechanism working in conjunction with an improved rules system (we are thinking in particular of an expanded version of the golden rule, which takes into account tangible as well as intangible investments), would guarantee fiscal discipline better than the current system, where changes in rates reflect at once the foundations, the volatility of market expectations, and the opaque nature of the fiscal rule.

The EDA would not buy securities on the markets. It is the EDA that would go on the market, not its clients. By also instituting a perpetual amortization schedule for loans to states, the EDA would manage all future debt of eurozone member states. This complete absorption would also be possible because the accumulation of reserves resulting from its perpetual amortization schedule would allow the EDA to proceed, if it so chooses, with systematic debt level reduction, so that it does not grow indefinitely.

Unlike the proposal from Giavazzi et al., the link between the amount of loan installments, underlying risk, and the creation of a sinking fund would avoid any debt mutualization. The non-mutualization principle that underlies the EDA also applies to potential "default"

(non-payment of one or several monthly installments) by a member state. Obviously, in order to handle such an event, the EDA provides for capital absorption, exactly as the ESM does. If, however, in the case of the ESM, the release of new capital following a member state's default definitely implies mutualization, the EDA does not have this disadvantage because the addition of capital is managed by an insurance scheme which, following the "bonus-malus" logic outlined above, makes states with higher risk profiles pay a higher premium, which also avoids mutualization in the case of capital.

As for the second risk – that of creating a "junior" debt that would be difficult for states to invest due to the Eurobonds issued by the EDA – it is eliminated by the progressive absorption of all its debt and not pandemic debt alone, as for Giavazzi et al. and others have proposed.

In short, by issuing a common bond that would allow for the reabsorption of all national debt in the euro area, the EDA would play a key role in reducing systemic uncertainty. At the same time, it would stabilize market expectations regarding overall debt sustainability and would align the cost of debt with each member state's "foundations''. This would allow rules to be adopted giving states more room to maneuver without sacrificing the fiscal discipline at the national level or the Union's financial stability.

The EDA would contribute to market stability not only because it would eliminate refinancing risk, but also because it would provide markets with the safe asset they have so far lacked. The Eurobond that the EDA would make possible would be as attractive for investors as American covered bonds and could therefore greatly contribute to the EU's geopolitical position. This touches on the legitimate ambitions, also pursued by Germany, of a foreign policy capable of credibly positioning Europe in the concert of major global players. Above all, a truly European safe asset would stabilize the portfolios of institutional investors (insurance companies and pension funds) and would have a significant impact on agent expectations, as can be seen in the United States. It is for these two reasons that a large stock of European safe assets is, in fact, an urgent need. A significant and growing supply of safe assets issued by the EDA would give investors an alternative to the sovereign bonds of central eurozone countries and would help put an end to the anomaly of negative returns without going through the politically unrealistic process of mutualization.

Furthermore, by progressively replacing national debt with Eurobonds, the EDA would put an end to the "vicious circle" which currently links a state's solvency to its banking systems, and vice versa. Investor "home bias" would disappear and the euro area would become more uniform, making completion of the banking union that much easier.

As for monetary policy, the creation of the EDA would exempt the ECB from the obligation of indefinitely pursuing its quantitative easing (QE) programs. Freed from the task of reducing spreads, the ECB could focus on its mandate, namely controlling inflation and helping to fill production gaps, which is particularly important at the moment. No longer having to ensure the debt sustainability through purchasing programs, the European Central Bank could choose the size of its balance sheet based solely on its own objectives and monetary policy by deciding how quickly to move away from QE.

The EDA is an essentially technical institution because it does not have the (in fine political) task of determining fundamental risk. Creation of the EDA would, in fact, entrust EU institutions with evaluating the condition of each country's public finances. This evaluation would include an analysis of debt viability, how well fiscal policy conformed with reformed rules (which would hopefully be more effective than previous ones), consideration of the macroeconomic context, and the national policy coordination with the ECB. In short, this task should be policy based and not technocratic, as is already the default today, but not in a sufficiently transparent manner. Once the EU bodies have given their evaluation of fundamental risk, the EDA would determine installments in a non-arbitrary manner based on its algorithm and price determination.

Last but not least, while it is true that the EDA can function perfectly well without any explicit or hidden form of mutualization, this does not rule out the possibility of it working in a mixed framework – i.e., a framework in which a centralized fiscal capacity is combined with national policies. The EDA could manage different loan portfolios for member states and the Commission by creating separate sub-portfolios (both mutualized and non-mutualized).

The advantages that would come from the Agency are obvious for member states who, like Italy and Spain, have been hit by successive waves of market pessimism, which has led to exorbitant and often unjustified financing costs. The EDA would filter market expectations, which weighed too heavily in the formation of bad equilibriums during the sovereign debt crisis. It would also benefit states, like France, who would have significant difficulties in maintaining their rating without drastically

reducing their debt. Finally, the Agency would also benefit countries, like Germany, who currently "benefit from" negative returns on their debt, since negative returns are a time bomb for private savings, retirement systems, and the insurance sector.

To recap: the idea of the EDA as a structural solution, which is rather unorthodox at first glance, has several characteristics which could make it politically viable:

1. The first and most important is that the absence of mutualization on which its operations would be based would de facto eliminate the moral hazard and any incentive to act like a freeloader.
2. It would stabilize financial market expectations and provide them with a safe asset.
3. Replacing the ECB in the financing of member states would facilitate the normalization of monetary policy, allowing the ECB to resume its primary role.
4. Last but not least, the EDA could be designed to support and effectively manage public debt with any type of governance, whether it is in a central fiscal capacity or a renewed role for national policies. In a complex (political and institutional) context like Europe's, this does not seem to be the only argument in favor of our proposal.

It is clear that the discussion around the role of fiscal policy, the desirable level of debt, use of resources, and the division of "federal" and national spending is a political discussion; yet it is imperative that the discussion happens at the political level of elected governments as well as the level of representative European bodies. The illusion of purely technocratic economic policy is largely responsible for past dysfunction in the EU. The Debt Agency could not, and above all should not be a substitute for democratic bodies in making political decisions such as determining the public budget or the use of funds. Nevertheless, by optimizing the cost of financing fiscal policy and protecting debt from market volatility, the agency would allow discussion in a context of stability and clarity about the costs and benefits of budgetary choices. Designed as such, it would represent an important advancement in the evolution of European economic governance.