

REVISING ECB OPERATIONS AND EURO AREA FISCAL RULES TO SUPPORT GROWTH AND EMPLOYMENT

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Some undisputed propositions

- The main goal of the Euro Area was to produce a single financial market
- The euro area has a single currency, a single central bank, a single monetary policy, but it does not have a single financial market
- A single financial market requires that all financial operators refer and have access to the same set of risk-free assets (yield curve) for pricing risks and for liquidity management
- Fiscal sovereignty in the EA means that national operators face 19 different yield curves. Structurally, this is not a single financial market
- The ECB is managed as if it were the central bank of a federal state, while it is the CB of a coalition of states. The efficacy of the geographical transmission of monetary policy critically depends on the convergence among sovereign conditions. Common fiscal rules and macro-constraints are not able to produce sovereign homogeneity
- Thus, we can have financial convergence, not financial integration. But, as the recent crisis has shown, convergence is fragile
- Other relevant implication is that structural differences in national funding costs produce structural differences in the cost of credit, especially for SMEs and households. The absence of a single financial market limits the singleness of markets for firms, goods and services

Creating the structural basis for the single financial market

- The solution to the EA's original sin is normally seen in some form of sovereign debt mutualisation, like euro bonds. In the current and foreseeable political conditions this is not practicable
- The solution that I propose for creating the single financial market is based on a reform of ECB operations that does not require any changes in the existing EU treaties
- The ECB can already issue Debt Certificates (DCs). There are no statutory limits for issuing DCs in the amounts and range of maturities necessary to produce the required single yield curve, which would be a really risk-free yield curve
- The ECB would match this emission by buying an equal amount of sovereign debt in the secondary market, according to the capital key of each EA country
- The ECB would accept only DCs as collateral in its operation with banks and only use DCs in its open market operations. The issuance of DCs would respond to the market's demand for liquidity. DCs would thus become one of the main policy tools of the ECB

Fiscal implications

- The object of this operational reform is to create a single financial market and to manage its liquidity, not to deal with the sovereign debt problem
- However, the reform has relevant fiscal effects:
 - Being less risky than the average EA sovereign debt, DCs produce a new seigniorage that the ECB would pay back to EA countries according to their capital key, thus giving them some fiscal space
 - The ECB acquisition of sovereign debt would decrease the debt held by the market which would then command a lower return and would become the reference for debt sustainability
- It could be objected that the reform would introduce moral hazard and weaken the current fiscal rules: Debt/NGDP \leq 60% and structural fiscal deficit \leq 0.5% (1%). If Debt/NGDP $>$ 60%, a fiscal surplus is needed to go under 60% in 20 years
- I argue that, on the contrary, the reform would permit to redesign the fiscal rules in a way that would better enable debt discipline, not secondarily by avoiding the current self-defeating fiscal stance

- The acquisition by the ECB of sovereign debt means that

$$(1) D \downarrow T = D \downarrow M + D \downarrow B$$

- Where T stands for total and M and B for debt held by the market and by the ECB
- Because $D \downarrow B$ would respond to the market demand for liquidity, we may suppose that its growth is linked to the growth on nominal income (g)

$$(2) D \downarrow B = a \cdot g$$

- Because the increase of total debt is equal to the fiscal deficit (F), from (1) and (2) we obtain:

$$(3) -D \downarrow M = a \cdot g \cdot D \downarrow B(-1) / D \downarrow M(-1) - F / D \downarrow M(-1)$$

Dynamic nature of the present proposal with respect to the schemes that focus on debt

- Because, apart from a and D_M at time zero, the variables would be related to individual EA countries, we may write:

$$(4) -D \downarrow M \downarrow i = a \cdot g \downarrow i \cdot K \downarrow i \cdot D \downarrow B(-1) / K \downarrow i \cdot D \downarrow M(-1) - F \downarrow i / K \downarrow i \cdot D \downarrow M(-1)$$

Where $K \downarrow i$ is the specific capital key of each EA country

- The dynamic path of the decrease of $D \downarrow M i$ depends on $a, D_B/D_M, g_i, K_i, F_i$

Simulation with 2014 debt values

Two hypothesis on initial $D\downarrow B$:

- H1, 1/3 of total public securities (€ 2.5 trillion, 27% total debt)
- H2, 1/2 of total public securities (€ 3.7 trillion, 40% total debt)

Since the emission of DCs would substitute current extraordinary measures, the net effect on ECB balance sheet would be:

- H1 = + € 0.5 trillion; ECB total assets € 3.3 trillion
- H2 = + € 1.7 trillion; ECB total assets € 4.5 trillion

Countries going immediately under the 60% constraint

	H1	H2
Austria	-	x
Estonia	x	x
Finland	x	x
France	-	x
Germany	x	x
Latvia	x	x
Lithuania	x	x
Luxemburg	x	x
Malta	x	x
Netherlands	x	x
Slovakia	x	x
Slovenia	x	x
Spain	-	x
Total	10	13

- The ECB debt acquisitions reinforce the effect of NGDP growth. Because fiscal rules are ancillary to debt sustainability, it is not necessary to maintain the current rules on fiscal deficit below the 60% constraint
- This is shown formalising two alternative strategies

S1: constant $D \downarrow M$

$$(6) 0 = a \cdot g \downarrow i \cdot K \downarrow i \cdot D \downarrow B(-1) / K \downarrow i \cdot D \downarrow M(-1) - F \downarrow i / K \downarrow i \cdot D \downarrow M(-1)$$

- From which:

$$(7) F \downarrow i = a \cdot g \downarrow i \cdot K \downarrow i \cdot D \downarrow B(-1)$$

- This fiscal deficit allows a decrease of D_M/Y

S2: constant D_M/Y

$$(9) -g \downarrow i = \alpha \cdot g \downarrow i \cdot K \downarrow i \cdot D \downarrow B(-1) / K \downarrow i \cdot D \downarrow M(-1) - F \downarrow i / K \downarrow i \cdot D \downarrow M(-1)$$

From which

$$(10) F \downarrow i = \alpha \cdot g \downarrow i \cdot K \downarrow i \cdot D \downarrow B(-1) + g \downarrow i \cdot K \downarrow i \cdot D \downarrow (M-1)$$

S2 permits a higher deficit than S1

- If we want to maintain a higher cushion of safety for debt, the two previous strategies could be converted into rules, e.g. complying with S1 for indebtedness between 60% and 30%, and with S2 below 30%.

Simulation of the new rules for Germany: starting values 2014, H1 and H2

- H1: Before reaching 30% the permitted fiscal deficit would not be different from the current 1%. However, the cost of total debt would be increasingly reduced, thus giving new space to public expenditure and/or taxes
- H2: the reflationary effect would come earlier and would be much more relevant

Years	H1					H2				
	D _T /Y	g	D _M /Y	D _B /Y	F/Y	D _T /Y	g	D _M /Y	D _B /Y	F/Y
0	74	4.5	53	22		74	4,5	42	33	
1	72	4.5	50	22	0.94	73	4,5	40	33	1,42
2	70	4.5	48	22	0.94	71	4,5	38	33	1,42
3	68	4.5	46	22	0.94	69	4,5	36	33	1,42
4	66	4.5	44	22	0.94	68	4,5	35	33	1,42
5	64	4.5	42	22	0.94	66	4,5	33	33	1,42
6	62	4.5	40	22	0.94	65	4,5	32	33	1,42
7	61	4.5	39	22	0.94	63	4,5	31	33	1,42
8	59	4.5	37	22	0.94	62	4,5	29	33	1,42
9	57	4.5	35	22	0.94	62	4,5	29	33	2,67
10	56	4.5	34	22	0.94	62	4,5	29	33	2,67
11	54	4.5	32	22	0.94					
12	53	4.5	31	22	0.94					
13	52	4.5	30	22	0.94					
14	52	4.5	30	22	2.22					
15	52	4.5	30	22	2.22					

All variables are expressed as %

Debt dynamics of the more indebted countries

- With the 10 or 13 countries adopting the previous new fiscal rules the current EA fiscal deflationary stance would convert into a reflationary one. This would also benefit the growth of NGDP of the more indebted countries.
- Imposing $F = 0$ until the debt ratio is higher than 60%, the table shows the number of years for the remaining six countries to go below the debt ceiling

	g, %	H2
Belgium	4	4
Cyprus	3.5	1
Greece	3	14
Ireland	4.5	4
Italy	3.5	8
Portugal	3.5	4

- Lower cost of debt and no fiscal surplus required above 60%
- Much shorter period to comply with 60%

Enforcement

- It is possible to devise rules that are less discretionary and provide stronger incentives than the current ones
- Example: not complying with the new rules for two or more years in a five year period the country would be expelled from the scheme, going back to the old much less favourable rules

- Results

- Creation of the single financial market for the Euro Area
- Deepening of the single market for firms, goods and services
- The ECB's monetary policy would be geographically effective
- Elimination of the sovereign-bank vicious loop
- Much shorter sovereign deleveraging period
- Conversion of the existing deflationary stance into a reflationary one
- Fiscal space instead of excessive monetary easing (which produces negative effects on financial resilience)
- Fiscal flexibility for unforeseen needs and asynchronous cycles

- Further suggestions

- Obligation to use the acquired fiscal space for public investments
- EU non-EA countries should be allowed to follow the new fiscal rules if adopting the proposed reform for their CB
- Adopting effective rules to limit sovereign indebtedness, the reform could be adopted by any country



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THE ECB, THE SINGLE FINANCIAL MARKET, AND A REVISION OF THE EURO AREA FISCAL RULES

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