



Completing the Single Financial Market and New Fiscal Rules for the Euro Area

MARIO TONVERONACHI

December 11, 2015

The eurozone crisis made it clear that while member countries share a common currency, they do not share a single financial market. Until market participants across the euro area face a single risk-free yield curve rather than a diverse collection of quasi-risk-free sovereign rates, financial market integration will not be complete. Unfortunately, the institution that would normally provide the requisite benchmark asset—a federal treasury issuing risk-free debt—does not exist in the euro area, and there are daunting political obstacles to creating such an institution.

There is, however, another way forward. The financial instrument that could provide the foundation for a single financial market already exists on the balance sheet of the European Central Bank (ECB): legally, the ECB could issue “debt certificates” (DCs) across the maturity spectrum and in sufficient amounts to create a yield curve. Moreover, reforming ECB operations along these lines may hold the key to addressing another of the euro area’s critical dysfunctions. Under current conditions, the Maastricht Treaty’s fiscal rules create a vicious cycle by contributing to a deflationary economic environment, which slows the process of debt adjustment, requiring further deflationary budget tightening. By changing national debt dynamics and thereby enabling a revision of the fiscal rules, the DC proposal could short-circuit this cycle of futility.

Under the envisioned proposal, the ECB would issue DCs according to the liquidity needs of the area and its monetary policy objectives and match this issuance with the purchase of national sovereign debt on the secondary market, with purchases made on the basis of the capital key of each euro-area country. The ECB would no longer accept sovereign bonds as collateral in its operations with banks, and the proceeds from the central bank’s newly earned seigniorage (the difference between the risk-free DCs and the higher-yielding national sovereign bonds) would be remitted to national governments, again on the basis of capital keys. Although concerns about fiscal moral hazard at the national level would likely be front and center, such objections are misplaced. This reform of ECB operations would hasten the rate at which many countries drop below the Maastricht Treaty’s ceiling on public debt ratios, and enable adherence to an even more demanding standard of debt sustainability.

Even assuming a scenario at the low end of the range, in which the ECB buys one-third of total public securities, the proposal would put some countries’ ratios of market-held debt to GDP immediately below the 60 percent threshold. For the rest, the greater the ECB’s initial issuance of DCs—and thus the greater the corresponding acquisition

of national sovereign debt—the faster these debt ratios would fall. The rate of debt adjustment would also accelerate with higher GDP growth, which makes revision of the budget rules crucial.

The proposal would create additional fiscal space at the national level by reducing the amount of sovereign debt held by the market and improving its rating, thus lowering debt service costs, and through the ECB’s remittance to national governments of the seigniorage the central bank would earn. At the same time, the change in debt dynamics ushered in by the proposal would render the current fiscal rules obsolete. The Maastricht Treaty’s fiscal targets should be understood as mere means to achieving its standard of debt sustainability. But the DC proposal significantly changes what fiscal stance would be required to reach a debt ratio below 60 percent of GDP, or lower.

Countries above the 60 percent Maastricht threshold could run balanced budgets—rather than attempting to run fiscal surpluses, as currently required—while their market-held debt (and total debt) would still decline as a percentage of GDP. For countries with debt ratios below 60 percent of GDP, the current ceiling on structural deficits of 0.5 percent of GDP would not be necessary; such countries would be free to adopt whatever deficit strategy was compatible with the Treaty’s debt constraint. Alternatively, if a more demanding standard of debt sustainability were sought—such as a debt ratio of 30 percent of GDP—countries with debt ratios between 30 percent and 60 percent could run whatever fiscal deficit was consistent with a declining debt ratio, while countries with debt ratios below 30 percent would be required to run whatever level of fiscal deficit would maintain a constant ratio of market-held debt to GDP.

A revision of the fiscal rules along these lines would entail significant fiscal easing, which would raise the overall rate of growth in the euro area and facilitate adjustment for the highly indebted countries. Public investment could begin to recover across the area, and member countries would have greater flexibility to respond to unforeseen events and cyclical downturns. With a more credible design in place, the euro might begin to look more like a project with a viable future rather than a historic mistake.

A more detailed discussion of the issues can be found at www.levyinstitute.org/publications/the-ecb-the-single-financial-market-and-a-revision-of-the-euro-area-fiscal-rules.

MARIO TONVERONACHI is professor of political economy at the University of Siena.