Making the ECB the Central Bank of a Non-Federal Coalition of States

Conference on
Europe at the crossroads: A Union of Austerity or Growth Convergence?
Session on *European Monetary Policy and Market Flexibility*

Athens, November 21-22, 2014
Organised by the Levy Economics Institute and *Economia civile*

Mario Tonveronachi
University of Siena and Economia civile

An inconsistent design of a currency union

- It is now widely held that, lacking political union, the design of the Euro Area is incomplete
- After 20 years from signing the Maastricht Treaty a significant political unification appears to be even more remote. Instead of pushing for political unification, the half-baked design is producing political fragmentation
- We must realistically recognise that the design is just inconsistent
- I propose to look at two fundamental inconsistencies:
  - A central bank modelled on a federal state, but serving a non-federal coalition of states
  - The goal to build a single monetary and financial market absent a common set of risk-free assets

Effects of the inconsistent design: the ECB

- The ECB is the only central bank in the developed world that relies only on banks to manage liquidity, thus leaving the private system to determine the size of its balance sheet, net of bank deposits at the central bank
- Despite its Chart allows the ECB to use open market operations as a standard tool of monetary policy, political and ideological problems *de facto* impede them
- According to the Guardians of the Treaty, if the ECB buys sovereign bonds it produces sovereign moral hazard and fiscal transfers. The OMT was born dead and was just an ‘open mouth operation’
- According to the Guardians of the ECB’s capital, if the ECB does not buy high quality financial assets it becomes a bad bank. How much high quality financial assets are available in the EA markets?
- The result is that the ECB may come to adopt unorthodox policies only when disaster looms, hence too late and, however, with interventions that are too limited in size

Effects of the inconsistent design: financial markets

- We are told that the recent crisis has de-integrated the financial markets of the Eurozone. In reality, it has magnified their pre-existing fragmentation
- This because national financial markets were not integrated. In the pre-crisis period we experienced <u>convergence</u> not <u>integration</u>
- Convergence is fragile, and fiscal rules, like the Fiscal Compact, may at best produce only temporary convergence
- A single financial market needs a unique issuer of risk-free assets, which are necessary for efficient market pricing, to price liquidity (yield curve), and as the favoured way to keep liquidity buffers and to post collateral
- Absent a common risk-free issuer, local financial conditions remain linked to the local sovereign and when sovereigns drift apart, local finance follows

What about the Banking Union?

- The promoters of the BU assert that it cuts the link between bank and sovereign crises, thus de-fragmenting the EA financial markets
- The BU is a necessary condition for a single financial market, but not a sufficient one. At best, but it is far from sure with the current design, it might avoid that bank crises affect public finance. The dependence of domestic financial conditions on national sovereigns will go on lightly disturbed
- The recent ECB-EBA comprehensive assessment applies heterogeneous haircuts to sovereign bonds held by banks. The same is true for the ECB's refinancing operations. The fragmented nature of the EA financial system is thus recognised as a stable feature

Reforming the ECB, not the Treaties

- My proposal is to take as given the political framework coming from the existing Treaties, and to reform the operational framework of the ECB in order to create the necessary basis for the single financial market

- To be clear, the proposal addresses the problem of the single financial market, and does not deal with the problem of the sovereign debt overhang and with the deflationary nature of our fiscal rules

- Furthermore, creating the conditions for the existence of the EA single financial market, the proposal would work both in normal and stressed times

- Given all the financial plumbing already existing in the EA (banking union included), how could we achieve this result?

Reform of the ECB's operations

- The ECB would emit Debt Certificates (DCs) covering the entire maturity spectrum of a normal yield curve
- The ECB would balance these emissions with the acquisition, in secondary markets, of sovereign bonds of the euro area in proportion of each country contribution to its capital
- The ECB would not accept sovereign bonds, but its own DCs, as collateral in its refinancing operations. This would push financial intermediaries to exchange sovereign bonds held for liquidity reasons (available for sale) with DCs
- To limit the role of the DCs to their liquidity function inside the euro area, only financial operators incorporated as firms in the EA could hold and trade them. This because DCs must serve as benchmark and for the EA's liquidity management, not for investment purposes
- A secondary market for DCs would be created and the ECB could use it for its open market operations

Effects of the reform

- With the ECB policy of containing inflation credible, DCs would be perfectly credit risk-free. A new seigniorage would derive from the difference with the average return from holding treasuries, which would be distributed back to countries according to their quotas in ECB capital. Positive moral hazard

- Financial operators all over the EA would face a single risk-free yield curve and a highly liquid DC market, which would disconnect their funding costs from local sovereign (obviously not from local economies)

- The ECB could operate full-fledged open market operations in DCs along the entire spectrum of maturities, not just short-term repos operations as it is currently obliged to do in order not to influence the markets of national sovereign debt

- The amount of DCs would derive from the liquidity needs of the EA's financial operators and would be totally independent from the dynamics of the member countries' public debt

Compliance with the Treaties

- The acquisition of sovereign bonds in secondary markets complies with the letter of the Treaties. Acquiring them for managing the liquidity of the area would also complies with the spirit of Maastricht, being a necessary tool for the working of the single financial market
- The ECB interventions would in no way be related to keeping sovereign interest rates sustainable, a questionable policy in terms of the existing Treaties
- Although they were never utilised, the DCs are included in the ECB financial accounts among the 'structural' tools foreseen for its open market operations, and its Chart does not fix limits for their amount and typologies
- However, could eventual restructuring of sovereign debt produce losses to the ECB capital, thus bringing us back to the political problem of sovereign debt mutualisation?

Central banks prisoners of old modes of thought

- The strange thing for central banks emitting paper money is presenting financial statements as if they were managing a non-fiat monetary standard. Like normal banks, their capital is computed as the difference between the value of assets and liabilities, which includes central bank's money
- Since central bank money is irredeemable, it is nonsense to treat it as a liability
- As far as central bank money is accepted (control of inflation), seigniorage puts a central bank in a Minsky hedge position. Its capital, computed as the present value of the future flows of seigniorage, is always positive

Central banks prisoners of old modes of thought

- The same would be true for the seigniorage coming from the DCs: the average future outflows for serving DCs would be lower than the interests coming from a differentiated portfolio of sovereign bonds, so that changes in the value of the latter are irrelevant

- To soothe orthodoxy, a safeguard could be included by means of a special fund financed by retaining in the first few years the DCs seigniorage

THANK YOU