Monetary-fiscal interactions in the euro area

Presentation
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based on *Reforming the Euro – Lessons From Four Crises* [work in progress],

by *John Cochrane, Luis Garicano*, *and Klaus Masuch*

The presentation reflects solely our own views, not necessary those of our current or previous employers or institutions, incl. the Executive Board or the Governing Council of the ECB.

Overview

- **Founding architecture** of the euro: monetary union **without fiscal union**
- Maastricht treaty: **monetary-fiscal separation**, but also a few **missing parts**
- Some **institutional differences** between the **ECB and the Fed**
- **Four crises** test the founding architecture
  - **Large ECB** balance sheet and **footprint**
  - **Sovereign-bank nexus** risks
  - Did **fiscal rules** work?
- Proposals for a medium-term **reform package**

The Founding Architecture of the euro: monetary union, no fiscal union

EU and the Euro are wonderful ideas/institutions. Our aim is to preserve, strengthen them.

Fundamental philosophy: monetary union, **no fiscal union,** clear monetary-fiscal separation

- ECB's "primary objective" is price stability,
- great independence, prohibition of monetary financing
- debt and deficit limits for member states,
- "no-bail out" principle for public debt

⇒ **sovereign default** as ultimate "solution" in case of public debt overhang in a member state is necessary for such a monetary union to function well and set proper incentives

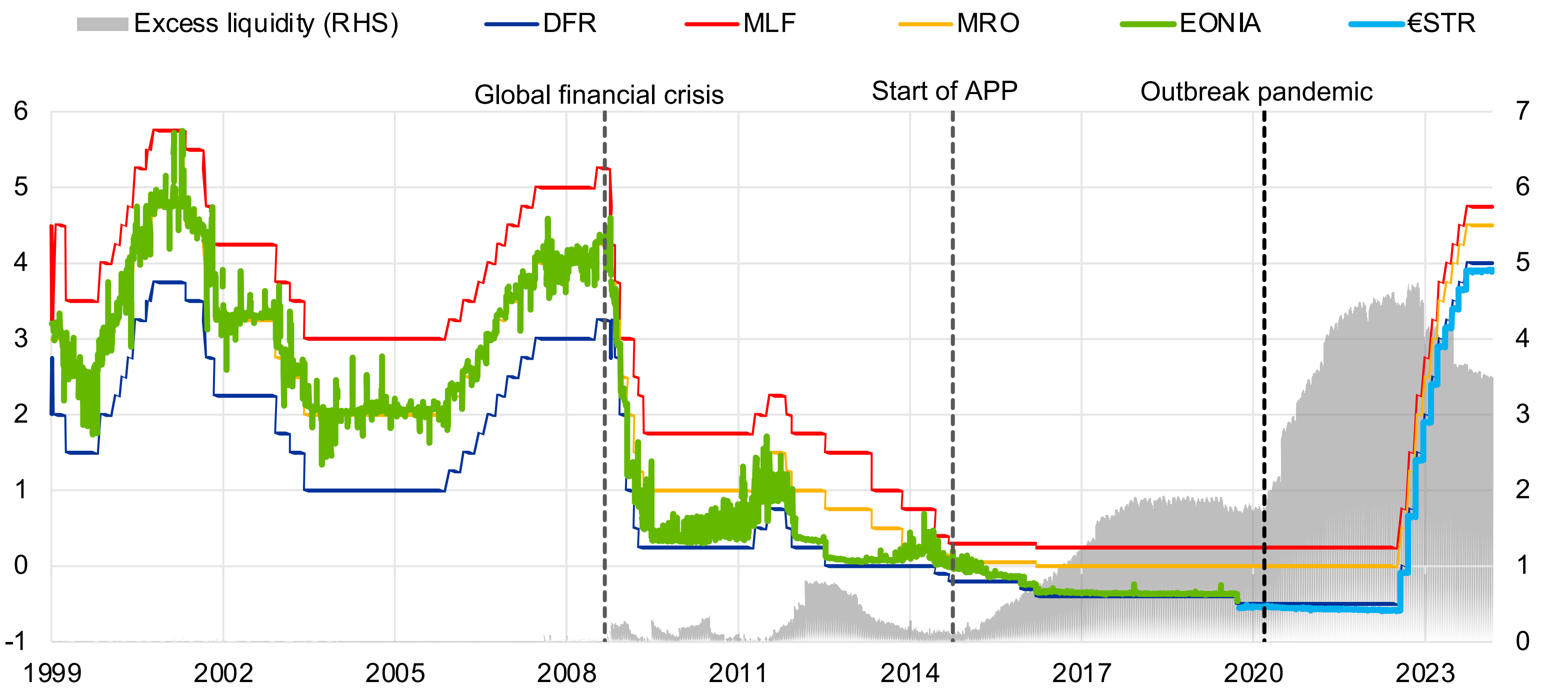
Consistent with founding philosophy, in first decade the **ECB** held a small balance sheet,

- with no excess reserves, steered money market rates within corridor,
- created new money via loans to banks against high quality collateral,
- did not buy any sovereign debts.

ECB was made clear that it would **not support individual member states in trouble**

Before 2008: No excess reserves, the ECB steered EONIA to the middle of the corridor

Key ECB interest rates, overnight rate and excess liquidity *(left-hand axis: %; right-hand axis: EUR trillion)*



Sources: MMSR, MOPDB, SDW.
Note: DFR = Deposit Facility Rate, MLF = Marginal Lending Facility Rate, MRO = Main Refinancing Operation Rate, EONIA = Euro Overnight Index Average, €STR = Euro Short-Term Rate.
This and other some other Charts are taken from: Isabel Schnabel, The Eurosystem's operational framework, 14 March 2024

The Founding Architecture was consistent with no fiscal union, but incomplete

Like all great institutional innovations, the treaty had **missing parts**, did *not* explicitly establish: **how countries could default** on sovereign debt within the monetary union,

- how **banks and financial systems** would be **insulated from default** (*No* regulatory risk weight on risky sovereign debt => bank–sovereign nexus risks)
- a fiscal or balance of payment **crisis resolution body** *(No "European IMF")*
- **banking union** (*No* common banking regulation, supervision, deposit insurance)

=> In interaction with adverse shocks, risks to distort incentives and create vacuums.

Four crises (2007/8-2023): ECB continued to aim at price stability. In doing so, given the missing parts of the architecture, moved towards interventions with significant fiscal implications and, as a side effect, also provided notable balance of payment support for several member states.

Some institutional features (differences between the ECB and the Fed)

Eurosystem comprises: ECB plus 20 national central banks (NCBs).

- **Eurosystem capital**: sum of capital of 20 NCBs.
- **NCBs** still have national, non-monetary policy tasks, including lender of last resort lending to solvent banks with liquidity problems (ELA).
- **ECB profits**: distributed to NCBs and then to respective national governments.

ECB sovereign bond purchase programs: mainly debt of *member states*. In 2022, the ECB/NBCs held one-third of the nominal amount of all outstanding sovereign bonds.

- … two types: supporting bond prices …
  1. of ***specific*** member states (MS) to ensure a smooth monetary policy transmission – [SMP (2010), OMT (2012), *flexibility* of PEPP (2020), TPI (2022)].
  2. *of **all** MS* (QE-type; capital key): monetary accommodation – [PSPP (2015), PEPP (2020)]

Policies and institutional changes during four crises (MS=member states)

- **2003-4**: Germany and France undermine fiscal rules
- **2009-11**: ECB supports bond prices of fiscally troubled countries, (without conditionality decided by member states).

  Italy (and Spain) reject EU/IMF programme (2011)
- **2010-11**: No early debt restructuring in Greece.

- **2014-15**: SSM asset quality review and stress test
- **2013**: CY: Protection of tax-payers via bail in of bank creditors
- **2012**: ECB's OMT with ESM loans, conditonality decided by MS
- **2011-14**: Institutional reforms decided by MS: (ESM, SSM, Fiscal compact, BRRD)
- **2012**: Greek public debt restructuring supports credibility of no bail-out

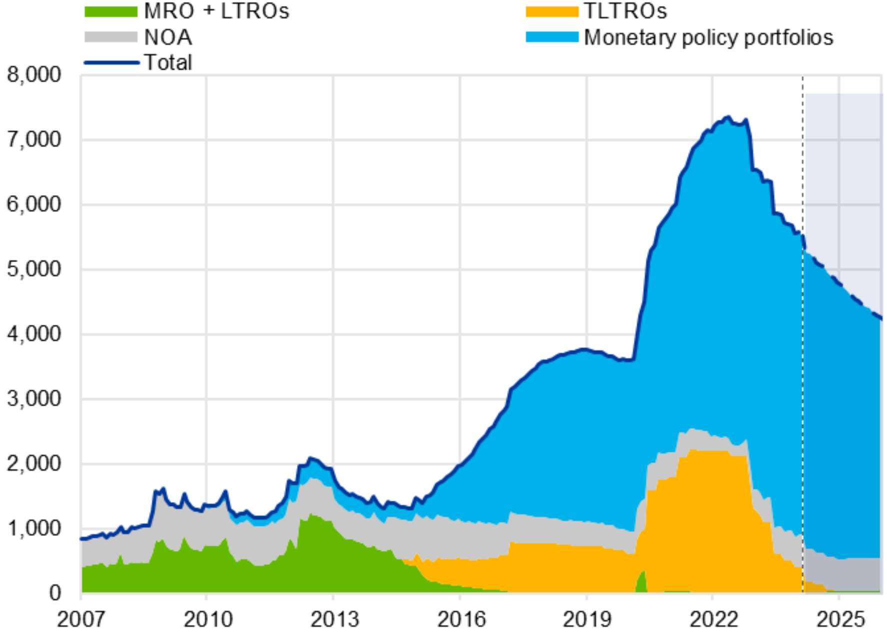
- **2014-19**: Large countries fail to lower high public debt in good times.
- **2014-23**: No *regulatory* progress on common deposit insurance or sovereign exposure of banks
- **2022-23**: ECB purchases bonds during high inflation
- **2022**: TPI to support prices of bonds of troubled sovereigns also without ESM conditionality
- **2020-23**: Some MS: higher debt/GDP in 2023 rel. to 2019 (pandemic, energy) in spite of high inflation
- **2020**: **NGEU:** cross-country **fiscal** transfers

Three phases of increases of ECB balance sheet and excess reserves

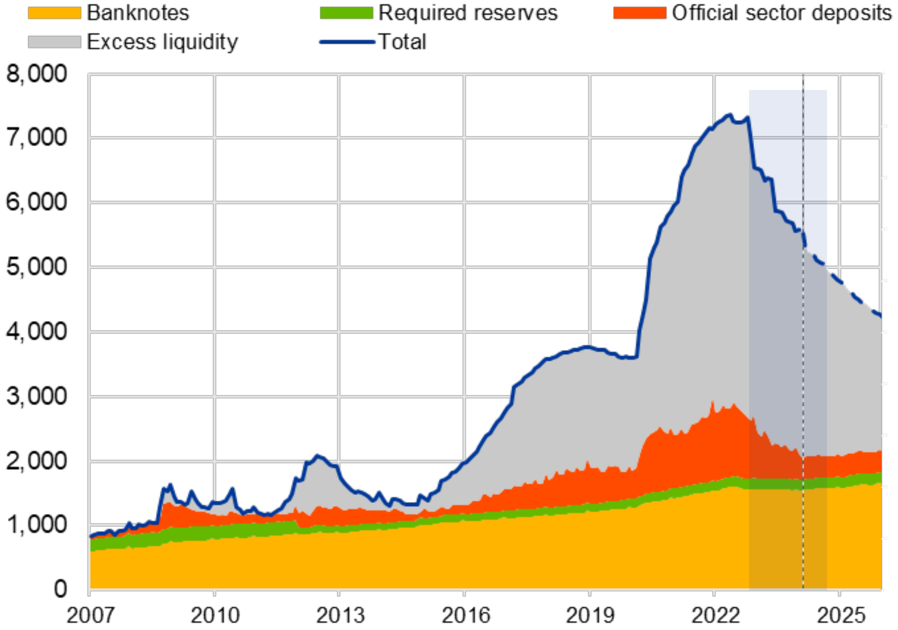
Eurosystem balance sheet: actual and projected

(EUR billion)

Asset side



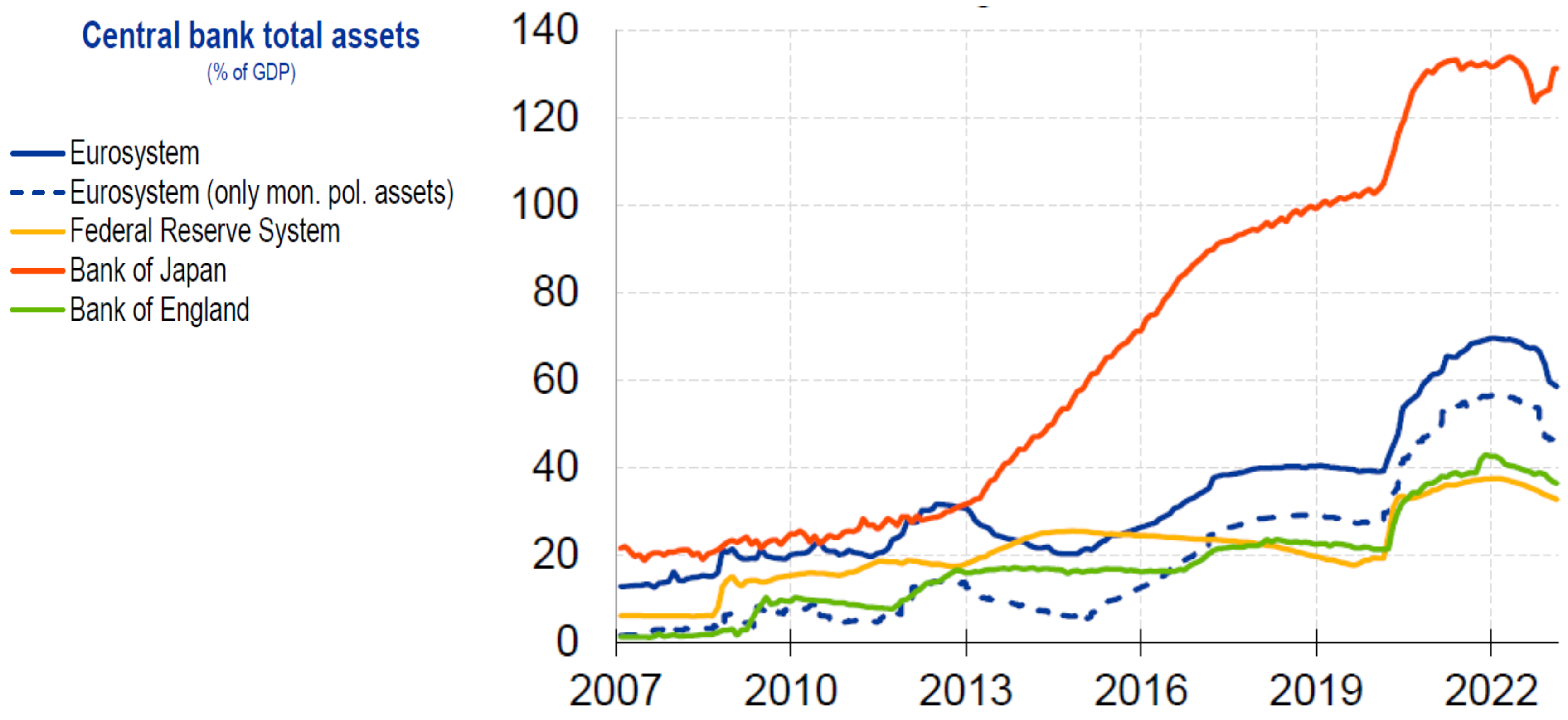
Liability side



Sources: ECB, ECB calculations.

Notes: NOA stands for net other assets. The main assumptions behind the projections are the following: the future paths of the monetary policy portfolio, MRO and 3-month LTRO participation are based on the median expectations by analysts as reported in the latest SMA surveys; the projection of banknotes is based on ECB internal models.

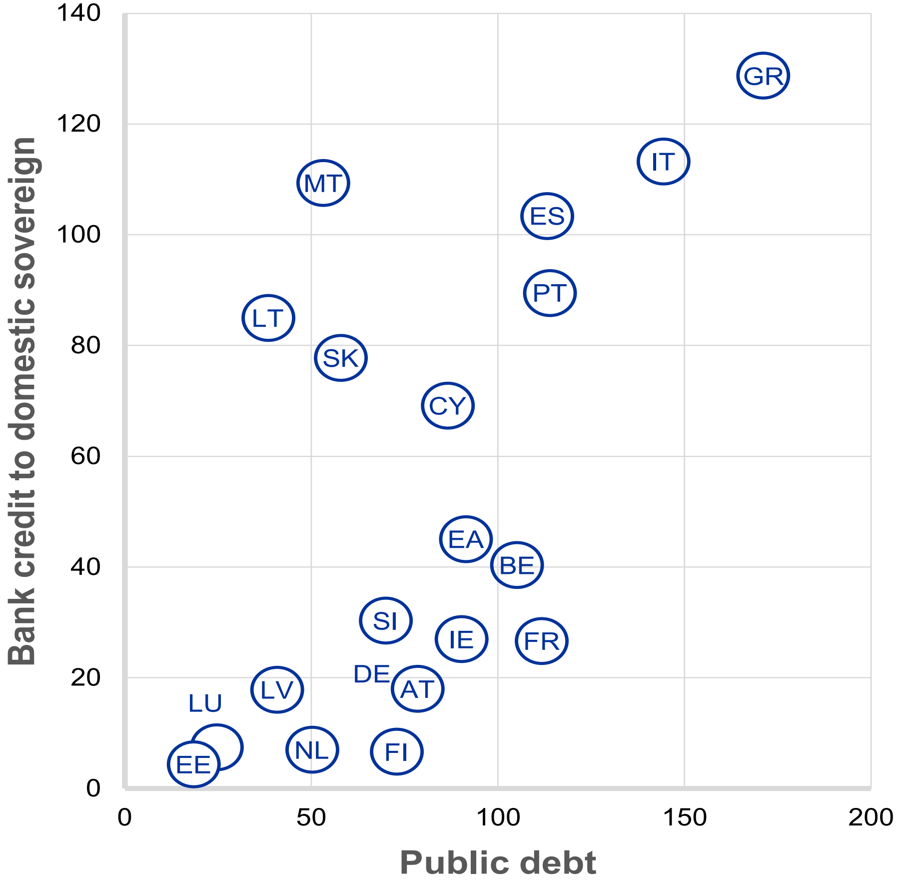
ECB balance sheet, excess reserves



Source: Bloomberg.
Note: Series based on a 22-day moving average to smooth monthly data.
Last observation: 22 March 2023.

Bank credit to domestic sovereign (% of CET1 capital) and public debt (% of GDP)

Bank credit to domestic sovereign and public debt
(x-axis: percent of GDP,
y-axis: percent of bank CET1 capital)



Sources: Eurostat and ECB supervisory data (COREP and FINREP).
Note: CET1 refers to Common Equity Tier 1 capital.
Consolidated data referring to Q4 2022.

Chart taken form : "The euro area needs better structural policies to support income, employment and fairness. " ECB Blog, 11 October 2023.

*ECB loans to banks at **favourable** rates, based on **non-marketable assets** as collateral*

*" … discouraging banks from seeking market-based funding solutions … risks weakening resilience … may go **against the principle of an open market economy. ...***

*These risks are especially high when banks have access to **longer-term refinancing operations** and are permitted to pledge **non-marketable assets** as collateral …*

*… **could encourage banks to engage in excessive liquidity transformation**, as they receive Level 1 high-quality liquid assets (HQLA) by pledging non-HQLA as collateral**….***

*"first half of 2023 … **non-HQLA accounted for about 80%** of mobilised collateral … "*

Isabel Schnabel, The Eurosystem's operational framework, 14 March 2024

Did fiscal rules work for large MS?: not for some large countries

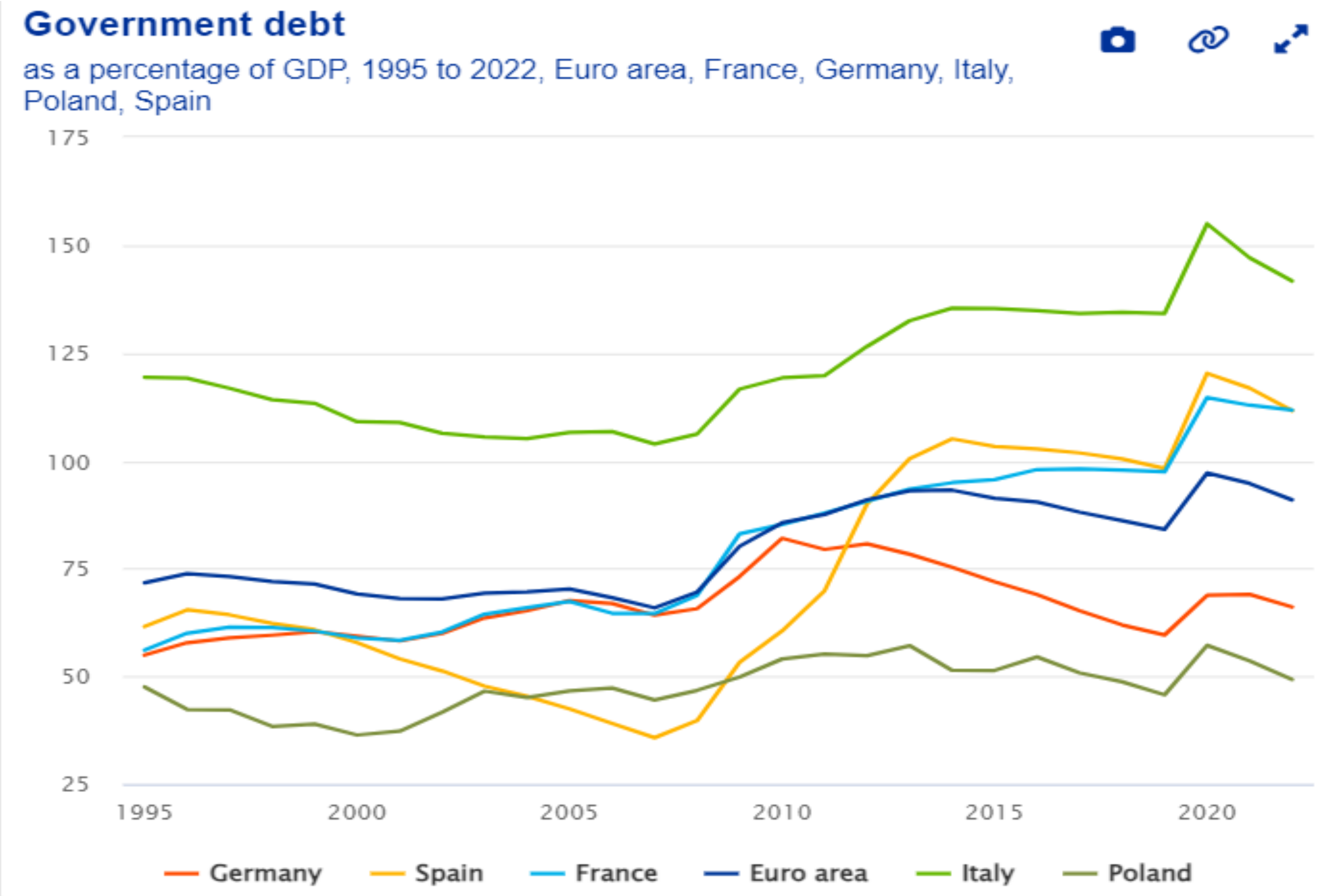


Table I.5.6: **Baseline: difference in total cost of ageing between 2024 and 2021 Ageing Reports (in pps of GDP)**

	2022	2070	Δ 2022-2070	of which in:					
				Δ 2022-30	Δ 2030-40	Δ 2040-50	Δ 2050-60	Δ 2060-70	
BE	0.5	0.9	*0.5*	-0.4	-0.5	-0.1	0.5	0.9	**BE**
BG	1.4	0.6	*-0.8*	1.1	-1.0	-0.6	-0.1	-0.1	**BG**
CZ	0.4	-0.4	*-0.8*	-0.9	0.0	-0.2	0.0	0.3	**CZ**
DK	-0.7	-1.1	*-0.4*	0.8	-0.2	-0.7	-0.6	0.3	**DK**
DE	0.6	-0.2	*-0.8*	-0.4	-0.3	-0.4	-0.1	0.4	**DE**
EE	-0.3	1.3	*1.5*	1.0	0.2	0.3	0.4	-0.3	**EE**
IE	-1.9	-2.5	*-0.6*	-0.9	-0.3	0.3	0.4	0.0	**IE**
EL	0.1	1.1	*1.0*	-0.5	1.2	0.9	0.2	-0.7	**EL**
ES	0.6	7.1	*6.5*	1.9	1.3	1.0	1.0	1.3	**ES**
FR	-0.5	0.5	*1.0*	-1.1	0.1	0.6	0.6	0.9	**FR**
HR	-3.0	-2.6	*0.5*	0.5	0.0	-0.1	-0.1	0.2	**HR**
IT	-0.5	-1.1	*-0.6*	-0.8	-0.4	-0.1	0.3	0.4	**IT**
CY	2.9	5.7	*2.8*	1.0	1.0	0.6	0.5	-0.3	**CY**
LV	0.7	0.1	*-0.6*	-0.5	0.1	0.1	0.2	-0.4	**LV**
LT	-1.1	2.5	*3.6*	1.2	0.7	0.7	0.7	0.3	**LT**
LU	-0.3	0.6	*0.8*	-0.8	0.0	-0.5	0.7	1.4	**LU**
HU	-1.4	-1.3	*0.1*	0.2	0.0	0.0	-0.1	0.0	**HU**
MT	-1.2	-0.3	*0.9*	-0.6	-0.5	-0.3	0.6	1.7	**MT**
NL	-0.6	-1.8	*-1.2*	-0.8	-0.8	-0.1	0.0	0.4	**NL**
AT	0.0	-0.3	*-0.3*	0.0	-0.5	-0.4	0.2	0.4	**AT**
PL	-2.8	-3.1	*-0.4*	1.1	-0.4	-0.1	-0.5	-0.4	**PL**
PT	0.0	1.1	*1.1*	-0.4	1.0	1.6	-0.8	-0.4	**PT**
RO	-4.8	-3.9	*0.9*	2.8	-1.4	-0.4	0.1	-0.3	**RO**
SI	0.7	-2.1	*-2.7*	0.0	-1.6	-0.9	-0.2	0.0	**SI**
SK	-1.2	-4.1	*-2.9*	1.2	-1.1	-1.4	-0.9	-0.7	**SK**
FI	-0.9	-0.8	*0.1*	0.1	0.2	-0.2	0.0	0.0	**FI**
SE	-1.1	-1.9	*-0.8*	0.6	-0.4	-0.4	-0.4	-0.4	**SE**
NO	0.1	-1.2	*-1.4*	0.1	-0.7	-0.3	-0.3	-0.1	**NO**
EA	-0.2	0.2	*0.5*	-0.5	-0.1	0.1	0.3	0.6	**EA**
EU	-0.5	-0.4	*0.1*	-0.3	-0.2	0.1	0.2	0.4	**EU**

Source: European commission, EPC.

Proposals mostly do not require a treaty change.

Monetary union without fiscal union is perfectly possible: it requires that over-indebted member states can restructure their debt in an orderly manner without a major financial disaster.

New institutions of facilities can be set up with **intergovernmental treaties** of those who are willing to move ahead.

The euro area needs a well-constructed **European fiscal institution (EFI)** for the management of fiscal troubles and balance of payment problems of member states.

Reform proposals – A European fiscal institution (EFI)

EFI can be an enhanced European Stability Mechanism (ESM), sufficiently capitalised.

No unanimity: Interventions at least require only qualified majority of participating countries. Only Member States who participate, will receive support.

EFI powers, tasks

- provision of **(super senior) loans** to member states in difficulties,
- purchases of national **sovereign bonds** at large discounts only,
- negotiations with member states about **conditionality/**adjustment program,
- **recapitalisation of banks** (after bail-in of shareholders, creditors),
- **technical assistance** for member states (incl. on reforms, debt restructuring)
- **issuing tradable Eurobonds** (incl. saving bonds to retail investors)
- regular **surveillance missions** to member states with published reports

Completing Banking Union and removing sovereign-bank nexus fragility

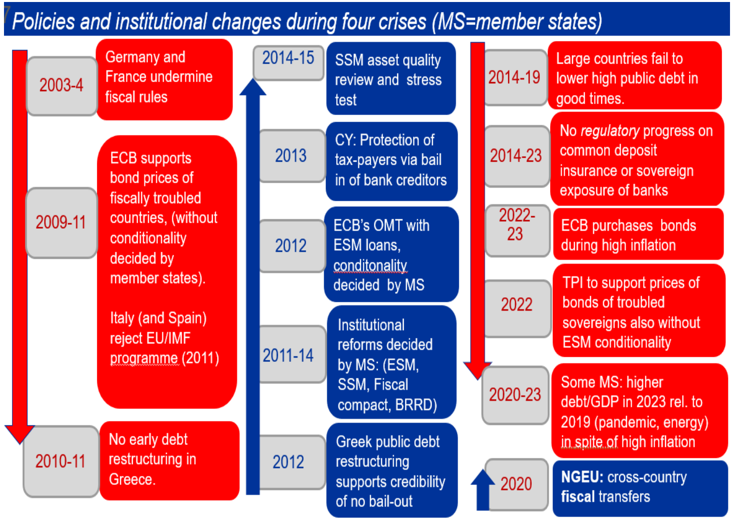
- **Sovereign risk** must be in the hands of investors and well-diversified financial institutions who can bear risk, not necessarily banks.
- Banks **must be de-linked from** influence from and protection by **national governments.**
- Appropriate **concentration charges or risk weights.**
- A **common European deposit insurance** with risk based insurance premia

The ECB would only purchase European debt issued either by EU Institutions, such as Commission, or euro area inter-governmental organisations, such as the ESM or the new EFI.

Outside a major systemic crisis, **the ECB would not subsidize banks relative to market conditions.** It would only allow non-marketable collateral for Emergency Liquidity Assistance (ELA), not for regular monetary policy operations (under fixed rates, full allotment approach).

Summing up

The past:



Proposals for the medium-term:

- Outside a major systemic crisis, the ECB would not subsidize banks relative to market conditions
- In steady state, ECB returns to a small balance sheet, only purchases European debt
- Completion of Banking Union and removing sovereign-bank nexus fragility
- Powerful European *fiscal* institution (EFI) for crisis management

Thank you for your attention!