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
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
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)]
<table>
<thead>
<tr>
<th>Time Period</th>
<th>Key Event</th>
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<tr>
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<td>Germany and France undermine fiscal rules</td>
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<td>No early debt restructuring in Greece.</td>
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<td>2011-14</td>
<td>Institutional reforms decided by MS: (ESM, SSM, Fiscal compact, BRRD)</td>
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<td>2012</td>
<td>ECB’s OMT with ESM loans, conditionality decided by MS</td>
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<td>CY: Protection of tax-payers via bail in of bank creditors</td>
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Three phases of increases of ECB balance sheet and excess reserves

Eurosystem balance sheet: actual and projected

(EUR billion)

Asset side

- MRO + LTROS
- TLTOs
- Monetary policy portfolios
- NOA
- Total

Liability side

- Banknotes
- Required reserves
- Official sector deposits
- Excess liquidity
- Total

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.
Central bank total assets (% of GDP)

- Eurosysterm
- Eurosysterm (only mon. pol. assets)
- Federal Reserve System
- Bank of Japan
- Bank of England

Source: Bloomberg.
Note: Series based on a 22-day moving average to smooth monthly data.
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 from: “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

Government debt
as a percentage of GDP, 1995 to 2022, Euro area, France, Germany, Italy, Poland, Spain
### Table 15.6: Baseline: difference in total cost of ageing between 2024 and 2021 Ageing Reports (in pps of GDP)

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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.
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:

- 2003-4: Germany and France undermine fiscal rules.
- 2010-11: No early debt restructuring in Greece.
- 2011-14: Greek public debt restructuring supports credibility of no bail-out.
- 2012: ECB’s OMT with ESM loans, conditionality decided by MS.
- 2014-15: SSM asset quality review and stress test.
- 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.
- 2014-20: ESB purchases bonds during high inflation.
- 2020-23: TPI to support prices of bonds of troubled sovereign also without ESM conditionality.
- 2020-23: Some MS: higher debt/GDP in 2023 rel. to 2019 (pandemic, energy)
- 2022-23: NGEU: cross-country fiscal transfers

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!