The ECB, the Single Financial Market, and a Revision of the Euro Area Fiscal Rules

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- The creation of the single internal market is the first pillar of the EU
- The main goal of the Euro Area was to produce a single financial market
- A single financial market requires that all financial operators refer to the same set of risk-free assets (yield curve) for pricing risks and for liquidity management
- Fiscal sovereignty in the EA means that the national operators of the 19 EA countries face 19 different yield curves. No 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 will never be able to produce sovereign homogeneity
- In these conditions we can have financial convergence, not financial integration and a single financial market. But, as the recent crisis has shown, convergence is fragile

- 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. Furthermore, mutualisation is proposed with even stricter fiscals rules, which would produce a stronger structural deflationary stance

- The solution that I propose is based on a reform of ECB operations that does not require any changes in the existing 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 for the EA, 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 and would be one of the monetary tools of the ECB

- The object of this operational reform is to create a single financial market and to manage its liquidity, not to deal directly with the sovereign debt problem
- However, the reform has relevant fiscal effects:
  - Being less risky than the average EA sovereign debt, the 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
- The guardians of austerity could object that the reform would introduce moral hazard and weaken the current fiscal rules: Debt/NGDP ≤ 60% and structural fiscal deficit ≤ 0.5%. 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

$$(1)\ D_T = D_M + D_B$$

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

$$(2)\ \dot{D}_B = a \cdot g$$

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

$$(3) - \dot{D_M} = a \cdot g \cdot \frac{D_{B(-1)}}{D_{M(-1)}} - \frac{F}{D_{M(-1)}}$$

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

- Because, apart from *a*, the variables would be related to each EA countries, we may write:

$$(4) - \dot{D}_{M_i} = a \cdot g_i \cdot \frac{K_i \cdot D_{B(-1)}}{K_i \cdot D_{M(-1)}} - \frac{F_i}{K_i \cdot D_{M(-1)}}$$

  - Where K_i is the specific capital key of each EA country

- The dynamic path of the decrease of D_M depends on a, g, $\frac{D_B}{D_M}$, F

  - With a 'neutral' monetary policy we may assume that a =1
  - Let us impose F=0 when debt held by the market is higher than 60%

Simulation with 2014 debt values

Two hypothesis on initial D_B
- H1, 1/3 of total public securities (=27% total debt, i.e. € 2.5 trillion)
- H2, 1/2 of total public securities (=40% total debt, i.e. € 3.7 trillion)

Net effect on ECB balance sheet substituting current extraordinary (largely ineffectual) measures
- H1 = + € 0.5 trillion; ECB total assets € 3.3 trillion
- H2 = + € 1.7 trillion; ECB total assets € 4.5 trillion

Advantages with respect to current rules
- Lower cost of debt and no fiscal surplus required above 60%
- Much shorter period to comply with 60% for highly indebted countries
- Many countries go instantly under the 60% ceiling

Number of years necessary to go under the 60% constraint

	g, %	H1	H2
Austria	3.5	1	0
Belgium	4	7	4
Cyprus	3.5	6	1
Estonia		0	0
Finland		0	0
France	4	4	0
Germany		0	0
Greece	3	20	14
Ireland	4.5	7	4
Italy	3.5	12	8
Latvia		0	0
Lithuania		0	0
Luxemburg		0	0
Malta		0	0
Netherlands		0	0
Portugal	3.5	9	4
Slovakia		0	0
Slovenia		0	0
Spain	4	3	0

- Moral hazard: not complying with the F=0 rule (if indebtedness is higher than 60%) or exceeding the 60% constraint for two or more years in a five year period the country would be expelled from the scheme (not from the EA) and subject to the current rules
- Because fiscal rules are ancillary to debt sustainability, under the 60% constraint there is no necessity for F=0.
- Under the 60% ceiling we can formalise two alternative strategies.

S1: constant $\boldsymbol{D_M}$

$$(6)\ 0 = a \cdot g_i \cdot \frac{K_i \cdot D_{B(-1)}}{K_i \cdot D_{M(-1)}} - \frac{F_i}{K_i \cdot D_{M(-1)}}$$

- From which:

$$(7)\ F_i = a \cdot g_i \cdot K_i \cdot D_{B(-1)}$$

- This fiscal deficit is consistent with the decrease of D_M/Y

S2: constant D_M/Y

$$(9)\ -g_i = a \cdot g_i \cdot \frac{K_i \cdot D_{B(-1)}}{K_i \cdot D_{M(-1)}} - \frac{F_i}{K_i \cdot D_{M(-1)}}$$

- From which

$$(10)\ F_i = a \cdot g_i \cdot K_i \cdot D_{B(-1)} + g_i \cdot K_i \cdot D_{(M-1)}$$

- S2 permits a higher deficit than S1. In both cases D_M/Y is kept under 60%

- 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 S2 below 30%.

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

Years	D_T	Y	D_T/Y	a	g, %	D_B/D_M	$\Delta D_M/D_M$, %	D_M/Y	F/Y, %
0	2.17	2.915	0.74	1	4.5	0.417		**0.53**	
1	2.20	3.046	0.72	1	4.5	0.436	0	0.50	0.94
2	2.23	3.183	0.70	1	4.5	0.456	0	0.48	0.94
3	2.26	3.326	0.68	1	4.5	0.476	0	0.46	0.94
4	2.29	3.476	0.66	1	4.5	0.498	0	0.44	0.94
5	2.33	3.633	0.64	1	4.5	0.520	0	0.42	0.94
6	2.36	3.796	0.62	1	4.5	0.544	0	0.40	0.94
7	2.40	3.967	0.61	1	4.5	0.568	0	0.39	0.94
8	2.44	4.145	0.59	1	4.5	0.594	0	0.37	0.94
9	2.48	4.332	0.57	1	4.5	0.620	0	0.35	0.94
10	2.52	4.527	0.56	1	4.5	0.648	0	0.34	0.94
11	2.57	4.731	0.54	1	4.5	0.677	0	0.32	0.94
12	2.61	4.943	0.53	1	4.5	0.708	0	0.31	0.94
13	2.66	5.166	0.52	1	4.5	0.740	0	**0.30**	0.94
14	2.78	5.398	0.52	1	4.5	0.740	4.5	0.30	2.22

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

Years	D_T	Y	D_T/Y	a	g, %	D_B/D_M	$\Delta D_M/D_M$, %	D_M/Y	F/Y, %
0	2,17	2,915	0,74	1	4,5	0,792		**0,42**	
1	2,21	3,046	0,73	1	4,5	0,827	0	0,40	1,42
2	2,26	3,183	0,71	1	4,5	0,864	0	0,38	1,42
3	2,31	3,326	0,69	1	4,5	0,903	0	0,36	1,42
4	2,35	3,476	0,68	1	4,5	0,944	0	0,35	1,42
5	2,41	3,633	0,66	1	4,5	0,986	0	0,33	1,42
6	2,46	3,796	0,65	1	4,5	1,031	0	0,32	1,42
7	2,52	3,967	0,63	1	4,5	1,077	0	0,31	1,42
8	2,57	4,145	0,62	1	4,5	1,126	4,5	**0,29**	1,42
9	2,69	4,332	0,62	1	4,5	1,126	4,5	0,29	2,67

- Results
  - Creation of the single financial market for the Euro Area
  - The ECB's monetary policy would be geographically effective
  - Elimination of the bank-sovereign vicious loop
  - Much shorter sovereign deleveraging period
  - Conversion of the existing deflationary stance into a reflationary one
  - Fiscal space instead of (more) ineffectual monetary easing (which also produces negative effects on banks' 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 this reform for their CB
  - Adopting strong rules to limit sovereign indebtedness, the reform could be adopted by any country

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