



# **Deepening Economic and Monetary Union: What else is needed?**

## **An ESM debate**

**VÍTOR CONSTÂNCIO**

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## **EMU DESIGN SHORTCOMINGS**

The initial EMU design, besides ignoring a mechanism to deal with liquidity crises, had other shortcomings that were predicated on several macroeconomic views prevalent at the time.

First, the idea that monetary policy exclusively dedicate to inflation control is enough to ensure both economic and financial stability, therefore dispensing fiscal or any other type of macroeconomic policy.

Second, that the financial sector is not capable of generating fluctuations in the real economy, therefore dispensing with European level supervision.

Finally, the idea that only public debt can destabilise the system whereas private debt could not as the private sector economy is self-equilibrating. However, historical evidence shows that private debt booms were mostly responsible for financial crises.

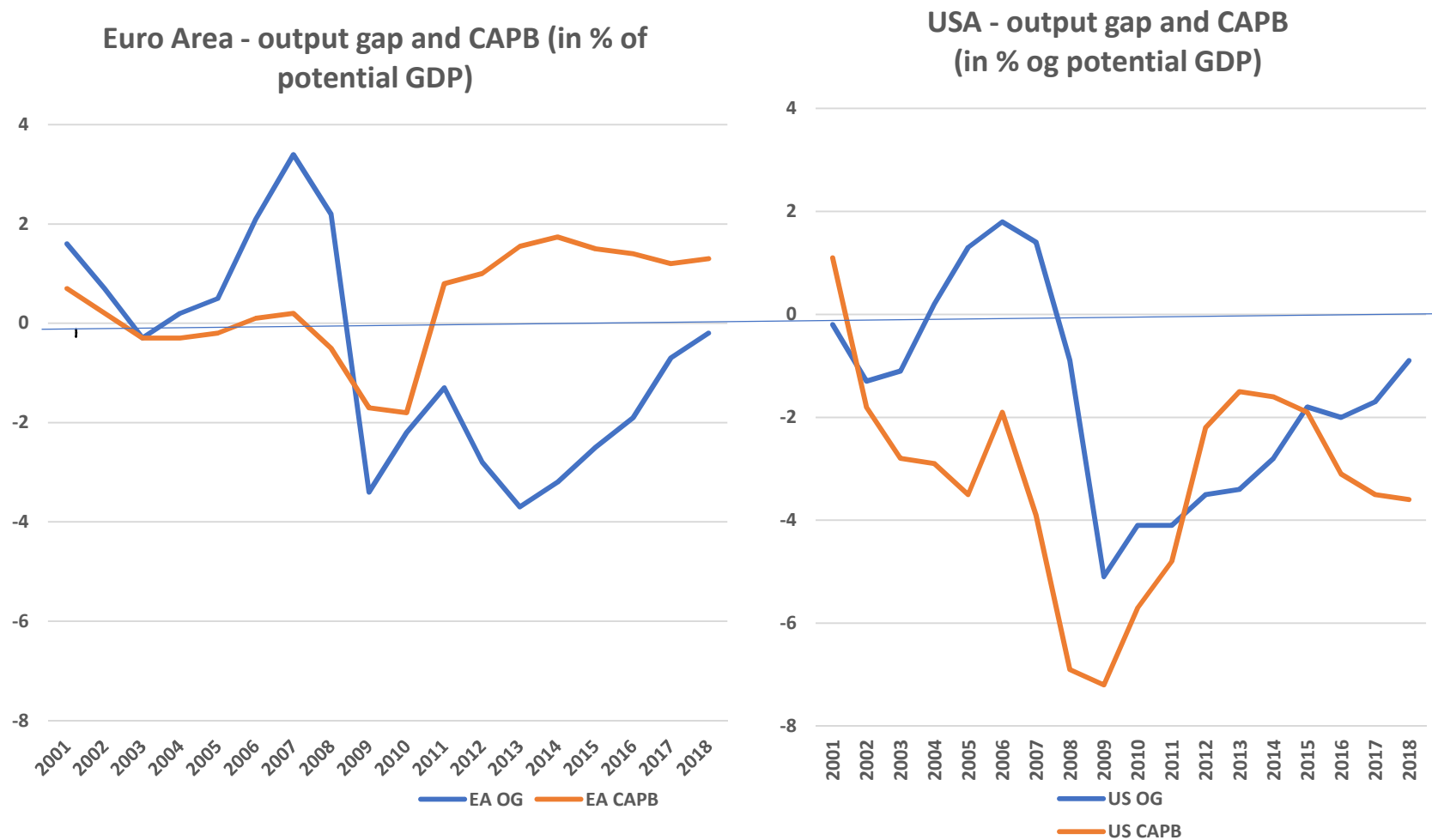
After the ESM creation and the now settled role of the ECB in liquidity provision, including intervening in the sovereign bonds' markets, there is still a remaining list of necessary reforms:

- 1) Correction of the procyclical fiscal policy bias at the euro area level via the revision of the Stability and Growth Pact; the creation of a European Stabilisation Fund; the better coordination of national fiscal policies to build up a European fiscal stance.
- 2) Completion of Banking Union and strengthening the banking sector with EDIS, the financial backstop to the European Resolution Fund and a European safe asset.
- 3) Creation of a Capital Markets Union with the introduction of a European safe asset.
- 4) Strengthening of macroprudential policy by expand ECB powers, enlarging the set of macroprudential instruments in the CRD/CRR.

**Among all these points my priorities go the creation of a European Stabilisation Fund, the revision of the Stability Pact and the issuance of a European safe asset.**

## Cyclically adjusted primary balance and output gaps in the Euro Area and the US (2001-2018)

### Fiscal policy in the euro area has been procyclical



Source: Ameco database, August 2019.

## **Fiscal Rules**

In general, fiscal rules are necessary to counter the “deficit bias” that may have many causes.

In a monetary union there are additional reasons for the existence of fiscal rules, related to debt and demand externalities.

A good fiscal rule should take these externalities into account and cater for two main goals: 1) control “deficit bias” to avoid excess debt accumulation; 2) allow public finance to play a macroeconomic stabilisation role as a shock absorber as established in currency unions theory.

However, the mainstream consensus has been that monetary policy should be the sole policy to deal with output and employment stabilisation, reserving fiscal policy mainly to microeconomic goals within the limits of a prudent debt level.

## Monetary policy constraints

Monetary policy is constrained in its effectiveness in the short term, when we face the risk of a significant slowdown:

- 1) The **interest rate channel** shows diminishing returns as interest rates along all maturities are already very low.
- 2) The **expectations channel** cannot by itself significantly move the economy. Consequently, forward guidance, price level targeting or long-term averaging of inflation cannot be effective.
- 3) Attempts to explore the **exchange rate channel** could only lead to currency wars that are destructive and self-defeating.
- 4) Unconventional monetary policy was effective to mitigate the crisis and to start a recovery. **Quantitative easing (QE)** was valuable to lower yields when policy rates were near zero, it still works, but also with visible diminishing returns.
- 5) Finally, **negative policy rates** have now been used in Europe to their limit and should not go down further. They affect financial firms' profitability and financial stability. The highly negative rates could also trigger asset price bubbles and allow zombie firms' survival, lowering productivity. Effects on pension schemes could lead to increased savings for old age, frustrating the expected increase in demand. Also a negative political economy backlash would emerge with the banks starting at a certain point to apply negative rates to retail deposits.

**All these points question the conventional belief that monetary policy can do everything, and that fiscal policy should be passive.**

## Recognition of monetary policy limitations

Ben Bernanke in 2003 advocated “helicopter money” for Japan . Last August, well-known former central bankers, like Stanley Fisher and Philipp Hildebrand, went farther along the same direction. Naturally, these monetary financing proposals would require a very unlikely Treaty change to be applied in the EU. Another version of “helicopter money” refers to central bank direct distribution of money to every citizen, an impractical proposal to implement. In the US there are also discussions of a more expansionary fiscal policy around the ideas of the flawed MMT.

Europe is far away from all such debates. **When the next recession comes, we should, however, be aware that monetary policy is lacking the tools to confront it alone. Monetary policy must continue to be expansionary but cannot do much more. If fiscal policy does not respond in a significant way, the euro area may face a new crisis.**

## **Secular Stagnation and low rates**

The problem goes deeper than simple short term recessionary risks. Secular stagnation, implying quite low growth, inflation and interest rates, undermines the role of monetary policy as policy rates reach the ZLB and should not go to significant negative levels.

This implies that fiscal policy must play a more active role.

If the private sector wants to save more than spend in real investment, three things happen.

- 1) First, there is a current account surplus and the corresponding investment abroad may have lower returns than domestic investment.
- 2) Second, interest rates get lower and, asset prices, including property prices, tend to rise.
- 3) Third, the State can go into deficit, dissaving to offset private excess saving. In such a situation, the State should expand its deficit and increase its investments as well as the supply of government bonds. This would also lead to higher interest rates and a lower current account surplus. A fiscal stimulus would thus solve several problems at once. The very large current account surplus also leads to hostile reactions from other countries, especially from the United States. This entails the danger of retaliation against Europe as a whole and Germany in particular.



## **Low rates and fiscal space**

The very low interest rates, that secular stagnation maintains will continue in the foreseeable future, offer a relaxation of fiscal space. Olivier Blanchard (2019) highlighted how the very low rates contribute to mitigate or even eliminate the budget deficit consequences for debt growth as well as its welfare effects .

Blanchard was cautious not to draw imprudent consequences for future fiscal policy. In fact, the past is not a guarantee for the future and there is the possibility that an exaggeration on the primary deficit and the debt could lead to a sudden upward revision of yields, changing their relationship with the growth rate. This means that very high debt ratios, some around 100%, did not cease suddenly to be a problem. However, the prospects of a prolonged period of low rates does provide some easing of concerns with the debt, especially when fiscal policy is called to perform a stronger role in our economies.

**In view of these new perspectives we need in Europe to undergo a conceptual change and promote the revision of our procyclical fiscal framework.**

## **The European Fiscal Rule**

A fiscal rule can be designed around norms for the debt, the deficit or the expenditure path. Not to be undone, the present European rule uses all three, in a maze of rigid quantitative targets and exceptions that require a Vade Mecum with more than 200 pages to explain it. It is too complex, difficult to manage and enforce, as it is open to contradictory commands.

The European Fiscal Board assessed that the Pact has “overlapping fiscal requirements that occasionally offer conflicting signals: a structural adjustment and a target for debt reduction.” And “policies are monitored using a multitude of indicators, which inevitably cause conflicting signals”. Sometimes, these conflicts make impossible the full use of the automatic stabilizers.

The definition of long-term target for the debt ratio to GDP is fraught with difficulties. There is no theoretical basis for any particular level.

## **The European Fiscal Rule**

Some economists despaired of finding well designed quantitative fiscal rules. Eichengreen and Wyplocz (2016) go as far as proposing a renationalisation of fiscal policy with more market discipline.

Blanchard, Leandro and Zettelmeyer (2019) recently presented a preliminary version of a proposal that would abolish the quantitative goals, substituted by guidance principles that would be enforced by the EU Commission in a more discretionary way, with the possibility of putting cases of non-compliance to European Court of Justice.

However, I am not yet convinced about those approaches and would prefer a two-pronged approach to revise the European fiscal rule, thinking mostly from the perspective of the euro area requirements:

- a) the Stability Pact should be revised along the lines of an expenditure rule,
- b) a European Stabilisation Fund would be created to deal with really significant asymmetric or symmetric shocks that cannot be easily accommodated by an expenditure fiscal rule.

## **The European Fiscal Rule**

An expenditure rule could be approved without a Treaty change.

A few details about such a rule:

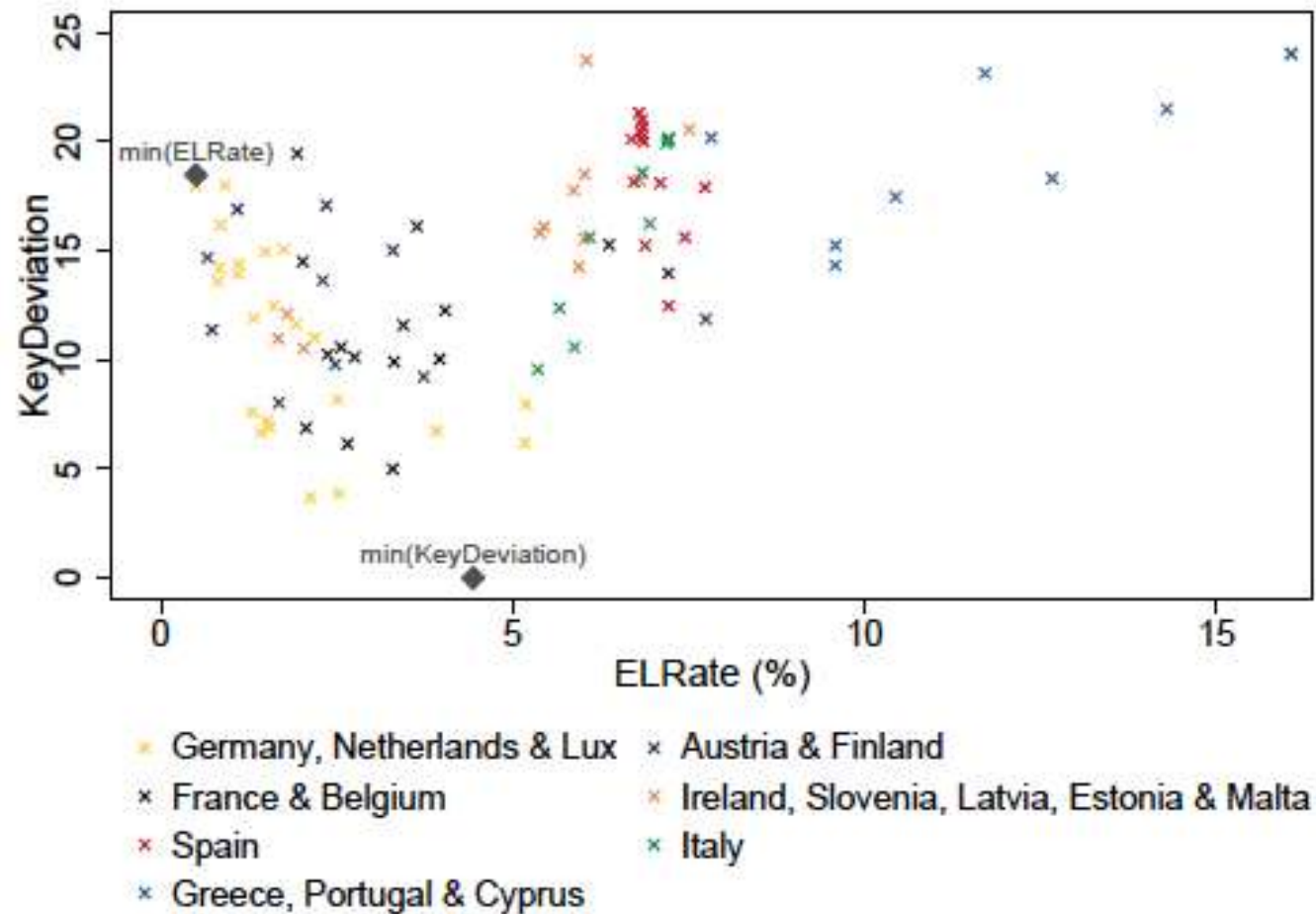
- The expenditures considered would be net of interest payments, unemployment subsidies and increases in revenues due to discretionary changes in taxation.
- There would not be an automatic formulaic annual progression towards the long-term target of 60% debt ratio
- The 3% Treaty limit for the nominal deficit would be kept, abandoning however targets for the structural balance.
- The annual target for expenditure growth would depend on a medium-term projection of nominal potential growth and on the judgemental conclusion about the proper convergence for the long-term debt ratio target.
- The judgement involved in that component would take in consideration a broader debt sustainability analysis and the conjunctural situation of the economy.
- National Fiscal Councils would limit their role to the preparation of macroeconomic projections, including those about potential growth over the medium term.

## **The need for a European safe asset**

### **Advantages of a European safe asset (without mutualisation)**

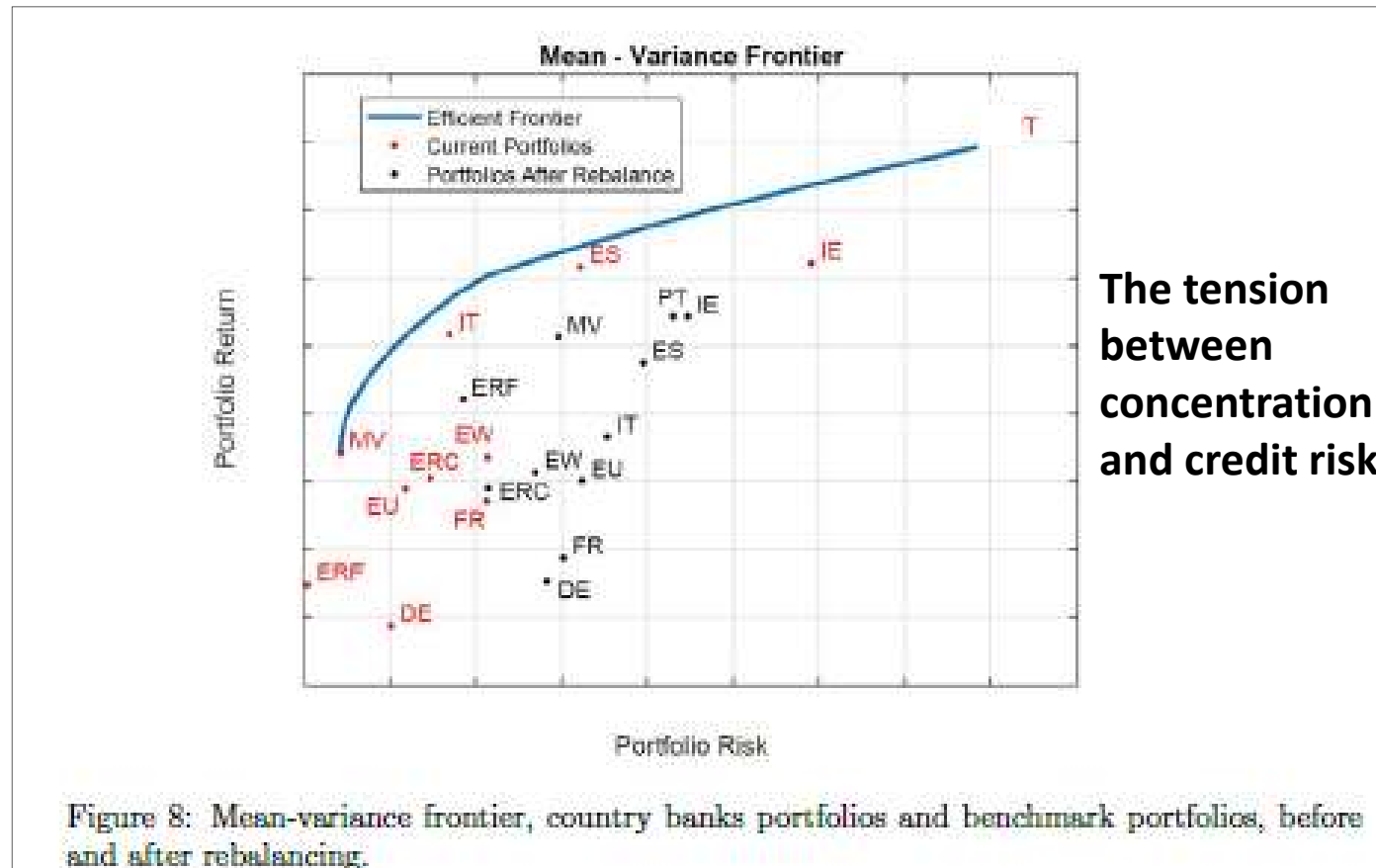
- 1) A European safe asset is crucial to solve the question of the concentration of banks' portfolios on domestic sovereign bonds, important for the stability and robustness of the European banking system
- 2) A European safe asset is crucial to create a true Capital Markets Union.
- 3) A European safe asset is crucial to reduce the scarcity of secure assets which reinforces the trend to lower yields and increases the temptation for the private sector to create pseudo-safe assets as it happened before the crisis, potentially endangering financial stability.
- 4) A European safe asset is crucial for a fully integrated European bond market which is essential to foster the international role of the euro
- 5) A European safe asset is crucial for monetary policy to benefit from a more representative European yield curve and more appropriate assets to purchase in open market operations that will be necessary even in normal times in the future.

**Figure 1** Concentration and credit risk in sovereign portfolios



**The tension  
between  
concentration  
and credit risk**

Source: Spyros Alogoskoufis, Sam Langfield (2019) "Regulating the doom loop" VoxEu 3 October 2019

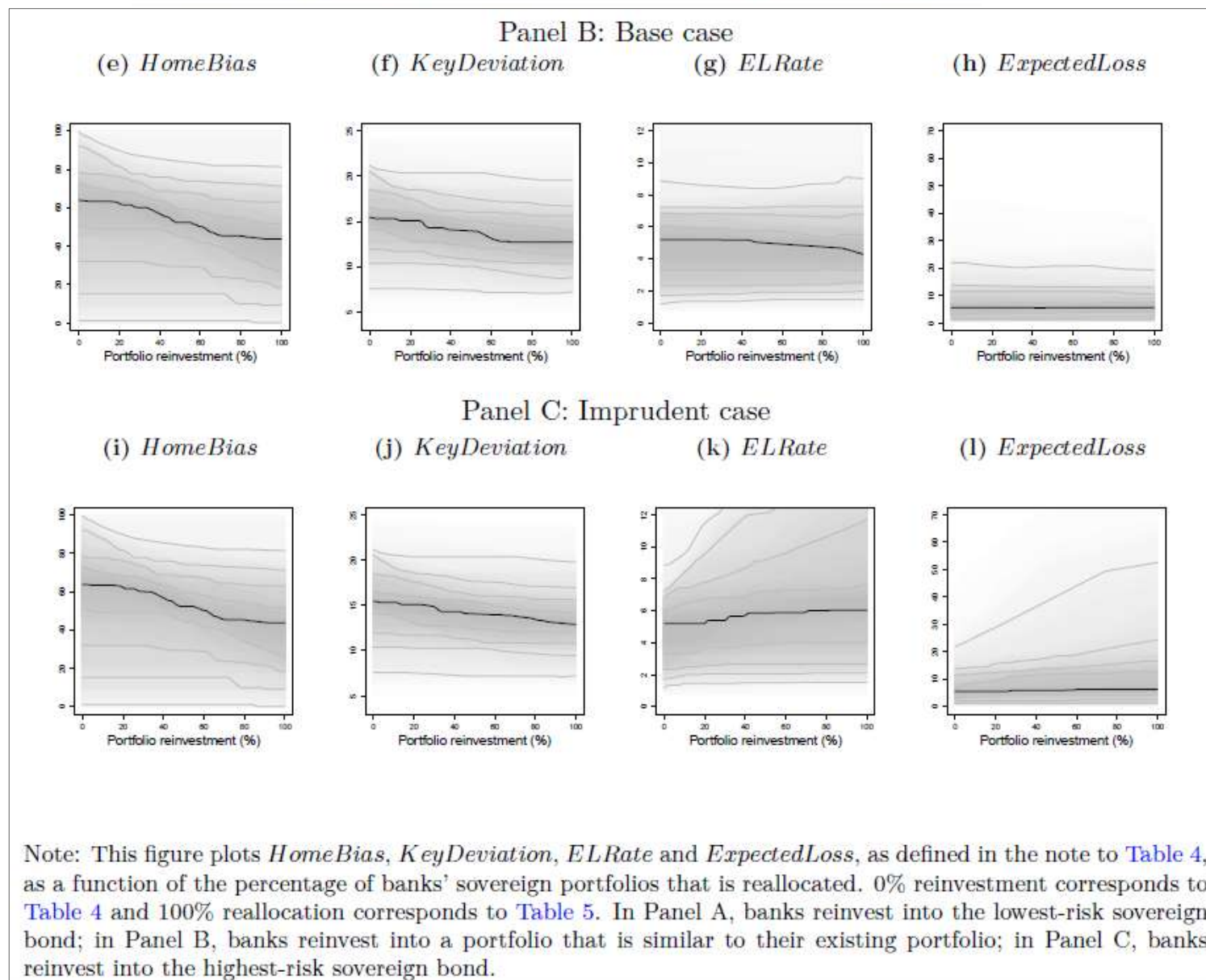


**The tension  
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[...]” we find that a diversification requirement such as the ones proposed can actually increase the risk of the resultant portfolios, while having little effect on the tail risk or contagion risk. Given that the reduction of risk is a major reason for a costly diversification requirement, our results suggest caution before its adoption.”

Source: Craig, B., Giuzio, M. and S.Paterlini (2019), “The effect of possible EU diversification requirements on the risk of banks’ sovereign bond portfolios”, ESRB WP 89, March 2019.

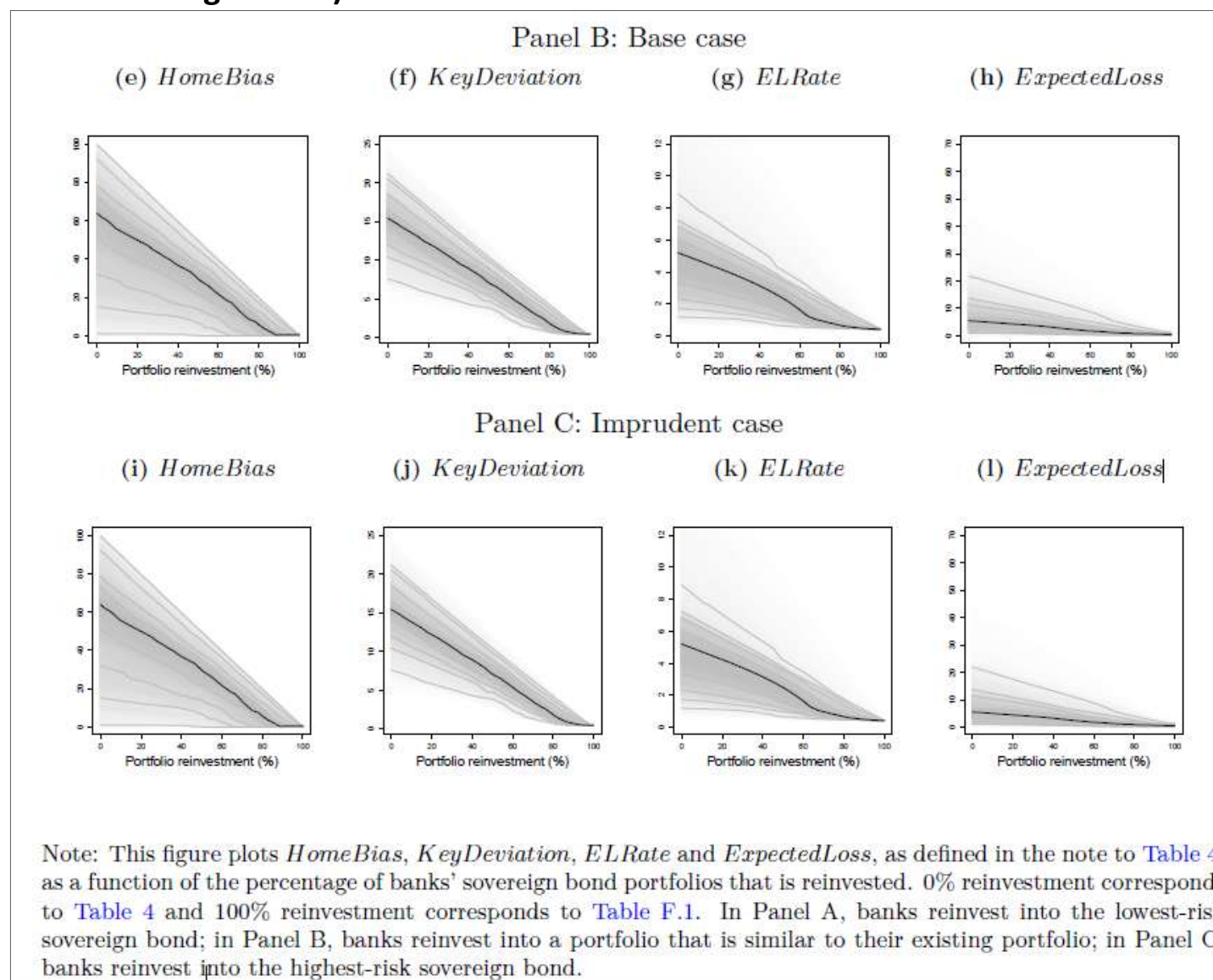
**Figure 2: Price-based reform to target concentration**



Source: S. Alogoskoufis and S. Langfield (2019), “Regulating the doom loop”, ECB WP 2313, September.



**Figure F.1.: Price based reform to target concentration ( with an area-wide low-risk asset and Positive risk weight floor)**



Source: S. Alogoskoufis and S. Langfield (2019), "Regulating the doom loop", ECB WP 2313, September.

**Table 9:** Summary of simulation results

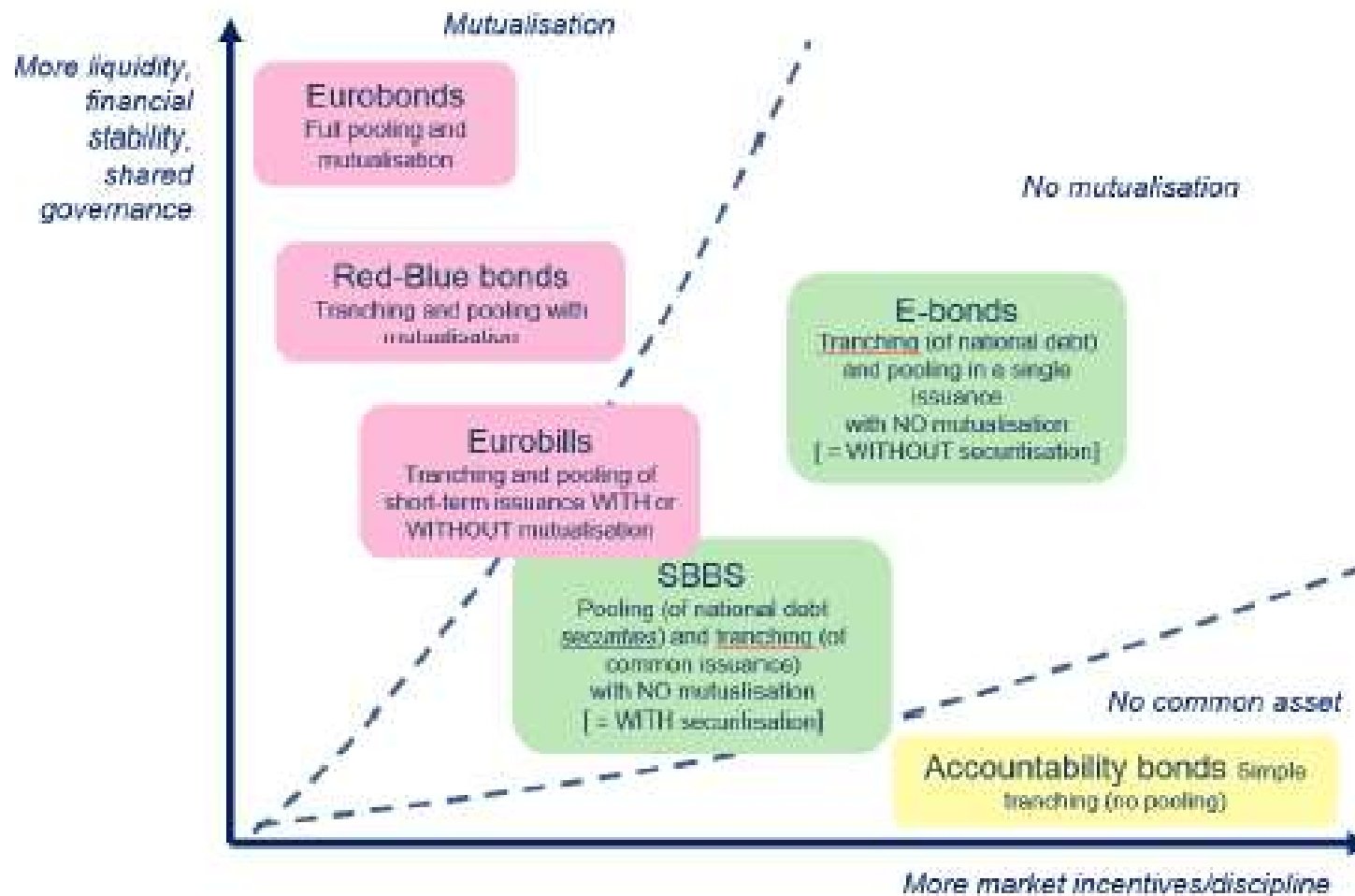
	Change in concentration	Change in credit risk
Price-based reform to target concentration (Figure 2)	↓	?
Price-based reform to target credit risk (Figure 3)	?	?
Quantity-based reform to target concentration (Figure 4)	↓	?
Quantity-based reform to target credit risk (Figure 5)	↓	?
Area-wide asset without credit protection (Figure 6, Panel A)	↓↓	?
Area-wide low-risk asset (Figure 6, Panel B)	↓↓	↓↓

Note: This table summarizes simulation results for the change in concentration and credit risk in banks' holdings of sovereign bonds induced by regulatory reform. Downward-facing arrows indicate a decrease in concentration or credit risk exposure for all bank portfolios relative to their initial conditions. Double arrows indicate a quantitatively large change. Question marks denote an ambiguous directional effect.

Only a European safe asset can offer a solution to the problem of excessive concentration of banks' portfolios on domestic sovereign bonds, without creating turbulence in national public debt markets and ensuring the simultaneous reduction of portfolios concentration and credit risk. The introduction of the European safe asset will have to be accompanied by mandatory regulation for the banks to diversify their portfolios away from national sovereign bonds.

Source: S. Alogoskoufis and S. Langfield (2019), "Regulating the doom loop", ECB WP 2313, September.

Figure 1: Design options for a European safe asset



Source: Gabriele Giudice, M. de Aramenda, Z. Kontolemis and D. Monteiro (2019), „A European safe asset to complement national government bonds”, MPRA Paper No. 95748, posted 28 August 2019, Online at <https://mpra.ub.uni-muenchen.de/95748/>

The **ESBies** or **SBBS** are a tranchéd synthetic bond backed by national sovereign bonds. The senior tranche would have very low risk levels, presumably below German debt, as a result of the diversification gains based on historical correlations and of the protection granted by lower-grade tranches. Market practitioners and rating agencies have been sceptical about the instrument revealing that major financial institutions would not issue or buy such synthetic product. National Debt Managing Offices (DMO) have fiercely opposed the scheme, particularly because it was supposed to be launched by private firms without coordination with planned official issues. Finally, in December the ECOFIN put aside further consideration of this project.

The main substantive concerns are:

- 1) can the senior tranche be as safe as claimed ;
- 2) can the junior tranche be sold at prices that do not imply that the senior tranche would need to offer a quite lower coupon than Bunds for the SBBS to be economically viable.

These obstacles could be overcome if, for instance, a small first loss tranche was to be covered by public guarantee, jointly provided by member states.

(See Brunnermeier et al (2017) and ESRB (2018))

- The Leandro/Zettelmeyer (2018) version of the so-called **Ebonds** proposes that a European public entity (desirably, the ESM) issuing securities whose product would be loaned to country members to cover a sizeable amount of national budgets financing needs, with an interest rate equal to all .
- These loans would have seniority over other national sovereign liabilities. Seniority, instead of diversification and tranching, would make **Ebonds** as safe as the safest present sovereign bond. The achievable amounts could be considerable, more than € 3 trillion, serving the different important goals of having a European safe asset.
- To allay concerns of National Treasuries they should all sit on the deciding body about the amounts and timing of issuance of the safe asset.
- Complementary regulations would ensure that the banks must use the new asset to substitute their excessive holdings of domestic sovereign debt.
- The absence of mutualisation should make the scheme agreeable to northern countries. Subordination of the remaining national debts could result in an increased cost of its issuance, which could be a concern for more indebted countries. However, reasonable analysis and simulations show that possible costs would be offset by the lower costs of issuance of the E-bonds benefiting all countries.

(See Leandro, A. and J. Zettelmeyer (2018))



Table 3: Expected losses on national bonds (in %) per E-bond issuance size (as a % of GDP)

	0% (no E-bonds)	5%	10%	15%	20%	25%	30%	35%	40%	45%	50%	55%	60%
DE	1,1	1,2	1,3	1,5	1,7	2,0	2,4	3,1	3,7	3,7	3,7		
NL	1,4	1,5	1,7	2,0	2,3	2,8	3,5	4,5	4,8	4,8			
LU	1,4	2,2	4,5										
AT	1,7	1,8	2,0	2,2	2,4	2,6	3,0	3,4	3,9	4,5	5,2	5,2	5,2
FI	1,0	1,1	1,3	1,5	1,9	2,4	3,0	3,0	3,0				
FR	1,8	1,9	2,1	2,2	2,5	2,8	3,1	3,5	3,9	4,1	4,1	4,1	4,1
BE	2,1	2,3	2,4	2,6	2,7	3,0	3,2	3,5	3,7	4,1	4,4	4,7	4,7
EE	4,7	10,1											
SK	2,9	3,2	3,8	4,5	5,4	6,1	6,1	6,1	6,1				
IE	5,0	5,5	6,1	6,9	7,8	9,0	10,2	10,7	10,7	10,7	10,7		
LV	7,7	9,4	11,8	15,7	16,5								
LT	6,1	7,2	8,6	10,8	13,4	13,4	13,4						
MT	5,6	6,0	6,6	7,3	8,2	9,2	10,6	11,8	12,0	12,0	12,0	12,0	
SI	5,0	5,6	6,2	7,2	8,4	9,8	10,7	10,7	10,7	10,7			
ES	4,1	4,5	5,0	5,6	6,4	7,1	8,2	8,8	8,8	8,8	8,8	8,8	
IT	4,8	5,1	5,4	5,7	6,0	6,4	6,9	7,4	8,0	8,6	9,2	9,9	10,4
PT	7,3	7,8	8,3	8,9	9,6	10,4	11,4	12,4	13,9	15,2	15,6	15,6	15,6
CY	17,6	18,5	19,6	20,7	22,0	23,5	25,5	27,5	29,7	32,3	34,9	37,6	38,1
EL	15,4	16,0	16,5	17,3	18,1	19,0	19,7	20,8	22,0	23,3	24,3	25,8	27,5
E-bond		0,0	0,0	0,0	0,0	0,1	0,1	0,3	0,6	0,9	1,2	1,5	1,7

Note: based on the fuller-evidence assumptions, the last row shows the EL on E-bonds; a blank figure denotes a situation where the E-bond scheme size exceeds the amount of eligible sovereign debt outstanding as of year-end 2017, so that no national bonds are issued.

Source: Gabriele Giudice, M. de Aramenda, Z. Kontolemis and D. Monteiro (2019), „A European safe asset to complement national government bonds”, MPRA Paper No. 95748, posted 28 August 2019, Online at <https://mpra.ub.uni-muenchen.de/95748/>

Table 5: Changes in average credit risk premia on total government debt (in bps) per E-bond issuance size (as a % of GDP of the euro area and each Member State)

	0% (no E-bonds)	5%	10%	15%	20%	25%	30%	35%	40%	45%	50%	55%	60%
DE	21	0	0	0	0	1	1	3	5	4	5	7	10
NL	28	0	0	0	0	1	1	2	-1	-3	-3	1	5
LU	28	0	-1	-25	-25	-24	-23	-20	-15	-9	-3	1	5
AT	34	0	0	0	0	0	1	3	6	10	13	11	10
FI	19	0	0	0	0	1	0	-4	-5	-2	4	8	12
FR	35	0	0	0	0	1	1	2	4	5	4	5	5
BE	43	0	0	0	0	0	1	2	4	7	9	10	10
EE	94	-60	-68	-68	-68	-67	-66	-64	-60	-55	-51	-47	-44
SK	57	0	0	0	-1	-7	-20	-31	-40	-38	-32	-27	-23
IE	101	0	0	0	0	-2	-5	-17	-30	-42	-52	-64	-60
LV	154	1	0	-5	-49	-139	-137	-135	-130	-124	-118	-113	-109
LT	122	1	0	0	-9	-46	-81	-110	-105	-99	-93	-87	-83
MT	111	0	0	0	0	0	0	-4	-18	-31	-43	-55	-76
SI	100	0	0	1	0	-3	-14	-33	-50	-64	-74	-69	-65
ES	83	0	0	0	0	-1	-3	-10	-20	-28	-36	-43	-45
IT	97	0	0	0	0	1	1	2	4	6	7	9	7
PT	146	0	0	0	0	0	0	-1	2	2	-7	-19	-32
CY	352	0	-1	-1	-2	-2	3	3	3	5	1	-5	-34
EL	308	1	-2	-1	0	2	-1	1	4	8	6	8	11

Note: average credit risk premia on total government debt is the weighted average of the premia paid indirectly on E-bonds issuance (via the senior loan) and of the premia paid on the remaining national debt (the junior part of which is show in Table 4). The first column shows the national (average) credit risk premia in the absence of E-bonds. The columns show the average cost for the totality of outstanding debt of a country for a given E-bonds issuance threshold. Risk premia on ineligible debt (i.e., non-central government loans) is assumed not to change with respect to the situation of no E-bonds.

Source: Own calculations.

Source: Gabriele Giudice, M. de Aramenda, Z. Kontolemis and D. Monteiro (2019), „A European safe asset to complement national government bonds”, MPRA Paper No. 95748, posted 28 August 2019, Online at <https://mpra.ub.uni-muenchen.de/95748/>

## Comparison: E-bonds vs. ESBies

Features	E-Bonds	SBBS
Issuer	Public entity ( the ESM)	Many private issuers
Safety	Safe even most countries default	Safe, except if many countries default of correlation deviate in a crisis
Tranching	No	Yes
Partial subordination	Yes	No
Costs for national debt	Goes up which is offset by cheaper E-Bonds segment	Competition from junior tranche may increase issuance costs of national debt
Redistribution	Very small	No
Encouragement of fiscal discipline	Yes, as costs of subordinated part would increase if country doesn't comply with fiscal rule	No effect
AMOUNT	25 to 30% of GDP > € 3 to 4 trillion	≈ 20 % of GDP ≈ € 2.5 trillion

Source: Inspired by J. Zettelmeyer (2018), "Europe's search for a safe asset", Presentation September 26, 2018.



## Conclusions

Reducing the risks still haunting the European monetary union, making it more robust, is an urgent task to allow the full benefits of having taken the step of sharing monetary sovereignty.

In the same vein, any hopes of enhanced sovereignty for Europe in a more fragmented and dangerous geo-political environment would be dashed without a dependable robust monetary union.

To achieve it, the present shortcomings around macroeconomic management and the financial stability framework should be corrected. The role of fiscal policy in macroeconomic stabilisation must be recognised with full reflection in a complete revamp of the Stability Pact and the creation of a Stabilisation Fund.

The creation of a European safe asset, to promote Capital Markets Union, the internationalisation of the euro and the stability of the banking sector, is the third important and urgent reform towards a more robust and efficient Euro Area.

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