European Fiscal Union: From Monetary Back Door to Parliamentary Main Entrance

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An 'unprecedented divorce' between monetary and fiscal authorities

A European fiscal union is suddenly no longer the wild dream of diehard EU federalists or the nightmare scenario of Eurosceptics, but a reality that takes shape through the back door of monetary crisis management. This article argues that the crypto-union, created involuntarily by the ECB, has prevented a second financial collapse and is the paradoxical consequence of trying to prevent a European fiscal union. But I also conclude that, indeed, an effective and legitimate solution requires this fiscal union to become part of the democratic process in member states.

A modern monetary system is characterized by fiat money, issued by a central bank that exercises its interest rate policy with a view to the state of the economy, not the state of the ruler's finances. Modern money is a public good for a collective, and not the private property of government. This requires some separation of monetary and fiscal authority so that the general public can trust that the legal tender is not debased and devalued for reasons of political opportunism. How much central bank independence this separation requires is a matter of political-constitutional preferences and differs across time and between places.

The economic constitution of EMU is based on a historically 'unprecedented divorce between the main monetary and fiscal authorities' (Goodhart 1998). Unlike a broken marriage, this was not seen as failure but as a great achievement of EMU, obviously more like ending an illegitimate relationship in many member states. Divorce was meant to depoliticize monetary policy completely and thus ensure price stability even against intense popular pressure for stimulus. The financial instability in European bond markets since 2009–10 has renewed doubts about the wisdom of this construct that some macroeconomists had raised before (e.g. Buiter *et al.* 1993; Eichengreen and Wyplosz 1998).

Confronted with the prospect of another systemic collapse, the ECB could hardly resist buying Treasury (and other) bonds from banks to keep them afloat (see also De Grauwe 2011). This Securities Market Programme (SMP) has given way to a massive recapitalisation programme of the European banking system since the launch of the Long-Term Refinancing Operation (LTRO) in December 2011. This recapitalisation has been tackled only half-heartedly by the fiscal authorities in member states and is long overdue. However, the quasi-fiscal activities of the ECB keep up appearances of separation at best. The Bank can thus claim to fulfil the mandate of any central bank, namely maintaining the stability of the financial system. Moreover, by operating only in secondary markets and through the banking system the Bank supposedly avoids moral hazard for profligate governments; but the policy creates moral hazard for the financial industry instead. The crisis has thus revealed that the separation, far from strengthening the central bank through splendid isolation, creates a paradoxical weakness. The ECB is drawn into bailing out sovereign debtors and insolvent banks precisely because EMU lacks fiscal backing for a joint monetary policy, unlike the central banks in the United States or Britain (Buiter 2009).

The next section shows how this paradox manifests itself in this crisis. One may therefore ask why complete divorce was untenable[1] and how some form of fiscal union could set monetary policy free again to do what it does most effectively, which is smoothing business cycles, rather than dealing with solvency

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[1] There are, of course, critics like Jens Weidmann (2012), Head of the Bundesbank, who maintain that the principle of complete divorce should have been upheld. However, these principled critics have so far failed to explain what they would do if confronted with another Lehman or Northern Rock 'moment', i.e. the threat of another systemic financial crisis.

problems of sovereign or private debtors. A degree of joint public debt management can provide the minimal fiscal union required to stabilise the monetary union, as a number of authors have suggested (Giovannini group 2000; De Grauwe and Moesen 2009; Delpa and von Weizsäcker 2010). The third section argues for a variant that is meant for policy coordination in normal times to get the policy mix with monetary policy right (Mabbett and Schelkle 2010). It also argues that the political authority for any form of Eurobond must come from democratically elected parliaments. The new European Semester, which has brought national parliaments into the EU process of fiscal surveillance since January 2011, could lend political authority to this new stabilising institution and make the involvement of parliaments more meaningful at the same time. This is outlined before the concluding section.

Fiscal union through the monetary back door

The ECB and the European System of Central Banks (ESCB) have become quasi-fiscal agents during the second phase of the crisis that started in 2007–08. This seems to confirm all the warnings that Eurosceptics had expressed before the onset of EMU. However, their scenarios missed the point. It was not collusion between the central bank and governments that created this heterodox role for the proudly independent institution in Frankfurt. Rather, the unforeseen feedback loop between bank balance sheets and government finances 'fiscalized' the monetary policy of the ECB in at least two ways. It was ultimately the concern for the stability of the banking system that created a fiscal union through the back door of monetary policy.

The financial-fiscal feedback loop, not a weak and broken Stability Pact, has proven to be the Achilles heel for independent monetary policy. If it were government finances as such that mattered, Belgian bonds should have been sold more heavily and Spain should not be in the spotlight, while Germany with its debt ratio of over 80 percent would not issue the benchmark bond. Under the Basel II regulations, Treasury bonds from OECD countries were classified as safe assets and they arguably were safe, with a few exceptions, Greek bonds being one of them. The Great Recession in the wake of the financial crisis wrecked government finances and worsened debt ratios through negative growth. When bond markets then started to discriminate between sovereign debtors, the bank balance sheets of those (European) banks and pension funds holding Greek, Irish and Portuguese bonds deteriorated rapidly.

In short, policymakers felt that they could not let even small sovereign debtors default, but urged these governments to take pro-cyclical austerity measures instead. In return for austerity, the ECB reluctantly provided refinancing for Treasury bonds of junk status. This has created a knife-edge equilibrium in which sovereign debtors pretend to be solvent and European banks pretend to be liquid. Thanks to the self-fulfilling nature of this feedback loop, many may very well be solvent and liquid respectively; but all depends on the lifeline thrown by central banks and on growth resuming eventually.

How can we recognize the 'fiscalization' of monetary policy when we see it, and the creation of a crypto-fiscal union through central banks? In his insightful discussion of quantitative easing, Blinder (2010) gives us several examples that shed light on the ECB through the lens of the US experience. Generally, Blinder (2010, 476) considers all those monetary policies to be 'quasi-fiscal' policies that "put taxpayer money at risk [..] equivalent to investing government funds in risky assets". This definition makes the implicit assumption that there are, one the one hand, monetary policies that deal with liquidity problems and are as such riskless for the taxpayer and, on the other, 'quasi-fiscal' monetary policies dealing with solvency problems, which ultimately fall on the taxpayer. This is a powerful fiction that allows the separation of macro-prudential and micro-prudential supervision. However, this distinction between liquidity and solvency issues vanishes in a crisis (Goodhart 1987). The market dynamic, as well as the handling of a systemic liquidity crisis, can push institutions into insolvency that were healthy if risky before. They fall prey to rising risk premia and penalty discount rates. Blinder's general definition is therefore a useful reminder of just how fictitious the complete divorce of monetary and fiscal policy is.[2]

Secondly and more specifically, Blinder (2010, 468) characterizes those operations as "the first breaching, however minor, of the wall between fiscal and monetary policy" whereby fiscal policy tried to engineer a stimulus programme through the Fed. The Treasury

[2] For instance, Belke and Dreger (2011) give a rough estimate of taxpayers' risk in the four big euro area countries from a restructuring of Greek debt, part of which is held by the ECB.

engaged in excess borrowing and deposited the excess funds at the Fed; the latter could then, without increasing bank reserves, expand its balance sheet on the asset side. In his definition of quasi-fiscal operations Blinder also includes the Fed's outright purchase of debt from Fannie Mae and Freddie Mac, the wholesale refinancing institutions for the mortgage market. This purchase was a measure to stop the free-fall of mortgage and housing markets and put taxpayers' money at risk.

Does the Securities Market Programme (SMP) qualify as a quasi-fiscal operation in this sense of investing public funds into risky assets? It was created in May 2010 and had, as of 17 February 2012, accumulated a volume of 219 billion euros. Under this programme, the ECB buys government bonds in secondary markets only while private bonds can be bought in primary and secondary markets.[3] This is in line with the Treaty, which does not allow the ECB to buy Treasury bonds from sovereign debtors directly. The preamble states in paragraph (4) that the Governing Council decides on the scope of the interventions and will do so in light of the commitments by member states to meet their fiscal targets and pursue fiscal consolidation. Intervening in secondary markets only, while not announcing a target bond yield, means that the ECB lets market forces decide what interest rates sovereign borrowers have to pay at each auction. Sterilization ensures at the same time that there is no money creation directly from the ECB's outright purchase of securities, i.e. the Bank does not increase its balance sheet, but reduces its lending to banks to that extent.[4] The SMP therefore resembles the Fed's purchase of bad debt from Fannie Mae and Freddie Mac, but without the stimulus from an extended balance sheet.

Another quasi-fiscal activity concerns the recapitalisation of banks through monetary policies on the liabilities side. Instead of capital injections from government funds that have been authorised by parliament, the central bank can help financial institutions to earn a margin that would allow them to restore their balance sheets out of their current income.[5] The central bank thus takes over the fiscal role in a solvency crisis. The long maturities and a negative real interest rate guaranteed by the ECB in the most recent vintage of Long-Term Refinancing Operations (LTRO) can be seen in this light.

Until July 2010, refinancing facilities for between 12 and 36 months stood at over 500 billion euros, then dropped sharply and were nil for this maturity class by January 2011. Under Mario Draghi, the LTRO were racked up by a staggering 489 billion euros in December 2011, disbursed as a fixed rate tender over three years at one percent interest. Another half trillion euros was offered at the time of writing at the end of February 2012. This meets European banks' enormous needs for refinancing in nervous markets (IMF 2012). However, the refinancing needs of governments are more than double that over the next two years, yet the SMP has been scaled back noticeably ever since the LTRO in December 2011 was launched. This change of tack means that the ECB now guarantees banks a sizeable margin over three years that they can use to recapitalise their fragile balance sheets and meet higher capital requirements. The European Banking Authority had urged banks to build up their capital base in a well-timed recommendation issued on 8 December 2011. The underlying hope may also be that banks should thus be able to absorb the losses that will occur if the ECB no longer acts as lender of last resort to sovereign debtors. However, in contrast to a government programme of recapitalisation, banks cannot be forced to forego the pay-out of large bonuses as long as there is a need for recapitalisation.

In sum, the monetary union crisis can be said to have led to a crypto-fiscal union, through central bank interventions that perform quasi-fiscal functions. In contrast to expectations, it is not directly the political pressure of governments that made the ECB assume these functions, but the stability of integrated financial, including bond, markets. The present move under the new President Draghi bears witness to this in that the Bank has tried to tackle the problem of financial stability more directly through a 'big bazooka' LTRO, while winding down the SMP. The SMP has pushed the Bank into a defensive position whenever private sector involvement, i.e. partial default of a sovereign debtor, has been on the table. The irony in all this is that the ECB would have been less susceptible to assuming this role if it had more fiscal backing from member states, contrary to what critics like Bundesbank President Weidmann (2012) say.

[3] See the decision of the ECB establishing a securities markets programme (ECB/2010/5).
[4] See URL: http://www.ecb.int/mopo/liq/html/index.en.html#portfolios.
[5] Blinder (2010) talks about this indirectly when he criticizes purchases of Treasury bonds as actually unhelpful in this respect, as they flatten the yield curve. The steeper this curve, the easier it is for financial institutions to restore their balance sheets out of earnings from the margin between short-term borrowing and long-term lending.

Existing and proposed varieties of Eurobonds

The idea of a Eurobond has been discussed for a while now, in fact the Giovannini report contemplated it as early as 2000. The innovation would be the joint liability for the issue, in addition to the individual liability of each member state for its share. The outright rejection of a Eurobond by some governments, such as those of Germany and the Netherlands, may lead an observer to believe that such joint liability would be a radical innovation. However, the European system of central banks is already built on this principle. The capital of the ECB is held solely by (all EU) national central banks included in the Eurosystem. National central banks have to pay any net losses that the ECB incurs, for example, in the pursuit of the lender of last resort function (Art. 33, s.2 and Art.29, s.1 ESCB Statute). That is, national taxpayers in all (!) EU member states would have to pay in proportion to the paid-up capital share of their central bank. In turn, if national central banks bail out domestic financial institutions that have significant business in other member states, the ECB can compensate such a central bank for the losses incurred out of its surplus from seignorage (Art. 32, s.4, ESCB Statute). Joint and several liability is thus inherent in the insurance pool that the common ownership of the ECB entails. The profits or losses of the ECB and national central banks are the tangible expression of this fiscal risk sharing through the monetary back door.

However, if one does not want to leave these decisions to un-elected policy-makers for good reason, then this fiscal union should be constructed in a more transparent way. The new emergency facilities, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), have no joint guarantee from the member states, each one is only liable for their own share in it. This has several disadvantages. Not only are the EFSF and the ESM finite funds in contrast to open-ended commitments of the tax and transfer states behind them. Any such finite fund tends to be tested and is bound to run out in a messy crisis. Moreover, whenever one of the guarantors gets itself into trouble or has its credit rating downgraded, the whole edifice becomes shaky. The recent downgrade of the EFSF was a faint warning of how fragile this construct is.

Knowing that fund solutions are not solutions, but temporary stop-gaps at best,[6] far-sighted scholars have proposed variants of Eurobonds that are deliberately designed as risk-sharing arrangements, rather than as ill-conceived attempts at containing liability.

- The short, non-technical report of the Giovannini group (2000) considers four options of integrated public debt issuance, but only two of the options involve joint liability. One is to have a Community institution, like the European Financial Stability Mechanism (EFSM), that borrows and then lends on to member states. The joint liability stems from the guarantee by the EU budget. This communiterization has recently been granted to the tune of 60 billion euros and can hardly be extended further when ten of the 27 EU countries backing the budget are not euro area members. The other option is indeed 'creation of a single euro-area debt instrument backed by joint guarantees'. The report is rather luke-warm and sees a number of technical and legal difficulties with the creation of such a joint liability when size and maturities are very different. However, the group, largely made up of financial investors, also lacked the expertise and the mandate to discuss the wider political and macroeconomic implications of this.
- De Grauwe and Moesen (2009) proposed a Eurobond to give countries like Greece guaranteed access to funding, albeit at the national market interest rate. Compliance with the fiscal framework would not be a condition of access. Instead, each country would pay its market rate, which would penalise the profligate (assuming they were accurately identified by the markets) and address German resistance to a common interest rate for countries that had breached the SGP. At the same time, the bond issue would be guaranteed by all the subscribing countries, and the coupon that bondholders receive would be calculated as the average of the market interest rates that the participating countries paid. This seemed to be an ingenious way to combat the 'flight to safety' and enlist market forces to discipline countries at the same time through the adjustment of bond prices.
- Delpa and von Weizsäcker (2010) propose a variant of the Eurobond that would deal with the stock problem of overindebtedness, rather than the flow problem of liquidity. The bond issue of every member country would be divided into a blue bond part of up to 60 percent of a country's GDP and a red bond part for the rest of its outstanding debt.

[6] As Kindleberger (2000) concluded long ago with regard to the IMF as a solution to the instability of the Bretton Woods system in its dying days.

> The blue bonds enjoy the joint guarantee of euro area members while the red bonds constitute purely national debt with junior status to which orderly default procedures apply. This two-tier Eurobond could thus be used to organise a radical solution to Europe's public debt problems. The proposal addresses a number of legal and practical problems and is clearly geared to alleviate what is policymakers' worst headache at the moment.

The two most detailed proposals have a lot going for them. They are politically realistic in that they do not try to give the Commission a role that member states and their electorates are not prepared to delegate at the moment. The De Grauwe and Moesen scheme, however, sees the Eurobond primarily as a vehicle to provide emergency liquidity, and does little to rein in the pro-cyclical behaviour that pushes countries into deeper recession or unsustainable booms while it also gives governments little incentive to treat national budgets as a matter of common concern. The Delpa and von Weizsäcker scheme, by contrast, gives incentives for countries to comply with the stipulation of a 60 percent deficit ratio; but its stated purpose of engineering an orderly debt default does not bode well for the political and market acceptance of the Eurobond idea.

Fiscal union through the parliamentary main entrance

An alternative proposal builds on these predecessors, but envisages the Eurobond as a vehicle for policy coordination in normal times. It has always been a weakness of the euro area's policy framework that the aggregate fiscal stance cannot be steered, for lack of a federal budget. Even if governments would have been able and willing to comply with the Stability Pact, it would have asked them to treat fiscal policy as a matter of national concern for consolidation rather than a matter of common concern for counter-cyclical stabilisation. The idea is as follows (Mabbett and Schelkle 2010): member states would have to agree annually – or more frequently if economic circumstances so require – on the overall volume of Eurobonds to be issued and the share of each member state. This would determine, within reasonable margins of error, the appropriate fiscal stance for EMU as a whole, based on the projected cyclical phase for the euro area. By determining the quota and thus the contribution of each country to the overall stance, the facility could take account of the fact that we still have asynchronous business and asset market cycles in the monetary union. The Eurobond issue would be guaranteed collectively by the member states, and all would pay the same interest rate. In contrast to De Grauwe and Moesen (2009), this Eurobond should not have any country names attached to it.

Access to the Eurobond would be granted only if a government complies with this European fiscal framework. There would be no guarantee that it can use up to 60 percent of its GDP, or in fact have to stay within any such arbitrary number. Eurobond conditions would send a signal to markets that could raise spreads for countries that had used up their access rights, so that borrowing to finance an excessive deficit might begin systematically to carry an interest rate penalty. Governments would still be able borrow outside this framework, comparable to the Red Bond in Delpa and von Weizsäcker (2010), and excessive deficit countries might still be able to borrow cheaply in good times. However, member states who do this may find their share in the Eurobond allocation reduced in the next period, in other words the variable national quotas can be used to sanction those who do not stay within the agreement. The Eurobond would thus make a start in giving EMU's fiscal framework some pecuniary substance, but also positive incentives for compliance.

Our proposal should be more acceptable politically as it is forward looking, introduced with respect to new bond issues, and not a vehicle to solve inherited public debt problems. This must be left to the ECB and the ESM over the next two decades. A retroactive introduction of joint liability would amount to overriding a national parliament's right to sanction the budget beforehand, as elected representatives of taxpayers. The involvement of national parliaments is an indispensable element of such a joint debt instrument in a European monetary union of democracies. In this sense, a fiscal union cannot be disentangled from a political union.

The European Semester provides an opportunity for such involvement. This process has brought national parliaments into the cycle of the EU's surveillance, rather than coordination, of national fiscal and reform policies. Based on National Reform Programmes (October 2010), the Commission drafted an Annual Growth Survey (January 2011) based on which the policy priorities were agreed in the Council (in March). Governments then sent their budgetary plans for scrutiny to the Commission (in April), which gave country-specific guidance on these plans (by

June/July) before national parliaments discussed and passed budgets in the autumn. The experience of the first cycle indicates, unsurprisingly, that it was a top-down process of one-way communication to which national actors tend to respond by ignoring it. The European Parliament passed a resolution in December 2011, noting in particular the tight deadlines that left national parliaments little room to respond or be involved when corrective action was requested (European Parliament 2011: paragraph 57). This is also a major criticism in an extensive evaluation of the European Semester by the Green Party Group in the European Parliament (Derruine and Tiedemann 2011).

The incentives to engage in the process would increase for both sides, if the content of the *ex ante* coordination would be the setting of an envelope for the budget balance that can be financed through Eurobonds. The EU institutions, Council and Commission, would then have a vital interest in signing up national elected representatives to the EU agenda, rather than merely lecturing them about prudent policy (hypocritically so in the case of the Council). National parliaments, in turn, would more clearly see the rewards of staying within an EU policy framework. They could still take responsibility for budgetary actions that are not agreed within this framework, but cannot expect any insurance or solidarity from the EU if they do so. The Eurobond would give tangible expression to the fact that the monetary union has created a community of risk, but also a club good of an insurance mechanism from which everybody can benefit, but to which everybody must also contribute.

Conclusion

In this article, I argued that the crisis has led to a paradox of fiscal union through monetary policy. This is a paradox because fiscal policy was deliberately left non-unionised so as to safeguard the independence of the ECB. I identified the Long-term Refinancing Operations at a fixed rate over three years to be a channel of a fiscal union through the back door, in addition to the usual suspect of the Securities Market Programme.

In contrast to many critics of this 'abuse' of monetary policy, I argued that it was the idea that monetary and fiscal policy can and should be completely separated that has led to this paradox. It was not government debt as such, but the feedback loop between bank balance sheets and government finances that left the ECB little choice but to intervene in this way, to stabilize the financial system in line with the mandate of any central bank. There was no fiscal actor who could take responsibility.

If one wants to relieve the ECB from its quasi-fiscal role, a minimum form of fiscal union is necessary. To this effect, a version of a Eurobond that serves macroeconomic policy coordination for the purpose of stabilisation (Mabbett and Schelkle 2010) was previously outlined. The issue of a Eurobond must be combined with the new policy process of a European Semester in order to be democratically viable and effective. The experience with the first round of the European Semester suggests that national parliaments have still little incentive to engage with EU fiscal surveillance and to consider their decisions as a matter of common concern, and understandably so as long as fiscal surveillance is a top down, one-way process with no positive rewards. In turn, the EU process must acknowledge that monetary union has created, more by default than by design, a risk pool and an insurance mechanism; this requires political endorsement from the representatives of those that ultimately pay for it.

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