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Making the ECB the central bank of a non-federal coalition of states

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1. Introduction

Starting in the mid-1980s with the 1986 Single European Act, the European authorities began the long-term process of creating a single European financial market. The European financial passport and numerous directives and regulations were intended to create a liberalised area with harmonised rules in which financial market operators would have found conditions favourable for integrating national financial systems into a single system. However the 1980s were also a period in which the liberalisation of both capital flows and direct financial investment, and the adoption of international standards (such as the ones proposed by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions) became the basis for the internationalisation of finance. As a result, for operators domiciled in the European Union (EU) the difference between financial internationalisation and financial Europeanisation has remained a matter of degree, one not significant enough to prefigure two different systems.

One relevant lesson of the recent crisis is that financial globalisation is not the same as financial integration. When a financial crisis hits, absent a single rescuer-of-last-resort, the global financial system reveals

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its true nature – a collection of national operators playing a global game. Led by market forces alone, globalisation is a fragile construct, easily producing fragmentation when national help becomes necessary to resolve a crisis.

The euro area (EA), now embracing 19 of the 28 EU member countries, had to face the recent crisis in not very different structural conditions. While the crisis produced EA cross-border negative externalities, lacking a central fiscal authority and common safety nets, each member country had to bear the costs of the crisis on its own. Limited last resort measures, like the temporary European Financial Stability Facility (EFSF) later substituted by the permanent European Stability Mechanism (ESM), were decided on only after the impact of the crisis on national public finances had produced a feedback loop between bank and sovereign risk capable of breaking apart the EA.

In section 2 we argue that the design of those measures in the context of the more general tightening of fiscal rules was not capable of dispelling markets' fears of sovereign defaults and the disintegration of the EA; indeed to some extent their combined deflationary effect reinforced such fears. Dangerously high sovereign returns in peripheral countries and financial fragmentation went on unabated. The effects of the first serious shock hitting a monetary union lacking a political one has shown how well founded were the criticisms levelled against such a design right from the start. We also argue that the crisis has not increased the probability of seeing the political completion of the EMU in the near future; on the contrary, the crisis has added political fragmentation to financial fragmentation. As a result, we must now realistically recognise that the design is not incomplete, but inconsistent.

In section 3 we explore two aspects of this inconsistent design: the European Central Bank (ECB), modelled as the independent central bank of a federal state whilst serving a non-federal coalition of states, and the renewed efforts to build a single financial market, or to keep financial fragmentation within acceptable limits, absent a common set of risk-free assets available to all EA operators. We argue that these aspects have impaired the ability of the ECB to contribute to lessening the effects of the ongoing crisis. However the crisis has exposed, not created, the fragility of the EA, which is deeply rooted in its inconsistent design. It has also shown that before the crisis the EA experienced convergence not integration.[1] We also argue that the recently born banking union is a necessary ingredient for building a single market, but not a sufficient one. Absent a common set of risk-free assets, the current modus operandi of the ECB cannot create a single financial market. In short, a single financial market requires pricing financial risks with respect to the specific features of financial and non-financial debtors starting from a common risk-free base, rather than by adding idiosyncratic mark-ups to different sovereign (i.e. quasi risk-free) rates. This means having operators that face a single risk-free yield curve.[2] In addition, it requires that all financial operators have access to the same risk-free assets for liquidity and trading operations. The euro area does not fulfil either of these conditions. The ECB can at best react to limit fragmentation, but with its current modus operandi cannot produce an integrated EA financial market.

In section 4 we offer a proposal for reform that seeks to deal directly with the conditions necessary to create a single financial market. Our perspective is informed by the belief that the prevailing social and political conditions in Europe will prevent any meaningful revision of EU treaties along federal lines, at least to the extent that would be necessary to create a financial level playing field. The advantage of our proposal is that it meets the objective of a single financial market without requiring any treaty changes. It does so by charging the ECB with the issuance of liabilities (henceforth described as 'debt certificates' or DCs) in an amount and tenor necessary to offer market participants common risk-free assets across the maturity spectrum. DCs are among the instruments already included among the liabilities of the ECB's balance sheet, and nothing in the EU legislation prevents the use of them as we propose

[1] As Cœuré points out, "the convergence of sovereign yields across countries in the euro area to very low levels before the financial crisis did not, in itself, imply market integration" (Cœuré, 2013, p. 2).

[2] For an early warning on the dangers posed to financial markets by the EA's construction, see Kregel (2000). For a recent discussion of the relevance of the risk-free yield curve and of the problems facing the EA, see ECB (2014).

here. In other words, instead of taking as ‘given’ the current modus operandi of the ECB and exploring fiscal and regulatory mechanisms to facilitate the unification of diverse national financial markets, we take as ‘given’ the political arrangement defined by the Maastricht Treaty and explore how to make ECB operations consistent with both the existing fiscal design and current EU treaties. Furthermore, while the recent crisis has focused the discussion on how to avoid serious financial disruptions such as the break-up of the euro area, we look at the coherence and efficacy of the institutional and structural design, which will also be important in more tranquil times, should such times ever return. Section 5 offers some concluding remarks.

2. The completion of the political design

Perhaps owing to the illusion that the architecture of the euro construct would serve as a lever to force further political and economic integration, the ECB and the Eurosystem were designed as if they existed within the context of a fully functioning federal state. There is nothing in the euro’s design to address the peculiarities of the EU-euro area political construct as established by the Maastricht Treaty, aside from (as we will see in the next section) some restrictions on the ECB’s monetary toolkit. As explained in the introduction, the absence of a uniform benchmark yield curve of risk-free assets blocks the emergence of a single financial market despite the existence of the ECB.

However, whether or not that was the original intention, the political design of the EU-euro area has never moved towards a federal system, remaining instead what we have elsewhere described as a flock of migrating ducks in flight, where good health is required to join the club and thereafter strict rules must be followed to make the long migration possible. It is instructive to recall that even under such strict rules, each ‘duck’ maintains its identity (Tonveronachi, 2013).

Unfortunately, the membership and flight rules for the euro area were badly designed, and were roughly consistent with what we may, for short, call the neoliberal approach. With governments targeting a neutral fiscal position and the central bank targeting inflation, the idea was that the liberalisation of markets would drive the convergence of the economies of the member countries towards individually and collectively sustainable paths and towards their integration into a single financial market. Opinions may differ as to whether the problem is that member state economies have not liberalised sufficiently or that the rules were seldom fully implemented. However, the fact that neoliberal policy prescriptions were not fully implemented does not make the entire design any less faulty. The understanding that the heterogeneous physiology of our 'ducks' was incompatible with the basic requirements of a sustainable, if not optimal, currency area should have militated against relegating public authorities to the role of mere referees. On the contrary, even following the orthodox theory of the second best, active and powerful centralised or coordinated public interventions (i.e. the introduction of more 'imperfections' in the jargon of the orthodox approach) should have been necessary to deal with these unavoidable imperfections. On the financial side, one missing area of intervention has been creating the conditions that should have rendered the cohabitation of the single central bank with national fiscal powers consistent with a single financial market.

The reforms prompted by the recent crisis have thus far followed the original design. The old fiscal rules were stiffened, macro rules were restated and more liberalisation was called for. In other words, more of the same ducks-flying-in-formation approach. Facing the risk of the EA's disintegration, the European Financial Stability Facility (EFSF), later substituted by the European Stability Mechanism (ESM), was created as the lender of last resort for EA countries facing serious sovereign debt problems. Although the EFSF and ESM were the result of intergovernmental agreements outside what is expressly considered by the EU treaties, they have to comply with the treaties' veto on fiscal transfers across member countries. As a result, their intervention follows the traditional IMF guidelines, taking the form of temporary loans whose repayment is guaranteed by a set of conditions. It is worth noting that despite the efforts of the ECB (which will be discussed in the next section), the hardening of the old design and the creation of a new safety net have not recreated the negligible national sovereign spreads that prevailed prior to the crisis.[3] Extreme deviations of sovereign spreads have probably been avoided, but quite certainly due more to the ECB interventions, effective or threatened, than to the other measures. The crisis has taught investors to be cautious about compliance with fiscal rules and on their effects on the sustainability of public debt. Above all, they have learned that convergence is not integration and that convergence is inherently fragile. From the point of view of EU operators this means continuing to work with significantly different national risk-free yield curves, hence facing conditions that are far away from a competitive financial playing field.

The necessity to move the EA design forward has not escaped the presidents of the European Council, the European Commission, the Eurogroup, and the ECB. In order to create a genuine Economic and Monetary Union, they proposed in a joint document (European Council, 2012) the creation of four unions over the next decade: a banking union, a fiscal union, an economic union and a political union. Recently, with the addition of the president of the European Parliament, a revised version of the report was produced, aimed at “completing Europe’s Economic and Monetary Union” (European Commission, 2015). The four unions remain at the heart of the proposal and the new catchword is to shift the EU governance from rules to institutions. The fundamental role of old and new institutions should be to enforce what are now called “benchmarks for convergence” that would de facto add to the existing rules and which “could be given a legal nature” (*ibid.*, p. 5). Besides, convergence relates here to rules, not to economic and social matters. The goal, returning to our similitude, is to create a remote control capable of forcing the ‘ducks’ to follow an enlarged set of rules. Only at the end of the convergence process, unrealistically set at 2015, some degree of fiscal centralisation, particularly in the form of a European Treasury (ET), could be introduced. However, the extremely vague ET proposal is more smoke than substance because it would be banned from active policies and from

[3] Sovereign spreads are measured with reference to the average sovereign interest rate of EA countries with an AAA rating.

producing long-lasting fiscal transfer inside the area; it would only act as passive cushion for systemic shocks interesting the entire area. It is clear that no fundamental regime change is foreseen in the above proposal. The new building blocks are specific unions necessary to transform the EMU into a so-called genuine union; there is no room for the term federation and its content. The EMU would remain a peculiar construction built on the principles of subsidiarity and proportionality, where centralisation should not go beyond what it is considered strictly necessary for reaching the common goals. Since these principles are the same as those that govern the EU, the EMU would then continue to be a stricter union inside the EU.[4] Albeit one with a certain peculiarity, that of having to render consistent the sharing of the common currency with national fiscal powers. Given that such powers will remain national, our opinion is that those reforms will be oriented to manage extreme circumstances for which it is easier to bend the existing treaties and reach a political consensus, than to create a consistent design.

In the three years that have passed since the initial ‘four presidents’ proposal, only the banking union (BU) has seen the light of day. The banking union has been proposed, supported and approved with arguments explicitly directed at eliminating both the vicious loop between sovereign crises and bank crises, and the fragmentation of the financial markets exposed by the recent crisis (see for example Mersch, 2013). The centrepiece of the BU is the Single Resolution Mechanism (SRM), for which the Single Supervisory Mechanism (SSM) represents the necessary ‘political’ precondition.[5] The focus of the SRM, in line with

[4] It is worth remembering that the Maastricht treaty, now incorporated into the European treaties, sees the EMU as the final architecture of the entire Union, apart from the two indefinite opt-outs granted to the UK and Denmark.

[5] To consider the SSM as a strong achievement per se, capable of making banks resilient, requires a level of faith in the Basel-type regulation and supervision that I am not ready to share. As for its ability to overcome national interests, the recent experience of the ECB dealing with, at least, the Irish crisis and its choice of the assets on which to base the current asset review does not bode well (see e.g. Legrain, 2014). Note also that the request by some European officials to promptly abandon zero-risk weighting for sovereign debt held by banks, which is legitimate if following the Basel approach and which the ECB is

the guidelines proposed by the Financial Stability Board, is to shift the cost of the banking crises from governments (bailout) to private investors (bail-in). Under this regime, mutual resources (the ESM) will only be available as a last resort, and then only as temporary loans to be repaid by ‘taxing’ banks. This fundamental separation of finance from fiscal resources explains why the banking union has been agreed upon in such relatively short time. Many criticisms have been raised regarding the effectiveness of the SRM. However, two points are relevant to our discussion. First, the charge that the SRM is asymmetric and will at most shield government finance from bank crises but will not protect banks from sovereign turbulence, to the extent that EU banks do not share common risk-free assets. This means that the financial system remains structurally fragmented. Second, and also true for some of the other proposals discussed below, we must distinguish between the tools used to manage crises from those aimed at producing a single financial market during calmer times. The banking union is consistent with a single financial market – it is a precondition for its existence, but it is not a sufficient one.

Apart from the political union, which concerns the democratic legitimacy and accountability of decision-making (translation: the necessity to calm EA voters’ opposition to centralisation), the other two unions look to higher degrees of cooperation and enforcement. The fiscal union, in particular, aims at ensuring

> “sound fiscal policy making at the national and European levels, encompassing coordination, joint decision-making, greater enforcement and *commensurate* steps towards common debt issuance. This framework *could* include also different forms of fiscal solidarity” (European Council, 2012, p. 3, italics added).

The only potential novelty contained in the first report with respect to the stricter fiscal rules, the link between some form of debt mutualisation and the effective enforcement of those rules, has disappeared in the latest one. It should be noted that issuing a consistent

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already implementing for the haircuts in its discount window and furthermore has recently applied in its comprehensive assessment, renders the playing field even more uneven.

quantity of common sovereign debt encompassing a wide maturity spectrum would create an effective, common risk-free yield curve that is the necessary precondition for a single financial market. Most probably, the disappearance of any hint to debt mutualisation owes to the conclusions of the report commissioned by the European Commission, in which the fear of moral hazard paralyses any action on even the most timid proposals, which would however be inadequate from our point of view because of their restriction to short-term maturities.[6]

To conclude, the reforms already approved and those that appear to be politically feasible are at most directed at avoiding disaster. The path to create the political and fiscal conditions necessary to attain the single financial market appears so removed from reality as to make it worthwhile to look for a different solution.

3. The current operational design of the ECB

The current approach to central banking focuses on the control of short-term interest rates, leaving efficient markets in charge of the transmission of these rates to the entire spectrum of financial assets, for both maturity and specific risk characteristics. A high degree of substitutability between assets is a precondition for the effective operation of such a mechanism in an efficient market. The monetary authority also counts on its actions to influence market expectations and often engages in forward guidance regarding the direction of reference interest rates and the expected impact on their term structure. The theory underlying the operation of an efficient market thus requires a risk-free issuer to set the benchmark yield curve used for pricing all other risky

[6] The report concludes that, "[g]iven the very limited experience with the EU's reformed economic governance, it may be considered prudent to first collect evidence on the efficiency of that governance before any decisions on schemes of joint issuance are taken. […] Treaty amendments would be necessary to arrive at joint issuance schemes including joint and several liability, certain forms of protection against moral hazard and appropriate attention to democratic legitimacy" (Expert Group on Debt Redemption Fund and Eurobills, 2014, p. 86).

assets. It is the debt of the sovereign that thus plays the crucial role of being the risk-free point of reference for efficient market pricing, liquidity preference included, and the preferred way to maintain liquidity buffers and to post collateral. Absent this single sovereign issuer, the euro area does not have common risk-free assets.

The existence of market 'inefficiencies' may not only require using stronger doses of monetary policy, but may also hinder the desired policy results. For instance, a monetary policy restricted to setting refinancing conditions is a hostage of banks' endogenous decisions to create or destroy secondary liquidity; thus, policy stimuli are not necessarily transmuted into the volume and cost of credit desired. This is why central banks often supplement their toolkit with open market operations, which give them the opportunity to more directly affect market liquidity and the shape of the yield curve. Again, since according to the orthodox approach a central bank should absorb liquidity risk but not credit risk, those operations should normally be limited to sovereign debt.

This is merely a sketch of the dynamics at work but it should make it clear that absent a common risk-free issuer the euro area contains a structural 'inefficiency' which affects financial service providers, private investors and the central bank.[7] Euro financial markets are structurally fragmented and the ECB encounters remarkable difficulties, not least political obstacles, to engage in full-fledged open market operations, not surprisingly termed unconventional operations in the ECB's own parlance.

At the height of the EA sovereign debt crisis, the ECB intervened in the secondary sovereign markets of some peripheral countries with its

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[7] According to Daluiso and Papadia (2013, p. 3), "[t]he situation in the €-area is different from that in the US, the UK, Switzerland and Japan in two respects. First, the possibility of an endogenous tightening of monetary policy is limited to the ECB and does not extend to the other central banks. In fact all these banks provide liquidity to the market on an outright basis, purchasing securities (FED, Bank of England and Bank of Japan) or foreign exchange (Swiss National Bank), unlike the ECB that provides the bulk of it on a repo basis. The amount of excess liquidity is thus determined in countries other than the euro-area by the central bank, not by commercial banks in their refinancing choices. Second, there is no differential pull-push factor in these countries, in which the rates are dominated by national securities".

Securities Markets Programme (SMP). It did so on the grounds that, with investors betting on the breakup of the euro area, markets were overshooting and thus impeded the transmission of the ECB's monetary policy. The move was criticised as contravening the spirit, if not the letter, of the Maastricht Treaty because, it was argued, the ECB was altering the evaluation of risks made by the markets and, by assuming sovereign credit risk, could cause forbidden fiscal transfers across euro area member countries to take place. Although it is difficult to agree that markets are always right, and, absent clear political decisions, the ECB's move was justified by the overarching goal of keeping the euro area intact, the above criticism touches a very sensitive nerve. The question this raises is what the ECB considers an acceptable sovereign interest rate for a member country.

This point is even more relevant to the ECB's announced outright monetary transaction programme (OMT), designed to buy selected sovereign debt in the secondary market with no seniority in favour of the ECB (a *pari passu* clause) and maintain the goals of the previous intervention. One further objection raised against OMT is that the country whose debt is to be acquired by the ECB should be or should enter into the ESM programme, which implies the imposition and monitoring of fiscal constraints. Obviously, this has infuriated the purists of the separation between monetary and fiscal policies.[8] Merely the announcement of the OMT programme was enough to calm the markets so that, up to now, it was not necessary to test the political consequences of its implementation.

Even if after the OMT announcement markets ceased to inflate sovereign returns of most EA peripheral countries with currency risk, sovereign spreads with respect to German Bunds have remained at substantial levels. The fragmentation of the EA financial markets is

[8] An interesting discussion of the legal and political aspects of the ECB's independence is offered by Bibow (2015). Also note that the Bundesbank's expert opinion supplied to the German Constitutional Court challenged the legality of the OMT programme.

highlighted by the ECB adopting for its refinancing operations eligibility criteria and haircuts related to external sovereign ratings.[9]

If these measures had been justified in terms of sovereign debt sustainability (exactly what level is 'sustainable' remains a subject of much controversy), the ECB would have discretionally influenced national fiscal conditions, which is forbidden by its statute. If the interventions were instead calibrated to the transmission of monetary policy, as the ECB argues, they should be of such strength, both in volume and in terms of the number of countries involved, to effectively eliminate the spreads of the sovereign debt of all euro area countries with respect to German Bunds. However, the moral hazard objections would thus become intractable. Thus, the current modus operandi of the ECB may succeed in preventing a euro area breakup, but not in de-nationalising financial systems.

The recent launch of quantitative easing (QE), labelled an expanded asset purchase programme by Draghi at his 22 January ECB press conference (Draghi, 2015), is a further example of the difficulties encountered by the ECB when adopting full-fledged market operations.[10] After months of internal quarrels, the Governing Council of the ECB decided unanimously that QE, with the *pari passu* clause and acquisition of sovereign bonds according to the national share in ECB capital (capital key), is a legal monetary instrument. It was decided by majority vote that QE should begin in March 2015, and decided with consensus (which means no open dissent existed that would have required a vote) that up to 20% of eventual losses coming from the additional purchases will be shared while 80% will be borne by national central banks. In other words,

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[9] After arguing that rating agencies only see a wisp of smoke when the fire is well advanced and afterwards they overestimate the damage, De Grauwe (2010, p. 3) asserts that "the ECB should discontinue its policy of outsourcing country risk analysis to American rating agencies. […] The reluctance of the ECB to do the credit analysis in-house is probably due to the fear that it may sometimes have to take difficult stances that do not please national governments. It is much more comfortable to have this job done by outsiders".

[10] We do not discuss here the effectiveness of ECB's QE when coupled with the EA's deflationary fiscal policies and the increasingly tight regulatory conditions imposed on banks.

80% of the additional asset purchases will be made pro quota by the national central banks, putting the burden on their own balance sheets, not on the ECB's. Furthermore, the acquisition of sovereign bonds will be limited to 25% of each issue and 33% of the entire debt (including the existing holdings under the previous SMP programme) and must concern investment-grade assets.[11] Starting from March 2015, the ECB and national central banks buy assets totalling 60 billion euros per month, including private and public assets. The acquisition of private assets constitutes the continuation of two previous programmes – the asset-backed securities purchase programme and the covered bond purchase programme 3 – which in the four months from their launch to the announcement of QE had added around €48 billion to the ECB balance sheet. The acquisition of public assets includes sovereign debt and the debt of European agencies and supranational issuers.[12] The provisional ending of the QE programme is pencilled in for September 2016; depending upon whether the inflation target has been reached (inflation below, but close to 2%), the programme may be terminated earlier or renewed. As for the motivations, with respect to the two previous programmes the main goal now is not the fluidity of the transmission channel of monetary policy, but avoiding deflation.

The QE programme is a clear political compromise. We may suppose that the doves of the Governing Council have obtained the recognition of the legality of QE with the *pari passu* clause and its application starting from March 2015.[13] The hawks obtained justifying the programme with inflation targeting and the pro quota acquisition of national sovereign bonds. As we will see, the limit on risk sharing may have a double reading.

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[11] The last condition is the same applied by the ECB for its conventional monetary operations.

[12] For a list of both types of institutions, see http://www.ecb.europa.eu/mopo/liq/html/pspp.en.html.

[13] An element of dissent inside the Governing Council was how to interpret the recent deflationary trend. Doves had to accumulate enough arguments showing that the current situation would be a protracted one, with the danger of creating a self-reinforcing trend.

If the effect of the expected euro devaluation were to be reinforced by the recovery of international prices, the programme would be halted irrespective of its effects on growth. More generally, it reaffirms the principle that it is not the state of the economy but inflation that sets the ECB's monetary stance. Distancing itself from the selective acquisition of OMT, the QE programme will leave markets to adjust portfolios according to their interest, not to the different needs of EA economies, and its effects on sovereign spreads will come again from convergence, not integration.[14]

The decision to share risks only up to 20% of the entire programme can be read as strengthening the idea that the EA does not have a full-functioning central bank. The relevance of risk sharing calls into question the interplay between the central bank and its sovereign. Briefly, a central bank would suffer losses for public debt held without seniority if its national government decided to default. If these losses rendered the capital of the central bank too low or negative, according to current wisdom the national government should intervene to recapitalise it, thus making its debt restructuring more onerous. In the Q&A of his press conference, Draghi (2015) downplayed the relevance of risk sharing for the QE programme when the entire set of 'unconventional' policies is considered. He clarified that full risk sharing is relevant to avoid the sovereign default of a specific member country and this is what OMT was designed for.[15] We have thus two monetary policies with two distinct objectives, unconventional inflation targeting with QE and avoiding with OMT the exit from the EA of a member country, an occurrence that the EU treaties do not consider. The ECB rationale for having two distinct

[14] Our opinion is that after the recent ruling of the European Court of Justice (ECJ) in favour of the ECB the real 'bazooka' remains the OMT. It remains to be seen if the ECJ's opinion will be fully accepted by the German Constitutional Court in its re-examination of the matter.

[15] "In OMT full risk-sharing is fundamental for the effectiveness of that policy measure […] because it's selective, it addresses specific countries, the countries are under stress, the debt sustainability is an issue and there are tail risks that could make things precipitate for certain individual countries […] to address these risks, OMT is there, ready to be acted, in case […] tail risks were to materialise, and that programme is under full risk-sharing" (Draghi, 2015, p. 4).

programmes is easily explained: the full risk sharing of OMT comes with the imposition and monitoring of a set of conditions, mainly fiscal in character, which, following the IMF's practices, should steer the country back into solvency.[16] In this role, the ECB is not acting as a traditional central bank, but as a European Monetary Fund. We can then understand the German objection that such a fund already exists in the form of the ESM. The difference, not one of detail, is that the ECB could do "whatever it takes" (as Draghi famously said), meaning the use of unlimited resources, while the ESM is poorly capitalised. Significantly, one of the objections raised by the German Constitutional Court against OMT is the absence in the programme of quantitative limits. Financial markets seem to be aligned with Draghi because sovereign spreads abandoned dangerous levels only after his "whatever it takes", and were not significantly affected by the ESM or its EFSF predecessor.

However, if we interpret the consensus on the 20/80 rule as affirming the principle that, as Draghi clarified at his press conference, it is up to the autonomous decision of the ECB to decide when and how to apply risk sharing, the fact of allowing risk sharing without the fiscal conditionalities attached to OMT sets a relevant precedent. We will return to this argument in the next section.

Summing up, similarly to the fiscal safety nets, the two unconventional monetary programmes were designed to avoid extreme occurrences, in this case sovereign failure and deflation. Irrespective of the fact that these programmes continue to encounter political limits and legal litigations, they are not designed to set the foundations of the EA single financial market.

4. A new operational design for the ECB

If, as argued in section 2, we cannot count on fiscal and political reforms to create the basis for a single financial market, and if the

[16] If the model is that of the Troika and Greece, we hardly feel reassured.

extended measures recently taken by the ECB do not go in that direction, we are left with the option of exploring the possibility of changing the modus operandi of the ECB in a way that does not require changes to treaties.

In its general outlines, our proposal is quite simple. Euro area financial intermediaries holding national debt in their portfolios would be given the opportunity to swap it for ECB liabilities, or ‘debt certificates’ (DCs), which would cover the entire maturity spectrum of the yield curve. As a result, the ECB would acquire, in the secondary market, a portfolio of sovereign securities of the euro area countries in proportion to the contribution of each country to the capital of the ECB, and national financial institutions would acquire a portfolio of risk-free ECB issued DCs. On completion, the ECB would suspend its acceptance of sovereign national bonds as collateral for its refinancing operations and restrict its operations to DCs.[17] This would create the incentive for financial intermediaries to swap higher yielding risky sovereign bonds held on their balance sheets for liquidity purposes for lower yielding DCs. Financial intermediaries would face a single risk-free yield curve and the ECB could swiftly base its open market operations on DCs without technical or political problems.[18]

Adding open market operations based on DCs to traditional refinancing operations would interfere neither with the statutory goals of the ECB, nor with its mission to control the liquidity of the EA. On the contrary, national considerations would not interfere directly or indirectly with the goal of assuring the swift functioning of the transmission of monetary policy. The ECB could design the auctions for the various maturities of DCs either to leave markets free to shape the yield curve, or to intervene when not satisfied with the transmission of monetary policy

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[17] This would also apply to Emergency Liquidity Assistance operations (ELAs) in charge of EA national central banks.

[18] The different purposes for which some central banks issue securities is discussed by Rule (2011) and by Gray and Pongsaparn (2015). According to the latter, the Hong Kong Monetary Authority issues 91-day to 15-year Exchange Fund Bills and Notes to establish the yield curve.

to longer maturities. As we have seen in the previous section, this is what standard open market operations have become.

Furthermore, a single EA market for risk-free assets could be created with a dimension that would make it highly liquid. The current situation in the euro area is characterised by potential mismatches between the domestic demand for liquidity coming from its degree of financialisation and the deepness of markets for national sovereign securities. As an example, we recall that the recent acquisition of large amounts of treasury bonds by the US Federal Reserve for its quantitative easing program produced some shortages in the availability of treasury bonds for trading operations and for the Fed itself. The issuance of DCs by the ECB would cut the link between the demand for liquidity and the supply of (quasi) risk-free assets at the national level.

In order to limit the role of DCs to the uses outlined above (i.e. providing a benchmark and not a financing vehicle), they would only be available to euro area markets, with the holding and trading of DCs limited to financial institutions incorporated as firms in euro area countries. We must of course justify our assertion that the proposal does not apply pressure to existing EU treaties or require their modification.

After the unanimous decision by the Governing Council of the ECB that QE with pro-quota acquisition of sovereigns in the secondary market is a legal monetary measure, the same operation made for managing the liquidity of the single EA financial market should comply even more with the letter and the spirit of the treaties. With regard to DCs, their issue is already included among the tools that the ECB can use as part of its toolkit for open market operations. They are listed among the liabilities in the ECB's financial statement, and were up to now utilised on a small scale, particularly in the early years and very briefly in 2007 and 2009 to absorb liquidity. The monetary policy guidelines of the ECB classify DCs as structural open market operations,[19] which would have a 12-month maturity and be sold at a discount in standard tenders managed by the national central banks. Despite the maturity specified in the policy

[19] "[Structural] operations are executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector" (ECB, 2011a, p. 10).

guidelines, the EU treaties and the charter of the ECB do not pose limits on the quantity and type of DCs.[20]

However, objectors may raise the question of the possibility of fiscal transfers across EA countries. The goal of our reform is to create a single financial market and to manage more efficiently its liquidity; in no way do problems related to sovereign debt sustainability enter into the picture. Because DC issues would be linked only to liquidity management, the ECB would not have to take any discretionary decision about relative sovereign rates and no moral hazard would result for any national issuance of public debt. The problem thus comes from secondary effects, from the fact that the losses from possible country defaults would weigh on the ECB's capital, which means they would be mutualised. Using half of Draghi's argument, we could argue that if the OMT is there to avoid sovereign default, there will be no losses coming from holding the portfolio of EA sovereign debt. But let us keep OMT as the argument of last resort and admit that our proposal implies risk sharing in the absence of any type of fiscal conditionality.

Our counter argument refers to the current practice adopted by the ECB of building a reserve fund, fuelled by part of its seigniorage and up to 100% of its capital, to cover possible losses coming from its operations in private assets. As long as the ECB's policy of containing inflation remains credible, its DC liabilities would be credit risk-free. A new seigniorage, let us call it S2, would then accrue to the ECB due to the difference between the average return coming from the portfolio of sovereign securities and the cost of serving DCs. At least part of S2 could be used to feed a specific reserve fund analogous to the one used for private assets. Note that independence gives the ECB the freedom to decide the share of seigniorage going to remunerate the owners of its paid-up capital.

Contrary to what the current debate on QE suggests, the fact that in our proposal DCs are costly liabilities implies that fiscal transfers across EA countries could happen, whose modalities depend also on how S2 is

[20] See ECB (2011a; 2011b; and 2012).

paid back to national treasuries.[21] If S2 is paid back according to national contributions to it (interest paid for the debt acquired by the ECB), so long as S2 is positive we have no fiscal transfer. If, due to large sovereign defaults, S2 becomes negative, the contribution by the reserve fund to cover the losses implies necessarily that a higher proportion is absorbed by non-defaulting countries.[22] If S2 is paid back according to the national shares in ECB paid-up capital, all countries receive the same percentage return from S2 but contribute to S2 according to the cost of their debt. So long as S2 is positive, we have annual fiscal transfers in favour of countries with lower than average cost of debt. If S2 becomes negative, the reserve fund is called upon to cover the loss and it is also possible that over a long period horizon the losses are not distributed in proportion to the countries that have originated them. If we suppose that a big default or that many concentrated defaults capable of producing a negative S2 are tail events, the upside risk would dominate in the long period, thus producing a sort of positive incentive for member countries to be fiscally 'virtuous'. However, once the reserve fund has reached a safe level, the distribution of S2 could become fiscally neutral following the payback policy of the first case.[23] In the long period, the difference between the previous alternatives thus concerns the shares of national contributions to the fund.[24]

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[21] The differences with respect to the debate regarding QE (see for instance De Grauwe and Ji, 2015, and De Grauwe, 2015), is that S2 may become negative since we cannot assume zero costs for the emission of the ECB's liabilities. As we will see, it is the possibility of a negative S2 that may imply fiscal transfers.

[22] The same result would follow if instead of having a reserve fund the member countries were called upon to recapitalise the ECB.

[23] The safe level of the reserve fund would depend on the possibility to activate the OMT 'bazooka' for losses exceeding a certain threshold.

[24] The previous analysis has focused on the flow aspect of the sustainability of the ECB's financial position, not on the possibility that its book value might become negative. In Minskyan terms, we adopt the view that as far as the central bank is capable, with the help of a cushion of safety of serving its debt without recourse to new debt or external recapitalisation, it assumes a hedge position and the present value of its capital is positive. Because the introduction of costly liabilities such as DCs requires putting up a reserve fund, we introduce a different perspective on the ongoing debate surrounding the meaning

Pro-tempore fiscal transfers could be reasonably justified as covering against systemic events. The consensus reached on the 20/80 rule for QE shows that the ECB is open to the solution of limited risk sharing without attaching the fiscal conditionalities of OMT. The question is whether the autonomy of the ECB when deciding on risk sharing could be challenged in the courts as contravening EU treaties.[25]

The obvious premise is that the monetary policy following from our proposal is in no way directed at producing fiscal transfers. It is directed at producing a single financial market and to manage its liquidity, for which effective alternatives do not exist. Discussing the EA separation between monetary and economic policy, Bibow (2015) recalls the so-called Pringle decision of the European Court of Justice (ECJ). In the Pringle case, the ECJ was called upon to judge whether the ESM might conflict with the union's exclusive competence in monetary policy assigned to the ECB. The court's assessment first focuses on policy objectives. In its ruling the court determines that the objective of the ESM does not concern price stability but securing the financing needs of the members' public sectors, which, in the ECJ's eyes, makes it the subject of economic policy. The court then also addresses the issue of whether any indirect effects on price stability would concern this assessment, and determines that what matters is that the ESM, in contrast to monetary policy, does not constitute a direct measure to maintain price stability (Bibow, 2015, p. 21).

It is of relevance to note that the institutional separation of monetary and fiscal policies has in the treaties the same cogence as the absence of fiscal transfers. If we apply the above ECJ reasoning to monetary policy, what is relevant is the policy objective (in our case the existence of a single financial market and its liquidity management), not any possible indirect fiscal effects. In addition, it is hard to exclude that the ECB's

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of a central bank's capital becoming negative. See for instance Buiter (2008) and De Grauwe (2014).

[25] Peter Praet, member of the Executive Board of the ECB, recalls the concept of monetary dominance enshrined in the Maastricht Treaty, meaning that the independence given to the ECB was meant to ensure that it had full control over its balance sheet (Praet, 2015).

conventional monetary policies are also capable of indirectly producing fiscal transfers across such a peculiar construction as the EA.

5. Conclusions

In both normal and turbulent times, a key structural condition for having a single financial market is for financial actors to face a common risk-free yield curve. The current design of the euro area with its multiple national fiscal authorities does not fulfil this condition. We have argued that a federalised future for the EA is subject to strong doubts and, in any case, should be seen as a long-term objective. Given these conditions, we explore ways to mend the current inconsistent design that fragments euro area financial markets and foments fragility. The reforms adopted or proposed up to now, such as the banking union, go in a direction consistent with the single financial market, but are not sufficient to create it. The financial market would remain structurally fragmented.

The heart of our proposal is mandating the ECB to issue debt certificates in the amount and with the maturities required for EA financial intermediaries to face an effective single risk-free yield curve. This would have the further benefit of rendering the ECB's refinancing and open market programmes fully operational without incurring political problems. The ECB would balance these issuances with the acquisition, in the secondary market, of sovereign debt of EA countries. This would create a new type of seigniorage, which would be distributed to national treasuries according to each nation's participation in the capital of the ECB. The latter and the explicit goal of DC issuance would not create moral hazard problems. We explain why the proposed reform would comply with EU treaties and would eliminate the need for the ECB to resort to questionable practices in times of stress.

Our proposal has nothing to do with the issue of sovereign debt sustainability, currently attracting most of the attention of policymakers and analysts. Obviously, EU policymakers must deal seriously with the debt problem in ways that do not force the Union into decades-long deflation. However, we are sceptical of proposals that mix the solution of the sovereign debt with matters concerning the single financial market and monetary policies. The contribution by Brunnermeier *et al*. (2011), which links the problem of managing the sovereign debt of EU countries to the issuance of common EU risk-free assets, is an outstanding example. Looking at it also helps to further clarify some aspects of our proposal. A special European debt agency (EDA) would manage the securitisation of national sovereign debts, in the measure of 60 percent of the EU's GDP, funding this acquisition with the issuance of two tranches of debt, the junior one taking on first the eventual losses coming from sovereign failures. According to the authors, the senior tranche (European Safe Bonds or ESBies) could be designed to be practically risk-free, thus representing the common risk-free asset that would disconnect financial intermediaries from local sovereign risks. Moreover, ESBies would be issued with different maturities, thus supplying the risk-free yield curve and the range of risk-free assets necessary to operators for liquidity management. The opinion of the authors is that their proposal retains the advantages of the issuance of Eurobonds while avoiding the criticisms levelled against them because private junior investors, not taxpayers, would sustain any eventual losses and the share of sovereign debt exceeding the 60 percent ceiling would be funded at market rates, thus retaining market discipline against profligate governments.

While we maintain some doubts on the issues of loss sharing and moral hazard, especially given that member countries should contribute to the capital of the EDA to enhance the safety of ESBies, other serious objections stand in the way of its adoption. First, the 60 percent ceiling could be in the future too high for some 'virtuous' countries, and the incentive to reach that ceiling could strengthen moral hazard. Second, making the status of risk-free assets dependent on credit-enhancing calculations may not be the safest way to provide high quality liquidity. Third, ESBies would not actually be risk-free assets, and their rating could be less stable and become lower than that of countries with the highest rating. For instance, we can imagine German banks preferring to hold German bunds instead of ESBies. Fourth, linking the creation of ESBies to the figure of 60 percent of the euro area's GDP would produce liquid assets in an amount that would be unrelated to the demand for liquidity, and according to this proposal such demand would also come from outside the euro area, thus creating the potential for high volatility. Fifth, the establishment of the EDA alongside the ECB would *de facto* create a dual structure for monetary policy. This is because, even if new issues of ESBies were sold through auctions, mechanical issuances linked to the 60 percent rule and decisions on the relative amounts to issue for the different maturities could easily affect the position and form of the yield curve.

To conclude, those who see in the current muddled design of the euro area an opportunity or an argument for pushing member states closer to federalisation might consider the proposal offered in this paper as a way to weaken their argument. We suggest that the sovereign debt problem is, in and of itself, a sufficient basis for a deeper political union. Moreover, the progress we have witnessed thus far, under the inconsistent design of the Maastricht Treaty, does not support the thesis that serious economic problems are enough to overcome political problems. On the contrary, one of the effects of the recent crisis has been to add political fragmentation to economic fragmentation. To the degree that the present proposal and the reform measures already implemented, or those that are feasible in the near term, will put the euro area on a more solid economic footing, these same measures will also serve to facilitate the political process.

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