

# Three proposals for revitalising the European Union

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## 1. Introduction

The result of the UK referendum on exiting the European Union (EU) is only the most visible sign of the shortcomings and fragmentation of the Union's political, institutional and policy frameworks and of the need to reform them.

In the economic field, the process of harmonisation of rules directed at creating a single internal market has added increasing constraints and rigidity to member countries in the context of an unchanged political-institutional design. The perception that, given the types of rules and the inevitable heterogeneity of member states, the convergence on the current set of rules is not capable of producing convergence on results, or anyway generalised better results, has produced a high level of socio-political fragmentation inside the Union. The physiology of the consequent demand for re-nationalising certain sovereign powers comes from the necessity for higher national flexibility. Having to exclude the option of a path towards significant levels of federal governance as unrealistic, the reality of a union made up of sovereign countries competing under common rules imposes a reflection on how feasible changes in the current set of rules could accommodate the increased demand for national flexibility.

The present paper, which is based on earlier works (Tonveronachi, 2015a, 2015b, 2016), analyses some politically and institutionally practicable routes capable of restoring margins of national flexibility and, through them, giving significantly more

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viability to the European project. Section 2 offers a short discussion on the institutional and political perspectives of the European Union, and is aimed at showing the existence of quite insuperable obstacles for the adoption of reforms requiring significant degrees of fiscal federalism and for revisions of the Treaty on the Functioning of the European Union (TFEU). Focusing on the European Economic and Monetary Union (EMU), that is on the euro design, the paper then presents three reform proposals, concerning the revision of the monetary operations of the European Central Bank (ECB, section 3), of the current fiscal rules (section 4) and of the financial regulatory approach (section 5), which do not require changes in the TFEU. Not only would these proposals contribute to overcome some of the main inconsistencies, rigidities and fragilities of the current design, but their implementation would also offer a new perspective of sustainability to the EMU, possibly making it capable of attracting those non-euro area EU countries that consider the mismanagement of both the recent crisis and its after-effects reason enough for resisting further losses of sovereignty. Section 6 concludes, synthesizing the general lines of the proposals and the results that we might expect from their implementation.

## **2. The EU institutional and political perspective**

Any regional agreement wanting to be more than the establishment of a free trade area needs relevant shifts of sovereignty from member countries to *ad hoc* designed central institutions. The shift should be proportional to the degree and type of economic, social and political integration. The higher is the chosen degree of integration, the longer the time necessary to attain it. In the meanwhile, the gradual building of centralised institutions and rules should follow from a clear final design and should ensure a sufficient degree of consistency in each step of the integration process. However, the unavoidable inconsistencies brought about by a dynamic structural process require the institutional framework to contain

some social and economic safety cushions against unforeseen shocks. The European Union is now more far away than in the past from satisfying these viability conditions, first of all for not offering clear indications on the final aims and objectives.

Differently from the spirit of the Maastricht Treaty, the transformation of the previous European Community into an ever-closer union, with its single currency appendix, has been relegated to the category of the improbable. Adding the disastrous management of both the recent crisis and its after-effects and the unsolved inconsistencies of the design of the euro area (EA), an already serious political fragmentation has been exacerbated.<sup>1</sup> Despite what was clearly stated in the European treaties, according to which all member countries, except Denmark and the UK, must actively implement convergence policies finalised to entering the EMU, demands for opting out from maximum harmonisation, not just from the euro and the banking union, are increasing and becoming of a permanent nature. The political union of the euro area, at least in the degree necessary to make it viable, is not on the agenda.

The recent *Five Presidents Report* (EC, 2015) clearly recognizes the political impossibility of forcing member countries to comply with the provisions of the European treaties on adopting the common currency, whose appendixes, like the banking union, now bring increased losses of national sovereignty. Thus, the *Report* counts on its proposed reforms of the euro area to produce enough incentives to convince non-EA EU countries to adopt institutional and economic convergence policies finalised to entering the euro area. Apart from the usual dose of rhetoric, proposing the enlargement of rules, their stricter enforcement and maintaining that convergence concerns rules and not economic and social matters, the *Report's* proposals do not contain anything new also because of real-politick constraints.

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<sup>1</sup> Worthy of mention is also the illusion that entering the European Union would have guaranteed the convergence towards, and enforcement of the democratic values and fundamental rights purported by its Charter; when the political fragmentation also touches these matters it necessarily increases internal inconsistencies.

The latter come from the ideological opposition, or political impossibility to modify the design given to the EMU by the Maastricht Treaty: monetary unification with fiscal rules thought of as proxies of the lack of a significant degree of political unification, which means the lack of mutualisation of sovereign risks. The discussions triggered by the recent crisis have made it clear that the geo-political core of Europe considers this arrangement not as a temporary solution, capable with its inconsistencies to force a path towards political unification. On the contrary, it is considered as the finished and consistent design of a union, made up of fiscally sovereign countries competing inside a common market with free circulation of goods, capital, firms and workers under the constraints coming from sharing a set of rules, which are more stringent for the countries adopting the euro (Issing, 2013, 2015). Hence, the distinctive features of the European design are fixed rules and processes, among which the monetary ones, as opposed to discretionary powers exercised by a central authority. In an association of heterogeneous countries, no set of rules is, however, neutral and history teaches that the convergence on rules rarely produces convergence on results. Specifically, Teutonic rules may produce Teutonic results only for few member countries, and not for the Union as a whole. Accepting the vision of the Union in terms of competition among country-systems, the design of the rules is crucial. If the current design produces serious divergence, the socio-political fragmentation will inevitably increase.

It should thus not be a surprise that the *Report* has failed to revive the convergence process and to quell criticism to the European construction. On the contrary, and with some inconsistency with respect to the *Report's* declared goals, the two or multi tiers union has been rendered *de facto* a permanent feature by the recent official attempt to appease nationalistic fervours and to avoid further exits from the European Union, by reinterpreting the European treaties' ever-closer union in terms of a milder cooperation in the context of a plurality of

currencies.<sup>2</sup> The cooperative vision implies the re-nationalisation of part of the sovereign powers that had been shifted to the Union in the past; its instrument is the restrictive use of the principles of subsidiarity and proportionality through which national legislations had been increasingly harmonised, often with few recognitions of physiological local specificities. For the EU and the euro area, the repatriation of powers on some matters could produce not the weakening of the union, but the attempt to give more consistency to a model of competitive country-systems. For example, as suggested in section 5, changing the approach to financial regulation, and in conjunction with the other reform here proposed, the renationalisation of powers for financial supervision could contribute to give the necessary flexibility to the overall design.

The opposition to an even limited repatriation of sovereign powers could come from the idea that it would disrupt the singleness of the European internal market. As a general proposition this argument is simply false. The internal market of the Union is substantially free, that is deregulated, but not single. Singleness requires that all the operators of the Union, without limits coming from their nationality, were in structurally level playing field conditions. This is not true in many fields, especially in the fiscal one but also, as we will discuss in the next section, in the monetary field. While the latter could be levelled, strong heterogeneities across national fiscal structures come to a large extent from the model of competitive country-systems, and the European treaties constitute a formidable bastion against the imposition of fiscal harmonisation. In these conditions, the false pretence of the singleness of the internal market cannot be invoked for opposing well-designed forms of national flexibility.

The current lack of interventions capable of showing *hic et nunc* that generalised benefits coming from the European membership exist also in crisis conditions, is entrenching more and more Europhiles into

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<sup>2</sup> It is relevant to note that this evolution would also render the current institutional incoherence permanent. The existing institutional framework built in accordance with the convergence towards the EMU dictated by the treaties, and with the goal to build a single European market, is not functional to a multi tiers system.

negative arguments, making them argue that the losses that would have to be sustained for leaving would be higher than the costs of remaining. This is a difficult exercise, given the uncertainty around the path that both the EU and EMU will follow, and around the future of globalised markets and the degree of national sovereignty that they would permit.

What is certain is that a significant mutualisation of European sovereign risks will have to wait for several decades, if it will ever become reality. Since the evolution discussed above is not showing anything substantially new, rather it reaffirms the current framework and rules, the path for potential reforms or new initiatives directed at giving viability to the union is rather narrow.

The perspective taken in the present work is to explore this narrow path, trying to offer more efficient and attractive solutions than those promoted by the *Five Presidents Report*. Focusing on the euro area, and taking as given the constraints coming from the TFEU, the following sections present reforms on the operations of the European Central Bank, on fiscal rules and on financial regulation that would improve the coherence and flexibility of both the institutional framework and the connected policies, would create a single financial market, would weaken the link between sovereign and bank crises, would transform the current structural deflationary stance into a reflationary one, and would make the harmonisation of financial regulation consistent with national specificities.

### **3. Reforming the monetary operations of the ECB**

The EA member countries share a single currency, a single central bank, a single monetary policy, but not a single financial market.

For a single financial market to exist, all EA financial operators should have access to a single set of risk-free assets for pricing risks and for managing liquidity. In short, they should face a single risk-free yield curve. Retaining their fiscal sovereignty, the 19 euro countries now produce 19 (more or less) risk-free yield curves. As a

consequence, the EA national financial markets are far away from forming a single regional market. The result is that we may experience monetary convergence, as it happened before the recent crisis, but not monetary integration. As the recent experience shows, also at the international level, convergence is a fragile achievement.

The European Central Bank was born and has been managed as if it were the central bank of a federal state. Its monetary policy operations are technically indistinguishable from those of a central bank serving a federal state. But the ECB is serving a coalition of states, each retaining its full fiscal sovereignty. The effectiveness of its single monetary policy thus depends on the fragile convergence of sovereign ratings as expressed by private financial markets. Since the inception of the crisis, the ECB has enlarged its weapons, also including the selective acquisition of national debt, justifying their adoption with the need to contain the fragmentation in the transmission mechanism of monetary policy across member countries. The fragmentation has been contained, but financial markets have learned from the management of the crisis that they cannot count on a common fiscal backstop to avoid costly private sovereign debt restructuring. This assessment is strengthened when the so-called virtuous countries invoke the explicit extension of bail-in to public debt, when they propose to insert provisions permitting exits from the euro, when they push for limiting the public debt held by banks, when they impose to the ECB to take into account the different rating of sovereign debts when accepted as collateral for banks' refinancing operations, when they oppose any Europe-wide mutualisation on (private) deposit guarantee schemes, when they oppose to drop unanimity in the decision of the European Stability Mechanism and to soften its conditionality, and so on.<sup>3</sup>

The result is that significant spreads across national sovereign debt are bound to remain, maintaining the EA financial markets structurally and meaningfully fragmented. The resulting heterogeneous and volatile

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<sup>3</sup> Interestingly, the last *Report* of the German Council of Economic Experts, 2016, contains many of these recommendations.

funding conditions for local financial and real operators also impinge on the economic aspect of the so-called single market. This while the creation of the euro area, defined as Economic and Monetary Union, was explicitly directed at deepening the single market by creating a single financial market. A clear inconsistency exists between the goal and the institutional framework.

The main fault of the Maastricht Treaty is that it recurs to national fiscal rules as if they were good proxies of shared fiscal sovereignty. Apart from recurrent enforcement problems, the point is that no set of fiscal rules, even if helped by macroeconomic constraints and liberalisation policies, can homogenise the credit rating of heterogeneous member countries.

Excluding the feasibility of a significant political union, the solution for the creation of the single financial market must be found in making the ECB operations consistent with serving a coalition of sovereign states.

In its general outlines, the following proposal is quite simple. Financial intermediaries holding euro area national sovereign 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.<sup>4</sup> The issuance of DCs is already included in the ECB 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 ECB monetary policy guidelines classify DCs as structural open market operations,<sup>5</sup> with a 12-month maturity and sold at discount in standard tenders managed by the national central banks. Despite the maturity specified in the

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<sup>4</sup> The different purposes for which some central banks issue securities are discussed by Rule, 2011, and by Gray, Pongsaparn, 2015. According to the latter, the Hong Kong Monetary Authority issues 91-day to 15-year Exchange Fund Bills and Notes to establish its own yield curve.

<sup>5</sup> "[Structural] operations are executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector" (European Central Bank, 2011b, p. 10).



policy guidelines, the EU treaties and the charter of the ECB do not pose limits on the quantity and maturity of DCs.<sup>6</sup>

The issuance of DCs would be backed by the acquisition, in the secondary market, of a portfolio of sovereign securities of the euro area countries in proportion to the contribution of each country to the paid-up capital of the ECB (capital key). On completion, the ECB and EA national central banks would suspend their acceptance of sovereign national bonds as collateral for their refinancing operations and emergency liquidity assistance and restrict their operations to DCs.<sup>7</sup>

As far as the ECB reputation for containing inflation remains credible, its DC liabilities would be effectively risk-free. A new seigniorage, let us call it *S2*, would then be earned by the ECB due to the difference between the average return coming from the portfolio of sovereign securities and the cost of serving DCs. *S2* would be paid back to national treasuries according to their specific capital key and spread.

Part of *S2* could be used to feed a specific reserve fund against default risks, analogous to the one in use for private assets. To dispel any doubt on the absence of debt mutualisation, when entering the scheme a country would have to formally commit to comply with the rules implied by the scheme, which are discussed in the next section. If not complying with them, the country would be expelled from the DC scheme and would have to buy its sovereign debt held by the central bank at the same price paid by the ECB.<sup>8</sup>

If DCs were fully included among the ECB's monetary tools, their issuance would only respond to the demand for liquidity by the financial market and to the monetary policy decided by the ECB following its statutory objectives. Thus, the DC scheme does not start

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<sup>6</sup> See European Central Bank, 2011b, 2011a, 2012.

<sup>7</sup> To note that to national sovereign bonds remaining in the investment portfolio of financial institutions the usual prudential rules would apply. In particular, there could be no more objections for applying different risk weights to different sovereign bonds when computing banks' capital requirements.

<sup>8</sup> The legal base of the entire scheme and some implications on fiscal transfers across member countries and on the capitalization of the central bank are discussed in Tonveronachi, 2015a.

from the problems posed by sovereign debt, but from the necessity to create the conditions for the single financial market, that is from the necessity to put all euro area private operators on a structurally level playing field. Differences in their funding conditions would not disappear, but would be less volatile and not come from the direct influence of sovereign debt. Funding conditions for non-financial firms could thus differ more significantly across regions inside the union than across national frontiers.

#### 4. Sovereign debt dynamics and a revision of the fiscal rules

Although the DC proposal complies with the legal constraints posed by the existing EU treaties, and thus does not require their revision, the scheme has relevant implications on the dynamics of sovereign debt that must be fully analysed.

Let us consider for the moment the entire euro area and its aggregate sovereign debt. As the results of the acquisition of sovereign debt by the ECB and its issuance of DCs, total debt ( $DT$ ) is divided between the share held by the central bank ( $D_B$ ) and the share held by the market ( $D_M$ ), which becomes the reference for debt sustainability.<sup>9</sup>

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

Since the emission of DCs is largely determined by the demand for liquidity coming from the financial sector, we can link the acquisition of sovereign debt to the rate of growth of nominal GDP ( $g$ ) through a coefficient  $a$ :

$$\frac{(D_{B(t)} - D_{B(t-1)})}{D_{B(t-1)}} = \dot{D}_B = a \cdot g \quad (2)$$

Given that the DCs constitute a further instrument of monetary policy, the coefficient  $a$  can fluctuate around the value determined by

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<sup>9</sup> This because the sovereign debt held by the ECB would be a revolving fund implying near zero real interest rates. Given that sustainability is the founding principle of the Maastricht criteria, it would concern total debt net of what permanently held by the ECB.

private markets when the central bank pursues a neutral monetary policy.

Since the growth of total debt is equal to the aggregate fiscal deficit ( $F$ ), from the previous equations we derive:

$$-\dot{D}_M = a \cdot g \cdot \frac{D_B(t-1)}{D_M(t-1)} - \frac{F}{D_M(t-1)} \quad (3)$$

Apart from  $a$ , which by its nature refers to the entire financial market of the euro area, the other parameters of the equation (3) can be transformed into national parameters to obtain the debt dynamic for any single member state  $i$ .

$$-\dot{D}_{Mi} = a \cdot g_i \cdot \frac{K_i \cdot D_B(t-1)}{K_i \cdot D_M(t-1)} - \frac{F_i}{K_i \cdot D_M(t-1)} \quad (4)$$

where  $K_i$  is the country's capital key.

Leaving for the moment  $F$  aside, the acquisition of debt linked to the dynamics of nominal GDP through the demand for liquidity decreases the amount of debt held by the market, the one significant for debt sustainability, with positive effects on its cost.

The initial decrease of the debt held by the market is followed by the dynamics shown by equation (4), whose relevance depends on the velocity of the adjustment process of  $D_M$ , hence from two parameters related to the entire area ( $a, D_B/D_M$ ) and three national parameters ( $g, K, F$ ).

Taking as a working hypothesis for our simulations the neutral stance of monetary policy, we may suppose that the demand of DCs increases in proportion of the nominal GDP of the entire area ( $Y$ ), that is that  $a$  is equal to one.

More problematic is the evaluation of the initial issuance of DCs, hence of the initial value of  $D_B$ , due to the demand coming from the private sector. If we consider the utilization of DCs as meant for the management of liquidity by financial firms and markets, their stock should be sizeable, especially if pushed by regulatory requirements, such as giving them prominence in the liquidity requirements introduced by Basel III and in those that are being proposed for investment funds. In what follows, we will adopt two

hypotheses on the value of the initial acquisition. *H1*, equal to one third of public securities of the euro area, amounting to €2,490,000 million and corresponding to 26% of the total gross sovereign debt of the area at the end of 2015; and *H2*, equal to one half of public securities, amounting to €3,740,000 million and 39.6% of total gross sovereign debt. Worthy of notice is also that the approximate €1,500,000 million of sovereign bond acquisitions expected from the current ECB asset purchasing programme (APP) would be included in the previous amounts; in other words, the DC scheme would encompass the APP programme. Given the special nature of the euro area and the special responsibilities that should be proper of the ECB for ensuring the singleness of the financial market, there is no reason its balance sheet should not be structurally larger with respect to 'normal' central banks.

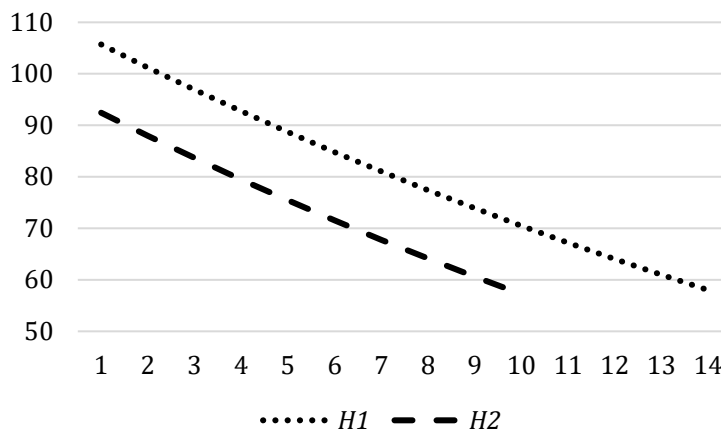
The initial level of  $D_B$  represents a crucial parameter for the velocity of the adjustment process. Figure 1 shows the simulation for Italy of the number of years that would be necessary for  $D_M/Y$  to go under the legal roof of 60% when adopting *H1* or *H2*, taking the end of 2015 as our starting point (for the other parameters see the tables below).

Table 2 shows the countries' share of ECB paid up capital ( $CK$ ) and the initial acquisition of national public debt according to *H1* and *H2*.

Starting from the data of the previous tables, table 3 shows the countries that would immediately go under the ceiling of 60%, according to *H1* and *H2*.

Not considering the other, more indebted countries for the moment, let us consider the implications in terms of debt dynamics and fiscal deficits for countries complying with the legal constraint since the starting period.

Figure 1 – Italy, adjustment of  $D_M/Y$  (%), according to H1 and H2,  $g = 3.5\%$



Sources: Eurostat database.

Currently, the fiscal rule dictates that in those conditions the structural deficit cannot be higher than 1% of the GDP, independently of the degree of indebtedness. Forcing the same fiscal constraint on countries with indebtedness at zero and 60% (see table 1), verges on the absurd. Let us think of a country, like Estonia, that with a negligible gross debt may find itself under the scrutiny of the Commission for excessive fiscal deficit. If we stick to the logic, more than to the letter, of the TFEU, the constraint is directed at maintaining the sustainability of sovereign debt; if the latter is defined by the 60% ceiling, the fiscal rule should permit deficits capable of remaining within this limit.

On condition they remain below the 60% ceiling, member countries could then adapt the fiscal deficit to their specificities, with the obligation to maintain the legal debt constraint. This flexibility is even more necessary under the DC programme because the increasing acquisition of debt by the ECB due to increases in nominal income could

rapidly put some countries in a negative debt position.<sup>10</sup> Below the 60% constraint several strategies could be followed for the deficit and debt dynamics. One strategy, which could satisfy the guardians of sustainability and would make the debt held by the ECB less risky, could be to utilise the benefits of the DC programme for establishing a safer sustainability level. Countries converging from above the new sustainability level would maintain the debt held by the market constant, entrusting the decrease of indebtedness to the growth of income (given its effects both on  $D_B$  and the denominator). Once reached the new sustainability level, the deficit would be calibrated in order to maintain compliance.

Table 1 – *Nominal GDP and sovereign debt in the euro area, end 2015*

	Y	Gross sovereign debt		Total debt/Y
		total	of which securities	%
EA (19 countries)	10,454,578	9,440,246	7,470,743	90.3
Austria	339,896	290,716	237,596	85.5
Belgium	409,407	434,186	353,111	106.1
Cyprus	17,637	18,964	5,893	107.5
Estonia	20,252	1,993	228	9.8
Finland	209,149	130,746	102,041	62.5
France	2,181,064	2,097,103	1,760,738	96.2
Germany	3,032,820	2,152,943	1,566,173	71
Greece	175,697	311,452	61,631	177.3
Ireland	255,815	201,266	125,565	78.7
Italy	1,642,444	2,171,671	1,822,226	132.2
Latvia	24,349	8,872	6,086	36.4
Lithuania	37,331	15,882	12,530	42.5
Luxembourg	51,216	11,174	6,250	21.8
Malta	8,788	5,621	5,176	64
Netherlands	676,531	441,664	347,511	65.3
Portugal	179,540	231,345	121,888	128.9
Slovakia	78,686	41,306	35,201	52.5
Slovenia	38,570	32,070	27,330	83.1
Spain	1,075,639	1,072,183	873,570	99.7

Sources: Eurostat database.

Notes: where not differently specified, the amounts refer to million euros.

<sup>10</sup> In particular, the Baltic countries would quite immediately become creditors of the ECB lacking enough debt for acquisitions made according to the capital key.

Table 2 – *Countries' capital key and initial  $D_B$* 

	CK, %	$D_B$ , million euros	
		H1	H2
Austria	2.79	69448.8	104173.2
Belgium	3.52	87657.4	131486.1
Cyprus	0.21	5352.6	8028.8
Estonia	0.27	6820.7	10231.1
Finland	1.78	44447.8	66671.7
France	20.14	501619	752428.6
Germany	25.57	636692.4	955038.6
Greece	2.89	71928.7	107893.1
Ireland	1.65	41062.2	61593.3
Italy	17.49	435520.5	653280.7
Latvia	0.4	9979.9	14969.8
Lithuania	0.59	14617.8	21926.7
Luxembourg	0.29	7181.6	10772.3
Malta	0.09	2292.4	3438.7
Netherlands	5.69	141632.2	212448.4
Portugal	2.48	61676.4	92514.7
Slovakia	1.1	27328.8	40993.2
Slovenia	0.49	12222.8	18334.2
Spain	12.56	312765.4	469148.2
Total	100	2490247.5	3735371.3

Sources: ECB and Eurostat databases.

Table 3 – *Countries moving immediately under the 60% ceiling*

	H1	H2
Austria	no	yes
Estonia	yes	yes
Finland	yes	yes
France	no	yes
Germany	yes	yes
Latvia	yes	yes
Lithuania	yes	yes
Luxembourg	yes	yes
Malta	yes	yes
Netherlands	yes	yes
Slovakia	yes	yes
Slovenia	yes	yes
Spain	no	yes

In formal terms, equation (4) may be re-written putting the change of  $D_M$  equal to zero.

$$0 = a \cdot g_i \cdot \frac{K_i \cdot D_{B(t-1)}}{K_i \cdot D_{M(t-1)}} - \frac{F_i}{K_i \cdot D_{M(t-1)}} \quad (5)$$

From which,

$$F_i = a \cdot g_i \cdot K_i \cdot D_{B(t-1)} \quad (6)$$

The higher are  $g$ , capital key and inherited debt, the higher is the dynamic equilibrium deficit. Because the annual increase of total debt is equal to the fiscal deficit, from equation (6) we may derive,

$$\frac{\dot{D}_{T_i}}{g_i} = a \cdot \frac{D_{B(t-1)_i}}{D_{T(t-1)_i}} \quad (7)$$

With the coefficient  $a$  near the unity, the growth of total debt is lower than the growth of nominal income and total indebtedness converges downwards.

The second strategy, for maintaining constant the level of  $D_M/Y$ , implies that  $\dot{D}_M = g$ ; hence equation (4) becomes,

$$-g_i = a \cdot g_i \cdot \frac{K_i \cdot D_{B(t-1)}}{K_i \cdot D_{M(t-1)}} - \frac{F_i}{K_i \cdot D_{M(t-1)}} \quad (8)$$

from which,

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

and,

$$\frac{\dot{D}_{T_i}}{g_i} = a \cdot \frac{D_{B(t-1)_i}}{D_{T(t-1)_i}} + \frac{D_{M(t-1)_i}}{D_{T(t-1)_i}} \quad (10)$$

The fiscal deficit and the rate of growth of total debt are now higher than with the previous strategy.

Utilising the data shown in the previous tables, assuming  $H2$  and putting the safer convergence ceiling at 30% of indebtedness, table 4 shows the dynamic simulation for Germany.



Table 4 – *Germany, convergence towards 30% of indebtedness, H2 and  $g = 4.5$*

Years	$D_T/Y$	$D_M/Y$	$D_B/Y$	$F/Y, \%$
1	0.71	0.39	0.31	
2	0.69	0.38	0.31	1.36
3	0.68	0.36	0.31	1.36
4	0.66	0.35	0.31	1.36
5	0.65	0.33	0.31	1.36
6	0.63	0.32	0.31	1.36
7	0.62	0.3	0.31	1.36
8	0.62	0.3	0.33	2.66

The fiscal deficits allowed following these strategies are higher than those coming from the current rules, especially once the safer sustainability level is reached. To the fiscal space thus created we must add the seigniorage paid back by the ECB, more generally the lower cost of servicing the debt. The countries that would converge to the new ceiling from below could adopt much higher fiscal deficits.

Let us now consider the countries that after the initial ECB acquisition of debt would remain above the 60% ceiling. According to the current rule, they should produce a fiscal surplus in order to bring their debt under the legal constraint in twenty years. Since in such a situation we presently find countries of the economic weight of Germany, France, Italy and Spain, the full compliance with this rule would reinforce the deflationary effects coming from the constraints limiting the deficit of the other countries. The fact that this rule is not for the moment rigidly applied should not constitute grounds for relief because it could be invoked in any moment and it is institutionally harmful to agree on rules and then not comply with them, even if they are deemed to be 'stupid'.

Adopting the DC scheme, many countries, some with strong economic relevance, could immediately produce higher deficits than the ones currently permitted, thus giving a reflationary push to the entire area. This means that the benefits would also go to the more

indebted countries, given the direct effect on nominal GDP and the indirect one on ECB debt acquisitions. Simulating the debt convergence path of the more indebted countries, we could thus count on higher growth rates than the ones permitted by the current conditions. Let us assume that as long as indebtedness remains above 60% these countries must respect the constraint of a balanced budget ( $F = 0$ ) instead of the surplus coming from the current rules. It would be a rather softer constraint, also taking into account the lower cost of debt produced by the DC scheme. In these conditions equation (4) becomes,

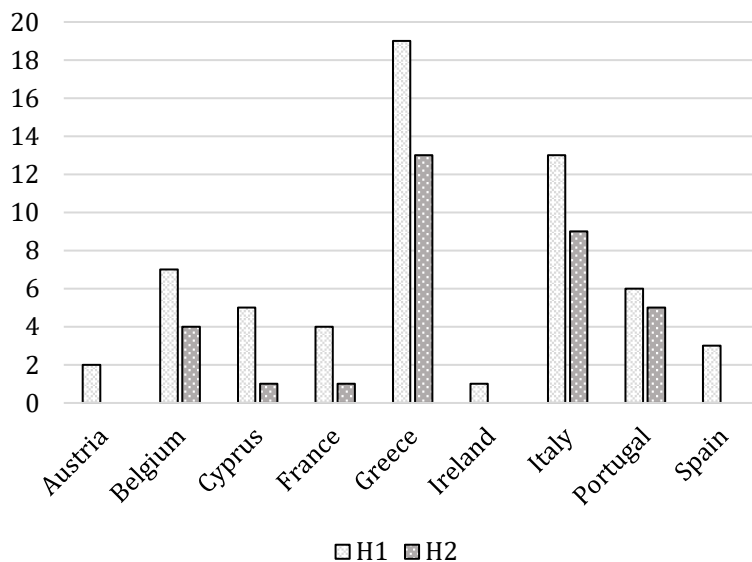
$$-\dot{D}_{Mi} = a \cdot g_i \cdot \frac{K_i \cdot D_{B(t-1)}}{K_i \cdot D_{M(t-1)}} \quad (11)$$

Figure 2 shows the velocity of convergence of indebtedness towards the 60% ceiling under the *H1* and *H2* hypotheses.<sup>11</sup>

Summing up, with respect to the current policies and rules, the DC scheme proposed here would allow to tailor fiscal policies more in accordance with the specific conditions of the member countries and their autonomous choices, which may change in time also due to changed general conditions. The countries that since the start would be situated well below the 60% ceiling could decide if and how much they should converge towards it. Once the legal constraint is satisfied, the countries converging from above could autonomously decide if they prefer to build a further margin of safety and at what level. This flexibility could be temporarily restricted adopting the cooperative scheme implied by the two strategies discussed above. Following these strategies would bring better results for every country and for the entire area, because it would maximise the enhancing effect of the DC programme on growth.

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<sup>11</sup> For both hypotheses, we assume the following values for  $g$ : Austria 3.5%; Belgium 4%; Cyprus 3.5%; France 4%; Greece 3%; Ireland 4%; Italy 3.4%; Portugal 3.5 %; Spain 4%. As far as the reflationary push would also help to bring the inflation rate towards 2%, the above values could result to be underestimated, especially if adopting *H2*.

Figure 2 – *Convergence by the more indebted countries*

The enforcement of the current fiscal rules has since the start suffered from several limits. Moreover, the use of discretion on their application beyond what was permitted by their limited flexibility has been often criticised for the unequal treatments applied to different member countries. A positive aspect of the scheme proposed here is its capability to improve the enforcement of the (new) rules. As we have mentioned in the previous Section, a country that does not comply with the new rules for two consecutive years for example, would be expelled from the DC scheme, would have to go back to the old system, and would have to buy its sovereign debt held by the central bank at the price paid by the ECB. The expulsion does not require changing the TFEU because the interested country would remain in the euro area. The incentive to comply with the new rules would thus be quite strong.

Not being an instant panacea for the sovereign debt problem, the reform would, however, entail a significant flexibility and the easing of

fiscal rules. In addition to satisfying the chosen debt threshold, the EA countries would obtain more flexibility to respond to special or unforeseen needs as well as to asynchronous cycles across the area. For countries that are in dire need of increasing and improving their infrastructures, the preferred solution might be to require that the fiscal space acquired when debt is below the 60% ceiling be used to finance public investments. The EA would thus present a positive and credible design for its future, capable of attracting those EU non-EA countries that are currently strongly resisting entering the euro.

As we have often underlined, the reforms proposed here start from the necessity to create a single financial market and not from the necessity to solve the sovereign debt problem of the euro area. Anyway, given their fiscal implications, they are open to a comparison with the many proposals directed at solving the fiscal problem.

Although this is not the place in which to present a detailed analysis of those proposals, it may be useful to briefly discuss some substantial differences and possible complementarities. First, the analysis offered in section 2 leads to the conclusion that, independently of their intrinsic merit, proposals implying significant doses of debt mutualisation require an unattainable socio-political convergence. Second, if the debt, whether mutualised or not, was managed by an authority other than the ECB, its monetary policy implications could create policy inconsistencies. Third, in the few proposals in which mutualisation is relegated to supposedly rare events and the issuance of the synthetic free-risk assets is devolved to the private sector, it is the latter that benefits from the new seigniorage thus created, not the countries through the weakening of their fiscal constraint. Fourth, we are generally offered static proposals, consisting of an initial intervention of a given amount on sovereign debt, which then require the current fiscal rules to keep it sustainable. On the contrary, the reforms proposed here have favourable dynamic implications on fiscal deficit and sovereign debt. Relevant complementarities could be found linking the national investments in infrastructures discussed above to European infrastructural projects financed, for example, through the

European Investment Bank by leveraging on the limited resources that it is politically feasible to mutualise.<sup>12</sup>

## 5. Financial regulatory reform

The effective unification of the European financial markets through the reform of the operations of the ECB makes it even more compelling to reflect on the adequacy of the current common financial regulatory framework.

The financial sector presents a problem that is analogous to the fiscal one discussed before, that is an approach aimed at the convergence towards common rules independently from the results that they may produce in heterogeneous systems. Starting from the need to take into account national specificities, and analogously to what has been proposed in the previous Section on making the fiscal rules flexible once the sustainability requirement for sovereign debt is satisfied, the proposal presented in the following pages aims at conferring flexibility to national supervisions once a common regulatory threshold is satisfied.

The micro-prudential approach that has been informing international financial regulation for at least three decades is based on the regulatory level playing field, first thought for international banks and later extended to all banks. In Europe, the banking union should maximise harmonisation across member countries for capital and liquidity requirements and for the supervisory process. Given the heterogeneity of the economic systems that belong to the banking union (*de facto* the euro area countries), this is equivalent to stating that the financial system is a superstructure that is neutral with respect to the underlying economic structure.

The design discussed in section 2, of a European Union made up of countries competing under rules and procedures that are made as

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<sup>12</sup> For the different proposals see for example Bibow, 2015; Brunnermeier et al., 2011; Paris, Wyplosz, 2014; Prodi, Quadrio Curzio, 2011; Quadrio Curzio, 2014.

uniform as possible, is thus substantially replicated for the financial sector. Excluding the passage towards a federal system in non-biblical times, we have taken that design as the reality to deal with. However, we have discussed in the previous Sections how to change some procedures and rules and make them more flexible in order both to put all operators of the area nearer to the conditions of a structurally level playing field for what concerns the management of liquidity and financial risks, and to favour convergence for sovereign debt. All this cannot, however, make the structural and dynamic heterogeneity of these countries disappear, so that convergence on results for competing sovereign countries could require the same flexibility for financial regulation that we have proposed for fiscal rules.

The analyses and proposals offered by Minsky on financial regulation may be useful in offering a better substantiation of this necessity.<sup>13</sup>

Even if banks manage only a share of financial operations, Minsky puts them at the centre of his analysis, because of their crucial role in the financing of the economy and in its stability, especially given their position in the payment system. As profit-seeking organisations, banks promptly adjust the typology and scale of their operations. As organisations that are in a structurally speculative position, banks must continuously validate their debt service with the returns coming from managing a vast set of risks. In the short run, their safety cushion comes from capitalisation, reserves and collaterals; in the long run, that cushion depends on their ability to make profits. As for any economic unit, extended periods of validated expectations lead banks to undervalue those risks and overestimate their safety cushion (stability leads to instability). If banks are not somehow constrained in their operations, their search for profits endogenously produces long spells of increasing bankarisation and financial fragility.

Minsky was well aware that financial regulation cannot be a static response to a dynamic system, were the technological innovations and structural changes of the real sector deeply interact with financial

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<sup>13</sup> See Minsky, 1977, 1986, and Montanaro, Tonveronachi, 2012.

innovations and banks' managerial choices. Because financial rules cannot do without a relative stability, they should be able to constrain the fragility of the financial system by keeping the payment system safe and sound and favourable funding conditions for the accumulation of capital; a daunting task because these two functions are in contradiction, given the risks involved in the second one.<sup>14</sup>

Public authorities should then ensure that the financial structure is such that it permits bankers and supervisors to better understand the implications of the risks that banks are permitted to take. This might mean to put limits to risk-taking and to the typologies of financial contracts.

In addition, rapid increases of bank assets should be avoided because experience shows that they are often associated with rapid increases in financial fragility. The growth of bank assets should therefore be regulated to correspond, at least in the medium term, to the sustainable, or target, growth of nominal GDP. Let us take this dynamic problem as the starting point for presenting Minsky's analysis and proposals by means of a simple formal exercise.

Let us assume that in the long term the growth of bank capital only comes from internal resources.<sup>15</sup> We can then write the following identity,

$$CG = (1 - POR) \cdot \frac{ROA}{L} \quad (12)$$

where  $CG$  is the rate of growth of capital,  $ROA$  the return on asset after taxes, an  $L$  the leverage ratio (own capital/total assets).

For a given leverage, the growth of capital and the growth of assets ( $AG$ ) coincide. Hence,  $AG$  depends on variables that, in the absence of regulatory interventions, have little or nothing to do with the target growth of nominal GDP. If the latter is lower than  $AG$ , increasing bankarisation will ensue, with banks putting themselves and the entire economy in conditions of increasing fragility. If higher,

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<sup>14</sup> For a more detailed reconstruction of Minsky's position, see Kregel, 2012.

<sup>15</sup> This approximation is only in degree, given that in the long run the external resources that a bank can obtain depend on its profitability, hence on its potential for internal growth.

a financial constraint will contain real growth, as often happens in less developed countries.

The micro-prudential regulation coming from the Basel Accords fully maintains this feature of unrelatedness with macroeconomic dynamics. Following the Basel approach, the unweighted leverage ratio may be expressed as the minimum capital requirement  $MCR$ , measured in terms of weighted assets ( $\text{Capital}/RWA$ ), multiplied by the average risk weight  $RW$  ( $RWA/\text{Total assets}$ ).

$$AG = (1 - POR) \cdot ROA \cdot \frac{1}{MCR \cdot RW} \quad (13)$$

When it was first introduced, the minimum capital requirement was set at a level substantially reflecting the *status quo ante* of the larger international banks. Even if since then the  $MCR$  has been the subject of heated discussions, these are focused on its micro-prudential dimension. The coefficient  $RW$  comes from methodologies for the evaluation of risks which are expressly intended to conform with those developed by the private system. Public intervention on banks' leverage is then founded on two coefficients whose metrics do not have any relation with the conditions affecting nominal GDP. Micro-prudential regulation may then favour the discrepancy between the growth of banks' assets and the growth of nominal GDP, as it happened unrestrainedly in the decade preceding the recent crisis.

The purpose of the exercise is to show the unfitness of the current regulatory framework to take into account national physiologies; on the contrary, it may constitute a further element of macroeconomic fragility. This is even more relevant for the euro area, which is aimed at the maximum possible harmonisation of micro-prudential rules and supervisory procedures. Given that national heterogeneities in the euro area can hardly stand such harmonisation,<sup>16</sup> we badly need changes directed at introducing elements of national flexibility.

This may be done substituting the Basel micro-prudential approach (bottom-up) with the Minskyan macro-prudential approach (top-down). According to the latter, in the medium term the growth of

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<sup>16</sup> See for example the contributions in Kattel et al., 2016.



banks' assets should be substantially in line with the growth of nominal sustainable GDP ( $Y_s$ ).

$$AG = (1 - POR) \cdot \frac{ROA}{L} \cong Y_s \quad (14)$$

Following Minsky,  $POR$  and  $L$  would become the instruments of regulatory policy, preferably adopting a homogeneous leverage and controlling the growth of any single banks by acting on its pay-out ratio. We could eventually divide the banking sector into a few typologies of banks with different systemic footprint to which different leverage constraints should be applied.

The adoption of Minsky's proposal for the euro area would require a significant change in the definition of the European banking passport. The latter currently allows any European bank to work in any other member state also through branches, which, being under the regulation and supervision of the home country, would escape the national flexibilization of the rules. The passport should then only allow foreign subsidiaries, that is national banks of foreign capital, which should be made fully compliant with the regulation and supervision of the host country. This is a change that would to some extent follow what has been decided by the USA for systemic foreign banks operating in its jurisdiction; besides, it would better reflect the European reality of non-federated competing countries. Under this new passport regime, the European regulatory harmonisation could concern a common leverage ratio for homogeneous categories of banks across the euro area, leaving national authorities free to act on the distribution of profits.

Since the Basel Accords represent the international standard for banking regulation, a proposal as the one outlined above could be judged to require Europe to make a huge leap. This is true if we look at the conservative battle that Europe is now fighting, much less so if we look to the more recent evolutions and discussions.

In the USA, the tendency is towards both the weakening, if not the formal elimination, of the use of internal models that large banks use for computing their regulatory requirements, and a drastic simplification of those requirements for community banks, which are

*de facto* constrained by an un-weighted leverage ratio. The first step comes from relying on the minimum leverage ratio that has been differentiated according to the systemic footprint of three bank categories (globally systemic, nationally systemic and non-systemic). The second step, fiercely opposed by Europe, is to take the results coming from applying standardised methods for risk evaluation as the floor for the values coming from the internal models.<sup>17</sup> The combination of the floors coming from leverage and standardised methods render the internal models irrelevant if the latter do not produce higher requirements; this, however, would induce banks to abandon them. Recently, the president of the Fed has briefly illustrated a proposal aimed at substituting the capital conservation buffer of systemic banks with a buffer based on the results coming from the individual stress tests (Yellen, 2016).

To better understand the US creative interpretation of the Basel rules, let us briefly recall the capital architecture of Basel III. To the requirement coming from Pillar 1 (4.5% of core capital) must be added the further requirement coming from Pillar 2 (that is, the evaluation of further risks coming from the convergence between the bank's evaluation, ICAAP, and the supervisors' one, SREP); we have then to add the capital conservation buffer of 2.5% (below which capital is reintegrated limiting the distribution of profits and bonuses); with country discretion, a further 2.5% is added as the anticyclical buffer;

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<sup>17</sup> See Tarullo, 2014. The position of the USA draws the right conclusions from the results obtained by the exercises promoted by the Basel Committee, aimed at verifying the effective existence of a common best practice for the evaluation of risks when using internal models. The exercise consisted in requiring a sample of international banks to compute with their own internal models the riskiness of the same portfolio with credit risk and of the same portfolio with market risk. The high variance of the results has clearly shown that the so-called level playing field cannot be reached using internal models. The proposal now under study by the Basel Committee to restrict the typology of internal models that banks could use would perhaps shrink without solving the problem, which would be better dealt with by relying, as the USA propose, on the standardized methods integrated by individual stress tests. We have also to remember that in the past many banks asked to adopt the internal models methodology just to save on capital requirements.

finally, large banks must add up to 3% according to their systemic footprint.

What the USA are proposing is a relevant simplification of Basel's baroque architecture. To the requirement of Pillar 1 only one further buffer would be added for the largest banks, which would be calibrated by means of the stress tests, would not be lower than 2.5%, and would retain the limits to the distribution of profits and bonuses of the conservation buffer. This single buffer would absorb the second pillar, the conservation buffer and the systemic buffer. All that remains to be potentially added would be the anticyclical buffer.<sup>18</sup>

Although agreeing with the US approach to the need to simplify the supervisory process and to reduce regulatory and supervisory costs, a Minskyan perspective collides with the procyclical character of the total capital requirement, only partly attenuated by the anticyclical buffer, which, however, has been so far infrequently applied.

A further step could be taken, making the scheme more simple and anticyclical at the same time. We can briefly illustrate the proposal by means of a simplified example taking the leverage ratio as the basic requirement. The banking sector would be divided in three categories of banks, globally systemic banks (G-SIBs), locally systemic banks (SIBs) and community banks, subject to a minimum leverage ratio constraint respectively of 6%, 5% and 3%. An anticyclical buffer would then be added, respectively of 3%, 2.5% and 2%.<sup>19</sup> The totals thus obtained (9%, 7.5% and 6%) constitute what we might call the neutral level, that is the level at which the growth of the banking assets equals the reference rate of growth of nominal income set by the authorities. If the growth of banking assets exceeds the reference level, the capital requirement is raised and limits are imposed to the

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<sup>18</sup> It is not yet possible to understand how much and in what direction the design outlined in the text will be modified by the next US administration.

<sup>19</sup> If we take the average *RW* at 50%, the total sums correspond to the Basel weighted capitalization of, respectively, 18%, 15% and 10%. The full downside utilization of the anticyclical buffer would produce minimum requirements of 12%, 10% and 6%.

distribution of profits and bonuses, and vice versa.<sup>20</sup> Following the Minskyan approach, the previous basic requirements and buffers should be calibrated considering the nationally specific structural features.

The previous approach could also contribute to a gradual weakening of the problems posed by systemic banks. Given a bank's profitability, an internal growth lower than the reference level could be imposed by acting on leverage and pay-out ratio.

Attempts to elude these constraints by resorting to mergers and acquisitions could be contrasted by fixing for any bank a limit to its total assets in relation to the nominal GDP. This measure would immediately lower the systemic relevance of the largest banks, while allowing consolidation for smaller banks.<sup>21</sup>

Adopting a reform following the previous lines, we would obtain for Europe analogous results to the ones discussed before following the Minskyan approach. The re-nationalised financial supervision would take into account macro and micro local needs, in addition consistently lowering its complexity and cost. The latter is a further element to consider with due attention for Europe.

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<sup>20</sup> The neutral level could be fixed either at a national or territorial level, or for any single bank. A too specific constraint could freeze the market shares independently of the specific conditions of a bank or its territory. A constraint set at the general level would more easily allow an industrial policy aimed at restoring more competitive conditions. To note that the constraint refers to internal growth, not to the growth coming from mergers and acquisitions. As we said before, experience shows that operational distortions, often the prelude of a crisis, are the normal result of a too accelerated internal growth.

<sup>21</sup> For example, in the United States this proposal has been put forward by Johnson, 2016. It is quite a paradox that the discussion on limiting banks' size are more lively, also on a political level, in the USA than in Europe, where the problem of the relative dimension of banks is much more serious. On the contrary, when presenting the banking union, the European authorities have highlighted its effect on cross-border mergers and acquisitions. This would worsen the problems posed by systemic banks because we cannot expect that type of consolidation among small banks. We also have to consider that the problem of systemic banks exceeds the purely economic dimension due to the distortions produced by their lobbying power in the democratic decision process. On the necessity to de-globalize banks and their regulation see Tonveronachi, 2013.

In a comparison with other regions, the European banks show distinctly lower values for structural profitability and leverage ratio. A higher *ROA* permits a higher resilience through a higher leverage ratio, maintaining a viable return on capital. Figures 3 and 4 show how with respect to the EU, the USA's higher *ROA* is consistent with a higher leverage ratio.

Figure 3 – *ROA*, %

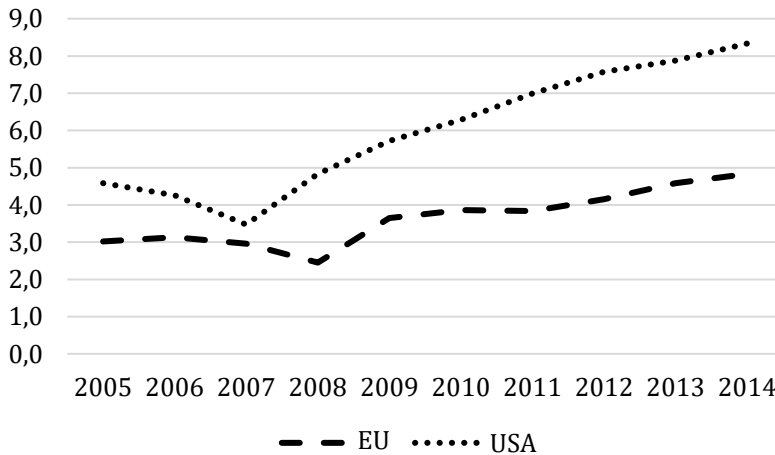


Sources: [www.mbres.it](http://www.mbres.it).

A distinctive feature of micro-prudential regulation is its complete neglect of the conditions affecting bank profitability. On the contrary, the regulatory monster that arises from the Basel Accords and from other requirements, such as the recent bank resolution regime, imposes such high regulatory and supervisory costs and competitive disadvantages with respect to non-banking activities that it undermines bank profitability and banking resilience in the short and long term. Given that the necessary investments in new

technologies require relevant funds, it is harmful that such relevant resources are being employed to comply with an ineffective and inefficient regulation, which in addition fuels further doubts on the convenience of belonging to the euro area.

Figure 4 – Leverage ratio (*Tangible total capital/Tangible total assets*), %



Sources: [www.mbres.it](http://www.mbres.it).

Regulatory changes outside the banking sector are then also necessary to avoid competitive distortions inside the financial sector and to ensure stability. For the reasons just presented, Europe should become the champion of promoting a profound revision at the international level of the regulatory frame concerning the so-called shadow banking, that is of those institutions and activities that imply assuming the same risks as banks and that, not being subject to equal regulatory constraints, benefit from competitive advantages and pose serious instability problems.

By adding instrument leverage (margins and haircuts) to financial leverage, the shadow system can build a huge pyramid of contracts that represent a further and powerful liquidity multiplier with respect to banks' and central bank's liabilities. Events affecting the trust in this

pyramid of fictitious liquidity produce a flight towards liquidity of better quality. Besides, banks were permitted to enter in that same game, on the asset and liability side, thus making them more part of the problem than of its solution. Given the enormous volume of those contracts, banks and the central bank cannot provide all the liquidity coming from the collapse of fictitious liquidity; hence a deleveraging process ensues that is bound to produce a financial crisis.<sup>22</sup> In other words, public authorities bear the responsibility for the emergence of an institutional inconsistency, having permitted the enormous growth of fictitious liquidity while keeping the central bank's intervention as lender of last resort substantially unchanged and only consistent with the conditions of simpler financial systems based on commercial banking. The central bank no longer offers an effective systemic safety cushion capable of promptly freezing enormous deleveraging processes.

Following Minsky's approach, the first step should be the adoption of a functional perspective starting from debt, defined as any form of commitment toward a counterpart. If a financial institution cannot serve its debt, it goes bankrupt. If it is expected not to be able to serve its debt, liquidity disappears and illiquidity soon leads to bankruptcy. This is true for any levered financial institution, not just for banks. We should then follow three principles. First, financial institutions should be permitted to use debt only if required to do so by the physiology of their activities, not as a means to amplify profits, and losses. Second, uniform regulation should apply to all levered institutions. Third, the physiology of debt only concerns what Minsky

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<sup>22</sup> The term fictitious liquidity is due to Kregel, according to whom the deregulation of the last decades "validated a plethora of diverse structures that were introduced to provide additional liquidity into the system as a result of competition between commercial and investment banking. [...] Indeed, the recent crisis can be described as the collapse of "fictitious" liquidity created by these structures, the failure of the banking sector to provide sufficient liquidity to prevent the onset of a 'debt deflation' (what Minsky defined as the ultimate attempt to access liquidity by "selling position to make position" - that is, selling assets in order to redeem liabilities), and finally, the inability of the Federal Reserve to intervene sufficiently quickly to ensure the provision of liquidity for the non-bank financial institutions which could not find support from the insured banks" (Kregel, 2012, p. 12).

calls the acceptance function, through which new credit is created; in the present institutional setting, this is the function performed by credit institutions, that is by banks.

The adoption of the previously described principles would produce far-reaching consequences. First, they would not require authorities to adopt a taxonomy for regulating different financial institutions in different ways, a taxonomy easily circumvented by financial innovations. Second, shadow banking would disappear, and with it a large portion of fictitious liquidity. Third, securitisation could regain the transparency that it had, and still has, in some European systems. Fourth, because the use of instrument leverage such as margins and haircuts would be forbidden in financial contracts, fictitious liquidity would take another fatal blow. Fifth, since trading would require full coverage by own capital, the issues of specialisation, separation and ring fencing would only concern putting banks' capital at risk in financial non-leveraged operations, which would be much less attractive anyway.<sup>23</sup> This would pose no problem once capital requirements for banking operations are satisfied separately.

It would be essential for the stability of any financial system to push the regulation of the shadow system in the direction outlined in the previous paragraphs by means of continuous downward adjustments of its instruments and financial leverage. For Europe, the push should also come from the need to protect banks' profitability from competitive distortions, which means protecting crucial activity in an area characterised by the vitality of small firms, which would benefit only marginally from the planned capital market union.

The regulatory reform proposed here also has relevant implications for the institutional structure of the area, especially regarding the banking union. The Single Supervisory Mechanism, the first pillar of the banking union, would be called to supervise the correct application of general principles, not to apply the same specific rules to all countries and all banks. Substantially abandoning the

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<sup>23</sup> These are structural forms of regulation aimed at shielding commercial banking from risks coming from proprietary trading and/or from interconnections with trading firms.



approach that requires to found capitalisation on risk sensitivity, supervision would mainly become a macro-prudential activity, with its operation entrusted to national supervisors under the control of central authority. Since this set of the proposed reforms entails a more relevant coordination at the national level, which concerns fiscal and regulatory authorities, it could be convenient to create a single supervisory authority for the entire financial system, institutionally separated from the system of central banks, which would include supervision at a central and national level, and resolution and guarantee schemes.<sup>24</sup> This solution would also help bring institutional homogeneity and clarity to the current heterogeneities, both across member countries and with respect to the centralised model. However, with respect to the other reforms proposed here, this institutional change would require introducing modifications in the Treaty of the Functioning of the European Union. Since authorities not disciplined by the EU treaties must be created by means of regulations, art. 291 of TFEU requires that their implementation powers rest with the Commission and the Council, as it was established for the European Supervisory Authorities and for the banking union's Single Resolution Authority. If it were not politically possible to introduce this new authority via treaty changes, maintaining the current configuration would be preferable because making the Commission the implementer of last resort for all financial supervision would create an institutional monster.

## 6. Conclusions

Considering the current EU design of competing sovereign countries as unchangeable in the foreseeable future, the reforms

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<sup>24</sup> This solution would also bypass the limit posed on the ECB by the Maastricht Treaty, which excludes the insurance industry from the ECB's supervisory reach. As Montanaro, 2016 observes, the financial developments of the last decades have made this Maastricht constraint dangerously obsolete.

presented in these pages aim at giving flexibility and a minimum consistency to that design without presuming to solve all its problems.

The creation of an effective single financial market by reforming the operations of the European Central Bank would decrease the rigidity that comes from applying a common monetary policy to an area made up of diverse and fiscally sovereign countries. Some of the residual rigidities would be weakened by combining the flexibility of national fiscal policies, made possible by adopting the monetary reform, with the regulatory flexibility deriving from a Minskyan type macro-prudential scheme. The concern for excessive sovereign debt would disappear and a part of the inconsistencies between central directives and national governability would be eliminated.

We have shown that the relevant fiscal margins coming from these reforms would convert the current deflationary stance in a reflationary one, also by fostering the infrastructural investments that are so badly needed to boost long term competitiveness in the entire area. Higher growth would improve banking profitability, helping many banks to overcome the problems inherited or exposed by the recent crisis. Even more, the proposed reforms in the regulatory field would structurally strengthen banks' profitability, while maintaining them capable of growth within appropriate physiological limits.

The combination of the reforms proposed in the previous pages constitute a challenge not only because it requires a certain degree of socio-political convergence, but also because of the private sector's many and well-placed vested interests. The hope is that Keynes was right in singling out old ideas and not vested interests as the main obstacle for solving economic and social problems.

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