

In the absence of fiscal union, the Eurozone needs a more flexible monetary policy: A comment

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In a recent article in this *Review*, Pietro Alessandrini and Michele Fratianni, 2015, (A&F) have addressed an important question: how can the euro area (EA) cope with inter-regional differences with no fiscal union? Indeed, in any country with its own currency and a national budget, differences in income and unemployment between regions can be alleviated via fiscal transfers. When unemployment is clustered in certain areas and migration is not a desired option, fiscal union triggers inter-regional automatic stabilizers and permits to target central government spending to low-income, high-unemployment regions.

Within this broader theme, A&F explore the current account (CA) balances of EA countries. For A&F, these have been responsible for what they describe as a balance-of-payment crisis in the EA. Accordingly, they are critical of fiscal austerity, which they claim caused a slowdown in the Southern countries with no parallel expansion of aggregate demand in the Northern countries, thereby triggering a reduction of the CA deficits of the South while leaving the CA of the North in large surplus.

Assuming that fiscal union in the EA will not be established anytime soon, A&F formulate policy measures that would check countries' CA balances and foster adjustment when differences occur. Their policy proposals are based on the belief that a policy-coordinated (as opposed to austerity-driven) reduction of "inter-member external disequilibria" would "strengthen stability" in the EA. Remedies include adding a constraint to EA members, notably by

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setting thresholds on CA balances to be “taken as seriously as fiscal imbalances”, as well as designing an active role for the ECB in “promoting the adjustment process to external imbalances” by means of “discretionary quantitative control” and differentiated funding costs, based on the monitoring of National Central Banks’ (NCBs) TARGET2 (T2) balances.

This comment takes issue with the model that A&F use to support their proposals. In this respect, I have two main remarks: 1) diverging CA balances shaped EA countries’ vulnerability but were not a cause of the EA’s 2010-2012 liquidity crisis; 2) A&F’s quantity-theoretic view of monetary policy implementation is inapplicable to a floating currency like the euro, or to the T2 payment system.

1.

A&F are concerned with the “sharp heterogeneity [...] in terms of current-account imbalances” and the lack of a symmetric adjustment mechanism that “ultimately induced a balance of payments crisis”. Given that the EA is a monetary union with a floating currency, not a multilateral exchange-rate regime, A&F must mean something different from a traditional balance-of-payment crisis. The latter is defined as a situation where the central bank is unable to enforce a given foreign exchange fixed parity as foreign reserves and borrowing potential are being exhausted, until there is no interest rate at which portfolio holders are willing to own the domestic currency, and the fixed rate commitment must be abandoned. Indeed, for the authors, in the absence of fiscal union, the EA behaves like a fixed-rate arrangement, intra-EA current account balances matter, and a balance-of-payment crisis is possible.

That trade flows in the EA have mattered during the EA crisis is true. Yet, it would be inaccurate to argue that if trade flows had been more balanced the EA would not have suffered the liquidity crisis that nearly triggered implosion of the single currency in 2012. On this point, it is unclear where A&F stand. While they stress that “a

monetary union, in the absence of a fiscal union, needs to have current-account equilibrium in the medium run”, they refer to, and agree with, Garber’s, 1999, concern for the potential threat posed by cross-border financial account transactions that “may occur because of misplaced doubt about the continuation of a country in the monetary union, fear of a default on its bonds, or problems in its financial system that cause a bank run” (Garber, 1999, p. 211). Indeed, as Garber claims, in a currency union, deposits get shifted for a variety of reasons, and banks can gain or lose liquidity quite independently from trade balances.

Financial transactions between different EA jurisdictions became a threat to stability after incomes peaked in 2008. With the austerity-driven double-dip recession in 2010, the risk of banking failures rising, and deposit insurance schemes being funded by credit-sensitive national authorities, bank deposits across the EA were no longer considered fungible. The ECB became increasingly unable to enforce the same cost of funding throughout the EA banking system, and the banks that lost deposits and access to the money market replaced deposits with Eurosystem loans.

Once the liquidity crisis erupted and the EA money market shrank, countries running CA deficits were the most exposed: given the limits to fiscal deficits, only countries running a current account surplus had a dependable source of liquidity. Also, current account surplus countries bore a smaller proportion of the rising unemployment with respect to the other EA countries. Accordingly, diverging CA balances shaped vulnerability, but were not the cause of the crisis, and convergence of CA balances was neither a necessary nor a sufficient condition to end the ongoing government solvency and liquidity crisis. This was ended by the ECB taking the role of conditional “lender of last resort” of government debt, a point that A&F only casually acknowledge in footnote 4, p. 283. The change in the operational practice of the ECB in the market for public sector securities (with the adoption of OMTs in September 2012) prevented collapse.

2.

Diverging CA balances remain, however, the authors' main concern. A&F explain that when the financial flows offsetting the CA imbalance of an EA country reverse, "monetary base flows from deficit to surplus countries". This should trigger a correction of the CA imbalance "by raising prices and wages in surplus countries in relation to prices and wages in deficit countries", a mechanism similar to the one described by Hume for the gold standard.

EA countries', however, belong to a monetary union whose currency is floating, not to a fixed-rate arrangement where gold or foreign assets are needed to operate. In the context of a floating currency, A&F's emphasis on the quantity of the "monetary base" reflects a quantity-theoretic view, typical of conventional theories of monetary policy implementation, that conflict with modern analysis of monetary policy. Among others, Disyatat, 2008, offers a good account of the gap between the way monetary policy is modeled and conceptualized in the mainstream academic literature and the way policy practitioners perceive their actions. As Bindseil, König, 2012, pp. 161-162, put it, "the monetary base is not a useful concept" and "it is not clear how to interpret this quantity, except if one believes in a textbook-style money multiplier".

Equally problematic is A&F's claim that the alleged adjustment mechanism was not allowed to operate by "institutional sterilization", i.e., by the fact that a "deficit country that loses monetary base through the TARGET2 mechanism can replenish part or all of the lost monetary base by buying liquidity from its NCB". The authors are concerned that "NCBs have been given a sterilization instrument [...] by offsetting the redistribution of the monetary base between large creditors and debtors of TARGET2 balances" (p. 292), and that the ECB "has lost control not only of the total amount of liquidity issued, but also of its distribution across Member States" (p. 288). Yet, it is unclear what policy action A&F disapprove of.

On the one hand, there is the Eurosystem monetary policy operational framework, with the ECB setting the terms and conditions

for funding banks' operations and the NCBs doing the actual lending operations. Since October 2008, the Eurosystem has been implementing the fixed-rate full allotment lending policy as a conscious decision to improve the transmission of monetary policy. The rate today is at 0%, and the negative rate on excess reserves maintains a positive opportunity cost of excess reserves to the banking system. Within this policy framework, banks cover their liquidity needs. Distribution of liquidity is subject to market mechanisms.

On the other hand, there is a payment system (T2) where transactions are settled in central bank money among participating banks and central banks. During the crisis, NCBs' T2 balances sharply diverged, but it is inaccurate to describe the T2 mechanism as one that "is expected to guarantee unlimited credit to each national central bank" (pp. 282-283) and where "a strong-currency NCB (one with consistent current account surpluses) may refuse to provide unlimited money to a weak currency NCB" (p. 283).

Every payment made to a bank (or central bank) outside the national jurisdiction must be settled via the local NCB, the ECB, and the other jurisdiction's NCB. Because the local NCB cannot credit the payment to a recipient outside its jurisdiction, it must credit the ECB instead. The ECB credits the NCB in the other jurisdiction, which then credits the ultimate recipient as needed. In this process, payments are settled with no additional credit being extended to, or supplied by a NCB. The NCB receiving the claim is not providing (and thus cannot refuse) "money" to another NCB. The only credit risk issue with T2 balances is the case of a country leaving the euro when its NCB has a large T2 liability and subsequently defaults. In such a scenario, the loss would be shared according to the capital key of the ECB, irrespective of the T2 claims of each NCB.

T2 balances of NCBs can change for more reasons than A&F seem to acknowledge. They have again widened, after 2014, at a time of falling divergence of current account balances and in absence of a liquidity crisis. This time, factors explaining the widening T2 balances include the Asset Purchase Programmes (APPs), the anemic interbank market, the narrow spread between the marginal lending facility and

the overnight money market rate, and other regulatory factors. In this same period, the T2 liabilities of the ECB itself have also increased steadily, reflecting APPs operations. This means there are claims to T2 that are offset by ECB (not NCB) T2 liabilities. In addition to the ECB's T2 balances, there are five central banks from non-euro countries, participating to T2, that also have T2 balances (that cannot be negative because they cannot credit the ECB with euros).

All this considered, NCBs' T2 balances do not seem to be the place where intra-EA current account flows can be effectively monitored.

While in 2012 the ECB successfully reclaimed one indispensable tool to operationally manage the euro, ending the government solvency and liquidity crisis, the deflationary bias of the euro area has not gone away. The lack of domestic demand remains acute, growth continues to stagnate, and the large output gap has exacerbated regional differences. Job creation needs a sufficiently large deficit spending by at least one macro sector. Since the public sector deficit remains constrained, and credit growth to the residents' sector remains subdued, the foreign sector has been giving the main support to the EA's, albeit modest, growth of the last two years, somewhat lessening regional divergence. Indeed, a reduction of the differences in unemployment and current account balances seems to be one likely consequence, not a cause, of overall improved conditions. Yet, as support from the EA's net exports is fading, job creation needs some combination of larger fiscal deficits and stronger credit growth.

A&F's proposal of adding a current account constraint to the existing fiscal constraint for EA countries could have a positive impact if a country running a large current account balance and having "fiscal room", as defined by the EU rules, were pressed to engage in expansionary fiscal policy. The problem with a "double constraint", however, is that the stronger the impact on other EA countries, the sooner "fiscal room" is exhausted. This does not mean that in the absence of fiscal union there is no stable solution; a coordinated pro-quota fiscal expansion would provide such stable solution.

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