

Resetting EMU: a one-off package deal for EMU's member states



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ABSTRACT

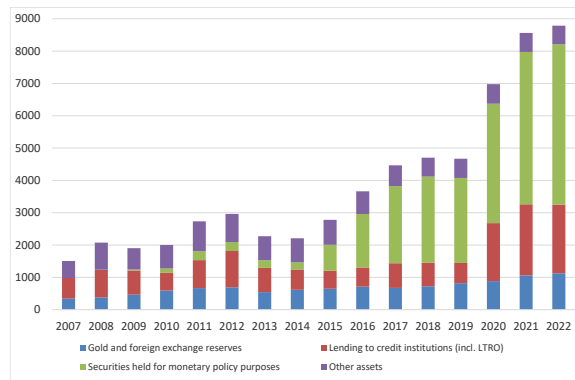
The debt which is acquired by the ECB under the PSPP is de facto already mutualized. The ECB could transform the liquidity surplus that has resulted from its purchasing programmes into new tradeable securities. The issuance of securities by a central bank is a market friendly instrument of open market operations, which already is used by many central banks all over the world. This would be a much smoother way of reducing bank liquidity than the other option: reselling its portfolio of bonds acquired under the PSPP. Second, a sizeable issue of ECB-securities will create a deep and liquid market for EMU-wide common safe assets, which gives the ECB the opportunity to conduct its open-market operations in the future exclusively in its own securities. Moreover, the presence of a well-developed market in a European common safe asset would greatly reduce the fragmentation risk of the eurozone. The debt acquired under the PSPP could remain on the Eurosystem's balance sheet into eternity, meaning that the relevant public debt ratios of all member states decline substantially. To eliminate public hazard and to make sure that this de facto bail-out will never be repeated, it should be included in the TFEU that in the future the ECB is no longer allowed to purchase public debt of any member state. This is the package deal: member states must accept a much stronger EMU with more market discipline and a well-developed market in common safe assets. The bonus: a reduction of public debt ratios by approximately 25%.

Introduction

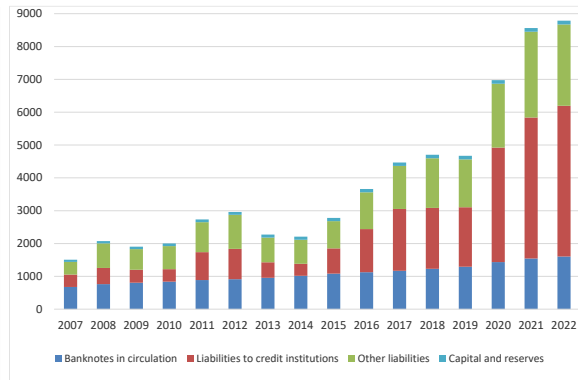
The unconventional monetary policies implemented during the last years have resulted in an enormous expansion of the balance sheet of the Eurosystem. On the asset side, we find a large expansion in the items 'lending to credit institutions' and 'securities held for monetary purposes'. On the liability side of the Eurosystem's balance sheet we see a huge increase in commercial banks' liquidity under the entry 'liabilities to banking institutions'.

Figure 1: The balance sheet of the Eurosystem (2007 – 2022)

Assets



Liabilities



Source: ECB. 2022 data er per June 30.

This situation is the heritage of a long period of monetary stimulus, in the context of a weak economy and a rate of inflation that was considered too low. However, since the acceleration of inflation since the second half of 2021, the ECB should find a way to tighten monetary conditions. This raises several important policy questions. The first one is how the ECB should deal with the public debt that is acquired by the Eurosystem under the Public Sector Purchase Programme (PSPP), part of the Asset Purchase Programme (APP). The second challenge is to find the best way for the ECB to reduce bank liquidity. Finally, the ECB should find a way to deal with the increasing tensions in the eurozone, more specific the increasing interest differential between Italian and German government bonds.

I will explain that the current situation offers a unique opportunity to help countries with their public debt, while at the same time strengthening the eurozone, which may reduce or even eliminate the eurozone’s fragmentation risk and introducing more market discipline.

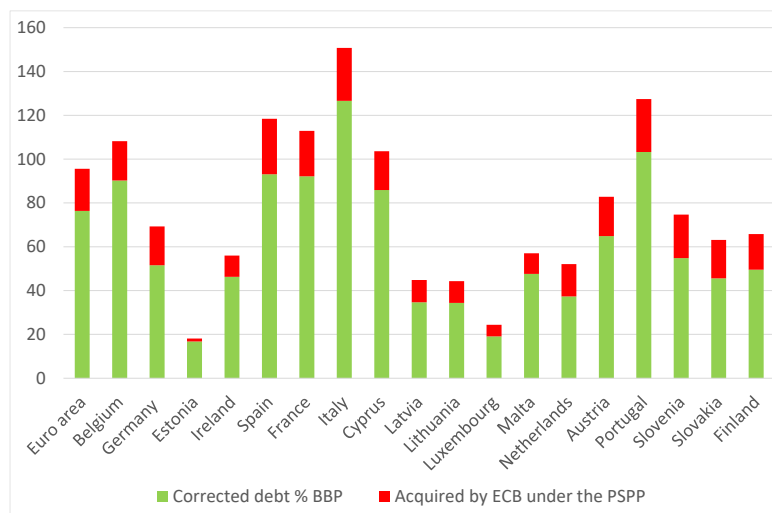
Question 1: how should the ECB deal with the acquired public debt?

Once public debt is acquired by the central bank, it has lost its monetary relevance. Therefore, it does not make sense to try to reduce public debt which is already owned by the central banks and thus ultimately its shareholders, viz. the governments (De Grauwe, 2021).

Essentially, the ECB has four options in dealing with repurchased government debt. First, it can decide to actively sell it. As explained above, this provides an unnecessary tightening of fiscal policy. It is also expected to lead to considerable turmoil in the financial markets. Second, the ECB can leave the acquired debt passively on the balance sheet of the Eurosystem and let the debt mature gradually over time. This has essentially the same

disadvantages, although the market turbulence will probably be smaller. An additional disadvantage, however, is that it will take decades before all the acquired debt has disappeared from the central bank's balance sheet. The third option is to simply write off the purchased government debt. The resulting loss, however, would lead to a substantial negative equity of the central bank. It could raise the danger of the central bank becoming dependent on funding from public finances, which could jeopardize its political independence. The fourth option, which I believe is preferable, is for the ECB to leave the debt on its balance sheet indefinitely (Boonstra, 2021). This does not lead to new inflationary pressures. Insofar as the buy-back programme has led to inflation, this is already incorporated in the current price level. In principle, therefore, that part of the debt does not have to be repaid. Viewed in this way, this action has few practical disadvantages. The public debt ratios of the member states can be corrected for the part of their national debt purchased by the Eurosystem.

Figure 2: Adjusted public debt ratios (2021)



Source: calculation based on data ECB

Moral hazard as a disadvantage

Figure 2 shows what this action would mean for the public debt ratios of the euro area member states. They would be reduced to pre-corona levels. It is, as it were, a reset of their public debt ratios. Technically this is easy, but the real caveat here is of course how to prevent moral hazard. Because, once it is decided that member states do not have to repay a significant part of their public debt and that their public debt ratios are corrected for this, the de facto result is of course a major bail-out. This would introduce a strong element of moral hazard, which may have a bad effect on future fiscal discipline. Why should a country stick to the Stability and growth (SGP) pact if, when all is said and done, it is bought out by the central bank anyway? Unfortunately, the experience of recent years has shown that it is



not a foregone conclusion that all member states follow the agreed fiscal policy rules. This is a serious problem, which can be tackled along the following lines.

First, even after the proposed debt correction, many countries still have public debt ratios well above the 60 percent of GDP agreed to in the SGP. It is conceivable that only countries that comply with the SGP deficit rules are "rewarded" with the conversion of part of the public debt bought up by the Eurosystem into a perpetual loan. Once fiscal policy slackens, this conversion action ceases.

Second, it must be clear in advance that the ECB in the future will not embark again on another massive purchasing programme of sovereign debt. This position is only sustainable if the ECB can fall back on other forms of open-market policies than purchasing public debt of the member states. This is possible, which I will explain in more detail below. It should be absolutely clear that the ECB in the future will refrain from purchasing sovereign debt of member states. This must therefore be laid down in European legislation (TFEU). Disciplining member states should then be left to the financial markets, as was originally intended. If in the future an EMU member state really runs into debt problems it can always turn for help to the European Stability Mechanism (ESM) or even the International Monetary Fund (IMF), but not to the ECB. As said, this does require the creation of conditions in which the ECB can conduct its monetary policy without having to buy up member states' sovereign debt.

Question 2: how to reduce bank liquidity?

If the ECB wants to regain its grip on the money market, it has several options to reduce bank liquidity. First, of course, it can wind down its LTRO lending to banks. Second, it can reverse its purchasing programme and start to sell securities on the market. As explained above, this option has serious negative side effects. Third, the central bank can try to decrease the degree of liquidity of the banks' reserves by offering the banks term deposits with a longer maturity. This is what the ECB actually did in the past, when it tried to reduce the liquidity impact of the Securities Market Programme. And, as a fourth option, the central bank may start to issue central bank securities. Like term deposits, this option would absorb liquidity. Moreover, it avoids one of the disadvantages of the former instrument: term deposits are not tradable, but securities are. Although holdings of central bank securities usually do not count as liquidity reserve, a bank or investor can always trade them on the open market. As a result, central bank securities reduce aggregate liquidity in the system, but individual holders can obtain liquidity by selling them to another investor. This in contrast to term deposits, which not only reduce liquidity but also flexibility. A further side-effect is, of course, that where access to the ECB's open market operations and standing facilities is restricted to Eurozone banks, ECB-securities can also be bought by banks from outside the Eurozone, including other central banks, and by non-bank investors.

Central bank securities are not a new, untested instrument. Far from that. Many central banks are very active users of this instrument.¹ The Swiss central bank (SNB), for example, has actively and massively issued central bank securities between 2008 and 2012 in a successful effort to neutralise the liquidity inflow that resulted from the massive capital flight into the Swiss franc during the euro crisis (Boonstra & Van Geffen, 2022). Although some central banks limit themselves to issuing short-term securities, others issue bonds up to maturities of 20 years. Compared with the other liquidity-reducing operations mentioned above, the issuance of central bank securities is much more effective. Using this instrument, it is possible to drain huge amounts of liquidity in a relatively short period, without much market turbulence. And in the context of the eurozone, it has one additional advantage. It would create a common safe asset, giving the European capital market its EMU-wide benchmark at last.

The European capital market: a market without a proper benchmark

The fragmentation of EMUs public bond markets is often mentioned as one of the vulnerabilities of the Eurozone. Over time, there have been a whole series of proposals to end this situation by the 'mutualisation' of public European debt (Boonstra, 1991; Muelbauer, 2013). Under such proposals, the public debt of individual countries is fully or partly combined by organizing a single European Public Debt Management Office and/or private entities that replace it by structured products. Moreover, there are other options to create a 'common safe asset' which do not by definition require mutualization of national public debt (Boonstra & Thomadakis, 2020). Although this discussion is far from concluded, for the time being no individual proposal can count on enough political support. However, a main exception is the recent issuance of so-called coronabonds as part of the NGEU-initiative. This article will not further dwell on this discussion, but it remains to be remembered that the fragmented sovereign bond market is a structural weakness of the eurozone.² You just have to make a mental exercise and try to imagine that the US Fed should conduct its open-market policies in a market without Treasury Bills, having to operate in bonds issued by individual states, to realise that the ECB operates in an extremely complex environment. It is one of the few major central banks, if not the only one, that doesn't have a one-to-one relation with a national sovereign.

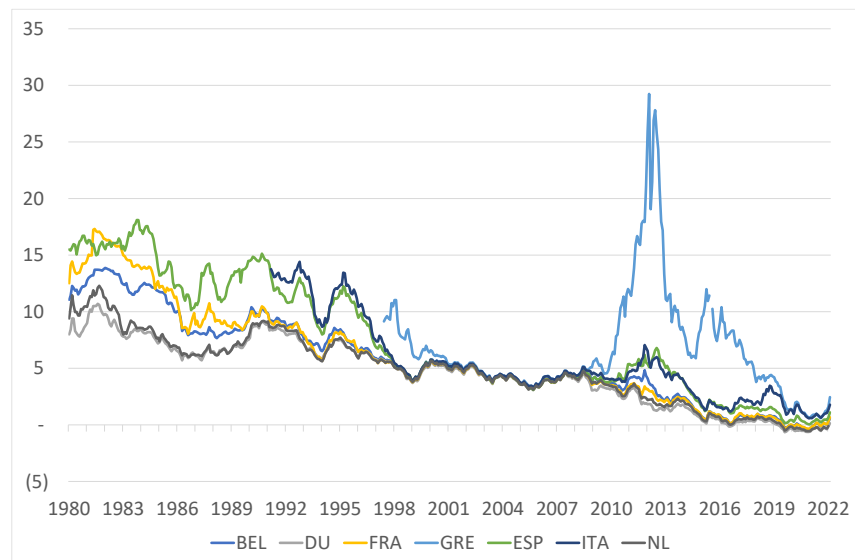
The euro crisis mercilessly exposed the weak spots of the Eurozone. The fragmentation of public bond markets along national lines offered speculators, in the absence of a well-developed market for EMU-wide common safe assets, the opportunity to put a crowbar in

¹ Gray and Pongsaparn (2015) indicate that over 30% of central banks issue or have issued central bank securities. Among them are Chili, Thailand, Korea, Sweden, Switzerland and Japan. A thorough discussion of the topic can be found in Hardy (2020).

² See Muelbauer (2013) for a thorough discussion of this topic.

EMU, driving countries apart by increasing the spread between the financially stronger and the weaker countries. This is illustrated in Figure 3.³

Figure 3: Effective yield on EMU-government debt (%)



Source: OECD via FRED database

During the years of Quantitative Easing (QE), this problem was masked by the massive purchases under the APP, but since a couple of months it is back on the agenda.

The euro as an international currency

After the introduction of the euro on the financial markets in 1999 it immediately became the second most important currency of the world. It is a major reserve currency, investment currency, payment currency, anchor currency, vehicle currency and trading currency. But, where many policymakers had hoped that the euro would challenge the dollar as the world's leading currency, the importance of the euro remains relatively limited compared to its American counterpart. Since 2018, the EU has launched initiatives to further strengthen the international role of the euro (European Commission, 2018). Indeed, it would be a good idea to strengthen the euro's international standing, if only to prevent that the euro will be overshadowed by the renminbi in the next decade. However, here as well, the fragmentation of Europe's bond markets is a major hindrance. There is no EMU-wide safe

³ In the years before the crisis the financially weaker countries enjoyed very low interest rates on their public debt that in general did not reflect the relatively poor quality of their public finances. Most of them did not use this windfall 'gain' since the start of EMU to consolidate their public finances.

asset, so to say. Meanwhile, the demand for safe assets has only increased due to regulation. Were such an asset available, this might be a great help. China, for example, has foreign currency reserves of over USD 3,000 billion. It would like to have a larger share of euro-denominated assets in its portfolio, but it is not very eager to invest in what it has once described as ‘bonds issued by European provinces’. A pan-EMU safe asset would potentially greatly improve the euro’s standing as a reserve currency. As long as there is a relatively small amount of euro bills or bonds available compared to the supply of e.g. US Treasuries, securities issued by the ECB may play a positive role in tackling both issues mentioned here.

Central banks issuing securities: how does it work?

The balance of the central bank

Let’s begin with a look at a stylized central bank balance (figure 4)

Figure 4: A stylized ECB bank balance

assets		liabilities
Gold and foreign exchange reserves (1. and 2.)		Banknotes in circulation (1.)
Lending to credit institutions (5.)		Liabilities to credit institutions (2.)
Securities held for monetary policy purposes (7.)		Debt certificates (4.)
		Other liabilities (5. + 3. + 6. + 7. + 8. + 9. + 10. + 11.)
Other assets (3. + 4. + 6. + 8. + 9.)		Capital and reserves (12.)

Note: The figure concentrates on the balance sheet items that are relevant for this analysis. The rest is summarized under the label ‘other’. The numbers between brackets in the specific items correspond with the lemma’s used by the ECB.

The most important items on the liability side, at least in normal times, are the **bank notes in circulation** and the **liabilities to credit institutions**. This last item covers the money banks hold as liquidity reserves at the central bank. This reflects the role of the central bank as the creator of base money (M0), including its actions as lender of last resort. It contains the money banks hold on current accounts (under the reserve requirement), the deposit facility, and the liabilities that are the result of their repo-transactions and the fine-tuning operations.



The item **debt certificates** is zero today, although the ECB had a small amount of outstanding debt certificates on its balance sheet in the early years of its existence. This was probably a legacy of some of its founding central banks. **Capital and reserves** are present to cover losses.

On the asset side, the first items are the official reserves (**gold and foreign exchange reserves**). These are buffers to finance foreign exchange transactions. For major central banks, like the ECB, this post is relatively unimportant, as agents in major countries usually have access to market finance in any relevant foreign currency and, just as important, their currencies have a large degree of international acceptance. For developing countries with inconvertible currencies, this item usually is more important. There, the central bank is the ultimate guarantor if a country's obligations in foreign currency.

The **lending to euro area credit institutions** is related to the conventional, regular monetary policy operations.⁴ The item **securities held for monetary policy purposes** reflect the financial assets required by the central bank under the unconventional interventions under the APP.

Liquidity scarcity versus surplus liquidity

Central banks prefer to operate in an environment of liquidity scarcity. In such an environment, banks are constantly in need of central bank liquidity, which the central bank can supply at will on its own conditions. The result is that the central bank has a very tight grip on both the interbank money market rate and the size of the monetary base. It also means that the growth of the balance sheet is driven by the demand for liquidity (liability-driven), while the growth of the asset side of the balance sheet follows. The moment a central bank starts to intervene in financial markets under one of the above-mentioned special programmes, it is the asset side that dictates the rate of expansion of the balance sheet. In that case, the liability side follows and, if the purchasing of securities results in a strong increase of bank reserves, an oversupply of liquidity may be the result.⁵ One of the consequences of a such an oversupply is that the ECB has less grip on money market rates, which no longer follow the refi rate, but have dropped to the floor created by the deposit rate. A further consequence is that banks, in case of a strong improvement of the economic climate, have more than enough liquidity to support a strong increase in lending. Probably even too much.

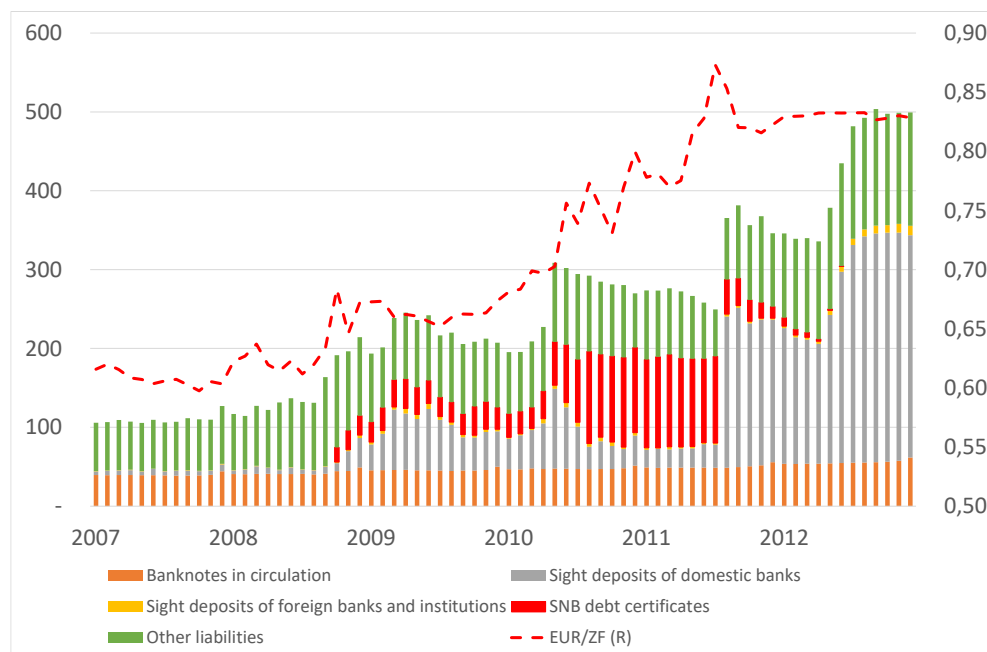
⁴ This item has two sub-items: the securities received as collateral under the main refinancing operations and securities received as collateral under the long-term refinancing operations.

⁵ Therefore, the ECB originally sterilised its purchases under the Securities Markets Programme by conducting liquidity absorbing operations.

Why should a central bank issue securities?

As explained above, the most important reason why many central banks start issuing securities is to reduce or prevent surplus liquidity. The background can be quite different. Sometimes, a central bank wants to drain surplus liquidity which is the result of a massive inflow of foreign capital. If such an inflow is too large in the opinion of the central bank, it can intervene in the FX market by buying the foreign currency. On the asset side of such a central bank's balance sheet, the amount of foreign exchange reserves increases. On the liability side we see an increase of bank liquidity. This liquidity can be drained with the issuance of central bank bills. This is what happened in Switzerland between October 2008 and June 2012, when a strong inflow of money from abroad resulted in an unwarranted increase in bank liquidity (Figure 5).

Figure 5: The Swiss experience



Source: SNB

It is also possible that a central bank wants to reduce bank liquidity without selling assets. This better illustrates the ECB's current situation. Such a central bank can issue bonds and sell them to domestic banks. This would c.p. not shrink the central bank's balance sheet but it does reduce the banks' liquidity reserves. This is offset by an identical increase in the amount of outstanding central bank bonds (substitution on the liability side of its balance sheet, see figure 6). The upper panel reflects the balance sheet prior to the issuance of securities, the lower panel the situation after the operation

Figure 6: Reducing banking liquidity by the issuance of central bank securities

Before bill issuance

assets	liabilities
Gold and foreign exchange reserves (1. and 2.)	Banknotes in circulation (1.)
Lending to credit institutions (5.)	Liabilities to credit institutions (2.)
Securities held for monetary policy purposes (7.)	Debt certificates (4.)
	Other liabilities (5. + 3. + 6. + 7. +8. + 9. +10. + 11.)
Other assets (3. + 4. +6. + 8. + 9.)	Capital and reserves (12.)

After bill issuance

assets	liabilities
Gold and foreign exchange reserves (1. and 2.)	Banknotes in circulation (1.)
Lending to credit institutions (5.)	Liabilities to credit institutions (2.)
Securities held for monetary policy purposes (7.)	Debt certificates (4.)
	Other liabilities (5. + 3. + 6. + 7. +8. + 9. +10. + 11.)
Other assets (3. + 4. +6. + 8. + 9.)	Capital and reserves (12.)

The lower panel of figure 6 illustrates that the asset side of the balance sheet is unchanged, while the central bank intervention only results in substitution at the liability side of the balance sheet, where deposits of commercial banks at the central bank are replaced by the newly issued central bank bonds.

The consequences

Once the ECB would start to issue securities, so-called ECB-bills, this may have an impact on market rates. It is clear that some crowding-out effects are to be expected. However, compared to the effect of actively selling its securities portfolio this effect may be relatively limited. Mopping up bank liquidity through the issuance of ECB-bills can probably be effectuated in a much shorter timespan than doing the same thing by selling the securities portfolio. The positive effect is that the ECB will improve its grip on the money market sooner than in other scenarios. One may expect that if the ECB were to start issuing ECB-securities, it will use short maturities as a pilot programme. First, because this would be less politically sensitive. Secondly, because this gives the ECB better options to change or even stop the programme if unforeseen negative externalities would arise. Given this short maturity, certainly of the first issues of ECB-securities, the ECB retains all options available to keep market conditions in a tight grip. Moreover, the ECB can steer the process by targeting its initial issues explicitly towards banks, although other investors can acquire them on the secondary market. The enthusiasm for ECB-bills, which will most likely carry a zero-risk weighting, may be substantial. The next logical step for the ECB would then be to issue securities with longer maturities if political conditions allow this. This would allow the ECB to lock up liquidity for a longer period without having to continually roll-over its tenders.

A new tool for open-market policies

As said, the arrival of a new, large issuer of a AAA-rated EMU-wide safe assets will have impact on market conditions. ECB-bills may affect the interest rates that other AAA-issuers have to pay on their national public debt. It will also crowd out lower-rated public debt, such as Italian, Spanish, or Portuguese government bonds, which may have to offer higher yields. However, these distortions will probably be smaller than in a scenario in which the ECB actively reduces its holdings of public debt. Moreover, any price effect may be mitigated by the extra inflow of money from foreign investors that are attracted by the new instrument. As the ECB initially should tread very cautiously, especially in the early stage when the market (and political) reaction is the most uncertain, we expect it to limit itself to short maturities when it starts its issuance programme. Ideally, of course it should aim to issue longer bonds as well in the future to establish a full yield curve with benchmark issues.

Once the ECB has established a well-developed market in its own securities, it has also a completely new instrument for its open-market operations. By increasing or reducing the amount of its outstanding securities it can determine money market conditions. The important point is, that in the future the ECB, in conducting its open-market policies, can refrain from buying or selling debt issued by the member states. This combination, reduction of public debt and the issuance of ECB-securities, opens opportunities for a package deal.

Conclusion: a package deal

The deal is simple. If EMU's member states agree that in the future the ECB is prohibited to buy public debt of the eurozone's countries, they will be rewarded by a substantial reduction of their public debt. From that moment onwards, countries that conduct irresponsible fiscal policies will have to be disciplined by financial markets. The ECB will not bail them out, although they can always turn to the ESM or even the IMF for help if necessary. Both issues necessitate a change of the European Treaties. The waiver of the public debt on the Eurosystem's balance sheet means a formalization of the monetisation of the part of their public debt that de facto already is monetized, which is not allowed under article 123 TFEU. But to strengthen the one-off character of this step it is absolutely necessary to include in the Treaty that in the future the ECB will never be allowed to purchase public debt issued by the member states again. This deal, which of course means a de facto reset of the eurozone, would in practice mean:

- 1) All member states see their public debt ratios decline by around 25%. This is an enormous bonus.
- 2) The danger of fragmentation of the eurozone will strongly decline or even disappear once there is a full-blown market in ECB-securities.
- 3) Market discipline in the eurozone will be strengthened substantially once it is clear that the ECB will conduct its future open-market policies in its own securities only and, essential, is under the Treaty is formally no longer allowed to purchase any public debt issued by member states.

It may be clear that it is essential that the prohibition to purchase national public debt in the future is included in the TFEU. If not, the debt cancelling will just result in more moral hazard, written large. This package deal may ultimately make EMU future proof. But without a package deal like this, EMU will have a long period before it of improvisation and muddling through. A period during which much can go wrong, including the demise of the euro. Which would be disastrous.

###

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