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Quantitative easing with bite: a proposal for conditional overt monetary financing of public investment

Abstract

To address the on-going crisis in the euro area it is proposed to introduce a scheme of conditional, overt monetary financing of public investment (COMFOPI). The inadequate response of monetary and fiscal policy is shown to explain the weak performance of the euro area compared with other advanced countries since the crisis. The measures currently on the table, including the Juncker Plan and quantitative easing QE, are unlikely to bring about the needed substantial improvement in economic growth, while putting growth on a sustainable footing. Advantages and dangers of monetary financing of fiscal policy are discussed in the light of the recent literature. COMFOPI is a form of QE in which bonds newly issued by the European Investment Bank are purchased, on secondary markets, by the ECB, and the financial resources are made available to national governments to finance investment projects. The scheme is explicitly time-limited by being made subject to a price-stability criterion ("conditional"). The provision of central bank money leads directly to higher spending in the economy ("overt"), unlike with QE which relies on indirect channels. A number of ways to operationalise the scheme are discussed.

Keywords: Euro area, monetary financing, quantitative easing, European Central Bank, European Investment Bank, public investment, sustainable growth

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I have benefited greatly from valuable discussions with colleagues from the IMK, the Austrian Chamber of Labour, the OFCE, Paris, the ECLM, Copenhagen, and at a conference marking the centenary of Federico Caffe's birth held in Rome. In addition criticisms and suggestions on earlier drafts were received from a number of colleagues. Without implicating them in the remaining errors and the views expressed here, I would like to thank, in particular: Pasquale d'Apice, Stefan Ederer, Bela Galgoczi, Willi Koll, Marc Lavoie and Simon Wren-Lewis.

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On current policies the euro area, and Europe more generally, face the very real prospect of a decade-long quasi-stagnation marked by stubbornly high unemployment, and being at constant risk of a renewed slide into recession, political turmoil and the break-up of the currency area (e.g. OECD 2014: 16, 55). Even if this fate is avoided, it is already clear that the goals set under the Europe2020 strategy, which are based on achieving smart and sustainable growth and are supposed to guide the actions of Member States and the EU authorities, have largely fallen out of reach, thanks to the persistent slump. Substantial policy changes are needed to ensure a strong and broadly based upturn that lastingly banishes fears of recession and deflation, restores balance sheets, and absorbs unused capacity, rapidly and sustainably reducing unemployment from its unacceptably high levels. What is required is a combination of a more vigorous approach to raising aggregate demand and output in the short-term with a medium-term strategy to expand the productive capacity of the European economy and re-engineer it so as to enable it to meet the challenges of the future.

This article considers some of the options for achieving these goals and discusses why the measures currently on the table are unlikely to bring the desired results. It puts forward a concrete proposal for the conditional overt monetary financing of public investment (COMFOPI), a form of quantitative easing in which bonds newly issued by the European Investment Bank are purchased, on secondary markets, by the ECB, and the financial resources are made available to national governments to finance investment projects. The scheme is explicitly time-limited by being made subject to a price-stability criterion (hence "conditional"). And it explicitly links the provision of central bank money to actual higher spending in the economy (hence "overt"), rather than this being based on a hope and a prayer as with quantitative easing.

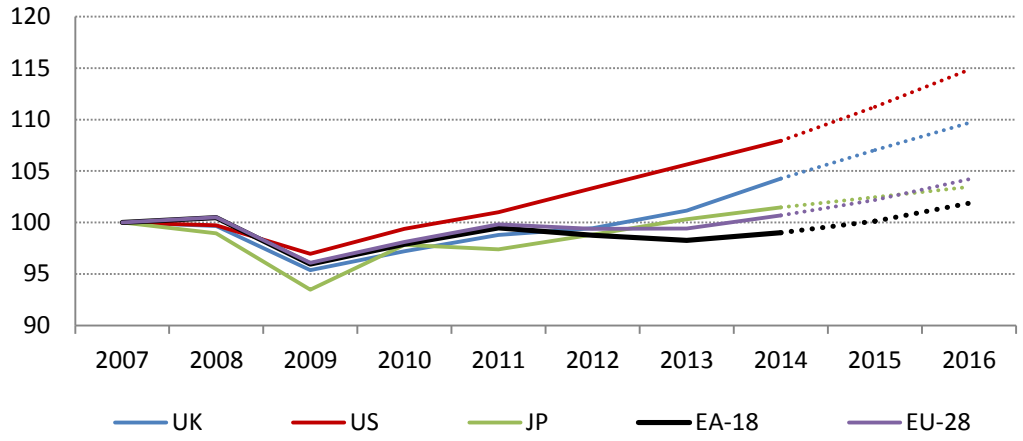
The structure of the argument and article is as follows. First the poor performance of the euro area since the crisis and the main macroeconomic policy differences to other advanced economies are set out (1). The current situation and prospects facing the euro area are discussed, along with the policy alternatives currently (at the start of January 2015) on the table. It is concluded from this discussion that there is a substantial risk of continued massive underperformance of the euro area – a prolonged slump and even renewed crisis leading to break-up (2). After an excursus on the concept of monetary financing and its place in economic theory and policy debates (3), a proposal is set out to combine quantitative easing by the ECB with additional public investment by the member states financed by emitting EIB bonds. A number of different options and modalities of the basic proposal and their respective advantages and drawbacks are discussed (4). Section five concludes.

1. Euro area performance since the crisis and its causes

The post-crisis performance of the euro area has been markedly inferior to that of other advanced industrialised countries. This is true, notably, of the USA, the UK and other EU countries that are not members of the monetary union, and, on some metrics, Japan. As can be seen in Fig. 1, the euro area is the only one of these countries or country groupings that by 2014 had not regained the level of economic output achieved prior to the crisis, in 2007.

Output in the EU28 as a whole and Japan was already substantially higher, compared to the starting level in 2007; the UK and, particularly, the USA have by 2014 left the euro area in the starting blocks. More worryingly still, the gap with the two English-speaking countries is forecast to widen further in the current and coming year, while that with the other European countries will not close.

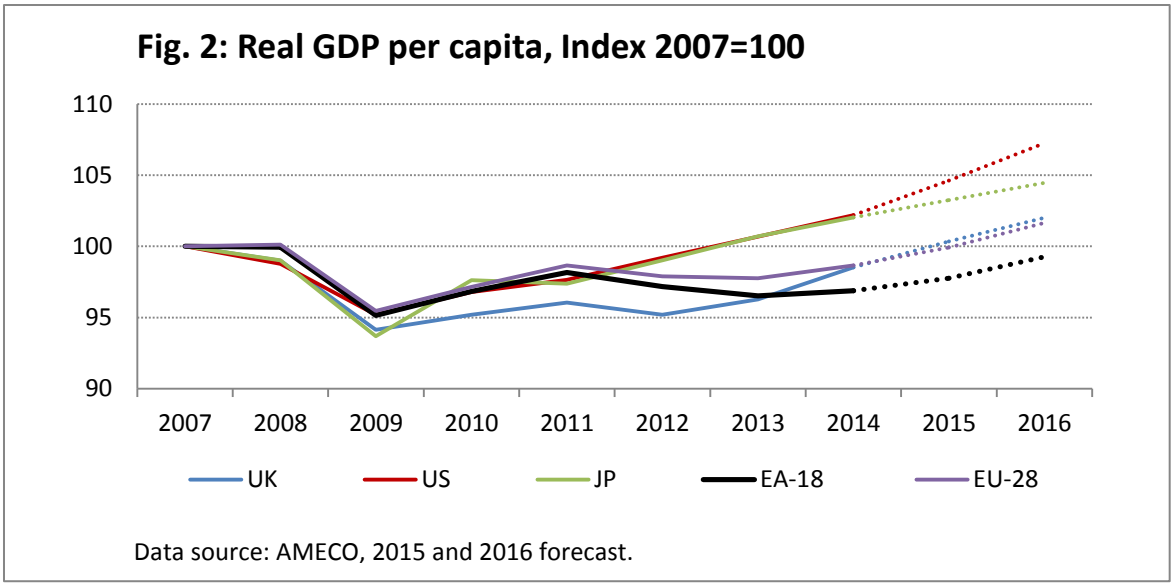
Fig. 1: Real GDP, Index 2007=100



Data source: AMECO, 2015 and 2016 forecast.

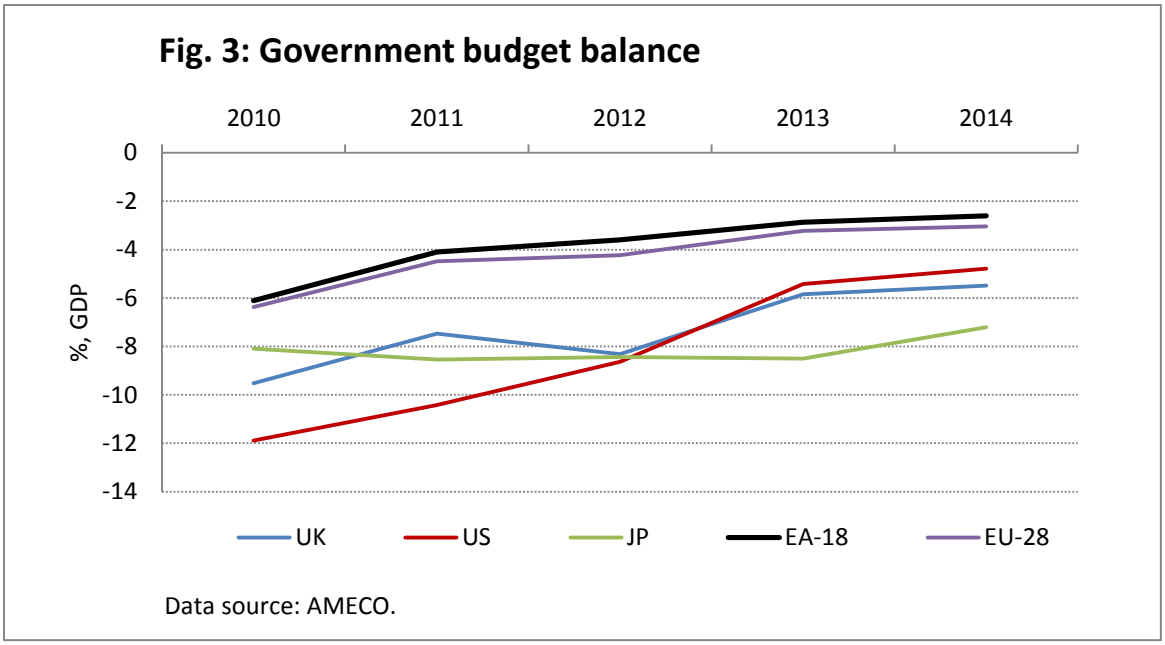
It is noteworthy that until 2011 the trajectory of economic growth in the euro area and that in the EU as a whole was virtually indistinguishable; however, from 2012 a substantial gap opened up. This strongly suggests that structural characteristics of EU member states, apart that is from their mere membership or not of the common currency area, are not a plausible explanatory factor for the poor performance of the euro area economies, as such characteristics change only slowly (De Grauwe 2014). Rather, some policy or other shocks seem to have affected euro area and non-EMU member states very differently starting in 2011.

One of the reasons for these performance differences is clearly demography. We can remove this factor – which can be taken as exogenous in terms of medium-run policy – by focusing on per capita GDP growth (Fig. 2). This adjustment does narrow the gap with the USA and UK. Yet it widens it substantially in the case of Japan, whose performance in per capita terms is almost on a par with that of the US, at least until 2014. On these figures, too, the euro area is a laggard by a long way – and is expected to remain so.



What other factors, beyond demography and the oft-cited lack of structural reforms, explain these very substantial degree of underperformance of the euro area, especially in the period since 2011? Clearly the euro area crisis is a complex phenomenon, which will not be revisited in full here (e.g. Horn et al. 2012), but differences in the stance of both fiscal and monetary policy compared to those in other countries can be identified as the key proximate causes.

The brief "Keynesian" phase in the immediate wake of the crisis was much more pronounced outside Europe, and the shift to contractionary fiscal policy after 2010/11 was more pronounced in the euro area than in the US, the UK and Japan (Fig. 3). In 2010 the fiscal deficit was between 8 and 10% of GDP in the UK and Japan and as much as 12% in the US; in Europe the deficit widened to only 6%, providing a much more limited cushion to the contraction of private spending. Although the existing level of the deficit was much lower and the growth pick-up weaker, the deficit was reduced faster in Europe than in the US and Japan between 2010 and 2011. Japan maintained its fiscal deficits virtually unchanged. For 2014 the Commission estimates a budget deficit of around 2.6% in the Euro Area; it is almost twice as high in the US (4.9%), more than twice as high in the UK – the tough austerity rhetoric notwithstanding – and 7.5% in Japan respectively. Within the EU, the deficit was consistently slightly higher outside than inside the euro area, although the gap was not particularly large.



Cyclically adjusted (structural) figures are, in principle, a better guide to the fiscal stance. Not least in the current environment their estimation is fraught with difficulty, however (OFCE/IMK/ECLM 2014: 42ff.). There can be little doubt, given the growth figures discussed earlier, that the cyclical position is less favourable in the euro area than in the other countries. The deficit figures therefore *understate* the extent to which fiscal consolidation has burdened the euro area economy as compared with fiscal developments outside it. For what they are worth, the AMECO figures for the cyclically adjusted deficits (not available for the US and Japan) point to a change in the structural balance between 2010 and 2014 of 3.9 %-points in the euro area; this compares with 3.4 and 2.4 %-points in the EU as a whole and the UK, respectively.

The pronounced differences in fiscal policy were amplified by those in the conduct of monetary policy.[2] Interest-rates were reduced in all major economies in the wake of the crisis, but more resolutely and rapidly in the US and UK. Rates were subsequently *tightened* by the ECB in the spring of 2011, a mistake avoided by the central banks in the English-speaking countries. Most notably, there was a completely different approach to quantitative easing (QE). Both the Federal Reserve and the Bank of England (BoE) launched pre-announced purchases over extended periods of, in particular, large volumes of government bonds: at the height of its QE operations the Fed was purchasing USD 80 bn per month, a figure steadily reduced to zero (taper) in the course of 2014 as the economy recovered. In addition to purchases of UK gilts the BoE injected money into the banks subject to conditions that it led to increased credit creation (Funding for Lending). Early in 2013 the Japanese central bank, under new management, announced a doubling of the inflation target and a bond-buying programme (Watt 2013).

The expansion of the ECB's balance sheet was markedly less pronounced than that in the other countries. It was mostly achieved via injections to the banking system, in particular the long-term and very long-term refinancing operations (LTRO, VLTRO). However,

[2] For a more extensive discussion see OFCE/IMK/ECLM 2014: 107ff.

conditionality was weak or non-existent and household and corporate lending remained negative, while M3 growth was sluggish. Repayments of earlier loans by the banks subsequently led to a major contraction of the ECB balance sheet of the order of a trillion euro (falling from around three to two trillion euro; OFCE/IMK/ECLM 2014: 111). The announcement of the OMT programme in September 2012 – a declaration of willingness in principle to buy sovereign bonds if needed to avoid speculative attacks against sovereign bonds, conditional on participation in an adjustment programme – was vital in stabilising expectations and improving confidence. It substantially reduced the crippling interest rate spreads faced by the "peripheral" euro area countries. It did not actually lead to quantitative easing measures, though. In the course of 2014 the ECB, in the face of its shrinking balance sheet, belatedly began to step up purchases of covered bonds and asset backed securities. A small "targeted" LTRO program was initiated (broadly on the funding for lending model).

These different stances were also reflected in exchange rate movements. The euro appreciated substantially and persistently against the currency of major trading partners in the wake of the policy tightening in early 2011. This trend that went into reverse in the latter part of 2014, in line with the Fed tapering and then ending its quantitative easing and the ECB preparing more substantial measures. Until recently the exchange rate was consequently exerting a depressing effect on both nominal and real output growth in the euro area.

In a recent analysis the OECD (2014: 16f) estimates that, combining interest rate policy and QE, and allowing for an estimated lower neutral real interest rate in the euro area, monetary policy has actually had a *negative* impact on growth in the currency union (by about half a point of GDP-growth each in in 2013 and 2014); by contrast monetary policy has been very substantially expansionary in the UK and the US. A study by Wu and Xia comes to a similar conclusion (OFCE/IMK/ECLM 2014: 108). Even if there is considerable uncertainty concerning such estimations, there can be no doubt that the differential stance of monetary policy is a decisive factor behind the glaring gap between the economic recovery in the UK and the US and the virtual stagnation in the euro area.

Combining the analysis of fiscal and monetary policy it is clear that a large part of the differential performance between the euro area member states and comparable countries reflects the inability or unwillingness of macroeconomic policy in the euro area to provide the necessary stimulus.

2. The current situation and policy options

The currency union has suffered from, and continues to endure, a massive shortfall in overall aggregate demand, the clear signs of which are: very low real economic growth (just 0.8% in 2014, rising to 1.1% in 2015, according to the EU Commission); double-digit, close-to-record unemployment, implying an absence of supply-side constraints on faster output growth; and extremely and persistently low inflation – headline inflation is currently (December 2014) at -0.2%, core inflation at 0.7%. The core rate (excluding energy, food, alcohol and tobacco) has been consistently at or below 1.0% since September 2013, and consequently inflation

expectations have begun to "de-anchor". There is a non-negligible risk of a slide into deflation. The resultant persistently low *nominal* GDP growth mires Europe in stagnation by delaying balance-sheet repair (in both the private and public sector) and leads to a reticence to invest (Lindner 2014). At 19.3% the investment rate is around two percentage points below the long-run average (even excluding the pre-crisis boom; European Commission 2014a).

At the same time the poor overall euro-area figures are the reflection of dire performance in peripheral countries together with more acceptable, but not booming, conditions in core countries such as Germany. This heterogeneity, coupled with the complex nature of policymaking in the euro area, which is characterised by a mix of European and national competences, raises difficult problems for effective policymaking.

There are two basic ways by which policymakers can raise nominal aggregate demand and GDP: fiscal policy and monetary policy. Each has specific advantages and limitations and faces specific constraints – economic, political, legal – on the extent to which it can be deployed and on its effectiveness. Some policies may have undesirable side-effects. So far, as we have seen, both monetary and fiscal policy have failed in the task of rapidly restoring adequate (nominal) demand growth. In this section we review briefly the options and scope for expansionary fiscal and monetary policies, in the light of the institutional set-up, the current economic and political state of the euro area and its member states. We consider in turn: national fiscal policy, European fiscal policy (in particular the Juncker Plan), and monetary policy, specifically the ECB's recently announced quantitative easing programme.

Expansionary fiscal policy by the member states, and particularly higher public investment, would be appropriate in the current situation characterised by low and even negative real interest rates on government bonds, combined with economic stagnation and particularly weak investment (public and private). However, the EU countries have imposed on themselves a complex and highly restrictive set of fiscal rules, at both national and supranational level, that seriously constrain their room for manoeuvre. Following an analysis of the specific positions of all euro area countries against the background of the fiscal rules, the OECD (2014: 61f.) concludes that the countries in the excessive deficit procedure (which include France, Portugal and Spain) have no fiscal space. Other countries (Austria Belgium, Italy, Netherlands and Slovakia) face apparently softer constraints but required preparations to meet the debt rule (the requirement to reduce debt-to-GDP ratios by $1/20^{th}$ of the gap between the current level and 60% of GDP every year) are binding except in Slovakia. Ultimately it is only Germany and tiny Luxembourg and Estonia that have some leeway if the rules are applied rigorously.

This leaves open the possibility of resorting to "exceptional circumstances". In its recent assessment of the Member States' budgetary submissions for 2015 (European Commission 2014b) the Commission notes that, assuming the submitted plans are realised, fiscal consolidation overall, which came to a halt in 2014, will remain on ice in 2015: aggregate fiscal policy will be neutral. It notes that this overall stance appears to "strike an appropriate balance" between consolidation and cyclical stabilisation concerns. At the same time it reports that several member states are not expected to meet their SGP commitments and calls on

seven countries (Belgium, Spain, France, Italy, Malta, Austria and Portugal) to take counter effective measures; a renewed examination is to take place in the spring of 2015.

On 13 January 2015 the Commission sought to specify the terms of some of the flexibility parameters in the fiscal rules (European Commission 2015). These clarifications provide some leeway to discount spending related to "structural reforms" and on public investment when analysing budgetary positions, permitting temporary deviations from otherwise required fiscal trajectories. The leeway is limited, however: alongside a whole series of qualitative conditions, the allowance for structural reforms may not exceed 0.5% of GDP and the medium-term objective should be attained within four years. Regarding investment, only national co-funding of various EU projects (including the Juncker Plan, see below) is eligible.

For the near future it seems plausible to assume that the Commission will not insist forcefully on further austerity measures beyond those already planned from the countries under the fiscal microscope. However, by no stretch of the imagination can the signs coming from the Commission be interpreted as suggesting that a substantial and lasting fiscal boost is likely.

Moreover, the European fiscal rules are only part of the problem. Under the fiscal compact governments have also incorporated so-called "debt-brakes", more or less on the German model into their national legislation or even, as in Germany, their constitution.

Changes to the way that the structural deficits are calculated – as proposed by Truger (2014) – could create additional fiscal space in countries with high unemployment (cf. Gechert/Rietzler/Tober 2014). However, the Commission reviewed its procedures for calculating output gaps in 2014 and there is no sign of imminent progress in this regard.

Looking beyond 2015, even if countries successfully bring deficits down, the debt rule – the obligation to reduce debt above 60% of GDP by one twentieth a year – will bite. Leaving out the small countries, the gap to the 60% debt limit is around 40% of GDP in the case of France, Belgium and Spain, and 70% in the case of Portugal and Italy, implying a need for an annual fall in debt ratios of 2 pp. of GDP in the former and as much as 3 ½ pp. in the latter. Unless nominal GDP growth accelerates markedly, substantial further consolidation going forward will be needed in a number of countries to meet the debt rule.

The only country that does have scope for discretionary fiscal expansion and is of relevant size is Germany. Yet the German coalition government has repeatedly reiterated its intention to achieve fiscal surpluses in coming years, not least with reference to its national debt brake. Faced with political pressure from European partners Germany has announced it is considering a €10 bn investment programme. But the package will not start until 2016, runs to 2018, and represents just 0.1% of GDP in each of the three years. This is peanuts even in national terms. Moreover, even if Germany were to go for substantial fiscal expansion, the knock-on effect on the peripheral countries, while positive, would be quantitatively limited.

Put very bluntly, the problem with national fiscal policy as a means to give a sustained boost to demand and investment in the euro area is that the country that can, won't. The countries that want, can't, at least not very much. The best that can be expected is creative use of the political leeway available to the European authorities, leading to a minor short-run easing of

the fiscal policy stance. Yet, any improvements in the pace of nominal GDP growth risk leading to a renewed tightening of policy in countries that have been granted temporary leeway.

A crucial conclusion emerges from the above analysis. The only way that *substantial and sustained* expansionary fiscal policy will be forthcoming in 2015 and subsequent years is through substantive changes in the fiscal rules, such as some form of golden rule to exempt credit-financed public investment. This would require changes to European treaties and legislation. Moreover, the spread of debt-brakes into national legislation (and even constitutions) thanks to the fiscal compact means that these legal frameworks would also have to be revised wherever they come into conflict with the economic exigency, which is to run an expansionary fiscal policy.[3]

As is well known, the **European level** budget is very small (around 1% of GDP), fixed for multi-annual periods, and the Union has no independent fiscal (i.e. borrowing) capacity. In late 2014 the Commission announced a so-called Investment Plan for Europe, more popularly known as the **Juncker Plan**, which is supposed to mobilise at least €315 bn in additional investment[4]. A list of appropriate investment schemes is under deliberation. The Plan runs for three years, so if fully realised the investment boost would amount to just over 1% of GDP each year. This would be welcome. However, the proposal is explicit that very little additional public finance is being made available. Member States will be invited to commit funds, the incentive being that any such expenses will not count against the fiscal deficit. The bulk of the funding is supposed to come from private investors; the fund is highly leveraged and the projects take the form of public-private partnerships. Given private investors' apparent reluctance to invest in the current economic environment, it has not been made clear what the proposed scheme really changes in their calculations to justify expectations of a substantial increase.

Clearly, private investment under such a programme can be made to expand, if sufficiently attractive risk-adjusted returns are promised. However, this raises the question to what extent will it merely divert investment that was anyway planned (deadweight effect). Given extremely low interest rates for (most) sovereigns it makes no economic sense to ensure high returns to (wealthy) private investors at the long-run cost of higher taxes. All in all, the scheme itself is unlikely to do harm – except for the risk that it might convince policymakers that anywhere near enough has been done. But it is an expensive and/or ineffective way to work around perverse fiscal rules. It would be foolhardy to expect the Plan to deliver a major boost to investment and output.

[3] An official survey of the national laws is planned for mid-2015. According to an unofficial survey, as of January 2015 twenty EU countries have implemented a legal balanced budget requirement (debt brake). Of these, 13 take the form of a simple law, seven either a constitutional provision or other legal device requiring more than a simple parliamentary majority to be reversed. See: http://en.wikipedia.org/wiki/European_Fiscal_Compact#Fiscal_compliance/

[4] The Commission provides regularly updated information here: http://ec.europa.eu/priorities/jobs-growth-investment/plan/index_en.htm/. For critical evaluations see Claeys/Sapir/Wolff 2014, Horn et al. 2015: 8ff., Münchau 2014, OFCE/IMK/ECLM 2014: 52ff.)

As is well known, conventional **monetary policy** has reached its limits. As discussed in the previous section, the ECB has engaged in some unconventional policy measures, if very much less than other central banks. On 22 January 2015 the ECB announced a large-scale programme of quantitative easing. It will buy €60bn of public and private sector assets a month until September 2016. The programme may be continued for longer if necessary to get inflation back on track. The purchases will be of sovereign bonds and investment-rated corporate bonds, with some special conditions to be imposed on the bonds of countries under reform programmes (notably Greece). The ratio of national bonds purchased will be in line with the ECB's capital key (which broadly means in line with GDP weights). There will be a risk-sharing mechanism under which 80% of any losses incurred by the euro system on bond purchases will be borne by national central banks. 20% of any losses will be shared (again using the capital key). Broadly speaking the programme will re-expand the ECB balance sheet by the "missing trillion" referred to in the previous section.

Will such a QE program be enough to turn the European economy around? Belated as it is, the entailed expansion of the money supply and the associated reduction in interest rates on sovereign bonds and also in the exchange rate will certainly have some expansionary real effects. The rise in the value and fall in the yield of sovereign bonds held by the banking sector creates incentives to lend to higher risk/yield purposes, including shares, and this may boost corporate investment. The wealth effects, if they are expected to be sustained, may lead to higher consumption. The measures will also tend to increase the rate of inflation and inflationary expectations, with beneficial effects on public and private debt dynamics.[5] Weale and Wieladek (2014) report some quantitative estimations of the effects of QE in the USA and UK; their own research suggests quite substantial effects, although they note the econometric challenges of estimating using very short time series.

However, there are a number of reasons to be sceptical.[6] Central bank purchases of existing government bonds is a blunt instrument. Such purchases do not themselves lead directly to higher spending on currently produced goods and services. They substitute cash (central bank money) for low-interest and low-risk government securities in private-sector portfolios, including those of the banks. This has a portfolio effect – shifting lending to riskier forms, including lending to the real economy – and also a wealth effect, by driving up asset prices. The indirect channels to higher spending are known, but the quantitative impact is not. If the additional money created is willingly held by the private sector, especially the banks, as was largely the case with earlier unconventional ECB measures, the quantitative impact will be very limited.

Sovereign interest rates, for peripheral countries like Spain and Portugal[7], are at historical lows, thanks to the slump generally and the spread-reducing effect of OMT. Sovereign-bond QE would have been much more effective in 2011. Because falling secondary-market interest

[5] On the channels of QE see Bank of England 2011,

[6] Cf. Watt (2015a). For what it is worth, this *ex ante* scepticism seems broadly shared, even in the financial industry which stands much to gain, at least in the short run. A survey of 32 euro area economists, most from the financial sector, was overwhelmingly sceptical: http://www.ft.com/intl/cms/s/0/e54c1e4e-91d0-11e4-bfe8-00144feabdc0.html/

[7] Greece is a special case given the 2012 debt restructuring programme (Watt 2015b).

rates only affect debt servicing costs gradually, such purchases, even in large volumes will not appreciably ease the fiscal constraints on euro area governments. While depreciation of the exchange-rate is an important transmission channel, it seems likely that this effect has largely already been priced in: QE had been widely expected and the euro has already depreciated substantially against the US-dollar and the currencies of other major trading partners. More fundamentally, the euro area currently runs a current account surplus of more than 4% of GDP. It must be doubtful whether a substantial and sustained further impulse can come via net exports under these circumstances. A number of commentators have suggested various reasons (housing market, company finance) why QE might well be less effective in the euro area than in the USA and UK (e.g. Muellbauer 2014).

There are also concerns about risks and negative side-effects of a QE strategy of this type. An explicit aim of the policy is to push financial market participants into other, riskier asset classes, raising the prices of riskier assets: this is, to some extent, a desirable end of policy. However, many European stock markets are already at record levels despite meagre real economic prospects. Blowing up bubbles in financial markets would bring with it the risk of sudden corrections and resultant financial turbulence. To the extent that the prime beneficiaries of the policy are those holding financial and real assets (notably shares and housing) whose prices are raised by QE, it will exacerbate an already worrying trend towards income and wealth concentration given the well-known highly skewed ownership of wealth.[8] The marginal propensity to consume out of this additional wealth is almost certainly low (as ECB economists recognise, cf. Carroll/Slacalek/Tokuoka 2014). Such impacts pose question-marks about the sustainability of a growth model driven by central bank asset purchases.

From the analysis in this section of the policy measures being actively discussed or now being launched by national and European authorities, we can draw the following conclusion. It is conceivable that, if simultaneously the three main policy areas – national fiscal policy, an EU investment programme and central bank QE – all surprise on the upside, the euro area economy might be jolted out of its current doldrums. The risk of a renewed slide into crisis would be averted. Somewhat higher growth, real and nominal, would gradually unwind balance sheet constraints and a slow period of recovery might set in, with unemployment declining slowly. A rapid and sustained recovery seems unlikely, however, not least because any acceleration of growth will swiftly be met by a tightening of fiscal policy. The IMF has just (19 January) revised *down* its forecasts for the euro area in spite of various tailwinds (lower oil prices, less restrictive fiscal policy and recent currency depreciation) including "further monetary policy easing (*already broadly anticipated in financial markets and reflected in interest rates*)" (IMF 2015: 2, emphasis added). It now expects growth of just 1.2% in 2015 and 1.4% in 2016.

And the downside risks appear significant. The EU investment plan may well flop unceremoniously. The evaluation of member state fiscal policy in the spring review might

[8] To its credit the Bank of England has been explicit about the distributional impact of its QE program (Bank of England 2012). This effect, it is true, may be counteracted indirectly by the inequality-reducing impact of higher employment, but this counter-argument is only relevant to the extent that other forms of quantitative easing that do not have direct inequality-raising effects are not available.

well stick closer to the letter of the treaties than assumed here. And the impacts of QE are inherently uncertain and the longer-term risks of igniting financial bubbles and relying on a policy that means an even more lop-sided distribution of income and wealth cannot be ignored.

In any case we need to ask ourselves whether our expectations have not been excessively diminished in the course of this long-drawn out crisis. Even the best outcome would imply that the negative economic and social impacts of the crisis will be with us for many more years to come. The agreed and eminently reasonable goals of the Europe2020 strategy would certainly lie in ruins. Yet they also constitute a commitment by European policymakers to citizens, alongside the fiscal and monetary rules, albeit a less binding one. Challenges such as climate change and environmental sustainability remain vital and urgent, even if they struggle for attention in the context of the immediacy of stagnation and unemployment. Achieving them will require a step-change in the ambition of policymakers. Various estimates put the needed additional investment in the hundreds of billions a year.[9] More specifically, it will require a set of policies that will deliver a sufficient volume of additional output and investment reliably and without dangerous side-effects, establishing the foundations for an economically, socially and environmentally sustainable growth model.

Before presenting a concrete proposal to reboot the European economy by giving QE "teeth" through an explicit link to public investment, it will be useful to review the concept of monetary financing in economics and discuss some recent proposals in this vein, along with some counterarguments.

3. Monetary financing in economics and economic policy: coming back in from the cold?

Monetary financing, as understood here, is the purchase of new government bonds by the national central bank in return for newly created base money so as to finance an expansionary fiscal policy. Such a policy is often described using the term "helicopter money", going back to a metaphor due to Milton Friedman in which the central bank throws newly printed banknotes out of a helicopter to the pleasantly surprised members of the community below; cf. e.g. Buiter 2014, Turner 2013: 3f., Wren-Lewis 2014. In the real world the channel by which the additional central bank money enters circulation is through a fiscal measure, of which there are three main types: the government can use the base money created by the central bank to cut taxes, to make transfers to households, or to engage in higher government spending.

In many countries the setting of monetary policy and the management of the public debt had traditionally been closely intertwined and involved close cooperation between the central bank and the treasury; for the British case see Goodhart 2012, for more general reflections Lastra 2012. In the 1970s inflation reared its head. Meanwhile rapid growth and inflation had made the task of managing government debt, a major concern in many countries after the First

[9] See the discussion in Chapter 4 of the independent Annual Growth Survey 2014 (OFCE/IMK/ECLM 2013).

and Second World Wars, much easier. This led to an almost ubiquitous sea-change: the separation of monetary from fiscal policy, the independence of central banks from operational interference by governments and, not least, the widespread prohibition of direct sovereign bank purchases of newly issued government debt: the temptation for politicians, whose horizons barely extended beyond the next election, to reap short-run economic gain at the cost of longer-term inflation pain had to be removed. Central bank independence became a condition of EU membership and, most relevantly in our context, direct monetary financing was explicitly forbidden by the Maastricht Treaty (Article 108, now Article 130 of the Treaty on the Functioning of the European Union). In Germany, famously, this had already been established with the 1957 Bundesbank Act, and the Bundesbank model was essentially adopted by the European Central Bank on its creation in the run-up to European Monetary Union.

As a result of these developments, for decades there was a virtually complete consensus among academic economists and policymakers that monetary financing was akin to an extremely dangerous drug that should forever be locked away. Its use was a "taboo" (Turner 2013: 3).[10]

As has repeatedly happened in economic history, though, an academic and policymaking consensus came under pressure when real-world conditions changed: as the problem of public debt management once more became acute, while the inflationary threat receded and indeed gave way to the threat of deflation, questions began to be raised about the wisdom of insisting on a clear and permanent separation between monetary and fiscal policy (Goodhart 2012: 129, Lastra 2012). It is therefore no coincidence that the question of monetary financing of expansionary fiscal policy first raised its head once again in Japan, in the wake of the persistent slump that began there in the 1990s, nor that the same phenomenon has emerged more recently in the context of the high public debts and deflationary threat in the euro area.

In 2003 Ben Bernanke, then chairman of the US Federal Reserve, gave a speech in Japan in which he proposed "explicit, though temporary, cooperation between the monetary and the fiscal authorities", in order to overcome the persistent stagnation and deflation afflicting the country, and bring rising public debt under control. So uncanny are the parallels to the current situation and policy debates in the euro area, and so useful is the speech in pinpointing the key issues – the opportunities and the risks – involved in such policy cooperation, that I will quote some passages at length (Bernanke 2003: no page numbers).

Bernanke started by analysing the difficulties that the Bank of Japan (BOJ), on its own, faced in overcoming the deflationary mind-set and stimulating the economy. He advocated a price-level, rather than an inflation target, and argued against putting undue emphasis on the alleged risks to the central bank balance sheet of acquiring risky assets that might subsequently have

[10] Turner continues: "To print money to finance deficits indeed has the status of a mortal sin—the work of the devil—as much as a technical error. In a speech in September 2012, Jens Weidmann, President of the Bundesbank, cited the story of Part II of Goethe's Faust, in which Mephistopheles, agent of the devil, tempts the Emperor to distribute paper money, increasing spending power, writing off state debts, and fueling an upswing which, however, 'degenerates into inflation, destroying the monetary system'".

to be sold at below their purchase price. He also argued that fiscal policy alone might have had weak effects due to "Ricardian" effects – i.e. higher private-sector saving – that come from the lack of confidence engendered by rising debt levels and ratios. Thus monetary financed fiscal expansion would increase the value of the fiscal multipliers.[11]

He then proposed the following:

"My thesis here is that cooperation between the monetary and fiscal authorities in Japan could help solve the problems that each policymaker faces on its own. Consider for example a tax cut for households and businesses <Bernanke subsequently specified that the same argument applies to higher government spending – AW> that is explicitly coupled with incremental BOJ purchases of government debt--so that the tax cut is in effect financed by money creation. Moreover, assume that the Bank of Japan has made a commitment, by announcing a price-level target, to reflate the economy, so that much or all of the increase in the money stock is viewed as permanent. Under this plan (…) the government's concerns about its outstanding stock of debt are mitigated because increases in its debt are purchased by the BOJ rather than sold to the private sector. Moreover, consumers and businesses should be willing to spend rather than save the bulk of their tax cut: They have extra cash on hand, but--because the BOJ purchased government debt in the amount of the tax cut--no current or future debt service burden has been created to imply increased future taxes. Essentially, monetary and fiscal policies together have increased the nominal wealth of the household sector, which will increase nominal spending and hence prices."

He then went on to enumerate a number of advantages of such an approach:

"The health of the banking sector <which many observers had held to be a crucial limitation on the effectiveness of monetary policy – AW> is irrelevant to this means of transmitting the expansionary effect of monetary policy (…) (F)rom a fiscal perspective, the policy would almost certainly be stabilizing, in the sense of reducing the debt-to-GDP ratio. The BOJ's purchases would leave the nominal quantity of debt in the hands of the public unchanged, while nominal GDP would rise owing to increased nominal spending. Indeed, nothing would help reduce Japan's fiscal woes more than healthy growth in nominal GDP and hence in tax revenues. (…)"

Crucially, he also emphasised that the proposed policy was in theory not costless, but in practice, *given the prevailing conditions*, it was:

"Of course, one can never get something for nothing; from a public finance perspective, increased monetization of government debt simply amounts to replacing other forms of taxes with an inflation tax. But, in the context of deflation-ridden Japan, generating a little bit of positive inflation (and the associated increase in nominal spending) would help achieve the goals of promoting economic recovery (…) In the face of inflation, which is often associated with excessive monetization of government debt, the virtue of an independent central bank is its ability to say "no" to the government. With protracted deflation, however, excessive money creation is unlikely to be the problem, and a more cooperative stance on the part of the central bank may be called for."

Lastly, Bernanke – who shortly afterwards, lest it be forgotten, became head of the independent US central bank – pointed out that, as long as these conditions prevailed, such actions were *not* contrary to the idea of central bank independence:

"Under the current circumstances, greater cooperation for a time between the Bank of Japan and the fiscal authorities is in no way inconsistent with the independence of the central bank, any more than cooperation

[11] "In addition to making policymakers more reluctant to use expansionary fiscal policies in the first place, Japan's large national debt may dilute the effect of fiscal policies in those instances when they are used. For example, people may be more inclined to save rather than spend tax cuts when they know that the cuts increase future government interest costs and thus raise future tax payments for themselves or their children." (Bernanke 2003, no page number).

between two independent nations in pursuit of a common objective is inconsistent with the principle of national sovereignty."

In a nutshell Bernanke's arguments suggest that monetary-fiscal cooperation is a) an effective policy, b) can be deployed when other policies have failed, and c) should then be so deployed provided there are safeguards to ensure that the policy is temporary, specifically that it will be discontinued once the central bank is confident that it can achieve price stability on its own and be in a position once again to say "no to the government".

A decade later the parallels with the situation in the euro area are obvious: persistent failure to reach the central bank price stability target, high and rising public debt, negative or sluggish growth and mass unemployment. Accordingly there have been a number of discussions of, and proposals for, various types of monetary financing in recent months. Adair Turner (2013) set out the arguments for, and the conditionality that needs to be ensured when resorting to, what he calls "overt monetary financing"[12]. Turner is explicit that it is vital to leave the central bank with the responsibility to determine the volume of monetary financing it considers compatible with the price-stability mandate it has been given (2003: 39). He echoes the arguments of Bernanke ten years earlier that monetary financing can be necessary in some circumstance, but adds a further one: even where it is not necessary, it can be *preferable* to other policies, if these have adverse side-effects, such as causing risks to financial stability (Turner 2013: 26f.).

Buiter (2014) establishes the theoretical conditions under which a helicopter drop – permanent base-money-financed fiscal expansion – will always stimulate aggregate demand. He concludes that the conditions do hold in modern fiat-money economies and that deflation and economic stagnation are unnecessary, a "policy choice" (Buiter 2014: 1). Only in the euro area, furthermore, are there legal impediments to such an approach. Article 123.1 "has commonly been interpreted as ruling out the financing of government deficits in the euro area". He notes that this is a legal barrier "(u)nless this can be fudged by the Eurosystem purchasing the sovereign debt in the secondary markets" (Buiter 2014: 45).

Gali (2014) shows that in a realistically parametrised New Keynesian model with typical nominal rigidities that monetary financing of expansionary fiscal policy (here: higher government purchases) has a very strong effect on output and a much smaller one on prices. The effects (the fiscal multipliers) are larger than with debt financing and the results do not depend on the existence of non-Ricardian (credit-constrained) households or a central bank that is already at the lower bound. Implicitly echoing Keynes' famous musing about the efficacy of burying newly printed money in bottles and relying on private enterprise to dig them up, Gali concludes that, in a standard New Keynesian framework, provided the output gap is sufficiently large money-financed fiscal stimulus would be welfare-enhancing even if the actual government spending were itself purely wasteful (Gali 2014: 33).

[12] I follow Turner in adding the adjective "overt". While arguably not strictly necessary, it helps to distinguish the proposal made in the next section from a QE that is combined, fortuitously, without coordination, with an expansionary fiscal policy; more on this below.

Giavazzi and Tabellini (2014) propose a tax cut (e.g. of 5% of GDP) by all euro area member states, financed by the issuance of long-term debt, all of which is bought by the ECB. The interest is returned to the Member States. Blyth and Lonergan (2014) and Muellbauer (2014) argue for programmes involving money-financed tax cuts, emphasising in particular the better distributional outcomes and reduced financial risks compared with a QE programme alone. An advantage of tax cuts over public investment is that they are effective more immediately. Issues relating to the effective and equitable distribution of the cash in the context of multiple national taxation and benefit systems are left open by these authors, however. While this may be resolvable, a more fundamental objection is that the empirical literature shows that fiscal multipliers are considerable higher for investment than for transfers, and this differential widens in the context of a recession (see the meta study of Gechert/Rannenberg 2014). Blyth and Lonergan's argument that a money-financed programme of tax cuts can be much smaller than a QE program, because of the more direct transmission, therefore applies *a fortiori* to money-financed public investment.

A recent study by the IMF (2014: 75ff.) shows clear longer-run benefits, on both the demand and the supply side, from public investment, especially when conducted in times of substantial economic slack. The average multiplier in advanced countries is 0.4 in the short run and 1.5 after three years, but in times of economic slack these rise to 1.5 and as much as 3 respectively (IMF 2014: 82). It also notes the substantial declines in the public capital stock and public investment (as shares of GDP) in advanced countries (IMF 2014: 79f.). Simulations by the IMK (Horn et al. 2015: 10f.) indicate multipliers of a similar order of magnitude for an investment push of 1% of GDP for the euro area for three years. However, this simulation assumes that all EMU countries debt-finance an investment push of this magnitude: as the previous section showed, this is highly unlikely under current conditions. Also the IMF study points out that, at high debt-to-GDP ratios, debt-financed infrastructure investment may become less effective due to negative confidence effects, echoing Bernanke's analysis of the Japanese situation.

These considerations suggest that, in the current environment, public investment is likely to be more effective than tax cuts or "cash" distributions in stimulating demand and output, and that monetary financing of such investment can be more effective than debt-financed public investment, which in any case is unlikely to be forthcoming in the euro area. Yanis Varoufakis, Stuart Holland and Jamie Galbraith have proposed an investment boost financed by the EIB and ECB jointly, as part of a "Modest proposal" to end the euro crisis (Varoufakis et al. 2013). It has some resemblance to the proposal made in the next section, although, importantly, it lacks an inflation safeguard and appears unclear, to me at least, on the mechanism for determining which investments are implemented and under whose responsibility.

A number of authors have pointed to the similarities between overt monetary financing and QE involving the purchase of existing sovereign bonds, as recently announced by the ECB. In both cases money is created by the central bank in order to buy an asset. In overt monetary financing it is used explicitly either to cut taxes (effectively distributing purchasing power directly to private households and raising private spending), or to finance government

spending on goods and services (and flowing to higher household wage and profit incomes). It is, in a sense, the explicit combination of two familiar instruments, QE and expansionary fiscal policy (e.g. Wren-Lewis 2014).

Consequently, QE by the ECB plus an autonomous, uncoordinated fiscal expansion by member states would be a sort of functional equivalent to overt monetary financing. The multipliers would probably be somewhat smaller (because at least initially debt ratios would rise from already high levels). The distributional and other drawbacks of QE would remain. But much the more important objection is that, as we have seen, such a serendipitous outcome is ruled out by the current fiscal rules, both European and national (see above and also Ederer 2015). Answering questions immediately after the announcement of QE President Draghi explicitly rejected the idea that QE would allow governments to backload fiscal consolidation.[13] This is in line with the oft-heard "meme" that all that the ECB can do it "buy time" for austerity and structural reforms to work. A serendipitous combination of QE and substantially more expansionary fiscal policies, much less a coordinated public investment programme, is simply not going to happen.

It may seem that another way to look at the issue of QE versus overt monetary financing is to differentiate between the permanent and the temporary purchase (monetisation) of sovereign bonds (see Reichlin et al. (2013), Turner (2013: 33f.), Wren-Lewis (2014, and some earlier work by him referenced there). QE appears to be temporary in nature: the central bank takes sovereign bonds on to its balance sheet, but will reverse the policy when circumstances change. There is no logical necessity for this reversal to occur, however, and Turner cites the example of purchases by the Federal Reserve before, during and after the Second World War that were ended in 1951, but never reversed. The monetary base was not expanded further but remained at its elevated level in nominal terms and this was compatible with low inflation. "All QE operations, therefore, carry within them the contingent possibility that they will turn out ex post facto to have been (in part or whole) permanent monetization, and this may be an appropriate policy." (Turner 2013: 33). Conversely an apparently permanent monetisation can be reversed, notably by raising minimum reserve requirements. Under both QE and monetary financing whether policy is reversed depends decisively on whether in the future inflation is above the central bank's target. It remains true, though, that the *ex-ante* expectations of the permanence of the operation are likely to be considerably higher in the case of overt monetary financing. This may be important in anchoring expectations and thus the effectiveness of the programme.

This issue of reversibility is also relevant to the counter-argument raised against QE and monetary financing, alike: that losses may be incurred on the central bank balance sheet and the costs borne by the taxpayer. As we saw earlier this is essentially to mistake an accounting convention for a real-world loss of resources. The "loss" consists of higher inflation (cf. Whelan 2014 – see box for illustration). That is often a problem, but occasionally it is not, it is a desirable policy goal. Moreover, as Wren-Lewis (2015) points out, fears of accounting losses from monetary financing of a helicopter drop cannot be a sensible counter-argument,

[13] The transcript of the Q+A session is available here: https://www.ecb.europa.eu/press/pressconf/2015/html/is150122.en.html

once it is accepted that QE is desirable in a given circumstance. Under QE the central bank can be forced to take losses if it sells bonds it has bought at high prices (and it buys when interest rates are low, and thus prices high) back to the market at lower prices. This would be a cost to taxpayers to the benefit of bondholders (read: the financial sector). But if the same amount of money were given to taxpayers in a helicopter drop there is also a balance-sheet loss as the money counts as a liability, but in this case the benefits would have been more widely spread. The same logic applies if the QE bond purchases are not reversed compared with the central bank holding monetary-financing "losses" on its books.[14] Wren-Lewis suggests that the interests of the financial industry may have something to do with the fact that governments and central banks prefer an indirect, inefficient and distributionally dubious strategy (QE) over a more effective one with less worrying distributional implications (overt monetary financing), which is considered taboo.

Why central bank accounting "losses" are not real – an illustration

There is a common-sense feeling that it cannot be a "real" solution to bury a sovereign debt problem in the balance sheet of the central bank. This common sense view is basically sound. However, under certain conditions it is not. And these happen to be the conditions currently prevailing in Europe.

For the simplest case, take a closed economy with a government, a central bank and a private sector; the latter can be considered simply as households, as the firms and banks in the private sector are ultimately owned by households. Suppose the government has run fiscal deficits such that the government debt is 100% of annual GDP. This means that households own financial assets (government bonds) worth the same amount. In order to reduce this debt the government can run (primary) fiscal surpluses, for example by raising taxes, for as long as it takes to pay down the debt. At the end of the process, of course, the financial assets held by the public are also at zero.

What happens if instead the central bank purchases the bonds from the public? The central bank creates ("prints") central bank money equal to one year's GDP and buys the bonds from the public. The government's debt to the public has disappeared. But the government now owes the same amount to the central bank (which has the bonds on its balance sheet) on which interest is also due. Yet the central bank is a government entity. If the government uses taxes to service the debt, the resulting "profits" of the central bank are transferred back to the government coffers at the end of the year. The sums merely change from one pocket to another of the government's "trousers".

[14] As shorthand, Wren-Lewis (2015) assumes the bonds are held by "pension funds". He writes: "The pension funds gain < from sovereign-bond QE – AW> but no one seems to lose. But if the expansion of money had been via a helicopter, then every citizen would gain instead. So why is acceptable to create new money and give it to pension funds (through losses on QE), but not create money to give to ordinary people or the government? The former is called monetary policy and is OK for a central bank to do, but the latter is called fiscal policy and this the central bank cannot do."

An implication of this is that the central bank could just as well pile up the bond documents it has purchased with central bank money on the square in front of its offices and set light to it. The government debt has been extinguished.

It seems that this cannot be right. Debt cannot disappear! Those familiar with double-entry bookkeeping imagine that they have spotted the logical flaw here. The money created by the central bank is treated in accounting terms as a liability of the central bank. It is matched in the books by assets of the same value (the bonds). The central bank has taken losses (the bonds have gone up in smoke) and, if sufficiently large, might be insolvent.

However, this confuses a central bank with a commercial bank or any other private actor. The distinguishing feature of the central bank is that it, and it alone, can create the general means of payment at will (and essentially costlessly). Consequently there is no impairment to the functioning of the central bank due to the fact that it has taken losses on the asset side of its balance sheet. It is true that the liabilities still exist, but now they do so *in the form of money*, which pays no interest and, in the modern fiat money system, cannot be "redeemed" for any valuable real asset.

Why then do we bother with tiresome taxation, and not just have the central bank print enough money to fund all the public spending we might want? The answer, in normal times, is not to prevent the insolvency of the central bank, but to guard against runaway inflation. The additional money created meets – if resources are fully used – a more or less fixed supply of real goods and services. The result is inflation. There is thus a real cost in the sense that all those holding money see its value fall; this is the "inflation tax" to which Bernanke referred (see above).

But in a situation of massively under-utilised resources, and when the central bank is desperately trying to push inflation up to its target and avoid the risk of a debt-deflationary spiral, inflation is not a cost of monetary financing it is a wanted feature of such a strategy. Under such circumstances monetary financing is not costly. On the contrary, it raises real incomes.

To close, we return to the issue of the monetary/fiscal-policy link. At heart opposition to both QE and monetary financing boils down to a gut feeling that monetary and fiscal policy are inherently completely different and must be kept separate. However, this is a purely semantic argument and smacks of intellectual laziness. As we have seen the relationship between monetary and fiscal policy has changed over time. It is true that QE and monetary financing have distributional implications. But so does monetary policy of all sorts, always. The standard argument is that this is permissible, and monetary policy can be performed by a technocratic institution, not an elected government, provided monetary policy is not implemented in order to achieve such effects, but solely so as to achieve the price stability mandate; the distributional impact is a by-product. Once again, then, we can conclude that there are no grounds for the taboo on monetary finance *subject to one important condition*: it must serve the interest of attaining price stability (or, more generally, meeting the

democratically legitimated mandate that has been given to the independent central bank). A key issue for any proposal relying on overt monetary finance is therefore to show that it meets this requirement.

Given that, monetary financing of public investment emerges as a means to turn the vice of deflation (or sustained too-low inflation) into a virtue: for a limited time public investment can be financed costlessly through the issue of base money. Indeed, such investment is not just a free lunch, it is a meal that diners are being paid to eat.

4. The Conditional Overt Financing of Public Investment (COMFOPI) proposal

Having reviewed the economic situation and prospects, likely policy settings in Europe going forward, and the opportunities and risks that theoretical reasoning suggests are offered by monetary financing in the current environment, we now present a concrete proposal for the euro area. It explicitly ties money financing and fiscal expansion, specifically public investment, together and does so in a way that seeks to make it compatible with, and effective within, the constraints set by the realities of European Monetary Union. Related to that, a particular concern is to introduce safeguards against a possible misuse or overuse of overt monetary financing.

The simplest form of financing would be for the ECB to credit the account of each member state government with an agreed share of the total volume of monetary financing. However, this would clearly contravene the Treaty prohibition against direct monetary financing. Moreover, there is no mechanism to ensure that governments use the finance made available to conduct investment projects that contribute to achieving common European goals. To resolve these two issues a more circuitous financing route is necessary, one that, however, remains transparent and ensures accountability of the relevant institutions (cf. Varoufakis et al. 2013, Wolff 2014).

4.1 The basic COMFOPI proposal

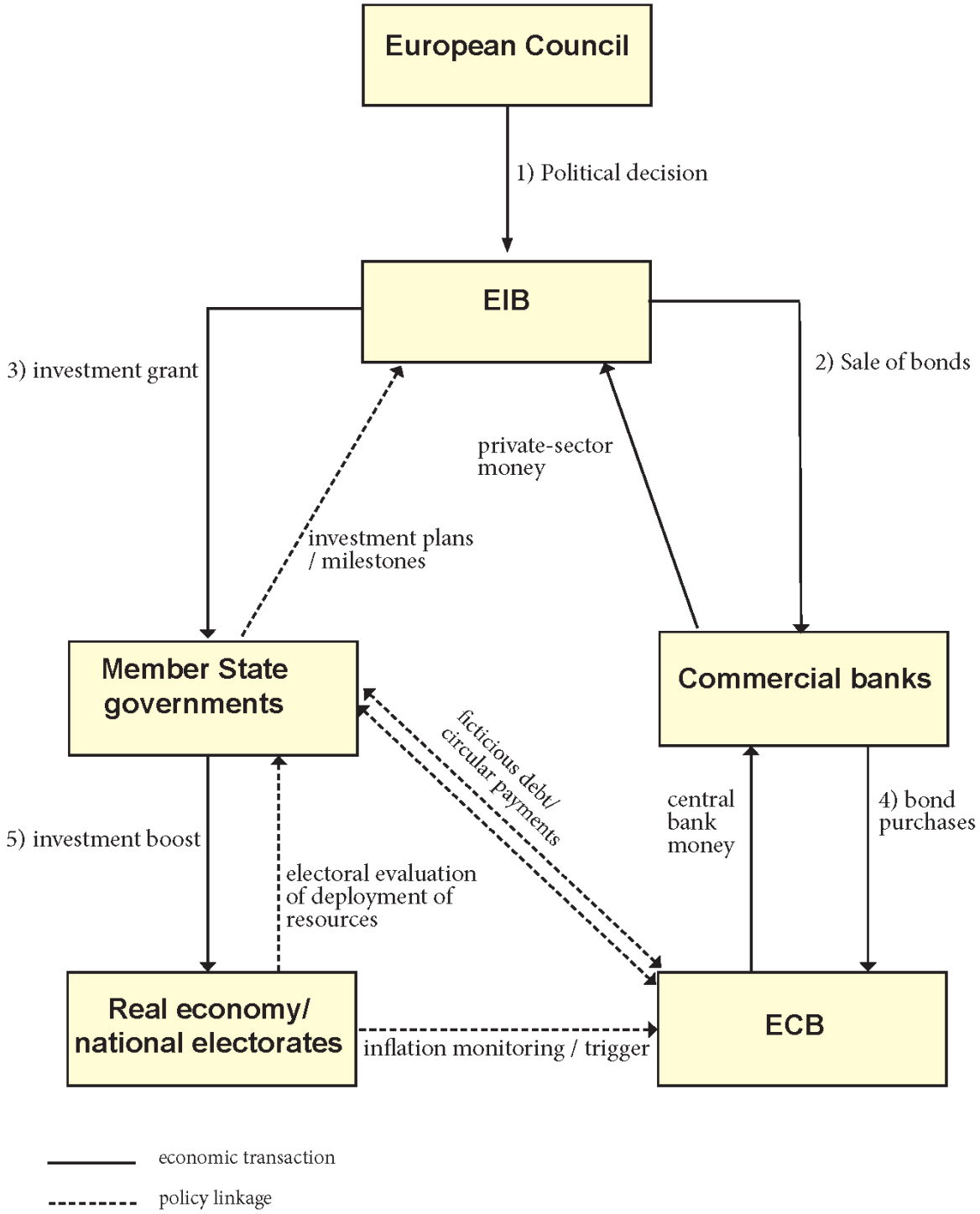
It is proposed to initiate a time-limited and conditional policy of quantitative easing in Europe via a pre-announced and substantial volume of purchases by the European Central Bank of newly created European Investment Bank bonds on the secondary market. The funds are made available as a grant to euro area member state governments for the purpose of financing public investment projects that meet certain minimal European guidelines. There is no co-financing requirement. A number of parameterisations and variations of the scheme can be envisaged, each with specific economic or political advantages and drawbacks. These are discussed below (4.2); first we set out the basic mechanisms:

- The scheme is established based on a decision by the European Council and initially given a timescale of, say, five years that clearly establishes this form of central bank support for public investment as a temporary phenomenon necessitated by the risk of deflation and/or longer-term stagnation and the break-up of the currency union. Within this framework, the

EIB emits long-duration bonds on a degressive scale. Starting from an initial level the volume of bonds issued is progressively reduced to zero.

- The ECB commits to purchasing these bonds on the secondary market and holding them on its books. The EIB's triple-A rating coupled with the preannounced central bank purchases will ensure extremely low interest rates. The ECB commitment is conditional, however. In order to ensure conformity with the ECB's Treaty obligation to ensure price stability – currently being infringed on the downside – a trigger mechanism is incorporated: if economic recovery is sufficiently strong that inflation (or nominal output) rises above a certain threshold, the ECB can progressively withdraw from the purchases. Following a withdrawal, the EIB would continue to issue bonds and make money available to Member States in order to avoid shocks to the financing process. This would be non-inflationary as private-sector liquidity would be absorbed because the bonds are purchased by the private sector.
- The EIB passes on the funds generated by its bond placements to Member States as a grant for public investment purposes. The precise way resources are allocated between Member States can be varied to meet different policy aims and considerations of political feasibility (see below). The EIB is not responsible for detailed vetting of proposals, as is the case with its normal lending. This programme is separate from its other operations. (The EIB normally performs extensive due diligence to secure its triple-A rating, but this is not required here since the bonds are held by the ECB). Equally the usual requirement for 50% Member State co-financing is waived.
- Member States submit projects for funding that meet a small number of European guidelines (e.g. conformity to the goals of the Europe 2020 strategy, climate-change commitments etc.). A starting point could be the list case drawn up for the Juncker Investment Plan. National projects may incorporate private-finance, but this is irrelevant to the proposal, as is whether the project generates a revenue stream or not (as opposed to a clear requirement to have net social benefit over costs). Some funding could also be reserved for pan-European projects, although the likely more extensive coordination demands involved risk implementation delays.
- Member States conduct the projects with monies being disbursed following the accomplishment of agreed project milestones. Member State governments are responsible and accountable to their electorates for the quality of the projects financed using the money made available to them.
- In principle Member States are in debt to the ECB, which now holds the bonds. However, as explained in the previous section, such debt is 'fictitious'. Whether or not the debt is serviced is economically irrelevant because service payments to the ECB are recycled to Member State governments at the end of the year as distributed central bank profits. In the simplest case – pure and permanent monetary financing – the bonds are withdrawn and no interest or principal payments are made; the "debt" takes the form of a permanent increase in the monetary base.

Fig. 4: Visualisation of the COMFPI scheme



Before looking at various specifications and options for implementing the COMFOPI proposal, it is worth noting some features of this approach that can be considered important strengths in the current economic and political context:

- A predetermined volume of additional real spending on goods and services is reliably and predictably injected into the sluggish European economy, independently of the state of the banking sector, raising real incomes and setting off multiplier and also anti-disinflationary

effects (cf. IMF 2014: 75ff.). This is in marked contrast to QE via purchases of existing private or public sector assets, which do not of themselves create additional real spending, but rather rely on indirect and uncertain channels and risk negative side-effects.

- Government budgets are not burdened with additional debt for as long as bonds are bought and held by the ECB. On the contrary, deficit and debt ratios will decline due to the faster nominal GDP growth. Multipliers will be larger to the extent that Ricardian effects due to (initially) rising debts and debt ratios are avoided.
- Investment in areas crucial for Europe's future can be rapidly implemented, raising productive capacity and productivity, and crowding in private investment, but without having to coax private capital through heavy subsidies as under the Juncker Plan or being restricted to projects that generate revenue streams. There will be no crowding out because there will be no increase in interest rates. There is no need to embark on the Herculean – and very likely impossible – task of changing the restrictive fiscal rules at European and national level.
- There will be some upward pressure on inflation for a limited period, which will aid deleveraging and re-establish confidence in the ECB achieving its mandate. At the same time it is assured that the ECB can end the monetary financing in line with that mandate. Meanwhile the letter of the Treaty prohibiting direct monetary financing is respected. Legal challenges to the "fudge" (Buiter 2014: 45) of secondary-market purchases are to be expected, but they occurred in the case of OMT and will also be forthcoming in the case of QE and real or supposed transgressions of the fiscal rules. Legal challenges will not prevent the scheme being launched. The prerequisite here is political, i.e. a qualified majority on the European Council.
- The scheme relies on already existent institutions and can be implemented quickly. The EIB can make investment decisions based on a simple or qualified majority of its Boards of Governors and Directors and cannot therefore be blocked by small numbers of individual countries.[15] Although the actual investments will take some time to come on stream, positive ex ante effects on confidence can be expected. The scheme is much less intricate and more transparent than the Juncker Plan.
- The proposal is in principle infinitely scalable, as the ECB can "finance" bond purchases with central bank money it creates at will, and it can be progressively wound down as necessary and contingent on incoming information about the state of the European economy. It is not mutually exclusive to other measures on the monetary or fiscal side (and could be rescaled accordingly).
- The scheme solves the problem of which assets the ECB should buy, offering a market of in principle unlimited size and a low-risk security (even if capital loss risk is economically not particularly important). It can be folded into the QE scheme already announced by the ECB.

[15] The governance structures of the EIB are explained here (p. 6ff.): http://www.eib.org/attachments/general/governance_of_the_eib_en.pdf/

4.2 Options and policy choices

A number of parameters and alternatives exist within this overall approach, each with specific advantages and drawbacks, which can be determined in the light of political feasibility and other considerations. They relate to the size and duration of the scheme, to the trigger underpinning the price-stability mandate of the ECB, the allocation of funds between member states.

- Size and duration: As a point of departure a five year programme is proposed with a degressive bond issue of €250 bn in the first year (2015), falling by €50 bn each year. This represents roughly 2 ½% of euro area GDP in the first year falling by ½p.p. each year. The aim is to boost spending as fast as possible, but also to allow for the time needed to deploy resources efficiently. It would take the programme to the end of the Europe 2020 strategy period. The total volume (€750 bn) represents some three-quarters of the balance-sheet expansion envisaged by the ECB under QE, but spread over a longer period. In the iAGS 2014 report capital investment needs of around €200 bn per year were identified, based on various policy commitments (for example in the area of climate change). In the Commission's AGS 2015 an investment gap of between €230 and €370 bn is estimated. This is a serious understatement, however: it is based on reattaining an investment share of between 21 and 22% of GDP but "accepts" the heavily depressed level of GDP as the benchmark for that calculation, and ignores the need for additional investment to meet agreed policy objectives. In the light of these comparators the proposal seems appropriately dimensioned, but it can be rescaled (and clearly would need to be smaller if it were targeted on the countries worst-hit by the crisis, rather than being spread across the whole currency area).
- Inflation target: The trigger to safeguard the independence of the ECB to pursue its mandate can be defined in various ways. For instance central bank purchases could be wound down to zero over a six month period after the core inflation rate in the euro area has exceeded 2.5% for three consecutive months. Other rates and durations could be chosen. Also a price-level or NGDP-level target would be conceivable, as recommended by many economists, in order to clearly signal a willingness to reverse past deflation or lowflation. Ultimately the operational definition of a trigger is an issue for consultations between the ECB and the eurogroup. It would be in accordance with the principle of forward guidance for the ECB to announce the trigger publicly in advance.
- The disbursement of funds by the EIB to Member States can in principle be designed in any number of ways. In purely economic terms a concentration of funding in countries with large output gaps and high unemployment would seem appropriate. Political considerations will probably require a broader distribution, however. The simplest and probably most politically feasible version would, like QE, disburse funds in accordance with the ECB capital key. The capital key gives more per capita to countries with high incomes, however. Another solution would be to distribute investment funding on the basis of population. Countries with higher financing costs and lower incomes and prices – i.e. the "crisis countries" – would benefit most in per capita terms. Consideration could also be given to basing the scheme on an "opt-in" basis. Countries may claim the ECB-backed EIB finance as they perceive their needs, and each country subsequently services

its nationally-specific debt to the ECB. Following the logic of the so-called PADRE proposal (Pâris and Wyplosz 2014a, b), the debts, rather than being actively repaid by Member States could be gradually paid down by the ECB refraining from transferring its seignorage profits to the Member States. Clearly the overall impact on investment in the euro area economy would likely be substantially reduced under a voluntary scheme: it must be supposed that Germany, for one, would refrain from participating. But it might constitute a viable option if political opposition to an area-wide (compulsory) scheme proves too strong.

5. Conclusion

The euro area remains in a perilous situation, economically and politically. The combination of expansionary monetary policy, fiscal austerity and so-called "structural reforms" has failed. The economic outlook has brightened somewhat, but remains bleak in many areas and at risk of sudden reverses. The threat of break-up has not been averted. In a number of countries opposition parties are gaining in strength that are openly calling for exit and/or default.

It is conceivable that a mix of less restrictive national fiscal policy, the European Investment Plan and aggressive quantitative easing by the ECB might jolt the euro area economy out of stagnation. This is highly uncertain however. This strategy also implies a number of risks (distribution, financial market stability) to balanced growth going forward. European and national rules block the substantial and sustained boost to public investment that is urgently needed. In order to underpin a broad-based and sustained recovery, boost public investment and finally make progress towards the Europe2020 goals, some form of public-investment-based QE, financed overtly but indirectly by ECB purchases, should be considered as part of policymakers' toolbox. It is not clear that it is absolutely necessary to bring about a cyclical recovery of the euro area. But it may well be necessary to underpin a sustained period of balanced and equitable growth. Moreover, even if not necessary, it appears a preferable stratgey in many respects, provided its use is constrained to the current conditions of deflation or persistent "lowflation". Faster demand growth would create a more favourable environment for supply-side reforms to have positive economic effects.

A concrete proposal has been discussed in this article, one that would permit the use of overt monetary financing in the European context, but also provide for its return to a locked compartment of the toolbox once its task has been accomplished. That decision needs to be taken by the central bank. The view that overt monetary financing of fiscal policy is a viable and possibly necessary approach appears to be gaining ground in the academic and policy debate. I hope that this contribution helps build the necessary political momentum to take this idea forward and will stimulate debate about how it could be operationalised in the difficult legal-political context of European Monetary Union.

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