

## **Monetary Union Stability: The Need for a Government Banker and the Case for a European Public Finance Authority**

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## **Monetary Union Stability: The Need for a Government Banker and the Case for a European Public Finance Authority**

### **Abstract**

This paper argues monetary union stability requires a government banker that manages the bond market and it offers a specific proposal for stabilizing the euro that does not violate the “no country bail-out” clause. There is accumulating evidence that the euro’s current architecture is unstable. The source of instability is high interest rates on highly indebted countries which creates unsustainable debt burdens. Remedying this problem requires a central bank that acts as government banker and pushes down government bond interest rates to sustainable levels. That can be accomplished by creation of a European Public Finance Authority (EPFA) that issues public debt which the European Central Bank (ECB) is allowed to trade.

The debate over the euro’s financial architecture also has significant political implications. That is because the current neoliberal inspired architecture, which imposes a complete separation between the central bank and public finances, puts governments under continuous financial pressures. Over time, that pressure makes it difficult to maintain the European social democratic welfare state. This gives a political reason for reforming the euro and creating an EPFA that supplements the economic case for reform.

Keywords: monetary union, stability, government banker, euro.

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## **Introduction**

The financial crisis of 2008 began as a private sector financial crisis. However, in many countries it has morphed into a public sector financial crisis owing to large budget deficits caused by reduced tax revenues, temporary fiscal stimulus, and large bailouts of the financial sector, combined with long-standing adverse trends in public debt-GDP ratios.

The crisis has raised a host of issues regarding the merits of fiscal policy and the limits to debt financed budget deficits. In Europe, it has raised another issue regarding fiscal policy and monetary unions. The standard argument (Kenen, 1969; De Grauwe, 1994) is that monetary unions (especially non-optimal currency unions) need a system of fiscal transfers. That is because regions are likely to be hit by asymmetric shocks and those shocks can be softened by inter-regional transfers which substitute for capital and labor mobility. Europe lacks such a system and euro skeptics therefore claim it needs to establish one or else some member countries may be compelled to exit the euro.

The current paper offers another interpretation of the euro's monetary union problem, which is that it lacks a government banker. The euro solved Europe's problem of exchange rate speculation by creating a unified currency with a single exchange rate managed by the European Central Bank (ECB). However, in doing so, it replaced the exchange rate speculation problem with a bond market speculation problem. That is because countries lost their national central banks able to issue money and assist in managing interest rates and financing government.

The paper argues that this flaw in the euro's structural architecture can be remedied by the creation of a European Public Finance Authority (EPFA) that would

have the discretionary powers to issue bonds that would be jointly and severally backed by euro zone member countries. In effect, the EPFA would function as the public finance sibling of the ECB which manages monetary conditions.

### **Neoliberal economics and the euro's design**

The euro was created in an era of neoliberal political and intellectual dominance. Neoliberal political theory argues for diminishing the role of the state and enhancing the power of the market, and within monetary theory this is expressed by claims that:

- (1) Fiscal policy is ineffective.
- (2) Money is neutral and the only effect of money growth is inflation.
- (3) The real economy quickly and automatically returns to full employment in response to negative demand shocks.

These theoretical claims shaped the euro's design and are reflected in both the legal arrangements governing the ECB and ECB policy. The essential feature was a change in the monetary – fiscal balance that followed from prohibiting central bank involvement with public finances.

Under the old system of national money central banks played a key role helping manage the public debt, finance budget deficits, and finance rescues of the financial sector. The euro's architecture undermined this government banker function by stripping national central banks of ability to issue means of payment. That has contributed to the public debt crisis centered on the PIIGS (Portugal, Ireland, Italy, Greece and Spain) countries. In contrast, the U.S. and U.K. have been able to use the Federal Reserve and Bank of England to push interest rates to near zero, help finance private sector financial bailouts, and engage in quantitative easing bond purchases that have helped finance

budget deficits at rock bottom interest rates. For the U.S. and U.K., that has lowered the budget cost of the crisis and helped avoid a public debt crisis of confidence.

In effect, national monetary systems make national governments master of the bond market, whereas the euro’s architecture makes the bond market master of national governments. Given the dominance of neoliberal economic thinking, this was an intended outcome of the euro’s design.

Figure 1 shows alternative monetary – fiscal institutional structures. The government budget can be “unrestricted” or subject to “deficit rules”. The central bank can play the role of “government banker” or it can be “detached”. The concept of detached captures a situation where the central bank is unconnected to government. The critical feature is the central bank is not allowed to buy government debt, which makes the concept of a detached central bank qualitatively different from the concept of central bank independence. The latter corresponds to a situation in which government distances itself from central bank decision making but central banks are allowed to purchase government debt.

Figure 1. Alternative monetary – fiscal institutional structures.

		Government budget rules	
		Unrestricted deficits	Deficit rules
Central bank	Government banker	U.S., U.K.	U.S. with a balanced budget rule.
	Detached	Euro countries ex-Maastricht	U.S. states, Euro countries with Maastricht

The modern era of pure fiat money (i.e. the era since the end of the gold standard in the 1930s) has been characterized by the combination “unrestricted deficits – government banker”, which corresponds to the current U.S. and U.K. arrangements. In recent years governments, including the U.K., have allowed central banks to become more independent but they are not detached.

Within the U.S. there has been a long-standing push to impose budget rules in the form of a balanced budget requirement, which would push the U.S. into the north-east quadrant. The south-east quadrant of deficit rules and detached central bank effectively constitutes the situation of many U.S. states which have no central bank and are subject to balanced budget requirements. The south-east quadrant also captures the formal situation of euro zone member countries. Within these countries the formal shells of central banks remain, but they are now regulatory agencies rather than central banks that issue means of payment. Along with this, the Maastricht Treaty imposes a budget deficit rule allowing countries average budget deficits of up to three percent of GDP. However, the current crisis has proved so serious that the Maastricht Treaty budget deficit provisions have essentially been ignored and euro zone countries have been allowed to ignore budget rules, placing them in the south-west quadrant.

### **Detached central banks and the problem of bond market instability**

Though euro countries have been allowed (at least for the moment) to ignore budget rules, they are still subject to monetary governance via a detached central bank. The problem with such governance is central banks are prohibited from buying government debt, leaving government bond markets open to speculative attack. In effect,

the euro solved the problem of exchange rate speculation and replaced it with the problem of bond market speculation.

The problem of bond market speculation can be captured by following simple model. Government bond investors in euro countries aim to earn a risk adjusted expected return equal to that which they could earn on safe bonds, implying the following condition

$$(1) 1 + i^* + z = E(R)$$

where  $i^*$  = safe bond interest rate,  $z$  = risk premium required for investing in a country's bonds, and  $E(R)$  = expected return to investing in a country's bonds. The expected return to individual euro country bonds is given by

$$(2) E(R) = p(Y(d(i,..),i,..),iD/Y(d(i),i,...),Z)X + [1 - p(Y(d(i), i,..),iD/Y(d(i),i,...),Z))][1+i]$$

where  $p(\cdot)$  = probability of default,  $i$  = country interest rate,  $d$  = budget surplus/deficit,  $D$  = debt-to-GDP ratio,  $Z$  = confidence variable, and  $X$  = payment in default state. The probability of default is such that  $0 \leq p \leq 1$ , and the default payment is such that  $0 \leq X \leq 1$ .

Signs above functional arguments represent assumed signs of partial derivatives. An increase in the country interest rate directly increases the probability of default by increasing the government's debt service burden ( $iD$ ). However, there are conflicting effects on  $Y$ . On one hand a higher interest rate directly lowers private sector demand. But balanced against this there is a positive demand effect from higher interest payments that works via the budget deficit since interest payments are transfer payments.

The model is closed by adding a dynamic interest rate adjustment mechanism given by

$$(3) \frac{di}{dt} = f(1 + i^* + z - E(R))$$

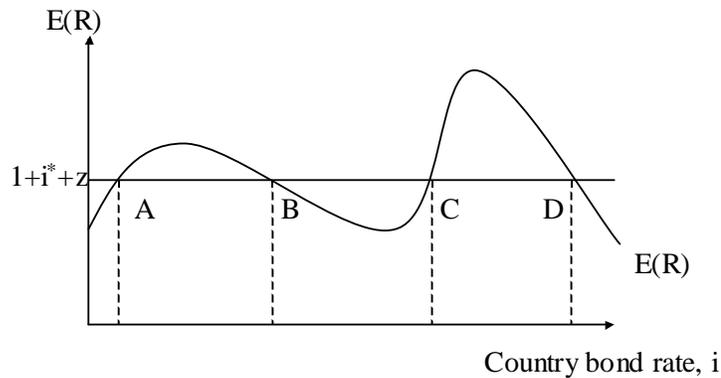
$$f(0) = 0, f' > 0, f'' > 0$$

If the risk adjusted return on safe bonds exceeds the expected return on a country's bonds, the country bond interest rate rises as agents sell the country's bonds to buy safe bonds.

Equation (2), describing the expected return function, is the critical equation. This expected return function can be volatile due to shifts of confidence ( $Z$ ) and also non-linear with respect to the country bond interest rate. The economic logic of non-linearity is because of competing effects. On one hand a higher domestic interest rate raises the expected return on a country's bonds. However, higher interest rates can also reduce the expected return due to increased default risk from higher debt service burdens and adverse impacts on income. Consequently, depending on the sensitivity of the  $p$  function and the sensitivity of  $Y$  to increases in  $i$  the slope of the ER function can change signs.

Figure 2 provides a graphical analogue of the model in which there are four equilibrium points. Equilibrium A is the stable "good" equilibrium with low interest rates. Equilibrium B is the unstable low interest rate equilibrium. Equilibrium C is the stable "bad" equilibrium with high interest rates, and equilibrium D is the unstable high interest rate equilibrium. PIIGS countries can be thought of as trapped in the bad high interest rate equilibrium given by C or D. The policy challenge is to move them to A.

Figure 2. The determination of country bond rates.



In the context of the euro zone the safe bond interest rate,  $i^*$ , can be identified with the interest rate on German bunds. Given that Germany is the strongest and largest euro zone economy, bunds are regarded as the safest bond. To a degree, as with money (Menger, 1892), there may even be an element of self-fulfilling prophecy. Having become the standard of safety, money flocks to that safe standard thereby increasing the liquidity of bunds and further driving down the German interest rate. That improves Germany's fiscal situation, which further increases the perceived safety of bunds. By becoming the safe standard, Germany gets to enjoy a premium ranking and a form of bond ranking seignorage.

The multiple equilibrium character of the model means it may exhibit hysteresis. For instance, suppose financial panic causes a sudden jump in the risk premium,  $z$ . In this event country bond rates may jump from the low interest rate good equilibrium at A to the high interest rate bad equilibrium at C or D. However, once the panic is over and the

risk premium drops back a country can remain trapped in the high interest rate equilibrium.

A similar outcome can occur if there is a sudden deterioration in confidence ( $Z$ ) about future conditions in country economies. In this event, the  $E(R)$  function shifts down. If the downward shift is large enough the country domestic interest rate may jump to the bad high interest rate equilibrium where it can remain stuck. That is because high interest rates create a self-fulfilling prophecy of increased likelihood of default, which means investors demand high interest rates to compensate for that increased risk.

The flaw in the system is that a government under speculative attack cannot use its central bank to intervene in the bond market and reduce the stock of outstanding debt. Without a central bank, governments are reduced to the same bond market standing as provinces and large corporations. That opens them to speculation, the vagaries of market discipline, and runs on debt just like any other borrower.

The euro's constitution prohibits the ECB from intervening to protect national government bonds. That prohibition is justified as the ECB should not give special treatment and intervention subsidies to individual countries as that could establish dangerous incentives. Countries would have an incentive to engage in populist fiscal policy, with low taxes and large budget deficits, knowing the ECB would come to their rescue. With all countries subject to the political pull of such behavior, that would generate monetary instability.

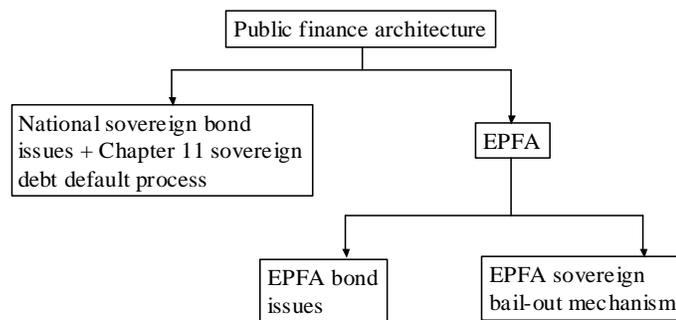
### **A new European public finance architecture**

The problem in the euro's architecture is that there is no institution to defend national bond markets. That restricts governments' ability to make optimal use of deficit

financing and it also exposes national bond markets to bond market vigilante discipline. This flaw can be remedied by creating a new public finance architecture that includes a European Public Finance Authority (EPFA) which would issue European bonds jointly and severally backed by all member countries. The critical feature of this proposal is the ECB would have the right to buy and sell EPFA bonds.

The proposed public finance architecture consists of three pillars and is illustrated in Figure 3. First, countries would retain the right to issue their own sovereign bonds that they alone back. These national bonds would be analogous to U.S. state and municipal bonds. They would be also subject to some form of sovereign debt default process that could be invoked in situations of extreme national financial distress, but EPFA bonds would be excluded. A sovereign default mechanism of this sort has been proposed by Gianviti et al. (2010). This default process would be similar to the Chapter 9 provision in U.S. bankruptcy law governing default by states and municipalities. With markets aware *ex-ante* of this possibility, standard bond market discipline would apply to this portion of the public finance architecture.

Figure 3. The proposed new euro zone public finance architecture.



Second, euro zone member countries would create an EPFA that would issue jointly and severally backed bonds and operate as follows. (1) The authority would be able to sell new bonds of all maturities at its discretion. (2) Bond sale proceeds would be paid over to national governments. (3) The ECB would have the right to buy and sell already issued EPFA bonds. (4) EPFA would be governed by finance ministers of euro zone member countries, representing their national governments. (5) Voting rights within EPFA would be allocated across countries on a per capita basis. (6) Distribution of bond sale proceeds would also be on a per capita basis, as would countries' obligation to pay debt interest on EPFA bonds. In effect EPFA would serve as a trust entity with regard to EPFA bond issues, receiving interest service from countries and distributing those payments to bond holders.

The third pillar of the public finance architecture would have EPFA oversee a European sovereign bail-out fund that could make emergency loans to member countries. This fund would be financed by sale of EPFA bonds. The important feature is access to the fund would be subject to economic policy conditionality imposed by EPFA. In effect, the fund would be a form of European IMF (Palley, 2010; Gros and Mayer, 2010). In the current crisis Greece has turned to the IMF for emergency financing. That has been a mistake. At the political level it diminishes the global standing of the euro. At the economic level, it is unnecessary. The IMF cannot produce euros, which are only produced by the euro zone monetary system. Consequently, Europe can organize its own bailouts without recourse to the IMF. Indeed, interest payments on IMF loans are form of tax leakage out of the European economy and are therefore bad at a time of demand shortage.

There are several important features of the proposed EPFA. First, and most importantly, it creates a European bond without any trace of national identity. That bond can therefore be legitimately traded by the ECB without violating the “no bail-out of countries” clause, which in turn creates space for open market operations. Consequently, the ECB can take on the role of government banker for Europe, a feature that is missing in the current institutional design.

Second, EPFA would be able to help finance annual budget deficits for countries via annual bond issues that could vary with the state of the overall Euro zone economy. All member countries would receive payments on a per capita basis. Countries that received payments in excess of their own needs could retire their own sovereign debt or build up a sovereign wealth fund by acquiring the national debt of other countries.

Third, there would be a small element of fiscal transfer via population growth because of the per capita formulation. Slow growing population countries would tend to see their debt obligation fall over time, while fast growing population countries would see their debt obligation rise. Germany is a slow growing population country and would therefore benefit from this. However, it would effectively be lending its credit worthiness to others to bring down their cost of credit so that these countries would still be individual beneficiaries. Moreover, the overall euro zone economy would also benefit by the strengthening of public finances.

Fourth, the EPFA would advance the political project of a democratic federal Europe, which is also widely viewed as being part of the core justification for the euro. It would be democratic because people of all countries would be treated equally via the EPFA voting structure, and it would be federal because of its unified frame that applies to

all. As noted by Nutti(2011), a full system of fiscal federalism, with fiscal transfers between countries, might evolve later. However, that is a separate decision that would rest on the evolution of political sentiments within euro zone countries.

### **Policy conduct in an ECB – EPFA system**

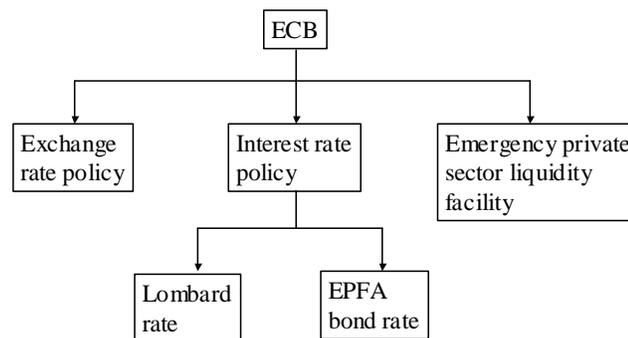
An ECB – EPFA system would create a euro zone policy architecture similar to that enjoyed by the U.S. and U.K. The ECB, like the Federal Reserve and Bank of England, would be responsible for monetary matters, including interest rate policy. It would also retain responsibility for exchange rates. The EPFA would have responsibility for issuing euro zone bonds. Since all proceeds from bond sales would be paid to national governments, spending decisions would remain entirely in the hands of government.

The critical innovation is the ECB would be allowed to buy and resell EPFA bonds at its discretion as part of its normal management of monetary conditions. It would therefore be able to conduct open market operations, something it rightly cannot do with individual country bonds. Moreover, it would be able to conduct OMO's across the entire EPFA maturity spectrum, thereby affecting the term structure of interest rates.

Figure 4 shows the major monetary responsibilities envisioned for the ECB under the new architecture. The first responsibility would be exchange rate policy regarding the euro. The second responsibility would be euro zone interest rate policy. In addition to being able to set the ultra-short overnight interest rate via its Lombard lending facility, the ECB would be able to conduct interventions along the entire term structure of EPFA bonds. In emergency situations it could also undertake quantitative easing actions. EPFA bonds would essentially determine the risk free interest rate for the euro zone and all other bonds, including euro zone country sovereign bonds, would price off them. This is

exactly how the U.S. monetary system operates. The third responsibility would be a facility providing emergency liquidity to the private financial sector. This would be analogous to the type of lending facilities the Federal Reserve established in the heat of the financial crisis of 2008-09.

Figure 4. Monetary policy responsibilities of the ECB.



A comparison of Figures 3 and 4 shows symmetry between the proposed EPFA and the ECB. The EPFA would essentially manage public finances, issuing European bonds and providing a sovereign emergency financing facility. The ECB would manage interest rates, and as part of that responsibility it would play the role of Europe's government banker. It would also provide an emergency financing facility for the private financial sector.

As part of this system it would be desirable for policy coordination between the ECB and EPFA as public finance policy and monetary policy should work together. Thus, EPFA willingness to help finance country budget deficits should be contingent on the ECB's assessment of monetary policy needs, and vice-versa.

A major strength of the proposed architecture is it has no arbitrary restraints such as the Maastricht Treaty's three percent budget deficit limit. Those restraints have been extremely politically unpopular as they are seen as undermining sovereignty and the democratic process. Moreover, they have proved impossible to enforce as countries have ignored them in times of economic stress. Consequently, they have yielded no benefits and only costs.

However, some form of constraint is needed or else individual countries will be tempted to ignore the debt sustainability implications of their budget policies. The proposed architecture imposes restraints at three different levels. First, EPFA bond financing would only be available if agreed to by majority voting of finance ministers whose countries contain a majority of the euro zone population. Consequently, such a process enhances democracy rather than impeding it. Moreover, countries that did not support EPFA bond issues could use their proceeds to pay down their own sovereign debt. As that debt will carry a higher risk rating than EPFA bonds, they would gain by lowering their overall debt service.

A second level of restraint would operate via the sovereign bail-out fund. That is because countries needing to use the fund would be subject to EPFA imposed policy conditionality. That conditionality would again be democratically imposed as it would be determined by majority opinion of finance ministers governing EPFA. The third level of restraint would be via market discipline operating in the market for individual country sovereign bonds.

These restraints mean budget discipline would be maintained but without the public finance disadvantages of the current system. That system completely separates

public finances from central banking by constitutionally barring the ECB from buying government debt. Consequently, it reduces national government to having the same bond market standing as provinces and corporations, and that is proving disastrous.

Once fully in place the EPFA would assist countries with normal budget deficit financing. However, there would be an initial transition period in which countries would be able to swap national debt for EPFA debt. This transition process would work as follows. EPFA would sell bonds and use the proceeds to buy country bonds on a per capita basis. Those country bonds would then be cancelled and EPFA member countries would be responsible for their per capita share of EPFA debt service. For countries like Luxembourg, which has little national debt to be cancelled, the transition process would see them credited with EPFA bonds that would offset their excess EPFA debt obligations.

### **Comparison to the “Blue” bond proposal**

Almost twenty years ago, Stuart Holland (1993), an economic adviser to Jacques Delors, proposed the idea of “Union” bonds issued by a European Investment Fund as a means of transferring member states’ national debt to the European Union. That idea was not adopted, but it has recently resurfaced in connection with the euro zone’s public debt crisis.<sup>1</sup> De Grauwe and Moesen (2009) propose a common euro bond. Building on that proposal, Delpla and von Weizsacker (2010) have recently proposed the idea of “blue” bonds that individual euro-zone countries could issue and which would be jointly and severally guaranteed by other euro-zone countries. The idea is to enable highly indebted member countries to access the better credit rating of financially stronger countries, thereby lowering their interest burden and improving their fiscal position.

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<sup>1</sup> My thanks to Mario Nutti (2011) for making me aware of the connection between Holland’s (1993) proposal and current proposals.

Though having some similarities of appearance with the blue bond proposal, the current EPFA proposal is in fact fundamentally different. The most fundamental difference is that the ECB would be able to buy and sell EPFA bonds and therefore manage the euro zone term structure of interest rate. Why is it able to do so under the EPFA proposal and not under the blue bond proposal? The answer is because EPFA bonds have no taint of national identification owing to the bond issuance process that ensures all countries receive equal per capita funding. That means ECB purchases of EPFA bonds would benefit all countries similarly and would not violate the ECB's no bail-out clause. This contrasts with the blue bond proposal whereby individual countries would decide how many blue bonds to issue and blue bonds would retain a national identification tag. Consequently, ECB blue bond purchases would benefit the country whose bonds were purchased. The blue bond proposal therefore remains stuck in the current system of national bonds, the only change being that some part of those bonds would have a European guarantee.

The second advantage is that EPFA would continuously issue bonds as part of assisting euro zone countries with normal budget deficit financing. The goal is to make this a normal element of public finance. That contrasts with the blue bond proposal which is inspired by the crisis and conceptualized as a crisis measure. For it, the goal is to help crisis countries swap existing high yield debt for lower yield debt by giving them partial access to Germany's credit rating.

The third advantage of the EPFA proposal is that it does away entirely with Maastricht styled restrictions like the three percent deficit rule. Within the EPFA proposal, all budget disciplines operate via the EPFA democratic decision making

process or via market discipline. Contrastingly, the blue bond proposal would continue Maastricht deficit limits and would impose a ceiling (the suggested number is sixty percent of GDP) on country's ability to issue blue bonds.

In sum, the EPFA proposal goes beyond the blue bond proposal because it aims to reshape the euro's financial architecture by restoring the role of government banker to the central bank. In effect, it fundamentally changes the euro's architecture by discarding its neoliberal design that separates the ECB from public finances. Like the blue bond proposal, the proposed EPFA provides debt interest relief to crisis countries by giving them access to lower interest European bond credit. However, it also gets rid of undemocratic sovereignty violating Maastricht style restrictions and enables the ECB to act as government banker and conduct open market operations in EPFA bonds.

## **Conclusion**

This paper has concerned both theory and policy. With regard to theory it is about the stability of monetary unions and the need for a government banker that manages the bond market. With regard to policy it offers a specific proposal for stabilizing the euro by creating a euro zone government banker.

There seems to be accumulating evidence that the current architecture of the euro is unstable and the euro will likely fall apart unless changes are made. The source of that instability is high interest rates on highly indebted countries which creates unsustainable debt burdens. Remediating that problem requires a central bank that acts as government banker and pushes down interest rates to sustainable levels. This can be accomplished by EPFA.

Analytically, the paper offers a third path for the euro. The current path, which includes modifications like the blue bond proposal, aims to continue with the Maastricht architecture that imposes numerical restrictions on budget deficits and debts and separates the ECB from public finances. A second path is for a fiscal transfer union. The third path, proposed by the paper, is for full monetary and public finance union that abandons Maastricht style quantitative restrictions but does not include fiscal transfers.

The debate over the euro's financial architecture is not just restricted to economics. It also has significant political implications. That is because the current neoliberal inspired euro architecture, which imposes a complete separation between the central bank and public finances, puts governments under continuous additional financial pressures. Over time, that pressure is likely to make it difficult to maintain the European social democratic welfare state. This gives a political reason for reforming the euro and creating an EPFA that supplements the economic case for reform.

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