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THE ECB AND THE SINGLE EUROPEAN FINANCIAL MARKET: A PROPOSAL TO REPAIR HALF OF A FLAWED DESIGN

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Preface

The flaws of the Maastrict Treaty are a frequent object of commentary but, as yet, Europe remains unable—or, perhaps more accurately, unwilling—to address these flaws. The European project will remain unfinished and the ability of the European Central Bank (ECB) to implement effective monetary policies will continue to be hobbled. As Mario Tonveronachi observes in this public policy brief, Europe has a currency union, but this does not mean that Europe has achieved a single financial market, an essential element for a functioning union. He reminds us that a single European market requires pricing in relation to common risk-free assets rather than in relation to a collection of individual idiosyncratic sovereign rates. And financial operators must have access to the same risk-free assets for trading and liquidity operations. The euro provides neither of these functions, and thus, while there has been a measure of convergence, a single financial market, and the financial integration it represents, remains unachieved.

Tonveronachi sees little prospect for the integration necessary to create a single market, given the prevailing social and political conditions in Europe. The brief reviews efforts made thus far to achieve greater European fiscal, banking, economic, and political unity. While attitudes and conditions may change in the years ahead, as there is no alternative to federalization other than a breakup of the euro, the near-term prospects for greater integration are dim. Tonveronachi takes these conditions as "given," but rather than sharing in the policy paralysis expressed by so many, he offers a proposal to use the ECB's operations to create a single financial market within the existing fiscal design and treaties.

The broad strokes of his proposal are that the ECB issue debt certificates in an amount and tenor, covering the maturity spectrum, that would create common risk-free assets for all of the participating (European) markets. Financial intermediaries holding national debt would have the opportunity to exchange the riskier national debt in their portfolios for ECB debt certificates. The ECB would therefore acquire the debt of euro-area countries in proportion to the contributions of each country to the capital of the ECB, and national private financial institutions would hold debt certificates issued by the ECB. The ECB would end its acceptance of sovereign national bonds as collateral for its refinancing operations and thereafter limit its operations to debt certificates. This would create strong incentives for financial intermediaries to swap riskier sovereign bonds for less risky, lower-yielding debt certificates. This would effectively create a single risk-free yield curve for financial intermediaries. Thus, these same intermediaries would face a single risk-free yield curve and the ECB would be able to base its open market operations on debt certificates without creating technical or political problems. In order to limit the use of debt certificates to their intended use (i.e., as a benchmark, not as a financing vehicle), they would only be available to euro-area markets, and holding or trading debt certificates would be limited to the euro-area countries and the financial firms incorporated in those countries.

This proposal has the virtue of falling within the scope of current treaties, and therefore many of the objections typically raised against such proposals do not apply. For example, acquiring secondary sovereign debt complies with existing treaties. Further, the ECB faces no monetary constraint as the issuer of debt certificates (it does not operate under a balance constraint) and would benefit from its seigniorage position. Concerns regarding losses and insufficient capital are, he notes, remnants of gold standard banking. Modern central banks, provided they issue paper money, do not face such limitations so long as inflation is contained.

Tonveronachi's proposal offers an immediate step toward achieving the broader goals of the euro and resolving the work left unfinished in the Maastricht Treaty. By inviting euro-area countries to create a single risk-free asset within the current institutional architecture, financial intermediaries and national governments would effectively tie themselves to a common risk-free yield curve, reduce their individual risk, and begin to reap some of the benefits of operating under a single European financial system. This might offer the most compelling argument for greater integration on several fronts: self-interested participation in an institution that creates a greater stability through voluntary integration and a common benchmark. Tonveronachi's proposal will not resolve all of the weaknesses of the euro or quell the social and political misgivings. However, he offers a step that Europe can take in the near term to create greater stability and shared purpose within the euro-area, sooner rather than later.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
September 2014

Introduction

The recent crisis increased the fragmentation of European financial markets, especially in banking services in the euro area. The interaction of unsustainable sovereign debt and the poor condition of bank balance sheets interfered with the transmission of the European Central Bank's (ECB) monetary policy and has attracted a great deal of attention as well as several proposals for reform. While the architecture designed by the Maastricht Treaty is still incomplete because it lacks a central fiscal authority, the most recent crisis has focused attention on a problem that was inherent to the initial design of the euro (i.e., the dependence of national banking systems on the prevailing conditions in their domestic economies). In other words, a currency union is a necessary but insufficient condition for the creation of a single financial market.

Starting in the mid-1980s, with the 1986 Single European Act, the European authorities began the long-term process of creating a single European financial market. The European financial passport and the numerous directives and regulations implemented were intended to create a liberalized area with harmonized rules in which financial market operators would have conditions favorable for integrating national financial systems into a single system. However, the 1980s were also a period in which the liberalization of both capital flows and direct financial investment, and the adoption of rules defined by international standard setters (such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions) became the basis for the internationalization of finance. As a result, the difference between international integration and the integration reached within the European Union remains a matter of degree, not the sea change originally envisioned. The most recent crisis exposed mistakes that we should have already learned in the aftermath of previous crises, not to mention some lessons from sound economics (e.g., financial globalization is not the same as financial integration). And this is also true for the European area. When a financial crisis hits, absent a single rescuer-of-last-resort, the global financial system reveals its true nature: a collection of national operators playing a global game. Globalization led by market forces alone is a fragile construct, and easily produces fragmentation when outside help becomes necessary to resolve a crisis.

The euro architecture for a subset (i.e., the 18 out of 28 countries that make up the euro area) of the European Union (EU) member countries has not changed that game. The common currency added another much-needed element to the formation of a single financial market, but it is not enough. Financial fragmentation was ready to reappear along national sovereign lines just after the outbreak of the crisis. This tells us that what the euro area produced before the crisis was convergence, not integration.

We must also consider a more general problem in addition to those problems specifically related to financial crises. Namely, what are the structural elements needed to create a single financial market? In short, a single financial market requires pricing financial risks with respect to the specific features of financial and nonfinancial debtors starting from a common risk-free base, rather than by adding idiosyncratic markups to different sovereign (i.e., quasi risk-free) rates. In addition, it requires that all financial operators have access to the same risk-free assets for liquidity and trading operations. The euro area does not fulfill either of these conditions.

The reforms previously adopted or currently under discussion regarding the sustainability of sovereign debt or the creation of the banking union deal with this problem either as a by-product or only partially.[1]

This policy brief offers a proposal for reform that takes a different approach and seeks to deal directly with the conditions necessary to create a single financial market. Our perspective is informed by the belief that the prevailing social and political conditions in Europe will prevent any meaningful revision of EU treaties along federal lines, at least to the extent necessary to create a level financial playing field. We know that fully integrated financial markets require all participants to face a single risk-free yield curve. But, lacking a central or federal government to issue the required assets, this curve does not exist for the euro area. The institutional design of the euro system, based on independent fiscal authorities and a central bank designed as if it served a federal state, cannot produce a single financial market, and this hobbles its ability to implement an effective monetary policy.[2]

The advantage of the proposal advanced in this brief is that it meets this objective of a single financial market without any treaty changes. It does so by charging the ECB with the emission of liabilities (call them "debt certificates," or DCs) in an amount and tenor necessary to offer market participants common risk-free assets across the maturity spectrum. In other words, instead of taking as "given" the current design of the ECB and exploring fiscal and regulatory mechanisms to facilitate the unification of diverse national financial markets, it takes as "given" the political arrangement defined by the Maastricht Treaty and explores how to make ECB operations consistent with both the existing fiscal design and current EU treaties. Furthermore, while the recent crisis has focused the discussion on how to avoid serious financial disruptions, such as the breakup of the euro area, this policy brief looks at the coherence and efficacy of the institutional and structural design (these will also be important in more tranquil times, should such times ever return).

The balance of the brief is structured as follows: section 2 discusses why the reforms recently approved or proposed cannot make financial market fragmentation disappear; section 3 presents the proposal for a new operational ECB design, and section 4 concludes.

Denationalizing Financial Markets

Perhaps owing to the illusion that the architecture of the euro construct would serve as a lever to force further political and economic integration, the ECB and the Eurosystem were designed as if they existed within the context of a fully functioning federal state. There is nothing in the euro's design that addresses the peculiarities of the EU–euro area political construct as established by the Maastricht Treaty, aside from (as we will see in the next section) some restrictions on the ECB's monetary tool kit. As stated in the introduction, this blocks the emergence of a single financial market because there is no uniform benchmark yield curve of risk-free assets.

However, whether or not this was the original intention, the political design of the EU–euro area has never moved toward a federal system, remaining what we have elsewhere described in terms of a flock of migrating ducks in flight, where good health is required to join the club and strict rules must be followed thereafter to make the long migration possible. It is instructive to recall that even under such strict rules, each duck maintains its identity (Tonveronachi 2013).

Unfortunately, the membership and flight rules of the euro were badly designed, and were roughly consistent with what, for short, we may call the neoliberal approach. With governments targeting a neutral fiscal position and the central bank targeting inflation, the idea was that the liberalization of markets would drive the convergence of the economies of the member countries toward individually and collectively sustainable paths. Opinions may differ as to whether the problem is that member-state economies have not liberalized sufficiently or that the rules were seldom fully implemented. However, the fact that neoliberal policy prescriptions were not fully implemented does not make the entire design less faulty. The understanding that the heterogeneous physiology of our ducks was incompatible with the basic requirements of a sustainable, if not optimal, currency area should have militated against relegating public authorities to the role of mere referees. On the contrary, even following the orthodox theory of the second best, active and powerful centralized or coordinated public interventions (i.e., the introduction of more "imperfections" in its jargon) would have been necessary to deal with these unavoidable imperfections.

The reforms prompted by the recent crisis have thus far followed the original design. The old fiscal rules were stiffened, macro rules were restated, and more liberalization was called for—in other words, more of the same ducks flying in formation. Relevant to our topic is the obligation introduced by the Fiscal Compact for euro-area countries to reduce their public-debt-to-GDP ratio to 60 percent or less within 20 years. The idea is that the 60 percent ceiling would guarantee debt sustainability, and thus re-create the negligible national sovereign spreads that prevailed prior to the crisis, with spreads measured in reference to the average sovereign interest rate of euro-area countries with an AAA rating. Note that the reduction of the debt ratio should not come solely from an increase in GDP, given the other clause requiring a zero structural government deficit. The credibility of such a long-term political commitment is dubious given past experience and the large and heterogeneous deflationary effects it will produce. Moreover, if the recent crisis has taught us anything, investors should remain cautious about using the debt ratio as the main indicator of future sovereign debt sustainability. Given current economic and institutional conditions, significant sovereign spreads are here to stay. Above all, convergence is not integration, and experience has revealed its inherent fragility. Some of the proposals discussed below also show that further steps to introduce changes in those conditions to enhance euro-area integration are considered necessary by high-level EU authorities (see note 1).

Given the EU's typically gradualist approach to reform—a gradualism that often goes against maintaining coherence in the overall design—the new fiscal policy regime could be considered as a first step that, if successful, could pave the way for the adoption, perhaps even in less than 20 years, of some form of debt mutualization or federalization. Some degree of federalization could also be facilitated by concomitant reforms introduced in the financial sector.

There is no question that in recent decades the EU has promoted a significant degree of regulatory financial harmonization across its member-states, making the national ducks more homogeneous. However, even before the crisis, the discrepancy between the formal rules on minimum harmonization and effective harmonization was becoming evident. The greater degree of financial market fragmentation produced by the recent crisis revealed additional dangers caused by leaving harmonization in national hands, and has encouraged EU authorities to push for a higher degree of centralization and harmonization. This has led to institutional reforms, such as the creation of the European Supervisory Authorities, which are entrusted with the creation of single rulebooks and single supervisory handbooks; and the European Systemic Risk Board, which is charged with sounding the alarm if unsustainable macro imbalances appear. It also led to enhanced regulatory and surveillance powers for the European Commission. More recently, the agreement on the Banking Union (BU), which is obligatory for euro-area members and open to the participation of other EU member countries, marks yet another shift toward centralization. However, there have been several reactions against greater financial harmonization and centralization, such as the ones against an effective banking union. These reactions are harbingers of the obstacles that any significant reforms toward creating a federal EU structure would likely face.

The fact is that national economies remain heterogeneous, while the common currency and the ducks' flight paths restrict the tools available to solve the specific problems they face.[3] Despite the fact that the Maastricht Treaty envisioned the euro as the future common currency for the entire EU, the opt-out concession granted to the United Kingdom and Denmark, together with the recent vicissitudes of the euro area, has de facto strengthened support for a two-tier union and added new elements of structural fragility. The UK, in particular, has fully exploited its beggar-thy-neighbor exchange rate freedom and is asking for more opt-outs. The current, and growing, sentiment in Europe is not only far from favoring a shift toward a federal design crucial for the completion of the euro area, but is also creating resistance to any attempt to increase harmonization. It would be an achievement to democratize the current level of centralization, thus rendering it more socially acceptable.

There is no question that the only alternative for the future of the Union, other than its disintegration—which includes its transformation into a simple free-trade area—is federalization. However, it is questionable that the rudder will be firmly kept in that direction, and, in any event, in the interim we must manage the fragility that is a result of its incoherent design.

It is therefore worthwhile to analyze the progress made thus far toward the recommendations in the report prepared by the European Council (2012) in collaboration with the EC, ECB, and Eurogroup. Starting with the need to create a new architecture for the European Economic and Monetary Union, the report proposes to create four unions over the next decade: a banking union, a fiscal union, an economic union, and a political union.[4]

The banking union has been proposed and supported with arguments explicitly directed at eliminating both the vicious loop between sovereign crises and bank crises, and the fragmentation of the financial markets exposed by the recent crisis (see, e.g., Mersch, 2013). The centerpiece of the BU is the Single Resolution Mechanism (SRM), for which the Single Supervisory Mechanism (SSM) represents the necessary "political" precondition.[5] Many criticisms have been raised regarding the effectiveness of the SRM, despite the recent modifications introduced after the arm-twisting between the Council and the European Parliament. However, two different points are relevant to our discussion. First, the SRM is asymmetric, and will, at most, shield government finance from bank crises; but it will not protect banks from sovereign turbulence, to the extent that they do not share common risk-free assets. Second, as is also true for some of the other proposals discussed below, we must distinguish between the tools used to manage crises (in this case, limiting financial fragmentation under stress conditions) from those proposals that aim to produce a single financial market during calmer times. As Cœuré (2013), "The convergence of sovereign yields across countries in the euro area to very low levels before the financial crisis did not, in itself, imply market integration" (2). The banking union is consistent with a single financial market—it is a precondition for its existence, but it is not a sufficient one.

As for the fiscal union, things appear much worse. Currently, the discussions relate to two projects. The first is the most recent of a long list of proposals directed at mutualizing part of the sovereign debt of euro-area countries. As already stated, issuing a consistent quantity of common sovereign debt that encompasses a wide maturity spectrum would create an effective, common risk-free yield curve that is the necessary precondition for a single financial market. As is evident from the conclusions of the report commissioned by the European Commission, the fear of moral hazard is paralyzing taking action on even the most timid proposals, which would, however, be inadequate from our point of view because of the restriction to short-term maturities.[6]

The second project, which has not progressed beyond the stage of a vague proposal, is to create a limited, centralized fiscal buffer for the euro area, funded pro quota by member-states. Its anticyclical function might help as a macro cushion to alleviate banks' losses, but, again, it would not be related in any way to the normal conditions required by a single financial market.

To conclude, if anything comes from the fiscal side along these lines (a big "if"), it might help to avoid severe financial market disruption, even to the point of eliminating the risk of a euro-area breakup, but it will not eliminate the differences between the sovereign debt of individual countries. As in the case of the BU, moderate fiscal reforms along the previous lines would help, but they will not solve the problem. Since the most probable outcome in the next few years is to merely add a watered-down version of the banking union to the fiscal compact, it is worthwhile to look for a different solution.

A New ECB Operational Design

The current approach of central banks focuses on the control of short-term interest rates, leaving efficient markets in charge of the transmission of these rates to the entire spectrum of financial assets, for both maturity and specific risk characteristics. A high degree of substitutability between assets is a precondition for the effective operation of such a mechanism in an efficient market. The monetary authority also expects its actions to influence market expectations and often engages in forward guidance regarding the direction of reference interest rates and the expected impact on the term structure. The theory underlying the operation of an efficient market thus requires a risk-free issuer to set the benchmark yield curve used for pricing all other risky assets. It is the debt of the sovereign that thus plays the crucial role of being the risk-free point of reference for efficient market pricing, liquidity preference included, and the preferred way to maintain liquidity buffers and to post collateral. Absent this single sovereign issuer, the euro area does not have common risk-free assets.

The existence of market "inefficiencies" may not only require using stronger doses of monetary policy but also hinder the desired policy results. For instance, a monetary policy restricted to setting refinancing conditions is a hostage of banks' endogenous decisions to create or destroy secondary liquidity; thus, policy stimuli are not necessarily transmitted to the volume and cost of credit as desired. This is why central banks often supplement their tool kit with open market operations, which give them the opportunity to more directly affect market liquidity and the shape of the yield curve. Again, since, according to the orthodox approach, a central bank should absorb liquidity risk but not credit risk, those operations should normally be limited to sovereign debt.

This is merely a sketch of the dynamics at work, but it should make it clear that absent a common risk-free issuer the euro area contains a structural "inefficiency" that affects financial service providers, private investors, and the central bank.[7] Euro financial markets are structurally fragmented, and the ECB encounters remarkable difficulties—not least, political obstacles—engaging in full-fledged open market operations.

At the height of the euro-area sovereign debt crisis, the ECB intervened in the secondary sovereign markets of some peripheral countries. It did so on the grounds that, with investors betting on the breakup of the euro area, markets were overshooting, and thus impeding the transmission of the ECB's monetary policy. The move was criticized as contravening the spirit, if not the letter, of the Maastricht Treaty because, it was argued, the ECB was altering the risk evaluation made by the markets; and, by assuming sovereign credit risk, this move could result in forbidden fiscal transfers across euro-area member countries. Although it is difficult to agree that markets are always right, and, absent clear political decisions, the ECB's move was justified by the higher goal of keeping the euro area intact, the above criticism touches a very sensitive nerve. The question this raises is what the ECB considers to be an acceptable sovereign interest rate for a member country.

This point is even more relevant to the ECB's announced outright monetary transaction (OMT) program. One of the main objections raised against OMT is the absence of quantitative limits on policy measures. Although the absence of such limits is necessary to "convince" markets, it may produce unwanted moral hazard effects. If previous measures had been taken for the purpose of sovereign debt sustainability—and what level is "sustainable" is a subject of much controversy—the ECB would have discretionally influenced national fiscal conditions, which is forbidden by statute. If interventions were calibrated to the transmission of monetary policy, as the ECB argued, the interventions should have been much stronger, both in volume and in terms of the number of countries involved (up to the point of effectively eliminating the spreads of the sovereign debt of euro-area countries with respect to German bunds). However, the moral hazard objections would have become intractable. Thus, the ECB succeeded in preventing a euro-area breakup, but not in denationalizing financial systems.

Perhaps even more crucially, political problems related to the heterogeneity of euro-area member-states' sovereign debt also affect the basic operations upon which the ECB relies (i.e., its refinancing operations, for both the eligibility of government bonds as collateral and the haircut to apply to them). After arguing that rating agencies see only a wisp of smoke when the fire is well advanced and overestimate the damage afterward, De Grauwe (2010) asserts that the "the ECB should discontinue its policy to outsourcing country risk analysis to American rating agencies. . . . The reluctance of the ECB to do the credit analysis in-house is probably due to the fear that it may sometimes have to take difficult stances that do not please national governments. It is much more comfortable to have this job done by outsiders" (3).

Before going into some of the details of our proposal, it is necessary to make it clear that in no way is it designed to address the problem of the sustainability of euro-area sovereign debt. The management of sovereign debt is left to other proposals, such as the ones briefly discussed in the previous section.[8] Moreover, the urgent need to complete the Maastricht Treaty on the fiscal side is due to the fact that solving the problem of common risk-free assets relaxes but does not eliminate the relationship between the sovereign and banks during periods of stress. As Angelini, Grande, and Panetta (2014) argue, "When the sovereign runs into trouble, so does the entire economy; country risk seems to be a key factor underlying the sovereign-bank relationship" (6). However, with serious doubts looming over that aspect of the completion of the Maastricht Treaty, a useful step forward is to create the necessary structural conditions for a single financial market without a federal agency that issues sovereign public debt.

In its general outlines, the proposal is quite simple. Euro-area financial intermediaries holding national debt in their portfolios would be given the opportunity to swap it for ECB liabilities, or "debt certificates" (DCs), which would cover the entire maturity spectrum of the yield curve. As a result, the ECB would acquire a portfolio of secondary market sovereign securities of euro-area countries in proportion to the contribution of each country to the capital of the ECB, and national financial institutions would acquire a portfolio of risk-free ECB-issued DCs. On completion, the ECB would suspend its acceptance of sovereign national bonds as collateral for its refinancing operations and restrict its operations to DCs. This would create the incentive for financial intermediaries to swap their higher-yielding risky sovereign bonds held on their balance sheets as securities available for sale for lower-yielding DCs. The result would be that financial intermediaries would face a single risk-free yield curve and the ECB could swiftly base its open market operations on DCs without technical or political problems.[9]

As long as the ECB's policy of containing inflation remains credible, its liabilities would be credit risk free. A positive gap would then accrue to the ECB, represented by the difference between the average return coming from the holding of sovereign securities, as a sort of additional seigniorage. With this seigniorage distributed pro quota to national treasuries, a kind of positive moral hazard incentive would be created, with "virtuous" countries benefiting more.

In order to limit the role of DCs to the uses outlined above (i.e., providing a benchmark and not a financing vehicle), they would only be available to euro-area markets, and holding and trading DCs would be limited to financial institutions incorporated as firms in euro-area countries.

In quantitative terms, government debt in the euro area was €8.6 trillion in 2012, with banks holding roughly €1.6 trillion of this debt (more than before the crisis). €1.6 trillion far exceeds what banks hold as securities available for sale (i.e., what is held for liquidity reasons), but it does not include a similar demand by other intermediaries. We can safely assume that DCs will absorb less than 20 percent of the euro area's total public debt. In any case, since DC emissions should be linked only to the demand for liquidity coming from resident financial institutions, the ECB would not have to take any discretionary decision about relative sovereign rates, and no moral hazard would result for the national emission of public debt. In terms of the ECB's total balance sheet, existing sovereign securities would migrate to the new scheme, thus containing any net increase in the ECB's balance sheet.

In this way, a single euro-area market for risk-free assets would be created, with a dimension that would make it highly liquid. The current situation in the euro area is characterized by potential mismatches between the domestic demand for liquidity coming from the degree of financialization and the deepness of markets for national sovereign securities. As an example, we recall that the recent acquisition of large amounts of treasury bonds by the US Federal Reserve for its quantitative easing program produced some shortages in the availability of Treasury bonds for trading operations and for the Fed itself. The emission of DCs by the ECB would cut the link between the demand for liquidity and the supply of (quasi) risk-free assets at the national level.

As for the consistency of this operational reform with EU treaties, we have already seen that acquiring sovereign bonds in the secondary market complies with the letter of the treaties, and doing so strictly for the purpose of managing the liquidity of the single financial market should also be seen as complying with the spirit of the treaties. Furthermore, the emission of DCs is already included among the tools that the ECB could use as part of its toolkit for open market operations; however, it seems from its financial statements that they were never utilized. The monetary policy guidelines of the ECB already allow for the emission of DCs, classified as structural open market operations,[10] which would have a 12-month maturity and be sold at a discount in standard tenders managed by the national central banks. Despite the maturity specified in the policy guidelines, the EU treaties and the charter of the ECB do not pose limits on the quantity and type of DCs.[11]

Further, the typical objections raised against schemes involving some form of EU mutual sovereign debt do not apply to our reform proposal. It could be argued that losses coming from sovereign defaults could reduce the ECB's capital, thus requiring new fiscal contributions by member-states. It is unique to the euro-area design that such an objection can be raised for losses resulting from sovereign debt, but not for losses coming from private debt collaterals posted by banks. However, as De Grauwe (2014) clearly explains, it is nonsense to bother about insufficient or negative capital of a central bank in a regime of paper money:

> Money is the "debt" of the central bank but the central bank can redeem this "debt" by issuing fresh money, i.e. by converting an old banknote into a new one. These banknotes do not constitute a claim on the assets of the central bank. As a result, the central bank does not need equity (in contrast to private companies). It can live with negative equity. As long as the central bank keeps its promise of price stability any amount of equity, positive or negative, is fine. Thus the constraint a modern central bank faces is unrelated to its equity position. The only constraint comes from its promise to maintain price stability. (3)

We might add that the structure of the financial statements of central banks is much outdated, inherited from the gold standard. As long as paper money is accepted, which requires the condition of containing inflation, the capital position of a central bank is always positive, because of the present value of an infinite string of positive flows resulting from seigniorage.[12] The only way in which a central bank may default is by issuing debt denominated in a foreign currency, but this is altogether another story. Therefore, a bank-type balance sheet is irrelevant for the policy operations of a central bank, and it is therefore irrelevant to speak of recapitalizing it in the event of losses in the value of its financial assets. The positive interest margin assured by seigniorage maintains a central bank in a Minsky-type hedge position. Regarding the additional seigniorage, it is quite improbable that any future restructuring of sovereign debt could make the average return from sovereign securities lower than the average cost of DCs. However, this could occur only for a limited time, thus not inverting the positive sign of the present value of future returns. In any case, if we must placate orthodox fears, in the first years of the implementation of the proposed reform the ECB could set aside a portion of this seigniorage to build an ad hoc fund.

Conclusions

In both normal and turbulent times, a key structural condition for having a single financial market is for financial actors to face a common risk-free yield curve. The current design of the euro area with its multiple national fiscal authorities does not fulfill this condition. We have argued that a federalized future for the euro area is subject to doubt, and, in any case, should be seen as a long-term objective.

Given these conditions, we must explore ways to avoid the current inconsistent design, which fragments euro-area financial markets and foments fragility. The reforms adopted or proposed up to now, such as the banking union, go in a direction consistent with the single financial market but are not sufficient to create it. The financial market would remain structurally fragmented.

The heart of our proposal is mandating the ECB to issue debt certificates in the amount and with the maturities required for financial intermediaries to face an effective single risk-free yield curve. This would have the further benefit of rendering ECB refinancing and open market operations fully operational without incurring political problems. The ECB would balance these emissions with the acquisition, in the secondary market, of sovereign debt of euro-area countries. This would create a new type of seigniorage, which would be distributed to national treasuries according to each nation's participation in the capital of the ECB. The latter, the explicit goal of DC emissions, and the amount of sovereign debt involved would not create moral hazard problems. The proposed reform would not only be fully compliant with EU treaties but would also eliminate the need for the ECB to resort to questionable practices in times of stress.[13]

Those who see in the current muddled design of the euro area an opportunity or an argument to move member-states closer to federalization might consider the proposal offered in this brief as a way to weaken their argument. We suggest that the sovereign debt problem is, in and of itself, a sufficient basis for a deeper political union. Moreover, the progress we have witnessed thus far, under the half-baked design of the Maastricht Treaty, does not support the thesis that serious economic problems are enough to overcome political problems. On the contrary, one of the effects of the recent crisis has been to add political fragmentation to economic fragmentation. To the degree that the present proposal and the reform measures already implemented, or those that are feasible in the near term, will put the euro area on a more solid economic footing, these same measures will also serve to facilitate the political process.

Acknowledgments

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Notes

1. See the European Council (2012) proposal on a genuine European Monetary Union, the report of the expert group on joint issuance of sovereign bonds (Expert Group 2014), and the agreement reached on the single resolution mechanism of the banking union (EC 2014).
2. For an early warning on the dangers posed to financial markets by such a construction, see Kregel (2000). For a recent discussion of the relevance of the risk-free yield curve and of the problems facing the euro area, see ECB (2014).
3. This is particularly true for the ex-planned economies that have recently joined the EU and the euro area.
4. We have to take the decade foreseen in the report with a grain of salt, especially if we compare it to the two decades under the fiscal compact.
5. To consider the SSM as a strong achievement per se, capable of making banks resilient, requires a level of faith in the Basel-type regulation and supervision that we are not ready to share. As for its ability to overcome national interests, the recent experience of the ECB dealing with, at least, the Irish crisis and its choice of the assets on which to base the current asset review does not bode well (see, e.g., Legrain 2014). Note that the request by some European officials, such as the president of the Bundesbank, Jens Weidmann, to abandon zero-risk weighting for sovereign debt held by banks—which is absolutely legitimate following the Basel approach, and which the ECB is already implementing for the haircuts in its discount window—renders the playing field even more uneven.
6. The report concludes, "Given the very limited experience with the EU's reformed economic governance, it may be considered prudent to first collect evidence on the efficiency of that governance before any decisions on schemes of joint issuance are taken. . . . Treaty amendments would be necessary to arrive at joint issuance schemes including joint and several liability, certain forms of protection against moral hazard and appropriate attention to democratic legitimacy" (Expert Group 2014, 86).
7. According to Daluiso and Papadia (2013), "The situation in the €-area is different from that in the US, the UK, Switzerland and Japan in two respects. First, the possibility of an endogenous tightening of monetary policy is limited to the ECB and does not extend to the other central banks. In fact all these banks provide liquidity to the market on an outright basis, purchasing securities (FED, Bank of England and Bank of Japan) or foreign exchange (Swiss National Bank), unlike the ECB that provides the bulk of it on a repo basis. The amount of excess liquidity is thus determined in countries other than the euro-area by the central bank, not by commercial banks in their refinancing choices. Second,

there is no differential pull-push factor in these countries, in which the rates are dominated by national securities" (3).

8. A large number of contributions now exist on how to reach some form of mutualization of public debt. For a selection, see Expert Group (2014), 14, note 30.
9. One way to look at the reform proposed herein is that it would also overcome the asymmetry of the single resolution mechanism of the banking union.
10. "[Structural] operations are executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector" (ECB 2011a, 10).
11. See ECB (2011a, 2011b, and 2012).
12. For a detailed discussion of this point, see Buiter (2008).
13. After having written the above proposal, we became aware of the contribution by Brunnermeier et al. (2011) that links the problem of managing the sovereign debt of EU countries to the emission of common EU risk-free assets. A special European debt agency (EDA) would manage the securitization of national sovereign debts, in the measure of 60 percent of the EU's GDP, funding this acquisition with the emission of two tranches of debt, the junior one taking first the eventual losses coming from sovereign failures. According to the authors, the senior tranche (ESBies) could be designed to be practically risk free, thus representing the common risk-free asset that would disconnect financial intermediaries from local sovereign risks. Moreover, ESBies would be issued with different maturities, thus supplying the risk-free yield curve and the range of risk-free assets necessary to operators for liquidity management.

    The opinion of the authors is that their proposal retains the advantages of the euro bonds while avoiding the criticisms leveled against them, because private junior investors, not taxpayers, would sustain eventual losses and the share of sovereign debt exceeding the 60 percent ceiling would be funded at market rates, thus retaining market discipline against profligate governments. While we maintain some doubts on the issues of loss sharing and moral hazard, especially given that member countries should contribute to the capital of the EDA to enhance the safety of ESBies, we have several other objections. First, given the role given to ESBies in ECB operations, the proposal should refer to the euro area, not to Europe. Second, the 60 percent ceiling could be in the future too high for some "virtuous" countries, and the incentive to reach that ceiling could strengthen moral hazard. Third, making the status of risk-free assets depend on credit-enhancing calculations may not be the safest way to provide high-quality liquidity. Fourth, ESBies would not actually be risk-free assets, and their rating could be less stable and become lower than that of countries with the highest rating; for instance, we can imagine German banks preferring to hold German bunds instead of ESBies. Fifth, linking the creation of ESBies to the 60 percent of the euro area's GDP would produce liquid assets in an amount that would be unrelated to the demand for liquidity, also coming from outside the euro area, thus creating the potential for high volatility. Sixth, the establishment of the EDA alongside the ECB would de facto create a dual structure for monetary policy. This is because, even if new emissions of ESBies were sold through auctions, mechanical emissions linked to the 60 percent rule and decisions on the relative amount to emit for the different maturities could easily affect the position and form of the yield curve.

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