EU Dimensions of Policy Response: The ECB and Financing Deficits

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Plan for this Talk

1. The Role of the ECB
   - Monetary financing of governments?
   - The ECB and debt sustainability
   - Helicopter money?
2. Financing budget deficits
   - ESM funding versus “Coronabonds”

The ECB as a Unique Institution

- Lots of public organisations are involved in dealing with this crisis (national governments, EU, ESM, EIB).
- All debating who bears the burden of borrowing money to deal with the crisis.
- But the ECB is **unique**: ECB can create money from nowhere with the push of a button. It does not have to borrow money from anyone.
- This is an enormous power, so we shouldn't be surprised the ECB's actions are playing (and will continue to play) a key role.
- The ECB's actions can help make "this time is different" actually true with less financial instability and less austerity after the crisis.

Monetary Policy in Exceptional Times

- In normal recessions, there are standard ways central banks can stimulate the economy
  - Cut interest rates. But the key policy rate is already negative and perhaps close to its lower limit.
  - Encourage banks to lend. But banks may be reluctant now given high default risk.
  - QE\Asset Purchases. This has been stepped up but is it just more of the same?
- What about exceptional measures?
  - Monetary financing of governments (Answer: No\Sort Of)
  - Preventing austerity during the recovery. (Answer: Probably)
  - Helicopter money (Answer: Maybe\Sort Of)

Can ECB Finance Government Spending?

- TFEU Article 123 (monetary financing clause)

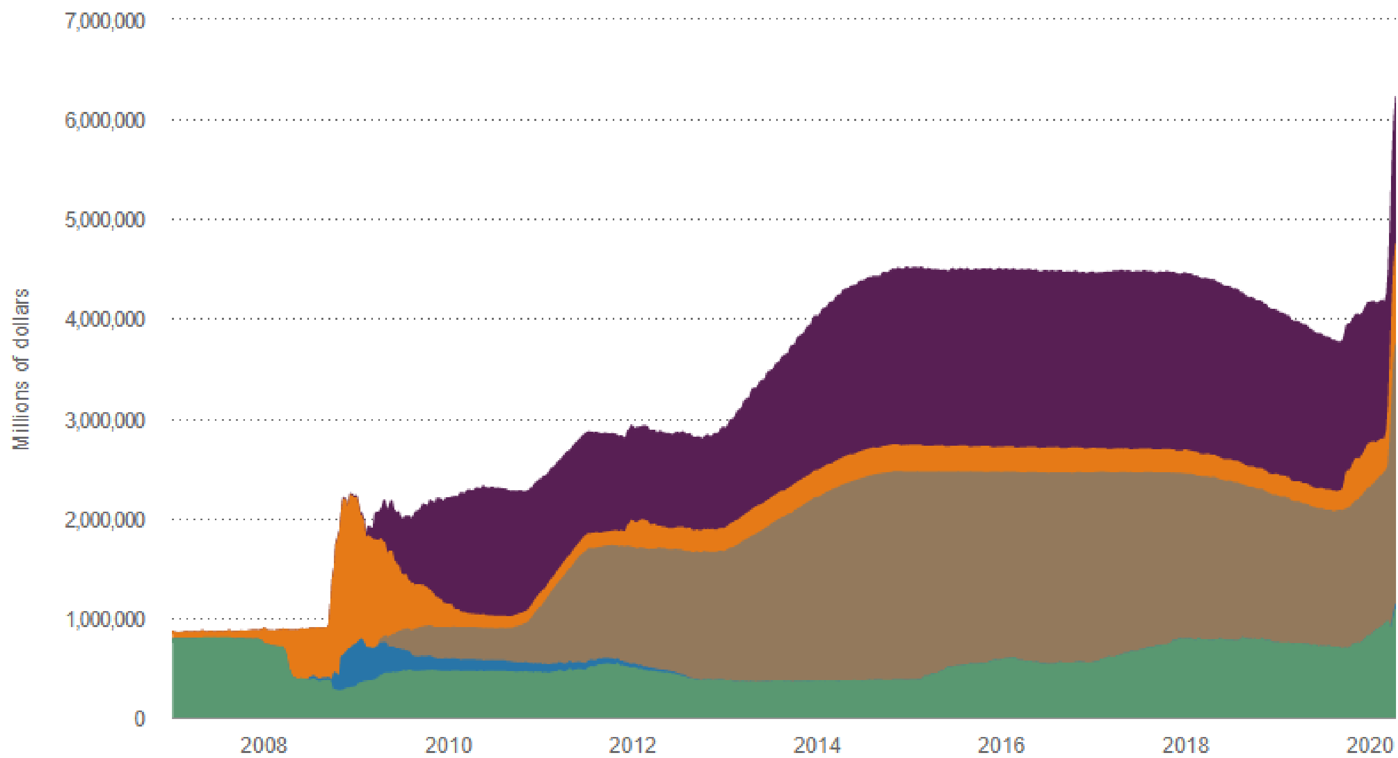
1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

- This doesn't actually ban directly handing over money to governments but ECJ would presumably say it runs counter to what was intended by the article and ECB legal staff will advise it was illegal. Unlikely to ever happen.

Sovereign Debt Purchases as Monetary Financing?

- QE purchases are done on secondary markets: The money doesn’t go straight to the government.
- Original plan: QE bonds purchased would mature with the government paying back the money to the CB. So no monetary financing, right?
- In practice:
  - Japan has debt/GDP of 200% but 90% of the 200% is owned by the Bank of Japan. No sign of BoJ reducing its holdings. Debt interest payments are recycled back to the government.
  - The Fed did not sell off many of the Treasury securities it purchased, maintaining a much larger balance sheet.
  - In effect, much of QE debt has been monetised
- It is very likely the Euro Area will end up in a similar situation.

The Federal Reserve's Assets



Debt Sustainability Under QE

- Governments will turn to austerity if they and\or financial markets perceive their debt burden as unsustainable.
- QE makes high levels of fiscal debt sustainable for two reasons
  - Lowers net debt as long as the central bank owns some of the public debt.
  - Lowers interest rates, so lowers the year-to-year burden.
- Italy is the most commonly cited country in the euro as possibly defaulting with a debt\GDP in 2019 of 136%.
- But Italy only paid 3.5% of its GDP in interest payments and one-sixth of that was to Banca d’Italia.
- Even a considerable increase in the debt-GDP ratio need not trigger a sovereign debt crisis.

Italy 2021 Doesn't Have To Be Greece 2011

	BE	DE 1)	EE	IE	EL	ES	FR	IT	CY	LV	LT	LU	MT	NL	AT	PT	SI	SK	FI	EA-19 2)
1970	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:
1975	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	:	0.6	:
1980	:	:	:	:	:	:	1.2	:	:	:	:	:	:	:	:	:	:	:	1.0	:
1985	:	:	:	:	:	:	2.5	:	:	:	:	:	:	:	:	:	:	:	1.7	:
1990		:					2.7												1.4	
1991	:	2.7	:	:	:	:	2.8	:	:	:	:	:	:	:	:	:	:	:	1.8	:
1992	:	3.1	:	:	:	:	3.0	:	:	:	:	:	:	:	:	:	:	:	2.5	:
1993	:	3.2	:	:	:	:	3.2	:	:	:	:	:	:	:	:	:	:	:	4.3	:
1994	:	3.3	:	:	:	:	3.3	:	:	:	:	:	:	:	:	:	:	:	4.0	:
1995	9.0	3.5	0.5	5.1	10.7	4.9	3.4	11.1	1.9	0.8	0.3	0.6	1.8	5.1	4.0	5.5	2.1	2.4	3.8	5.3
1996	8.6	3.5	0.6	4.4	10.3	5.0	3.6	11.0	2.3	1.3	0.8	0.6	2.0	4.7	3.9	4.8	2.0	2.5	4.1	5.4
1997	7.8	3.4	0.4	3.7	8.3	4.5	3.5	9.1	2.3	0.9	0.7	0.5	2.4	4.4	3.6	3.8	2.3	2.4	4.1	4.9
1998	7.5	3.4	0.6	3.3	7.7	4.1	3.4	7.8	2.9	0.6	1.1	0.5	2.9	4.2	3.6	3.1	2.1	2.5	3.4	4.5
1999	6.9	3.1	0.4	2.4	7.6	3.4	3.0	6.4	2.9	0.6	1.5	0.4	3.8	3.9	3.4	2.9	2.3	3.4	2.9	4.0
2000	6.7	3.2	0.3	1.9	6.9	3.2	2.9	6.1	3.2	0.9	1.7	0.4	4.1	3.3	3.6	3.0	2.4	4.0	2.7	3.8
2001	6.6	3.0	0.2	1.4	6.3	3.0	3.0	6.1	3.2	0.9	1.5	0.4	3.7	2.9	3.6	3.0	2.3	4.0	2.6	3.7
2002	5.8	3.0	0.3	1.3	5.6	2.6	3.0	5.4	3.0	0.7	1.3	0.3	3.9	2.6	3.4	2.8	2.2	3.6	2.0	3.5
2003	5.4	2.9	0.2	1.2	4.9	2.3	2.8	5.0	3.2	0.7	1.2	0.3	3.5	2.4	3.2	2.7	1.9	2.5	1.8	3.2
2004	4.9	2.8	0.2	1.1	4.8	2.0	2.8	4.6	3.0	0.7	0.9	0.2	3.7	2.3	3.0	2.6	1.7	2.2	1.7	3.0
2005	4.4	2.8	0.2	1.0	4.7	1.7	2.7	4.5	3.2	0.5	0.8	0.2	3.8	2.2	3.2	2.6	1.5	1.7	1.6	2.9
2006	4.1	2.7	0.2	1.0	4.4	1.6	2.6	4.4	3.0	0.4	0.7	0.2	3.7	2.0	3.1	2.8	1.4	1.5	1.5	2.8
2007	4.0	2.7	0.2	1.0	4.5	1.6	2.7	4.7	2.8	0.4	0.7	0.3	3.5	2.0	3.1	3.0	1.2	1.4	1.4	2.9
2008	4.0	2.7	0.2	1.3	4.8	1.6	2.9	4.9	2.6	0.5	0.7	0.4	3.3	2.0	2.9	3.1	1.1	1.3	1.4	3.0
2009	3.9	2.6	0.2	2.0	5.0	1.7	2.5	4.4	2.3	1.5	1.2	0.4	3.3	2.0	3.1	3.0	1.3	1.5	1.3	2.8
2010	3.6	2.5	0.1	2.8	6.0	1.9	2.5	4.3	2.0	1.8	1.8	0.4	3.1	1.8	2.9	2.9	1.6	1.3	1.3	2.8
2011	3.5	2.5	0.1	3.4	7.5	2.5	2.7	4.6	2.1	1.7	1.8	0.5	3.2	1.8	2.8	4.3	1.9	1.5	1.4	3.0
2012	3.5	2.3	0.1	4.2	5.3	3.0	2.6	5.2	3.1	1.6	2.0	0.5	3.0	1.7	2.7	4.9	2.0	1.8	1.4	3.0
2013	3.3	1.8	0.1	4.3	4.1	3.5	2.3	4.8	3.4	1.5	1.8	0.5	2.9	1.6	2.6	4.8	2.5	1.9	1.3	2.8
2014	3.2	1.6	0.1	3.9	4.0	3.4	2.2	4.6	3.2	1.4	1.6	0.4	2.7	1.5	2.4	4.9	3.2	1.9	1.2	2.6
2015	2.9	1.4	0.1	2.6	3.5	3.0	2.0	4.1	3.2	1.3	1.5	0.4	2.3	1.3	2.3	4.6	3.2	1.8	1.2	2.3
2016	2.7	1.2	0.0	2.3	3.2	2.8	1.8	3.9	2.7	1.0	1.3	0.3	2.1	1.2	2.1	4.1	3.0	1.7	1.1	2.1
2017	2.3	1.1	0.0	2.0	3.1	2.5	1.7	3.8	2.5	0.9	1.1	0.3	1.8	1.0	1.8	3.8	2.5	1.4	1.0	1.9
2018	2.1	0.9	0.0	1.6	3.3	2.4	1.7	3.7	2.4	0.7	0.9	0.3	1.5	0.9	1.6	3.4	2.0	1.3	0.9	1.8
2019	2.0	0.9	0.0	1.4	3.0	2.3	1.5	3.5	2.3	0.7	0.8	0.3	1.3	0.8	1.5	3.1	1.6	1.2	0.8	1.7
2020	1.8	0.8	0.0	1.1	2.7	2.1	1.3	3.3	2.0	0.7	0.5	0.3	1.3	0.7	1.4	2.9	1.5	1.1	0.8	1.5
2021	1.7	0.7	0.0	1.0	2.6	2.0	1.1	3.1	1.7	0.6	0.4	0.3	1.2	0.6	1.2	2.8	1.4	1.1	0.7	1.4

An Alternative Transfer from the Eurosystem to National Governments

- Despite their independence and various “Chinese walls” that accompany this, central banks are public bodies and they transfer most of their profits to national governments.
- However, a large amount of the profits the Eurosystem has made in the past have not been transferred but retained in the form of “revaluation accounts”.

Revaluation Accounts

INCOME RECOGNITION

The application of the prudence principle, in the light of the above-mentioned factors, calls for an appropriate design of the income recognition rules. Consequently, the unrealised gains, i.e. gains arising from the revaluation of assets, are not recognised as income in the profit and loss account, but are recorded in a revaluation account on the liabilities side of the balance sheet; they do not form part of distributable profits. On the other hand, the unrealised losses are included in the profit and loss account at year-end. This rule applies to the revaluation of currency holdings, as well as of security holdings (other than those that are "held to maturity") and derivatives. In addition, gains and losses arising on any security or currency are not used to offset gains or losses arising from another security or currency (hereinafter referred to as the "non-netting principle").

The Eurosystem Has €507 Billon in Revaluation Accounts

- A change in (relatively arbitrary) accounting principles could see this €507 billion added to 2020 central bank profits and returned to national governments.
- Coincidentally, the Eurosystem owns €509 billion in gold.
- Possible proposal: **Eurosystem sells the gold and returns the proceeds to national governments.** (Transfer equivalent to 4% of Euro Area GDP)
- This would not in any way impair the Eurosystem's ability to meet its policy targets.
- I am reasonably sure this is legal but ..

These Guys Wouldn't Like It …

Helicopter Money?

- If monetary financing is illegal, how about going past the government and giving money straight to businesses and households? **Fire up the helicopters**.
- It's not clear this would be actually illegal but …
- Given the way the ECB does its accounting, this would end up increasing its notional "liabilities" without generating any increase in assets.
- And there is a lot of dogma within central banks (including the ECB) on the issue of central bank assets having to exceed liabilities by some amount.

Helicopter Money: Practical Issues

- How does the Eurosystem get the money in people's bank accounts?
  - If they have to consult governments to get the bank account details, doesn't this end up looking a lot like a monetary-financed tax cut and thus monetary financing.
  - Similarly for any system based on things PPSNs.
- But Eric Lonergan argues that helicopter money already exists in one form: Banks can (under certain conditions) borrow at negative rates from the Eurosystem.

Helicopter Money for Businesses

1. ECB loans money to banks at minus 3 percent on condition they use the funds to make loans to specific types of businesses at minus 2 percent.
2. Business A gets a one-year loan for €10 million at minus 2 percent.
3. The bank disburses €200,000 to Business A and keeps the remaining €9.8 million through to maturity unless there is a low probability of default on the loan.
4. Business A just got €200,000 in helicopter money.

- Could a large-scale programme of negative rate loans to businesses meeting certain criteria be possible and legal? Maybe but again …

These Guys Wouldn’t Like It …

Eurobonds versus ESM

- Lots of discussion of the idea that the crisis should be financed by a new instrument called "Eurobonds" or "Coronabonds".
- Eurobonds already exist: The debt issued by EIB and ESM is jointly guaranteed by the national governments of the Euro Area.
- But there have been many objections to the use of the ESM, mainly related to the conditionality involved.
- I summarise the pros and cons of the use of ESM on the next page.
- Bottom Line: I think the cons are over-stated, the pros are under-stated and objectors underestimate the political difficulties of condition-free grants to states.

Positives and Negatives of ESM

Negatives	Positives
The borrowed money should be disbursed as grants rather than debt.	Perhaps so ideally. But unconditional disbursement was never likely to get sufficient support across all member states. The EU budget is perhaps a better way to disburse "grant like" funds but if this happens it will be targeted and follow usual spending oversight procedures rather than unconditionally providing money to some member states.
Lending volume limit is too low	Article 10 says this can be raised.
Requires an initial debt sustainability analysis	With current sovereign yields and ECB policies, it is likely debt is sustainable. Most sovereign defaults stem from a "buyers strike" and heavy buying from ECB more or less rules that out.
Requires "strict conditionality" which is politically unpopular in the borrowing country and could trigger a quick return to austerity or politicised structural reform requirements.	Article 3 says conditionality should be "appropriate to the financial assistance given." Weak conditionality (without austerity or structural reforms) may be appropriate if (for example) 50-year loans are provided.
Raises national debt levels and could threaten sovereign default.	But funding will be cheaper and at longer maturities for the borrowing countries. Any later sovereign default can be orderly and done while the country remains in the euro.
ESM is a preferred creditor. This could spook private financial markets and again trigger sovereign default.	True. But it also makes it safer for other ESM members to provide the funds, lowers the cost of ESM borrowing and perhaps reduces pressure for strict conditionality.