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CONFRONTING ECB'S AUSTERITY MANDATE

Summary

The ECB's involvement in the fiscal disciplining of EU member states through its collateral policies has not been discussed much by central banking scholars. It is only in recent years that any literature has emerged, but the overall orientation of this work is troubling.

From both sides of the long-standing intellectual divides on matters of European Monetary Union, calls are made for the ECB to deepen and enhance its role in the fiscal disciplining of member states.

If this path is taken, the consequences for financial stability inEurope will be severe. The ECB's collateral policies need reform – but in the exact opposite direction: collateral policies must be unequivocally non-discriminatory and countercyclical.

This set of collateral polices is essential if the ECB is to be able to effectively pursue a market-maker of last resort role in times of crisis – which in turn is a sine qua non if the ECB is to be successful in tackling future market liquidity crises.

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Confronting the ECB's austerity mandate

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1. INTRODUCTION

Europe's obsession with fiscal balancing – no matter the circumstances and at whatever cost – was challenged in the autumn of 2019 by both Mario Draghi and Christine Lagarde, the outgoing and the incoming presidents of the European Central Bank respectively. A couple of months later, the jaws of observers of matters of euro area governance dropped even further: Jens Weidmann, head of the Bundesbank and long-standing fiscal prudence hawk in the German central community, said that it would be a mistake if fiscal balance became "a fetish" (Arnold 2019). At the start of 2020, a Financial Times editorial effectively called for a paradigm shift, arguing for an abandonment of four decades of conventional wisdom on sound macroeconomic policies, to allow for a new era in which fiscal expansion would again be accorded a key role in managing economies, not least in efforts to steer clear of deep recessions (FT 2020a).

All of these interventions are astonishing and would, until recently, have been quite unthinkable. And yet they seem to have failed to affect the policy stance of the European member states to any great degree. Niels Thygesen, chairman of the EU's fiscal board, said last September that Europe's finance ministers "don't agree on too much" (Fleming and Khan, 2019) – and reports suggest that this remains the case half a year later, at the time of writing (Barber 2019; FT 2020b). Calls for a change of sentiment on balanced budgets leaves policymakers in Germany and its northern European allies especially unimpressed.

We suggest, however, that the ECB should not relinquish. On the contrary, the ECB ought to redouble its efforts, by by confronting its own fiscal austerity mandate. For the last 15 years the ECB has been involved in the fiscal disciplining of member states through its collateral policies. In this policy brief, we explain how the ECB came to adopt this disciplinary role, having first fervidly rejected it. We also show how a new debate has emerged in recent years, which calls for the ECB's involvement in fiscal disciplining to be reinforced and enhanced.

The ECB is yet to take a clear position in this debate. However, there is every reason to call upon the ECB to take a stand. There should be no more hypocrisy about fiscal policy being completely beyond the scope of ECB policies. Instead, the ECB should face the music and formulate a stance: should fiscal disciplining be further embedded and engrained in monetary policy through the ECB's collateral framework; or should we seek reform in the opposite direction?

In this policy brief, we advocate the latter. The ECB's disciplinary austerity mandate is unfortunate and dangerous, and if further strengthened would be even more so. The way forward is to fully disconnect with past practices. Monetary policy should not be an instrument for fiscal disciplining. On this crucial point, the ECB should revert to the system we had when the euro was first launched 20 years ago.

The reason that this is imperative is that any other course of action would effectively ignore a ticking time bomb under Europe's financial stability. Beyond that, it would be a welcome signal of consistency and wholeheartedness if the ECB were to demonstrate in this palpable way that the case made for fiscal stimulus by its highest ranking officials is more than cheap policy talk designed to impress journalists at press conferences, or a foresighted exercise in laying a path that can be used to shift the blame for the next crisis onto the finance ministers who failed to heed the ECB's warnings.

2. THE BACKSTORY OF THE FISCAL MANDATE OF THE EUROPEAN CENTRAL BANK

The architects of the Economic and Monetary Union (EMU) saw the "sound" public finances of all member states as key to its success. The Stability and Growth Pact (SGP) of the EMU was conceived and operationalised in 1997, a few years ahead of the introduction of the euro, to ensure fiscal prudence. The SGP sought to commit member states to achieving "budgetary positions close to balance or in surplus" (European Commission 2005, Buiter 2005: 7). Member states committed to restricting their fiscal deficits to a maximum of 3 % of GDP and to reducing government debt to less than 60 % of GDP. A fiscal deficit would only be subject to sanctions, however, after a corrective "excessive deficit procedure" (EDP) and then only if the European Council made a discretionary decision to impose them.

Critics argued that when the imposition of sanctions was made subject to decision by the Council, rather than being rules-based and automatic, the effectiveness of the SGP as a vehicle for balanced budgets was totally undermined. To such critics, it was unsurprising that the SGP was violated only a few years after the introduction of the euro, in 2003. More surprising, perhaps, was that the violating countries were France and Germany and that they violated the SGP not only by breaching the 3 % threshold for fiscal deficits, but also by suspending the agreed procedures for countries not abiding by the fiscal rulebook.

These events in 2003 did not bear strong testimony to the credibility of the SGP, and so a process was initiated to reform it. The criteria originally laid down to define what would constitute a breach of SGP rules had been widely seen by critics of the SGP as too lax. Yet, when member states agreed to a reform of the SGP, in early 2005, the criteria were further weakened by expanding the conditions under which a fiscal deficit in excess of the 3 % threshold could be considered compatible with the SGP (Buiter 2005: 9-10)

Critics lamented that the SGP had been rendered a toothless paper tiger, first by its lack of enforcement on France and Germany, and then by revisions that watered-down provisions that were already (too) lax. Analysts and scholars concerned with the soundness of the public finances of EU member states now turned to the European Central Bank to step up where member states had fallen short: the ECB could use its collateral policies to achieve the fiscal disciplining that other European institutions had failed to accomplish.

At a press conference in April that year, Jean-Claude Trichet, president of the European Central Bank at that time, was asked to comment on the view that the ECB was not helping financial markets "reward sound public finances and punish unsound finances", but that it was instead impeding markets in those very functions (Orphanides 2018: 2). Trichet did not concede to the argument. In the following months, he and a number of other officials at the ECB refused any proactive role for the ECB vis-à-vis the fiscal policies of EU member states (Issing 2005; Papademos 2005).

However, before the end of the year, the ECB had nevertheless adapted its monetary policy so as to perform a key disciplinary function vis-à-vis member states with unsound public finances. It had, effectively, adopted an austerity mandate. How did this turn of events come about?

3. THE ECB'S INVOLVEMENT IN FISCAL DISCIPLINING

Financial markets can be relied upon, a widespread rationale goes, to discipline the fiscal policies of issuers of government bonds. "If fear of default on government debt" could be cultivated in financial markets "whenever governments with high debt run excessive deficits", then whoever holds that government debt would demand a higher yield (Orphanides 2018: 1). This higher cost of financing government debt would greatly discourage fiscal imprudence and hence exert a strongly preventive effect. In this idealised mode of thinking, the sheer operation of market discipline "could potentially replace the role of the SGP as a mechanism for securing fiscal soundness in the monetary union" (ibid).

Although little such disciplinary pressure had in fact been exerted on member states from the inception of the euro in 1999 until the revision of the SGP in 2005, proponents of market-based economic governance purported that rather than critically revisit the idea that market discipline was a force that could and should be reckoned with in compelling member states to balance their budgets, the way forward would be to reform the ECB's collateral policies. The contention was that the disciplinary forces of the market had been blunted by the ECB's collateral policies and that, if revised, these policies could have the opposite effect – enabling and facilitating market discipline on public finances.

How were the ECB's collateral policies thought to be impeding market discipline? Several commentators argued that the ultimate culprit for fiscal indiscipline was the uniform and preferential treatment of the government bonds of EU countries in ECB credit operations (Buiter and Sibert 2005; De la Dehesa 2005; Fels 2005a, 2005b; Ulrich 2005; Wyplosz 2005). For Buiter, this "highly visible signal of the Eurosystem's perception of the financial standing of the Eurozone sovereign debtors" is the only plausible explanation for the concurrence of wildly different fiscal fundamentals for different eurozone countries and nearly non-existing yield differentials on their government bonds following the inception of the EMU (Buiter and Sibert 2005: 10).

The ECB's collateral framework stipulated that central bank bills and government bonds of all eurozone countries would belong to the highest liquidity category, and hence be subject to the lowest possible haircut (0.5%). This categorisation had a performative effect. When assets are certified as liquid, by being assigned the highest possible liquidity in and through the liquidity categories of the ECB's collateral framework, they become liquid. The liquidity of Greek, Portuguese and Italian sovereign debt, argues Buiter, owes much to this certification by the Eurosystem:

> By putting the 12 Eurozone national sovereigns in one liquidity category with the Eurosystem – the only issuer of euro denominated debt instruments certain to be free of default risk – some of the Eurosystem's aura of guaranteed solvency rubs off on every debt instrument in Category 1, however poor the fiscal fundaments of the national government that issued it. Few market participants are likely to entertain the possibility that a financial instrument may be highly liquid yet also subject to non-trivial default risk (Buiter and Sibert, 2005: 11).

For Buiter as well as Wyplosz, two of the most vocal critics of the ECB's uniform and preferential treatment of all eurozone government bonds, independent of fiscal fundamentals, the solution was straightforward. To enable market discipline,

the ECB would need to bring its collateral policy in line with the Treaties – which were unequivocal in ruling out any bailout of member states, whether by the collective of EU states or the ECB. If the ECB's collateral framework had constituted an implicit bailout guarantee – and hence "misled" markets not to differentiate between the default risks of the government bonds of different eurozone sovereigns – the obvious way forward would be quickly to do away with equal treatment of sovereign debt.

Buiter and Sibert recommended introducing haircuts on government bonds that were differentiated in accordance with their credit rating. Government bonds with an AAA rating would be assigned the lowest haircut, those with an AA-rating would be subject to the second lowest haircut, and A-rated sovereign debt to the third lowest haircut, and so forth (Buiter and Sibert 2005: 27).

Eventually, in little more than six months, the ECB abandoned its resistance to engaging with the agenda of contributing to the sound public finances of EU member states. In November 2005, a reform

of its collateral framework was agreed, although in a less granular form than its critics had wished for. From 2006 onwards, government bonds would be eligible in credit operations with the ECB only if they had a credit rating of at least A-. Sovereign debt rated lower than that by credit rating agencies would be ineligible altogether – with predictably severe consequences for the liquidity of the afflicted government bonds.

4. SHOULD THE ECB DEEPEN ITS COMMITMENT TO AUSTERITY?

In recent years, the collateral policies of the European Central Bank have been subject to renewed interest from scholars and central bank analysts (Bindseil et al 2017; Blot et al 2018; Gabor and Ban 2016; Macchiarelli and Monti 2018; Nyborg 2017; Orphanides 2017). Some authors in this literature advocate a revision of the ECB's collateral framework so as to further embed and engrain a disciplinary function vis-à-vis the fiscal policies of EU member states.

Interestingly, such reforms are proposed from both sides of the fundamental 'Rhine Divide' in European thinking on matters of euro area governance – otherwise considered difficult to transcend (Brunnermeier et al 2017. In Orphanides's advocacy, concerns with liquidity loom large, in line with a 'Southern' perspective on euro area governance, whereas for Nyborg (2017), liability and solvency are the key concerns, in line with typical 'Northern' views on such issues.

Both authors give in-depth accounts of the role of the ECB's collateral framework in its response to the sovereign debt crisis. But although their narratives are diametrically opposed in this regard, they nevertheless both end up recommending a shift towards rules-based, automatic haircuts, proportional to a country's deviation from key indicators of sound public finances.

Both Orphanides and Nyborg share the conviction that access to liquidity should be as closely tied to the forces of market discipline as possible. The core idea is that central bank credit operations should be devised so as to function as a disciplinary system of reward and punishment. Good quality collateral – government bonds of fiscally prudent states – should give low-cost access to central bank money; poor quality collateral – government bonds of fiscally reckless states – should cause access to central bank money to be possible only at very high cost. In this system, central bank credit provision would be merit-based, in other words. Liquidity provision organised along these lines would strengthen and reinforce the role of the ECB in performing a disciplining function over the fiscal policies of member states.

The main problem with such a deepening of the fiscal mandate of the ECB is that it would not serve the primary purpose of ensuring financial and monetary stability, as we have argued in more detail elsewhere (Vestergaard and Gabor 2020). If haircuts were proportional with fiscal deficits and public debt to GDP (through a rules-based automatic mechanism), collateral policies would exert a procyclical and destabilising influence not just on collateral markets, but on financial systems more generally.

Ironically, such a scheme of granular disciplinary haircuts would be detrimental not only to market liquidity, but also to central bank balance sheets, because the need for liquidity provision is insatiable in a collateral policy regime that is systemically procyclical. Most importantly, perhaps, using haircuts on sovereign debts (pledged as collateral in order to access central bank liquidity) in a disciplinary logic would not resolve, but prolong, market liquidity crises – and in the process would gravely exacerbate the sovereign debt problems of the countries most afflicted by them.

5. COLLATERAL POLICY FOR MARKET-MAKING OF LAST RESORT (MMLR)

Ultimately, the only way a central bank can address a market liquidity crisis is by committing to put a floor under the value of the securities that are subject to liquidity spirals. The best way to do so is by intervening in the markets where banks fund themselves, backstopping the values of core assets used by banks to obtain funding in money markets. If the market values of core collateral assets can be stabilised through central bank interventions in repo markets, then the market liquidity of those assets will be restored, to the benefit of funding liquidity too.

The protracted nature of Europe's crisis, as compared with the sharper but shorter US crisis, was a result, first and foremost, of the ECB's reluctance to support market liquidity by guaranteeing a floor to the collateral values of the core assets in European credit intermediation, that is, the government bonds of eurozone member states.

"A key lesson of the crisis", says Mehrling, is that supplying "funding liquidity is not enough, since in a crisis funding liquidity does not get translated into market liquidity, no matter how hard (the central bank) works to push funds out the door" (Mehrling 2011: 137). The role of "translating" funding liquidity into market liquidity is normally a function performed by profit-seeking private dealers, but Mehrling's suggestion is that when the private dealers stop performing this function – as is the case in a market liquidity crisis – the central bank is well-advised to step in and become the market-maker of last resort.

Rephrasing Bagehot's rule in a manner suitable for an era of collateralised finance, Mehrling suggests that the appropriate role for central banks in times of crisis is best encapsulated by the proviso to trade "freely at a wide bid-ask spread, against good security in the money market and in the class of good securities in the capital market" (Mehrling 2014: 110). Mehrling does not elaborate on the issue of what might constitute "good securities", however, and thus stops short of addressing the crucial issue of what might constitute appropriate collateral policy in a market liquidity crisis.

We argue that if central banks adopt a market-maker of last resort (MMLR) role, the effectiveness of this role will hinge on whether its approach is countercyclical or not. Effective MMLR requires that a central bank lend against all eligible collateral on equal terms – thus suspending the link to market valuations – and that it abandons a short-sighted, nominal approach to the risk management of its own balance sheet.

In propositional form, the main points we make with respect to the collateral policies of central banks pursuing MMLR are as follows.

First, the key to successful liquidity provision in times of crisis is not so much whether or how favourable the terms are, but whether liquidity is provided in a manner that convinces markets that collateral values are fully backstopped. Second, haircuts are an integral element of money hierarchies; without them, securities would not be convertible into bank money through repos. In normal times, central banks rightly use haircuts to manage credit and liquidity risks on their own balance sheet, but in times of crisis, haircuts should be used as a signalling device; by lowering them, central banks communicate to markets that the collateral values of core assets are solid, which is a crucial prerequisite for restoring market liquidity. Third, while the convertibility of assets with different degrees of moneyness depends on intricate mechanisms of daily collateral valuation and margining, in times of crisis these practices should be temporarily suspended to ensure the preservation of their moneyness beyond the crisis, thereby contributing crucially to the stabilisation of market liquidity.

Until Draghi launched his game-changing commitment that the ECB would do whatever it would take to backstop the value of all eurozone government debt, crisis management strategy had been ambivalent and hence unsuccessful in abating the market liquidity crisis. By expanding collateral eligibility but raising haircuts (especially on government bonds and bank debts with low credit ratings), the ECB was sending mixed signals to the markets, undermining the liquidity it was trying to restore. To stop collateral valuation spirals, central banks should suspend rather than follow the collateral valuation practices of financial markets.

It is difficult to escape the sense that the ECBs strategy reflected, at least in part, that the structural changes in European finance over the previous few decades had not been sufficiently taken into account. The shift towards a credit system where money and capital markets are inextricably intertwined, and where government bonds are the core collateral assets for credit creation, fundamentally alters the challenges of modern central banking. In an era of collateralised finance, central banks simply cannot afford not to take upon themselves the role of market-makers of last resort, backstopping the market value of core assets, if they are to be successful in containing market liquidity crises.

The US Fed was quick to adopt a role of market-maker of last resort and the Bank of England soon followed suit, formalising this role in its 2015 Red Book. The ECB, however, only took this path with hesitation, delay and reluctance, at cross-purposes with itself. The continental-European central banking community remains divided and torn even today – a full decade after a banking crisis became a sovereign debt crisis and evolved to threaten the survival of the EU.

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