



Wilfried  
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# Rebalancing the Euro Area

A Proposal for Future Reform

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## Policy Brief

December 2018

Under a monetary union, fiscal and monetary discipline have to go hand in hand if macroeconomic stability is to be maintained. The question is how to set up the right institutions to achieve this stability in a credible manner. This policy brief proposes a new institutional arrangement for the euro area to restore fiscal discipline. It places the responsibility for compliance entirely on the shoulders of the member states. It also provides for the mutualisation of 30% of the member states' debt-to-GDP ratio. This would help to maintain a stable currency and to limit the risk of contagion should another crisis occur in the future. However, this comes at a cost. Under the fiscal scheme proposed, member states, which would be fully fiscally sovereign, would need to run long-term sound fiscal policies to benefit from euro membership. In addition, this brief proposes a reform of Target2 under which overspending economies would have to pay the financial cost of accessing extra euros, which would deter the accumulation of internal imbalances within the euro area. All this is expected to change the current fragility of the architecture of the euro, provide member states with the right incentives to abide by sounder economic principles and make them fully responsible for the policies they adopt.

**Keywords** Euro-area internal asymmetries – Fiscal sovereignty – Capped debt mutualisation scheme – Target2 reform

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<sup>1</sup> The author would like to thank the staff of the Wilfried Martens Centre for European Studies for their valuable comments and suggestions.



# Introduction

The adoption of a common currency, with a single monetary policy, imposes severe constraints on the member states (MSs). Individual countries cannot adjust to a crisis by resorting to changes in monetary policy or the value of their currency, but must rely on sound fiscal policies and well-functioning markets to overcome it. The euro is even more stringent than one of its main predecessors, the classical gold standard (1870–1914), as countries at that time kept their own national currencies (though fixed to gold) and thus could change the exchange rate against gold and even abandon the gold standard, if necessary. Under the gold standard, a country that repeatedly accumulated trade and public deficits had to reduce the amount of money in the economy in order to maintain the convertibility of its bank notes. In this way it was able, in the end, to bring costs and prices down, and to help restore equilibrium in the balance of payments. In the euro area, this is not an option as MSs no longer have national monetary policies. All the adjusting to macroeconomic and fiscal imbalances must be carried out by reducing domestic spending, both public and private (the ‘internal devaluation’ or ‘austerity’ policies).

Before the global financial crisis, we could see that the MSs had accumulated substantial imbalances, which were permitted (and even fostered) within the architecture of the euro. During the years of the euro area crisis, these imbalances increased, and their destabilising effects on the whole area became apparent. The dominant vision of how to enhance economic integration in Europe and to tackle asymmetries emerged during the crisis. It insists on the need for long-term convergence and coordination enforced by the centre, and on gradual integration and centralisation in economic and fiscal matters. However, there is another option. It would allow MSs to regain control over their economic and fiscal policies—and in this way to revitalise their national democracies. Bureaucratic controls would be kept to a minimum, and the primary mechanism for adjusting to asymmetric shocks would be the operation of markets in more flexible economies.

The original architecture of the euro focussed on the establishment of a strong currency isolated from political pressures to monetise fiscal deficits. This, along with the no-bailout clause and the independence of the European Central Bank (ECB), was aimed at securing *monetary dominance*,<sup>2</sup> and thus the running of a currency focused on maintaining its purchasing power over time. The original euro

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<sup>2</sup> By ‘monetary dominance’ I mean the independence of the central bank so that it can pursue a monetary policy that is committed to maintaining price stability and is not subject to the fiscal needs of the Treasury.



was based on a genuine—if underdeveloped—vision of subsidiarity. Monetary and exchange rate policies were transferred to the centre: to the ECB and the European Council, respectively. However, there were no compelling reasons to centralise fiscal and economic policies, which were left in the hands of MSs though they were subject to the fiscal limits set for public deficit and debt in the ‘Stability and Growth Pact’. Decentralisation could be maintained provided three conditions had been met—and it can still be maintained if they are met:

1. Each national government must run a sustainable budget over time, so that other MSs do not bear the costs of the failure of an errant treasury.
2. Market-based mechanisms of adjustment to asymmetric shocks need to be dramatically improved so as to minimise the need for fiscal and economic centralisation. This aspect of monetary unions has been well known since 1961, when Mundell argued in a seminal paper that well-functioning labour, goods and services markets can make up for the absence of central economic and fiscal instruments.<sup>3</sup>
3. The ECB must commit to a credible policy of maintaining price and financial stability over time. To do this, it has to remain independent of political pressures and must not act as the lender to governments and the public sector, whether on the national or EU level.

## Overcoming fiscal deficits through a capped mutualisation of national sovereign debt

Ten years after the outbreak of the global financial crisis, it is imperative to deal with the gigantic stock of debt accumulated by many EU MSs. It is possible to conceive of a scheme of partial debt mutualisation that would serve the interest of debt reduction and national reforms. It would make the euro area more resilient

<sup>3</sup> R. Mundell, ‘A Theory of Optimum Currency Areas’, *American Economic Review* 51/4 (September 1961). For an assessment of the optimality of the euro from 1999 to 2017 through the calculation of an index of internal asymmetries within the euro area, see J. Castañeda and P. Schwartz, ‘How Functional is the Eurozone? An Index of European Economic Integration Through the Single Currency’, *Economic Affairs* 37/3 (October 2017). The index shows that convergence did not happen even in the years before the outbreak of the global financial crisis.



and would probably help the member economies to perform better. Under this proposal, MSs would be collectively responsible for the issuing and backing of only a set percentage of each state's public debt.<sup>4</sup> The exact percentage would probably have to be decided through political negotiations. However, given the experience of the recent crisis, the ideal targeted debt-to-GDP ratio should probably be lower than the current 60%: around 30%.<sup>5</sup> This may seem too stringent, but the Maastricht limits for debt and deficit have clearly proven inadequate to ensure the sustainability of public finances in the event of a severe crisis.<sup>6</sup> For example, in the years leading up to 2008, Spain had successive budget surpluses and a debt-to-GDP ratio of under 40%. By 2014 it had drifted to high deficits and very quickly reached a 100% debt-to-GDP ratio. At the same time, it is important to acknowledge that, given the current political climate regarding euro reform, such a proposal represents a long-term objective, rather than a shorter-term prerequisite. It is also important to acknowledge that a continuing process of deep structural reforms can play a key role in reducing debt-to-GDP ratios by increasing economic growth.

The experience of established federations shows that it is unheard of for members of a monetary union, which do not control their own monetary policy, to sustain debt-to-GDP ratios close to or even significantly higher than 100%.<sup>7</sup> This is even more important for a monetary union that does not want to embrace substantial fiscal integration. This is also how the US became much more integrated after the War of Independence. In 1790, as proposed by Secretary of the Treasury Alexander Hamilton, the federal government absorbed the debt of the individual states, and a new national bank was established.

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<sup>4</sup> This proposal was made some time ago, though in a different fashion, in P. De Grauwe and W. Moesen, 'Gains for All: A Proposal for a Common Eurobond', *CEPS* (April 2009); and J. Delpla and J. von Weizsäcker, *The Blue Bond Proposal*, Bruegel Policy Brief (May 2010). My proposal follows, though with significant changes and additions, the scheme set forth in P. De Grauwe, 'The Governance of a Fragile Eurozone', *Australian Economic Review* 45/3 (2012).

<sup>5</sup> In its 2010 and 2012 assessments of the effectiveness of macroeconomic policies to tackle the global financial crisis, the IMF encouraged a 40% debt-to-GDP ratio, holding that this would allow governments to be in a better position in future crises. See the following two articles by O. Blanchard, G. Dell'Ariccia and P. Mauro: 'Rethinking Macro Policy', IMF Discussion Note 10/03 (February 2010); and 'Rethinking Macro Policy II: Getting Granular', IMF Discussion Note 13/03 (April 2012). However, even 40% may not be enough if a country has accumulated substantial disequilibria.

<sup>6</sup> See O. Blanchard, G. Dell'Ariccia and P. Mauro: 'Rethinking Macro Policy'.

<sup>7</sup> For example, compare the debt-to-GDP ratios of most of the US states: the average is 6% and the standard deviation is much smaller than in the eurozone. See the data from 1999 to 2017 on C. Chantrill (compiler), *US Government Spending* (website).



## Transitory provisions

It is important to provide for a transition period that is sufficiently long (e.g. 10 years) to enable MSs to define their national fiscal policies in order to achieve such a target. This period would give them the time needed to adjust their policies. It would also allow markets to assess the true country risk of (and thus the borrowing costs for) each MS.<sup>8</sup> Decisions on the specific fiscal measures to be taken would be at the discretion of individual MSs, as would decisions on the structural reforms needed to rebalance their economies and increase efficiency in markets.

To avoid turmoil in the financial markets, within this transitory period the facility for debt mutualisation could cover the full amount of the MSs' existing public debt. But over a 10-year period, the amount covered would be reduced each year until the desired 30% cap or target was reached.<sup>9</sup> This might be deemed politically unfeasible because the current excessive debt levels would entail too high a financial burden for some countries. Where this was an issue, the MSs could agree to put the scheme into effect only after the MSs concerned had reduced their debt to a more moderate level—such as 60% of GDP. This would give MSs a greater incentive to return to lower debt ratios more quickly and in this way to benefit from the mutualised debt programme. At the same time, debt reduction could also be attained by increasing economic growth. This would open the way to developing debt reduction strategies for states such as Italy and Greece through fostering wider structural reforms and starting EU-level investment programmes in these countries. This is important as a way to maintain political (and public) support for such a debt reduction strategy and to ensure that the strategy is not automatically associated with austerity.<sup>10</sup>

The amount covered annually by this scheme would not be negotiated with the MSs every year but would be announced for each MS before the start of its own 10-year schedule. In essence, for each country the Commission<sup>11</sup> would announce

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<sup>8</sup> Indeed, once the new rules were announced, one could expect a period of greater financial disturbance in the markets that is difficult to specify in advance. (It would be similar to the floating of a currency after a long period of being fixed by the government.) However, volatility in markets could be kept to a minimum if the new institutions are strong, the new scheme is highly transparent and information on the scheme is freely available.

<sup>9</sup> In a similar vein, at the moment, countries with a debt-to-GDP ratio higher than 60% must reduce the debt in excess of this by an average of 5% annually over three years (see Excessive Deficit Procedure at [https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/launching-excessive-deficit-procedure\\_en](https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/launching-excessive-deficit-procedure_en)).

<sup>10</sup> In fact, debt reduction policies implemented through spending adjustments are more likely to enhance economic growth over the medium term. See A. F. Alesina and S. Ardagna, *Large Changes in Fiscal Policy: Taxes Versus Spending*, NBER Working Paper 15438 (2009).

<sup>11</sup> See below for more details on the institution that would be in charge of this new facility.



when the facility for debt mutualisation starts operating, together with a 10-year calendar detailing the coverage of national public debt per year. The debt covered under the scheme would diminish every year and reach the desired 30% debt-to-GDP ratio at the end of the tenth year (see Table 1 below). Thus every country would be allowed to issue the set number of bonds every year. These bonds would be covered under the mutualised debt scheme;<sup>12</sup> however, the scheme would not cover any further issue of bonds.

**Table 1 Debt reduction scheme: adjustment calendar**

	COUNTRY 1	COUNTRY 2
<b>Initial fiscal position</b> (public debt-to-GDP)	<b>Low indebted (60%)</b>	<b>Highly indebted (100%)</b>
<b>Year 1</b>	55%	89%
<b>Year 2</b>	52%	79%
<b>Year 3</b>	48%	70%
<b>Year 4</b>	45%	62%
<b>Year 5</b>	42%	55%
<b>Year 6</b>	39%	49%
<b>Year 7</b>	36%	43%
<b>Year 8</b>	34%	38%
<b>Year 9</b>	32%	34%
<b>Year 10</b>	30%	30%

*Notes:* The less indebted country reduces its debt by 6.6% a year. The highly indebted one would have to carry out a more drastic fiscal adjustment, reducing its debt by 11% a year. In both cases the adjustment rate would be higher than the annual 5% rate included in the EU's Excessive Deficit Procedure (see note 9 above). While technically sound, this would be considered politically highly unpalatable at present. However, politics is unpredictable and more favourable conditions may arise in the future.

<sup>12</sup> These mutualised bonds would be named and branded as such in the market so that they could be distinguished from the ordinary national bonds issued by the MSs, which would not be covered by the scheme but only by the MSs' own revenues.



## Who pays for this scheme? And who will benefit from it?

Contributions to the facility for debt mutualisation would function in a manner similar to how those made to the European Financial Stability Facility function. Each MS would back the new bonds by providing guarantees in proportion to its share in the ECB capital, but with no actual disbursement of funds. Once the system was in place, each MS would be entitled to appeal to this facility to issue the number of mutualised bonds required to cover the agreed upon yearly debt-to-GDP ratio. If a country were to run a higher debt, it would issue national bonds backed only by its tax revenues. In the event of a default, other MSs would be jointly responsible for repaying only the mutualised debt, in proportion to their contribution to the ECB capital. In this way, the conditions and the coverage of the pan-EU mutualisation facility for the debt would be clearly established *ex ante*, limiting the exposure of the other MSs. And this, in turn, would help to contain the risk of a sovereign debt crisis spreading across the euro area.

Therefore, this would be very different from the negotiations conducted in connection with bailout programmes during the recent crisis. This is because this facility would set in advance the distribution of fiscal and financial responsibilities between a given MS and the other MSs in the euro area.

The proposed fiscal benchmark would also make it easier for international capital markets to assess the risk of each country more accurately. The interest rate paid by governments would reflect the credibility of their own policies and the assessment of their long-term budgetary position. This would tackle one of the major factors that explain the recent crises. This is the (nominal) convergence of public debt yields across MSs. While public debt levels varied from country to country, in each case the debt carried the same risk in the years running up to the global financial crisis, and was one of the major drivers of overspending in countries with significant external imbalances.

This scheme is very similar to the one used to implement and pay for the European Financial Stability Facility. It provides financial benefits to both low- and high-indebted treasuries in the euro area. Presumably the pan-EU mutualised bonds would carry lower interest rates than those of over-indebted countries, which would therefore benefit from lower borrowing costs for a significant percentage of their debt.<sup>13</sup> Consequently, MSs with high public debt-to-GDP ratios would have clear

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<sup>13</sup> In the future the pan-EU bonds could also be issued to pay for the expenditures connected to the limited 'federal' competences which may be assigned to the EU level at some later point in time: e.g. defence, foreign policy or border protection.



incentives to keep their debt figures as close as possible to the amount covered under this facility. Moreover, every MS would be fully responsible for maintaining sound debt-to-GDP ratios, and the EU institutions would not administer bailout programmes to assist countries in distress (see below). This would contribute to avoiding the type of contagion to other MSs and the euro area as a whole that we observed in the recent euro crisis. On the other hand, less indebted countries would contain their exposure to the possible failure of a MS. In this way they would presumably also benefit from more certainty and (overall) lower borrowing costs.<sup>14</sup> It is true that low-indebted treasuries would subsidise a pre-defined ratio of the debt of the other more indebted MSs and thus pay a price for it. However, within this scheme the likelihood of the recurrence of fiscal imbalances is substantially minimised and, in the event of a sovereign debt crisis, the contagion effect would be better contained.

## Reduction of intrusiveness and over-regulation

Under this scheme MSs retain their fiscal sovereignty. However, any new issues of bonds above the amount collectively covered only carry the guarantee of the individual MS and thus become more and more costly. Under the proposed framework responsibility is not a matter of political negotiations between each MS and the EU institutions. Rather, it is ultimately market discipline that, in the form of ever-higher borrowing costs, imposes this responsibility on over-spending governments.

There would be no need to monitor MSs' budgets and spending plans on a yearly basis as the Commission does at the moment. The proposed pan-EU facility for debt mutualisation would not require an agreement on fiscal targets. And nor would it be necessary to monitor compliance and to administer sanctions. The amounts guaranteed by this facility would work as an incentive to benefit from lower borrowing costs. They would not function like the fiscal targets that the Commission currently imposes on each country. Under this institutional framework we would overcome the limits of the current macroeconomic and fiscal surveillance system, which was approved after the euro crisis (the 'Six Pack' and the 'Fiscal Compact')—and not least its politicisation.

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<sup>14</sup> During the crisis MSs with low fiscal deficits and debt figures were fully exposed to the crisis and also had to bear higher interest rates ('by association', one might say). This was because it was not clear to what extent they would support the MSs with higher deficits and debt levels. The scheme proposed here would limit their exposure.



An example of the flaws of the current system is provided by the dispute in the autumn of 2018 between the Commission and Italy's new government over the country's budget figures. Particularly where it involves a country like Italy, the third largest economy in the euro area, the open disagreement of the Commission and a MS on a key matter triggers warnings that go beyond the MS itself (and Italy is indeed paying a high price for the dispute, in the form of increased borrowing costs) and impact the sustainability of the area as a whole. With the fiscal scheme proposed here, there would be no need to engage in endless painful political negotiations, which can result in very high costs for the euro area and severely impact the affected populations' support for the euro.

## Independent budget office

To guarantee transparency in the implementation of the facility, an independent body could be established. This could be done under either (1) the ECB or (2) a new budget office under the remit of the European Commission, in order to avoid any interference with the running of monetary policy.<sup>15</sup> This body would be accountable to the European Parliament's Committee on Economic and Monetary Affairs. Its main functions would be (1) to regularly disclose the number and value of the bonds issued by each MS and (2) to regularly publish fiscal deficit and debt projections for each MS for the medium and long term. The disclosure of this information would help to assess the sovereign debt risks associated with each MS and thus the likelihood that an individual MS would fulfil its obligations under the debt reduction scheme.

What is being proposed is a partial mutualisation debt facility for the euro area, with fiscally sovereign MSs. However, it would not be an effective tool for keeping fiscal policies in check if it were not accompanied by other institutional reforms and strict conditions. I will discuss them in the following sections.

## Strict prohibition of member state bailouts

To make the new fiscal scheme fully functional, credible and effective over the long term, the prohibition of bailouts should be established as an overriding and unbreakable rule. This would signal the strength of the euro area as a 'club' of fiscally sound economies. It would also make the national governments

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<sup>15</sup> Equivalents of such an independent budget office have been established at the national level across the EU and in still other economies, such as the US.



responsible for implementing sustainable economic policies to remain part of the club, thus helping to contain future crises within national boundaries. In the absence of a strict ‘no-bailout’ rule, there are no effective incentives for MSs to deliver a sustainable fiscal policy over time, and the proposed new fiscal architecture of the euro would lose credibility and become flawed. Under our proposal, any MS that is unable to service its debt will be entirely responsible for it. No pan-EU financial assistance should be granted. It would be up to the MS to renegotiate its debt with its creditors and to restructure its finances to pay for it. In the US, for example, the federal government does not bail out states in crisis.<sup>16</sup> The no-bailout rule should be strictly observed by the ECB too, which should not be allowed to purchase MS sovereign debt in primary markets, but only in secondary markets for the implementation of its monetary policy decisions.

This means that, under this scheme the usefulness of the European Stability Mechanism—let alone that of a hypothetical European Monetary Fund—is highly doubtful. In fact, such institutions are likely to be dangerous as they would run contrary to the commitment to exclude bailouts. In this context, we should make a distinction between the EU programmes created to bail out MSs in crisis, such as the European Stability Mechanism, and the operations and programmes of a fully functional central bank such as the ECB. Liquidity assistance to tackle a banking panic would remain a key competence of the ECB and of the national central banks in the euro area.<sup>17</sup> Similarly, there would still be a need for the Outright Monetary Transactions and other ECB programmes meant to ensure the correct transmission of monetary policy decisions in times of crisis.<sup>18</sup>

## Expulsion or suspension of a MS

Under this proposal a fiscally errant MS may have to leave the euro area. The treaties provide for situations where a MS leaves the EU as a whole, but not for situations where a MS leaves the euro area. This adds unnecessary

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<sup>16</sup> In fact, all the states except Vermont are legally prohibited from running deficits. This is stipulated in their own state constitutions or in other legislation.

<sup>17</sup> This is what the ECB started to do in 2007 (and continued to do throughout the crisis) with the provision of extraordinary liquidity to the banking sector through the Long-Term Refinancing Operations. This meant both an increase in lending to banks and the extension of the maturity of the facilities involved.

<sup>18</sup> Further explanation is required on the key difference between these ECB programmes and the new programme, announced in 2015, whereby the ECB directly purchased MSs’ government bonds. While the Outright Monetary Transactions and other similar programmes involved the purchase of sovereign debt in secondary markets, the 2015–18 Asset Purchase Programme effectively involves financial assistance to MSs in crisis (and thus the monetisation of their deficits). The ECB should be able to support a stable rate of growth in the amount of money in the euro area and thus be able to run quantitative easing policies, if need be, without having to (de facto) bail out MSs.



rigidity to the euro legislative body. Economic history teaches that monetary unions are indeed dynamic, and their membership does vary over time. New countries are added, while others withdraw, whether temporarily or permanently. Some monetary unions collapse in their entirety, the Latin Monetary Union being a case in point. As Schwartz, Carrillo and Castañeda have proposed, a MS unable to pay its debts could be temporarily suspended or could opt out of the euro area in order to make the necessary adjustments to its economy more effective and less painful.<sup>19</sup> The affected country would be better able to run its national currency along with the euro, and to adjust its prices and costs outside the restrictions imposed by the euro. Of course, the country would need to go through a (painful) period of macroeconomic adjustment, though with a devalued national currency. Moreover, it would have to renegotiate its debt with its creditors. This is how countries have responded to severe crises under previous monetary unions, where nations under extraordinary financial difficulties have temporarily withdrawn from the gold or silver standard. Most of them eventually return to it when the economy was ready for this move.

## Clear rules for the ECB as lender of last resort

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In the event of a crisis, a European bank in a given MS would be able to use that country's mutualised government bonds at their nominal value to access the liquidity provided by the ECB. These bonds would be the core of the list of eligible assets accepted by the ECB as collateral to assist a bank in need of extra liquidity. As for the sovereign bonds issued by a MS without the guarantee of the rest of the euro-area MSs, it would be at the discretion of the ECB to accept them as valid collateral at nominal value or at a discount according to their market value 'in normal times'—that is, the trend value at which the MS's national bonds had been listed before and during the crisis. Accepting the MS's sovereign debt at its market value in normal times would make the system less dependent on sudden changes in market ratings, and thus less pro-cyclical and more stable for both the ECB and the MS.

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<sup>19</sup> P. Schwartz, F. Carrillo and J. Castañeda, 'Saving Monetary Union? A Market Solution for the Orderly Suspension of Greece', in P. Booth (ed.), *The Euro – the Beginning, the Middle . . . and the End?* (London: IEA, 2013).



## The conditions for acting as the lender of last resort

By offering liquidity to banks in times of crisis, the ECB would be fulfilling one of its major tasks: preserving financial stability in the euro area. Under our fractional reserve banking systems, the central bank should be ready to act whenever a solvent bank is in need of liquidity. This is what we call the *lender of last resort* function of central banks. But to assist banks with liquidity problems (and thus maintain financial stability) without incentivising banks to take on too much risk in the future, the ECB should respect the rules that Walter Bagehot set forth in 1873: in times of crisis, central banks must promptly provide (1) unlimited liquidity, (2) against good collateral and (3) at an interest rate higher than the normal policy rate.<sup>20</sup>

Under the fiscal scheme proposed here, this would mean accepting as collateral national sovereign bonds issued without the collective guarantee of countries in the euro area, but at a more realistic market value. This is in sharp contrast to what the ECB did both before and during the euro crisis, most notably with regard to Greece.<sup>21</sup> For at that time it accepted the sovereign bonds of MSs in crisis virtually at face value or with a minor ‘haircut’.<sup>22</sup> In this way, of course, it subsidised governments in crisis at the expense of MSs with no sovereign debt problems. The latter MSs assumed—in proportion to their contribution to the capital of the ECB—the higher risk that the MSs in crisis would default.

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<sup>20</sup> W. Bagehot, *Lombard Street: A Description of the Money Market in London* (Indianapolis: Liberty Fund, 2001); originally published in 1873. For a detailed analysis of central banks as lenders of last resort to banks in times of crisis, see G. Wood, ‘The Lender of Last Resort Reconsidered’, *Journal of Financial Services Research* 18/2–3 (December 2000).

<sup>21</sup> As Lastra explains, the ECB has the competence to provide liquidity assistance to the whole euro area. But the provision of liquidity to individual banks falls under the competence of the national central banks ‘at their own cost, but with the fiat of the ECB’ (R. M. Lastra, ‘Lender of Last Resort and Banking Banking Union’, in J. Castañeda, D. Mayes and G. Wood (eds.), *The European Banking Union: Prospects and Challenges* (Routledge, 2016), 116).

<sup>22</sup> This was the case for Greek bonds during the euro crisis and until May 2010, when these bonds were trading in markets at a 50%–60% discount. From May 2010 Greek bonds were accepted only as collateral with a much more significant haircut. See G. Claeys and I. Goncalves, ‘Is the ECB Collateral Framework Compromising the Safe-Asset Status of Euro-Area Sovereign Bonds?’, Bruegel blog entry (8 June 2018).



# Reforming TARGET2 by charging a price for access to liquidity

Cross-border payments in euros are made through a real-time gross payment settlement mechanism called ‘Target2’.<sup>23</sup> This settlement system is run by the European System of Central Banks (ESCB), which is made up of the national central banks plus the ECB. Target2 guarantees that whenever a bank needs to make a payment in euros to another bank in a different MS, it can have access to the euros needed to settle the payment. To credit and debit these payments in real time, each bank uses its account at its national central bank, where it keeps its (mandatory) minimum reserves. The Bundesbank provides the following description of the procedure: ‘At the end of the business day, all the intraday bilateral liabilities and claims are automatically cleared as part of a multilateral netting procedure and transferred to the ECB via novation, leaving a single NCB [national central bank] liability to, or claim on, the ECB’.<sup>24</sup>

Within the operation of Target2, the ESCB essentially acts as an intermediary for the provision of liquidity to the debtor bank.<sup>25</sup> In this way the ESCB offers a service to the banking sector for the purpose of fostering the smooth functioning of the payment system in euros.

## Why have asymmetries been exacerbated under Target2?

The ECB provides liquidity in euros to debtor banks against collateral—mainly government bonds, but also private bonds and asset-backed securities.<sup>26</sup> In normal circumstances, when bond spreads are small and the risk of default on sovereign debt is very low, accepting these bonds at face value has no major implications. However, in times of crisis, and especially when an asymmetric shock occurs and affects individual MSs’ credit positions at different levels of severity, the market will value the sovereign debt of euro-area MSs at quite different prices. To protect the value of its balance sheet, the ECB changed

<sup>23</sup> ‘Target2’ stands for ‘Trans-European Automated Real-time Gross Settlement Express Transfer System’.

<sup>24</sup> Bundesbank, ‘Target2 – Balance’, (n.d.).

<sup>25</sup> In the US there are two companies offering clearing facilities: (1) Fedwire, operated by the Fed banks, and (2) CHIPS, operated by a private company, PayCo.

<sup>26</sup> For a more detailed analysis of the assets that the ECB accepts, see G. Wolff, *Eurosystem Collateral Policy and Framework: Was It Unduly Changed?*, Bruegel Policy Contribution 14 (November 2014).



the eligibility criteria and haircuts applied to the collateral accepted during the crisis.<sup>27</sup> In its main refinancing operations, the ECB currently assesses the haircut to be applied to eligible assets according to the type of asset and issuer, the residual maturity of the asset and the rating of the asset (taking the best rating of the four major accepted agencies).

However, when it comes to making a payment to a creditor bank in another jurisdiction, the ECB charges neither fees nor interest rates to those banks in need of euros. And this carries very significant distributive effects. The latest figures available (September 2018)<sup>28</sup> show that creditor countries such as Germany, Luxembourg, the Netherlands and Finland hold huge credit positions at the ECB (€956, €221, €102 and €62 billion, respectively) but earn no interest on them.<sup>29</sup> On the other hand, it can be argued that this payment system also benefits the export sector in surplus countries as they find it easier to sell their products in other MS markets.

In the historical precedents of the euro, the classical gold standard or the Latin Monetary Union (1865–1927), the clearing systems in place (even though not automatic and subject to bilateral negotiations) made the deficit country pay the creditor country in an agreed currency (at the time usually gold and bills of exchange). Consequently, the debtor country suffered a fall in its money supply and the creditor country registered a corresponding increase. As this resulted in lower inflation in the debtor economy and higher inflation in the economy of the creditor, it facilitated an adjustment of the imbalances between the two economies over time. Beyond this still, since the clearing of the balances was not automatic, during the time the surplus country held an (unpaid) credit position, it charged an interest rate to the debtor, and this deterred the deficit country from overspending and from issuing too much currency at home. In the US, a comparable jurisdiction, imbalances arise across the Fed's regional banks, but these are settled periodically in order to avoid the accumulation of deficits.<sup>30</sup>

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<sup>27</sup> Exceptions were made for Greece and Cyprus so that the ECB could continue to accept their sovereign bonds as collateral, though at a higher discount.

<sup>28</sup> As published online by the ECB: 'TARGET Balances of Participating NCBs' (2018).

<sup>29</sup> A modest 2% interest rate paid on these balances (certainly a low rate in 'normal times') would amount to approximately €19.2, €4.4, €2.0 and €1.2 billion for Germany, Luxembourg, the Netherlands and Finland, respectively.

<sup>30</sup> See F. Westermann, 'Europe's Target-2 Can Learn from US', OMFIF (5 July 2018).



What Target2 does is to produce results that are precisely the opposite of what one would expect from a sound clearing system:

- The money flows from the creditor country to the deficit country, so the money supply in the latter grows at a faster rate.
- Credit positions are not settled.
- No interest is charged to the deficit country for access to the funds.

All this creates the incentive for overspending countries to keep on borrowing and to accumulate greater and greater deficits. And this, in turn, exacerbates existing asymmetries within the euro area.

## How to reform Target2

Setting a price for the use of Target2 to reflect the true cost of accessing liquidity would make the payments more costly to the net importing economies. And this would disincentivise overspending in these economies, which would help to alleviate the accumulation of trade imbalances over the long term.

Within Target2, the ESCB acts as the 'bank of banks' in the provision of a key financial service to the banking institutions operating in euros all around the world. Accordingly it should be entitled to charge an interest rate, most naturally the one currently applied to banks in the weekly auctions of liquidity via open market operations. This is the 'main refinancing operations interest rate' (it is usually a positive figure, but at the time of writing it stands at 0%). Charging banks an interest rate to access liquidity would (1) send the right signal to both creditor and debtor countries regarding the true market price of cross-border transactions, and (2) increase the profits of the ECB, which would be distributed to the MSs in accordance with their share of the bank's capital.

As for clearing the current debit/credit balances, one must take into account the value of the debit position of countries such as Italy (€489 billion or 30% of GDP) and Spain (€396 billion or 25% of GDP).<sup>31</sup> The sheer size of these debts makes it politically and economically unfeasible to suggest that they will be

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<sup>31</sup> The figures given for both countries are from September 2018.



repaid in the near future.<sup>32</sup> The best we can do is to implement the measures suggested above to avoid the accumulation of further imbalances.

## Conclusions

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The current levels of public debt in several euro-area countries are symptomatic of the euro's institutional flaws. Moreover, they threaten the future sound running of the common currency. In this paper I have suggested making changes to the architecture of the euro so that MSs would be responsible for their own policies. The countries would ultimately benefit from running more sustainable public finances, and the risk of a crisis spreading across the rest of the euro area would be minimised. I have recommended adopting a partial debt mutualisation programme so that MSs attain a sound fiscal position over a 10-year period. I have also recommended imposing a price mechanism on the running of Target2 to avoid the accumulation of financial imbalances across the euro area. The combination of these reforms would contribute to reducing the current fiscal and macroeconomic imbalances within the euro area. In this way, the reforms would make the euro a stronger currency over the long term, while reducing the need to impose further regulations in the euro area.

It would be up to the MSs to decide their own fiscal and other macroeconomic policies. Each would be fully responsible for achieving the benefits but also for bearing the costs of membership of the euro area. In this way counterproductive spats between the Commission and MSs could be avoided—such as the clash we have recently witnessed in connection with the first budget of the new Italian government.

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<sup>32</sup> Actually settling such debit positions, either in euros or in the form of the MSs' long-term sovereign debt assets, would ultimately entail very substantial deflation in the debtor countries and inflation in the creditor countries.



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Brussels, BE 1000

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Editor: Federico Ottavio Reho, Strategic Coordinator and Research Officer, Martens Centre

External editing: Communicative English bvba

This publication receives funding from the European Parliament.

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