EA QE with adequate risk sharing: some remarks

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EA QE: starting points

View 1: "The problem with QE is it works in practice but it doesn't work in theory." (*Ben Bernanke*)

View 2: "...Let me start by saying that each monetary policy operation always has some fiscal implication...Usually, these fiscal implications are dealt with easily within a one-country framework, between the central bank and the treasury. But in the euro area, there is no European treasury..." (*Mario Draghi*)

What is lacking? Models which encompass both views.
This is unfortunate, given what is at stake.

Current EA architecture: 2 principles

- **Single monetary policy: price stability**

  - narrow mandate

  - primary objective: price stability for the euro area as a whole.

- **Many fiscal policies: no baill-out clause**

  - currently firmly anchored at national level

  - substance of no-bail out clause:

  Sovereign debt issued by a national government constitutes a liability to be backed by tax revenues collected in this country.

  It creates no obligation for other governments to back it through their own resources.

$\rightarrow$ **EA QE:** recipe for potential drama, since it means that CB takes outright sovereign risk on its balance sheet in order to satisfy its primary objective

EA QE: clash of two principles?

2 principles translate into 2 views: **Stimulus vs. Incentives**

Stimulus: QE needed, *everything else seems secondary*
Incentives: QE to be avoided, *everything else seems secondary*

- Initial perception: clash unavoidable
- But this is not true: EA QE is inevitably multidimensional
- **EA QE with adequate risk sharing**:

  - coexistence of both principles, commensurate with current incompleteness of EA

  - good starting point for new EA crisis management to come
- Communication challenge:

  - Greek drama follows different (ie old) script (if any)

  - ECB avoids double campaign: old vs. new script

  - however, success of QE hinges on clear announcements!

EA QE design issues

Issue I: Risk sharing

EA QE with adequate risk-sharing offers a mechanism which recognises both principles

- The 80:20 split in favour of no risk sharing recognises the allocation of fiscal responsibilities in EA and thereby avoids an inappropriate pooling of outright sovereign risks
- Technically, budget constraints of governments remain separated in all states of the world
- This ensures that for marginal operations (ie those motivated by QE) the (in)effectiveness of these operations can be discussed in line with the standard literature (as known from the UK, US, Japan)
- The adequacy of risk sharing follows from the current EA architecture and can be flexibly adjusted

EA QE design issues

Issue II: Portfolio composition
$\rightarrow$ Benefits from adequate risk sharing occur under any portfolio composition!
$\rightarrow$ Adequate portfolio composition a priori unclear

- **Option 1: EA QE with flexible country-specific weights**

Pro: country-specific fine-tuning of stimulus
Contra: marginally we get 19 BoE's, contradicting the singleness of MP

- **Option 2: EA QE according to capital key**

Pro: *if effective in the core*, rigid key lifts average inflation up and preserves inflation differentials (respecting improved competitiveness dynamics)
Contra: it forces us to relearn that entry into MU implies a loss of instruments to address country-specific imbalances

EA QE with adequate risk-sharing and purchases according to capital key

Tools and options to address country-specific concerns:

- **Country-specific accommodation:**

  - Traditional demand-side policies (i.e. both monetary and fiscal) lack effectiveness: MP is not country-specific and FP is curtailed if there is lack of fiscal space.

  - This creates a premium for comprehensive supply-side adjustment and flexible structures.

- **Relative competitiveness of member states within the EA:**

  - Real devaluations, where needed, have to be achieved through price and wage restraint relative to the respective area-wide trends.

  - This creates a premium for downward flexibility of nominal prices and wages.

  - Fiscal devaluations, operating through changes in national tax codes, may offer a certain alternative, but the design issues are complicated and implementation lags may be prohibitive.

EA QE with adequate risk-sharing and purchases according to capital key

Tools and options to address country-specific concerns:

- **Sovereign default:**

  - Governments of member states are without protection from their own central bank and have no control over their domestic price level. This makes them vulnerable to sovereign default.

  - This creates a premium for mechanisms that prevent speculative runs and facilitate, at the same time, a smooth restructuring of sovereign debt whenever fundamentally unavoidable.

  - To prevent non-fundamental default dynamics, insurance needs to be provided at the supranational level, ultimately involving the central bank as a lender-of-last resort.

  - Default dynamics resulting from fundamental imbalances should be addressed via a restructuring of government debt, allowing for a bail-in of private creditors.