THE UK AND THE EUROZONE: SOVEREIGN DEBT MANAGEMENT AND MONETARY POLICY

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Abstract
Events in the wake of the 'credit crunch' can be understood only against institutional structures within which interdependent monetary and fiscal policy are administered. In the Eurozone, the attempt to keep a central monetary authority (together with its associated national central banks) independent from 17 diverse fiscal authorities was flawed. When sovereign debt approaches unmanageable levels, the Maastricht Treaty presents austerity as the single option. In the UK, the electorate has an opportunity to choose between monetary financing (inflation) and fiscal consolidation (austerity). Policy choices within the Eurozone and the UK are set against Keynes's focus on unemployment and more recent concerns to retain (or restore) price and/or financial stability.

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1. Introduction

Although John Maynard Keynes had persuaded politicians of the overriding importance of direct fiscal measures as a solution to the chronic unemployment of the 1930s, policymakers neglected an important proviso: 'my suggestions for a cure . . . are not meant to be definitive; they are subject to all sorts of conditions of the time' (Keynes 1937, pp. 221–2), and an implicit warning of longer-term inflationary consequences:

> Of course, I do not want to see money wages forever soaring upwards to a level to which real wages cannot follow. It is one of the chief tasks ahead of our statesmanship to find a way to prevent this. (Keynes 1944, p. 429)

What Keynes had deemed appropriate for the Great Depression and a nation at war was unlikely to serve as a workable prescription for less extreme conditions. In particular, a general requirement for periods of fiscal-deficit spending to be offset by periods of fiscal surpluses was neglected.

When fiscal-deficit spending becomes the norm, sovereign debt may outstrip the tax base (the ultimate source from which sovereign debt can be repaid). If there is a sovereign currency, that problem can be resolved by monetary financing: the real value of debt has frequently been eroded by excessive money growth. Despite the exchange controls that were generally in force across post-war Europe, currency realignments were a common feature.

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The scant attention that was afforded to the interdependence between fiscal-deficit spending and sovereign-debt management was, in part, a reflection of the view that monetary policy had little relevance to macroeconomic performance. Only as rapidly rising price inflation emerged as a problem too big for the subtle art of 'statesmanship . . . to prevent' was serious attention given to the relevance of monetary policy.

2. Managing debt to deliver monetary policy

With the ending in 1971 of the Bretton Woods regimen of fixed-exchange values and the subsequent widespread experience of stagflation, scepticism grew over the use of fiscal instruments to maintain full employment. As interest turned to classical monetary theory with its focus upon price stability, the relevance of broad money growth emerged as deserving greater consideration. Within a decade, that idea – supported by close statistical correlations between the rate of broad money growth and price inflation – had become embedded within official UK policy as the Medium-Term Financial Strategy (MTFS), 1980–85.

As monetary policy was directed towards achieving specific money growth targets, attention was given to the linkage to sovereign borrowing and commercial bank lending. With fractional reserve banking, credit money is created by bank lending. Where 'narrow money' comprises banknotes in circulation and reserves held by commercial banks, 'broad money' grows in line with banknotes in circulation and bank deposits. The use which is made of these liquid assets is shaped by a variety of events and institutional changes. For example, the removal of exchange controls, the deregulation of financial markets and the lifting of credit controls required prescient judgments to be made in interpreting the implications for broad money growth. Thus, in his 1986 Budget speech, Nigel Lawson observed that

> [t]hroughout the 1980s – and in sharp contrast to the 1970s – broad money has grown far faster than money GDP. Experience has demonstrated that this has not posed a threat to inflation. This rapid growth largely reflects the increased attractions of holding interest-bearing deposits, at a time both of low inflation and high real interest rates, and of innovation and liberalisation in the financial system. (Lawson 1986)

With the benefit of hindsight, the statistical correlation between broad money growth and inflation was judged to have changed but, at the time, the Treasury made repeated attempts to bring the MTFS back on target by 'overfunding' fiscal deficits.

When the Treasury sells bonds to the non-bank private sector, buyers draw upon their bank deposits, so reducing commercial banks' reserve balances. With the sale of a greater volume of bonds than is necessary to fund a fiscal deficit (i.e. with 'overfunding'), monetary growth is directly checked. Yet, when this happened in the 1980s, commercial bank liquidity was restored by the unusual large-scale acquisition of commercial bills by the Bank of England, which facilitated the continuation of bank credit creation. In retrospect, a judgement was reached that commercial bank lending was driving both the volume of bond sales and the maturity structure of sovereign debt. By the end of 1985, the conclusion (again from Nigel Lawson) was that

> the position had become ridiculous. The bill mountain had grown to fresh heights; yet £M3 had in the latest twelve months grown by 14 per cent compared with a 5 to 9 per cent target rate. The conclusion

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> I reached was that overfunding should be abandoned and net sales of bonds confined, as in the old days, to financing the Budget deficit. (Lawson 1992, p. 459)

Thereafter the policy of targeting broad money growth gave ground to greater concerns for exchange rate stability as a prerequisite for Eurozone membership. For the UK, this came to an end on (Black) Wednesday, 16 September 1992. With markets judging that the sterling rate could not be maintained, the UK was forced to leave the Exchange Rate Mechanism of the European Monetary System. Thereafter, the time was never deemed quite right for the UK to re-board the Eurozone bandwagon.

In having retained its sovereign currency, the UK has been free to decide how best to address the most recent of macroeconomic concerns. In the aftermath of the credit crunch, policymakers in the UK (and the USA) decided upon 'underfunding' as an appropriate response to recessionary conditions. 'Quantitative easing' (QE) is the term now used to designate the process of underfunding.

3. Quantitative easing

The principal instrument of monetary policy has long been the manipulation of short-term interest rates. QE was, therefore, presented as an unconventional policy instrument for use in exceptional circumstances, when the short-term nominal rate has already been set close to zero. In a deep recession, when prices are falling, it is a rational decision to defer expenditures wherever possible, which is detrimental to business activity. Based upon that fear, one of the motives for a new policy initiative (i.e. for the Bank of England to engage in QE) was to prevent key inflation indices becoming negative. Over the period 2009–12, QE involved the Bank of England buying £375 billion of UK sovereign bonds, paid for by claims on the Bank in the form of commercial banks' reserve balances.

While QE was expected to facilitate commercial bank lending, in the wake of the credit crunch commercial banks were faced by the contradictory goals of rebuilding their balance sheets while extending loans to business. In the event, a decline in commercial bank lending countered the impact of QE on broad money growth.

With the short-term rate close to zero, QE delivers a monetary initiative through debt-management operations that reduce long-term rates. Although it is administered by the Bank, QE is under the auspices of the Treasury. However, the Bank's net profits/losses always accrue to the Treasury, which means that the indemnity, provided by the Treasury against any QE losses incurred by the Bank, is an institutional nicety. As, too, is the recent transfer of £37 billion of accumulated interest on bonds acquired through QE to the Treasury: an element of creative accountancy gives the appearance of contributing to Chancellor of the Exchequer George Osborne's goal of eliminating the structural deficit by 2015.

At some stage, the Bank is expected to resell its sovereign bonds back into the market. Alternatively, there might be an 'internal' exchange, whereby the Treasury receives bonds from the Bank in return for Treasury bills. Thereafter, the Treasury would resell the bonds within the normal process of deficit financing. By either route, QE would be reversed. Of course, the Treasury (rather than the Bank of England) might have managed the whole QE process to the same effect, with QE purchases of sovereign bonds funded by the sale of Treasury bills rather than by an increase in bank reserves: 'It would have been a debt-management operation in

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form as well as in substance; the economic effects would have been very much the same' (Allen 2012, p. 832).

In recognising these as alternative routes (by either the Bank or the Treasury) to the same end, the questionable nature of the independence of any central bank from its sovereign comes under scrutiny. While the distinction is of little practical relevance in the UK, within the Eurozone it raises crucial issues.

4. Eurozone: Bailouts and bank loans

The debacle of sub-prime lending in the USA and the sharp decline in inter-bank lending coincided with a reaction to levels of sovereign debt in Europe which, in a number of cases, were perceived to have exceeded the limits of sustainability. As borrowing costs for 'peripheral' Eurozone sovereigns began to rise alarmingly, initial remedial measures encompassed international loans ('bailouts' under the aegis of the 'troika' of the European Central Bank, the European Union and the International Monetary Fund), partial default on sovereign debt (aka 'restructuring') in the case of Greece and, most recently, incipient monetary financing.

In deciding that it must act to preclude more extensive sovereign defaults,[1] the European Central Bank (ECB) could not be seen to undermine the drive for fiscal consolidation and structural reforms. Furthermore, the monetary financing of sovereign debt is prohibited under the Maastricht Treaty. This is why sovereigns are required first to commit to 'troika' conditions for bailout funding before the ECB begins Outright Monetary Transactions (OMT); that is, the purchase of sovereign debt. The official line is that the ECB will consider OMT to the extent that (*a*) they are warranted from a monetary policy perspective, and (*b*) the sovereign in question has committed to an austerity programme. This initiative has been criticised as unconstitutional by Jens Weidmann, president of the Deutsche Bundesbank, and others who view the process as blatant monetary financing.[2]

Possibly of greater concern to the ECB is that a Eurozone sovereign might itself initiate monetary financing by selling bonds to its national central bank. If the bonds are undated, monetary financing is complete, since interest payments on bonds held by a national central bank revert (as net profits) to its sovereign; and there would be no principal to repay. If bonds are dated, then rollover and future monetary refinancing remain open as options. To the extent that funds borrowed from a national central bank are used to make payments elsewhere in the Eurozone, these show as TARGET2[3] clearing system liabilities to one or more other central bank(s). Since this debt bears interest at the ECB's marginal rate, currently 0.50 per cent, it is much cheaper to service than bailout funds to respective sovereigns. The only constraint upon the credit which a national central bank may obtain in this way is ineffective 'bluster' from the ECB.

Ireland provides an illustrative case. In 2009, the Irish sovereign was coerced into guaranteeing the debts and deposits of those banks which had been left floundering by the collapse of property prices. This led eventually to the requirement of some €64 billion for recapitalisation, equivalent to about 30 per cent of Ireland's national income. With no prospect of finding that sum either from taxation or borrowing in capital markets, around €40bn was borrowed indirectly from the Central Bank of Ireland (CBI). The principal mechanism was a gift from the Irish sovereign of promissory notes to Anglo Irish Bank, which that bank then

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used as collateral to borrow from the CBI. The borrowed funds were then used to reimburse creditors (largely northern European banks and other financial institutions) of Ireland's failed banks, which added to the TARGET2 debt of the CBI.

With annual promissory note payments set at around €3bn, the burden remained untenable against Ireland's tax base. In 2012 a ruse had a trial run. Instead of €3bn from tax revenue, sovereign bonds were issued and swapped for the promissory notes then falling due. That move attracted little attention.

One year later, the ruse was applied in full. The Irish sovereign issued €2bn bonds directly to the CBI to replace the remaining promissory notes. The Irish Bank Resolution Corporation (IBRC, successor to Anglo Irish Bank) was then placed into liquidation. No prior approval had been obtained from the ECB; and the impending move was rushed in the face of a leak to the press. To preclude possible court injunctions by creditors of the IBRC, Dáil Éireann sat into the night to pass the necessary legislation, as Ireland's President flew back from Rome to sign that legislation into law. The clandestine nature of the operation was underlined by the codename 'Project Red'.[4] At a press conference the next day, ECB President Mario Draghi made the following remarks:

> On Ireland, let me say this, there wasn't a decision to take. The Governing Council unanimously took note of the Irish operation and I'm going to refer you to the Irish government and the Irish central bank for the details of this operation which was designed and undertaken by the Irish government and the Irish central bank. I can only say today that we took note of this. (Draghi 2013)

Sovereign debt within the Eurozone had been openly monetised and (so it then appeared) would remain so pending a schedule of debt repayments beginning in 2038 and running through until 2052.

The likely extent of such a debt reshuffling exercise is unknowable. What is clear is that the sovereign debt incurred by Ireland, in order to repay the creditors of its troubled banks, exceeds the capacity of its tax base. Yet, as Mario Draghi's response suggests, monetary financing is not something the ECB Governing Council would wish to approve: Article 123.1 of the Maastricht Treaty forbids the direct purchase of sovereign bonds by Eurozone national central banks. However, the CBI acquired €25bn of sovereign bonds by a circuitous route, which leaves its legitimacy a moot issue. Even had it been declared illegal, the ECB possesses only the 'doomsday' sanction, namely to eject the CBI from the TARGET2 clearing system and, thereby, Ireland from the Eurozone.

By a more recent announcement, at some stage

> [t]he Central Bank of Ireland will sell the bonds but only where such a sale is not disruptive to financial stability. They have however undertaken that minimum of bonds will be sold in accordance with the following schedule: to end 2014 (€0.5bn), 2015–2018 (€0.5bn p.a.), 2019–2023 (€1bn p.a.), 2024 and after (€2bn p.a.). (Department of Finance 2013, p. 10)

In the event of that schedule being met, all the bonds would be in private hands by 2032. If net sale proceeds were below the acquisition price, there would be a net liability for the CBI to pass to the Irish sovereign. That might, or might not, be offset by the gain from deferring repayment of the principal of €25bn. Alternatively the ruse might be repeated, in which case monetary financing of that debt would be further extended.

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5. Restructuring or devaluation

Although the ethos that drives voting in Germany (and other northern sovereigns) demands monetary stability, an electorate's ability to secure that outcome is greatly diminished by a sovereign's Eurozone membership. That is the democratic deficiency of the 'greater Europe' project. The convergence criteria within the Maastricht Treaty (1992) set the pre-entry requirements for Eurozone membership (which included upper limits on fiscal deficits and sovereign debt). When these were not met, the overriding ambition of political idealism allowed the plan to go ahead. Although the limits on fiscal deficits and sovereign debt were reiterated by the Stability and Growth Pact (1997), transgressors were liable to fines which, had they been enforced, would have made a bad situation worse. With no credible sanctions, the only constraint was that of self-restraint.

For a nation with a sovereign currency, exchange rate depreciation/inflation is a policy option that delivers a partial sovereign debt default as effectively as any direct debt 'restructuring'. It follows that the restructuring of Greek debt in 2012 was no different in principle from (say) the serial devaluations of the French franc through to the adoption of a new denomination in 1960. For Greece, debt restructuring was an acknowledgement of an inadequate tax base from which to repay sovereign liabilities. There is no blood in stone. By contrast, Ireland's conduct in repaying creditors in full is regarded as exemplary. While this might explain the muted response of the ECB to Ireland's bonds-for-promissory-notes swap, it is as plausible to suggest that the ECB was powerless to prevent it. Also noteworthy is the double standard in forcing losses upon uninsured depositors of Cypriot banks: 'creditor states, led by Germany, were all too willing to make taxpayers bail out bank investors when the taxpayers were Irish and the investors their own banks, insurers and pension funds' (*Financial Times* 2013).

6. The viability of the Eurozone

There were no precedents for the separation of multiple fiscal authorities from a single independent monetary authority. Yet, while it might have been argued that the European Union was entering uncharted waters, the long-term viability of the euro project was questioned at the outset by Milton Friedman, among others: the euro's 'real Achilles heel will prove to be political; that a system under which the political and currency boundaries do not match is bound to prove unstable' (Friedman and Mundell 2001, p. 10).

With that expectation having been resoundingly confirmed, for the Eurozone to survive it will be necessary to allow monetary financing to wipe a number of slates clean. There will be resentments. Thenceforward, a number of sovereigns must be subjected to fiscal discipline imposed from the centre. There will be further resentments. A long haul is inevitable in which the uncertain prospects are redolent of lines by Shakespeare:

> I am in blood stepped in so far that, should I wade no more,
> Returning were as tedious as go o'er.
>
> (*Macbeth*, III. iv. 137–8)

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Notes

1. 'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough' (Draghi 2012).
2. 'If a central bank can potentially create unlimited money from nothing, how can it ensure that money is sufficiently scarce to retain its value?' (Jens Weidmann, quoted in Armitstead 2012). Though less overt than OMT, the ECB has already acquired in secondary markets large volumes of sovereign bonds issued by peripheral Eurozone members.
3. Trans-European Automated Real-time Gross Settlement Express Transfer System (see Whittaker 2011).
4. Action by aggrieved creditors remains a live issue (see Bradley 2013).

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