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Monetary financing of public investment: a viable way forward for the euro area?

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This article poses the question of whether monetary financing of public investment constitutes a viable way forward for the euro area. The problems of low inflation, high unemployment and public debts seem scarcely resolvable in an environment that is constrained by the virtual exhaustion of monetary policy and legal limitations on expansionary fiscal policy. The author draws on the literature on monetary finance to identify key features of a scheme that could function in the context of EMU. He proposes to achieve an indirect monetary financing of public investment by the ECB committing to take newly issued EIB bonds on to its balance sheet. This would be essentially costless in a deflationary environment and could be expected to exhibit high multiplier effects. The independence of the ECB is maintained by making bond purchases subject to an inflation ‘trigger’.

Keywords: *monetary finance, monetary policy, public investment, euro area, ECB, EIB*

JEL codes: *E02, E12, E22, E24, E31, E58, E62, E63, H54, H63*

1 INTRODUCTION

On current policies the euro area faces the very real prospect of a decade-long quasi-stagnation marked by stubbornly high unemployment, and a constant risk that a negative shock leads to a renewed slide into recession, political turmoil and the break-up of the currency area. Even if this fate is avoided, recovery is currently painfully slow and it is already clear that the goals set under the Europe2020 strategy, which are supposed to guide the actions of member states and the EU authorities, have largely fallen out of reach. Substantial policy changes are needed to ensure a strong and broadly based upturn that lastingly banishes fears of recession and deflation, restores balance sheets, and absorbs unused capacity, rapidly and sustainably reducing unemployment from its unacceptably high levels. What is required is a combination of a more vigorous approach to raising aggregate demand and output in the short term with a medium-term strategy to expand the productive capacity of the European economy and re-engineer it so as to enable it to meet the challenges of the future. Faced with the apparent limited traction of the increasingly unconventional policies adopted and the need for insurance against shocks there has recently been growing interest in the option of monetary financing of public expenditure, or helicopter drops as they are commonly referred to, as an important element.

This article puts forward a concrete proposal for the overt monetary financing of public investment, a form of quantitative easing in which bonds newly issued by the European

* I have benefited greatly from valuable discussions with colleagues from the IMK, the Austrian Chamber of Labour, the OFCE, Paris, and the ECLM, Copenhagen. Without implicating them in the remaining errors and the views expressed here, I would like to thank, in particular: Pasquale d’Apice, Stefan Ederer, Dirk Ehnerts, Bela Galgoczi, Willi Koll, Marc Lavoie and Simon Wren-Lewis. The present article draws on and updates a proposal originally made in Watt (2015).

Investment Bank (EIB) are purchased, on secondary markets, by the European Central Bank (ECB), and the financial resources are made available to national governments to finance investment projects. The scheme is explicitly time-limited by being made subject to a price-stability criterion. And it explicitly links the provision of central bank money to actual higher spending in the economy, rather than this being based on a hope and a prayer as with quantitative easing.

The structure of the argument and article is as follows. First the poor performance of the euro area since the crisis and the reasons for scepticism concerning fundamental improvements given currently practised policy alternatives are discussed (Section 2). After a brief excursus on the concept of monetary financing and its place in economic theory and policy debates (Section 3), a proposal is set out to combine quantitative easing by the ECB with additional public investment by the member states financed by emitting EIB bonds. A number of different options and modalities of the basic proposal are discussed (Section 4). Section 5 concludes.

2 EURO AREA UNDERPERFORMANCE AND POLICY LIMITATIONS

The post-crisis performance of the euro area has been markedly inferior to that of other advanced industrialised countries. This is true, notably, of the USA, the UK and EU countries that are not members of the monetary union, and, on some metrics, Japan. The euro area is the only one of these countries, or country groupings, that by 2014 had not regained the level of economic output achieved prior to the crisis, in 2007.

It is noteworthy that until 2011 the trajectory of economic growth in the euro area and in the EU as a whole were virtually indistinguishable; however, from 2012 a substantial gap opened up. This strongly suggests that the often-emphasised structural characteristics of EU member states, aside from their mere membership or non-membership of the common currency area, are not a plausible explanatory factor for the poor performance of the euro area economies, as such characteristics change only slowly (DeGrauwe 2014). Nor is demography a convincing explanation: evaluation per capita reduces the performance gap with the UK and US somewhat, but widens it considerably vis-à-vis Japan.

This suggests differences in the stance of both fiscal and monetary policy, compared to those in other countries and linked to the specific institutional features of the euro area, can be posited as key proximate causes.

The brief 'Keynesian' phase in the immediate wake of the crisis was much more pronounced outside Europe, and the shift to contractionary fiscal policy after 2010/2011 was more pronounced in the euro area than in the US, the UK and Japan. In 2010 the fiscal deficit was between 8 per cent and 10 per cent of GDP in the UK and Japan, and as much as 12 per cent in the US; in Europe the deficit widened to only 6 per cent, providing a much more limited cushion to the contraction of private spending. Although the existing level of the deficit was much lower and the growth pick-up weaker, the deficit was reduced faster in Europe than in the US and Japan between 2010 and 2011.¹

1. Cyclically adjusted (structural) figures are, in principle, a better guide to the fiscal stance. Not least in the current environment, their estimation is fraught with difficulty however (OFCE/IMK/ECLM 2014: 42ff). There can be little doubt, given the growth figures discussed earlier, that the cyclical position is less favourable in the euro area than in the other countries. The deficit figures therefore understate the extent to which fiscal consolidation has burdened the euro area economy as compared with fiscal developments outside it.

The pronounced differences in fiscal policy were amplified by those in the conduct of monetary policy.² Interest-rates were reduced in all major economies in the wake of the crisis, but more resolutely and rapidly in the US and UK. Rates were subsequently *tightened* by the ECB in the spring of 2011, a mistake avoided by the central banks in the English-speaking countries. Most notably, there was a completely different approach to quantitative easing (QE). Both the Federal Reserve and the Bank of England (BoE) launched pre-announced purchases over extended periods of, in particular, large volumes of government bonds: at the height of its QE operations, the Fed was purchasing US\$80 billion per month, a figure steadily reduced to zero (taper) in the course of 2014 as the economy recovered. In addition to purchases of UK gilts, the BoE injected money into the banks subject to conditions that it led to increased credit creation (Funding for Lending).

The expansion of the ECB's balance sheet was markedly less pronounced than that in the other countries. It was mostly achieved via injections to the banking system, in particular the long-term and very long-term refinancing operations (LTRO, VLTRO). However, conditionality was weak or non-existent, and household and corporate lending remained negative, while M3 growth was sluggish. Repayments of earlier loans by the banks subsequently led to a major contraction of the ECB balance sheet of the order of €1 trillion (OFCE/IMK/ECLM 2014: 111). The announcement of the OMT programme in September 2012 – a declaration of willingness in principle to buy sovereign bonds if needed to avoid speculative attacks against sovereign bonds, conditional on participation in an adjustment programme – was vital in stabilising expectations and improving confidence. It did not actually lead to QE measures, though. In the course of 2014 the ECB, in the face of its shrinking balance sheet, belatedly began to step up purchases of covered bonds and asset-backed securities. A small 'targeted' LTRO program was initiated (broadly on the funding for lending model). Not until 2015 was a fully fledged QE program launched. There were initially positive impacts on the exchange rate and core inflation rose a little. Outcomes would doubtless have been worse – and very possibly catastrophic – without the QE program. Yet real and nominal target variables have not been lastingly shifted onto higher trajectories. The outcomes were so sobering that the ECB was obliged to ramp up the measures in the spring of 2016.

Combining the analysis of fiscal and monetary policy it is clear that a large part of the performance differential between the euro area member states and comparable countries reflects the inability or unwillingness of macroeconomic policy in the euro area to provide the necessary stimulus.

The currency union has suffered from, and continues to endure, a massive shortfall in overall aggregate demand, the clear signs of which are: very low real economic growth, double-digit unemployment, and extremely and persistently low inflation. The last time Harmonised Index of Consumer Prices (HICP) inflation was in accordance with the ECB's mandate was the start of 2013. The more indicative core rate (excluding energy, food, alcohol and tobacco) has been consistently at or below 1.0 per cent since September 2013; the substantial QE program in 2015 achieved an initial small boost, but no lasting rise. Consequently inflation expectations have begun to 'de-anchor'. The resultant persistently low *nominal* GDP growth mires Europe in stagnation by delaying balance-sheet repair (in both the private and public sector) and leads to a reticence to invest (Lindner 2014). At 19.3 per cent the investment rate is around two percentage points below the long-run average (even excluding the precrisis boom; European Commission 2014).

2. For a more extensive discussion, see OFCE/IMK/ECLM (2014: 107ff).

What is the scope for more expansionary fiscal and monetary policies, given the institutional set-up, the current economic and political state of the euro area and its member states? There are a number of serious reasons for scepticism (for more details and references, see Watt 2015: 6ff).

Expansionary fiscal policy by the member states is tightly constrained by a complex and highly restrictive set of fiscal rules, at both national and supranational level. If the rules are applied strictly, only Germany of the larger countries has substantial fiscal leeway. Yet Germany has very low unemployment and the German coalition government has repeatedly reiterated its intention to achieve fiscal surpluses in coming years, not least with reference to its national debt brake, even if unplanned expenditure related to the refugee crisis in 2015 provided a small stimulus.

In practice the EU Commission has effectively turned a blind eye to violations of the fiscal rules in a number of larger countries, such as Spain, Italy and France. This has offered some temporary relief of the fiscal squeeze, but cannot provide the sort of lasting fiscal boost needed to break deflationary pressures and dynamise the recovery. Any improvements in the pace of nominal GDP growth risk leading to a renewed tightening of policy in countries that have been granted temporary leeway.

The only way that *substantial and sustained* expansionary fiscal policy will be forthcoming is through substantive changes in the fiscal rules, such as some form of golden rule to exempt credit-financed public investment (Truger 2016). This would require changes to European treaties and legislation. Moreover, the spread of debt-brakes into national legislation (and even constitutions) thanks to the fiscal compact means that these legal frameworks would also have to be revised.

The European-level budget is very small (around 1 per cent of GDP), fixed for multi-annual periods, and the Union has no independent fiscal (that is, borrowing) capacity. In late 2014 the Commission announced a so-called Investment Plan for Europe, more popularly known as the Juncker Plan, which is supposed to mobilise at least €315 billion in additional investment.³ The Plan runs for 3 years, so if fully realised the investment boost would amount to just over 1 per cent of GDP each year. After approximately 1 year the Commission claims that the investment boost is on track, although how much of this investment would have occurred anyway is disputed (and ultimately unknowable) (Claeys/Leandro 2016).

While a further expansion of QE is possible, doubts about its effectiveness are widely shared, whereas one of the QE channels is about positively affecting expectations. The scope for further stimulus via exchange-rate depreciation is very limited given the already large current-account surplus. There are also concerns about risks and negative side-effects of a QE strategy of this type (distribution, bubbles). Such impacts pose question-marks about the sustainability of a growth model driven by central bank asset purchases.

In any case we need to ask ourselves whether our expectations have not been excessively diminished in the course of this long-drawn-out crisis. Even the best outcome would imply that the negative economic and social impacts of the crisis will be with us for many more years to come. The agreed and eminently reasonable goals of the Europe2020 strategy would certainly lie in ruins. Yet they also constitute a

3. The Commission provides regularly updated information here: http://ec.europa.eu/priorities/jobs-growth-investment/plan/index_en.html/. For critical evaluations, see Claeys et al. (2014); Horn et al. (2015: 8ff); Münchau (2014); OFCE/IMK/ECLM (2014: 52ff).

commitment by European policymakers to citizens, alongside the fiscal and monetary rules, albeit a less binding one.

3 MONETARY FINANCING IN ECONOMICS AND ECONOMIC POLICY: COMING BACK IN FROM THE COLD?

Monetary financing, as understood here, is the purchase of new government bonds by the national central bank in return for newly created base money so as to finance an expansionary fiscal policy. Such a policy is often described using the term ‘helicopter money’, going back to a metaphor credited to Milton Friedman in which the central bank throws newly printed banknotes out of a helicopter to the pleasantly surprised members of the community below (cf., for example, Buiter 2014; Turner 2013: 3f; Wren-Lewis 2014). In the real world the channel by which the additional central bank money enters circulation is through a fiscal measure, of which there are three main types: the government can use the base money created by the central bank to cut taxes, to make transfers to households, or to engage in higher government spending.

For decades there was a virtually complete consensus among academic economists and policymakers that monetary financing was akin to an extremely dangerous drug that should forever be locked away. Its use was a ‘taboo’ (Turner 2013: 3).

As has repeatedly happened in economic history, though, an academic and policymaking consensus came under pressure when real-world conditions changed: as the problem of public debt management once more became acute, while the inflationary threat receded and indeed gave way to the threat of deflation, questions began to be raised about the wisdom of insisting on a clear and permanent separation between monetary and fiscal policy (Goodhart 2012: 129; Lastra 2012). It is therefore no coincidence that the question of monetary financing of expansionary fiscal policy first raised its head once again in Japan, in the wake of the persistent slump that began there in the 1990s, nor that the same phenomenon has emerged more recently in the context of the high public debts and deflationary threat in the euro area.

In 2003 Ben Bernanke, then chairman of the US Federal Reserve, gave a speech in Japan in which he proposed ‘explicit, though temporary, cooperation between the monetary and the fiscal authorities’, in order to overcome the persistent stagnation and deflation afflicting the country, and bring rising public debt under control (Bernanke 2003).

Bernanke analysed the difficulties that the Bank of Japan (BOJ), on its own, faced in overcoming the deflationary mindset and stimulating the economy. He also argued that fiscal policy alone might have had weak effects due to ‘Ricardian’ effects – that is, higher private-sector saving – that come from the lack of confidence engendered by rising debt levels and ratios. He then proposed:

... a tax cut for households and businesses that is explicitly coupled with incremental BOJ purchases of government debt – so that the tax cut is in effect financed by money creation. Moreover, assume that the Bank of Japan has made a commitment, by announcing a price-level target, to reflate the economy, so that much or all of the increase in the money stock is viewed as permanent. Under this plan ... the government’s concerns about its outstanding stock of debt are mitigated because increases in its debt are purchased by the BOJ rather than sold to the private sector. Moreover, consumers and businesses should be willing to spend rather than save the bulk of their tax cut: They have extra cash on hand, but – because the BOJ purchased government debt in the amount of the tax cut – no current or future debt service burden has been created

to imply increased future taxes. Essentially, monetary and fiscal policies together have increased the nominal wealth of the household sector, which will increase nominal spending and hence prices. (Bernanke 2003)

He emphasised that the proposed policy was in theory not costless, but in practice, *given the prevailing conditions*, it was:

Of course, one can never get something for nothing; from a public finance perspective, increased monetization of government debt simply amounts to replacing other forms of taxes with an inflation tax. But, in the context of deflation-ridden Japan, generating a little bit of positive inflation (and the associated increase in nominal spending) would help achieve the goals of promoting economic recovery ... In the face of inflation, which is often associated with excessive monetization of government debt, the virtue of an independent central bank is its ability to say 'no' to the government. With protracted deflation, however, excessive money creation is unlikely to be the problem, and a more cooperative stance on the part of the central bank may be called for. (Ibid.)

In a nutshell Bernanke's arguments suggest that monetary–fiscal cooperation (i) is an effective policy, (ii) can be deployed when other policies have failed, and (iii) should then be so deployed, provided there are safeguards to ensure that the policy is temporary, and specifically that it will be discontinued once the central bank is confident that it can achieve price stability on its own and be in a position once again to say 'no to the government'.

A decade later the parallels with the situation in the euro area are obvious: persistent failure to reach the central bank price stability target, high and rising public debt, negative or sluggish growth and mass unemployment. Accordingly there have been an increasing number of discussions of, and proposals for, various types of monetary financing. Adair Turner (2013) set out the arguments for, and the conditionality that needs to be ensured when resorting to, what he calls 'overt monetary financing'.⁴ Turner is explicit that it is vital to leave the central bank with the responsibility to determine the volume of monetary financing it considers compatible with the price-stability mandate it has been given (ibid.: 39). He echoes the arguments of Bernanke 10 years earlier that monetary financing can be necessary in some circumstances, but adds a further one: even where it is not necessary, it can be *preferable* to other policies, if these have adverse side-effects, such as causing risks to financial stability (ibid.: 26f).

Buiter (2014) establishes the theoretical conditions under which a helicopter drop – permanent base-money-financed fiscal expansion – will always stimulate aggregate demand. He concludes that the conditions do hold in modern fiat-money economies and that deflation and economic stagnation are unnecessary, a 'policy choice' (ibid.: 1).

Gali (2014) shows that in a realistically parametrised New Keynesian model with typical nominal rigidities that monetary financing of expansionary fiscal policy (here: higher government purchases) has a very strong effect on output and a much smaller one on prices. The effects (the fiscal multipliers) are larger than with debt financing and the results do not depend on the existence of non-Ricardian (credit-constrained) households or a central bank that is already at the lower bound.

Giavazzi/Tabellini (2014) propose a tax cut (for example, of 5 per cent of GDP) by all euro area member states, financed by the issuance of long-term debt, all of which is bought by the ECB. The interest is returned to the member states. Blyth/Lonergan (2014) and Muellbauer (2014) argue for programmes involving money-financed tax

4. I follow Turner in adding the adjective 'overt'. While arguably not strictly necessary, it helps to distinguish the proposal made in the next section from a QE that is combined, fortuitously, without coordination, with an expansionary fiscal policy; more on this below.

cuts, emphasising in particular the better distributional outcomes and reduced financial risks compared with a QE programme alone.

There are trade-offs between the different fiscal policy options within a monetary financing programme. An advantage of tax cuts or cash transfers over public investment is that they are effective more immediately. Clearly a decision is required on the precise form they take, implying different distributional outcomes. The empirical literature shows that fiscal multipliers are considerably higher for investment than for transfers or tax cuts, however, and this differential widens in the context of a recession (Gechert/Rannenberg 2014; Gechert et al. 2016).

A recent study by the IMF (2014: 75ff) shows clear longer-run benefits, on both the demand and the supply side, from public investment, especially when conducted in times of substantial economic slack. The average multiplier in advanced countries is 0.4 in the short run and 1.5 after 3 years, but in times of economic slack these rise to 1.5 and as much as 3 respectively (IMF 2014: 82). It also notes the substantial declines in the public capital stock and public investment (as shares of GDP) in advanced countries (IMF 2014: 79f). Simulations by the Macroeconomic Policy Institute (IMK) (Horn et al. 2015: 10f) indicate multipliers of a similar order of magnitude for an investment push of 1 per cent of GDP for the euro area for 3 years. However, this simulation assumes that all European Monetary Union (EMU) countries debt-finance an investment push of this magnitude: as the previous section showed, this is highly unlikely under current conditions. Also the IMF study points out that, at high debt-to-GDP ratios, debt-financed infrastructure investment may become less effective due to negative confidence effects, echoing Bernanke's analysis of the Japanese situation.

These considerations suggest that, in the current environment, public investment is likely to be more effective than tax cuts or 'cash' distributions in stimulating demand and output, and that monetary financing of such investment might be more effective than debt-financed public investment, which in any case is unlikely to be forthcoming in the euro area. Yanis Varoufakis, Stuart Holland and Jamie Galbraith have proposed an investment boost financed by the EIB and ECB jointly, as part of a 'modest proposal' to end the euro crisis (Varoufakis et al. 2013). It has some resemblance to the proposal made in the next section, although, importantly, it lacks an explicit inflation safeguard.

A number of authors have pointed to the similarities between overt monetary financing and QE involving the purchase of existing sovereign bonds. In both cases money is created by the central bank in order to buy an asset. In overt monetary financing it is used explicitly either to cut taxes, hand out grants or finance government spending on goods and services. It is, in a sense, the explicit combination of two familiar instruments, QE and expansionary fiscal policy (for example, Wren-Lewis 2014).

Consequently, QE by the ECB plus an autonomous, uncoordinated fiscal expansion by member states would be a sort of functional equivalent to overt monetary financing. The multipliers would probably be somewhat smaller (because, at least initially, debt ratios would rise from already high levels). The distributional and other drawbacks of QE would remain. But much the more important objection is that such a serendipitous outcome would have to overcome the obstacle of the current fiscal rules, both European and national (see above and also Ederer 2015).

A counterargument raised against QE and monetary financing alike is that losses may be incurred on the central bank balance sheet and the costs borne by the taxpayer. This is essentially to mistake an accounting convention for a real-world loss of resources. The 'loss' consists of higher inflation (cf. Whelan 2014). Moreover, as Wren-Lewis (2015) points out, fears of accounting losses from monetary financing of a helicopter drop cannot be a sensible counterargument, once it is accepted that QE is desirable in a given circumstance. Under QE the

central bank can be forced to take losses if it sells bonds it has bought at high prices (and it buys when interest rates are low, and thus prices high) back to the market at lower prices.

When the central bank purchases government bonds from the public, it creates ('prints') central bank money and takes bonds from private-sector balance sheets onto its own. The government now owes the same amount to the central bank as it had to the public, and interest is also due. Yet the central bank is a government entity. If the government uses taxes to service the debt, the resulting 'profits' of the central bank are transferred back to the government coffers at the end of the year. The sums merely change from one pocket to another of the government's 'trousers'. The money created by the central bank is treated in accounting terms as a liability of the central bank. But the debt itself has become economically meaningless. The distinguishing feature of the central bank is that it, and it alone, can create the general means of payment at will (and essentially costlessly). Consequently there is no impairment to the functioning of the central bank due to the fact that it has taken losses on the asset side of its balance sheet. It is true that the debt has not 'disappeared', but it exists *in the form of money*, which pays no interest and, in the modern fiat money system, cannot be redeemed for any valuable real asset.

The reason we do not normally want the central bank to finance fiscal deficits with money creation is not to prevent the insolvency of the central bank, but to guard against runaway inflation. But in a situation of massively under-utilised resources, and when the central bank is desperately trying to push inflation up to its target and avoid the risk of a debt-deflationary spiral, inflation is not a cost of monetary financing: it is a wanted feature of such a strategy.

To close, we return to the issue of the monetary/fiscal-policy link. Opposition to both QE and monetary financing often derives from a belief that monetary and fiscal policy are inherently completely different and must be kept separate. However, this is a purely semantic argument. As we have seen, the relationship between monetary and fiscal policy has changed over time. It is true that QE and monetary financing have distributional implications. But so does monetary policy of all sorts, always. The standard argument is that this is permissible, and monetary policy can be performed by a technocratic institution, not an elected government, provided monetary policy is not implemented in order to achieve such effects, but so as to achieve the price stability mandate; the distributional impact is a by-product. Once again, then, we can conclude that there are no grounds for the taboo on monetary finance *subject to one important condition*: it must serve the interest of attaining the democratically legitimated mandate that has been given to the independent central bank. A key issue for any proposal relying on overt monetary finance is therefore to show that it meets this requirement.

4 A CONCRETE PROPOSAL FOR CONDITIONAL OVERT MONETARY FINANCING OF PUBLIC INVESTMENT

This section makes a concrete proposal for the euro area. It explicitly ties money financing and fiscal expansion, specifically public investment, together and does so in a way that seeks to make it compatible with, and effective within, the constraints set by the realities of EMU. Related to that, a particular concern is to introduce safeguards against a possible misuse or overuse.

The simplest form would be for the ECB to credit the account of each member state government with an agreed share of the total volume of monetary financing. However, this would clearly contravene the Treaty prohibition against direct monetary financing. Moreover, there would then be no mechanism to ensure that governments use the

finance made available to conduct investment projects that contribute to achieving common European goals. To resolve these two issues a more circuitous financing route is necessary, one that, however, remains transparent and ensures accountability of the relevant institutions (cf. Varoufakis et al. 2013; Wolff 2014). The challenge is to raise public investment spending without governments breaking fiscal rules, making use of the central bank's ability to issue base money, without transgressing the legal constraints on monetary policy.

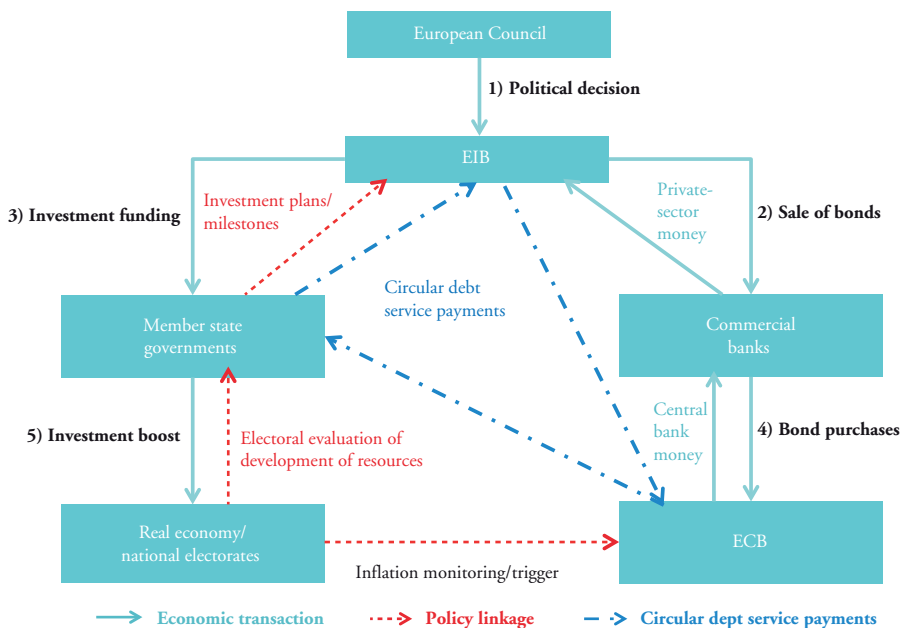
4.1 The basic proposal

A proposal to achieve this could be envisaged along the following lines. A time-limited and conditional policy of QE in the euro area is initiated via a pre-announced and substantial volume of purchases by the ECB, on the secondary market, of newly created EIB bonds. The funds are made available to euro area member-state governments for the purpose of financing public investment projects that meet certain minimal European guidelines. There is no co-financing requirement. Any debt service payments circulate within the 'public sector', between member state governments, the EIB and the ECB. A number of parameterisations and variations of the scheme can be envisaged (see Section 4.2); first we set out the basic mechanisms:

- The scheme is established based on a decision by the European Council and initially given a timescale of, say, 5 years that clearly establishes this form of central bank support for public investment as a temporary phenomenon necessitated by the risk of deflation and/or longer-term stagnation and the break-up of the currency union. Within this framework, the EIB emits long-duration bonds on a degressive scale. Starting from an initial level, the volume of bonds issued is progressively reduced to zero.
- The ECB initially commits to purchasing these bonds on the secondary market and holding them on its books. The EIB's triple-A rating coupled with the pre-announced central bank purchases will ensure extremely low interest rates. The ECB commitment is conditional, however. In order to ensure conformity with the ECB's Treaty obligation to ensure price stability – currently being infringed on the downside – a trigger mechanism is incorporated: if economic recovery is sufficiently strong that inflation (or nominal output) rises above a certain threshold, the ECB will progressively withdraw from the purchases.
- The EIB makes the funds generated by its bond placements available to member states for public investment purposes. The precise way resources are allocated between member states can be varied to meet different policy aims and considerations of political feasibility (see below). Member states submit projects for funding that meet a small number of European guidelines (for example, conformity with the goals of the Europe2020 strategy, climate-change commitments, etc.). The EIB is not responsible for detailed vetting of proposals, as is the case with its normal lending. This programme is separate from its other operations. Equally the usual requirement for member-state co-financing is waived. Projects can but need not themselves generate a revenue stream (but must be shown to have a positive social cost–benefit relationship).
- Member states conduct the projects with monies being disbursed following the accomplishment of agreed project milestones. Member-state governments are responsible and accountable to their electorates for the quality of the projects financed using the money made available to them.

- The lending by the EIB to member states is not counted under the EU fiscal rules. There are a number of important reasons for this. The maximum amount of lending to any member state is decided collectively with a view to a common goal of relaunching the European economy. There is also European control over the type of spending; in particular, this is limited to positive-social-return investment projects, excluding for instance higher current transfers. More fundamentally, debt remains within the public sector. Debt-service payments flow from member states to the (member-state-owned) EIB, to the European public entity the ECB; because the central bank distributes its profits to member states, the flow is essentially circular.⁵

A graphic visualisation of the scheme is given in Figure 1.



Source: Author's depiction.

Figure 1 Visualisation of the COMFPI scheme

5. In Watt (2015) it was argued that the issue of debt-servicing was entirely 'fictitious' and the bonds could be withdrawn and no interest or principal payments made; the 'debt' takes the form of a permanent increase in the monetary base. While, as the previous section has shown, this is true in simple macroeconomic terms, in a pure and permanent monetary financing by the central bank, the incorporation of the EIB in the proposal complicates matters. The EIB cannot absorb (large) losses on its balance sheet. For this institutionally driven reason, not out of a rejection of monetary financing in principle, the transfer to member states should take the form of loans, and the ensuing, rather artificial circular flow of payments accepted as necessary to make such a scheme feasible given European constraints. I am indebted to a number of colleagues for helping me to clarify my thoughts on this issue, including Fabian Lindner, Thomas Theobald, Marc Lavoie, Jan Priewe and Massimo Cingolani. Of course they bear no responsibility for the outcome as presented here.

A number of features of this approach can be considered important strengths in the current economic and political context:

- A predetermined volume of additional real spending on goods and services is reliably and predictably injected into the sluggish European economy, independently of the state of the banking sector, raising real incomes and setting off multiplier and also anti-disinflationary effects (cf. IMF 2014: 75ff). This is in marked contrast to QE via purchases of existing private or public sector assets, which do not of themselves create additional real spending but, rather, rely on indirect and uncertain channels and risk negative side-effects.
- Government budgets are not burdened with additional debt under European rules for as long as bonds are bought and held by the ECB. The fiscal burden of servicing the loans is approximately zero. Deficit and debt ratios will decline due to the faster nominal GDP growth. Multipliers will be larger than with bond-financed expansionary fiscal policy (in the unlikely event that this can be done, given EU rules) to the extent that Ricardian effects due to (initially) rising debts and debt ratios are avoided.
- Investment in areas crucial for Europe's future can be rapidly implemented, raising productive capacity and productivity, and crowding-in private investment, but without having to coax private capital through subsidies as under the Juncker Plan or being restricted to projects that generate revenue streams. There will be no crowding-out because there will be no increase in interest rates.
- There will be some upward pressure on inflation for a limited period, which will aid deleveraging and re-establish confidence in the ECB achieving its mandate. At the same time it is assured that the ECB can end the monetary financing in line with that mandate. Meanwhile the letter of the Treaty prohibiting direct monetary financing is respected. Legal challenges to the 'fudge' (Buiter 2014: 45) of secondary-market purchases are to be expected, but they occurred in the case of OMT and will also be forthcoming in the case of QE and real or supposed transgressions of the fiscal rules. Legal challenges will not prevent the scheme being launched. The prerequisite here is political, that is, a qualified majority on the European Council.
- The scheme relies on already existent institutions and can be implemented quickly. The EIB can make investment decisions based on a simple or qualified majority of its Boards of Governors and Directors and cannot therefore be blocked by small numbers of individual countries.⁶ Although the actual investments will take some time to come on-stream, positive ex-ante effects on confidence can be expected. (At the same time, the incorporation of the EIB is not vital and, in principle, a dedicated institution could be set up for the purpose.)
- The proposal is scalable and it can be progressively wound down as necessary and contingent on incoming information about the state of the European economy. It is not mutually exclusive to other measures on the monetary or fiscal side (and could be rescaled accordingly).
- The scheme eases the problem of which assets the ECB should buy, offering a market of, in principle at least, unlimited size and a low-risk security.

6. The governance structures of the EIB are explained here (pp. 6ff): http://www.eib.org/attachments/general/governance_of_the_eib_en.pdf/.

4.2 Parameters and options

A number of parameters and alternatives exist within this overall approach, each with specific advantages and drawbacks, which can be determined in the light of political feasibility and other considerations. They relate to the size and duration of the scheme, to the trigger underpinning the price-stability mandate of the ECB, the allocation of funds between member states.

- *Size and duration:* As a point of departure, a 5-year programme could be proposed with a degressive bond issue of €250 billion in the first year (2015), falling by €50 billion each year. This represents roughly 2½ per cent of euro area GDP in the first year falling by ½ a percentage point each year. The aim is to boost spending as fast as possible, but also to allow for the time needed to deploy resources efficiently. The total volume (€750 billion) represents some three-quarters of the balance-sheet expansion envisaged by the ECB under QE, but spread over a longer period. In the iAGS 2014 report, capital investment needs of around €200 billion per year were identified, based on various policy commitments (for example, in the area of climate change). In the Commission's AGS 2015, an investment gap of between €230 and €370 billion is estimated. This is a serious understatement, however: it is based on reattaining an investment share of between 21 and 22 per cent of GDP but 'accepts' the heavily depressed level of GDP as the benchmark for that calculation, and ignores the need for additional investment to meet agreed policy objectives. In the light of these comparators the proposal seems appropriately dimensioned, but it can be rescaled according to need.
- *Inflation target:* The trigger to safeguard the independence of the ECB to pursue its mandate can be defined in various ways. For instance, central bank purchases could be wound down to zero over a 6-month period after the core inflation rate in the euro area has exceeded 2.5 per cent for 3 consecutive months. Other rates and durations could be chosen. Also a price-level or NGDP-level target would be conceivable, as recommended by many economists, in order to clearly signal a willingness to reverse past deflation or lowflation. Ultimately the operational definition of a trigger is an issue for consultations between the ECB and the eurogroup. It would be in accordance with the principle of forward guidance for the ECB to announce the trigger publicly in advance.
- *The disbursement of funds by the EIB to member states* can in principle be designed in any number of ways. In purely economic terms a concentration of funding in countries with large output gaps and high unemployment would seem appropriate. Political considerations will probably require a broader distribution, however. The simplest and probably most politically feasible version would, like QE, disburse funds in accordance with the ECB capital key. The capital key gives more per capita to countries with high incomes, however. Another solution would be to distribute investment funding on the basis of population.

5 CONCLUSION

The euro area remains in a perilous situation, economically and politically. The combination of expansionary monetary policy, fiscal austerity and so-called 'structural reforms' has failed. The economic outlook has brightened somewhat, but remains bleak in many areas and at risk of sudden reverses. The threat of break-up has not been averted. In a number of

countries opposition parties are gaining in strength that are openly calling for exit and/or default, and indeed at the time of writing the UK appears to be on a path leading out of the EU.

It is conceivable that a mix of less restrictive national fiscal policy, the European Investment Plan and aggressive QE by the ECB might jolt the euro area economy out of stagnation. Experience to date suggests scepticism, however. This strategy also implies a number of risks (distribution, financial market stability) to balanced growth going forward. European and national rules block the substantial and sustained boost to public investment that is urgently needed. In order to underpin a broad-based and sustained recovery, boost public investment and finally make progress towards the Europe2020 goals, some form of public-investment-based QE, financed overtly but indirectly by ECB purchases, should be considered as part of policymakers' toolbox. It is not clear that it is absolutely necessary to bring about a cyclical recovery of the euro area. But it may well be necessary to underpin a sustained period of balanced and equitable growth. Moreover, even if not necessary, it appears a preferable strategy in many respects, provided its use is constrained to the current conditions of deflation or persistent 'lowflation'. Faster demand growth would create a more favourable environment for supply-side reforms to have positive economic effects.

A concrete proposal has been discussed in this article, one that would permit the use of overt monetary financing in the European context, but also provide for its return to a locked compartment of the toolbox once its task has been accomplished. That decision needs to be taken by the central bank. The view that overt monetary financing of fiscal policy is a viable and possibly necessary approach appears to be gaining ground in the academic and policy debate. How best to implement such ideas in practice is inevitably highly complex. I hope that this contribution helps to take this idea forward and will stimulate debate about how it could be operationalised in the difficult legal–political context of European Monetary Union.

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