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The Transformation of Eurozone Fiscal Governance: Mitigating Fiscal Discipline through a Proliferation of Off-Balance-Sheet Fiscal Agencies

Andrei Guter-Sandu* and Steffen Murau†

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The Eurocrisis dispelled the "neoliberal" Eurozone governance approach that the "efficient" crowd intelligence of private financial institutions would "discipline" the balance sheets of national sovereigns. Instead, during the Eurocrisis, the private balance sheets of Eurozone financial institutions contracted sharply and had to be bailed out by European treasuries. Rather than disciplining public balance sheets, private balance sheets forced the treasuries of the most crisis-ridden countries to massively expand and take on new debts for the bailouts. Even though these events should have sensitised European policymakers to the evolving complex role of public balance sheets for Eurozone governance, the official reforms—first and foremost the Fiscal Compact—reinforced the orientation towards market discipline. While these developments have been well-noted, what has been less explored is the proliferation of alternative channels for governance in the Eurozone. Indeed, we argue that the Eurocrisis has triggered a process of strengthening a distinct governance logic that emphasizes "off-balance-sheet fiscal agencies". Our paper traces the evolution of this mechanism of "governing through off-balance-sheet fiscal agencies" by looking at four off-balance-sheet agencies that acquired fiscal responsibilities: first, the European Investment Bank which predates the Eurozone; second, the European Stability Mechanism, which emerged during the Eurocrisis and may be transformed into a European Monetary Fund; third, the Single Resolution Fund, which comes close to a European deposit insurance scheme for systemically relevant banks; and fourth, the European Commission's plans for a special purpose vehicle to securitize national sovereign bonds and issue "European Safe Bonds".

* London School of Economics and Political Science, a.guter-sandu@lse.ac.uk
† Boston University, smurau@bu.edu

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1. Introduction

The Coronavirus pandemic saw Eurozone member states mobilising unprecedented sums of money to deal with its fallout. The European Central Bank (ECB) dished out loans left and right and hoovered up massive amounts of securities. It even crossed a small Rubicon when it announced that it would issue €750bn of mutualised debt to be used as grants and loans to pandemic-stricken EU member states (Brunsden, Khan, and Fleming 2020). European Treasury Departments have similarly been dabbling in innovative policy responses. From bailouts of big companies and no-questions-asked grants and guarantees to SMEs, to various forms of payroll retention schemes, temporary benefit top-ups, and even a universal basic income experiment in Spain, finance ministries have been busy devising ways of keeping the economy in survival mode whilst lockdowns ground everything to a hold. The concerted monetary-fiscal response helped contain the fallout from the pandemic and bought some time in the hope that a vaccine would soon be widely available.

For the past decade, the prodigious power that central banks like the ECB have accumulated—which, some have argued, even remains underutilised (Braun and Downey 2020; Woodruff 2019)—has attracted a growing number of scholars interested in the guiding forces of contemporary capitalism and has overshadowed to some extent developments in the functioning of Treasury Departments. For instance, a new lens has emerged that seeks to make sense of the increasing intertwining between states, central banks, and private financial markets. Dubbed "critical macro-finance" (CMF), this theoretical framework posits that in pursuit of policy goals states increasingly govern *through* financial markets, with central banks as pivotal actors that harness their reach into private financial markets and steer them towards achieving state aims (Dutta et al. 2020; Gabor 2020; Braun, Gabor, and Hübner 2018; Gabor and Vestergaard 2018; Mertens and Thiemann 2018). Private financial markets act as conduits for monetary policy, which confers them tremendous power given that central banks must ensure the wheels of the financial system are greased well enough for its transmission mechanism to function efficiently (Braun 2018).

Indeed, no encompassing narrative on the scale of CMF has emerged to make sense of how Treasuries, particularly in the Eurozone, fulfil their mandates and how this has transformed since the 2007-9 Financial Crisis and the ensuing 2009-12 Eurocrisis. For the most part, the post-crisis scholarship on developments in the fiscal arm of the state has focused, for good reason, on the austerity measures that have acted like a straitjacket on the fiscal capacities of many states (Crespy 2020; Perez and Matsaganis 2018; Stockhammer 2016; Matthijs and McNamara 2015; Blyth 2013). The massive bailouts and vast stimulus programmes unleashed to prevent economies from collapsing led to the swelling of national debt across countries. Increasing risk premia on sovereign debt, falling investor confidence, deteriorating credit ratings, and the discovery of a seeming debt threshold beyond which countries became insolvent (Reinhart and Rogoff 2010; later debunked, see Herndon, Ash, and Pollin 2014) led to the development of what has been called the "consolidation state" (Streeck 2014), a set of policies designed above all to restructure public finances and reduce governments' deficit ratios below the growth rate. In order to consolidate public finance, austerity measures of various types, self-imposed or dished out as conditionalities for sovereign bailouts, became the default policy to accomplish this. Furthermore, a flurry of new regulations—the 'Six Pack', the 'Fiscal Compact', the 'Two Pack'—designed to increase fiscal surveillance and strengthen the grip of EU's institutions on national budgets came into force in the aftermath of the Eurocrisis (Laffan and Schlosser 2016).

But behind this very visible battle fought through lengthy political deliberations, negotiations, and even referenda that froze or retrenched fiscal capacities in targeted countries and at the European level, other developments were in fact taking place that were supplementing or replacing Treasury functions through technocratic means and largely by stealth. In this paper, we argue that—even though the basic tenets of the what has been called the 'neoliberal' European economic governance model (Ojala 2020; Parker and Pye 2018) are still in place and have been re-emphasized repeatedly, e.g. via the 2010 European Semester and the 2012 Fiscal Compact as political responses to the 2009-12 Eurocrisis—Eurozone fiscal governance has increasingly developed a workaround. This is based on the continuously widening use of what we call 'off-balance-sheet fiscal agencies' (OBFAs), which by now has reached a systemic level and can justifiably be called a new mode of Eurozone fiscal governance. Activities that treasuries are not allowed or able to carry out by law, agreement, or political compromise increasingly get outsourced to balance sheets that are less restricted legally and politically—in some cases, they are even registered under a different jurisdiction. This process resembles in many respects the dynamics that lay at the core of shadow banking, which emerged in the 1970s to circumvent bank regulation. Similar to shadow bank special purpose vehicles, OBFAs create actual assets and liabilities that are guaranteed by treasuries but do not appear themselves on treasury balance sheets—only in the form of implicit contingent assets and liabilities which are not subject to accounting standards. Taken together, the balance sheets of treasuries and OBFAs in the Eurozone form a 'fiscal ecosystem'—a somewhat opaque medley of treasuries and OBFAs on a European and a national level that has a developed a specific division of labour given numerous constraints, many of them self-inflicted by the neoliberal fiscal governance logic. Within the logic of the Eurozone's fiscal ecosystem, the core ideas of the Eurozone's neoliberal fiscal governance remain prevalent in name only. Instead, they are alleviated by the spreading model of 'fiscal governance through OBFAs'.

Figure 1 depicts the setup of the Eurozone's fiscal ecosystem. For sake of simplicity, we focus on three countries—Germany, France and Italy—as representations of Eurozone countries with current and financial accounts that are in surplus, balanced, and deficit, respectively; still, the model could easily be extended to all Eurozone countries (EMU-19). On one hand, the model shows the national and supranational treasury balance sheets—i.e. the German, French and Italian national households, which have the right to raise taxes and issue bonds, as well as the EU "treasury" which we write in quotation marks as it does not have full rights to taxation and bond issuance. On the other hand, the model depicts a number of OBFAs, which complement and support the work of treasuries. On a European level, we can find the *European Investment Bank* (EIB), the *European Investment Fund* (EIF) and the *European Bank for Reconstruction and Development* (EBRD) as investment agencies; the *European Stability Mechanism* (ESM) to provide capital insurance of last resort; and the *Single Resolution Fund* (SRF) as solvency insurance for systemically important banks. On the national level, the model shows German, French and Italian national development banks (the *Kreditanstalt für Wiederaufbau*, KfW, the *Agence Française de Développement*, AFD, and the

Cassa Depositi e Prestiti, CDP) as well as national deposit insurance schemes (the *Einlagensicherungsfonds des Bundesverbandes deutscher Banken*, EBdB, the *Entschädigungseinrichtung deutscher Banken GmbH*, the *Fonds de Garantie des Dépôts et de Résolution*, FGDR, and the *Fondo di Garanzia dei Depositanti*, FGD).

For each of those institutions represented as balance sheets, we list different instruments that they issue as liabilities and hold as assets. The left side of the balance sheets indicates assets, the right side liabilities. We follow the Minskian idea that assets are financial devices promising a future cash inflow, whereas liabilities lead to future cash outflows (Minsky 1986). Note that while we abstract here from actual physical assets such buildings and roads, this perspective allows us to think of them as a form of bonds which yield future cash inflows.[1] The crucial cash-outflow-commitments are the sovereign bonds issued by treasuries or different forms of OBFA bonds. Importantly, our model distinguishes between 'actual assets and liabilities' in the upper row of each balance sheet and 'contingent assets and liabilities' in the lower row. Actual assets and liabilities can in principle be recorded on-balance-sheet at a particular point in time; the difference between both is the institution's 'equity capital'. However, an adequate analysis of the Eurozone's fiscal ecosystem must pay similar attention to contingent assets and liabilities. Those are implicit or explicit guarantees by higher-ranking balance sheets to create emergency liquidity in a crisis, which are not accounted on-balance-sheet in a crisis—they may also be called insurances or backstops. Fiscal governance through OBFAs, in its essence, replaces actual liabilities on treasuries' balance sheets with contingent ones.[2]

The remainder of this paper will analyse and explain different functions that OBFAs come to fulfil as supplements for national treasuries and the EU 'Treasury' in the Eurozone's fiscal ecosystem. Section 2 provides a historical background on how fiscal coordination was envisaged in official EU policymaking circles in line with a 'neoliberal' model and conceptualises the rise of OBFAs through the notion of fiscal governance at a distance. Section 3 carves out the new mode of governance through OBFAs which partly mitigates the neoliberal logic. We show how this affects four different activities that treasuries usually carry out. Thus, OBFAs support public investment, offer solvency insurance for banks, provide capital insurance of last resort for other treasuries, and expand the stock of safe assets. Section 4 concludes.

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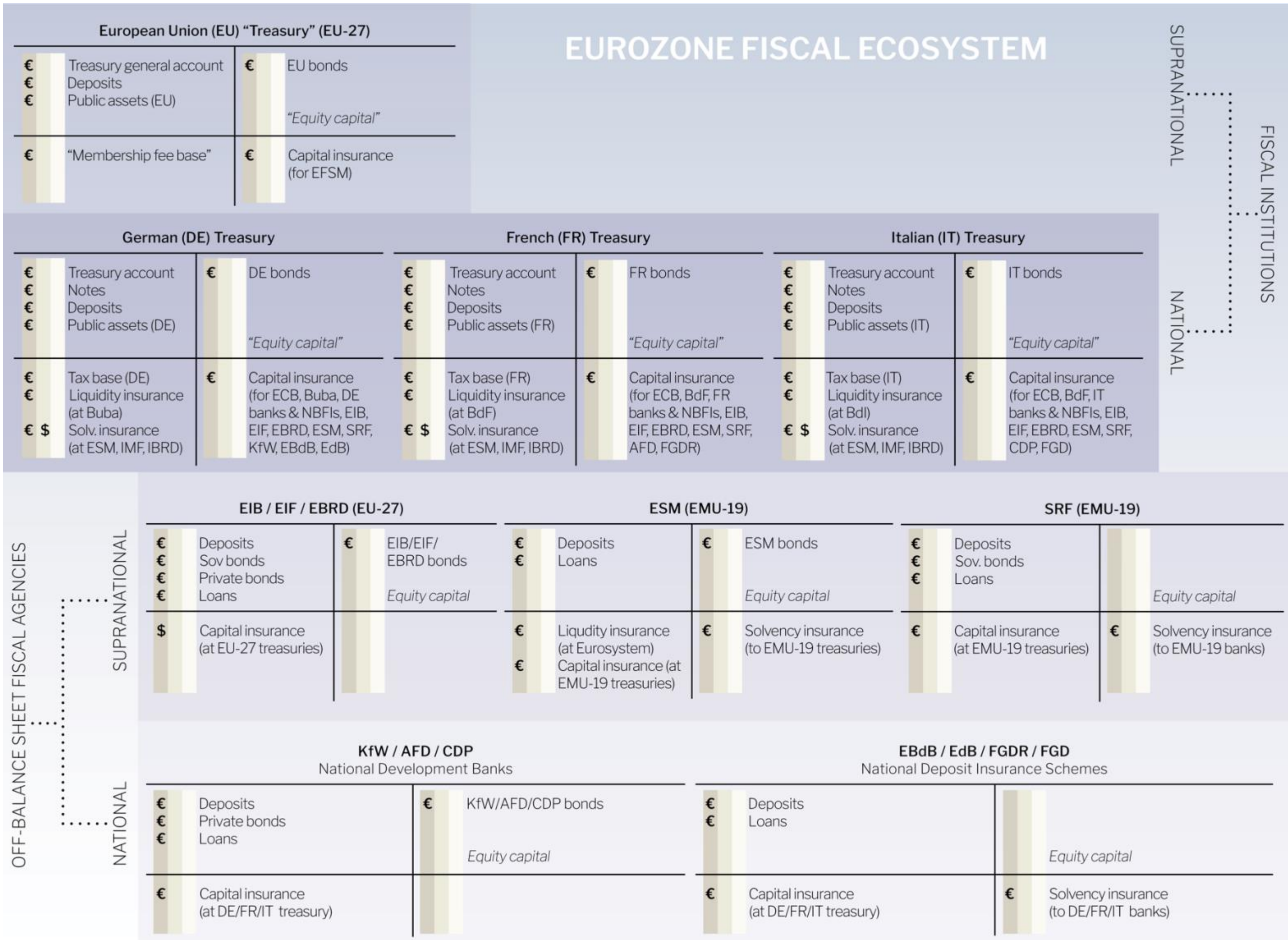
[1] It is important to stress that the balance sheets in this model are idealised economic balance sheets, not the actually reported balance sheets. A particular intricacy with treasuries as institution is that they often do not even public official balance sheets. In Germany, for example, the ministry of finance only operates with a cameralistic accounting methodology that registers cash inflows and outflows but does not compile actual balance sheets that would list everything the state owns and owes. The particular difficulty lies in assessing the value of public assets such as roads which cannot be resold and therefore do not have a market price. By consequence, this makes it close to impossible to come up with a statement about a state's 'equity capital'. Finally, it is always intricate to put a treasury's most important 'asset' on-balance-sheet: the tax base. The right of a treasury to tax its citizens is the main source of future cash inflows but can hardly be treated as an accounting item in a meaningful way. In our methodology, we treat the tax base as a contingent asset.

[2] Our way of depicting the Eurozone fiscal ecosystem as a hierarchical web of interlocking balance sheets in Figure 1 applies the methodology developed in Murau (2020), which presents a full model of the Eurozone architecture that comprises four different segments: central banking, commercial banking, non-bank financial institutions and shadow banking, as well as the fiscal ecosystem.

Figure 1—The Eurozone's Fiscal Ecosystem, made up of treasuries and off-balance-sheet fiscal agencies

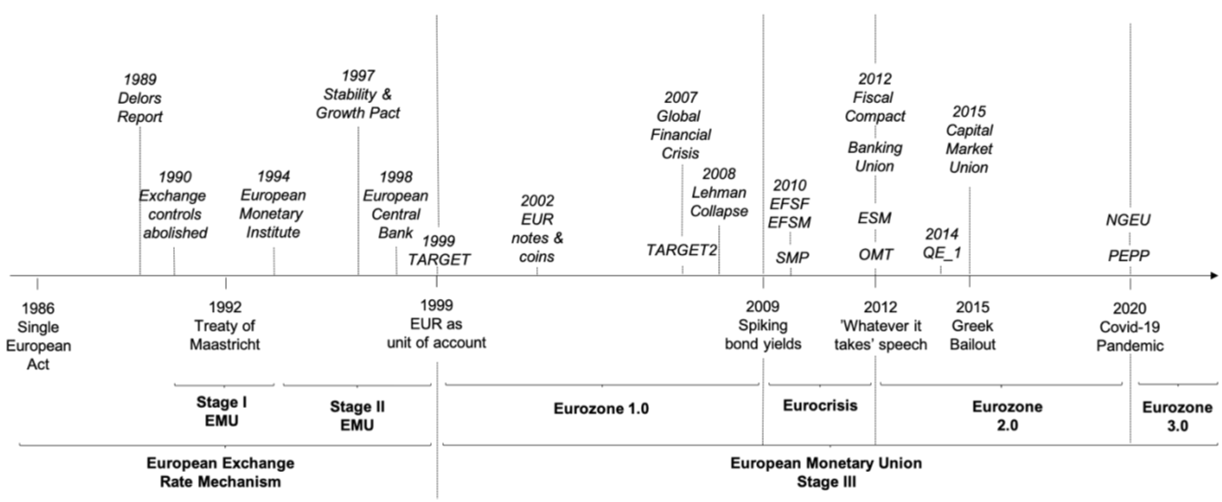


2. The Neoliberal Model of Eurozone Fiscal Governance

In the wake of the Eurozone crisis, a new buzzword appeared in the discourse of European and national officials. Although never defined univocally, the notion of 'governance' was adopted widely (and differently) as a discursive platform to legitimize and advance specific visions of Eurozone reform (Jabko 2019). Improving economic governance throughout the EU was seen as a sure-fire way to avoid political contention and mobilise the electorate. In a broad sense, economic governance encompasses the entire set of institutions and procedures used to pursue economic policy objectives, with monetary and fiscal policy traditionally conducted in a coordinated manner. In the EU, however, the latter, due to historical idiosyncrasies like the Eurocrisis, ended up operating differently.

In this section, we provide a historical summary of how the conceptualisations of monetary and fiscal governance in the EU have developed in connection with the design of the Eurozone's monetary architecture. Figure 2 provides an overview on the steps of European monetary integration, starting with the 1986 Single European Act during the European Exchange Rate Mechanism. After years of preparation, European Monetary Union (EMU) became effective as Stage III in 1999 when the Euro was introduced as unit of account and the TARGET system was put in place in between National Central Banks (NCBs) within the Eurosystem. In our periodization, the first decade from 1999 to 2009 can be referred to as the 'Eurozone 1.0'. The phase from spiking sovereign bond yields in 2009 until ECB President Mario Draghi's famous 'Whatever it takes' speech in 2012 are the years of the 'Eurocrisis'. From 2012 onwards—marked by institutional innovations set up during the crisis and two large scale reform projects, Banking Union and Capital Market Union—we witnessed the phase of the 'Eurozone 2.0'. The year 2020 arguably marks the beginning of a new 'Eurozone 3.0', in which the Covid-19 induced global economic and financial crash has led to the emergence of new tools and policies the scope and implications of which we are only finding out now.

Figure 2—The Evolution of European monetary integration, 1986-2020



Abbreviations: EFSF: European Financial Stability Facility; EFSM: European Financial Stability Mechanism; EMU: European Monetary Union; ESM: European Stability Mechanism; EUR: Euro; NGEU: Next Generation EU; OMT: Outright Monetary Transactions; PEPP: Pandemic Emergency Purchases Programme; SMP: Securities Markets Programme; QE: Quantitative Easing; TARGET: Trans-European Automated Real-Time Gross Settlement Express Transfer System

The evolution of economic governance in the EU follows the periodisation outlined above closely. In the early days of the European Economic Community (EEC), the debate about economic governance was dominated by competing ideas about the most efficient way to improve economic integration and coordination. The so-called 'monetarists' or adherents to 'locomotive theory' argued for transferring monetary policy to the supranational level first and deeper economic integration would follow, whereas the 'economists' or adherents to 'coronation theory' argued for the reverse (Verdun 2013). In the 1970s, the Werner Report saw scope for a 'Centre of Decision for Economic Policy' that would reside at the supranational level and would oversee, among others, the coordination of national fiscal policies (Werner 1970). Lacking support, the plan never came to fruition, and the 1980s saw the discussion move forward to the topics of the European Monetary System and the Single European Act.

Towards the end of the decade, the Delors Report introduced a starker distinction between monetary and fiscal policy, with the former under the purview of a proposed supranational body, the European System of Central Banks, and the latter more firmly embedded in the national context (Delors 1989). Driven by commitments to their independence from national governments and political cycles, monetary technocrats found it much easier to delegate sovereignty to an independent monetary authority endowed with the straightforward mandate of preserving 'sound money' than did finance or economic ministers, which had responsibility over a much wider mandate and entertained diverging ideas about how to exercise it (McNamara 1998). At the same time, although most levers of macroeconomic governance would remain under the prerogative of national governments, a compromise was struck that saw a role for "binding rules for budgetary policies" (Delors 1989, 16).

Indeed, the Delors Report, which would feed into the 1992 Treaty of Maastricht and would inform the 1997 Stability and Growth Pact, announced the creation of a version of a Eurozone that would envisage a tight coupling of national treasury balance sheets with *ex ante* rules. These determine how treasuries are allowed to use their 'elasticity space' (Murau 2020)—i.e. the extent to which their balance sheet can be extended through the issuance of sovereign debt. The Eurozone 1.0 would be bound particularly by two indicators: the ratio of government deficit to GDP and the ratio of government debt to GDP, which should not exceed the reference values of 3% and 60% respectively (currently Art. 126 TFEU). This form of (fiscal) governing at a distance (Rose and Miller 1992) did not directly control national treasuries' balance sheets but subjects them increasingly to quantitative targets. This ensured that despite the leeway afforded to national treasuries they are still constrained by a supranational disciplinary logic that would forestall monetary instability at the European level induced by budgetary imbalances. Moreover, the disciplinary logic of Eurozone 1.0 was meant to be reinforced by an automated mechanism discussed in the Delors Report: the "disciplinary influence" of "market forces" on public finances, which would "penalise deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies" (Delors 1989, 20). Although the Report acknowledges that this mechanism could be 'too slow and weak' or 'too sudden and disruptive', it nonetheless suggests that there is scope for market forces to supplement the binding rules emanating from the supranational level.

Given this double disciplinary bind, the fiscal governance model implemented in the Eurozone 1.0 has often been referred to as 'neoliberal' (Ojala 2020; Van Apeldoorn 2009; Gill 1998). Even though overworn, the widespread use of the label 'neoliberal'[1] to characterize the functioning of the fiscal pillars of the EU is indicative of a particular understanding of Eurozone economic governance (Arestis and Sawyer 2007; McNamara 1998). This governance model is predicated on the assumptions that private financial markets are by and large efficient and, following the infamous crowding-out argument, generally better equipped to make investment decisions than political actors. The main objective of treasuries was to keep the budget balanced and reduce the overall debt burden, i.e. lower the volume of treasury bonds outstanding relative to GDP—ideas reflected in the Stability and Growth Pact (Art. 121 and 126 TFEU). Monetary policy was supposed to be kept separate from political decision-making and fiscal policy, amounting to the strict prohibition of monetary financing (Art. 123 TFEU). Importantly, the fiscal governance idea for the Eurozone 1.0 was that private financial markets should 'discipline' public treasuries' balance sheets. Often legitimised with the time inconsistency argument derived from Neo Keynesian economics, this fiscal governance model seems to be primarily a workaround for the conundrum that Eurozone treasuries could not agree on fiscal integration and profoundly mistrusted each other with regard to the respective ways of managing their state households.

The 2009-12 Eurocrisis dispelled to a great degree the myth that financial markets could exercise a disciplinary pressure on national budgets. The allegedly efficient private balance sheets of banks and non-bank financial institutions in the Eurozone contracted sharply and had to be bailed out by European treasuries (Pisani-Ferry 2011). Rather than 'disciplining' the elasticity space on treasury balance sheets, they forced the treasuries of the most crisis-ridden countries to massively expand and take on new debts for the bailouts. But instead of abandoning the notion that national treasuries have to be disciplined altogether, the official reaction from EU policymakers was to double down on the other pillar of the disciplinary logic—that of strengthening its capacity for fiscal governance at a distance. Indeed, the economic governance of Eurozone 2.0 strengthened the capacity for fiscal surveillance and the enforceability of the rules-based coordination regime (Laffan and Schlosser 2016). First of all, the Stability and Growth Pack was bolstered by the so-called 'Six Pack' which made it harder, for instance, to undo corrective measures; second, a new treaty dubbed the 'Fiscal Compact' sought to ensure compliance with the rules including via allowing the European Court of Justice to impose monetary sanctions on member states; third, the 'Two Pack' centralized powers further in the hands of the European Commission, which was now to allowed to enhance its surveillance capacity of Member States' budgetary plans. All in all, the fiscal governance model ensuing the Eurocrisis tightened the constrains on domestic budgetary powers, leading to accusations that the Eurozone is 'incomplete', lacking sufficient fiscal firepower or a fiscal union, or cannot function efficiently because it is not an 'optimal currency area' (De Grauwe 2013; Harold 2012; Hallerberg, Strauch, and von Hagen 2009; Krugman 2012).

[1] Or sometimes 'ordoliberal', which, although technically different, indicates a similar mechanism of governing at a distance and of market discipline (Bonefeld 2017; Schäfer 2016; Feld, Köhler, and Nientiedt 2015; Nedergaard and Snaith 2015; Ryner 2015).

But these accusations tend to disregard a different dynamic that is at play in a context of fiscal constraints. Previous research has already emphasised how contentious budgetary politics can trigger organisational innovations that act as fiscal policy placeholders. Park (2011) has showed how balanced budget rules imposed by the US in the aftermath of the Second World War led to Japan creating an off-budget type of developmental banking geared towards pursuing public policy goals. Similarly, Quinn (2017) argued that, in the US, budgetary constraints in the 1960s were not just restraining, but also productive and led policymakers to creatively engage with financial markets in order to pursue policy objectives through alternative means. In a wider lens, studies analysing the advent of neoliberalism and financialisation similarly identify a relation between the fiscal crisis that Western capitalist states faced in the 1970s and the development and spread of various government-backed financial innovations that ensured that consumption continued in the context of stagnating wages and rollback of safety nets (Streeck 2014; Panitch and Gindin 2013; Krippner 2012; Crouch 2011).

In the case of the Eurozone, particularly since the onset of Eurozone 2.0, a similar process has been unfolding. Quasi-fiscal agencies, which we have called OBFAs and which emerge in the context of fiscal constraints, bypass fiscal rules and budgetary politics and are thus indicative of an increasing engagement with a form of 'off-balance-sheet policymaking'. This has been noted in some of the literature on national public investment banks (Mertens and Thiemann 2018), but the argument presented here is that OBFAs are a wider phenomenon suggestive of a transformation in economic governance at the European level. Specifically, they act as fiscal policy substitutes or complements, and fulfil various functions, as outlined in Figure 1 and explained in the next sections. Drawing on CMF, with its emphasis on the financial system as a hierarchical web of interlocking balance sheets (Gabor 2020), we will analyse in what follows the underlying links that run through fiscal agencies and their organisational proxies, OBFAs. We argue OBFAs are indicative of a transformational process occurring at the heart of Eurozone governance which gives technocrats more leeway to pursue public policy goals by governing through off-balance-sheet mechanisms.

3. Eurozone Fiscal Governance through Off-Balance-Sheet Fiscal Agencies

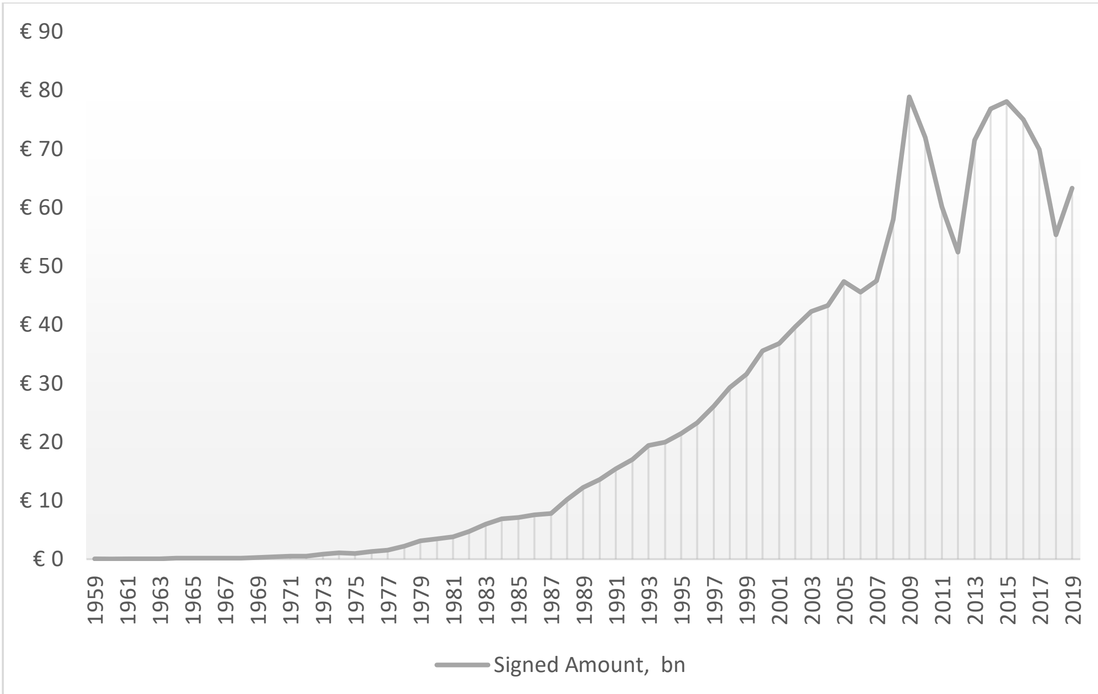
The Eurozone's model of fiscal governance through OBFAs affects four different activities that treasuries usually carry out: OBFAs support public investment, offer solvency insurance for banks, provide capital insurance of last resort for other treasuries, and expand the stock of safe assets. This section looks at those four aspects, explain theoretically how OBFAs complement treasury balance sheets in those activities, and trace historically the proliferation of and shift towards OBFAs. We demonstrate how fiscal governance through OBFAs mitigates four norms deeply embedded in the neoliberal fiscal governance logic of the Eurozone 1.0: keeping treasury budgets balanced as prescribed in the Stability and Growth Pact, the prohibition of monetary financing, the no-bailout clause, and reducing the overall volume of public indebtedness. As our balance sheet examples indicate, fiscal governance through OBFAs makes it possible that treasuries avoid issuing 'actual liabilities' on-balance-sheet that the governance at a distance mechanisms sanction, and instead issue 'contingent liabilities' for OBFAs which circumvent the stipulations originating from the neoliberal model of Eurozone fiscal governance.

3.1 Supporting public investments

A first activity that national and supranational OBFAs undertake within the Eurozone's fiscal ecosystem is complementing treasuries in financing and carrying out public investment. This is traditionally the role of state banks or state development banks. Calling them banks is actually a misnomer in so far as they are not in the business of issuing deposits as their liabilities and hence creating 'money'. Instead, they issue bonds as their liabilities to raise deposits which are then used to finance public investment. These bonds are functionally equivalent to when a treasury issues sovereign bonds in order to finance public investments but do not appear as part of the overall state indebtedness.

State development banks are not a recent phenomenon but have a history as special purpose vehicles to support phases of large-scale investment. The Italian CPD dates back to 1850 and received a boom in its relevance after the unification of Italy. The French AFD was founded in 1941 during the Second World War by the exiled government in London. The German KfW was founded in 1948 to help finance the reconstruction after the war. The EIB was founded in 1957 as part of the Treaty of Rome to support the creation of the European Single Market, and the EBRD dates back to 1991 when it was conceived to support the economic transition in Eastern Europe after the fall of the Iron Curtain. Hence, when EMU became effective in 1999, all those institutions were already part of the Eurozone's fiscal ecosystem. During the Eurozone 1.0 years, however, little attention was paid to them. It was a time when the neoliberal fiscal governance model seemed to be prospering and the private financial system was attributed a successful role in providing investment. This changed considerably after the Eurocrisis when the EIB substantially expanded its lending volume (see Figure 3) and shifted again in the centre of scholarly attention (see e.g. Liebe and Howarth 2019). These organisations have been pivotal to building a "hidden investment state" (Mertens and Thiemann 2019) at the heart of the EU and to pursuing public policy objectives outside the confines of national or supranational treasury balance sheets.

Figure 3—EIB lending volume 1959-2019, in EUR billion

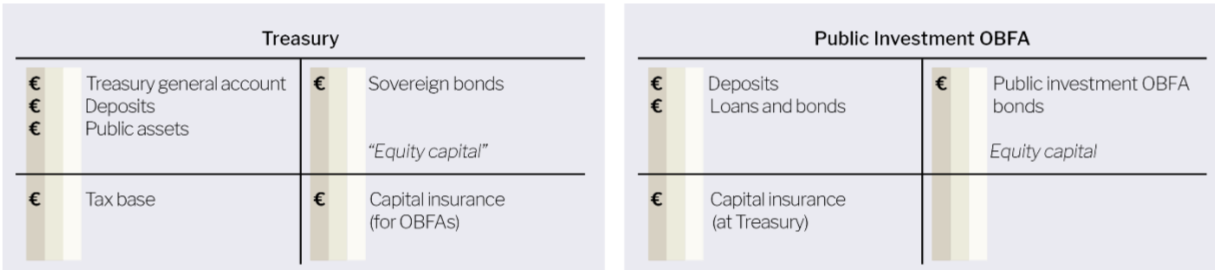


Source: European Investment Bank data portal

The role of public investment OBFAs in the Eurozone should be seen in light of the governance logic connected to treasuries. The Stability and Growth Pact was introduced to put the balance sheet developments of different Eurozone treasuries in tune. At the same time, it introduced artificial restrictions on treasuries' elasticity space. These restrictions were asymmetric in the sense that they were less binding in expansionary phases but decisive in contractionary phases. As the Eurozone 1.0 was by and large expansionary, OBFAs played less of a role. However, when the Eurocrisis hit, the associated bailouts and the setting in of the bank-sovereign doom loop heralded a contractionary phase that was even further supported by the Fiscal Compact and the European Semester, public investment OBFAs enjoyed a revival as sources of elasticity. Part of the reason for this is that the EU "treasury" is not allowed to issue its own bonds for funding EU projects. Some exceptions to this notwithstanding, the EU "treasury" balance sheet is highly inelastic and dependent on the multiannual households negotiated by the EU member states. The EIB and its subsidiary, the EIF created in 1994, are OBFAs that in some respect mitigate those restrictions.

Figure 4 represents the relation between treasuries and public investment OBFAs. To circumvent restrictions posed on its ability to issue sovereign bonds as an *actual* liability, the treasury can sponsor a public investment OBFA which takes over the role. Instead, the treasury just has a *contingent* liability as it provides a backstop for the public investment OBFA. This contingent liability allows the OBFA to essentially operate as a quasi-autonomous arm of the treasury, extending its activities, but without being constrained by the same regulations governing the treasury.

Figure 4—Public investment financing through an OBFA



The year 2020, which arguably marks the beginning of a Eurozone 3.0, augurs a further proliferation of OBFAs to finance public investment. In March, the EIB announced it will mobilise up to EUR 40 billion additional lending (EIB and EIF 2020). In July, with treasury balance sheets pushed to the limits due to the Covid-19 response, the European Heads of State and Government voted for a Covid-19 relief package known as Next Generation EU (NGEU) that not only grants extended rights to the EU "treasury" to issue bonds up to a limit of EUR 750 billion until the year 2026 but also sets up the Recovery and Resilience Facility (RRF) as a new OBFA to finance public investment (European Council 2020). This ties in with recent developments for national treasuries in countries that used to be at the forefront for advocating fiscal restraint. In September, the Dutch ministry of finance launched the EUR 20 billion National Growth Fund (Rijksoverheid 2020). Not long before that, two leading German economic think tanks had called for a EUR 450 billion national investment fund (Bardt et al. 2019).

In sum, governing through OBFAs for the purpose of fostering public investment has a long tradition in Europe. OBFAs became part of the Eurozone, even though they are not specific EMU-19 institutions but cater to the entire EU. With reduced relevance during the Eurozone 1.0, public investment OBFAs witnessed a revival in the Eurozone 2.0 and seem to be among the primary governance choices to tackle the issues of the Eurozone 3.0.

3.2 Offering solvency insurance for banks

A second activity in which OBFAs support national and supranational treasuries in the Eurozone fiscal governance regime is in providing solvency insurance for the banking system. Traditionally, solvency insurance implies that depositors in a bank have their deposits insured in case the bank goes bankrupt. Those deposit insurance schemes typically work with contributions that banks have to pay to balance sheets that act as insurance vehicles. However, these insurance vehicles only administer emergency liquidity up to a certain limit. Any such *ex ante* limit may be too low in case of a deep systemic crisis and may necessitate that national treasuries as ultimate capital backstop use their elasticity space and stock up the insurance vehicles. Therefore, these vehicles have a treasury guarantee as implicit contingent asset, which makes them *de facto* OBFAs. Figure 5 shows the connection between treasuries and solvency insurance OBFAs to provide solvency insurance for the banking system.

Figure 5—Solvency insurance for banks through an OBFA

The prohibition to monetise public debt incorporated in the Eurozone's mode of fiscal governance (Art. 123 TFEU) implied that national treasuries could only issue new sovereign bonds on the secondary market where they would be bought by private banks, and not sell them on the primary market to central banks. The disciplining effect of market forces inscribed in the neoliberal mode of fiscal governance would prevent national treasuries from overissuing sovereign debt and would instead incentivise them to keep their budget balanced. Prohibiting the ECB and NCBs from buying treasuries on the primary market was a stark change from other monetary architectures in which this is a normal and legitimate practice (Ryan-Collins and van Lerven 2018).

The Eurocrisis turned the logic of this regime upside down. Instead of exhibiting stabilising behaviour as expected by the efficient markets hypothesis, the shadow banking system collapsed in the 2007-9 Financial Crisis and spilled over to European banking systems (Nesvetailova 2010; Milne 2009). From 2009 onwards, banking systems did not at all deliver on their intended role to induce discipline and control European treasuries to exhibit fiscal prudence. By contrast, treasuries had to forego prudence and take on masses of new sovereign debt in order to bail out national banks at the brink of bankruptcy. Hence, the Eurocrisis showed the inherent flaws of the neoliberal fiscal governance regime which was a fair-weather construct in so far as it did not foresee the inherent instability of finance and the possibility of endogenous default (Minsky 1986)

The main response to the banking crisis for the Eurozone 1.0 was the introduction of a Banking Union—a project announced via the Four Presidents' Report in 2012 (Van Rompuy et al. 2012). Even though the actual meaning and the actual policies of the Banking Union have changed repeatedly, it has three main pillars (Howarth and Quaglia 2016): First, the supervision of large Eurozone banks would no longer be carried out by national supervisors but will be organised supranationally at the ECB (through the so-called 'Single Supervisory Mechanism', SSM). Second, a Eurozone-wide resolution mechanism is put in place to make it possible that systemically important banks can enter into bankruptcy while maintaining their systemic function during the crisis (the so-called 'Single Resolution Mechanism', SRM). Third, all Eurozone banks would become subject to standardised regulations for deposit insurance (the 'European Deposit Insurance Scheme', EDIS). While the SSM and SRM were quickly put into force between 2013 and 2016, the EDIS plans have stalled due to fierce objections by some member states (cf. European Commission 2020a).

While these mechanisms primarily target the banking and central banking segments of the Eurozone architecture, they also have implication for the Eurozone's fiscal governance regime, which further point to a proliferation of OBFAs. On one hand, the Single Resolution Fund (SRF) is an OBFA that was introduced via the Regulation (EU) No 806/2014 (SRM Regulation). From 2016 to 2023, systemically important Eurozone banks have to pay in contributions until they reach the target level of at least 1% of total deposits covered. These contributions should be available in the next crisis to provide emergency liquidity while the resolution plans for systemically important banks are carried out (Single Resolution Board 2020). However, there is no guarantee that the full sum will be enough. Instead, implicit guarantees are in place by national treasuries to supply more funds. Due to contingent nature of these assets and liabilities, the SRF should best be understood as an OBFA.

On the other hand, the plans for a Eurozone-wide deposit insurance scheme would foresee the creation of a European Deposit Insurance Fund (EDIF) as a new Eurozone-wide OBFAs next to the SRF. So far, national deposit insurance schemes operate with OBFAs such as the EBdB, the EdB, the FGDR and the FGD. According to the draft regulation of the European Commission finalised in 2015, the EDIF "should be financed by direct contributions from banks" while still receiving implicit fiscal backstops from national treasuries as "only extraordinary public financial support should be considered to be an impingement on the budgetary sovereignty and fiscal responsibilities of the Member States" (European Commission 2015, 23).

In sum, we can see that also the project of Banking Union, insofar as it involves institution-building on a European level, follows the logic of governing through OBFAs. This is partly a consequence of the disciplining stipulations for the behaviour of treasuries and the Eurosystem built in the original Eurozone architecture, following along the lines of the neoliberal mode of fiscal governance.

3.3 Providing capital insurance of last resorts for other treasuries

Third, OBFAs support treasuries in acting as capital insurers of last resort for other treasuries.[2] Once a crisis hits, treasuries are the ultimate backstops to provide emergency elasticity—in other words, to take on new debt and provide emergency loans or transfers to other balance sheets in a monetary architecture. An intricate question is whether such support should also be granted to other national treasuries in the Eurozone—the big conflict line of "monetary solidarity" (Schelkle 2017; Hübner 2019).

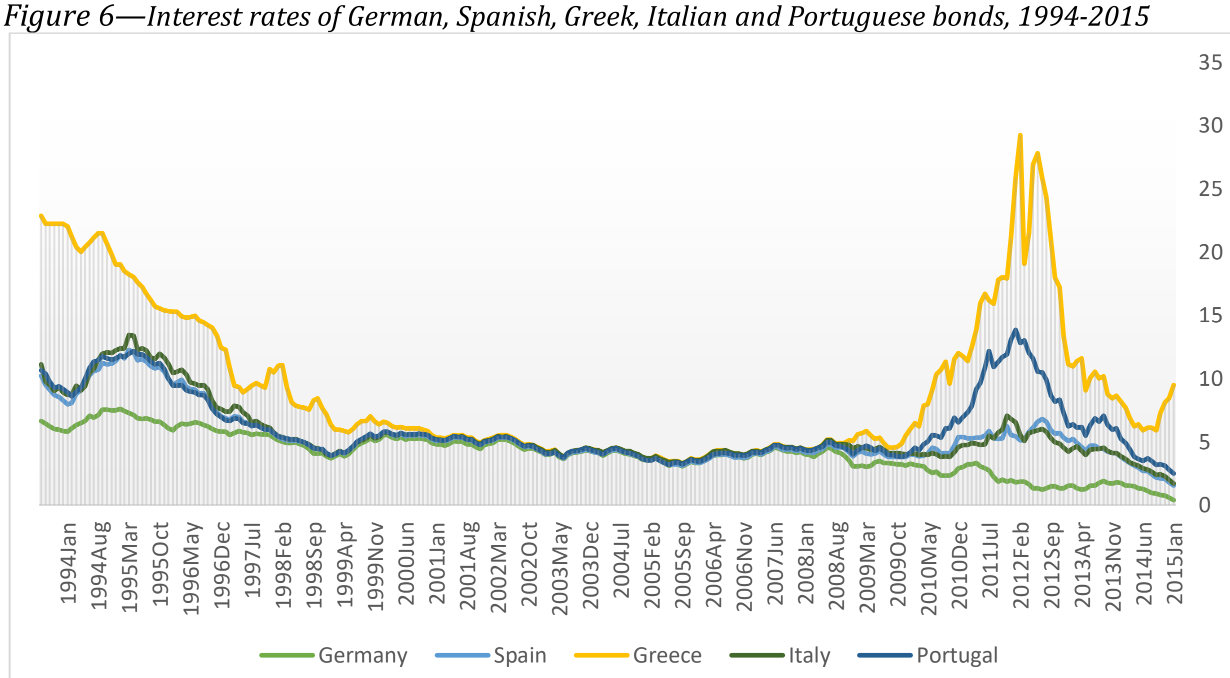
The Treaty of Maastricht foresaw for the Eurozone 1.0 that treasuries should not be made liable for the sovereign debt accumulated by other treasuries through the

[2] In the context of the Eurozone literature, what we call "capital insurance of last resort" is often referred to as a "lender of last resort" function (see e.g. Schmidt 2020). We find this label somewhat misleading as it conflicts with the traditional role that central banks play when they expand their balance sheet and create reserves to provide emergency liquidity for banks through the discount window—an activity that lies at the heart of monetary policy.

abovementioned no-bailout clause. The fear some Eurozone treasuries exhibited that others would demand to have their debts shifted onto them fed into the neoliberal fiscal governance model (Brunnermeier, James, and Landau 2016). This resulted in the no-bailout clause which ruled out that surplus treasuries (i.e. the German one in our model) would provide implicit or explicit capital insurance as contingent liability for deficit treasuries (i.e. the Italian one in our model) which would hold this as a contingent asset. With the introduction of EMU in 1999, countries such as Italy, Spain, Portugal and Greece received better refinancing conditions as the interest spreads on their sovereign bonds fell dramatically and reached the same level as German sovereign bonds. Figure 6 indicates this development. Contrary to the desire of surplus countries, it suggests that markets' outside perception may very well have been that an implicit capital insurance from Germany for those other treasuries was in place as *ex ante* treaty regulations cannot overrule financial necessities in a monetary union, and that by introducing the single currency, all European sovereign bonds would face the same credit risk as the German ones.

This arrangement faced its ultimate test when the 2007-9 Financial Crisis hit, infected European banking systems and spilled over to national treasuries' balance sheets causing a sovereign bond crisis. As Figure 6 shows, interest rates on sovereign bonds for Greece, Italy, Portugal and Spain skyrocketed from 2009 onwards. With the sudden rise in refinancing costs, the debt levels those countries had attained during the Eurozone 1.0 became untenable. The group of countries hit hardest by the crisis—often referred to as GIPS—were facing bankruptcy, defined as a default on their promises to pay back their maturing sovereign debt, unless someone came to help them service their debt. However, the no-bailout clause ruled out that other Eurozone treasuries would help them out.

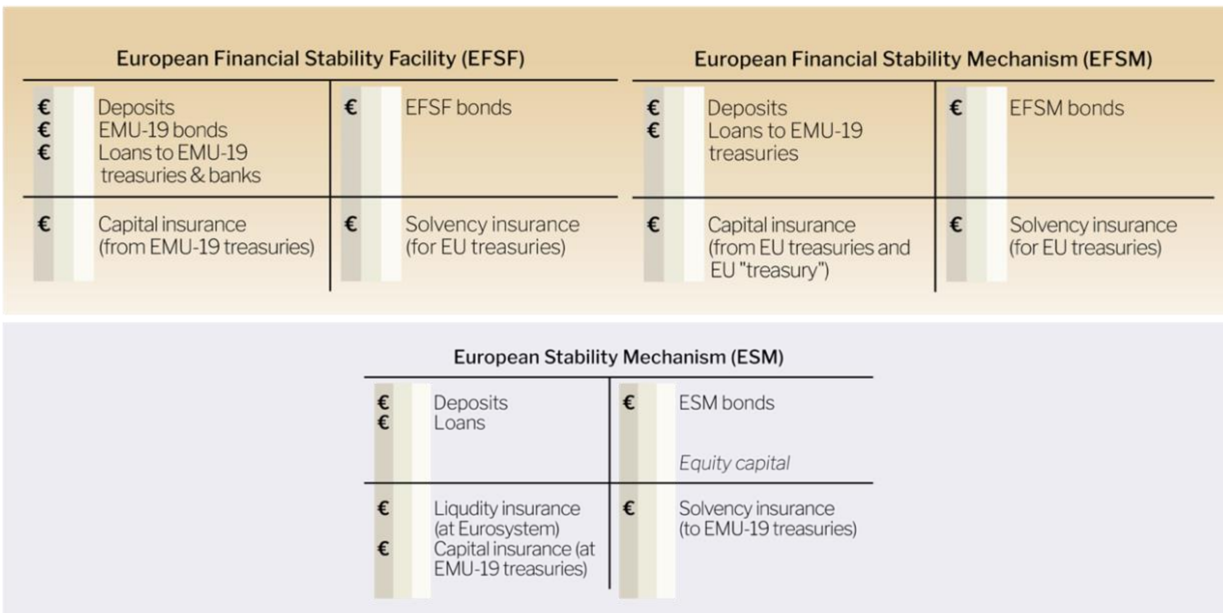
Figure 6—Interest rates of German, Spanish, Greek, Italian and Portuguese bonds, 1994-2015



Source: ECB Statistical Data Warehouse

The solution to this dilemma was the introduction of OBFAs to provide capital insurance of last resort to Eurozone treasuries in crisis (see Figure 7). On one hand, it avoided the national bankruptcy of a Eurozone member state—an undefined situation for the monetary union which would have likely toxic implications for the entire Eurozone financial system. On the other hand, it allowed the creditor states to maintain the façade that the no-bailout clause was still in place and worth the paper it was written on. The immediate necessity to prevent sovereign default heralded the new model of fiscal governance through OBFAs.

Figure 7—The transition from EFSF and EFSM to ESM



In 2010, during the peak phase of the Eurocrisis, two temporary emergency OBFAs were set up: the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM). The EFSF was sponsored by Eurozone treasuries as a special purpose vehicle under Luxemburg law. It was authorized to issue bonds on private capital markets with an initial borrowing limit of EUR 440 billion in 2010 that was increased to EUR 780 billion in 2011. The EFSM is a similar special purpose vehicle that is partly guaranteed by the EU Commission using the EU budget as collateral. It has the authority to raise up to EUR 60 billion through bond issuance. Between 2011 and 2015, both the EFSF and the EFSM gave loans to the Irish, Portuguese and Greek treasuries against conditionalities to prevent their sovereign default.

In 2012, those temporary OBFAs were replaced by the European Stability Mechanism (ESM). In contrast to the EFSF and the EFSM, the ESM is a permanent OBFA based on an international treaty. It has an authorised capital of EUR 700 billion of which EUR 80 billion have been paid-in *ex ante* and EUR 620 billion are callable (ESM Treaty). A Eurozone country is only allowed to make use of the ESM after signing the Fiscal Compact, which makes the introduction of a national debt break and the commitment to the amended Stability and

Growth Pact mandatory. In effect, a Eurozone country that wants to request support from the ESM has to rhetorically submit to the norms of the neoliberal model of fiscal governance to then be partly relieved from them by creating elasticity on an OBFA. This has become a dominant feature of fiscal governance in the Eurozone 2.0.

During the Eurozone 2.0 years, very much in line with the mode of fiscal governance through OBFAs, Brussels think tanks repeatedly launched the idea of transforming the ESM further into a European Monetary Fund (EMF). In the proposal of Sapir and Schoenmaker (2017), for example, a hypothetical EMF would build on the existing structures of the ESM but in addition offer an orderly procedure to deal with sovereign default. Moreover, it would no longer be bound by the unanimity rule. Instead, it could act more proactively and function as proper counterpoint to the ECB in matters of financial stability. In a nutshell, the EMF à la Sapir and Schoenmaker would provide a version of the long debated 'fiscal union', though not by coming to a solution in the conundrum of politically unifying different national treasuries and potentially uploading competencies to an EU household but by going for the 'governance through OBFA' model all the way and fully politicising a newly created OBFAs on a European level, endowed with a greater amount of competencies. Even though the EMF proposal is currently on hold, it may be pulled out of the hat once the next sovereign debt crisis hits.

In sum, Eurozone fiscal governance at the beginning of the Eurozone 3.0 is in a situation where the no-bailout clause is still in place as a treaty level norm and a relic of the original neoliberal governance model but is alleviated by workarounds based on OBFAs which provide a solution neither the creditor nor the debtor countries are fully happy with. Where populist voices in creditor countries bemoan the fact that taxpayer money is used to pay for deficit countries debt, the debtor countries receive only just-enough emergency loans to keep them alive while having to face conditionalities that they perceive both as humiliating and restricting their policy space. Governance through OBFAs defines the current *modus operandi* in a conflict about sharing responsibilities over the issuance and service of public debt that has been looming on the continent for generations.

3.4 Expanding the stock of safe assets

Fourth, OBFAs may be used to increase the amount of safe assets for the financial system. The most common safe assets are treasury bonds. Holding them allows all other balance sheets such as banks, non-bank financial institutions and households to 'store wealth' even in times of crisis, i.e. maintain a level of balance sheet expansion over time. From this point of view, treasury bonds are themselves a public good that is in high demand and constant undersupply—in fact, the more the credit system expands to support a growing economy, the greater the shortage of safe assets becomes. In the United States, Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac are OBFAs that support the treasury in supplying safe assets (Gorton, Lewellen, and Metrick 2012). The Eurozone does not itself have any such vehicles but the European Commission has plans for it in the making to address the Eurozone's shortage of safe assets. Very much in line with the model of fiscal governance through OBFAs, the EU Commission proposed the development of a European supranational OBFA that would supply 'Sovereign Bond-Backed Securities' (SBBS) to create genuine European safe assets.

In economists' parlance, a safe asset may be defined as a "a simple debt instrument that is expected to preserve its value during adverse systemic events", as it is "information insensitive" and has "special value during economic crises" (Caballero, Farhi, and Gourinchas 2017, 26–27). Safe asset theory derives from a 'standard model' in the tradition of Eugene Fama's efficient market hypothesis. Accordingly, this standard model assumes a world in which all future cash flows from treasury balance sheets are certain, which makes their sovereign bonds risk-free benchmark assets (Giovannini 2013). The contemporary financial system has come to rely heavily on safe assets as collateral for repo markets and monetary policy implementation. Moreover, the Basel regulations require banks to maintain a certain amount of safe assets in relation to their equity capital (Brunnermeier et al. 2012, 1–2).

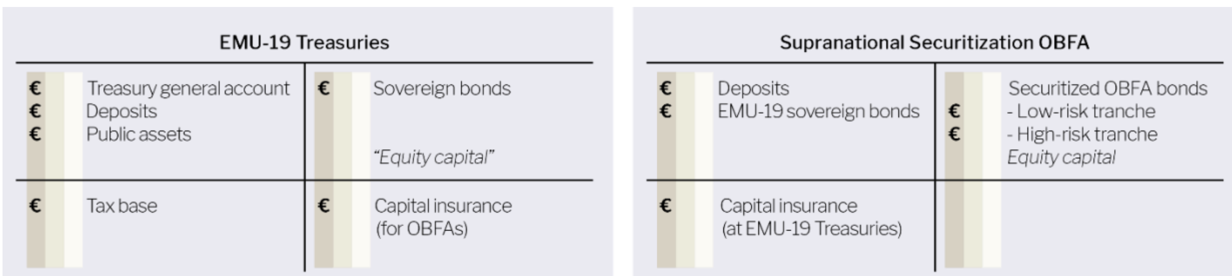
The Eurozone fiscal ecosystem, as is widely argued (Leandro and Zettelmeyer 2019), faces a safe asset shortage. Eurozone balance sheets do not create a sufficient volume of 'information insensitive' debt to satisfy the demand for it. Arguably, the neoliberal model of Eurozone fiscal governance, which has a very one-dimensional understanding of sovereign debt and is geared towards reducing the overall volume of sovereign debt issued, has contributed to this safe asset shortage. While there is ample debt of 'deficit' country sovereign debt to which markets do not attribute the role of being a safe assets. The main safe asset, German sovereign bunds, by contrast are so sought after that they continuously have negative interest rates—investors pay the German treasury money in order to be able to store their wealth with them. To satisfy their demand for safe assets, European banks and non-bank financial institutions routinely turn to the US and hold US sovereign bonds as safe assets.

Arguably the first-best solution to achieve a Eurozone safe asset would be to create a European treasury that issued EU or Eurozone sovereign bond ("Eurobonds"), backed by the treasuries of all member states. But this is not only highly contested among Eurozone member states but also clashes with the no-bailout clause in the TFEU. To nevertheless provide a Eurozone-wide safe asset that helps overcome the segregation of Eurozone banking systems, a number of second-best proposals have been developed (Claeys 2018; Gabor and Vestergaard 2018; Leandro and Zettelmeyer 2019). Among the suggestions floated, the EU Commission jumped on the SBBS proposal developed by van Riet (2017) (European Commission 2020b). It goes back to the proposal of the euro-nomics group (Brunnermeier et al. 2012) for the introduction of European Safe Bonds (ESBies). Both rely on the creation of a new supranational OBFA that buys up sovereign bonds and securitises them.

Brunnermeier et al. (2012) propose that a new OBFA, the European Debt Agency (EDA), should hold Eurozone sovereign bonds as assets and issue ESBies as liabilities. The underlying sovereign bonds would be bought according to a fixed ratio. Therefore, the EDA would not be able to bail out a Eurozone treasury in financial trouble. The senior tranche of ESBies would be the safe asset, the junior tranche would be risky and sold on to willing investors in the market (ibid: 4-5). For the portfolio of sovereign bonds, they propose a weighed share according to GDP-size over last five years. An alternative would be the weights of the ECB used to determine the allocation of seigniorage.

Van Riet (2017) discusses the ESBies proposal with a lot of sympathy and brings up the possibility that the ESM could take over the role on the proposed EDA (ibid: 46). A supranational vehicle would buy government bonds, package and securitise them into two distinctive tranches. The larger senior tranche, amounting to 70% of the portfolio, would become the single safe asset, the synthetic Eurobond. The junior tranche, offering higher yield for higher risks, would take the first losses (Gabor and Vestergaard 2018: 19). Figure 8 represents an idealized depiction of such securitization OBFA to expand the volume of safe assets.

Figure 8—Eurozone safe assets through supranational securitization OBFA



In sum, the current official strategy to tackle the perceived safe-asset shortage in the Eurozone through a supranational securitisation vehicle is similarly indicative of the new mode of governance through OBFAs, whereby off-balance-sheet instruments are created in order to bypass institutional or political constraints that would otherwise amplify the issue of shortage of safe assets.

4. Conclusion

This article has analysed how the neoliberal model of Eurozone fiscal governance embedded in the original Maastricht Regime has been gradually superseded or at least complemented by a mode of fiscal governance through OBFAs. The budgetary constraints inscribed in the Maastricht Treaty and the flawed logic of market discipline led policymakers wrestling with crises to devise creative ways of expanding the Eurozone fiscal ecosystem so that instruments that are normally under the purview of treasuries are still available but off-balance-sheet. As our analysis has shown, this has resulted in the proliferation of Eurozone OBFAs, which in this case can increase the scope for public investment and expand the stock of safe assets to support a growing economy, all the while providing solvency insurance for banks and capital insurance for treasuries as mechanisms that shelter the economy in case of distress.

Still, Eurozone governance through OBFAs—while arguably being a creative, pragmatic and relatively successful form of technocratic bricolage—reinforces an age-old problem afflicting the EU: its democratic deficit (Kratochvíl and Sychra 2019; Follesdal and Hix 2006). The EU always had to juggle problems with its "input legitimacy" while compensating for this with its problem-solving competence, or "output legitimacy" (Schmidt 2020; Scharpf 2009). To do so, it has built a web of bureaucracy and an arcane institutional structure that allows it to improve the capacity of governance at the EU level so that it can deliver policies in the name and for the benefit of the EU citizens in a highly power-dispersed system, and thus increase output legitimacy. The proliferation of OBFAs, as a technocracy-driven process, ties into this trend. OBFAs tend to be initiated by technocratic actors, more often than not driven by the European Commission, and as such are situated in between states and markets (Braun, Krampf, and Murau 2020).

Difficult decisions lie ahead for what we have called Eurozone 3.0, the new Eurozone institutional and ideational set-up ushered in by the twin pressure of the climate crisis and the Covid-19 crisis. Driven by the imperatives of environmental sustainability and digital transformation, as well as by breaking apart state aid rules and engaging in hitherto sacrilegious issuance of common debt, however temporarily, the EU is confronted with the issue of having to lay to rest the neoliberal model of economic governances in which market forces exert disciplining power upon national budgets and to engage in a more politicised form of governance which puts additional pressure upon its democratic legitimacy. A way to close this democratic deficit while embracing the emerging mode of fiscal governance through OBFAs as a fact of life and endogenous response to real-world problems could be to place the supranational OBFAs under the authority of the European Parliament.

Indeed, the 2019 European Elections and the farce of abruptly jettisoning the principle of *Spitzenkandidat* has effected a profound blow to attempts of increasing the European Parliament's relevance. Receiving budget authority over OBFAs would be an effective channel for instilling it with a new sense of purpose. As OBFAs are mostly mission- rather than profit-driven agencies, their governance can be integrated into the deliberative cycles of the European Parliament. Some of these OBFAs, furthermore, have the potential to improve input legitimacy not only through representative avenues, but also through direct forms of participation. For example, many public investment banks are highly localised and narrowly focused organisations, which means that there is scope for participatory forms of governance at the local level, in which unions, local SMEs, and civil society actors can contribute to carving the public objectives of OBFAs alongside management and technocrats. Governing through OBFAs, as this paper has shown, is a mode of governance in its own right and should be more widely acknowledged, as it presents both shortcomings but also opportunities for increasing governing capacity and even, perhaps, democratic legitimacy.

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Legal Documents

ESM Treaty: Treaty establishing the European Stability Mechanisms
SRM Regulation: Regulation (EU) No 806/2014
TFEU: Treaty on the Functioning of the European Union

About the authors

Andrei Guter-Sandu is an Economic and Social Research Council (ESRC) Postdoctoral Fellow at the Centre for Analysis of Risk and Regulation and the Department of Accounting at the London School of Economics and Political Science. His research interests include social and sustainable finance, central banking, and public governance of grand challenges.

ORCID-ID: https://orcid.org/0000-0003-3143-6555

Steffen Murau is a postdoctoral fellow at the Global Development Policy (GDP) Center of Boston University, City Political Economy Research Centre (CITYPERC) of City, University of London, and Institute for Advanced Sustainability Studies (IASS) in Potsdam. His research interests include monetary theory, shadow banking, the international monetary system and the European Monetary Union.

ORCID-ID: https://orcid.org/0000-0002-3460-0026

Conflicts of interest

We have no conflict of interest to report.