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1. Introduction

Ever since the financial crisis of 2008, central banks in the rich Western hemisphere are engaged in extraordinary interventions to stabilise financial markets. They act as lenders and money market makers of last resort. Lending of last resort (LoLR) came in the form of open-ended liquidity provision at very low-interest rates, against a vastly extended range of lower rated collateral. Even this massive LoLR was not enough in 2008-2009, however, as the liquidity crisis amounted to a run of banks on banks in wholesale money markets. Supply and demand in these inter-bank markets could no longer be matched at prices acceptable to both sides and central banks became market makers of last resort (Sibert and Buiter 2007).

But these interventions were soon motivated by the need to stabilise public finances. This became obvious in the Euro Area (EA) when the Greek government was effectively shut out of bond markets in early 2010 and the panic rapidly spread to the Irish and Portuguese segments. The turmoil in bond markets has been widely interpreted as a symptom of the EA's incompleteness as a fiscal union. The proponents of this «incompleteness» view (e.g., De Grauwe 2013) point out that the US and the UK central banks bought early on a

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high share of government bonds in secondary and/or primary markets and held them to maturity (Mabbett and Schelkle 2019, figs. 1-3). But this lending of last resort to sovereigns also indicates that the need to stabilise public finances is not confined to the EA. And it raises the question why monetisation of public debt is supposedly functional in these cases while emerging market authorities have been lectured for decades that this poor practice leads, sooner or later, to capital flight and hyperinflation. If this warning is not merely Western hubris and double standards, then central banks in the West must also be wary of *fiscal dominance*, i.e., their hands being forced by the financing needs of the sovereign.

This article argues that a central bank is forced to provide monetary re-insurance of the fiscal state whenever complex and oversized financial markets create tail risks of sovereign default. This is not the same as fiscal dominance (Sargent and Wallace 1981; Brunnermeier 2016). By providing extraordinary support when tail risks occur, a central bank can actually hope to escape dominance by the needs of other actors and (re-) gain room for manoeuvre. However, incentives for governments are sometimes more aligned with bond-holding banks and this can put central banks under a regime of *financial dominance* (Brunnermeier 2016). By this term I mean here the threat that endemic default of banks, insurers and pension funds forces the central bank to provide liquidity to fundamentally sound and insolvent institutions alike. In this case a dilemma arises: should the central bank resist such exploitation of its powers and risk serious financial instability? Central banks have been criticised for being too much inclined to give in to financial dominance and have started to address this criticism. I illustrate this interpretation with evidence from recent financial instability in the UK that is compared with Italy after a Eurosceptic government was sworn into office, both in autumn 2022.

In the next section, I outline the concept of monetary re-insurance and its limits. Then I show how the ECB has come to develop monetary re-insurance of fiscal states and the financial system; this intervention was at times quite contested and criticised for giving in to profligate governments and/or reckless banks. Then I revisit the instances of financial instability in the UK and Italy in 2022 that show how central banks have begun to address the re-insurance dilemma of stability and dominance. Finally, I discuss why monetary re-insurance must remain limited if the instrument is to help fiscal states to deal with tail risks and to withstand financial dominance.

2. Monetary re-insurance and its limits

Re-insurance is insurance that primary insurers take out to cover excess loss, which could affect them badly. In principle, this could be done – and has been done in marine insurance ever since the explorations of the New World started – through *co-insurance*. That is, a syndicate of other primary insurers would underwrite part of the risk. But collective action problems of such syndicates, the huge potential losses from major industrial accidents and infrastructure failures plus, finally, advances in the probabilistic calculation of excess loss led to the invention of re-insurance in the 19th century (James 2013, pp. 9-11). Excess loss stems from downside tail risks that usually materialise when individual risks are or become highly correlated. An example of such correlated risks that cannot be diversified is that life-insurers have to pay out for fatalities as a consequence of a nuclear disaster or war. Similarly, a market panic, starting in one segment, can spread and thus become common or systemic, overwhelming the primary insurer who are the shareholders of banks. This is in contrast to having to pay out life insurance for the usual, weakly related causes, such as age, illness, work, and car accidents. They can be shared with the general population who will not all be affected at the same time by old age, illness or accidents.

Re-insurance is usually taken out when the primary insurer wants to avoid the excess loss. Excess loss against which primary insurers try to guard does not have to be catastrophic but insuring against tail risk comes at a cost. This reduces moral hazard, that is risk-taking incentivised by the availability of insurance because in re-insurance all loss below the excess threshold has to be borne by the primary insurer. The somewhat soft definition of what is «excess» does not completely contain it, especially when the context is an incomplete contract or implicit agreement between governments, not a commercial contract. This is an element in the dilemma of monetary re-insurance that I will identify below, inspired by Brunnermeier (2016).

In economic theory, it is often assumed that only states can bear common shocks to their jurisdiction, the national territory. Public debt can pull future taxpayers into the risk pool *ex post*, thus greatly softening the budget constraint that can sink private companies. But governments do not want to take on the political liability of re-insurance explicitly, possibly for fear of Samaritan's Dilemma (Rodrik and Zeckhauser 1988). This dilemma says that whenever citizens are affected adversely, the government faces a dilemma. On the one hand, it must be credible that the government will not honour claims of citizens that could be borne by the claimant or are self-induced harm. On the other hand, as an elected government it is bound to maintain the economic survival of households and firms as a going concern. The financial crisis is a case in point: it started when the abuse of financial innovation and incompetent risk management by banks came to light. Even so, financial firms had to be rescued wholesale, at great cost to tax-paying residents in the guise of a protracted recession. However, governments had successfully shifted Samaritan's dilemma onto independent central banks[1].

Governments may also be reluctant because they suffer from the same problem as private re-insurance: how to build up enough financial capacity to be usable when disaster strikes? Public debt is an alternative to liquid investments but the «classic insurance cycle problem» (James 2013, p. 16) also applies to them: issuing bonds becomes costly when risk premia and thus interest rates go up[2]. *Fiscal dominance*, i.e., forcing the central bank to buy government bonds, is one solution from the government's point of view. Cross-national pooling of catastrophic risks would be a more sustainable solution, one that private re-insurers have done for a long time. But it is hardly ever done by nation-states although the EU is now arguably making a start (Schelkle 2023).

The financial crisis of 2008, the pandemic of 2020-21 and catastrophic climate change in the future call for a great push in reliable public re-insurance. Central banks, or monetary re-insurance, can be seen as having met this challenge on a

[1] Mabbett and Schelkle (2019). Eric Monnet's contribution in this issue deals with the time when governments bore the brunt of Samaritan's dilemma, which is the flipside of having some steering capacity through credit policy.

[2] Private insurers face the problem that fixed-rate financial instruments like government bonds fetch low prices when interest rates go up and/or selling them makes bond prices fall even further.

grand scale as well. It does not require a re-insurer of fiscal states to be plugged into their fiscal system: re-insurance can be categorically different from the welfare state schemes of which it covers the excess loss (Schelkle 2023). More specifically, the ECB can pool catastrophic risks across its members simply by being a central bank for a union of nation-states. Central banks extended cross-national pooling through swap arrangements among themselves, led by the US Federal Reserve (FED), because crisis times lead to demand for the safe haven currency even if financial instability originated in the safe haven. A central bank does not have the problem of financing the insurance pay-out as it can create the liquidity in the quantities demanded. In the process, it acquires a portfolio of assets that it can liquidate or hold to maturity as and when market conditions have normalised.

Above all and related to that, insolvency, i.e., negative equity in accounting terms, is of no immediate concern to a central bank, in contrast to governments and private companies. Negative equity becomes a problem only if the central bank continues to buy assets that market actors do not want to hold because they will predictably fail. The increase in liquidity that cannot be reversed by selling assets back to the market must then sooner or later have inflationary consequences. It undermines trust in the central bank that issues a currency as a public good, which can transfer purchasing power and property rights to every holder. But if negative equity materialises in the course of a central bank acting as a monetary re-insurer of an exceptionally catastrophic incident, negative equity is immaterial and merely an accounting convention.

Monetary re-insurance is different from monetary de-risking, which Daniela Gabor analyses inter alia in her contribution in this issue: de-risking is an activity of public authorities in normal times and changes the risk profile for private investors, incentivising their business towards higher returns, while the additional risk is borne by the central bank. Re-insurance limits the spread of the down-side risk that is shifted on the central bank, which can arguably bear it at a lower cost. But a central bank will, in return, insist on macroprudential regulation of banks that will lower the return for financial institutions thus insured (Brunnermeier 2016). This lower return is the equivalent of paying a premium in private re-insurance. There is no such equivalent of a premium to pay for monetary re-insurance of government bonds; certainly not in the case of the ECB because officially there was no such re-insurance foreseen.

So, what are the limits of a central bank generally, the ECB specifically, as a re-insurer of last resort? Extending monetary re-insurance to fiscal states in Europe, directly or indirectly via financial system rescues, comes at a political and institutional cost to central banks. They can come under a regime of financial and/or fiscal dominance. Fiscal dominance was a concept that Sargent and Wallace (1981) used to capture «some unpleasant monetarist arithmetic». Their model of a monetarist economy, in which money supply determines the price level, shows that the central bank cannot maintain control over inflation on its own. If the government insists on issuing public debt that the public (represented by the financial sector) does not want to hold in amounts above a certain limit, the central bank will have to buy the bonds sooner or later, expanding the money supply and generating inflation. Trying to resist this with tight money will simply create deflation with the real value of bonds growing until it exceeds the public's limit and the central bank is then forced to buy the bonds. A more appropriate title for the famous Sargent and Wallace article would be «Some unpleasant arithmetic for monetarists» because it tells economists and policymakers of that creed that even in a perfectly monetarist world, tight monetary policy cannot prevent inflation if the government does not cooperate. *Monetary dominance*, i.e., the ability of the central bank to issue its currency in line with its inflation goal, independent of public debt management, is not in any central bank's powers.

Brunnermeier (2016) gives us the unpleasant arithmetic from a Keynesian macro-financial point of view. In my interpretation, his unpleasant news for pump-priming Keynesians is that financial dominance is probably the most binding constraint, binding even on cooperating monetary and fiscal authorities. The latter's game of chicken may be superseded by banks' strategy of financial dominance[3]. They can force the central bank to come to their rescue because they are so highly leveraged («undercapitalised») that a fall in asset values can create

[3] Brunnermeier's notion of financial dominance is a more strategic, instrumental power version of the power of inaction by Cornelia Woll (2014).

very quickly a systemic crisis. The less obvious explanation is the alignment of interests of governments and banks that can make bank balance sheets so loaded with domestic government bonds that the threat of fire sales can generate a doom loop of weakening banks and weakening public finances (Brunnermeier 2016, pp. 13-14, 37-39). This is ultimately a consequence of governments trying to alleviate their commitment problem regarding sovereign default. By incentivising domestic banks to hold government bonds, they take them hostage: foreign bond investors will ask for lower risk premia because they find it less likely that the government will then default on its debt, as this would ruin banks, savers, the economy at large. This commitment does, however, backfire if there is a really big shock and it would be much better for the government and the economy if it defaulted – and could do so without bringing down the banking system (Brunnermeier 2016, pp. 29-43). But governments cannot respond, so the central bank will have to step in and give up on price stability to avoid a doom loop of sovereign and banks. Brunnermeier's interest is in the kind of macroprudential policy that could alleviate this problem, freeing up monetary policy for price stabilisation.

My interest here is how did the ECB, or central banks more generally, navigate this tradeoff between acting as a re-insurer while trying to evade a regime of fiscal or financial dominance? The ECB had to respond to the charges of fiscal and financial dominance as the extraordinary times became the new normal. Its own Governing Council voiced the concerns about the protracted low interest rate policy and then Quantitative Easing (QE) which included the buying of government bonds in secondary markets. Two German members of the Executive Board resigned in protest against the ECB's asset purchase programmes and all Bundesbank Presidents criticised the ECB's accommodation of banks and governments in dire straits publicly. For a while, the central bank also faced a legal challenge in the German constitutional court for every new instrument it came up with. In what ways was the re-insurance it provided different from fiscal dominance?

A pertinent source for an answer is a speech by Mario Draghi in June 2019, shortly before his term ends, in which he looks back at the changes in monetary policy over the ECB's second decade. He starts by noting that both the Bank of England (BoE) and the Federal Reserve Bank (FED) were created to end financial instability. The ECB was no exception: «The euro was introduced 20 years ago in response to repeated episodes of exchange-rate instability and the need to secure the Single Market against competitive devaluations» (Draghi 2019). He goes on to say that a first calm decade came to an end: «The second decade [...] has seen profound shifts in the prevailing environment – including both financial and sovereign debt crises – and our monetary policy strategy has had to adapt with it» (Draghi 2019). In contrast to the US, the «environment» of the ECB was weak demand that unleashed disinflationary pressures and uncoordinated, procyclical fiscal policies that were at odds with the ECB's accommodative policy. He justifies a number of extraordinary interventions that I will characterise as monetary re-insurance policies for excess losses. They are different from fiscal dominance, although the line between the two can become blurred when financial dominance is the underlying driver.

3. Monetary re-insurance in practice

The first monetary re-insurance policy was Draghi's announcement of «whatever-it-takes»: «Monetary policy responded first in the summer of 2012 by acting to defuse the sovereign debt crisis, which had evolved from a tail risk for inflation into a material threat to price stability. Announcing Outright Monetary Transactions (OMT) established our commitment to counter unwarranted redenomination risks in sovereign debt markets and acted as a powerful circuit breaker» (Draghi 2019). In a situation of increasing capital flight, not merely out of Greece and other beleaguered countries but out of the monetary union, the OMT promised to buy government bonds in an open-ended intervention and in creditor status at par with private bond buyers. The idea was to put a price floor under the bonds shunned by markets, which also means a ceiling for bond yields. This would not only allow governments to issue bonds at affordable rates but also maintain their asset value on banks' balance sheets, which otherwise could lead to a downward spiral of failing banks and overstretched governments.

Draghi (2019) concedes that the OMT was never activated, yet points out that «the effect of its announcement was equivalent to that of a large-scale asset purchase programme: spreads in vulnerable countries fell on average by more than 400 basis points over the next two years». If the OMT is re-insurance against the risk of exiting the EA («unwarranted redenomination») and a diabolic loop («circuit breaker»), then his remark implies the QE can act as re-insurance. Asset purchasing was typically communicated as a stimulus to speed up recovery. But bringing down interest rates by 4% and more helped highly indebted governments to step back from the brink of insolvency.

An alternative to OMT re-insurance is of the essence for countries like Italy, given the proviso that the OMT can only be activated if the government signs a bailout programme with the European Stability Mechanism (ESM). However, negotiating a bailout programme would take too long for any country that does not already have a programme. The «Transmission Protection Instrument» (TPI), introduced in July 2022, fills this gap now. It contains the same features as the OMT, notably open-ended purchases of public bonds that have no privileged status in case of default, and the clause that the beneficiary country must not obviously violate rules on fiscal policy and macroeconomic imbalances (ECB 2022).

A negative interest rate policy is another instrument that Draghi (2019) mentions and characterises as part of the package, along with QE, to counter a deflationary dynamic. It generated another heated debate, above all in Germany[4]. Just when the banking union came into effect and the EA seemed to definitely turn the corner, «the euro area economy was hit by a further downward shock to inflation in the form of a 60% collapse in oil prices in mid-2014, which pushed inflation into negative territory. With underlying inflation already weakening, inflation expectations began to be affected». Amidst political and legal challenges to an expansionary policy,

[4] In a speech to German layers, Executive Board Member Isabel Schnabel (2020a) recalls the «narratives» around negative rates: «German media have, for example, made references to "Count Draghila" who "sucks dry" German savings accounts, or "the biggest expropriation project since the Soviet dismantling of industry and East German forced collectivisation" [...]. Such images are hardly conducive to objective debate. And this kind of aggressive language is not limited to the media. Politicians of various parties have referred to Mario Draghi as "the gravedigger of German savers" or "the speculators' accomplice", who has "continuously expropriated" savers». She rebuffs the criticism robustly.

«there was a material risk that falling inflation could become self-fulfilling: the public could begin expecting a smaller monetary policy response to future inflation undershoots, and revise their inflation expectations further downwards». A fall in energy prices could easily have been countered by a green levy that would have raised the market price. The real danger was that governments could not agree on it and that market actors would look right through a contested, temporary tax hike. Deflation, a spiral of falling prices and wages that raises the real value of debt and claims, was on the cards. An increase in the real debt burden can sink economies with high public and/or private debt levels very quickly and ensuing defaults spread the risk to others. It was the Great Depression scenario that was already visible in the data. Hence, the unprecedented move to pay banks for borrowing and lending: «The negative rate policy challenged market expectations that when rates reached zero, they could only go up and not down» (Draghi 2019). The ECB did turn the corner, but it was a close shave.

In April 2020, three months after the first cases of COVID-19 infections were detected in Europe, Isabel Schnabel (2020b) reviewed the ECB's response to «a shock of unprecedented intensity and severity». Negative rates were granted again as part of «our traditional role as a lender of last resort to solvent banks. [...] [W]e offer banks liquidity over longer horizons at the rate of our deposit facility – that is, at a negative rate – without any conditions attached». Note that negative rates and unconditional support, e.g., against low-quality collateral, are *not* part of what mainstream economists claim is the «right» LoLR. Rather, the ECB continued the tradition of breaking the Bagehot rule when a banking crisis was serious enough[5]. There is a good reason for the trespass: following this rule of lending at a penalty rate against good collateral would make LoLR in a systemic crisis virtually impossible (Sibert and Buiter 2007). Extending support at a high cost may be the final straw for over-stretched banks and good collateral quickly disappears in fire sales that drive down its price and liquidity.

[5] The norm of the Bagehot rule is to lend in an emergency only at a penalty rate and against good collateral. While this sounds plausible, the norm is observed more in the breach than in the observance (Grossmann and Rockoff 2015).

But LoLR as monetary re-insurance, with exactly the characteristics that Schnabel (2020b) mentions, helped banks to tide their customers – and thus themselves – over a potentially devastating fall in cash flows: «In Italy, for example, bank lending conditions for firms remained remarkably resilient in recent years despite significant swings in market-based funding conditions of the sovereign, banks and firms». Moreover, a new instrument, the Pandemic Emergency Purchase Programme (PEPP), can easily be seen as a form of monetary re-insurance that was rolled out very quickly to give hardest-hit welfare states in Italy and Spain room for manoeuvre. Broad-based indices of financial conditions had shown considerable tightening and 10 year government bond yields went up, including for Germany. In this situation, the PEPP took out all the stoppers that so far had restricted asset purchases: «Within PEPP, purchases can therefore be allocated flexibly across time, asset classes and jurisdictions. This is also why the Governing Council decided to make bonds issued by all euro area sovereigns, including those issued by the Hellenic Republic, eligible for purchases under the PEPP».

In sum, the ECB extended monetary re-insurance during the financial, sovereign debt, and public health crises since 2007-8. I argue that we can see the following instruments in this light:

1. LoLR to the banking system covered the excess loss of a systemic financial melt-down in the rich parts of the world, which can explain why it did not follow the norm of the Bagehot rule.
2. The OMT, now TPI, commitment promises to stabilise government bond prices of countries in possibly open-ended amounts, thus covering the excess loss of sovereign default and protecting the political decision over membership.
3. Negative interests on banks' deposits with the central bank, rewarding them for on-lending, cover the excess loss of debt deflation that could lead to endemic default of businesses.
4. QE programmes became increasingly more tailored to the most vulnerable member states, covering the excess loss from their tail risks and the spillovers that could follow from these national disasters to other countries.

In the process, the ECB prioritised stabilisation over resistance to being dominated by the agenda of governments or banks. This creates a dilemma: instead of being the re-insurer of last resort, it can be pushed into the role of primary insurer of first resort. But if it refuses to be pushed into that role, the central bank may be responsible for serious financial and fiscal instability. The next section tries to show that the central banks' dilemma is not confined to the EA and illustrates how central banks navigate an extremely difficult situation. Moreover, this is not confined to the long financial crisis since 2008. Central banks and governments are now confronted with the worst of all worlds, stagflation that requires policies to change tack. The central bank's dilemma is more obvious than ever.

4. Financial instability in the UK and Italy in 2022

The two cases that can illustrate this dilemma and central banks' new awareness are the UK under the short-lived government of Liz Truss and Italy with the incoming far-right government of Giorgia Meloni. They are both most-likely cases for financial or fiscal dominance, but for entirely different reasons. The UK is a financial centre and stand-alone currency area in which the electoral system tends to endow governments with strong majorities, in the case of the Truss administration inherited from predecessor Johnson's victory in 2019. Italy is a member of the EA and a highly indebted country, where the electoral system makes it likely that shifting coalitions govern but rarely outlive the full length of their term. The outcome of interest was also entirely different but certainly in unexpected ways. The Truss administration was forced to resign over financial instability that the Bank of England was willing to accommodate only up to a point of its choosing; Meloni's eccentric eurosceptic coalition was not confronted with financial turmoil but has to live with an elevated and volatile risk premium on government bonds to which members of the government become increasingly sensitive (see Appendix).

4.1. *UK: The Bank of England encounters Trussonomics*

The turmoil in British bond, derivatives, and currency markets in September 2022 was triggered by the newly appointed government's announcement of unfunded tax cuts and universal energy subsidies to the tune of £43 billion[6]. Before announcing the so-called «mini-budget», Finance Minister Kwarteng had rejected the offer to scrutinise the plan as usual by the Office for Budget Responsibility (OBR), an independent body for fiscal forecasts sponsored by the Treasury and introduced by a Tory Finance Minister, George Osborne. Moreover, the Permanent Secretary to the Treasury, Tom Scholar, had been dismissed shortly after the new government took office; he was a well-respected senior civil servant who had served under Labour and three subsequent Tory governments. Both the OBR and the Treasury's top mandarin were seen, correctly, as the embodiment of Treasury orthodoxy that the new government opposed in the name of growth through free markets and the assertion of national interests[7].

Financial markets did not welcome their liberation with regressive tax cuts as foreseen in the «Growth Plan». It was simply not credible that this stimulus programme of about 2% of GDP every year until 2026-2027 could help growth in a situation of military and economic warfare in Europe (Riley 2022). It was more likely to stimulate inflation by adding even more excess demand already constrained by supply bottlenecks as well as denting growth by exacerbating the uncertainty for investment and trade Britain was experiencing in the wake of Brexit. The market reaction was harsh and immediate: a bond sell-off led to a jump of bond yields, in the case of 5 year bonds to levels not seen since October 2008, shortly after the Lehman collapse. The Pound fell briefly to a 37 year low against the US-dollar and lost 0.75% against the Euro (King 2022). The adverse reaction lasted until the Truss government, with a new Finance Minister, essentially scrapped the plan and then the Prime Minister resigned.

Why were financial markets not impressed? Unsurprisingly, it did not help that the government was openly at odds with the central bank, given that the Treasury orthodoxy is usually shared by central bankers. A day before the mini-budget was presented on 23rd September, the Bank of England (BoE)

[6] A Wikipedia entry on «September 2022 United Kingdom mini-budget» contains a wealth of detail (accessed on 8th January, 2023).

[7] Elliott (2022), economics editor of the left-of-centre Guardian newspaper, contains a succinct list of elements that make up the Treasury orthodoxy.

had announced that it would start selling the huge amount of government bonds it had acquired since 2008, decreasing money supply in an attempt at bringing down inflation (BoE 2022a). While Liz Truss was still in office, a deputy-governor of the UK central bank told a parliamentary committee that the BoE had not been briefed about the budget plan (BBC 2022). While the BoE has no right or responsibility to be consulted, Jon Cunliffe suggested that the adverse market reaction was predictable, strongly implying that it was a legitimate expectation on the central bank's part to be at least informed before public announcement. The Truss government obviously expected that the central bank would simply do what it had done when Rishi Sunak had to borrow £300 billion during the pandemic-related recession. This left financial investors wondering whether they could still sell Treasury bonds at stable prices now that the Bank of England had signalled it wanted to buy them no longer so as to bring down double-digit inflation rates (BBC 2022). A good share of investors decided it was safer to get rid of Treasury bonds quickly.

Some pension funds were caught out by the rise in bond yields that the market reaction to the mini-budget immediately triggered. They had taken out derivatives to hedge against falling interest rates on bonds in which they are heavily invested. Now that bond yields rose unexpectedly sharply, they had to make payments, so-called margin calls, to the other side of the contract that had betted on rising rates. This created an immediate liquidity squeeze, which the pension funds tried to alleviate by selling bonds, driving bond prices further down and yields up. Faced with financial instability all around them, the central bank promised a time-limited bond-buying programme to stabilise prices, allowing pension funds to raise liquidity at a price floor that the Bank of England offered them. Thus, the pension funds predicament had a welcome side-effect from the point of view of the beleaguered government: like the financial industry, it wanted the Bank to be still in the business of bond buying. From the central bank's point of view, this looked like a double whammy of financial and fiscal dominance.

The case for monetary re-insurance was weak, given the government's reckless disregard for all expert advice and possibly opportunistic behaviour on the part of pension fund managers. The Governor of the BoE, Andrew Bailey, called their bluff in an improbably bold move that Armstrong (2022) characterised as a calculated gamble in the *Financial Times*. It turned out that the pension funds did not take up the central bank's offer very much. So, Bailey set pension funds and other eligible firms an ultimatum of three days by which they had to accept the Bank's offer, or the programme would end as scheduled (Armstrong 2022). He announced this at the Institute of International Finance in Washington, D.C., where political, economic, and business elites were discussing, *inter alia*, the UK's emerging market problems. The Pound weakened again in response to his ultimatum and there was much criticism of Bailey for possibly aggravating financial instability. But nothing happened when the deadline passed. The gamble had paid off from the Governor's point of view.

Bailey had exposed the pension funds' opportunistic cry for help, while they waited for a more profitable price at which they could sell: these pension funds obviously did not need re-insurance. Bailey also demonstrated to the government that the central bank would not let its hand be forced by self-inflicted harm for which the Prime Minister only had herself to blame (Armstrong 2022). After the Finance Minister had been sacked by Truss, the Bank of England announced on 18th October that it would resume its bond-selling programme as previously stated (BoE 2022b). On 20th October, Liz Truss stepped down as the shortest serving Prime Minister in the UK's history. Bank officials went public afterwards and let it be known how damaging they found the whole episode.

4.2. *Italy: The ECB encounters Italian Eurosceptics*

The majority for a centre-right coalition was the most likely outcome of the Italian elections at the end of September, which can explain the muted market reaction (Reuters 2022a). The spread vis-à-vis German Bunds hardly rose and remained at almost 2.4% (238 basis points). What calmed markets further was that Meloni's Brothers of Italy, a far-right party, had clearly the best election result, strengthening her hand in forming a stable four-party coalition. This was corroborated by the fact that the government formation took only a month (Jones 2023). For the EU, it was a sobering fact that the only party that had not participated in the national reform government under Mario Draghi did so well. But Giorgia Meloni stressed that she shared the North-Atlantic position on Russia's war in Ukraine. Domestically, she appointed an experienced Finance Minister from the Lega and focused on important cultural issues like the prohibition of illegal rave parties.

In marked contrast to the UK government, the Meloni government did not unsettle markets with a badly timed «dash for growth» budget; an orthodox «stability-first» was what observers noted (Marsh and Williams 2022). In fact, there was hardly any discussion of budgetary plans, due at the end of December. Finance Minister Giancarlo Giorgetti put together a budget that raised the budget deficit from a forecast of 3.4% of GDP in September to 4.5%. This was largely due to tax breaks and subsidies for businesses and households. There were no tax cuts but tax amnesties for delinquent firms to pay their arrears at reduced penalties. The Government relied on its large majority and drove the budget through both chambers with no-confidence votes, a well-known practice «to truncate debate over amendments and push through legislation» (Reuters 2022a). Jones (2023, p. 23) notes that this authoritarian style was nothing new: «Draghi governed with a strong hand – the so-called Draghi method – picking his own ministers and welding an oversized parliamentary coalition together by using more confidence votes – or three-line whips – than all but one Italian government of the past three decades». Again, financial markets hardly reacted. The historical account by Jones (2023) can explain this by highlighting that the «Meloni project» is in economic respects about continuity with previous conservative governments rather than rupture, whatever her anti-immigration rhetoric and some pet projects like no adoption rights for same-sex couples suggest.

How about the EU with its fiscal rules and its new governance through recovery funding? The Commission accepted the budget proposal under the European Semester cycle in mid-December. It was drafted in compliance with all the stipulations and included elements of the Draghi budget plans given that it had to be put together at record speed (Jones 2023). The EU's fiscal rules are still suspended and so the Commission could not really object to a deficit that is considerably higher than 3% (EU 2022). Until 2026, Italy is, in absolute amounts, the biggest beneficiary of the recovery funds introduced in 2021, with €68.9 billion in grants and €122.6 billion in loans. The

EU report indicates that there would be almost no investment where it not for the EU transfers and cheap credit.

However, at a press conference shortly after the Italian elections on 26th September, ECB President Lagarde sent a warning. In the European Parliament's Committee on Economic and Monetary Affairs, she was asked by a member of the Renew party family about the use of the Transmission Protection Instrument (TPI): «I think it's correct that the ECB mentioned the TPI should only be treated as a last resort and, indeed, buying the debt of heavily-indebted countries could encourage their governments to take on even more debt since they know that the TPI would protect their country. So I was wondering, with regard to these developments, could you please reflect on the use of the TPI in relation to the Italian elections yesterday?» (EP 2022, p. 7). Lagarde repeated that she had not any specific country in mind when she said this, but: «[A]s opposed to other tools that we have in the toolbox, such as, for instance, OMT, [the TPI] aims at a different set of situations [...]. It's a situation where essentially things are going on track and in accordance with the rules and in respect of the fiscal framework and in compliance with fiscal sustainability and where there are unwarranted disorderly market dynamics that are not justified by fundamentals or by economic policy errors that would have been made. Those are more relevant to the OMT than the Transmission Protection Instrument» (EP 2022, p. 8). It is noticeable that the ECB President stresses that the TPI is not an OMT for countries without an ESM programme. The latter would open the Pandora's Box of monetary re-insurance the central bank is keen to keep firmly shut. But in a situation of «unwarranted disorderly market dynamics», fundamentals quickly deteriorate and it would then be impossible to distinguish between those who had weak fundamentals before and those whose fundamentals deteriorated as a consequence of the market disorder.

The TPI is an instrument that can address the financial market «tantrums» that the FED encountered repeatedly when it wanted to normalise its monetary stance. In the EA, the tantrums may also be political. In mid-December, ministers in the Meloni government «lashed out» at the ECB for raising interest rates by 0.5%: «Deputy Prime Minister Salvini branded the ECB's conduct "unbelievable, baffling, worrying". [...] Defence Minister Guido Crosetto, a close ally of Meloni and co-founder of her Brothers of Italy party, said on Twitter that raising interest rates "makes no sense" and called the ECB's move to start winding down its sovereign bond purchases "crazy"» (Reuters 2022b). The background was of course that Italian bond yields went up relative to Germany's and were about 1% higher than the spreads of Spain. The ECB may at some point find itself in a discussion of whether the Italian government committed policy errors different from those of other governments.

Lagarde's insistence that the TPI is not for those who want ECB support without ESM conditionality is also supportive of an unloved institution searching for a new role (Mascher, Strauch and Williams 2020). An already legislated proposal is to make the ESM provide a backstop to the Single Resolution Fund for banks, as part of the banking union. When still in opposition, Meloni opposed this ESM reform. Consequently, the Italian government has been the last member holding out, obviously not keen to give the ESM more competencies. The Finance Minister put it as a matter of democratic principle: «We are aware of the commitment undertaken by Italy and that at present all the other participants have proceeded with the ratification, but [...] there is a clear need for a proper and broad debate in parliament before deciding whether or not to ratify the treaty» Giorgetti said in parliament (Reuters 2022b). He was less concerned about parliament's involvement when he cut short the debate on his budget only two weeks later. The Banca d'Italia has put up a fact-check site in which it rebuffs most of the criticisms levelled against the reform (Banca d'Italia, n.d.). Giorgetti argued for making it a kind of development bank for investment and energy subsidies. The government is in a bound, given its well-known opposition to the ESM. The Meloni government's opposition is somewhat ironic, given that the reform tries to repurpose part of the ESM to rein in financial dominance, away from its sole focus on sovereign bailouts and possibly protecting the public purse.

5. Conclusion: The dominance of financial dominance

Re-insurance is the insurance of last, not first resort. Monetary re-insurance, i.e., re-insurance extended by central banks, has many advantages over fiscal re-insurance, above all deep pockets and the ability to act swiftly. But it is also able to pool risks cross-border, either as a key currency like the dollar, through formal cooperation like swap lines, or as European integration – in the case of the ECB. But this ready availability comes at a cost – it can be exploited by those re-insured.

The most ferocious critique of the ECB, especially in Germany where this led to one Constitutional Court case after the next, suggested that the ECB sacrifices savers for profligate governments (Schnabel 2020a). In other words, fiscal dominance is the problem. Profligacy in this context is seen as stemming from a form of collective moral hazard, taking the risk of excessive debt with the expectation that the ECB will bail out the government and/or banks if anything goes wrong.

But if monetary interventions are truly re-insurance and not co-insurance, moral hazard is largely taken care of. The «co-payment» or loss below the excess threshold is then so high that endogenous risk-taking should not be a problem. Miscalculation and over-optimism that really bad shocks will not happen are more likely to be a problem and typically more in the case of the financial industry (and their private clients they talk into risky investments). This is because, in a financial boom, budget constraints tend to become soft, every investment tends to be validated by sizeable profits, and the value of assets goes only in one direction. Macroeconomists know this as the pro-cyclicality of finance. Democracies, especially in the EU, do not enjoy such leeway. Democratic political systems must put up with an enormous amount of scrutiny and checks and balances, from the media and parliaments, courts, and independent auditing bodies, domestically and internationally. The UK government under Liz Truss proves the point for a recession: Brexit and open disdain for the OBR and its own civil service gave it the freedom to engage in an uncontrolled experiment of fiscal policy-making that was checked only after its launch, by the Bank of England. Disagreement with the re-insurer of last resort can explain the surprising phenomenon that market actors challenged the old financial centre like an emerging market that made the government step down. Italy's new eurosceptic government was not inclined to pick a fight with its monetary protector, although a phase of rising interest rates may test the opportunism of Meloni's coalition.

Those who see the European monetary union as incomplete argue that it is desirable that a central bank stands ready and buys up government bonds when hit by a major shock. The assumption is that this gives fiscal states more room for manoeuvre and protects them against being attacked by bond investors who sell. My analysis, inspired by Brunnermeier (2016), raises some doubts about this form of intervention by a key branch of the governments, the central bank. A central bank that can limit itself to re-insurance, covering only the tail risk, such as a systemic crisis, allows also the fiscal authorities to refuse helping banks that are highly leveraged, made foolish investments, or engaged in innovations of which they ignored the risks. They also give bank managers a reason to resist the lure of excessive bond holdings that supposedly commits the government to bail them out. Completeness is an ideal that would quickly undermine itself.

Appendix

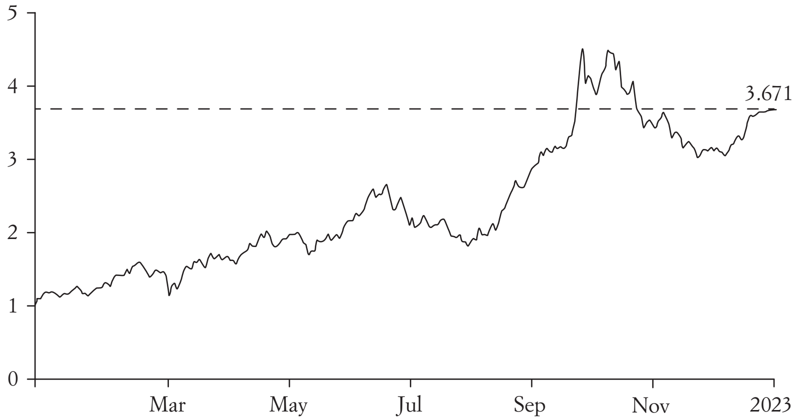

FIGURE 1. United Kingdom Government Bond yield, 10 years.

Source: Trading economics, https://tradingeconomics.com/united-kingdom/government-bond-yield.

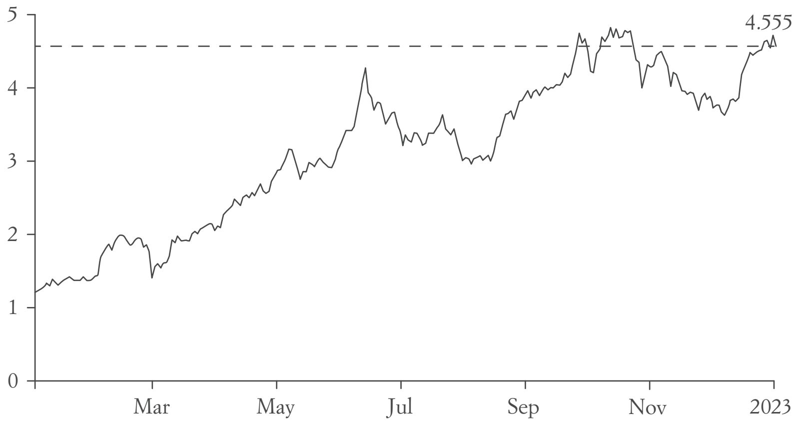

FIGURE 2. Italy Government Bond yield, 10 years.

Source: Trading economics, https://tradingeconomics.com/united-kingdom/government-bond-yield.

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Monetary re-insurance of fiscal states in Europe

Summary: Ever since the financial crisis of 2008, central banks in the rich Western hemisphere are engaged in extraordinary interventions to stabilise financial markets. They act as lenders and money market makers of last resort. But these interventions were also motivated by the need to stabilise public finances. This became obvious in the Euro Area (EA) when the Greek government was effectively shut out of bond markets in early 2010 and the panic rapidly spread to the Irish and Portuguese segments. The turmoil in bond markets has been widely interpreted as a symptom of the EA's incompleteness as a fiscal union. But monetary re-insurance is not the same as fiscal dominance. Yet incentives for governments are sometimes more aligned with bond-holding banks and this can put central banks under a regime of financial dominance. By analyzing speeches of Executive Board members, the article shows how the ECB has come to develop monetary re-insurance of fiscal states and the financial system, while safeguarding against becoming dominated by other institutional actors. The need for monetary re-insurance of fiscal states is not confined to EA members. To illustrate this point, the article compares recent financial instability in the UK with Italy and shows how central banks navigate this dilemma of re-insurance and financial dominance.

JEL Classification: E58 - Central Banks and Their Policies; E62 - Fiscal Policy; G22 - Insurance.

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