
Gaps in the Institutional Structure of the Euro Area

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The monetarist view of the foundations of EMU

- A determined central bank can always control inflation by controlling money growth.
- Fiscal-monetary interaction consists of attempts by the fiscal authorities to get the central bank to buy more government debt than is consistent with stable inflation, and is inherently bad.
- An institutional design with a single, large central bank and a fractured fiscal authority of many smaller treasuries is therefore less likely to be subject to inflationary pressure from the fiscal side than is the usual single-country fiscal-monetary pair of institutions.

Aspects of central banking and inflation control missed by this view

- Essential fiscal backing
- Inflation as a cushion
- The fiat money lender of last resort

Essential fiscal backing

- The fiscal theory of the price level (Leeper, Woodford, Cochrane, and me, among others) pointed out in the 1990's that standard macro models, in ignoring fiscal-monetary interactions, could reach misleading conclusions about how inflation is determined.
- These papers did not explicitly model currency unions, but from their perspective it was clear at the start that the Euro could be unstable. (See my 1999 paper "The Precarious Fiscal Foundations of EMU" in *The Economist*.)
- Their implication: A central bank can "independently" determine the time path of prices only if its every policy action engenders a validating response from the fiscal authorities.

- In other words, there is no automatic mechanism by which fiscal discipline can be compelled by a central bank that controls money growth.

Implications of recognizing the symmetric roles of fiscal and monetary policy

- Interest rate increases counter inflationary pressure only if there is a fiscal response that prevents the rate increase from feeding directly through to an increased rate of issue of nominal government debt.
- The central bank balance sheet matters to its ability to control inflation, unless everyone is sure that recapitalization from the fiscal authorities is available when necessary.

Fiscal backing in the EMU

- Legislatures may, at least eventually, recognize that steady expansion of nominal government debt is inflationary.
- The causal link is much attenuated for a country that's a small part of a currency union, however.
- In a currency union, the fiscal response to monetary policy actions must be present in *all* members of the union.
- Recapitalization by bond issuance requires agreement among all currency union members.

Inflation as a Cushion

- Unexpected inflations and deflations tend to roughly offset surprise fiscal stresses in well-managed economies.
- They produce effects on the government budget constraint that are not trivial.
- They are not available to countries in the EMU or to US states, which do not have their own currencies.
- In the US, there are other fiscal cushions that offset the loss of the inflation cushion. Not in the EMU.

Fiat currency liquidity

- Nominal government bonds need never default.
- They promise to deliver only paper, which a government with its own currency can always print
- Unanticipated inflation or deflation produces unpleasant or pleasant surprises in the return to holders of nominal debt, but this is quite different from default.
- The prospect of default, with a given configuration of future tax and spending uncertainties, implies much more uncertainty for investors than the prospect of inflation, as there are so many ways to default.

Lender of last resort with fiat debt

- The lender of last resort function is important when many private debt contracts become subject to contagious worries of default risk.
- An institution that is not itself subject to such worries, can intermediate to provide liquidity in such a situation.
- A central bank that has fiscal backing from a government that can issue fiat debt is the most effective lender of last resort, as it is least subject to doubt about its own ability to deliver on credit contracts.

Two ways forward for EMU

1. Make everyone realize that they have signed on to loss of the inflation cushion, loss of an effective lender of last resort, and the need for occasional national bankruptcy with EMU receivership. My view: this is not a stable solution in the long run.
2. Fix the institutional gaps:
 - Fiscal coordination that combines a bankruptcy and receivership mechanism with a risk-sharing mechanism;
 - A true Eurobond for the ECB to use in its open market transactions. This would have to be issued by an agency that could buy (or not buy) country debt and that had some power to tax — e.g. by the right to add a surcharge on the VAT.

- Fiscal stability regulation at the EMU level, to allow an effective EMU lender of last resort.

Politically impossible?

- The Eurobond-issuing institution would imply fiscal transfers and would need democratic legitimacy.
- So far, there does not seem to be much movement in this direction among European political leaders or voting publics.
- But the current state of the southern-tier economies, of the ECB balance sheet, and of the European banking systems, implies there are losses that must be allocated.
- Might the prospect of this allocation coming about via a chaotic, destructive process be enough to generate the needed political initiative?