Learning the Hard Way about Fiscal-monetary Interactions: Europe and the US*

Christopher A. Sims (Princeton University)**

We'll discuss origins and policy options for the crises in Europe and the US. Then we'll discuss whether economics, economists, or certain kinds of economics, are part of the problem or part of the solution.

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.

---

* 2012년 6월 20일(수) ~ 21일(목), 고려대학교 인촌기념관 및 국제관에서 개최된 한국경제학회 창립 60주년 기념 제15차 국제학술대회(주제: Prospects for the Future: Shaping New Approaches and Issues in Economics) Special Lecture의 발표문임을 밝힙니다.

Aspects of central banking and inflation control missed by this view

- Essential fiscal backing – the role of the central bank balance sheet.
- Inflation as a cushion.
- The fiat money lender of last resort.

The central bank balance sheet

- The Japanese or US central bank, pre-crisis, had as assets mainly nominal debt issued by their own country.
- Like most central banks, these act as marketing agents for government debt. Mature debt is paid oat the central bank.
- So long as the central bank doesn't refuse this role, thereby allowing treasury default while the central bank remains solvent, nominal debt has no default risk.
- The central bank therefore itself has negligible balance sheet risk: Its assets and liabilities are currency-matched, and usually fairly closely maturity-matched.

What if the central bank net worth at market values is negative?

- With liabilities mainly currency and deposits, the central bank has promised nothing to its "creditors" that it cannot always pay.
- But if it wishes to control inflation, negative net worth can limit its ability to do so.
- Contractionary policy requires selling assets to shrink the balance sheet. If it can be seen that the central bank will run out of assets before it has eliminated all liabilities, its contractionary open market operations will not be effective.

Fiscal backing

- Most central banks, and this includes the ECB, do not have the classic US/Japan style balance sheet: they have foreign-currency denominated assets.
- They are nonetheless able to control inflation despite balance sheet risk if they have unquestioned fiscal backing.
- If it is understood that if necessary the treasury will print up securities and give them to the central bank for recapitalization, the central bank can control inflation, even if its current net worth is negative.
- But for this to work, the debt provided by the treasury must be non-defaultable.

Contradictions in the design of the ECB

- One vision of the ECB was that it was to be entirely independent of fiscal authorities, not carrying Euro area government debt on its balance sheet.
- This entailed "market discipline" for fiscal policy, so that interest rates would rise on debt issued by less responsible treasuries.
- Of course this in turn entailed a non-zero probability of default.
- But this vision implied that there would be no treasury capable of issuing non-defaultable debt if the ECB itself needed recapitalization.

Actual ECB policy

- Before the crisis, the ECB conducted policy with an interest rate instrument, like most central banks.
- It did not buy government debt, but it treated all Euro area government debt as riskless collateral in short-term lending, so rates on debts of different country were nearly identical.
- This of course negated any possibility of "market discipline" for government fiscal policies.

Fiscal theory of the price level

- Leeper, Woodford, Cochrane, and I, 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.
- This was a theory for the case of non-defaultable, nominal government debt.
- 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 De Economist.)

Implications of scal theory

- 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.
- 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 – or, if there is no fiscal response, there is an increased probability of outright default.

- 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 at 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 at 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

- 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.
- 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.
- Financial 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.
- Note that by preserving the possibility of individual-country default, this arrangement would avoid the need for country-by-country control over budget policy. “Fiscal union” would come only through the modest taxing power given to the Euro-bond institution.
- 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?

The US situation: How we got here

- The US has the institutions it needs: an independent central bank with regulatory authority, backed by a government capable of running primary surpluses and issuing nominal debt.
- In the period before the crisis, regulatory institutions set up in the wake of the 1930's were weakened. For example, the SEC was run by appointees who saw its main task as getting out of the way of innovation.
- The "Great Moderation", in which volatility in most part of the economy shrank noticeably, induced players in the financial markets to make bigger bets as they tried to generate sufficient risk to produce excess returns.
- Economists and regulators could see that the housing market posed a risk of crashing. There were attempts to assess the financial consequences of such a crash, but they failed, in part because of a lack of data, to recognize the extent to which the housing market had been leveraged in the non-bank financial system.

The way forward for the US

- The problem for the US is not institution-building; it is getting existing institutions to function properly.
- The US debt is high, but it has been higher before without causing problems.
- The US public sector is not too big, and taxes are not too high.
- As in many countries, the aging population, combined with implicit commitments about retirement funds and medical care, will force difficult fiscal choices, the more difficult the longer they are postponed.
- The US problem is that these issues involve some people taking losses, and allocating losses is something that seems to create difficulties for democratic governance.

Fiscal and monetary policy in the US

- Some of the problem in the US and Europe is debt overhang – real values of public and private debt greater than expected at the time of issue because of unexpectedly low inflation.

- Temporarily above-normal inflation would be helpful with this.
- Policy-makers at both the ECB and the Federal Reserve have been unwilling to state that this is their objective, indeed have specifically denied that they contemplate such a policy.
- Their excuse is a fear, unjustified in my view, that they might not be able to bring down inflation once it started.
- This situation – timid policy when recovery is still incomplete because of exaggerated fear of an inflation that has not occurred – echoes the mistakes of the US Fed in the late 1930's.

Expansive policy and fiscal backing

- For the US, expansive policy requires an understanding by markets that when, later, monetary restraint is required, there will be fiscal backing for that policy.
- At the same time, though, it requires an understanding by markets and the public that not all the outstanding debt will be backed by taxes – that some inflation is in prospect.
- For Europe, the required future fiscal backing is not in prospect with existing institutions, which is why many northern European officials oppose expansive monetary policy.

Conclusion

- While economic analysis can tell us, if fiscal and monetary policy are considered jointly, how to resolve the financial crisis and restore growth, the limiting factors in both the US are essentially political.
- We must keep our fingers crossed.