The future of the Euro

Christopher A. Sims
Princeton University
sims@princeton.edu

October 24, 2011

Two extreme views

- Southern: The crisis could be ended if the ECB would simply enter the market for Euro-area government bonds, bringing interest rates down to levels without the "panic premium".
- Because the ECB can print money, there is no doubt that they could do this. There might in principle be inflation risk, but for now this is a remote concern.
- Northern: The ECB and the Euro have run off the rails of their initially conceived track.
- They should not, even indirectly, support the prices of government debt securities. Markets should be allowed to "discipline" country fiscal policies.
- The role of the ECB is to supply a *currency*, not to buy government debt, not to be a lender of last resort.

What is a central bank for?

- When the Bank of England was formed in 1694, the answer was very clear: It was formed to buy government debt to finance the "War with France", and in this it was very successful.
- Most central banks manage the market for their governments' debt.
- The ECB treaty specified that it was *not* to buy any government's debt. It was supposed to be independent of any fiscal authority, and indeed there was and is no Euro-area-wide fiscal authority corresponding in scope to the ECB.
- Most central banks also serve as a lender-of-last-resort, and, because this was recognized as requiring fiscal backing, the ECB was meant *not* to serve this function.

A powerful combination: a central bank and nominal government debt

- Nominal government debt promises only to pay fiat money. Combined with an ability to print money, this makes nominal government debt's counterparty risk negligible (barring doomsday machine political gaming).
- This gives it a liquidity premium, and makes it potentially usable as a reserve asset.
- Inflation can emerge if the debt is not fully backed by fiscal effort, but the effects of inflation are uniform across assets and asset-holders and involve no court-mediated or politically-mediated disputes over creditor priority.
- A central bank can print money to support asset prices or to act as LLR, but if it has no fiscal backing, its only way to recover from balance sheet shocks is to use seignorage, i.e. inflate.
- With a long run fiscal commitment, a central bank plus nominal government debt provide a powerful shock absorber

Did joiners of the Euro understanding they were giving this up?

- Probably not.
- Indeed the ECB did buy government debt (just not directly from governments) and it did not differentiate among governments in taking such debt as collateral.
- Interest differentials among Euro area governments were small, and the Euro did start to compete as a reserve currency.

What if the crisis forces us to the original-track vision for the Euro?

- No Euro-level LLR. Countries left to stabilize banking systems involving large institutions and systemic risks that run across national borders.
- No nominal-debt fiscal cushion. Outright default whenever Euro value of future surpluses falls below Euro value of debt, even where otherwise fairly mild inflation would have taken care of the imbalance.
- Much diminished role for the Euro as international reserve currency.
- Little or no liquidity premium on government debt.

Euro survival?

- This scenario implies such large losses relative to matched country-level nominal debt and central banks that it seems likely the Euro would not survive.
- But this is a very bad outcome, so bad that even otherwise implausible policy changes or political initiatives may be worth considering.

An outline of a proposal

- Some Euro-level institution, perhaps the EFSF, begins issuing Euro debt, backed by an adequate fiscal resource, ideally a Euro-wide tax, e.g. a few points of VAT.
- To attain the scale it would need to make a deep market for the debt, it would need to buy much of the existing country government debt.
- With authority to tax, it would have to have political accountability, perhaps through a representative council.
- The ECB is empowered to use the Euro-level debt in open market operations, and can appeal to the issuing authority for backing if it needs a capital injection.
- With this in place, country-specific government debt could be left to market discipline without affecting the availability of a LLR or the liquidity premium on the Euro bonds.

Criticisms of the proposal

- It's dangerous. There would be a temptation to have the ECB bail out countries in fiscal trouble, without corresponding fiscal effort from the Eurobond authority.
- Such a pattern has been observed before — e.g. Argentina and Brazil — when regional governments are powerful relative to the center.
- It requires that European governments do things they have said they absolutely will not do, so is unrealistic.

Criticisms of the proposal

- It's dangerous. There would be a temptation to have the ECB bail out countries in fiscal trouble, without corresponding fiscal effort from the Eurobond authority.
- Such a pattern has been observed before — e.g. Argentina and Brazil — when regional governments are powerful relative to the center.
- It requires that European governments do things they have said they absolutely will not do, so is unrealistic.
- However, the consequences of a collapse of the Euro would be so dire that it also seems unrealistic to think that will be allowed to happen.
- Probabilities have to add up to one.