Institutional evolution in the EMU

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The view from 20 years ago

The view from five years ago: the missing institutions

- Eurobond
- Sovereign default

Suppose the gaps are unpatched

- Default $\Rightarrow$ EMU "police" arrive to discipline an already unhappy nation.
- Defense against multiple equilibria speculative attacks is weak.
- The ECB must make decisions about which countries' debt to buy, and at what interest rates — treating all sovereign debt as "safe" is impossible.

Could the EMU survive without patching?

- Consider the threat of a large-country default, with no defined framework for prioritizing debts and setting haircuts.

- The prospect of default could be so unpleasant as to make exit from the Euro once again enter the political discussion in the affected country.

- For that reason, the ECB might feel it should do "whatever it takes" to prevent the default, even though this creates a high probability of balance sheet problems.

- This then could imply either accepting inflationary consequences, or opening discussion across the EMU of an ECB recapitalization that is easily seen as (and might actually be) a fiscal transfer to a fiscally undisciplined country.

Separating fiscal from monetary policy

- A Eurobond fund, substantially capitalized (like ESM), so it could provide quick recapitalization for ECB.
- With power to tax, perhaps ordinarily not exercised since it would tend to earn seigniorage.
- With power to *not* buy the debt of countries it sees as on an unsustainable fiscal path.
- With some form of political legitimacy: Perhaps simply appointment of its board by the European parliament, plus a clear and narrow definition of its objective and powers, as with a central bank.

Smooth default

- Many agree that sovereign default must be admitted as possible, and that some way to make it orderly is needed. The point of the Eurobond fund is to allow country default and market default premia
- But one view is that what is needed is a mechanism that makes it clear in advance how painful default will be, so as to minimize the chance that it occurs.
- This enhances the disadvantage of EMU membership.
- What would be better is to mimic as closely as possible the "smooth default" via inflation that is available to countries with their own currencies.

Suspension of convertibility

- EMU is often compared to the gold standard, a regime that was in place in many countries for a long time.
- Most countries under the gold standard had episodes of "suspension of convertibility".
- This meant that the pound, though defined in terms of gold, was for some finite, though uncertain, span of time, not convertible to gold on demand.
- This creates fiscal space.

Special cases

No uncertainty. Suspend now, cut real primary surplus to lower level from t to $t + T$, but resume original level at T. Then the pound devalues (relative to its nominal gold value), but then starts to appreciate, which allows lower nominal rate.

Constant probability of return to parity, lower primary surplus until then. Lower interest costs because of expected gains on return to parity.

Permanent inconvertibility: Then it's just a devaluation.

Adapt this to EMU?

- Inconvertibility of the pound applied to currency as well as debt.
- Remaining in EMU implies continuing to use Euro currency.
- Therefore in the EMU suspension would have to apply to a country's interest-bearing debt alone.

Could this be stable?

- Once inconvertible, what would be the incentive to come back?
- With a Eurobond agency, a surprise inconvertibility episode would create a fiscal transfer from the rest of the Union to the inconvertible country.
- Might make the Eurobond agency holdings not subject to inconvertibility.

Discouraging political economy of prospects for reform

- Discussion of formal, orderly default seems not to be happening.

- Eurobonds have been suggested in several versions, starting years ago, but because they are recognized as entailing some fiscal risk sharing, they are not even discussed as a serious option.

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- But as we have stood around vainly waiting for new institutions to arise, an ugly duckling in the pond may be transforming into a swan.
- It has broken the prohibition on purchase of sovereign debt, and his now holding a substantial portfolio of such debt.
- It finances its purchases by issue of an interest-bearing, Euro-denominated instrument that is implicitly backed by EMU-wide fiscal resources: ECB reserve deposits. This meets the objective of providing an EMU-wide rate to be the main ECB monetary policy instrument.
- Though for the time being it buys debt of all countries according to

the capital key, it clearly in some circumstances would have to decline purchase of some countries' debt.

- It has made the "whatever it takes" commitment that implies it is a lender of last resort, ready to extinguish bad elements of an array of multiple equilibria.

So is the ECB's institutional innovation enough to fill the gaps?

- The objective of separating monetary and fiscal policy is not being met.
- The ECB's holdings of government debt are justified as necessary for monetary policy purposes, which is true, but
- The influence of ECB policy on relative wealth of countries is becoming larger, without public recognition that this is going on or is legitimate.

Conclusion

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