

Public debt monetisation and the credibility of the ECB

What stops public debt being monetised to avoid the pain of prolonged austerity after the pandemic? An obsolete economic theory of ‘credibility’.

By Pompeo Della Posta

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In the conditions, akin to wartime, resulting from the Covid-19 pandemic, public debt is being created – and more will have to be created – to meet the exceptional fiscal needs arising. Many economists, of different orientations (Blanchard and Pisani-Ferry, Giavazzi and Tabellini, Gali, De Grauwe), suggest that this debt should be ‘monetised’ – bought up on primary markets by central banks, with the creation of new money. This would avoid the accumulation of public debt and the consequent need to adopt future austerity policies for its repayment, hindering growth.

The main objections to such direct-money financing of public expenditure in the European economic and monetary union (EMU) relate to its institutional feasibility – given the requirements of the Treaty on the Functioning of the European Union – and the negative effects it would supposedly have on the anti-inflationary credibility of the European Central Bank.

The first objection is, of course, rather serious—although only so long as insufficient political will prevents its resolution via treaty change, to which I shall return. To deal with the second, it is worth recalling the evolution of the theory of ‘credibility’.

‘Rational expectations’

The first generation of credibility theory, dating back to the 1970s and 1980s – in particular the contributions of Kydland and Prescott and Barro and Gordon – contended that central banks should follow monetary rules rather than exercise discretion. In the latter case, it was asserted, the ‘rational expectations’ of economic actors would anticipate the central bank’s ‘time inconsistency’ problem, namely its purported incentive to renege on the initial

promise not to run an expansionary monetary policy and instead reduce unemployment by managing a surprise injection of money to increase the price level – thereby reducing real wages and inducing employers to hire more workers.

The expectation of inflation would, it was contended, pre-emptively become a self-fulfilling prophecy, leaving no real effect on unemployment and production, which would remain anchored to levels presumed naturally dictated by the market. ‘Tying the hands’ of central banks by imposing strict rules on them, then, would solve the ‘time inconsistency’ problem.

This theory – however questionable its deterministic chain of argumentation – was convenient for those believing in the unconditional virtues of free markets and unconcerned about unemployment in the post-Keynesian era. It became the theoretical basis on which the ECB’s institutional architecture was built, to preserve its anti-inflationary credibility.

Optimum currency areas

This conclusion conflicted with the basic approach of the parallel flow of literature on optimum currency areas (OCA). From a different perspective, this also implied tying the hands of the central bank, although through participation in a fixed exchange-rate system or a monetary union, rather than by imposing stringent domestic rules.

More specifically, OCA theory examined the conditions to be met for a currency or monetary union – in which exchange-rate and monetary independence were renounced – to be optimal. It did so by asking how likely an asymmetric shock affecting a country would be (Kenen’s

product-diversification criterion), how easily it could be absorbed by automatic market mechanisms (Mundell's criterion on mobility and flexibility of labour and capital) and how effective the forsworn exchange-rate instrument might have been (McKinnon's criterion on the degree of openness).

Credibility theory, being based until then on deterministic models, should not have been part of this debate, but it was wrongly credited as being the 'new' OCA theory (Tavlas). In this view, since monetary independence produced only an inflationary bias, without any substantive benefit, giving it up by joining a currency or monetary union would always be optimal, because it would avoid running the risk of inflation.

Justice was only done when the second generation of credibility theory took instead a stochastic approach – recognising contingency and randomness. This led to the same conclusion as OCA theory: if production is hit by an unexpected and asymmetric shock, one can no longer conclude that rules (whether a domestic or an external tying of hands) are always preferable to discretion.

If the problem is uncertainty as to central-bank behaviour over time, credibility is at issue, but this is not the problem when a stochastic shock affects the economy and needs to be absorbed in the here and now (Lohmann). The rules, therefore, should not be fixed, but rather state-contingent (Svensson) and policy-makers cannot gain credibility by following policies that are not credible (Drazen and Masson). How, in 1992, for example, could the Italian central bank gain credibility and an anti-inflationary reputation by following a fixed rule of exchange-rate stability that damaged the Italian economy?

Less costly

And, in the current situation, how could the ECB lose its anti-inflationary credibility if it agreed to buy government bonds on the primary market or if it financed citizens directly by

crediting their current account – which would not entail any inflationary risk and would be less costly for the euro-area economies than recourse to debt? After all, that is what the Bank of England and the Federal Reserve are doing. In fact, the future repayment of these debts would risk jeopardising the economic-recovery capacities of the countries in question, which would have to resort to recessionary austerity policies.

During the eurozone crisis, European countries already followed restrictive fiscal policies, the opposite of what the United Kingdom and the United States did. It is not to these policies – which perversely increased the ratio of public debt to gross domestic product, due to their larger contractionary effect on the denominator – that we owe the end of the crisis. Rather, that came with the reassurance of the 'whatever it takes' monetary commitment by the then ECB president, Mario Draghi.

Restrictive fiscal policies were implemented not because they were coherent or validated but because of the distrust of European countries towards one another. It was this mistrust which fostered the belief that, without limiting fiscal looseness, the associated 'moral hazard' would produce excessive growth of public debt.

It seems that today we shall make a similar mistake – this time in terms of an inappropriate monetary, rather than fiscal, policy. The reason, however, is the same – mutual mistrust and the fear that the expectation of debt monetisation would induce irresponsible, 'freeriding' behaviour.

Such fear is engendered by the continuing incompleteness and indeed fragmentation of economic and monetary union. Which carries a high cost – a cost that should be sufficient to foster the political will necessary to avoid it and so to enjoy the full benefits of EMU.

Pompeo Della Posta is associate professor of political economy at the University of Pisa.