

Paul Krugman - New York Times Blog

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Who Has Draghi's Back?

Correction: There is not, I'm told, any formal Treasury backing for the Fed; there were informal assurances early in the crisis, and everyone takes it for granted that any losses that exceed the interest the Fed normally turns over would be made whole, but in principle the Treasury could let the Fed go bust. I guess that after President Rand Paul appoints his father as Treasury secretary this becomes a real concern.

Many people now accept the point I associate with Paul De Grauwe, which is that the debt crisis in Europe is very much a creation of the euro; countries that have given up the ability to print money become vulnerable to self-fulfilling panics in a way that countries with their own currencies aren't. Now come Corsetti and Dedola to argue that things are more complicated than that.

It's a pretty dense argument — in fact, I'm going to need more coffee before I make another try at getting the whole thing. Partly they argue that defaults can still happen even with a printing press. Mainly, though, they argue that the ECB could serve as liquidity provider of last resort to euro countries; the euro isn't really, or at least not exactly, a foreign currency from their point of view.

Indeed, the ECB's various operations — the LTRO scheme of lending with sovereign debt as collateral, and then OMT (the promise that it will buy sovereign debt directly if necessary) have been highly successful at limiting spreads. But why doesn't the ECB do more?

Part of the answer is politics and dissent. But they also argue a more fundamental point, which I was aware of but which they make much more explicit: the ECB is constrained, in a way the Fed isn't, by the lack of a fiscal backstop. The Fed actually has a formal agreement that the Treasury department will make good any losses it incurs from unconventional monetary policy. The ECB doesn't have any such agreement, in part because there's nobody with whom to make that deal.

The moral is that the fiscal flaws of the euro run even deeper than people realize. Not only does it suffer from lack of the kind of fiscal integration that has, for example, done so much to cushion Florida from the effects of a housing bust; it also suffers from a central bank that has a bias toward timidity because it doesn't have a fiscal authority backing it up.

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