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.


** ©2012 by Christopher A. Sims. This document may be reproduced for educational and research purposes, so long as the copies contain this notice and are retained for personal use or distributed free.
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 off 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.