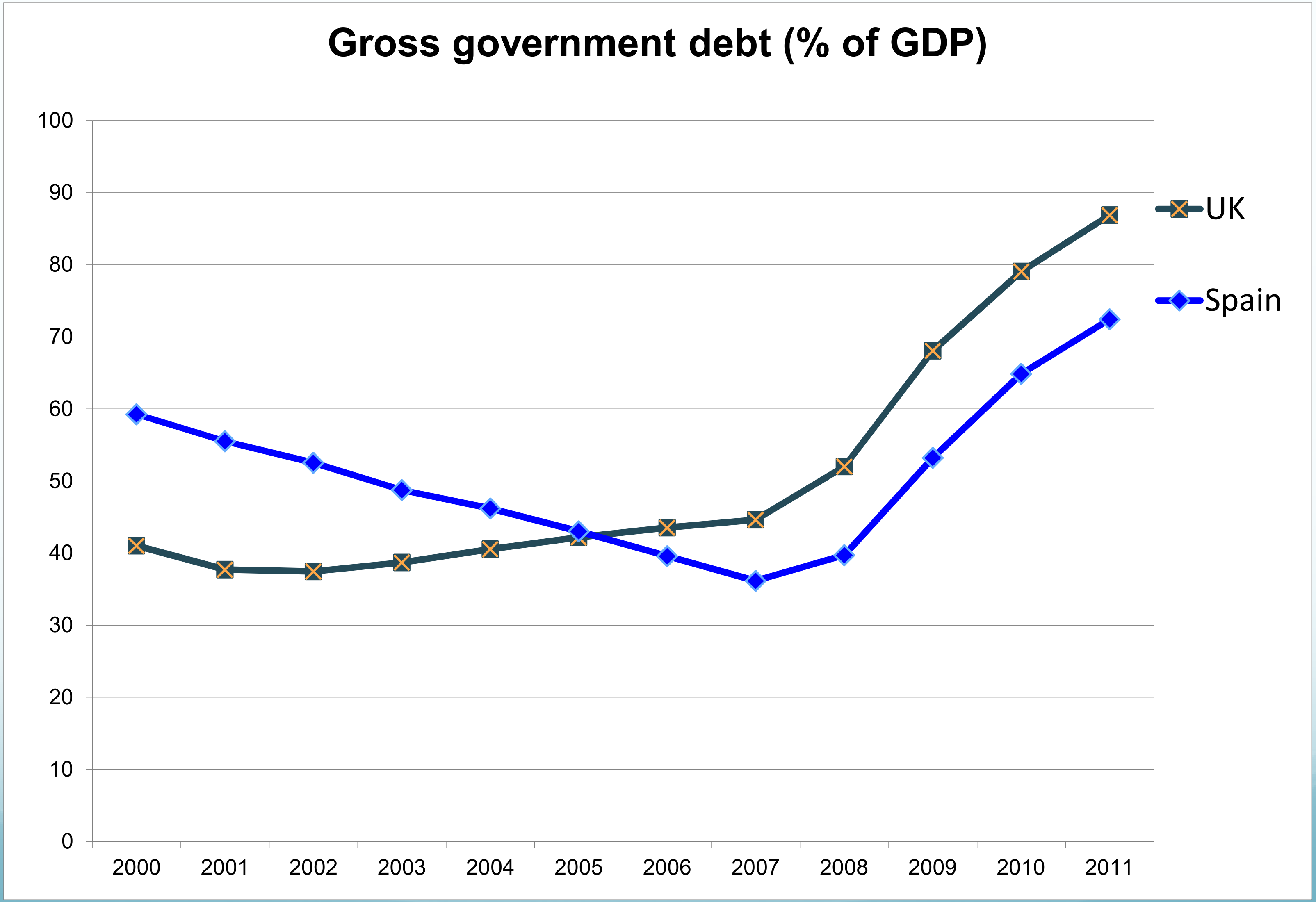
Managing the Fragility of the Eurozone

Paul De Grauwe
London School of Economics

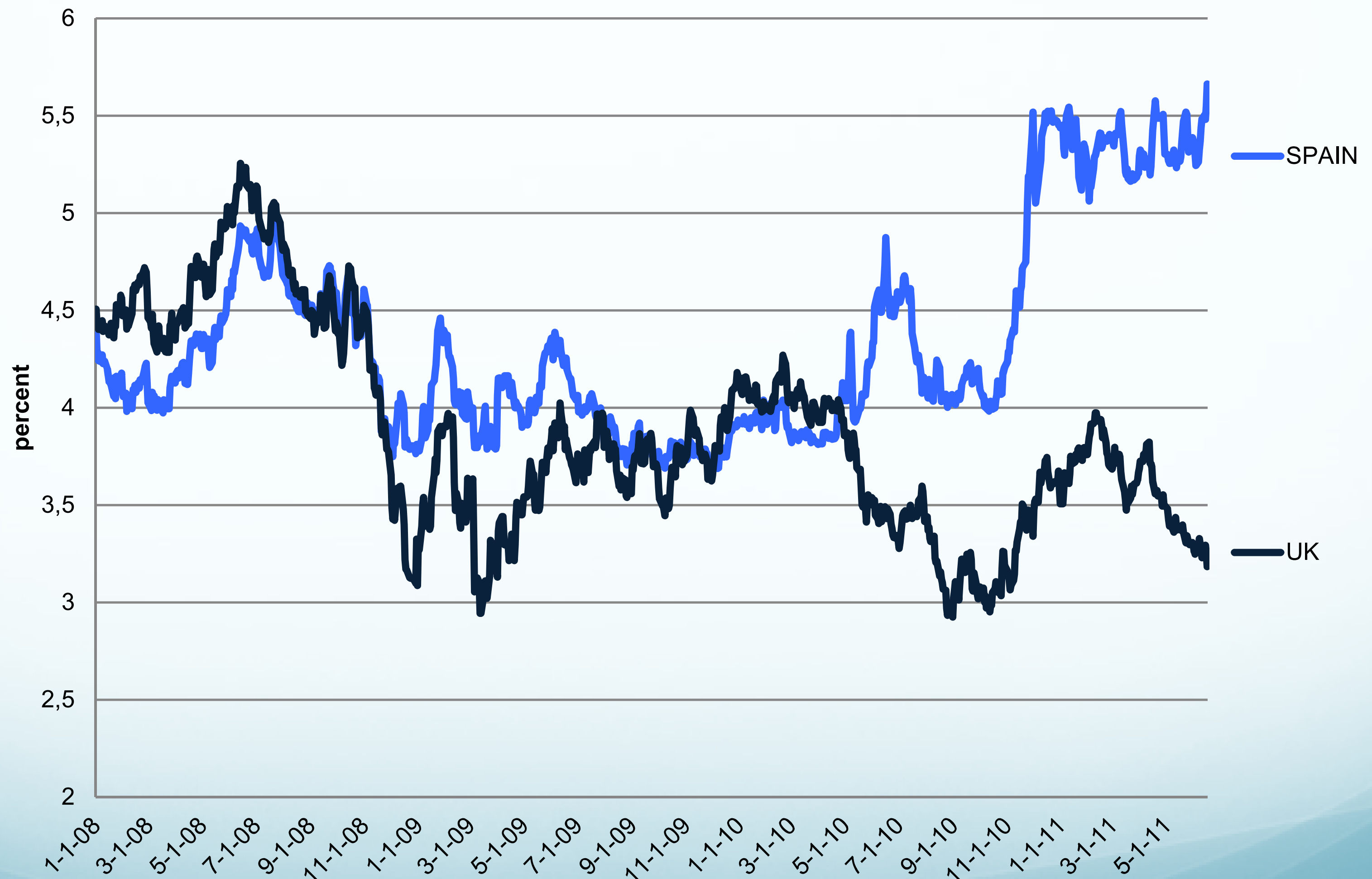
The causes of the crisis in the Eurozone

- Fragility of the system
- Asymmetric shocks that have led to imbalances
- Interaction between the two

Paradox


Gross government debt (% of GDP)
100
90
80
70
60
50
40
30
20
10
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
UK
Spain

10-Year-Government Bond Yields UK-Spain



Nature of monetary union

- Members of monetary union issue debt in currency over which they have no control.
- Result: governments cannot give guarantee that cash will be available to pay out bond holder
- It follows that: Financial markets acquire power to force default on these countries
- Not so in countries that are not part of monetary union, and have kept control over the currency in which they issue debt.
- These countries provide implicit guarantee that cash will always be available

Self-fulfilling crises

- Members of a monetary union are very susceptible to movements of distrust.
- When investors fear some payment difficulty (e.g. triggered by a recession),
  - Government bonds are sold
  - Interest rate increases
  - liquidity is withdrawn from the national market (a "sudden stop").
- Similar problem with banks

- This can set in motion a devilish interaction between liquidity and solvency crises.
  - Once a member-country gets entangled in a liquidity crisis, interest rates are pushed up. Thus the liquidity crisis turns into a solvency crisis.
  - Investors can then claim that it was right to pull out the money from a particular national market.
- It is a self-fulfilling prophecy: the country has become insolvent only because investors fear insolvency.

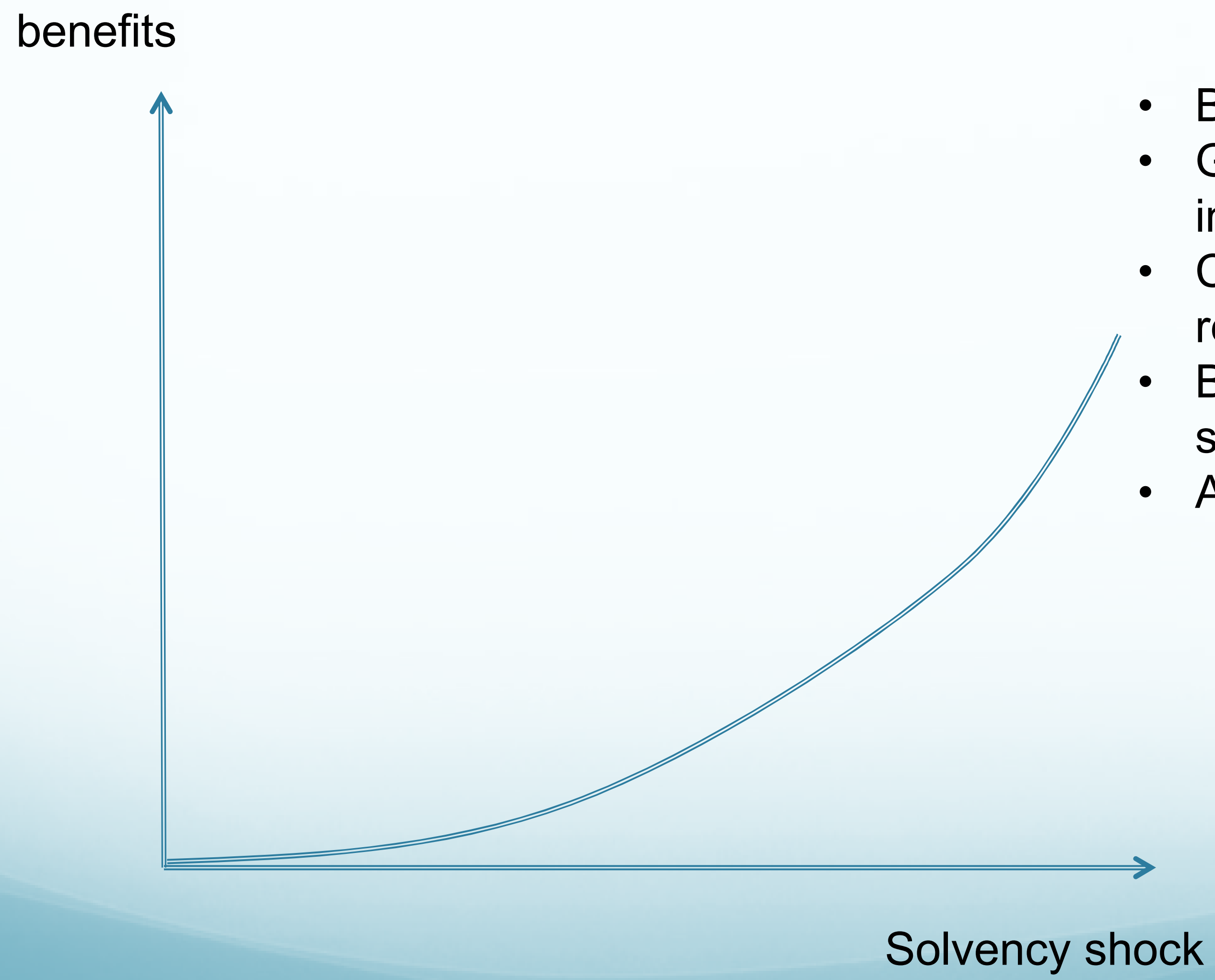
Multiple equilibria

- Multiple equilibria arise because of self-fulfilling prophecies inherent in market outcomes
- Suppose market distrusts government B. Bonds are sold, raising yield; as a result, probability of default increases; markets were right to distrust government B; **bad equilibrium**
- Suppose markets trust government A: willingness to buy bonds at low interest rate; risk of default is low; market was right to trust that government; **good equilibrium**

Model with good and bad equilibrium

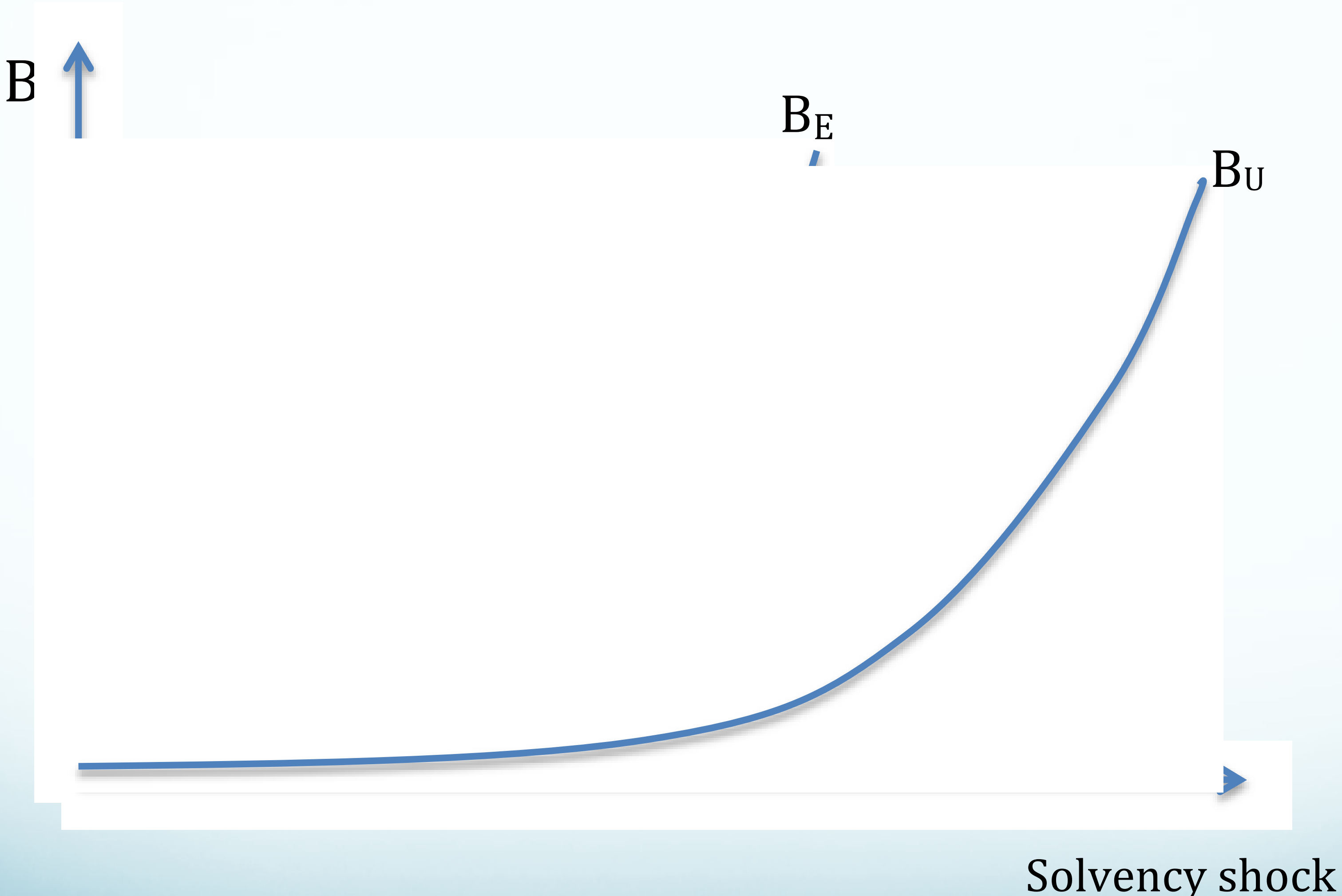
- Starting point is: there is a cost and a benefit of defaulting on the debt,
- Investors take this calculus of the sovereign into account.
- I will assume that the country involved is subject to a shock, which takes the form of a decline in government revenues.
  - The latter may be caused by a recession, or a loss of competitiveness.
- I'll call this a solvency shock.

Benefits of default



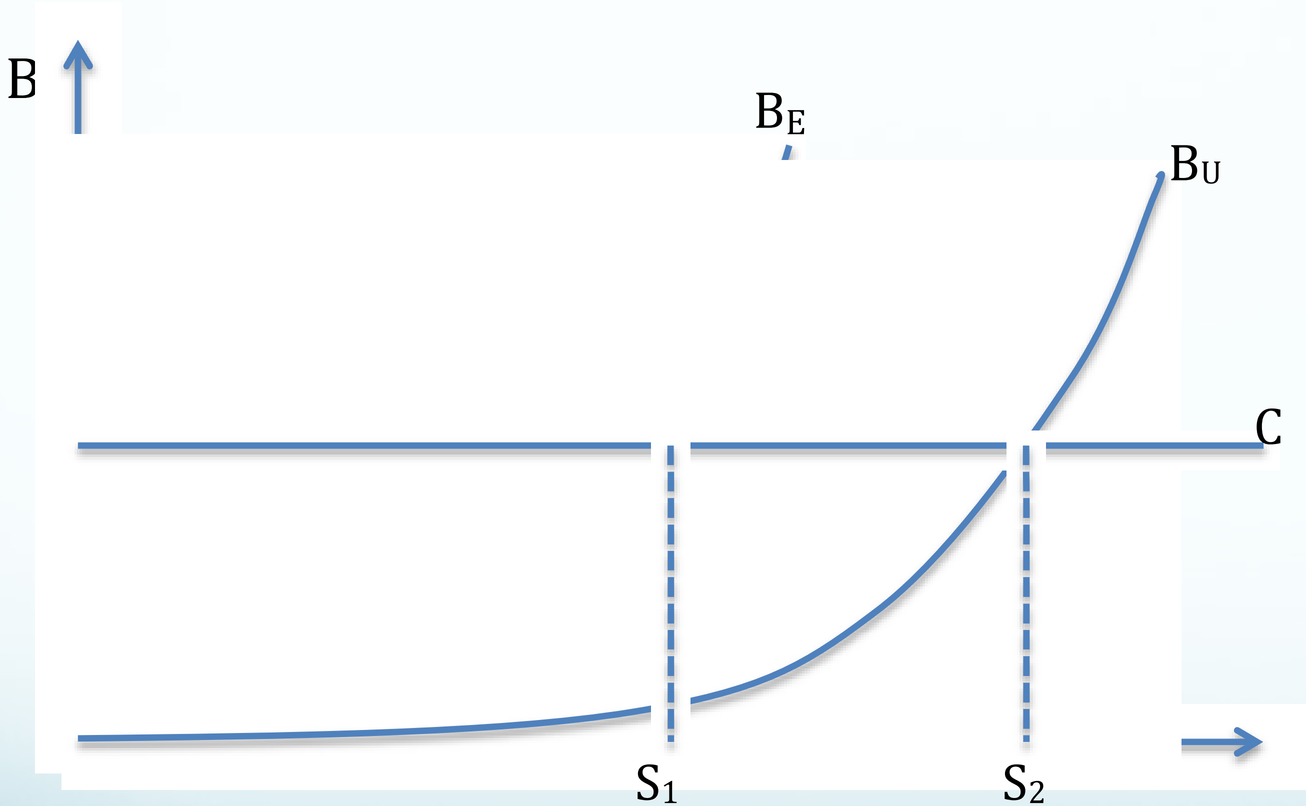
- Benefit of default:
- Government reduces interest burden;
- Cost of taxation reduced
- Benefit increases with size of solvency shock
- And size of govt debt

Two benefit curves



B_U = Benefit when default is not expected
B_E = Benefit when default is expected

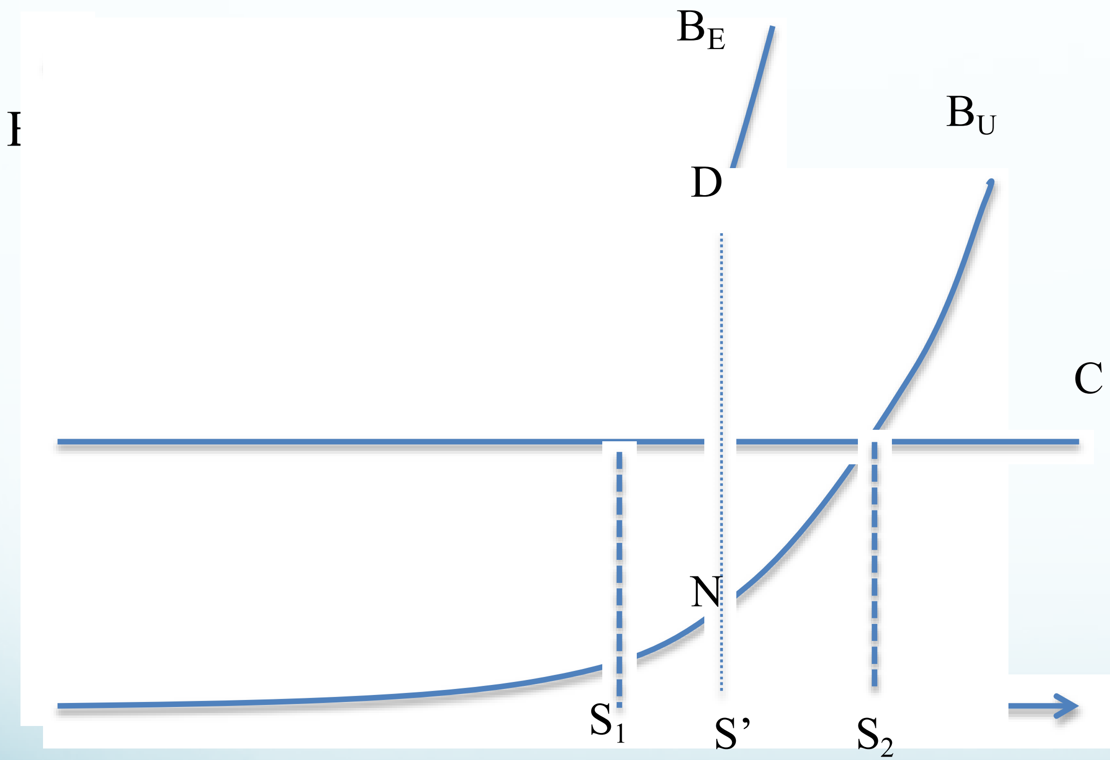
Cost and benefit of default



Cost arises because of loss of reputation and thus difficulties to borrow in the future

Three types of shocks

Figure 5.6: Good and bad equilibria



Small shock: **$S < S_1$**

There will be no default because cost exceeds benefits,
Consistent with expectations

Large shock: **$S > S_2$**.

Default is certain because benefits exceed costs
Consistent with expectations

Intermediate shock:

$S_1 < S < S_2$

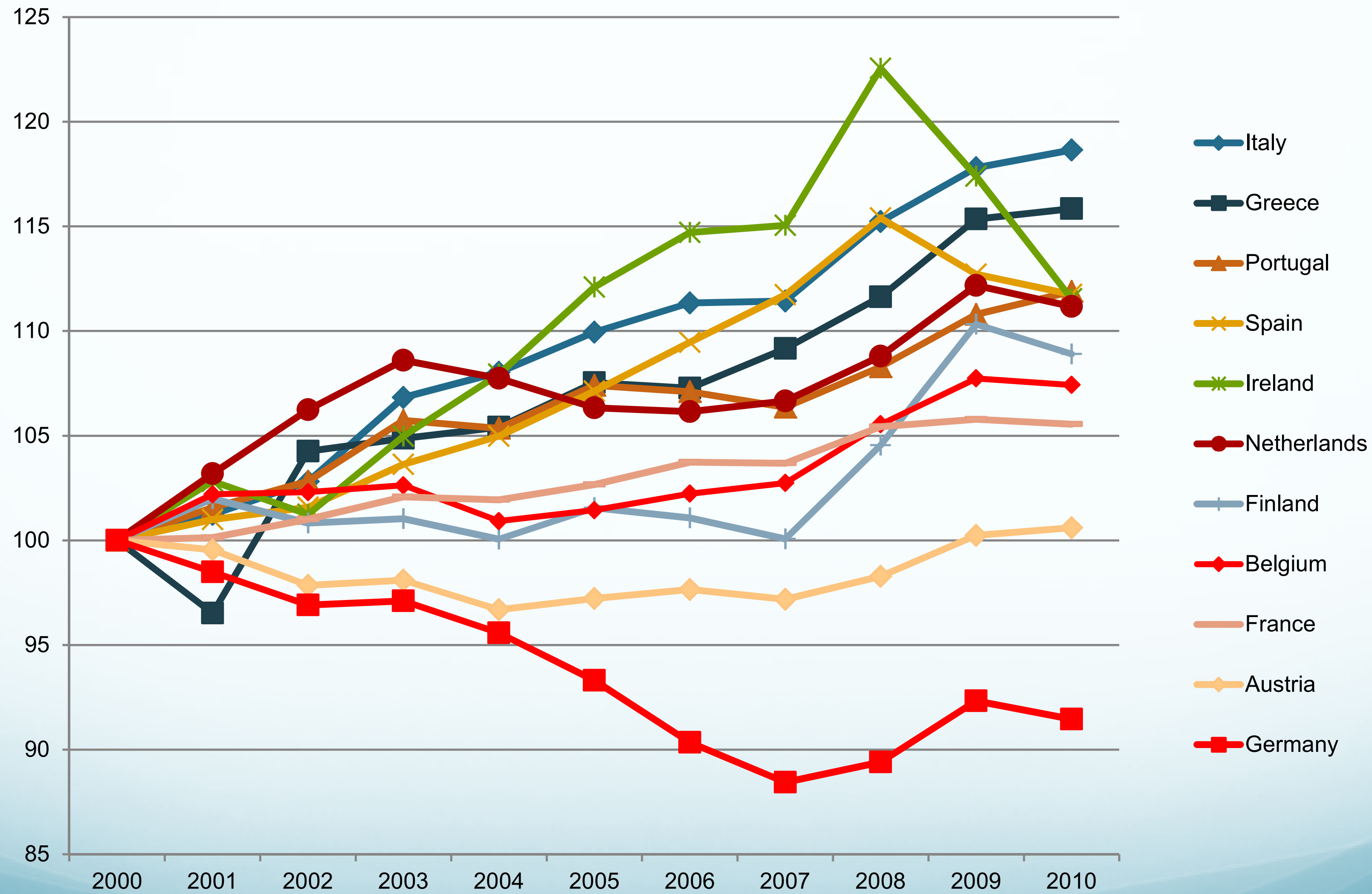
Two equilibria: N and D
Both consistent with expectations

- When solvency shock is not too small nor too large:
- One obtains two possible equilibria:
  - a bad one (D) that leads to default,
  - a good one (N) that does not lead to default.
- Both are equally possible.
- The selection of one of these two points only depends on what investors expect.
  - If the latter expect a default, there will be one;
  - if they do not expect a default there will be none.
  - This remarkable result is due to the self-fulfilling nature of expectations.
- We have coordination failure

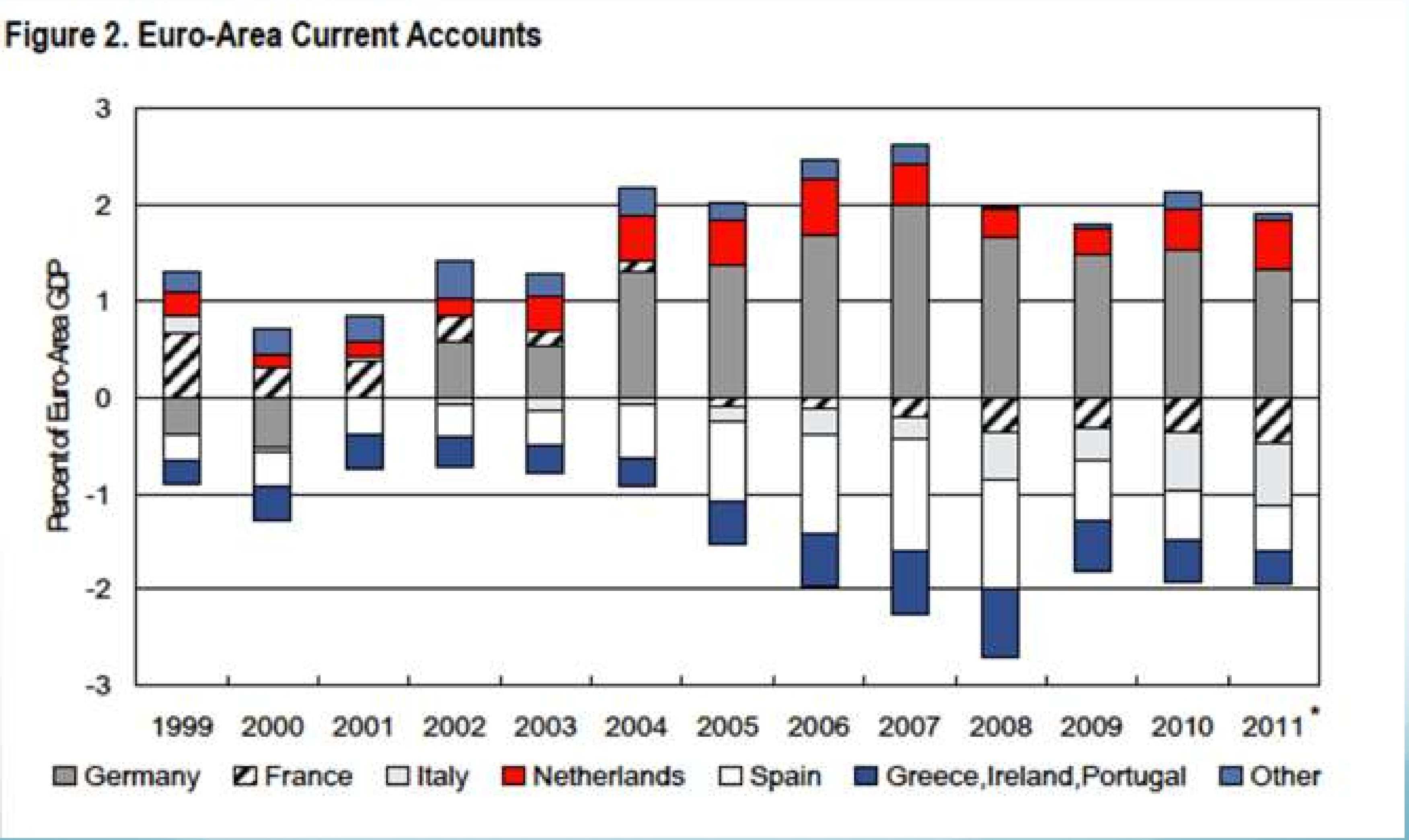
Asymmetric shocks

- one of the fundamental imbalances in the Eurozone is the increased divergence in competitive positions of the members of the Eurozone since 2000.
- These arise because Eurozone is not OCA
  - Too many asymmetric shocks
  - In turn due to design failure
    - Money is centralized
    - All the rest national
    - This creates potential for very different economic trends

Figure 5: Relative unit labor costs Eurozone (2000=100)



Increasing current account imbalances



Source: Citigroup, Empirical and Thematic Perspectives, 27 January, 2012

- Countries that lost competitiveness from 1999 to 2008 (Greece, Portugal, Spain, Ireland) have to start improving it.
- Given the impossibility of using a devaluation of the currency, an internal devaluation must be engineered, i.e. wages and prices must be brought down relative to those of the competitors.
- This can only be achieved by deflationary macroeconomic policies (mainly budgetary policies).
- Inevitably, this will first lead to a recession and thus to increases in budget deficits.
- Interacting with fragility and risk of debt crisis

How to solve this?

- Short run:
  - ECB is key
  - Austerity and recession
- Medium and long run:
  - Consolidating national budgets and debt levels
  - Common macroeconomic policies

The common central bank as lender of last resort

- Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because central bank will provide all the necessary liquidity to sovereign.
- This outcome can also be achieved in a monetary union if the common central bank is willing to buy the different sovereigns' debt.
- This is what happened in the Eurozone during the debt crisis.
- The ECB bought government bonds of distressed member-countries,
  - either directly,
  - or indirectly by the fact that it accepted bonds as collateral in its support of the banks from the same distressed countries.

- Bond buying program by ECB has been badly implemented
- By announcing that it would be limited in size and time
- ECB gave signal to bondholders to sell
- Thereby maximizing the need to buy by the ECB
- The right strategy: announce program unlimited in size and time
- This can create confidence minimizing need to buy

- Since December 2011 ECB has provided support to sovereign debt markets indirectly
- By providing liquidity to banks
- Hoping these would buy government bonds.
- Because banks have invested only fraction in government bonds, ECB had to expand balance sheet much more than it would have done under direct LOLR
- In addition, panicky banks can and will withdraw support in times of crisis

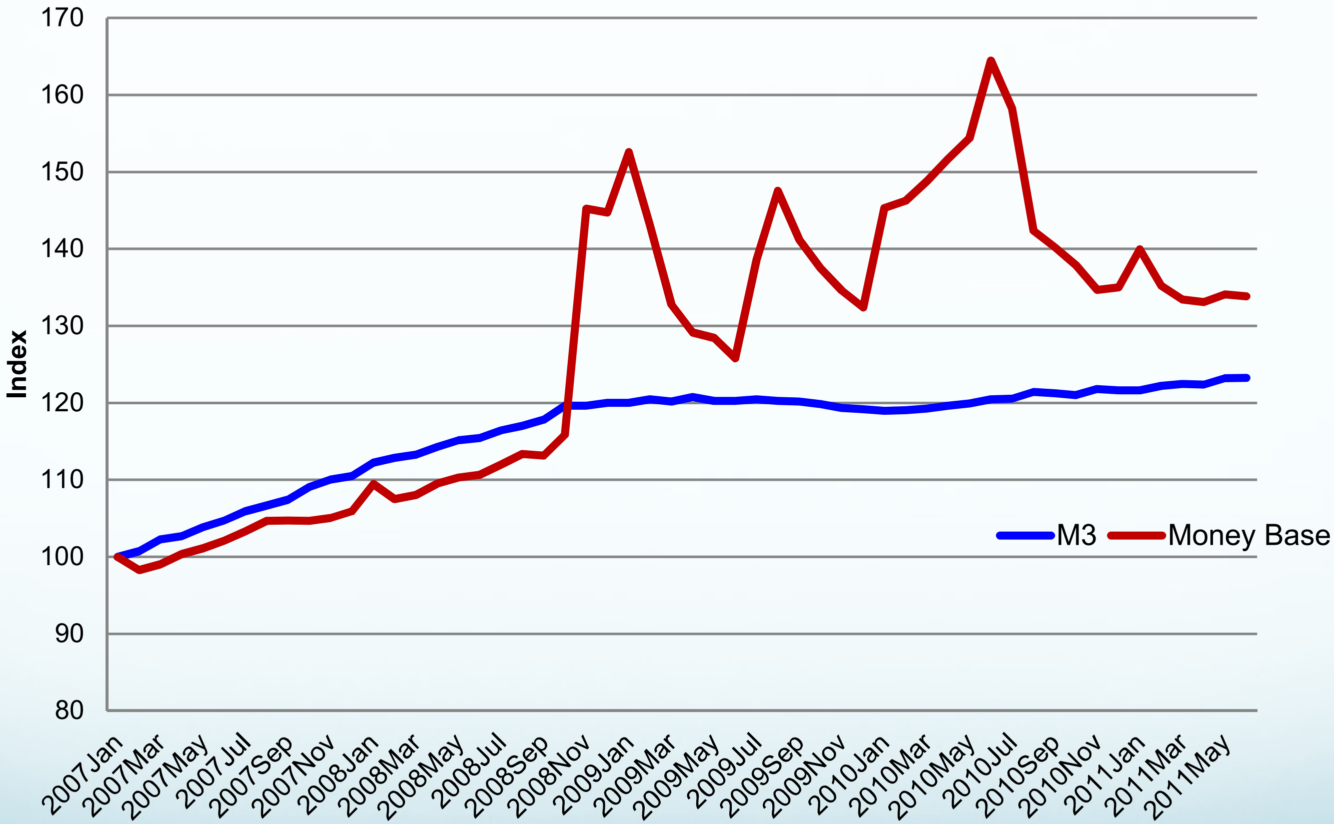
What is the criticism?

- Inflation risk
- Moral hazard
- Fiscal implications

Inflation risk

- Distinction should be made between money base and money stock
- When central bank provides liquidity as a lender of last resort money base and money stock move in different direction
- In general when debt crisis erupts, investors want to be liquid
- Central bank must provide liquidity
- To avoid deflation

Figure 2: Money Base and M3 in Eurozone (2007=100)



- Thus during debt crisis banks accumulate liquidity provided by central bank
- This liquidity is hoarded, i.e. not used to extend credit
- As a result, money stock does not increase; it can even decline
- No risk of inflation
- Same as in the 1930s (cfr. Friedman)

Moral hazard

- Like with all insurance mechanisms there is a risk of moral hazard.
- By providing a lender of last resort insurance the ECB gives an incentive to governments to issue too much debt.
- This is indeed a serious risk.
- But this risk of moral hazard is no different from the risk of moral hazard in the banking system.
- It would be a mistake if the central bank were to abandon its role of lender of last resort in the banking sector because there is a risk of moral hazard.
- In the same way it is wrong for the ECB to abandon its role of lender of last resort in the government bond market because there is a risk of moral hazard

- The way to deal with moral hazard is to impose rules that will constrain governments in issuing debt,
- very much like moral hazard in the banking sector is tackled by imposing limits on risk taking by banks.
- In general, it is better to separate liquidity provision from moral hazard concerns.
- Liquidity provision should be performed by a central bank; the governance of moral hazard by another institution, the supervisor.

- This should also be the design of the governance within the Eurozone.
- The ECB assumes the responsibility of lender of last resort in the sovereign bond markets.
- A different and independent authority takes over the responsibility of regulating and supervising the creation of debt by national governments.
- This leads to the need for mutual control on debt positions, i.e. some form of political union

- To use a metaphor: When a house is burning the fire department is responsible for extinguishing the fire.
- Another department (police and justice) is responsible for investigating wrongdoing and applying punishment if necessary.
- Both functions should be kept separate.
- A fire department that is responsible both for fire extinguishing and punishment is unlikely to be a good fire department.
- The same is true for the ECB. If the latter tries to solve a moral hazard problem, it will fail in its duty to be a lender of last resort.

Fiscal consequences

- Third criticism: lender of last resort operations in the government bond markets can have fiscal consequences.
- Reason: if governments fail to service their debts, the ECB will make losses. These will have to be borne by taxpayers.
- Thus by intervening in the government bond markets, the ECB is committing future taxpayers.
- The ECB should avoid operations that mix monetary and fiscal policies

Is this valid criticism? No

- All open market operations (including foreign exchange market operations) carry risk of losses and thus have fiscal implications.
- When a central bank buys private paper in the context of its open market operation, there is a risk involved, because the issuer of the paper can default.
- This will then lead to losses for the central bank. These losses are in no way different from the losses the central bank can incur when buying government bonds.
- Thus, the argument really implies that a central bank should abstain from any open market operation. It should stop being a central bank.

- Truth is that in order to stabilize the economy the central bank sometimes has to make losses.
- Losses can be good for a central bank
- Also there is no limit to the losses a central bank can make
- because it creates the money that is needed to settle its debt.
- A central bank does not need capital (equity)
- There is no need to recapitalize the central bank

Short-term
What kind of fiscal policies?

- Fiscal policies are influenced by wrong diagnosis of crisis
- With exception of Greece crisis is due to private debt expansion
- Necessitating deleveraging of private debt
- This can only happen if governments accept expansion of its debt
- Present fiscal policies deny this and lead Eurozone into recession.
- Without solving budgetary problems

Fiscal policies that will not kill growth

- Stimulus in the North, where spending is below production (current account surplus)
- Austerity in the South (but spread out over more years)
- This also allows to deal with current account imbalances
  - It takes two to tango
  - Symmetry in policies is key
  - European Commission does not do this sufficiently in the implementation of “six-pack” legislation
- Investment program financed by issue of Eurobonds by EIB

Medium and long run: common budget and debt

- By consolidating (centralizing) national government budgets into one central budget a mechanism of automatic transfers can be organized.
  - This works as insurance mechanism transferring resources to the country hit by a negative economic shock.
- Such a consolidation creates a common fiscal authority that can issue debt in a currency under the control of that authority.
  - This protects member states from being forced into default by financial markets.

- Without consolidation of national debts into European debt, fragility is maintained
- Leading to inevitable repeats of future crises
- We can not all the time ask ECB to step in
- We have to strengthen Eurozone structurally
- This can only be done with a budgetary union
- Cfr. Consolidation of state debts into US Federal debt by Alexander Hamilton 200 years ago.

But…

- Budgetary centralization requires far-reaching degree of political union.
- There is little willingness in Europe today to significantly increase the degree of political union.
- This unwillingness to go in the direction of more political union will continue to make the Eurozone a fragile construction.
- This does not mean, however, that one should despair. We can move forward by taking small steps.

One “small step: Joint Eurobond issue as a crisis prevention tool

- This is essential in reducing excessive power of financial markets in destabilizing a monetary union
- And in internalizing the externalities created by financial markets
- Will be difficult because mutual trust is lacking

Objections to Eurobonds

- The proposal of issuing common Eurobonds has met stiff resistance in a number of countries.
- This resistance is understandable.
- A common Eurobond creates a number of serious problems that have to be addressed

Moral hazard again

- Common Eurobond issue contains an implicit insurance for the participating countries.
- Since countries are collectively responsible for the joint debt issue, an incentive is created for countries to rely on this implicit insurance and to issue too much debt.
- This creates a lot of resistance in the other countries that behave responsibly.
- This moral hazard risk should be resolved.

The design of common Eurobonds

- Should take care of these objections
- This can be achieved by working both on the quantities and the pricing of the Eurobonds
- A combination of
  - Blue and red bonds (Bruegel): participation in common eurobond limited to given % of GDP (blue bond; senior); the rest is red bond (junior).
  - Differential interest rates (De Grauwe and Moesen): countries pay an interest rate related to fiscal position

Common macroeconomic policies

- First steps have been taken
- Six-pack legislation
- Gives authority to European Commission to enforce common macroeconomic policies: Macroeconomic Imbalance Procedure (MIP)
  - ECB monitors imbalances (scoreboard)
  - Can start Excessive Imbalance procedure
  - Can impose santions
- But will it work?
- And it this sufficiently embedded in democratic decision making process?

Evaluation of MIP

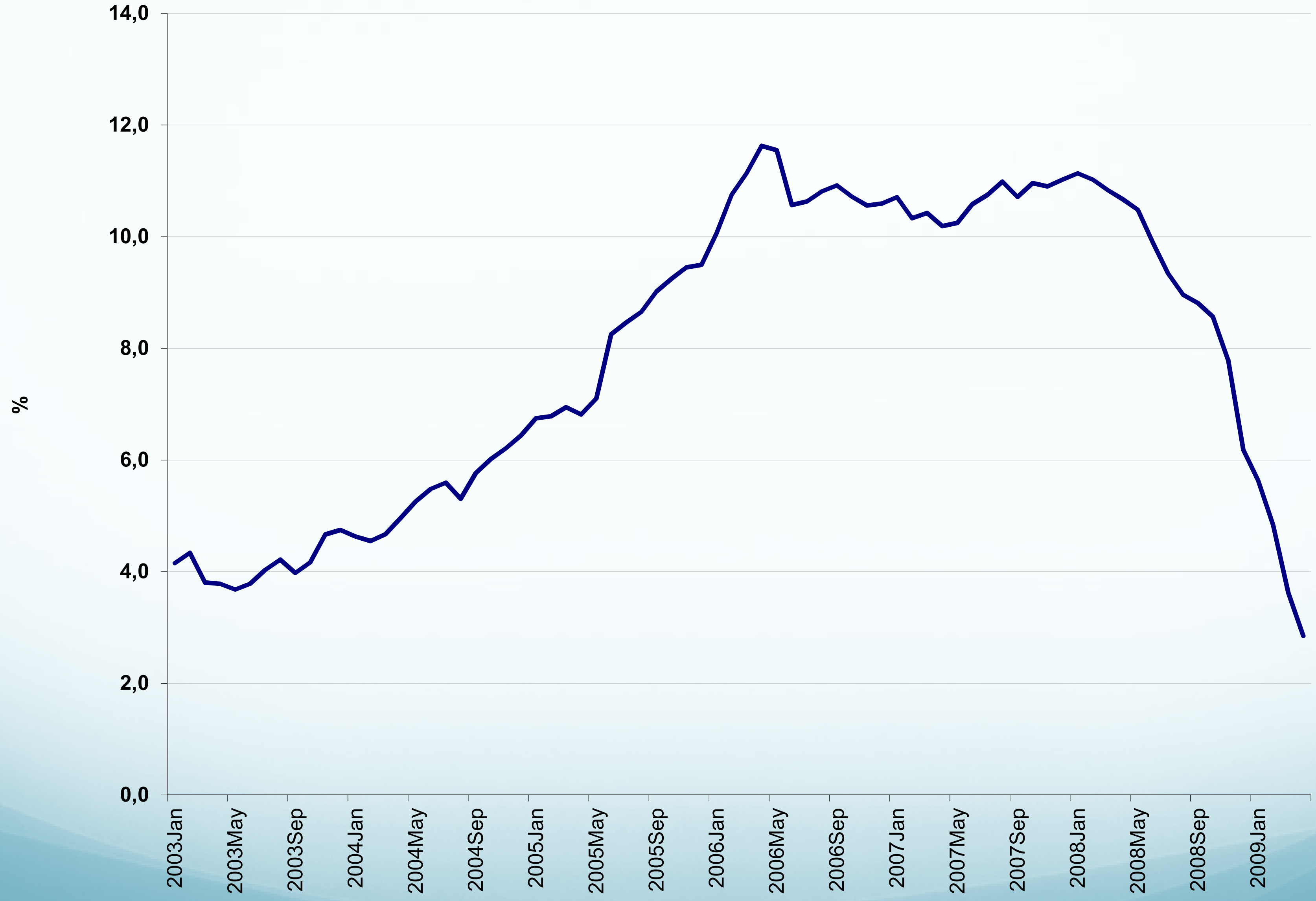
- Once an imbalance is identified and an excessive imbalance procedure is started
- what instruments do authorities have to correct these imbalances?
- Take case of Spain again during the boom.
- How do you stop a credit-fueled boom?
- Answer: by restricting credit.
- National government can do little about this.

- Spain tried: Banco de España used macro-prudential control
- This, however, did little to stem the boom and bubble in real estate market.
- Only ECB can restrict bank credit, but it is supposed to look at Eurozone-wide bank credit developments

A Note

- ECB failed to contain surge in bank credit in the Eurozone prior to the financial crisis
- Prior to crisis massive expansion of bank credit
- This also made the bubbles in Spain and Ireland possible

Growth rate of bank loans in Euro area



Do governments have right instruments?

- This leads to problem of the instruments the government has to end credit-induced boom
- Government has very few instruments
- Only macroeconomic instruments available are fiscal policies
- Countries experiencing credit-fueled boom show surpluses in government budgets and declining debt-to-GDP ratios (see previous figures)
- It is very difficult to force a government with surpluses to have even bigger surpluses

Supervisors and ECB left off the hook

- What is left unspecified is role of supervisors and central bank
- In general the whole imbalance procedure is based on assumption that governments are at the root of the imbalances
- While the main cause of the Spanish-type imbalance has a monetary financial origin
- that government does not control
- But supervisors and ECB do

- As a result, these supervisors and ECB are left mostly outside the excessive imbalance procedure
- while they should be at the center of it
- We should have no illusions: the MIP will not prevent future crises
- Although rules are necessary
- It would be mistake to think that rules and monitoring of rules alone can make monetary union sustainable
- We need more: a budgetary union

Conclusion

- A monetary union can only function if there is a collective mechanism of mutual support and control.
- Such a collective mechanism exists in a political union.
- That is necessary to complete the monetary union
- In the absence of a political union, the member countries of the Eurozone are condemned to fill in the necessary pieces of such a collective mechanism.
- The debt crisis has made it possible to fill in a few of these pieces.
- What has been achieved, however, is still far from making the Eurozone a complete monetary union
- And thus insufficient to guarantee its survival.