Managing the Fragility of the Eurozone

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10-Year-Government Bond Yields UK-Spain

percent

SPAIN

UK

1.1.08 3.1.08 5.1.08 7.1.08 9.1.08 11.1.08 1.1.09 3.1.09 5.1.09 7.1.09 9.1.09 11.1.09 1.1.10 3.1.10 5.1.10 7.1.10 9.1.10 11.1.10 1.1.11 3.1.11 5.1.11
Nature of monetary union

- Members of monetary union issue debt in currency over which they have no control.
- 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.
- Consider case of UK and Spain
UK Case

- Suppose investors fear default of UK government
  - They sell UK govt bonds (yields increase)
  - Proceeds of sales are presented in forex market
  - Sterling drops
  - UK money stock remains unchanged
  - maintaining pool of liquidity that will be reinvested in UK govt securities
  - If not Bank of England can be forced to buy UK govt bonds

- Investors cannot trigger liquidity crisis for UK government and thus cannot force default (Bank of England is superior force)

- Investors know this: thus they will not try to force default.
Spanish case

- Suppose investors fear default of Spanish government
  - They sell Spanish govt bonds (yields increase)
  - Proceeds of these sales are used to invest in other eurozone assets
  - No foreign exchange market and floating exchange rate to stop this
  - Spanish money stock declines; pool of liquidity for investing in Spanish govt bonds shrinks
  - No Spanish central bank that can be forced to buy Spanish government bonds
  - Liquidity crisis possible: Spanish government cannot fund bond issues at reasonable interest rate
  - Can be forced to default
  - Investors know this and will be tempted to try
• Situation of Spain is reminiscent of situation of emerging economies that have to borrow in a foreign currency.

• These emerging economies face the same problem, i.e. they can suddenly be confronted with a “sudden stop” when capital inflows suddenly stop leading to a liquidity crisis (see Calvo, et al. (2006), Eichengreen and Hausmann: Original Sin).
Additional difference in the debt dynamics

- In UK case: currency depreciates
  - Increase in inflation
  - Stimulus to output growth

- In Spanish case: no currency depreciation
  - No increases in inflation or growth

- This has profound effect on debt dynamics
Figure 3: Inflation in UK and Spain
Figure 4: Growth GDP in UK and Spain
Solvency calculation is affected

Primary surplus needed to stabilize debt ratio:

\[ S \geq (r - g)D , \]

\( S = \) primary budget surplus,
\( r = \) nominal interest rate on the government debt,
\( g = \) nominal growth rate of the economy
\( D = \) government debt to GDP ratio.

| Table 1: Primary surplus needed to stabilize debt at 2011 level (percent GDP) |
|-------------------------|------------------|
| UK                     | -1,21            |
| Spain                  | 2,30             |
• Previous analysis illustrates important potentially destructive dynamics in a monetary union.

• Members of a monetary union are very susceptible to liquidity movements.

• When investors fear some payment difficulty (e.g. triggered by a recession), liquidity is withdrawn from the national market (a “sudden stop”).
I am not arguing that all solvency problems in the Eurozone are of this nature. In the case of Greece, for example, one can argue that the Greek government was insolvent before investors made their moves and triggered a liquidity crisis in May 2010.

What I am arguing is that in a monetary union countries become vulnerable to self-fulfilling movements of distrust that set in motion a devilish interaction between liquidity and solvency crises.

Similar to banks
Multiple equilibria

- Multiple equilibria arise because of self-fulfilling prophecies inherent in market outcomes.
- 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**
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**

This effect is amplified when government B belongs to monetary union: in that case the distrust leads to liquidity squeeze making it impossible for government B to fund its bond issues at reasonable interest rate

This can lead to forced default
The bad news about a bad equilibrium

- Banking crisis
- Automatic stabilizers switched off
Banking crisis

- When investors pull out from domestic bond market, interest rate on government bonds increases, and prices plunge; domestic banks make large losses.

- Domestic banks are caught up in a funding problem.
  - As argued earlier, domestic liquidity dries up (the money stock declines)
  - making it difficult for the domestic banks to rollover their deposits, except by paying prohibitive interest rates.

- Thus the sovereign debt crisis spills over into a domestic banking crisis, even if the domestic banks were sound to start with.
Automatic stabilizers are switched off in MU

- This dynamics makes it very difficult for members of monetary union to use automatic budget stabilizers.

- A recession leads to higher government budget deficits.

- This in turn leads to distrust of markets in the capacity of governments to service their future debt, triggering a liquidity and solvency crisis,

- which in turn forces them to institute austerity programs in the midst of a recession.
Competitiveness and sovereign debt

• one of the fundamental imbalances in the Eurozone is the increased divergence in competitive positions of the members of the Eurozone since 2000.
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 (through the operation of the automatic stabilizers) to increases in budget deficits.
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
Incredibly stupid
The right strategy: announce program unlimited in size and time
This can create confidence minimizing need to buy
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
What kind of fiscal policies?

- Fiscal policies are dictated by Germany
- And implemented by European Commission
- Forcing everybody at the same time to reduce spending and to raise taxes
- This leads Eurozone into recession
- Without solving budgetary problems
- Cfr. Savings paradox of Keynes
• Right approach should be:

• Stimulus in the North, where spending is below production (current account surplus)

• Austerity in the South (but spread out over more years)
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.
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
Medium and long run: Common macroeconomic policies

- First steps have been taken
- Six-pack legislation
- Gives authority to European Commission to enforce common macroeconomic policies
- aimed at avoiding future macroeconomic divergences
- that risk producing new crises
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.