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The Future of Eurozone: what reforms are needed

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The Future of Eurozone: what reforms are needed

Paul De Grauwe
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Outline of presentation

- Design failures in the Eurozone
- Future of the Eurozone
  - Short-term: how to reboot Eurozone
  - Long-term: redesigning the Eurozone

Design failures of Eurozone

- Eurozone has been ill-designed
- It will have to be redesigned to survive in the long run. How?
- Let me first explain the nature of these design failures.

Eurozone’s design failures: in a nutshell

1. Dynamics of booms and busts are endemic in capitalism and continued during Eurozone

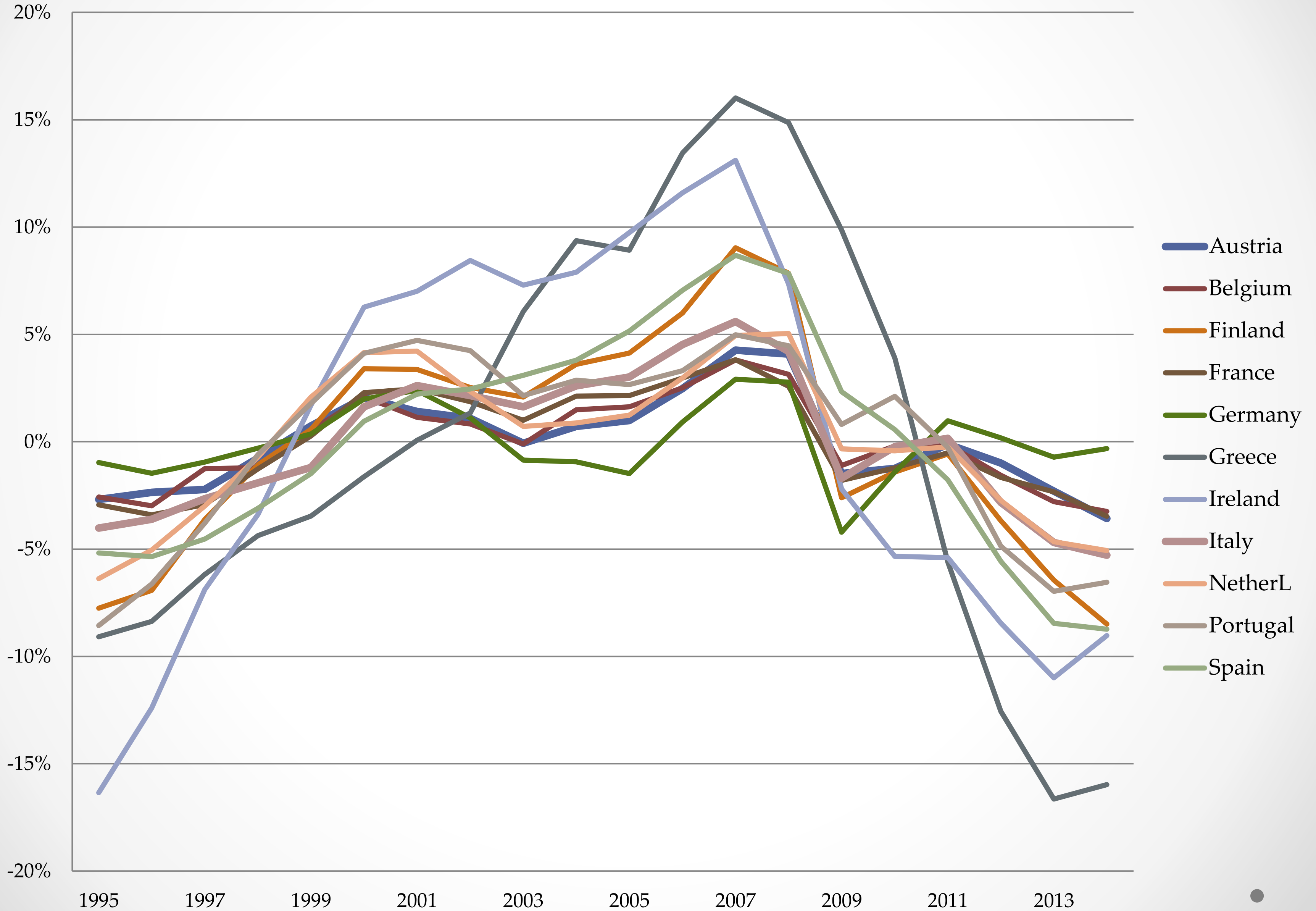
2. Stabilizers that existed at national level were stripped away from the member-states without being transposed at the monetary union level.
    - This left the member states “naked” and fragile, unable to deal with the coming disturbances.

3. This was reinforced by deadly embrace sovereign and banks

Let me expand on these points.

Booms and busts

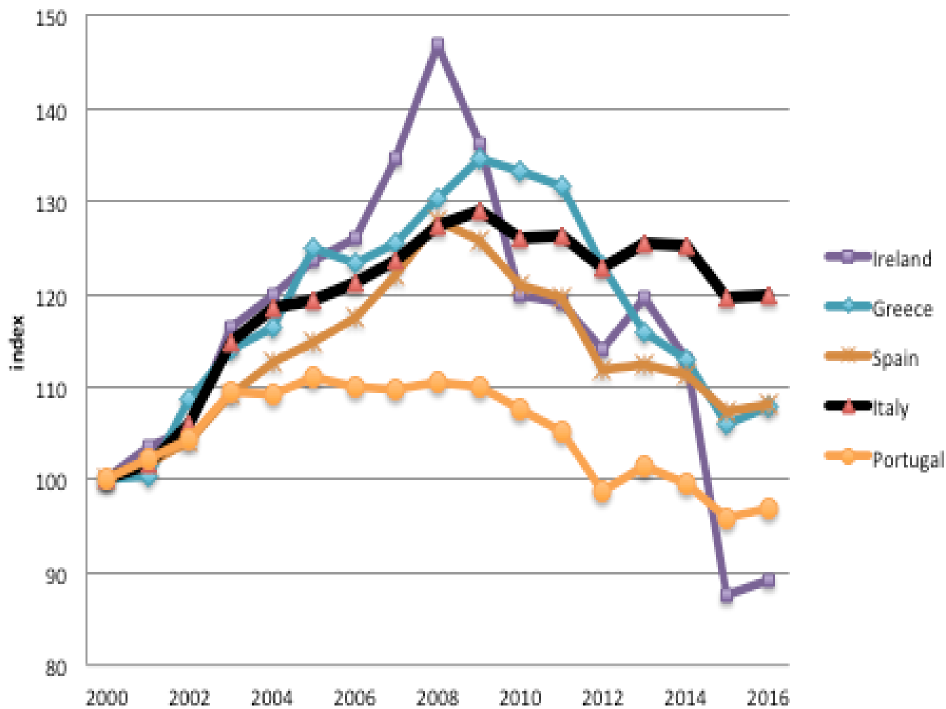
- These were strongly synchronized in Eurozone
- Asymmetry was in the amplitude of the booms and busts
  - Some countries (Ireland, Greece, Spain) experiencing wild swings
  - While others (Germany, France, Netherlands, Belgium) experiencing mild swings

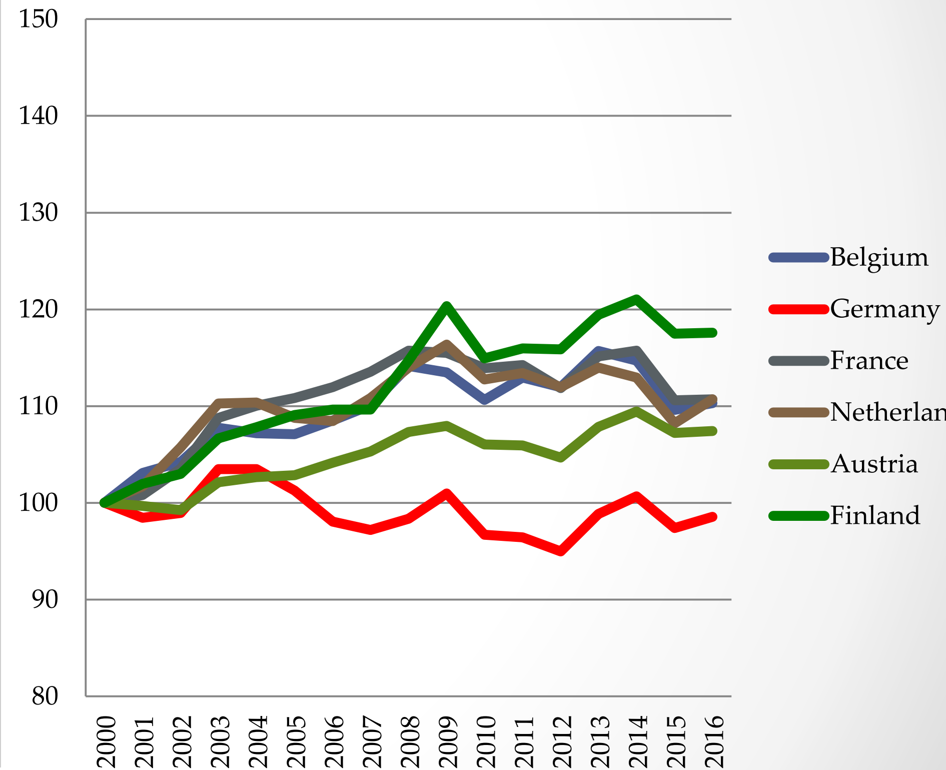


Business cycle component of GDP
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
NetherL
Portugal
Spain

- This led to two problems
  - Build-up of large divergences in competitive positions
  - Instability in government bond markets during downswing

Diverging trends in competitiveness





- Adjustment through internal devaluation very painful
- Asymmetry in adjustment puts all the costs of the adjustment onto the deficit countries
- All this leads to political upheaval
- And dynamics of rejection

Design failure:
no stabilizers left in place

- Absence of lender of last resort in government bond market in Eurozone
- exposed fragility of government bond market in a monetary union
- Self-fulfilling crises pushing countries into bad equilibria

Fragility of government bond market in monetary union

- Governments of member states cannot guarantee to bond holders that cash would always be there to pay them out at maturity
- Contrast with stand-alone countries that give this implicit guarantee
  - because they can and will force central bank to provide liquidity
  - There is no limit to money creating capacity

Self-fulfilling crises

- This lack of guarantee can trigger liquidity crises
  - During recession, budget deficits increase automatically
  - Distrust leads to bond sales
  - Interest rate increases
  - Liquidity is withdrawn from national markets
  - Government unable to rollover debt
  - Is forced to introduce immediate and intense austerity
  - Intensifying recession and Debt/GDP ratio increases

- This leads to default crisis
- Countries are pushed into bad equilibrium
- That can lead them into default

- Thus absence of LoLR tends to eliminate other stabilizer: automatic budget stabilizer
  - Once in bad equilibrium countries are forced to introduce sharp austerity
  - pushing them in recession and aggravating the solvency problem
  - Budget stabilizer is forcefully switched off
- Investors know this and flee from the government bond markets hit most by recession to invest in bond markets less hit by recession
- Destabilizing capital flows in monetary unions

Redesigning the Eurozone

How to redesign the Eurozone?

- Role of ECB
- Budgetary and Political Union

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 in times of crisis.

ECB has acted in 2012

- On September 6, ECB announced it will buy unlimited amounts of government bonds.
- Program is called “Outright Monetary Transactions” (OMT)
- Success was spectacular

Spreads of 10-year government bond rates in the Eurozone, 2008–17

30,00
25,00
20,00
15,00
10,00
5,00
0,00

2008M01
2008M05
2008M09
2009M01
2009M05
2009M09
2010M01
2010M05
2010M09
2011M01
2011M05
2011M09
2012M01
2012M05
2012M09
2013M01
2013M05
2013M09
2014M01
2014M05
2014M09
2015M01
2015M05
2015M09
2016M01
2016M05
2016M09
2017M01

Greece
Portugal
Ireland
Italy
Spain
Belgium
France
Austria
Finland
Netherlands

- This was the right step: the ECB saved the Eurozone
  - But then ECB waited too long to stop deflationary dynamics
  - Only in January 2015 when it started QE, did it act to fight deflation
- However, the second Greek crisis of 2014-15 casts doubts about the willingness to activate OMT in future
- And surely there will be new crises when next recession hits
- We need more than lender of last resort

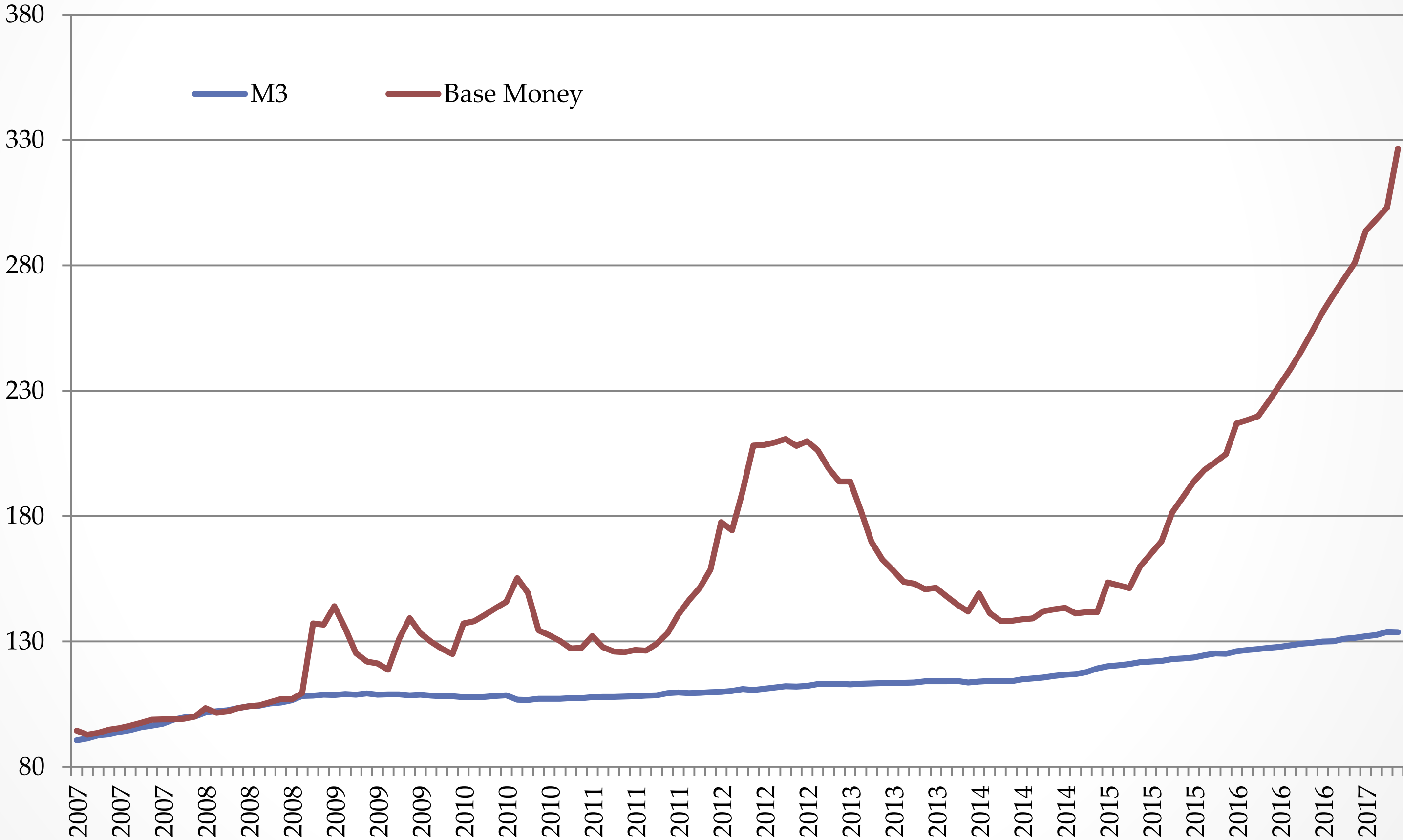
Criticism of OMT

- Points of criticism
  - Inflation risk
  - Moral hazard
  - Fiscal implications
- Is this criticism valid?

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

Money base and money stock (M3) in the Eurozone (2007–17); 2007 December = 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

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

Separation of liquidity provision from supervision

- 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 (European Commission) 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

Metaphor of burning house

- 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.

The long road to fiscal and political union

- Third building block in the completion of the monetary union is budgetary.
- The existence of national government budgets and debts is at the core of the fragility of a monetary union.
- Collective action at the union level is necessary to solve this problem.
- The key is that parts of the national budgets and debt should be consolidated into one central component.

Two reasons

- First, such a consolidation creates a common fiscal authority that can issue debt in a currency under the control of that authority.
  - This protects the member states from being forced into default by financial markets.
  - It also protects the monetary union from destabilizing capital flows within the Eurozone.
- Second, by consolidating (centralizing) national government budgets into one central budget a mechanism of automatic transfers can be organized.
  - As was stressed earlier, such a mechanism works as an insurance mechanism transferring resources to the country hit by a negative economic shock.

- This solution of the systemic problem of the Eurozone requires a far-reaching degree of political union,
  - i.e. member countries should be willing to transfer sovereignty over taxation and spending to European institutions.
- 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.
- But small steps can be taken

A Strategy of small steps: *1.* Common unemployment benefits scheme

- Many proposals have been made: e.g. Four Presidents report
- Common unemployment schemes should be allowed to have deficit during recession compensated by surpluses during boom
- This means issuing common bonds
- First step on the road to budgetary union

A Strategy of small steps:
2. The joint issue of common bonds

- By jointly issuing Eurobonds, the participating countries become jointly liable for the debt they have issued together.
- By pooling the issue of government bonds, the member countries protect themselves against the destabilizing liquidity crises

Eurobonds and moral hazard

- The 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.
- How to solve?
  - Co-insurance
  - Blue and red bonds

Eurobonds or "safe asset"?

- There is a need for creation of common assets
- Recently proposals have been made to use the market system to create common asset: the "safe asset" proposals of ESRB
- Question:
  - Eurobonds: public
  - Safe assets: private
-
-

Proposal to create "safe asset"

- ESRB(2018) and Franco-German economists have proposed to create "safe asset"
- No joint liability
- Every government is fully responsible for servicing his own debt
- Will this do the job of creating asset that eliminates destabilizing capital flows?

Nature of risk in safe asset

- The Junior tranche is the most risky, then mezzanine.
  - When losses are posted on the underlying portfolio of government bonds junior tranche takes first hit, mezzanine second.
- The third tranche, senior tranche, is safe.
  - The proponents of these SBBSs take the view that a 30% junior plus mezzanine tranche are large enough as a buffer to take potential losses on the underlying sovereign bonds so as to make the senior tranche (70%) risk free.
- Proponents claim that SBBSs will eliminate destabilizing capital flows in Eurozone by a movement from the risky asset (junior and mezzanine tranches) into the safe asset (the senior tranche).

Criticism

- National government bond markets will continue to exist. They are necessary to price the SBBSs
  - Destabilizing capitals flows across borders will still be possible
- Pattern of correlations of yields:
  - During crisis: Yields in high risk assets get highly positively correlated reflecting the dynamics of contagion.
  - At the same time as investors are looking for safe havens, the yields in the safe assets tend to decline sharply
  - and become negatively correlated with the high risk yields.

- Implication: during crises it is very unlikely that the senior tranche in the SBBS can maintain its status of safe asset.
    - It will consist of bonds investors dump in order to acquire “safe-haven” bonds.
    - The senior tranche will continue to depend on the cash flow generated by bonds that panicking investors deem to be extremely risky.
    - The perception that this senior tranche is equally safe as the safe-haven sovereign bonds (e.g. German bonds) is very unlikely when markets are in panic mode.
    - As a result, it is also likely that investors will flee the senior tranches of the SBBS to invest in the “real thing”, i.e. super safe sovereign national bonds.

A Strategy of small steps: 3. Banking Union

- Banking Union is key in resolving the deadly embrace between sovereign and banks
- Three components:
  1. Common supervision
  2. Common deposit insurance
  3. Common resolution

- Common supervision has started at end of 2014 with ECB as the single supervisor of the large banks (covering 85% of bank activities in Eurozone)

- No decision on common deposit insurance
- First steps towards common resolution
  - But clearly insufficient
  - Common resolution fund will be built up gradually to reach €55 billion
  - This is clearly insufficient
  - Governance of resolution is so complicated as to be impractical in times of crisis
- Much more will have to be done
- Without common resolution mechanism common supervisor (ECB) will be weak

Conclusion

- Long run success of the Eurozone depends on continuing process of political unification.
- Political unification is needed because Eurozone has dramatically weakened
  - the power and legitimacy of nation states
  - without creating a nation at the European level.
- This is particularly true in the field of stabilization

Conclusion: Integration fatigue

- Budgetary union is needed but is far away
- Willingness today to move in the direction of a budgetary and political union in Europe is non-existent.
- This will continue to make the Eurozone a fragile institution
- Its long-term success cannot be guaranteed