



What next for the Eurozone?

London School of Economics, Jan 23, 2013

Luis Garicano, London School of Economics

INET COUNCIL ON THE EURO ZONE CRISIS

Credits

Present work joint with Euro-nomics economists:

Markus Brunnermeier, Luis Garicano, Philip Lane, Stijn Van Nieuwerburgh, Marco Pagano, Ricardo Reis, Tano Santos and Dimitri Vayanos (2011) "European Safe Bonds", The Euro-nomics Group, www.euro-nomics.com.

And with INET Euro-Council:

Patrick Artus, Erik Berglof, Peter Bofinger, Giancarlo Corsetti, Paul De Grauwe, Guillermo de la Dehesa, Lars Feld, Jean-Paul Fitoussi, Luis Garicano, Daniel Gros, Kevin O'Rourke, Lucrezia Reichlin, Hélène Rey, Andre Sapir, Dennis Snower, Hans-Joachim Voth, Beatrice Weder di Mauro

And with Jesus Fernandez-Villaverde, Tano Santos (Forthcoming)

“Spain raised €7bn through a successful bond sale on Tuesday, providing a welcome fillip to the embattled eurozone country and underscoring a seismic shift in investor sentiment towards [Spain](#) and the bloc’s periphery.

Bankers on the deal said investors placed orders of almost €23bn for the 10-year bond sale – the most in Spain’s history according to officials, who hailed it as an endorsement of their [handling of the country’s crisis](#).”

FT, January 22, 2013

A strange moment

- Positive market sentiment
 - “Don’t stand in the way of a committed central bank”
 - Now we have a lender of last resort
 - For states (OMT)
 - For banks (LTRO)
- And yet, crisis is far from over
 - Persistence of financial boom
 - Leverage/debt overhang
 - institutional damage
 - Incorrect price signals: Dutch disease
 - Politics without growth
 - Breakdown of Spain
 - Of Eurozone
 - Of Europe (UK)



Plan of the talk

1. A crisis of governance
2. Can peripheral countries grow again? The case of Spain
 - A host of legacy problems
 - And an unreformed economy-credit boom caused institutional deterioration apart from debt overhang
3. A road map for the Euro
 - ECB intervention: necessary but not sufficient
 - Banking union SSM: good news, but nothing for current crisis
 - The crucial issue of legacy debt (INET)
 - A joint asset without joint liability (Euro-nomics)

1. The problem

A CRISIS OF GOVERNANCE

Euro Design Problem

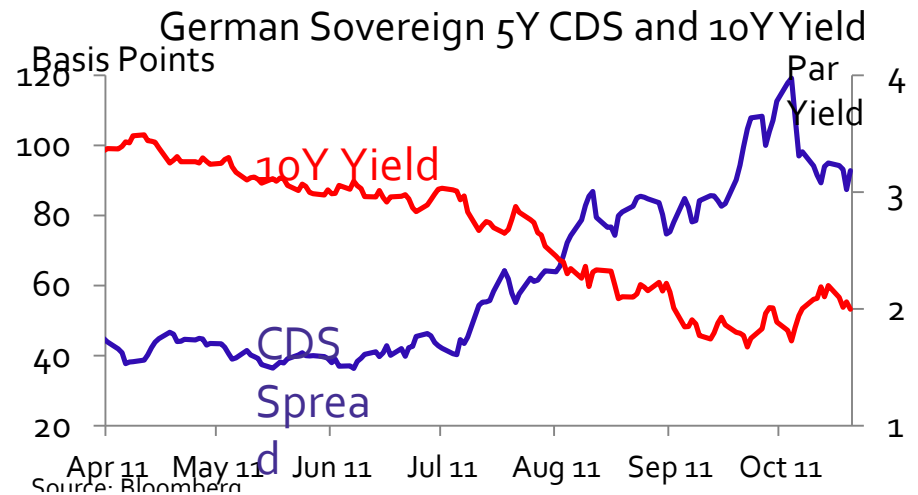
- Raising monetary policy to a supranational level while maintaining fiscal policy and banking supervision at the national level– credit bubbles
- Giving up national-level control over the money supply exposes members of a currency union to rollover crises
- Giving up exchange rate adjustment exposes members of the currency union to painful and long adjustment processes in the case of real overvaluation

Flight to Safety



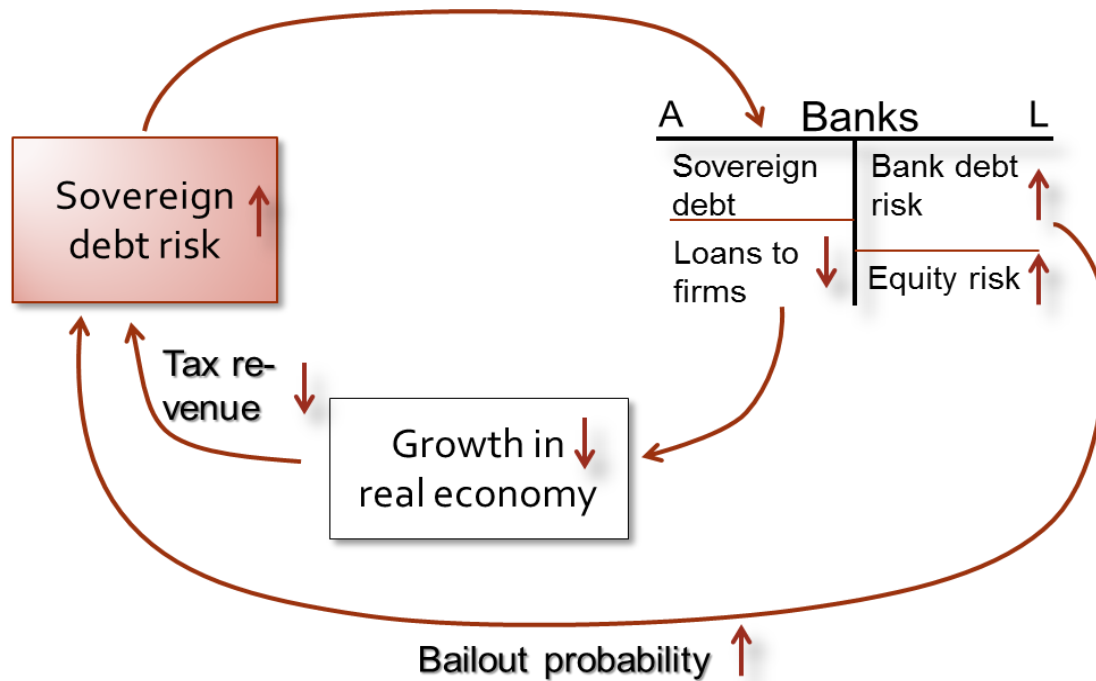
*coordinate on which safe asset
to flock to in times of crisis*

- appreciates in times of crisis



Diabolic Loop

Contagion due to diabolic loop – “twin crisis”



□ Trigger

- Bank insolvency (Ireland, Spain)
- Public debt / slow growth (Greece, Portugal, Italy)

Banks need safe asset for transactions

A crisis of governance: Euro Governance

An incomplete monetary union

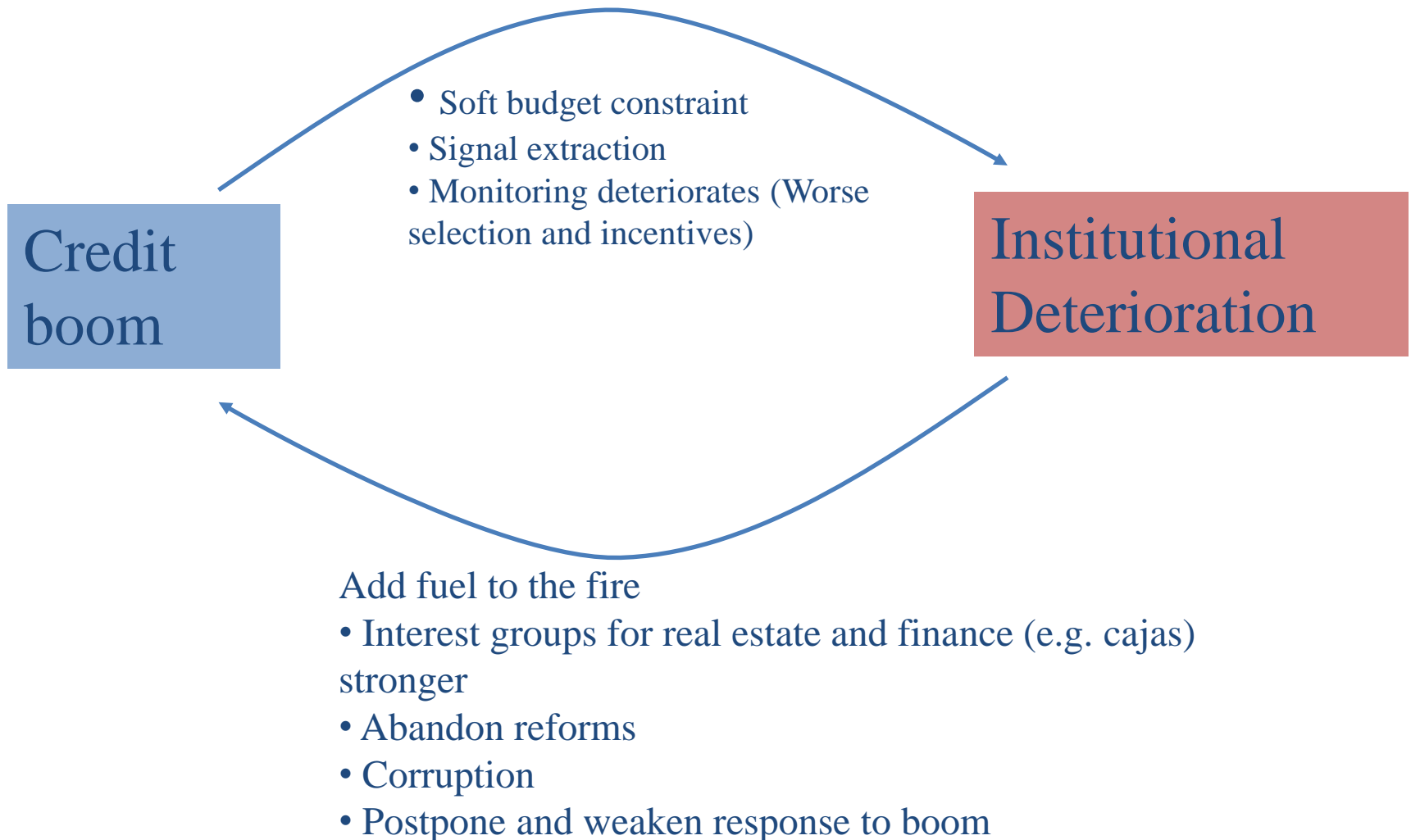
- Well known flaws to those who put it in place (Delors report)
- A method to this madness
 - Bike metaphor
 - Overreach on purpose, leave an incomplete construction, advance step by step by step (Coal and Steel-EC-EU-EMU)
 - A political objective: tie Europe together, Germany to France, irreversibly, to accept the growing asymmetry in sizes and power
 - **SHOULD NEVER UNDERESTIMATE GERMANY AND FRANCE COMMITMENT TO EUROPE IDEA**
- But obvious solution, real EMU, seems out of reach
 - How much is enough? Will answer this during talk

Long term growth consequences

- Normally think of persistence of credit boom through:
 - debt overhang and
 - government budget (waste)
- Other channels are important
 - (Fernández-Villaverde, Garicano, Santos (2013))
 - Like in a resource curse, price signals wrong, led to increase in drop out rates, drop in human capital
 - Institutional deterioration that follows boom

Political Credit Cycles

(Fernández-Villaverde, Garicano, Santos, 2013)



A crisis of governance: Countries

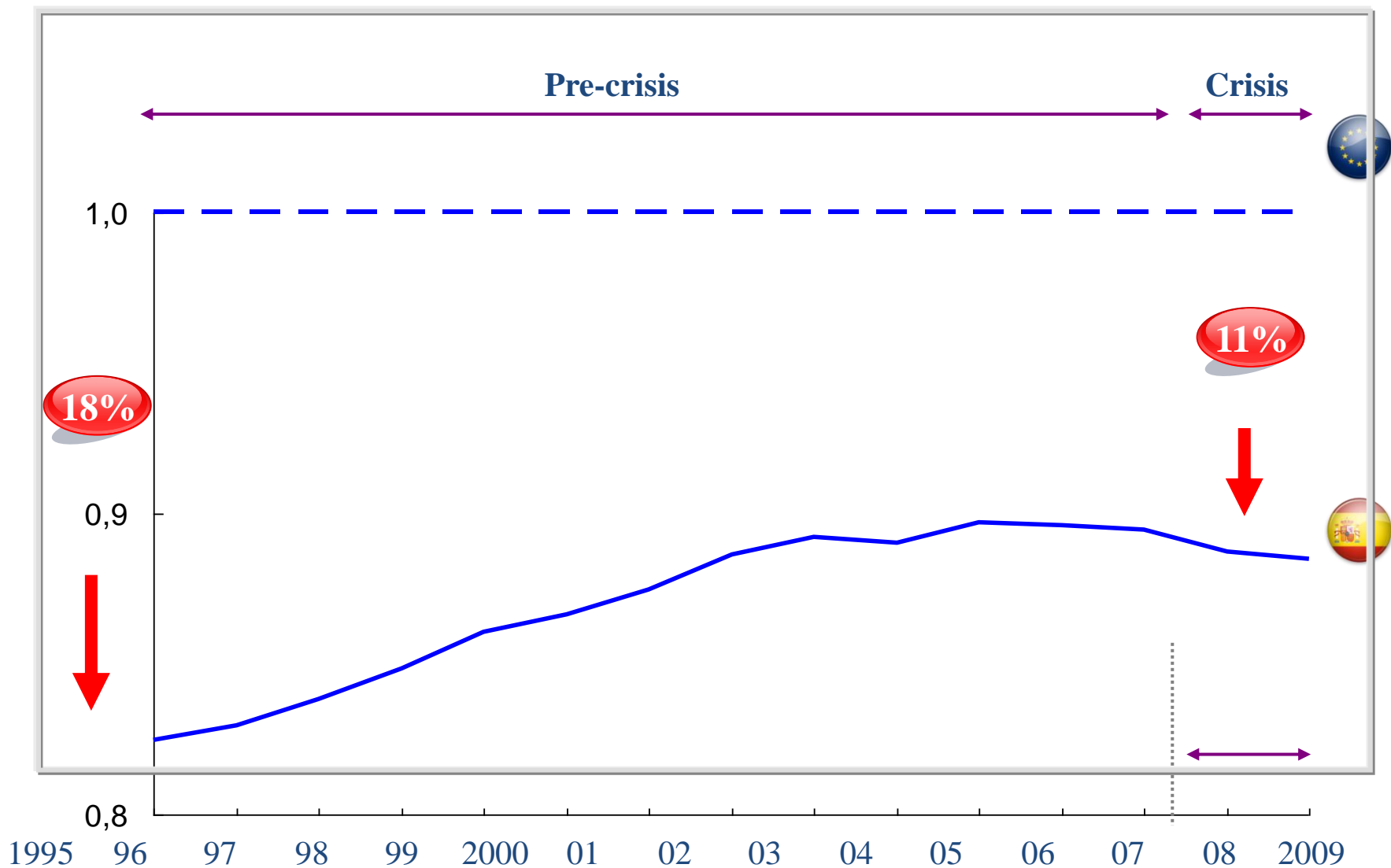
Weak, unreformed institutions

- Unreformed economies: Structural reforms as necessary today as in 2000
- Euro credit boom allowed to postpone inevitable reforms
 - Greece: already at 100% Debt/GDP in 2000
 - “urgent” 1950s pension reform proposals rejected in 2001
 - Portugal: stagnation
 - GDP in 2012 lower than in 2001! (Spain plus 17%)
 - Spain: no TFP growth 95-07, jobs created in construction
 - Ireland: catch up phase exhausted by 2000 (Honohan and Walsh, 2002)

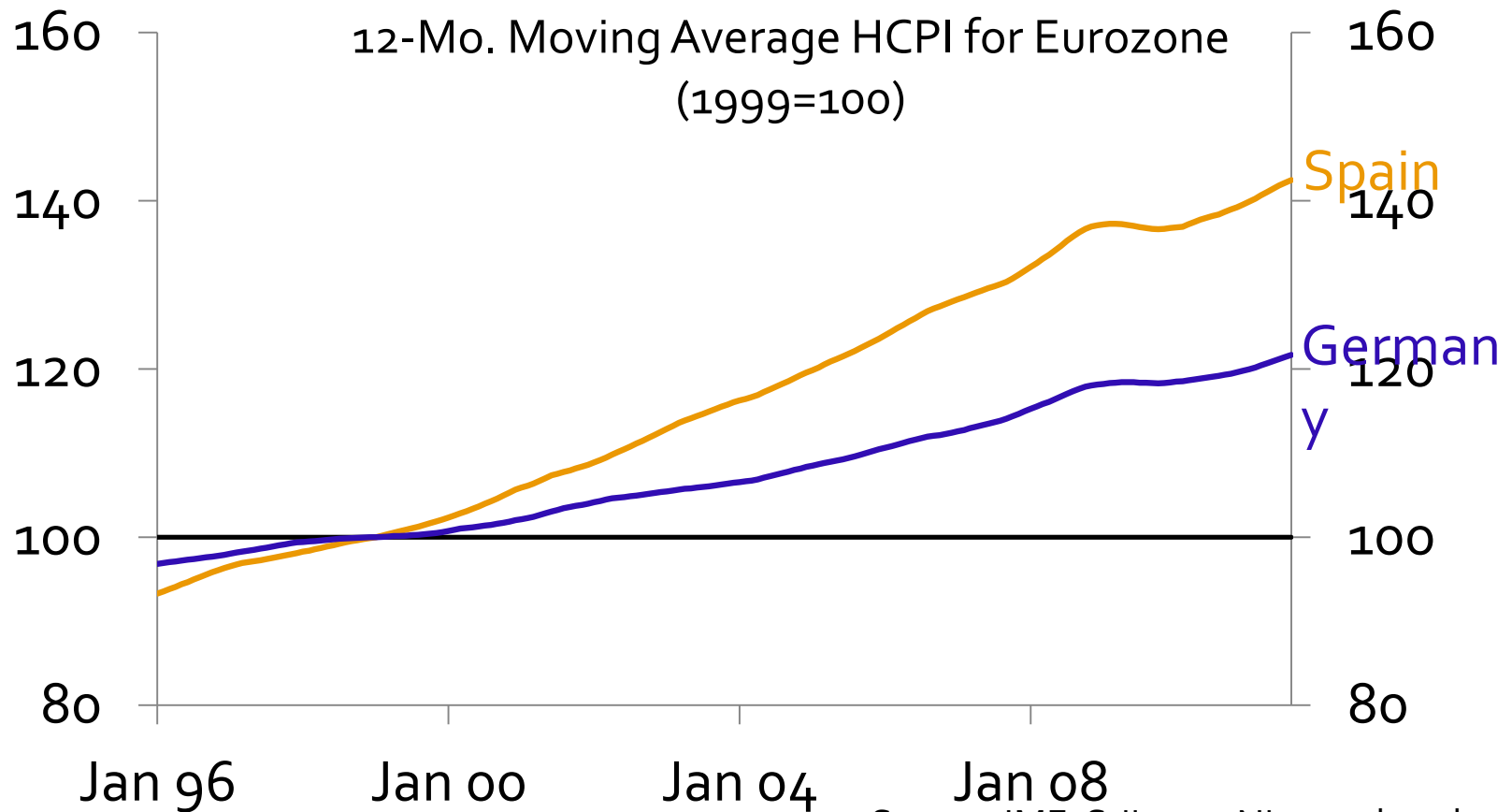
2. A Case Study

SPAIN: PERSISTENCE THROUGH DEBT, INVESTMENTS AND INSTITUTIONS

Convergence

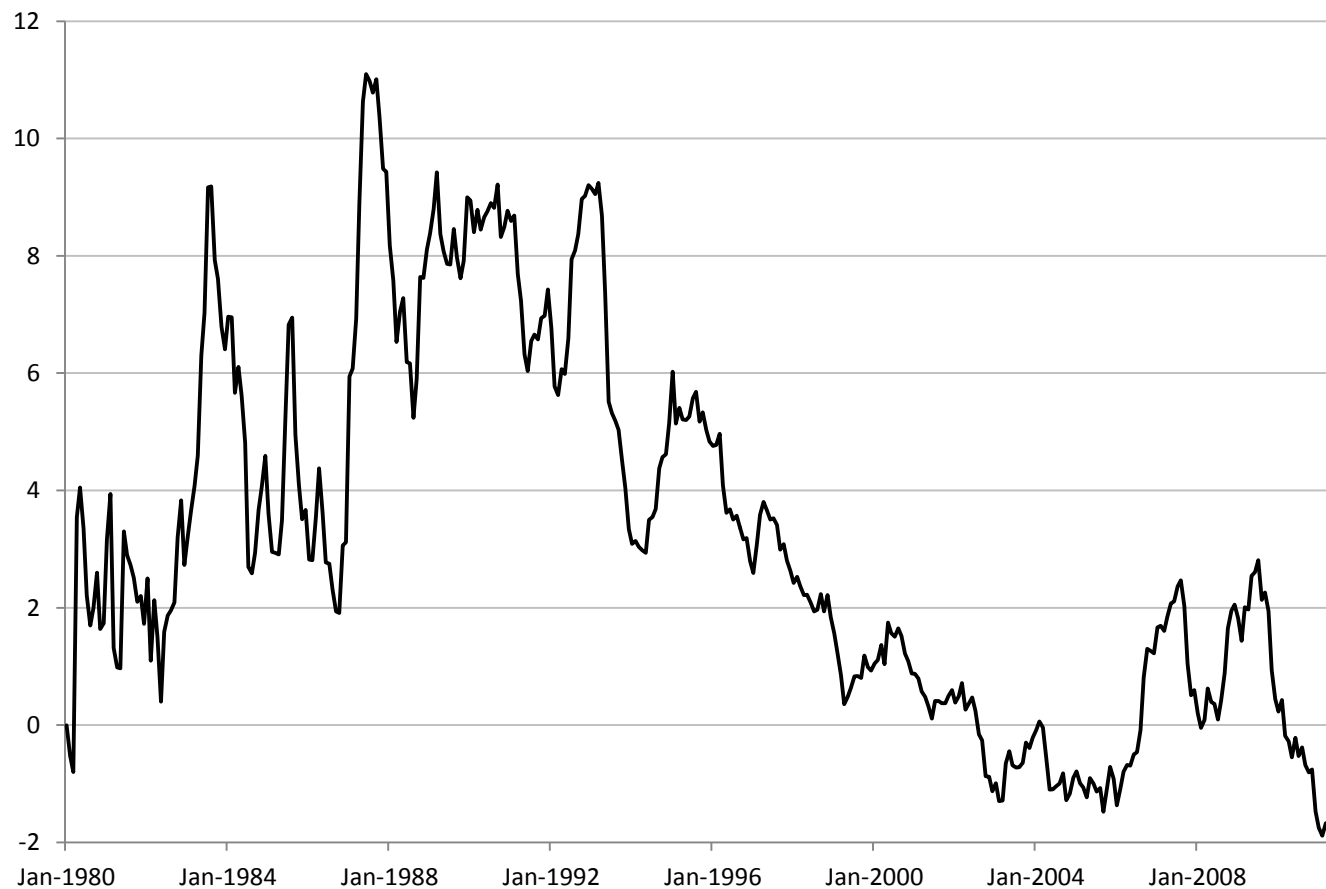


Euro Zone: Persistent Inflation Divergence



Source: IMF. Stijn van Nieuwerburgh

Spain: Real Interest Rate



Cheap Financing, Directed to What?

Demand

- Spaniards traditionally have had their savings in real estate (second, third home “for the kids”) After wars, inflation and defaults, strong prior that bricks are the only safe assets

Supply

- Large pool of unskilled unemployed workers
- Institutional set up , with easy temp contracts, conducive to low skill segment

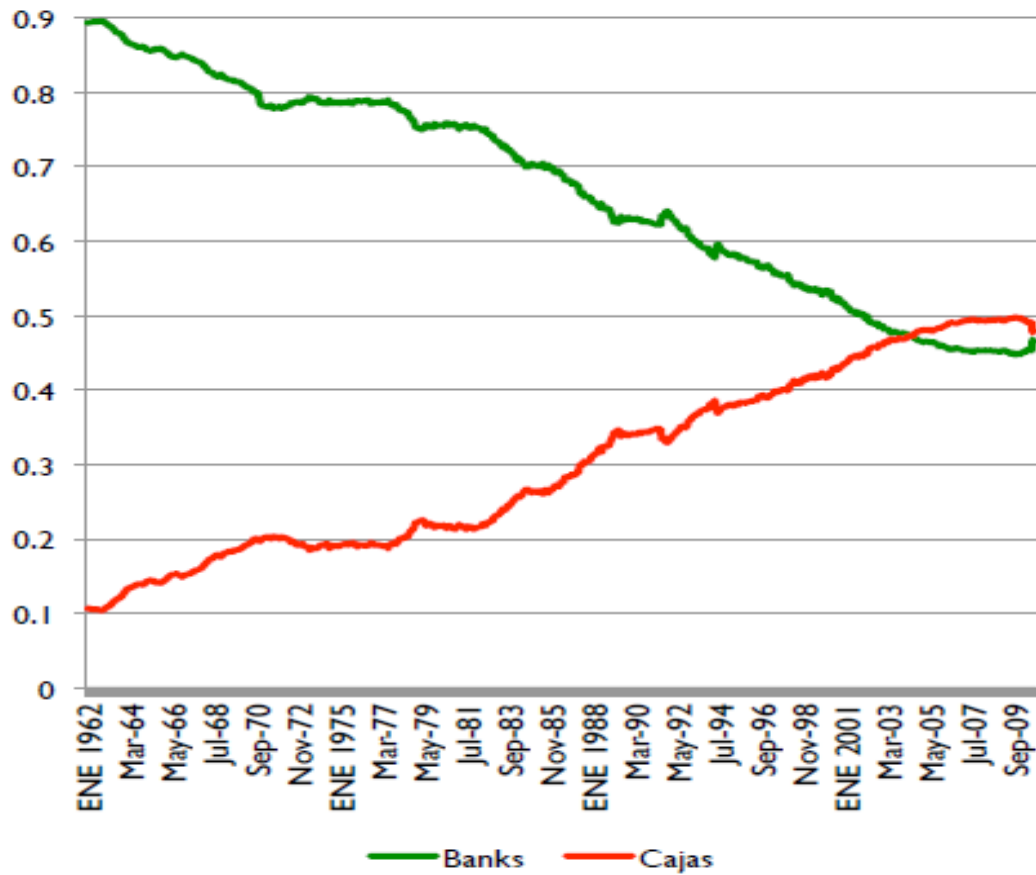
Financing channel

- Tiny margins (generally Euribor plus .25%) due to brutal competition from Cajas deregulated, growing out of their home territories
- Only willing to make loans with collateral ... RRE and CRE which can securitize in large, liquid, well functioning covered bond markets (like MBs but with recourse)
- Cajas/Developers/Regions one and the same
 - Zoning rules allow town level use changes

Financing Channel: The Cajas

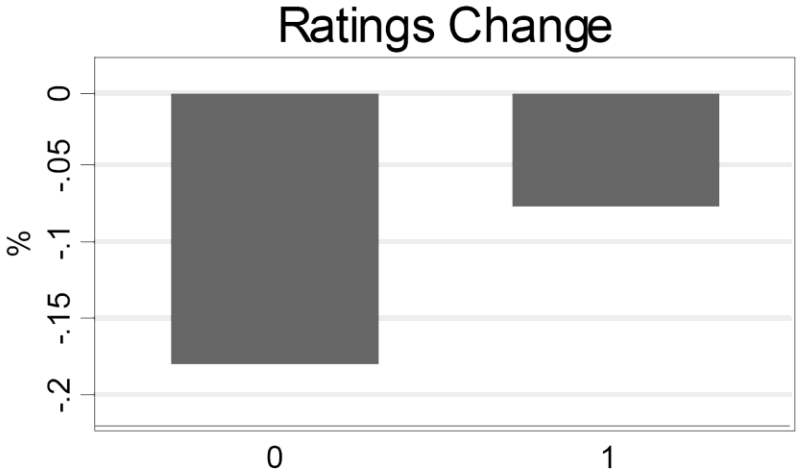
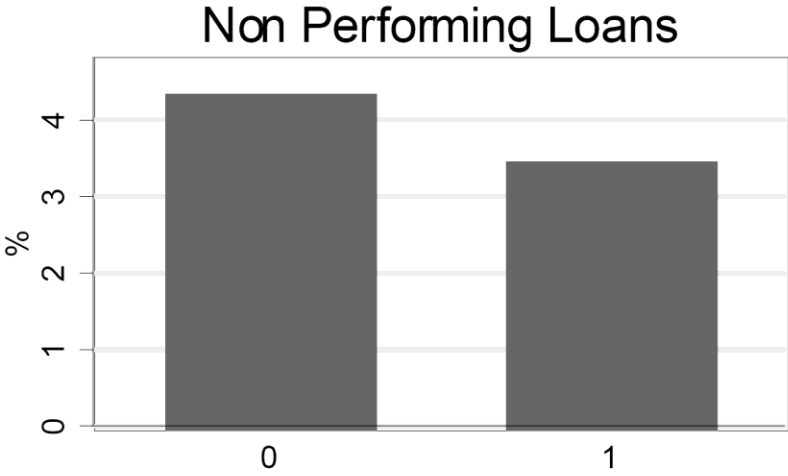
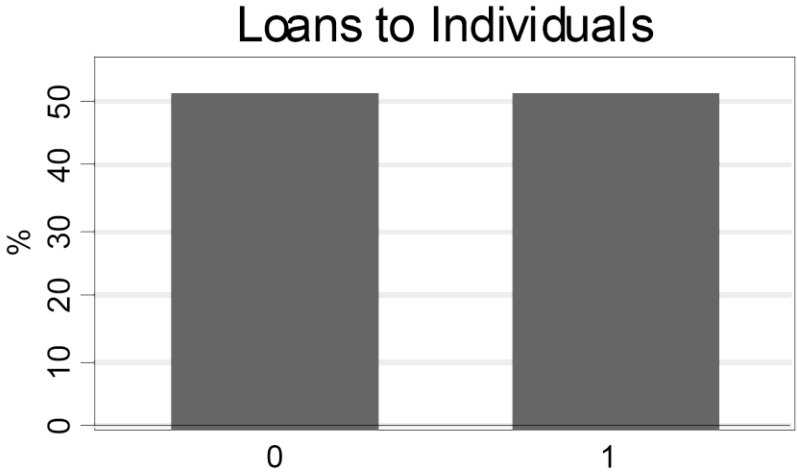
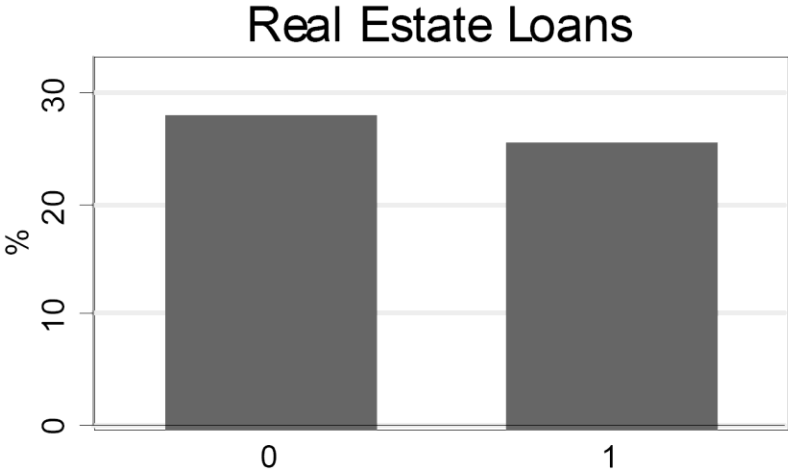
- Transition to democracy: Parties, Trade Unions created from above, without participation from society
 - Centralized power structure, controlled from center which dispenses favors
 - Then decentralization (Regions) created from above without any demand from most regions (reaction to Catalan and Basque dem
 - serves to create a gigantic patronage system, colonizing regional governments, Universities, and..
- Cajas: originally small, provincial
 - Deregulated post 1992 (Single Market)
 - But had easy access to money with EMU
 - Used, in many cases, as regional development banks, favor bank,

Share of loans



Source: Bank of Spain

Fig 4: Impact of Chairman’s Banking Experience on Loan Book

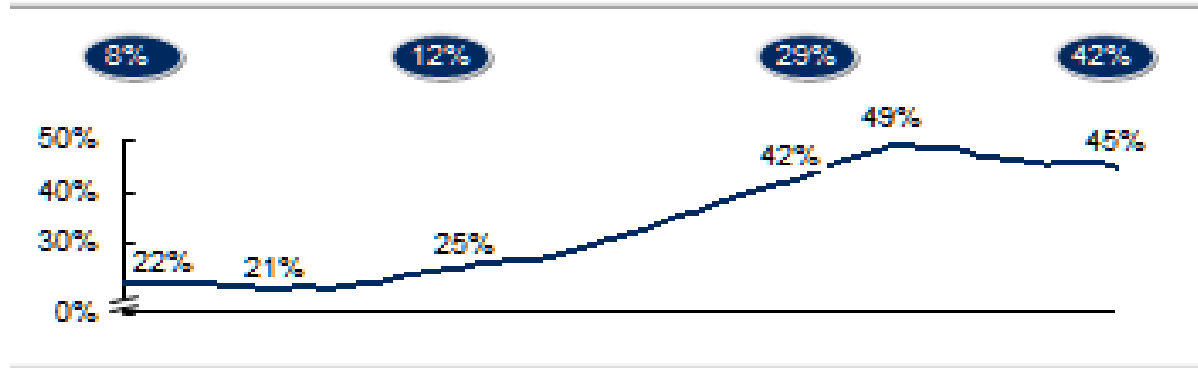


Garicano and Cunat, 2010

0: No Banking Experience, 1: Banking Experience

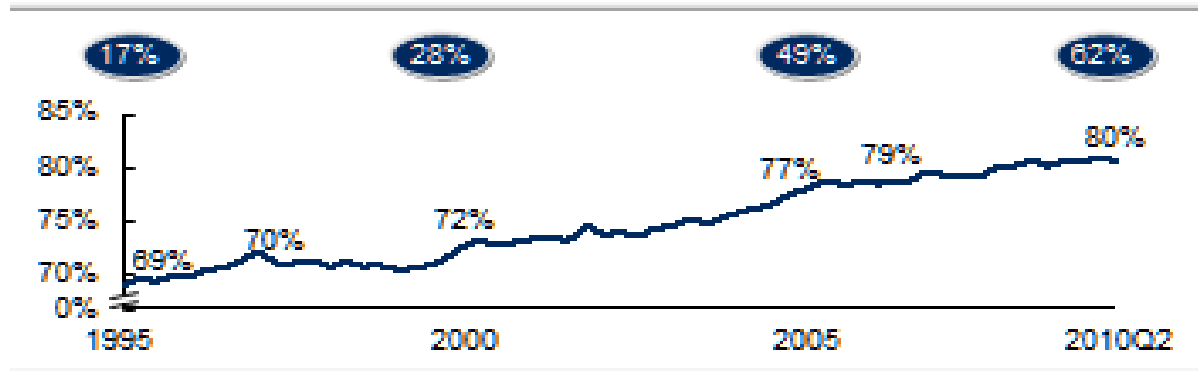
Construction and CRE

CRE Credit as
a share of all
business credit



% GDP

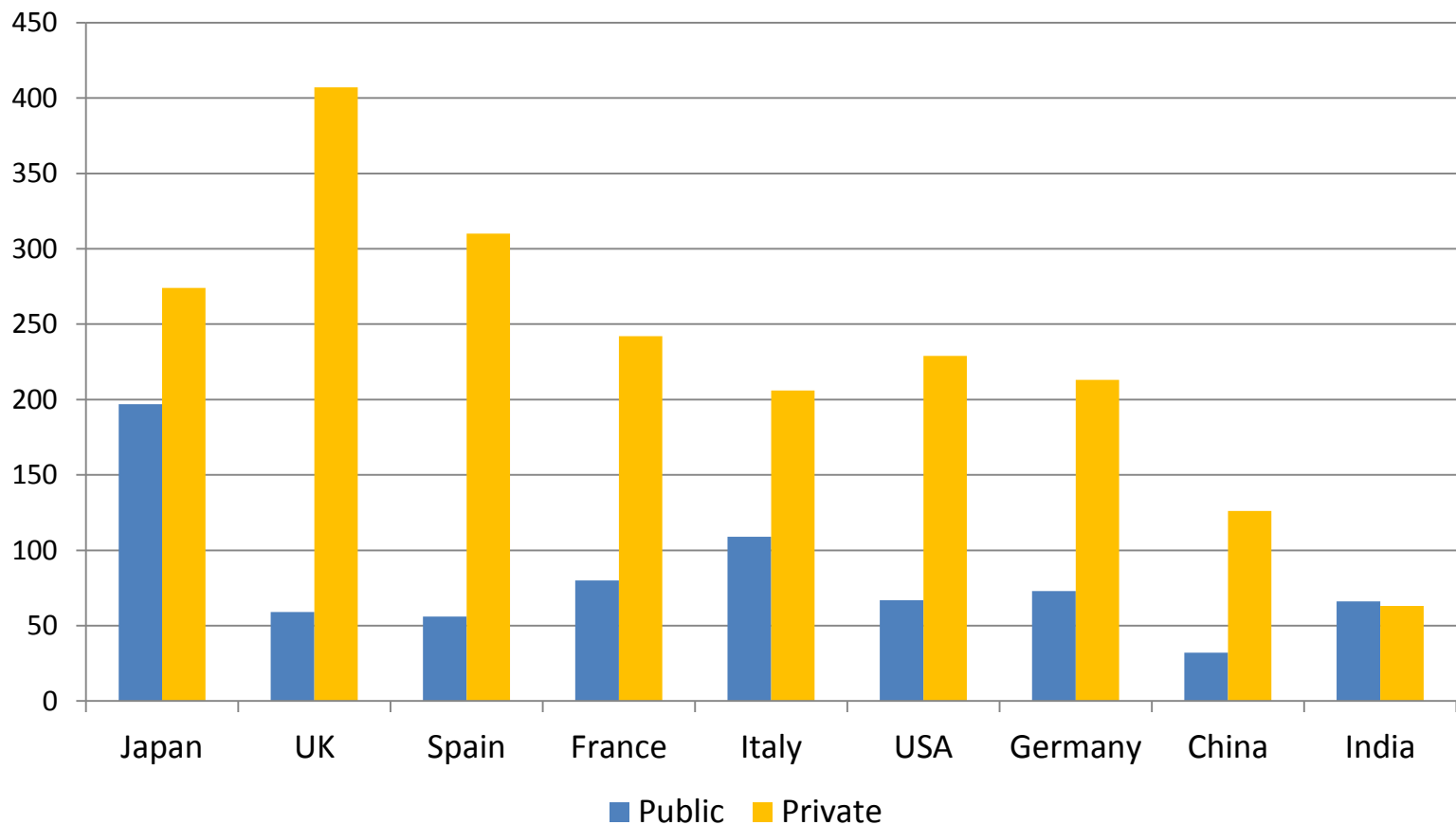
Mortgage
credit as a
share of all
consumer
credit



% GDP

Source: Bank of Spain Data, Beltran Garicano et al. (2010) Fedea McKinsey Report

Private Debt

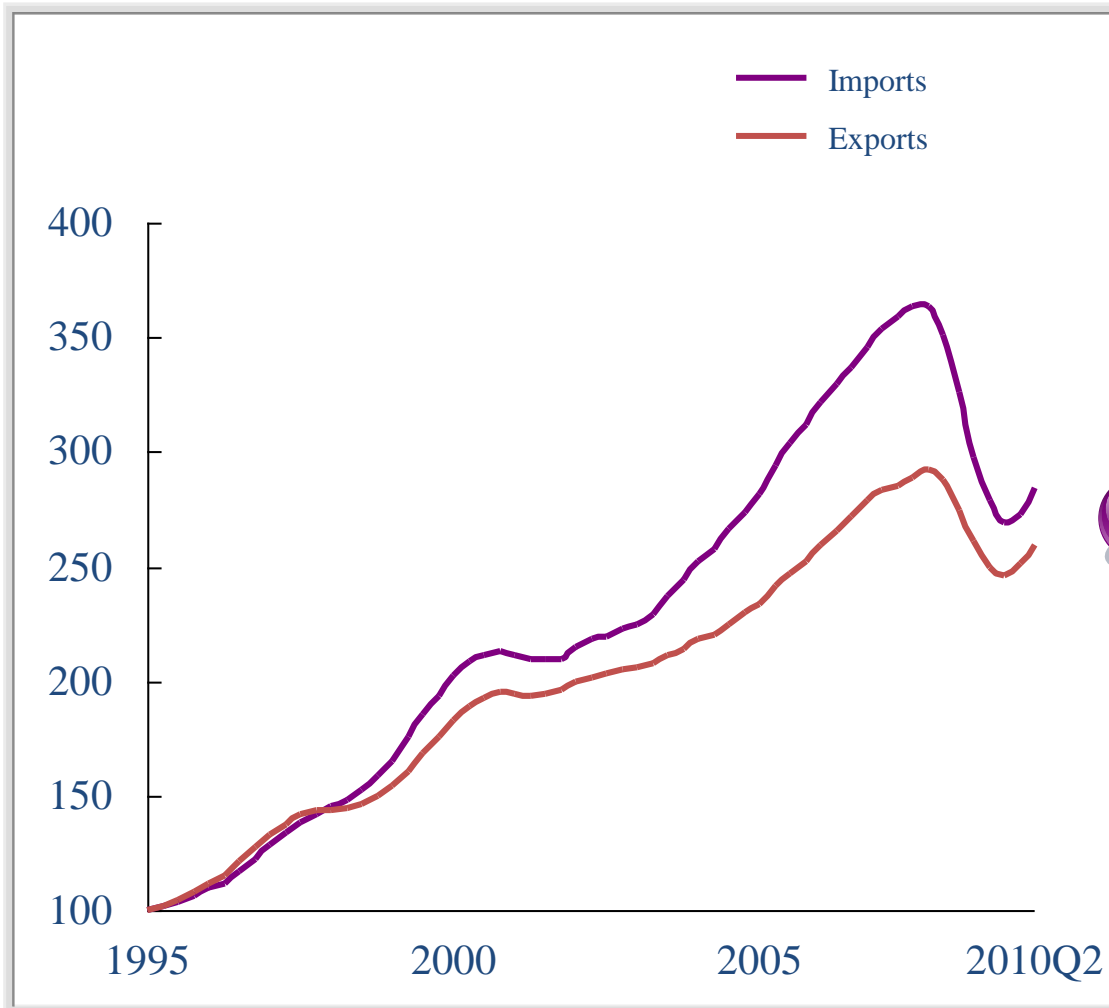


Private and Public debt as a percentage of GDP.

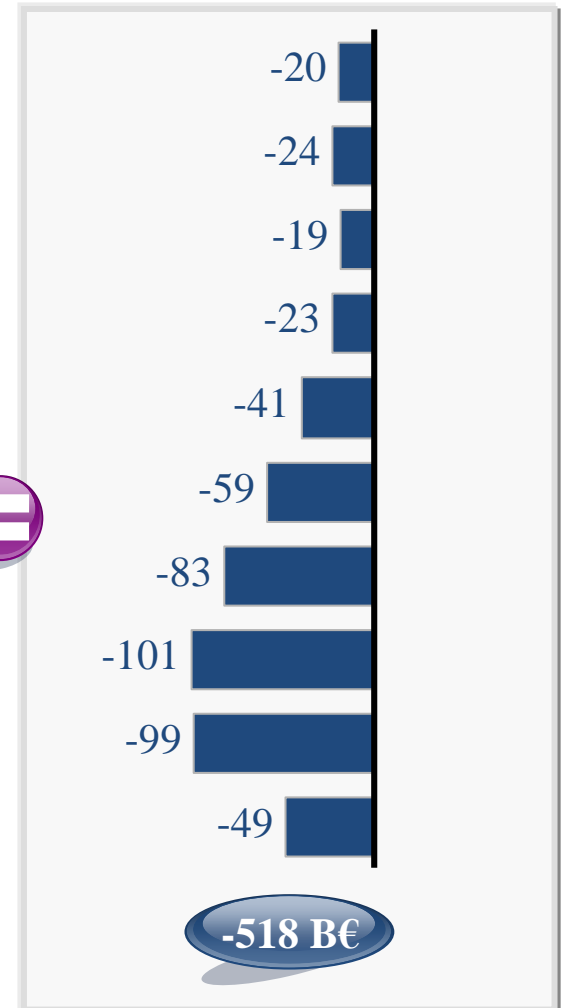
Source: McKinsey & Company, "Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences," Enero 2010

External Financing Gap

Fuente: Banco de España



Total



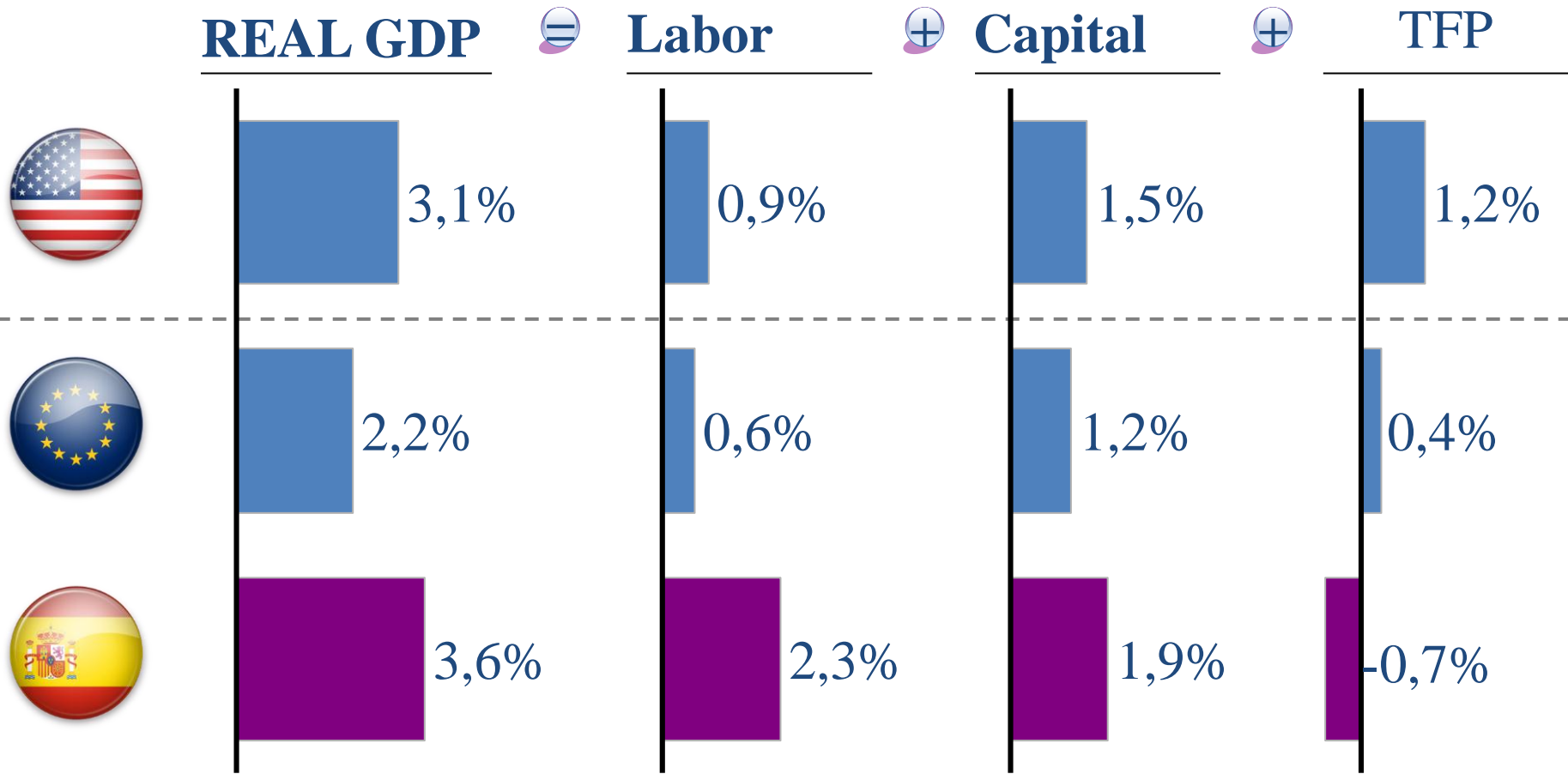
Long-Term Consequences

- (1) Competitiveness, productivity, growth:
reverting skill biased tech change
- (2) Deficit: tricky political economy
- (3) Banks stuck with bad assets

Growth without Productivity

Average Annual Growth. 1995 – 2007

Contribution to GDP



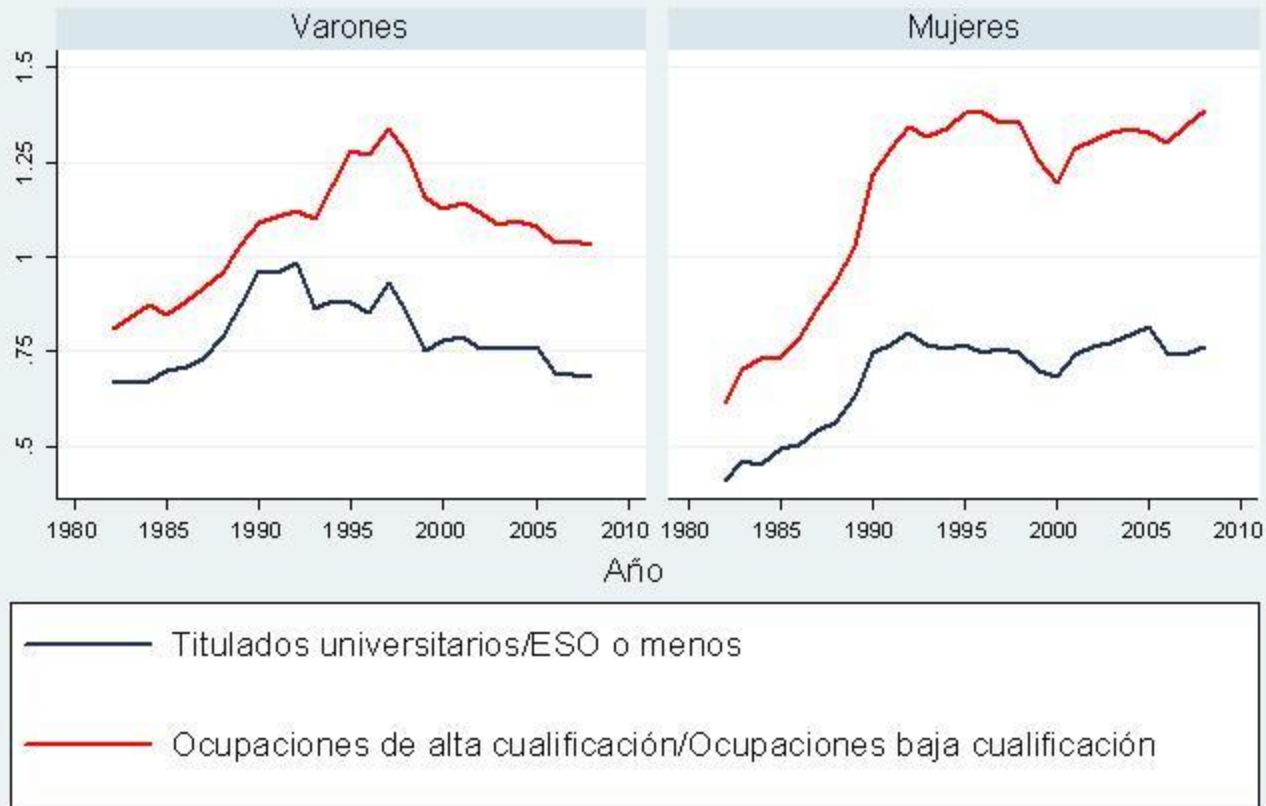
1 Para EU-15 los datos son del período 1995 – 2005 y sólo incluye países para los que el efecto multifactorial puede ser calculado: AUT, BEL, DNK, ESP, FIN, FRA, GER, ITA, NLD & UK

Human Capital Investments

- What is unusual of Spanish disease is distortion in human capital investment decisions
 - Bubble (sun and bricks) investments require very little human capital
- Wage signals encourage dropping out of school
 - Huge share of Ni-Nis (no job, no education)
 - Great difficulty in solving employment dilemma.

Wage Premia

Gráfico 1: Prima salarial a la educación



Source: NadaEsGratis: ¿Vale la pena estudiar? (VI) La inusual caída de la ganancia salarial resultante de la educación avanzada, Garicano, Felguero, Jimenez, 9/12/2010

Very Unusual!!

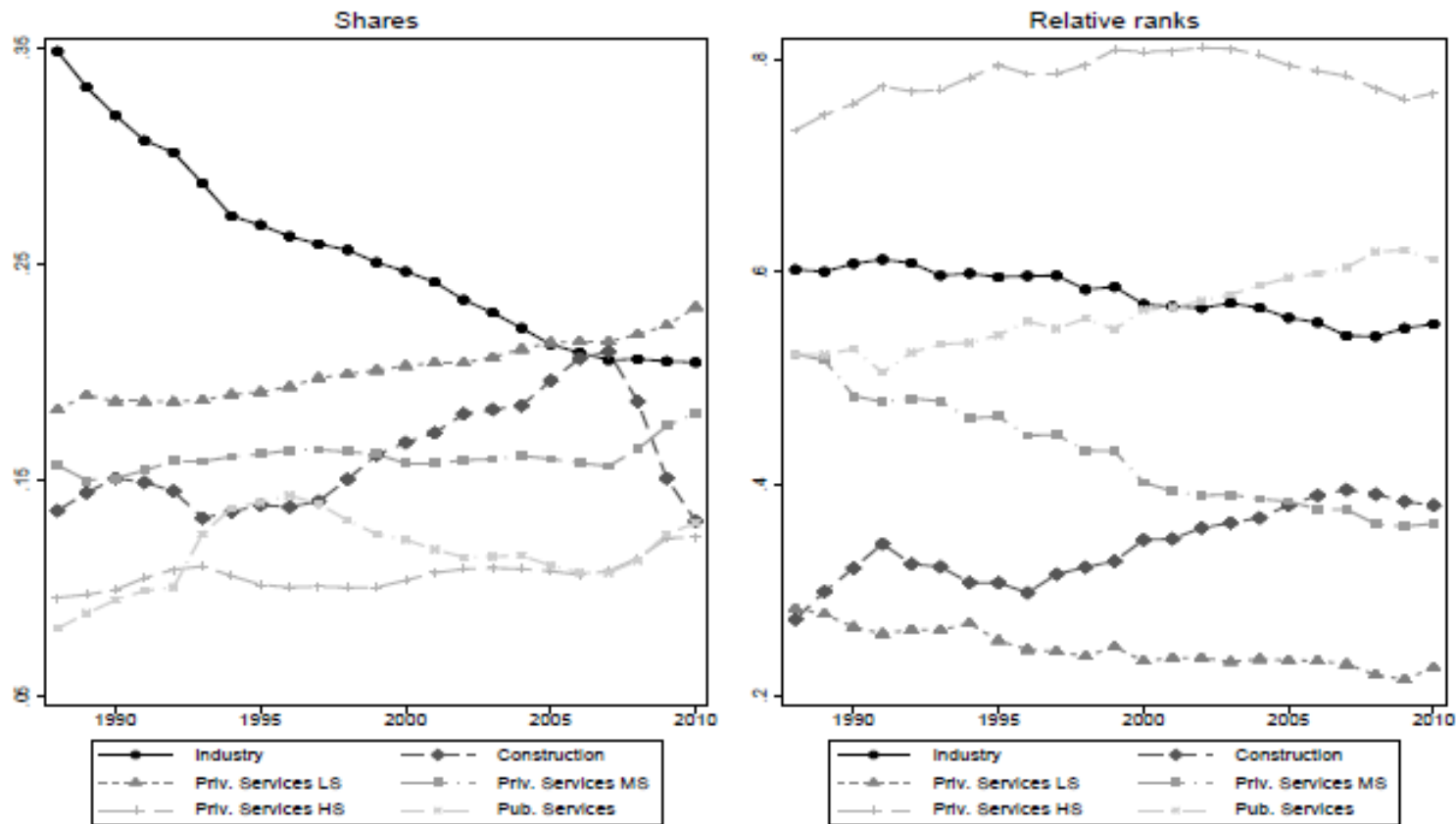
Table 3. Changes in Overall Inequality Ratios (%)

	United States*		Spain**			Germany***	
	1973-1989	1989-2005	1988-1996	1997-2006	2007-2010	1980-1990	1990-2000
	90/10		90/10			85/15	
Men	18.3	16.4	15.97	-9.53	9.55	8.3	10.7
Women	25.7	12.7	30.44	0.63	5.16		
	90/50		90/50			85/50	
Men	10.2	14.2	11.57	-5.35	3.81	5.8	5.1
Women	11.3	9.8	14.11	2.77	2.82		
	50/10		50/10			50/15	
Men	8.1	2.1	3.94	-4.41	5.53	2.5	5.6
Women	14.4	2.8	14.31	-2.09	2.27		

Notes: * Overall Hourly Inequality Measures from Autor *et al.* (2008). ** Ratios of quantiles estimated from Spanish Social Security data. *** Overall Daily Inequality Measures from Dustmann *et al.* (2009)

Source: Bonhome and Hospido March 2012, WP
Princeton 19/4/2012

Large Growth of Labor Prices and Quantities in Construction

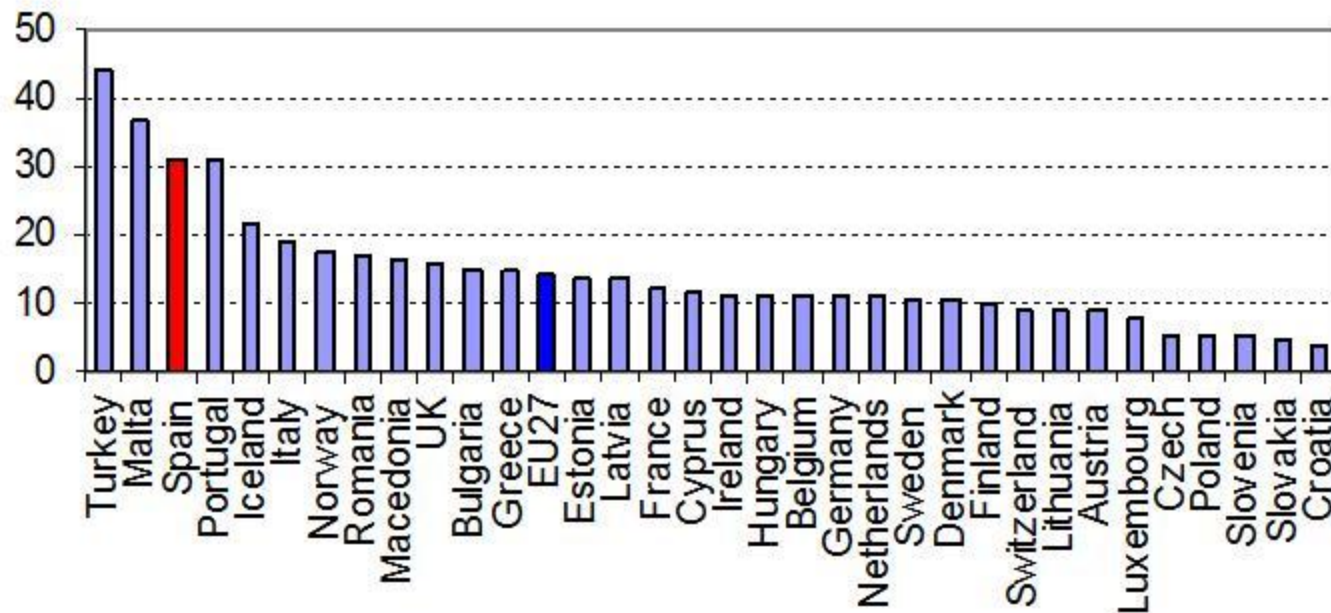


Source: Bonhome and Hospido March 2012, WP

High School Dropouts

Gráfico 1 : Abandono escolar temprano

(% de población de 18 a 24 años con un nivel educativo de secundaria obligatoria o menos, que no está estudiando o en proceso de formación, 2009)

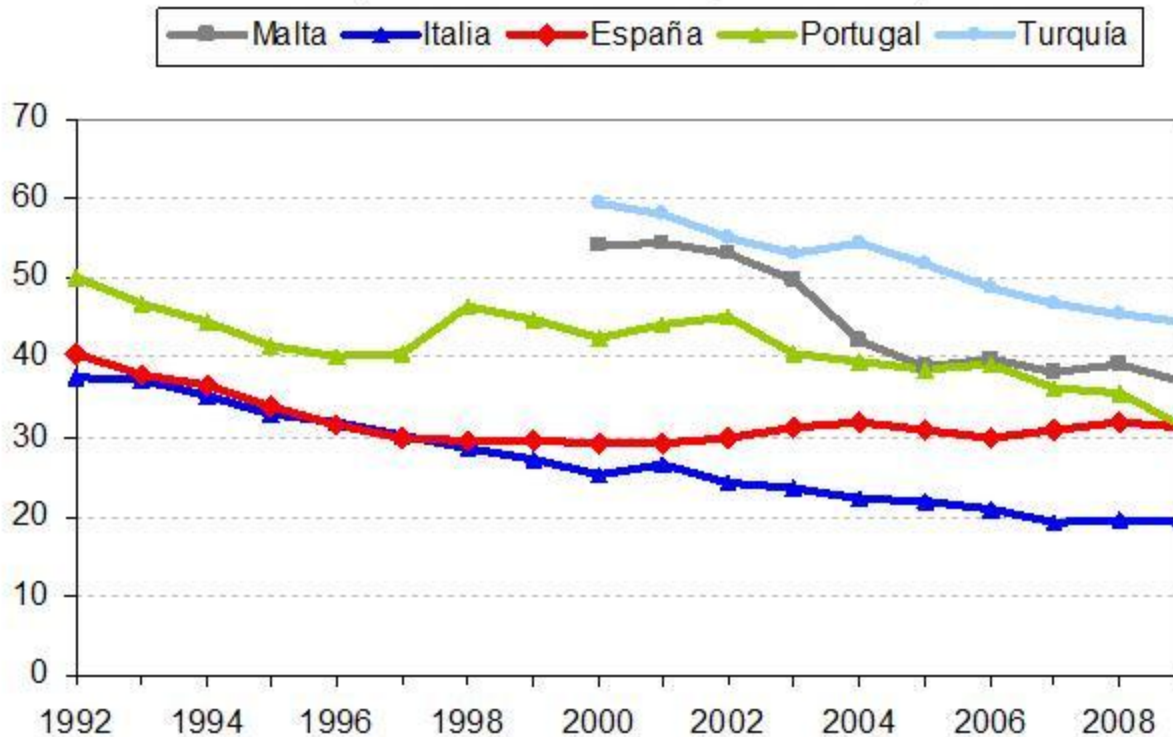


Fuente: Eurostat

Evolution of Dropout Rate

Gráfico 2 : Abandono escolar temprano

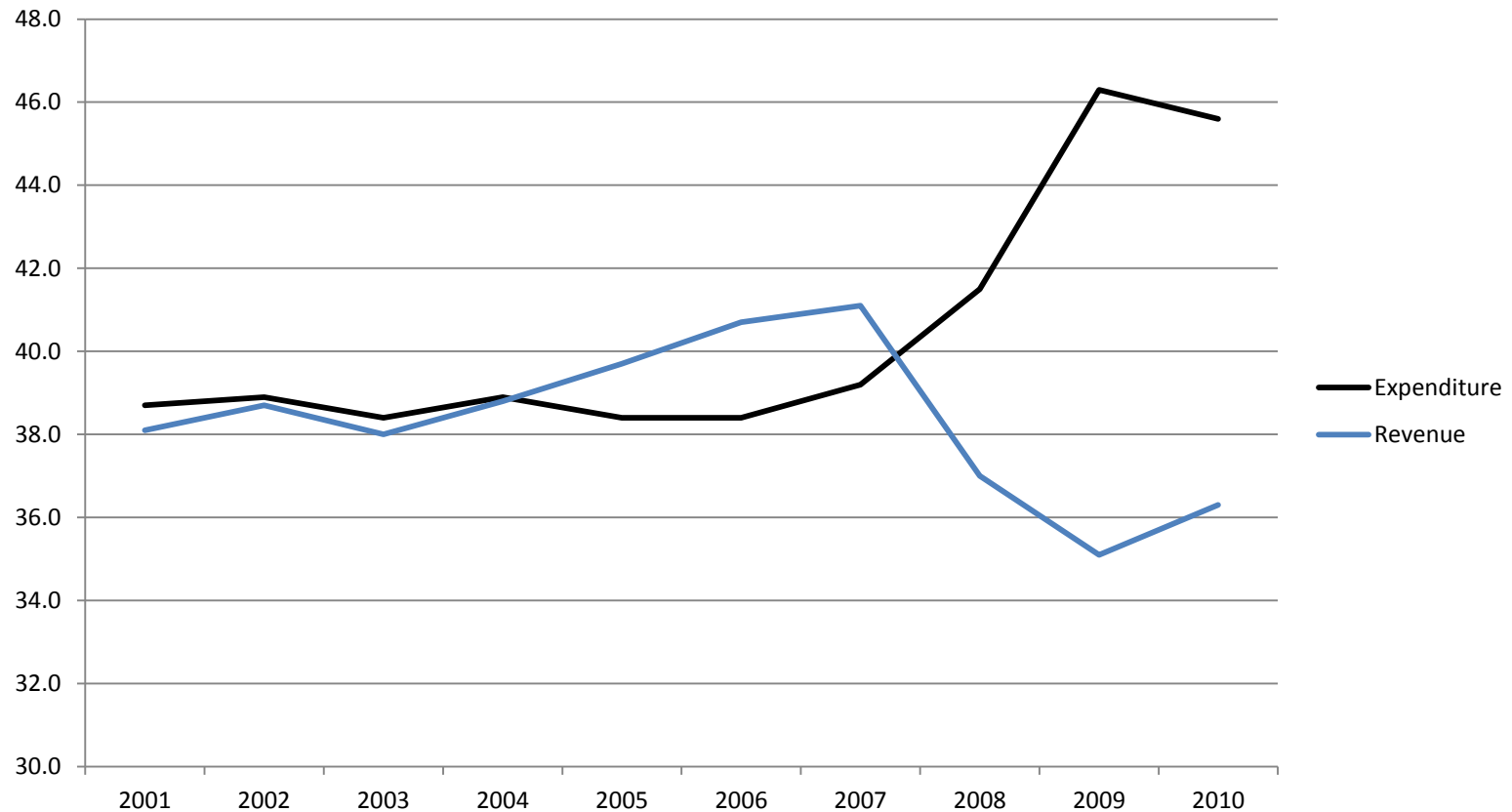
(% de población de 18 a 24 años con un nivel educativo de secundaria obligatoria o menos, que no está estudiando o en proceso de formación, 1992-2009)



Fuente: Eurostat

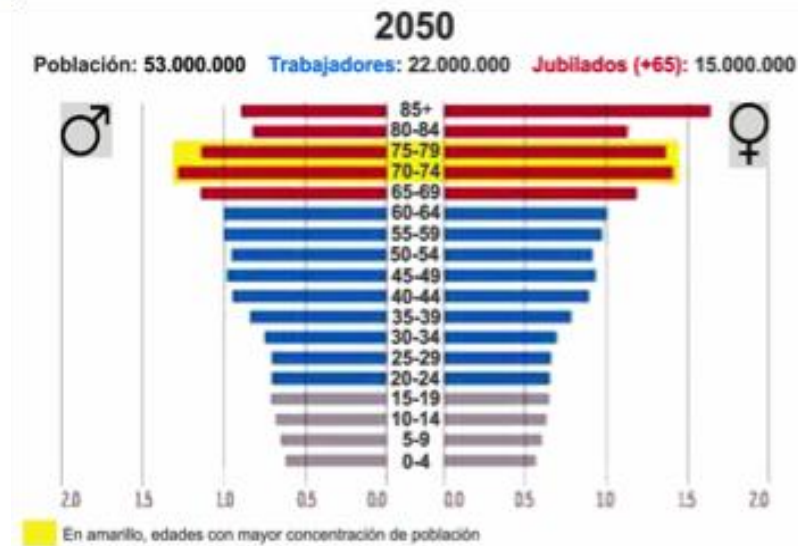
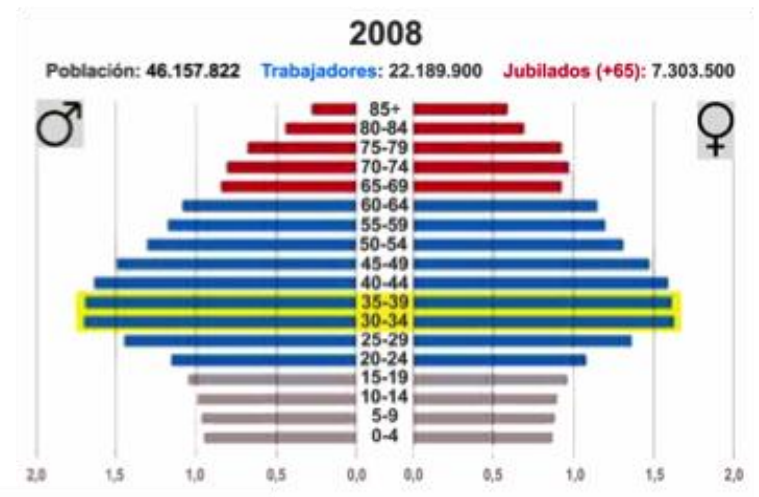
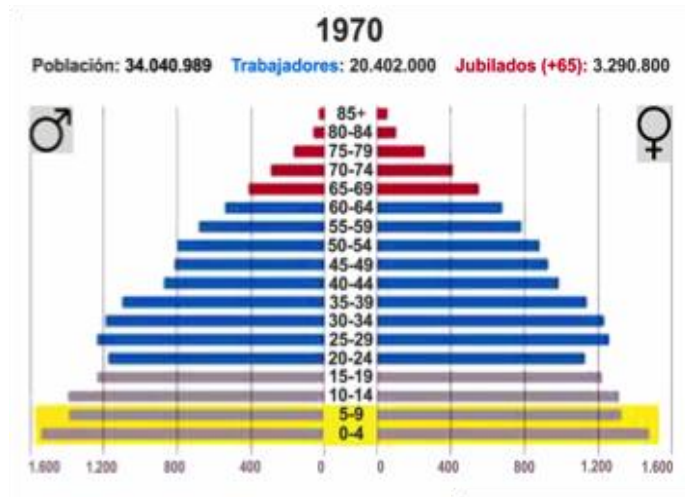
NadaEsGratis: Alerta Roja Generación Ni-Ni: 750,000 jóvenes ni estudian ni trabajan (De Florentino Felgueroso y Luis Garicano) 30/09/2010

With Little / No Public Deficit To Start With

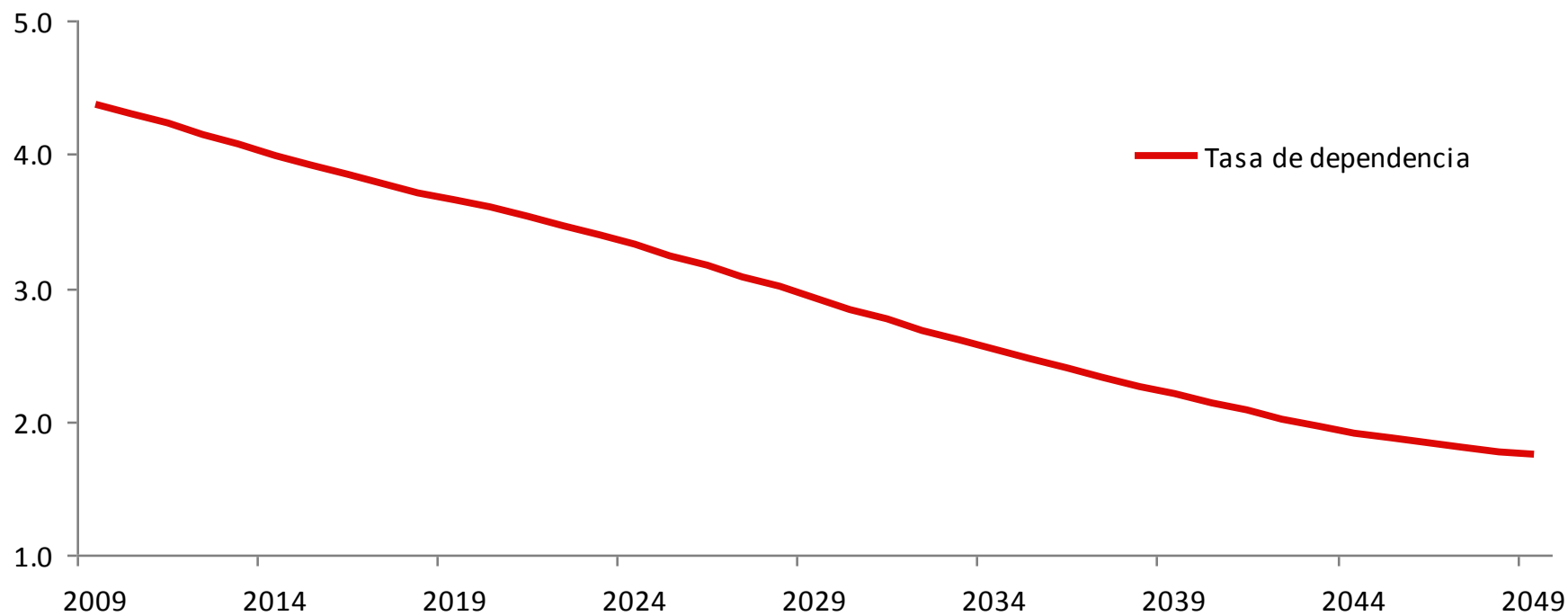


Eurostat

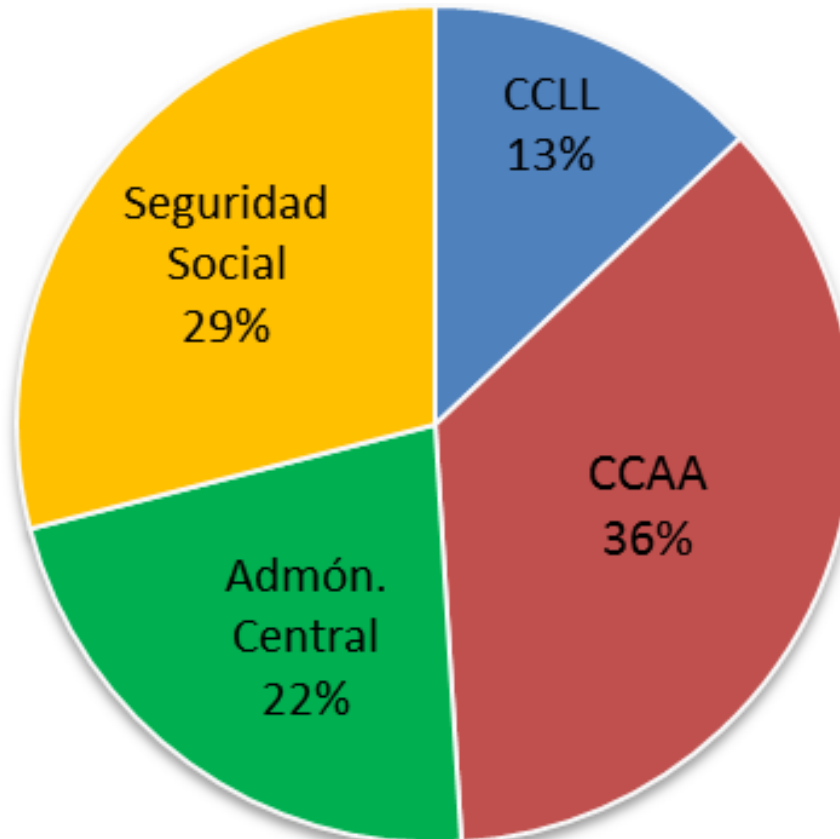
Political Economy: Pensions First!



Dependency Ratio



Regions Account for Large Share of Expenditure



Institutional issues

- Institutions badly damaged by the bubble
 - Build a regional state under no budget constraint
 - Populism
 - No sense of costs
- Now: reform without reformers
 - E.g. Spanish SEC appointment, public TV appointment
- Outright corruption: over the last 4 months, huge financing scandals for
 - Top of Catalan Nationalist party
 - Top of Popular Party

Large Housing Inventory (Upper Bound*)

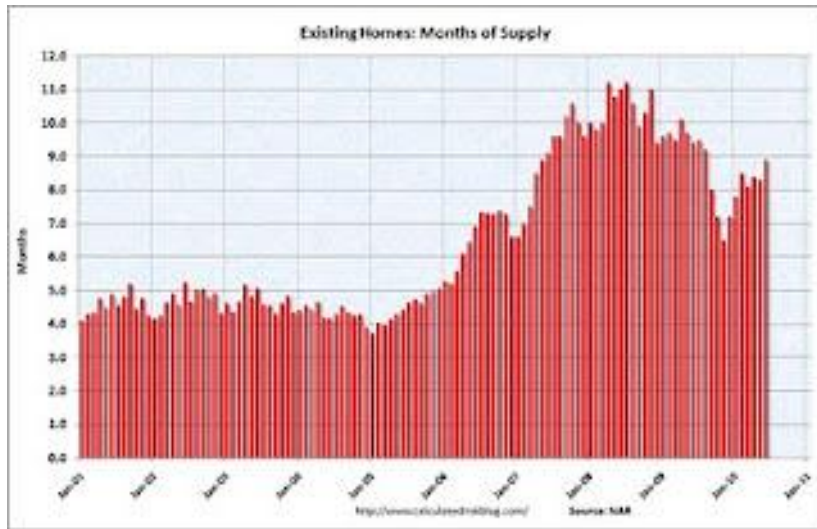
(Thousands)	2004	2005	2006	2007	2008	2009	2010
Finished Housing Units	564	592	659	647	632	424	276
Sales	295	336	410	412	333	241	200
Unsold	269	255	248	235	299	183	76
Inventory	269	524	772	1007	1306	1489	1565

*Unaccounted sales are promotions for own use or in cooperatives

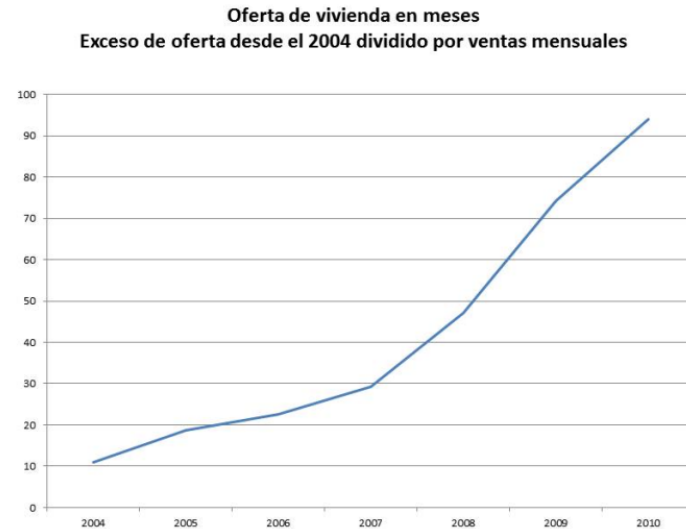
NadaEsGratis: El mercado inmobiliario: ¿de dónde saca el ministerio evidencia de mejoría?
by LUIS GARICANO on 19/05/2011

Gigantic Housing Stock

US 12 months



Spain: 100 months?



Lusi Garicano, NadaEsGratis: El mercado inmobiliario: ¿de dónde saca el ministerio evidencia de mejoría? (19/5/2011)

POLICY RESPONSE, SPAIN

Three axis

- Financial System
- Dealing with competitiveness loss
- Fiscal Crisis

Three axis: Finance

- Financial System
 - Extremely slow, hesitant: Protecting Cajas sector against embarrassment?
 - Finally, three measures
 - Stress test by outsider firm (Oliver Wyman)
 - Large recap, obligatory, with EU lent money at very low rates
 - Bad bank (SAREB) already functioning (Chaos)
 - Key issue here: No private defaults means state swallows all public debt): choosing the Irish way
 - European help??? The betrayal by the gang of three

Three axis: Competitiveness

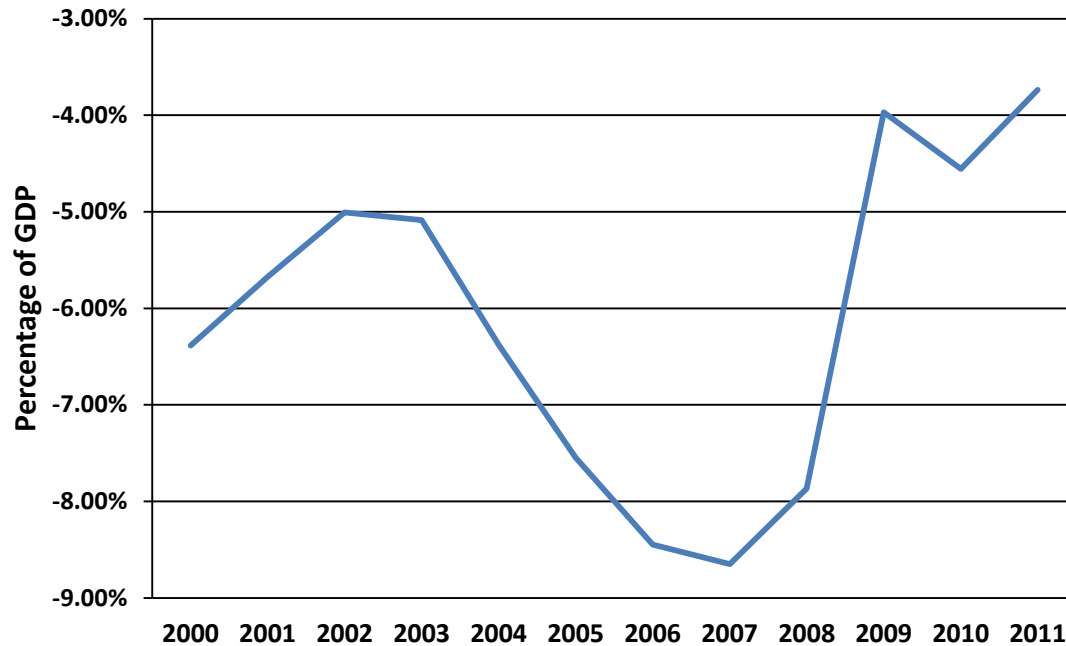
- Dealing with competitiveness loss
 - Labor reform
 - Internal devaluation, but no training or matching help
 - Some liberalization of trade and other sectors
 - Key sector: professional services, untouched
 - Key issue here: retraining the “lost generation” (nothing right now)
 - Human capital ignored

Three axis: Public debt

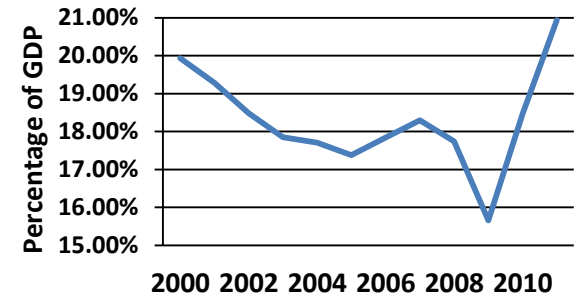
- Fiscal sustainability: when is debt going to stabilize?
 - Debt at around 100% of GDP end '13
 - Average interest rate at 4.5%
 - Inflation rate at 2%
 - Growth? IMF -1.5%, 0 in best case? (see what we discussed before)
 - But primary deficit (excluding banks) at 4% of GDP! (need +3 +4)
- Note: Keynesianism in one country not possible (who'd finance it?)
- Obvious cut is pensions (needed long run, anyway) and civil service
 - But government has no will
- Key issue here: regions
 - The need for regions to impose discipline, perceived as "Spain's problem" causing Catalonia to choose a dramatic fuite en avant – we are out of here

Hope: Goods

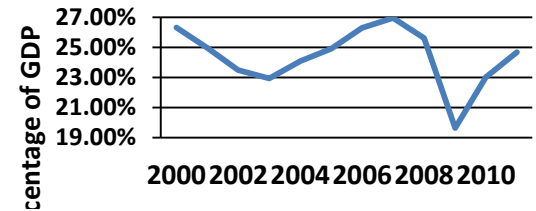
Balance of Payments. Goods Balance as a share of GDP over time



Balance of Payments. Goods Receipts as a share of GDP over time

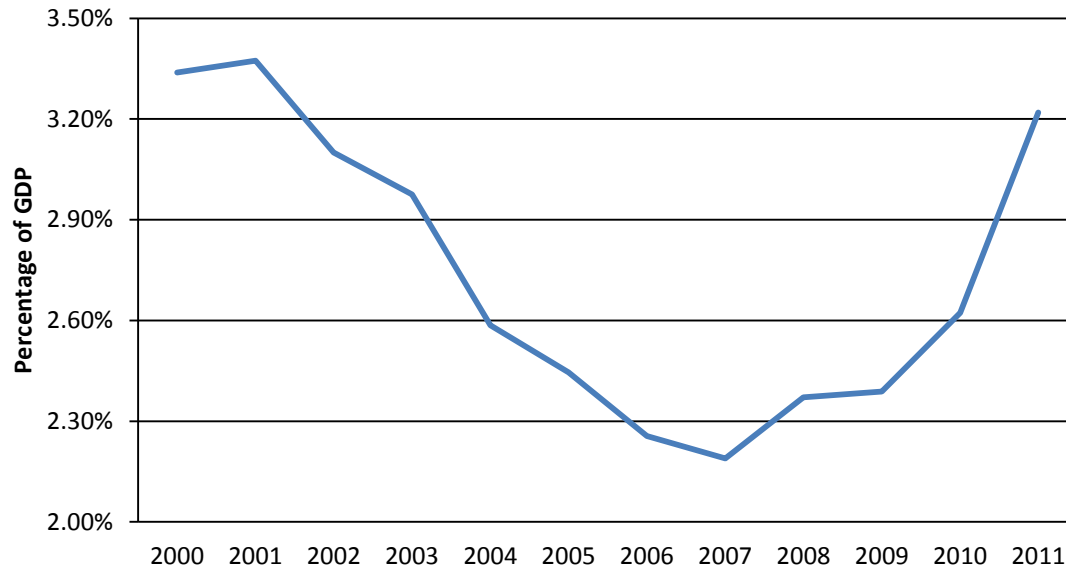


Balance of Payments. Goods Payments as a share of GDP over time

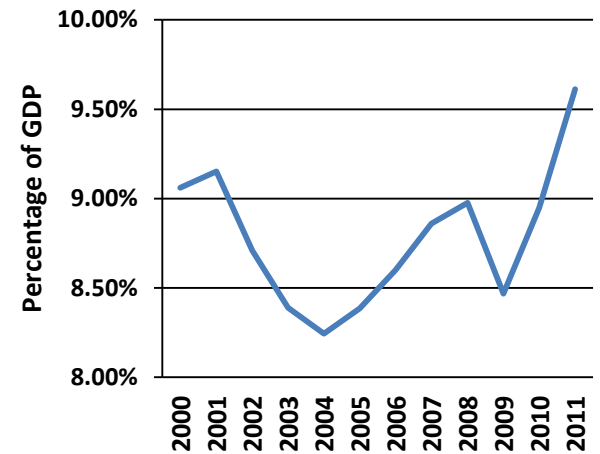


Hope: Services

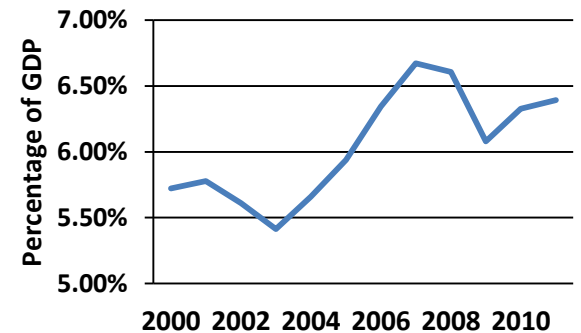
Balance of Payments. Services Balance as a share of GDP over time



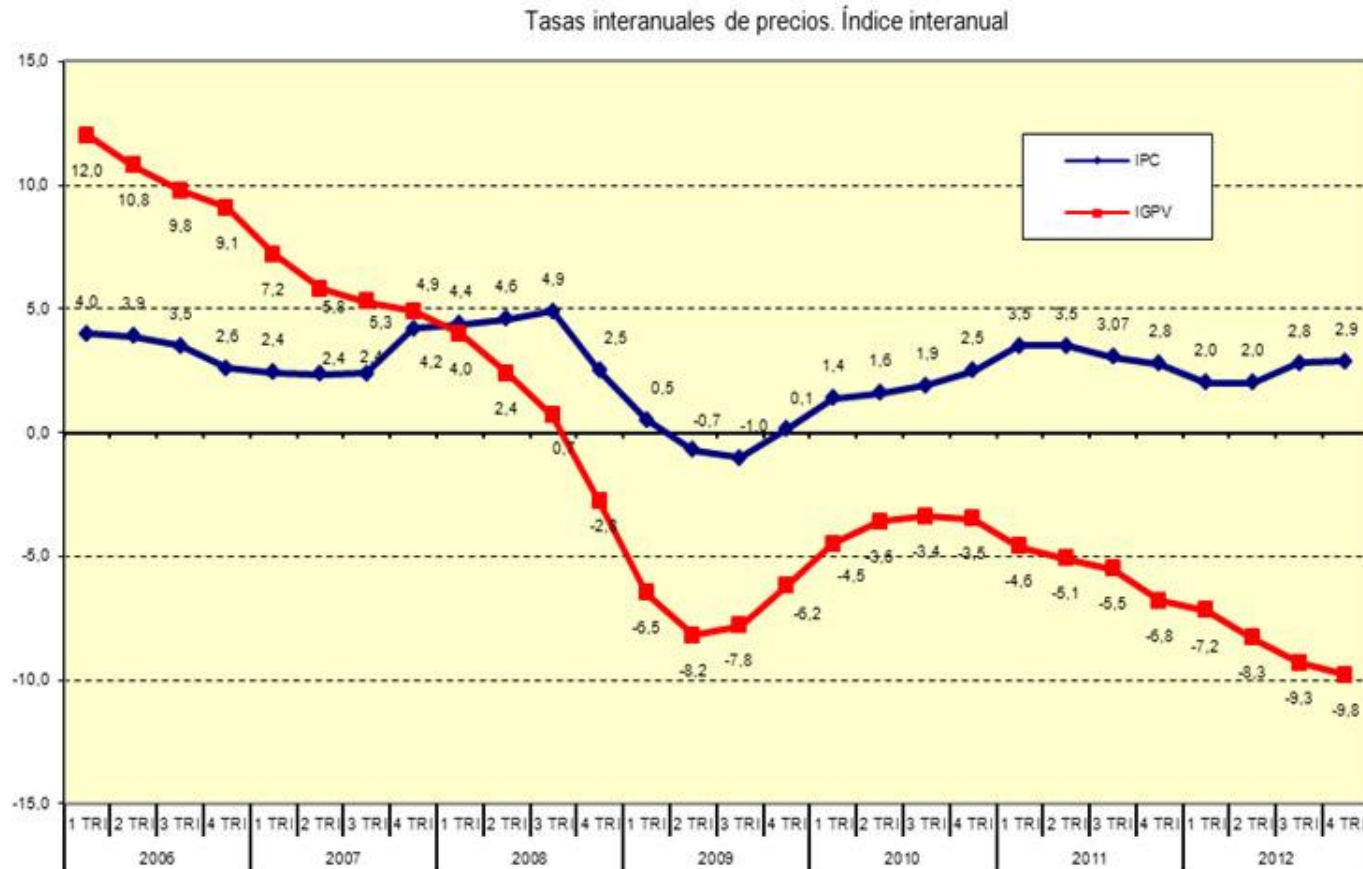
Balance of Payments. Services Receipts as a share of GDP over time



Balance of Payments. Services Payments as a share of GDP over time

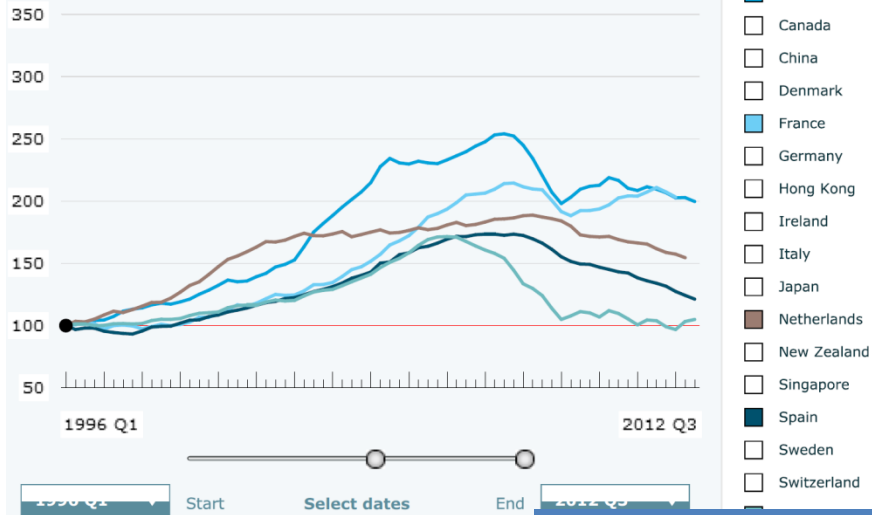


Nominal house prices falling at 10% yoy

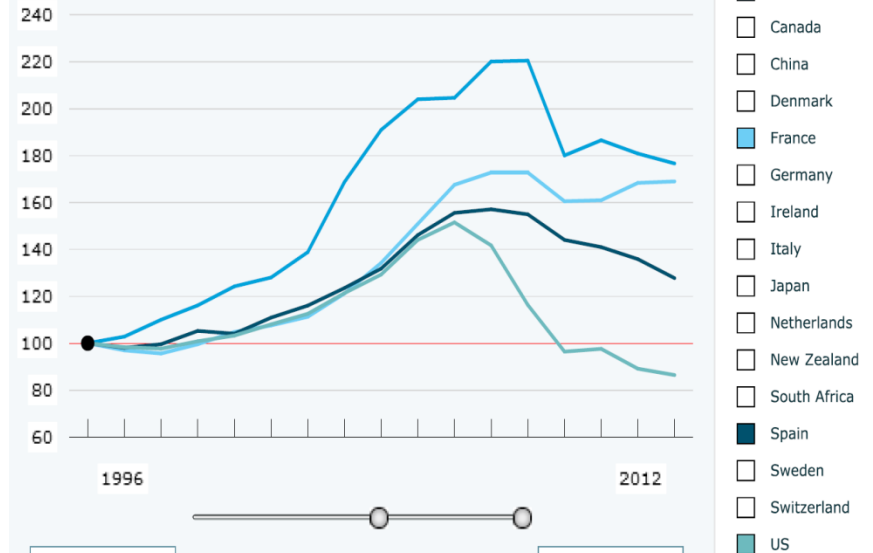


Hope?: housing

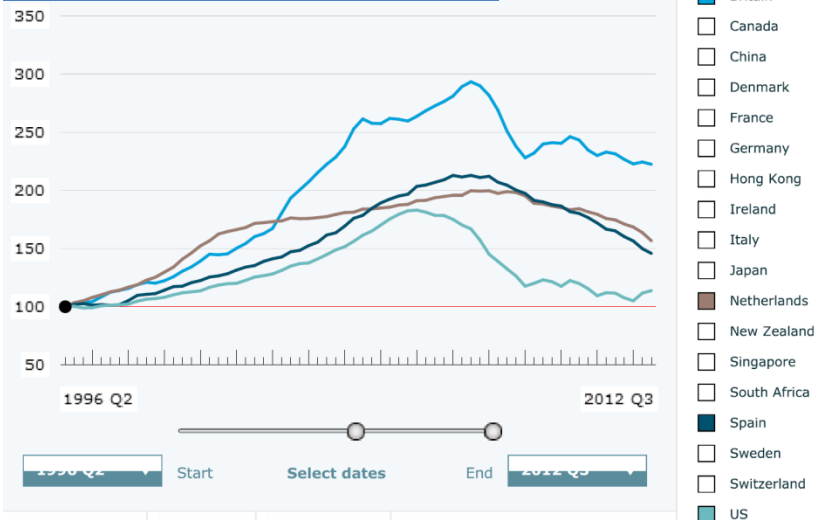
Price to rent



Price to income



Real house prices

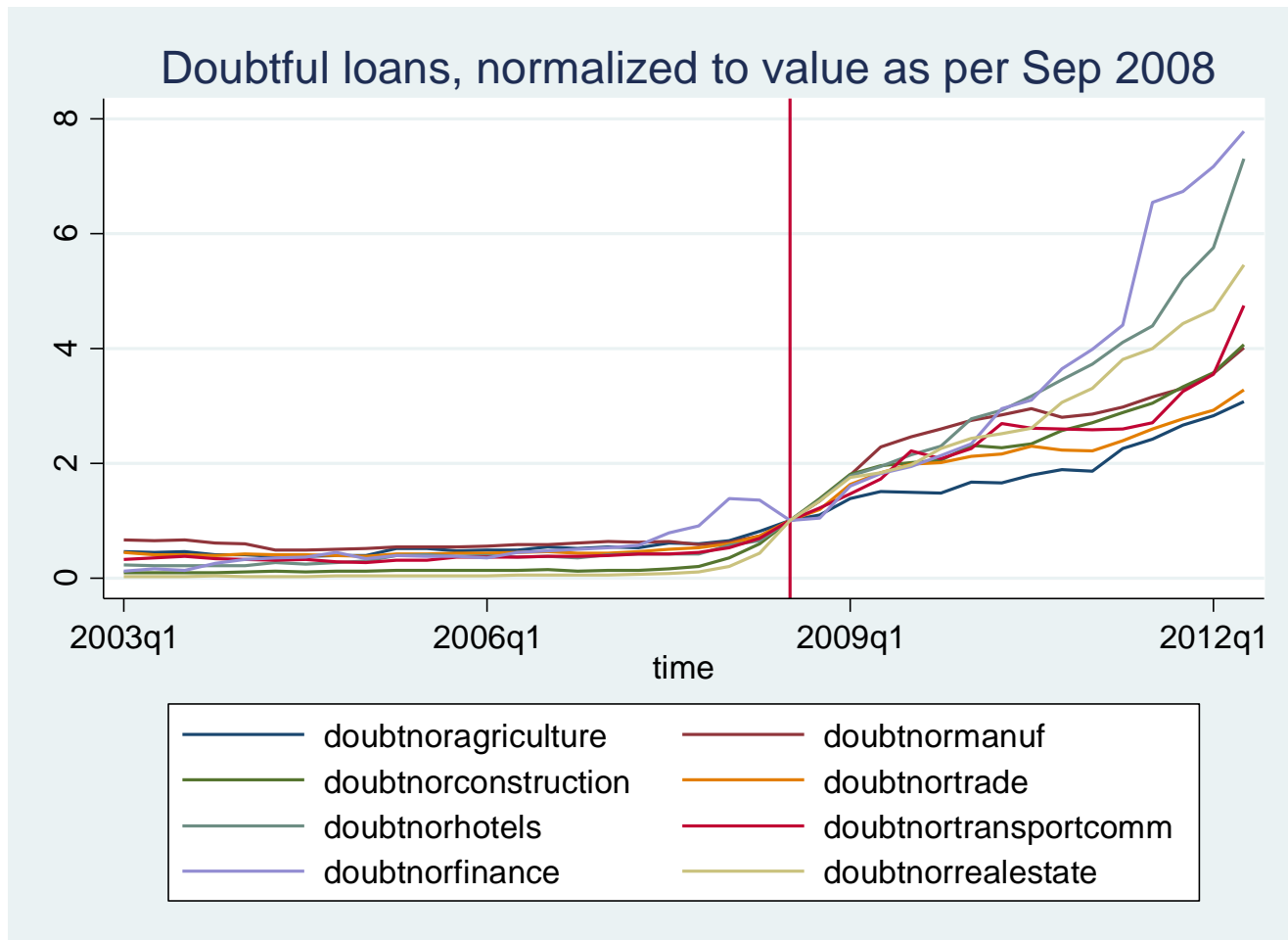


Deepening recession (with a starting point of 25% unemployment)



Sources: Markit, INE

Fast growth in problem loans in all sectors



Crisis Must be Tackled

- Slipping towards disaster
 - Unemployment,
 - deepening recession,
 - Large credit contraction (-8%)
 - Large fiscal contraction (-?)

Big risk now is political: politics without growth

- It is clear that Europe is going to keep Spain against the precipice
- Only when confronted with clear evidence things will really break down will more burden sharing take place
- But this requires Spaniards to be desperate
 - Can they hold it?
 - IN Greece, risk is Syriza (Argentina)
 - In Spain, risk is the breakdown
 - How will investors value and deal with risk of breakdown?
 - Risk somewhat reduced

Politics without growth: Catalonia/UK

- Renegotiation of deals is hard without growth to oil the mechanism
 - A bad moment to make demands
- Uncertainty biggest enemy of growth
 - Asset and liability division is largest issue? Same as debt overhang, who will pay?
- Emotional element is uncontrollable
 - What can “we are hurt” possibly mean?
- A bad idea, which introduces risk and uncertainty at a bad time
 - England could be alone without Scotland and Europe
 - England could be with Scotland no Europe
 - England could be with Scotland and Europe
 - Same for Spain, who pays? Who understands what is going on?

Politics without growth: UK

- Of course it matters! Schengen, visas, students
 - What we (LSE) export has to be consumed here
 - Huge troubles with hires and student recruits since new, misguided visa policy
- And being inside gives UK best of all worlds
 - Banking Union (14 Dec 2012) – UK Does not participate
 - But extracts double majority (EBA needs majority of non SSM members)

3. INET Proposal

REBALANCING IN A MONETARY UNION

Rebalancing in a Monetary Union

No exchange rate control

- cannot rebalance through exchange rate

Fiscal contagion— no fiscal stabilizers

- Lack unemployment insurance

No banking backstop

- Diabolic loop

Four Goals

- Restore Faith in the Euro Area
- Stabilize Interest Costs and Reverse Unemployment and output declines in deficit countries
- Reduce Debt Levels in medium term
- Address Structural Flaws in Eurozone Design to restore credibility.

Key Insight

- Solution must separate the legacy costs of the initial flawed design of the Euro, from the steady state solution
 - On the legacy costs, all countries must recognize they signed up to a flawed Eurozone and that we are today where we are, at least in part, a result of these flaws
 - On the long term solution: only minimal risk sharing-needed, related to banking and financial union
 - Too much heterogeneity in Europe, no common identity, people are bewildered by the situation
- Cost of break up or of continuing on current path likely to be an order of magnitude larger than suggested solution

Are Eurobonds a necessary part?

- NO
 - Politically not feasible
 - Economically not necessary (although desirable)
- Our (INET) solution limits sharing to
 - The needs of a banking union (Catastrophic insurance)
 - Preexisting debt

1. Short run emergency measures

Partial mutualization is part of solution

Legacy problem must be solved together

- Fair (a mistake by all)
- Necessary (to stop the downward spiral of debts)
- Good incentives can be kept
 - As long as banks lose money first
 - Adjustment plans are maintained

Purpose of partial mutualization

- Recapitalize banks
- Joint financing of excess debt
- Growth measures
- Two conditions
 - Limited in time
 - Limited cost

Partial Mutualization: Preserving incentives

- Partial mutualization is compatible with good incentives
 - Guarantee new debt issuance up to an agreed level
 - Financing of Debt Beyond 60% of GDP provided adherence to adjustment is continued over medium term.
 - Supported by ESM banking license and ECB purchases

Other short run measures

- Current (post Sept 7th) role for the ECB correct
 - Must aim to improve transmission of monetary policy, eliminate convertibility premium
 - Only support countries in good standing
- Fiscal adjustment
- Voluntary debt restructuring

Legacy debt?

- The June 29th summit a step in the right direction
 - But shocking reversal (a betrayal) in the 3 creditors statement from this week that legacy problem is for country itself
 - And declaration of German Parliament
 - And of Jens Weidman, who seems to want to kill banking union and the Euro
 - Weidmann as saying that only those risks that come to exist under common supervision may be supported by shared liability. Legacy problems should need to remain the liability of national regulatory regimes. "Anything else would be a financial transfer and those should be made transparent and not hidden under the cloak of a banking union." he said. "The primary goal of a banking union cannot be the sharing of risks

Summit language

(29 June 2012)





- - 29 June 2012 -
- We affirm that it is imperative to break the vicious circle between banks and sovereigns. The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly. We ask the Council to consider these Proposals as a matter of urgency by the end of 2012. When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly. This would rely on appropriate conditionality, including compliance with state aid rules, which should be institution specific, sector-specific or economy-wide and would be formalised in a Memorandum of Understanding. The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme. Similar cases will be treated equally.
- • We urge the rapid conclusion of the Memorandum of Understanding attached to the financial support to Spain for recapitalisation of its banking sector. We reaffirm that the financial assistance will be provided by the EFSF until the ESM becomes available, and that it will then be transferred to the ESM, without gaining seniority status.

2. A minimum long run solution

Euro design problems

- Easy financing facilitates large bubbles
- Sudden stops
- Relative price deviations hard to correct

Long Term design

- Banking union to stop diabolic loop between banks and sovereigns— on its way 
- A joint borrowing tool – receding (more likely before)
 - Without joint liability 
- Financial Reform (not in the cards except Spain) 
- A sovereign debt restructuring mechanism 
- Fiscal rules (fiscal compact)

Banking Union (Excellent news)

- Common supervision (SSM) agreed on December 2012
 - On time!
 - Over 30bn assets
 - Implemented on March 2014
- A unique resolution regime (by Jan 2014)- ECB pressure will help
- Direct bank recaps from ESM by July 2013

Banking Union (Still required)

- Euro FDIC based on industry premia
- A systemic levy to fund resolution of systemically important institutions
- Fiscal risk shared
 - EU level backstop comes in after crisis costs exceeds a threshold, e.g. 20% GDP

Eurobonds?

The ESBies Proposal: Euro-nomics Group

- European debt agency (EDA) buys sovereign bonds from each EZ member.
 - Fixed proportions (60%) relative to lagged GDP.
 - In secondary market!! (uses market prices)
- It issues senior bond (ESBies) and junior bond (EJB).
 - ESBies are fixed fraction of total collateral (70%).
- Large market: Esbies around 4tn.
- Pass-through: No joint guarantees!

The ESBies Proposal: EDA

A	L
Sovereign bonds	European Senior Bonds (ESBies) <hr/> European Junior Bonds (EJB)

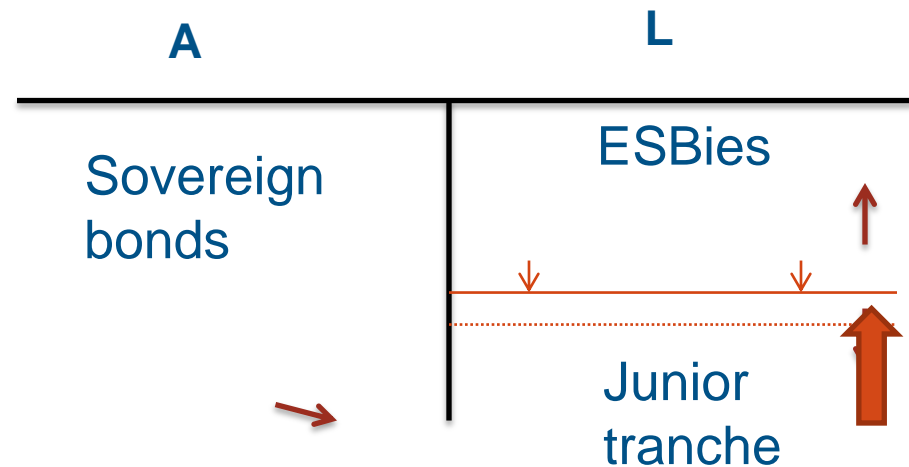
ESBies Breaks Diabolic Loop...

Breaks diabolic loop between banking and sovereign credit risks

- ECB grants ESBies preferential treatment + haircuts for sovereign debt
- Appropriate Basel risk weights + higher weights for sovereign debt

... Redirects Flight-to-safety Flows...

- Create standardized/safe Euro asset in huge scale.
 - Liquidity/safety premium.
 - 0.7% (in normal times) * 3.9 tn = 27.3 bn per annum (NPV=2.730 tn)
- Redirect flight-to-safety (FTS) flows from across national borders to across tranches.
 - Flows are distortionary and are amplifying the crisis.
 - FTS premium earned only by AAA countries.



... and Stabilizes Markets in the Short run

- Give credible path out of current panic: moving us back to the **good equilibrium**
- Increases sovereign debt prices by preventing bad illiquidity equilibrium, market freeze, fire sale prices
- **Initially**, focus on newly issued sovereign debt
 - Primary market purchases in proportion to GDP
 - Ex. Could buy €940bn in Italian debt, next 3 years
 - At least 3 years for all countries to make necessary structural adjustment and ride out business cycle
- Program countries (Greece, Ireland, Portugal) would not participate in ESBies until later

CONCLUSION

- A feasible and incentive compatible combination of short run and long run measures can stop crisis
- We must find a way to help peripheral countries “import” governance from the North
 - A serious governance problem: if Asian crisis countries could do it, why not Spain?