LSE European Institute inaugural lecture

The Eurozone's Design Failures: can they be corrected?

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Design Failures in the Eurozone. Can they be fixed?

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A short history of capitalism

- Capitalism is wonderful human invention steering individual initiative and creativity towards capital accumulation and ever more material progress
- It is also inherently unstable, however.
- Periods of optimism and pessimism alternate, creating booms and busts in economic activity.
- The booms are wonderful; the busts create great hardship for many people.

Booms and busts are endemic in capitalism

- Many economic decisions are forward looking.
- Investors and consumers look into the future to decide to invest or to consume.
- But the future is dark. Nobody knows it.
- As a result, when making forecasts, consumers and investors look at each other.
- This makes it possible for optimism of one individual to be transmitted to others creating a self-fulfilling movement in optimism.

- Optimism induces consumers to consume more and investors to invest more, thereby validating their optimism.
- The reverse is also true. When pessimism sets in, the same contagion mechanism leads to a self-fulfilling decline in economic activity.
- Animal spirits prevail.

Role of banking sector

- During euphoria and booms households and firms cheerfully take on debt to profit from perceived high rates of return
- Banks jump on this and provide credit
- Excessive debt accumulation made possible by excessive bank credit
- Until crash
- Deleveraging becomes necessary both by banks and non-banks
- Deep recession

Stabilizing an unstable system

- The involvement of financial institutions in booms and bust dynamics makes capitalism particularly unstable
- Since Great Depression we have learned to bring in some stabilizers
- that have softened the instability
- Two stabilizers:
  - Central Bank as a Lender of Last Resort
  - Government budget as an automatic shock absorber

Lender of Last Resort

- Central Banks were originally created to deal with inherent instability of capitalism
- Were given double task:
  - Lender of last resort for banks: backstop to counter panic and run on banks
  - Lender of last resort of governments: to counter run in government bond markets
- Why this double task?

Deadly embrace

- Banks and governments face same problem: unbalanced maturity structure of assets and liabilities
  - Making both banks and governments vulnerable for movements of distrust
  - Which will lead to liquidity crisis
  - And can degenerate into solvency crisis
  - I will develop this point further
- Banks and governments hold each other in deadly embrace:
  - When banks collapse sovereign is in trouble
  - When government collapses banks are in trouble

Government budget as shock absorber

- The need to have government budget is shock absorber is based on Keynes' savings paradox paradox
- When after crash private sector has to reduce debt it does two things
  - It tries to save more
  - It sells assets
- Private sector can only save more if government sector borrows more (i.e. higher budget deficit)
- If government also tries to save more, attempts to save more by private sector are self-defeating and economy is pulled into deflationary spiral

Stabilizers are organized at national levels

- These stabilizing features relatively well organized at the level of countries (US, UK, France, Germany)
- Not at international level nor at the level of a monetary union like the Eurozone
- These design failures were only recognized after the financial crisis, also because OCA-theory was pre-occupied with exogenous shocks not with an endogenous dynamics
- And even then in many countries, especially in Northern Europe still not recognized because of dramatic diagnostic failure, focusing on government profligacy

Eurozone's design failures: in a nutshell

1. Endogenous dynamics of booms and busts continued to work at national level and monetary union in no way disciplined these into a union-wide dynamics.
   - On the contrary the monetary union probably exacerbated these national booms and busts.

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.

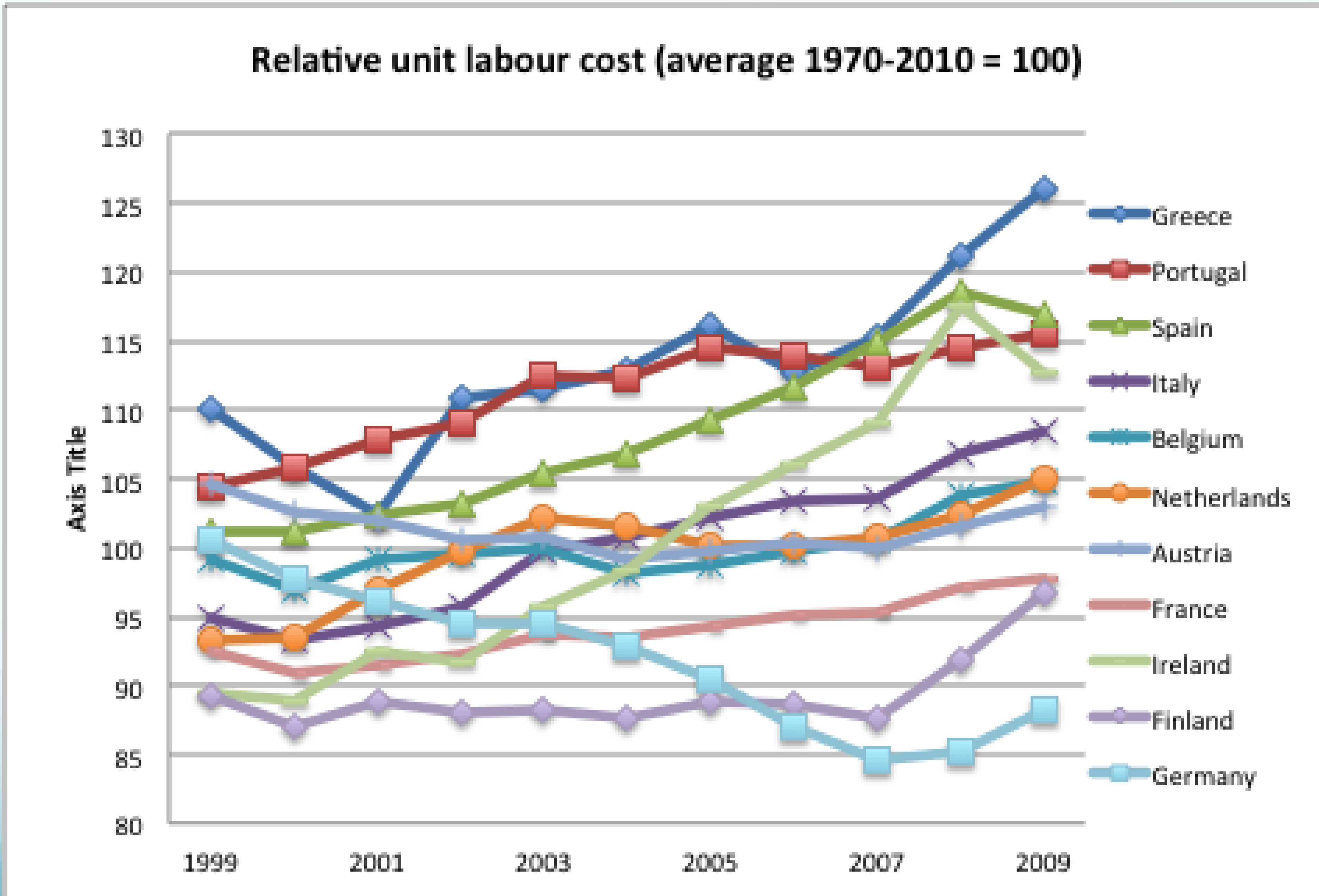
3. Let me expand on these two points.

Design failures
Booms and bust dynamics: national

- In Eurozone money is fully centralized
- All the rest of macroeconomic policies is organized at national level
- Thus booms and busts are not constrained by the fact that a monetary union exists.
- As a result, these booms and busts originate at the national level, not at the Eurozone level, and can have a life of their own for quite some time.
- At some point though when the boom turns into a bust, the implications for the rest of the union become acute

Monetary union can exacerbate national booms and busts

- In fact the existence of the monetary union can exacerbate booms and busts at the national level.
- This has to do with the existence of only one policy interest rate when underlying macroeconomic conditions are very different.
- The fact that only one interest rate exists for the union exacerbates these differences,
  - i.e. it leads to a stronger boom in the booming countries and
  - a stronger recession in the recession countries than if there had been no monetary union.


Relative unit labour cost (average 1970-2010 = 100)
130
125
120
115
110
105
100
95
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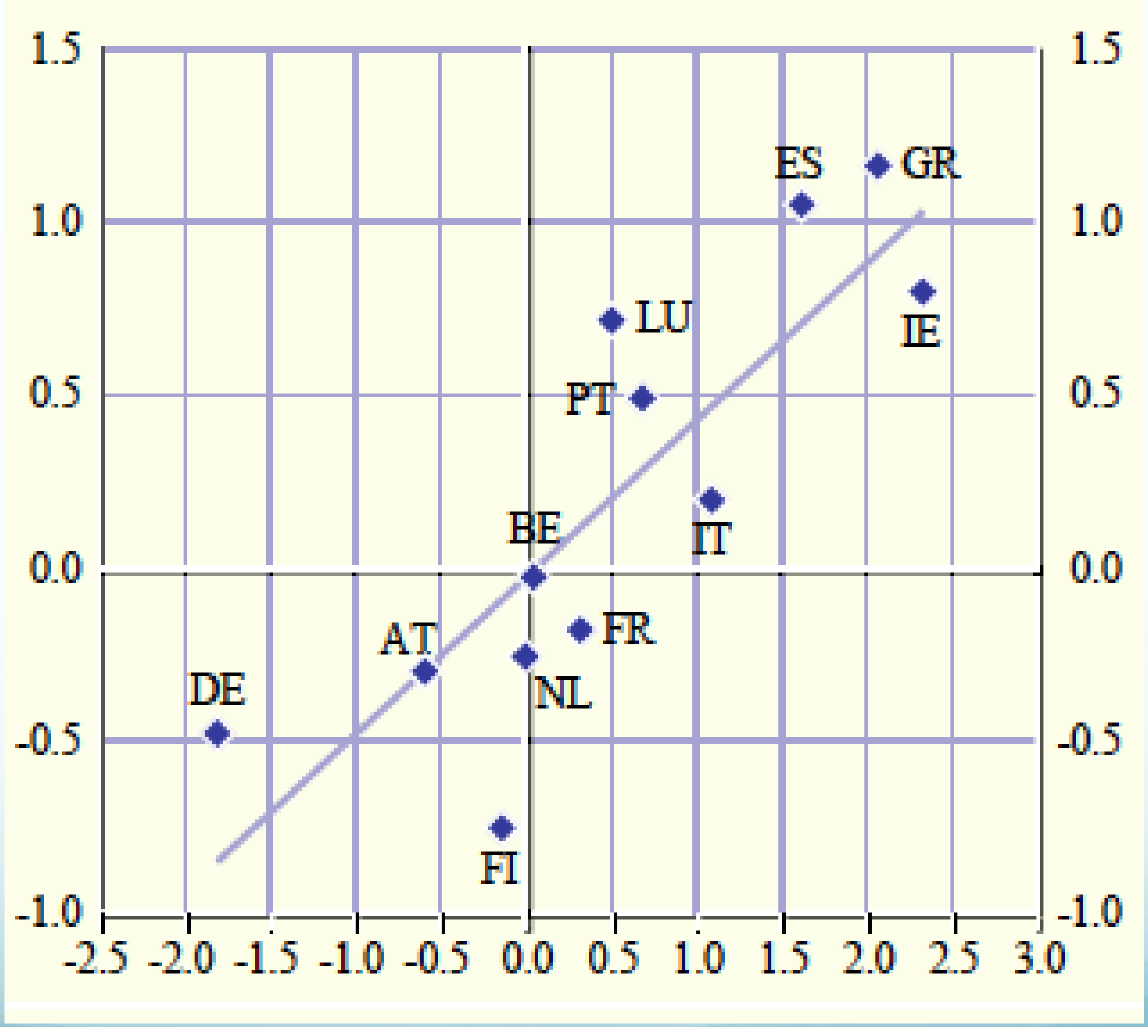
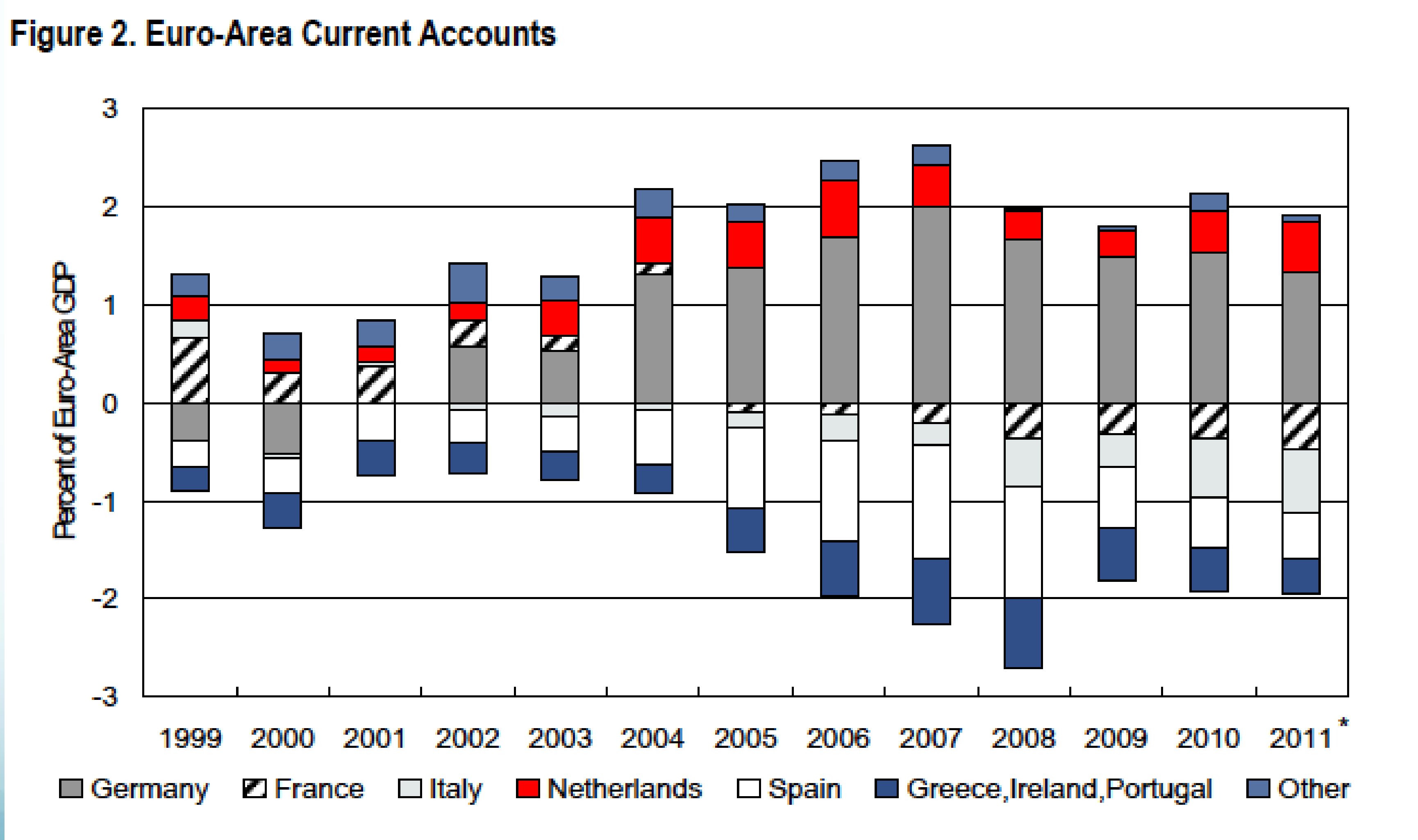
80
Axis Title
1999
2001
2003
2005
2007
2009
Greece
Portugal
Spain
Italy
Belgium
Netherlands
Austria
France
Ireland
Finland
Germany

Average yearly inflation differential (y-axis) and average change in relative unit labour cost (x-axis)



ECB, Monthly Bulletin, Nov. 2012

Increasing current account imbalances



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

Design failures:
no stabilizers left in place

- Absence of lender of last resort in government bond market
- exposed fragility of government bond market in a monetary union

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
  - 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
  - Producing deep recession and Debt/GDP ratio increases
- This leads to default crisis
- Countries are pushed into bad equilibrium

- This happened in Ireland, Portugal and Spain
  - Greece is different problem: it was a solvency problem from the start
- 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 swithched off
  - Back to pre-1930s conditions

Deadly embrace between banks and sovereign

- Once in bad equilibrium a third design failure was exposed
  - Countries in bad equilibrium also experience banking crisis due to “deadly embrace” noted earlier
  - When sovereign is pushed in default so are banks

Summary

- Thus the Eurozone was left unprepared to deal with endemic booms and busts in capitalism
  - Probably these were even enhanced because of the existence of the monetary union
- While nothing was in place to stabilize an unstable system that pushed some countries into bad equilibria and others in good equilibria
- In fact some of the pre-existing stabilizing forces were switched off

How to redesign the Eurozone

- Short run:
  - ECB is key
- Medium run:
  - Macroeconomic policies in the Eurozone
- Long run:
  - Consolidating national budgets and debt levels

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.
- In doing this central bank prevents panic from triggering a self-fulfilling liquidity crisis that can degenerate into solvency crisis
- And pushing countries into bad equilibria

ECB has finally acted

- On September 6, ECB announced it will buy unlimited amounts of government bonds.
- Program is called “Outright Monetary Transactions” (OMT)
- In defending OMT, Mr Draghi argued that “you have large parts of the euro area in a bad equilibrium in which you may have self-fulfilling expectations that feed on themselves” . . So, there is a case for intervening . . . to “break” these expectations, which. . . do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank”

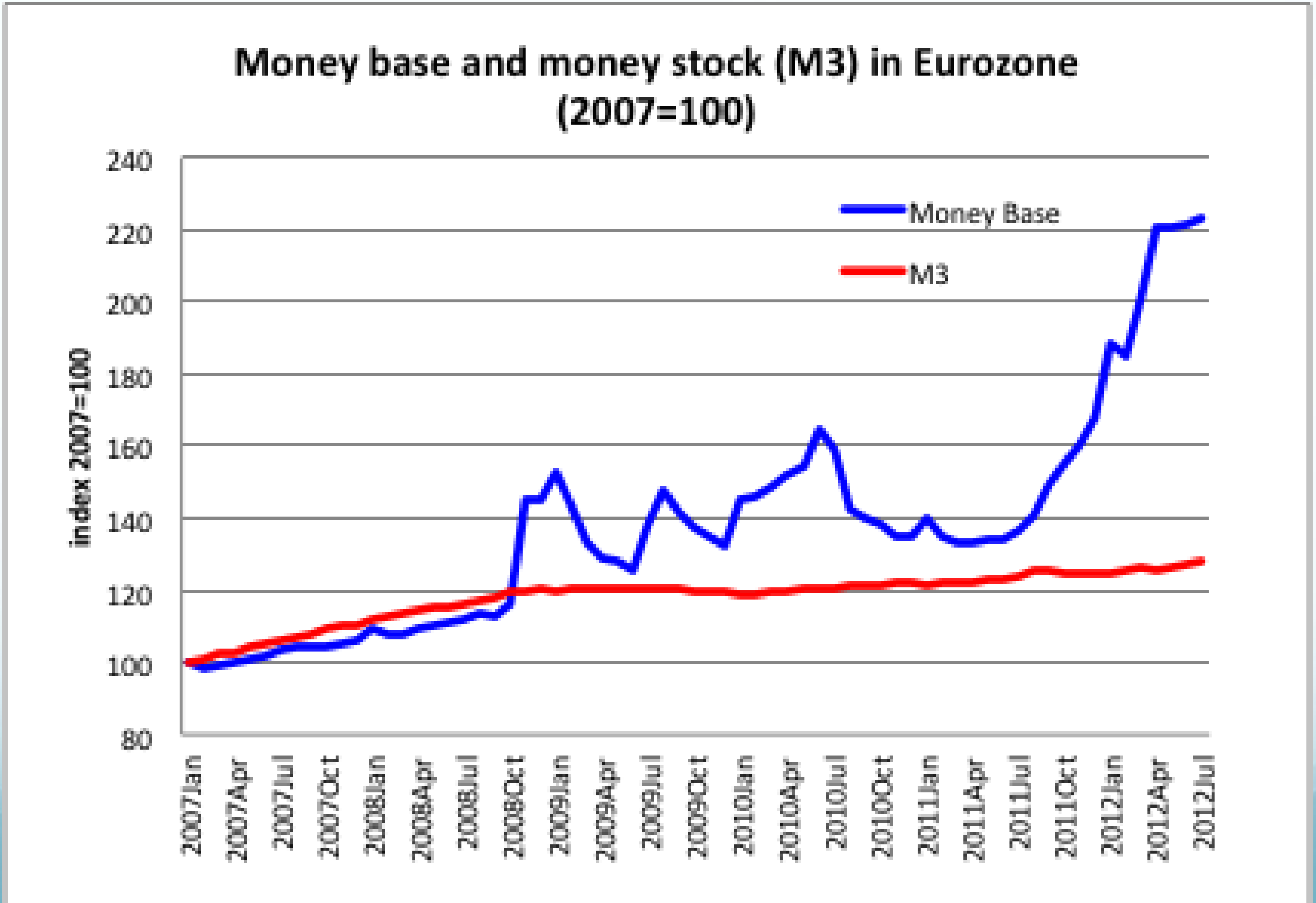
- This is the right step: only the ECB can now save the Eurozone
- There is danger though that its effectiveness will be reduced by politically inspired limitations
  - Bonds with maturity less than 3 years will be bought
  - Conditions of even more austerity may be imposed
- Note also that while necessary, OMT is insufficient

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



Money base and money stock (M3) in Eurozone
(2007=100)
Money Base
M3
index 2007=100
240
220
200
180
160
140
120
100
80
2007Jan
2007Apr
2007Jul
2007Oct
2008Jan
2008Apr
2008Jul
2008Oct
2009Jan
2009Apr
2009Jul
2009Oct
2010Jan
2010Apr
2010Jul
2010Oct
2011Jan
2011Apr
2011Jul
2011Oct
2012Jan
2012Apr
2012Jul

- 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

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.

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.

Sometimes central bank has to make losses

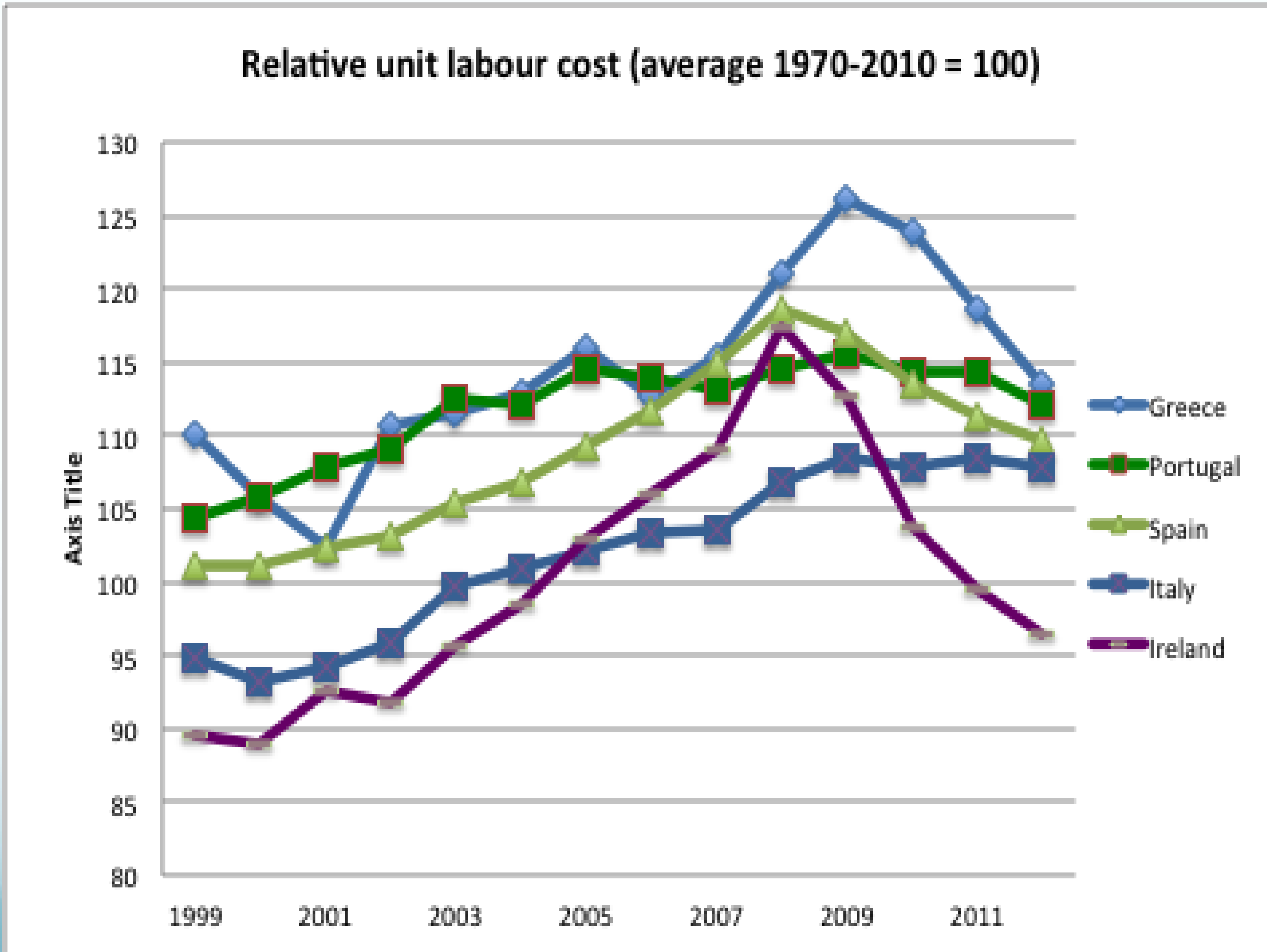
- Truth is that in order to stabilize the economy the central bank sometimes has to make losses.
- Losses can be good for a central bank if it increases financial stability
- Objective of central bank should be financial stability, not making profits

Central bank does not need equity

- 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.
- Only limit arises from the need to maintain control over the money supply.
- A central bank does not need assets to do this: central bank can literally put the assets in the shredding machine
- A central bank also does not need capital (equity)
- There is no need to recapitalize the central bank

Medium run:
Fiscal policies that will not kill growth

- Macroeconomic policies exclusively geared towards austerity in the South reinforce the split between countries in bad and in good equilibria
- These countries have started strong “internal devaluations” at the cost of deep recessions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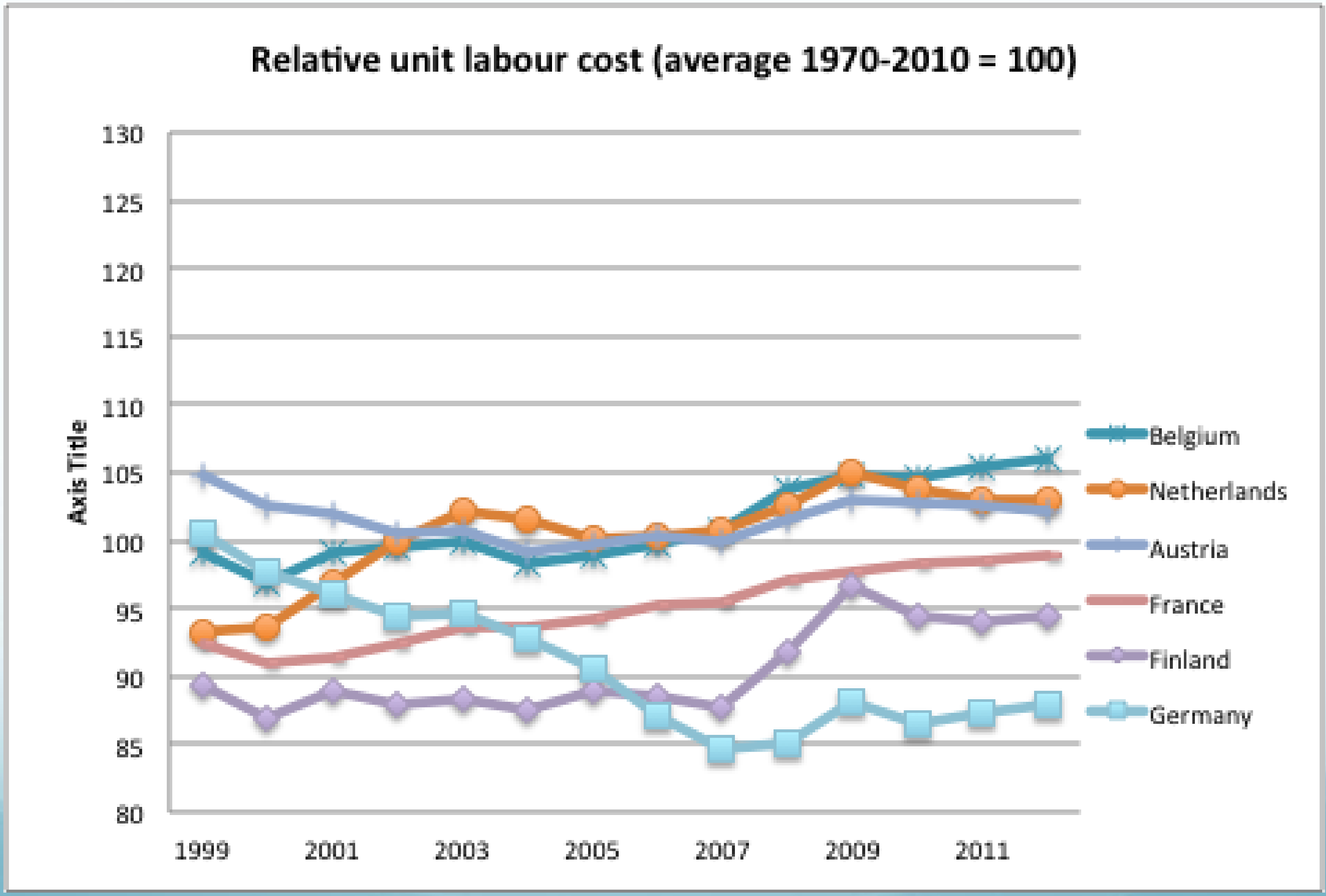
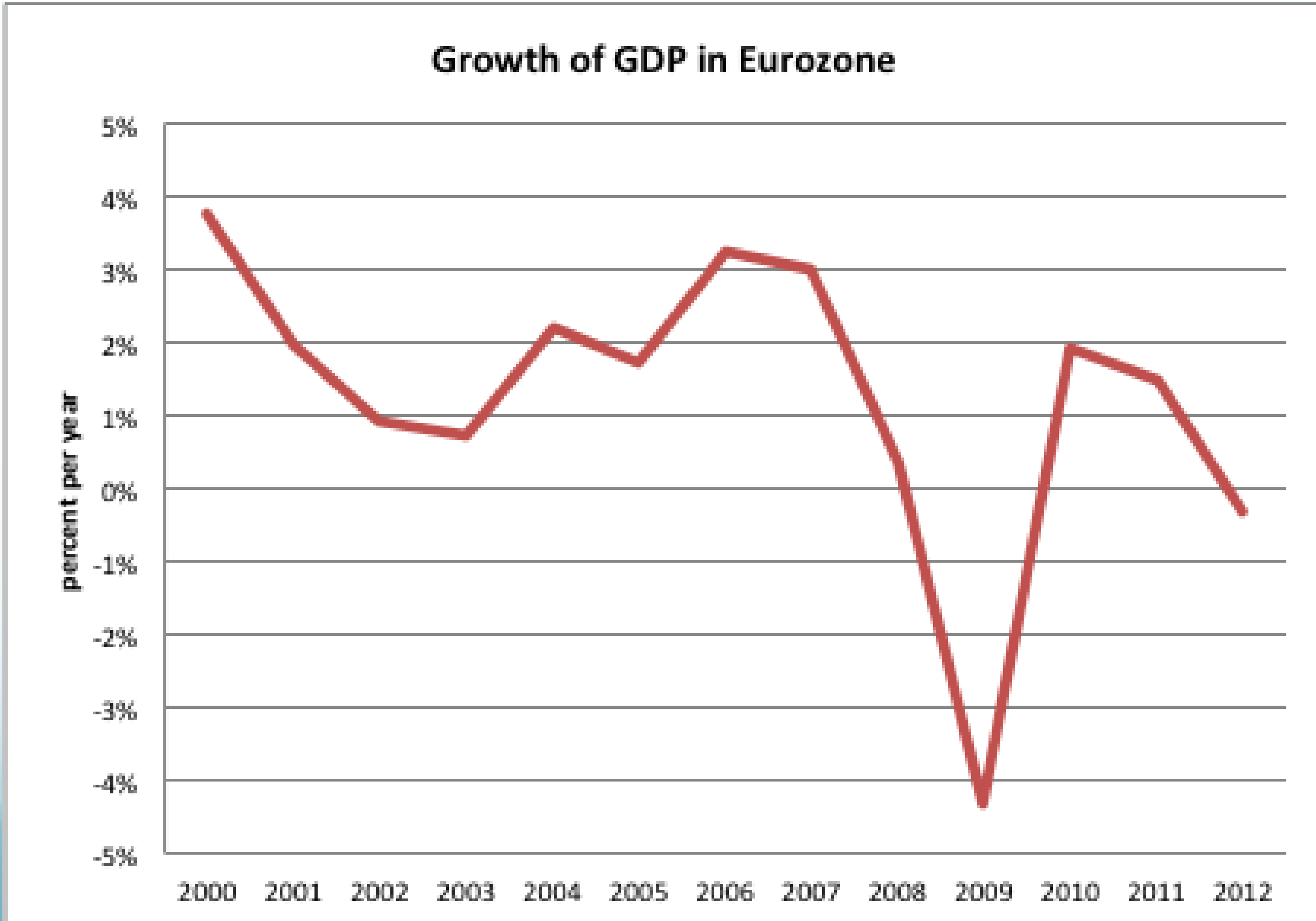
What has been the contribution of the Core countries in the adjustment?



Interpretation

- Burden of adjustments to imbalances in the eurozone between surplus and deficit countries is borne almost exclusively by deficit countries in the periphery.
- This asymmetric system introduces a deflationary bias in the Eurozone
- Explaining the double-dip recession that is now starting in the whole of the Eurozone


Growth of GDP in Eurozone
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
-5%
percent per year
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

Towards symmetric macroeconomic policies

- 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
- This symmetric approach should start from the different fiscal positions of the member countries of the Eurozone

Figure 6: Gross Government debt ratios in creditor countries of the Eurozone

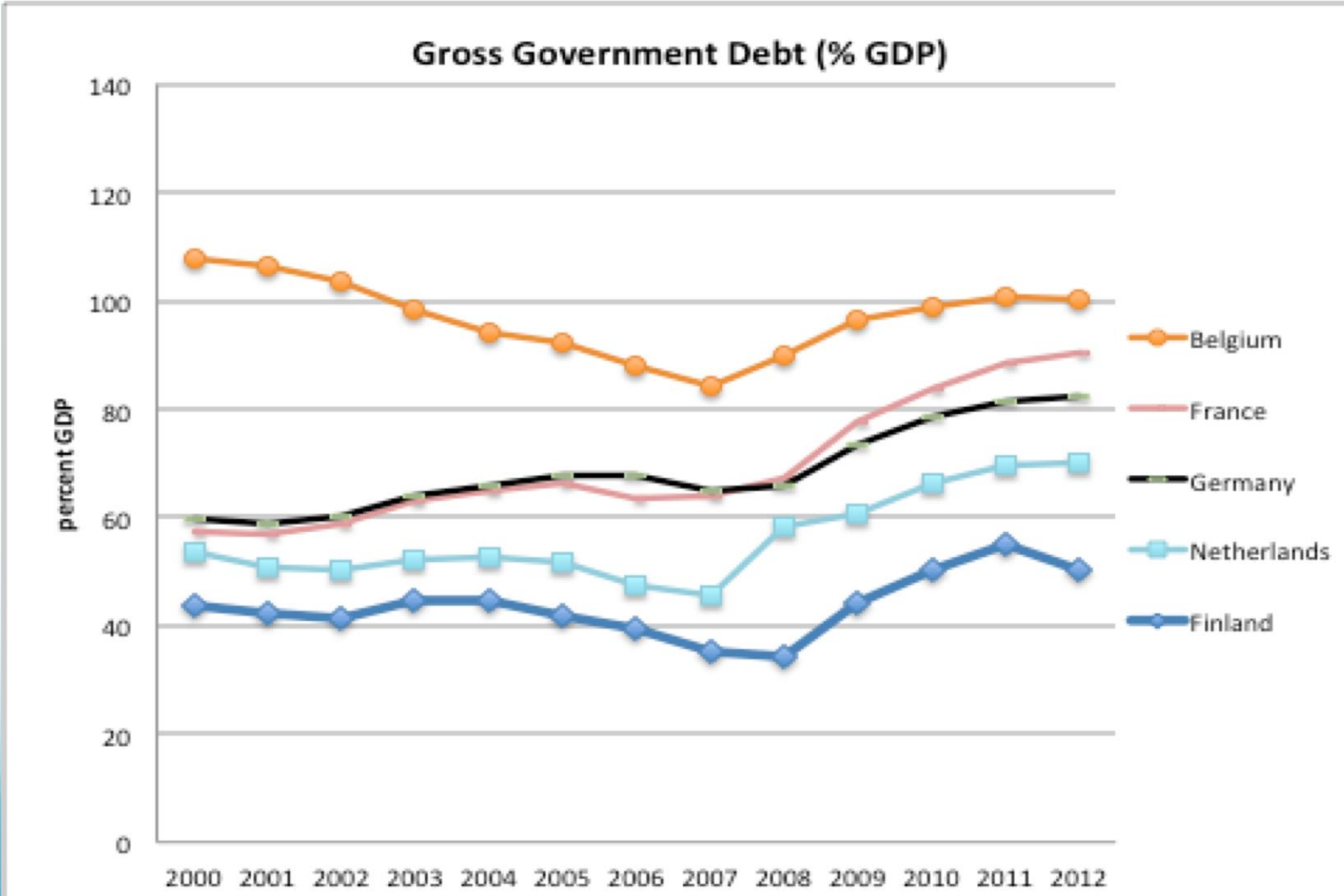
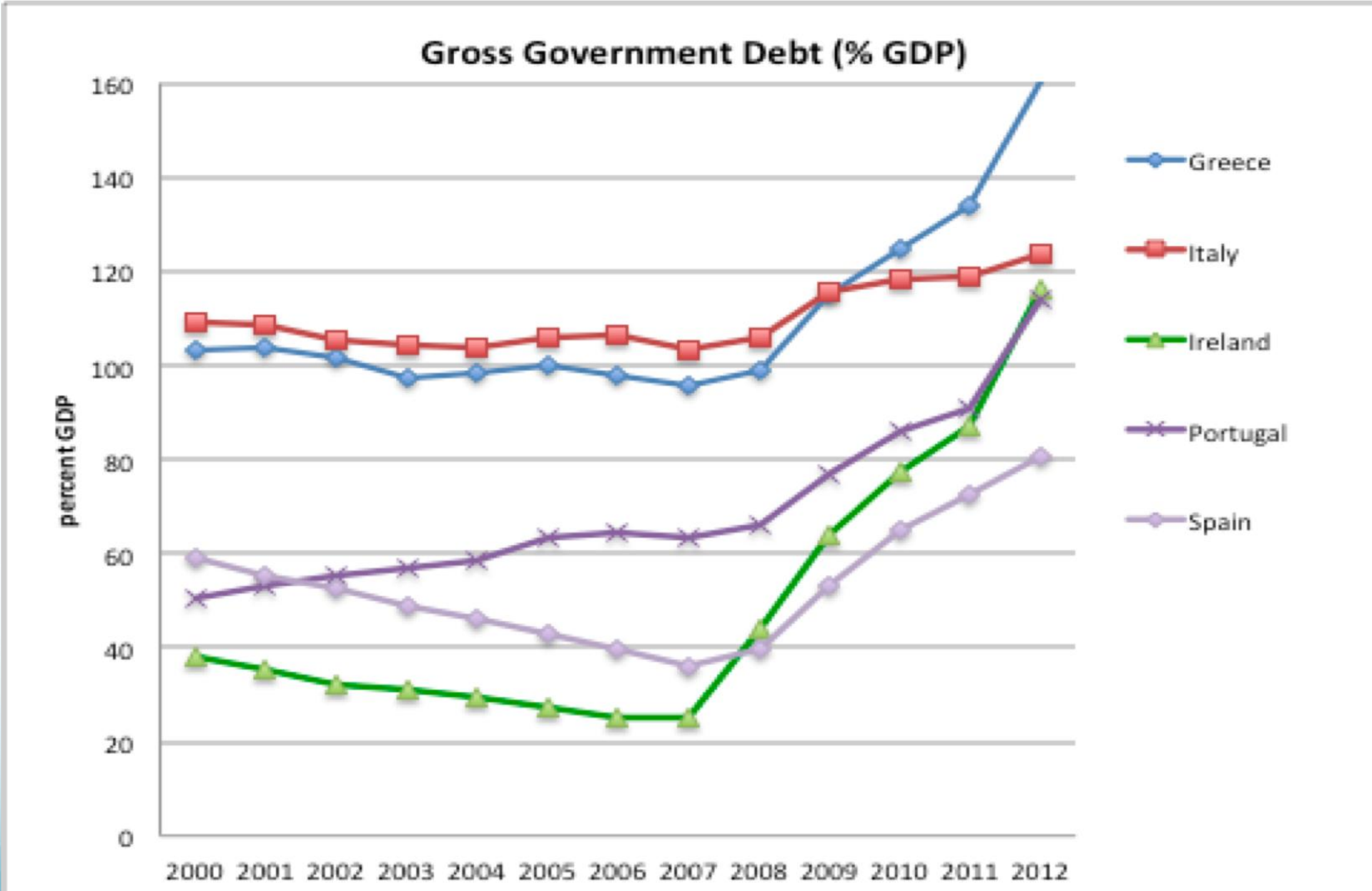


Figure 7: Gross Government debt ratios in debtor countries of the Eurozone



Source: European Commission, AMECO

Here is the proposed rule

- The creditor countries that have stabilized their debt ratios should stop trying to balance their budgets now that the Eurozone is entering a new recession.
- Instead they should stabilize their government debt ratios at the levels they have achieved in 2012.
- The implication of such a rule is that these countries can run small budget deficits and yet keep their government debt levels constant.
- For Germany this implies a significant stimulus

Long run: Towards a fiscal union?

- Ideally a full fiscal union is called for
  - A consolidation of national debts 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.
- Fiscal union also makes insurance possible to compensate countries for bad luck

However

- Full fiscal unification is so far away that one has to think of more modest approach
- Here are some suggestions:
  - Partial pooling of debt aimed at reducing fragility of national bond markets (Eurobonds)
    - We can not all the time ask ECB to step in
    - We have to strengthen Eurozone structurally
    - Pooling also requires disciplining mechanism
  - Banking union (common supervision and common resolution mechanism)
    - European authority with taxing power necessary

Banking union not possible without fiscal union

- To cut link from banks to sovereign a European bank resolution system is necessary, requiring a European institution with taxing power.
  - ESM has insufficient resources to do the job
- To cut the link from sovereign to local banks, there must be mutual support of sovereigns, i.e. some form of debt pooling
  - If not, default of sovereign leads to default of banks, forcing other sovereigns to step in to save the banking system

- All this requires transfer of sovereignty:
- More political union is necessary to make Eurozone sustainable in the long run

Conclusion

- The recent decision by the ECB to act a Lender of Last Resort is a major regime change for the Eurozone
- It has significantly reduced existential fears that slowly but inexorably were destroying the Eurozone's foundations.
- The ECB's new role although necessary is not sufficient to guarantee its survival
- Signals must be given that the Eurozone is here to stay

- These signals are:
  - A partial debt pooling that ties the hands of the member countries of the Eurozone and shows that they are serious in their intentions to stick together.
  - Symmetric macroeconomic policies to avoid a long and protracted deflation that will not be accepted by large parts of the Eurozone population
- In the long run a significant political union will be necessary,
- Euro is currency without a country
- To make it sustainable a European country has to be created

- Are Europeans willing to create such a country?
- I have my doubts
- But let’s give it a try
- by taking small steps towards the long run outcome.

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