

# Research impact: making a difference

## Breaking the vicious circle of the Eurozone debt crisis

Research by Paul De Grauwe influenced the European Central Bank in its management of the debt crisis that threatened to break up the Eurozone

### What was the problem?

The Eurozone economy suffered a major sovereign debt crisis in 2010, which fuelled mounting fears through 2011 and 2012 that the single currency area could break up, with potentially devastating consequences for member economies, employment levels and living standards.

The countries that had joined the Eurozone were unable to issue debt in their own currencies and, as a result, had lost the ability to guarantee that bond investors would be paid when bonds matured. This lack of guarantee left the member governments vulnerable to movements in financial markets driven by fear and panic.

The behaviour of private investors was, in fact, driving down government bond prices, threatening to create a vicious circle of economic recession, increased government debt levels and banking crises. The European Central Bank (ECB) had launched a programme of limited purchases of government bonds, known as the Securities Market Program, which had failed to stem the crisis.

### What did we do?

Through his research LSE Professor Paul De Grauwe demonstrated that the European Central Bank was the only institution that could prevent Eurozone countries from being pushed into a vicious circle that he called a “bad equilibrium”. He found that the ECB would need to act as the lender of last resort in the Eurozone government bond markets, by giving a guarantee to bondholders that the money would always be available to pay out on maturing bonds.

The key element of this function would be a commitment by the ECB to buy unlimited amounts of government bonds of individual member states and, in so doing, break any vicious circle and prevent the emergence or perpetuation of a bad equilibrium. De Grauwe had found that the prices of government bonds of a number of Eurozone countries were driven by market sentiments that were unrelated to what was actually occurring in those economies.

De Grauwe examined the conditions necessary for the ECB to act successfully as a lender of last resort. He found that when the ECB acted in this capacity, it needed to ensure that it did not jeopardise its role in controlling inflation and minimised the danger that it was encouraging investors to take risks – a concept known as ‘moral hazard’.

He warned that the limited nature of the Securities Market Program would make it ineffective. In particular he said the ECB’s decision to make the bonds it bought under the programme senior to

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private holders of government debt – giving them greater protection in the event of a default – would encourage those investors to sell their holdings and result in further downward pressure on prices.

## What happened?

On 6 September 2012 the European Central Bank committed itself to unlimited purchases of government bonds in a programme it called Outright Monetary Transactions. Announcing the decision, ECB President Mario Draghi used the phrase “bad equilibrium” and gave an explanation that echoed De Grauwe’s conclusions.

A week after that decision, the Financial Times chief economics commentator Martin Wolf wrote that ECB’s action marked a “belated acceptance of the strong arguments” made by De Grauwe.

The European Central Bank abandoned the Securities Market Program and dropped its seniority claim on the government bonds it bought under the Outright Monetary Transactions programme, also suggesting that De Grauwe had influenced the way this new policy was designed.

The European Commission asked De Grauwe to advise on long-term reforms to make the Eurozone less fragile and more sustainable. De Grauwe presented the first draft of a paper, *Design Failures of the Eurozone: can they be fixed?* at a workshop organised by the Commission in November 2012.

De Grauwe’s research was cited frequently by public and media figures engaged in the debate over Eurozone policy. Nobel laureate economist Paul Krugman referred to De Grauwe’s analysis of the fragility of the Eurozone as a new way to analyse monetary union, and several leading economists cited De Grauwe for demonstrating the need for a lender of last resort. De Grauwe wrote seven articles for VoxEU, Europe’s leading policy discussion website, with one article attracting almost 170,000 reads.

Much of De Grauwe’s research now focuses on the long-run conditions for successful governance of the Eurozone. His analysis is included in the most recent edition of his book *The Economics of Monetary Union*, which has been translated into eight languages, including French, Italian, Spanish, Chinese and Japanese.

“Paul De Grauwe’s academic work has played a crucial role in stabilising the Eurozone. His research helped provide the intellectual cover needed by the ECB, and in particular its President Mario Draghi, to face down opponents of a more activist ECB, and take on these lender of last resort functions.”

**Simon Tilford, chief economist  
of the Centre for European  
Reform**

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