Hosted by the European Institute

The Future of the Euro

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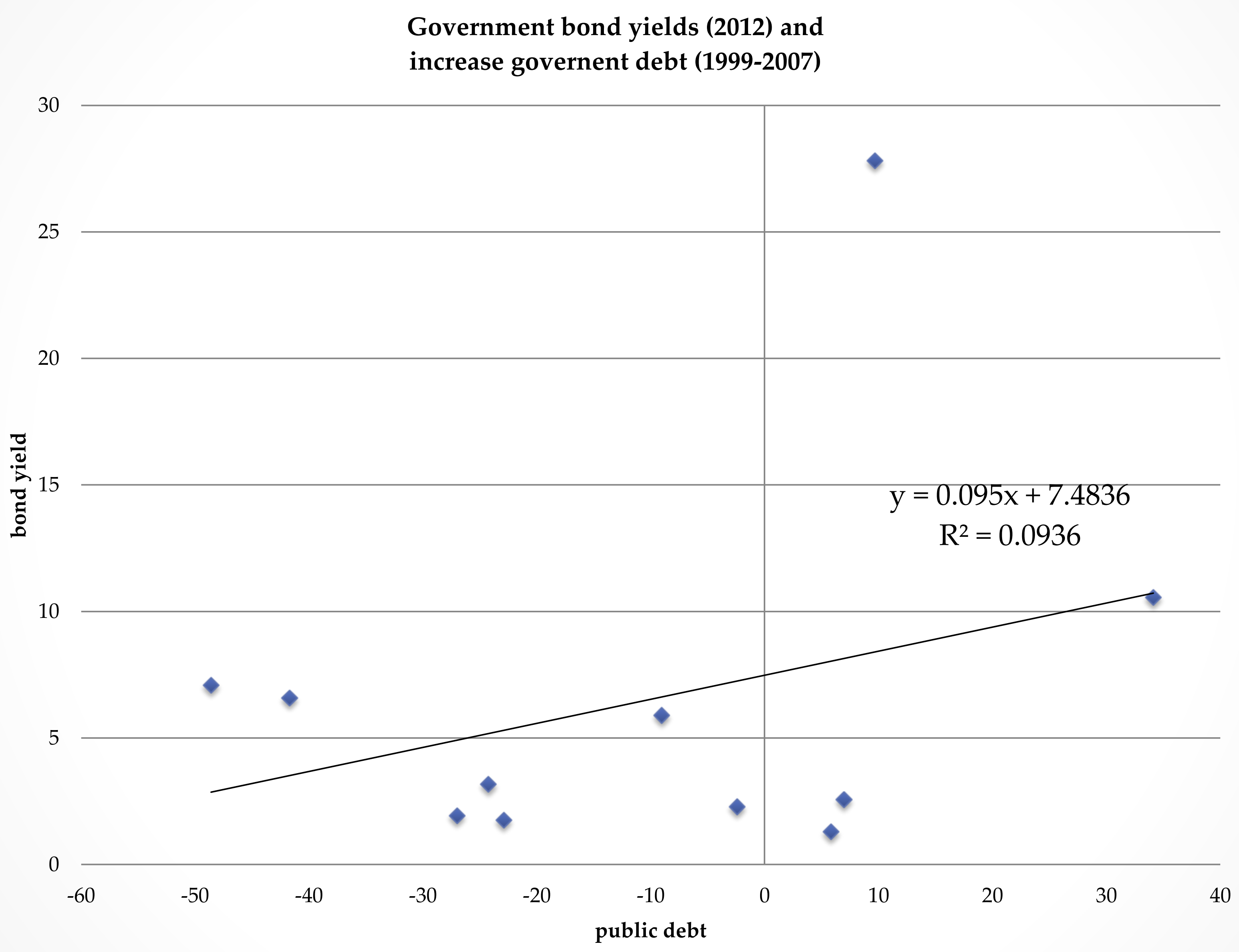
Outline of presentation

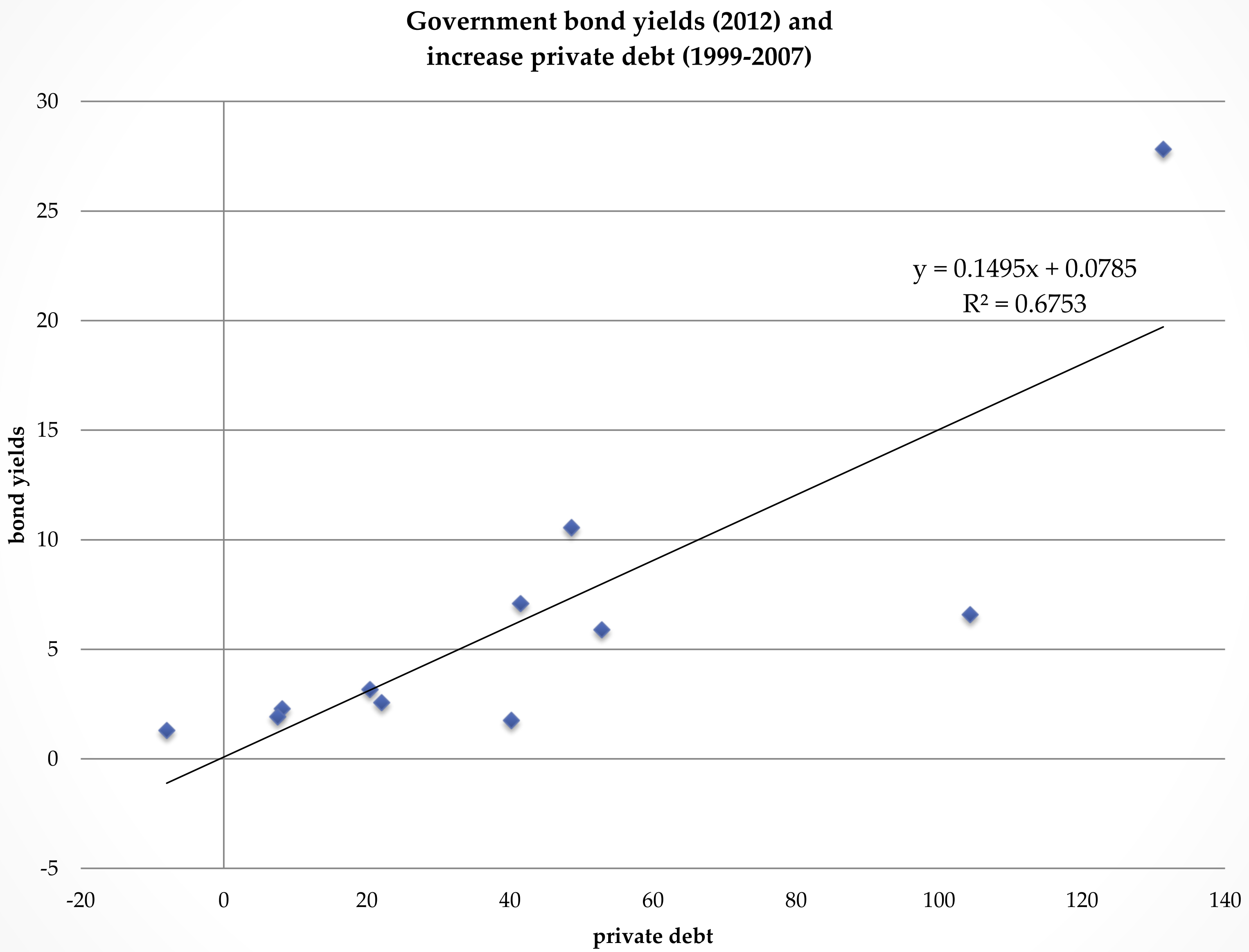
- Diagnosis of the crisis
- Design failures of the Eurozone
- Future of the Eurozone
    - How to redesign the Eurozone so as to make it sustainable in the long run

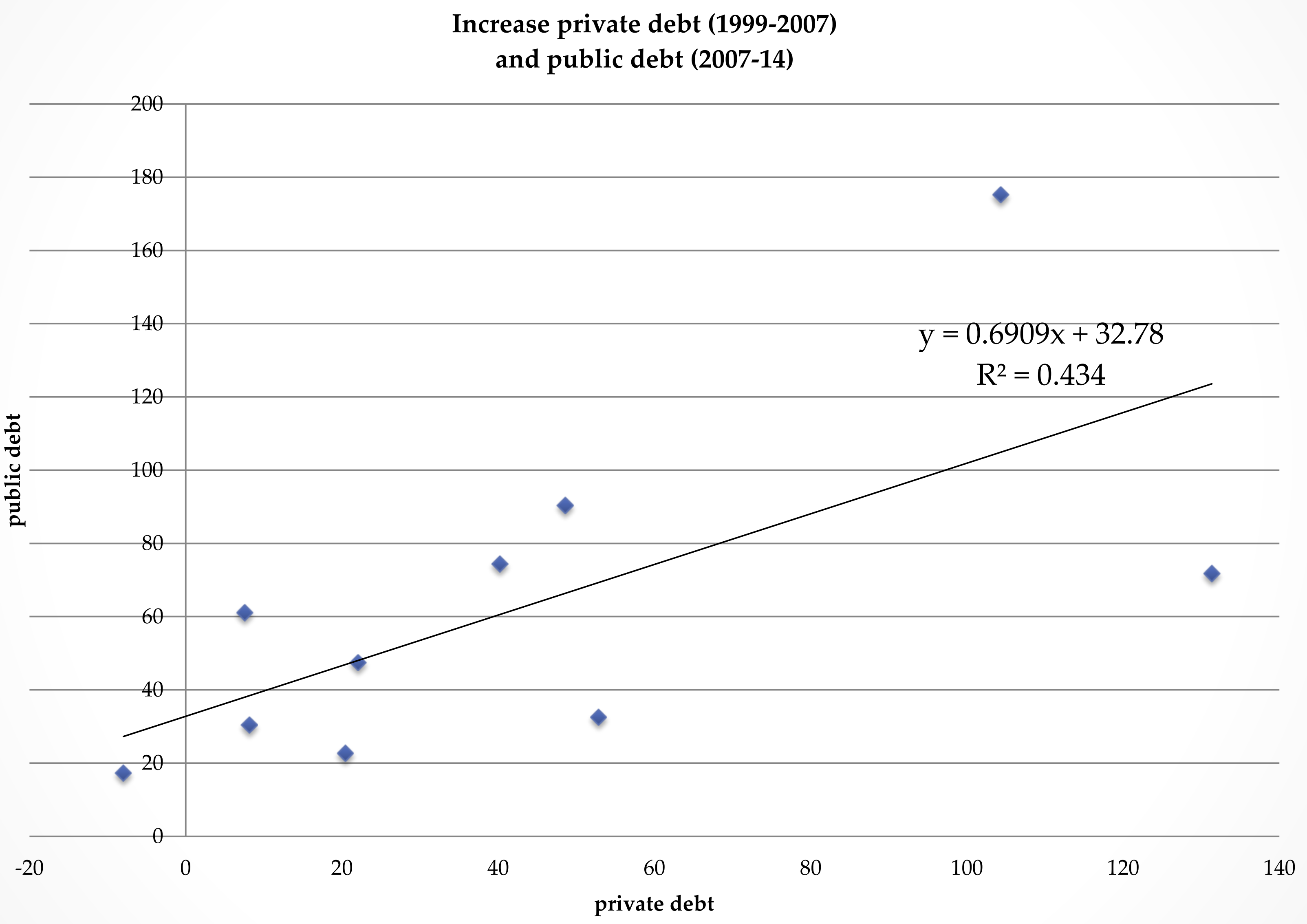
Diagnosis of the crisis

- What explains sovereign debt crisis of 2010-12 better?
  - Public debt accumulation prior to crisis?
  - Or private debt accumulation prior to crisis?



Government bond yields (2012) and
increase governent debt (1999-2007)
30
25
20
15
10
5
0
bond yield
-60
-50
-40
-30
-20
-10
0
10
20
30
40
public debt
y = 0.095x + 7.4836
R² = 0.0936


Government bond yields (2012) and
increase private debt (1999-2007)
y = 0.1495x + 0.0785
R² = 0.6753
bond yields
private debt
30
25
20
15
10
5
0
-5
-20
0
20
40
60
80
100
120
140



Increase private debt (1999-2007)
and public debt (2007-14)
y = 0.6909x + 32.78
R² = 0.434
public debt
private debt
200
180
160
140
120
100
80
60
40
20
0
-20
0
20
40
60
80
100
120
140

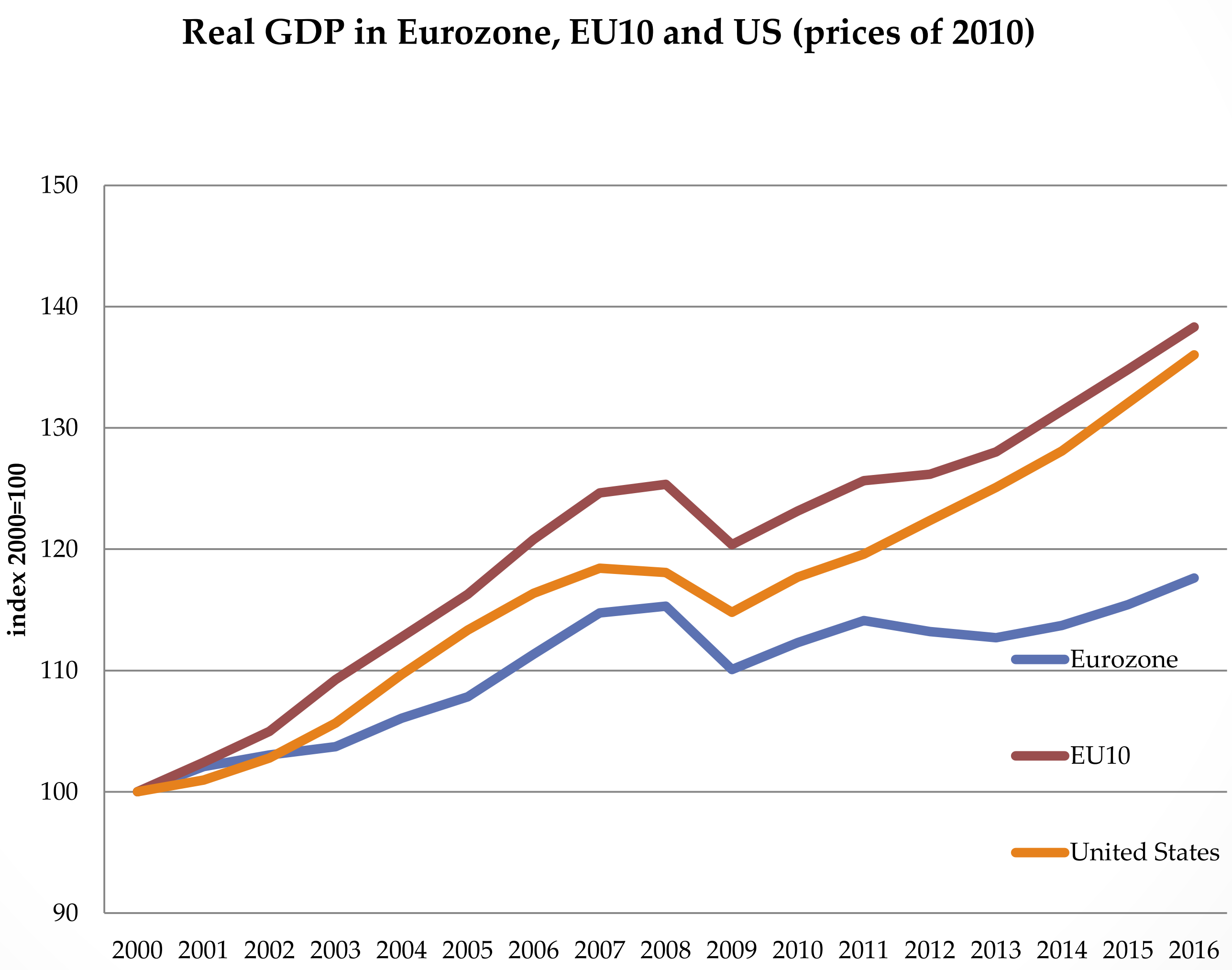
Booms and busts in capitalism

- We find that origin of crisis is a classical boom bust story
- 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.
- During boom debt accumulation; when crash comes debts are unsustainable
- Government has to pick up the pieces allowing its debt to increase
- In doing so it saves capitalism

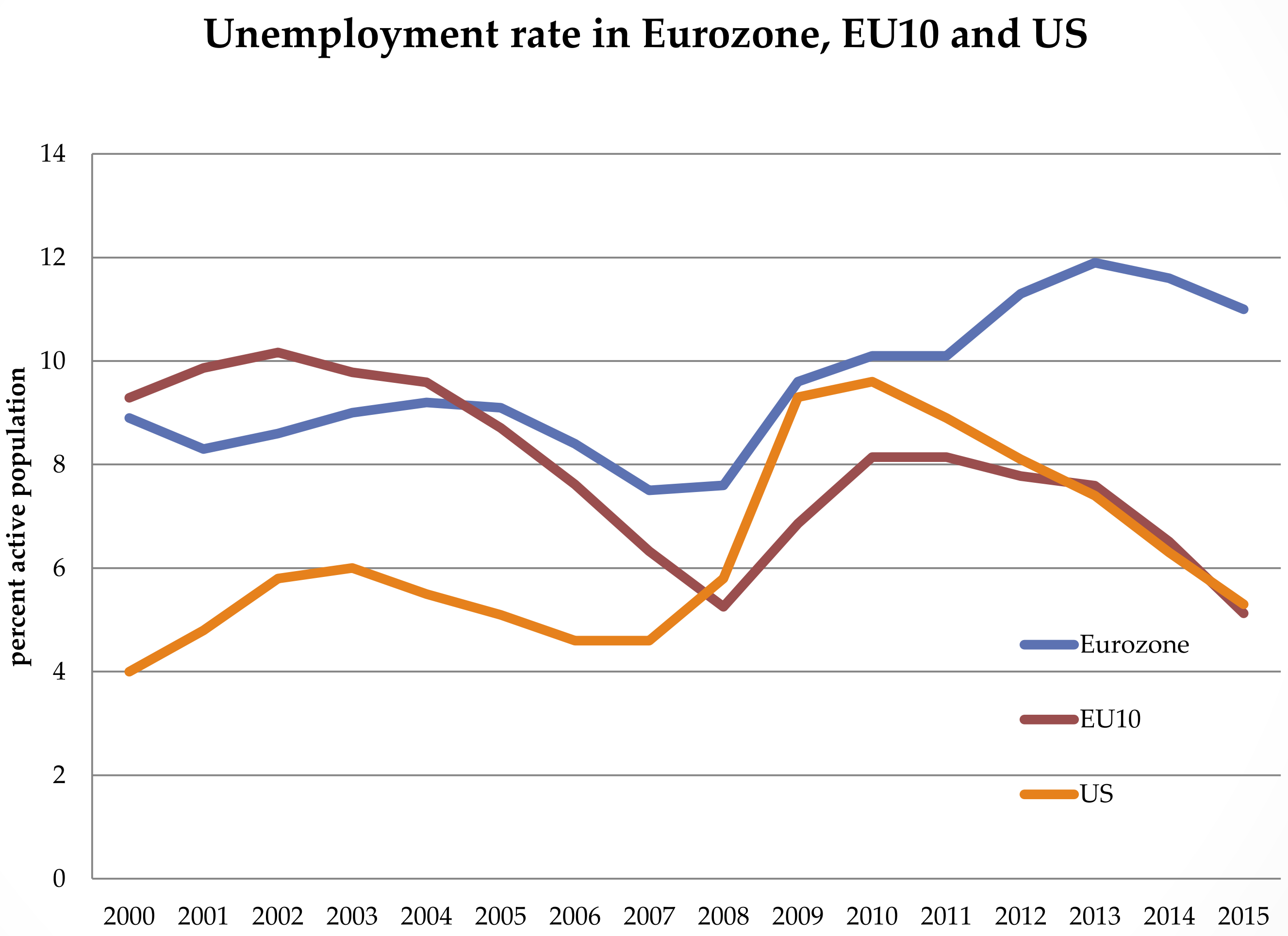
Wrong diagnosis

- However policies have been influenced by another diagnosis: it is governments' profligacy
- This has led to applying wrong medicine,
  - i.e. excessive austerity in periphery
  - without fiscal stimulus in center
  - Intensifying recession
- Result: bad macroeconomic performance in Eurozone
- This diagnosis influenced by neo-liberal paradigm

Stagnation in Eurozone



Increasing unemployment



Design failures in 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

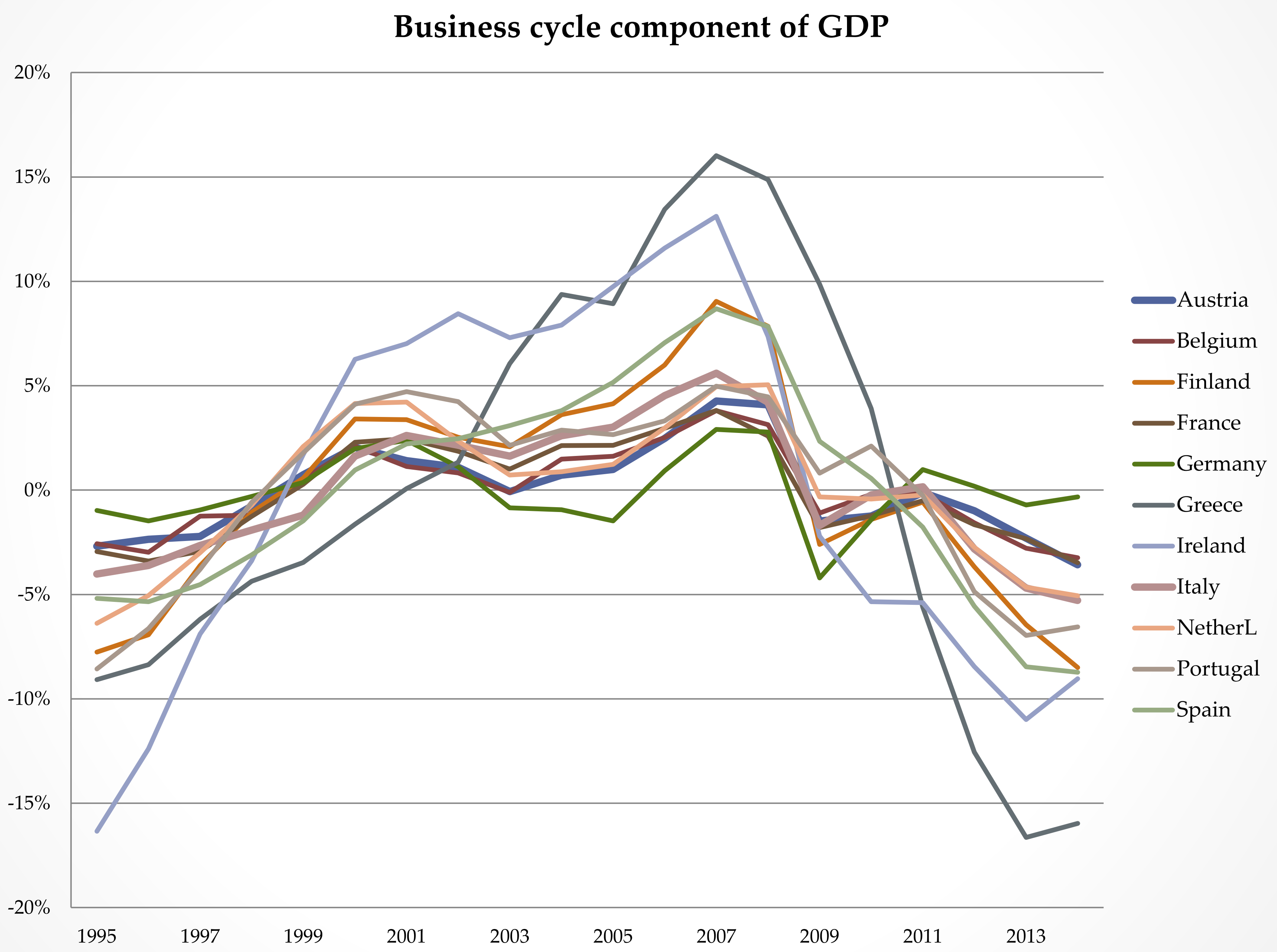
1. Dynamics of booms and busts are endemic in capitalism and continued during Eurozone,
    - triggering large divergent movements in competitiveness
    - while adjustment mechanisms are failing

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. “Deadly embrace” between banks and governments

Let me expand on these points.

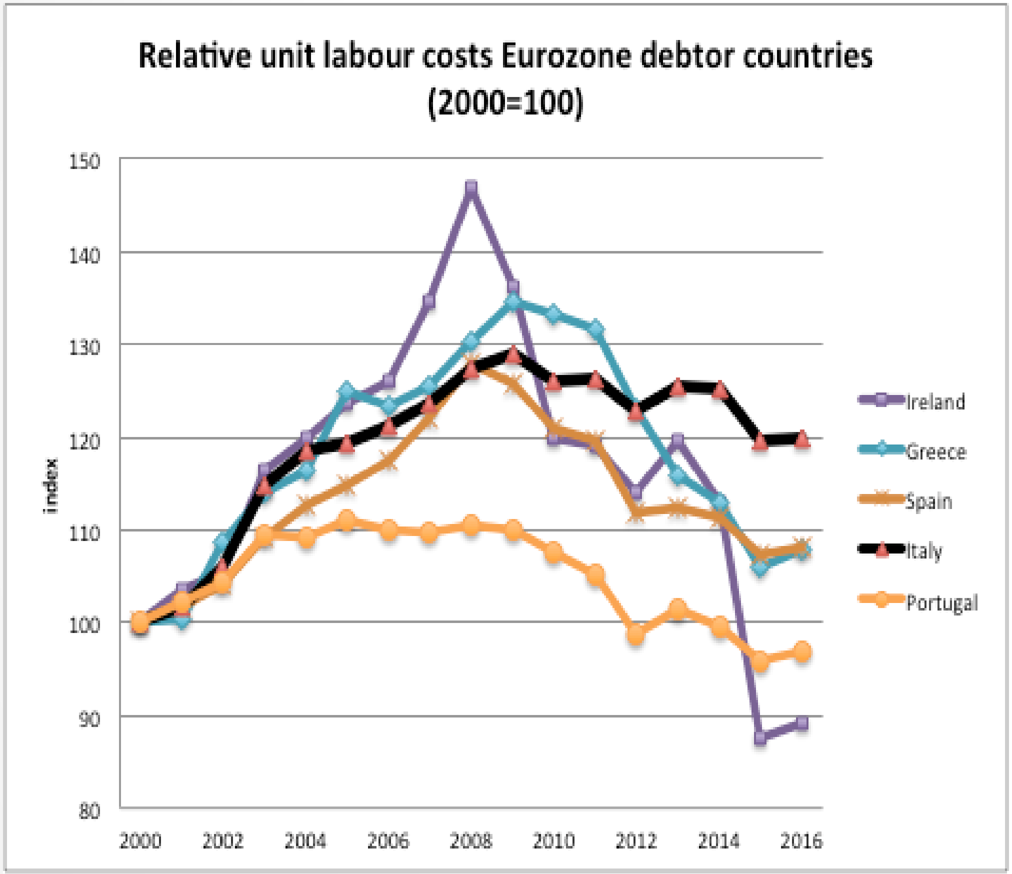
Booms and busts

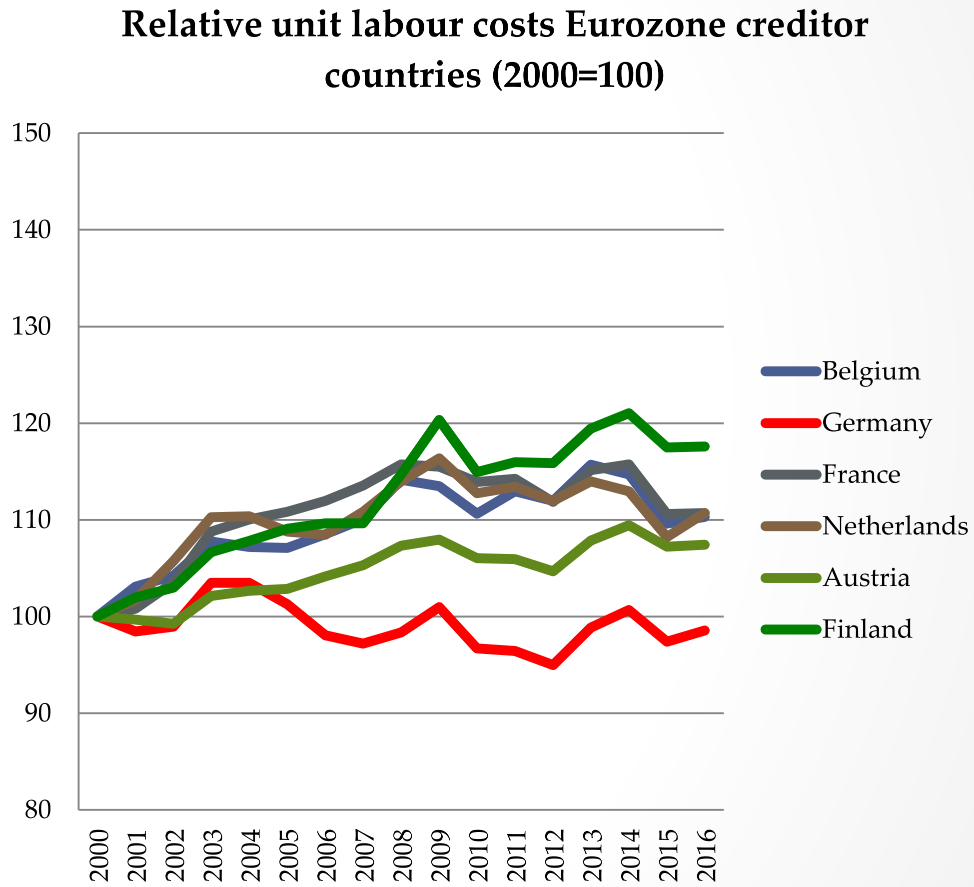
- These were strongly synchronized in Eurozone
- Asymmetry was in the amplitude of the booms and busts
  - Some countries (Ireland, Greece, Spain) experiencing wild swings
  - While others (Germany, France, Netherlands, Belgium) experiencing mild swings


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

Second problem:
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

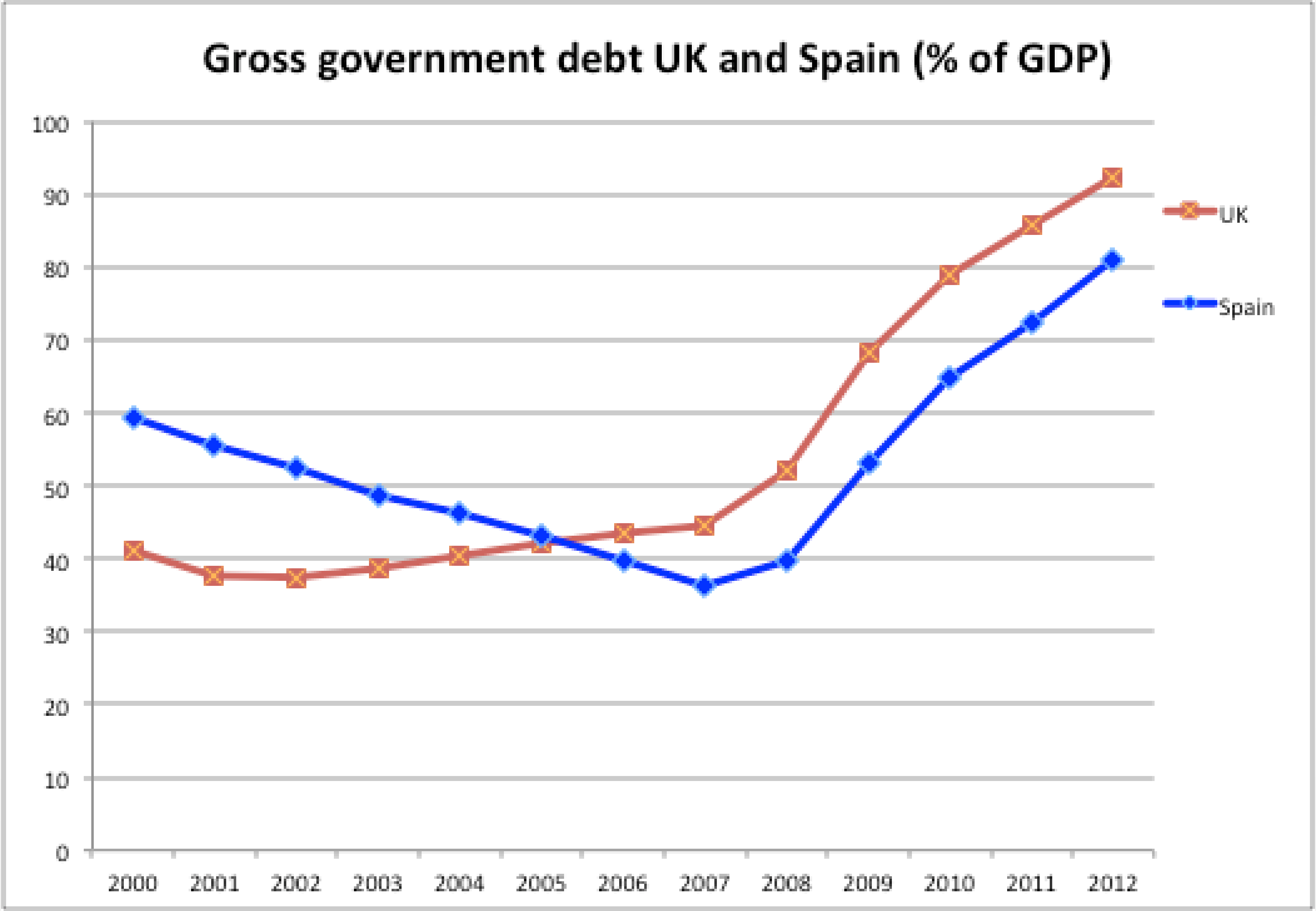
- Governments of member states cannot guarantee to bond holders that cash would always be there to pay them out at maturity
- Contrast with stand-alone countries that give this implicit guarantee
    - because they can and will force central bank to provide liquidity
    - There is no limit to money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

Self-fulfilling crises

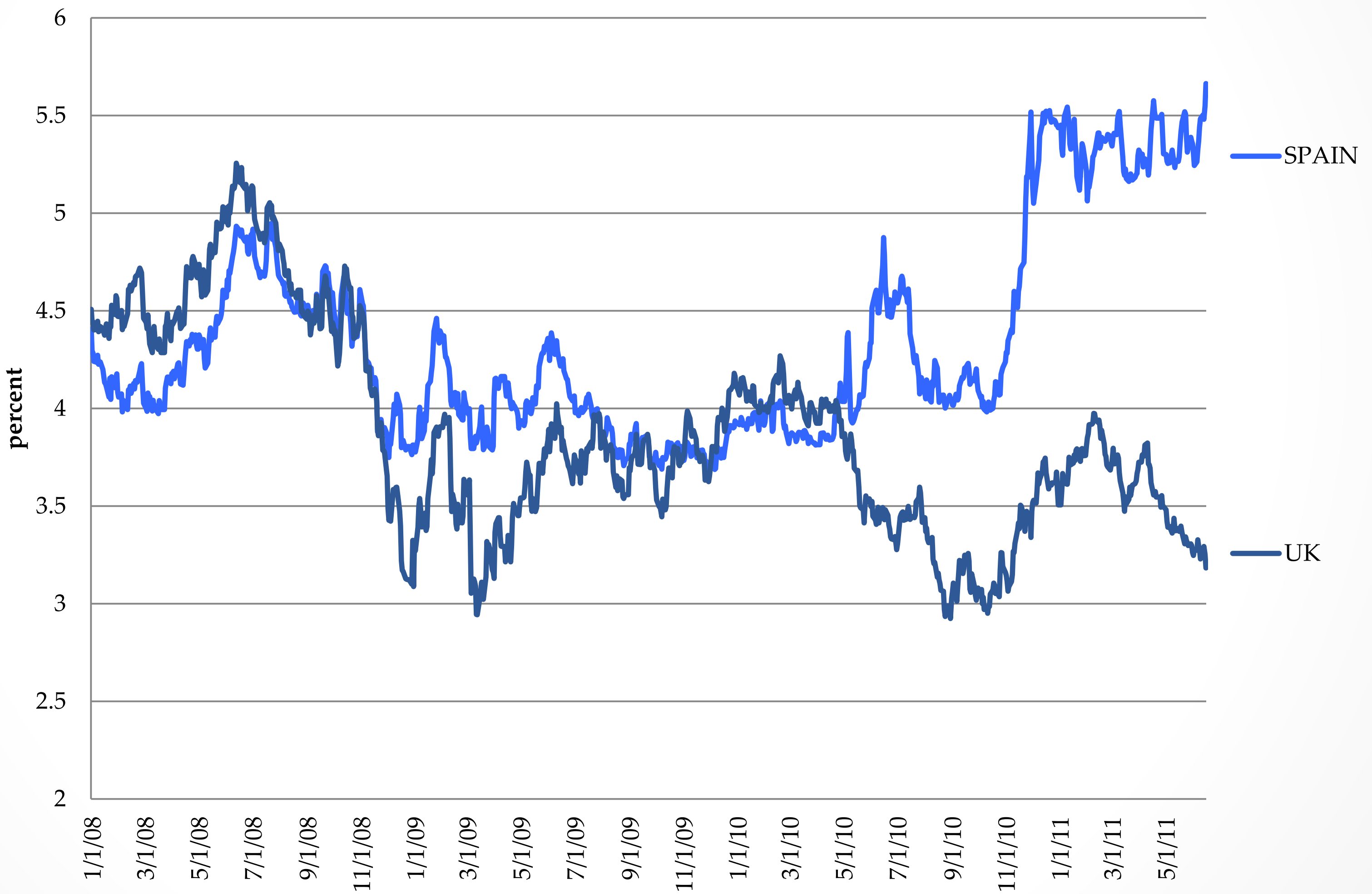
- This lack of guarantee can trigger liquidity crises
  - During recession, budget deficits increase automatically
  - Distrust leads to bond sales
  - Interest rate increases
  - Liquidity is withdrawn from national markets
  - Government unable to rollover debt
  - Is forced to introduce immediate 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
- When they default, banks are also pushed 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
- Case study: pain in Spain


Gross government debt UK and Spain (% of GDP)
100
90
80
70
60
50
40
30
20
10
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
UK
Spain

10-Year-Government Bond Yields UK-Spain



- Eurozone is not designed to face the instability of capitalism (booms and busts)
- It will have to be redesigned to make it possible to withstand these booms and busts
- instead of amplifying them
- Some changes have been made since the sovereign debt crisis.
- I will ask the questions whether these changes are sufficient to make the Eurozone sustainable

Redesigning the Eurozone

How to redesign the Eurozone?

- Role of ECB
- Banking Union
- Budgetary and Political Union

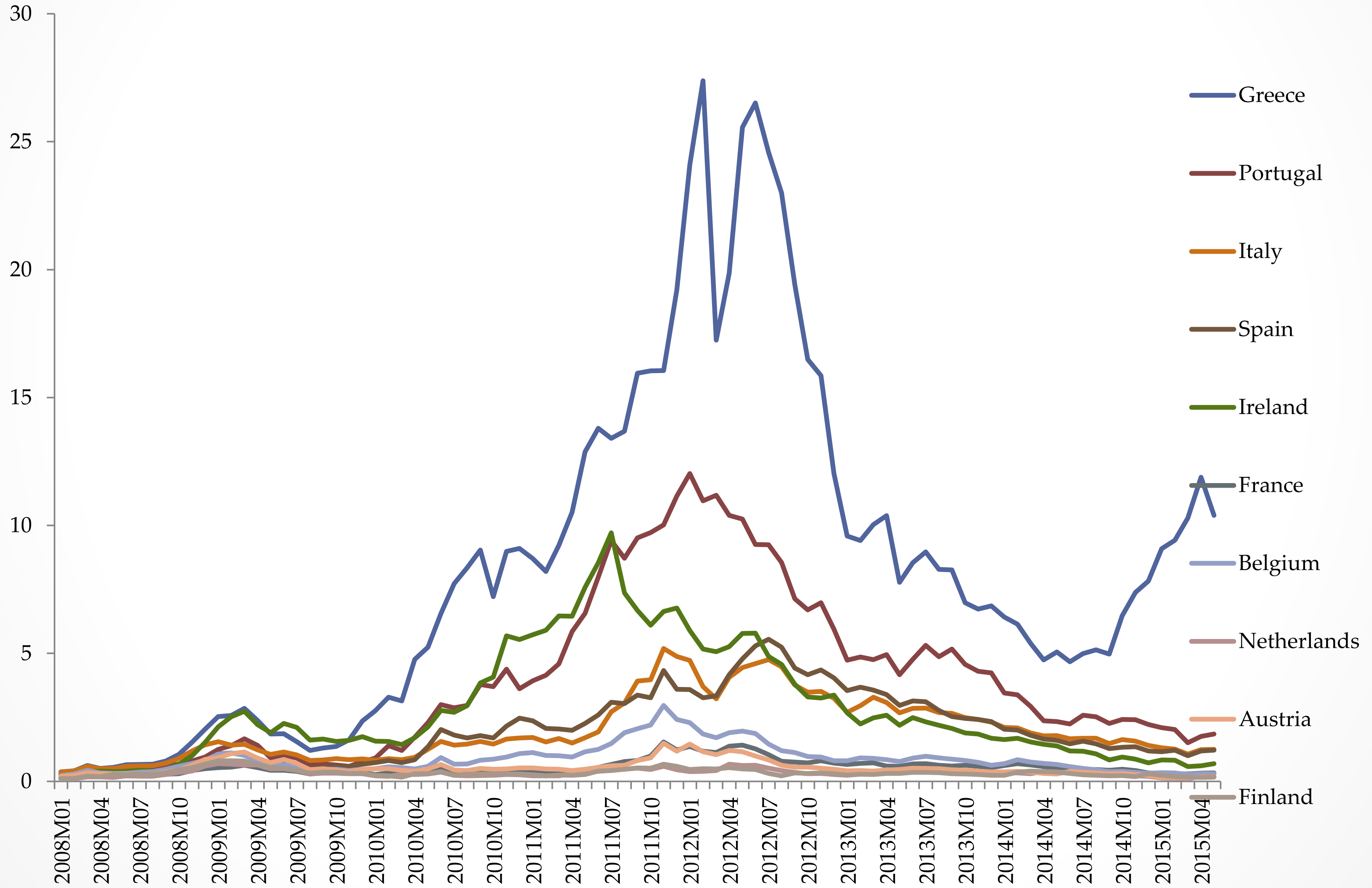
The common central bank as lender of last resort

- 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

Success OMT-program



- This was the right step: the ECB saved the Eurozone
- 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

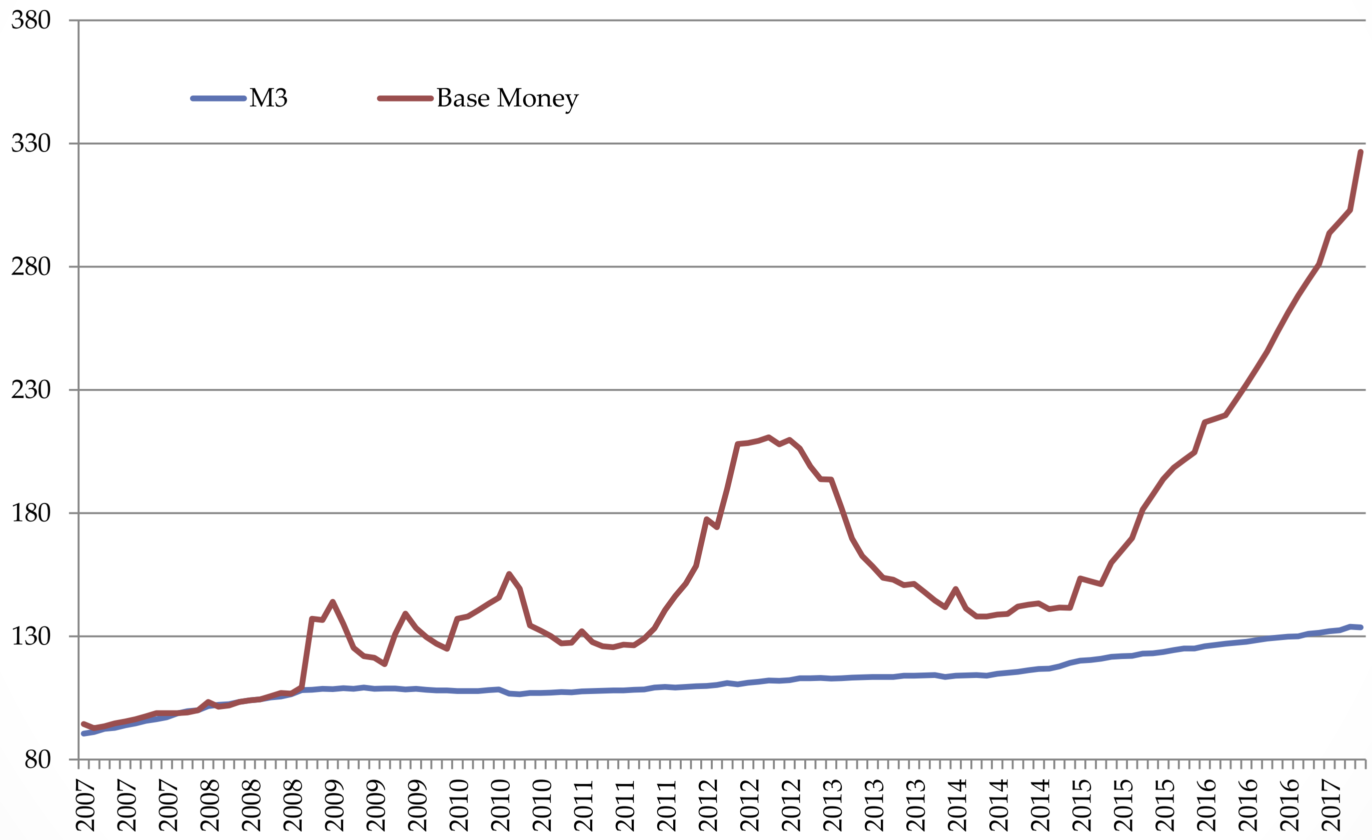
Criticism of OMT

- 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 December 2007=100



Source: European Central Bank

- 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 much;
- 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

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.

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

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

Banking Union

- Banking Union is key in resolving the "deadly embrace" between sovereign and banks
- It allows to de-link the solvency of the banks in one country from the sovereign of that country
- Contrast: Nevada– Ireland
    - Nevada government was shielded from banking crisis because US government (with deep pockets) resolved the banking crisis
    - Not so in Ireland

- Banking union has three components:
  1. Common supervision
  2. Common deposit insurance
  3. Common resolution

- Common supervision has started in 2014 with ECB as the common 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

Towards a budgetary and political union

- Most important component of political union is budgetary union.
- What do we mean with budgetary union?

Budgetary union has two dimensions

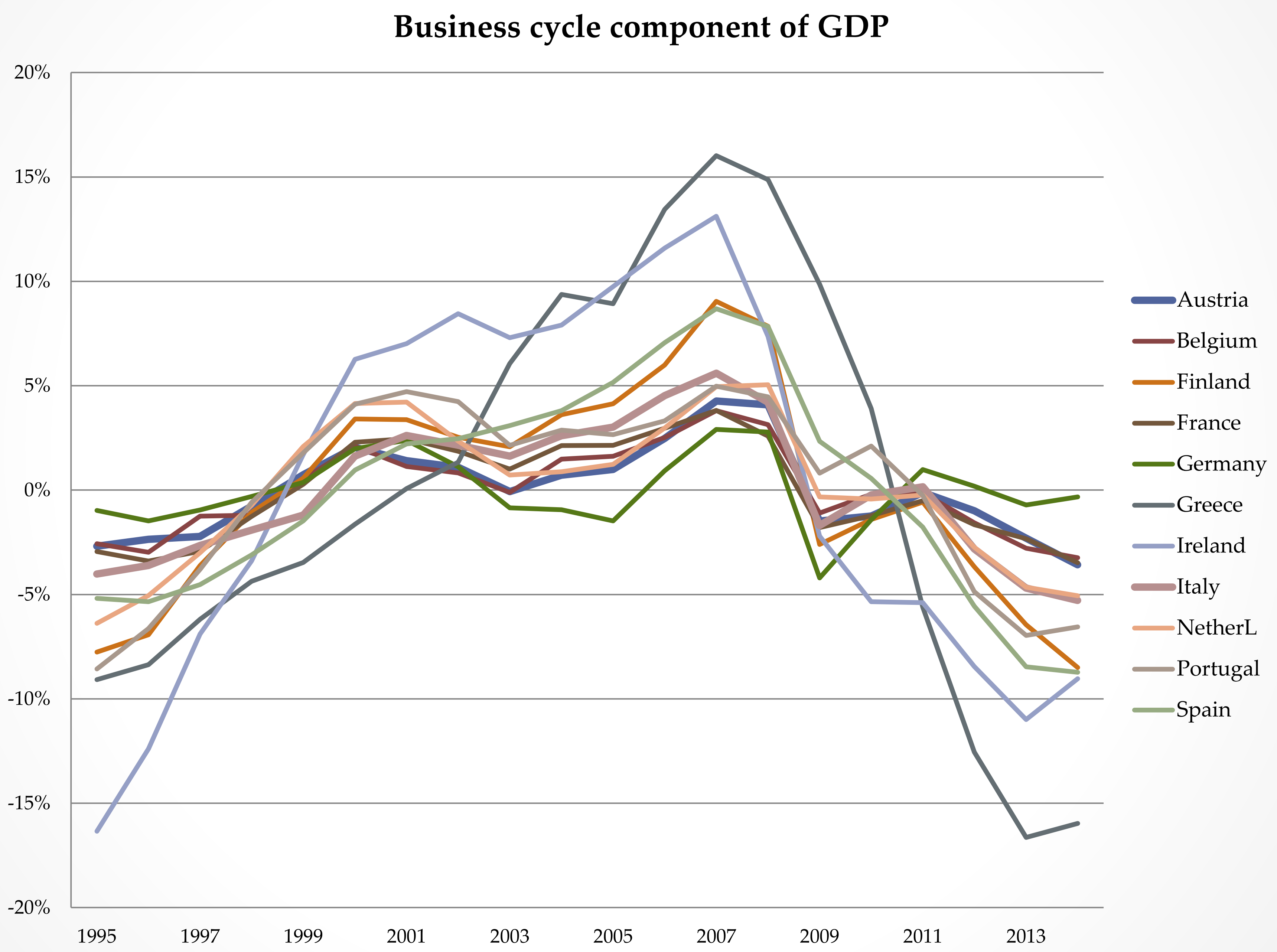
1. consolidation of national government debts.
   - A common fiscal authority that issues debt in a currency under the control of that authority ("Eurobonds").
   - This prevents destabilizing capital movements within the Eurozone
   - and protects the member states from being forced into default by financial markets.

2. Insurance mechanism

- mechanism transferring resources to the country hit by a negative economic shock.
- Limits to such an insurance: **moral hazard** risk,
- But that is problem of all insurance mechanisms
- Budgetary union also allows to stabilize the business cycle at the Eurozone level

Why is budgetary union needed?

- In order to understand the need for a budgetary union it is important to analyze the nature of the shocks that have hit the Eurozone
- Let’s look at the booms and busts that occurred in Eurozone more closely
- I show the same figure shown earlier


Business cycle component of GDP
20%
15%
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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

Interpretation

- Since start of Eurozone, cyclical (temporary) movements have been the dominant factor of growth variations in GDP.
- Cyclical movements of GDP are highly correlated in the Eurozone.
- Asymmetry between Eurozone countries
  - not so much to be found in a lack of correlation in growth rates
  - but in the intensity of the boom bust dynamics of growth rates.

Implications for budgetary union

- Cyclical component of output growth is very important
- Conclusion: efforts at stabilizing the business cycle should be strengthened relative to the efforts that have been made to impose structural reforms.
- Structural reforms and flexibility are important when the monetary union faces permanent shocks
- Not when the shocks are booms and busts (cyclical)
- Then stabilization is important

- The neo-liberal paradigm that has dominated policies in Eurozone has emphasized structural reforms
  - Pushing countries into attempts to liberalize labour and product markets in the midst of recessions
  - Intensifying the recession
  - discrediting these policies and the policymakers
  - And boosting radical anti-European political parties

Strategy of small steps

- Budgetary union (consolidation of national debts and insurance mechanisms) is necessary in long run
- Budgetary union as defined here can only be a very long-run process
- There is no political willingness today to realize this quickly
- Only strategy of small steps can have some probability of success

Common unemployment benefits scheme as a small step

- 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

Objection: That could be done at national level

- In principle, smoothing (over time) could be done at the national level
- However, the large differences in amplitude in business cycle movements makes a national approach impractical:
  - It leads to large differences in the budget deficits and debt accumulation between countries.
  - These differences quickly spillover into financial markets: countries that are hit very hard by a recession experience **sudden stops** and liquidity crises (see De Grauwe(2011)).

- This is likely to force them to switch off the automatic stabilizers in their national budgets (De Grauwe and Ji(2013)).
- This can push countries into a bad equilibrium preventing stabilization
- In addition, these liquidity outflows are inflows in some other countries in the monetary union, typically those that are hit least by the recession.
- Their economic conditions improve at the expense of the others.

- Stabilization of common business shocks with different amplitudes at the national level leads to destabilizing capital flows within system
- Financial markets fail to provide for stabilization and insurance during recessions.

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 very weak.
- This will continue to make the Eurozone a fragile institution
- Its long-term success cannot be guaranteed