THE SOVEREIGN DEBT CRISIS AND THE FUTURE OF THE EUROZONE

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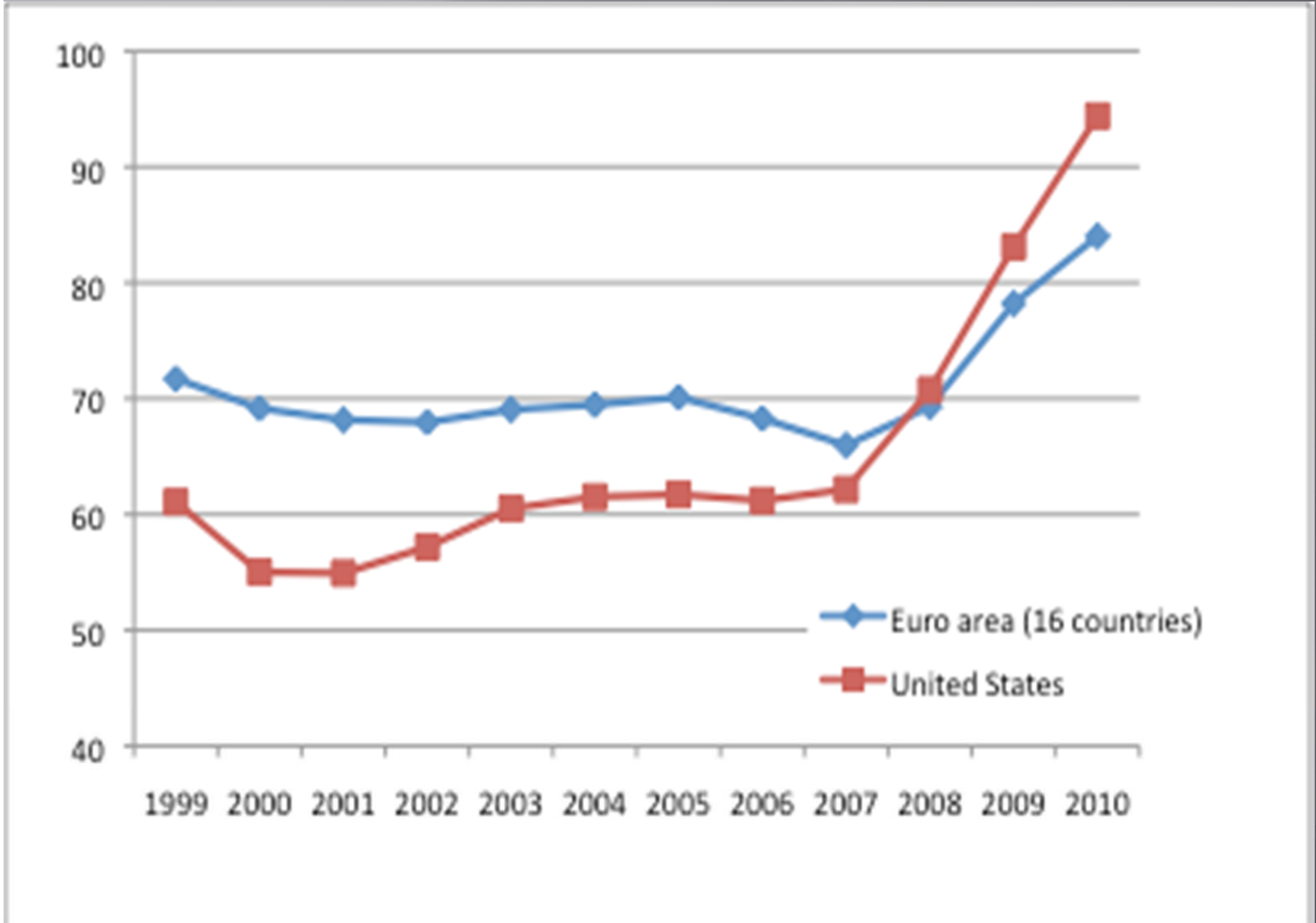
Paradox

- How could a relatively small country's debt degenerate into generalized government debt crisis in eurozone
- Paradox becomes more intense when looking at next figure

Government debt ratios in US and Eurozone

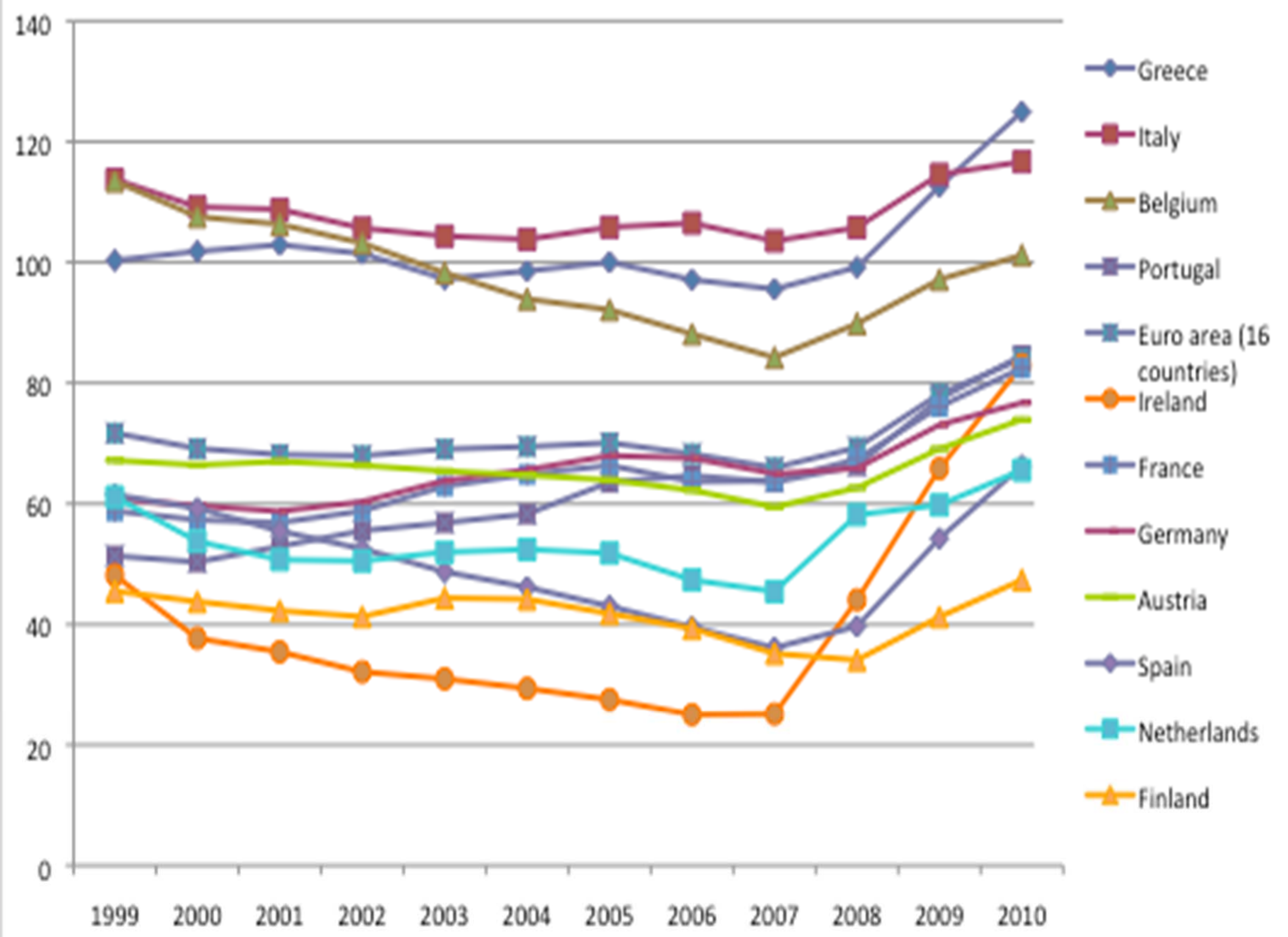


Bron: Europese Commissie, Ameco

- Before the crisis debt ratio declined in eurozone
- Strong increase since 2007
- But much faster in US
- In 2010 <us debt ratio 10% higher than in Eurozone
- Why debt crisis in Eurozone and not in US?

- Answer has two parts :
- average debt to GDP ratio of the eurozone hides large differences between countries and
- the eurozone does not have a mechanism to deal with these differences.

Government debt ratios in eurozone



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Large differences in levels and speed of change

- Given overall strength of the government finances within the eurozone it should have been possible to deal with a problem of excessive debt accumulation in Greece, which after all represents only 2% of eurozone GDP
- Yet it has appeared impossible to do so.
- Why?

- Because there is no mechanism to "internalize" this problem, i.e. to automatically organize transfers to the country experiencing these problems.
- Thus when Greece was hit nobody wanted to help
- Forces of contagion were set loose
- Two dimensions to contagion

Contagion from one country to other countries

- Investors who lost money with Greek government bonds
- fear losses in other sovereign bond markets
- Panic
- Other countries with weak government finances are picked
- Interest rates increase, increasing risk of default
- Self-fulfilling prophesies

Contagion from government bond markets to banks

- Most government bonds are held by banks
- Most often by banks in other Eurozone countries
- Sovereign default risk becomes bank default risks in many eurozone countries
- Risk of banking crisis


Outside pressure
Government-debt holders, latest, % of total
Resident financial institutions
Other residents
Non-residents (euro area)
Non-residents (rest of world)
0
20
40
60
80
100
Italy
Spain
Germany
Belgium
France
Ireland
Portugal
Greece
Source: Barclays Capital

- Contagion is result of intense financial integration in eurozone
- When one country gets into financial difficulties, financial problems elsewhere
- Nothing was foreseen to deal with these problems of contagion
- No institutions existed capable of transferring financial resources
- So as to stop forces of contagion

Contrast with US: Monetary union embedded in political union

- Political union implies some form of budgetary union
- US Federal budget Is 25% US GDP
- Makes it possible to automatically redistribute to deficit region
- key of the eurozone problem: it is a monetary union without a political union.
- In a political union there is a centralized budget that provides for an automatic solidarity mechanism in times of crisis.
- This is absent in the eurozone: EU central budget only 1% of EU GDP

In monetary union there is need for automatic solidarity

- Put differently: monetary union needs insurance mechanism capable of helping member-countries hit by economic distress
  - Not only out of altruism
  - But also out of self-interest
- This has long been stressed by economists
- Economists advice was not followed
- Eurozone was created without such a mechanism
- Why?

Moral Hazard

- The main reason was that, as with any insurance mechanism, there is the risk of moral hazard.
- Moral hazard: those who obtain insurance reduce effort to avoid risk they are insured against
- It is understandable that countries were not willing to automatically transfer resources to deficit countries
- This line of thought very strong in Austria, Germany and the Netherlands

- Moral hazard is serious problem
- but has received too much attention
- at the expense of contagion problem
- Thereby endangering the survival of the eurozone
- Financial solidarity is essential
- Monetary union forces member countries to show some solidarity, whether they like it or not.

- In addition, problems of Ireland and Spain have nothing to do with moral hazard
- These countries got into trouble not because their governments followed irresponsible fiscal policies
- hoping to be bailed out by the others
- Their problem arose from unsustainable private debt explosion
- I’ll come back to this

official EU doctrine before the crisis

- insurance mechanism is not necessary for a smooth functioning of the eurozone.
- Stability and Growth Pact will do the trick.
  - Just make sure that countries abide by the rules.
  - If they do so, i.e. if they are always well-behaved, there is no need for an automatic insurance mechanism provided by a centralized budget, or by a European Monetary Fund.

Fire codes and fire brigades

- Analogy: if people follow the fire code regulations scrupulously there is no need for a fire brigade.
- The truth is: there will always be some people who do not follow the rules scrupulously,
- making a fire brigade necessary.
- And an important detail: This fire brigade should be willing to extinguish the fire before it punishes the guilty.

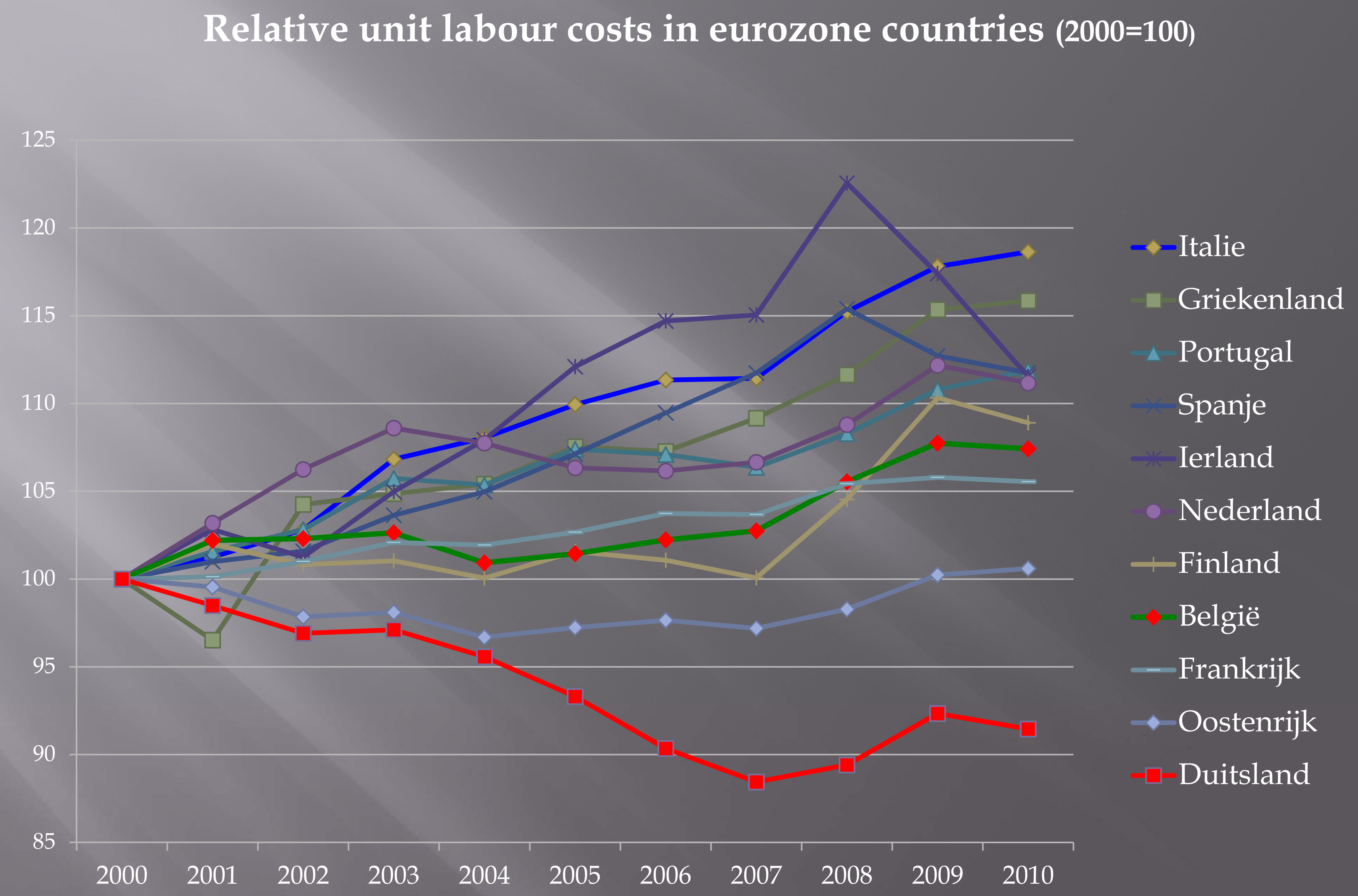
Eurozone had firecode, no fire brigade

- Eurozone had an elaborate set of rules to prevent fires and decided that therefore it would not need a fire brigade.
- When it finally set up a fire brigade, the latter was busy trying to punish the guilty before it started extinguishing the fire.
- No wonder the fire spread to other countries

What's more: there are no institutions to avoid crises

- Eurozone has no institutions to deal with crises
- There are no institutions to help avoid crises
- Crisis is result of divergent economic developments
- Some countries experienced strong booms; other anemic growth
- This leads to divergent wage and price developments

Divergent trends in competitiveness



Bron: Europese Commissie, Ameco
http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm

- Countries in monetary union cannot devalue anymore
- This necessitates “internal devaluation”: deflationary process wages and prices
- Painful
  - Declining output
  - Increasing unemployment
  - Rising budgetary problems due to economic downturn and **Fisher debt deflation** paradox

Causes of divergent wage and price developments: Political

- Divergencies are result of structural problem of eurozone:
  - Monetary policy completely centralized in hands of ECB
  - Other instruments of economic policy in national hands (fiscal policies, wage policies
- i.e. absence of political union (again)

- Thus each country follows its own fiscal policy
  - With different tax policies (e.g. corporate income tax policies in Ireland)
  - Different spending policies
- Each country has its own wage policies and wage bargaining system
- Social policies differ
- Creating national economic cocoons while money and finance is fully integrated

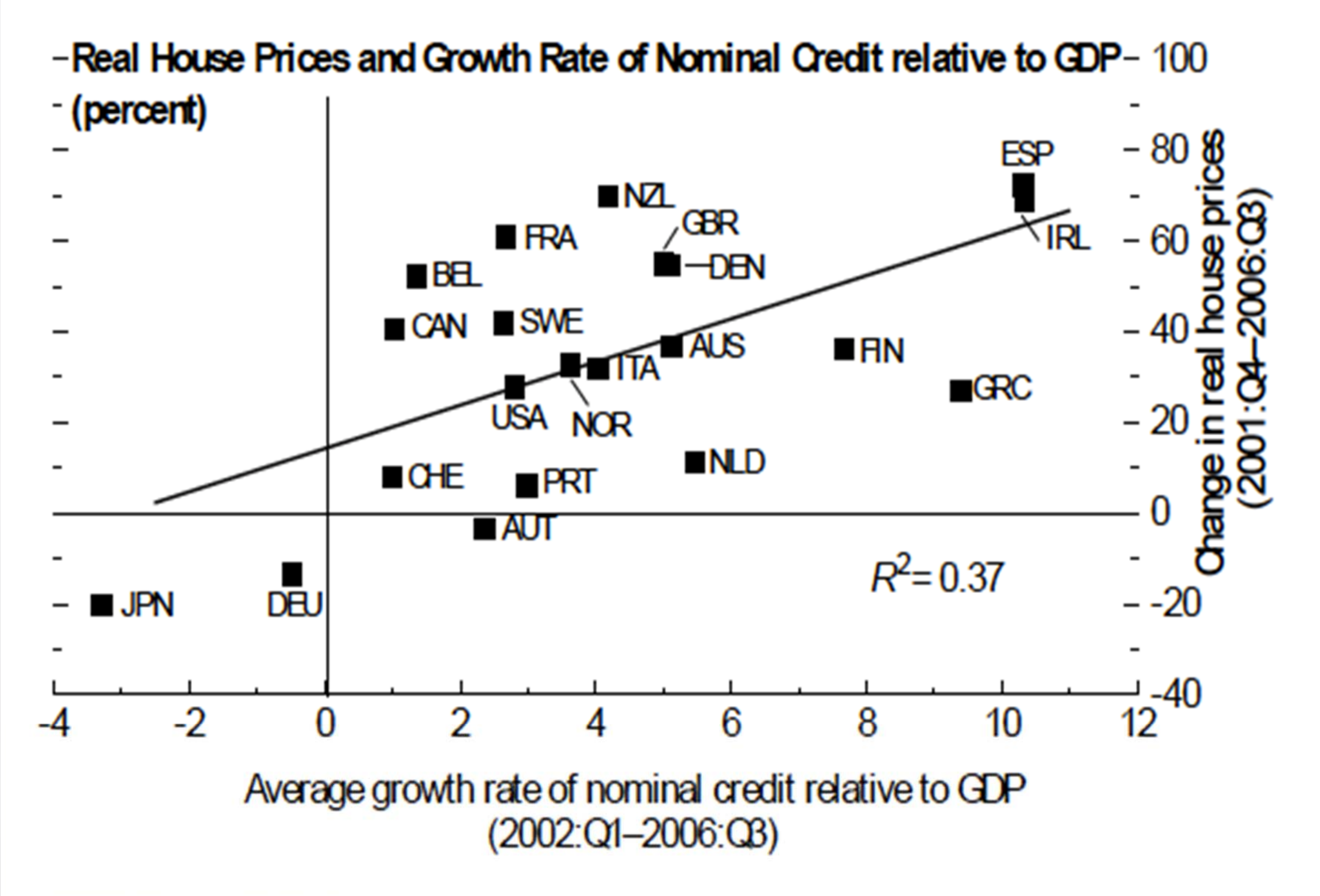
Importance of “animal spirits”

- Market systems are regularly gripped by moves of optimism and pessimism (animal spirits)
- Optimism leads to asset bubbles including real estate bubbles
- Asset bubbles are fueled by willingness to incur debt
- Until the crash

- Animal spirits have largely a national component in the eurozone.
- Thus, while in the early 2000s, a wave of optimism (helped by a strong decline in real interest rates) gripped countries like Spain and Ireland, pessimism prevailed in Germany.
- These animal spirits have a self-fulfilling property and lead to bubbles and booms in the countries gripped by optimism, and the reverse in the others.

- Severity of booms and bubbles ultimately depends on how they are financed.
- In particular, these bubbles and booms become intense when they are made possible by bank credit.
- In fact there is a two-way interaction between bubbles and booms on the one hand and bank credit.

- When a bubble and boom starts, bank credit increases automatically, (boom-and-bubble increases value of assets),
- thereby increasing the value of collateral presented to banks in order to obtain a loan.
- Conversely the increase in bank credit intensifies the boom and the bubble.
- These features have been analyzed in great detail by Borio(2003), White(2006), Brunnermeyer, at al. (2009).

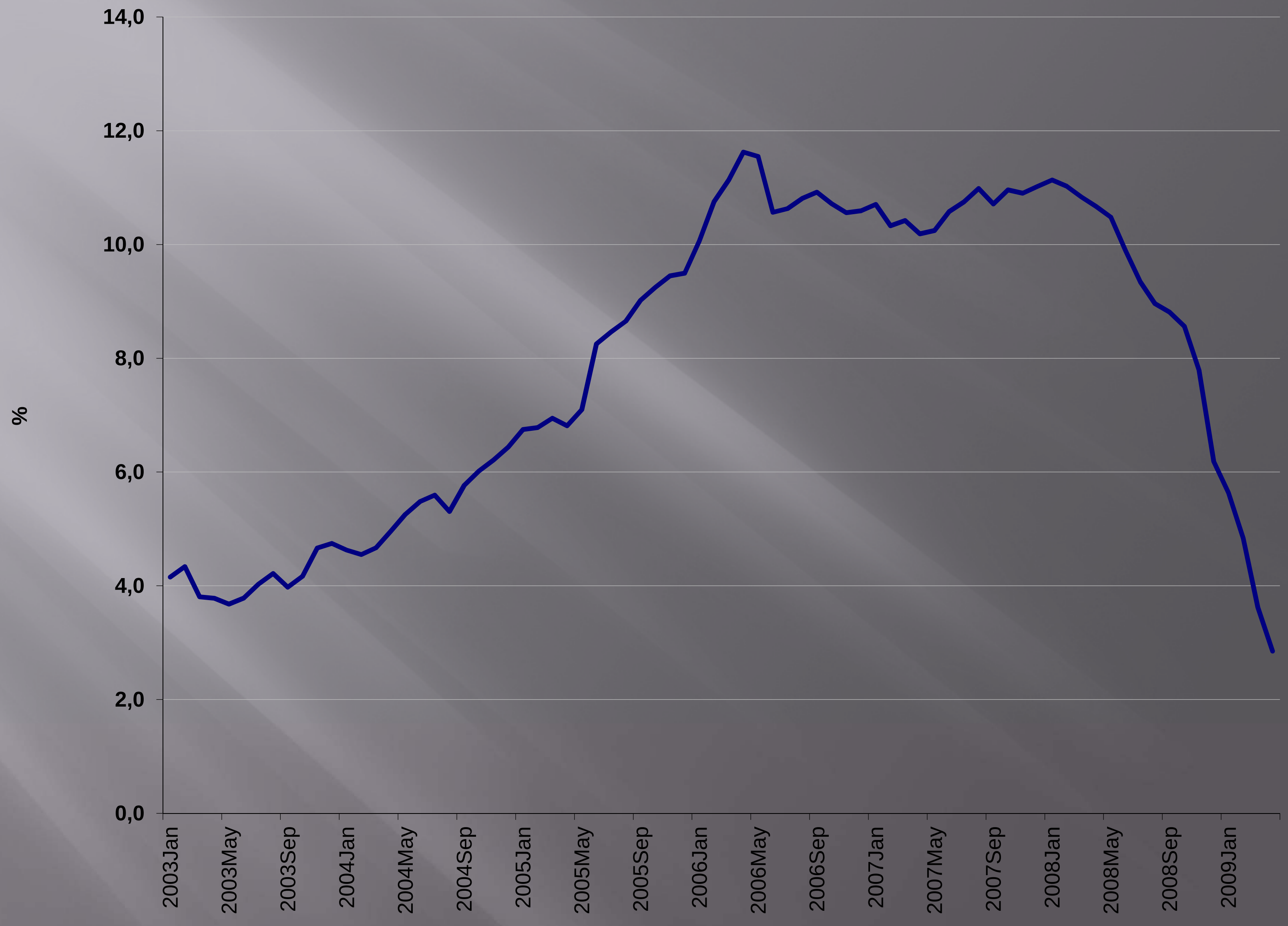


Source: IMF, 2009

- Appearance of unsustainable private debt levels is the result of a combination of animal spirits and bank credit.
- This phenomenon has been very pronounced in Ireland and Spain.
- This also leads to the conclusion that not only national governments bear responsibility for these developments (because they fail to counteract them by anticyclical budgetary policies)
- but also the monetary authorities (because they fail to exert a stronger control on bank credit).

- Thus, it can be argued that the responsibility of the European monetary authorities in the development of unsustainable private debt levels is strong.
- But ECB has only one instrument to deal with divergent developments in credit driven asset bubbles
- However, ECB also failed to check aggregate bank credit

Figure 2: Growth rate of bank loans in Euro area



To summarize

- Eurozone was big step forward in the integration process
- But is was unfinished
- No significant steps were taken to move into a political union
- With twofold consequence
  - No instruments to prevent economic divergencies
  - No insurance mechanism to deal with crisis situations

Reactions of European leaders

- Too little, too late
- Different diagnosis of the sources of the crisis
- Too much dominated by "moral hazard" diagnosis :
  - high budget deficits and debts are the result of irresponsible behavior of national budgetary authorities
  - These governments should be punished
  - So that they will not repeat their sins

- This diagnosis may be right for Greece
- But is completely wrong for Ireland and Spain where source of crisis has been excessive debt accumulation by private sectors and banks
- Made possible by reckless lending (also) by banks from Northern Europe
- Thus there are many sinners who should be punished
- Moral hazard diagnosis has led to proposals that have intensified the crisis.

A sovereign debt default mechanism

- At recent European Council meeting, member countries agreed to introduce a sovereign debt default mechanism (SDDM).
- as a condition to make EFSF permanent
- Thus collective action clauses (CACs) will be added to government bond contracts
- Making it possible to apply haircuts when governments apply for financial assistance
- so that bond holders will also be forced to pay price ("moral hazard thinking")

- This is a bad decision that will make the eurozone more fragile by making financial crises an endemic feature of the eurozone
- This has already be shown to be true:
- As soon as the decision was made, bond holders panicked and massively sold government bonds
- forcing ECB to pick up the pieces

Analogy with ERM

- The ERM was a fragile institutional arrangement with frequent crises.
- Member countries of the ERM pegged their exchange rates among each other.
- At any time, however, they could reconsider this peg and devalue their currencies.
- Existence of this option to devalue their currencies created an unstable environment prone to speculative attacks.

- Once speculators expected a devaluation, self-fulfilling dynamics would be set in motion.
- Central bank of country concerned had to raise the domestic interest rate.
- Costly for the domestic economy and for the government budget.
- Cost-benefit ratio of keeping the exchange rate fixed increased,
- leading to a temptation to devalue.

- Speculators “smelled” this,
- they intensified their speculative activities
- leading to a further increase in the interest rate
- and a further deterioration of the cost-benefit ratio of keeping the exchange rate fixed.
- In most cases this made the devaluation inevitable.
- In the end the ERM collapsed.

SDDM suffers from same instability

- Proposed sovereign debt default mechanism (SDDM) for the eurozone introduces similar incentive structure for speculators and national authorities as in the ERM.
- Governments solemnly declare that in times of payment difficulties they will devalue the government bonds (that's what a haircut means)
- this will introduce the speculative dynamics in the eurozone that destroyed the ERM.

- Once the option to devalue becomes the declared policy and is linked to mutual financial assistance,
- the speculative dynamics will become unstoppable
- as it introduces exactly the same incentive structure as in the ERM:
- Governments whose bonds are sold face a higher interest rate, which makes the service of their debt more difficult.

- This changes the cost-benefit ratio of maintaining full debt service and increases the temptation to devalue the bonds (applying a haircut).
- Investors “smelling” this temptation will intensify their selling of sovereign bonds,
- thereby increasing the cost-benefit ratio even further.
- Making debt crisis inevitable

- The sovereign debt default mechanism, if implemented, will lead the eurozone governments to downgrade their own sovereign debt.
- There is no surer way to self-destruction.

There are positive developmens

- Most important one: the creation of the European Financial Stability Facility (EFSF)
- It would have been inconceivable last year
- Greek crisis forced European leaders to make a step forward
- But its lending policies are too harsh: stick is too big and carrot too little
- Contrast with IMF

Is there a future for the euro?

- Basic problem: absence of political union
- Steps towards political unification are essential for maintenance of eurozone
- Without these steps eurozone has no future.
- There is little willingness to take big steps
- Example: budgetary union. It is unlikely that significant progress is made soon

- There is integration fatigue
- Cannot be solved in the short run
- Do we have to despair?
- Not necessarily: small steps can be taken
- These small steps can act as signals about the determination of member-countries to safeguard the eurozone
  - European Monetary Fund
  - Joint Eurobond issues

European monetary fund

- Explicit budgetary union is not only way to provide for an insurance mechanism within a monetary union.
- It can also be organized using the technique of a monetary fund that obtains resources from its members to be disbursed in times of crisis (and using a sufficient amount of conditionality).
- Analogy with IMF
- European Financial Stabilization Facility (EFSF) goes in the right direction but uncertainties remain

The need of Eurobonds: political

- The crisis has degenerated into an existential crisis of the euro zone.
- Investors now ask themselves the question of whether the euro zone, as we know it today, will survive.
- This lack of trust in the future of the euro zone leads to endemic instability.
- It has the effect of transforming bad news about one particular country into bad news for other countries, and for the system as a whole.

- This vicious circle inherent in the endemic instability must be halted.
- This can only happen if the member countries are willing to design a mechanism that will convince the market about the seriousness of their commitments towards the euro zone.
- Solemn declarations by leaders of government will not be sufficient. They are seen as “cheap talk”.

- A common Eurobond is such a mechanism.
- By jointly issuing Eurobonds the participating countries become jointly liable for the debt they have issued together.
- This is a very visible and constraining commitment that will convince the market that member countries are serious about the future of the euro.

Conclusion

- The challenges for the eurozone are formidable
- Eurozone can only survive if steps are taken towards political union
- The really big steps (e.g. fiscal union) cannot be taken now. There is no political momentum now.
- Small steps, however, can be taken
- If they involve enough commitment
- they signal to the markets that member states want to move in the direction of political union