The Legacy of the Eurocrisis and the Future of the Euro

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Outline of presentation

• Legacy of the sovereign debt crisis
• Design failures of Eurozone
• Redesigning the Eurozone:
  o Role of central bank
  o Role of banking union
  o Towards a budgetary and political union?
Legacy of the crisis
Eurozone split into creditor and debtor nations

Figure 5: Cumulated current accounts

![Cumulated current accounts graph showing the percentage of GDP for various countries from 1991 to 2013. The graph illustrates the financial situation of Belgium, Germany, Ireland, Greece, Spain, France, Italy, the Netherlands, Austria, Portugal, and Finland.]

- Belgium
- Germany
- Ireland
- Greece
- Spain
- France
- Italy
- Netherlands
- Austria
- Portugal
- Finland
• Creditor nations have imposed their rule: Thou shall repay thy debt
• In order to achieve this, austerity rule is imposed
• This has created asymmetric adjustment mechanism where most of the adjustment has been borne by the debtor nations
• Without compensating stimulus by the creditor nations
Relative unit labour costs Eurozone: creditor nations

- Finland
- Belgium
- Netherlands
- France
- Austria
- Germany
• Asymmetric adjustment mechanism has created deflationary bias in the Eurozone
• Leading to significant poorer economic developments in Eurozone as compared to rest of developed economies
Stagnation in Eurozone

Figure 1: Real GDP in Eurozone, EU10 and US (prices of 2010)
Increasing unemployment

Figure 5: Unemployment rate in Eurozone, EU10 and US
Increasing savings as a result of austerity

Figure 6: Current account Euro area
Deflation threat

Figure 7: Inflation in US and Eurozone
• Most striking feature of legacy of Eurocrisis is that despite intense austerity programs that have been triggered since 2010
• there is no evidence that these programs have increased the capacity of the governments of the debtor countries to continue to service their debt
• On the contrary: deflation makes it harder to reduce debt burdens
Stagnation increases debt burdens

Gross government debt to GDP ratio

- Ireland
- Greece
- Spain
- Italy
- Portugal

percent GDP

• It is my contention that a more symmetric fiscal adjustment (creditor nations stimulate their economies) would have reduced the price the periphery had to pay (in terms of lost output) to achieve a given improvement in their government budget balances.
Fallacy of composition

• The imposition of austerity programs in the Eurozone has been victim of the “fallacy of composition”.
• What works for one nation fails to work when everybody applies the same policies.
• When one nation is forced to deleverage through austerity (i.e. is trying to save more) this may work when it is alone to do so.
• When, however, all the countries try to save more at the same time, i.e. they all attempt to create current account surpluses, each country’s attempt to do so makes it harder for the others to achieve their objectives, forcing them to increase their austerity efforts.
• In the end, they are not more successful but GDP will be lower everywhere.
Options for the future

1. Solving legacy of eurocrisis
   - Debt restructuring
   - Debt monetization?

2. Correcting for design failures
Solving legacy problem

- Legacy of the crisis has led to unsustainable debt levels
- Debt default (restructuring) in a number of countries will be inevitable
- Only issue: when?
Figure 9: Debt Laffer curve

Expected debt repayment vs. Debt stock
• Rational solution dictates that creditor nations accept a loss now (after all they are equally responsible for the mess)
• Unlikely to happen
• Large part of claims are now in public hands
  o In many Northern countries, Manichean views of good and evil prevail, leading to an emotional desire that evil be punished.
  o This attitude makes it difficult for politicians in these countries to choose the rational outcome that would increase economic welfare for everybody.
Design Failures of Eurozone
Eurozone’s design failures: in a nutshell

1. Dynamics of booms and busts are endemic in capitalism
   - 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. Deadly embrace sovereign and banks

Let me expand on these points.
Design failure I
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
Design failure II: no stabilizers left in place

- Lender of last resort existed in each member country at national level.
- 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
  o Distrust leads to bond sales
  o Interest rate increases
  o Liquidity is withdrawn from national markets
  o Government unable to rollover debt
  o Is forced to introduce immediate and intense austerity
  o 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
  o Greece is different problem: it was a solvency problem from the start
• Thus absence of LoLR tends to eliminate other stabilizer: automatic budget stabilizer
  o Once in bad equilibrium countries are forced to introduce sharp austerity
  o pushing them in recession and aggravating the solvency problem
  o Budget stabilizer is forcefully switched off
Eurozone undermines legitimacy of governments

- Austerity undermines legitimacy of governments that entered Eurozone with mandate to provide some protection against booms and busts of capitalism
- This mandate is being eroded.
- At the same time austerity has weakened capacity of governments to service their debts
Redesigning the Eurozone
How to redesign the Eurozone

• Role of ECB
• Coordination of macroeconomic policies in the Eurozone
• Political Union
  o Banking Union
  o Fiscal 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
Figure 7: Spreads 10-year government bond rates eurozone

- Greece
- Portugal
- Spain
- Italy
- Ireland
- Belgium
- France
- Austria
- Netherlands
- Finland
• This was the right step: the ECB saved the Eurozone
• But then ECB waited too long to stop deflationary dynamics
• Only in January 2015 did it act to fight deflation
Figure 2: Balance Sheet FED and ECB (2004-14)
Governance issue of OMT

• The European Central Bank’s power has increased significantly as a result of the sovereign debt crisis.
• With the announcement of the OMT program it has become clear that the ECB is the ultimate guarantor of the sovereign debt in the Eurozone.
• In this sense the ECB has become a central bank like the Federal Reserve and the Bank of England.
• There is one important difference though.
Who prevails?

• In the US and the UK: primacy of the government over the central bank,
  o i.e. in times of crisis it is the government that will force the central bank to provide liquidity.

• This is not the case in the Eurozone: governments depend on the goodwill of the ECB to provide liquidity.
  o Governments have no power over the ECB and cannot force that institution, even in times of crisis, to provide liquidity.

• Thus, in the Eurozone today there is a primacy of the central bank over the governments.
Democratic legitimacy of OMT

- The ECB consists of unelected officials, while governments are populated by elected officials.
- It is inconceivable that these governments will accept to be pushed into insolvency while unelected officials in Frankfurt have the power to prevent this but refuse to use this power.
- When tested such a model of the governance of the Eurozone will collapse and rightly so.
Conundrum

- The role of the ECB as a lender of last resort is essential to keep the Eurozone afloat.
- But, present governance of this crucial lender of last resort function is unsustainable
  - because its use depends on the goodwill of the ECB,
  - thereby making democratically legitimate governments’ fate depend on the judgment of unelected officials.
Towards a sustainable LOLR

• LOLR has to be made subordinate to the political power of elected officials,
  o as it is in modern democracies such as the US, Sweden, the UK, etc.
• Can only be achieved by a Eurozone government
  o backed by a European parliament
  o With primacy over the central bank.
• If not, Eurozone remains fragile: volatility in the government bond markets.
Coordination of macroeconomic policies

- Macroeconomic imbalance procedure strengthening the coordination of macroeconomic policies are being put into place.
  - the monitoring of a number of macroeconomic variables
    - current account balances,
    - competitiveness measures,
    - house prices
    - bank credit
  - aimed at detecting and redressing national macroeconomic imbalances;
However

• This procedure is implemented in asymmetric way
  o Deficit countries experience much more pressure to act, i.e. to reduce spending than surplus countries
• Competitiveness measures have same problem
  o This leads to downward pressure on wages
• Deflationary bias is not solved
• The creditor countries prevail
• Creating political problems
• and rejection of system in which European Commission is seen to defend interests of creditor nations and remains unaccountable
What should be done today?

• Policy mix should be:
  o Monetary and fiscal expansion
• ECB has started QE
• Fiscal policy should focus on public investment
• Why?
• It is one of the major victims of ill-advised macroeconomic policies in Eurozone
Austerity programs led to strong decline in public investment

Figure 8: General government gross fixed capital formation (%GDP)
• Leading to less aggregate demand today
• And less supply in the future
• Thus, start public investments
• These can be initiated everywhere,
• but especially in Germany, a country that can borrow almost for free
Throw away dogmas

• We have to free ourselves of dogmas
• One such dogma: balanced budget, i.e. no bond financing of investments
  o All investments should be financed by current revenue
  o No well run company follows such a rule
• Result: governments are reducing their responsibility to provide essential public goods (infrastructure, energy investments, environmental investments)
• This reduces long-term growth of the Eurozone
Towards a political union

Two components of political union are necessary

- Banking Union
- Fiscal Union
Banking Union

• Banking Union is key in resolving the deadly embrace between sovereign and banks

• Three components:
  1. Common supervision
  2. Common deposit insurance
  3. Common resolution

• Common supervision starts now 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
  o Common resolution fund will be built up gradually to reach €55 billion
  o This is clearly insufficient
  o Governance of resolution is so complicated as to be impractical in times of crisis
Fiscal and political union

• Only governance that can be sustained in the Eurozone is one where a Eurozone government backed by a European parliament acquires the **power to tax and to spend**.

• Put differently, the Eurozone can only be sustained if it is embedded in a fiscal and political union.
Fiscal union has two dimensions

1. consolidation of national government debts.
   o A common fiscal authority that issues debt in a currency under the control of that authority.
   o This protects the member states from being forced into default by financial markets.
   o This restores the balance of power in favour of the sovereign and against the financial markets
2. mechanism of automatic transfers
   o insurance mechanism transferring resources to the country hit by a negative economic shock.
   o Limits to such an insurance: *moral hazard* risk,
   o But such a mechanism is essential for the survival of a monetary union, like it is for the survival of a nation state.
   o Without a minimum of solidarity (that’s what insurance is) no union can survive.
Integration fatigue

• All this is well known.
• Willingness today to move in the direction of a fiscal and political union in Europe today is non-existent.
• This fact will continue to make the Eurozone a fragile institution,
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 cannot last

• The eurocrisis is not over