Legacy of the Eurocrisis and the Future of the Euro

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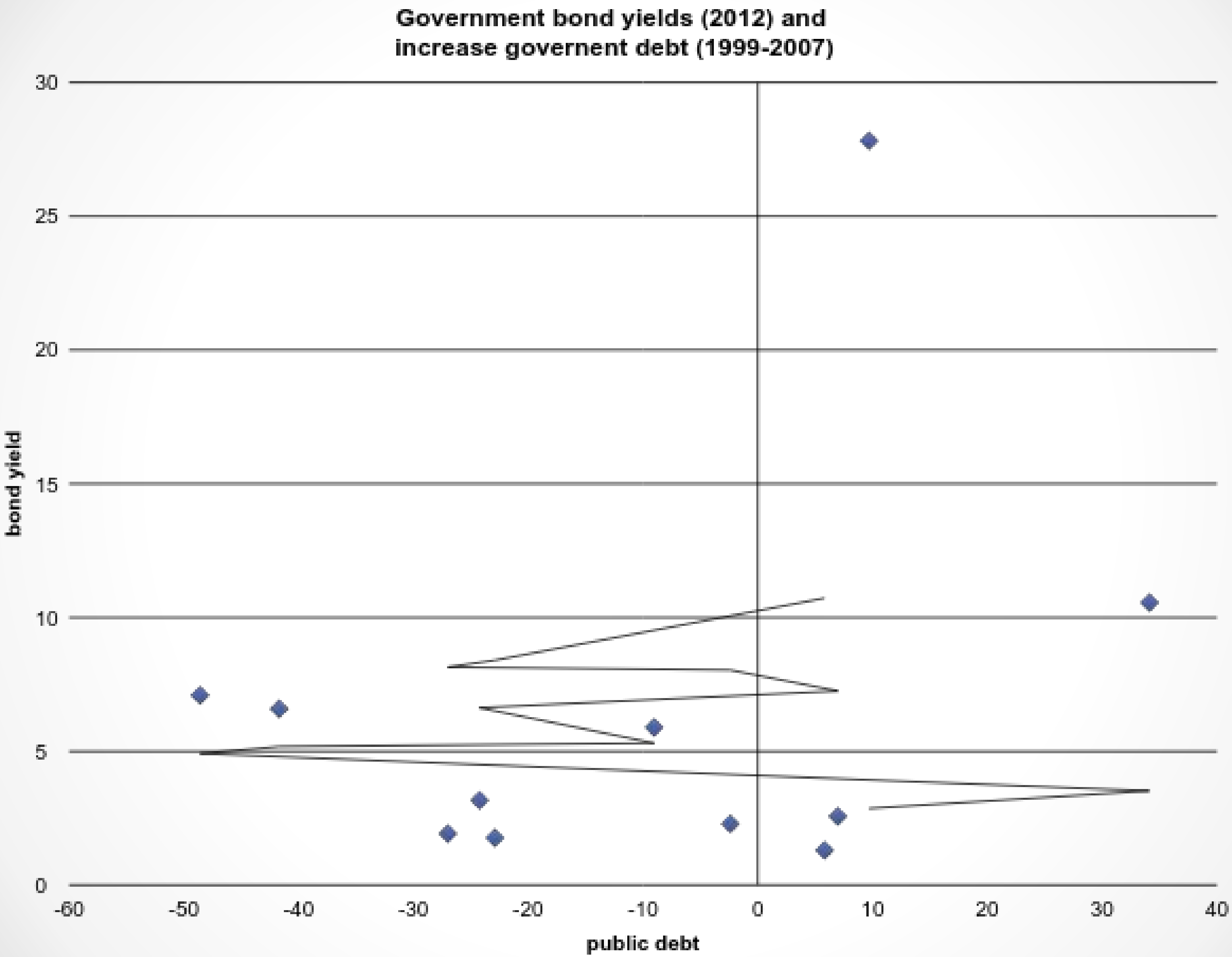
Outline of presentation

- Diagnosis of the Eurocrisis and its legacy
  - Stagnation and unsustainable debt
  - How to reboot the Eurozone
- Design failures of Eurozone
- Redesigning the Eurozone:
  - Role of central bank
  - Macroeconomic coordination
  - What kind of budgetary and political union?

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)
bond yield
30
25
20
15
10
5
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-60
-50
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-20
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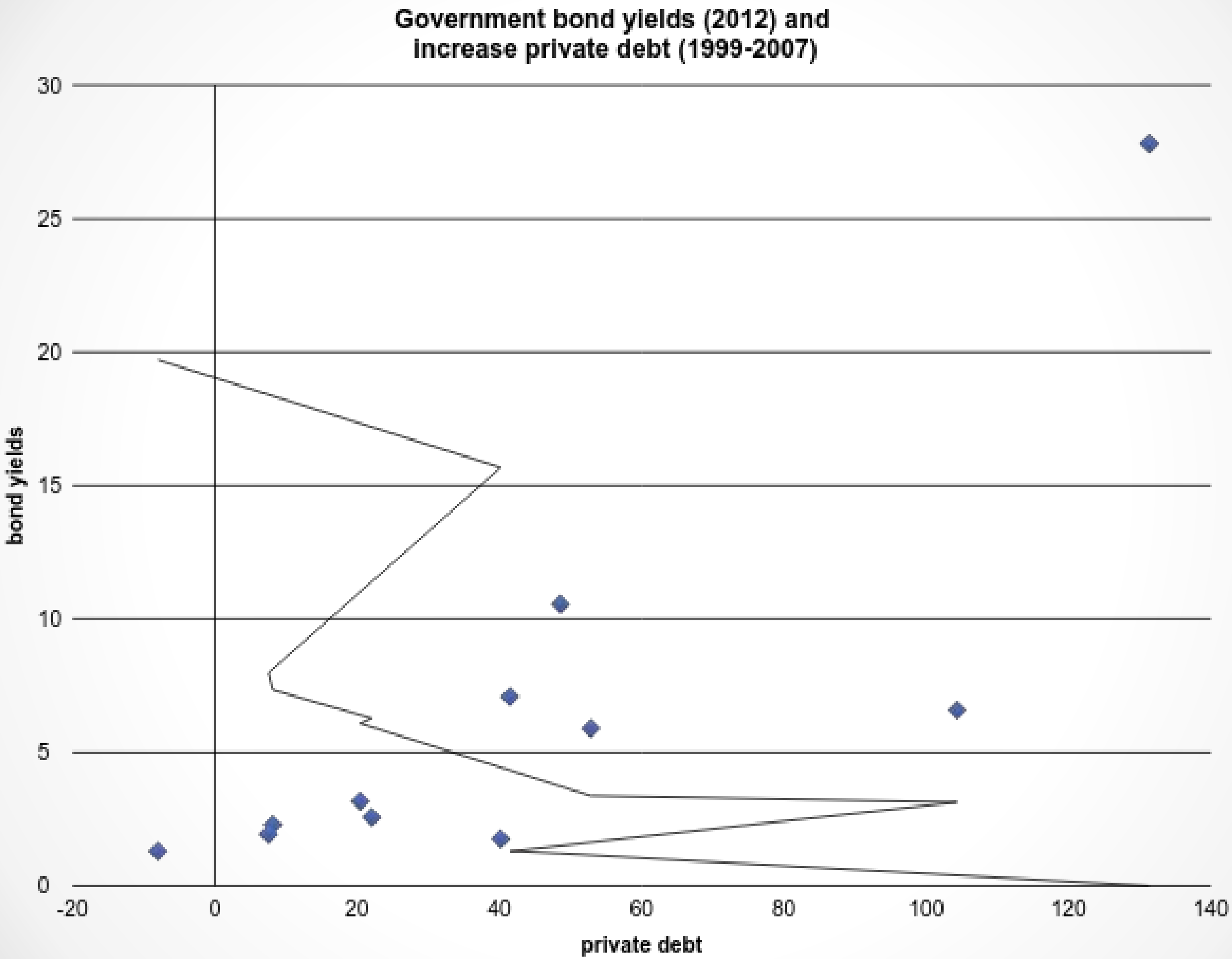
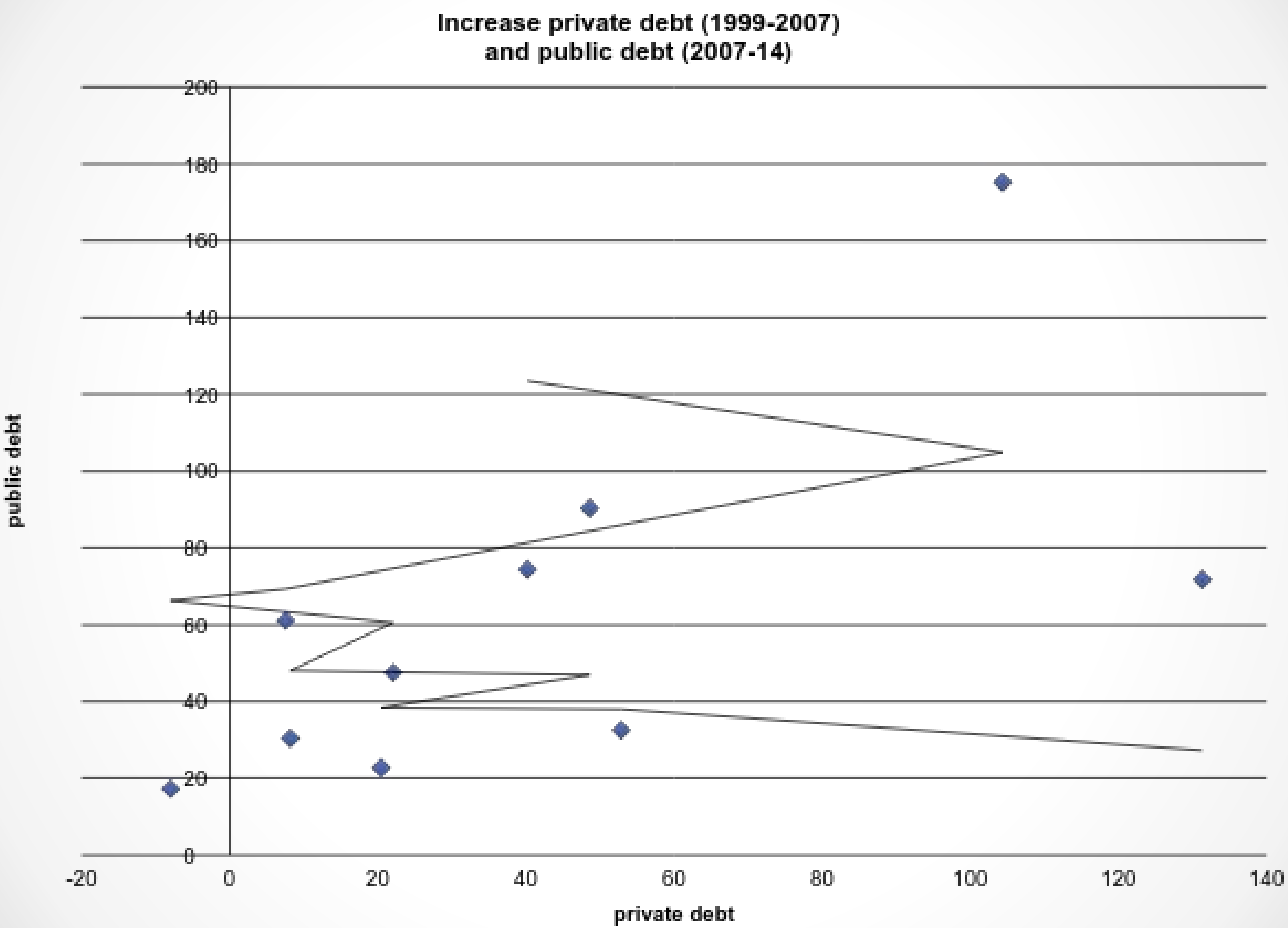
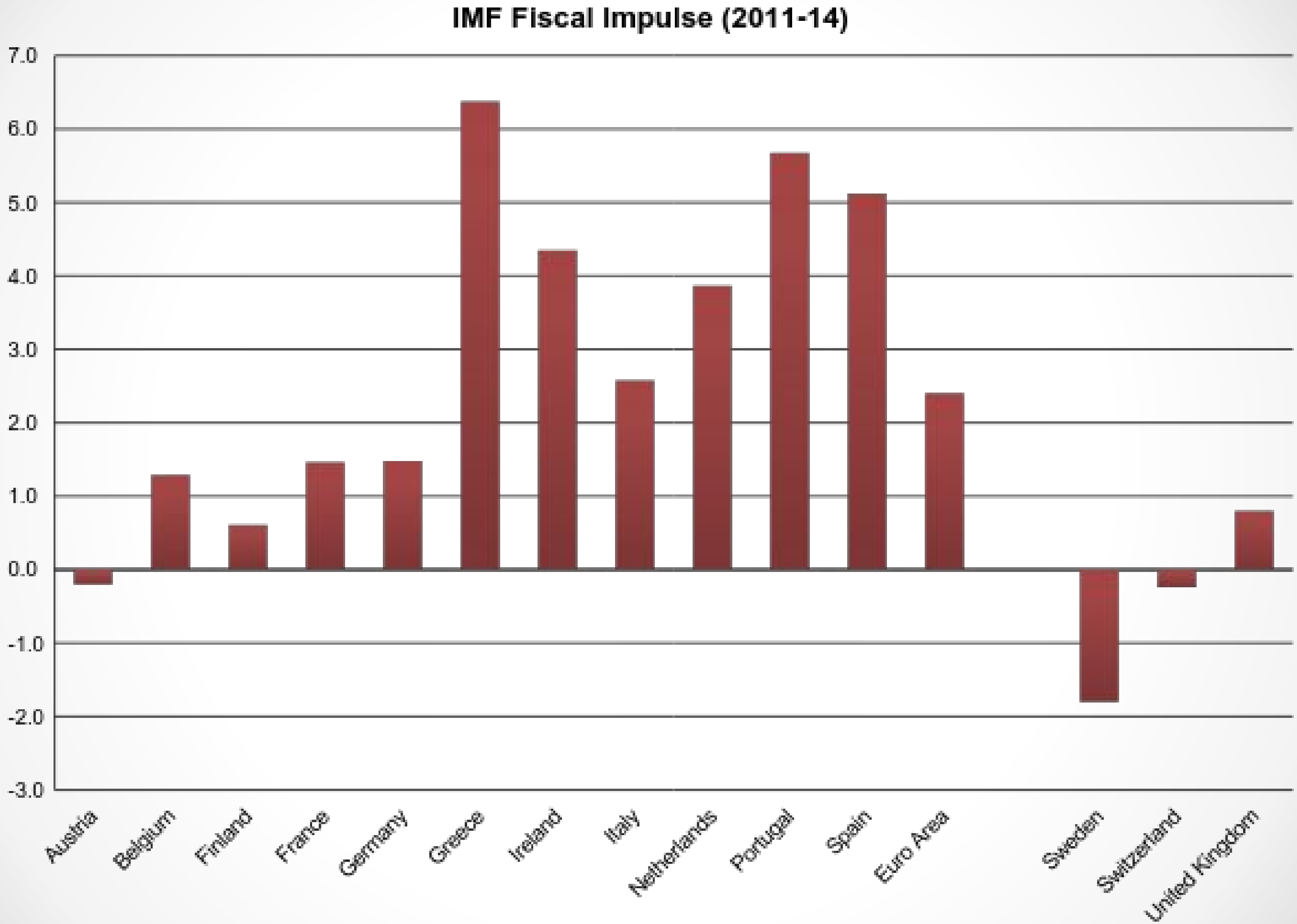
10
20
30
40
public debt

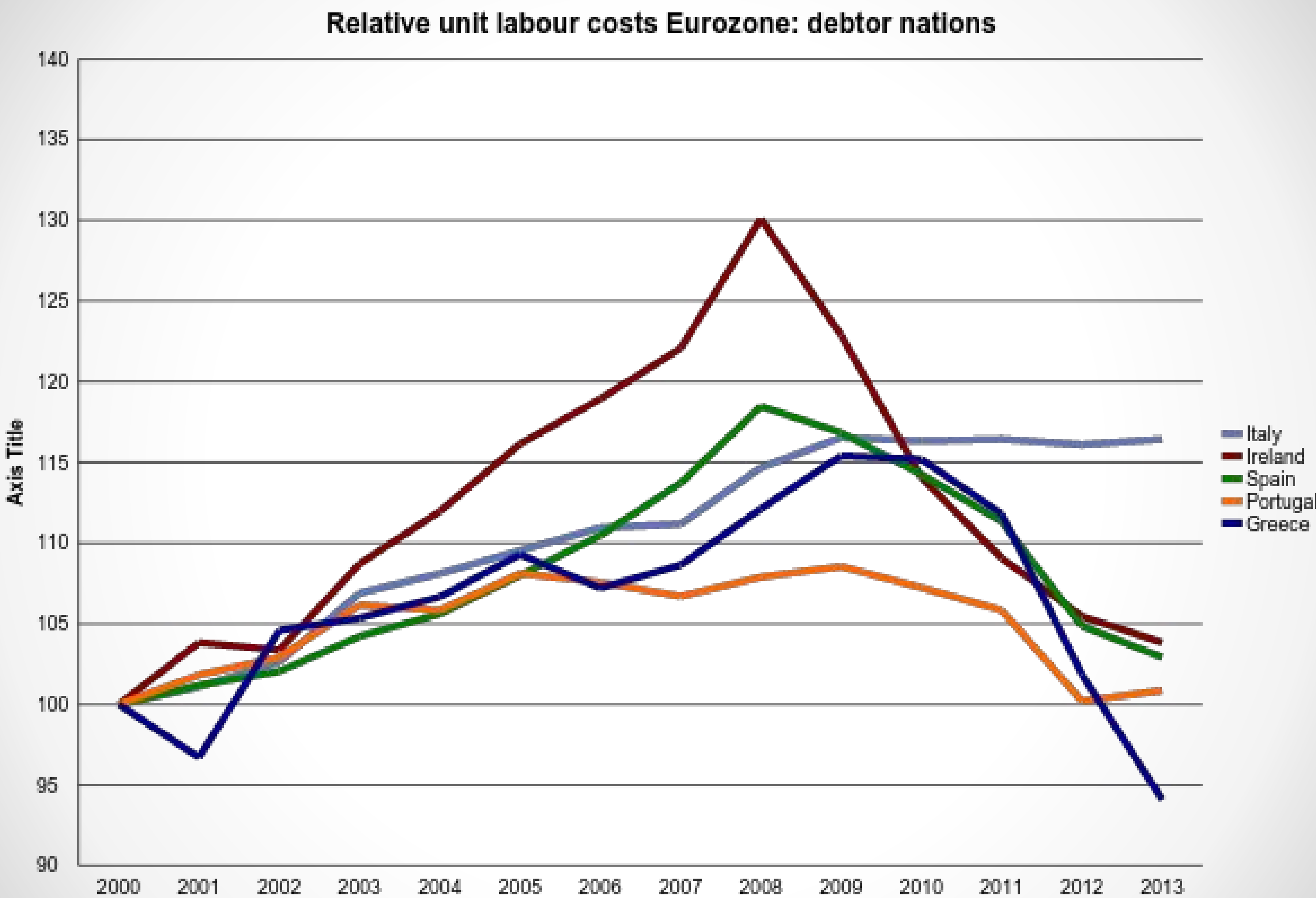

Government bond yields (2012) and
increase private debt (1999-2007)
bond yields
private debt
30
25
20
15
10
5
0
-20
0
20
40
60
80
100
120
140



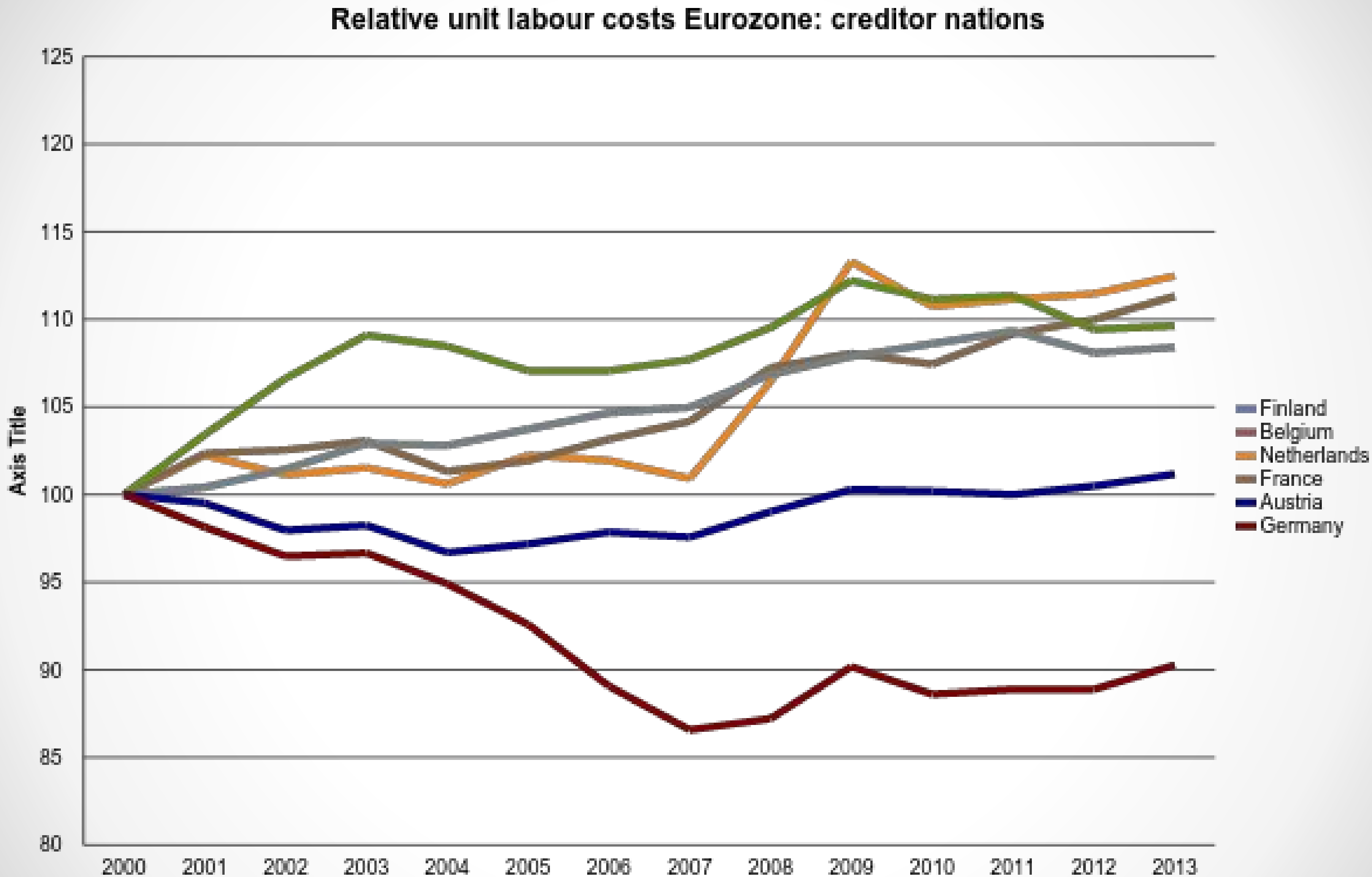
Increase private debt (1999-2007)
and public debt (2007-14)
public debt
200
180
160
140
120
100
80
60
40
20
0
-20
0
20
40
60
80
100
120
140
private debt

- We find that origin of crisis is a classical boom bust story
- 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
- Result: economic stagnation in Eurozone
- Let’s look at the evidence


IMF Fiscal Impulse (2011-14)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
Netherlands
Portugal
Spain
Euro Area
Sweden
Switzerland
United Kingdom



Relative unit labour costs Eurozone: debtor nations
140
135
130
125
120
115
110
105
100
95
90
Axis Title
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Italy
Ireland
Spain
Portugal
Greece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125
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100
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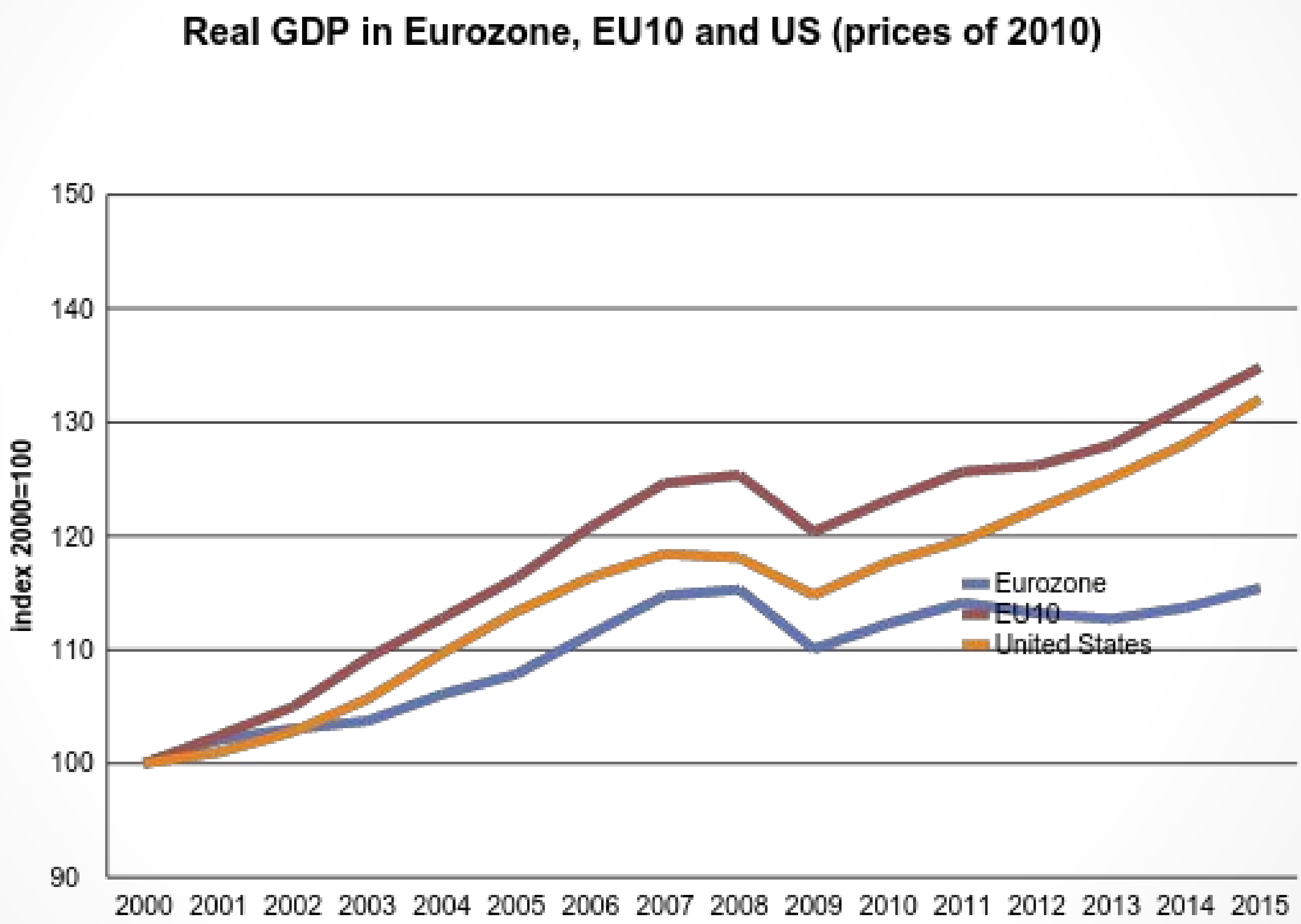
85
80
Axis Title
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Finland
Belgium
Netherlands
France
Austria
Germany

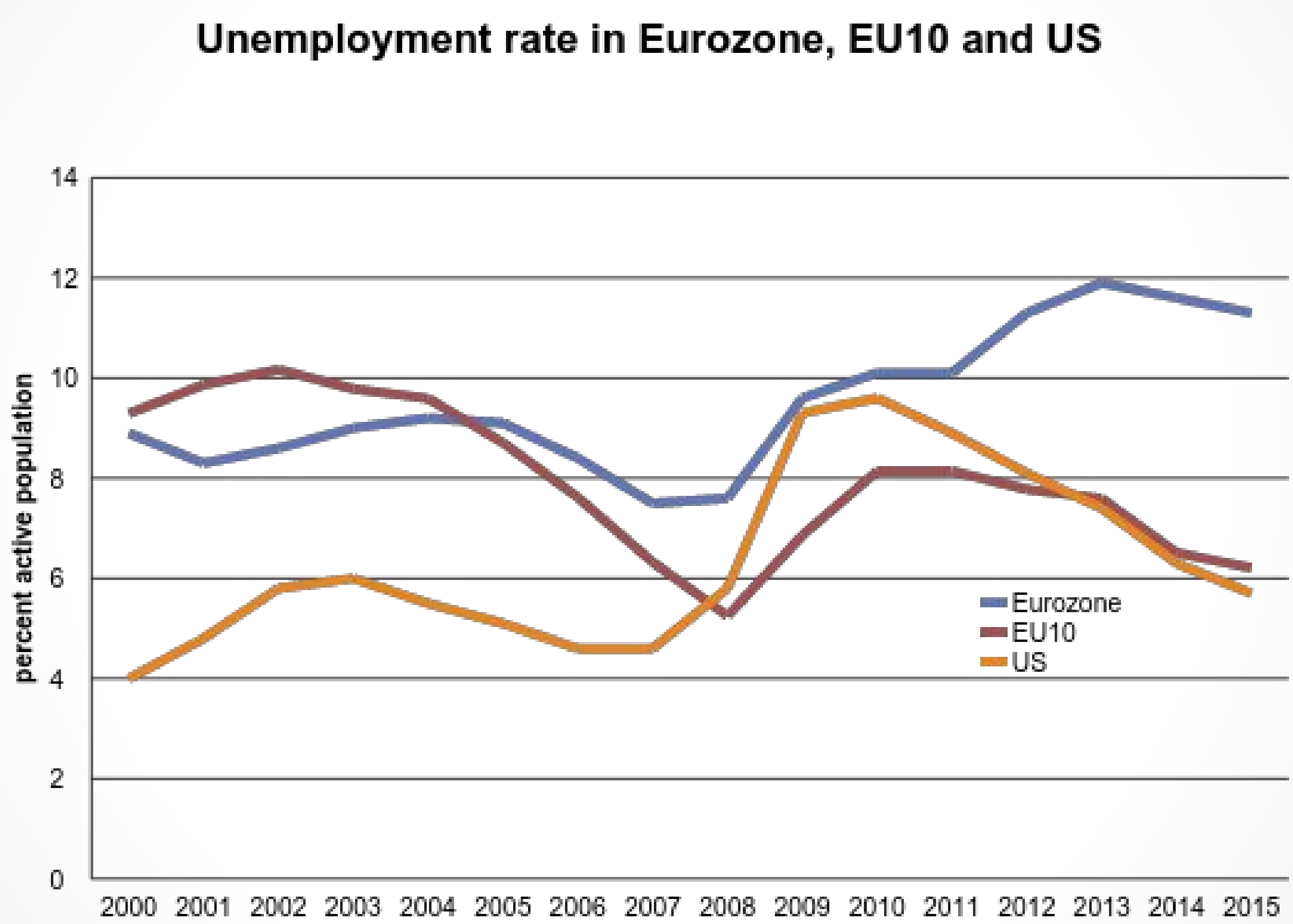
Interpretation

- The sovereign debt crisis that emerged in 2010 led to panic both in financial markets and in Brussels
- Leading to the imposition of austerity measures
- Mostly in the problem countries
- While the core countries also were led to engage in austerity, instead of stimulus
- These austerity programs reinforced each other in a system that is highly interdependent
- This led to double-dip recession in 2012-13 and slow recovery since then

Legacy Stagnation in Eurozone

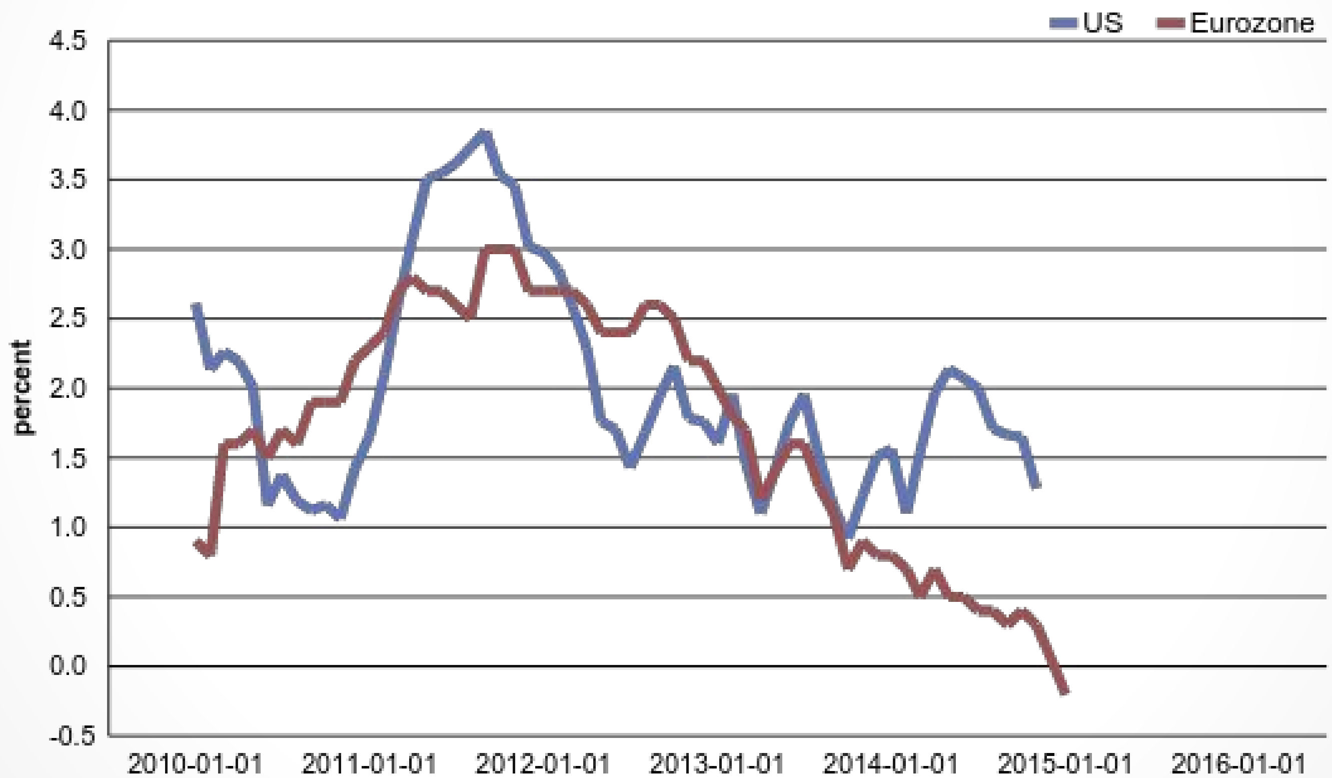


Increasing unemployment

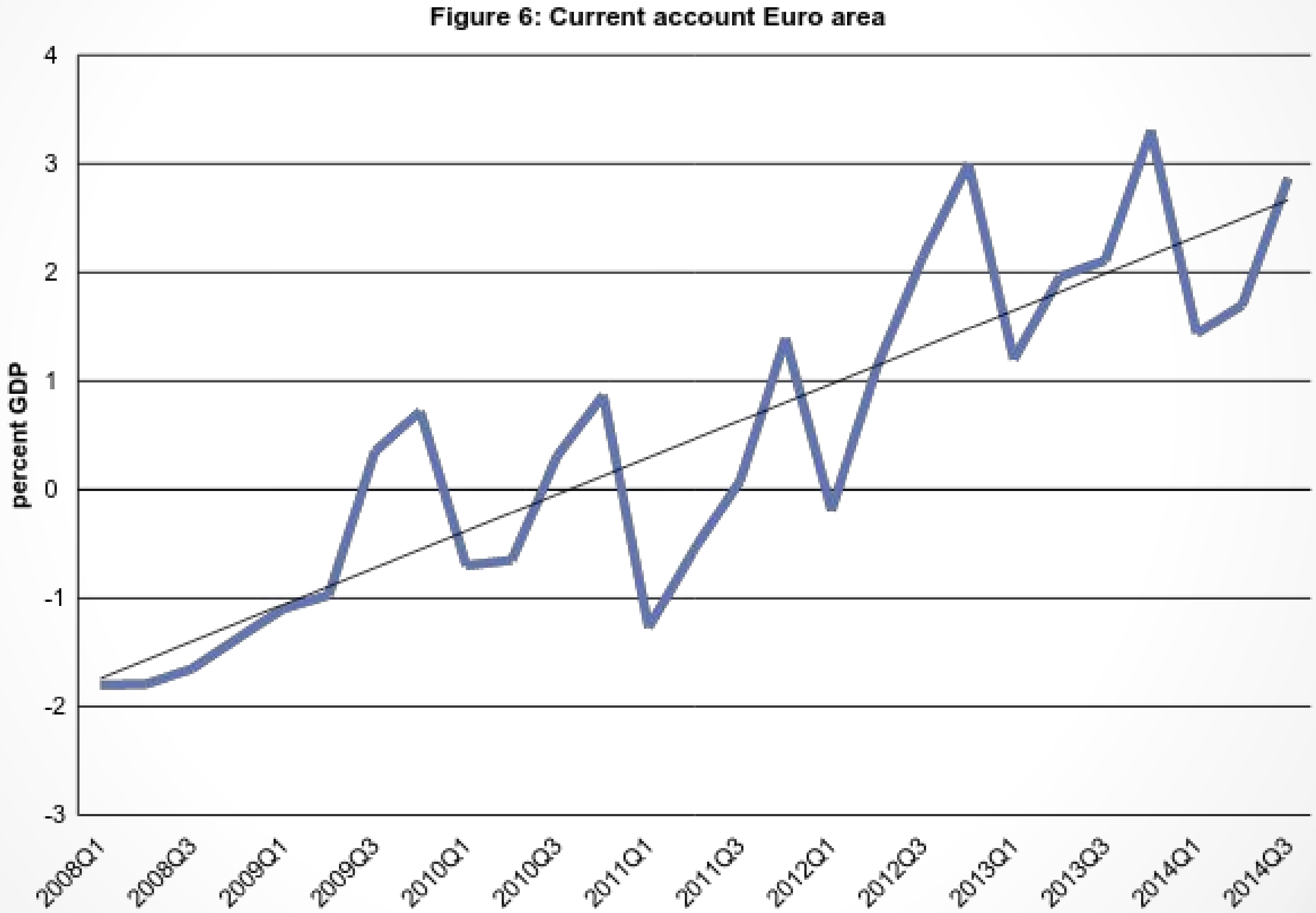


Deflation threat

Figure 7: Inflation in US and Eurozone



Increasing savings as a result of austerity



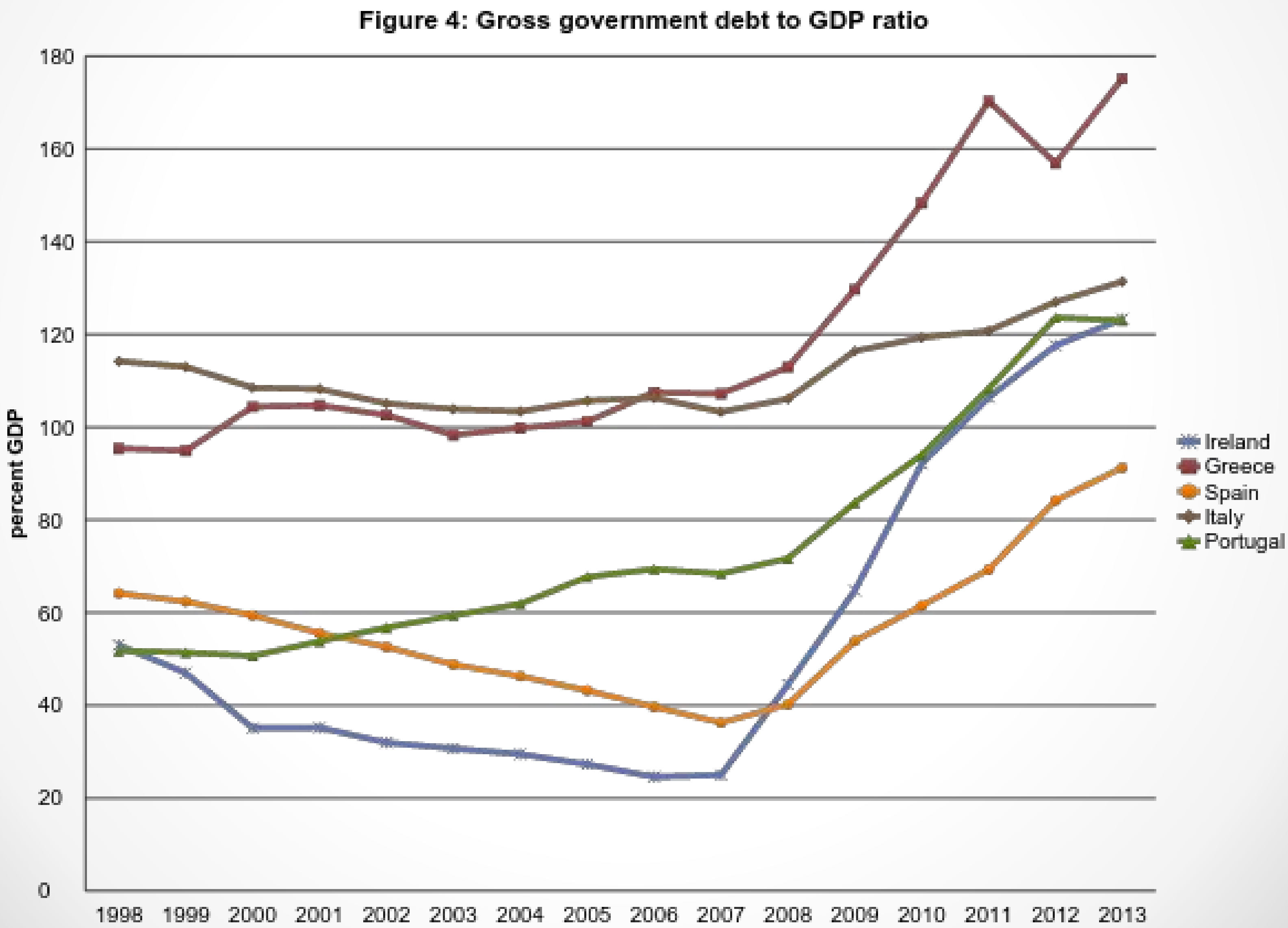
Fallacy of composition

- 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.

Legacy: unsustainable debt

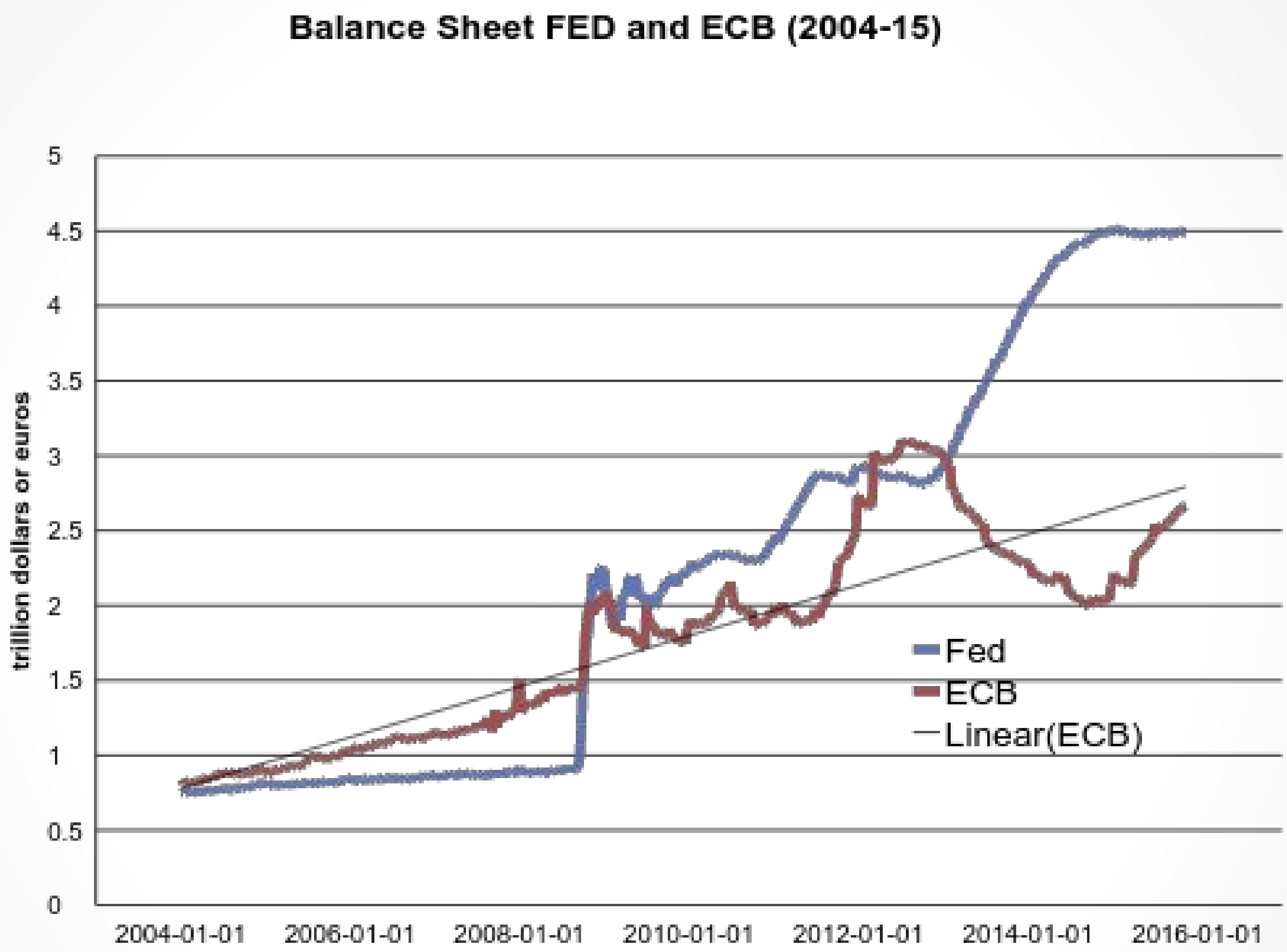
- Most striking feature of legacy of Eurocrisis is that despite intense austerity programs that have been triggered since 2010
- there is no evidence that these programs have increased the capacity of the governments of the debtor countries to continue to service their debt
- On the contrary: deflation makes it harder to reduce debt burdens

stagnation increases debt burdens



How to reboot Eurozone

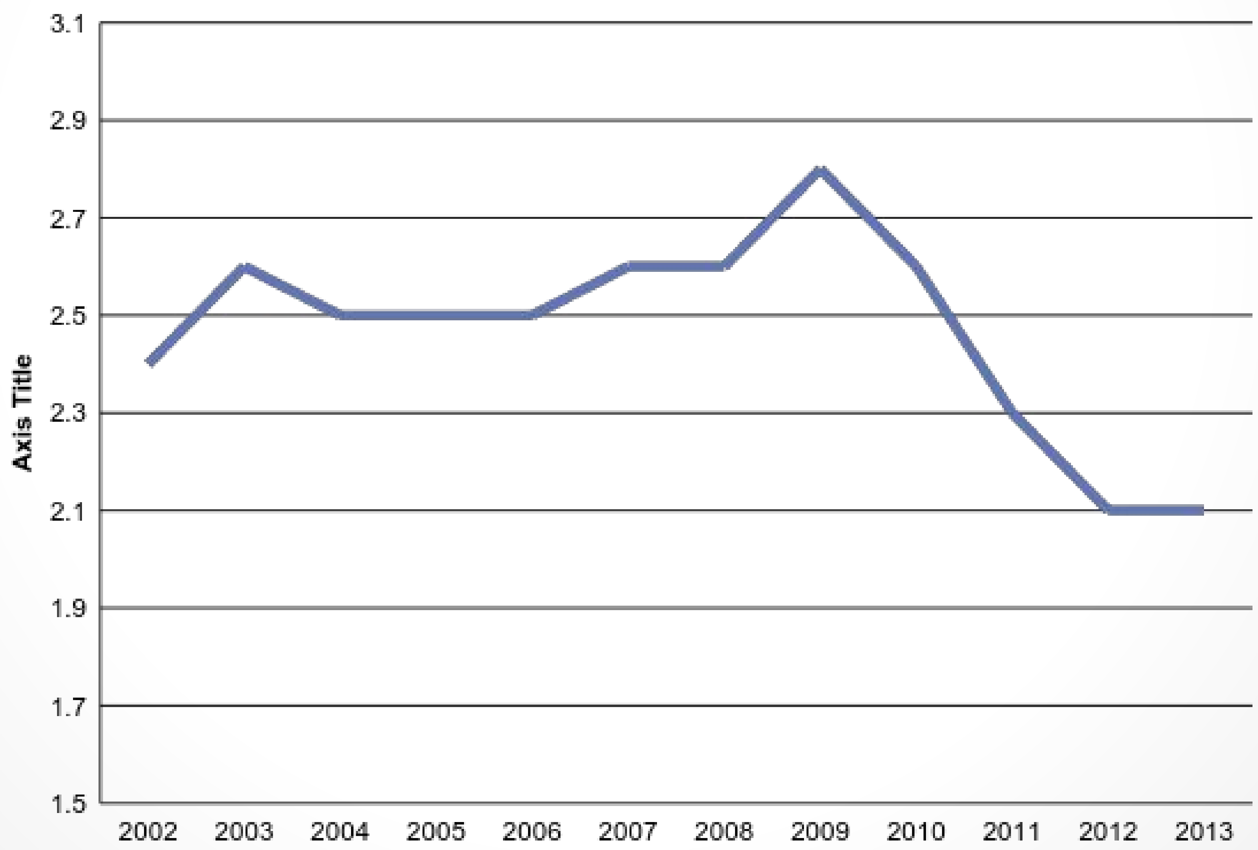
- There is no secret on how to do this:
- Monetary and fiscal policy mix of stimulus
- Since early 2015 monetary policy is on track to provide boost
  - It has suffered because of long delays
  - And major policy errors during 2013-14


Balance Sheet FED and ECB (2004-15)
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
trillion dollars or euros
2004-01-01
2006-01-01
2008-01-01
2010-01-01
2012-01-01
2014-01-01
2016-01-01
Fed
ECB
Linear(ECB)

- It is well-known that monetary policy stimulus is necessary but not sufficient when interest rates are close to zero: liquidity trap
- It has to be supplemented by fiscal stimulus
- In the Eurozone fiscal stimulus should primarily be focused on public investment.
- Because public investment has been the main victim of austerity
- Thereby reducing aggregate demand and long-term growth potential

Austerity programs led to strong decline in public investment

Figure 8: General government gross fixed capital formation (%GDP)



Throw away dogmas

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

And institute golden rule

- Public investments can be financed by bond issue
- Balanced budget rule should apply to the non-investment government expenditures

Why is it difficult to apply the right policy?

- Misdiagnosis of crisis which was mentioned earlier
- But misdiagnosis itself occurs because of deeper problem:
  - Ideological preconception that markets are self-equilibrating
  - So that prolonged situations of low demand and mass unemployment do not occur
  - Make sure that markets can function properly by structural reform
  - Example: organize labour market like potato market: if too many potatoes (workers) lower the price (wages)

- This ideological misconception also makes it difficult to accept that government should boost public investment
  - Governments are unproductive even wasteful
  - Only private sector is productive
  - Only minimal role for public investment in this view of the world.

- Second reason: the Eurozone has developed into a system where creditor nations impose their rule
- It derives from fragility of Eurozone
  - When distrusted by financial markets (rightly or wrongly) countries cannot defend themselves
  - They can be pushed into illiquidity and insolvency
  - They are at the mercy of the creditor nations

- By default we land into a political decision mode at the level of the Eurozone where creditor nations call the shots.
  - They are just concerned about getting their money back
  - And impose austerity on the debtor nations
  - Without any willingness to compensate the deflationary effects by fiscal stimulus

- What austerity programs in Eurozone illustrate is failure of conducting fiscal policies that are right for the system as a whole:
  - Nobody at Eurozone level is responsible for stabilization of the system
  - Fallacy of composition
- At the same time monetary policy was contractionary
- This led to wrong policy mix of fiscal and monetary contraction
- There is therefore no surprise in the stagnation of the Eurozone

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 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

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 switched off

Redesigning the Eurozone

How to redesign the Eurozone

- Role of ECB
- Coordination of macroeconomic policies in the Eurozone
- Budgetary and Political Union

Role of the ECB

- ECB: lender of last resort: OMT
- Criticism

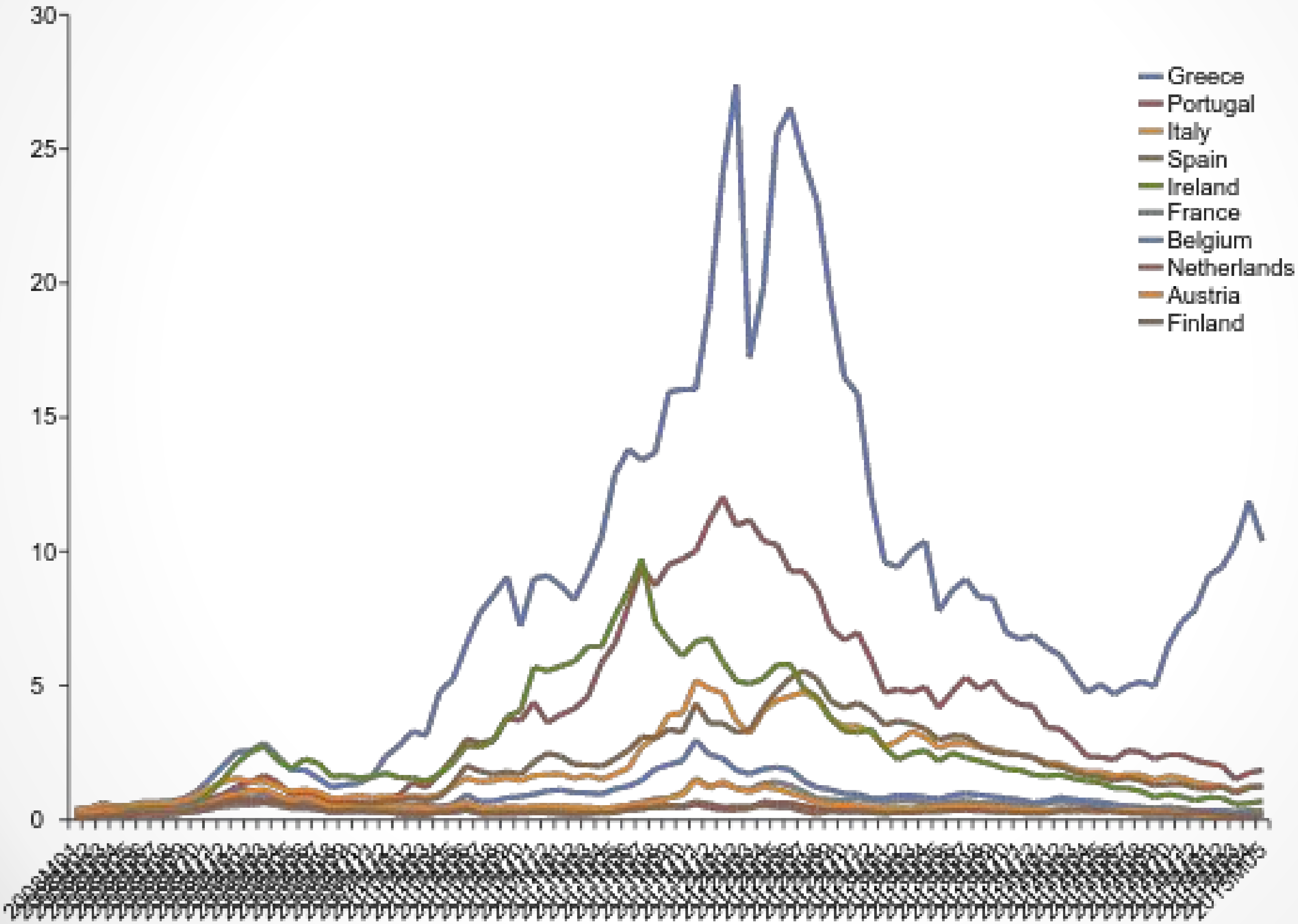
The common central bank as lender of last resort

- 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 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
- But then ECB waited too long to stop deflationary dynamics
- Only in January 2015 did it act to fight deflation
- I return to this issue

Criticism of OMT

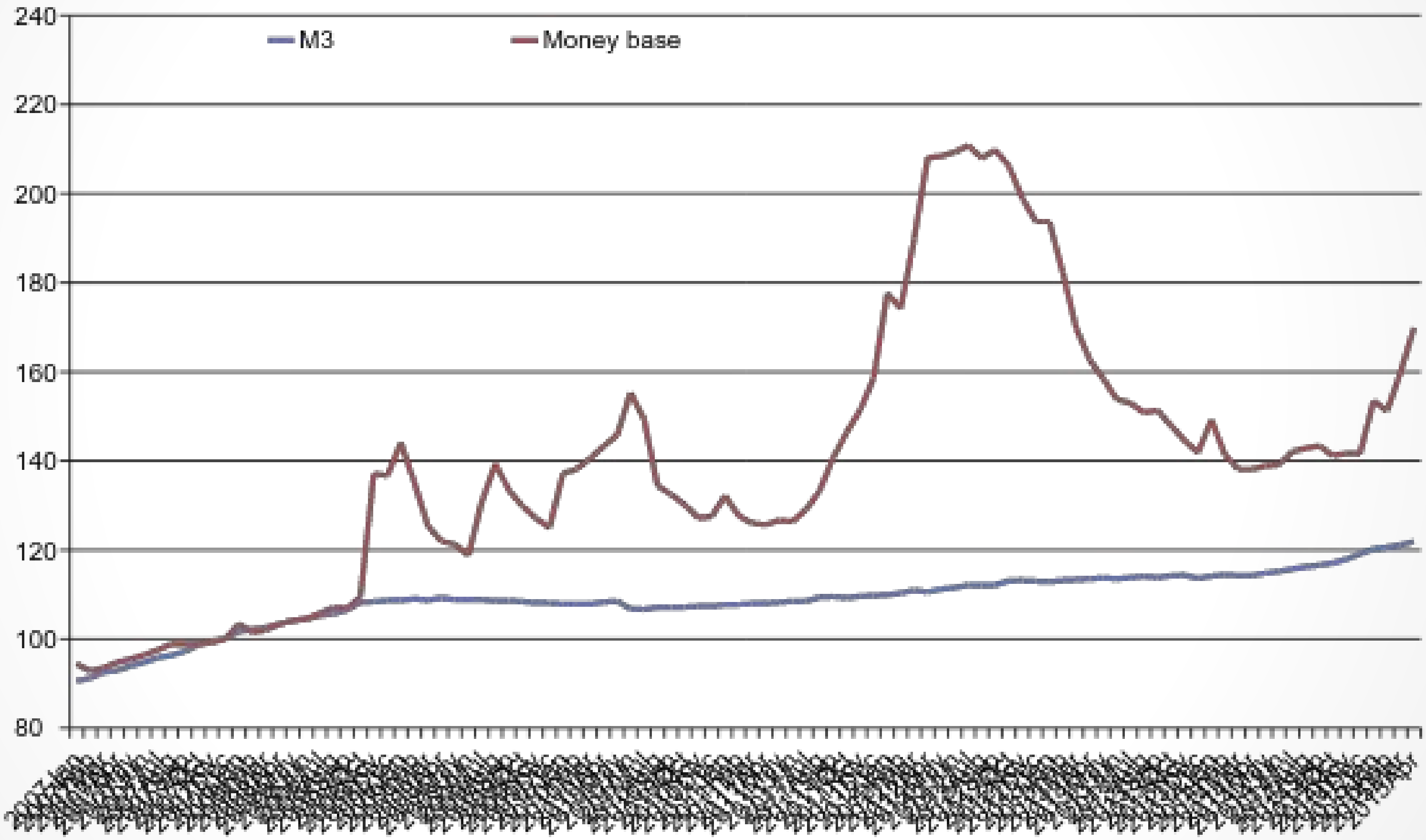
- Points of criticism
  - Inflation risk
  - Moral hazard
  - Market efficiency
  - Fiscal implications
- Is this criticism valid?

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=100

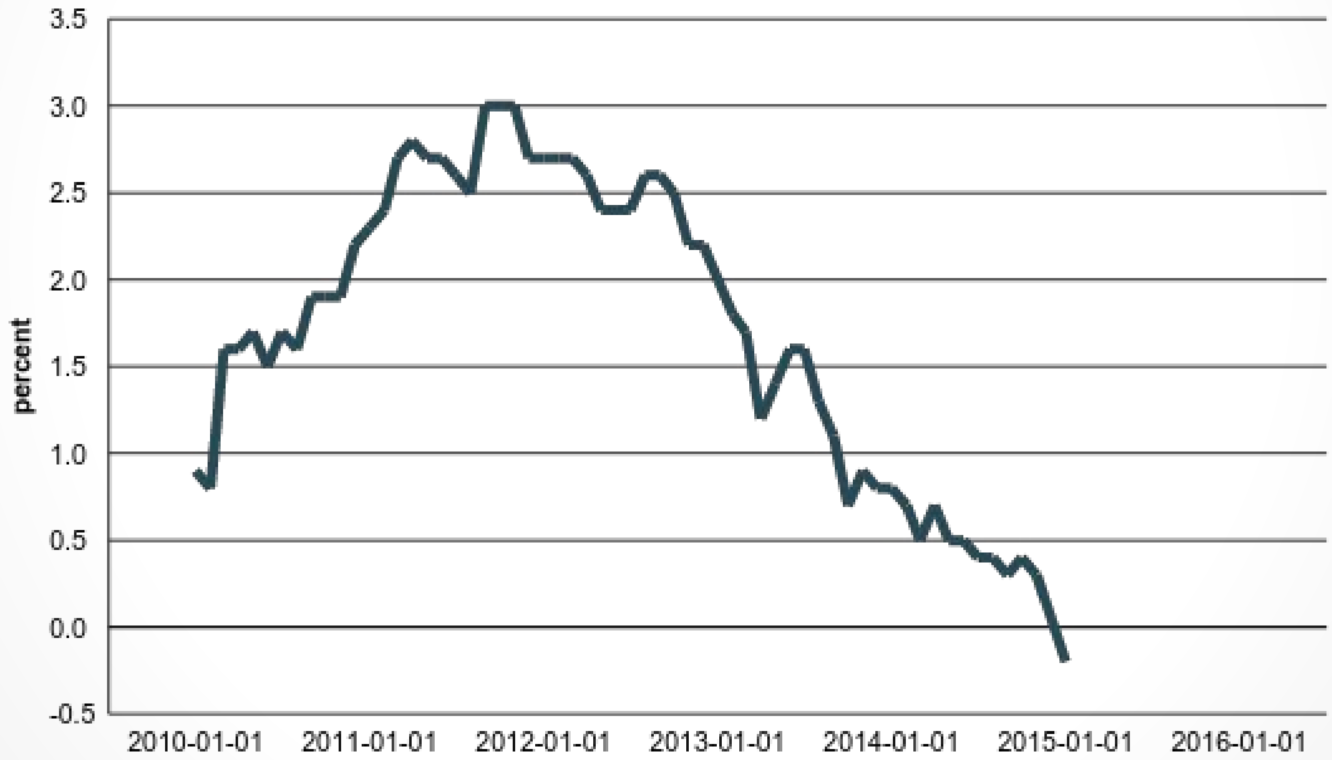


- Source: European Central Bank, Federal Reserve System, Bank of England

- 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)

Deflation threat

Figure 7: Inflation in Eurozone



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.

Market efficiency

- Spreads reflect underlying economic fundamentals.
  - argument developed by German Constitutional Court
  - Attempts by ECB to reduce spreads are attempts to counter the view of market participants.
- ECB is in fact pursuing economic policy, which is outside its mandate.
- Implicit in this argument is assumption of market efficiency
  - spreads observed from 2010 to the middle of 2012 were the result of deteriorating fundamentals
  - Thus, the market was just a messenger of bad news.
- Implication of efficient market theory is that the only way these spreads can go down is by improving the fundamentals, mainly by austerity programs

- I have argued that markets are sometimes gripped by panic.
- These movements can drive the spreads away from underlying fundamentals,
  - very much like in the stock markets prices can be gripped by a bubble pushing them far away from underlying fundamentals.
- In absence of central bank this can lead to sudden stop (liquidity crisis)
- Countries can be pushed in bad equilibirum
- Role of central bank is to avoid this outcome

Fiscal consequences

- Fourth 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
- This is same criticism leveled against QE

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

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.

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Who prevails?

- In the US and the UK: primacy of the government over the central bank,
    - 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.
    - 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,
  - as it is in modern democracies such as the US, Sweden, the UK, etc.
- Can only be achieved by a Eurozone government
  - backed by a European parliament
  - 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;

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However

- This procedure is implemented in asymmetric way
  - Deficit countries experience much more pressure to act, i. e. to reduce spending than surplus countries
- Competitiveness measures have same problem
  - This leads to downward pressure on wages
  - In name of competitiveness everybody tries to reduce wages
- Deflationary bias is not solved

Towards a political union

Most important component of political union is 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.
   - This prevents destabilizing capital movements within the Eurozone
   - and protects the member states from being forced into default by financial markets.
   - This restores the balance of power in favour of the sovereign and against the financial markets

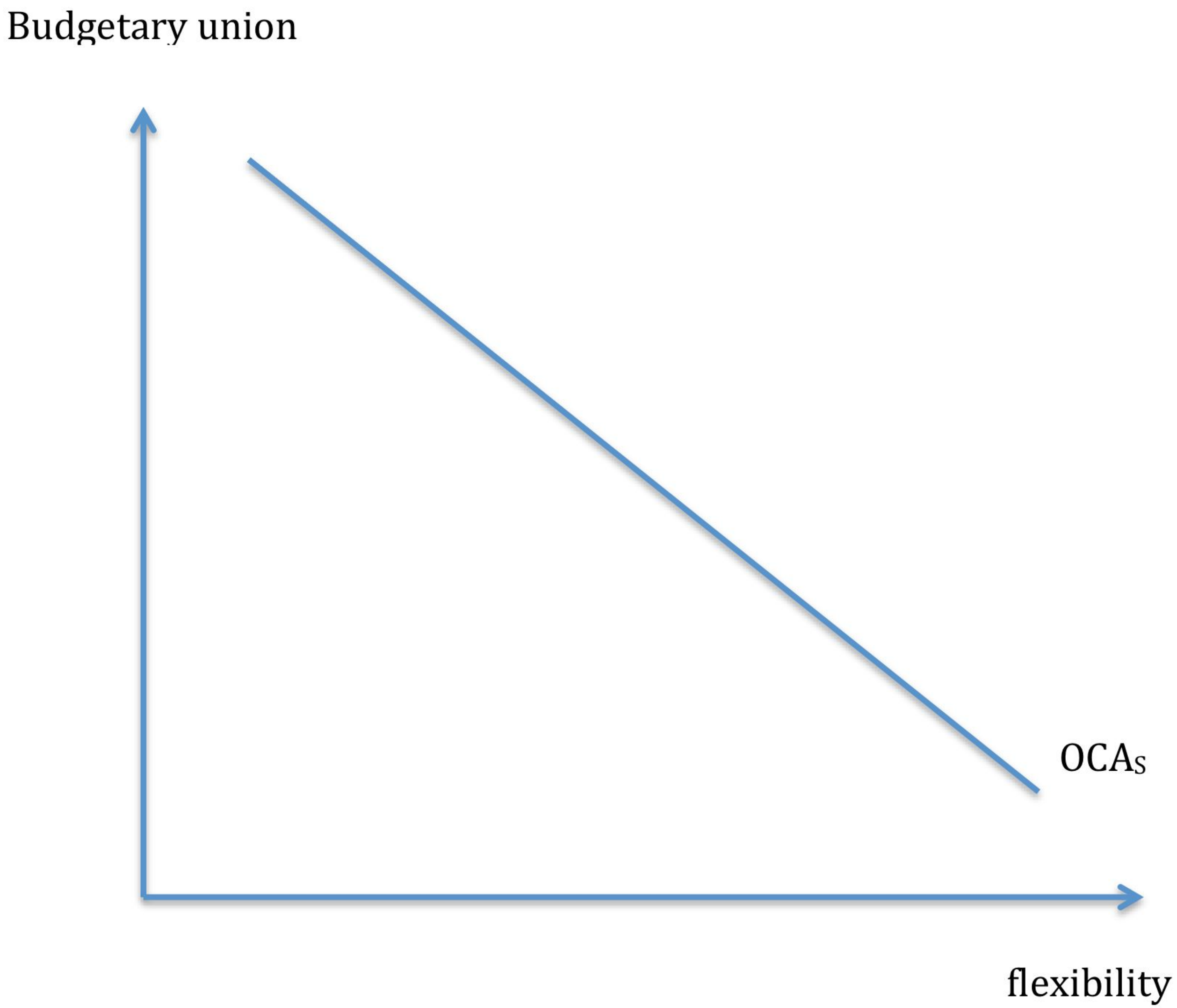
2. Insurance mechanism

- 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

The case for a budgetary union

- The case for a significant budgetary union is a strong one
- Let me develop the case

Figure 1: Tradeoff between budgetary union and flexibility



Implications

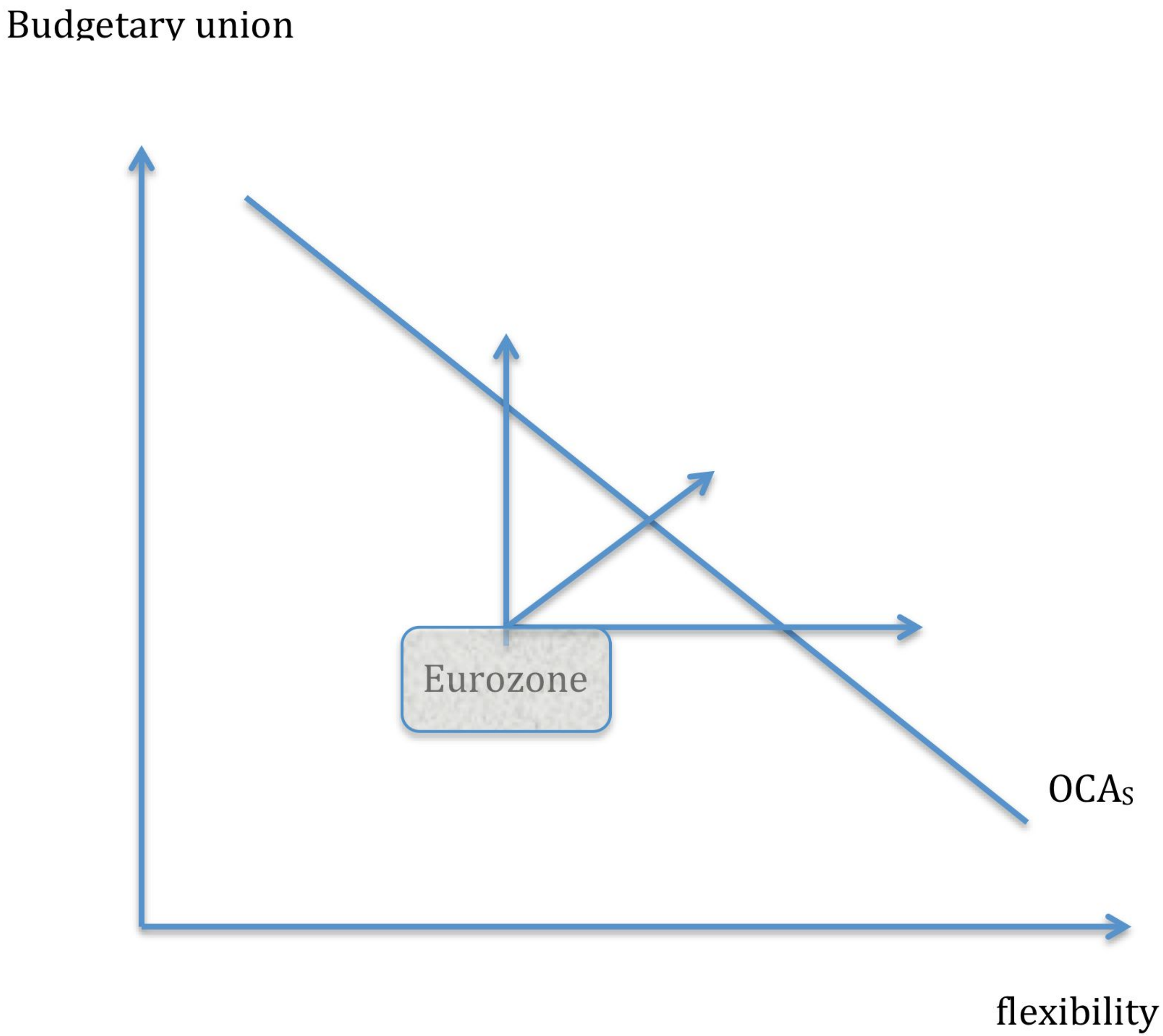
- Flexibility may sound great for many economists and central bankers. It is, however, costly for most people that are forced to be flexible.
- Flexibility means that these people may have to accept a wage cut or may be forced to emigrate.
- We learn from previous Figure that a movement towards budgetary union alleviates the (painful) need to be flexible.
- It may also make a monetary union more acceptable to large segments of the population.

Nature of shocks

- Two types of asymmetric shocks:
  - Exogenous asymmetric shocks: permanent shocks like productivity shock; mostly supply shocks
  - Endogenous shocks: they are result of unsynchronized business cycle movements. Driving force: animal spirits that lead to booms and busts

- When a permanent (exogenous) supply shock occurs flexibility is only option to adjust to shock.
- When asymmetric demand shocks occur it is not optimal to use flexibility.
  - In that case fiscal transfers (insurance) is appropriate response.
  - This is provided by a budgetary union.

Figure 2: How to move the Eurozone towards the OCA$_S$-area?



- Previous figure suggests that the present Eurozone is not an optimal currency area.
- When exogenous asymmetric supply shocks prevail, the Eurozone will have to move along the horizontal arrow to become optimal. (more flexibility is needed).
- If endogenous asymmetric demand shocks prevail (booms and busts), Eurozone must move along the vertical arrow to become optimal.
  - In this case flexibility does not help.
  - Instead a common insurance mechanism (provided by a budgetary union) becomes necessary to deal with these shocks.

Additional insight

- Flexibility in labour markets is something national governments can do. There is no need to further integration to increase flexibility.
- Budgetary union, however, is of a different nature. It requires political integration.
- In other words while flexibility is in the realm of national governments, budgetary union is a European affair (Sapir(2015).

Empirical evidence about nature of shocks

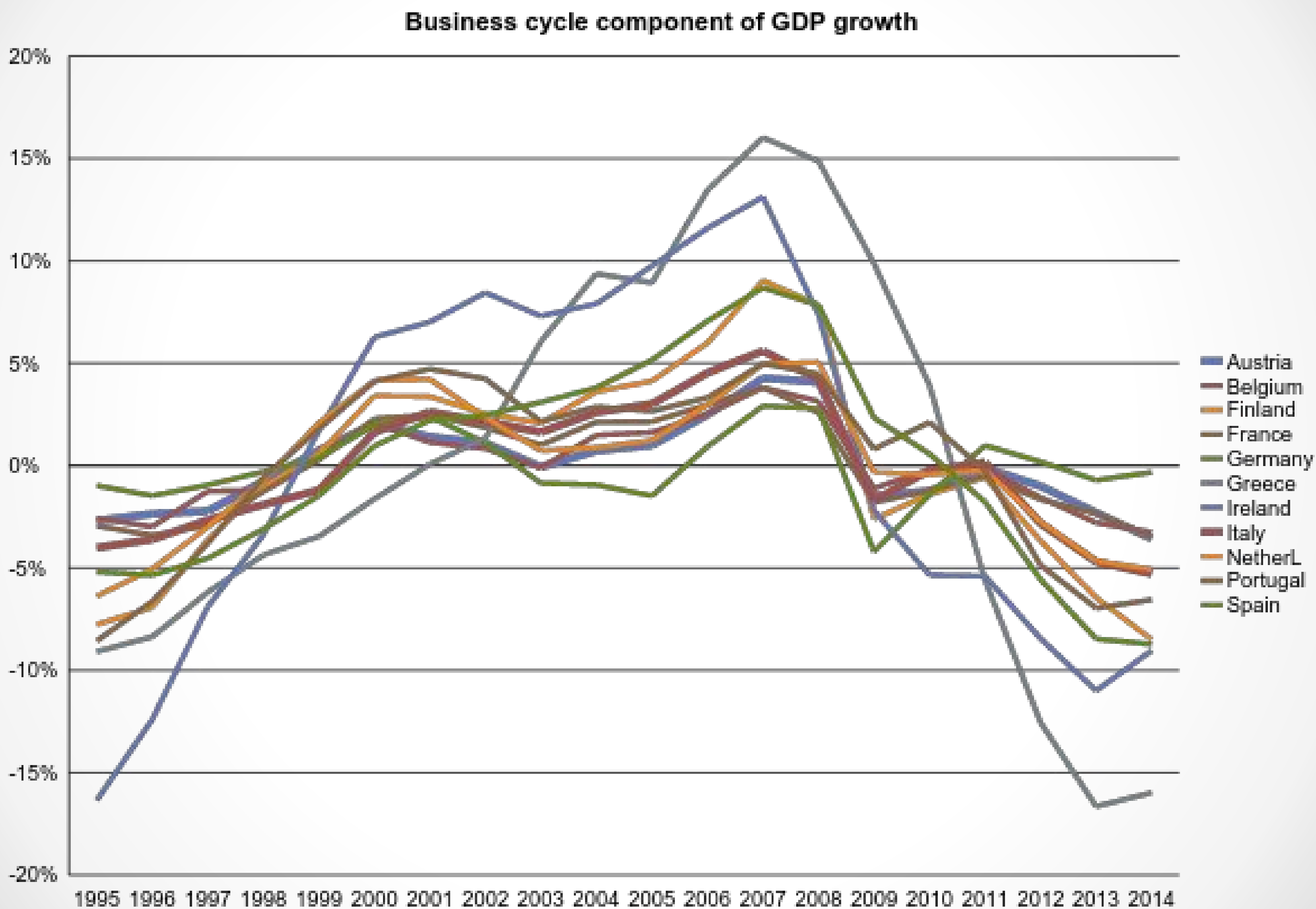
- We compute trend and cyclical components of GDP of Eurozone countries
- Using HP-filter
- and then compute correlations
- And relative variance of cyclical and trend component

Correlation coefficients cyclical components GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Netherl	Port
Austria										
Belgium	0,97									
Finland	0,97	0,98								
France	0,93	0,95	0,97							
Germany	0,69	0,57	0,55	0,59						
Greece	0,73	0,82	0,84	0,74	0,09					
Ireland	0,85	0,89	0,92	0,95	0,41	0,81				
Italy	0,91	0,96	0,98	0,96	0,50	0,86	0,93			
Netherlands	0,93	0,94	0,93	0,91	0,60	0,75	0,86	0,90		
Portugal	0,98	0,89	0,89	0,87	0,37	0,82	0,87	0,90	0,94	
Spain	0,85	0,91	0,94	0,87	0,27	0,97	0,90	0,95	0,86	0,90

Mean trend growth and mean (absolute) business cycle change in GDP (in percent) during 1999-2014

	Mean cycle	Mean trend	ratio
Austria	1,79%	1,77%	1,01
Belgium	1,72%	1,67%	1,03
Germany	1,55%	1,23%	1,26
France	2,15%	1,49%	1,44
Netherlands	2,66%	1,66%	1,60
Finland	4,35%	2,02%	2,15
Spain	4,58%	2,07%	2,21
Ireland	8,01%	3,35%	2,39
Portugal	3,67%	0,81%	4,53
Italy	2,86%	0,41%	7,05
Greece	9,09%	0,90%	10,11



Business cycle component of GDP growth
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014
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

- We found overwhelming importance of the cyclical component of output growth
- This leads to conclusion that efforts at stabilizing the business cycle should be strengthened relative to the efforts that have been made to impose structural reforms.
- In terms of Figure 3 this means that one should pursue efforts along a relatively steep upward sloping path
- This calls for budgetary union

- We have also found that business cycles are well synchronized but that intensity of booms and busts is not
- This makes standard proposals to create fiscal space at Eurozone level (e.g. unemployment insurance schemes) problematic
    - These work well when business cycles are desynchronized
    - Then: Countries in boom contribute to countries in recession
    - But when all countries experience boom and bust at the same time but with different intensities such an insurance scheme is not optimal
    - It dampens cycle in one country at expense of making it more intense in other country
    - And it creates political problems

- Put differently: most countries are likely to experience a boom and a recession at about the same time,
- But with different intensities and amplitudes.
- There is therefore relatively little need for inter-country smoothing of business cycle movements.
- The more pressing need is to smoothen volatilities over time.

- In principle, this kind of smoothing (over time) could be done at the national level
- However, the large differences in the amplitude in the business cycle movements makes a purely national approach impractical
  - it leads to large differences in the budget deficits and debt accumulation between countries.
  - These differences quickly spillover into financial markets when countries that are hit very hard by a downward movement in output 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.
- To avoid all this a common approach is necessary.
- Budgetary union, including mutualisation of debt, is only way to deal with this.

Integration fatigue

- Willingness today to move in the direction of a budgetary and political union in Europe is non-existent.
- This will not only continue to make the Eurozone a fragile institution
- It forces a hegemonic political union by default
-

Hegemonic political union

- Absence of institutional steps towards political union has introduced a political system where creditor nations impose their rule
- It derives from fragility of Eurozone
  - When distrusted by financial markets (rightly or wrongly) countries cannot defend themselves
  - They can be pushed into illiquidity and insolvency
  - They are at the mercy of the creditor nations

- De facto and by default we land into a political decision mode at the level of the Eurozone where creditor nations call the shots.
- This is an hegemonic political union
- Such a union will be rejected
- It is unsustainable
- That's why we have to move to a political union based on democratic principles

Objection

- Some will object: all this is not necessary
- All what is needed is disciplining national governments
- This view overlooks the nature of capitalism with its booms and busts
- These will regularly push some countries (even the disciplined ones) into crisis mode (illiquidity and threats of insolvency)
- We have to create a political union that is fit to deal with these booms and busts
- This can only be through budgetary union

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