Design Failures in the Eurozone. Can they be fixed?

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A short history of capitalism

- Capitalism is a wonderful human invention steering individual initiative and creativity towards capital accumulation and ever more material progress.

- It is also inherently unstable, however.

- 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.
Booms and busts are endemic in capitalism

- Many economic decisions are forward looking.
- Investors and consumers look into the future to decide to invest or to consume.
- But the future is dark. Nobody knows it.
- As a result, when making forecasts, consumers and investors look at each other.
- This makes it possible for optimism of one individual to be transmitted to others creating a self-fulfilling movement in optimism.
Animal spirits and self-fulfilling dynamics

• Optimism induces consumers to consume more and investors to invest more, thereby validating their optimism.

• The reverse is also true. When pessimism sets in, the same contagion mechanism leads to a self-fulfilling decline in economic activity.

• Animal spirits prevail.
Role of banking sector

- During euphoria and booms households and firms cheerfully take on debt to profit from perceived high rates of return
- Banks jump on this and provide credit
- Excessive debt accumulation made possible by excessive bank credit
- Until crash
- Deleveraging becomes necessary both by banks and non-banks
- Deep recession
Stabilizing an unstable system

- The involvement of financial institutions in booms and bust dynamics makes capitalism particularly unstable
- Since Great Depression we have learned to bring in some stabilizers
- that have softened the instability
- Two stabilizers:
  - Central Bank as a Lender of Last Resort
  - Government budget as an automatic shock absorber
Lender of Last Resort

- Central Banks were originally created to deal with inherent instability of capitalism

- Were given double task:
  - Lender of last resort for banks: backstop to counter panic and run on banks
  - Lender of last resort of governments: to counter run in government bond markets

- Why this double task?
Deadly embrace

- Banks and governments face same problem: unbalanced maturity structure of assets and liabilities
  - Making both banks and governments vulnerable for movements of distrust
  - Which will lead to liquidity crisis
  - And can degenerate into solvency crisis
  - I will develop this point further

- Banks and governments hold each other in deadly embrace:
  - When banks collapse sovereign is in trouble
  - When government collapses banks are in trouble
Government budget as shock absorber

- The need to have government budget is shock absorber is based on Keynes’ savings paradox.

- When after crash private sector has to reduce debt it does two things:
  - It tries to save more
  - It sells assets

- Private sector can only save more if government sector borrows more (i.e. higher budget deficit).

- If government also tries to save more, attempts to save more by private sector are self-defeating and economy is pulled into deflationary spiral.
Stabilizers are organized at national levels

- These stabilizing features relatively well organized at the level of countries (US, UK, France, Germany)
- Not at international level nor at the level of a monetary union like the Eurozone
- These design failures were only recognized after the financial crisis.
- And even then in many countries, especially in Northern Europe still not recognized because of dramatic diagnostic failure, focusing on government profligacy
Eurozone’s design failures: in a nutshell

1. Endogenous dynamics of booms and busts 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. Let me expand on these two 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
Monetary union can exacerbate national booms and busts

- In fact the existence of the monetary union can exacerbate booms and busts at the national level.

- This has to do with the existence of only one policy interest rate when underlying macroeconomic conditions are very different.

- The fact that only one interest rate exists for the union exacerbates these differences,
  - i.e. it leads to a stronger boom in the booming countries and
  - a stronger recession in the recession countries than if there had been no monetary union.
Average yearly inflation differential (y-axis) and average change in relative unit labour cost (x-axis)
Increasing current account imbalances

Source: Citigroup, Empirical and Thematic Perspectives, 27 January, 2012
Design failure II: no stabilizers left in place

- Absence of lender of last resort in government bond market
- 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 bondholders 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
- Back to pre-1930s conditions
Source: Financial Times, [http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JS0wncy](http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JS0wncy) and Datastream
Source: Financial Times, [http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JS0wncys](http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JS0wncys) and Datastream

Figure 4

Austerity (2011) and GDP growth (2011-12)

\[
y = -1.4419x + 3.6454
\]

\[R^2 = 0.8601\]
Austerity (2011) and increases in Government Debt/GDP (2010IV-2012III)

\[ y = 3.4745x + 4.2737 \]
\[ R^2 = 0.85037 \]

Source: Financial Times, [http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JS0wncys](http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JS0wncys) and Datastream

Note: The Greek government/debt ratio excludes the debt restructuring of end 2011 that amounted to about 30% of GDP
Design Failure III
Deadly embrace between banks and sovereign

- Once in bad equilibrium a third design failure was exposed
  - Countries in bad equilibrium also experience banking crisis due to “deadly embrace” noted earlier
  - When sovereign is pushed in default so are banks
Summary

- The Eurozone was left unprepared to deal with endemic booms and busts in capitalism
  - Probably these were even enhanced because of the existence of the monetary union
- While nothing was in place to stabilize an unstable system that pushed some countries into bad equilibria and others in good equilibria
- In fact some of the pre-existing stabilizing forces were switched off
How to redesign the Eurozone

- Short run:
  - ECB is key

- Medium run:
  - Macroeconomic policies in the Eurozone

- Long run:
  - Consolidating national budgets and debt levels
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.

- In doing this central bank prevents panic from triggering a self-fulfilling liquidity crisis that can degenerate into solvency crisis.

- And pushing countries into bad equilibria.
ECB has finally acted

- On September 6, ECB announced it will buy unlimited amounts of government bonds.
- Program is called “Outright Monetary Transactions” (OMT)
- In defending OMT, Mr Draghi argued that “you have large parts of the euro area in a bad equilibrium in which you may have self-fulfilling expectations that feed on themselves” . . So, there is a case for intervening . . . to “break” these expectations, which . . . do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank”
Spreads 10-year government bond rates in eurozone

- Greece
- Portugal
- Ireland
- Spain
- Italy
- Belgium
- France
- Netherlands
- Austria
- Finland
Figure 2

Change in spread and initial spread in %
(from 2012Q2 to 2013Q1)

\[ y = -0.3382x - 0.2352 \]
\[ R^2 = 0.97772 \]

Source: Datastream (Oxford Economics)
Figure 3

Change debt/GDP and spread since 2012Q2

Source: Datastream (Oxford Economics)
• This is the right step: only the ECB can now save the Eurozone

• There is danger though that its effectiveness will be reduced by politically inspired limitations
  • Bonds with maturity less than 3 years will be bought
  • Conditions of even more austerity may be imposed

• Note also that while necessary, OMT is insufficient
• ECB should act today
• Spreads increase again in periphery
• Making recovery impossible
• “Quantitative easing” in Eurozone:
  • ECB buys government bonds of periphery
  • This will improve monetary transmission process
  • And reduce degree of segmentation in financial markets of Eurozone
What is the criticism?

- Inflation risk
- Moral hazard
- Fiscal implications
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
Figure 1: Money Base, Money Stock (M3) in Eurozone (2007 December=100)
Figure 2: Inflation, growth MB and M3 (average yearly growth rates)
• 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)
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.
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
But

- As the central bank should only intervene to take care of liquidity crisis it is unlikely to make losses
- It only makes losses if it provides liquidity to an insolvent nation (e.g. Greece)
- Thus, ECB should follow Bagehot’s rule: provide unlimited amount of cash to solvent but illiquid governments
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
Medium run:
Fiscal policies that will not kill growth

- Macroeconomic policies exclusively geared towards austerity in the South reinforce the split between countries in bad and in good equilibria.

- These countries have started strong “internal devaluations” at the cost of deep recessions.
Relative unit labour cost (average 1970-2010 = 100)
What has been the contribution of the Core countries in the adjustment?
Interpretation

- Burden of adjustments to imbalances in the eurozone between surplus and deficit countries is borne almost exclusively by deficit countries in the periphery.
- This asymmetric system introduces a deflationary bias in the Eurozone.
- Explaining the double-dip recession that is now starting in the whole of the Eurozone.
Towards symmetric macroeconomic policies

- Stimulus in the North, where spending is below production (current account surplus)
- Austerity in the South (but spread out over more years)
- This also allows to deal with current account imbalances
  - It takes two to tango
- This symmetric approach should start from the different fiscal positions of the member countries of the Eurozone
Figure 6: Gross Government debt ratios in creditor countries of the Eurozone
Figure 7: Gross Government debt ratios in debtor countries of the Eurozone

Source: European Commission, AMECO
Here is the proposed rule

- The creditor countries that have stabilized their debt ratios should stop trying to balance their budgets now that the Eurozone is entering a new recession.

- Instead they should stabilize their government debt ratios at the levels they have achieved in 2012.

- The implication of such a rule is that these countries can run small budget deficits and yet keep their government debt levels constant.

- For Germany this implies a significant stimulus
Note on Germany

- Germany can now borrow at historically low interest rates
- How come German government cannot find investment projects that earn a social rate of return of more than 1.5%
- Is this lack of imagination?
- Or engrained fear of DEBT?
Long run: Towards a fiscal union?

- Ideally a full fiscal union is called for
  - A consolidation of national debts creates a common fiscal authority that can issue debt in a currency under the control of that authority.
  - This protects member states from being forced into default by financial markets.

- Fiscal union also makes insurance possible to compensate countries for bad luck
However

- Full fiscal unification is so far away that one has to think of more modest approach

- Here are some suggestions:
  - Partial pooling of debt aimed at reducing fragility of national bond markets (Eurobonds)
    - We can not all the time ask ECB to step in
    - We have to strengthen Eurozone structurally
    - Pooling also requires disciplining mechanism
  - Banking union (common supervision and common resolution mechanism)
    - European authority with taxing power necessary
• All this requires transfer of sovereignty:

• More political union is necessary to make Eurozone sustainable in the long run
Conclusion

- The recent decision by the ECB to act as a Lender of Last Resort is a major regime change for the Eurozone.
- It has significantly reduced existential fears that slowly but inexorably were destroying the Eurozone’s foundations.
- The ECB’s new role although necessary is not sufficient to guarantee its survival.
- Signals must be given that the Eurozone is here to stay.
These signals are:

- A partial debt pooling that ties the hands of the member countries of the Eurozone and shows that they are serious in their intentions to stick together.
- Symmetric macroeconomic policies to avoid a long and protracted deflation that will not be accepted by large parts of the Eurozone population.

In the long run a significant political union will be necessary.

- Euro is currency without a country
- To make it sustainable a European country has to be created