The Eurozone crisis – April 2012

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The Eurozone crisis of 2011–12 is a sequel to the financial crisis of 2008–09. It would have been much easier to contain and resolve had there been no global financial crisis, no deep recession in the advanced countries. It is therefore too facile, indeed wrong, to say that the Eurozone crisis is essentially or even mainly due to inherent faults in the monetary union. Nevertheless, the crisis has exposed genuine faults that were neither manifest nor life-threatening before 2008–09. They might have been remedied with gradual progress towards a deeper economic union. But all that is for the economic historians. We are where we are, and it is not pretty.

Government bond yields for several of the 17 countries in the economic and monetary union (EMU) were unsustainable in November 2011. They then fell back, with the ECB's longer-term refinancing operation (LTRO). But they are climbing again – more on that below. The spread over the German ten-year government bond (the Bund) was close to zero for most of the period from 1999 to 2008. Now, however, of the EMU government bonds, only Germany is regarded as a risk-free 'safe asset'. Even that is not totally clear, since the credit default swap (CDS) premium for Germany was at 110 basis points in November 2011 (it was 40 in July). The CDS market is by no means a reliable guide to default risk, but it does give information about sovereign bond prices[1], and the message is disturbing.

1 Portes (2010), Palladini and Portes (2011).

In late 2011, until the LTRO, there were no buyers in the markets for Eurozone sovereign debt except the ECB, sporadically, and domestic financial institutions under open or implicit pressure from their governments. Many of those institutions have used some of their new ECB funding for renewed purchases of their home sovereign bonds, but this simply exacerbates the already dangerous nexus between fragile banks and fragile sovereigns. The liquidity crunch of late 2011 has also moderated but could quickly return. The European Financial Stability Fund (EFSF) could not sell some of an early November bond issue and is a fragile reed. France has lost its AAA rating, and all Eurozone banks are under rating review. Deposits in Greek banks have been falling steadily for many months, and there are signs of similar but slower 'bank walks' in other countries deemed at risk. The sovereign CDS market itself is in question, because the authorities sought to engineer a deep restructuring of Greek debt without triggering the CDS. This would have shown that the 'insurance' provided by CDSs is not insurance after all. Although eventually the swaps were triggered, the markets are still very uneasy.

There are bits of good news: ECB monetary policy is still 'credible', on the evidence of market inflation expectations (2.02% at a five-year horizon, 2.22% at a ten-year horizon, as at 4 April 2012). The underlying bad news there, however, is that the ECB interest rates have been too high and are still too high despite the cut of 50 basis points in December 2011. The technocratic prime ministers in Greece and Italy are very experienced, very able, and fully conscious of what their countries must do to restart economic growth. That said, they are not elected politicians, and their legitimacy and authority may be correspondingly limited. Since the necessary measures would be painful and challenging even with a popular mandate, one may question whether technocratic governments can carry them out. Resistance in both countries is very strong.

For the countries at the heart of the crisis but the geographical periphery of the Eurozone, the sources of their predicaments are varied. Importantly, they are not primarily due to membership of the single currency, nor to fiscal profligacy. Greece

is of course an exception to the latter generalisation, because its fiscal excesses were both large and duplicitous, partly hidden from the statisticians. But its problems are due also to major structural weaknesses, especially of its institutions[2]; extreme political polarisation; and reckless (for the lenders as well as borrowers) capital inflows that for years disguised these underlying flaws. It is wrong to reduce these factors to inadequate 'competitiveness' that could be cured by currency devaluation.

Ireland's woes arise from an extraordinary housing boom (incontestably a housing price bubble) fed by equally reckless capital inflows through its banks into property development and mortgage finance, lubricated by crony capitalism. The original sin which has led Ireland to its penance was not, however, this process itself but rather the government guarantee of the bank debts thereby incurred. In a stroke, this socialisation of private debt transformed a country with one of the lowest ratios of public debt to GDP into one with an exceptionally high debt ratio.

Spain too had its housing boom and capital inflow into construction. These were exacerbated by the foolish behaviour of the politically influenced regional banks, the *cajas,* which fell into deep difficulties when the bubble burst. Portugal has many economic ills: poor education, an uncompetitive production structure, product and labour market rigidities. But its primary mistake was not to use the very large capital inflow during the pre-crisis decade to modernise the economy.

Three of these four countries (the GIPS) had sound fiscal positions but from 2003–04 onwards were running large current-account deficits within the monetary union; Greece also had a big current-account deficit. These were financed by equally large capital flows from the surplus countries, especially Germany – a capital flow 'bonanza'[3] for the periphery, with the usual consequences. In particular, much of the funds went into real-estate purchase and development. This raised the relative price of non-traded goods and pulled resources out of tradeables. The Eurozone as a whole ran a balanced current

2 Jacobides *et al* (2011).
3 Reinhart and Reinhart (2008).

account with the rest of the world – the imbalances were internal. Germany played the same role in the Eurozone as China in the global economy. Unlike the United States, however, the GIPS were not 'free spenders' – Ireland and Spain had housing booms, but they and Greece all saw a fall in consumption as a share of GDP and a rise in the investment share during 2000–07 (the investment share fell slightly in Portugal). And unlike China, the capital flows from Germany (and some other countries, like France) came primarily from banks – they were private not official flows.

Correspondingly, the macroeconomic problem in EMU now is the fiscal consequence of the financial crisis in bank-based financial systems. Creditor countries have been unwilling to let their banks suffer the consequences of bad loans – rather, they have managed to put the entire burden on the taxpayers of the debtor countries. This may seem clever, but it is short-sighted, not to say hypocritical. It also disregards the EU and Eurozone financial integration that policymakers have promoted – using an American analogy, should Delaware, where Citibank is incorporated, be responsible for Citibank's liabilities?

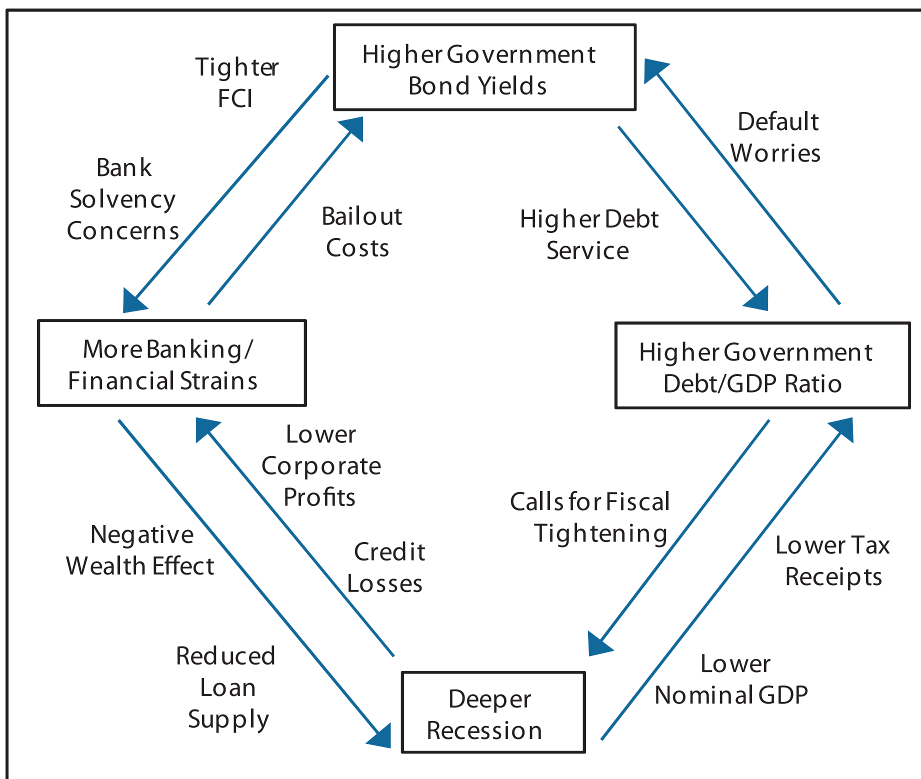
The result is that Greece is insolvent, Ireland's debt is also excessive and should be restructured[4], and Portugal's IMF programme is not feasible. Spain and Italy, however, are solvent, if financial markets return to normal conditions and both countries carry out appropriate macroeconomic and structural policies. But Italy and Spain are under pressure from the markets. They fear that Spanish banks will suffer further from bad real-estate loans, and the state will have to bail them out. Italian political instability and irresolution has reinforced contagion from the weaker countries, and Italy too may enter a self-fulfilling vicious spiral: rising debt-service costs hurt the fiscal position (Italy is close to primary fiscal balance), that hits market confidence, spreads rise, and debt service begins to look unsustainable despite the primary balance. The markets have also been losing confidence in French banks, despite the protestations of health from the banks and their regulators; this has now calmed, but that may be temporary.

4 Portes (2011).

Common to all these cases is an interconnected sovereign and banking crisis: the banks hold large amounts of sovereign debt that has become questionable, and the sovereigns are questioned because of the danger that they will have to rescue their banks.

So we have the 'doom loops' represented in this useful diagram[5] and exacerbated by elements of Fisherian debt deflation:

Figure 1. The European Peripherals Crisis



The euro (monetary union) is not the cause of this crisis, although the ECB's interpretation of its role has been blocking a solution. The ECB has been 'in denial', maintaining as late as May 2011 that it was inconceivable that a Eurozone country

5 Goldman Sachs (2011) *Global Economics Weekly* 11/38, November.

could default on its debt. The agreement of 21 July 2011 to restructure Greek debt was, of course, recognition of default, regardless of whether the restructuring would be 'voluntary' or not. The ECB told Ireland in autumn 2008 (backed by the threat of withdrawal of repo facilities) that it was not allowed to consider debt default. Where else in the world can a central bank tell a government what it can or cannot do in fiscal matters?

Politicians share responsibility, however, with their indecision and endlessly repeated 'too little, too late' measures – such as the agreement of 21 July 2011, which was recognised only three months later to be wholly inadequate. Moreover, the French President and German Chancellor have made two egregious errors with disastrous impact on the markets: the Deauville statement of October 2010 that introduced in an ill-considered manner the possibility of private sector involvement in dealing with Eurozone country debt; and the Cannes statement a year later that explicitly proposed that an EMU member country could exit the euro. There is no legal basis for this[6], and it had been regarded as a taboo. Some have drawn an analogy with the statement by the President of the Bundesbank in early September 1992 that "devaluations cannot be ruled out" in the EMS – which was followed immediately by the exit of Italy and the UK.

Several ways out have been proposed. If the banks' capital is inadequate, then they should be recapitalised. But with what external funding, if government participation is excluded? Part of the problem is that the markets have been denying even short-term funding to the banks. Consequently, the banks are deleveraging by selling assets and not rolling over loans, with dangerous consequences worldwide. At one point, there was talk of expanding or 'leveraging' the EFSF. But non-euro countries would not contribute, leveraging through borrowing from the ECB is not allowed, and Eurozone countries simply do not want to put up more funds.

6 See W Munchau (2012), *Financial Times*, 9 April.

The extreme way out is to get out: might an exit of Greece from the Eurozone end the instability? No, for it would immediately lead to devastating bank runs in all countries that might conceivably be thought candidates to follow Greece. What firm or household in Portugal, Ireland, Spain, Cyprus, would not seek to avoid even a low probability that its bank deposits might be devalued overnight? The likely outcome would be multiple exits, quite possibly the breakup of the monetary union. And that would be disastrous not only for the exiting 'weak' countries but also for those that would then suffer massive exchange-rate appreciation and the economic dislocation consequent on massive contract uncertainty. The various plans for exit or Eurozone breakup are all deeply flawed.

The only stable solution, therefore, is for the ECB to accept explicitly, in some form, the role of lender of last resort (LLR) for the monetary union. (One might alternatively regard this as a form of quantitative easing.) This does come within the Maastricht Treaty mandate:

> In accordance with Article 105(1) of this Treaty, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community…
> 5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.
> *Treaty of Maastricht (1992), Article 2 and Protocols Art. 105.5 (numbering changes in Lisbon Treaty, but no change in text)*

It would not violate the 'no bailout clause' (which does, however, exclude ECB purchases of Eurozone sovereign debt on the primary market). And in fact, the ECB has been purchasing member state bonds on the secondary market since May 2010, without any successful legal challenge.

To stop self-fulfilling confidence crises, therefore, the ECB should commit to cap yields paid by solvent countries with unlimited purchases in the secondary markets. Arbitrage will then bring primary issue yields down to the capped level. Note ‘solvent’: the then Governor of the Bundesbank was right to oppose such purchases for Greece in May 2010, because it was evidently insolvent.

There is no more inflation risk in such a policy than there is in quantitative easing – and that risk is negligible, as shown by the examples of the US, the UK, and Japan. The ECB can always tighten as and when necessary. The risk preoccupying the ECB is that of moral hazard: it clearly views ‘market discipline’ as the only way to bring about the macroeconomic policies it favours. The evidence? Berlusconi’s departure and replacement by Monti; and a technocratic government in Greece led by the former ECB Vice-President, willing to accept the harsh austerity policies demanded by the IMF-ECB-EC troika. Financial market pressures have been consciously used to drive governments to implement austerity and reforms.

Thus the ECB does only ad hoc government debt purchases under its Secondary Market Programme, in the guise of ‘normalising the monetary transmission mechanism’ that is impaired by debt-market instability. Even those have ceased, for the time being. This is a version of the ‘constructive ambiguity’ beloved of central bankers – but in this case, it is manifestly destructive rather than constructive. The piecemeal approach, acting only under pressure and with delay, has proved very costly. In effect, the ECB has been playing a game of ‘chicken’ with the politicians and the markets. It is particularly dangerous both because there are three players, of which two have no single decision-maker; and because the parameters defining the game are not well defined, since no one can tell when a vicious spiral may turn into an overwhelming confidence crisis that the authorities will be unable to control.

On the other hand, the ECB does need political backing to take on the LLR role overtly. The German and French leaders would have to make the case that this is the only way to preserve the monetary union. And the ECB would also need to receive explicit

indemnities (guarantees) from Finance Ministers of the 17 against capital losses the bank might incur on its sovereign bond purchases. Both the US Federal Reserve and the Bank of England have received such indemnities in respect of their quantitative easing programmes.

When that guarantee has been secured, the ECB should make an expectations-changing announcement of the new policy, just as the Swiss National Bank did when it moved to cap the value of the Swiss franc. As that example shows, it is highly likely that if the commitment were made, the markets would recognise that betting against the bonds (a speculative attack) could not succeed, because the ECB would then have unlimited capacity to resist. Hence it would not have to buy much if at all.

Ideally, this short-run stabilising policy would be complemented by long-run plans for fiscal stability and integration, as well as by the issue of Eurobonds (issued at the Eurozone level with 'joint and several liability'). That would establish the kind of 'convergence play' that drove the markets smoothly into EMU at the end of the 1990s. There are several Eurobond proposals now on the table, but the leaders of the major countries have so far rejected them.

Although the ECB policy proposed above could buy time for economic reforms to work, long-run debt sustainability requires economic growth. But we should be clear: fiscal contraction is contractionary[7]. The evidence accumulates daily, for the UK as well as for Eurozone countries. The only counterexample is that of Ireland in the 1980s. But this is a very special case: a rather backward country catching up to the technological frontier; exporting into a boom in its major trading partners (especially the UK); creating an exceptionally favourable environment for foreign direct investment; and exploiting a well-educated diaspora willing to return.

The austerity policies championed by Germany and other apostles of fiscal rectitude, implemented enthusiastically by the European Commission, are not the solution, but

7 Guajardo *et al* (2011)

rather a major part of the problem. They are driving the Eurozone into a new recession.[8] The debt of several Eurozone countries is not sustainable if they contract.

Moreover, fiscal contraction together with private-sector deleveraging is not feasible without a current-account surplus. We teach this in first-year macroeconomics:

$$CA = (S_p - I_p) + (T - G)$$

The current account must equal the sum of private-sector net saving and government net saving. In the Eurozone, the surplus countries are those with the most 'fiscal space'. There will be no exit from the current debt traps and stagnation unless the surplus countries are willing to accept that they must allow the others to expand. This requires that they either relax their fiscal policy or adopt other policies that will reduce private net savings. The overall position would improve if the euro were to depreciate significantly – another reason for further monetary easing. But that is true for the US and Japan as well.[9]

The LTRO was an inspired move to bypass German objections to the ECB taking on the LLR role. But it is a temporary expedient. There is no evident exit strategy, even though the President of the Bundesbank is calling for exit much sooner than the specified three-year horizon. Moreover, channelling funding to the banks and relying on them to buy sovereign bonds simply raises the weight of those bonds in their assets and worsens the unhealthy interdependence between banks and sovereigns.[10] And it reduces the pressure on the banks to rationalise their portfolios and improve their business models.

Germany and France have benefited greatly from the single currency over its first decade. Their business communities see this. One must still hope that the core Eurozone countries will eventually act in their own best interests. The global financial crisis need

8 See http://eurocoin.cepr.org/ , where the Eurocoin coincident indicator has been firmly in negative territory over the past several months.
9 This is not to say that 'competitive quantitative easing' at the zero lower bound for interest rates will be ineffective or 'beggar-thy-neighbour' policies – see Portes (2012).
10 See De Grauwe (2012) and Wyplosz (2012).

not lead to the demise of the single currency through a Eurozone crisis. This crisis could be resolved successfully if policymakers were to change course.

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