# The eurozone crisis
## Chronicle of a death foretold?

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*15 May 2012*
Koc-TUSIAD Economic Research Forum, Istanbul

# *Chronicle of a Death Foretold*
## Gabriel Garcia Márquez

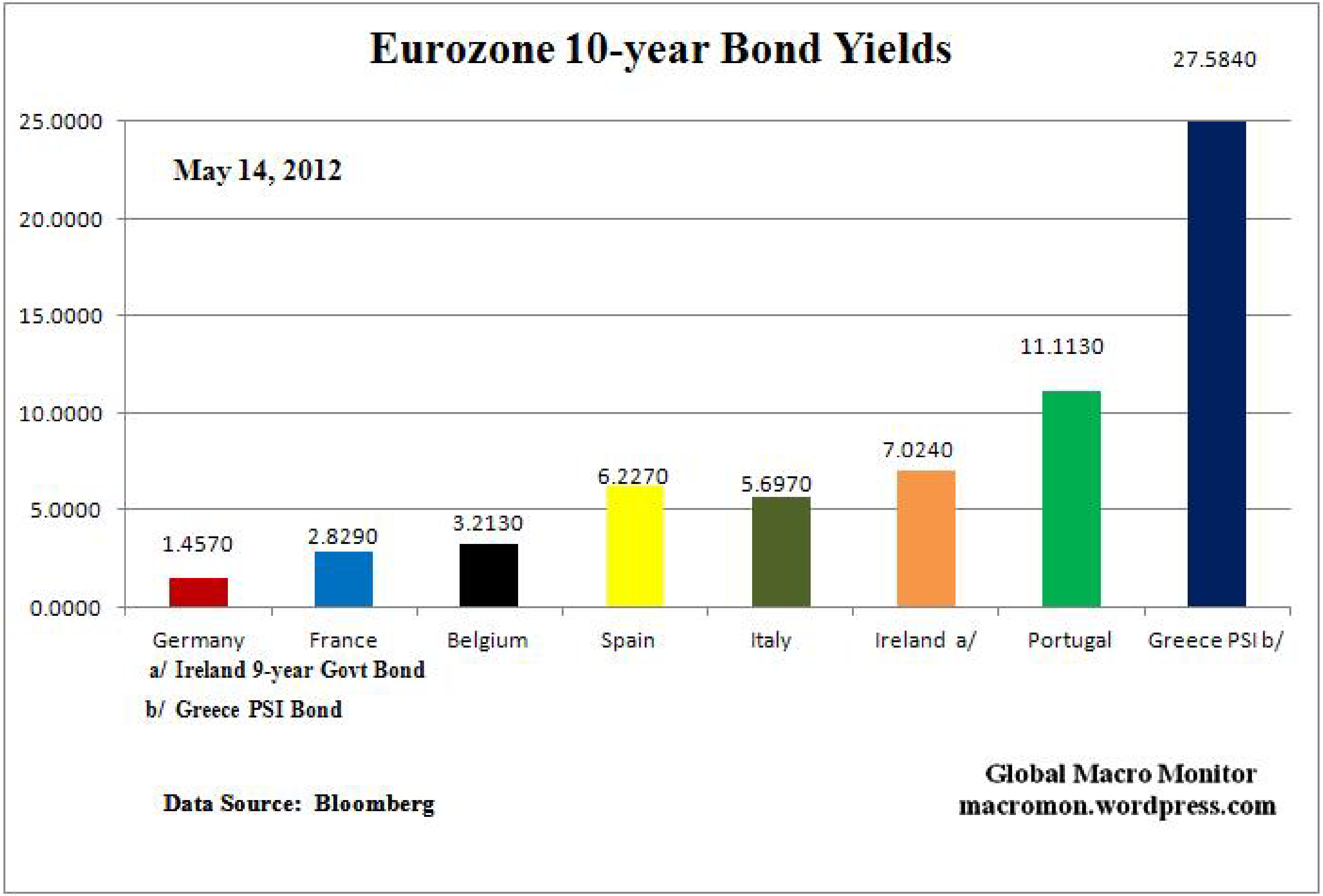
- The killers widely proclaim their intention, but no one does anything, nor tells the designated victim – and in the end, they do kill him, because that is what everyone came to expect, so they had to do it

- The euro critics proclaim its demise through the financial markets, but although the markets could be stopped, no one does anything, and the disaster does arrive, because that is what everyone comes to expect

# Road map

- Where are we? – nearing the end-game
- How did we get here? – the basic cause was not intra-zone disparities in competitiveness, but rather the capital flows unleashed by monetary union and financial deregulation
- Long-term refinancing operation (LTRO) is a clever manoeuvre but short-term rather than long-term, with bad side effects
- The only medium-term solution: *ECB securities market purchases must cap sovereign bond yields* to ensure financial stability
- If not, breakup – with dire consequences for countries exiting *and* those remaining in euro zone (if it continues to exist) and for EU
- Meanwhile, austerity and recession make it impossible to grow out of debt – so fiscal and monetary strategies must be reconsidered

# Unsustainable with 2% inflation



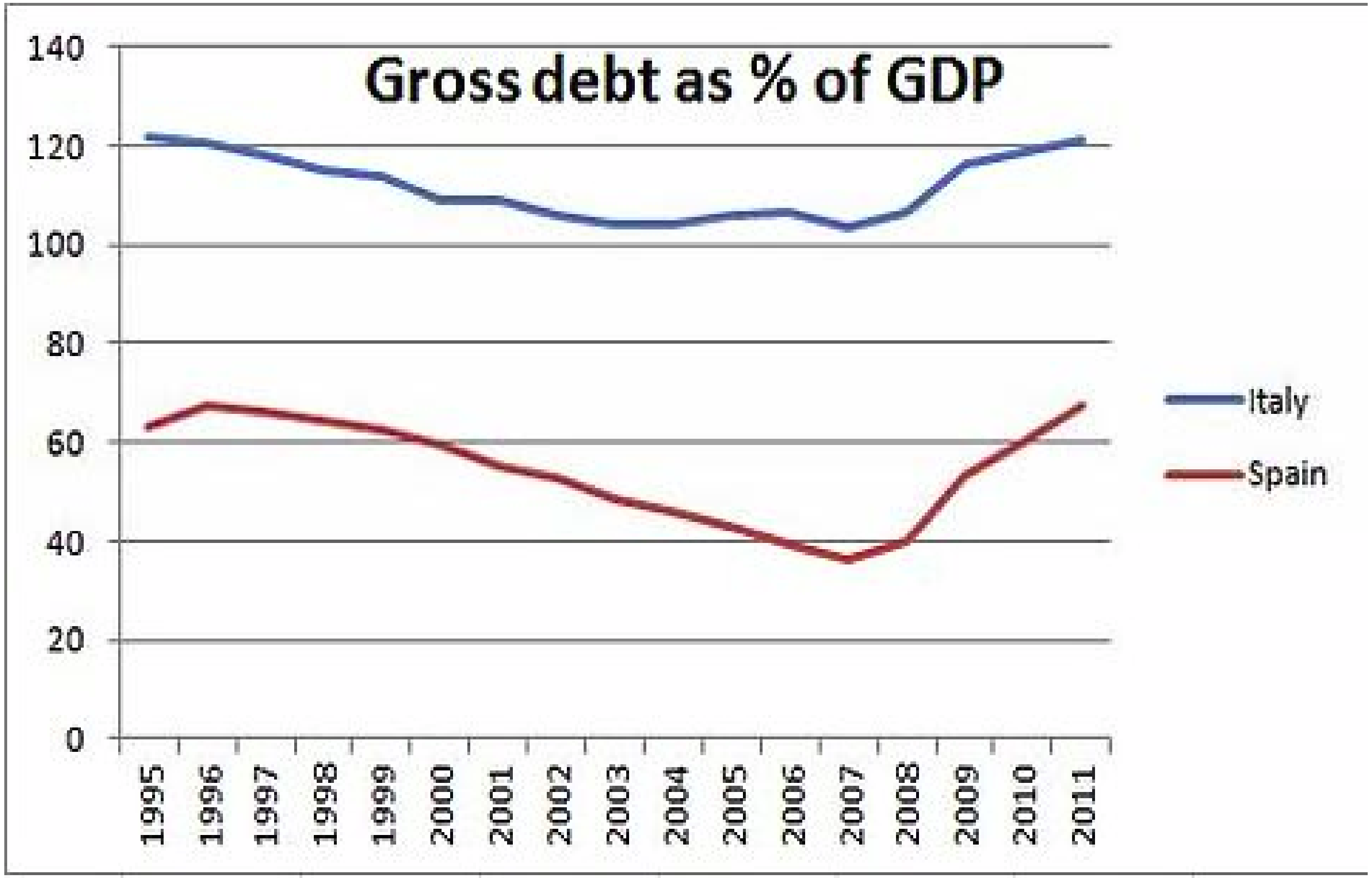
# Where are we?

- Spreads unsustainable: Bund at 1.46, spread over bund for Italy 4.24, Spain 4.77, Portugal 9.66, Ireland 5.57, France 1.37 (only bund is ‘risk free’)
- Non-residents are not buying eurozone sovereign debt (except that of Germany) – even within the euro zone, we see financial ‘de-integration’
- LTRO reversed liquidity crunch, but that could quickly return, and banks still need recapitalisation
- Deposits in Greek banks falling steadily for several months, ‘bank walk’ has started in some other countries – capital flight exceeds CA improvement
- Euro zone back in recession – while inflation expectations 5-yr are 1.85, 10-yr 2.15

# Causes – *not the euro, nor fiscal excesses (except Greece)*

- **Greece**: fiscal profligacy and duplicity, deep structural weaknesses, political polarisation, capital inflow
- **Ireland**: housing boom, capital inflow to (through) banks, crony capitalism (bankers and construction), then government guarantee of bank debts
- **Spain**: housing boom, capital inflow to construction, *cajas*/politics
- **Portugal**: product and labour market rigidities, poor education, uncompetitive production structure, capital inflow (financing current account deficit) wasn't used to modernise

# Pre-crisis, Spanish public debt was low, Italy's had been falling steadily for over a decade




Source: IMF WEO Database (see Krugman NYT blog 2 December 2011, 'Profligate Zombies')

# Capital flows were key

- Not ‘free-spending southerners’ – consumption as a share of GDP *fell* in these countries 2000-07 relative to previous decade, while investment share rose (except slight fall in Portugal)
- They experienced a capital inflow ‘bonanza’ (much of it from Germany and France) feeding excessive credit growth, with corresponding current account deficits and some accompanying real exchange rate appreciation

# The problem today

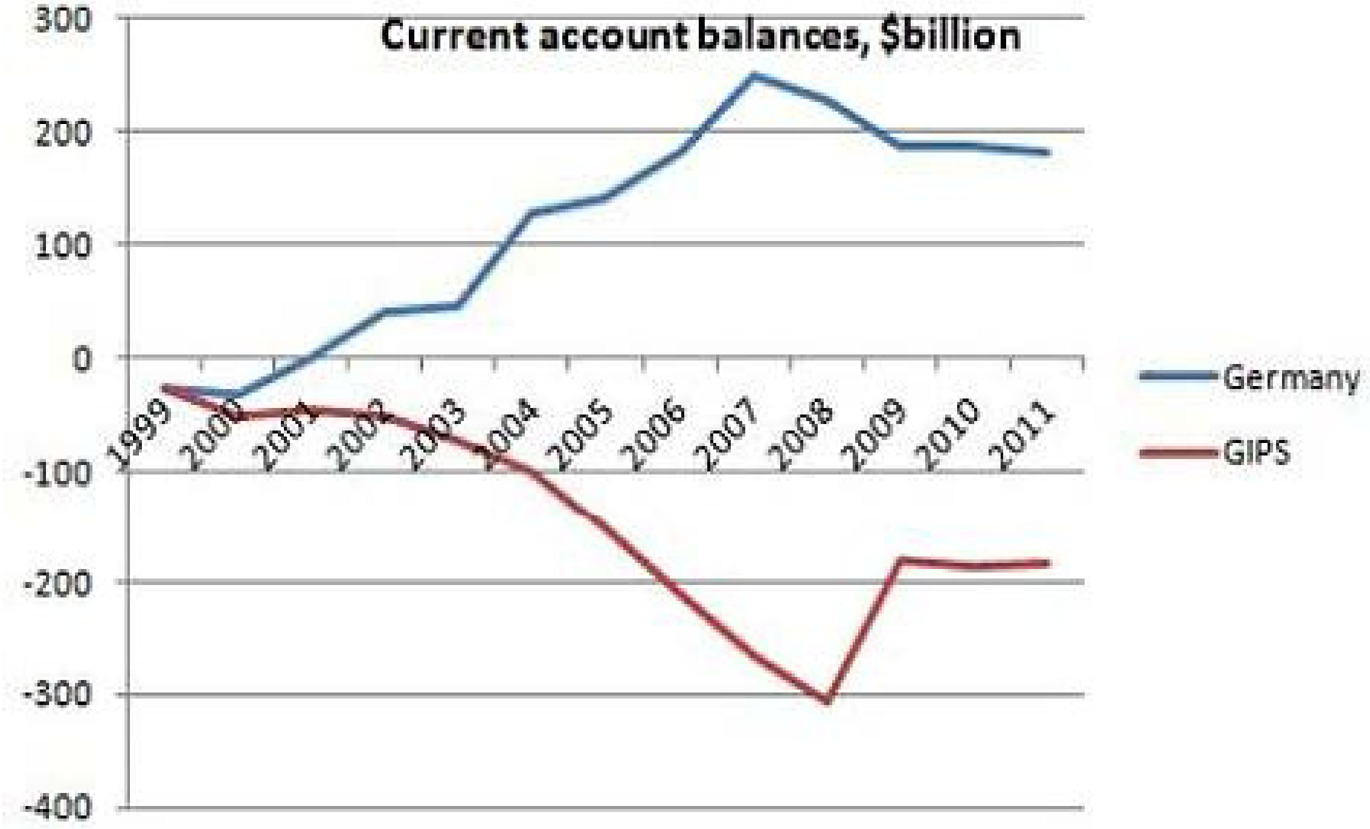
- But the problem then and now is *not primarily 'competitiveness'* as measured, for example, by unit labour costs, which have not diverged that widely
- Indeed, export market shares did not deteriorate significantly for these countries
- Rather, we see mainly *fiscal consequences of crisis in bank-based financial systems*
- Greece is insolvent despite debt reduction, Ireland's debt may also be unsustainable, perhaps Portugal too – but not Spain or Italy unless markets take over

# The authorities are still in denial

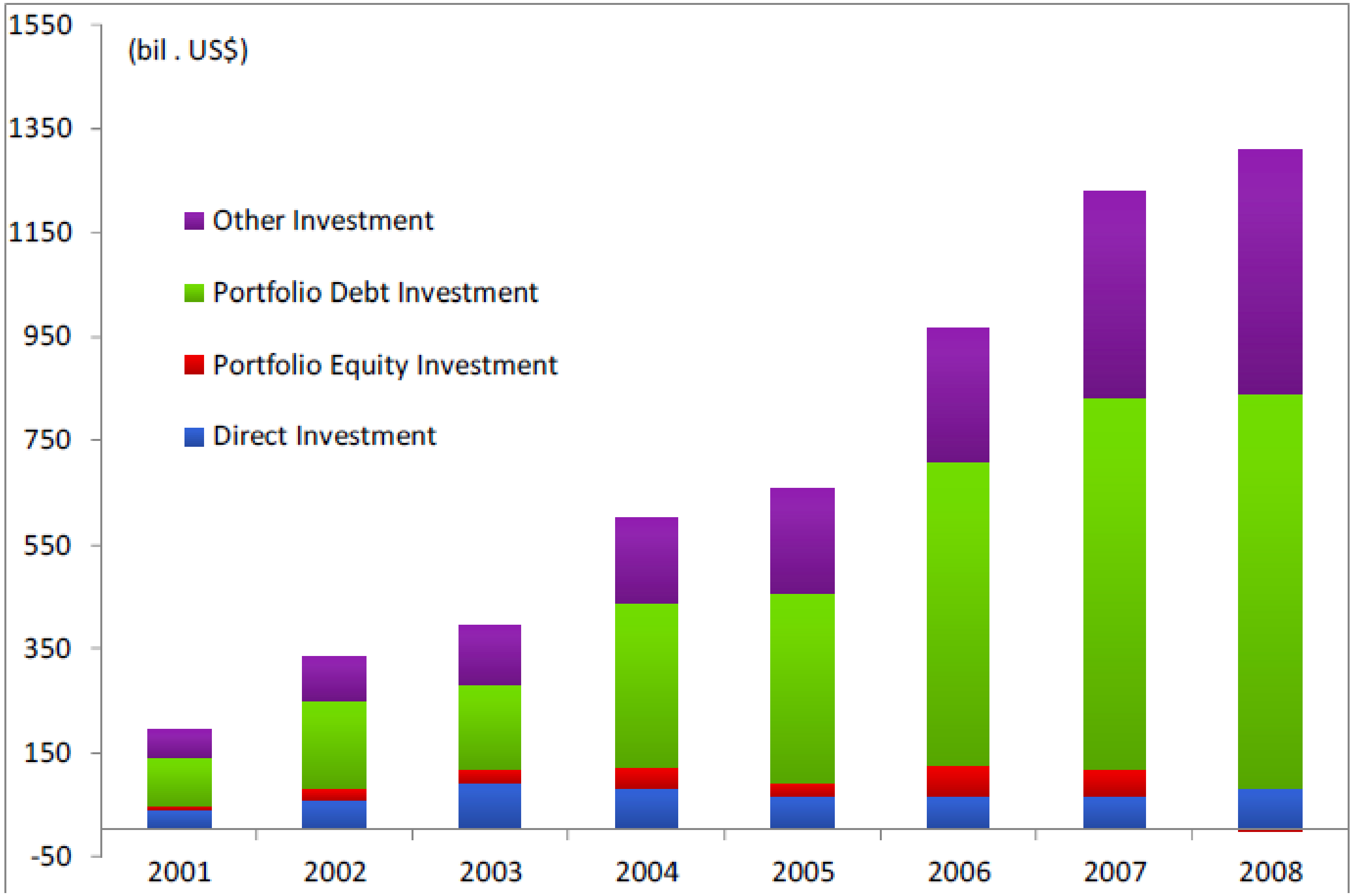
- ‘Ireland is a success story’ [*Ireland is back in recession*]
- ‘Portugal is on track’ [*for a second bailout package, because it won’t be able to refinance in early autumn*]
- ‘Improving health of [Spanish] banking sector’ [*new big bailouts every month, no clue how much is needed*]

Quotes from Klaus Regling, CEO of EFSF, speaking in Vienna on 10 May 2012 – comments my own...

# German capital outflow corresponded to – and financed – deficits of periphery

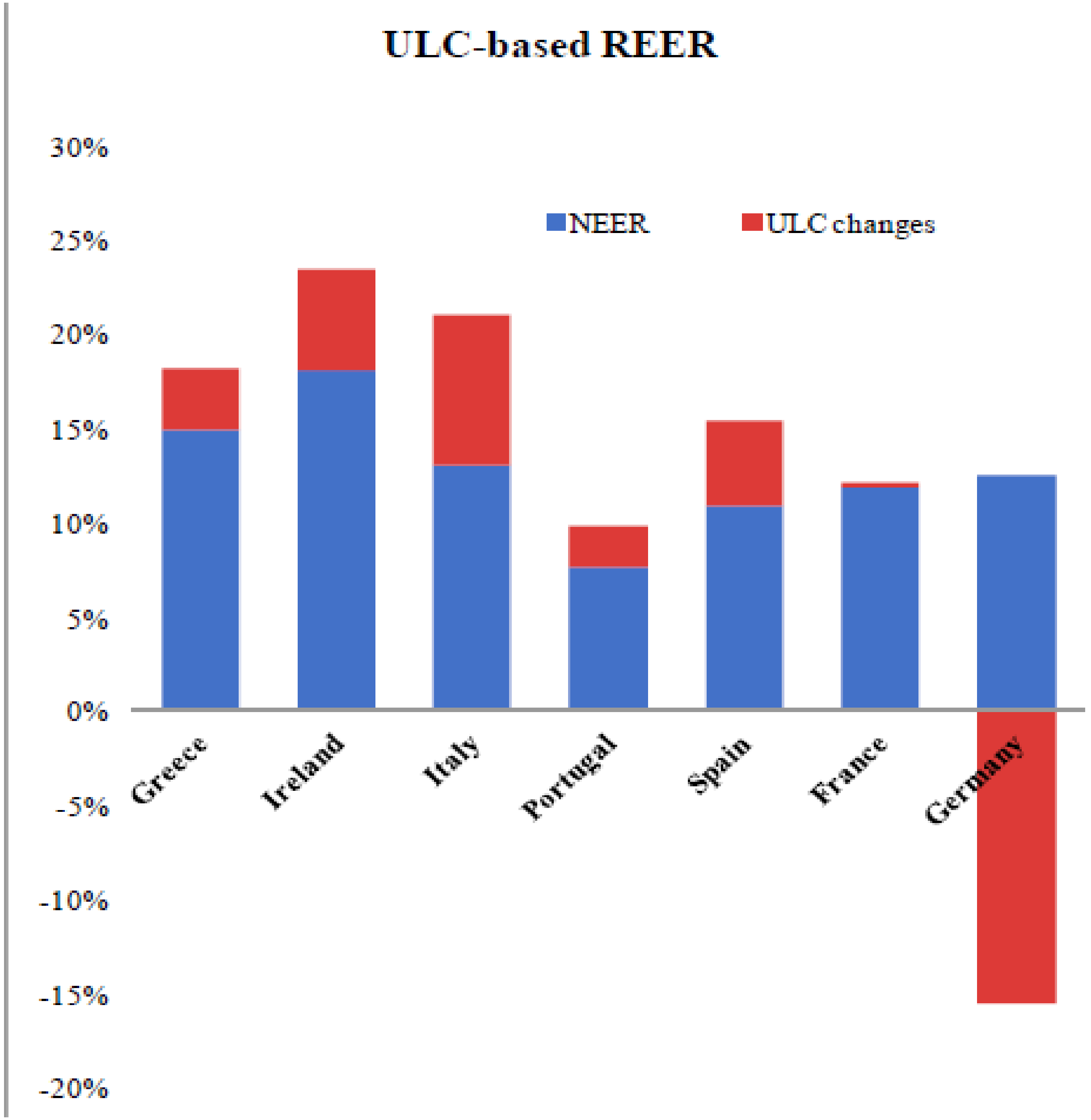


# Huge capital flows from Germany and France to periphery were bank and portfolio debt, not FDI



# Most of the real appreciation was due to nominal appreciation of the euro

Source: Tressel *et al.*, ‘External imbalances in the euro area’, *Economic Policy* Panel paper 20-21 April 2012



## So a different story: boom in non-tradeables due to capital inflows, with loss of competitiveness due mainly to euro appreciation

- Borrowing didn't go into investment in tradeables sector with productivity improvements – rather, into non-tradeables, especially construction
- Prices rose there, resources flowed there
- Capital flows weren't accommodating CA deficits
- Truly relevant relative price is not terms of trade, nor even ULC-based real effective exchange rate (REER), but rather *ratio of traded to non-traded goods prices*

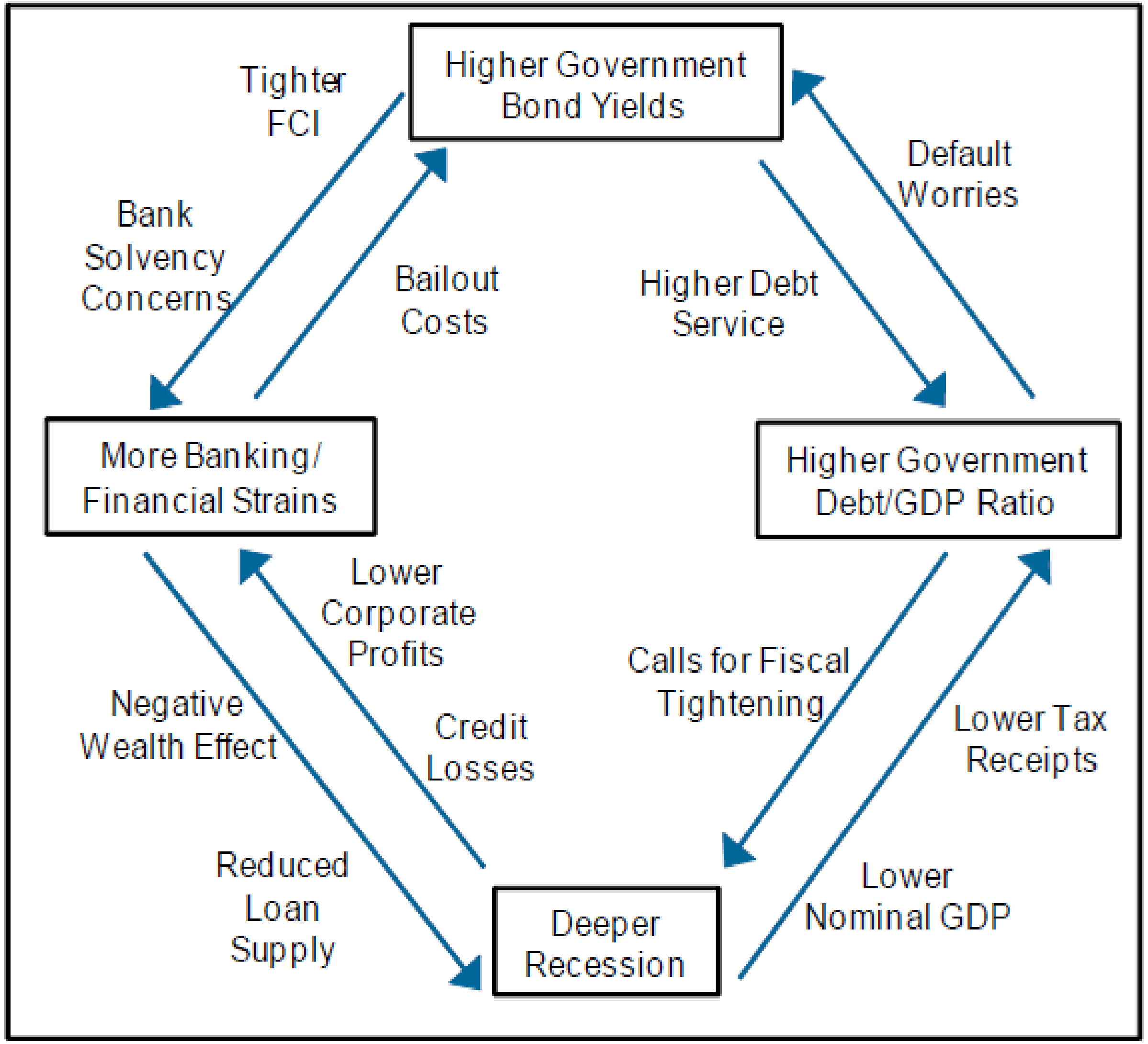
# Now ECB and politicians share responsibility

- Common to all: *interconnected sovereign and banking crisis* with debt trap exacerbated by austerity policies, no growth
- The euro (monetary union) *not* the cause – although ECB interpretation of its own role blocks solution
- Keys to past two years are ECB denial as well as political indecision, lack of political leadership
- ECB indeed told Ireland that it *was not allowed* to restructure debt (where can central bank tell government what it can or cannot do in fiscal matters?) – with threat of withdrawal of repo facilities

# The underlying political reality

European creditor countries have been bailing out their own banks that made foolish loans to these countries by transferring fiscal costs to debtor country taxpayers, meanwhile taking the moral high ground – that's pure hypocrisy!

## ‘Doom loops’ (see also Fisher’s ‘debt deflation’ – falling prices and velocity of money exacerbate vicious spirals)




Source: GS Global ECS Research

Source: Goldman Sachs, Global Economics Weekly 11/38, 30 November 2011

# LLR comes within the Treaty mandate

***ECB must accept explicitly the role of LLR (call it QE?)***

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)*

- the ECB has been purchasing member state bonds on the secondary market since May 2010, without any successful legal challenge (the Secondary Market Programme)

# ECB could deal with the bond markets

- ECB should commit to *cap yields paid by solvent countries with unlimited purchases in the secondary market* (it is legally barred from purchasing new issues – that is ‘financing governments’ – but arbitrage will bring primary issue yields down to the capped level)
- Note: Weber was right about Greece – it wasn’t solvent – but Italy and France are solvent, Spain too
- Why not do it? Inflation risk? None in short run, and ECB can deal with it in long run. **Moral hazard**? Yes, but*…This is clearly the issue for ECB* – they think they can and must exert pressure for ‘reforms’
- So ECB Council members say ECB won’t do it – while they actually do some purchases without taking responsibility – *‘destructive ambiguity’*
- Delay costly – and ultimately, either they do it, or they bear responsibility for demise of euro – this is a particularly dangerous game of ‘chicken’

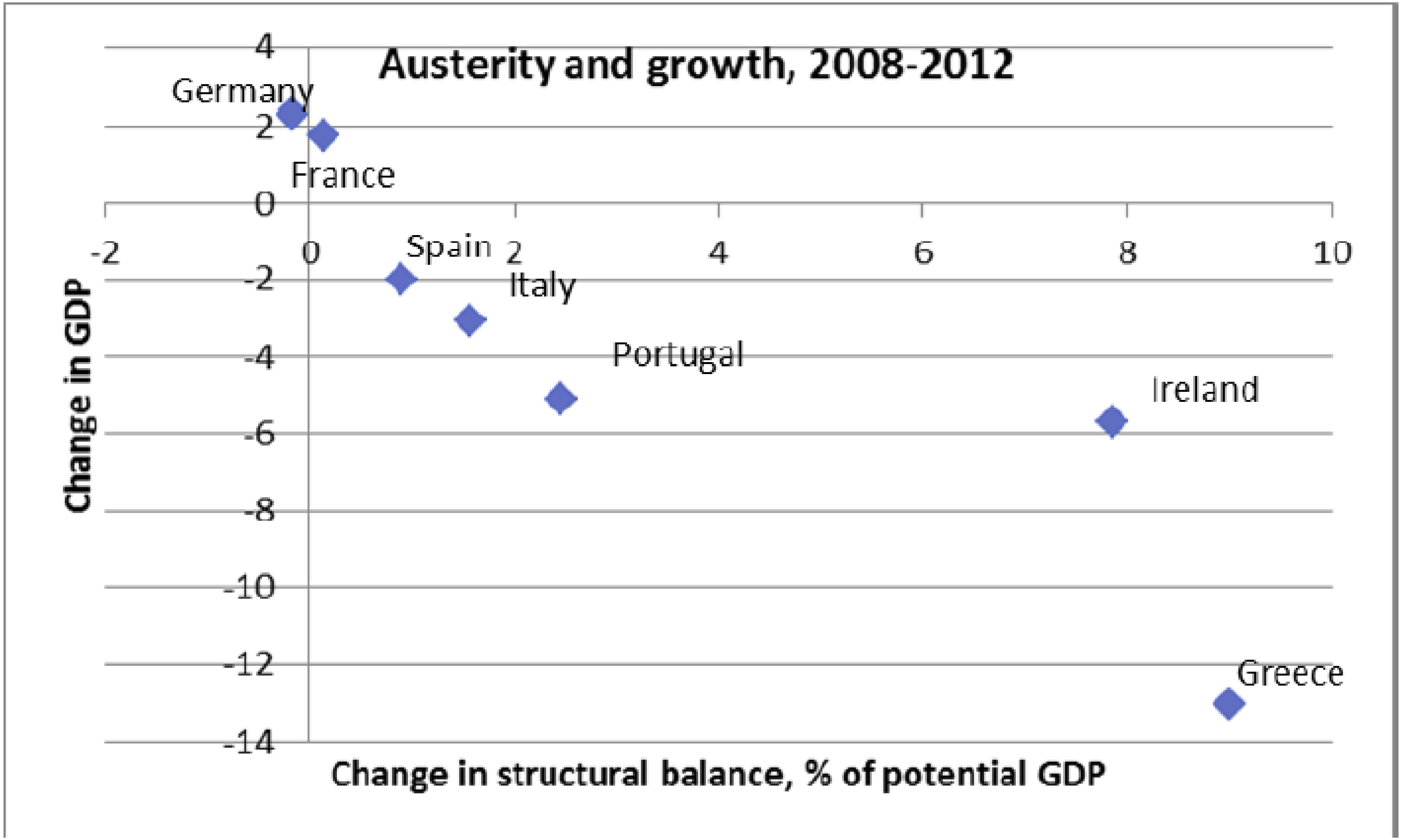
# But ECB needs political backing…

- There is potential capital loss to ECB, so it needs explicit indemnities (guarantees) from Finance Ministers of the 17 – the political/fiscal counterpart of a ‘Treasury operation’ (as both Fed and BoE received in QE)
- Then ECB must make an expectations-changing announcement – just as Swiss National Bank did to cap SF
- If the commitment were made, the markets would recognise that betting against the bonds (a speculative attack) will not succeed in the face of ECB unlimited capacity to resist, so that in fact it will not have to buy much (again, see Swiss example)

# ...and it's not there – yet

- Politicians and ECB both seem to think that they must continue to use financial market pressures to drive governments to implement reforms (otherwise moral hazard)
- And they won't (yet) accept Eurobonds, further expansion of 'firewalls' (EFSF and ESM)
- But there are some slight signs of acceptance that fiscal 'austerity' is proving counter-productive... (good news)
- ...along with remarks that a Greek exit from the euro zone might not be disastrous (very bad news – because wrong)

# Austerity isn't working




Source: P Krugman, 10 May 2012

# Austerity makes it all more difficult

- ECB can buy time for the economic policies to work, but for long-run debt sustainability, need growth
- Some countries need deep institutional changes to reduce corruption and enable tax collection, not just labour and product market reforms
- *Austerity is not the solution* – rather, part of the problem
- Current account is savings minus investment – deleveraging public and private sector simultaneously (excess of savings over investment in both) is not feasible without current account surplus [$CA = (S_p - I_p) + (T - G)$]
- So surplus countries (Germany) must raise domestic demand and intra-eurozone imports, thus permitting deficit countries to raise *CA*
- *And euro must depreciate – need further monetary ease*

# What must be done

- ECB to act as LLR for solvent countries
- Reconsider fiscal and monetary policy to go beyond austerity
- Reconsider policy towards Greece to avoid exit from euro
- Move towards some version of Eurobonds
- Financial re-integration: move towards a unified banking system with a single supervisor for cross-border banks and ESM as backstop

**Sorry, I’m dreaming…**

**time for Q&A**