RESEARCH

Economic Watch

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Economic Analysis

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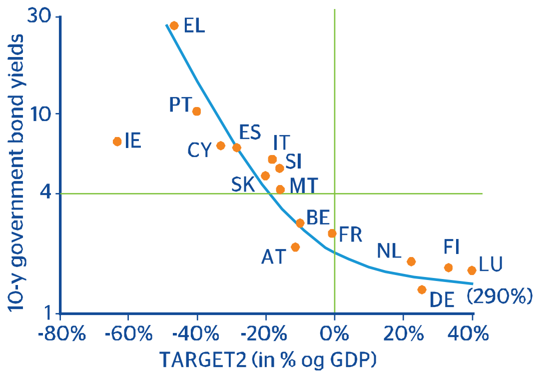
A Solution to the Euro Debt Crisis: Back from the Future

The problem

The Eurozone is living the most crucial time since its establishment. Sovereign debt spreads are spiralling at the highest rates from the beginning of the European debt crisis despite the reforms undertaken both at the Eurozone and national levels. Financial markets are almost closed to foreign capital in many member states that are suffering a sudden stop only mitigated by the liquidity made available by the Eurosystem. The consequence of this diverging process is a vicious circle environment, driven by self-fulfilling expectations, in which higher interest rates and TARGET2 imbalances reinforce each other. In fact, they are the two sides of the same coin, as Chart 1 transparently shows.

Chart 1
10-years government bond yields (in %, logarithmic scale) and TARGET2 balances (in % of GDP, latest data available). In Luxembourg TARGET2 represents 290% of its GDP

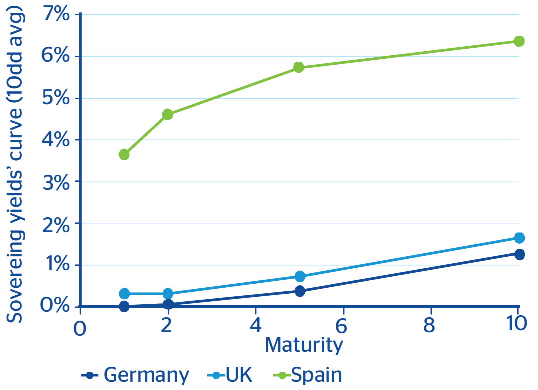


Source: ECB and Euro Crisis Monitor (Osnabrück University)

This situation creates an unsustainable heterogeneity in the access to financial markets between Eurozone members with devastating effects on the economies of many of them. Given that financial stability is a crucial condition for economic recovery, with the current levels of the financial tensions and the uncertainty implied by them fiscal adjustments and structural reforms implemented by countries with large imbalances are self-defeating (Padoan, Sila and van den Noord, 2012). This situation should not last since it not only threats the weakest members of the Eurozone. As current financial conditions reflect the expectations of a partial break up of the Euro, the potential consequences of this event may also be disastrous for the members remaining in the Eurozone and for the world economy. European leaders should be aware of these dangers and stand ready to make the necessary bold decisions to address them in the next European Council that will take place in June 28 and 29.

These expectations are based on the heterogeneity of the economic conditions of member states, but it is also clear that spreads are overshooting with respect to any sensible long-run sustainable level, since the differences in fundamentals are not sufficient to explain the differences observed in the prices of sovereigns in the Eurozone. As De Grauwe (2011) has shown the imbalances of Spain and the UK are very similar, but the government bond yields for the UK are only slightly higher than those of Germany, as Chart 2 shows. This evidence reflects the importance of institutions that ensure less volatility in risk premia and anchor expectations of economic agents, reducing the uncertainty of both demand (investors) and supply (Treasury) about prices and bid-to-cover ratios.

Chart 2
Government bond yields in Spain, Germany and UK



Source: Bloomberg, June 2012

Since the financial crisis broke up in 2007, the Eurozone has shown some flexibility to deal with unexpected problems. The LRTO and the SMP by the ECB, and the EFSF, the ESM, the six pack or the Treaty on Stability, Coordination and Governance are good examples of that. However, as Figures 1 and 2 show these advances have not been enough to avoid escalating financial tensions and a greater uncertainty about the future of the Eurozone. EFSF interventions have not worked as expected or, in the best case, have not been efficient. They have covered all the funding needs of the public sector, but at the cost of expelling private demand from the market, given the expected senior creditor status of European funds. These advances have not worked because they are running against the market belief that the euro can indeed break.

The solution

An alternative strategy should be implemented to restore the functioning of sovereign bonds markets, contributing to reduce the interaction between banking and sovereign risk. This strategy should avoid past mistakes ensuring:

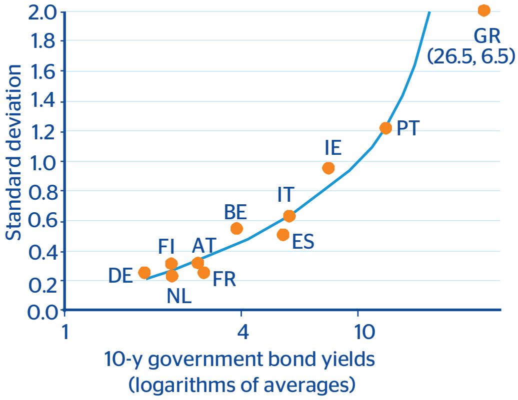
a. **Long-run consistency:** Short and medium-run policies should be consistent with a long-run design of the Eurozone and its institutions.

b. **Risk premia based on fundamentals.** Sovereign prices should reflect differences in fundamentals, but not expectations of a Euro break up.

c. **Anchoring the expectations of sovereign debt prices.** Reducing excessive volatility of government debt yields is essential in order to incentivize its demand in primary and secondary markets. The positive correlation between interest rates and volatility (Chart 3) introduces an additional source of uncertainty that affects negatively the demand of government bonds.

Long-run consistency has to be ensured with a clear roadmap for the Eurozone. A correct design of the future of the Eurozone is not enough. Bad equilibria must be avoided and to that end economic policy should aim at getting the economy onto the path of the right equilibrium. This can be understood as a standard dynamic programing problem, in which the solution entails identifying first the appropriate steady state of the economy and, then, solving backwards to implement the plan that guarantees that the good equilibrium is achieved. To ensure that non-predetermined variables jump onto the path that converges to the long-run solution, the Eurozone needs to identify the short-run changes in their policies and institutions that facilitate greater political, financial, fiscal and economic integration in EMU, avoiding the diverging track towards a partial or complete break up of the euro, as markets are discounting now with a significant probability.

Chart 3
Average and standard deviation of 10-y government bond yields from August 2011 to June 2012



Source: Bloomberg

In other words a consistent solution requires bold actions to change economic institutions in the Eurozone not focusing so much on their current limitations but on their expected future role. According to this strategy, Eurobonds should be part of the long-run steady sate, once Eurozone countries have undergone a similar convergence process as in the run-up to the Euro. In the past, convergence in interest and inflation rates was a necessary condition for a single monetary policy. Now, fiscal convergence and the reduction of other imbalances are key to support a process of sound –limited- mutualization of debt. The long-run solution will take time to be implemented. Until it is ready, the Eurozone needs an alternative.

A transitory mechanism that should be consistent with the long-run objective of tailoring a stable Monetary Union but also capable of dealing with the pressing very short-run risks that lie ahead in the next months or even weeks. And this mechanism is a modified and more efficient ESM. The ESM should intervene in the sovereign debt markets to anchor market expectations of the sovereign risk premia, with explicit objectives, in the same vein as the ECB anchors inflation expectations or the Central Bank of Switzerland anchors exchange rate expectations. Proceeding in this way the ESM will stir the demand of European sovereign bonds, allowing member states to issue new debt in primary markets with much less uncertainty. These spread targets should be country specific allowing for some natural variation of risk premia among countries, depending on the health of their respective fundamentals. These fundamentals can be inferred by assessing the performance of each country in the set of macroeconomic imbalances included in the alert mechanism by the European Commission. In order to increase the effectiveness of these interventions, the ESM should not have preferred status (Gross, 2012) and should have unlimited access to the ECB, if needed.

Design, pros and cons

On the positive side, the ESM would stabilize sovereign debt markets and would assume the sovereign risk of weakest countries, letting the ECB to manage the interest rate to control inflation. This preserves the independency of the ECB and improves efficiency with respect to the current SMP. Second, the ESM will issue a safe European asset (the predecessor of the Eurobond), whereas SMP does not create any investment safe asset, just liquidity. By creating this risk-free asset the Eurozone would be contributing to reduce the world scarcity of this type of assets (Caballero, 2010, IMF, 2012) as well as attracting new funds to the Eurozone. Third, it will have the advantages of a big market player in sovereign debt markets. Fourth, if the buying of the public debt of countries with higher risk premia were necessary, by issuing debt at a lower interest rate the ESM would make substantial profits. Fifth, the ESM would reinforce the incentives of countries to correct imbalances if these qualify as determinants of the explicit objectives for bond yields by the ESM (Muellbauer, FT, 2012). Lastly, by reducing financial tensions, the ESM would contribute to increase the effectiveness of fiscal adjustment and structural reforms in countries with larger imbalances.

Among the potential caveats, it is said that the unlimited funding by the ECB through the collateral discount of the ESM may be a very big risk for the central bank. We think that these risks are exaggerated since this collateral is of much better quality than those of commercial banks and the sovereign debt of the SMP. Commercial banks my actually buy securities issued by the ESM which would also greatly improve their collateral as well, contributing to a proper disconnect among the balances of banks and their sovereign and hence to a healthier financial integration in Europe. Second, it is also said that ESM interventions will distort the market. However, markets are already heavily distorted and transitory interventions by the ESM are intended to reduce these distortions. Is the Central Bank of Switzerland creating a distortion or correcting an exchange rate misalignment due to the current financial tensions? To be fully effective the ESM should establish and announce a country-specific cap to the spread of troubled Eurozone members. Alternatively, and to provide a better information to the market, the ESM could actually announce a soft upper bound so that the limit does not have to be changed very often. Additionally, conditionality and the determination of explicit risk premia as a function of macroeconomic imbalances creates proper incentives in the direction of reducing public debt. Third, it can be argued that the Maastricht Treaty had a no-bailout clause. However, these ESM interventions would not be a bailout since they would be limited to support national sovereign debts that are sustainable under a proper adjustment and conditionality, and at normal levels of interest rates. As stated before, the ESM would end up making profits. Additionally, it does not exclude the possibility of debt restructuring where necessary, as proposed by Wyplosz (2012), avoiding to bailout specific sectors, public administrations or firms. Finally, critics to ESM interventions say that they will create a moral hazard problem and incentives to increase public debt. Given the costs of the current economic recession, it is clear that the perils of moral hazard do not correspond with reality (Wolf, 2012).

Still an effective mechanism through the ESM may not be ready in a few weeks or months. In the meantime, both the EFSF and the ECB may intervene in sovereign debt markets. The ECB should activate its SMP again, but this time with a clear political commitment and support by EMU countries: this should be a temporary arrangement until its portfolio of sovereign bonds can be handed over to the ESM once it is operative.

Conclusions

Good and workable ideas for a better design of the UEM may be put forward and implemented in successive meetings of European leaders. But these blueprints might never see the light if the Euro actually breaks down. Time is of the essence. European leaders must take the necessary steps to ensure that confidence in these initiatives gathers momentum. They should act fast to make them operative without further delay.

The strategy proposed in this article is as ambitious as challenging, and will require a lot of political determination. It true that the costs and benefits will be different across members. Core countries have to support the needed flexibility of European institutions and should contribute to a limited mutualization of public debt, to benefit from a more stable and balanced monetary union, in which to lay the foundations of a more solid economic recovery. Peripheral countries will have to implement rigorous adjustments and ambitious structural reforms, losing sovereignty in favor of European institutions, to avoid a massive credit crunch and to benefit from much better access to financial markets. But, with a well-designed roadmap, benefits may exceed the costs for all members.

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