Can the Euro Survive?

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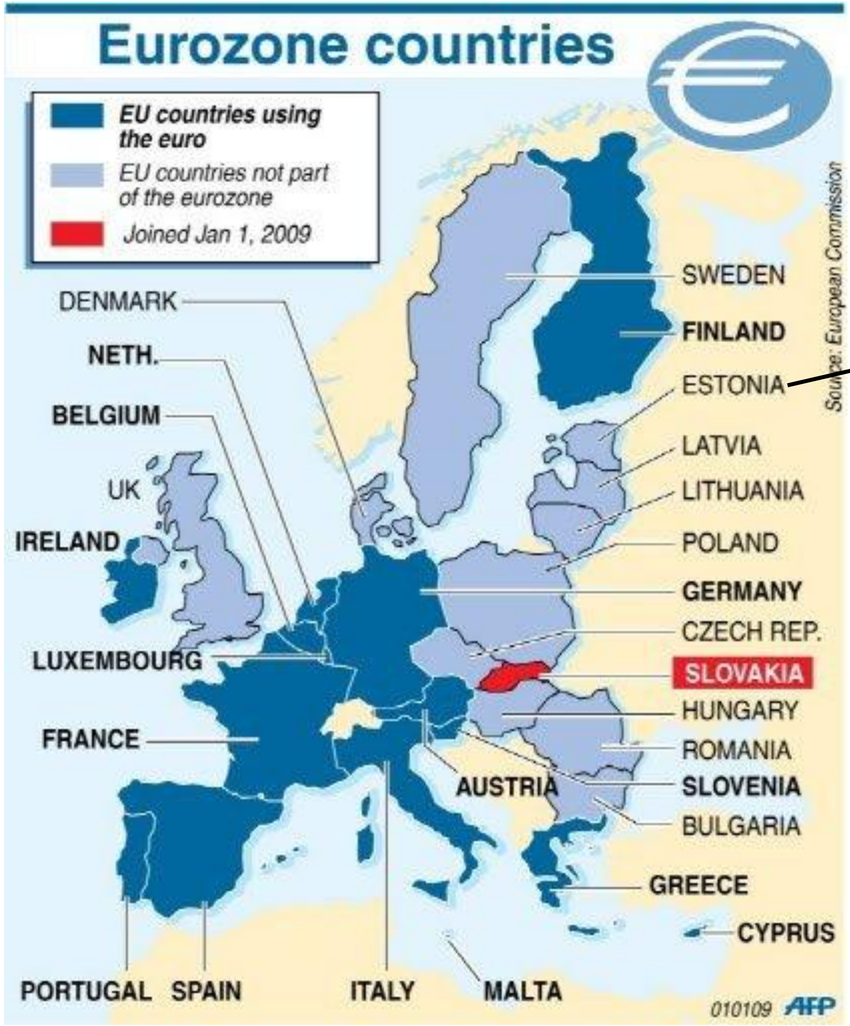
"Europhoria"

- Introduced as actual currency - January 2002
- Currently 17 members of Eurozone, Estonia being most recent
- Prior to 1999, Portugal, Ireland, Greece and Spain (PIGS) all had significant spreads of 10-year bond yields over Bund yields
- 2001-09, PIGS' 10-year bonds traded as if as safe as German bonds – spreads often less than 20 basis points
- Expectation of risk-pooling in Eurozone, e.g, cross-border fiscal transfers

Euro-zone

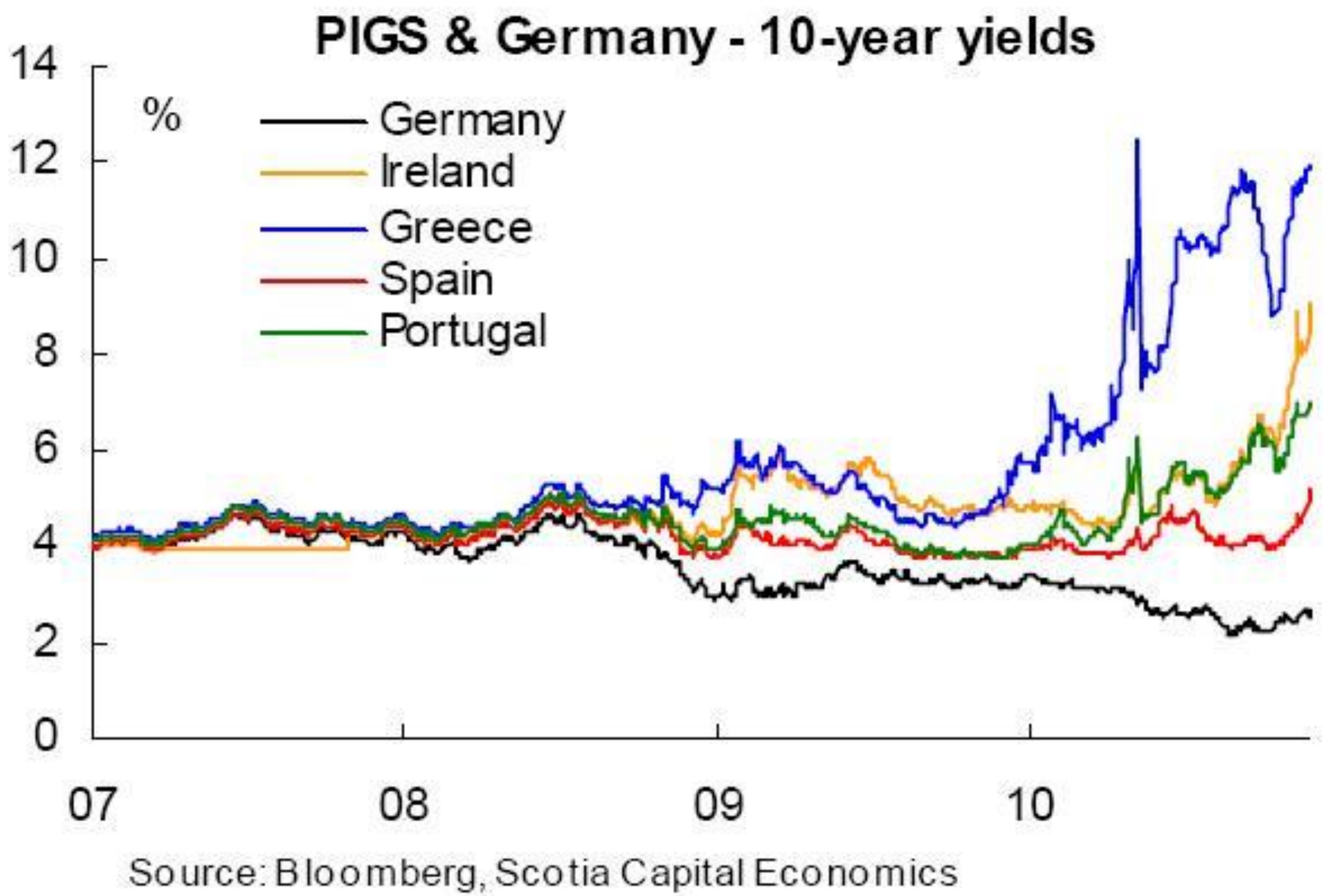


Joined Jan 1, 2011

Euro crisis: a drama with 4 actors

- **Mismanagement and deception by Greek authorities – October 2009, budget deficit revealed to be 12.7% of GDP *not* 6%**
- **Having failed to forecast Dubai sovereign debt crisis, ratings agencies focused not only on Greece, but other Eurozone countries – downgrading led to increased yield spreads**
- **Hesitation among Eurozone governments in giving clear signal of support to Greece**
- **ECB generated uncertainty about willingness to accept Greek bonds as collateral**

PIGS can't fly!



Is it all about public debt?

- Other than Greece, root cause of debt problem was unsustainable accumulation of private compared to public debt
- Triggered debt-deflation dynamic, forcing governments to take over private debt
- Prior to 2008, debt/GDP ratios of several Eurozone countries were actually declining – notably Ireland and Spain
- As austerity measures have been implemented, deleveraging of private sector has become harder, with potential for further deflation

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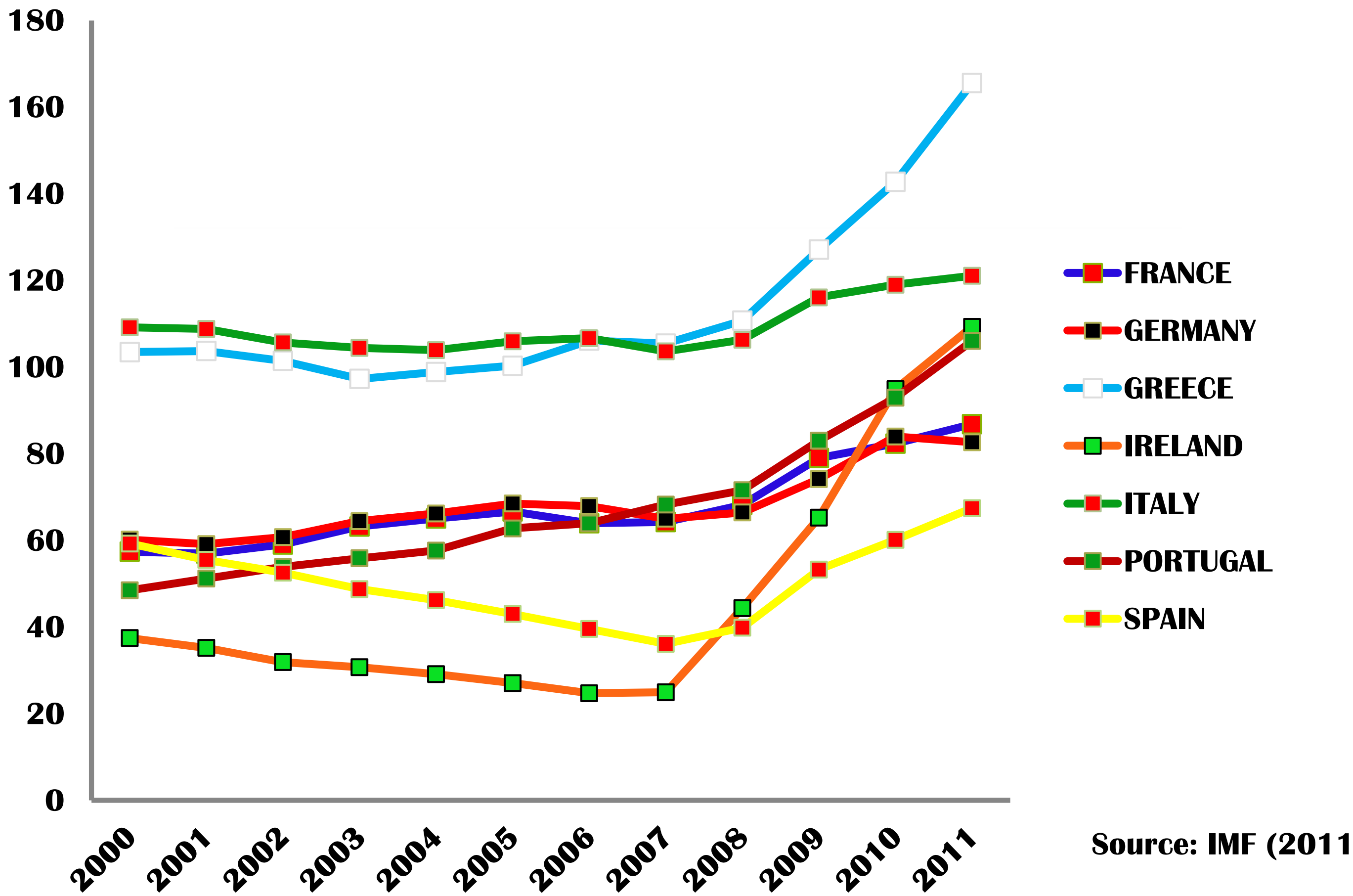
Eurozone debt

Government debt in selected Eurozone countries (% of GDP)



Source: IMF (2011)

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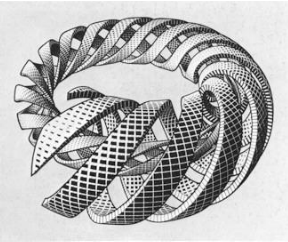
A paradox



- Since start of financial crisis, government debt ratio in UK has increased by more than in Spain, i.e., 89% vs. 72% of GDP
- Yet yield on Spanish bonds has increased strongly relative to UK bonds
- Why such difference in evaluation of sovereign default risks between Spain and UK?
- “Achilles heel” of monetary union such as Eurozone: Spain has no control over currency in which it issues its debt

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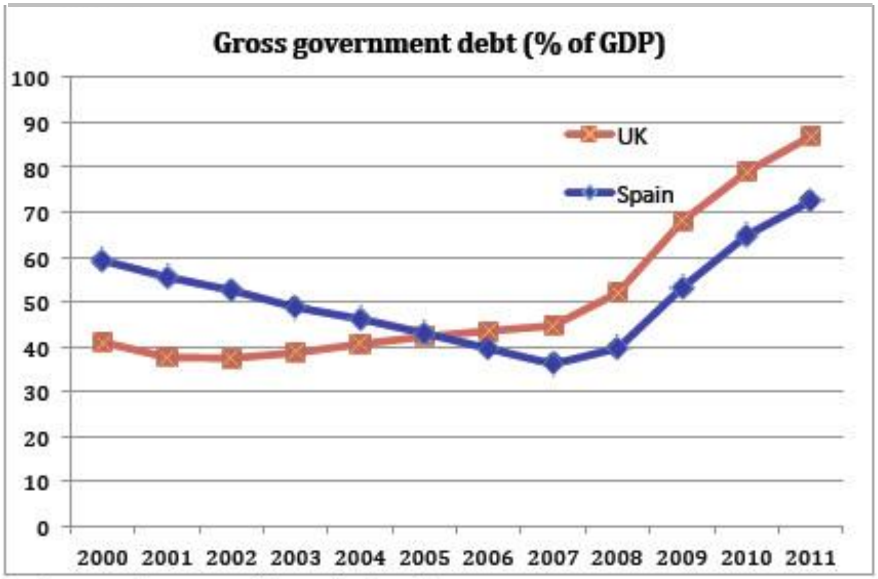
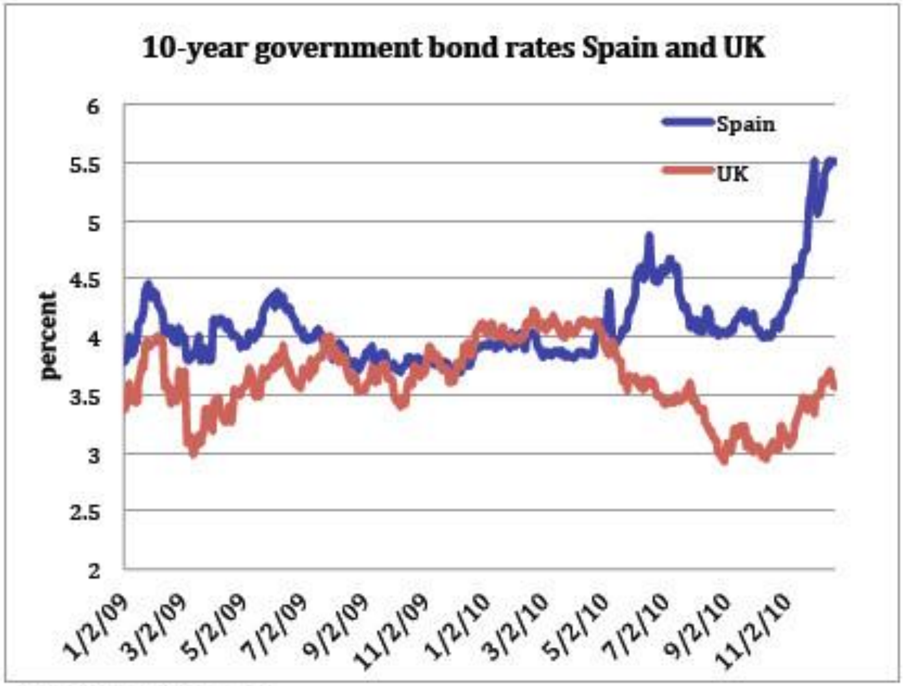
Spain vs. UK



Source: European Commission, Ameco



Source: Datastream

“Pain and misery…”

- If investors have concerns over default in Spain, interest rates rise as bonds are sold
- Euros leave Spanish banking system, and liquidity crisis occurs as cost of rolling over Spanish debt increases – “sudden stop”
- Also, Spanish economy cannot get boost from currency depreciation
- Fear of default in Spain becomes self-fulfilling prophecy as liquidity crisis turns into solvency crisis - risk of contagion elsewhere

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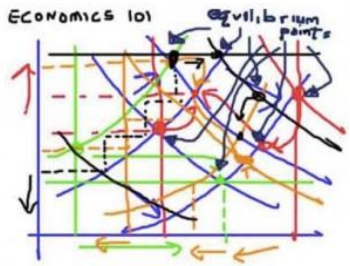
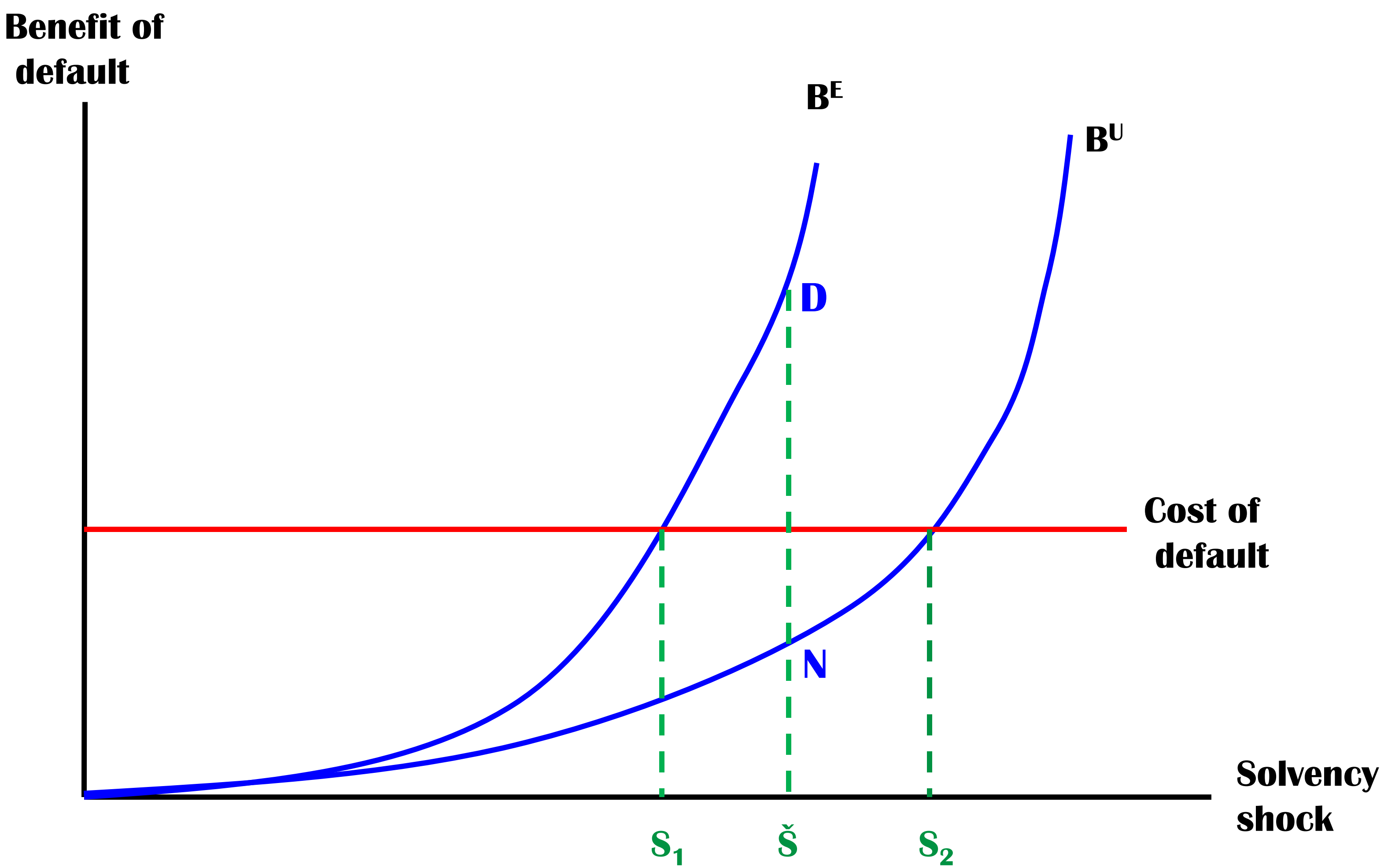


Good vs. bad equilibria



Source: De Grauwe (2011)

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Avoiding bad equilibria

- ECB should act as *lender of last resort*
- Prevents solvent countries such as Spain being pushed into bad equilibrium, i.e., resolves *coordination failure*
- Coordination failure due to rational expectations, i.e., fear of insufficient liquidity results in insufficient liquidity for country(ies)
- Cost of not acting as lender of last resort in EU bond markets is more costly bailout of its banking system

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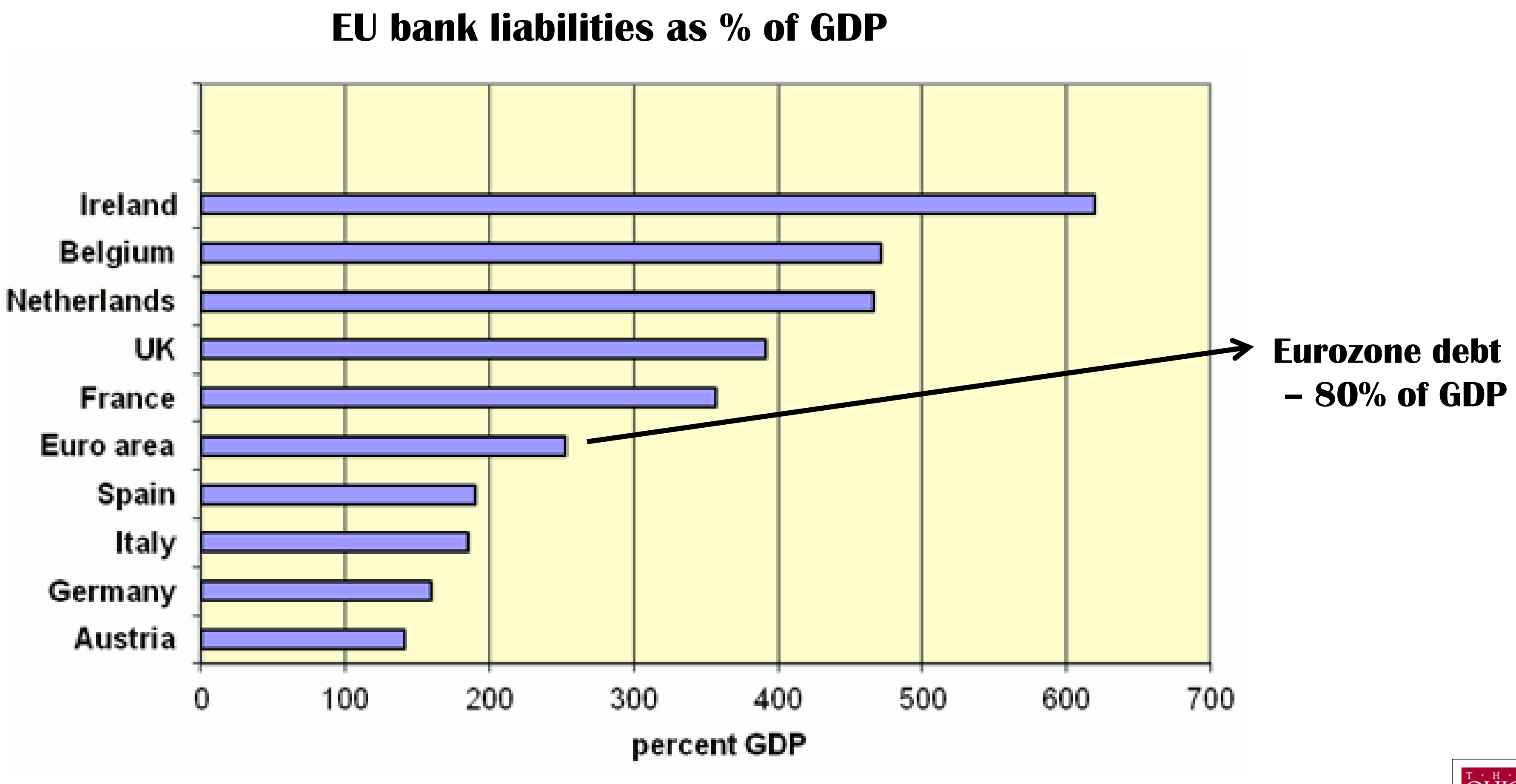
EU bank liabilities



Source: IMF (2008)

Arguments against ECB

- Risk of inflation? Money *base* vs. *stock*
- Fiscal consequences? Risk should be taken to ensure financial stability in EU
- Moral hazard? Need to separate role of insurance from fiscal supervision
- Bagehot doctrine? Only lend in case of illiquidity not insolvency – but with uncertainty ECB is necessary
- Legal? ECB allowed to purchase bonds in secondary market, i.e., it *can* provide liquidity

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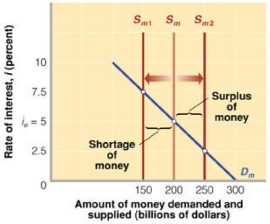
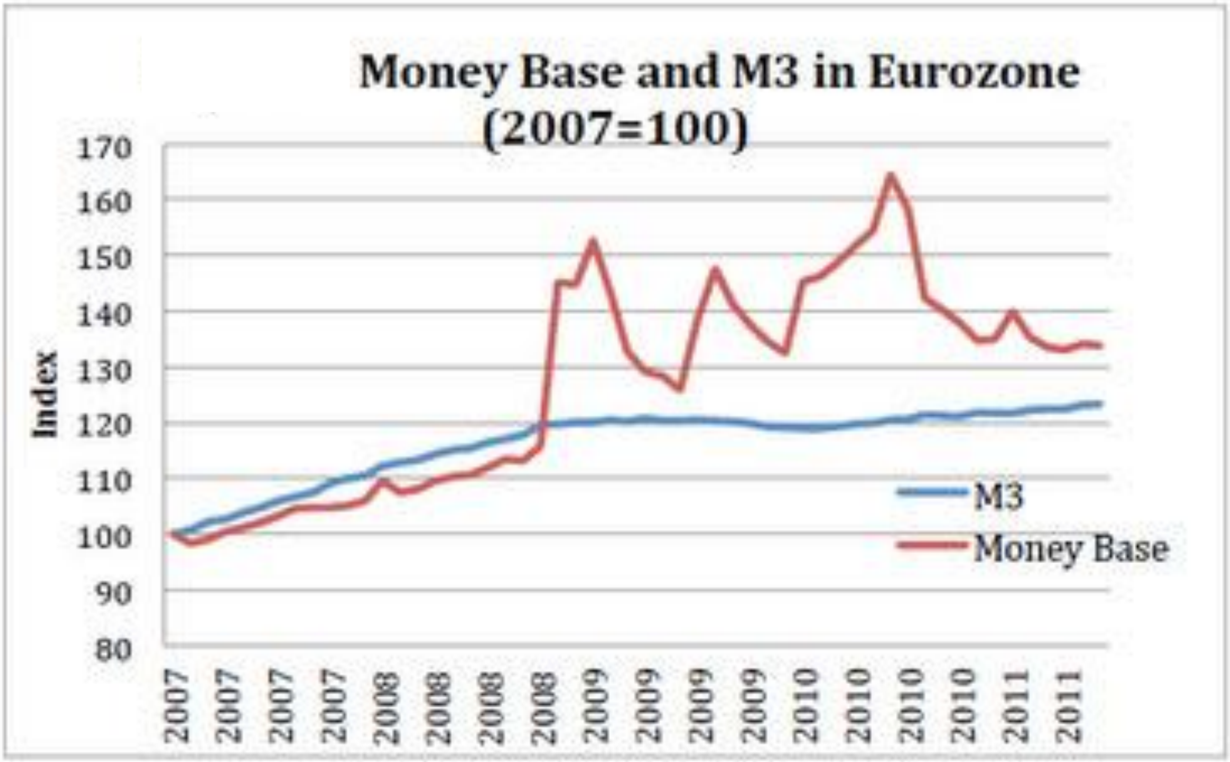
Money base vs. stock





Source: ECB, Statistical Data Warehouse

What if Euro collapses?

- **UBS have estimated costs of collapse:**

  - *peripheral* country (Greece) first year at 40-50% of GDP, 15%/annum thereafter

  - *core* country (Germany): first-year at 20-25% of GDP, 11%/annum thereafter

- **Costs of a rescue seem a bargain by comparison – but German taxpayers would prefer to punish “spendthrift” Italians and Portuguese**

- **However, breakup of Eurozone, and possibly European Union, would be much worse**

Can the Euro survive?

- **Concern in Northern Europe is to not provide incentive for more irresponsible behavior by "Club-Med" countries**
- **This view treats crisis as series of *individual* problems as opposed to a *systemic* problem**
- **Illiquidity of single country becomes problem for whole Eurozone – especially with financial market integration**
- **Reluctance of ECB to be lender of last resort in sovereign bond market has probably been key reason for contagion not being stopped**

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Final thought from Krugman…

"….What's needed, clearly, is for Europe — and ultimately that probably means the ECB — to provide for Spain and Italy the kind of backstop countries with their own currencies can provide for themselves. Without that, the whole euro system is at risk of unraveling…."

(New York Times, September 11, 2011)

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