

## The Eurozone Debt Crisis: From its origins to a way forward

Diego Valiante

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### Key Points and Recommendations

*The eurozone debt crisis has now reached a turning point. This Policy Brief argues for a more organised intervention by the European Central Bank (ECB) to stop contagion through the creation of a quantitative easing programme, coupled with a political agreement among member states for a more federalist budget for the eurozone.*

*The paper examines the roots of this crisis and how institutions have repeated some of the mistakes of the Argentine crisis in the late 1990s. It analyses the reasons why the ECB should start a quantitative easing (QE) programme to contain government bond yields, and shows that this can be done with limited impact on inflation-targeting policies. The importance of reinforcing the new policy announced by the ECB, which has lain dormant during the eurozone crisis, is also highlighted as a pre-condition for a broader political agreement to stabilise market conditions and to harmonise fiscal policies. This brief recommends that responses be organised on three levels: institutional competences, monetary policy support and fiscal policy coordination.*

### Introduction

As the government debt crisis in the euro area unfolds, it causes panic in financial markets and a degree of resentment among EU member states. The risk that the crisis will persist and stifle growth in the whole euro area is fairly high. Caution should guide the actions of European institutions in implementing exit strategies, because in a general downward economic trend the risk of 'fire sales' of assets and a deterioration in public finances may undermine any commendable privatisation and liberalisation efforts (Manasse, 2011; Gros, 2011). In such conditions, liquidity problems can easily become solvency issues and spread among eurozone countries (via so-called 'contagion' effects). From the outset, European governments have believed that the sovereign crisis was merely a short-term liquidity problem, and this in turn has led to a

political deadlock among member states. The responses offered so far have been unable to stop the contagion or to provide long-term strategies to fill gaps in competitiveness and growth. 'Kicking the can down the road' has contributed to the widespread belief that the crisis was somehow temporary, unconnected to the broader political project of the eurozone.

Sounder long-term proposals for a re-setting of institutional competences for the eurozone need to be brought to the table. The ECB could play a key role in this new institutional framework. Responses must be organised on three levels: institutional competences, a monetary policy response, and a fiscal policy response.

### *Fiat lux*

Let us rewind a few years. The sovereign crisis has many political and institutional aspects in

Diego Valiante is a CEPS and ECMI Research Fellow. He gratefully acknowledges comments from Cinzia Alcidi, Paul De Grauwe, Willem Pieter De Groen, Mirzha de Manuel and Daniel Gros.

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common with the Argentine crisis that culminated in default in 2001. In the case of Greece, even economic indicators seem to be following the same path, with a strikingly similar timeframe, but different intensity (see table below).

Table 1. Main macroeconomic indicators (5-year average)

	Argentina	Greece
	1996-2000	2006-2010
GDP growth	3.2%	0.7%
Current account (% GDP)	-3.7%	-12.3%
Unemployment	16.7%	9.4%
Public deficit (% GDP)	-2.9%	-9.45%
Public debt	40.1%	118.1%
Deposits flight (change in bank deposits last 12 months)*	-7%	-10%

\* For Greece, the period is April 2010-April 2011; for Argentina, it is December 2000-December 2001.

Source: Alcidi et al. (2011).

The two countries went into insolvency for two different reasons, however. Argentina chose parity with the dollar to face the hyperinflation that put the country under severe strain during the 1970s and 1980s and – thanks to the currency board – inflation came down drastically to a single digit in only a few years. Inflation had been a longstanding issue in Argentina since the decision in the 70s to devalue the currency by over 100% in order to boost the economy (the so-called ‘Rodrigazo measures’; see Escudé 2002, 2006), while the world was entering a deep oil crisis. Thus, at the beginning of the 90s, the currency board again gave some credibility to the economic and monetary policies of Argentina and the country soon regained access to financial markets.

For its part, Greece entered parity with the euro as part of a broader political project to push financial integration across Europe (first leg), to be followed, eventually, by more harmonised fiscal policies capable of pursuing complementary economic integration (second leg). As a result, the centralisation of monetary policies to the ECB moved the issue of credibility straight on to national fiscal policies. Greece has always had a fairly closed and corporatist economy in which a crucial source of economic initiative comes from public overspending. The

crisis has only rendered this situation more unsustainable.

As fiscal policies in both Argentina and Greece have failed to gain credibility over time, by not being able to minimise the negative effects of unprecedented monetary policy decisions, capital and deposits have flown into similar investments (in the same currency) outside the country (in the case of Greece) or more simply into the parallel currency (the dollar for Argentina). Both countries also had a very low level of foreign investments,<sup>1</sup> largely due to the concurrent devaluation of neighbouring countries’ currencies in their regional areas (Brazil and Turkey, respectively), and to aspects of traditionally corporatist economies.

As with Argentina, the eurozone debt crisis has seen exit strategies being implemented by international organisations, with the similarly questionable level of institutional and political support that contributed to Argentina’s serious troubles and eventual default.

On Argentina, the IMF courageously concluded:

Indeed, to the extent that the currency board arrangement encouraged the build-up of balance sheet mismatches, an earlier exit (e.g., in 1992-94 or in 1996-97) would have been preferable. Such an exit, had it been undertaken sooner, would not have been painless, but it would likely have been less painful than what actually occurred. This illustrates the importance of an appropriate macroeconomic policy mix and, more specifically, **an exchange-rate regime that fits a country's economic and political realities** (*emphasis added*), (IMF, 2003, p. 70).

And again:

In the end, the Fund chose to continue to provide financing in the hope that the government would deliver on its commitments and that confidence and growth would return – in effect, allowing the authorities to “gamble for redemption”. While this strategy, when adopted in early 2001, might have **succeeded in a more favourable external and political environment**, by mid-2001 the chances of success had become

<sup>1</sup> This was a structural issue for a closed economy such as Greece, while for Argentina it gradually became an important issue as the economy started to decline.

minimal. At this stage, the provision of significant new financing only postponed the inevitable and, by raising the debt burden, also meant that the costs of the eventual collapse were all the greater (*emphasis added*). (IMF, 2003, p. 67).

In both Argentina and the eurozone, political decisions – the drastic reduction of historically high inflation and promoting financial and economic integration, respectively – have not been sufficiently supported over time by correct monetary policy decisions and complementary fiscal policies. The decision to issue debt in a currency that the issuing country cannot control comes at a cost (Kopf, 2011), which in both cases was underestimated in a period of growth. This could have been the opportunity to establish financial stability mechanisms and exit procedures to be used as a threat to promote fiscal adjustments. Argentina has also taught us that austerity measures cannot be implemented without a plan for investment to avoid a downward pressure on the economy. As a result, wrong decisions at the fiscal and monetary policy levels have reinforced each other, locking these countries in to a brutal spiral of disruption.

In other words, as a result of hard-pegged exchange rates, both Argentina and the eurozone saw a gradual deterioration of their public finances and general economic conditions due to capital mobility and global market events (the financial crises of 1998 and 2007).

### A ‘game change’

With the benefit of hindsight, the objective for EU policy-makers today is to succeed where the IMF failed with Argentina, and to avoid the implosion of the eurozone and the return of Greece and other countries to a variable exchange rate to facilitate fiscal adjustments. The decision in 1998 to fix exchange rates without introducing exit procedures<sup>2</sup> and mechanisms to support imbalances (through a roadmap to create harmonised fiscal policies), also carries a high

<sup>2</sup> The exit of one or more countries may risk contagion effects and turn out to be unworkable for procedural reasons (Eichengreen, 2007, 2011). For instance, in the process of redenomination of all contracts in the new national currency, the country may need to block capital outflows as the fear of devaluation will push people to shift all remaining deposits and assets into other euro area countries.

price. But the eurozone is a political decision that comes from the willingness of European citizens to promote economic and financial integration. That political project is still valid.

To define a response at institutional level, the role of key institutions, such as the International Monetary Fund, must be carefully assessed. The IMF has offered financial aid to Argentina and Greece to support a decision (the parity with the dollar and the creation of the eurozone) made by governments and not by central banks. In effect, the political role of the IMF in this and the Argentine crisis may be an intrinsic problem. Monetary funds are generally tools designed to work with short-term liquidity funding problems and therefore the conditions attached to the intervention as ‘lender of last resort’ must be based on short-term monetary policy issues, rather than long-term fiscal and political objectives (solvency problem). According to the IMF:

There was not sufficient attention paid to the fact that the structural reforms that were seen as critical to growth had largely stalled. Fiscal policy assessments were not based on an adequate appraisal of the risks to debt sustainability in the event of a slowdown in growth (IMF, 2003, p. 71).

And again:

**[..] in a situation in which the debt dynamics are clearly unsustainable, the IMF should not provide its financing** (IMF, 2003, p. 72).

The lesson from that failure was that the IMF should only consider direct financial intervention when the three conditions below are met:

1. A short-term liquidity problem, rather than a long-term solvency issue;
2. The country’s lender of last resort (central bank) does not have enough resources to tackle the liquidity crisis; and
3. Intervention must be conditioned on a change in the monetary and fiscal policy of the beneficiary.

In the case of Argentina, the condition for the IMF intervention could have been the exit from parity with the dollar, which was clearly unsustainable (at least a few years after its introduction), rather than supporting decisions made by governments (with its official blessing). Likewise, the fund



should not have intervened in the eurozone crisis and taken on the ECB's role of lender of last resort, which has the means to play this role. An intervention to help Greece and its central bank to exit the euro area, providing funding and jointly defining a new exchange rate around its economy and competitiveness, would have been the only reason for the IMF to intervene. Yet the IMF has implicitly decided to support, with the funding of a eurozone member state, a situation fed by a political impasse. The idea of being able to solve a long-term structural political problem through short-term funding relief, such as the IMF or similar tools (e.g. the European Financial Stability Facility - EFSF) linked to austerity fiscal measures, is questionable. Long-term fiscal problems and competitiveness issues should be the prerogative of institutions, such as the European Commission (on a mandate of the European Parliament), which are able to set the right framework for fiscal policies to be effective, with the independent support of central banks.

### Quantitative easing for the euro area

As the public debt situation becomes more complex, the ECB (via the Eurosystem of central banks) - with the tacit approval of France and Germany - has recently decided to buy limited amounts of government bonds, thereby taking a partial role of lender of last resort to respond to the gravity of this crisis (ECB, 2011). The ECB acknowledges that by allowing "selective/restricted defaults", contagion effects would most likely spread among euro area countries and, with no support for the implementation of austerity measures, pressures from public opinion would gradually lead those countries to quit the eurozone and adjust exchange rates, with all the unpredictable consequences that this would have.

In effect, the ECB has so far defended inflation targeting, even at the cost of creating intolerable social conflict and economic disparities. The existence of the eurozone itself should come before price stability. The ECB's intervention would therefore not have to save a political project but rather support countries that have lost control of their monetary policies.

The ECB, as emergency backstop of the eurozone, should therefore have intervened from the very beginning to stabilise the eurozone's secondary

markets for government bonds and most importantly, to make sure liquidity issues would not turn rapidly into solvency crises. A political impasse has slowed down intervention by subjecting each bail-out programme to heavy political (and public opinion) backfire from funding countries and injecting uncertainty into global markets.

As long as the eurozone refrains from deploying all its potential resources to make markets believe that countries are doing everything possible to avoid default, the situation will not stabilise (Zingales, 2011).

The decision to buy bonds in the market may not be enough. The Eurosystem should therefore stand ready, with immediate effect, to contribute with a quantitative easing (QE) programme to purchase government bonds of the euro area in the secondary market, in the same way that they racked up the covered bonds from financial institutions during the crisis to stabilise the money market and so real interest rates. The ECB should disclose the amounts and modalities of the auctions of its Securities Markets Programme. In effect, as the lender of last resort in the euro area (De Grauwe, 2011), the ECB intervention to support the sovereign bond secondary markets would be a natural thing. This is crucial when markets have lost confidence that current fiscal policy interventions (EFSF and ESM) will be able to rescue huge eurozone debts, such as the Italian one. The central bank's action should resolve the coordination issues among member states that create instability in financial markets, high volatile patterns and a potential freeze in the interbank money market. This is where the ECB plays a key complementary role to fiscal policies.

Finally, competing QE programmes, such as those of the UK and the US, also contribute to the appetite for lower-risk eurozone bonds among international investors, which may consider that markets supported by their own central banks are safer.

### Two classic objections to QE

The two classic objections to QE by the ECB are the risk of moral hazard by member states, and the risk of deviation from the price stability objective set out in the ECB statute and the European Treaty (TFEU, Art. 121.1).

The moral hazard problem, as with financial institutions, is a problem of supervision and monitoring costs. In an institutional setting such as the eurozone, formal control over member states' new issuances can be carried on jointly by the European Commission and the European Central Bank. Procedures must be designed to impose – on countries benefiting from a QE programme – formal approval for new emissions by the ECB and Commission if no austerity measures have been implemented. Additional sanctioning measures can be imposed through cutting the resources pumped into the economy of the troubled country to support austerity measures. In this way, European institutions would also exercise stricter indirect control of national fiscal budgets (see below, final section). The ECB will only intervene to support secondary markets so bond yields.

The impact of QE on the price stability mission must be assessed from a legal and economic/financial standpoint. Legally, looking closely at the Treaty (Art. 121), the purchase of government bonds in secondary markets would not infringe the rules assigning competences to the European Central Bank and its price stability mission (Butier, 2009), especially if the programme is backed up by greater contributions of NCBs to the capital of the ECB. In addition, another banking crisis fuelled by sovereign defaults would definitely hamper monetary transmission channels. The Eurosystem, as shown below, was already active in purchasing covered and government bonds to help financial institutions, both in 2009 and 2010 (roughly €60.87 billion; ECB, 2010).

From an economic and financial standpoint, the Eurosystem can certainly carry out QE via several tools available on its balance sheet.<sup>3</sup> So far, the Eurosystem has provided liquidity to financial institutions with a net lending of €135.28 billion<sup>4</sup> (total lending of €505.13 billion). The average annual net interest rate<sup>5</sup> on its assets is 1.02%.

<sup>3</sup> Interestingly, the BoE is carrying out its QE by funding an off-balance sheet fund that has the power to acquire UK gilts like other financial institutions in the market.

<sup>4</sup> The net lending is calculated as the difference between the total lending of the ECB to financial institutions minus all deposits held in the Eurosystem.

<sup>5</sup> The difference between the annual weighted average interest rate paid on deposits (liabilities) and the annual

Table 2, below, compares key items of the balance sheet of the Federal Reserve, the Eurosystem and Bank of England.

At the end of the first quarter 2011, the eurozone has the world's biggest gold reserve and, comparing key indicators (shaded areas) with the Bank of England (BoE) and the FED, the Eurosystem consolidated balance sheet so far shows very low market activism, in line with its decision not to be directly involved in the sovereign debt crisis. The Eurosystem has only been active in offering repurchasing agreements ('repo') for financial institutions to support markets indirectly.

Total assets are 3.4-times gold and FX reserves, while securities held in portfolio represent only 25.76% of total assets in comparison to over 90% for the BoE and over 80% for the FED. In addition, the Eurosystem consolidated balance sheet holds only 5.45% of total outstanding government securities, and just 1.29% purchased in the last year for monetary policy purposes. The BoE and FED have proportionally more than three- and two-times this amount. By July 2011, the Eurosystem had purchased the government bonds of Greece, Portugal and Ireland for roughly €74 billion, plus circa €33 billion by the ECB directly.

As a result, the ECB can both increase the size of the balance sheet and adjust the assets side with very limited impact (if any) on inflation targeting policies. Expanding the assets side can be achieved with two sets of operations. Firstly, by tightening repo transactions policies (removing discretionary decisions in the application of requirements such as the 'minimum rating') and dismissing most liquid financial instruments – such as most of the €60.87 billion purchased under the Securities Markets Programme (SMP) – thereby trying to exploit up to €316,66 billion that are currently booked on the balance sheet as revaluation accounts.

weighted average interest rate received on lending operations towards euro-area credit institutions.

Table 2. FED-BoE-ECB key balance sheet indicators (€ mil)\*

	Federal Reserve	Eurosystem	Bank of England
Gold (Q1 2011) ^	261,480.86	363,250	9,975.93
FX currencies (Q1 2011)^	89,134.39	222,419.64	52,357.99
Tot.	350,615.25	585,669.64	62,333.91
Total assets	2,275,768***	2,000,471	256,502.48
xtimes Gold/FX	X6.49	x3.42	x4.12
Notes and coin (M0)	716,979	855,737	67,974
% tot. assets	31.5%	42.78%	26.50%
xtimes Gold/FX	x2.05	x1.46	x1.09
M2 aggregate	6,472,795	8,489,167	2,359,698
Government securities <sup>o</sup>	1,139,160	457,426**	224,613
Other securities	701,633	60,873	8,883
Tot.	1,840,793	518,299	233,496
% tot. assets	80.89%	25.76%	91.03%
xtimes M0	x2.57	x0.61	x3.44
Capital	35,969	81,480	5,011
% tot. assets	1.58%	4.07%	7.37%
Reserves balances (minimum and excess)	892,809	208,285	145,345
% tot. assets	39.23%	10.41%	56.66%
Govt debt (securities outstanding)	10,129,952	8,323,500	1,268,200
Govt sec held/Tot.	11.25%	5.45%**	17.71%
Interbank rates (Aug 4 <sup>th</sup> ) <sup>∞</sup>	0.09%	0.851%	0.54%
Nominal interest rates	0.25%	1.50%	0.50%
Excess reserves rates	0.25%	0%	n/a
Deposit Facility	0.28% (term dep. on July 26th)	0.75%	0.25%

\* Updated to end July/August 2011 where not otherwise indicated. Exchange rates at end of Q2 2011 (EUR/USD: 1.4391; EUR/GBP: 0.88274; ECB data warehouse; gold price at Q2 2011; World Gold Council).

\*\* Estimates (assuming that the Eurosystem does not hold other securities than covered and government bonds). The ECB holds €33.94 billion directly and roughly another €74 billion for monetary policy operations. The remaining government bonds are held by national central banks and may have been sitting on their balance sheets from the inception of the euro.

\*\*\* It includes gold reserves at their current value.

<sup>o</sup> Securities of their national government(s) held in portfolio or resources allocated to purchases (e.g. BoE).

<sup>^</sup> Value at end of Q1 2011. In the US, gold reserves and receivables are usually posted on balance sheets at a price of \$42 2/9, roughly \$11 billion. Gold and FX do not usually generate monetary income.

<sup>∞</sup> Federal funds rate (US), EONIA (EU), and SONIA (UK).

Sources: Author from FED, BoE and ECB database, World Gold Council, AMECO database, and Eurostat.

Table 3. Outstanding securities portfolio breakdown  
(top 4 euro countries; € bil)

Central bank	Securities held in portfolio	Covered bonds	Government debt
Germany	36.2	15.6	20.6*
Italy	84.4	10.1	74.32
Spain	87.83	7.39	80.43*
France	90.4	21.3	59.5
<b>Tot.</b>	<b>295.83</b>	<b>54.39</b>	<b>234.85</b>

\*Estimates.

Source: Author from central banks' annual reports.

The table above shows the current securities holdings of the top four eurozone central banks. In line with its official political position, and despite the fact that it is the biggest economy of the eurozone, Germany's central bank only holds roughly €20 billion in government debt. The *Banque de France* has the biggest securities portfolio, closely followed by Spain and Italy. Most of these government bonds have been sitting on the NCBs' balance sheets since well before the crisis began.

Additional contributions to a QE programme can also come from national central banks, which can fuel additional available resources into the capital of the Eurosystem, roughly €81 billion (including past reserves), or directly into the capital of the ECB (around €10 billion). Tightening repo transactions policies, dismissing most liquid financial instruments, and increasing the capital contribution of NCBs' actions would certainly have no impact on price stability mechanisms.

Secondly, there are other available tools that may have an indirect but very limited impact on inflation targeting policies. For instance, the Federal Reserve buys treasuries on secondary markets (through public auctions) and typically wires funds into current accounts held by clearing house banks at the central bank. Financial institutions receiving these funds use very limited amounts because the FED gives an interest on excess reserves that is higher than the federal funds rate and roughly the same as term deposit facilities (see Table 2, above). The payment of this interest may require liquidity injections into the system, but - assuming governments will sooner or later be back on track

- transactions may be sterilised by selling those securities when markets recover. For its part, the ECB does not offer any interest on excess reserves at the moment and the main interbank rate is consistently higher than the US one, the use of the same tool should therefore be coupled with actions in the interbank money market by acting on discount rates and reserves requirements. In addition, the ECB should disclose details of the QE, in particular the total amount of expected purchases and how these securities will be bought (preferably through public auctions).

The potentially deployable firepower would certainly be big enough to restore market confidence that European institutions are able to face risks of default and to sustain countries' market fundamentals in the medium term. In addition, the ECB can always use, as a 'last resort' tool, the possibility to act on nominal interest rates to expand the monetary base.

### Why quantitative easing?

The Eurosystem is already indirectly active in the sovereign bond market by financing financial institutions and by offering repo lending at better-than-current-market conditions, thereby supporting artificial market access for countries such as Greece and Portugal. By only accepting Greek and other public debt securities as collateral, however, the ECB has not removed the risk that it is indirectly taking on, even if it is 'off balance sheet'. If Greece and other peripheral countries default, in effect there is a high chance that the European banking system will experience a profound crisis, which would freeze the interbank market and call the ECB indirectly into play by accepting losses on the collateral it is currently holding. The ECB is therefore not only providing repo money with lower-than-market-value haircuts, it is also indirectly placing implicit guarantees on the default of sovereigns. In this way, financial institutions enjoy the benefits of a potential recovery, while the costs will ultimately be borne by the ECB.

A direct intervention would create more favourable conditions for a 'game change', even though it is certainly not the only action needed to solve this crisis. In effect, a programme of government bond purchases in the secondary market can have multiple effects.



1. It would stabilise market mechanisms more naturally, by minimising perverse downward market pressures and temporarily recreating more favourable market conditions, boosting the appetite for risk among investors. For instance, US treasuries yields have remained stable and even at a lower-than-expected level when the FED announced the end of the QE2 and throughout the recent discussions about the debt ceiling, showing that the support of the central bank managed to create confidence and a risk appetite among international investors over time. Of course, this risk appetite will only be short term if the US does not address its fiscal position. Bond purchases via market auctions at current prices may lower haircuts, with beneficial effects on other riskier financial instruments too (such as corporate bonds). Improved market conditions would also indirectly benefit the interbank market, the money market and real interest rates. Purchases must then be targeted to those key instruments ensuring market liquidity. Eighty-six percent of bonds purchases by the FED are in treasuries of between 2.5 and 10 years' maturity. Finally, the ECB must disclose the size of the quantitative easing programme, as well as the kind of instruments and maturities of each purchase over time.
2. Booking government debt securities on the balance sheet of the central bank has other positive implications. First, burden sharing – through contributions by NCBs to the capital of the ECB – may allow the Eurosystem to provide more flexible and immediate responses to liquidity crises than rescue plans, which require lengthy political processing through national parliaments. Second, the political pressure to apply fiscal austerity measures would be exercised by the ECB and other EU institutions on the more credible threat that the programme would stop as soon as fiscal measures stop or slow down. Third, the debt will finally sit on the Eurosystem balance sheet, which would allow more control if the country gets into liquidity troubles or succeed with their fiscal adjustments (sterilisation). Finally, it can be more easily restructured as a reward if the country succeeds with structural reforms.
3. 'Buying debt' will also slow down the pro-cyclical mechanisms of rating downgrades and will limit their role in this crisis, even though it does not solve the issue of the role of ratings in capital requirements regulation.
4. It will limit the hold-up of financial institutions versus domestic governments (by holding these instruments) and so their moral hazard.
5. A QE would free the European Commission of the heavy political burden to seek approval for liquidity rescue plans. In effect, the ECB intervention would allow the Commission and national governments to seek fiscal policy coordination on more structural issues, such as internal real imbalances and growth. European institutions would have enough time to work, in line with the Treaty, on long-term solutions to boost competitiveness and reforms in the eurozone. This would also give them enough time to consider the developments in a global economy whose centre of gravity is inexorably moving away from Western countries towards emerging economies.

A well-designed programme can stabilise markets by signalling that the ECB is willing to embark upon its role of lender of last resort to avoid the break-up of the eurozone.

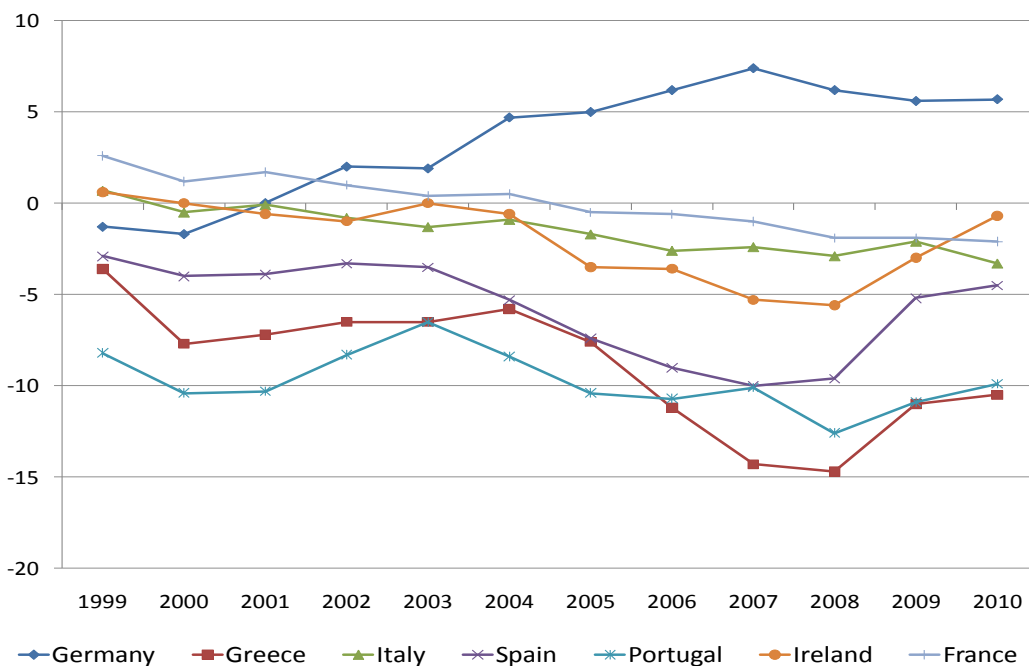
### Internal imbalances: towards a more 'federal' solution?

Once mechanisms have been put in place to prevent moral hazard and to ensure the ECB's independence, the decision of the ECB to approve a broader purchase programme to support eurozone member states may provide European institutions with a tool to push fiscal adjustments and structural reforms (with a European objective) in member states. QE actually draws the missing link between a common monetary policy and a mechanism for more coordinated fiscal policies. Member states would irredeemably not be able to bargain their part of burden sharing (as indirectly done by the ECB), so they would try to exercise greater control by promoting adjustments, structural reforms and austerity measures with the support of a eurozone budget. If they keep ignoring the reforms, the ECB can stop the programme, which would plunge member states back into deep waters.



In effect, internal imbalances are at the core of this crisis. Since its inception, the single currency has boosted regional imbalances in the euro area in favour of those countries that could compete more in global markets. Countries such as Germany,<sup>6</sup> Finland and the Netherlands have enjoyed and are enjoying high surpluses<sup>7</sup> in the short term, also thanks to the euro, which has allowed them to further exploit their long-term advantage in competitiveness over southern European countries.

Figure 1. Eurozone's current accounts balances (% of GDP)



Source: Eurostat.

Figure 1 shows trends in current accounts deficit/surplus among major eurozone countries. Not surprisingly, Germany - historically a competitive country with a high level of innovation - immediately experienced a bounce into the surplus area (and now consistently above 5%) since the introduction of the single currency. Countries like Italy and France, on the other hand, have seen a gradual deterioration of their

<sup>6</sup> It is also true that in the mid-1990s Germany implemented reforms that blocked salaries for some years while it invested in innovation, but this does not explain the perfect timing in which the current account rose above 5% after the introduction of the euro.

<sup>7</sup> The recent slowdown in the global economy is currently affecting the current account balance of these countries, which still remains fairly high in comparison to peripheral eurozone countries.

current account balance since the euro was introduced.

Bail-out programmes have so far been simply short-term measures in which wealthier countries have contributed with a minimal part of their budget to strengthen the system that allowed them to become stronger. It is also undeniable that the eurozone has supported uncompetitive countries, bringing their debt burdens into the area of apparent sustainability. In practice, this situation has created, on the one side, moral

hazard by myopic governments and leaders that saw the possibility to borrow at a lower cost to finance public expenditures, rather than as an opportunity to reinforce fiscal positions and promote less popular structural reforms to fill the competitiveness gap. On the other side, structural reforms may take years and cannot be carried out without the support of public and private investment.

Bolder and more long-term proposals for a eurozone fiscal budget must be brought to the table (Jutta et al., 2011). Contributions to a more federalist eurozone budget may be supported by a Eurobonds issuance, and could also be indexed to the level of surplus (or growth) that countries enjoy (thanks to the common currency). A more federal budget could provide fiscal support, in particular to those countries carrying out painful fiscal adjustments and long-term economic reforms, which will always lag behind in a competitive (and non-federalist) regional area. Proposals must of course be supported by stronger intervention powers, with effective sanctioning systems. Reforms cannot be implemented only through austerity, but they need to be softened by investments, which will minimise the probability that the country falls into a mechanism of 'loss aversion'. More specifically, loss aversion means

that if the general public of the country under stress perceives a choice between two losses – fiscal austerity measures (loss with high probability but ‘low’ impact) versus the risk of exiting the euro area (loss with low probability but much higher impact) – they may become risk-seekers, thereby pushing the country to fail fiscal adjustments (as for Argentina) and quit the eurozone to revert to a floating nominal exchange rate.

### Four potential scenarios

The uncertainty around the political process can produce four potential scenarios for the eurozone.

#### 1. ‘Dream’ scenario

The temporary rescue plans (supported by the ECB until the European Financial Stability Facility enters into force) succeed in dealing with liquidity issues and pushing austerity measures. The economy becomes more open and capital inflows increase. The sustainability of public finance and confidence in the government bond market gradually return to normality. The economy returns to a level of growth sufficient to promote prosperity. There is no debt restructuring or default and the debt dynamics become more sustainable.

#### 2. ‘Pessimistic’ scenario

No political support to expand rescue plans and accept a stronger ECB intervention. Greece and possibly other countries unilaterally decide to exit the eurozone. The currency will adjust and euro-denominated debt remains until maturity, if it is not under domestic law (e.g. 90% of Greek debt is under domestic law). However, in the short term, there will anyway be a default<sup>8</sup> until the procedure to exit the eurozone has been fully implemented. An exit procedure from a common currency union has never been implemented before and may take years. The country will then be officially on its own. In the meantime, this will not stop contagion effects among other EU countries.

<sup>8</sup> It may not necessarily be nefarious for a sovereign to default. History shows that sovereign defaults are typically followed by sustained economic recovery, as in the case of Argentina (Panizza et al., 2009).

#### 3. ‘Muddle-through’ scenario

Rescue plans and temporary ECB intervention do not succeed in pushing Greece and other peripheral countries back on the track of sustainable public finances (dream scenario). The eurozone will keep providing resources through rescue plans approved by member states until the wealthier countries decide to turn off the tap. This situation could trigger a hard restructuring or simply a default for Greece (followed perhaps by other countries, such as Portugal and Spain, in the short term). The interbank market will most likely freeze if the ECB does not intervene again. However, Greece and Portugal (as well as other potentially defaulting countries) may only decide to remain in the eurozone in the short or medium term. Risk will certainly spread to other countries, mainly because markets anticipate the fact that there will not be enough support (without strong ECB intervention) to rescue countries such as Spain, and Italy, for instance. As stated, market confidence in eurozone sovereigns is built on the implicit guarantees of stronger countries. If they threaten to withdraw these guarantees, the value of peripheral sovereign debt plunges according to their economic fundamentals. Even more solid countries, such as France, will eventually suffer contagion effects. The future tensions that this situation may create would cause the eurozone to break up and to perhaps keep the common currency area only in a few continental countries.

#### 4. ‘Game change’ scenario

The ECB shows its muscle and decides to intervene directly in the market to solve the short-term liquidity needs with a medium-term QE programme, as discussed above. The intervention also succeeds in designing appropriate burden-sharing among NCBs through a greater contribution to capital and reserves, and it also stimulates member states to reach greater coordination of fiscal policies. In effect, parallel to the ECB intervention, eurozone member states – feeling they are losing direct control over burden-sharing mechanisms in the European Monetary Union – and the European Commission decide to seek political agreement on a process to strengthen economic integration via a more federal budget (supported by issuance of European financial instruments). In the meantime, under this scenario, the Commission will inject new resources for long-term

investment (to support austerity measures) and – jointly with the ECB – will supervise the implementation of austerity measures and predispose an official exit procedure from the eurozone, threatening to use the procedure and stop the QE and other liquidity support for countries that do not comply. Additionally, member states will be forced to find a broad and stable political agreement thanks to the indirect burden-sharing imposed by the independent ECB intervention. Once a more federal budget is agreed, the Commission could elaborate a long-term strategy to boost competitiveness in troubled countries and to implement even more structural reforms and investments in innovation. Essential to this broader action is the definition of an effective mechanism of sanctioning/rewarding for ‘net-receiver’ countries, as well as an exit procedure from the eurozone if sanctions are not enough.

## Conclusions

The eurozone is at a turning point. Either we can sink in the mire of our debt and go back to weak national policies that will destroy the euro area, or we can decide to build a more integrated European economy by redoubling efforts towards more coordinated fiscal policies and the single market. In effect, monetary union has been a great tool to boost financial integration in the euro area, but it has not managed a slower economic integration process and competitiveness gaps. Despite high-level commitments, the original sin of the crisis lay in the decision to harmonise monetary policies without strengthening eurozone fiscal policies coordination.

The way forward must be designed around three actions: redefining institutional competences among international organisations, strengthening ECB policy as the ‘lender of last resort’ and increasing coordination among euro area members around fiscal policies.

The whole eurozone has been built on the implicit guarantees of stronger countries. If markets feel at any stage that these guarantees are no longer there because certain countries are not using all possible means to avoid a default, they withdraw capital and investments in weaker countries in favour of the stronger ones or other regional areas of the global economy.

Alternatives to the two-tier, long-term exit strategy (quantitative easing and a more federal budget) described above seem so far unable to tackle the financial instability and structural regional imbalances that lie behind the inception of the monetary union. The role of European monetary funds and the IMF cannot be elevated to a panacea for this crisis, as they are tools to help countries in very specific and limited circumstances. The time for endless political compromises is over and more should be done to avert an unsettling and rather painful decline.

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