From Financial to Political and Social Risks in the Eurozone

Paul De Grauwe
London School of Economics

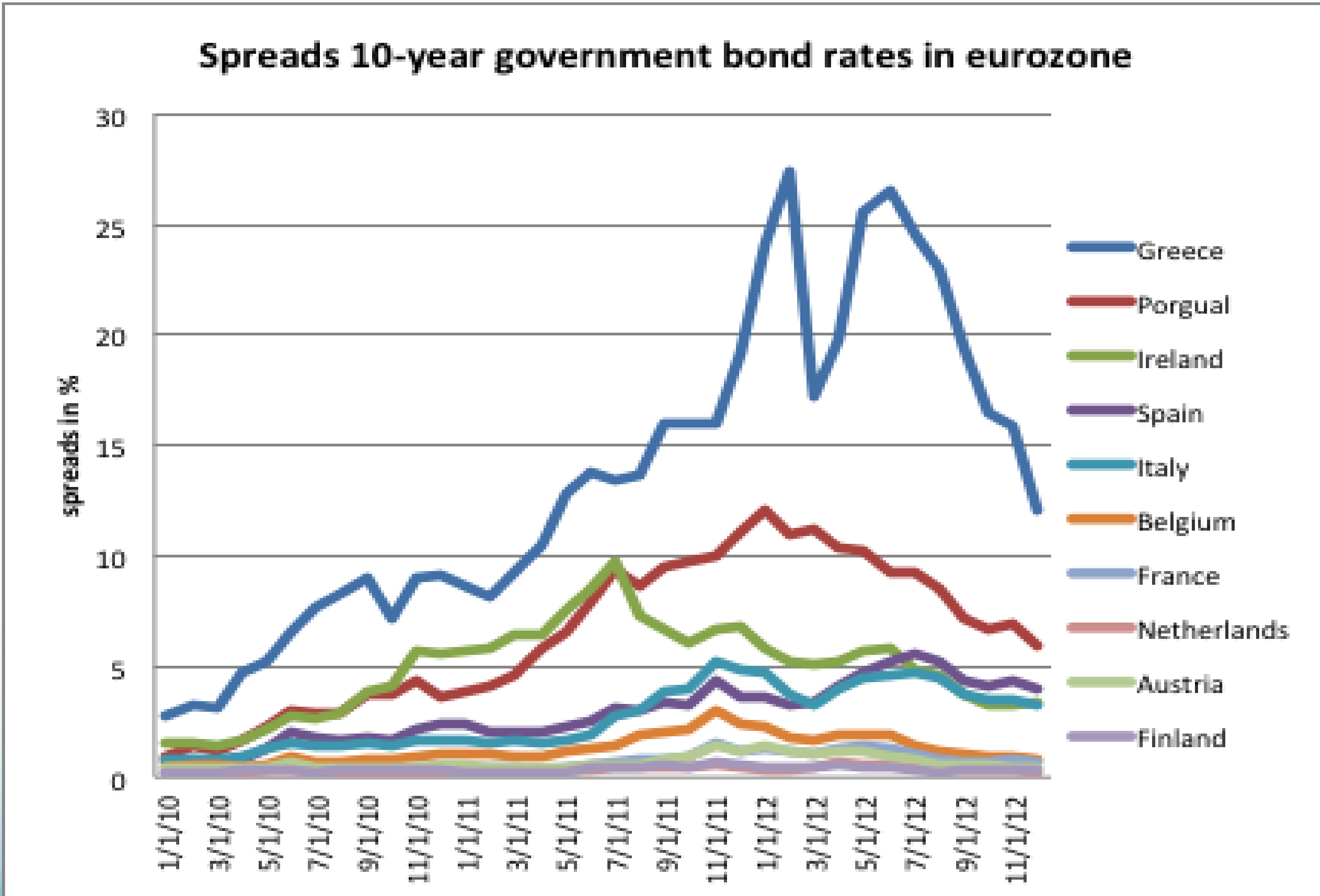
"Social developments in the European Union 2012" Conference, Friday 5 July 2013, EESC, Brussels

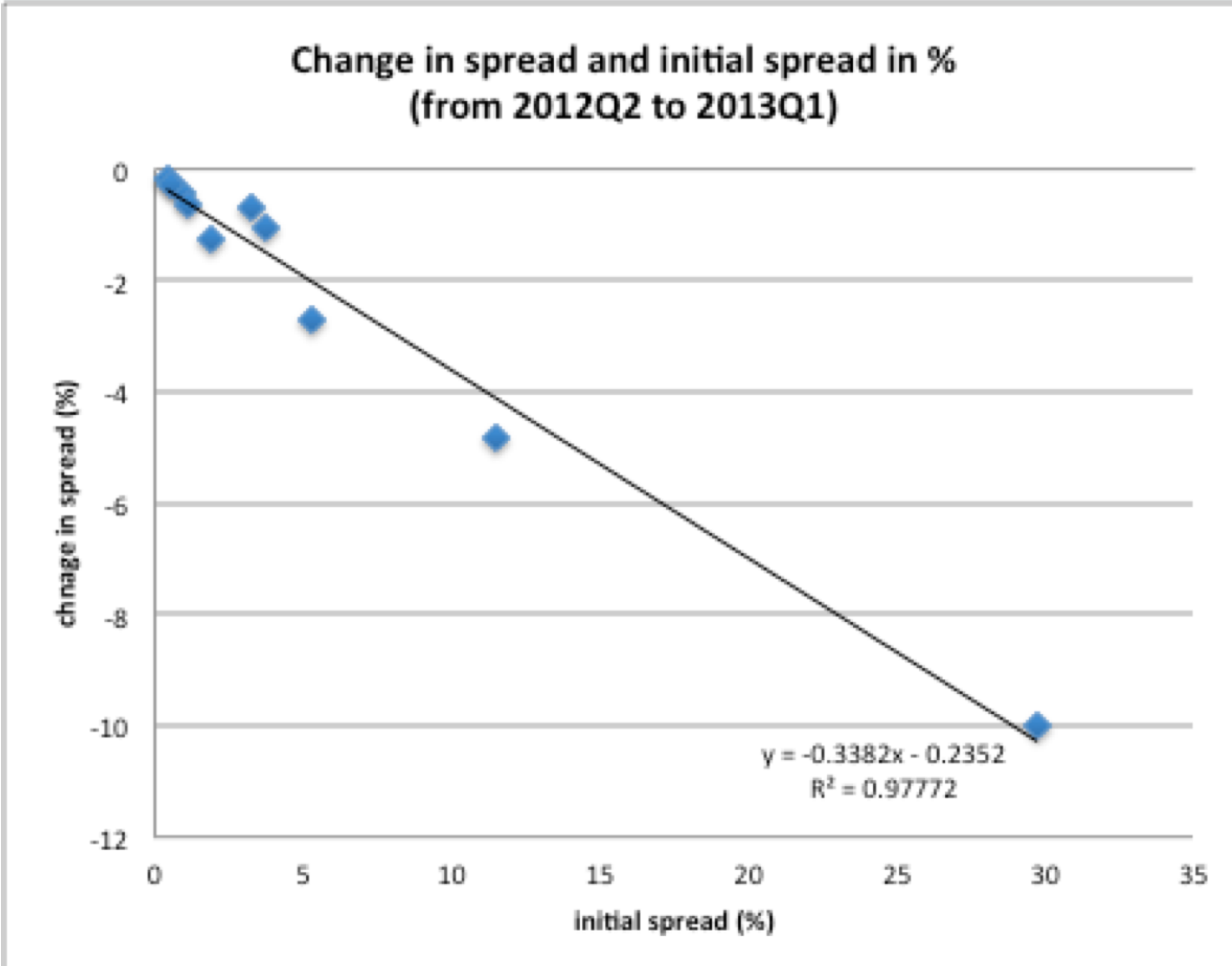
Introduction

- Last year saw fundamental changes in the workings of the Eurozone.
- The most important change was the decision of the ECB, announced in July and formulated in September, to commit itself to unlimited purchases of Eurozone government bonds in the secondary market in times of crises.
- This indicated a significant change in the regime.
- Prior to this decision, the Eurozone had been a fragile construction in which self-fulfilling crises destabilized entire countries.

ECB as lender of last resort

- This stabilized the markets (see next two graphs).
- But criticism has continued, especially in Germany.
- This has led the ECB to increase the number of conditions for employing the OMT facility.


Spreads 10-year government bond rates in eurozone
spreads in %
30
25
20
15
10
5
0
1/1/10
3/1/10
5/1/10
7/1/10
9/1/10
11/1/10
1/1/11
3/1/11
5/1/11
7/1/11
9/1/11
11/1/11
1/1/12
3/1/12
5/1/12
7/1/12
9/1/12
11/1/12
Greece
Porgual
Ireland
Spain
Italy
Belgium
France
Netherlands
Austria
Finland



Source: Datastream (Oxford Economics)

New risks for the Eurozone

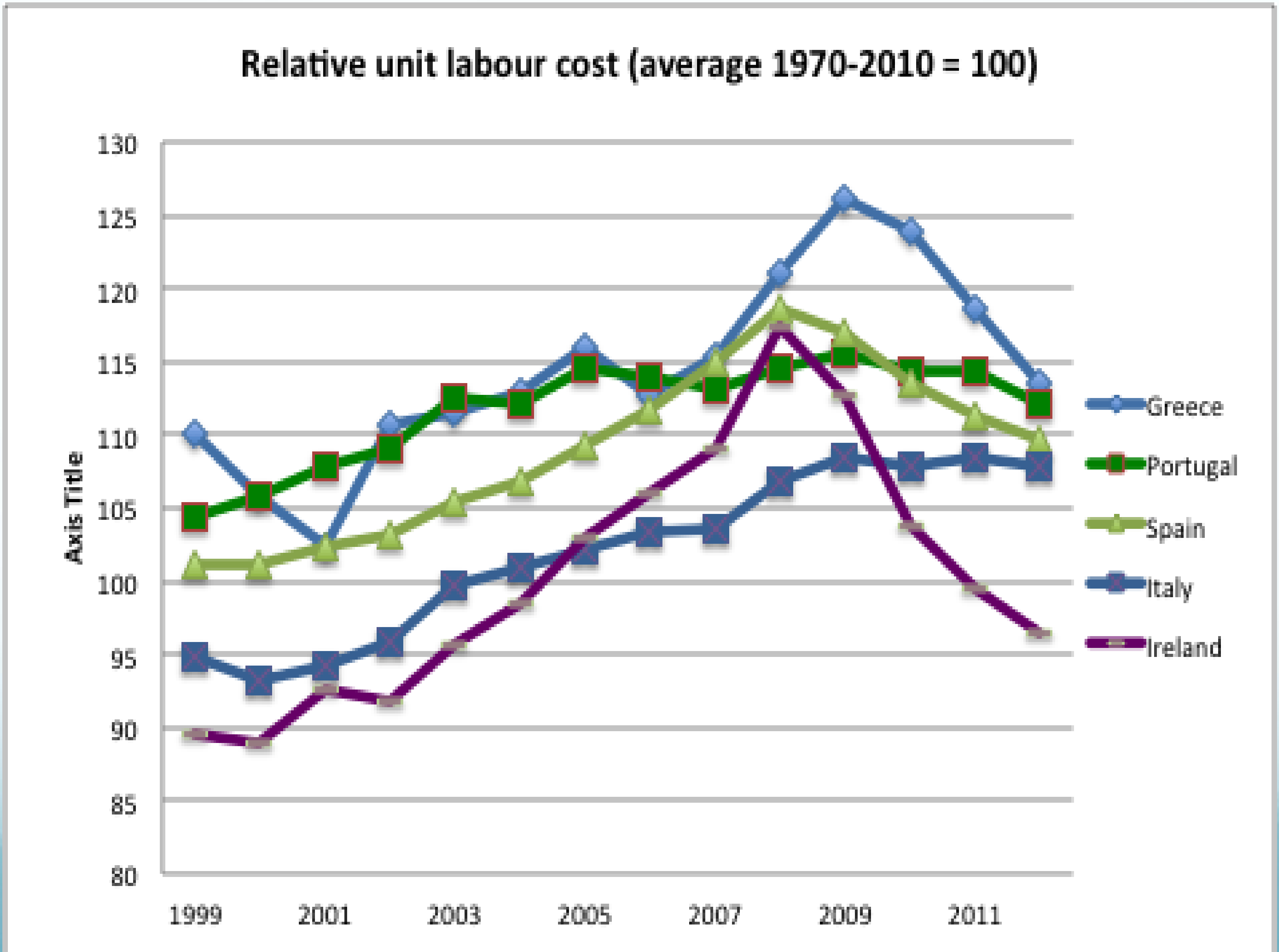
- The greatest threat to the Eurozone today does not come from financial instability.
- Rather, it comes from the potential social and political instability resulting from the economic depression which has developed in Southern European countries.
- This has led to increases in unemployment not seen since the Great Depression.
- New risk: In some countries, continually rising youth unemployment increases the appeal of politicians who promise that life outside the Eurozone would be better.

Failures of macroeconomic management in the Eurozone

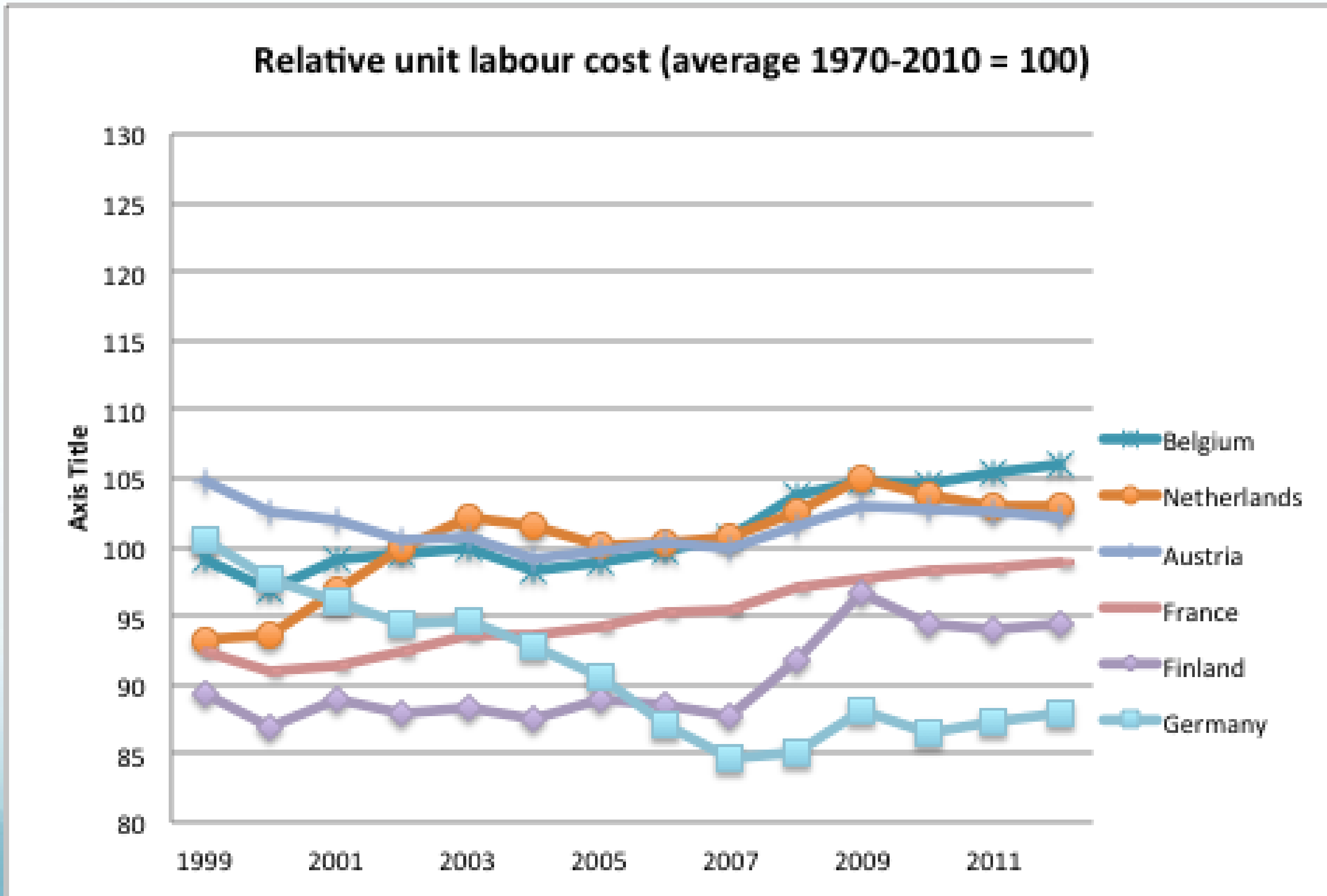
- The Southern European countries (including Ireland) are those which have accumulated current account deficits (thus debt) in the past,
- while the Northern European countries have built up current account surpluses (creditor position).
- This has forced the Southern countries to beg the Northern ones for financial support.
- The latter have reluctantly done so, but only after imposing tough austerity programs on the former, forcing quick and deep spending cuts.

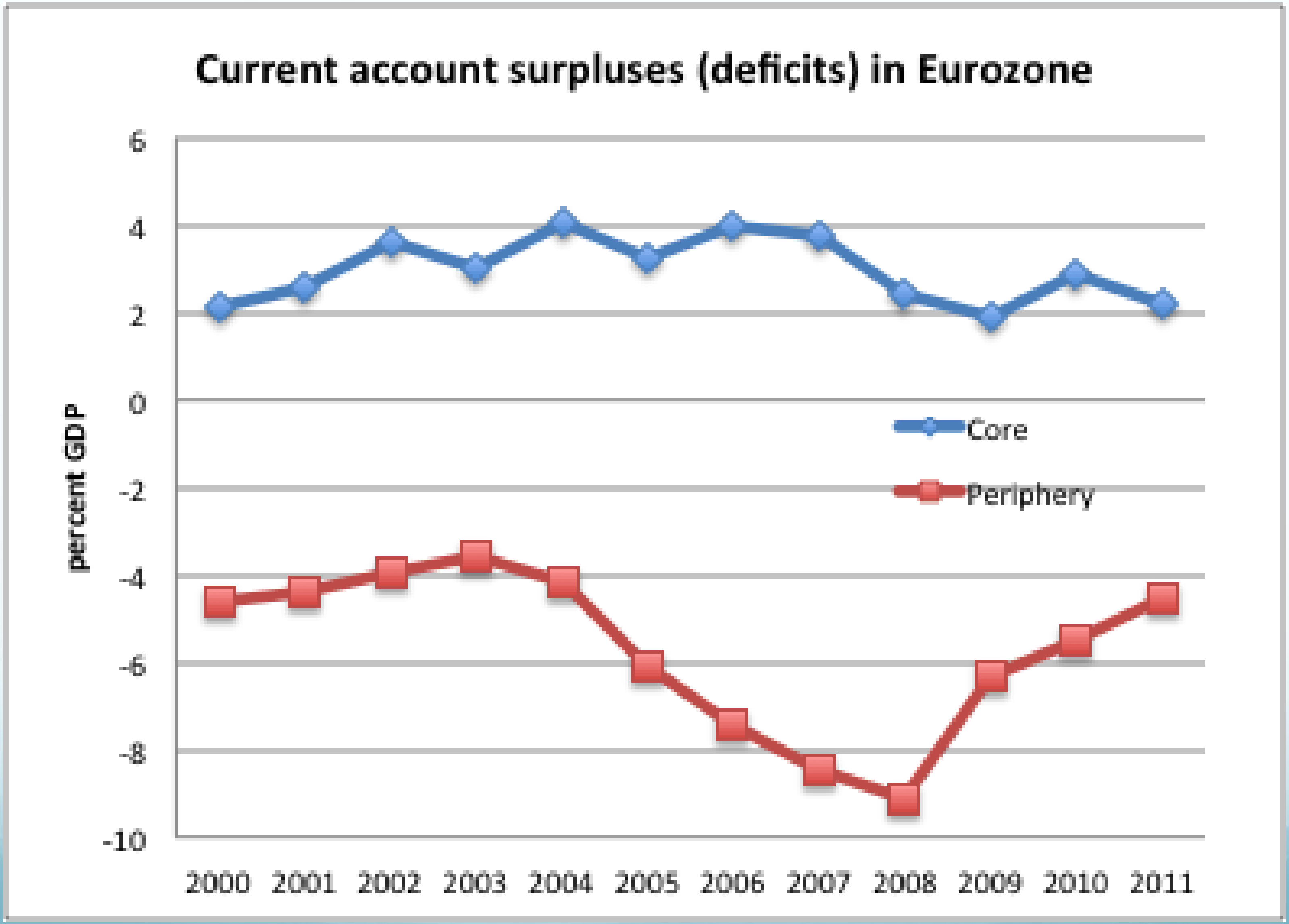
- Spending cuts in the South were indeed necessary.
- However, they were enforced too quickly and too drastically.
- More importantly, the Northern countries were not willing to offset the spending cuts in the South by increasing their own spending in order to stabilize growth in the Eurozone as a whole.
- This has led to an asymmetric adjustment process.

Asymmetry prevails



What has been the contribution of the Core countries in the adjustment? Zero

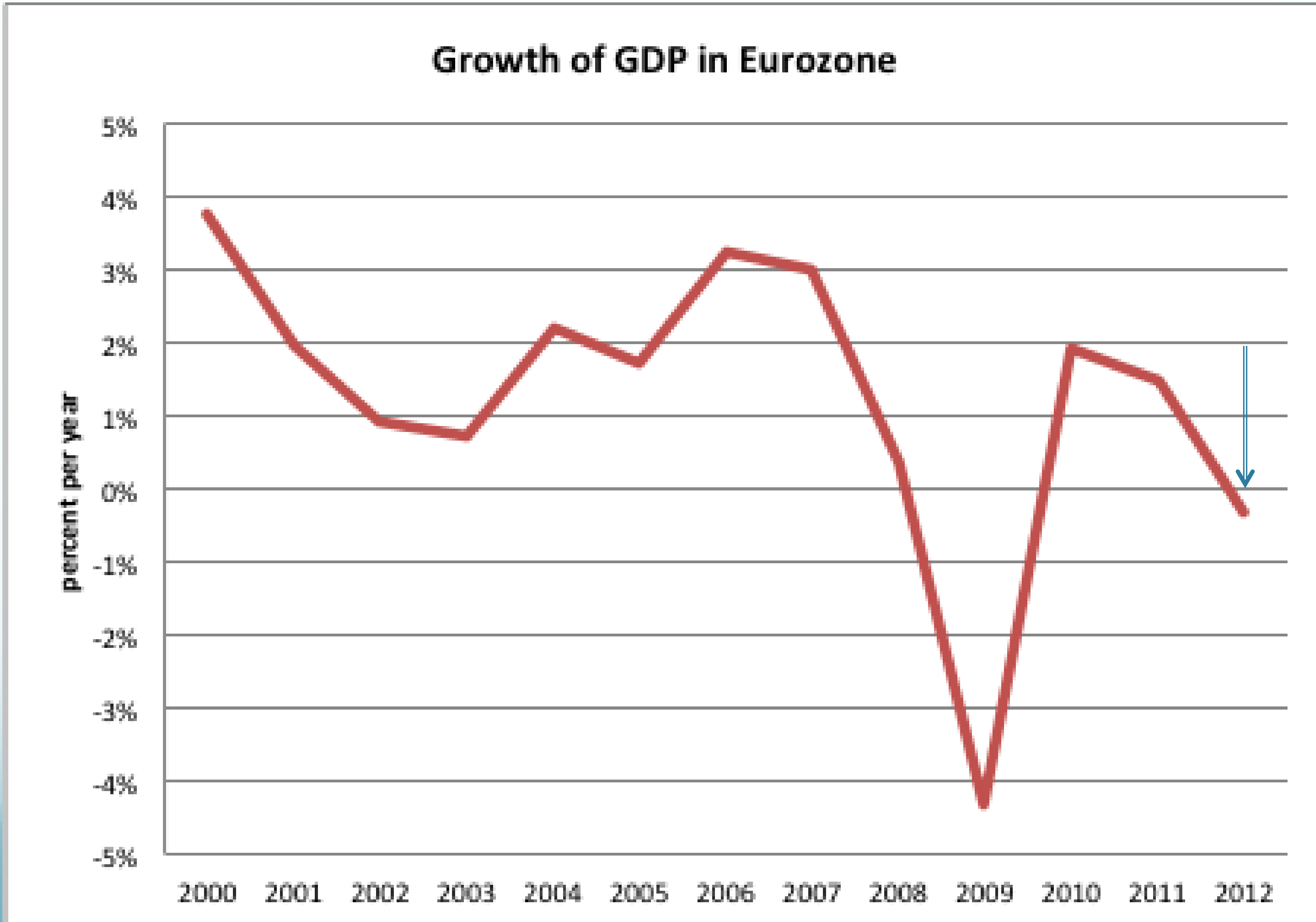



Current account surpluses (deficits) in Eurozone
6
4
2
0
-2
-4
-6
-8
-10
percent GDP
Core
Periphery
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011

Interpretation

- The burden of adjustments to imbalances in the Eurozone between surplus and deficit countries is borne almost exclusively by deficit countries in the periphery.
- The surplus countries do not seem willing to make life easier for the deficit countries, or to take their share of responsibility in correcting external imbalances.
- Result of asymmetry: double dip recession

Eurozone falls in new recession



Towards symmetric macroeconomic policies

- Stimulus in the North, where spending is below production (current account surplus)
- Austerity in the South (but spread out over more years)
- This will also improve the current account imbalances.
  - It takes two to tango
- This symmetric approach should be based on the different fiscal positions of the Eurozone countries.

Figure 6: Gross Government debt ratios in creditor countries of the Eurozone

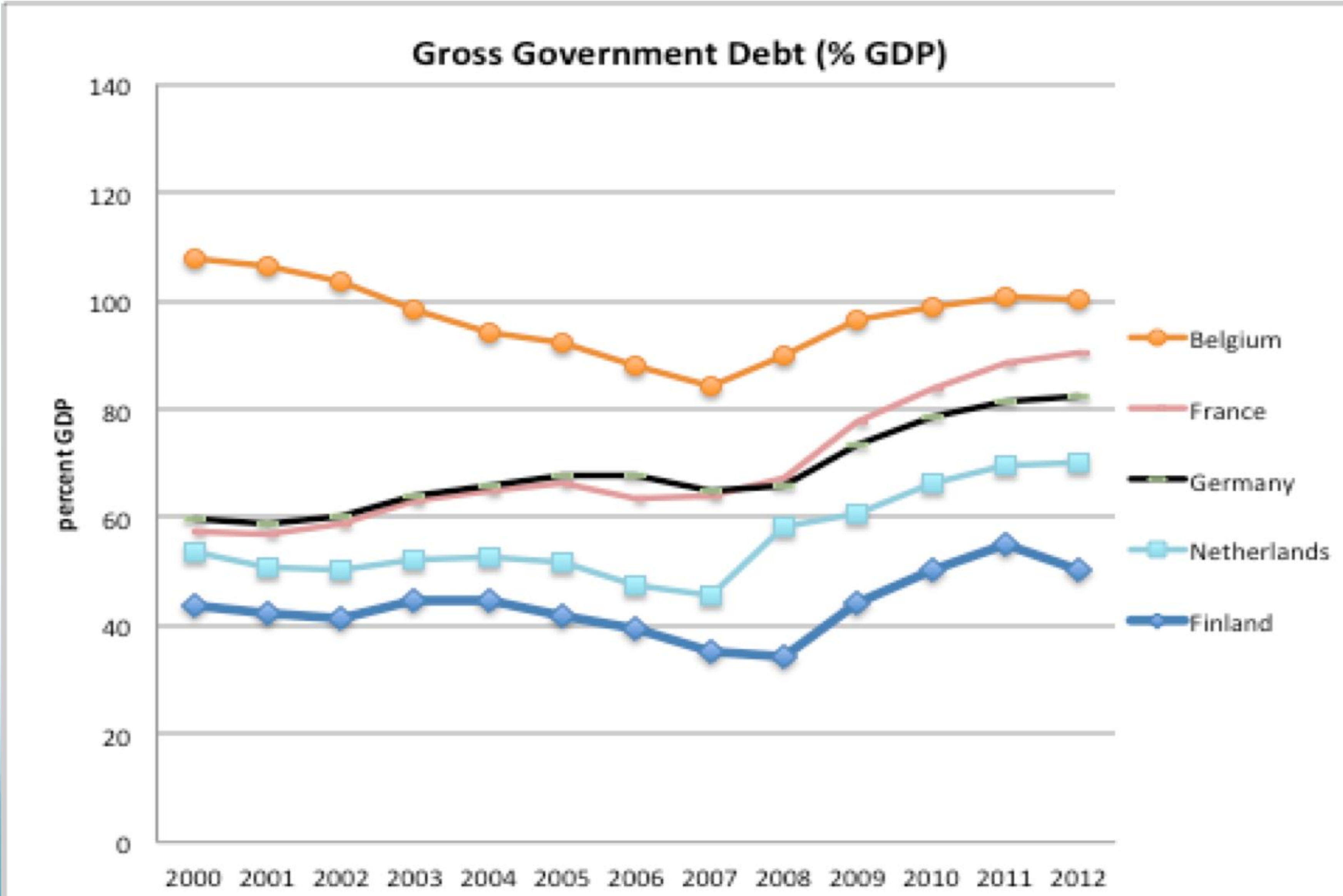
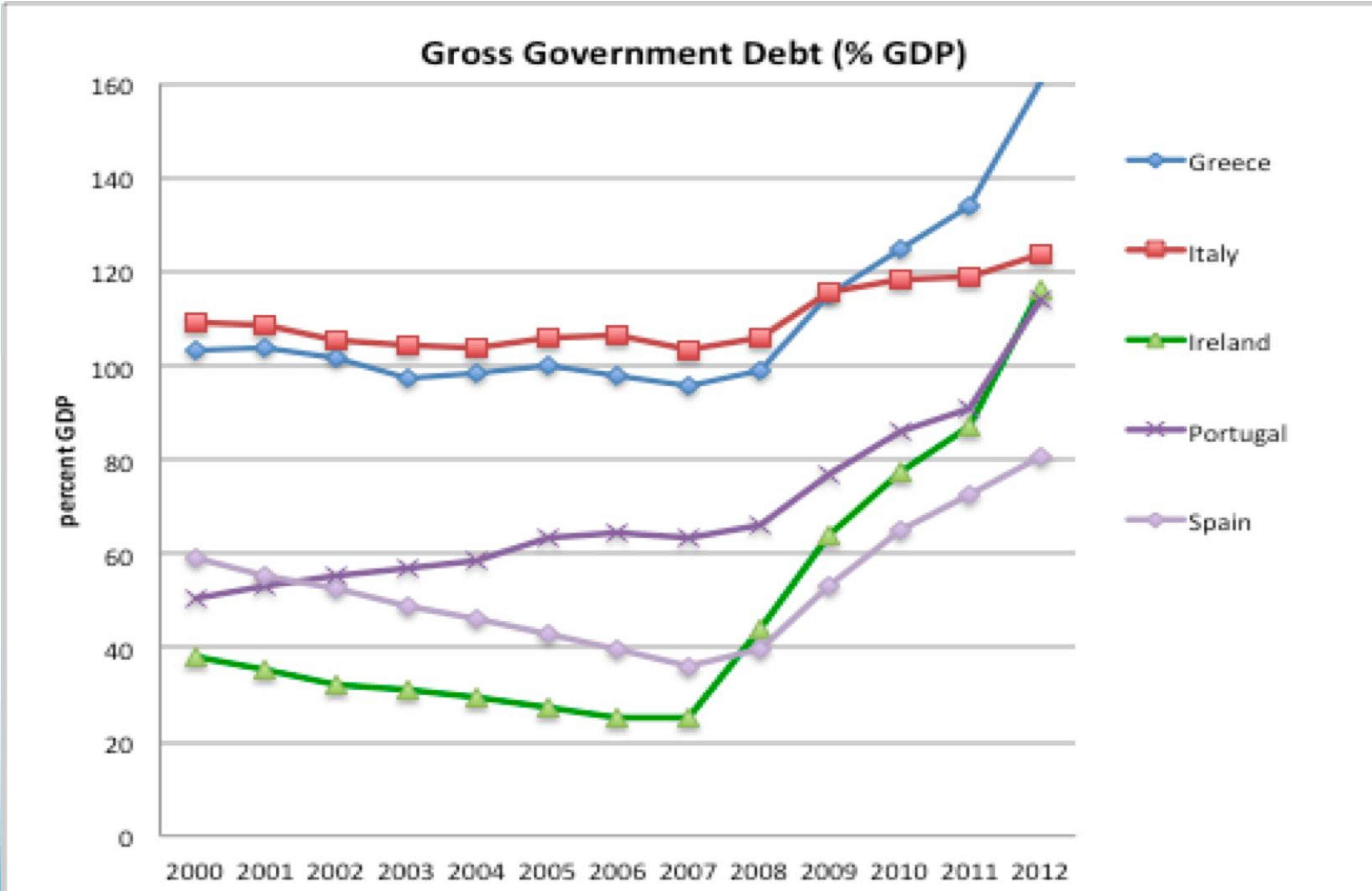


Figure 7: Gross Government debt ratios in debtor countries of the Eurozone



Source: European Commission, AMECO

- The debtor countries have not been able to stabilize their government debt ratios (in fact, these are still on an explosive path).
- The situation of the creditor countries is dramatically different.
- Creditor countries have managed to stabilize these ratios (though the situation in France is unclear).
- This opens a window of opportunity to introduce a rule that can contribute to more symmetrical macroeconomic policies in the Eurozone.

Here is the proposed rule

- The creditor countries that have stabilized their debt ratios should stop trying to balance their budgets now that the Eurozone is entering a new recession.
- Instead, they should stabilize their government debt ratios at the levels they achieved in 2012.
- The implication of such a rule is that these countries can run small budget deficits and still keep their government debt levels constant.
- For Germany, this implies a significant stimulus.

- Whether such a rule will be implemented very much depends on the European Commission.
- The EC should invoke exceptional circumstances, i.e. the start of a recession that is affecting the entire Eurozone and threatens to undermine its stability.
- The EC should urge creditor countries to temporarily stop trying to balance their budgets.
- The EC should convince creditor countries that it is in their and the Eurozone’s best interest that they stabilize their government debt ratios instead.

Conclusion

- The recent decision by the ECB to act as a lender of last resort is a major regime change for the Eurozone.
- It has significantly reduced existential fears that could have destroyed the Eurozone’s foundations.
- The ECB’s new role, although necessary, is not sufficient to guarantee the survival of the monetary union.
- It is necessary that macroeconomic policies be made more symmetric.

- The asymmetric nature of macroeconomic adjustments has put most of the adjustment burden on the deficit countries.
- This has created a deflationary bias in the Eurozone.
- It also explains the double dip recession which hit the Eurozone at the end of 2012.
- More symmetric macroeconomic adjustment mechanisms are the key to avoiding a long and protracted deflation.
- However, a significant proportion of the Eurozone population will be hesitant to adopt such measures.

- Symmetry in macroeconomic policy is key to solving this problem and eliminating the new social and political risks.
- There is a very strong sense of moral hazard thinking in Northern Europe today, which implies that “well-behaved” countries should not change their policies.
- i.e. the Northern countries followed the right policies, whereas the South misbehaved and therefore should adjust.

- Citizens from Northern Europe should be made aware that the crisis is not only the result of Southern European countries’ irresponsibility in accumulating large external debts.
- It is also the result of Northern Europe continually providing bank credit to the South during the boom years.
- For every reckless borrower in the South there was a reckless lender in the North.

- The responsibility for the Euro crisis is shared between the North and the South of the Eurozone.
- Solutions to the crisis therefore also imply that every country must take its share of responsibility.