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Crisis in the eurozone and how to deal with it

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1. Causes of the crisis: A drama with three actors

The crisis that started in Greece culminated into a crisis of the Eurozone as a whole. How did we get into this mess? To answer this question it is useful to distinguish the three actors that have played a role in the development of the crisis: Greece, the financial markets (including the rating agencies) and the eurozone authorities. Let us analyse the role of these three actors in the drama.

1.1 Greece

The role of Greece can be summarised in just a few sentences. Mismanagement and deception by the Greek authorities made the crisis possible. The Greek government now struggles with a huge credibility problem, which makes the resolution of the crisis difficult, because "nobody trusts these guys anymore". Any announcement by the Greek government about its intention to redress the budgetary situation will be met by great skepticism for years to come.

1.2 The financial markets

The destabilising role of financial markets has been illustrated dramatically again. Periods of euphoria alternate with periods of depression amplifying movements in asset prices that are unrelated to underlying fundamentals. This is not new, of course, but the speed with which this has occurred is baffling. Just a year ago, the sovereign bond markets were gripped by a bubble leading to record-low levels of long-term interest rates at a time when governments were adding unprecedented amounts of new bonds in the market. In a few weeks time, the situation turned around dramatically and bond markets crashed in a number of countries.

The rating agencies take a central position in the destabilising role of the financial markets. One thing one can say about these agencies is that they systematically fail to see crises coming. And after the crisis erupts, they systematically overreact, thereby intensifying it. This was the case two years ago when the rating agencies were completely caught off guard by the credit crisis. It has again been the case during the last few months. The sovereign debt crisis started in Dubai. Only *after* Dubai postponed the repayment of its bonds and we had all read about it in the Financial Times, did the rating agencies realise there was a crisis and downgrade Dubai's bonds. Having failed so miserably in forecasting a sovereign debt crisis, they went on a frantic search for other possible sovereign debt crises. They seized upon Greece, which of course was a natural target. But they did not limit their search to Greece. They 'visited' other countries, mostly southern European countries and started the process of downgrading. This in turn led to a significant increase in government bond rates in these countries.

Thus, it can be said that the rating agencies make systematic 'type I' errors during periods of euphoria, i.e. they fail to cry wolf, when there are wolves in the forest. During periods of depression they make systematic 'type II' errors, i.e. they cry wolf all the time, when most of the wolves have left the forest. As a result, they amplify the destabilising movements in the financial markets.

All this would not be so bad were it not that it prevents clear thinking about how to reduce budget deficits and government debt levels. The source of the explosion of government debt levels is the unsustainable levels of private debt prior to the financial crisis. During the boom years, the private sector added a lot of debt. Then the bust came and the governments picked up the pieces. They did this in two ways. First, as the

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economy was driven into a recession, government revenues declined and social spending increased. Second, since part of the private debt was implicitly guaranteed by the government (bank debt in particular), the government was forced to issue its own debt to rescue private institutions.

The present scare about excessive government debts risks setting in motion the so-called 'Fisher paradox' (Fisher, 1932). As governments are forced by rating agencies to reduce their debt levels, the further deleveraging of private sector debt is made impossible. The private sector can only reduce its debt if the government is willing to increase its own debt. Forcing the government to reduce its debt level today while the private sector also tries to reduce its own debt level leads to a self-defeating dynamics in which neither the private nor the public sectors succeed in reducing their debt. This dynamics then also pull down the economy into deflation. This dynamics that was analysed by Irving Fisher in the 1930s does not seem to be part of the intellectual tool kit of the rating agencies.

1.3 The eurozone authorities

The crisis was allowed to unfold because of hesitation on the part of and ambiguities created by both the eurozone governments and the European Central Bank (ECB).

The eurozone governments failed to give a clear signal indicating their readiness to support Greece. The failure to do so mainly resulted from disagreements among member state governments concerning the appropriate response to the Greek crisis.

The ECB, in turn, created ambiguities about the eligibility of Greek government debt to act as collateral in liquidity provision. As is well known, the ECB relies on ratings produced by American rating agencies to determine the eligibility of government bonds as collateral. Prior to the financial crisis, the minimal rating needed to be eligible was A- (or equivalent). In order to support the banking system during the banking crisis, the ECB temporarily lowered this to BBB+. At the end of 2009, however, the ECB announced that it would return to the pre-crisis minimal rating from the start of 2011 on. Since the Greek sovereign debt had been lowered to BBB+, this created a big problem for financial institutions holding Greek government bonds, which now face the prospect that their holdings of Greek government bonds may become extremely illiquid. No wonder so many market participants dumped Greek government bonds, precipitating the crisis. Similar uncertainties about the future ratings of other eurozone government bonds hang as a Damocles sword over the government bond markets in the eurozone.

2. What's to be done: The short-run

The Greek government debt crisis should be stopped. There are at least three reasons why it is imperative that this crisis be stopped. First, allowing the Greek crisis to lead to default risks leading to contagion that will affect other government bond markets in the eurozone. Second, and following up on the previous statement, such a contagion to other government bond markets will affect the banking sector in the eurozone. Many banks have started to recover from the banking crisis by arbitraging the yield curve, i.e. by borrowing short from the central bank at very low interest rates and investing in longer-term government bonds. The steepness of the yield curve has been an important source of profits for the banks. A crisis in the government bond markets, i.e. sharply declining bond prices, would lead to large losses on banks' balance sheets, possibly triggering a new banking crisis in the eurozone.

The third reason why the Greek government bond crisis needs to be stopped is at least as important as the first two. If not stopped, the crisis will lead to increases in government bond yields in a significant number of eurozone countries. This will put pressure on the governments of these countries to sharply contract fiscal policies, leading to deflationary effects and risk pulling down the eurozone economies into a double-dip recession. Such an outcome would not only be bad news for the unemployed, but would also make it even more difficult for the eurozone countries to reduce their budget deficits and debt levels.

There are quite a lot of analysts these days that welcome the discipline imposed by the market on the profligacy of governments. The high interest rates imposed by the markets will teach the bad governments to discipline their budgets, we are told by these analysts, which tend to be employed by major banks. The irony is that these analysts are able to tell us this good news today because the same bad governments saved them and their employers less than two years ago after years of unchecked profligacy.

While there can be little doubt that the crisis must be stopped now rather than later, much doubt has been voiced that the European Union, or for that matter the member countries of the eurozone, have the means to do so. These doubts have been voiced both at the legal level and at the level of the financial capacity of the Union to organise a bail-out.

The legal skeptics argue that the no-bail-out clause in the Treaty forbids the member states of the Union to provide financial assistance to another member state. But this is a misreading of the Treaty. The no-bail-out clause only says that the European Union shall not be liable for the debt of governments, i.e. the governments of the Union cannot be *forced* to bail-out a member state (see Article 103, section 1). But this does not exclude the possibility that the governments of the EU would freely decide to provide financial assistance to one of the member states. In fact this is explicitly laid down in Article 100, section 2:

> Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned.

Thus eurozone governments have the legal capacity to bail out other governments.

There can be equally little doubt that the eurozone member countries have the financial capacity to bail-out Greece if the need arises. It would not cost them that much. In the event that Greece were to default on the full amount of its outstanding debt, a bail-out by the other eurozone governments would add about 3% to these governments' debt. A small number compared to the amounts added to save the banks during the financial crisis.

One can conclude that the member countries of the eurozone have the legal and financial power to bailout Greece. The only obstacle appears to be political, i.e. the lack of consensus among the different member states about the necessity to do so. Happily, at the Summit meeting of 11 February, the European leaders announced their willingness to provide the financial means to support the Greek government were it to run into financial difficulties, while maintaining sufficient pressure on the Greek government to put its budgetary house in order.

There is a risk, however, that this announcement will not be sufficient to pacify the financial markets. There is one important element missing. This is an announcement by the ECB about its collateral policy. As argued earlier, the uncertainty about what the ECB will do in the coming months with Greek government debt remains. The ECB should clearly signal that it will continue to accept Greek government debt as collateral, independently of the ratings concocted by the agencies. This was not announced by the ECB President Jean-Claude Trichet on 11 February. As a result, the recovery of the Greek government bond market will be made more difficult, thereby making the Greek budget-cutting exercise more painful and thus less successful.

The experience we now have with the ECB policy regarding the eligibility of government bonds as collateral in liquidity provision leads to the conclusion that there is an urgent need for the ECB to change this policy. More precisely, the ECB should discontinue its policy of outsourcing country risk analysis to American rating agencies. The latter have a dismal record. As argued earlier, they have made systematic mistakes, underestimating risks in good times, and overestimating risks in bad times. Relying on these agencies to decide about such a crucial matter as the selection of government bonds is simply unacceptable. It helps to destabilise the financial markets in general and the eurozone in particular. Surely, the ECB should not be a primary source of financial instability in the eurozone. In addition, this policy gives tremendous power to a few rating agencies that simply do not deserve to wield so much power.

The ECB is better placed to do the job of analysing the creditworthiness of member countries of the eurozone than the rating agencies. It has a pool of highly skilled analysts who are equally capable if not more so than the analysts working for the rating agencies.

The reluctance of the ECB to do the credit analysis in-house is probably due to the fear that it may sometimes have to take difficult stances that do not please national governments. It is much more comfortable to have this job done by outsiders. Such an abdication of responsibilities should not be allowed.

3. What's to be done: The long term

The crisis has exposed a structural problem of the eurozone that has been analysed by many economists in the past. This is the imbalance between full centralisation of monetary policy and the maintenance of almost all economic policy instruments (budgetary policies, wage policies, etc.) at the national level.

Put differently the structural problem in the eurozone is created by the fact that the monetary union is not embedded in a political union. This imbalance leads to creeping divergencies between member states and no mechanism to correct or to alleviate them. These divergencies in turn are at the core of budgetary divergencies and crises. Figures 1 and 2 show the evidence of these structural problems.

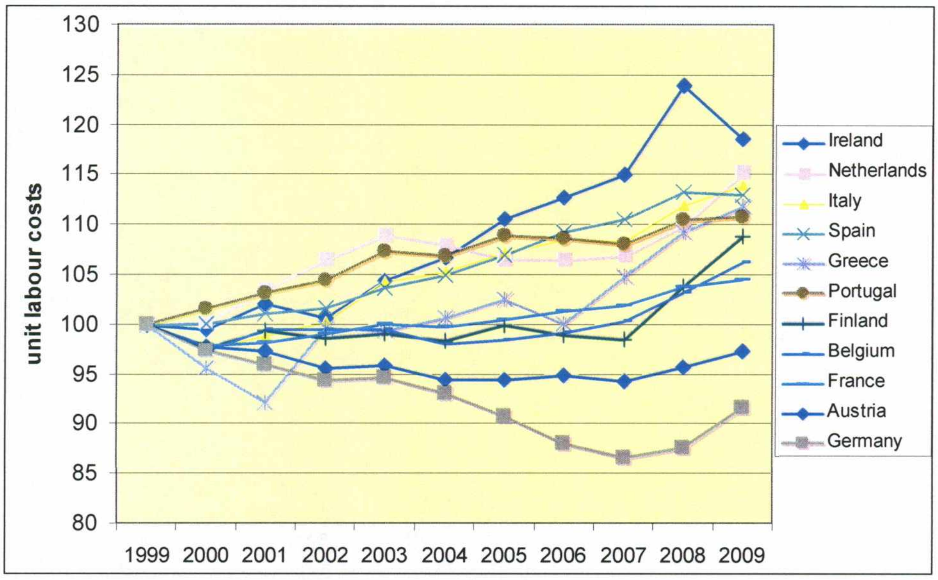
Figure 1 shows the well-known evolution of the relative unit labour costs (ULC) within the eurozone since the start in 1999. We observe how a few countries, namely Germany and Austria, experienced significant improvements of their competitive positions while Ireland, Greece, Italy, Spain and Portugal saw their competitive positions deteriorate by more than 10%. These divergent developments have much to do with the fact that important economic decisions – about wage agreements, budgetary policies, social policies, credit regulations, etc. – are decided at the national level.

These divergent movements in competitiveness also lead to budgetary divergences whereby countries that lose competitiveness experience a stronger deterioration of their budgetary situations. This is shown in Figure 2, where we plotted the relative unit labour cost of each country (achieved in 2008) on the horizontal axis and the budget surplus (deficit) in 2008 on the vertical axis. We observe a negative relationship confirming the proposition that countries that experience a deterioration of their competitive position (and increase in relative unit labour costs) also experience a deterioration of their budgetary position (and an increase in their budget deficits).

Thus the lack of political integration leads to a build-up of economic and budgetary divergencies leading to a crisis. When the crisis erupts, the same absence of political integration makes it difficult to resolve the crisis, as was illustrated in the previous sections.

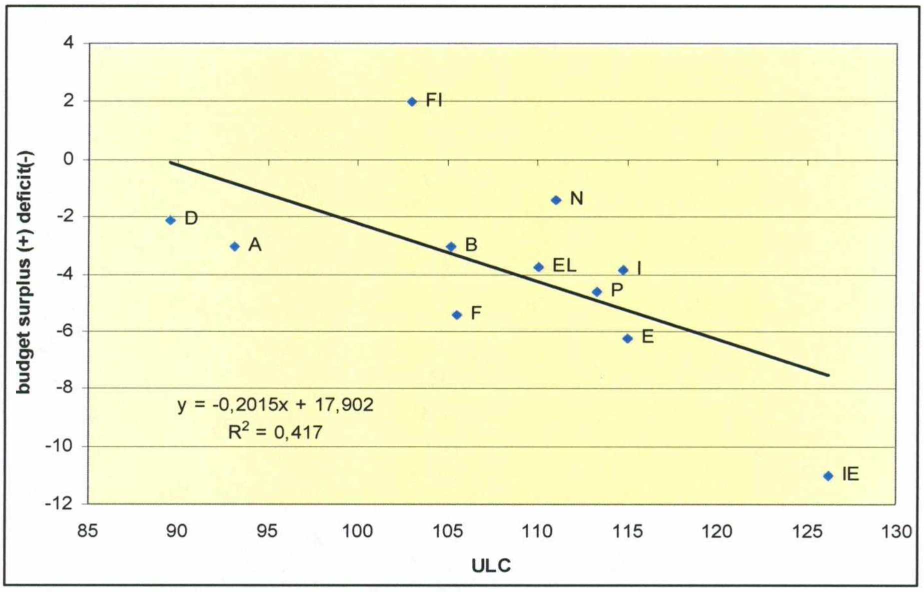
This structural problem has to be fixed before we are hit by the next crisis. But that is also the hard part. There is no appetite in the eurozone today for moving towards a more intense political union. Even the thought of adding just 0.1% to the EU budget makes some countries extremely jittery. Thus, a very small-scale fiscal union that would transfer just a few percentage points with respect to budgetary and tax responsibilities appears to be out of the question.

Figure 1. Relative unit labour costs in the eurozone



Source: European Commission, AMECO database.

Figure 2. Relative unit labour costs (1999-2008) and budget surplus (+), deficit (-)



Source: Computed based on European Commission, AMECO database.

One is led to the conclusion that the inability to create a more intense political union in the eurozone will continue to make it a fragile construction, prone to crises and great turbulence each time such a crisis must be resolved.

While a grand plan for political unification does not seem to be possible, smaller but focused steps towards such a future union can be taken. Two such steps are worth mentioning here. One is the idea of creating a European Monetary Fund (EMF), an idea recently put forward by Gros & Mayer (2010). The EMF would be a new European institution that would obtain its funding from countries with excessive budget deficits and debt levels. In times of crisis, it would have the means to support countries in need of financial assistance, while at the same time it would have the authority to impose conditions for the granting of financial assistance.

A second step would consist of creating a common euro-bond market. Such a common euro-bond market was proposed by Gros & Micossi (2008) and De Grauwe & Moesen (2009). The latter propose to create new common euro government bonds in which each country would participate on a pro-rata basis of its capital share in the ECB. The interest rate each of the participating countries would have to pay would depend on the interest rates each of these governments pay when they issue bonds in their own markets. Thus, the more profligate governments like Greece would have to pay a higher interest rate than the more disciplined governments. The common bond interest rate would then be the weighted average of these national interest rates. Such a scheme would go a long way towards assuaging fears about moral hazard implicit in common bond issues – fears that are very strong in countries like Germany. In addition, by creating a new bond market with sufficient size, it would also be attractive to outside investors.

These proposals are only small steps towards political unification. They have the important quality of being signals of a determination on the part of the members of the eurozone to commit themselves to a future intensification of the process of political union. Such signals are of crucial importance today. They make it clear that the members of the eurozone are serious in their desire to preserve their institution. Without these (or similar) steps, there can be little doubt that the eurozone has no future.

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