

# Could the euro implode?

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# Summary of a script in three acts and a prologue

- Prologue: what was forgotten in 1999
- First act: the financial crisis goes sovereign
- Second act: leaders buy time and produce a weak policy response
- The final act: searching for a *deus ex machina*

# Prologue

Oops! The founding fathers created a monetary union and forgot to follow up with a fiscal and political union.

# THE EUROSYSTEM



ORGANISATION

€ European Central Bank

1 Nationale Bank van België/  
Banque Nationale de Belgique

2 Deutsche Bundesbank

3 Eesti Pank

4 Central Bank of Ireland

5 Bank of Greece

6 Banco de España

7 Banque de France

8 Banca d'Italia

9 Central Bank of Cyprus

10 Banque centrale du Luxembourg

11 Bank Ċentrali ta' Malta/  
Central Bank of Malta

12 De Nederlandsche Bank

13 Oesterreichische Nationalbank

14 Banco de Portugal

15 Banka Slovenije

16 Národná banka Slovenska

17 Suomen Pankki – Finlands Bank



## First act:

# The financial crisis goes sovereign

- Attack on national debt
- What would it take to stabilize debt
- Banks' exposure to sovereign debt
- External Imbalances
- Euro is too appreciated for the South

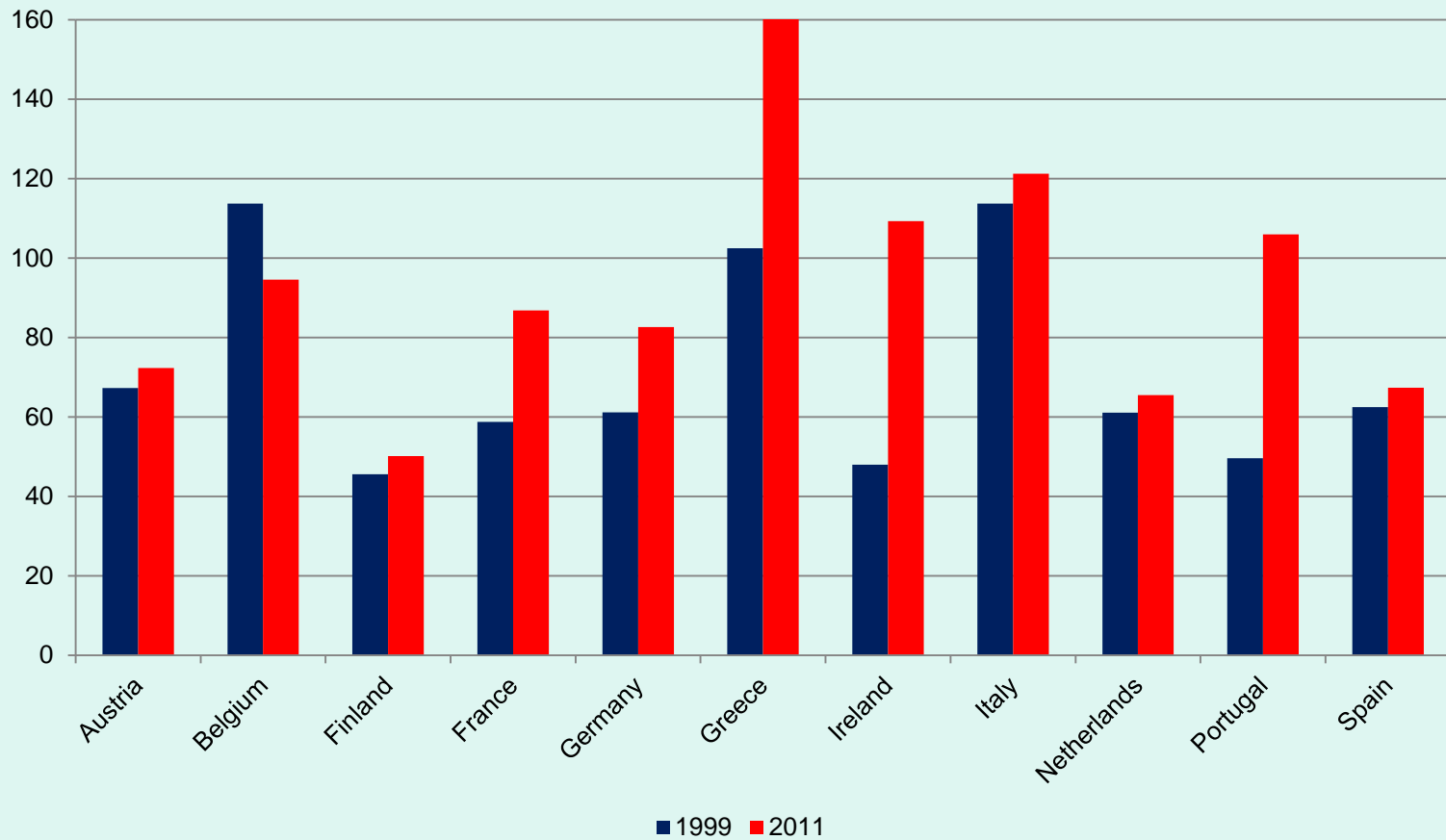
The subprime financial crisis (2008-2009) triggered the European sovereign debt crisis (2010-ongoing).

- Public debts were already high but were made worse by government rescue plans and the large safety net placed around banks.
- A sovereign debt crisis starts with rising interest rate spreads relative to a risk-free rate. In the euro-area, the risk-free rate is the yield on German bonds.
- Greece was the first (2010) followed by Ireland, Portugal, Spain and Italy (the ugly acronym PIIGS).

Maturity	Greece	Portugal	Ireland	Italy	Spain	France	Germany
2-year	135.5	14.5	7.78	5.04	3.76	1.01	0.17
10-year	34.93	13.25	8.21	7.13	5.71	3.37	1.85

## **Annual yields to maturity of sovereign debt – percentage**

Source: Bloomberg, updated January 6, 2012



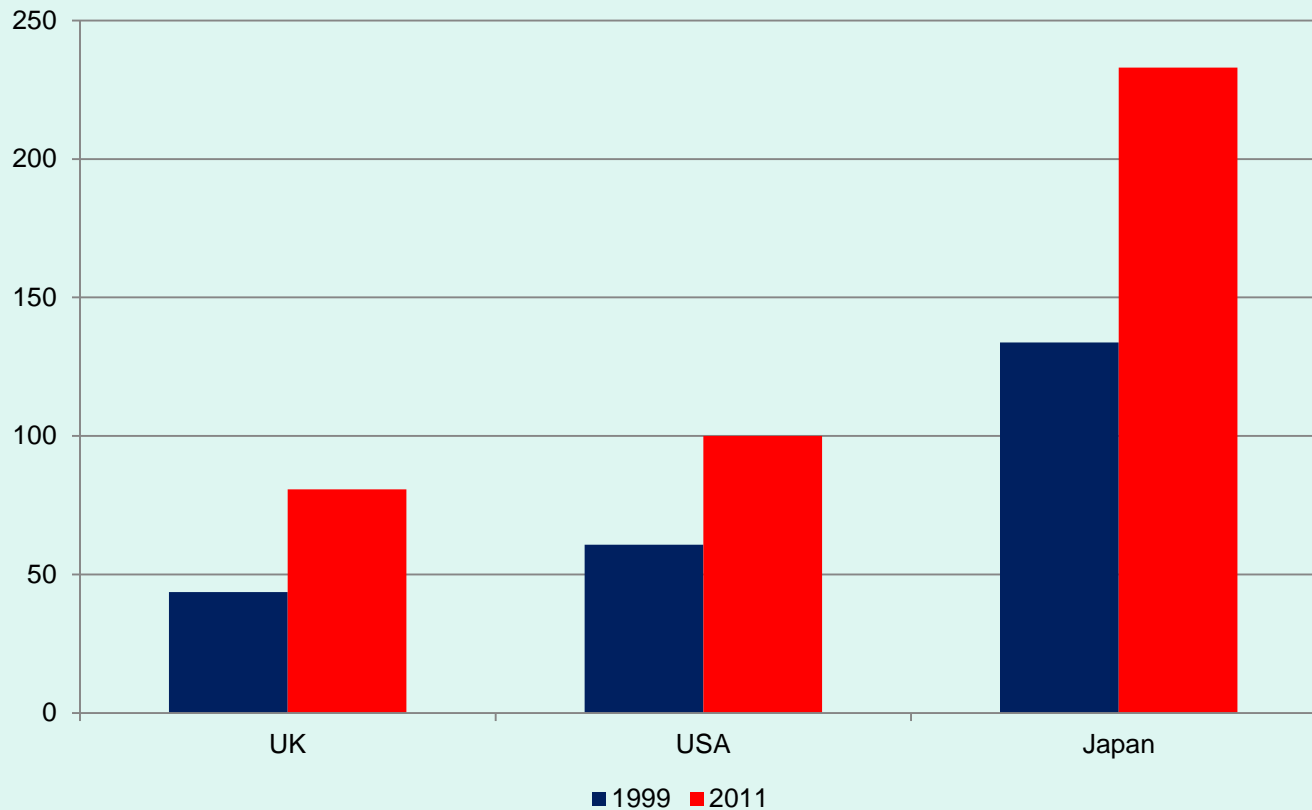
## Government gross debt to GDP, percent

Greece's debt ratio went up sharply

Ireland and Portugal have doubled theirs

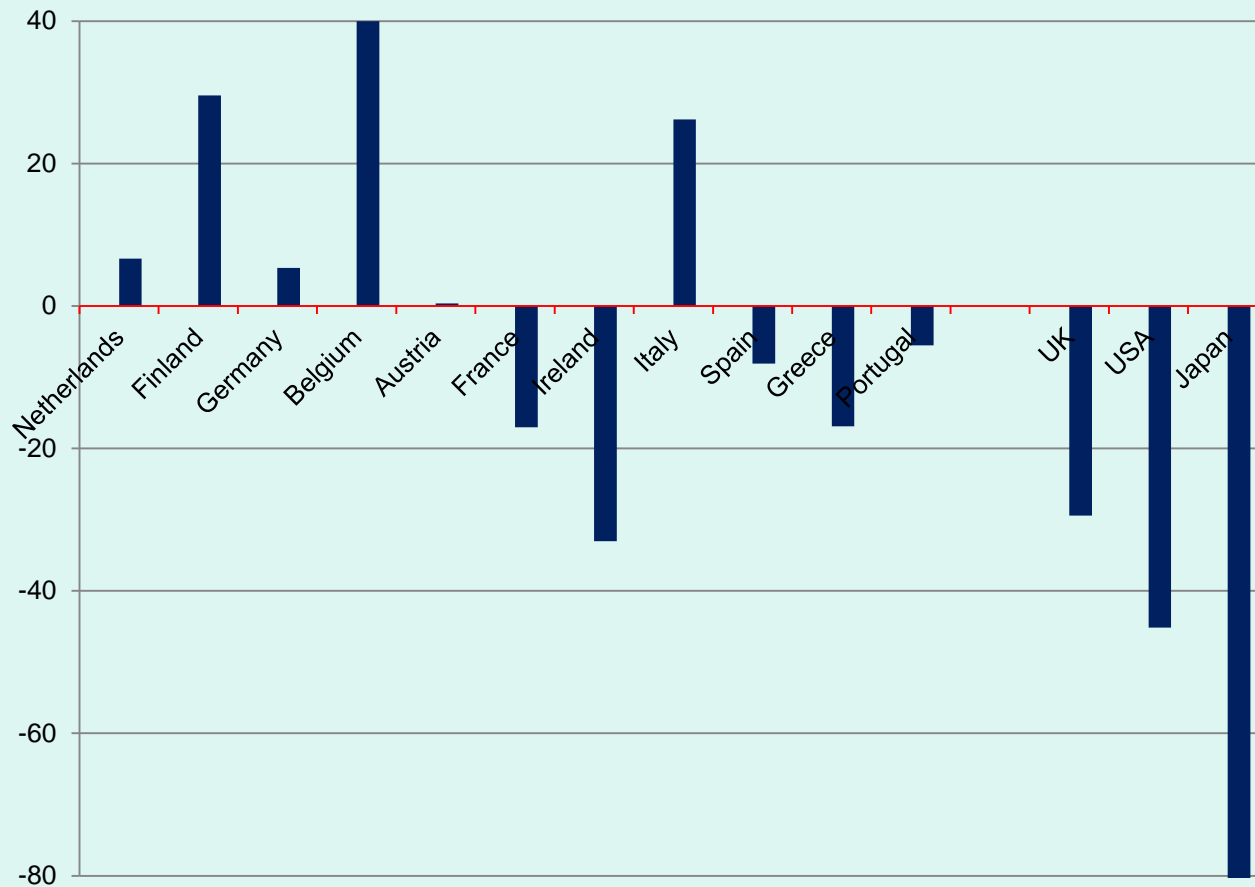
France and Germany up

Italy and Spain slightly up Others lower or kept appr. constant



## Gross govt debt as a per cent of GDP

Growth from 1999 to 2011 much higher in UK, USA and Japan than euro-area countries, excluding Ireland and Portugal.



Cumulative government primary surpluses as a percent of GDP over the period 1999-2012, a measure of fiscal discipline. Source: International Monetary Fund

# What would budget surpluses have to be to stabilize debt ratios of PIIS countries?

In the following table I am showing the permanent value of government budget primary surplus as a per cent of GDP required to stabilize the ratio of debt to GDP at the 2011 value. (A primary surplus = cash surplus minus interest payments on debt)

The assumptions are that the cost of debt is the average of the 2 and 10 year yields shown above and that the rate of inflation and economic growth are those forecasted by the IMF.

Greece is excluded because the country will default in March in the absence of the next bailout tranche.

	Portugal	Ireland	Italy	Spain
avg. Cost of debt	13.9	8	6.1	4.7
2012 inflation forecast	2	2	2	2
real cost of debt	11.9	6	4.1	2.7
2012 growth forecast	-1.8	1.5	0.3	1.1
2011 gross debt/GDP	106	109	121	67
primary surplus to GDP to stabilize debt ratio	14.7	4.8	4.6	1.1
Primary surplus/GDP 1999-2011 avg	-0.44	-2.2	1.81	-0.39

### **Primary surplus ratios to stabilize debt ratios at 2011 levels**

Avg cost of debt = avg of 2-year and 10-year yield on government bonds

2012 inflation and growth forecasts are from the IMF

Debt-ratio-stabilizing primary surplus ratio must go on forever!

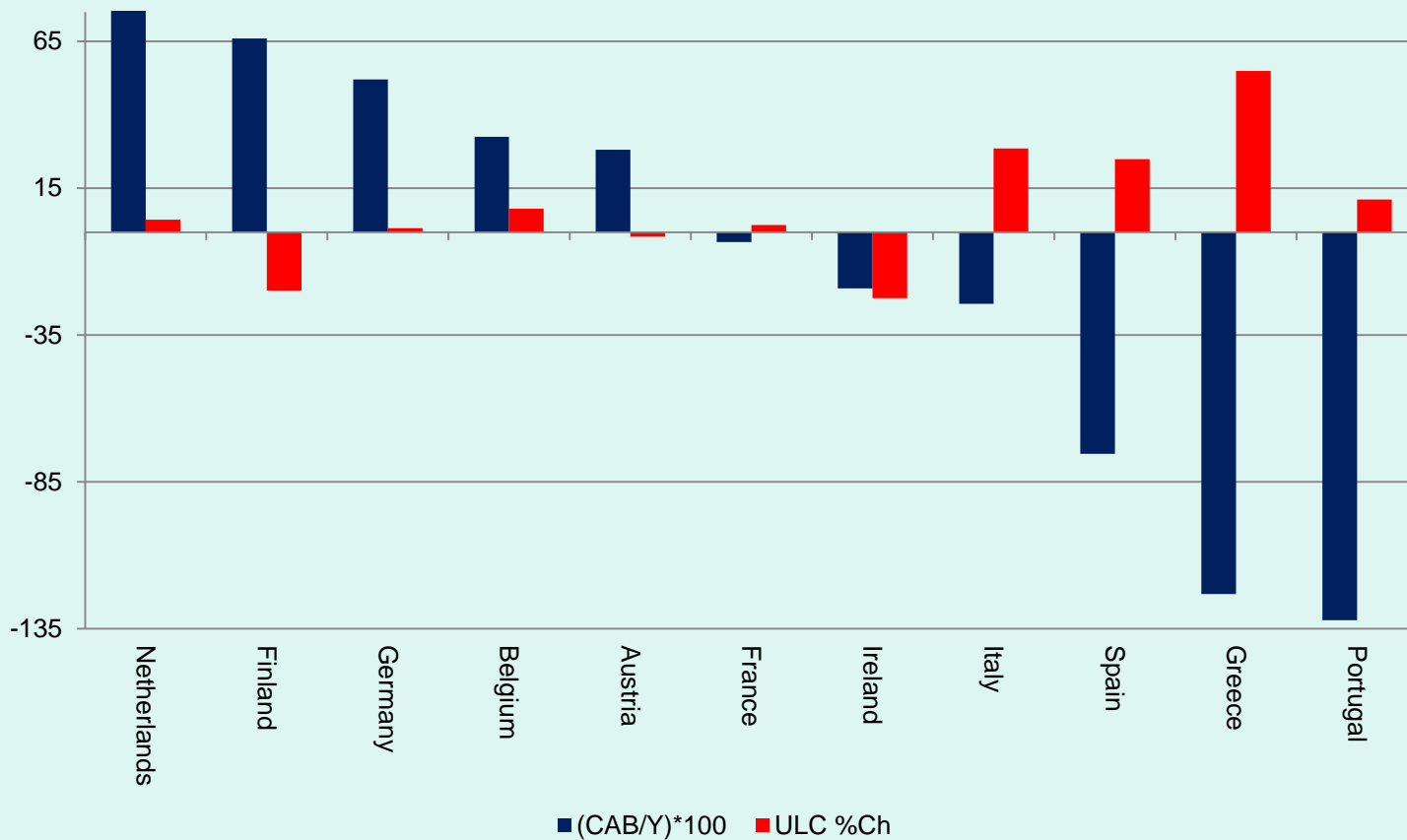
## EUROPEAN BANKS' SOVEREIGN DEBT EXPOSURE

### TOWARDS BELGIUM AND PIIGS COUNTRIES (billions euros)

CREDITOR ↓/DEBTOR→	Belgium	Portugal	Ireland	Italy	Greece	Spain	Total	Tot. Sovereign
Austria	0.1	0.3	0.1	1.5	0.8	0.3	3.1	37.4
Finland	0.2	0.0	0.0	0.0	0.0	0.0	0.2	1
Germany	8.7	10.0	0.1	73.6	17.6	34.3	144.3	583
France	15.2	4.6	2.4	47.1	11.0	6.3	86.6	235.3
Netherlands	11.8	2.0	0.5	9.8	3.0	2.2	29.3	112.1
Belgium	29.7	3.0	0.6	25.2	4.7	3.5	66.7	108
Italy	0.3	0.3	0.3	144.7	1.8	1.4	148.8	195
Ireland	0.1	0.3	5.3	0.7	0.0	0.4	6.8	10.9
Greece	0.0	0.0	0.0	0.1	56.1	0.0	56.2	60.8
Portugal	0.0	13.7	0.8	1.2	1.7	0.3	17.8	21.3
Spain	0.9	6.5	0.1	9.4	0.8	201.0	218.7	231
UK	5.1	2.4	5.4	9.8	4.1	5.9	32.7	214
Total	72.0	43.0	15.7	323.1	101.6	255.6	811.1	1809.8

Total European banks' exposure is 22% of sovereign debt of Belgium and PIIGS countries

German and French banks have the highest non-domestic exposure



## Current-account imbalances as a percent of GDP and growth in unit labor costs, cumulative 1999-2011

Strong asymmetry between Northern and Southern euro-area countries both in imbalances and labor costs.

# Interpreting the plot

Sovereign debt levels and budget deficits (relative to income) are just as high in the UK, US and Japan as in most European countries.

Yet, the speculative attack has focuswed on euro area. This attack would have not occurred if the euro hare had been a fiscal-political union and the ECB were structured like the Fed, the Bank of England and the Bank of Japan.

Banks remain very fragile partly because of old credit risk and new risk from large sovereign debt exposure.

The euro area is very heterogeneous with northern countries with external surpluses and southern countries with deficits. It follows that the euro is over-appreciated for the South and under-appreciated for the North.

Second act:  
The weak policy response

## Save Greece

- to save German and French banks with bailout money in tranches and austerity plans.
- Has not worked. Greek economy is in a free fall.
- Without another tranche, Greece will default by mid 2012.

## Safety net

- EFSF (European Financial Stability Facility) to become in 2013 the ESM (European Stability Mechanism).
  - €440 bn the first and €500 the second. Too small relative to the size of the problem (€1.5-2.0 trillion)
  - Poorly structured: cash component of funding is small; member states guarantee one other and raise their own credit risk when a drawing occurs; ESM funding is senior to national debts and will make it more expensive for PIIGS to sell their debt in the markets.

## ECB

- has bought PIIGS debt in the secondary market (its charter impedes it to be a lender of last resort to governments). The total is around €75 billion, of which €50 billion in Greek bonds
- Has lent liberally to banks and in particular to Greek banks (here it has been a lender of last resort)

## European Summit of Dec. 9, 2011

- Germany wanted and obtained
  - strict and enforceable budgetary rules (but Art. 104 of the Treaty already prescribes fiscal rules and have not worked);
  - no expansion of the safety net;
  - no eurobonds; and
  - no expansion of the lending-of-last-resort role for the ECB

# The final act: Searching for a *deus ex machina*?

Three possible scenarios:

- The first, the status quo, implies an implosion of the euro area.
- The second, with a lender of last resort, provides a temporary fix.
- The third, with lender of last resort and eurobonds, sets the stage for a permanent fix.

## Scenario 1: as outlined in the Dec. European Summit

- Austerity continues but growth continues to slide unless we discover negative fiscal multipliers!
- With spreads persisting at current levels (markets are not kind to immiserizing growth), austerity would be unsustainable. Greece is showing signs of this phenomenon
- There is a pain level beyond which a country will find it worthwhile to default (i.e., restructure) on its debt, re-introduce a national currency and then depreciate it against the euro.
- Suppose PIIGS were to drop out of the euro. The Northern countries would face stiff appreciation of the euro and would lose some of the benefits of the integrated, fixed-exchange rate, market. The German export-oriented industry would suffer.
- In the end, no winners.

## Scenario 2: German austerity with an expanded lender of last resort

- Fiscal rules apply strictly but ESM is given a banking charter, meaning that it can borrow from the ECB, say with a leverage ratio of 3 or 4.
- There would be no need to change the Treaty because the ECB already exercises its lender-of-last-resort role to banks.
- With resources of €1.5-2.0 trillion, ESM could provide a sufficiently long time window for governments to stabilize debt-to-GDP ratios
- One risk is the inflationary consequence of the added liquidity created by the ECB. But this risk is no bigger than the risk created by the Fed with quantitative easing.
- Another risk is that this scenario does not fix the structural weakness of the euro-area: the absence of a fiscal-political union.

### Scenario 3: Scenario 2 plus eurobonds

- There are several eurobond proposals but the common feature is joint responsibility as opposed to “shared” (as in ESM) responsibility
- Eurobonds could be used to replace part or the entirety of sovereign debt.
- Would require strict fiscal rules (as in Scenario 1), harmonization of national budgets, revenue sharing, tax harmonization and inter-governmental transfers; in essence the steps for political unification.
- The Treaty would have to significantly change and would take time.
- This is the reason for buying time with an extended ESM.

Are European leaders up to the challenge? Until now they have shown that they are not!