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Eurozone design and management failures

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Europe's sovereign debt crisis is a defining moment for the Eurozone. This Vox column argues that the crisis exposes weaknesses in the monetary union's design, governance, and management – many of which were pointed out long before the euro existed. But, despite this, it adds that the Eurozone still has the ability to make good.

The sovereign debt crisis has tested, for the first time in its short existence, the resilience of the Eurozone design, governance, and management, showing some of its weaknesses and failures.

Its design was criticised long before the monetary union was created (European Commission 1990). Many academics pointed to three basic design weaknesses.

- First, the Eurozone is not an optimum currency area, because it lacks two necessary requisites, i.e. price and wage flexibility and labour and capital mobility.

As the Eurozone does not comply fully with either of the two, it needs to have a very large common or single budget to face potential asymmetric shocks affecting some of its members, as has happened now.

- Second, a single monetary policy requires a single or common fiscal policy, because if one or several members increases its spending and debt disproportionably, it produces negative externalities on the others, who tend to buy their debt without exchange-rate risk.

Achieving such a single fiscal policy implies a progressive political union.

- Third, a single monetary policy may have perverse effects when applied to members with divergent growth and inflation rates by becoming simultaneously too strict for members with low rates of growth and inflation and too lax for members with higher rates of growth and inflation.

In spite of these design weaknesses, the Eurozone was created with a minimum budget (around 1% of its total GDP) and a single monetary policy based on a harmonised measure of consumer inflation (the Harmonised Index of Consumer Prices, HIPC). This index weights consumer prices in each member by its GDP. To avoid negative fiscal externalities, two instruments were introduced: (i) the Stability and Growth Pact, with strong sanctions, and (ii) a fiscal and monetary no-bailout clause in the Treaty (Article 125).

Build-up to the Eurozone's sovereign debt crisis

For some years, this design worked; investors trusted it. The bond spreads on Eurozone members' debt closed to almost zero – an outcome that we now know did not reflect the fundamentals. In the meantime, the ECB was keeping its repo intervention rates low, due to the fact that Germany, Italy, and France, which represent two-thirds of Eurozone GDP, were growing slowly. These rates, however, proved too lax for the fast-growing Eurozone members who suffered higher inflation rates. This in turn meant that real interest rates were very low (close to zero) for some, but high for others. The difficulty was that the low real rates were in the fast-growing, high-inflation nations, while the high rates were in the slow-growing, low-inflation nations.

Both factors produced a credit bubble in the fast growing members as they increased their leverage and eventually produced asset bubbles both in financial and real estate assets. It was in this unstable situation that the unexpected financial crisis of August 2007 struck. It surprised most households, firms and banks from these member states with a high level of leverage and with very high private external debt levels.

Eventually, part of this high level of private debt became sovereign debt when governments were forced to increase public expenditures in order to avoid a larger recession or to bail out some distressed private banks and because, at the same time, they suffered a big fall in tax revenue coming from the burst of the bubbles. It can be said that the present sovereign debt crisis in some Eurozone member states has been a product both of design failures and an unexpected financial crisis.

Failure in crisis management

During the Eurozone sovereign-debt crisis, governance and management has been also put to the test by investors. Serious failures were uncovered.

- First, Greece was the first member to show solvency problems, after Papandreou took over in October 2009 and uncovered unexpected levels of deficit and debt.

The IMF came immediately to its rescue with its financing and its strong conditionality programme. Nevertheless, it was rejected by the EU's Council of Ministers. They considered Greece's problem to be an exclusively internal issue. They did not, however, have the experience or the necessary funding to deal with the problem. After several months trying to discuss a bailout package, while Greece's solvency deteriorated quickly, a strong reaction by investors forced EU leaders to put up urgently a much needed large rescue fund (the European Financial Stability Fund or EFSF) in the early morning of 10 May 2010, six months after the problem was uncovered.

Had the IMF been allowed to do its job from the start, the Eurozone could have avoided contagion, the present debt crisis and probably right now Greece would be restructuring its debt in the markets without being a shock to investors.

- Second, the EFSF had a design flaw; it was not allowed to buy debt in the secondary markets from the member states affected by solvency problems.

From March 2011, it was allowed to buy debt, but only in the primary markets and under exceptional circumstances. Therefore, the EFSF could only make three to five-year loans at very high interest rates (5.8% when its funding costs were just below 2%, in the case of Ireland) because it was agreed that the country to be bailed out needed to suffer a strong "cost of finance" punishment, in addition to a huge fiscal adjustment and tough reforms.

Instead of helping the affected country by buying its debt at a market discount in the secondary market for five years (allowing the country to get out of its debt crisis faster) and then selling the debt five years later (making a large profit), the EFSF is only allowed to add expensive debt on top of the existing pile of debt, causing a further deterioration in solvency and increasing the probability of default. When a country has solvency problems they cannot be cured by very expensive liquidity, but by debt relief. The present system, by contrast, ends up creating a debt overhang.

- Third, with the plan to turn the temporary EFSF into something permanent from 2013, EU leaders decided that investors should be punished as a trade-off for helping Eurozone sovereigns.

The permanent mechanism, the European Stability Mechanism, or ESM, was set up such that all subsequent Eurozone sovereign debt issues would contain collective action clauses (these facilitate debt defaults by removing individual investors' vetoes). The idea is that private investors would also pay in the event of a default. The Eurozone leaders seem to have forgotten that these investors were mainly their own banks, insurance companies, investment funds, and pension funds.

Investors reacted by discounting the expected future losses after 2013 from the present price of the Eurozone member state debts. This provoked a large fall in their prices, and a correspondingly large jump in their spreads. This in turn triggered the need for an Irish bailout.

- Fourth, several very well-thought-out proposals to create "Eurobonds" have been rejected (for example, see Gros and Micossi 2008 on this site).

Clearly this is the most efficient way to resolve the present sovereign debt crisis – by creating a Eurozone bond market as large, deep, diversified and liquid as that of the US Treasury bond market.

Moreover, one of the proposals would allow issuing Eurobonds only up to 60% of the debt of each member state (which is considered to be the maximum sustainable level by the Treaty, see Depla and von Weizsäcker 2010), so that member states with larger debts would have to issue debt under their own guarantee, paying much higher spreads and being punished by having accumulated too much debt.

If Eurobonds had not been rejected, not only would they have avoided attacks from the markets and contagion to other members, but they would have attracted many large AAA sovereign debt international investors heavily exposed to dollar treasury bonds, achieving a perfect hedge. This rejection is even more difficult to understand when the debt issues by the EFSF and in the future ESM are already quasi-Eurobonds.

- The fifth failure in crisis management is the most recent "Pact for the Euro". Not only does the Pact fail to reverse this trend but in fact worsens it.

The post-2013 ESM is not allowed to buy debt in the secondary markets. The country to be helped needs to pay 200 basis points over its cost of funding, under stronger conditionality and only in exceptional circumstances. Moreover, the ESM contains three new clauses that may undermine its viability: the seniority clause, the unanimity clause, and private participation clause. First, ESM and IMF loans would be senior to the debt bought by private investors, so that when a member state access to the ESM, all debt in private hands becomes junior and loses its rating. For this reason, investors again have discounted expected losses from the actual price of the debt, provoking another strong increase in the spreads, which has triggered the Portugal bailout. Second, each loan requires unanimity from the Eurozone member states, giving a veto to any single member, increasing the probability of sovereign debt restructurings at the cost of private investors. Finally, once the Commission and the ECB determine that a member state is insolvent, then the ESM will only make loans if private investors make them simultaneously. This, of course, is internally inconsistent: a member state is insolvent precisely because private investors are unwilling to refinance its debt.

- Sixth, the new Pact for the Euro has chosen the unit labour costs of each member state versus Germany as a measure of their competitiveness within the Eurozone. This is not adequate.

Germany voluntarily entered the Eurozone at an appreciated exchange rate, and later it was forced to make an internal devaluation by reducing wages. As a consequence, today most, if not all, the member states are not competitive versus Germany and thus they should produce an internal devaluation to equal Germany's. But many of them do not compete with Germany on goods or on services, either inside or outside the Eurozone.

Conclusion

In sum, the three bailouts, affecting some of the weakest member states in terms of solvency, have been eventually triggered by management failures that have created large uncertainty among investors as well as contagion. The two countries that have already been bailed out have impaired their solvency due to their inadequate treatment.

In the last few days, some comments by EU leaders about the need for Greece to do a "voluntary" restructuring, which is another oxymoron, have again produced an increase in spreads in Spain, Italy, and Belgium. Last but not least, the Spiegel created another story about Greece leaving the Eurozone. Greece should be able to swap part of its debt for bonds of the EFSF to get out of its difficult situation, but again, this has been rejected.

It may be that this is the only politically available way to walk very slowly towards a future single fiscal policy, but these series of weaknesses and failures in the Eurozone governance and management of the crisis are not solving the present Eurozone crisis and are extremely costly and painful for many of its citizens.

The Eurozone is in reality quite a closed economy, in the sense that is has no current-account surplus or deficit with respect to the rest of the world. As a result, all its members are in the same boat, given that surpluses in some member states are the counterpart of deficits in other member states and surplus members have financed their surpluses of exports of goods and services to the deficit countries. Moreover, no member state can leave the euro without incurring unbearable costs (Eichengreen 2007). These are the reasons why they should be able to find a consensus and a cooperative way out of the present messy situation and stabilise the Eurozone and the euro for good.

References

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