The Eurozone: Clean-up Time

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A crisis that should not have happened

- A debt crisis
- Collapse of the interbank market
- Politically-charged bailouts
- Ever widening conditionality
- Intense summitry
- ECB under threat

None of that should have happened

These are all institutional failures
A debt crisis

- Large debts by end 2009
  - Not the whole story

Gross liabilities of general governments (% GDP)

Source: OECD
A debt crisis

• Large public debts by end 2009
  ▪ Not the whole story
  ▪ Other explanations
    • Current account divergences
    • Inflation differentials
    • Bank crises
    • Euro = foreign currency

• Necessary conditions in a monetary union
  ▪ Fiscal discipline
  ▪ Break doom loop between banks and governments
A debt crisis

• Fiscal discipline never achieved

Lowest budget balance (% of GDP): EA12 vs. Rest of OECD

Source: Economic Outlook, OECD
A debt crisis

- Fiscal discipline never achieved
- An accident waiting to happen
  - Triggers: global crisis and Greek data fudge
- When market access loss occurs
  - Central bank is lender in last resort
  - ECB unwilling to play this role: euro as a foreign currency
- When debt is in foreign currency
  - IMF is first port of call
  - Debt restructured if unsustainable
  - Door was closed
A debt crisis

• The trend-setting formula for Greece
  ▪ No lender in last resort
  ▪ No IMF alone
  ▪ No debt restructuring

No solution
No solution, indeed

Interest rate spreads
Cleanup No.1

- Establish fiscal discipline
  - Stability and Growth Pact will not do
    - Rule vs. discretion: impossible trade off for politicians
    - Sovereignty: a fundamental contradiction
  - Economists believe in incentives: no bailout anymore, ever
    - Hard to establish credibility now

- Debt legacy
  - Crucial for credibility of no-bailout clause
  - Formulae without transfers exist
Collapse of interbank market

- The doom loop: borders reappear
  - No lender in last resort
    - ELA remains national
  - Asymmetric information
    - Worse across borders
    - National supervisors not trusted

- One money, one banking system
  - Single regulation
  - Single supervision
  - Single resolution

Was known
Deemed too sensitive
Collapse of interbank market

• Deep implications
  ▪ ECB had to step in: Target 2
  ▪ Greece was bailed out to protect other banks
  ▪ Took years to clean up banks (finished?)
    • Low growth
  ▪ Ireland pressed to bail banks out
  ▪ Cyprus mismanagement
  ▪ ELA used to pressure Greece
Collapse of interbank market

• Answer came swiftly: Banking Union
  ▪ Single Supervision Mechanism
  ▪ Single Resolution Mechanism
    ▪ Single Resolution Fund

• Not so single
  ▪ SRM too complex
    ▪ Political meddling guaranteed
  ▪ SRF yet to come, could be too small
    ▪ Still no lender in last resort

• Stress tests: botched?
Cleanup No.2

- Need for a complete banking union
- SSM all encompassing
- SRM streamlined
- SRF may be too late, too little
  - Various solutions
  - Mutualisation unavoidable
Politically-charged bailouts

• Troika: a three-headed monster
  ▪ ECB on the “wrong side of the table”
  ▪ IMF as junior partner
  ▪ Conflicted Commission

• IMF vs. Troika
  ▪ IMF structurally committed to its “clients”
  ▪ Troika dominated by member government(s)
    • Conflicts of interest
    • Ideological interferences
Cleanup No.3

- No more bailouts
  - What is ESM for?
- IMF available
  - Should be the rule
- ECB on the right side of the table
  - The central bank of each and every member country
  - Disengaged from enforcement of fiscal discipline
Ever widening conditionality

- From debt stabilization to structural reform
  - A classic mission creep
  - Bad economic management not limited to fiscal policy
  - Poor track record
- Confused justification for real problem
  - Externalities minimal
  - Incentives in right direction
- Power grab?
  - EU Commission
  - EU vs. national sovereignty
Ever widening conditionality

• A history of failures
  ▪ Lisbon strategy
    • Remember objective?
      "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010"
The most competitive and dynamic knowledge-based economy

GDP per capita (US dollar)

Source: OECD
Ever widening conditionality

• A history of failures
  ▪ Lisbon strategy
    • Remember objective?
    "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010”

• Recent changes in the wrong direction
  ▪ MIB procedure
  ▪ European semester
    • Political trade off fiscal discipline vs. reforms
  ▪ Deepen conflict with national sovereignty
Cleanup No.4

• Keep UK in EU!
• Focus on Single Market
• Complete Banking Union
Intense summitry

- No crisis management procedure
- Commission sidelined
  - Rules-based institution
  - Politicized institution
    - Big issues are for the bosses
- Impossible inter-governmental method
  - Mismanagement of debt crisis
  - Mismanagement of migrant crisis
- One country cannot fill vacuum
Cleanup No.5

Political scientists to the rescue!
ECB under threat

• Asymmetric shocks are inherently mission impossible

• The cyclical convergence dream
  ▪ Not only monetary policy shocks
  ▪ Conflicts of interest

• Divergent views
  ▪ Economic principles
    • The role of monetary and fiscal policies
    • The special case of moral hazard
  ▪ Democratic principles
ECB under threat

• Mission impossible

• Back to the mandate?
  ▪ The misplaced concern for independence

• Results
  ▪ Bailouts
  ▪ Procrastination
Procrastination

QE: end 2008 in US and UK, March 2015 in Eurozone
ECB under threat

- Mission impossible
- Back to the mandate?
  - The misplaced concerned for independence
- Results
  - Bailouts
  - Procrastination
  - Visible intimidation
    - The case of OMT (aka “whatever it takes”)
- No lender of last resort
Cleanup No.6

• Independence: *de jure* vs. *de facto*

• Mandate OK

• Practice
  - Clear separation of tasks
    - Should not comment on budgets and reforms
  - No dealing in national debts
    - Own debt instruments
    - Eurobonds when they come to exist

• Improved accountability
Conclusion

what a mess!