

Two stylized views on the European debt crisis

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Two stylized views on the European debt crisis

View 1: Centered around 'no bail out principle'

View 2: Centered around 'no default principle'

View 1

Key danger associated with creation of European monetary union: member countries with free-riding incentives (particularly detrimental in fiscal domain)

Challenge: These incentives need to be counteracted:

- Supranational central bank (ECB) to be protected against risk of reckless national fiscal policies
- Absence of fiscal union requires a strong fiscal framework with binding rules on national deficit and debt developments
- No bail out principle is cornerstone of this architecture
- Borrowing behaviour of deviant member countries to be disciplined by market forces
- Ultima ratio: possibility of open default of member countries

View 1

Implications:

- This view is not consistent with ECB-purchases of sovereign debt of selected member countries
- Sovereign debt of member countries should not be risk-free

Implicit assumptions:

- Default of countries poses no systemic risk
- Discretionary (ad-hoc) deviations from rules are costly

View 2

Key chance associated with creation of European monetary union:
single currency improves financial integration

Challenge: how to respond to a financial crisis?

- Financial crises have, by nature, a systemic dimension. Financial integration reinforces this dimension at European level
- Financial crises need resolute action; costs will explode if reactions are timid and uncertain
- Supranational central bank (ECB) key actor because of its 'lender of last resort' - function. Crucial: areawide ability to supply safe assets in unlimited amounts
- Solvency of countries with financial sector problems can be guaranteed if ECB stands behind sovereign debt with unconditional and unlimited support
- No default principle is particularly valuable in integrated markets
- Ultima ratio: if unavoidable, restructuring of debt and partial bail outs, to be coordinated at supranational level

View 2

Implications:

- Functioning of monetary union requires willingness of ECB to purchase sovereign debt of selected countries that are under stress
- ECB has the ability to ensure that sovereign debt of member countries is seen as risk-free

Implicit assumption:

- Moral hazard is of secondary importance
- Better rules and improved surveillance can be re-established after the crisis is over

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Problem:

- Since intensification of EA sovereign debt crisis in 2010 both views coexist
- 'Markets' struggle to update their beliefs about nature of slow and complicated compromises
- Outcomes so far: contested policy responses to developments in Greece, Portugal, Ireland, Cyprus as well as Italy and Spain

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Current compromise line taken by ECB (announced Sept. 2012):

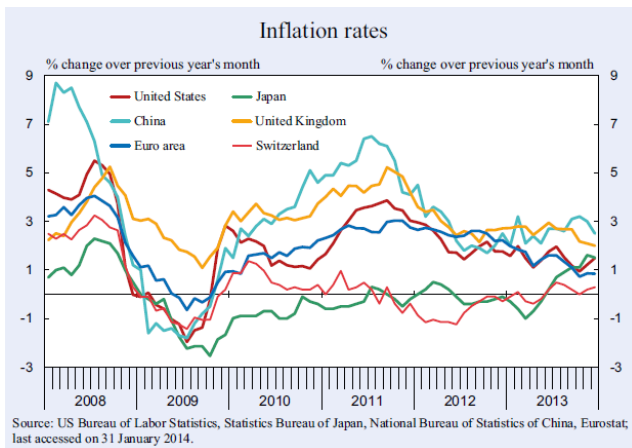
→ Conditional support via OMT (Outright monetary transactions)

- unlimited ECB-support of countries via purchases of sovereign debt possible
- conditional, however, on countries being on strict ESM-adjustment programs with IMF participation
- interventions in short-term papers only (residual maturities of 1 to 3 years)
- ECB without seniority status

so far: announcement effect with good success

Selected charts on monetary and fiscal policy indicators

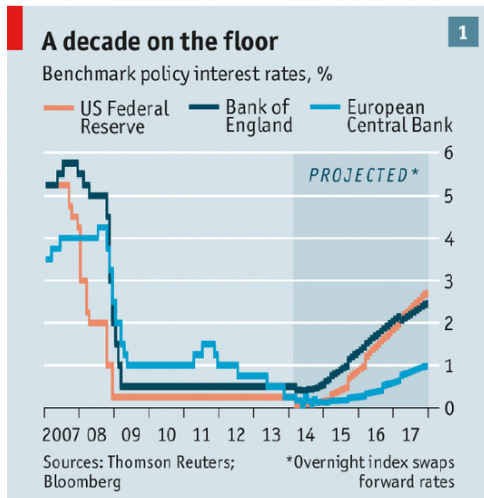
Inflation



Source: EEAG Report on the European Economy, 2014

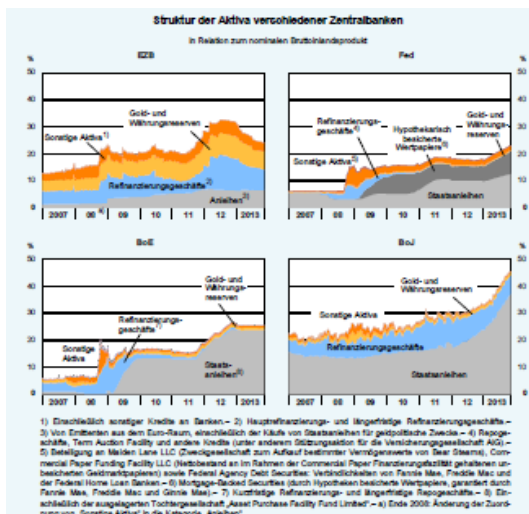
Selected charts on monetary and fiscal policy indicators

Central bank policy rates



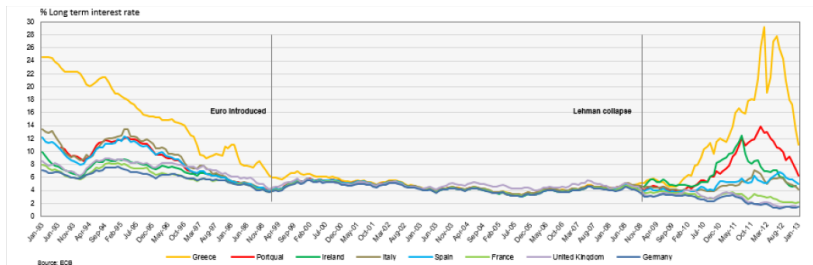
Selected charts on monetary and fiscal policy indicators

Central bank balance sheets



Selected charts on monetary and fiscal policy indicators

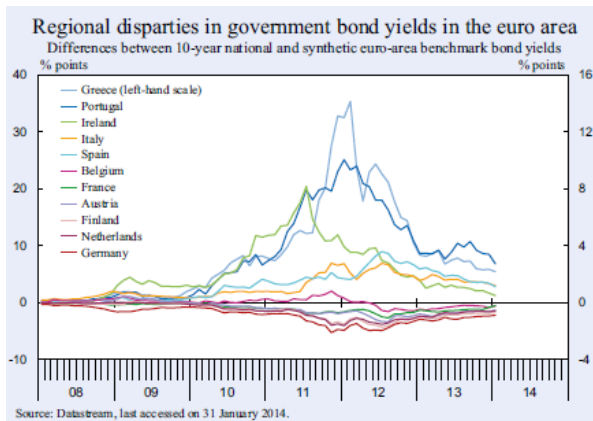
Euro area: 10 year government bond yields, 1993-2012



Source: Worldeconomics, 9 May 2013

Selected charts on monetary and fiscal policy indicators

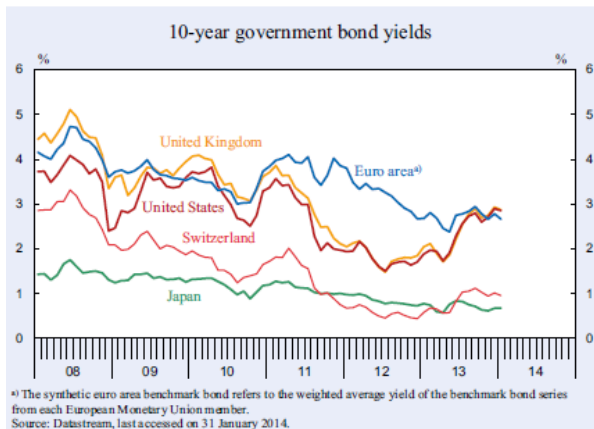
Euro area: 10 year government bond yields, 2008-2013



Source: EEAG Report on the European Economy, 2014

Selected charts on monetary and fiscal policy indicators

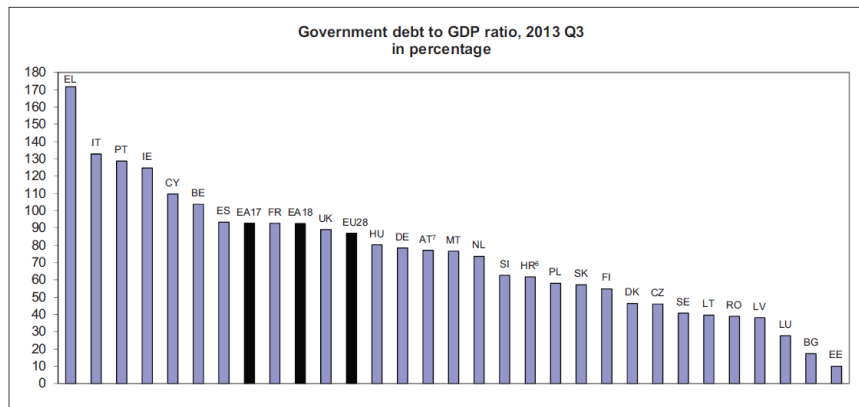
10 year government bond yields, Selected countries, 2008-2013



Source: EEAG Report on the European Economy, 2014

Selected charts on monetary and fiscal policy indicators

EU countries: debt-to-GDP ratios (levels, 2013)



Source: Eurostat, Newsrelease Euroindicators, 22 January 2014