Two stylized views on the European debt crisis

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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: 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

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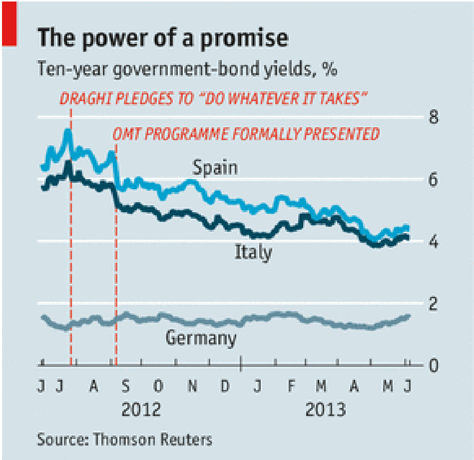
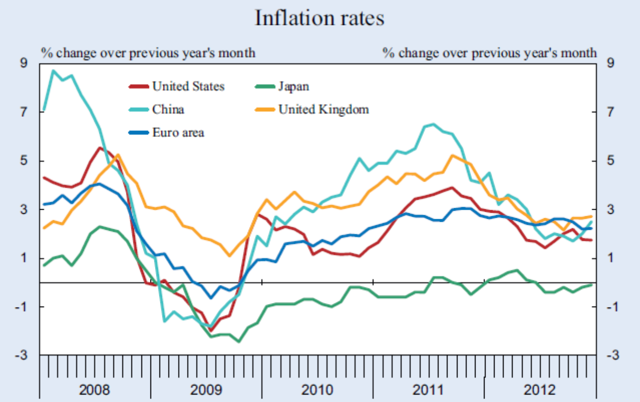
Current compromise line taken by ECB (announced Sept. 2012):
→ OMT not yet activated and announcement effects so far with good success:



Selected charts on monetary and fiscal policy indicators

Inflation



Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2013.

Source: EEAG Report on the European Economy, 2013

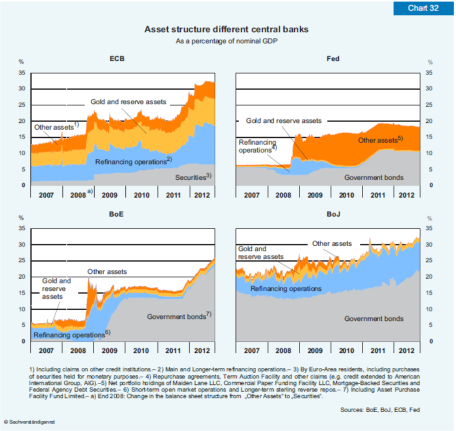
Selected charts on monetary and fiscal policy indicators

Central bank policy rates

Source: The Economist, 6 April 2013

Selected charts on monetary and fiscal policy indicators

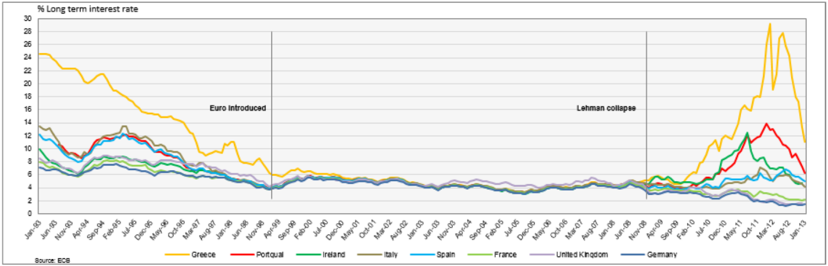
Central bank balance sheets



Source: German Council of Economic Advisors, Annual Report, 2012

Selected charts on monetary and fiscal policy indicators

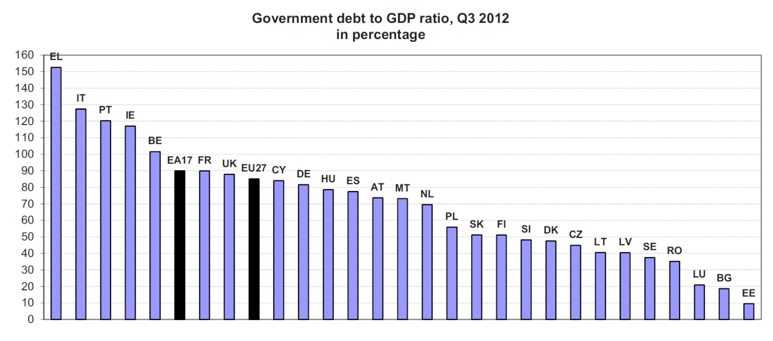
Euro area: 10 year government bond yields



Source: Worldeconomics, 9 May 2013

Selected charts on monetary and fiscal policy indicators

EU countries: debt-to-GDP ratios (levels, 2012)

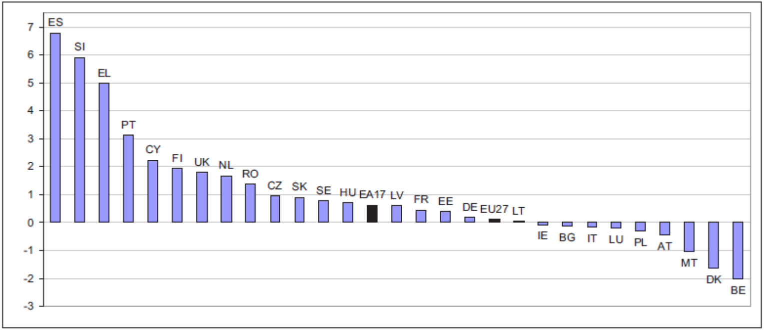


Source: Eurostat, Newsrelease Euroindicators, 23 January 2013

Selected charts on monetary and fiscal policy indicators

EU countries: debt-to-GDP ratios (annual changes 2013 vs 2012)

Figure 1: Changes in government debt to GDP ratio, 2012Q4 compared with 2012Q3, in percentage points



Source: Eurostat, Newsrelease Euroindicators, 22 April 2013