The Incomplete and Dysfunctional Crisis Management of the Eurozone

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Kurt Hübner
Institute for European Studies
University of British Columbia, Vancouver

1. Compared to the situation about a year ago it seems that the stress level for the Eurozone has drastically decreased. The debates and sentiments no longer turn around a collapse of the common currency area nor is it being speculated that one or the other economy are leaving. Rather, the number of members of the Eurozone will increase to 18 when Latvia will join in 2014. Hedge funds again started pouring money into the banking system of Greece. Talk is that things turn to the better. In brief, unlike a year ago trust and credibility seems to have returned. All good then?
2. I will argue that the crisis only took a break and will return soon. The reason I give is twofold. First, the Eurozone has moved into a recession zone and overall onto a low growth trajectory, and this will further complicate crisis management. Low or in some cases even negative growth will bring more companies, and also banks to the brink. Unemployment rises and social tensions increase. No good environment for crisis management. Second, the Eurozone is stuck in a policy trap where some actors demand the continuation of strict austerity and others ask for relaxation or even for turnarounds of the current strategy. This trap makes policy decisions in other areas, like the essential banking union, more difficult. As long as the general route of the crisis management is contested reforms in other policy areas are getti ng overly complicated as the political compromise zone is not drawn firm. Hence, crisis management suffers further damage.

3. In my talk I will argue that the EU and the Eurozone members need to make use of the current calm before the next storm moves in. In particular, the incomplete crisis management needs to be overcome. What I mean by this is that only an optimum policy mix between fiscal and monetary policy plus a well-defined version of structural reforms can overcome the crisis. Let me start with a discussion of the discussion on austerity. This debate seems to me crucial to understand the current situation of the Eurozone as well as the policy trap. Also, this discussion has gained traction and a lot of importance over the last few weeks. For this reason, let me start talking about what has been notoriously labeled as 'Rogoff-Reinhart (RR) affair'. Austerity policy in the Eurozone has not been caused by RR but it played a not minor role; moreover, the RR debate touches the center of the austerity recipe in Europe (and beyond).
4. Science and politics are two sub- systems of societies that function according to different logics. Science is a self-controlling sub-system that is based on knowledge, i.e. empirical facts and theory-based arguments are connected in meaningful ways. Politics is a sub-system that is tasked with governance and functions with formal and informal discourses about collective goods that result in generalized norms, regulations and laws. Actors of this sub-system aim for political majorities. Both sub-systems are interlinked but each shows a high level of autonomy. It is well known, for example, that the political system likes to make use of knowledge generated within the science sub-system to justify particular politics. Academics, on the other side, often are eager to provide the political sub-system with knowledge in order to influence political discourses.
5. A example of the mutual interests of actors of both sub-systems is the '90% rule' provided by RR. Those two excellent US- economists published briefly after the global financial crisis of 2008 a monumental work about eight centuries of sovereign debt. Rightly so, it is a widely praised book that provides rich empirical data. Already it's title 'This time is different' indicates that it has important insights to contribute to the history of public

debt. Since the publication of this book RR turned to economic pop stars. The demand on the side of the public to get kind of brief versions of the tomb was gigantic. Both authors, and probably more Rogoff than Reinhart, were eagerly responding to this demand with a huge supply of comments, interviews, and consulting work. Demand and supply seemed to have met in a 'good equilibrium'. The main message of the post-book statements and briefer publications was clear: economies with a public debt ratio above 90% will suffer strong and significant losses in economic growth. Hence, reducing public debt is quintessential for regaining economic growth.

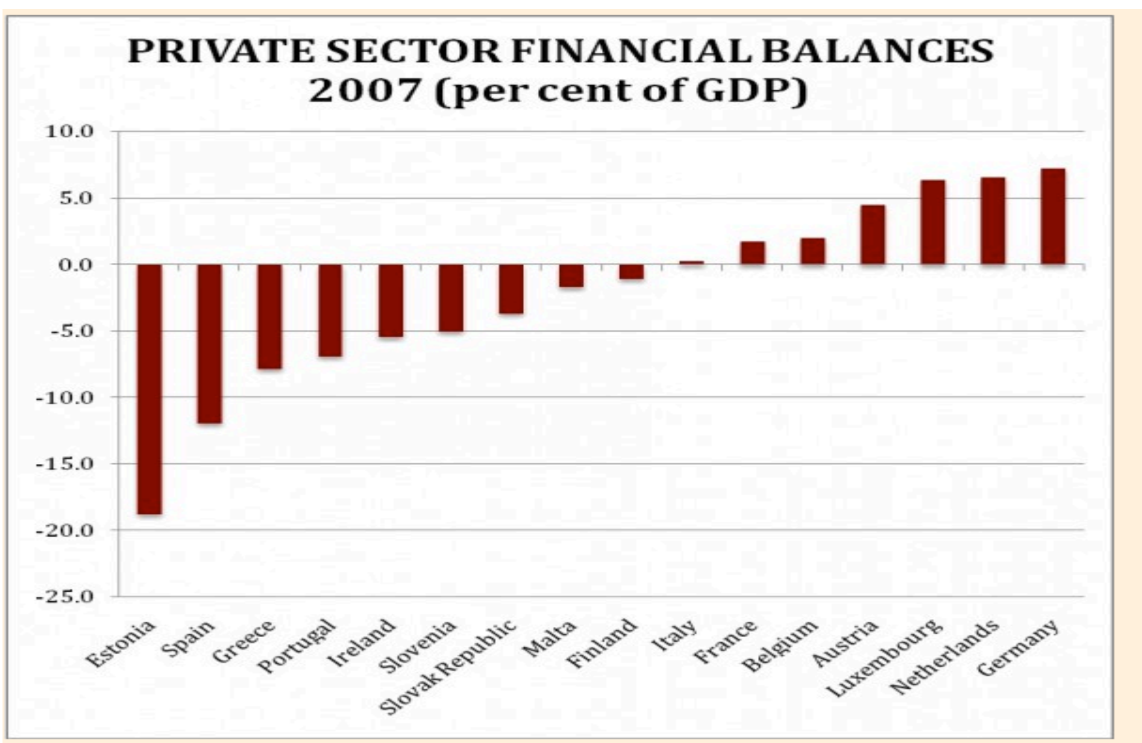
6. This argument was highly welcomed by politicians for whom the reduction of public debt by means of fiscal austerity was the key political target. I don't argue that RR were causal in favoring this approach. I am saying that they provided rather unbalanced input that fired the austerity approach. The self-control mechanisms of the science sub-system needed their time to review this policy advice, or better; the statistical validity of the advice. A recent intervention of a three- scholar group from University of Massachusetts, Amherst, who belong to the Post-Keynesian camp of economists replicated the study based on the data provided by RR. Surprisingly enough, they were not able to come up with the same results as the original study. What they found were coding errors, biased statistical weights and omissions. As a matter of fact, the debt ratio-economic growth nexus was not negative as claimed by RR but still positive, and the growth effect of public debts beyond the 90% threshold was relatively small. This result was embarrassing for RR and should have been even more embarrassing for the political users of the 'rule'. The willingness to rethink and reflect on the side of the 'Austerians' so far was pretty underdeveloped. Their belief in the blessings of 'expansionary devaluation' seems to be unbroken. We know from Thomas Kuhn that a change in paradigm needs more then one falsification. Rather, changes in paradigms should be seen caused by slow and steady flows of new

7. Even before the falsification exercise from Amherst was published we had an ongoing debate about the underlying causality of the proposed 90% rule. Rather then reading the chain from public debt to economic growth, so the suggestion, it should be read from economic growth to public debt. This interpretation got quite substantial support by studies done by the IMF that showed that the government multiplier is much higher in times of liquidity traps as in ' normal times'. What sounds a bit technical is actually very important: Reductions in public expenditures in order to decrease public debt imply relatively strong reductions in other sectors and thus result in relatively large growth reductions. In other words, strong frontloaded austerity can be self-defeating: austerity strategy turns recessions into depressions. The probability for such an outcome is even higher in cases of balance sheet crises. During such episodes all actors with high debt start to deleverage. Those actions are rational from an individual perspective but run into the 'fallacy of composition', i.e. if all sectors deleverage simultaneously the outcome is a recession. Since the start of the crises of Eurozone economies we collected quite hard evidence that austerity has a self-defeating tendency. We also know from historical as well as current experience, and EU-Commission President Barroso recently echoed the insights of scholars, that austerity meets political and social limits. Why is it then that political representatives of some northern economies of the Eurozone insist on the continuation of austerity? How can we explain, for example, that the President of the Deutsche Bundesbank, Jens Weidmann, so vehemently opposes any relaxation of austerity, and insists that no reform fatigue should be allowed. Why is he going so far to question the relevance of empirical critique:" " Sometimes one can get the impression that the lack of two or three data points is used as an argument to put everything upside down and to state that public debt would generate economic growth. This actually would be misguided and definitely a wrong conclusion".
8. The most straightforward answer is that he argues from a truly literal

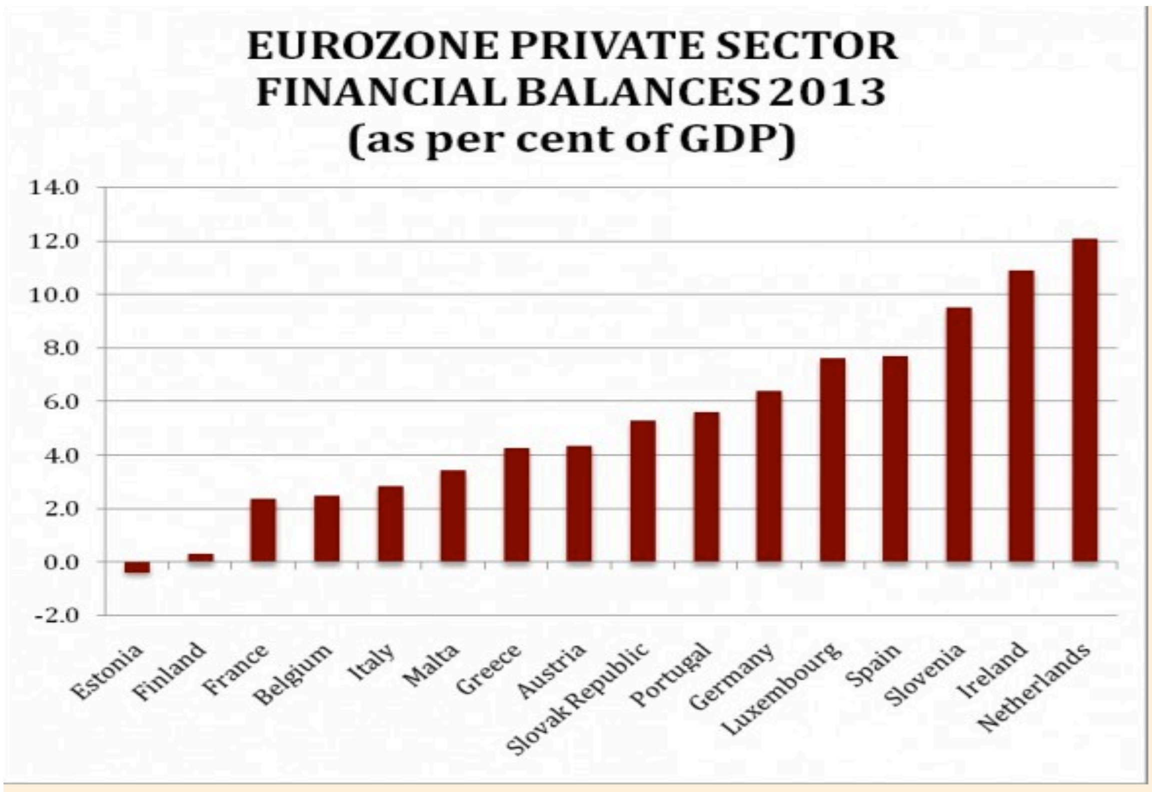
reading of the Treaty and concludes, rightly, that bailouts are strictly forbidden. In a currency union such a provision implies that each member has to clean up any economic mess in its own house. Given that currency depreciations are no longer a policy tool, the only tool available is internal devaluation, i.e. austerity. Such a stance has a lot of support from the economic profession but it needs to be noted that it also comes with quite some controversy. The concept and policy of internal devaluation has a long tradition in the field; more recently, the work by Alberto Alesina from Harvard made powerful inroads into the policy debate. His work and that of his likeminded colleagues showed that it needs credible cuts in order to move economies out of debt-recessions. In other words, strong front-loaded austerity is the way to go. This position was widely welcomed in the policy community but met hefty critique in the profession. Even the IMF intervened and demonstrated empirically (based on the same cases selected by Alesina) that strong cuts in public expenditures do not per se generate a return to economic growth; the contrary seems to be true. Clamping to austerity has more sources then the belief in economic thinking. From a German perspective austerity seems to be handled as a moral imperative because overspending needs to be punished and not forgiven. Debt cancellation is a anathema in the German political discourse, even though one can argue that in times of balance sheet crises drastic debt cuts are unavoidable. Even more relevant for the clamping to austerity seems to me the dimension of moral hazard that comes into the game as soon as financial assistance, even below the level of a bailout, is being offered to troubled actors. How to avoid that debtors use assistance of creditors to postpone any reforms? Creditors have to insist that debtors mobilize all economic and political resources to come into a position to repay the credit. Without strict conditionality, so the argument, credits only will be used to buy time and to postpone reforms, and thus to save politicians from the political price of austerity. This is a real danger that needs to be dealt with. Given the creditor status of

Germany its insistence on austerity comes not as areal surprise. Still, the puzzle is that the German government continues to play hardball despite the obvious contra factual outcomes. Imposing front-loaded austerity seems to me not the best and not the only way to deal with moral hazard.

9. The insistence of austerity adds to the pain, and is the main reason that the Eurozone moved into recession area and onto a low growth trajectory. Despite harsh austerity public debt ratios don't decrease but actually increase. Given that the Eurozone crises are rooted in too large private debts (only exemption here is Greece) it is the private sector that needs to amend its balance sheets. The following graphs (thanks to Martin Wolf who used data provided by the IMF) are self-evident. The private sector (household and business) financial balance (receipts minus spending) equals the general government balance plus the foreign balance (net capital flow).



The net capital flow is by definition the inverse of the current account. Economies with current account deficits have positive net capital inflows. Graph 1 shows that in many member economies of the Eurozone the private sector was significantly more spending then earning. To make it very clear: The Eurozone crises started as private debt crises and only turned to public debt crises due to the rescue operations for national banking systems! What happened until 2013? Graph 2 tells the story. The private sectors were enormously deleveraging. Debtors started in brief time to amend their balance sheets. This is exactly what we would expect. However, what are the effects?



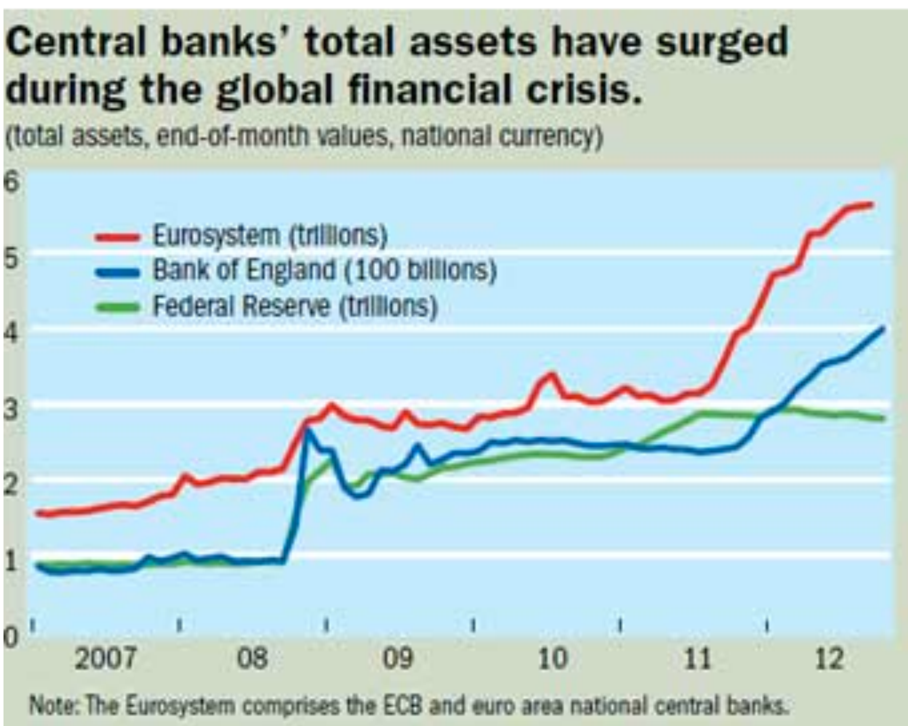
The turnaround of the private sector needs opposite balance sheets of the government and/or positive current accounts. Now, it is well known that not all economies can run trade surpluses, and thus it needs mainly negative government balance sheets if the growth-reducing effects of deleveraging of the private sector should be avoided. Insistence on public austerity in times of private deleveraging confirms the 'paradox of thrift' already analyzed by Keynes.

In other words, the austerity medicine is a killer medicine. Why then have we not seen the collapse of the Eurozone? The answer to this question brings us to the next policy debate: What should the role of the ECB in the framework of economic governance of the Eurozone look like? Since the start of the Eurozone crises we know that the EU is slow, reactive and incoherent in its policy responses. Financial markets quickly became aware of this weakness and started speculative attacks of troubled Eurozone economies and by asking for high yields. Those attacks led to further incoherent crisis responses that never generated the kind of trust financial markets require for the sake of their own business models. In this situation the ECB had to start its drastic transformation. In brief time it reinterpreted its mandate and became eventually the creditor of last resort for the Eurozone. My argument here is that it is exactly the insistence on misguided and slow fiscal policy responses that urged the ECB to change its policy mandate in order to avoid an economic and political collapse of the Eurozone. In other words, the insistence on fiscal austerity came with the unintended outcome of transforming the ECB!

10. This drastic transformation of the ECB met fierce critic from Germany, concrete: from the German Bundesbank. In quick time, the unofficial German successor of ECB- head Trichet stepped down followed by an early retirement of the chief economist of the ECB, Juergen Starck. Funny enough, Chancellor Merkel sent her chief economic advisor, a former student of Axel Weber, to Frankfurt, and he quickly turned into the most important policy hawk who fanatical questioned and objected all ECB action in regards to its new role as creditor of last resort function. The situation is not without irony. The Germany-driven decision to opt for harsh and front- loaded austerity was running into the 'paradox of thrift' and eventually resulted in prolonged recessions. Given the insistence on debt reduction, fiscal policy became pro cyclical. This in turn made growth even less likely. Given that we can assume that the fiscal multipliers are strongly negative, this policy would have generated more and more panic attacks of financial market actors if the new ECB President Mario Monti

not had joined other international central banks with a turn towards quantitative easing and the clear promise to do everything to save the Eurozone. His promise to use the unlimited firepower of the ECB calmed down financial markets and so far stopped further panic attacks.

11. The price is high, though. The ECB drastically extended its balance sheet and added low quality item to its balance. As graph 3 shows the growth of the balance sheet was quite impressive, in particular since 2011. The ECB started to engage in long-term financing operations and actually was bailing out troubled governments. This policy change coincides nicely with the turn towards fiscal austerity and the start of panic attacks on the side of financial markets. It became the job of the ECB to act as creditor of last resort. However, the Bank was required to accept collateral of low quality in exchange for liquidity. This switch comes not without problems, at least if a worst-case scenario would happen.



11. However, the options for the ECB are restricted. As long as austerity reigns and at the same time all attempts and proposals for the mutualization of public debt are being excluded, it is up to the ECB to safe the day. Only in case a ‘true’ banking union would come that includes a recapitalization fund as well as a resolution fund, the ECB could slowly reduce its exposed position. The communication strategy of the ECB so far was successful and already helped to reduce the actual injection of funds. The higher the level of trust, the less the ECB needs to provide. In the last few months the balance sheet has been reduced. Still, it is a long way until the crises are over. All indications show that Eurozone banks still carry too high shares of bad debts, and thus that they need huge amounts of funds to recapitalize. The ECB can do only so much. Liquidity injections into the banking system are not used to increase credits to the private sector but to increase the capital base of banks. Consequently, the growth process of the private sector is hindered. Low growth is the result. And this feeds again instability. In other words, in order to make ECB policies efficient the banking system of the Eurozone needs to be recapitalized. Cyprus showed also the necessity to separate sovereign debt issues from insolvency issues of the banking system.

    Creditor economies are not keen to move towards a banking union, though. It is again Germany that builds up huge stumbling blocs by citing legal treaty concerns. The Commission soon will present its own view. I don’t think that Germany will lose this fight. What are the German concerns? In the last instance it is all about commitments and factual payments in a worst-case scenario. In other words, German politicians are eagerly interested to minimize financial risks for German taxpayers. I made already the point that their actions come with the unintended consequence to actually destabilize the Eurozone. Then again, why are German politicians act against their interests? In many respects the answer needs to be found in the economic-intellectual discourse in Germany that is rather unique in the Western world. This could be best illustrated with the TARGET 2 debate where under the leadership of the economist Hans-Werner Sinn most commentators agreed that Germany would finance to a ridiculous high amount the ‘Spendarians’ and ‘unwilling reformers’ in the South. Let me at least try to give you the gist of the debate.

13. The Trans-European Automated Real-time Gross Settlement Express Transfer System 2 (TARGET 2) is a European settlement system that handles euro transactions made between about 4,500 credit institutions and other financial actors which are eligible to participate directly or indirectly in the system. TARGET 2 offers advantages, maijnly that payment by commercial banks are made safely to accounts of national central banks; the payments are not limited, and payments are made immediately without any pause. Costs are uniform. Every TARGET 2 transactions involves two banks and/or two central banks. A ransfer of funds creates claims of the receiving bank and liabilities of the sending bank. Given that transactions include national central banks, at the end of the day the original transfers create net liabilities respectively claims of national central banks against each other. The ECB acts in this case as a clearing house. It is possible that national central banks can build up large claims against the ECB, and others have large liabilities. Exactly this happened to the German Bundesbank since 2010. Claims in the overall amount 0f Euro 500 billion piled up. The German debate interpreted those claims as ‘German credits’ credits to suffering debtor economies of the Eurozone. However, those claims are against the ECB and not against particular national central banks. In case the Eurozone would be dismantled the claims would get los. However, the losses of the German central bank would be restricted by the share of the Bundesbank in the capital of the ECB (27%). Still loses would occur. The rising claims of Germany and the rising liabilities of troubled peripheral economies reflect the fundamental lack in trust of investors into those economies. What happened between 2010 and 2012 was a huge capital flight inside the

Eurozone, and TARGET 2 balances exactly reflect this flight. It also tells us that we live in a world with ‘good’ and ‘bad’ Euros. In the last few months the imbalances got smaller. This only reflects the calmer sentiments towards the survival of the Eurozone. The slow return of trust has been produced by the ECB, and it is interesting to see recently more and more financial actors started to critique the austerity approach. Economic growth is seen as critical, and – as has been argued – austerity defeats a return to growth.

14. To conclude. The crisis management is incomplete, and moreover dysfunctional in a macroeconomic perspective. National interests and the fixation to orthodox recipes are a guarantee that the crisis is far from over. The ECB has not yet been tested. Comes September 2013, the situation may change to the better. Independent from the out of the general elections in Germany we can expect fierce test runs by financial markets, and we can expect a new positioning of Germany in the crisis management. Things are in flux.