From financial to social and political risks in the eurozone

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Introduction

Last year saw fundamental changes in the workings of the eurozone. The most important change was the decision of the ECB, announced in July and formulated in September, to commit itself to unlimited purchases of eurozone government bonds in the secondary market in times of crisis. Surely, this constituted a regime change. Prior to this decision the eurozone had been a fragile construction. This fragility was the result of the fact that when becoming a member of the eurozone, national governments lost their power to call in their own central bank in times of crisis to pay out the bondholders. Thus bondholders had no guarantee that the cash would always be available to pay them out at maturity. This lack of guarantee could and did generate self-fulfilling liquidity crises. The slightest doubts that a government might experience payment difficulties were sufficient to lead investors to massive sales of government bonds thereby precipitating a liquidity crisis (De Grauwe, 2011a).

In this chapter I first argue that the decision of the ECB to commit itself to unlimited purchases of government bonds has eliminated the existential fears about the future of the eurozone and has stabilised financial markets. In section 2 I ask the question of whether financial stabilisation will be sufficient to save the euro. I argue that new risks have arisen from the continuing deep recessions in Southern eurozone countries (Greece, Italy, Portugal, Spain). In section 3 I formulate how the macroeconomic policies should be redesigned in the eurozone so as to reduce these new risks.

1. The ECB became the lender of last resort in government bond markets

What the system needed was a lender of last resort. Last year, the ECB stepped in and committed itself to be a lender of last resort (LOLR). Although the ECB prefers to call these operations 'Outright Monetary Transactions' (OMT), these are true lender of last resort operations. Although the ECB attached a number of conditions to the application of its OMT facility, in particular that countries should apply for it and commit themselves to further austerity programs, the fact that the ECB provided such a facility, in which it committed itself to unlimited purchases of the bonds of troubled governments, dramatically reduced the fragility of the system. It also took away the existential fear that existed in the eurozone and that destabilised the system. Prior to the ECB's decision investors feared that the eurozone might collapse. The new stand taken by the ECB reduced this existential fear that was destroying the eurozone.

Figure 1 shows that the government bond market has been pacified since July 2012. Thus the many critics, especially in the North of Europe, who asserted that the ECB should not intervene in the secondary bond markets have been proven wrong. The ECB has made the right decision to become a lender of last resort, not only for banks but also for sovereigns, thereby re-establishing a stabilising force needed to protect the system from the boom and bust dynamics. This view was forcefully argued by a number of economists before the ECB decided to act (see De Grauwe, 2011b; Wyplosz, 2011 and Wolf, 2011).

However, the credibility of the OMT-program suffers because of continuing vehement criticism. Many arguments continue to be voiced against the view that the ECB should be a lender of last resort in the government bond markets. Some of them are phony, in particular the inflation risk argument (see De Grauwe, 2011b; Wyplosz, 2011). Others are serious, like the moral hazard risk. This is the risk that governments that profit from the bond purchase programme of the ECB will have less incentive to reduce budget deficits and debts.

This moral hazard risk, however, should be taken care of by the establishment of separate institutions aimed at controlling excessive government debts and deficits. These are in the process of being set up

(European Semester, Fiscal Pact, automatic sanctions, etc.). This disciplining and sanctioning mechanism then should relieve the ECB from its fears concerning moral hazard (a fear it did not have when it provided €1,000 billion to banks at a low interest rate in the context of the LTRO programme at the end of 2011 and early 2012).

The continuing fierce criticism against the notion that the ECB should be a lender of last resort in the government bond markets explains why the ECB attached a number of conditions to its OMT-programme. These conditions are likely to reduce the effectiveness of that programme. First, the ECB will restrict its bond purchases to bonds with a maturity of three years or less. There is no good economic argument to impose such a restriction. In fact, it may even increase the fragility of the sovereigns. These will now have an incentive to issue bonds with shorter maturities than they would have done otherwise, making them more vulnerable to liquidity crises.

Second, the ECB has attached as a condition to the use of the OMT-programme that the countries concerned apply to the ESM which may then subject these countries to additional austerity programmes. This creates the problem that countries are pushed further into a recession as a condition of obtaining relief from the ECB. It is difficult to understand the economic logic of such an approach. It is in my view the result of a moralistic approach to the problem that is very popular in the North of Europe and that wishes countries applying for support to be punished first for their sins.

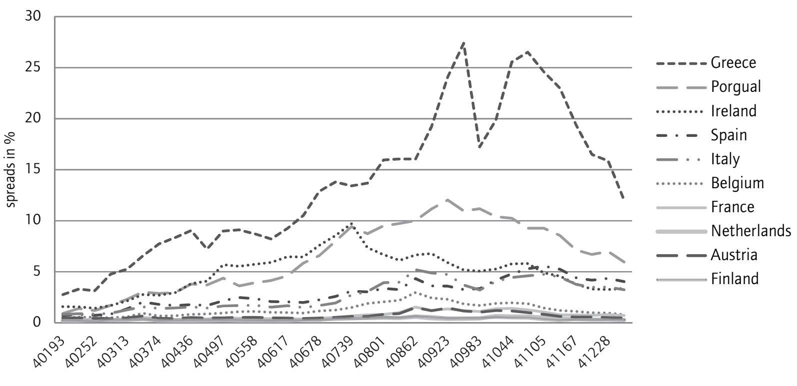
There is an additional danger to this second condition. The ESM will be at the centre of the procedure for triggering the ECB's liquidity provision in the context of the OMT programme. The decisions of the ESM, however, will de facto be subject to a veto power of Germany and other countries. One can only hope that common sense will prevail and that the popular opposition in Germany against the ECB's lender of last resort activities will not make it impossible for the ECB to exert these activities.

2. New risks for the eurozone

From the previous analysis one can conclude that the ECB saved the eurozone from imminent collapse during 2012. But does this mean that the eurozone is saved? In the short and medium run, yes. In the long run, no. The greatest threat for the eurozone today does not come from financial instability but from the potential social and political instability resulting from the economic depression into which Southern European countries have been pushed and that has led to increases in unemployment not seen since the Great Depression. In some Southern eurozone countries, the unemployment rate now stands far above 20% (in Greece, Spain and Portugal). The most dramatic development is the increase in youth unemployment, that in Greece and Spain now stands above 50% and around 30-40% in Italy and Portugal. If not reversed soon, this situation may lead to social and political upheaval in societies that have become incapable of providing a future for their young citizens.

Thus, the most important development during 2012 is the change in the nature of the risks in the eurozone. In the beginning of 2012 the risks were mainly financial, i.e. there was a risk that some governments might not find the cash to pay out the bondholders. The ECB solved that problem. At the start of 2013 the risk has become a social and political one.

Figure 1 **Spreads 10-year government bond rates in eurozone**



Source: Datastream.

It is the risk that in some countries the continuing increase in unemployment and decline in real income might lead desperate young people to start listening to politicians who promise them that life outside the eurozone would be better.

There can be little doubt that part of the problem faced by Southern eurozone countries is related to the poor functioning of their labour markets. For example, in these countries strong employment protection laws have the effect of making it difficult for the young to enter the labour markets. As a result, youth unemployment has become a severe structural problem. However, these structural problems cannot explain the dramatic decline in economic growth in these countries and the equally dramatic increase in unemployment. This state of affairs is the result of a deep failure of macroeconomic management in the eurozone.

3. Failures of macroeconomic management in the eurozone

Macroeconomic policies in the eurozone have been dictated by financial markets. The Southern European countries (including Ireland) are the countries that have accumulated trade account deficits in the past, while the Northern eurozone countries[1] have built up trade account surpluses. As a result, these countries have become the debtors and the Northern countries the creditors in the system. This has forced the Southern countries to beg the Northern ones for financial support. The latter have reluctantly done so but only after imposing tough austerity programmes pushing these countries into quick and deep spending cuts.

The recent explosion of the government debt to GDP ratios makes spending cuts in the South indeed inevitable. But these cuts were enforced too fast and too drastically. More importantly, the Northern countries were not willing to offset the spending cuts in the South by increasing their own spending, in order to stabilise growth in the eurozone as a whole. The necessary austerity imposed on the Southern European countries could have been offset by demand stimulus in the

1. We define Northern eurozone countries as Austria, Belgium, Finland, Germany, and the Netherlands.

Northern European countries. Instead, under the leadership of the European Commission, tight austerity was imposed on the debtor countries while the creditor countries continued to follow policies aimed at balancing the budget.

This has led to an asymmetric adjustment process where most of the adjustment has been done by the debtor nations. The latter countries have been forced to reduce wages and prices relative to the creditor countries (an 'internal devaluation') without compensating wage and price increases in the creditor countries ('internal revaluations').

In figure 2, I show some evidence about the nature of this asymmetry. The figure shows the evolution of the relative unit labour costs[2] of the debtor countries (where we use the average over the 1970-2010 period as the base period). Two features stand out. First, from 1999 until 2008-2009, one observes the strong increase of these countries' relative unit labour costs. Second, since 2008-2009 quite dramatic turnarounds of the relative unit labour costs have occurred (internal devaluations) in Ireland, Spain and Greece, and to a lesser extent in Portugal and Italy.

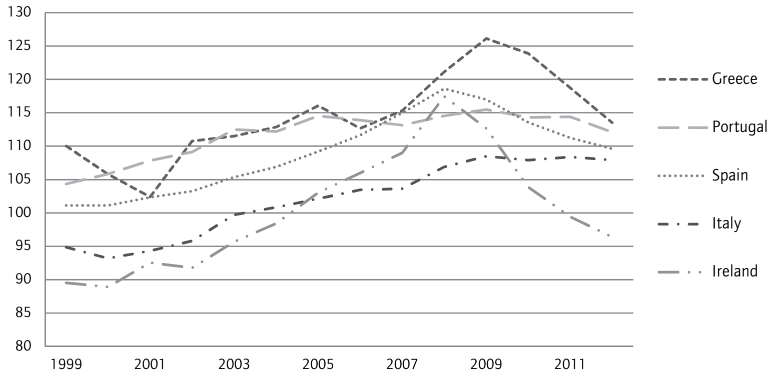
These internal devaluations have come at a great cost in terms of lost output and employment in the debtor countries. As these internal devaluations are not yet completed (except possibly in Ireland), more losses in output and employment are to be expected.

Is there evidence that such a process of internal revaluations is going on in the surplus countries? The answer is given in figure 3, which presents the evolution of the relative unit labour costs in the creditor countries. One observes that since 2008-2009 there has been very little movement in the relative unit labour costs in these countries. The position of Germany stands out. During 1999-2007 Germany engineered a significant internal devaluation that contributed to its economic recovery and the buildup of external surpluses. This internal devaluation stopped in 2007-2008. Since then no significant internal revaluation has taken place in Germany. One also observes from figure 3 that the

2. The Relative unit labour cost of a country is defined as the ratio of the unit labour costs of that country and the average unit labour costs in the rest of the eurozone. An increase in this ratio indicates that the country in question has seen its unit labour costs increase faster than in the rest of the eurozone, and vice versa.

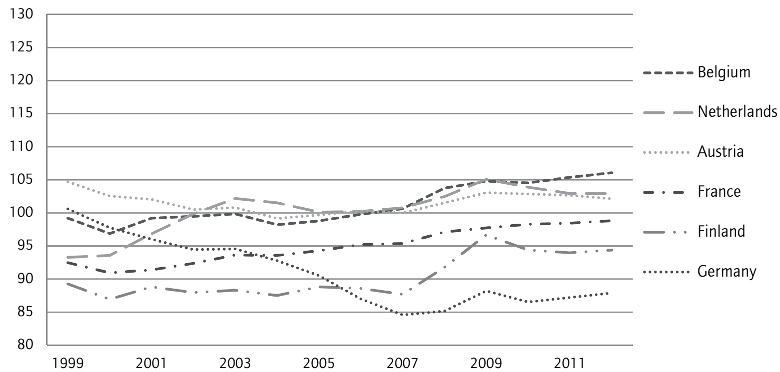
other countries remain close to the long-run equilibrium (the average over 1970-2010) and that no significant changes have taken place since 2008-2009.

Figure 2 **Relative unit labour cost (average 1970-2010=100)**



Source: European Commission, AMECO.

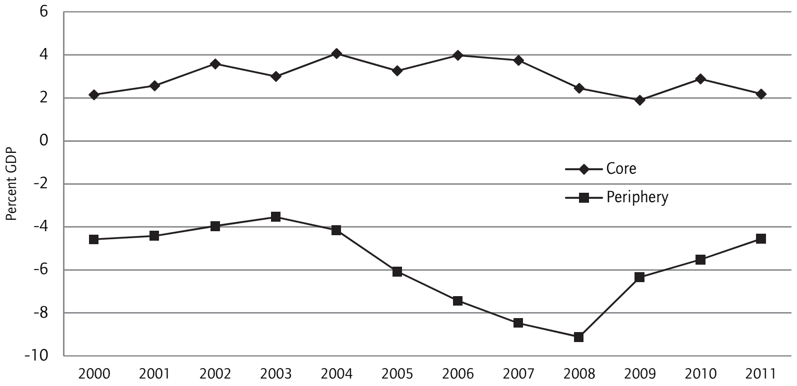
Figure 3 **Relative unit labour cost (average 1970-2010=100)**



Source: European Commission, AMECO.

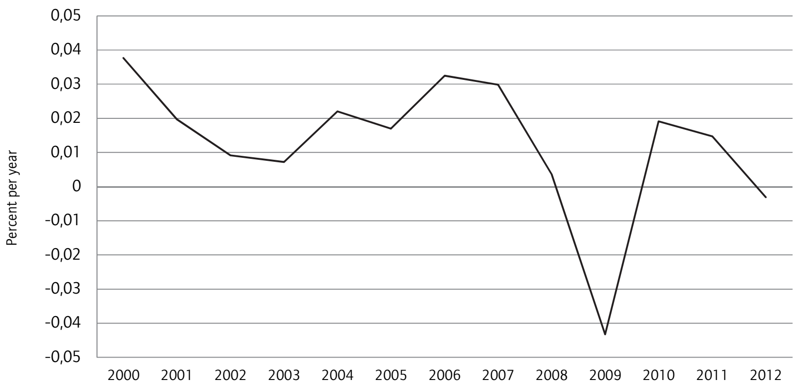
We obtain a similar conclusion from figure 4. There we see that the Periphery countries have started a process of reduction of current account deficits that is much more spectacular than the decline in the current account surpluses of the Core countries.

Figure 4 **Current account surpluses (deficits) in the eurozone**



Source: European Commission.
Note: Core countries are Austria, Belgium, France, Germany, Netherlands, Finland; Periphery is Greece, Italy, Ireland, Portugal, Spain.

Figure 5 **Growth of GDP in the eurozone**



Source: European Commission, AMECO.

Thus, one can conclude that the burden of the adjustments to the imbalances in the eurozone between the debtor and the creditor countries is borne almost exclusively by the debtor countries in the periphery. This creates a deflationary bias that explains why since 2012 the eurozone has been pulled into a double-dip recession, as can be seen from figure 5.

As argued earlier, the risk is real that citizens in Southern European countries that are subjected to prolonged deep economic downturns, increasing unemployment to levels not seen since the 1930s, revolt and reject a system that was promised to them to be economic heaven.

4. Towards symmetric macroeconomic policies in the eurozone

How can macroeconomic management be organised in a way that will avoid a prolonged period of historically low growth, with the risk of creating lost generations in many member countries of the eurozone?

The answer is that macroeconomic policies should be organised symmetrically. This symmetric approach should start from the different fiscal positions of the member countries of the eurozone. In figures 6 and 7 I show this difference. I present the government debt ratios of two groups of countries in the eurozone, the debtor and the creditor countries. One observes from figures 6 and 7 that while the debtor countries have not been able to stabilise their government debt ratios (in fact these are still on an explosive path), the situation of the creditor countries is dramatically different. The latter countries have managed to stabilise these ratios. This opens a window of opportunity to introduce a rule that can contribute to more symmetry in the macroeconomic policies in the eurozone.

Here is my proposed rule. The creditor countries that have stabilised their debt ratios should stop trying to balance their budgets now that the eurozone is entering a new recession. Instead they should stabilise their government debt ratios at the levels they have achieved in 2012. The implication of such a rule is that these countries can run small government budget deficits and yet keep their government debt levels constant. Germany, in particular, which in 2013 is close to achieving a balanced budget, could afford to have a budget deficit of close to 3% of GDP while keeping its debt to GDP ratio constant[3]. This would provide a significant stimulus for the eurozone as a whole.

Figure 6 **Gross government debt ratios in creditor countries of the eurozone**

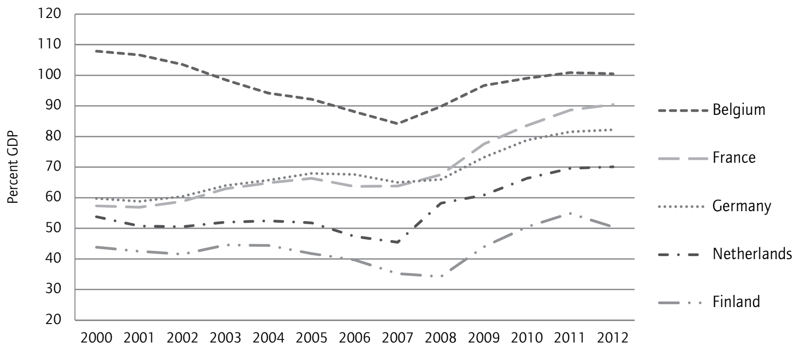
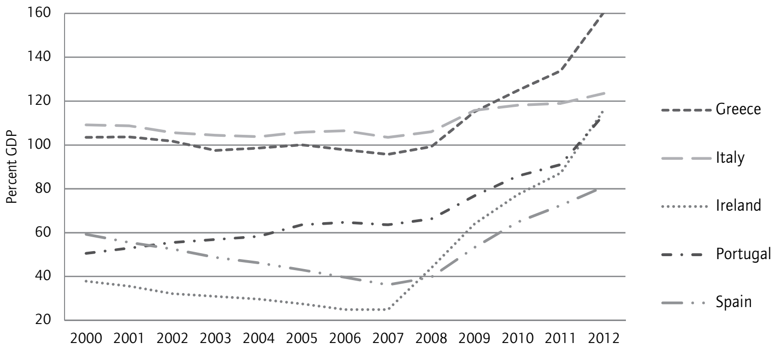


Figure 7 **Gross government debt ratios in debtor countries of the eurozone**



Source: European Commission, AMECO.

3. I use the forecast of nominal growth of GDP in Germany in 2013 (real growth + inflation) made by the European Commission at the end of 2012. This forecast was 3.5%. This allows Germany to stabilise its Debt to GDP ratio while running a budget deficit of 2.9%.

The idea that Germany should take a leadership role and stimulate its economy is often criticised on two grounds. First, it is said, Germany's financial capacity is limited and second, a German stimulus would have only limited effects on the rest of the eurozone. This criticism is unfounded. First, the German government now can borrow at historically low interest rates (about 1.5% for 10-year bonds). This means that investors are signalling to the German government that they would be happy to buy more German government bonds. It is difficult to understand why the German government does not want to borrow more when it is so cheap to do so. There must be investment projects in Germany that have a higher social rate of return than 1.5% a year.

Second, the German economy represents about 33% of the eurozone's GDP. In addition, about 60% of its trade is with the rest of the eurozone. Thus a stimulus in Germany would lead to significant increases in imports from the rest of the eurozone, thereby stimulating growth in the eurozone. In this connection the IMF has estimated that the fiscal multipliers (that measure by how much GDP increases when the government increases spending by one euro) are now significantly higher than 1.

Such a stimulus would also make it easier to deal with the trade account imbalances between the North and the South of the eurozone, as noted earlier. By stimulating spending the Northern countries would wind down the surpluses they have accumulated against the South. This is a necessary condition for the South to be able to reduce its trade account deficits *vis-à-vis* the North.

Whether the symmetric rule proposed here will be implemented very much depends on the European Commission. The latter should invoke exceptional circumstances, i.e. the start of a recession affecting the whole eurozone and threatening to undermine its stability, and urge the creditor countries to temporarily stop trying to balance their budgets. As an alternative rule, the European Commission should convince the creditor countries that it is in their and the eurozone's interests that they stabilise their government debt ratios instead.

Conclusions

The recent decision by the ECB to act a lender of last resort is a major regime change for the eurozone. It has significantly reduced the existential fears that slowly but inexorably were destroying the eurozone's foundations.

The ECB's new role although necessary is not sufficient, however, to guarantee the survival of the monetary union. I have argued that it is necessary that macroeconomic policies be made more symmetric. The asymmetric nature of the macroeconomic adjustments, which put most of the adjustment burden on the deficit countries, has created a deflationary bias in the eurozone. It also explains the double dip recession into which the eurozone has been pushed at the end of 2012. More symmetric macroeconomic adjustment mechanisms are key to avoid a long and protracted deflation that will not be accepted by large parts of the eurozone population. Indeed the greatest risk for the survival of the eurozone today is the risk emanating from social and political upheavals in countries that are forced into a deflationary spiral. Thus while the ECB's decision to act as a lender of last resort has reduced the risk of a financial implosion, this risk has been substituted by a new risk, i.e. the risk of implosion due to uncontrollable social and political disturbances in the South of Europe.

In order for more symmetric macroeconomic policies in the eurozone to be implemented, the citizens in these countries must be convinced that this is the right approach. There is a very strong sense of moral hazard thinking in Northern Europe today that implies that 'well-behaved' countries should not assist those that have misbehaved. Doing so would reward bad behavior. Fundamentally, citizens from Northern Europe should be made aware that the crisis is not only the result of Southern European countries' irresponsibility in accumulating large external debts. It is also the result of Northern Europe, which during the boom years was very happy to provide too much bank credit to the South. For every reckless borrower in the South there was a reckless lender in the North. Thus the responsibility for the Euro crisis is shared between the North and the South of the eurozone. Solutions to the crisis therefore also imply that everybody take their share of the responsibility.

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