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A *credible* economic order for the Eurozone?

Ramon Marimon

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Europe's history is littered with crises. This column argues that the latest Eurozone crisis is the latest in a long line out of which the region has to evolve. The problem, it says, is that the current package being discussed fails to draw a line under this crisis. While the proposal is reasonable, it is not credible.

From the start, crisis has been the midwife of EU integration – the aftermath of World War II led to the European Economic Community, the Exchange Rate Mechanism crisis led to the euro, and so on. These choices were taken since alternative paths were worse for everyone.

The Eurozone crisis, now in its second year, may, but should not be, an exception. The 11-12 March 2011 "Pact for the Euro" and the expectations surrounding the European Council meeting of 24-25 March 2011 to finalise it seem to suggest that once more virtue will arise out of necessity. To see how likely this transformation is, it is worth looking at the confusion that has preceded the Pact – confusion that may not have resolved itself yet.

The confusion arises out of the coexistence of three different views, present from almost the beginning of the crisis. I will call them:

- The "moral hazard" view;
- The "together we shall overcome" view, and
- The "we shall overcome together, when we all march with the same stride" view.

The first is fairly clear, especially to trained economists; if some public or private finances have gone astray, this is the problem of those who took the risks in taken up debts and commitments. Rescue solutions only trigger more irresponsible behaviour and deeper crises in the future. A simple corollary of this view is that the ECB should never engage in buying up sovereign debt of troubled Eurozone countries (the ECB has lost Axel Weber, an excellent economist, as its future chair for endorsing such views).

Those who vindicate the second view often see the problem as a struggle between us (the Europeans) and them (the markets). They stress that what is needed is a clear commitment showing 'them" that we are all in it together and, therefore, that we do not allow a European (restrict it to Eurozone, if you wish) country to fail – or, by extension, the financial sector of a country to fail.

A corresponding corollary is that we need a European Rescue Fund (call it EFSF, ESM, or both) with very big pockets. Just like the blackjack player who follows a winning strategy that only requires proper counting and big pockets. In the IMF tradition, the Greek and Irish rescue packages have been conditional on austerity plans. Nevertheless, the denial to even consider partial forms of default, or debt restructuring, is rooted on this second view.

The third view came to the forefront later in the crisis, with Merkel as the main proponent (with Sarkozy on her arm). It does not fully deny either of the other two views, but rather emphasises the European heterogeneity (which, after many years of boom on the periphery, and apparent convergence, has been dramatised by the crisis). This view does not want to transform a rescue into persistent redistribution. Therefore, it postulates the need to take a more global view and first resolve the differences. The decaffeinated version of this vision is what inspired the “Pact for the Euro”.

The views compared

It is easy to see virtues in all of these views.

- The first, by reminding us that any insurance or rescue mechanism is subject to *moral hazard*, and therefore in designing the mechanism one must take this into account;
- The second, by emphasising that *commitment* is a key element in making a policy – even more so a rescue operation – credible, and by implicitly acknowledging that a fair amount of commitment is embedded in the EU and, in correspondence, that the EU must also be committed to its members;
- The third, by taking a broader view of the problem and focusing on the need to undertake pending reforms, in order to improve competitiveness and grow.

It is also easy to see why these views are flawed and can lead to non-credible proposals.

For example, almost all advanced economies would have unsustainable levels of debt if they had to systematically refinance them at very high interest rates – say 10-year bonds above 7%, which is below the current cost for Greece, Ireland, and Portugal. However, these very high interest rates for debt refinancing are the reflection of two factors: the risk of default (which can certainly be exacerbated by speculation) and the fact that non-contingent debt is a very inefficient financing mechanism (which calls for speculative attacks at times of refinancing, similar to the Exchange Rate Mechanism speculative attacks of the 1990s). The "*moral hazard*" view disregards these endogenous factors – beyond the control of the borrower – and, therefore, proposes inaction when support is justified and needed. In fact, the establishment of a first rescue mechanism – the European Financial Stability Fund – on 10 May 2010 shows how this view leads to a non-credible proposition for the Eurozone.

This rescue was a triumph for the supporters of the "*we shall overcome*" view, who think that recognition of any need for partial default, or debt renegotiation, calls for contagion. However, non-credible rescue plans are more likely to create contagion. In fact, market interest rates for Greece and Ireland's debt are back at the levels of the days when they were "rescued" and it is increasingly recognised that even the "rescue fund" rates – between 5% and 6% – may not be sustainable, given their current growth prospects.

Unfortunately, decreasing these rates further below the market rates does not seem feasible. Leaving aside the expected general increase on interest rates due to the oil-price shock, the reason such further flexibility may not be possible is that either there is an implicit subsidy and redistribution from lenders (who could get better returns for their savings) to borrowers, or the new rates are the price of almost risk-free bonds. The former is politically unfeasible, the latter requires much better rules on how these countries' liabilities are settled, which takes us back to "drawing the lines": recognising partial default, or debt renegotiation, with the corresponding seniority for "rescue fund" loans.

The latest rescue package

Not surprisingly, beyond avoiding a major collapse, the current rescue packages, with their plans more for austerity than growth, have not resolved the crisis and are generating more resentment than gratitude in recipient countries, and more resentment than satisfaction in "donor countries". On the other hand, not being a credible resolution for larger countries, such as Spain, has had the positive effect of waking up Spaniards to the need to confront reforms.

Here the third view has taken centre stage. The weekend's package conditions further action on the rescue fund drawing up a "competitiveness plan" containing a range of measures. Among the listed measures, one is unavoidable, and not restricted to the Eurozone. Namely, Eurozone nations are to develop better plans, regulations, and transparency to deal with the current and future banking crises. Another measure is the old "cry wolf" – a call to reinforce debt limits or to write these limits into the constitution – and, in the German-French version, more strict sanctions.

The other measures are reasonable and can encourage competitiveness and even, in some cases, the conducting of joint policies. For example, the design of an optimal monetary response to an external oil price shock is different of an optimal monetary response to an external oil price shock is different depending on whether salaries are indexed or not. Harmonising indexing would thus make the Eurozone more an optimal currency area as far as monetary point is concerned. Regarding most of these measures, in going from its original pure vision to the "Pact for the Euro" there has been a move from "let's solve our differences" to "let's promise to solve them". In summary, we have seen an exercise in "community peer pressure" (never to be dismissed), but is it a credible plan to resolve the Eurozone crisis?

I have a serious doubt, for three reasons. The exercise seems to miss the point; it confuses roles, and it doesn't draw a line under the crisis. Taking these in turn.

- It misses the point in that the strength of the EU – even more so that of the Eurozone – does not lie in periodically making promises for 2010, 2020,… 2050.

The strength lies in the fact that the EU is a long-term partnership in which there are potential gains for all.

That is, the issue is not to pass a set of exams – often with ill-defined questions and answers that are difficult to assess – but to relate future gains or losses to current actions in a way that there is no more redistribution across countries or regions than the one commonly agreed upon (as with the old structural funds).

- The package confuses roles by making the EU or the Eurozone responsible for the specific measures that countries have to take in order to be more competitive and grow.

This raise issues of democratic accountability, but it is also a perverse mechanism. One used by weak governments to justify necessary reforms. As such, it removes their burden of finding and implementing reforms, and it is a source of citizens' resentment against the European project.

- More importantly, in this second year of the Eurozone crisis, the package doesn't draw a line under the crisis, or at least not yet.

There is a very important role for the European Stabilisation Mechanism, which

is to transform non-contingent debt liabilities (often short- term) into long-term state-contingent contracts. That is, to confront the "maturity mismatch" problem (and defuse the speculation gambles in debt-refinancing times), by setting rules of future payments conditional, for example, on whether the country is in a recession, etc.

It is possible to build on long-term dynamic contract theory to design these contracts and see how they can be implemented as debt-renegotiations. It also requires a non-trivial exercise of assessing expected returns and liabilities, as well as default scenarios. That is, to draw the lines on existing debts of which a part is sustainable without a persistent subsidy, which in turn requires an assessment of the expected returns of different policies and reforms.

This must be a professional exercise, better done with independence from political pressures. It should result in statements such as: *Greece may or may not reform their pension system, it is up to them; here is the different amount of credit (or implicit interest) they can get under the different scenarios. Furthermore, this line of credit could improve in the future as Greek net liabilities diminish.*

There are elements in the current discussion, regarding the European Stabilisation Mechanism, which point in this direction (although even the recent proposal of the EEAG Report ignores this aspect of long-term contracting). Unfortunately the political rhetoric is not this one. It is a welcome reasonable plan, but not a credible one.

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