

The Euro Crisis: Is the Policy Response Effective?

**Asia-Europe Economic Forum:
European troubles, Asian worries**

Pierre-Olivier Gourinchas
UC Berkeley & SciencesPo

Brussels, January 21, 2013

Outline

- Overview of the policy response
- What has been effective? and why?
- Challenges ahead:
 - Can the ECB hold the Eurozone together?
 - On the need to push ahead with fiscal union
 - On the need to pivot to growth

The Policy Response

- The policy response has often been precipitated by events in the market.
- It also reflected an evolving paradigm, relying initially mostly on domestic fiscal discipline and ad-hoc financial assistance as required, and gradually mobilizing more systematically the firepower of the common currency area through the European Central Bank, and the European Stability Mechanism.

The Policy Response

Although sometimes haphazard, the overall body of reforms is impressive, at least on paper.

- Financial assistance:
 - packages for Greece, Ireland, Portugal –May 2010, March 2012
 - EFSF, followed by ESM –May 2010, July 2011
- Fiscal discipline and monitoring:
 - strengthening of Stability and Growth Pact ('6-pack') –2011
 - Fiscal treaty (TSCG) – December 2011
- Monetary
 - liquidity provision (collateral rules, LTRO) – December 2011
 - backstop (OMT) – September 2012
- Financial Stability
 - European authorities (ESRB, EBA....) – January 2011
 - Banking union (single supervisor...) – July 2012

What worked?

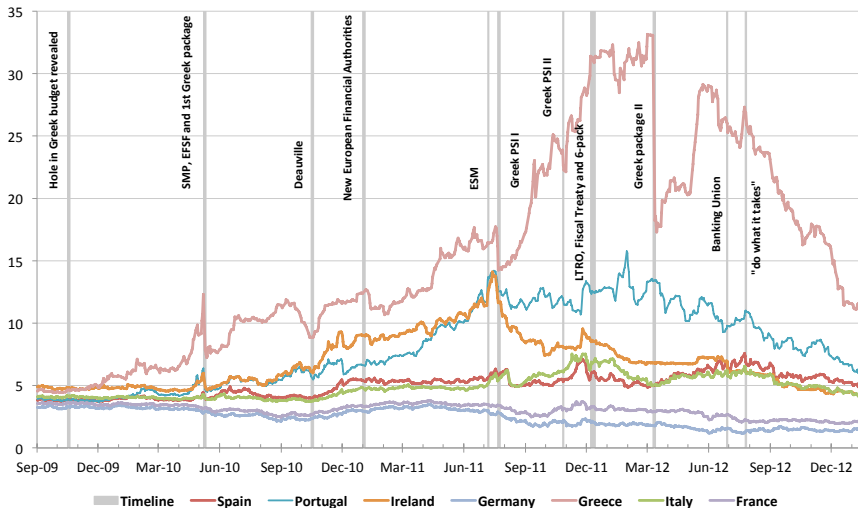


Figure : yields on 10-year government bonds. Source: MorganMarkets

What worked?

- It is clear from the spreads that most of these measures failed to stem the crisis durably.
- Yet the crisis has abated since Sept. 2012, coinciding with the OMT.
- Two hypothesis:
 - 'Death by a thousand cuts'. No single measure was sufficient, but the accumulation of reforms finally stopped the crisis.
 - **Game changer**: the decision by the ECB to "do what it takes" convinced markets.

What worked?

There are good reasons to think that the OMT is a game changer. Why?

- Insufficient fiscal resources committed through ESM and EFSF to backstop the public and quasi public debt.
- New fiscal rules are untested and inherit little to no credibility from SGP.
- Fiscal multipliers are high at the zero-lower bound making fiscal consolidation difficult.
- ECB commitment to backstop sovereign debt (whatever they may call it) can eliminate the risk of default and multiple equilibria – precisely what many of us had been advocating (de Grauwe (2011), Gourinchas & Jeanne (2012))

Is the policy response sufficient?

Far from it! It would be tempting to 'declare victory and go home.'
But deeper questions remain:

- First, we are in a state of **suspended animation**: OMT has been put on the table, but not deployed. Can a honeymoon last that long?
- Second, the common pool problem created by a common monetary backstop and 17 Treasuries has not been resolved.
- Third, durable growth is essential to the long term sustainability of public (and quasi public) debts.

What is missing?

Moving ahead with **better fiscal integration**:

- Individual fiscal discipline ('house in order') is insufficient.
- Need to maintain **monetary dominance** and avoid expectations of indirect monetization of deficits.
- Public debt is a **common good** in a monetary union. Provision of **safe asset** underpins financial stability.
- **Fiscal Federalism** (Oates, 1972): control issuance at the federal level (internalizing externality).
- Two options:
 - US approach: local balanced-budget rule; large federal budget issue common debt. Large transfer of sovereignty.
 - Alternative approach: countries' debt issuance is authorized by a **Eurozone fiscal council**, consisting of the union of national independent fiscal councils. No joint and several liability, but countries that meet debt issuance limit automatically **pre-qualify** for ESM and OMT assistance if needed.

What is missing?

Do we need Mundellian Transfers?

- Idea is appealing: cross country insurance compensates for lack of risk sharing mechanisms
- Farhi and Werning (2012): self-insurance is insufficient because of the (external) effects of stabilization.
- Important question: how large are the shocks that need insuring if we already pool banking and financial risks?
- What form should these transfers take (fiscal capacity?)

What is missing?

Implementing structural reforms

- Growth performance of the Eurozone is insufficient compared to other advanced economies, especially since the crisis.
- Durable growth is critical for the sustainability of public (& quasi public) debts and the capacity of different regions to absorb idiosyncratic shocks
- Structural reforms are notoriously difficult to implement, but efforts at improvements
- One possibility: **contractualization of reforms** (EC Blueprint, Nov 2012).
 - Financial assistance in the form of risk sharing mechanisms
 - Possible application to labor market reform: unemployment insurance vs. common labor contract
 - Conceive fiscal transfers as catalysts for structural reform, rather than substitute.

Diverging Labor Market Fortunes

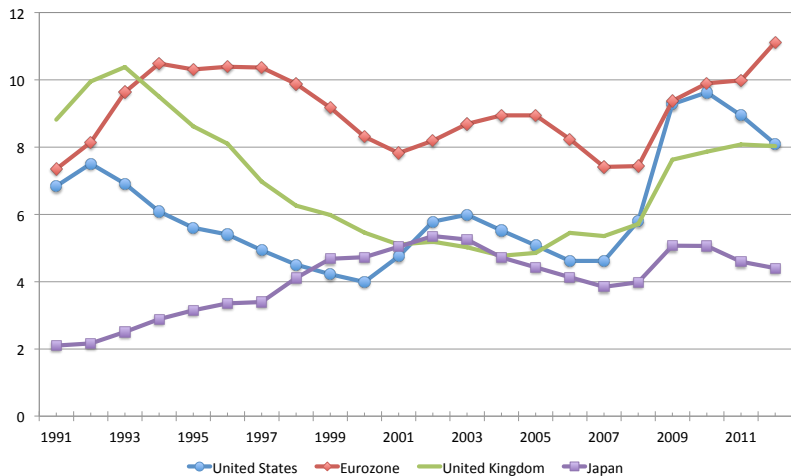


Figure : Unemployment rates. Source: OECD

What is missing?

Completing the work on the **banking union**:

- single supervisor (ECB) should eventually cover all banks.
- create correct incentives for information to flow from national supervisors to the ECB
- accelerate the recapitalization and restructuring of impaired banks through domestic "bad banks"
- move towards a european resolution mechanism, via the ESM, to absorb losses from future systemic crisis
- lastly, move towards a common deposit insurance scheme, prefinanced by banks and opening access to ECB liquidity and ESM assistance.