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Economic Watch

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Economic Analysis

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Solving the European debt crisis in the very short run

The euro area is trapped in a crisis that is generating a huge lack of confidence in global financial markets, and threatens to become systemic and lead developed economies into a new recession. Prima facie, this crisis of confidence is surprising when we compare aggregate imbalances in the euro area and in other developed economies. According to current projections, the European Monetary Union (EMU) will end 2011 with a deficit close to 4.4% of Gross Domestic Product (GDP), compared to 9.6% in the United States or 8.9% in the United Kingdom, with lower levels of public and household debt, a slight surplus in the current account balance –while both the US and the UK show a deficit– and a stronger international investment position (see Table 1).

Table 1
Debt and deficits in EMU, the US and the UK (% of GDP)

		EA17	US	UK
Net lending, general government	2011	-4.4	-9.6	-8.9
General government debt	2011	87.6	100.0	84.8
Household debt	2010	67.3	92.1	106.1
Corporate debt	2010	119.1	74.6	123.7
Current account balance	2011	0.1	-3.1	-2.7
International investment position	2010	-7.2	-17.0	-13.9

Sources: AMECO, Haver, IMF, national sources and BBVA Research

Therefore, imbalances at the aggregate level are not the problem; it is rather the vast heterogeneity across EMU member states and the absence of efficient political institutions to handle this heterogeneity, reflecting a real failure of economic policy coordination. This limitation of European institutions is preventing the European Central Bank (ECB) from acting as lender of last resort, as the Federal Reserve and the Bank of England have done, by increasing their balance sheets during the crisis much more than the ECB (see Figure 1). While public debt purchases of the Bank of England and the Fed represent 15% and 11% of GDP, respectively, the ECB figure is much smaller, only 2% of GDP. And in both countries, the intervention has been carried out in a less pressing situation, with no financial crisis and just to avoid a second recession. As has been recently highlighted by P. de Grauwe (2011), the limitation of the ECB to act as a lender of last resort is one of the main reasons behind the current crisis in which EMU is trapped.

When the Eurozone was created, European leaders decided that, in the absence of a true federal fiscal policy, countries would retain their full fiscal sovereignty with control mechanisms that turned out to be ineffective to counter the sudden increase in structural deficits, as the crisis has shown. In order to sustain this arrangement, the ECB was required to avoid the bail-out of national public debts, since otherwise the euro area would face potential problems of free-riding: national fiscal authorities could enjoy the benefits of expansionary fiscal policies, transferring the costs to the rest of EMU members through the monetization of fiscal deficits by the ECB.

In the current circumstances, the optimal solution to the sovereign debt crisis is quite simple to state but extremely complex to implement. It is necessary, on the one hand, to develop a more highly integrated fiscal framework and ensuring the coordination and effective control of national policies in order to prevent free-riding, while allowing countries, on the other hand, to finance sustainable fiscal policies with Eurobonds (as proposed by Delpla and von Weizsäcker, 2011). In this context, the ECB would be able to act as lender of last resort of this debt without necessarily jeopardizing its independence.

Figure 1
Central banks' balance sheets (2007=100)

Source: Harver.

The problem with this long-term solution is that it needs time, possibly even years, to be designed and implemented properly, and also requires a reform of the European treaties. And Europe does not have so much time; on the contrary, the sovereign debt crisis should be solved urgently in a very short period of time. Therefore, regardless of the changes that European institutions should begin to design for the long term, in the short run we need very convincing and effective action to reduce financial stress and risk premiums, and to immediately stabilize debt markets. Rather than replacing long-term steps, these short-term measures should be complementary.

The problems of this long-term solution is that it is time.-consuming (it requires years) as it requires Treaty changes that are politically difficult to decide and long to implement. In the short-term, there is a pressing need to reduce drastically spreads and stabilize debt markets. But short-term solutions are complementary to a good design for the long term.

To restore all lost confidence as soon as possible, well-designed short-term solutions require simultaneously action in three areas:

1. An implicit contract within countries whereby the full capacity of the ECB and the European Financial Stability Fund (EFSF) is used to restore confidence, while countries implement all adjustments needed to eliminate imbalances.
2. Structural reforms to stimulate growth.
3. Greater political capital and leadership at national and European levels.

Each of these steps alone is not sufficient, but all of them are necessary. For example, greater political capital and leadership are necessary to reach rapidly the commitments needed in the short run, until an optimal long-term solution is implemented. Both the timing and the way these measures should be executed now are extremely important. Given the current financial tensions, it is necessary to overreact to get a step ahead of the markets and not behind, as has happened so far.

A contract for EMU: new commitments and conditionality

First, EMU needs resolute commitments from each and every one of the countries that want to be in the euro area, assuming their responsibilities and contributing to the implementation of a common and comprehensive solution. Given the economic heterogeneity across the region, these commitments cannot be the same for all countries. Those with smaller imbalances, particularly Germany, have to strongly support action by the ECB and the EFSF. The ECB should back the EFSF as much as needed to ensure its effectiveness, becoming indirectly a lender of last resort. Both the EFSF and the ECB need to operate with great flexibility and impressive firepower.

The rulings on the independence of the ECB make it clear and explicit the prohibition to directly purchase eurozone government debt in the primary market. It also restricts purchases in the secondary markets to avoid “privileged access”[1]. However, it seems obvious that any market support of the ECB while a permanent solution to the crisis is designed by European authorities should be considered as a way to confront a “market failure” that severely distorts the monetary policy transmission mechanism, instead of a way to implement monetary financing.

The argument of inflation fears related to intervention in debt markets is overblown, for several reasons. First, the ECB’s facility to the EFSF would be compensating for the plunge of the liquidity provided by regular investors, which have now totally or partially reduced their demand for European debt. Second, the deceleration of activity in the eurozone implies that the risk of inflation in the short run is small, even if combined with more liquidity. Even it can be argued that the risks of inflation in the eurozone are tilted to the downside. Third, even if medium-term inflation risks are real, the ECB should establish a correct hierarchy of risks; those related to the collapse of debt markets are much more important and urgent than those related to higher inflation. If the latter materialize, lowering inflation by withdrawing excess liquidity in the economy is something that central banks know how to do. Indeed, the ECB has not shown special fears in providing large amounts of liquidity to financial institutions after the start of the crisis –much larger than the ones provided through the SMP so far. Fourth, the experience in the U.S. and the U.K. shows that confidence in their currency and their long-term debt has not plunged following their intervention, despite having temporarily higher inflation; on the contrary, debt markets are pricing their debt higher or on par with that of the eurozone. With respect to inflation expectations, evidence from the US and UK shows that QE may have helped to reduce the probability of persistent low inflation (or even deflation in late 2008), but it has not contributed to increase long-term inflation expectations, that are currently stable around levels similar to those previous to the financial crisis

In return to ECB and EFSF action, countries benefiting from it should accept strict conditions, committing to reduce their imbalances. They must ensure firm and effective controls by European institutions and, in some cases, by the International Monetary Fund (IMF). The European Commission should be able to impose the necessary sanctions when the incentive of lower financing costs is not sufficient to ensure the correction of imbalances.

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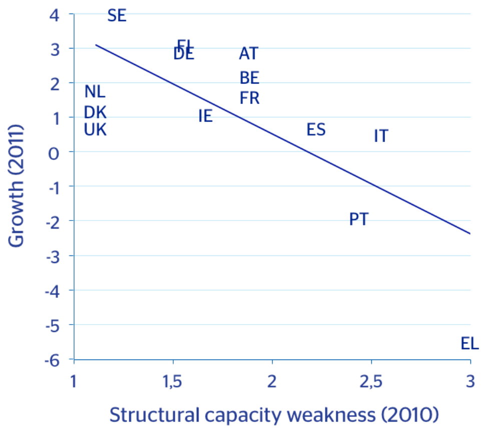
[1] The article 123 of the European Treaty “1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments”. The Article 124 prohibits privileged access: “Any measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited”

This type of contract has implicitly been working over the past quarters, when collective decisions by European authorities trying to solve the crisis were approved in exchange of structural adjustment and reforms. Now it is probably the time to bring it to a step further.

Growth and structural reforms

Second, Europe needs to pursue the necessary structural reforms to increase potential growth, since the best way out of debt crises is through growth. And for this, more competitive and increasingly unified markets are needed. Here again, the large heterogeneity in structural capacity implies that reforms should also be different across countries. The recent experience in Italy shows that structural reforms may be decided rapidly. As for implementation, it is not uncommon that reform efforts in different areas in one country are all developed simultaneously. The evidence of Figure 2 suggests that improvements in structural capacity may also affect the economic recovery in the short run.[2]

Figure 1
Growth and structural capacity weakness



Source: European Commission (2011) and Cardoso and Doménech (2010)

Those economies that present major structural weaknesses should be the most ambitious in the design and implementation of these reforms, which should be part of the conditions imposed by the EFSF. Among them, to avoid the danger of a new recession as a result of a credit crunch, some countries will need to completely clean up their banks' balance sheets (due to Greek debt restructuring, or bad legacy assets and real estate loans), minimizing entirely the cost to taxpayers. This exercise should be rigorous, transparent and credible, to immediately reopen funding markets and restore liquidity to avoid growth stagnation. In the very short term, it is imperative to support liquidity in the financial sector with mutual guarantee mechanisms at the European level.

Political capital and leadership

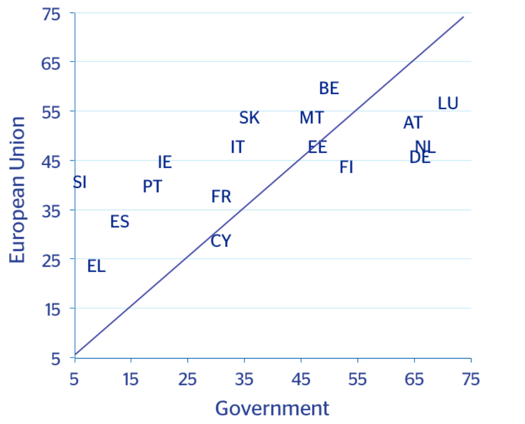
Third, greater political capital and leadership is essential to explain and convince European citizens of the deep reforms and strong commitments needed.

Using information provided by the last Eurobarometer, there is widespread agreement in the public opinion about the effectiveness (Figure 3) and capacity (Figure 4) of European

[2] The horizontal axis in Figure 2 measures the need for structural reforms in five medium-term indicators and four long-term ones. All these indicators are important determinants of income per capita. Thus, in a sample of 16 developed economies, the structural capacity indicator is significantly correlated with GNP per working-age person (-0.73). More details about this indicator can be found in Cardoso and Doménech (2010).

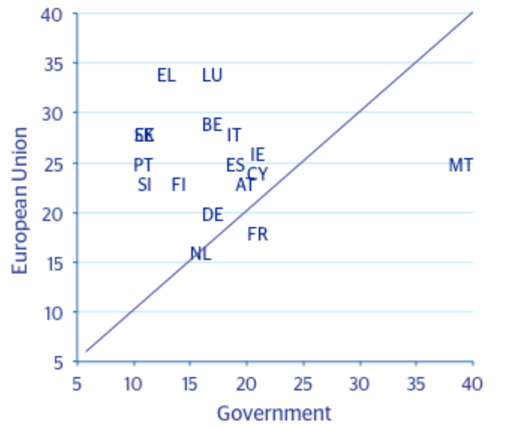
institutions and national governments to combat the crisis up till now. Looking at Figure 3, it is worth noting that public opinion regarding the effectiveness of the European Union is on average more favorable (given the greater number of countries above the diagonal) and less volatile than for national governments. Thus, the percentage of population that believes that national governments have managed the crisis very or fairly effectively ranges between 6 (Slovenia) and 71 per cent (Luxembourg).

Figure 3
Have these institutions acted effectively to combat the crisis?



Source: Eurobarometer (2011)

Figure 4
Which institution is best able to take effective actions against the crisis?



Source: Eurobarometer (2011)

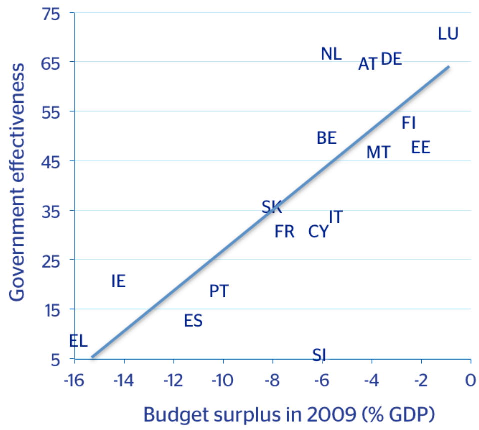
It is also worth noting that public opinion on the effectiveness of national governments is closely related to fiscal deficits. Figure 5 shows that those countries where fiscal deficits in 2009 were higher also show a worse opinion on the ability of governments to manage the crisis.[3] The correlation between both variables is high (0.76) and statistically significant, even when taking into account the fall in GDP growth rates between 2007 and 2009. In principle, a higher deficit and a bad public opinion about the national government could simultaneously be the consequence of the economic crisis. However, Figure 6 shows that there is no correlation between the intensity of the crisis (measured by the fall in GDP growth rates between 2007 and 2009) and public opinion about the effectiveness of national governments.[4] An alternative explanation is that those countries that, over and above the effects of the economic crisis, presented higher fiscal deficits after the crisis are now facing harder fiscal adjustments, at the cost of greater social discontent. In fact, public opinion about the national government is negatively correlated (-0.52) with the reduction of fiscal deficit between 2009 and 2011.

To resolve the European confidence crisis, it is essential to avoid a recurrence of the mistakes observed in the past, when governments acted ignoring the risks that were building up together with excessive growth in quantities and prices in several markets, and in debt levels by different agents. After the crisis started, there was also excessive indulgence in its diagnosis and in the scope of the measures taken. The management of the Greek debt crisis is a good example. First, there was a late recognition of the need to restructure Greek public debt; second, the European authorities were unable to isolate Greece's solvency problem from other countries´ liquidity problem; and third, more

[3] Both the public opinion on the effectiveness of governments in managing the crisis and the budget balance in 2009 showed a statistically significant positive correlation (0.70 and 0.60 respectively) with the indicator of governments' effectiveness in 2009, published by the World Bank (2011).
[4] In the same vein, the correlation between public opinion about the effectiveness of national governments and the increase in the unemployment rate is negative (-0.37) although not statistically significant, whereas the correlation with the structural capacity indicator proposed by Cardoso and Doménech (2010) is very high (-0,73) and significant.

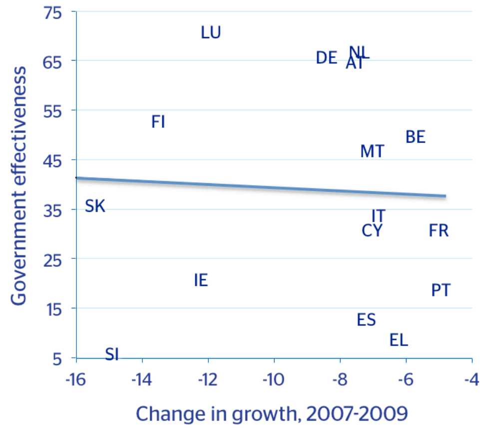
recently authorities have insisted on making a voluntary restructuring of Greek debt, trying to avoid triggering a credit event (this resistance could prove to be counterproductive and deter the effectiveness of CDS as a tool to hedge against defaults).

Figure 5
Public budget surplus and national government effectiveness to combat the crisis



Source: Eurobarometer (2011) and European Commission.

Figure 6
Change in GDP growth and national government effectiveness to combat the crisis



Source: Eurobarometer (2011) and European Commission.

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Now it will be essential to avoid that EMU members renege on the commitments made, or that they do not implement structural reforms because of the instability of governments or the lack of the necessary parliamentary support. In some countries, in order to successfully face the current challenges, the only way to implement reforms will be through ample coalition governments or parliamentary agreements backed by qualified majorities.

Conclusions

European countries are running out of time to prevent current financial tensions that ultimately may cause very disruptive risk scenarios. They must respond to the challenges they face with urgency, determination and responsibility, making sense of history. The longer it takes to resolve the current situation, the greater the economic, political and social costs.

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