

The Eurozone: Clean-up Time

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A crisis that should not have happened

- A debt crisis
- Collapse of the interbank market
- Politically-charged bailouts
- Ever widening conditionality
- Intense summitry
- ECB under threat



None of that should
have happened

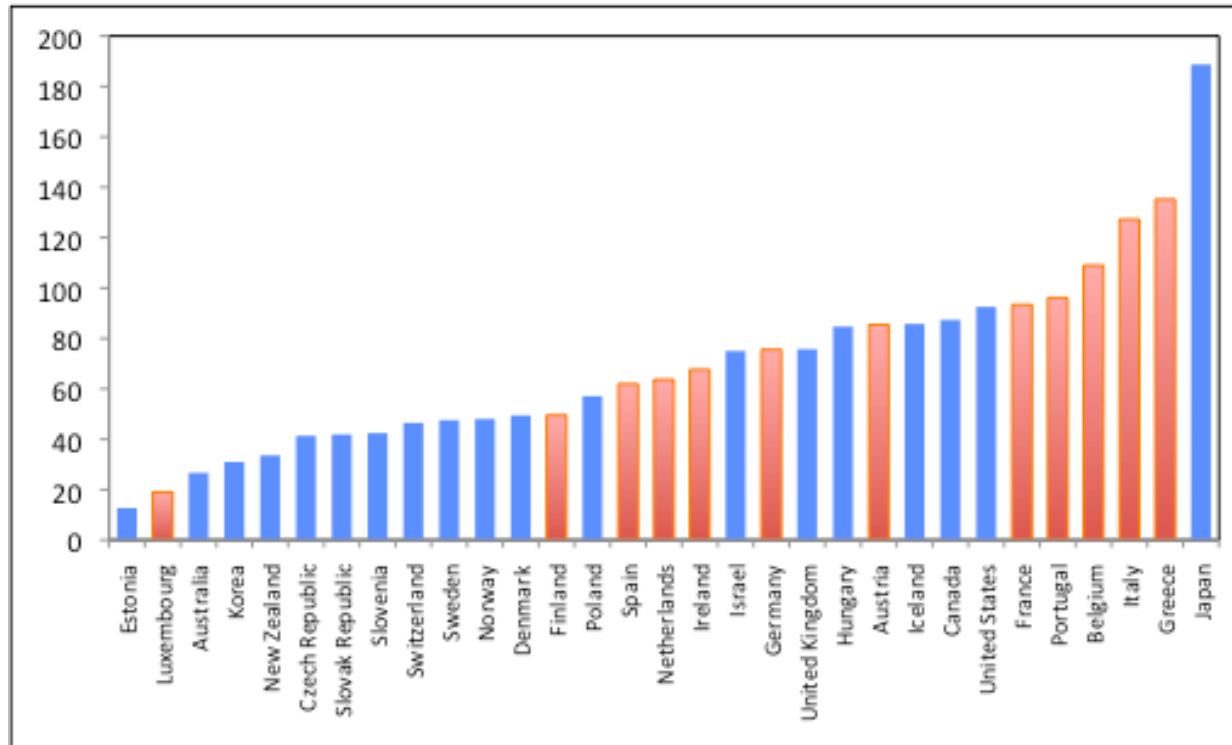
These are all institutional failures

A debt crisis

- Large debts by end 2009

- Not the whole story

Gross liabilities of general governments (% GDP)



Source: OECD

A debt crisis

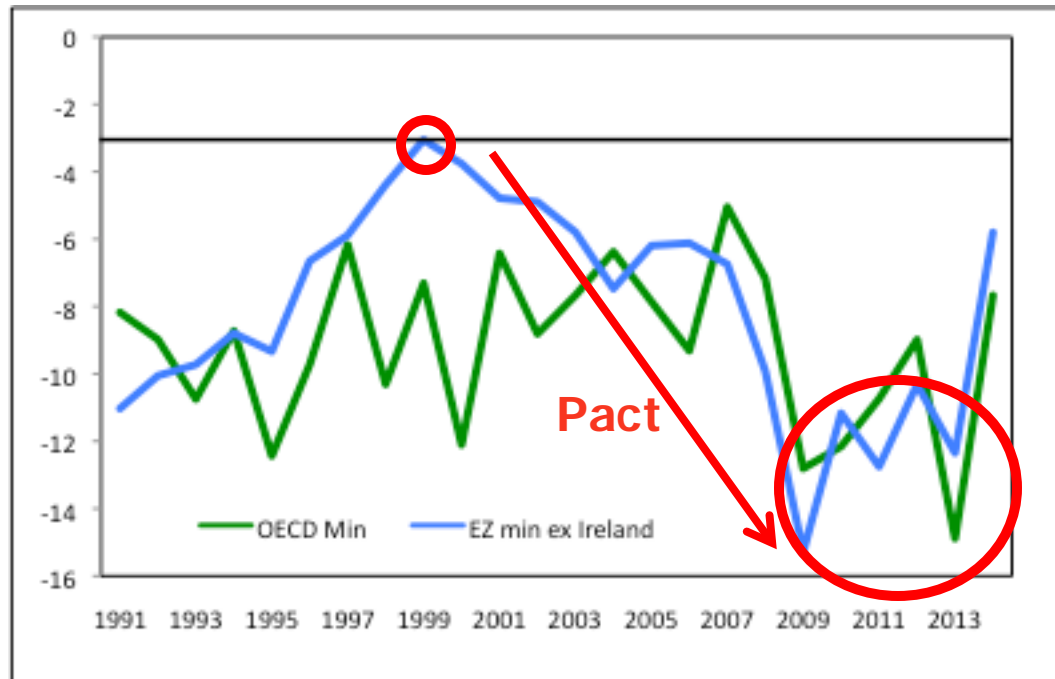
- Large public debts by end 2009
 - Not the whole story
 - Other explanations
 - Current account divergences
 - Inflation differentials
 - Bank crises
 - Euro = foreign currency
- Necessary conditions in a monetary union
 - Fiscal discipline
 - Break doom loop between banks and governments

} Public spending and credit boom

A debt crisis

- Fiscal discipline never achieved

Lowest budget balance (% of GDP): EA12 vs. Rest of OECD



Not much worse, but vulnerability

A debt crisis

- Fiscal discipline never achieved
- An accident waiting to happen
 - Triggers: global crisis and Greek data fudge
- When market access loss occurs
 - Central bank is lender in last resort
 - ECB unwilling to play this role: euro as a foreign currency
- When debt is in foreign currency
 - IMF is first port of call
 - Debt restructured if unsustainable
 - Door was closed

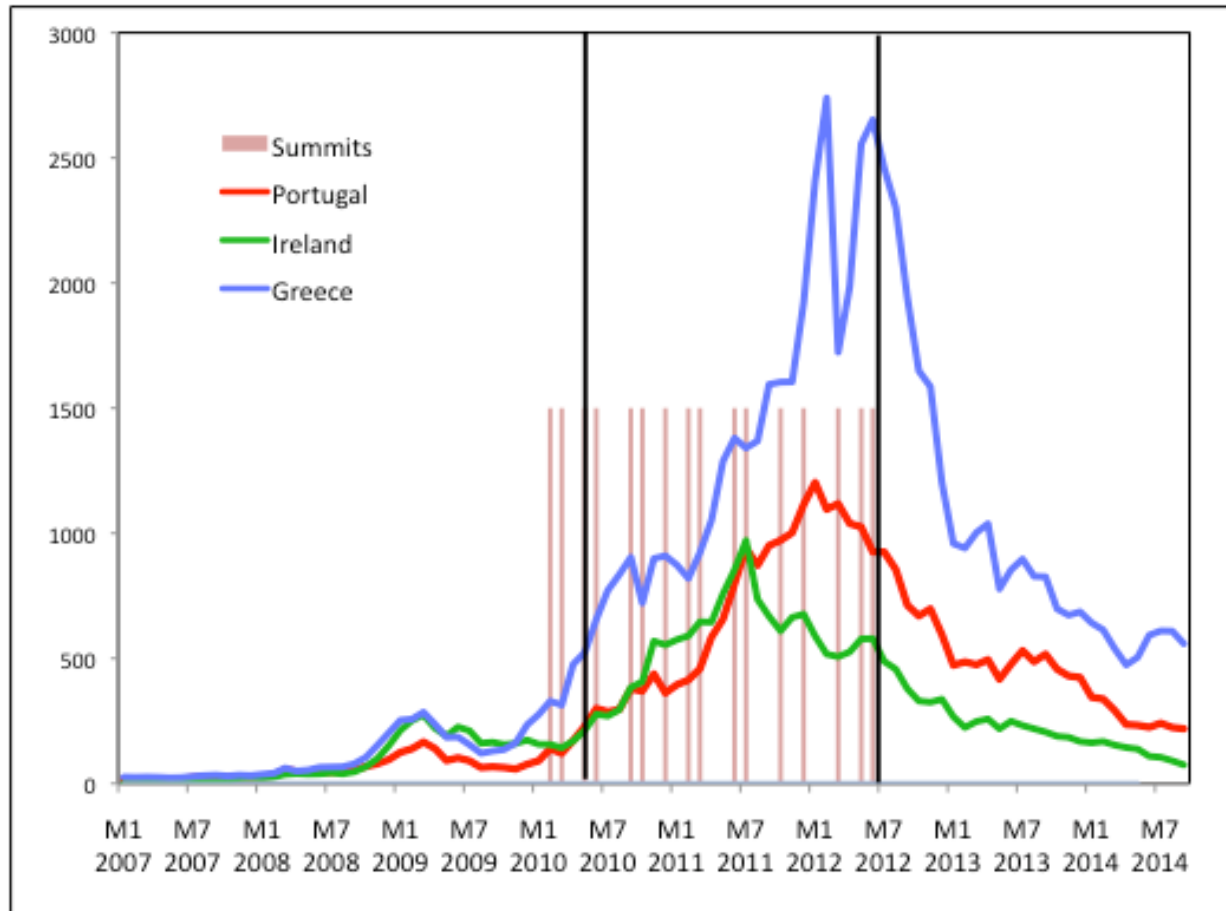
A debt crisis

- The trend-setting formula for Greece
 - No lender in last resort
 - No IMF
 - No debt restructuring

No solution

No solution, indeed

Interest rate spreads



Cleanup No.1

- Establish fiscal discipline
 - Stability and Growth Pact will not do
 - Rule vs. discretion: impossible trade off for politicians
 - Sovereignty: a fundamental contradiction
 - Economists believe in incentives: no bailout anymore, ever
 - Hard to establish credibility now
- Debt legacy
 - Crucial for credibility of no-bailout clause
 - Formulae without transfers exist

Collapse of interbank market

- The doom loop: borders reappear
 - No lender in last resort
 - ELA remains national
 - Asymmetric information
 - Worse across borders
 - National supervisors not trusted
- One money, one banking system
 - Single regulation
 - Single supervision
 - Single resolution

Was known

Deemed too sensitive

Collapse of interbank market

- Deep implications
 - ECB had to step in: Target 2
 - Greece was bailed out to protect other banks
 - Took years to clean up banks (finished?)
 - Low growth
 - Ireland pressed to bail banks out
 - Cyprus mismanagement
 - ELA used to pressure Greece

Collapse of interbank market

- Answer came swiftly: Banking Union
 - Single Supervision Mechanism
 - Single Resolution Mechanism
 - Single Resolution Fund
- Not so single
 - SRM too complex
 - Political meddling guaranteed
 - SRF yet to come, could be too small
 - Still no lender in last resort
- Stress tests: botched?

Cleanup No.2

- Need for a complete banking union
- SSM all encompassing
- SRM streamlined
- SRF may be too late, too little
 - Various solutions
 - Mutualisation unavoidable

Politically-charged bailouts

- Troika: a three-headed monster
 - ECB on the “wrong side of the table”
 - IMF as junior partner
 - Conflicted Commission
- IMF vs. Troika
 - IMF structurally committed to its “clients”
 - Troika dominated by member government(s)
 - Conflicts of interest
 - Ideological interferences

Cleanup No.3

- No more bailouts
 - What is ESM for?
- IMF available
 - Should be the rule
- ECB on the right side of the table
 - The central bank of each and every member country
 - Disengaged from enforcement of fiscal discipline

Ever widening conditionality

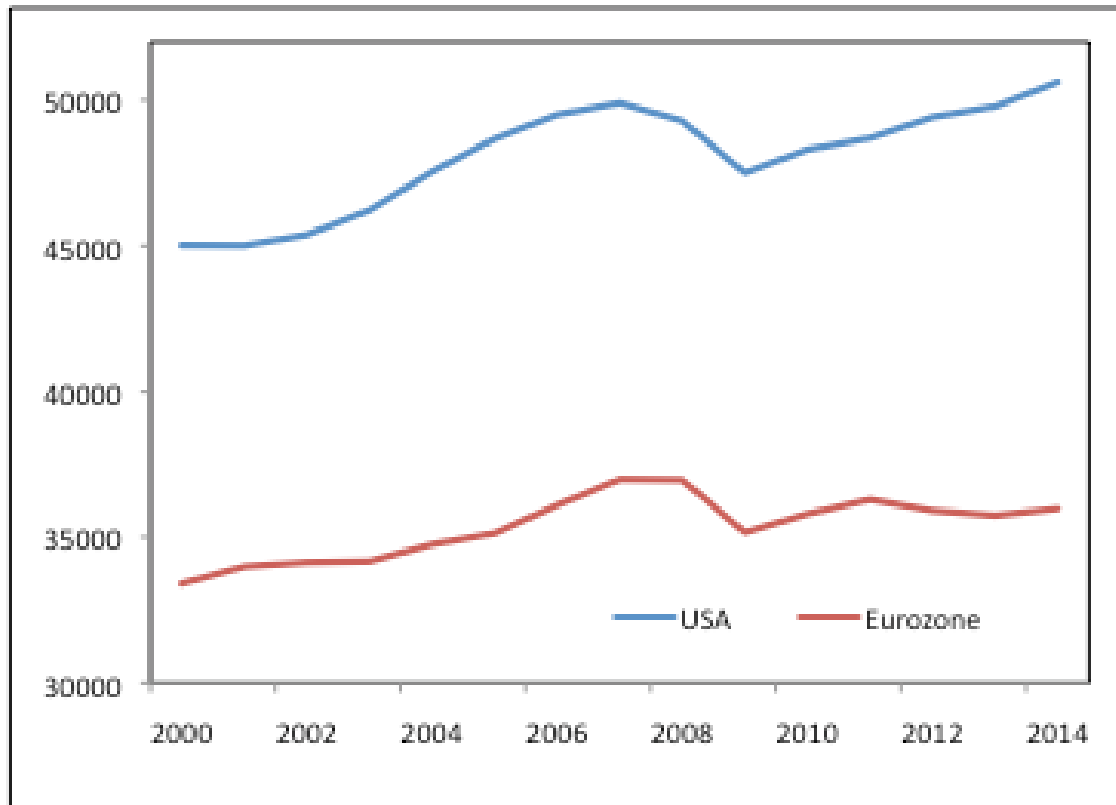
- From debt stabilization to structural reform
 - A classic mission creep
 - Bad economic management not limited to fiscal policy
 - Poor track record
- Confused justification for real problem
 - Externalities minimal
 - Incentives in right direction
- Power grab?
 - EU Commission
 - EU vs. national sovereignty

Ever widening conditionality

- A history of failures
 - Lisbon strategy
 - Remember objective?
"the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010"

The most competitive and dynamic knowledge-based economy

GDP per capita (US dollar)



Source: OECD

Ever widening conditionality

- A history of failures
 - Lisbon strategy
 - Remember objective?

"the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010"
- Recent changes in the wrong direction
 - MIB procedure
 - European semester
 - Political trade off fiscal discipline vs. reforms
 - Deepen conflict with national sovereignty

Cleanup No.4

- Keep UK in EU!
- Focus on Single Market
- Complete Banking Union

Intense summitry

- No crisis management procedure
- Commission sidelined
 - Rules-based institution
 - Politicized institution
 - Big issues are for the bosses
- Impossible inter-governmental method
 - Mismanagement of debt crisis
 - Mismanagement of migrant crisis
- One country cannot fill vacuum

Cleanup No.5



Political scientists to the rescue!

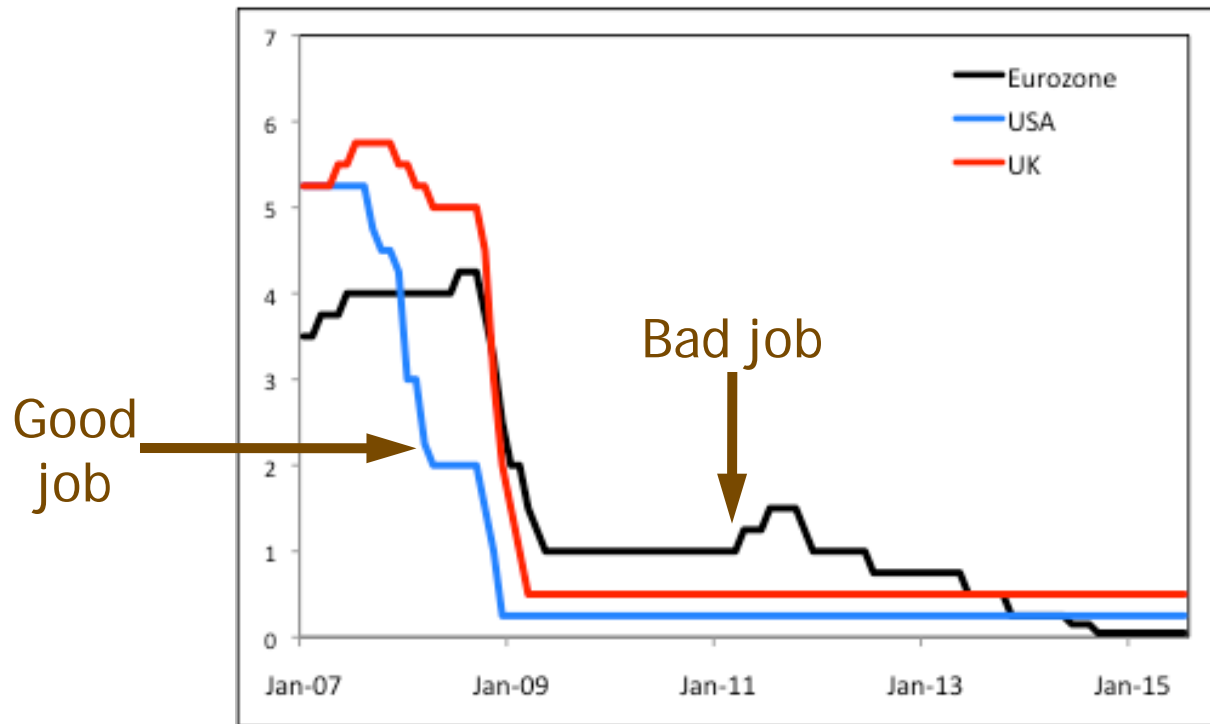
ECB under threat

- Asymmetric shocks are inherently impossible
- The cyclical convergence dream
 - Not only monetary policy shocks
 - Conflicts of interest
- Divergent views
 - Economic principles
 - The role of monetary and fiscal policies
 - The special case of moral hazard
 - Democratic principles

ECB under threat

- Mission impossible
- Back to the mandate?
 - The misplaced concern for independence
- Results
 - Bailouts
 - Procrastination

Procrastination



QE: end 2008 in US and UK, March 2015 in Eurozone

ECB under threat

- Mission impossible
- Back to the mandate?
 - The misplaced concern for independence
- Results
 - Bailouts
 - Procrastination
 - Visible intimidation
 - The case of OMT (aka “whatever it takes”)
- No lender of last resort

Cleanup No.6

- Independence: *de jure vs. de facto*
- Mandate OK
- Practice
 - Clear separation of tasks
 - Should not comment on budgets and reforms
 - No dealing in national debts
 - Own debt instruments
 - Eurobonds when they come to exist
- Improved accountability

Conclusion



what a mess!