A German perspective on EMU and the European debt crisis

Discussion by
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The Euro: (Greek) tragedy or Europe’s destiny
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Central Bank independence – I

• The author argues that the SMP compromises ECB’s independence.
• But in ECB’s defence:
  - SMP went *against* the wishes of EMU’s most influential government. In a narrow sense, this is a sign of political independence.
  - SMP is consistent with the objective of price stability, as long as it averts falling prices (deflation)
Central Bank independence – II

- But without doubt the SMP:
  - Confirms that ECB cannot pre-commit credibly against national fiscal policies
  - Violates the spirit of the Maastricht Treaty
  - Creates moral hazard
  - Reduces incentives for imposing market discipline on national fiscal authorities
  - Undermines popular support for the Euro in Germany
Central Bank independence – III

• What are the deeper causes of the above?
• Irresponsible policies of certain European governments.
• Institutional flaws in EMU’s design: No credible monitoring/prevention mechanism averting unsustainable fiscal/macro-imbalances.
• Ineffective handling, from all parties, of the Greek crisis at its crucial early stages (Nov 09 – May 10).
Central Bank independence – IV

- Overall, the ECB was put between a rock and a hard place
- Its policy dilemma was either to validate moral hazard or risk a chaotic Greek default and a euro-meltdown
- ECB chose the SMP as the least of the two evils
- It sought to buy time for European governments to address their previous policy mistakes.
- If the top priority was the euro’s survival, then under the circumstances the ECB made the right policy decision
- The outcome, however, is still negative.
- The risks highlighted in the paper are serious and real
Rescue funds - I

• The author argues:
  - the currently implemented rescue packages increase moral hazard
  - the euro-plus pact will be hard to implement, as it will be subject to the same enforcing problems with the SGP
• He favours market-based solutions, conditioning rescue packages to prior successful restructuring agreed between national authorities and private creditors
Rescue funds – II

• Historic experience confirms that market pressure is more effective than peer pressure in delivering fiscal adjustment and structural reform.
• Author’s proposal is well founded, as it is based on the right set of private and sovereign incentives.
• It will not necessarily guarantee sound fiscal policies but will increase its prospects.
Interest rates of EFSF loans

• Rescue packages aim to provide highly indebted countries a chance to restore sustainable public finances.
• Increased interest rates would undermine this purpose.
• No obvious negative spill-over effect on AAA countries by keeping interest rates on EFSF loans low.
• Higher interest rates risk derailment of fiscal adjustment. This may well cause contagion on AAA countries
• Given that the EFSF loans have now been given, increasing their interest rates is very likely to be unproductive
Common debt issuance (Eurobonds)

- Empirical evidence suggests a relatively modest liquidity premium and a reasonably-sized premium on the share of long-term debt
- At first sight Eurobonds may be slightly/moderately helpful to periphery countries
- But the moral hazard argument against Eurobonds is overwhelming
- On their own, Eurobonds cannot solve the euro area crisis
- They will discourage reform in periphery countries and undermine public support for the euro in core countries
Euro exits

• As thing stand, the euro zone is clearly unsustainable
• To avoid euro-exits periphery countries should promote structural reforms to regain competitiveness
• Adjustment can also be assisted by higher private consumption and relaxed fiscal policy in core countries
• But consumption and savings are private decisions on which core governments have no control
• Higher public spending in core countries will also be rejected in the political process
• Realistically, adjustment will mainly occur at the periphery
A Greek euro-exit?

• Devaluation will be very large (50%-60%).
• Short-run impact will be enormous, resulting in welfare reduction higher than any benefits of devaluation.
• Euro exit will remove the only credible nominal anchor Greece currently relies upon.
• Given institutional deficiencies, return to pre-euro inflation/devaluation spiral looks very likely.
• Greece’s best bet: supply-side reforms within the euro, similar to those applied by the UK in the 1980s.
Permanent solution to the ECB crisis

- Structural reforms in periphery
- Some kind of fiscal union: But will European citizens (at core and periphery) accept this?
  - If, and only if, fiscal union is in place:
    - Common debt issuance of reasonable size can be discussed
    - The ECB to be given officially the role of the lender of last resort
Overall assessment of the German perspective of the EMU crisis

• German approach based on sound economics and principles
• But the euro is an economic and political project
• Politics are not always based on sound economics/principles
• Long-term crisis resolution must address Germany’s concerns
• But short-term crisis management must involve pragmatism
• Pragmatism is an idea towards which there is principles-based scepticism in Germany
• Adjustment cost on troubled countries should not exceed the level necessary to prevent moral hazard
• Adjustment cannot be fully consistent with the sound principles characterizing German steady-state preferences
Important questions for euro’s future

• What is Germany’s top priority? European integration or internal price and currency stability/credibility?
• Is Germany prepared to pursue its envisaged inclusive euro zone without guarantees of eventual success?
• For how long is Germany prepared to try?
• At the cost of which deviations from German steady-state preferences in the short- and long-term?
• Germany’s position on these questions remains somewhat unclear
• Swift clarification will be to Germany’s, the euro’s and everybody else’s interest