

AEA/ACES Session on “The First Ten Years of the Euro: Achievements and New Challenges”

San Francisco, January 4, 2009

# The Likely Future of the Eurozone

Simon Johnson

MIT, Peterson Institute for  
International Economics, and NBER

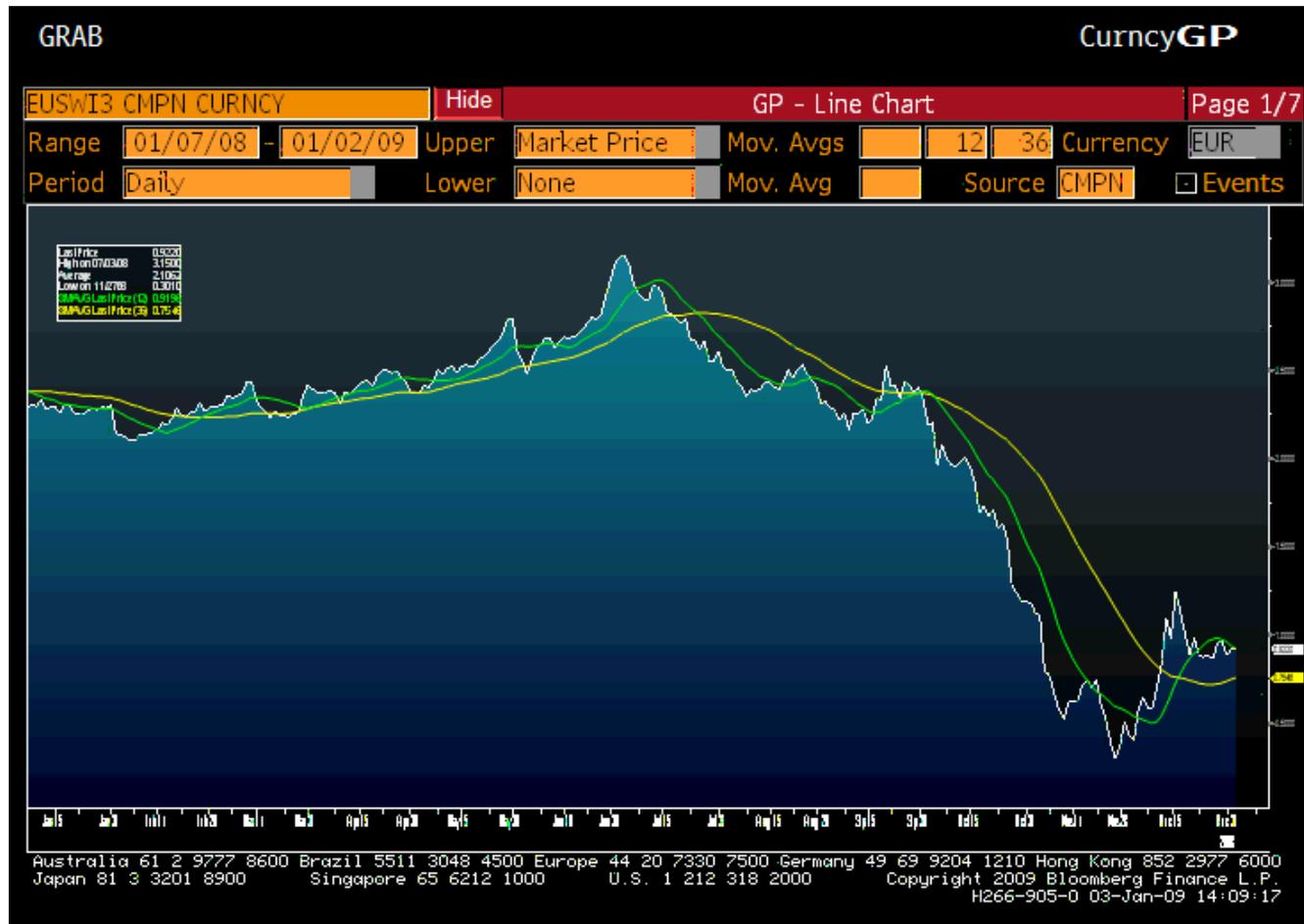
<http://BaselineScenario.com>

# The US Macroeconomic Predicament in One Slide: 5 year Inflation Expectations



# Inflation Expectations in the Eurozone

(2.35% at end September and 0.92% now; annual average, over 3 years.)



# Three Questions

- Why hasn't the European Central Bank cut interest rates by more since mid-September?
  - If inflation expectations are substantially below target inflation
- What does this tell us about the ECB?
  - Its view of the world, decision-making process, politics
- How does this help us think about the longer-run viability of the eurozone?
  - Given that fiscal adjustment has been repeatedly postponed in some member countries
  - And that we are now in a new world, apparently with big differential shocks across eurozone members

# What happened in Europe/Eurozone since September 17, 2008?

- Financial sector under pressure after Lehman/AIG
  - Irish deposit guarantees
  - Bank recapitalization as emergency response
  - Spillover from problems in major financial institutions in UK, Switzerland
- Movement of crisis through Iceland to East-Central Europe
  - Countries caught at peak of credit booms financed by capital inflows
  - Effects on eurozone felt through trade and financial linkages
- Growing pressure in financial markets on some weaker eurozone sovereigns, particularly from mid-October
  - Long-standing government balance sheet issues
  - Concerns about access to capital markets in stress situations

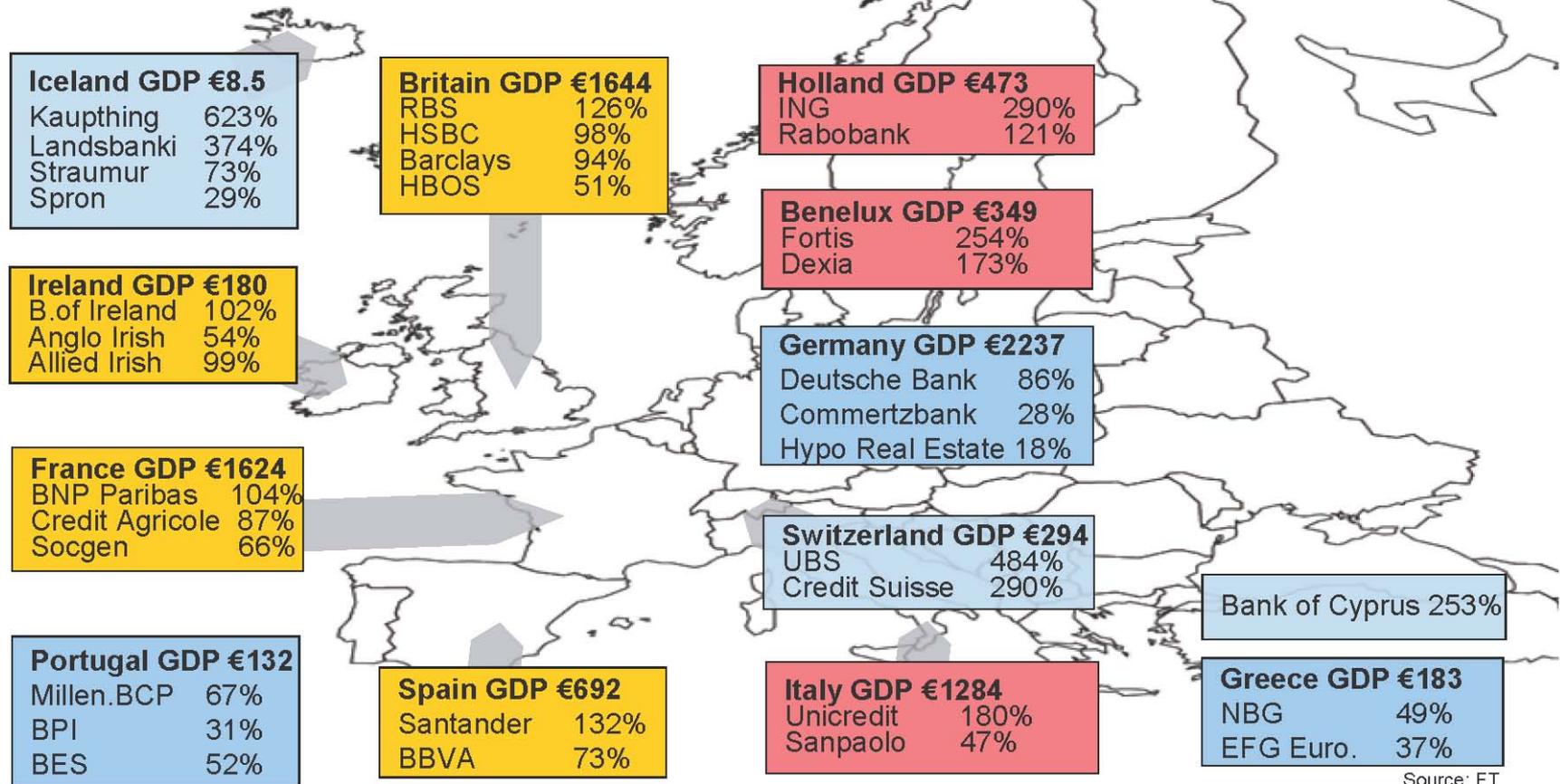
# The Nature of These Shocks

- Large, with differential impact across countries
  - variation in exposure to Eastern Europe
  - size and stability of financial sector differ
  - Initial fiscal positions not homogeneous
    - E.g., Germany vs. Italy
    - See Greece's Article IV, May 2008, Figure 3
      - <http://www.imf.org/external/pubs/ft/scr/2008/cr08148.pdf>
- Ability of fiscal policy to respond is limited
  - By initial balance sheet
  - Or by internal politics

# ...provided they are credible

Assets of some banks are too large to guarantee

## Total bank assets to 2007 GDP In percentage and billions of Euros



Source: FT

# CDS Spreads October 23: Eurozone Sovereigns



# CDS Spreads January 2: Eurozone sovereigns



# Greek-German government bond spreads, since 2002



# What Happens if Greece Has a Problem?

- Debt rollover requirement in 2009: ~20% of GDP
- CDS market, pricing risk of default >10% over next 5 years
- Who would provide a bailout, and on what basis?
  - The IMF? (no)
  - The EU? (with what money)
  - Richer members of the eurozone? (on what terms)
- And problems would likely spread, e.g., sequential runs seen in CDS spreads over past 18 months
  - Northern Rock to Alliance and Leicester/Bradford and Bingley
  - Morgan Stanley to Goldman Sachs, etc
- Could the eurozone afford to bailout other members of the PIIGS group?
  - G7/EU/IMF strategy for Eastern Europe probably not an option
  - Weaker eurozone members would need substantial fiscal adjustment

# Global Slump Potential

- Attempts to increase savings by
  - US consumers (likely only partially offset by fiscal stimulus)
    - Calculate effects of lower inflation expectations on real debt payments for households; discontinuity in mortgage defaults
  - Emerging market corporates and households
    - Sovereigns feel limited space for fiscal stimulus (the few exceptions are small relative to the world economy)
- What about Europe/eurozone?
  - Corporates and households are unlikely to want to spend more (or save less)
  - Under pressure, governments unlikely to provide stimulus of even 1% of GDP
    - Fiscal First strategy in the US creates an incentive to free ride, hoping to recover through exports
    - More expansionary monetary policy in the US could be contagious, but this is not the immediate priority
      - But may come after Hubbard-type housing proposal is rebuffed

# What Has the ECB Done?

- A great deal, since summer 2007, in terms of:
  - Liquidity provision
  - Actions supporting financial stability
- Also interest rate cuts: 175 basis points since the summer, down to 2.5% (“main refinancing operations”)
  - But remember: through the summer, eurozone was denying that major global slowdown was underway, and ECB tightened by 25 bp in July
    - After not cutting from onset of global financial crisis
  - In this context, why hasn’t the ECB cut interest rates by more?
    - Definitely appears to be an outlier relative to other major central banks

# A Standard Answer

- ECB still needs to build or assert credibility
  - Based on independence from politicians/fiscal authorities
  - And on being perceived as tough against inflation (e.g., “the German wage round”)
- Therefore will prefer to wait until lower actual inflation is “in the data”
- This approach has contributed to the success of the eurozone
  - And to the fact that countries still want to join, e.g., from East-Central Europe, Iceland (?!)

# Alternative Answers

- Decision-making process, which seeks consensus + eurozone politics
- Some powerful voices want relatively tight monetary policy
  - Germany, specifically: see inflation dangers in current situation
- Definite risks to global inflation from expansion of Fed role
  - No one has a good model or even complete explanation for current situation
- Tilts analytical balance away from more forward looking indicators of inflation

# A Bigger Question

- Is this a Sargent & Wallace environment, with several countries running unsustainable fiscal policies?
  - i.e., inconsistent with 2% inflation
- Market view (from CDS spread and bond yields): if there is a serious recession, Greece and some other countries could default
  - Riots in Greece consistent with this
  - Italy: multi-decade fiscal issues not clearly resolved
  - Severe housing-related problems in Spain
  - Implications of bank bailouts in Ireland

# What Could Shift These Countries Onto A More Sustainable Path?

- The eurozone could get stronger, with more fiscal authority
  - Analogy to Russia after 1998, imposing political and borrowing constraints on regions
  - Obviously, this would only happen if there were a severe crisis
- The euro could depreciate, through shift to more expansionary monetary policy. Unlikely, because:
  - Core countries think shocks relatively small
  - Strong preference against inflation
  - Core does not want to bail out the PIIGS in this fashion

# The PIIGS Path Not Taken

(depreciation of British pounds against euro)



# Immediate Consequences

- Tension between core conservative euro members vs. less fiscally conservative/more shocked countries
  - Presumably slows moves at ECB-level
- Scenarios depend on world recession
  1. If severe, ECB will keep policy “too tight”, i.e., PIIGS will need massive reductions in leverage, difficult fiscal adjustment, and deeper recession than they would want
    - Crisis potential: how could Greece refinance 20% of GDP?
  2. If quick global recovery, then PIIGS again postpone serious adjustment
    - Presumably such adjustment occurs down the road, either smoothly or (more likely) rapidly in the face of another big shock

# Further Scenarios:

- The eurozone breaks up?
  - But definitely not in the interest of weaker members to leave
  - So could some of the stronger members exit?
- Most likely
  - Pressure towards fiscal contraction
  - Or at least avoidance of stimulus
    - So this is a further reason world heads towards slump

# Conclusion

- Parts of eurozone lacked political will or ability to keep implicit and explicit fiscal policy in line with long term stability
- The euro provided the opportunity to have a credit boom while the world economy was smooth
  - Wages and pensions were out of line in both public and private sector
  - Fiscal policy should have been much more countercyclical
- Now, when credit boom comes to an end, we see some parts of Europe postponed change and situation cannot persist
  - Unless a miracle occurs at the level of the global economy
- Calls into question the eurozone logic
  - the idea that euro creates credibility and change behavior
  - Have governments, voters responded as if euro is credible?