The Politics of the Euro Area Crisis, Greece and the ECB

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MIT

Geneva, 17 February 2015

Headlines

"Talks Collapse as Athens Rejects Bailout Extension." *Financial Times.*

"Meeting on Greek Debt Produces an Ultimatum." *New York Times.*

"Greek Financing Talks Break Down Amid Deep Divisions Over Bailout." *Wall Street Journal.*

"Greek Rescue Talks Collapse in Acrimony." *The Guardian.*

Athens: 2015


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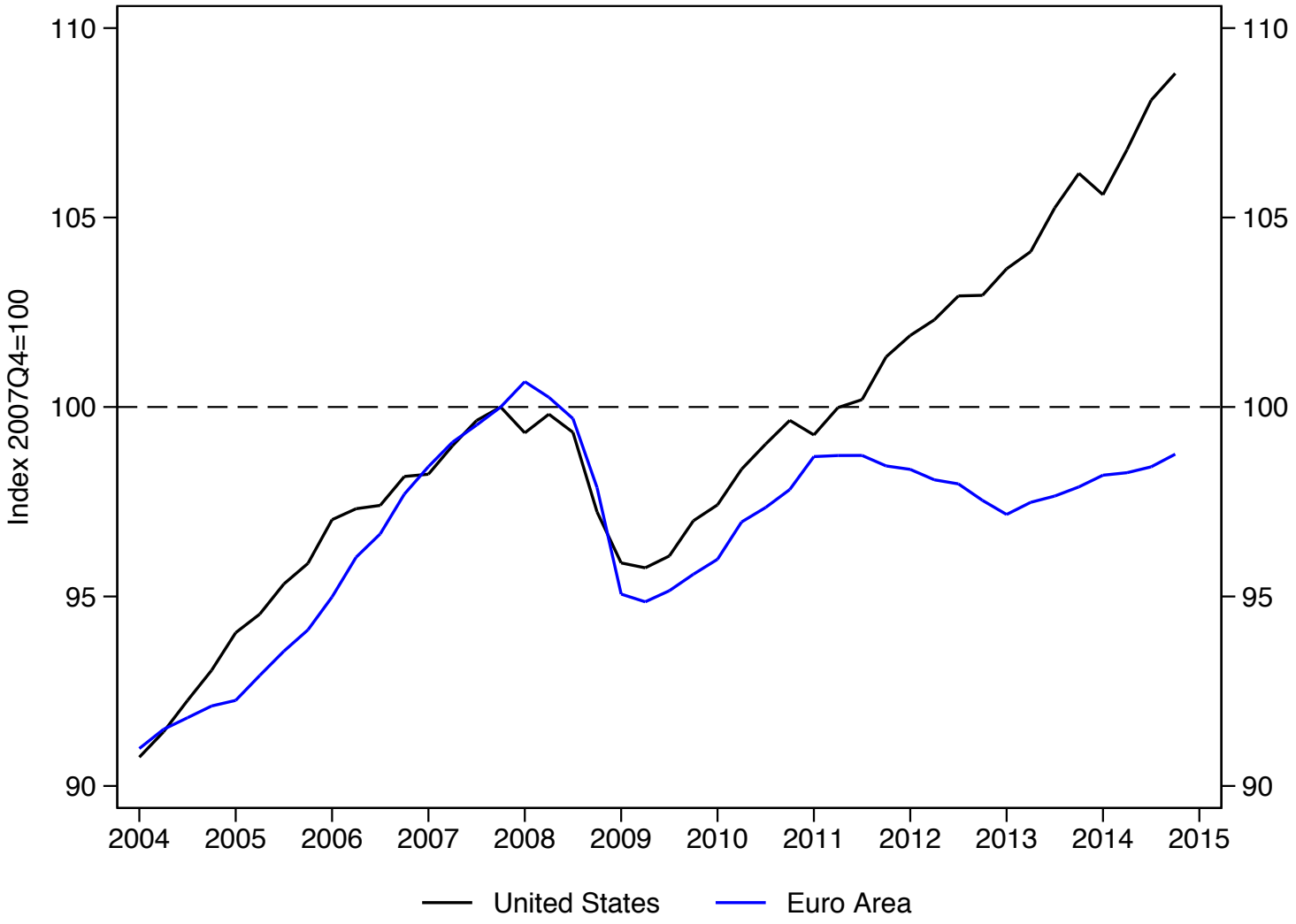
Athens: 2010

The euro area crisis



Real GDP in US and euro area. Index: 2007Q4 = 100

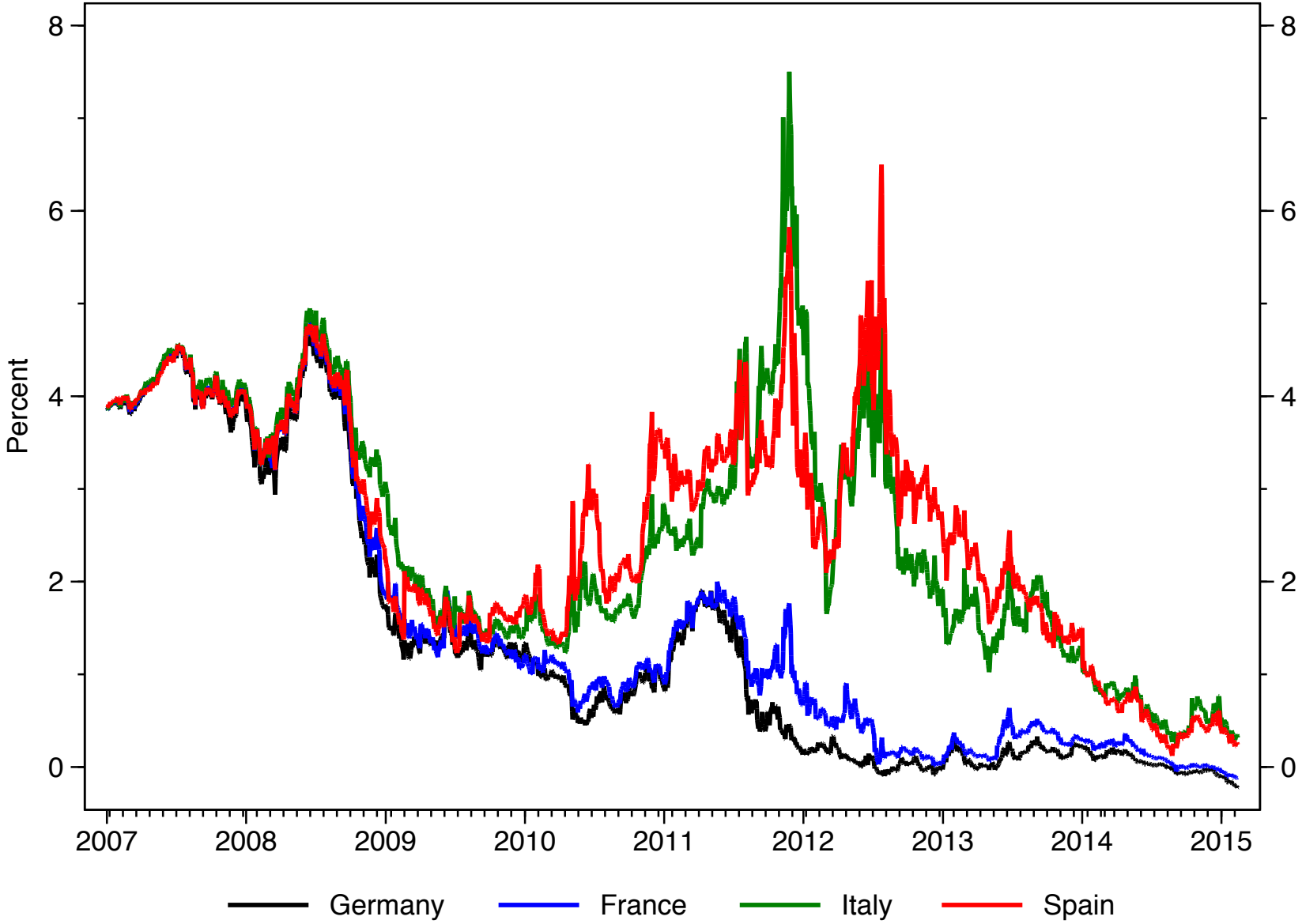
The narrative of the crisis: Causes or symptoms?

- Sovereign debt crisis?
- Banking crisis?
- Competitiveness crisis?
- Confidence crisis?

Why Europe failed?

- Every crisis generates losses. Key question: Who pays?
- Proper crisis management minimizes total cost and manages fair distribution.
- The euro tied member states, removed crisis management tools from individual member states.
- This elevated the importance for cooperation among governments to contain total crisis cost.
- But the necessary political structure to encourage cooperation was absent.

A confidence crisis



Yields on two-year government bonds

A political crisis: Politics over economics

"What we have, in fact, is a crisis of the ability of the European Union's *political* bodies to act. This glaring weakness of action is a much greater threat to the future of Europe than the excessive debt levels of individual euro area countries."

Helmut Schmidt, October 19, 2011

The triumph of local politics

- The common currency created opportunities to exploit the crisis to shift losses from stakeholders in one member state to stakeholders in other member states.
- Electoral consideration induced certain governments to leverage the crisis for their own political gain.
- Rather than work towards containing total losses, politics led governments to focus on shifting losses to others.
- The result was massive destruction in some member states and a considerably higher total cost for Europe as a whole.

Who done it? A stroll in Deauville

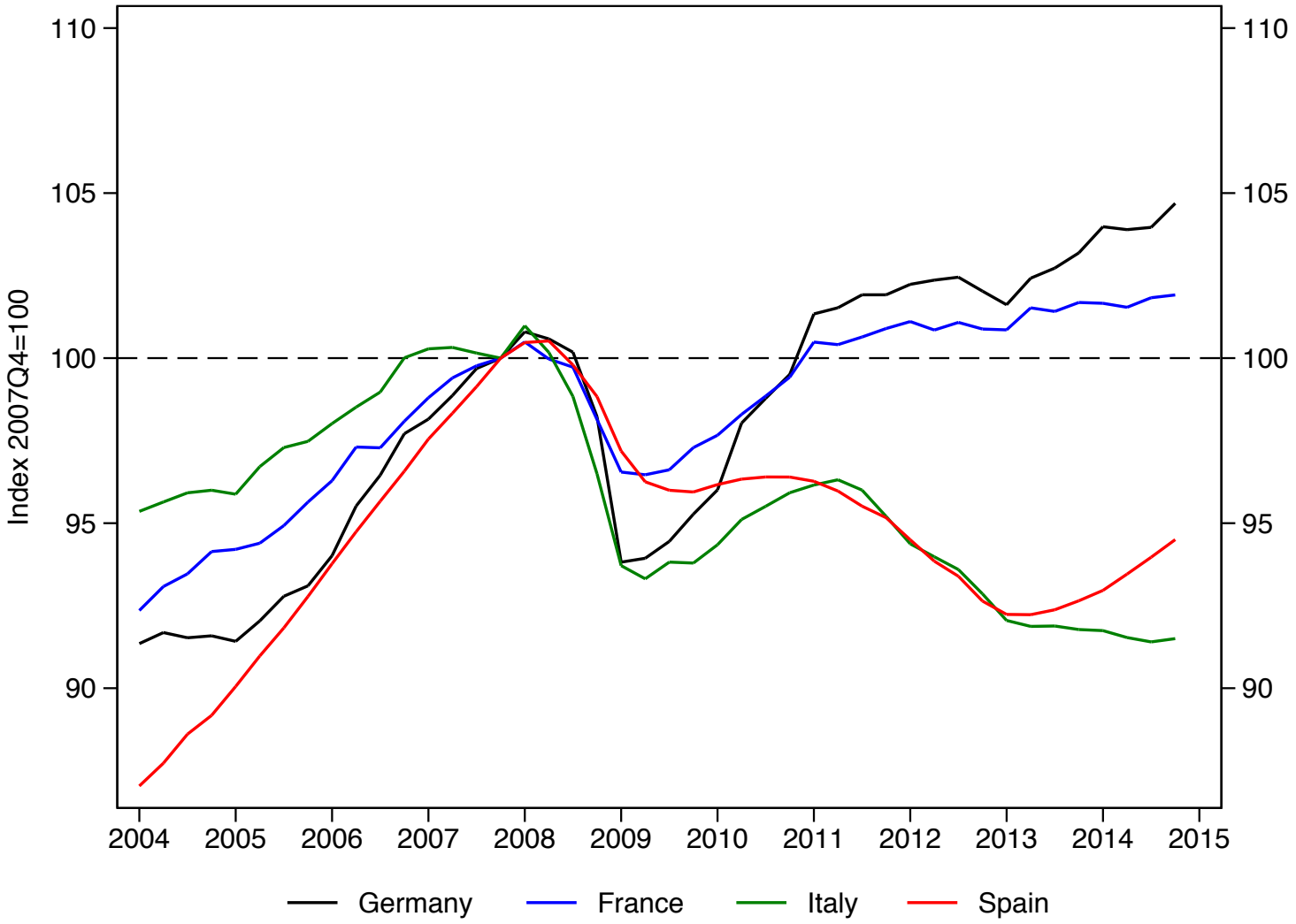
October 18, 2010: Deauville

- Agreement between French and German government to introduce the Private Sector Involvement (PSI) doctrine.
- Whenever a euro area member state faced liquidity pressures (not necessarily solvency concerns), the imposition of losses on private creditors would be demanded before euro area governments agreed to allow any temporary assistance.
- Message to potential investors: Euro area sovereign debt should no longer be considered a safe asset with the implicit promise that it would be repaid in full.
- Although it was a blunder for the euro area as a whole, the PSI doctrine proved beneficial to Germany and France, widening yield diffferentials with periphery.

Examples of shifting losses

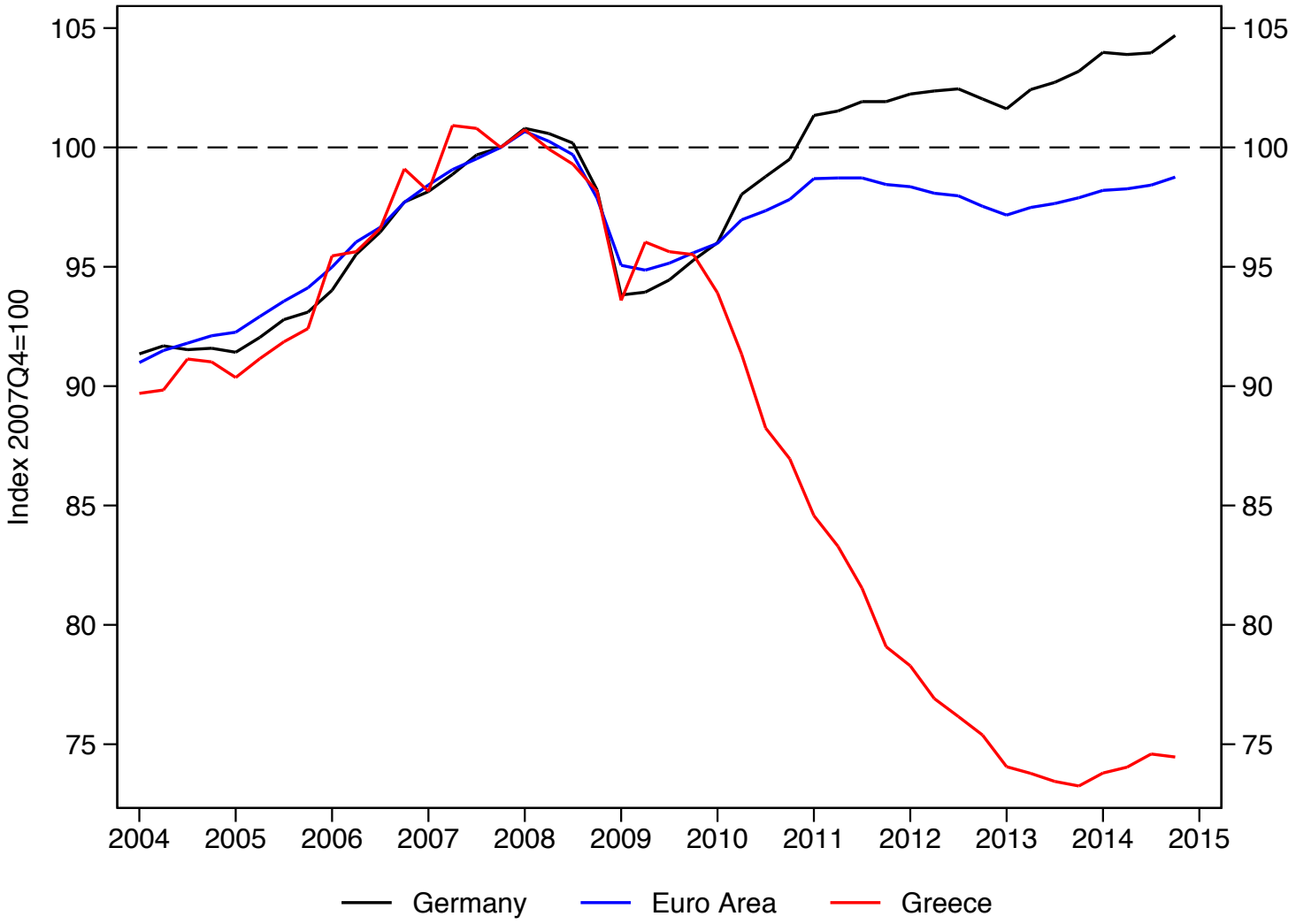
- PSI concept introduction. Who benefited and who lost by injecting credit risk in euro area sovereign debt?
- Greek debt in 2010. Who was exposed? Who was protected by postponing a haircut on Greek debt?
- Greek debt in 2012. Who benefited from imposing a haircut while excluding the ECB after banks in some member states unloaded their holdings to it?
- Timing and sequencing of decisions had important distributional consequences among stakeholders in different members states.

Winners and losers



Real GDP. Index 2007Q4=100

What about Greece?

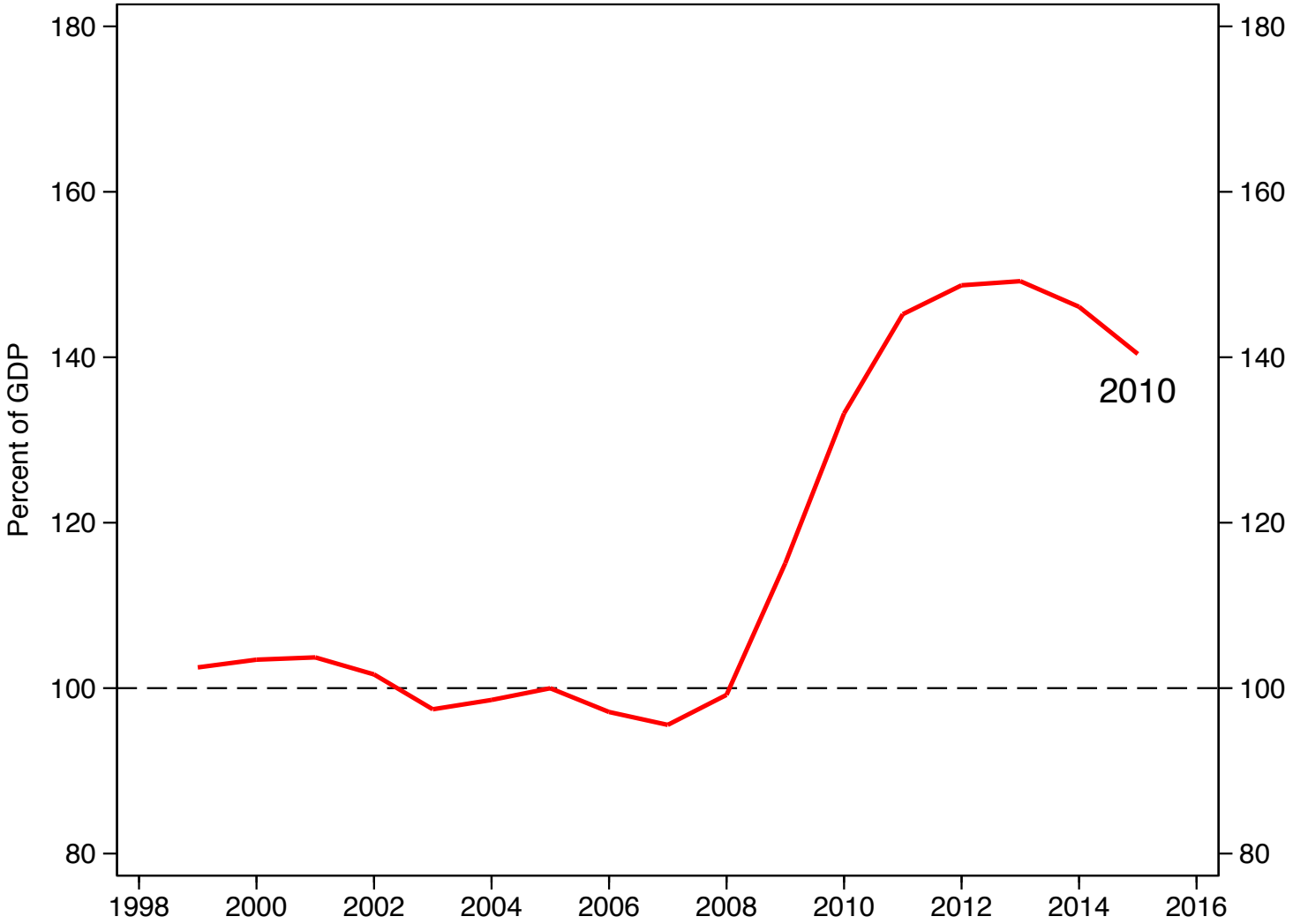


Real GDP. Index 2007Q4=100

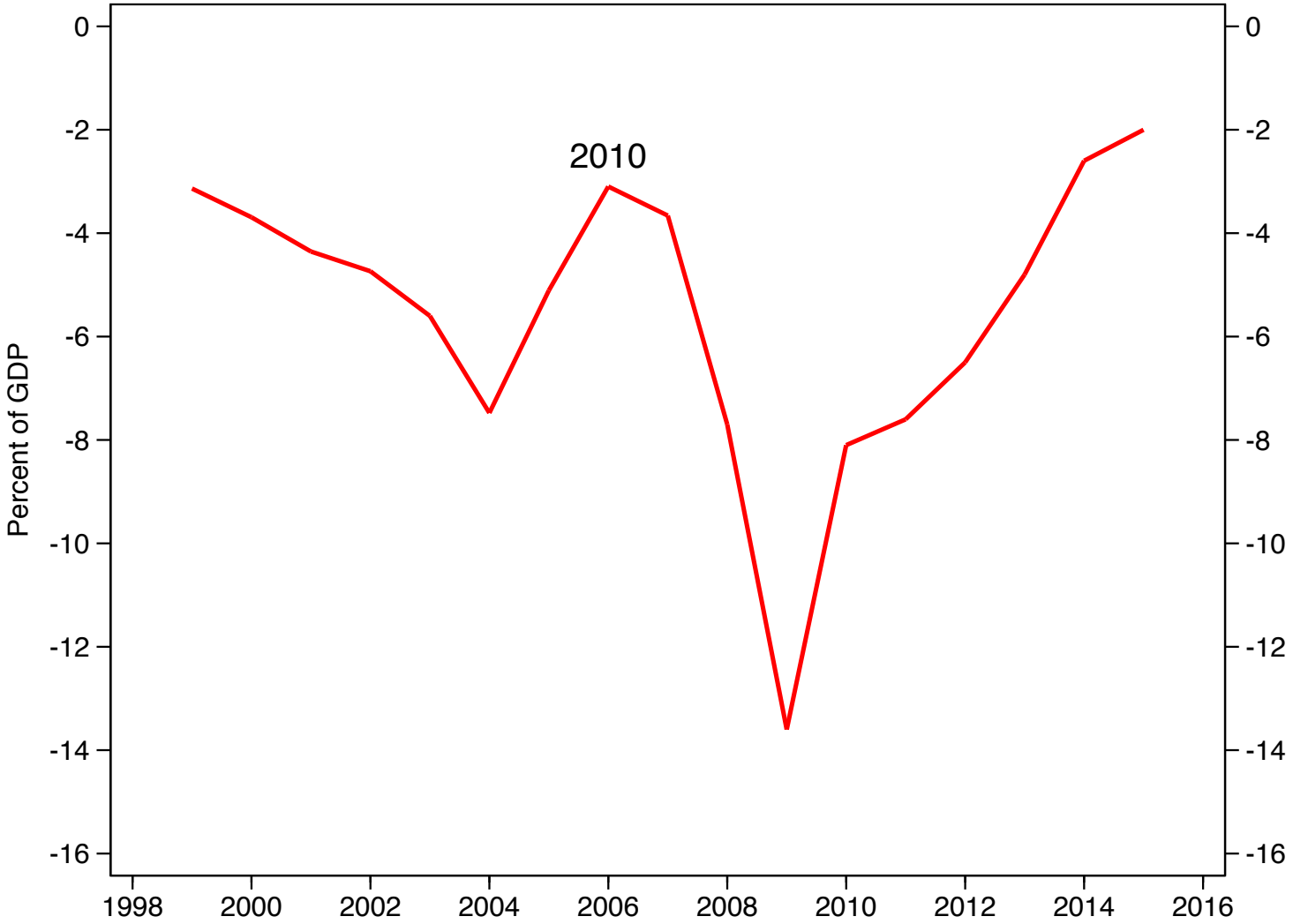
What happened in Greece?

- Greek government requested IMF assistance in 2010.
- Program designed with heavy involvement of German government and European Institutions.
- Severe austerity imposed but program was assessed to restore stability and growth by 2012.
- Greek debt was deemed sustainable without haircuts.
- Independently, ECB started purchases of Greek government debt (SMP).

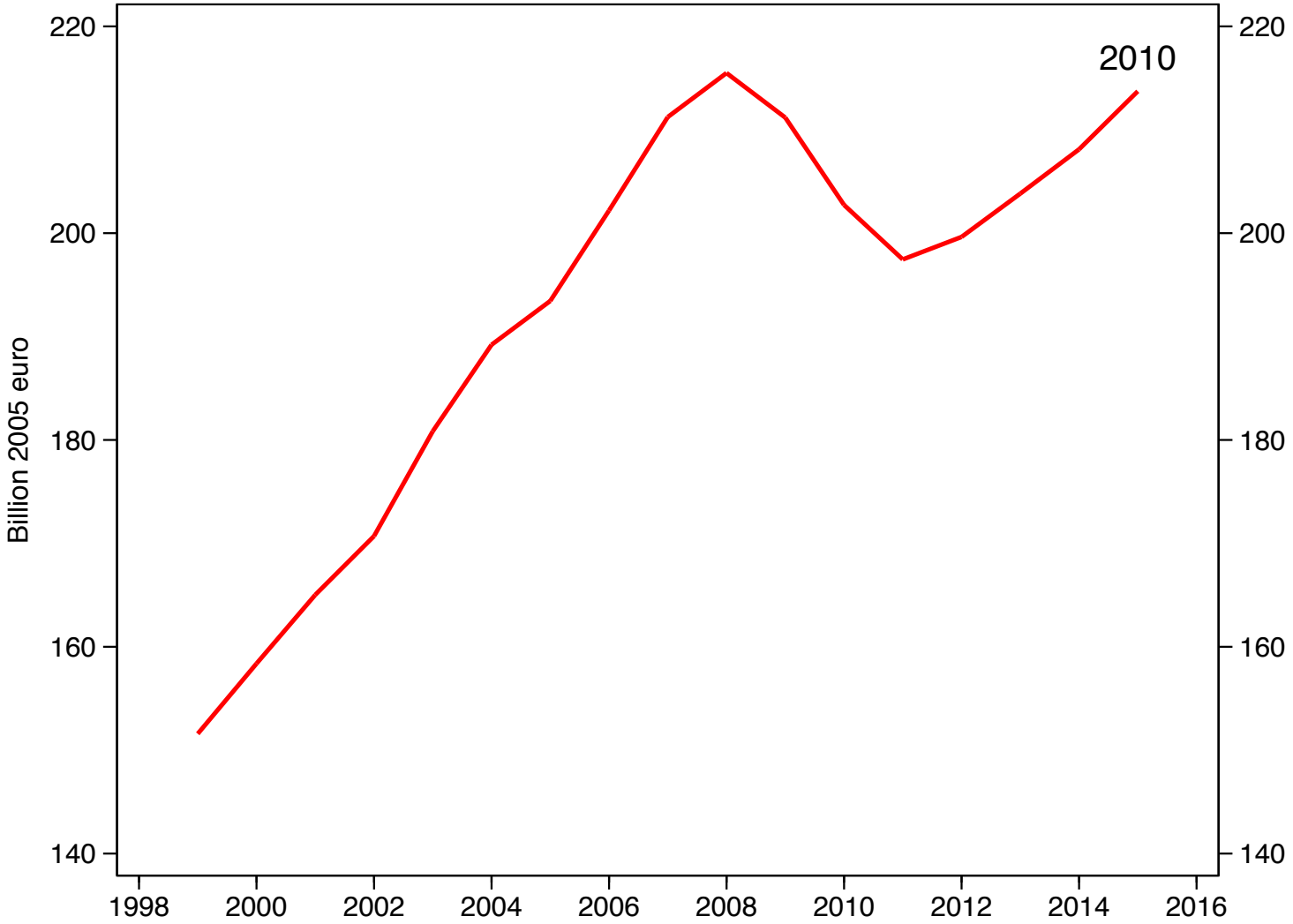
May 2010 program: Debt to GDP ratio



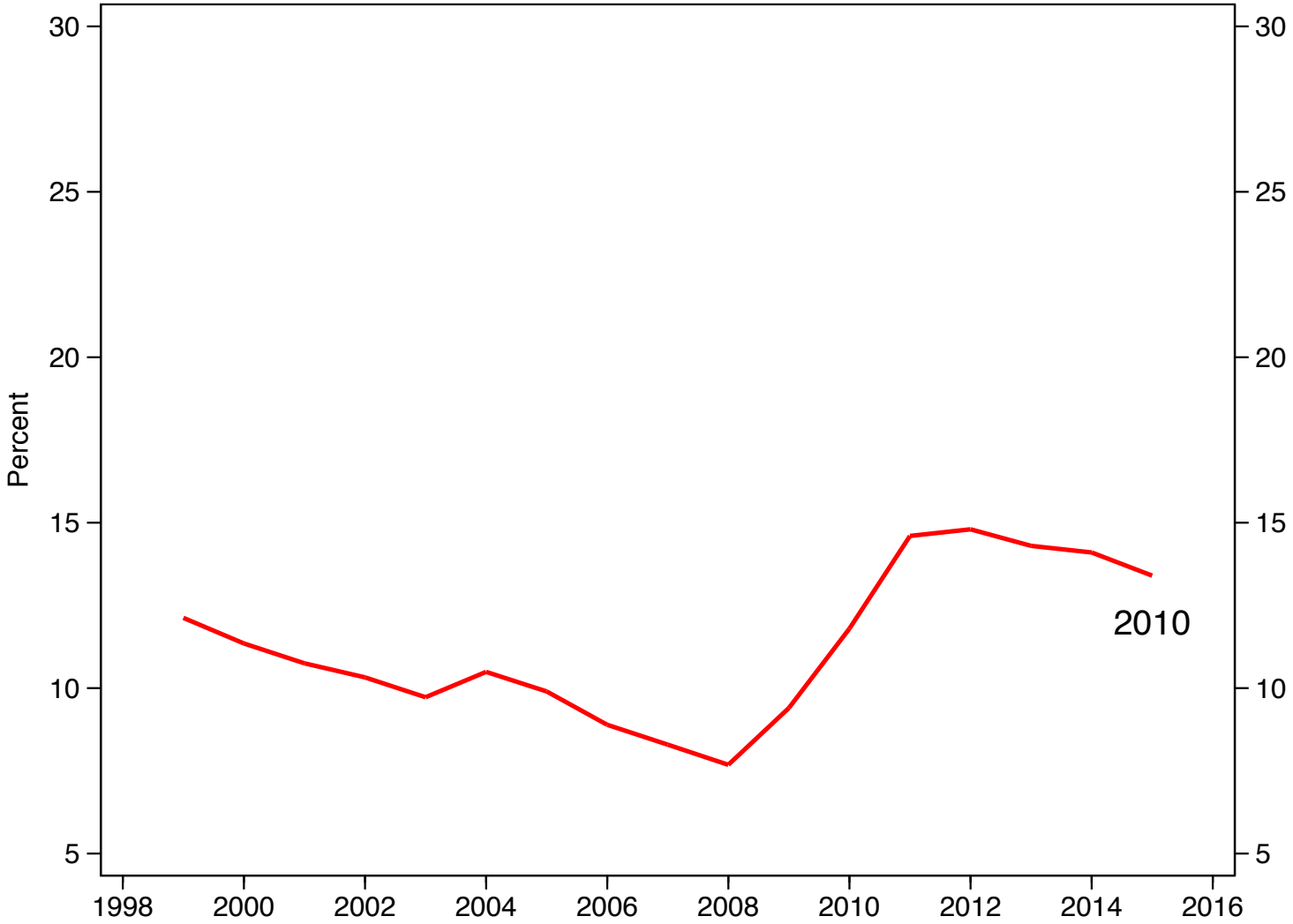
May 2010 program: Deficit to GDP ratio



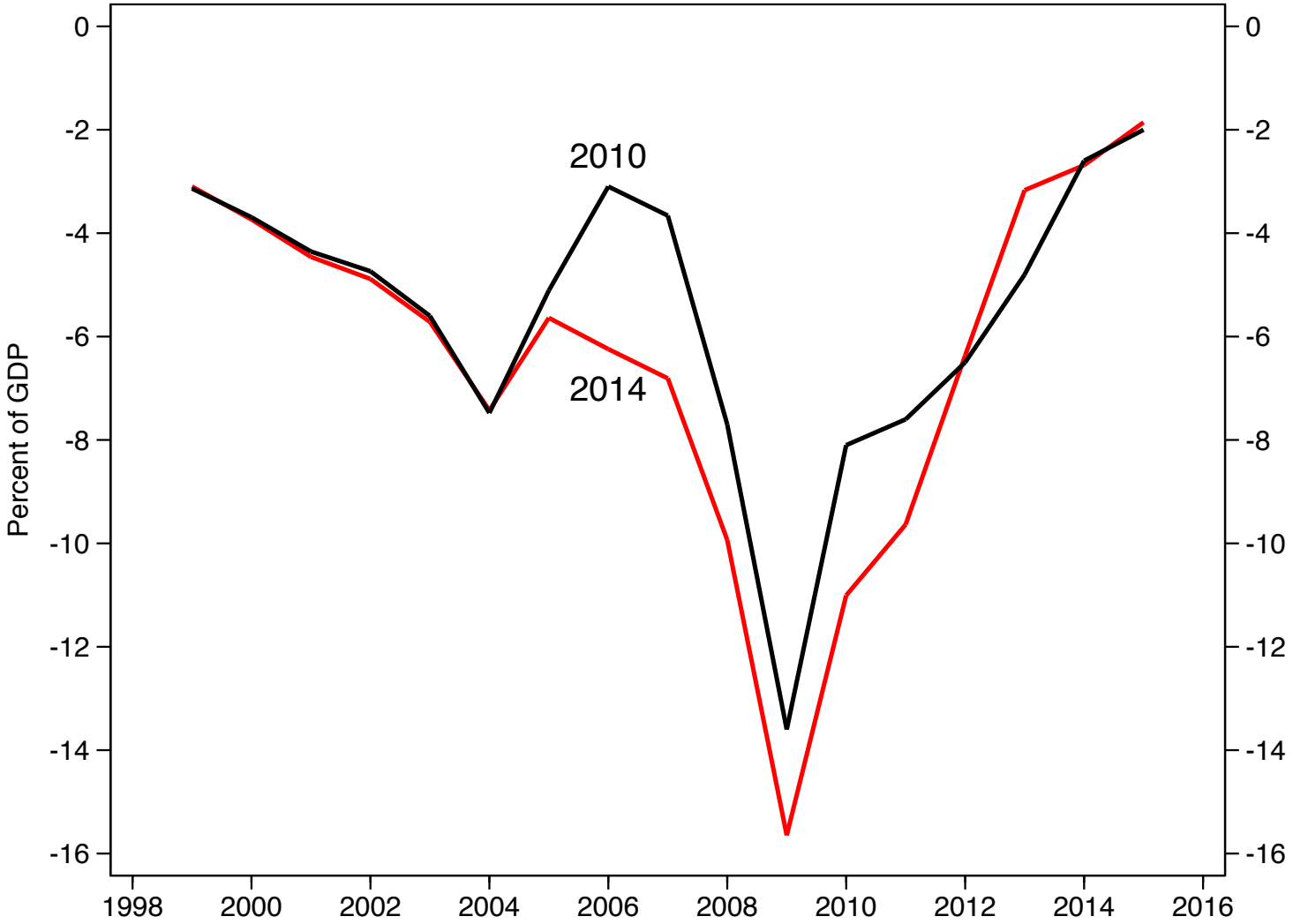
May 2010 program: Real GDP



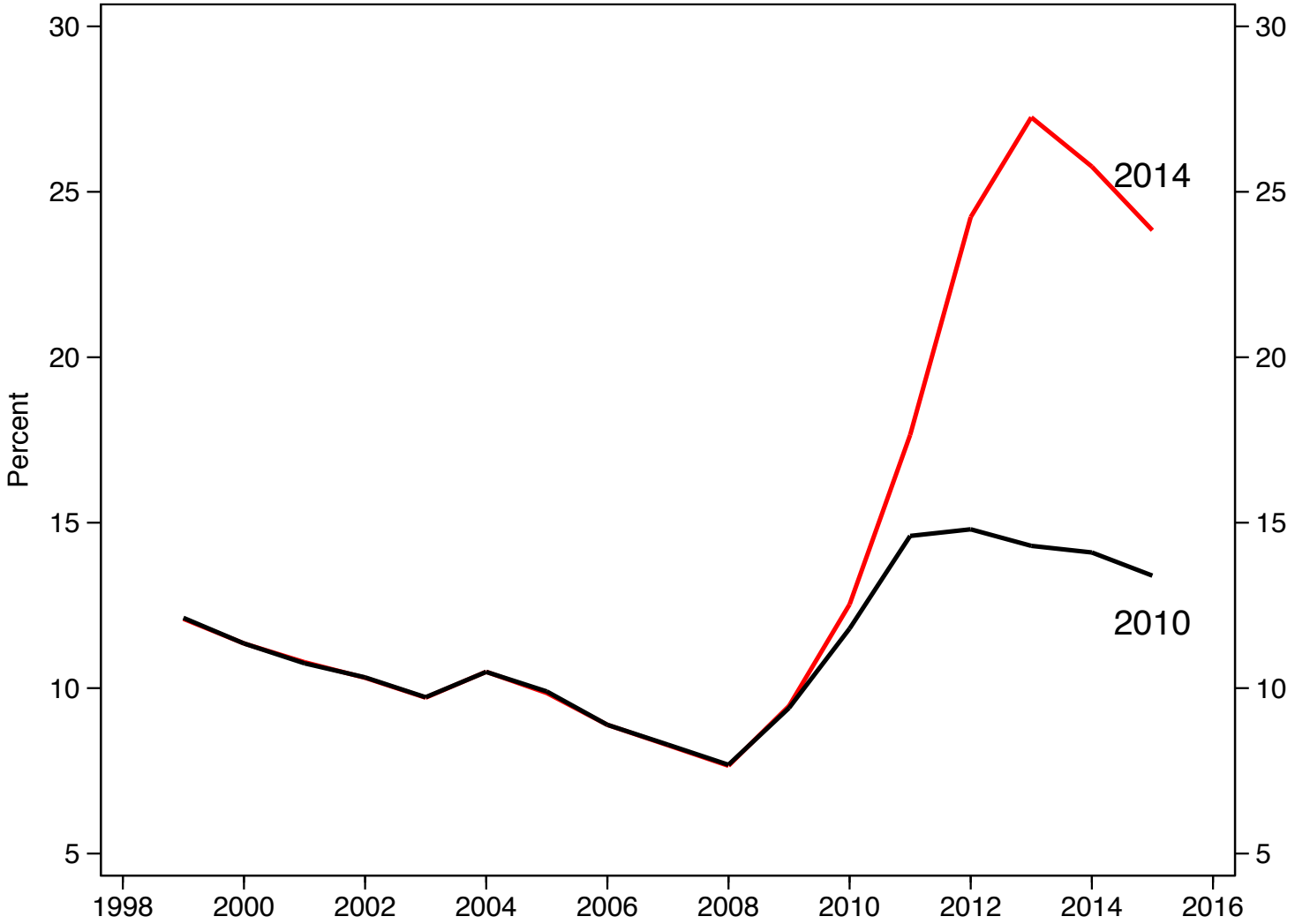
May 2010 program: Unemployment



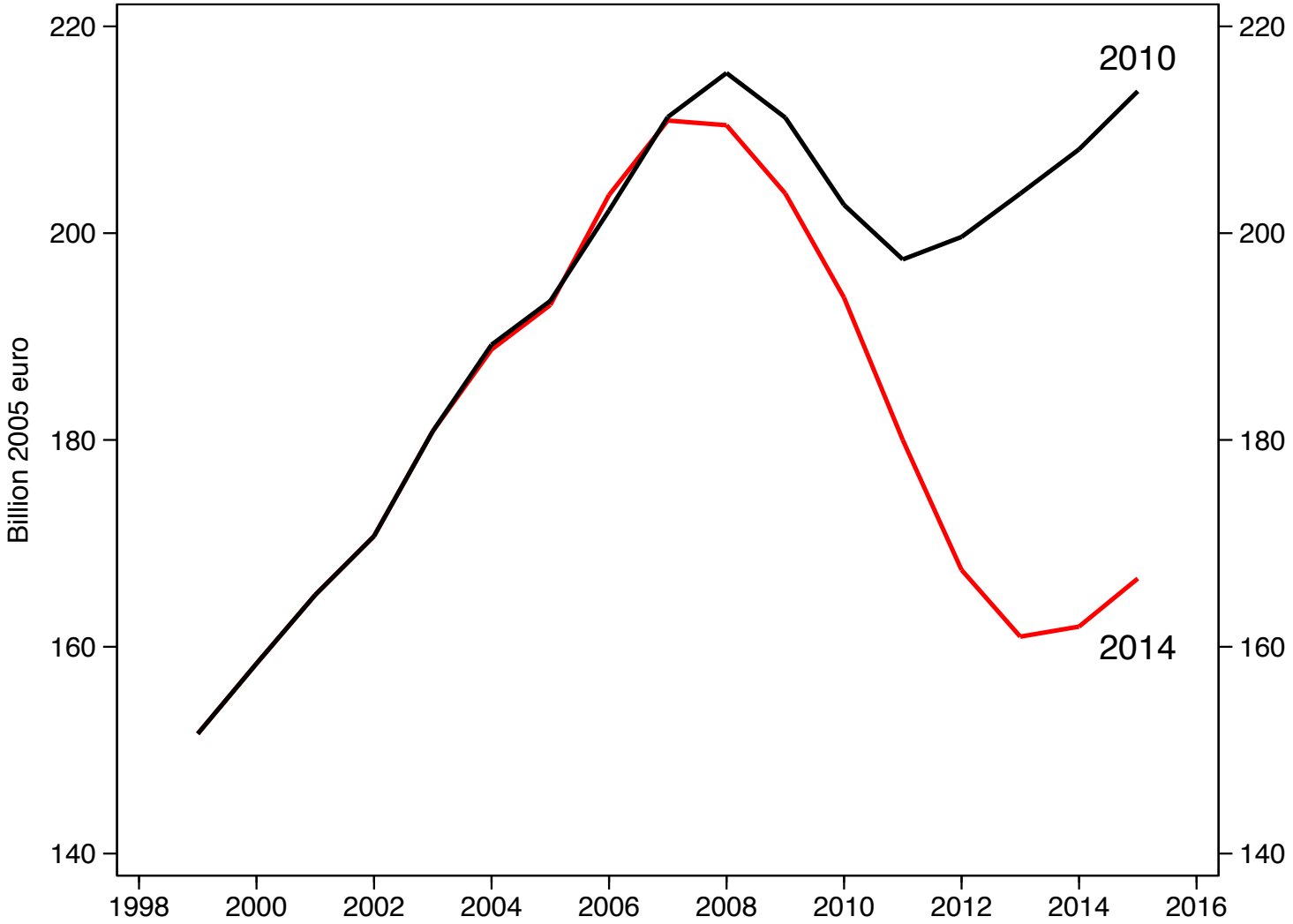
Outcome: Deficit to GDP ratio



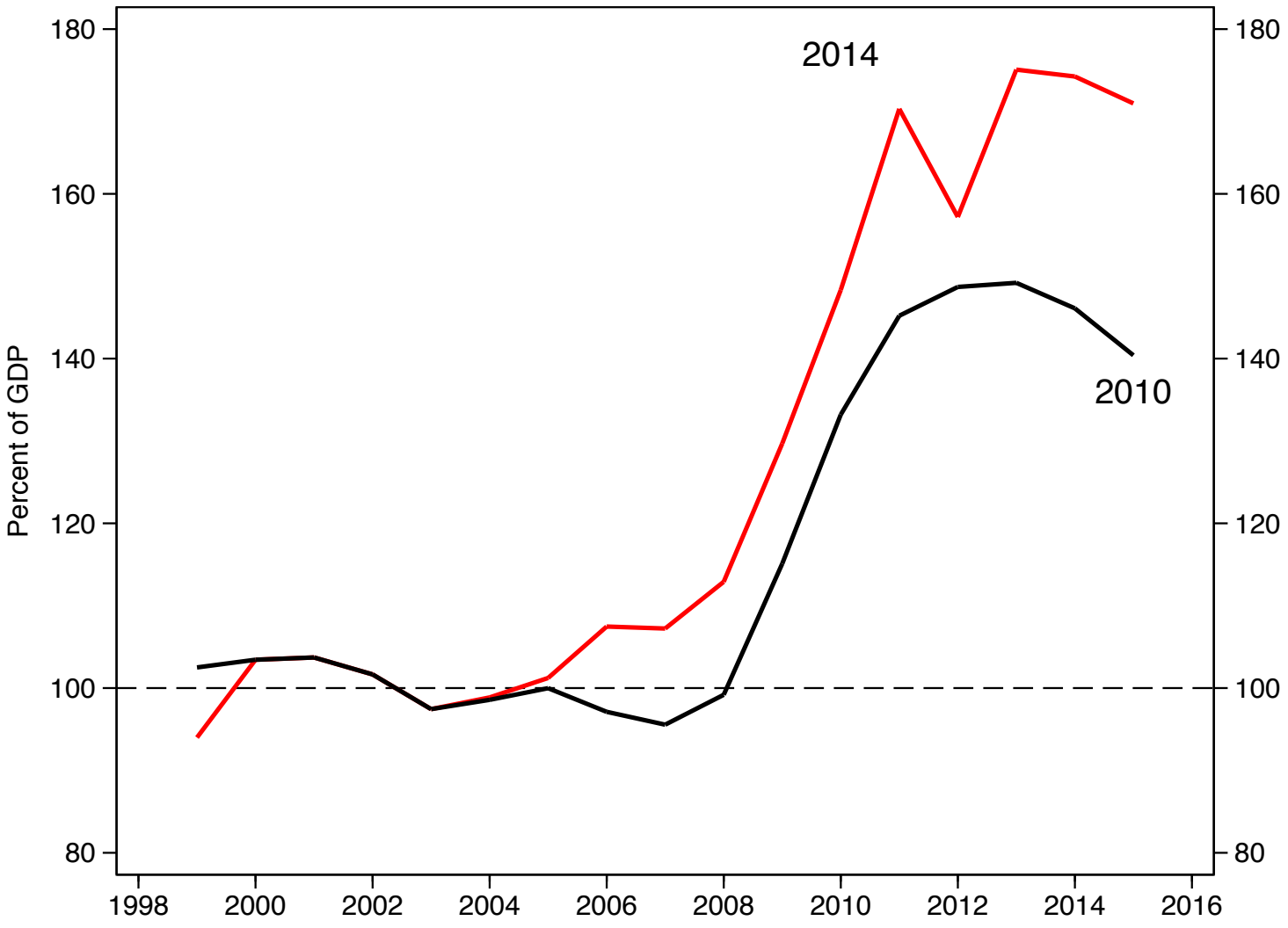
Outcome: Unemployment



Outcome: Real GDP



Outcome: Debt to GDP ratio



2014 estimate includes effect of 2012 haircut

Ex post evaluation

"There were notable successes ... "

"However, there were also notable failures. Market confidence was not restored, the banking system lost 30 percent of its deposits, and the economy encountered a much-deeper-than-expected recession with exceptionally high unemployment. Public debt remained too high and eventually had to be restructured, with collateral damage for bank balance sheets that were also weakened by the recession."

"... the baseline macro projections can also be criticized for being too optimistic."

"There are also political economy lessons to be learned."

(IMF, June 2013)

What was the Troika program about?

"It was about protecting German banks, but especially the French banks, from debt write offs"

(Karl Otto Pohl, Former Bundesbank President)

Why did the IMF go along in 2010?

"The Dutch, French, and German chairs conveyed to the Board the commitments of their commercial banks to support Greece and broadly maintain their exposure."

(IMF Board meeting, May 9, 2010)

Did the French and German governments honor their part of the plan?

Who's to blame for Greece?

- Greek government policies started the problem.
- Flaws in euro construction made the problem worse.
- Who should bear the cost of the botched Troika program?
- Who should pay for restoring growth if an unworkable program was imposed on Greece to protect German and French banks from losses in 2010?
- What is the responsibility of other governments?
- What is the responsibility of European Institutions?

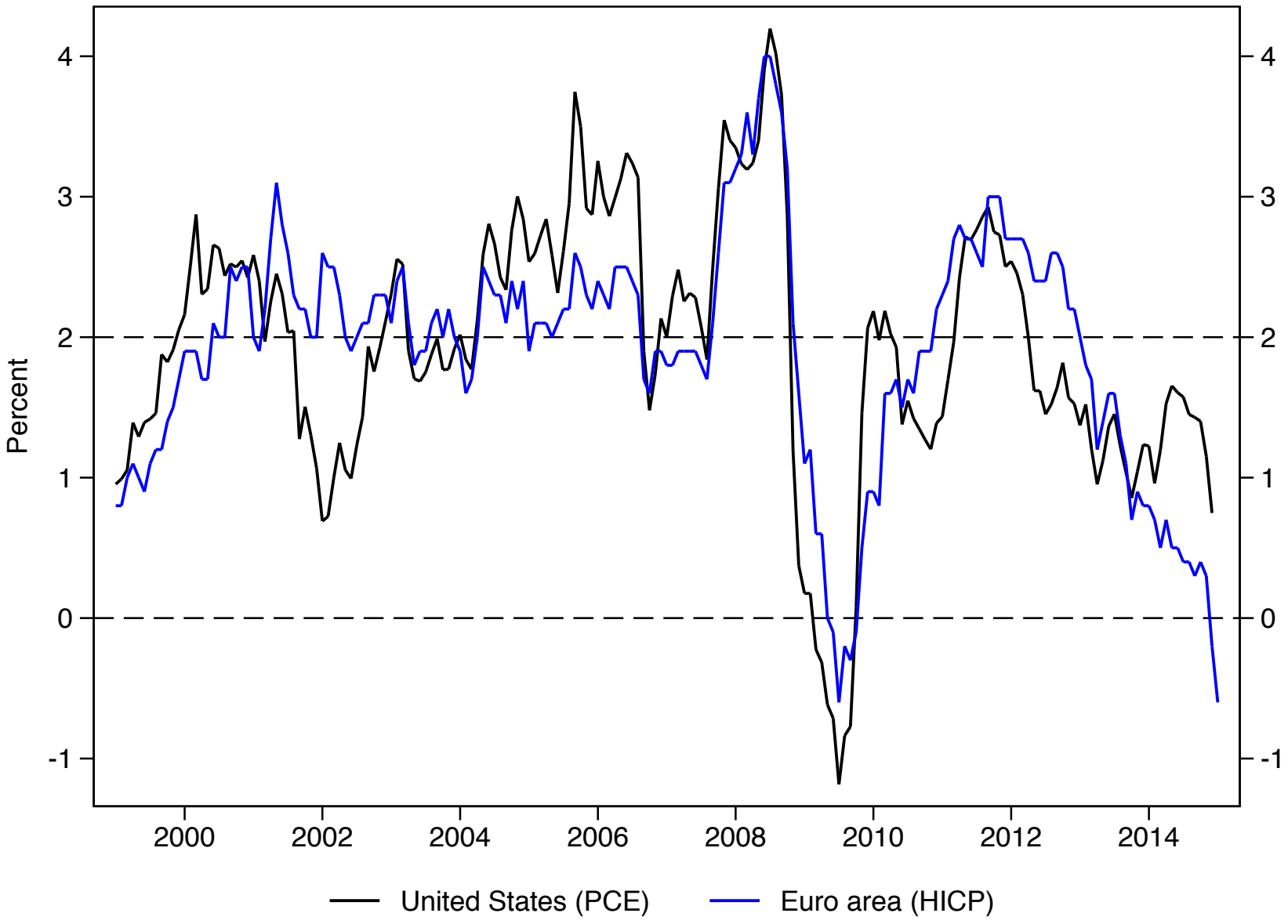
A nightmare for the ECB

- Focus on crisis management?
- Focus on monetary policy?
- Respect the mandate or yield to politics?
- Tradeoffs for survival of the euro area?

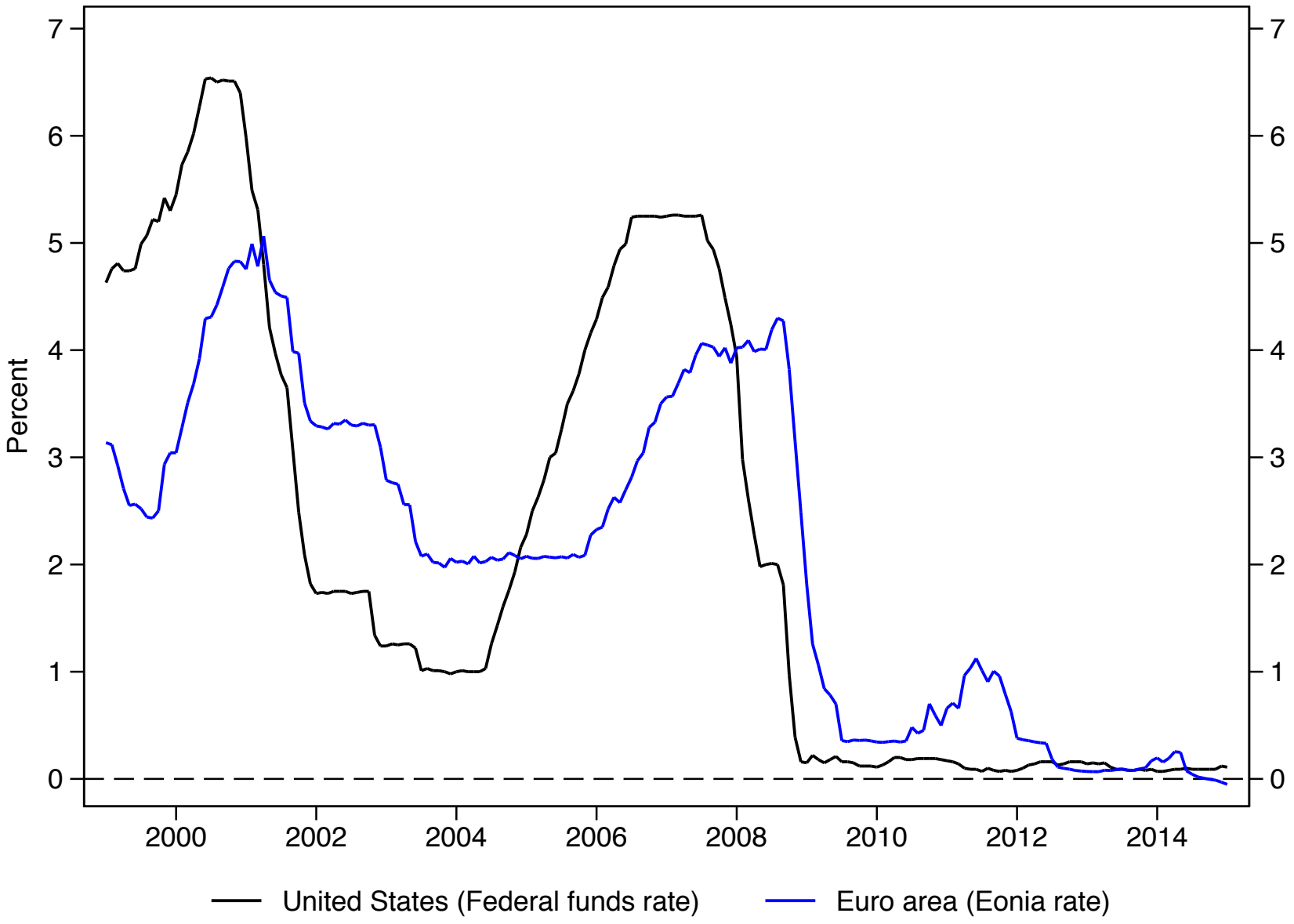
Possible descriptions of a new role?

- "The enforcer." *Economist*, 7 February 2015
- "Germany's debt collector." *New York Times* op ed by Paul Krugman, 6 February 2015

Fed vs ECB: Inflation



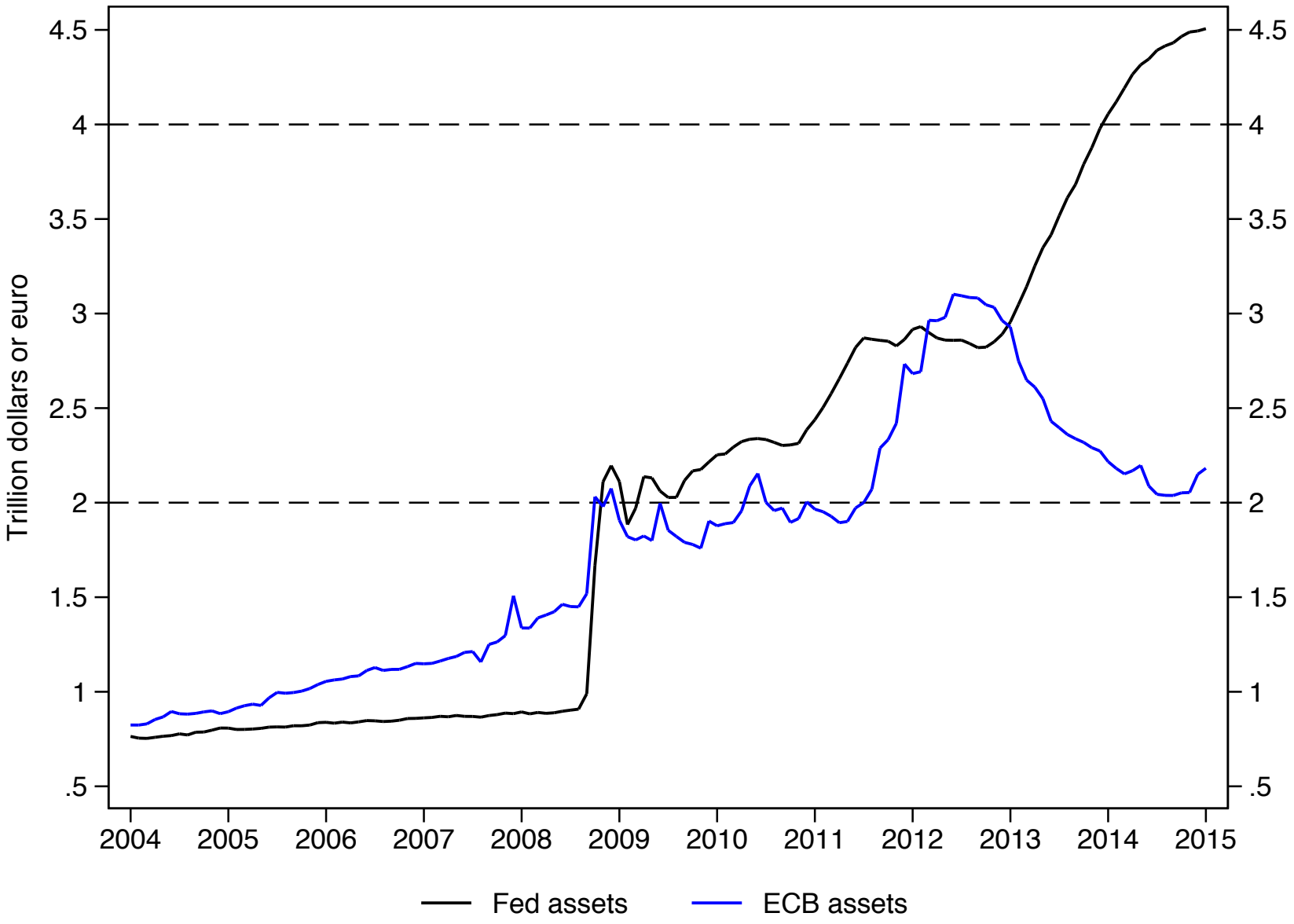
Fed vs ECB: Overnight interest rate



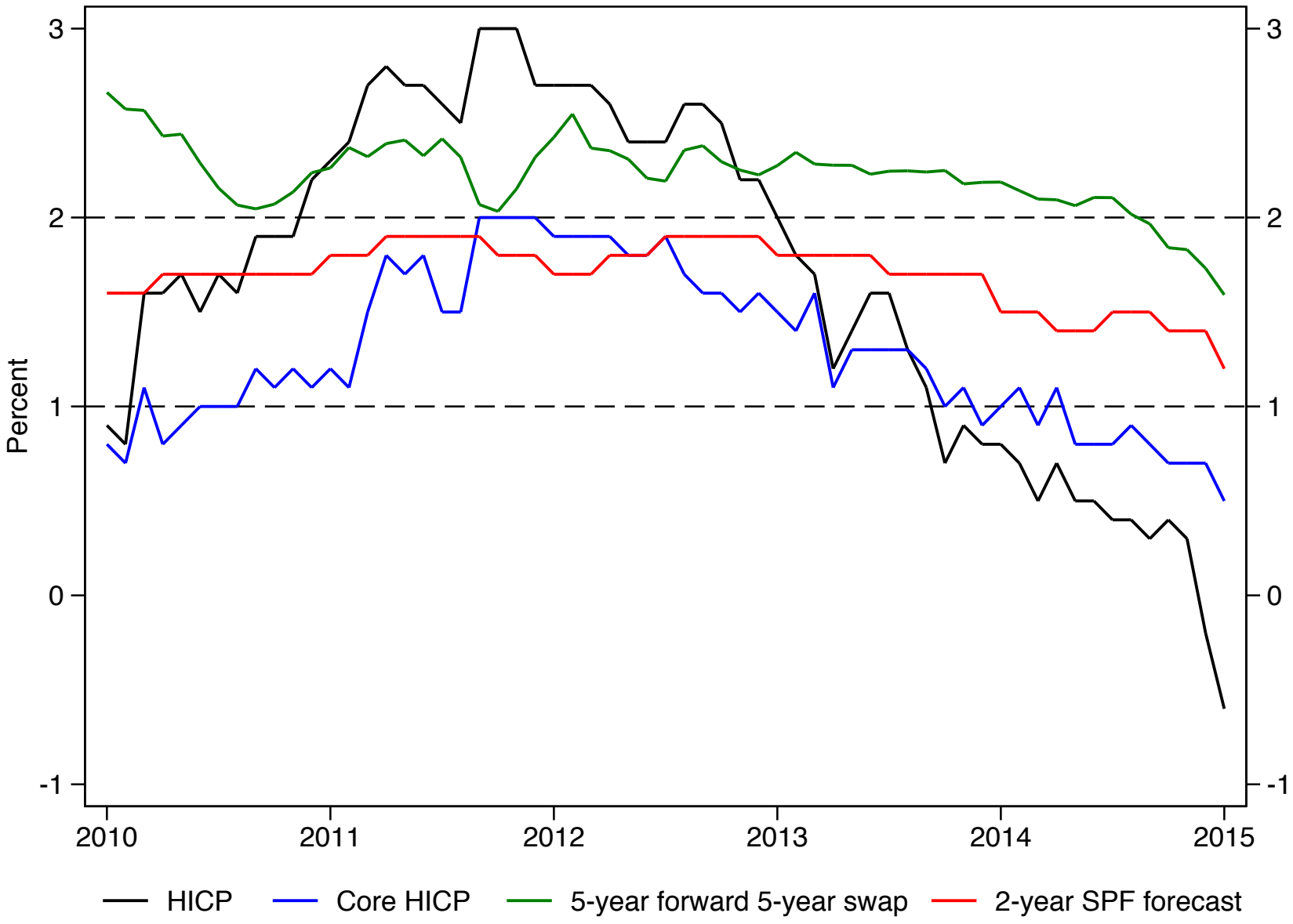
At the zero bound?

- The stance of monetary policy is no longer well summarized by the nominal interest rate.
- Focus shifts on size and composition of balance sheet.
- Size of balance sheet becomes a useful indicator of the stance of monetary policy.

ECB vs Fed policy: Tightening vs easing



ECB policy: inflation and inflation expectations



Has the ECB been violating its mandate?

Euro area forecasts as published by ECB

	GDP Growth			Inflation		
Forecast Date	2014	2015	2016	2014	2015	2016
Sept. 2013	1.0			1.3		
Dec. 2013	1.1	1.5		1.1	1.3	
Mar. 2014	1.2	1.5	1.8	1.0	1.3	1.5
June 2014	1.0	1.7	1.8	0.7	1.1	1.4
Sept. 2014	0.9	1.6	1.9	0.6	1.1	1.4
Dec. 2014	0.8	1.0	1.5	0.5	0.7	1.3

What is the role of the ECB?

- When is it proper NOT to pursue the indicated monetary policy that best fulfils the ECB's mandate according to the Treaty?
- When should policies be adjusted to appease the government of a specific member state or members of parliament in any specific member state?
- When should policies be adjusted to appease public opinion in any specific member state?

ECB QE: Latest decision

- "[The Governing Council] decided to launch an expanded asset purchase programme, encompassing the existing purchase programmes for asset-backed securities and covered bonds. Under this expanded programme, the combined monthly purchases of public and private sector securities will amount to €60 billion."

- "They are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term."

Joint responsibility for a single monetary policy?

- "With regard to the sharing of hypothetical losses, the Governing Council decided that purchases of securities of European institutions (which will be 12% of the additional asset purchases, and which will be purchased by NCBs) will be subject to loss sharing. The rest of the NCBs additional asset purchases will not be subject to loss sharing."

Where do we stand?

- Misdiagnosis of the problem hinders resolution.
- The status quo remains unstable. The euro, in its current form, is a threat to the European project.
- Once the political nature of the crisis is properly diagnosed, discussion of remedies can take place.
- A realignment of political power is necessary to move forward.
- European institutions would contribute better by focusing on fulfilling their mandates.