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

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Geneva, 17 February 2015
“Talks Collapse as Athens Rejects Bailout Extension.” *Financial Times.*

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


“Greek Rescue Talks Collapse in Acrimony.” *The Guardian.*
Athens: 2015
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
“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
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 differentials 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 member 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

![Graph showing Real GDP over time from 1998 to 2016. The x-axis represents years from 1998 to 2016, and the y-axis represents Billion 2005 euro. The graph shows a general trend of increasing GDP from 140 billion in 1998 to 220 billion in 2010, followed by a slight decline and then a steady increase towards 2016.](image-url)
May 2010 program: Unemployment
Outcome: Deficit to GDP ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent of GDP</th>
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<tbody>
<tr>
<td>1998</td>
<td>-16</td>
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<tr>
<td>2000</td>
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<td>2014</td>
<td>0</td>
</tr>
<tr>
<td>2016</td>
<td>2</td>
</tr>
</tbody>
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Graph showing the deficit to GDP ratio from 1998 to 2016.
Outcome: Unemployment
Outcome: Real GDP

![Chart showing real GDP from 1998 to 2016, with peaks in 2007 and 2008, and a decline thereafter.]
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

![Graph comparing inflation rates between the United States (PCE) and the Euro area (HICP) from 2000 to 2014. The graph shows fluctuations in inflation rates, with the United States (PCE) line generally staying above the 2% mark, while the Euro area (HICP) line shows more variability, with a sharp drop around 2008.]
Fed vs ECB: Overnight interest rate

- United States (Federal funds rate)
- Euro area (Eonia rate)
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

Trillion dollars or euro

Fed assets
ECB assets
ECB policy: inflation and inflation expectations

![Chart showing ECB policy: inflation and inflation expectations](chart.png)
Has the ECB been violating its mandate?

<table>
<thead>
<tr>
<th>Forecast Date</th>
<th>GDP Growth</th>
<th>Inflation</th>
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<tbody>
<tr>
<td>Sept. 2013</td>
<td>1.0</td>
<td></td>
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<tr>
<td>Dec. 2013</td>
<td>1.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Mar. 2014</td>
<td>1.2</td>
<td>1.5</td>
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<tr>
<td>June 2014</td>
<td>1.0</td>
<td>1.7</td>
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<tr>
<td>Sept. 2014</td>
<td>0.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Dec. 2014</td>
<td>0.8</td>
<td>1.0</td>
</tr>
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</table>
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?
“[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.”
“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.