

FUTURE OF THE EURO

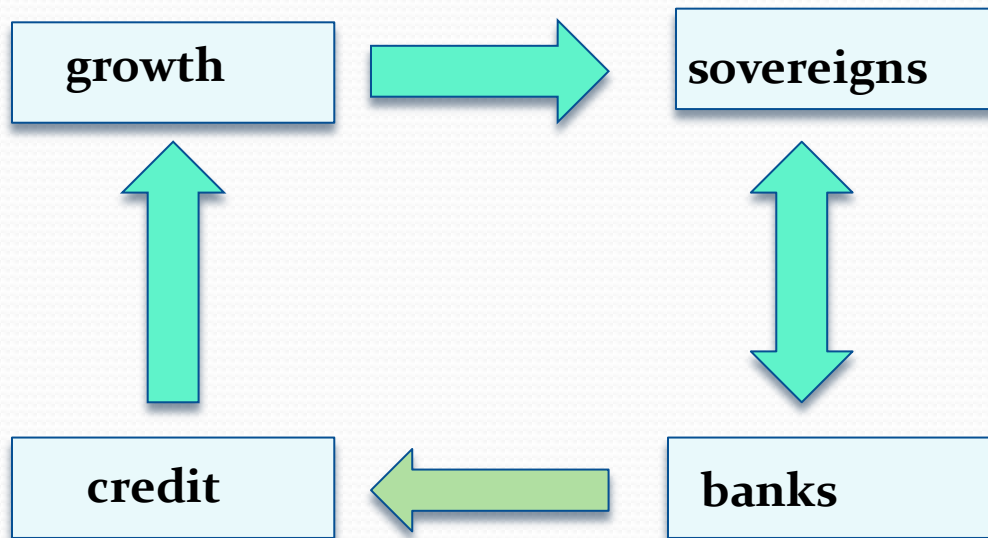
October 2012

Jean-Pierre Landau

a financial crisis

- **initial shock**
 - *usually small when compared to ultimate consequences*
 - *total Greek public debt < 1.5% of euro area GDP*
- **amplification mechanisms**
- **possibly aggravated by misguided policy responses**
- **revealing underlying vulnerabilities**

feedback loop



we did not see that : the link between sovereigns and banks

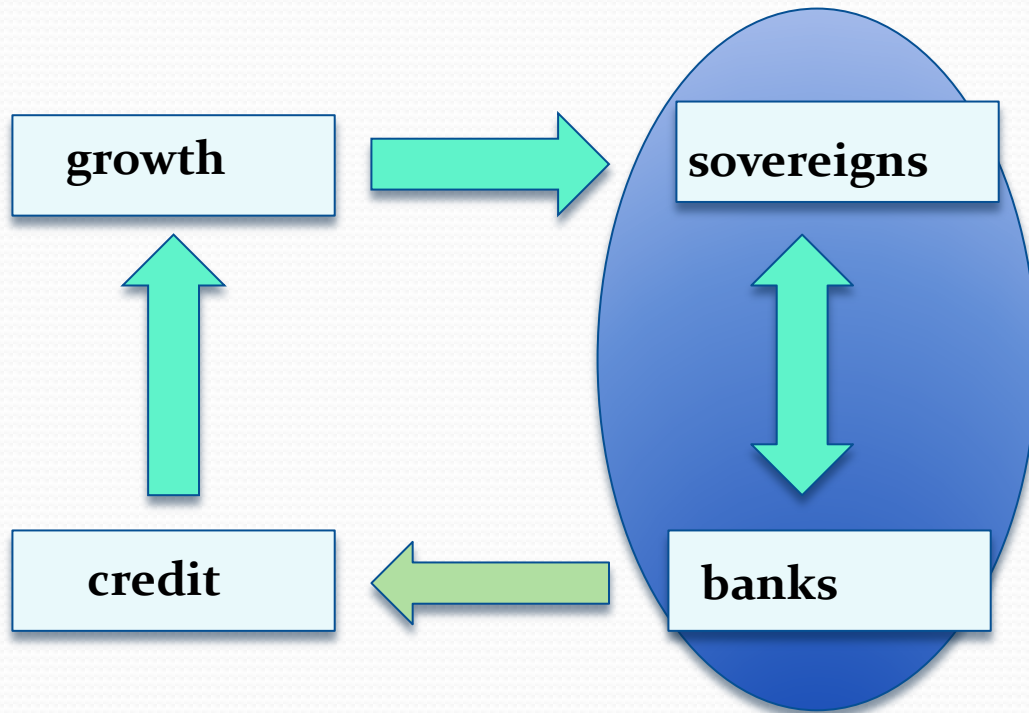
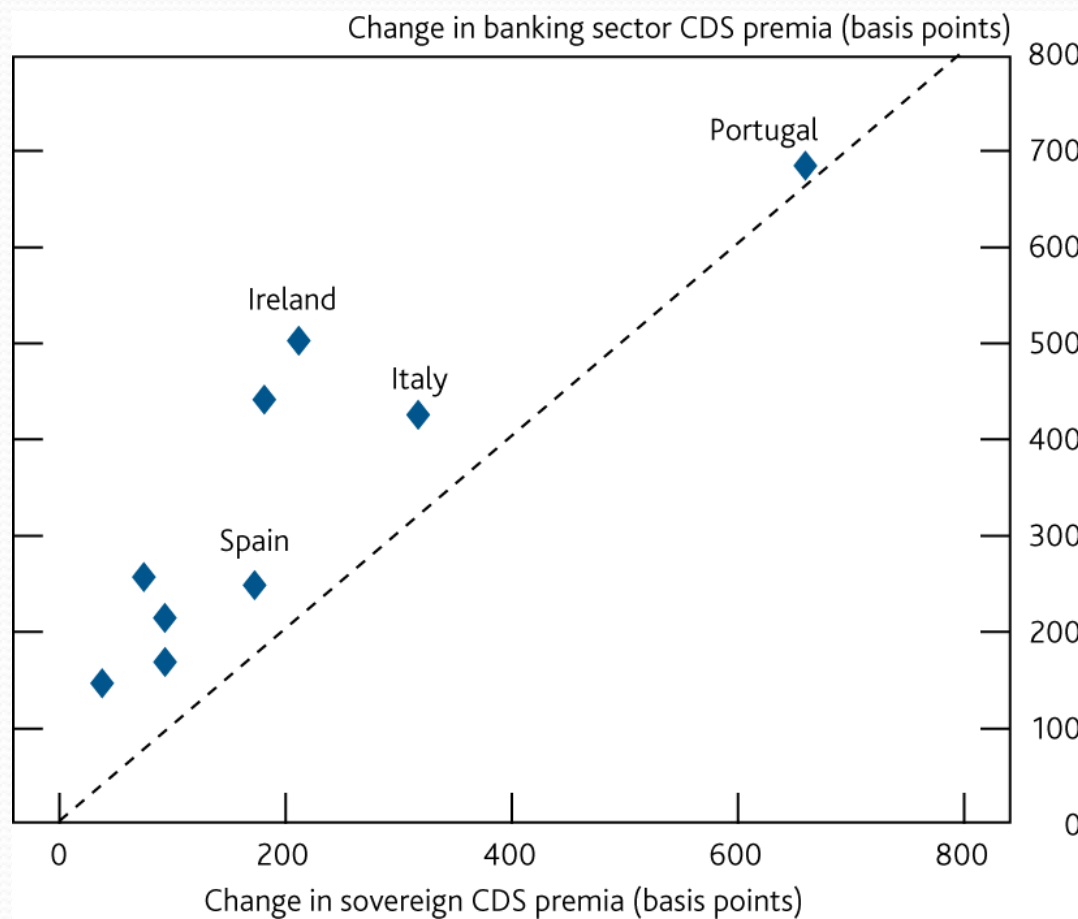
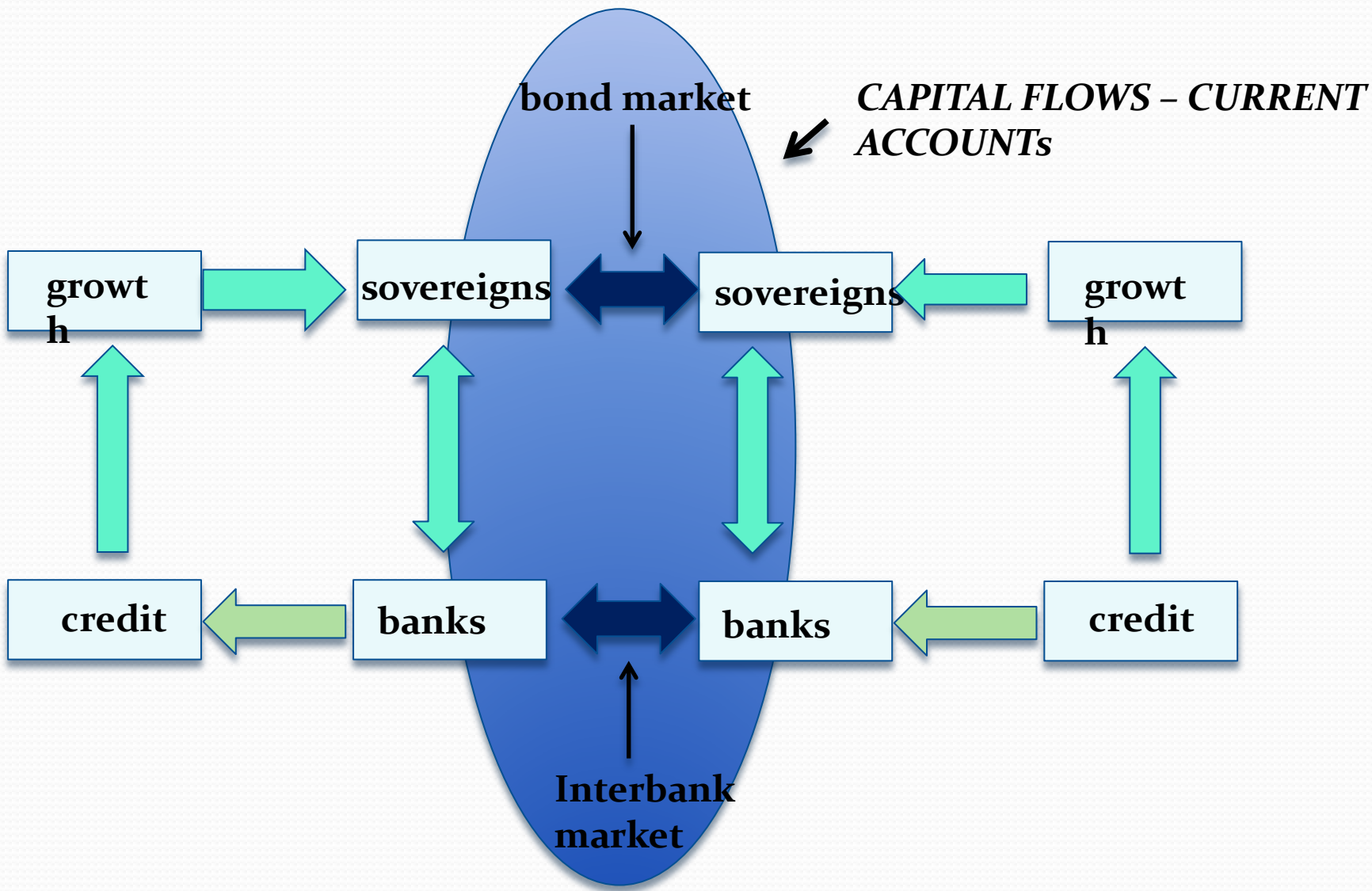


Chart 5.2 Changes in sovereign and banking sector CDS premia^{(a)(b)(c)(d)}





the illusion of perfect financial integration

- capital flows from 'North' to 'South' seen as an engine of convergence
- implicit assumption: cross border same credit risk than domestic
 - All banks are (equally) backed by the sovereign
 - All sovereigns back each other (ignorance of the “no bail out”)
- Shock on Sovereign : Greece + contagion + “wake up call”

financial integration conducive to credit bubbles

Euro Area Household Debt Ratios

Percentage of Disposable Income

	1999	2007	Change
Greece ^a	26	75	49
Ireland ^b	113	205	93
Portugal	95	143	48
Spain	66	118	52
Germany	107	95	-12

Memo:

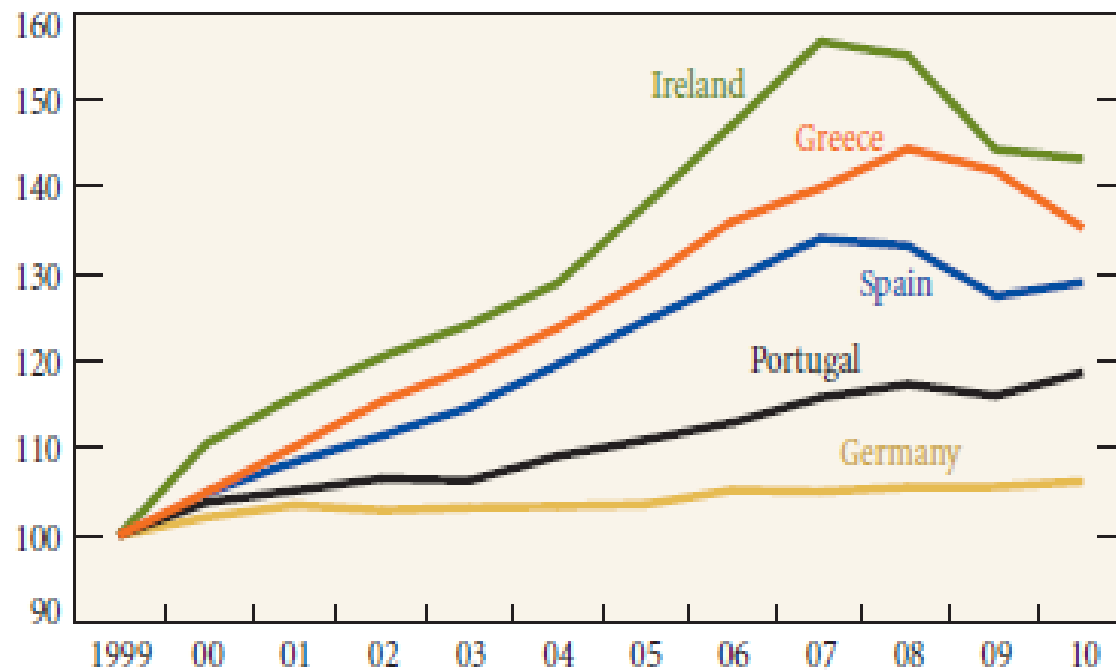
United States	88	122	33
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source : Higgins and Klitgaard

Chart 5

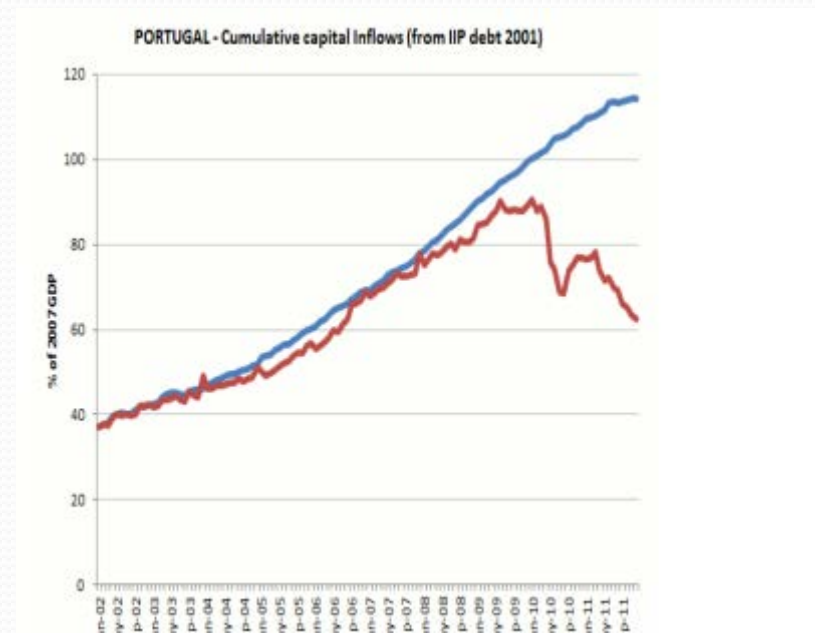
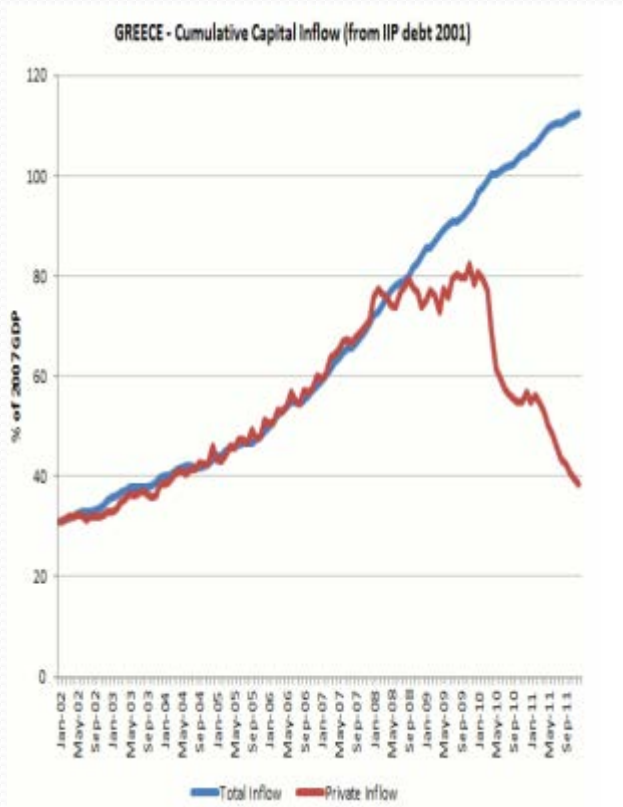
Private Real Consumption Spending

Index: 1999 = 100



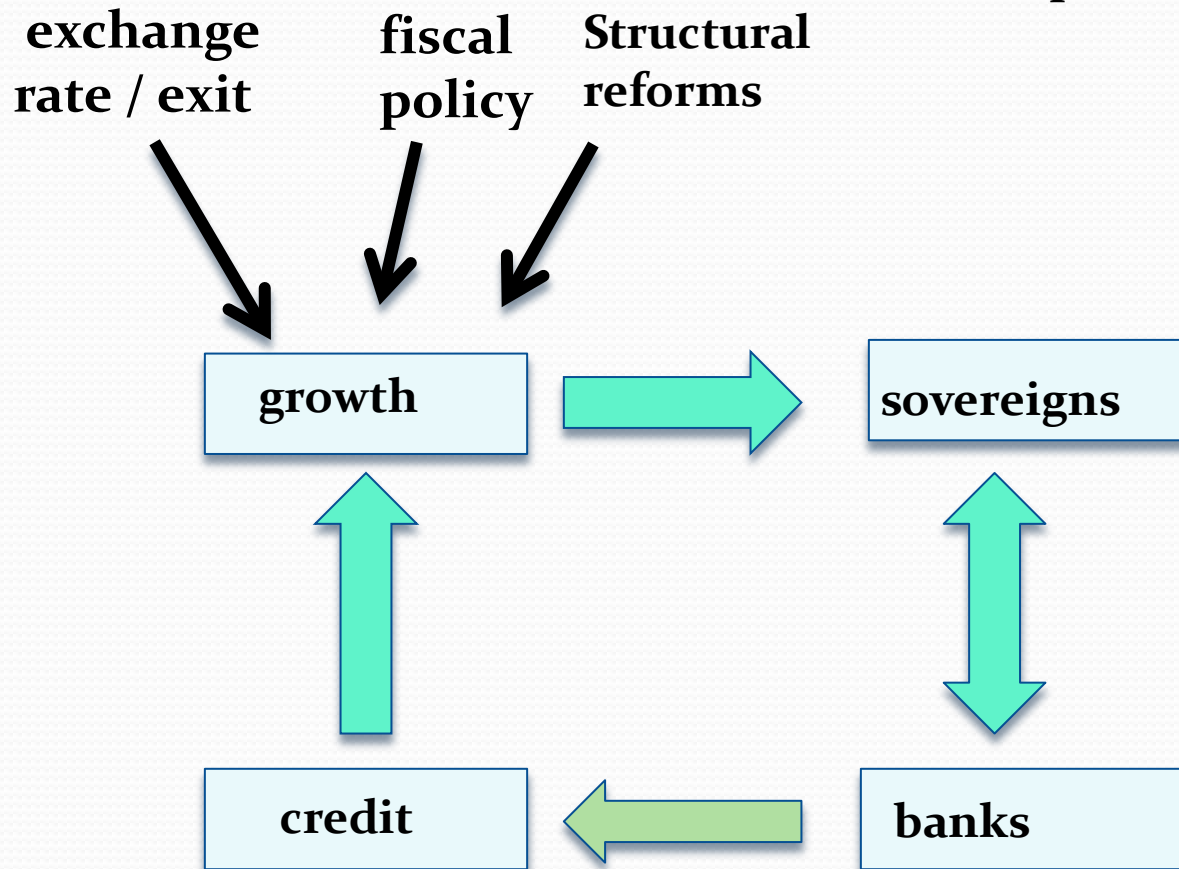
source : Higgins and Klitgaard

the crisis : a collapse of cross border financial intermediation

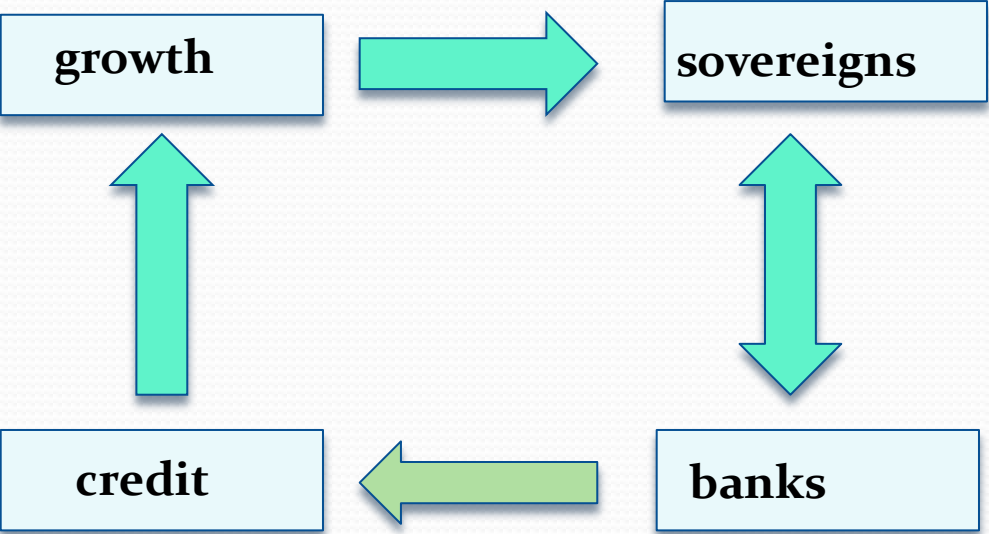


source : Merler and Pisani Ferry

stopping the feedback loop (1)

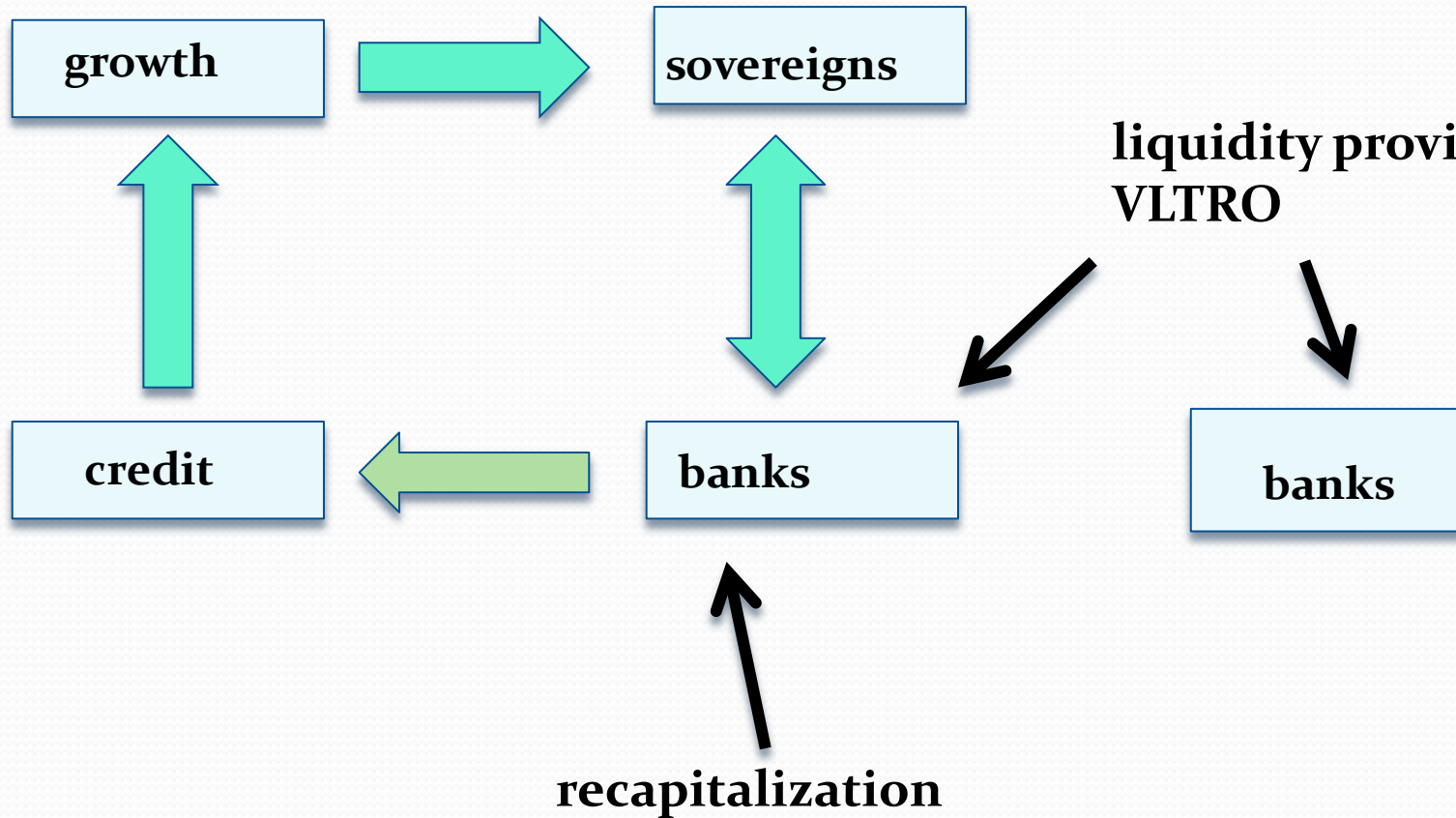


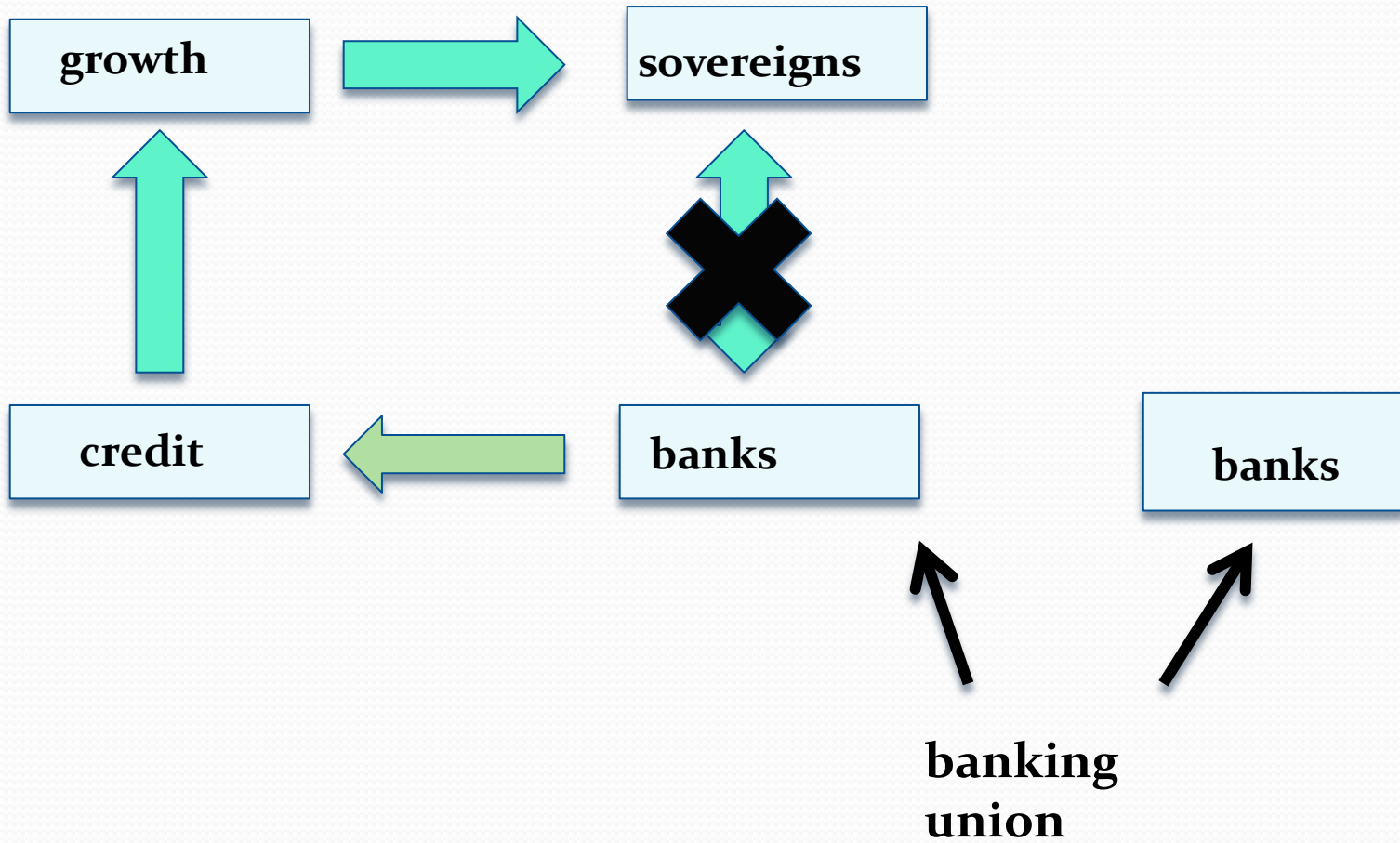
stopping the feedback loop (2)



recapitalization

stopping the feedback loop (3)

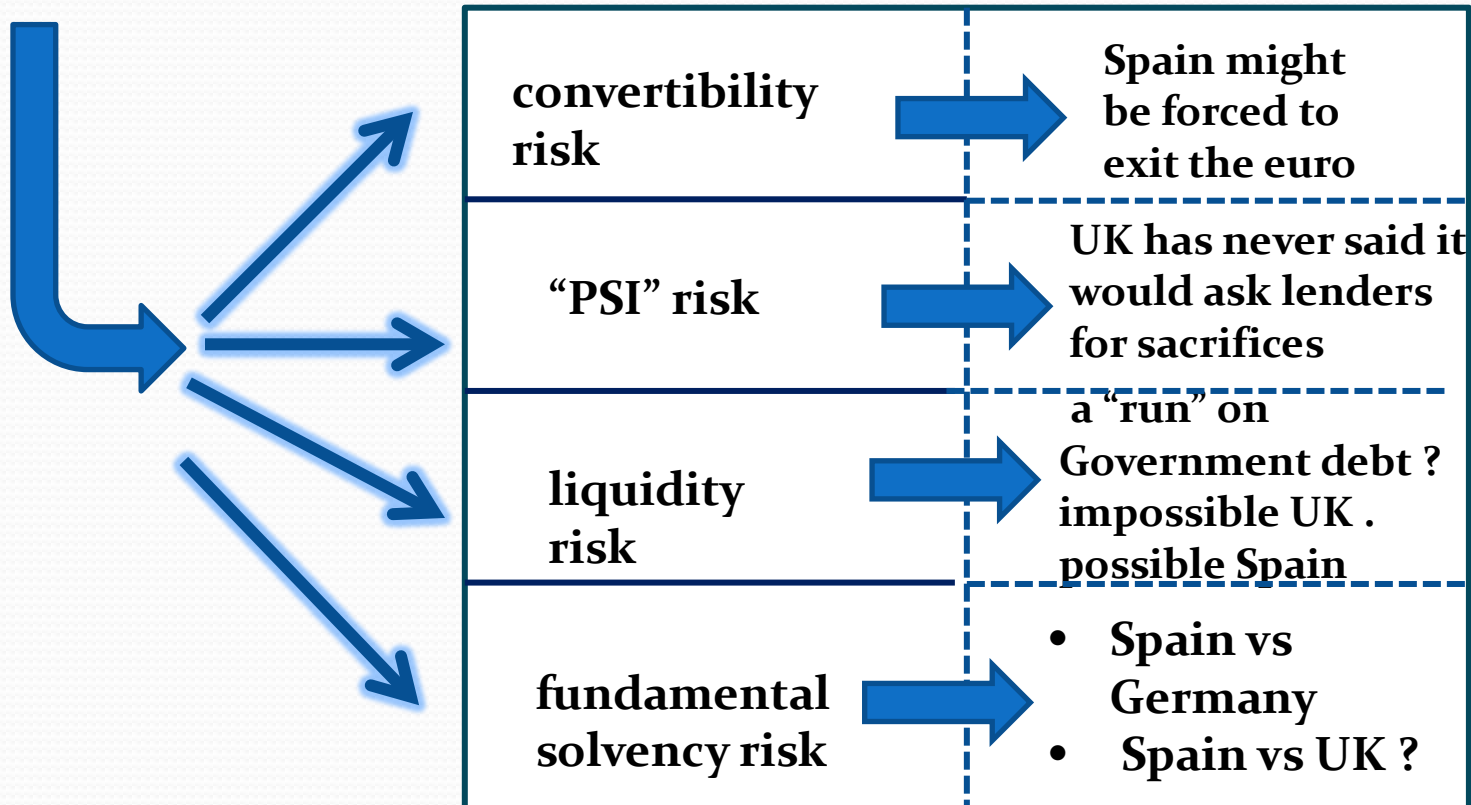




**stopping the
feedback loop (4) :
the Sovereigns**

	10 year yield (Oct 3)
Spain	5.75
Germany	1.44
UK	1.69

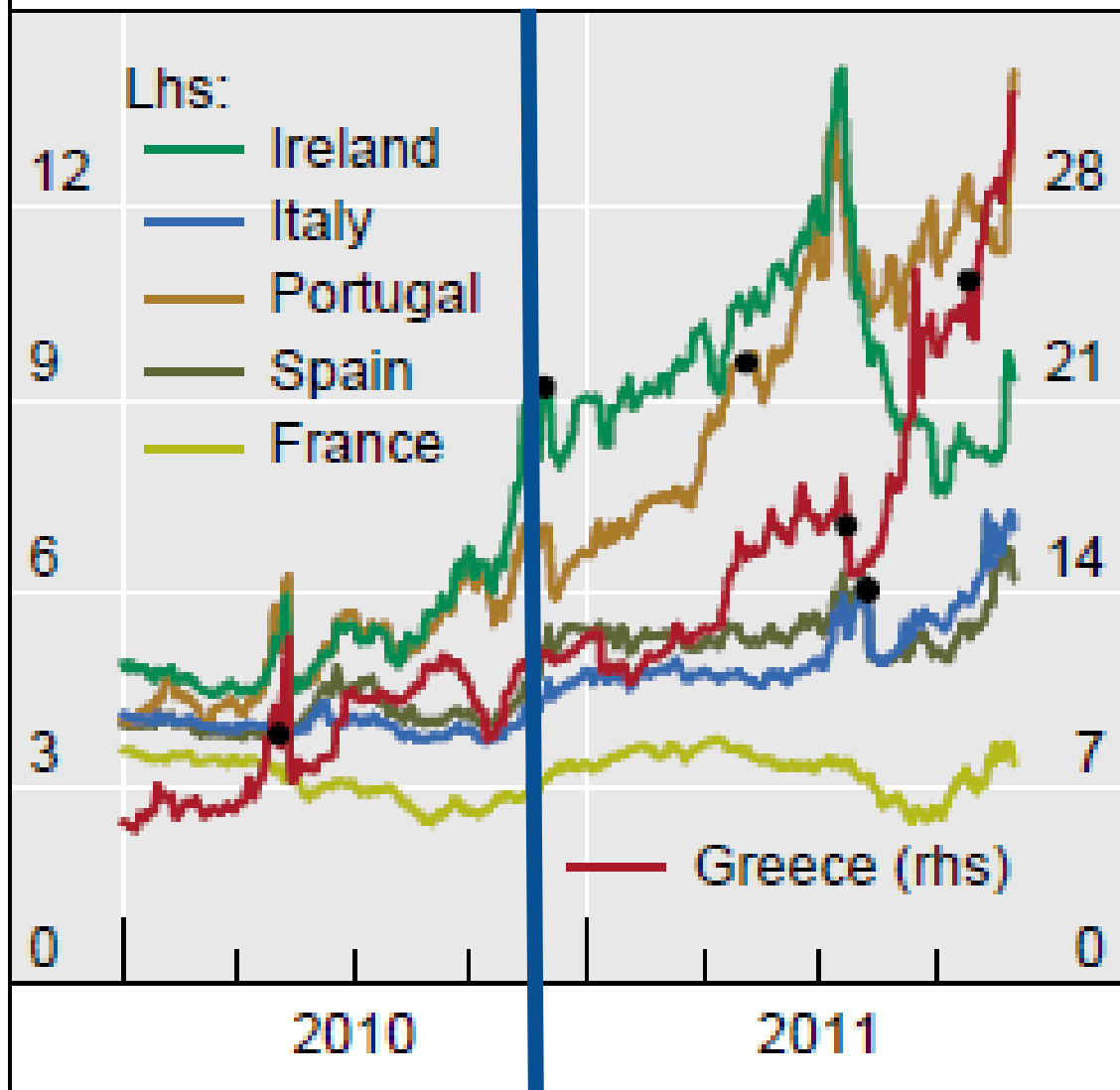
	10 year yield (Oct 3)
Spain	5.75
Germany	1.44
UK	1.69



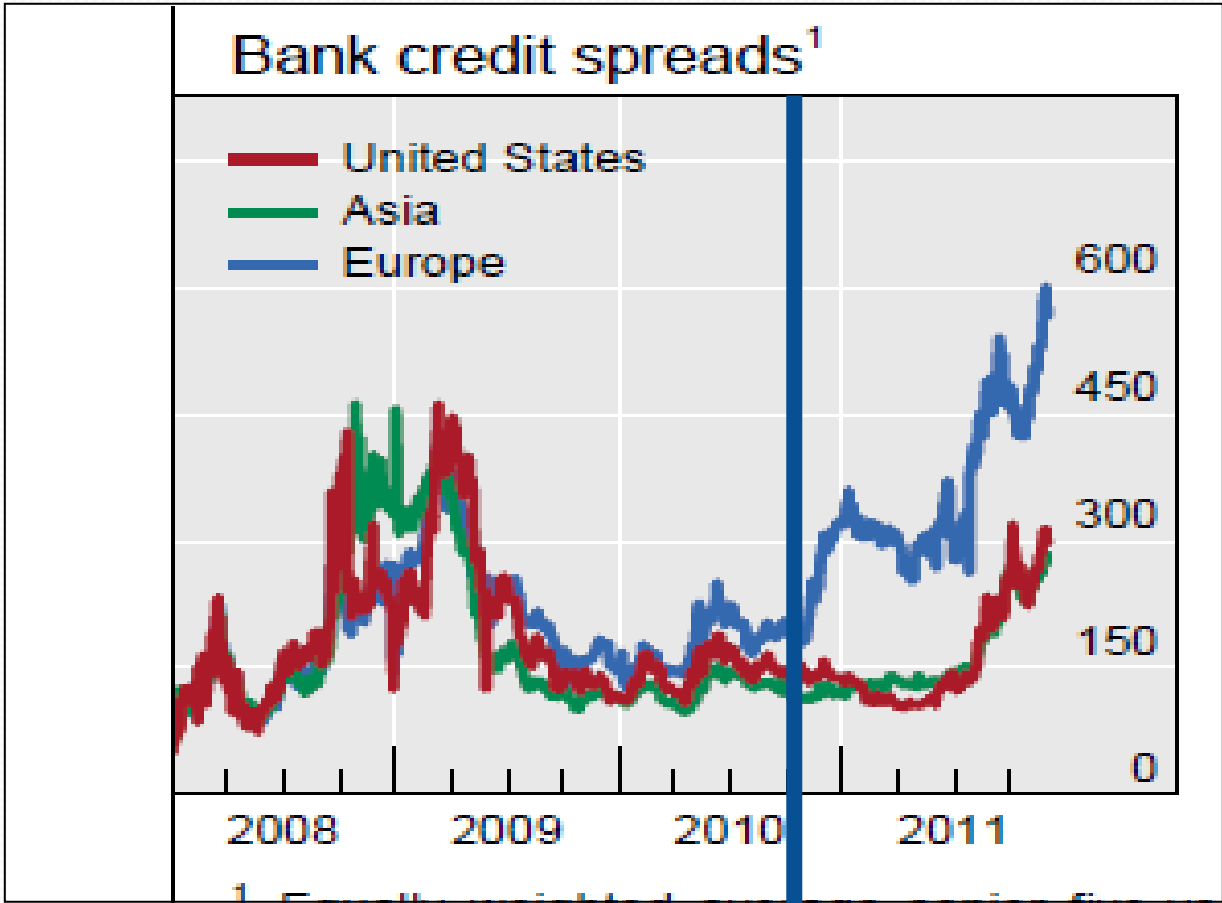
	10 year yield (Oct 3)
Spain	5.75
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Bond yields¹



Deauville : agreement on PSI



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private sector involvement (PSI) : good policy or bad mistake?

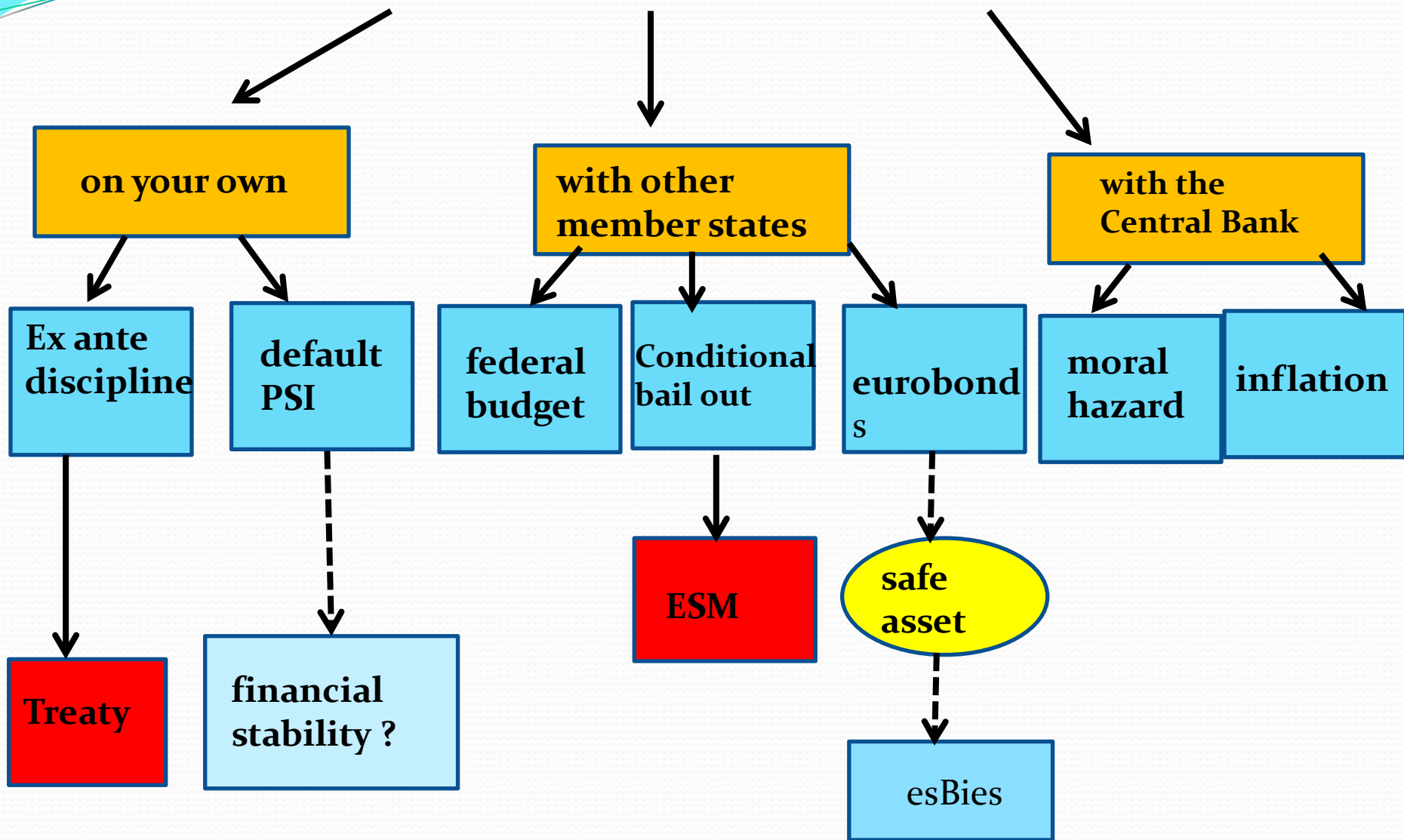
Benefits

- **eliminate moral hazard**
- **reestablish market discipline on sovereigns**

Costs

- **credit risk on OECD sovereign debt**
- **doubts on OECD sovereigns willingness to pay**
- **solvency - liquidity spirals**
- **loss of store of value**

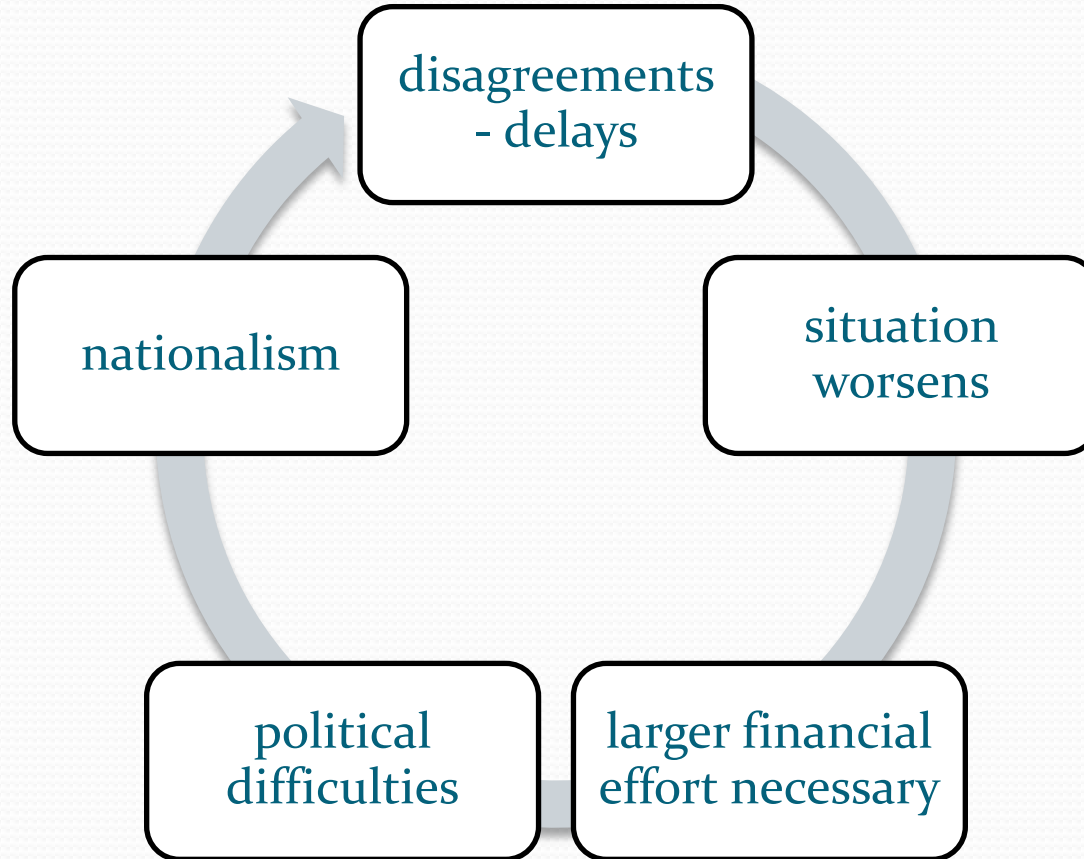
how do you absorb a fiscal shock ?



agenda

- banking union
 - *delink sovereign and bank risks*
 - *ensure stability of intra euro capital flows*
- redefine relationships between sovereigns
 - *Discipline – Treaty*
 - *ESM*

political feedback loop



conclusion : the misguided search for clarity

- “extreme” scenarios unlikely
 - *No miraculous agreement on fundamental issues*
 - *No fiscal federalism*
 - *No break up - ECB won't allow it*
- Long period of “muddle through “
- a LT question of “ fiscal dominance “ (id US)

references

- **Saving Imbalances and the Euro Area Sovereign Debt Crisis** (Higgins and Klitgaard). Current Issues in Economics and Finance. Vol 17 no 5 . Federal Reserve Bank of New York
- **The future of public debt: prospects and implications** (Cecchetti, Mohanty and Zampolli) BIS Working Paper No 300
- **Sudden stops in the Eurozone** (Merler and Pisani-Ferry) VOE EU March 2012