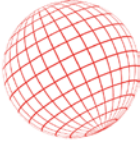


The eurozone: now what?

Lucrezia Reichlin
London Business School & Now-Casting Economics Ltd

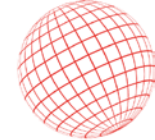
Hutchins Center
January 16th 2015 Washington



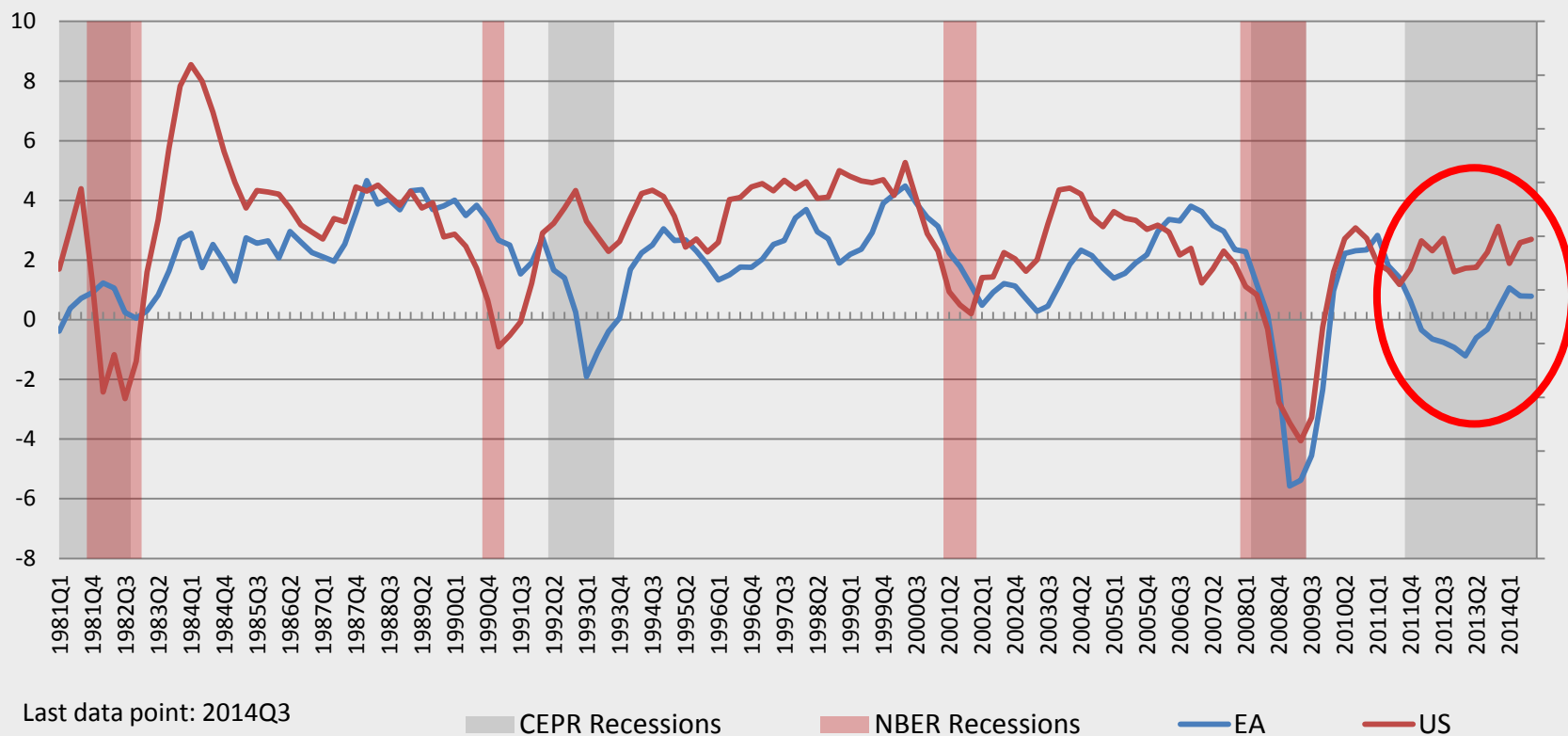


THE EURO-ZONE: THE RECENT PAST

The US and the euro area GDP growth: decoupling since 2011



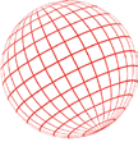
Real GDP YoY



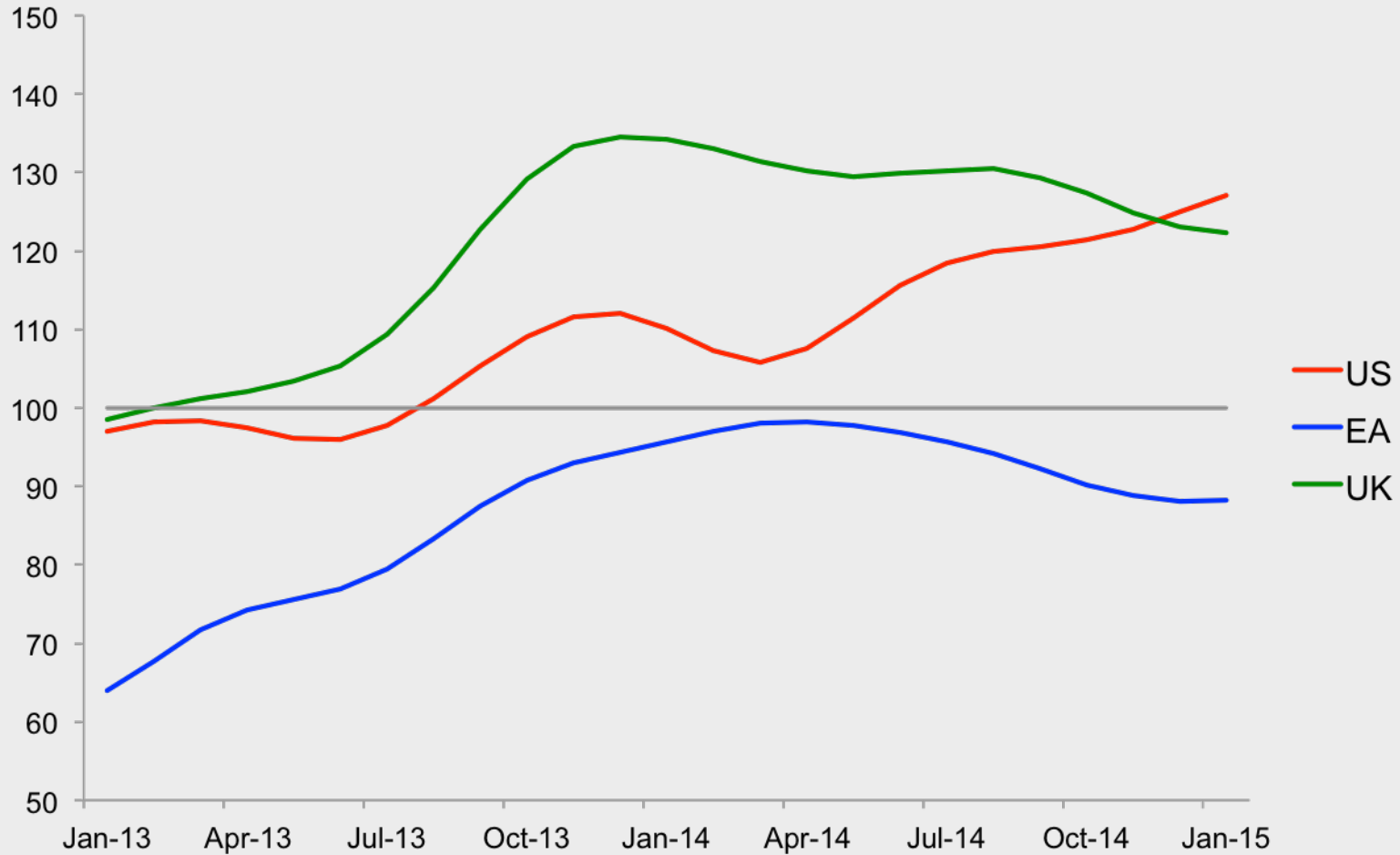
Last data point: 2014Q3
Sources: OECD, EAWM

Now-Casting Index (NCI™)

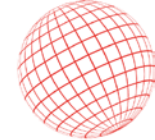
New euro area slowdown since early 2014



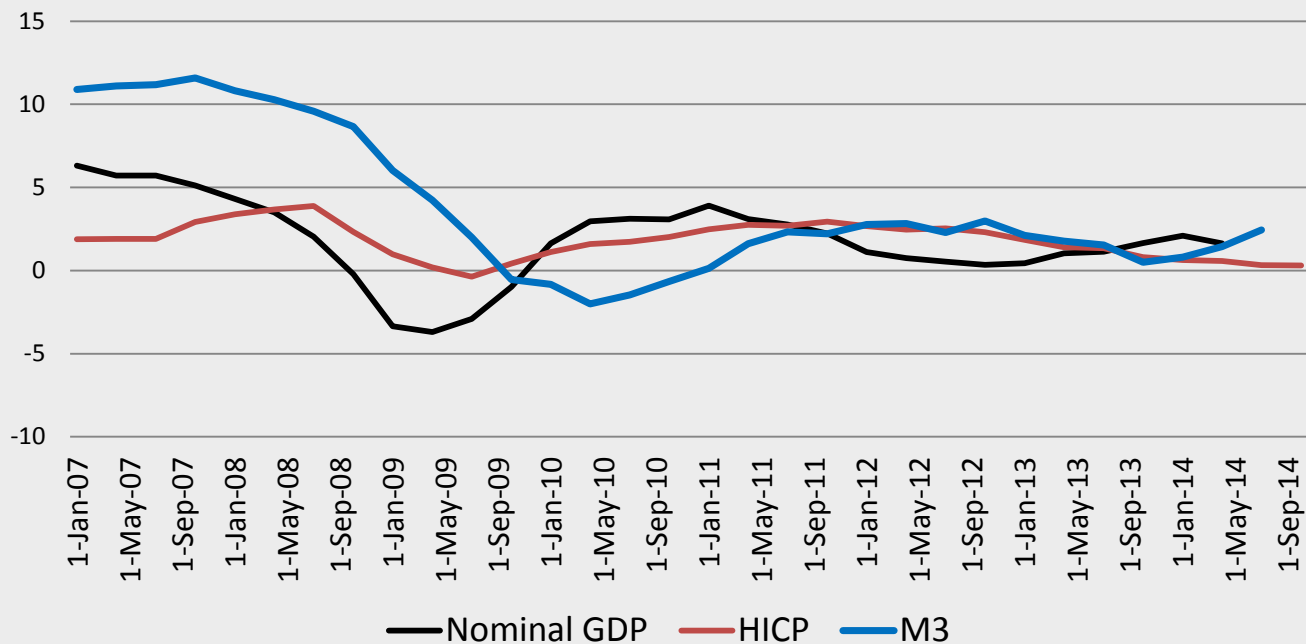
Now-Casting.com
economics in real time



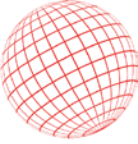
Nominal GDP, M3 and HICP



YoY growth rates

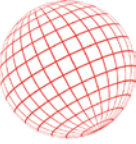


Three explanations for the cyclical decoupling of the euro area with respect to the UK and the US



1. Monetary policy – the ECB has been late to recognize and respond to deflationary pressures
2. Pro-cyclical fiscal policy (motivated by the need of fiscal consolidation) :
 - it has weighted on demand
 - it has been self-defeating
3. Debt overhang will continue to weigh on the recovery

THE THREE PROBLEMS ARE RELATED

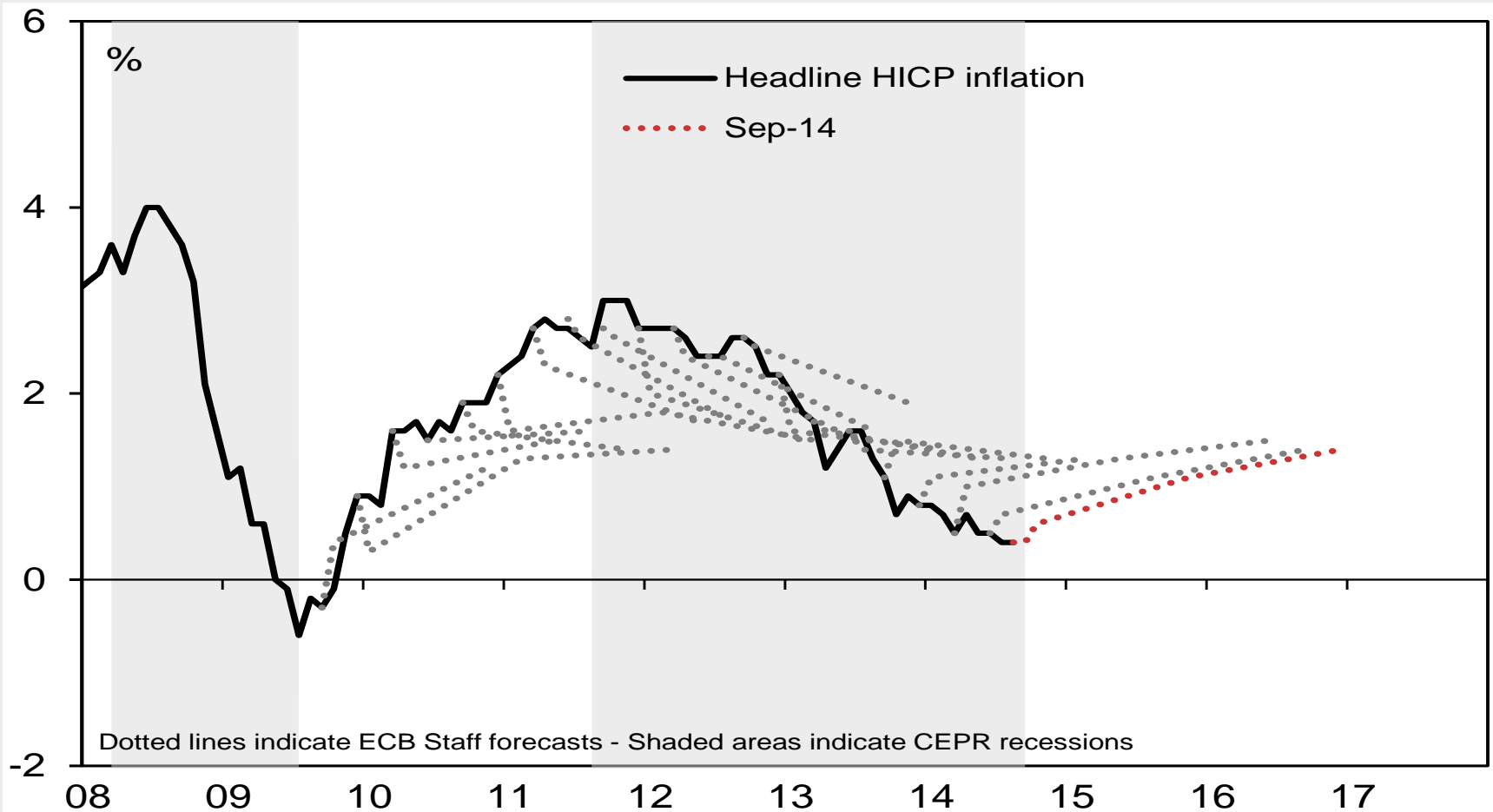
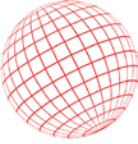


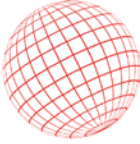
1. Monetary policy

- ECB late in recognizing threat of deflation
- Zero lower bound since 2011
- TLTRO not the right tool at this juncture

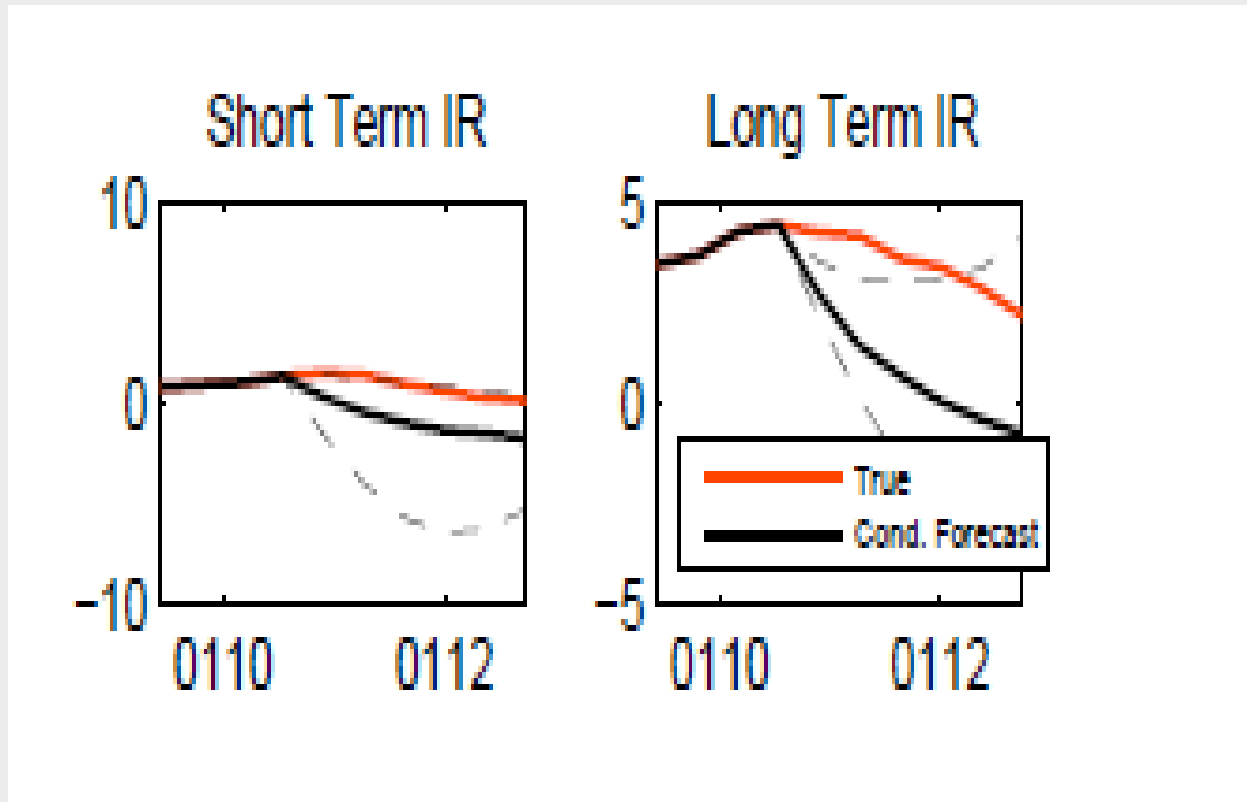
Inflation and inflation expectations

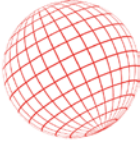
ECB projections



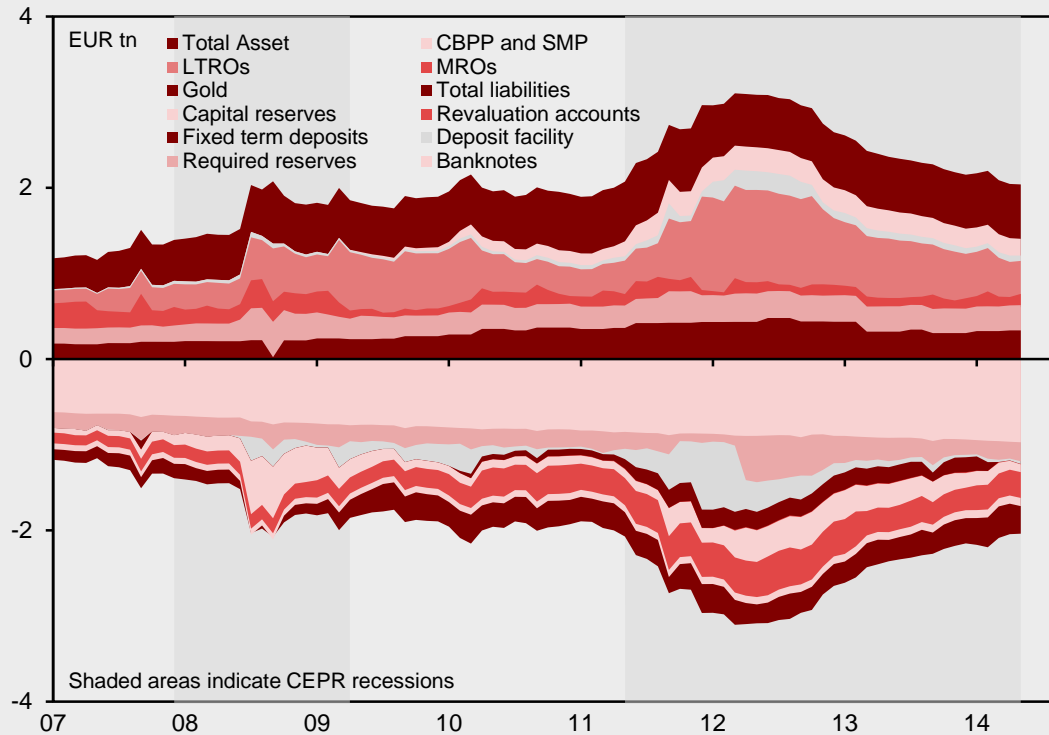


Zero lower bound and risk premia





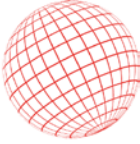
Euro-system balance sheet



Source: ECB, Haver Analytics, Goldman Sachs Global Investment Research

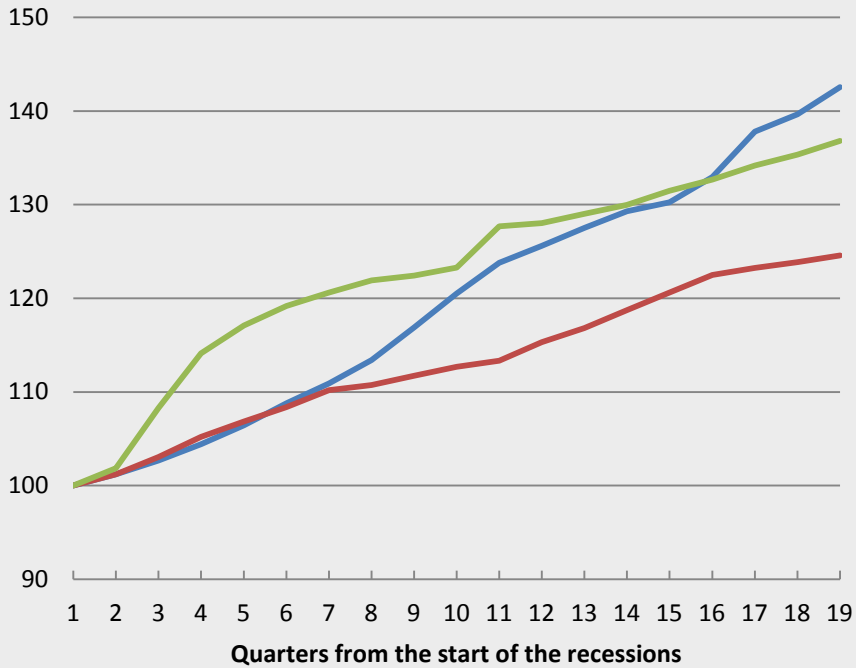
2. Fiscal policy

Three recessions compared



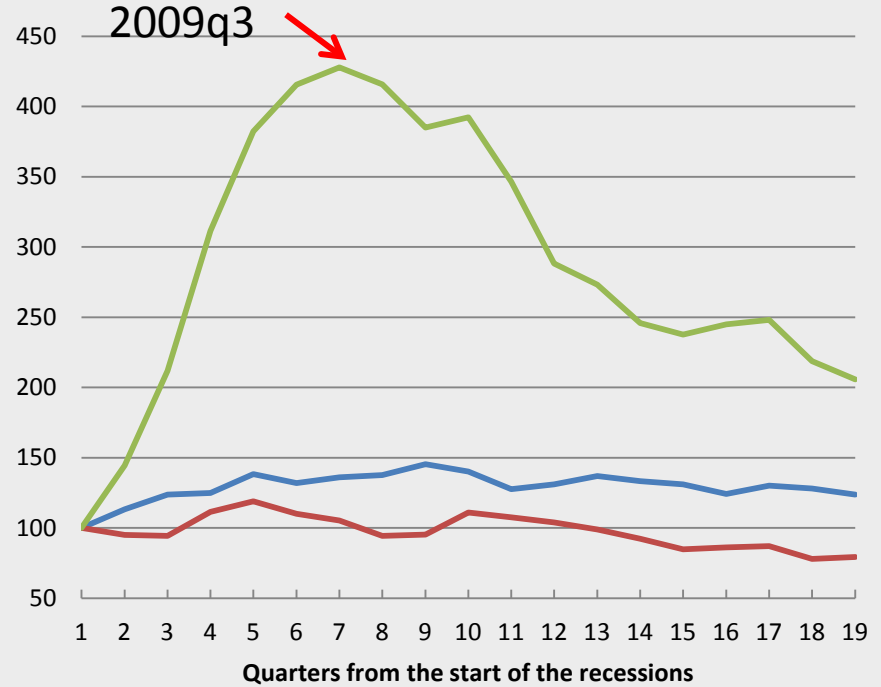
LARGE INCOME SHOCK WITH GLOBAL RECESSION
HUGE DELEVERAGING SINCE 2009q3

Gov. Debt/GDP, index (recession start=100)



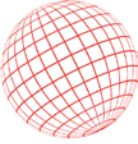
— 1980-82 — 1991 — 2008-2012

Gov. Deficit/GDP, index (recession start=100)



— 1980-82 — 1991 — 2008-2012

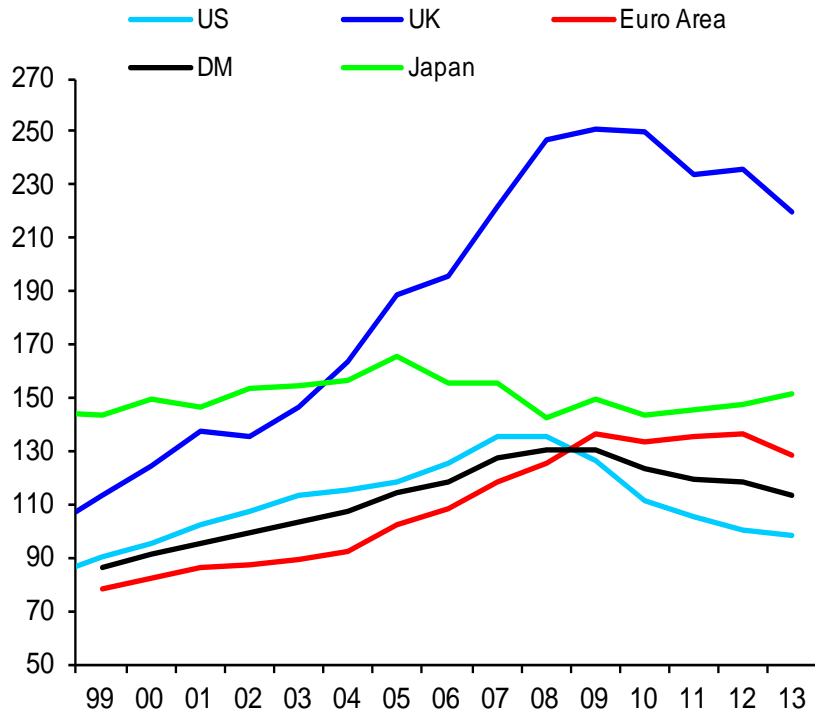
3. Debt overhang



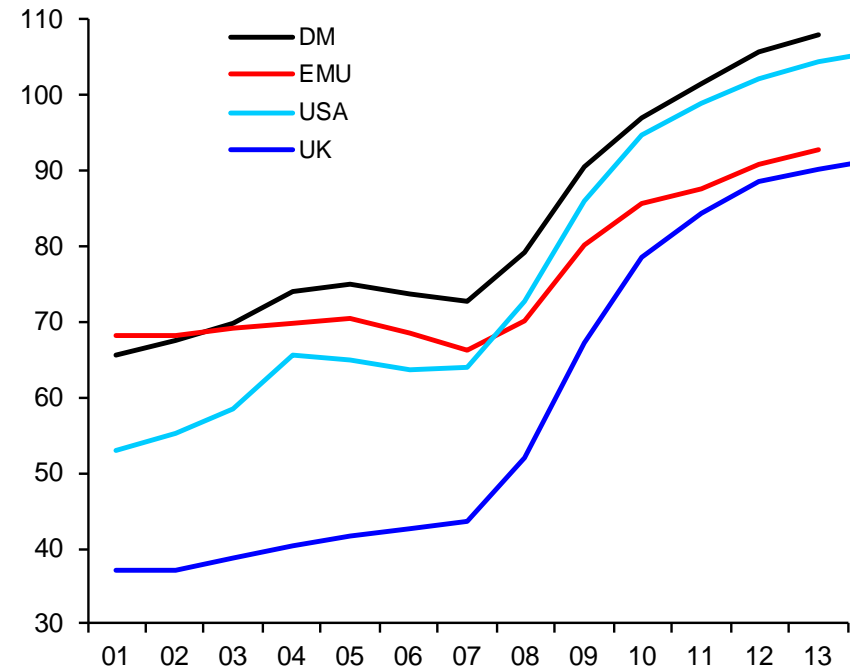
i. Adjustment in the financial sector only started in 2013 while public debt is still increasing

ii. Public sector debt to GDP ratio lower than in other DMs but not stabilized
Ultimately a redistribution problem

Private debt - Financials (% of GDP)



Public Debt (% of GDP)

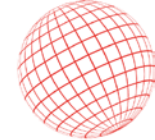


Source: Authors' calculation based on OECD, IMF and national accounts data. See Data Appendix at the end of the report.

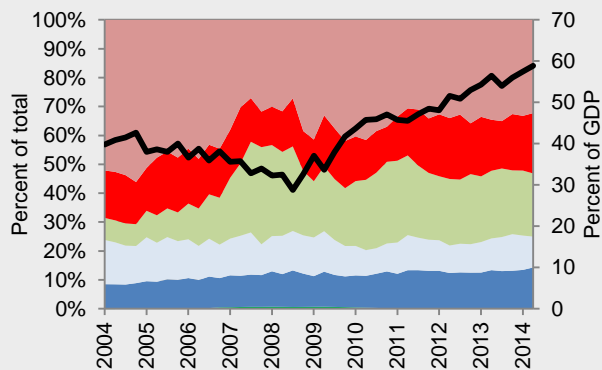
Note: DM = developed markets; EM = emerging markets; EMU = Eurozone .

Debt (public) overhang

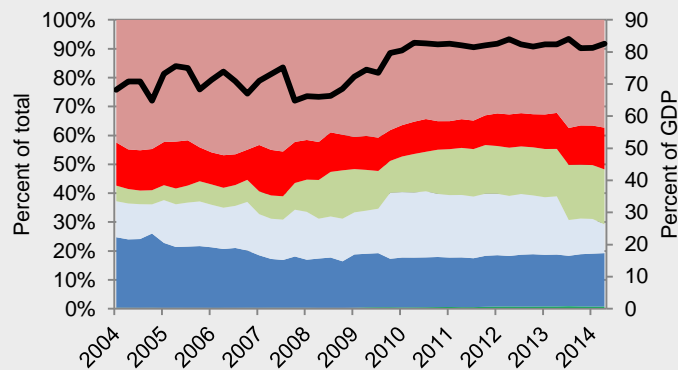
CORE COUNTRIES



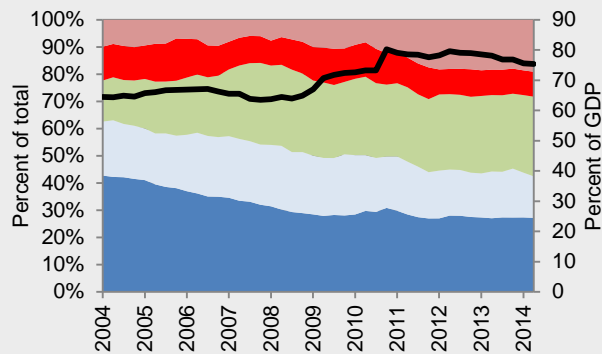
Finland



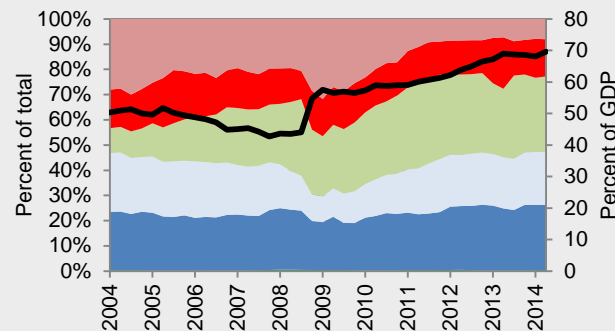
Austria



Germany



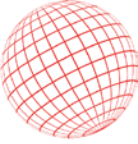
Netherlands



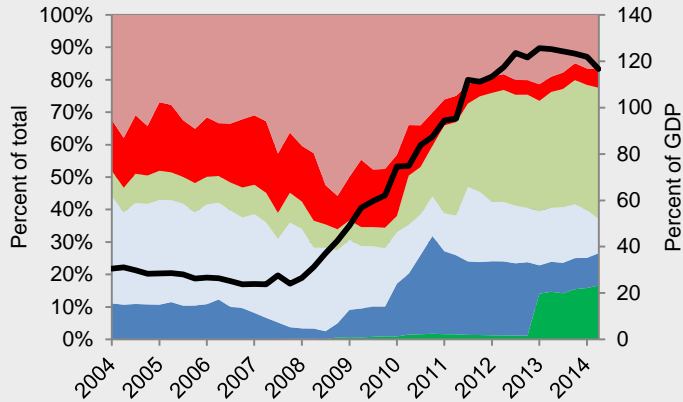
■ Domestic central bank
 ■ Domestic bank
 ■ Domestic nonbank
 ■ Foreign official sector
■ Foreign bank
 ■ Foreign nonbank
 — Total debt (rhs)

Debt (public) overhang

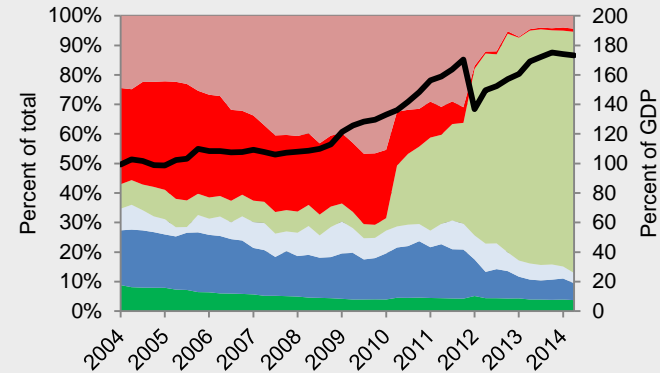
PROGRAMME COUNTRIES



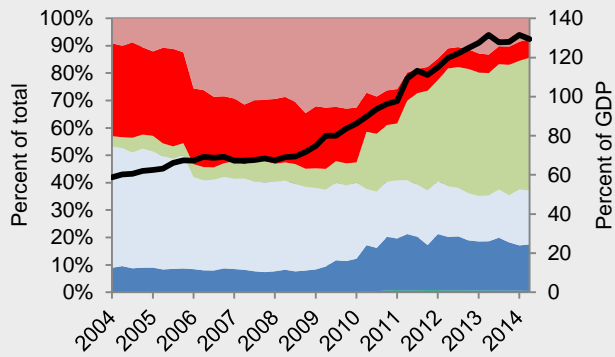
Ireland



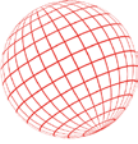
Greece



Portugal



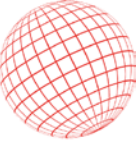
■ Domestic central bank
 ■ Domestic bank
 ■ Domestic nonbank
 ■ Foreign official sector
■ Foreign bank
 ■ Foreign nonbank
 — Total debt (rhs)



The three issues have to be analyzed jointly

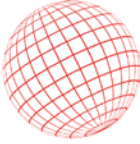
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1. Delayed ECB action (QE) explained by concerns about moral hazard in a situation in which some sovereigns may be considered insolvent
2. Pro-cyclical fiscal policy motivated by same concerns
3. Debt overhang induces deleveraging which would require an aggressive response in fiscal and monetary policy but that cannot be implemented because of concerns on moral hazard and distribution of credit risk

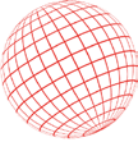


What is next?

- Very little action on the fiscal front and on debt overhang is to be expected although a change in the Treaty may be in the cards in the future
- The ECB is now ready to act on monetary policy but lack of action on the other two fronts is problematic



THE ECB NEXT MOVE – WHAT IS AT STAKE?

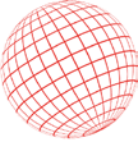


General issue

- QE in a monetary union without common budgetary authority is a unique experiment

Issue: complex relation between fiscal and monetary aspects - distribution of credit risk and risk sharing

- Must be understood in the context of the leverage situation and credibility of public debt consolidation policies at national level (...)
- If the ECB ends up buying a large proportion of government debt and assuming sovereign/credit risk in its balance sheet, threat of restructuring will be eliminated and so will market discipline
- QE would effectively mean the ECB is insuring the private sector from sovereign risk.



The paradox of the Treaty

In principle the rationale of QE is purely a monetary policy one (inflation objective) but ECB must deal with a paradox:

- On one hand, in order to limit the redistributive effects of monetary policy the Treaty has rules to impose legal restrictions on the ability of central banks to assume or finance fiscal functions and, via the 'no bail out' clause, limits cross-country sharing of fiscal risks within the union
- On the other hand, when pressured, the ECB is called to defend the common currency and it has done so by preventing exit or default. Knowing that the ECB will ultimately defend the euro, the market will expect that debt is implicitly guaranteed by ECB. Hence governments have an incentive to free-ride on the central bank

Therefore for any QE program not to be a pure monetary financing operation, it is crucial to design a plan which will have the double objective of not killing all market incentives while providing forceful monetary stimulus

The current policy discussion tradeoff: size and decentralization

- Go for large program (≥ 1 trillion), possibly weighting by GDP (capital key) or even market cap but decentralize risk to b/s national central banks
- Go for small program (≈ 500 bn), either triple A only or possibly GDP weighted and share risk

Program must be large to convince the market, but given concerns on credit risk by creditor countries, the price of a large program will have to be decentralization of risk with uncertain effect on yields of peripheral bonds

Many intermediate options are on the table

RISKS of decentralization: further balkanization of financial markets

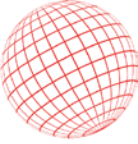
Especially if stagnation and undershooting of inflation target continues raising debt sustainability concerns

One of the lessons of the crisis has been that:

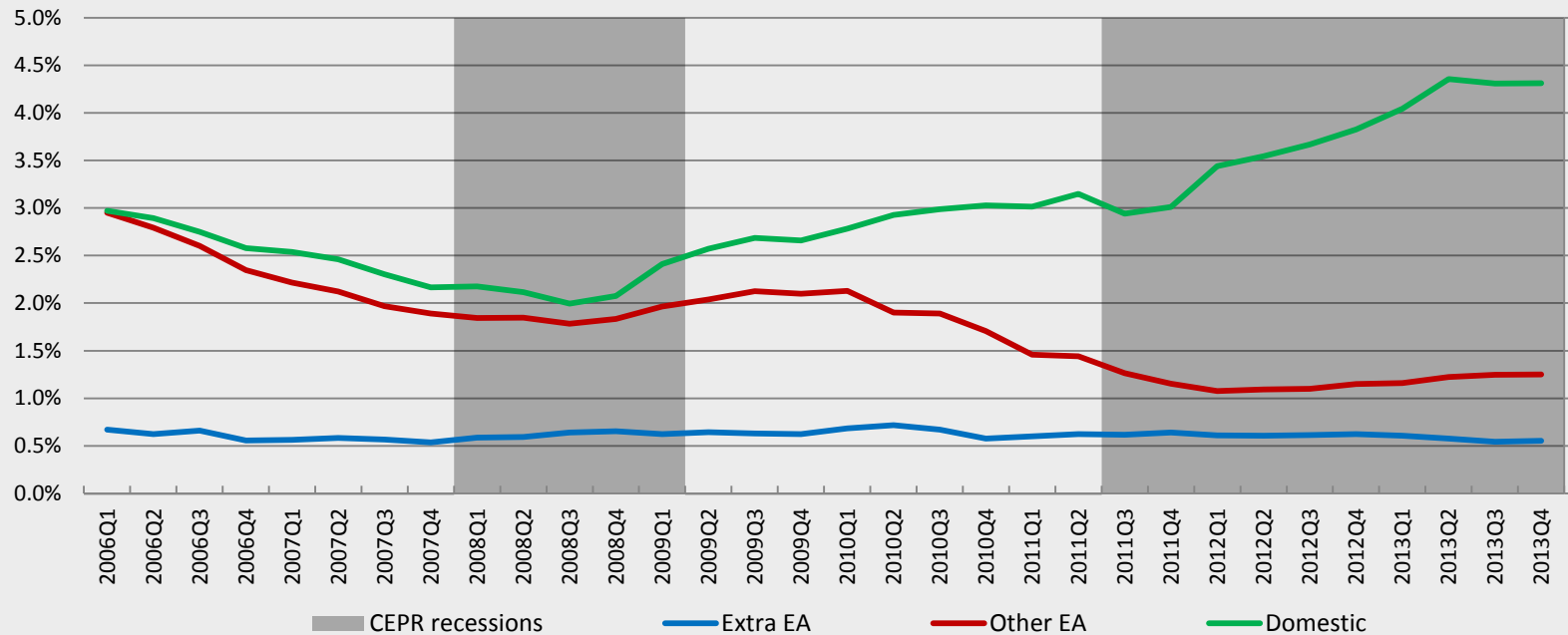
- In a monetary union, a crisis takes the form of home bias leading to financial fragmentation
- This impairs the transmission of monetary policy

This issue is not solved ... see charts

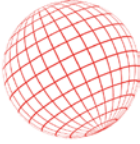
Home bias in sovereign holdings by banks



MFIs: Gov. Securities / Total Assets

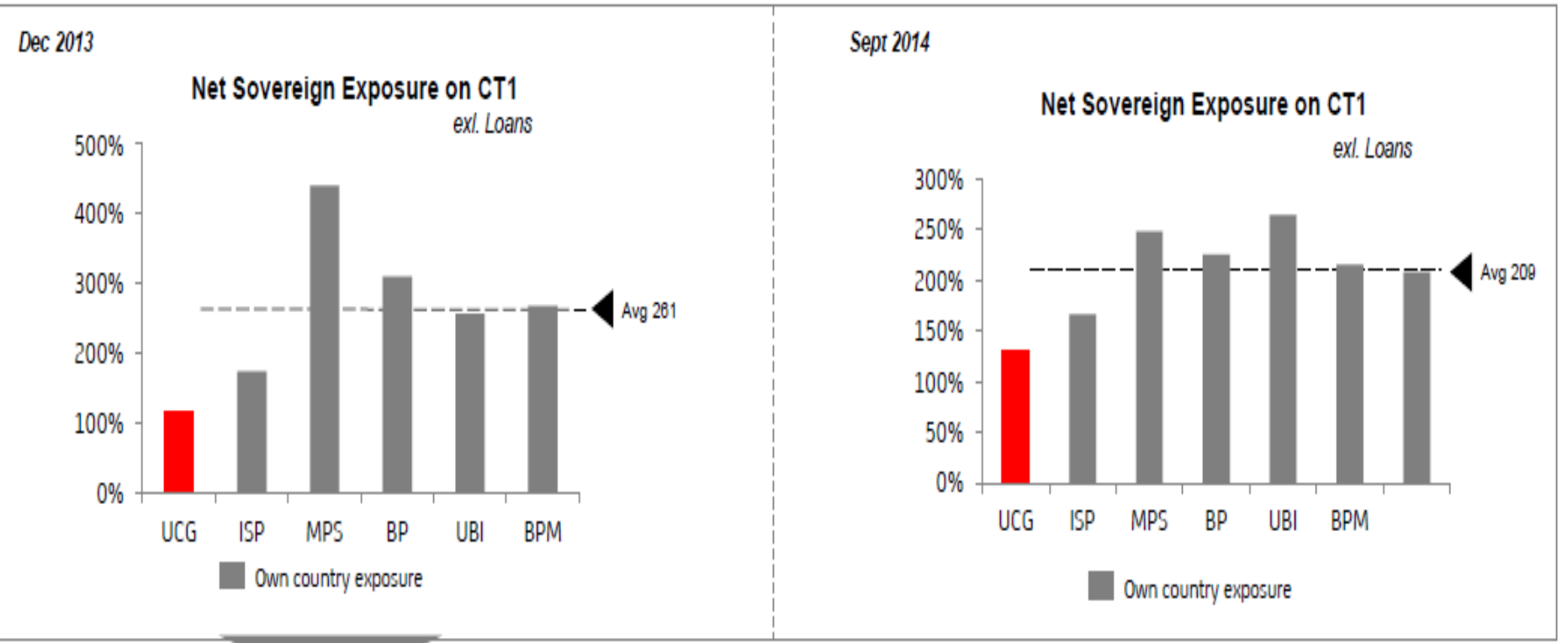


Source: ECB

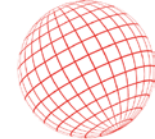


“Diabolic loop”

Italian banks – exposure to own sovereign



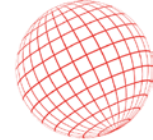
Diabolic loop mechanism well understood - yet



... little has been done to avoid it

- This is worrying because the solvency of sovereigns is by no means assured
- Sustainability calculations in particular for Italy are worrisome
- *“Risk on-risk off”*
 - The market is disregarding these doubts because of the perceived guarantee provided by the ECB
 - But were the doubts to return in the market, yields could quickly increase again, hitting hard the balance sheets of banks

Instead of decentralizing large QE program could be designed so as to deal with two issues



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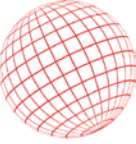
ISSUE 1 (FRAGMENTATION)

Need to force the banks to diversify the geographical origin of the sovereign fixed income portfolio

(For the functioning of the EMU it is crucial that banks have a diversified portfolio of sovereign debt)

ISSUE 2 (MORAL HAZARD and RISK SHARING):

Rather than decentralize, create a safe asset from senior tranche of composite security



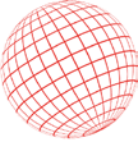
Garicano-Reichlin proposal (2014)

Monetary Policy Aspect

- QE should use of a synthetic safe bond formed by the senior tranches of a set of national bonds in fixed proportions (weighted by GDP)

Regulatory Aspect

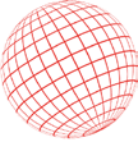
- The ECB and the Single Supervisory Mechanism (SSM) would announce that only the senior tranche of the security so produced could be counted as risk-free for the purposes of the risk weighting and liquidity coverage ratio calculations, which implies changing the current treatment of sovereign bonds for these purposes



Advantages

- Creates a large safe asset potentially to be targeted by QE – tranching as alternative to decentralization
- Reduces substantially the geographic bias in the flight to safety, as the safe asset would be (regulatorily) a Europe-wide one

It is important to emphasize here that this synthetic debt would not involve any risk sharing among different governments or any debt mutualization: each government would continue to issue its own debt and face its own interest rates in the market

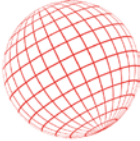


Various alternatives

The decision matrix with tranching

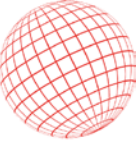
	Buying individual securities	Buying a composite security
Without Tranching	<ol style="list-style-type: none">1. Buy outright debt from each country2. Buy only debt from AAA countries3. Let NCBs buy their own country debt	<ul style="list-style-type: none">• Buy a composite security formed by each country debt in fixed proportion (Bastain, 2014)
With Tranching	<ul style="list-style-type: none">• First create a senior bond in each country, then have ECB buy the senior bond	<ul style="list-style-type: none">• Create a synthetic Eurowide security with a senior and junior tranche, buy senior tranche (Garicano-Reichlin, 2014)

Pros and Cons

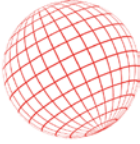


	Buying individual securities	Buying a composite security
Without Tranching	<ul style="list-style-type: none">• Pros: simple, fast—it does not require creating new securities• Cons: Moral hazard and redistribution. Can be minimized if NCB keeps credit risk, but then does it make markets doubt commitment to Union?	<ul style="list-style-type: none">• Pros: Creates a large, liquid security• Cons: Moral hazard and redistribution—security is not a safe asset
With Tranching	<ul style="list-style-type: none">• Cons: Complex, hard to implement• Pros: Incentives and redistribution issues eliminated• Cons: But market for junior tranche? Funding costs for peripheral banks	<ul style="list-style-type: none">• Pros: A new large safe asset market. Deals with diabolic loop, and eliminates geographic bias in flight to safety• Cons: Liquidity? Market for junior debt

Scenarios?



- Our proposal not likely to be considered in the short run ... will perhaps become more relevant in the future
- The preliminary ruling of the European court gives the ECB a freer hand to act
- But policy action must go beyond the ECB
- Otherwise the excessive burden on monetary policy will be dangerously divisive



END