The eurozone: now what?

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Hutchins Center
January 16th 2015 Washington

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THE EURO-ZONE: THE RECENT PAST

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

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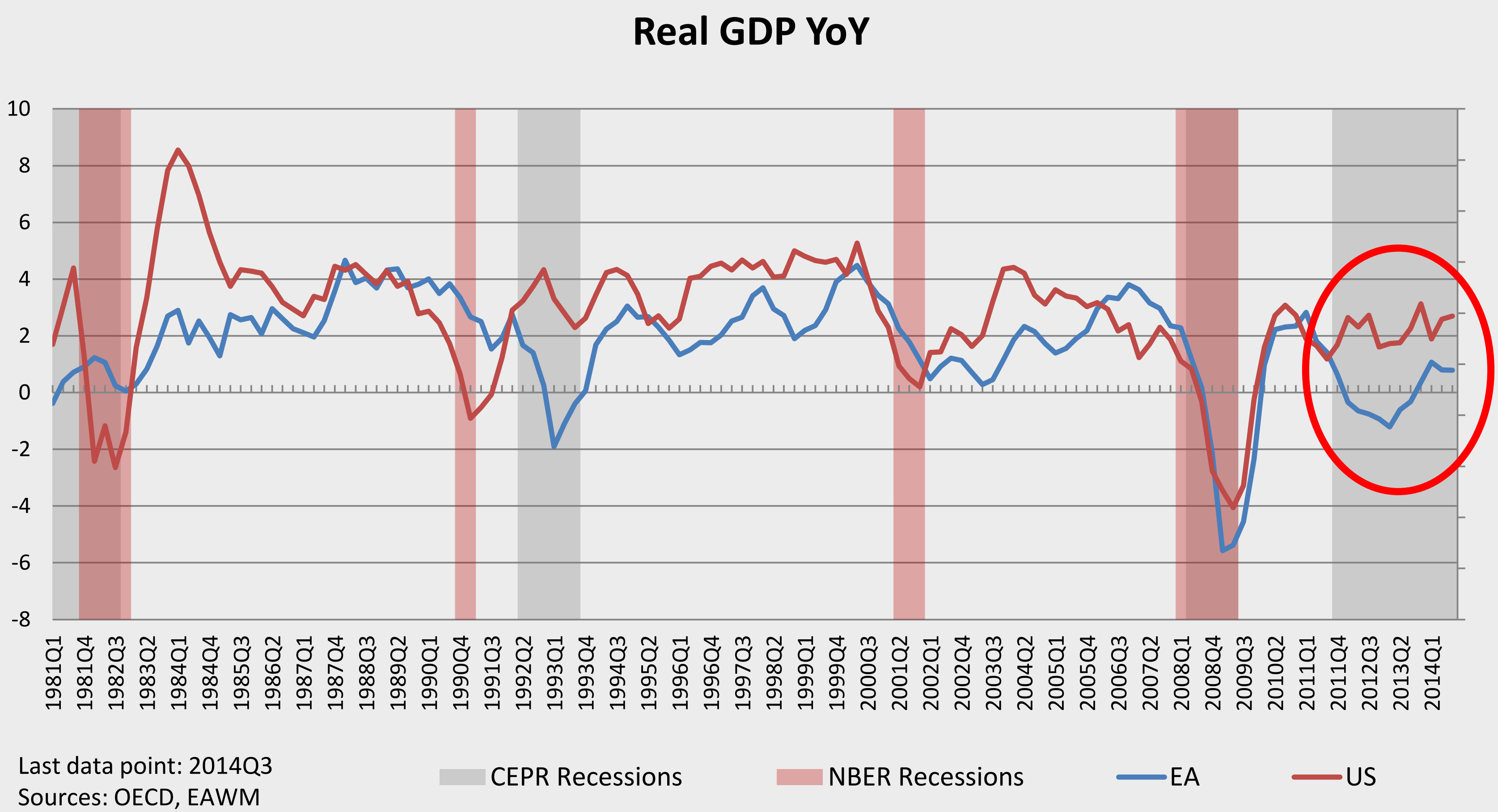

Last data point: 2014Q3
Sources: OECD, EAWM

Now-Casting Index (NCI™)
New euro area slowdown since early 2014

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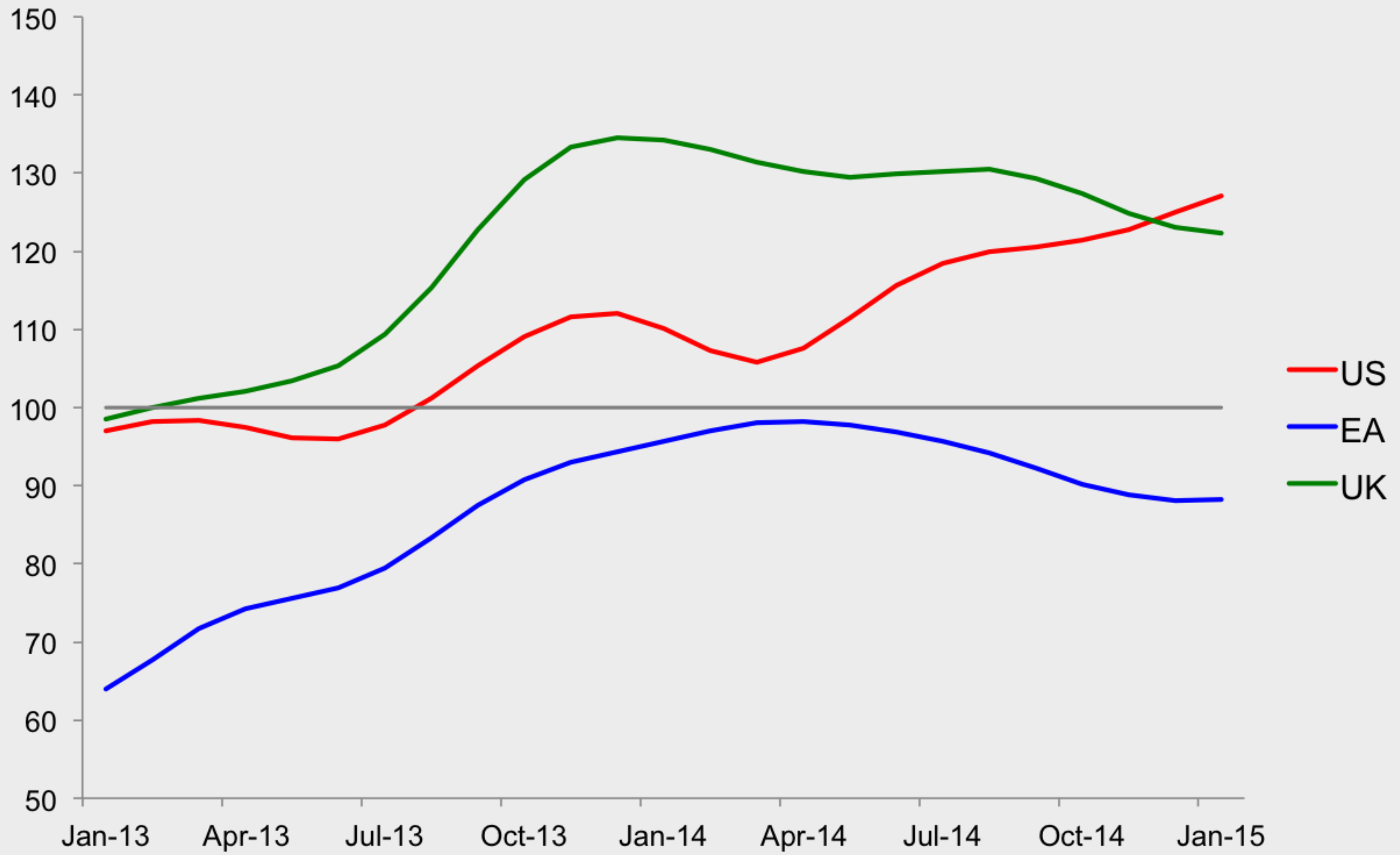

Nominal GDP, M3 and HICP

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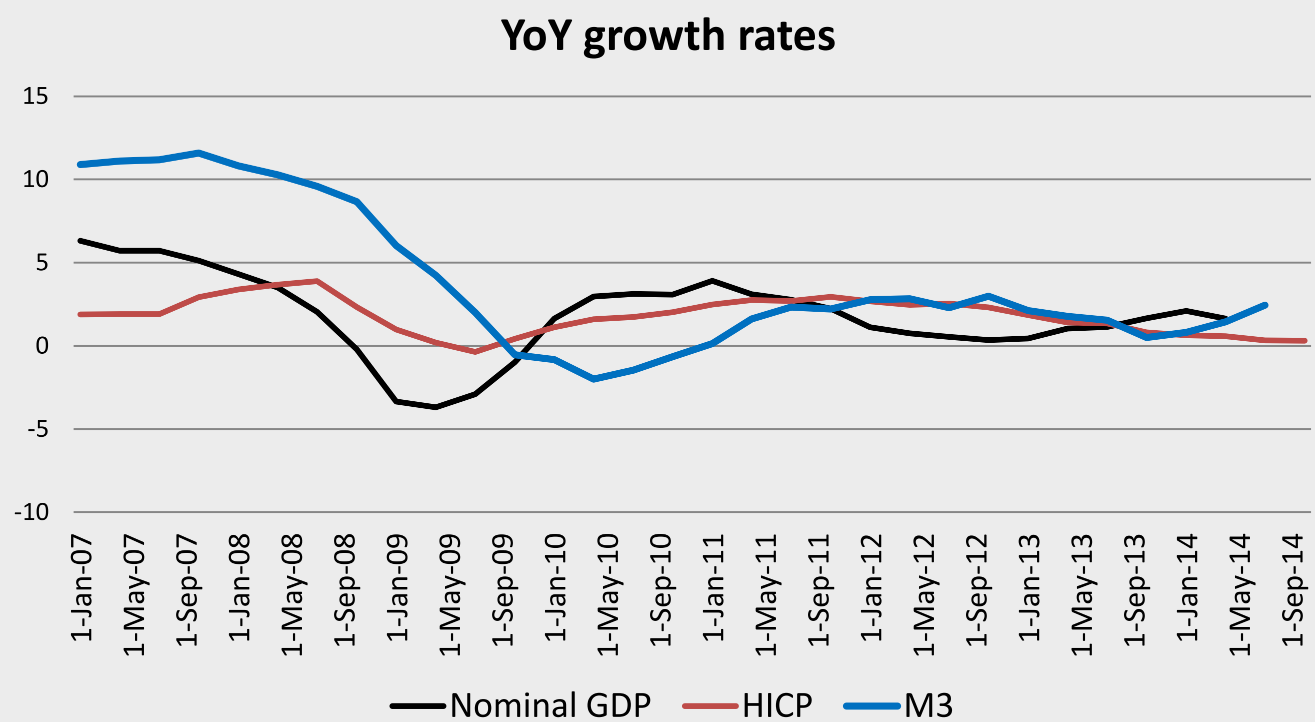

Three explanations for the cyclical decoupling of the euro area with respect to the UK and the US

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

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- 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

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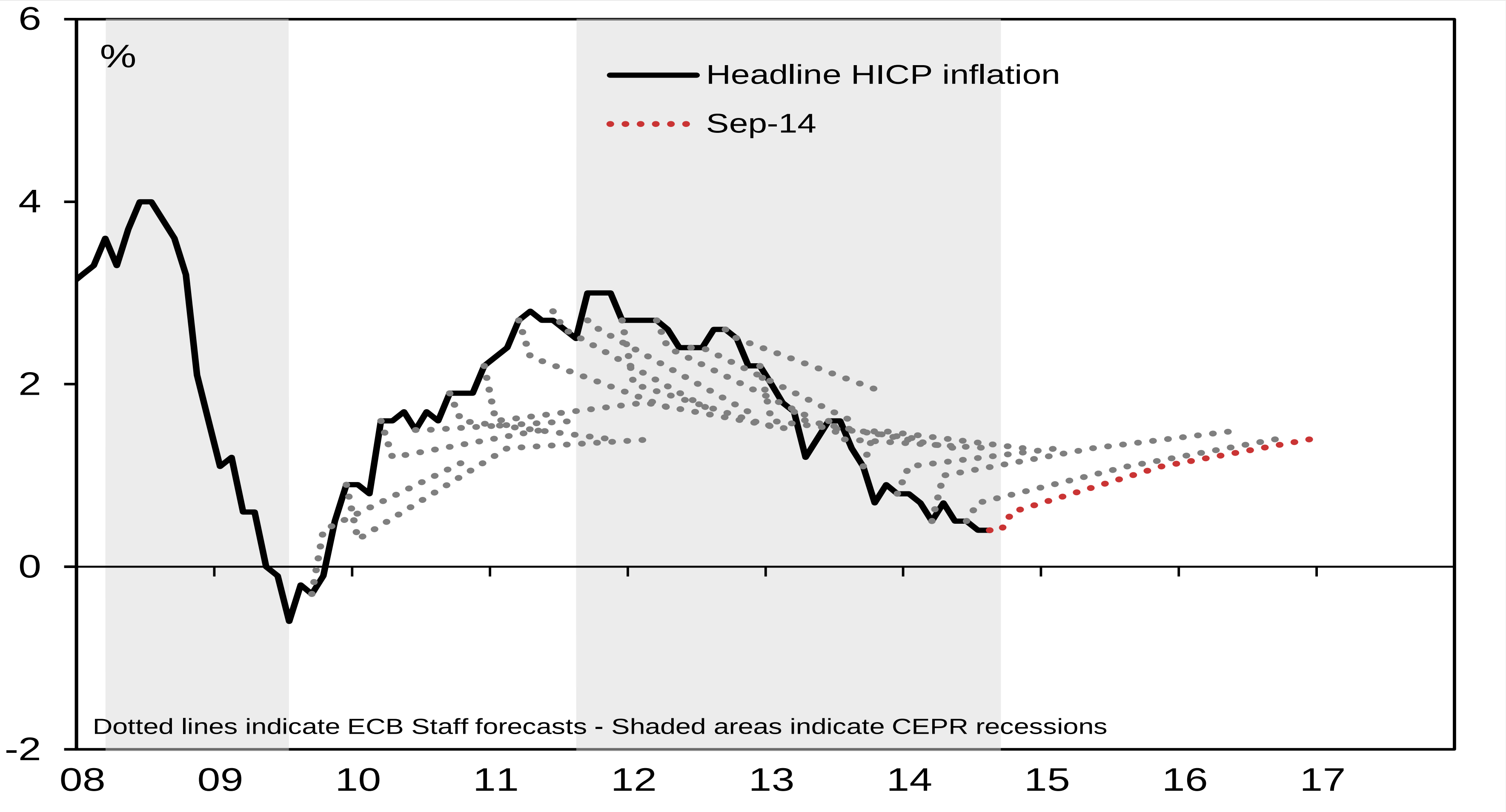

Zero lower bound and risk premia

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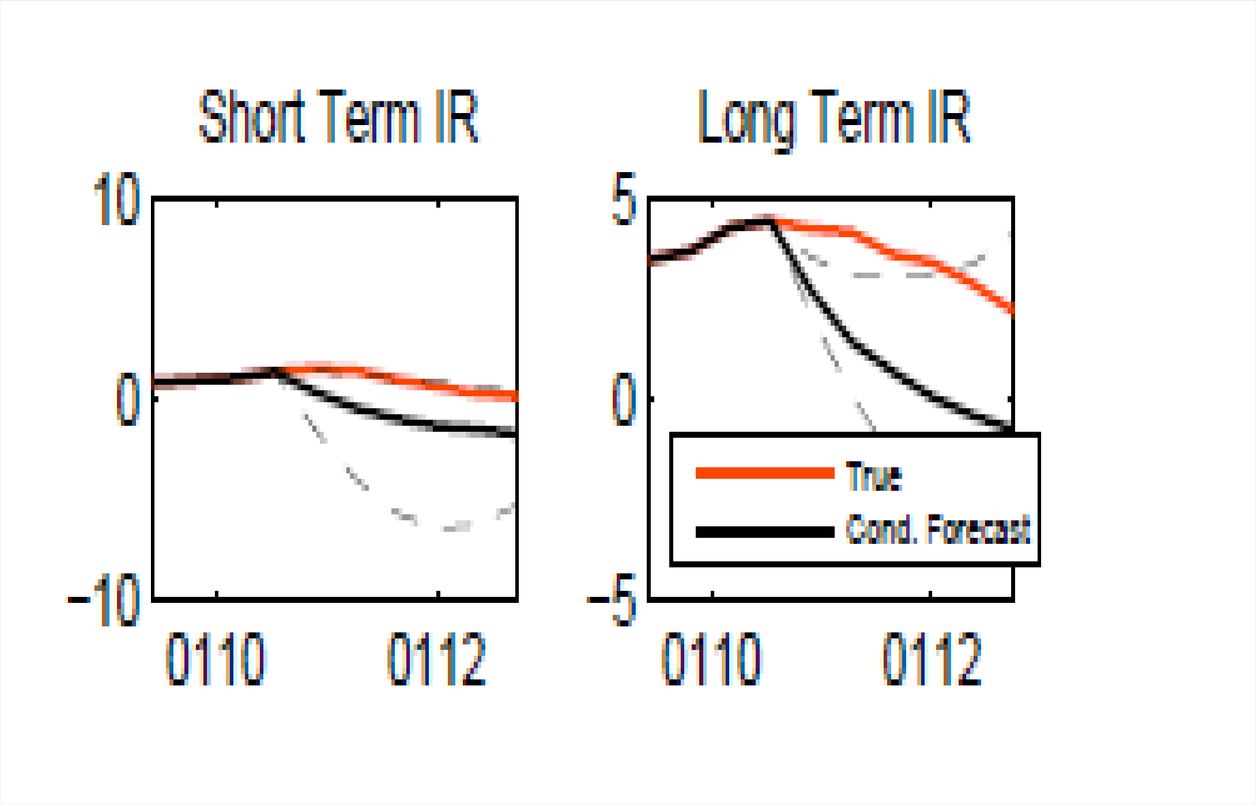
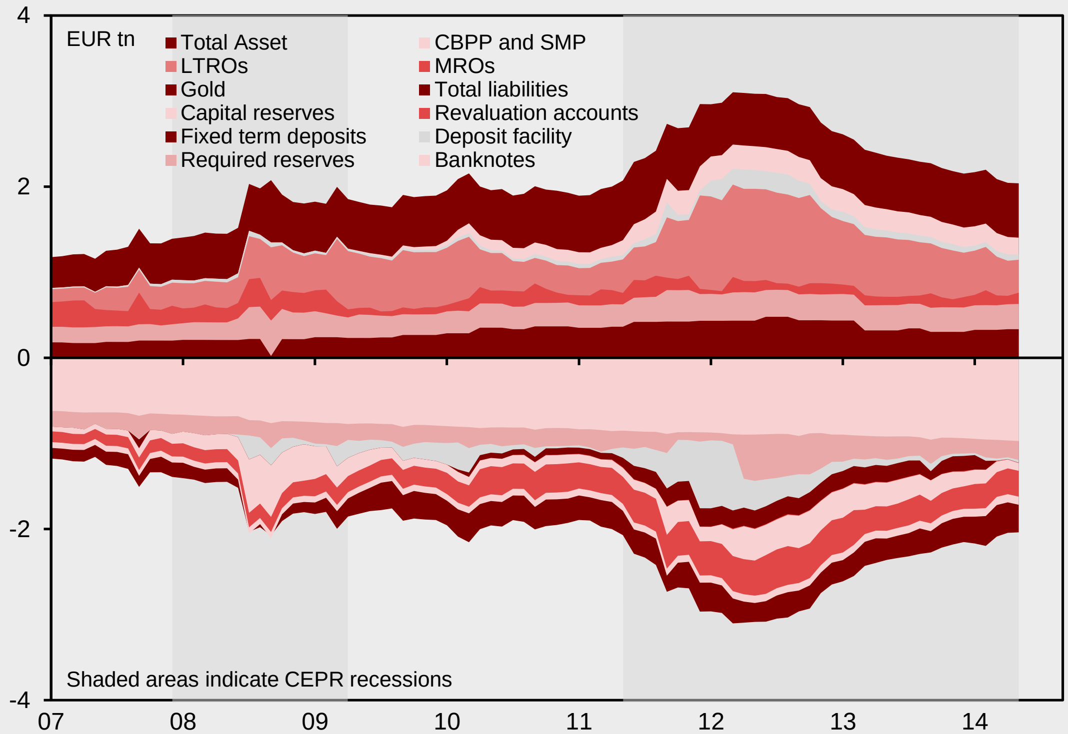


Euro-system balance sheet



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

2. Fiscal policy
Three recessions compared

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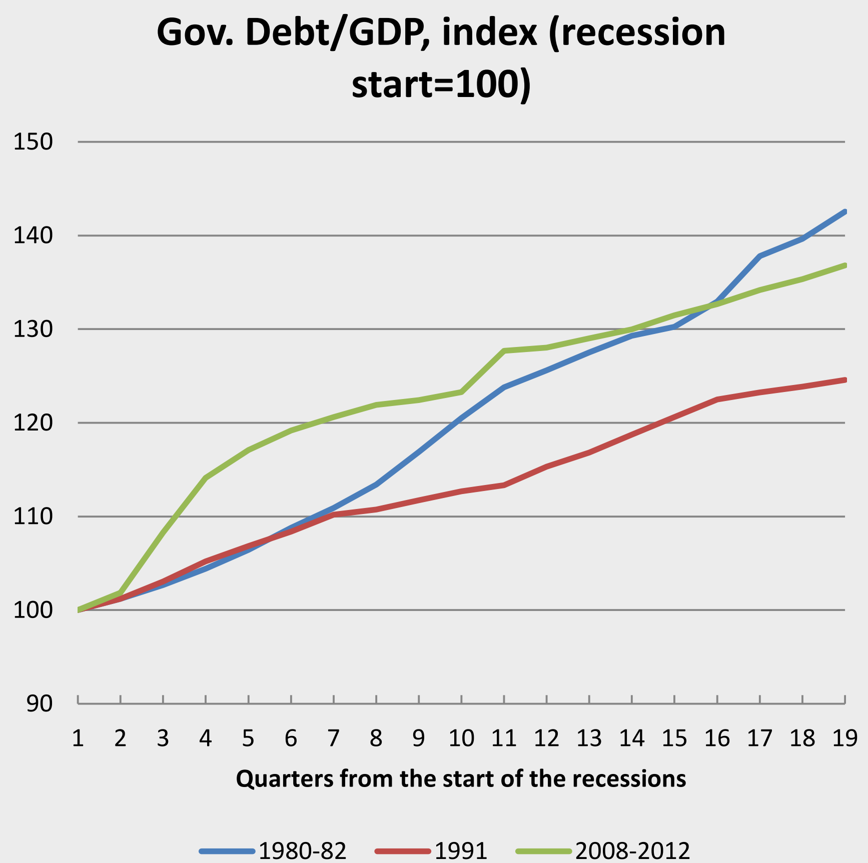
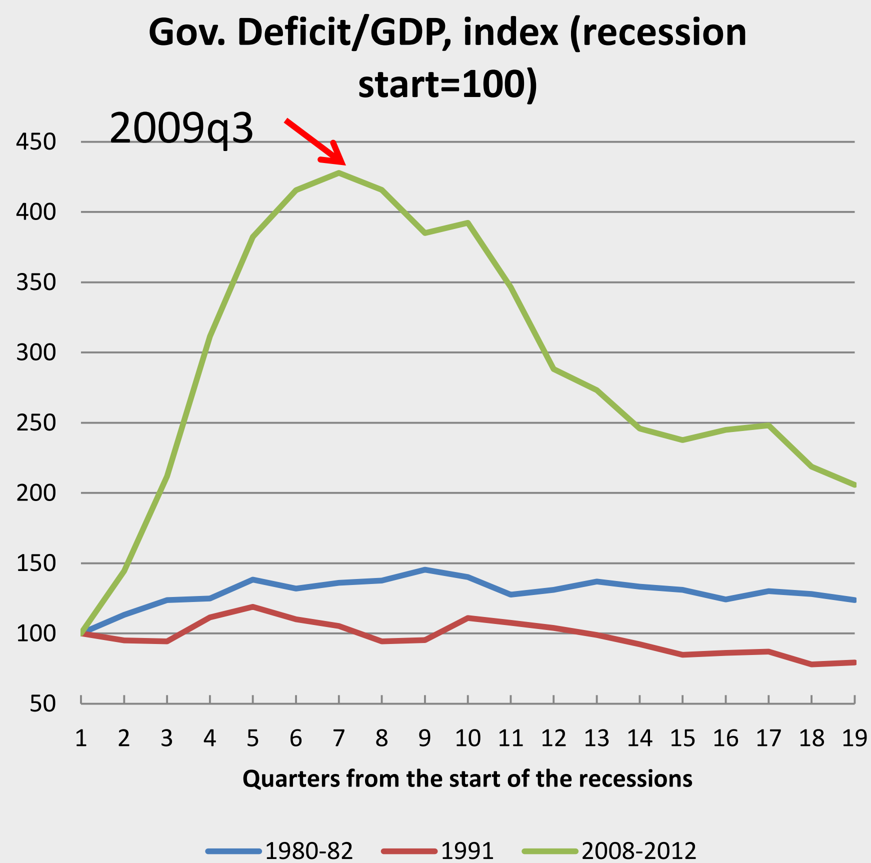
LARGE INCOME SHOCK WITH GLOBAL RECESSION
HUGE DELEVERAGING SINCE 2009q3

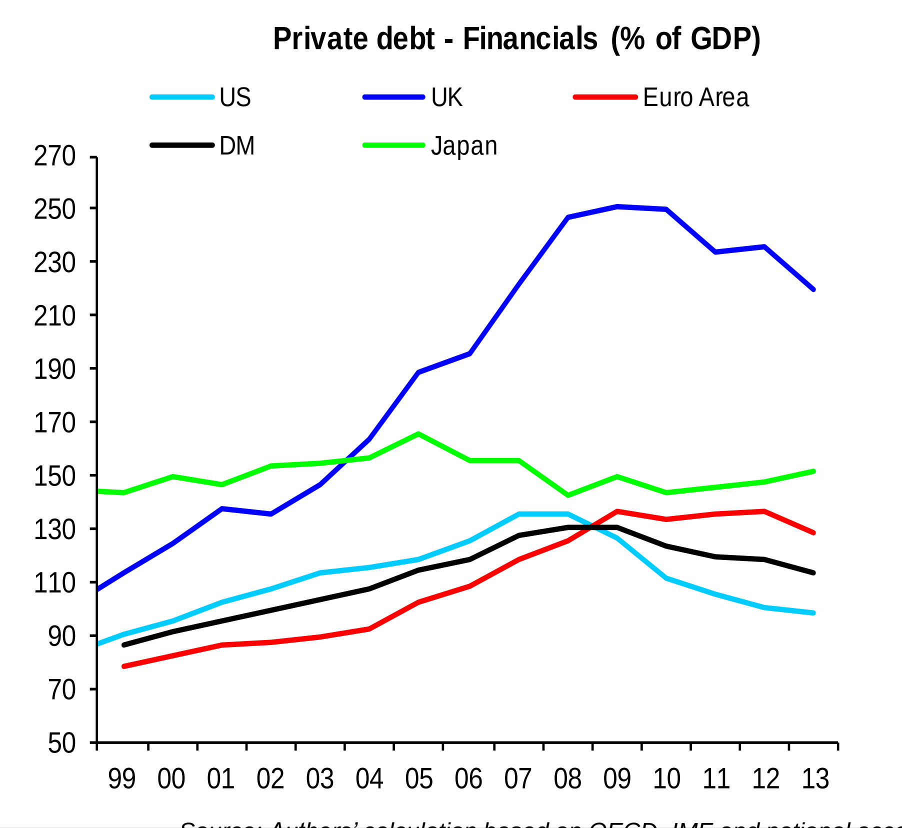


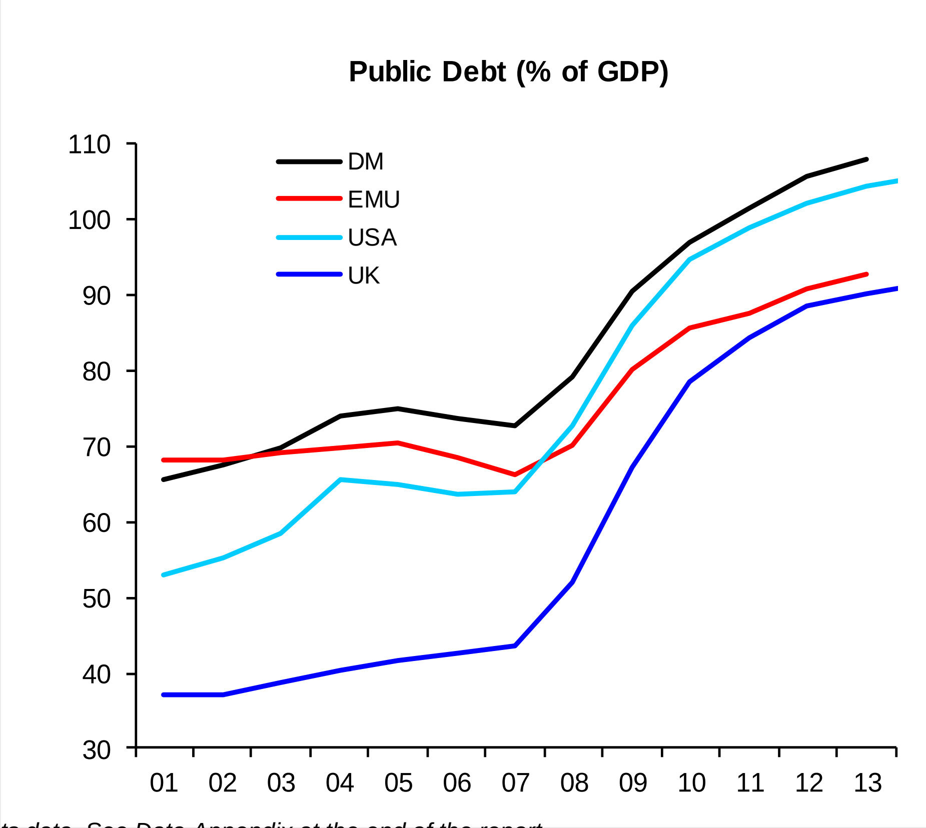


3. Debt overhang

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

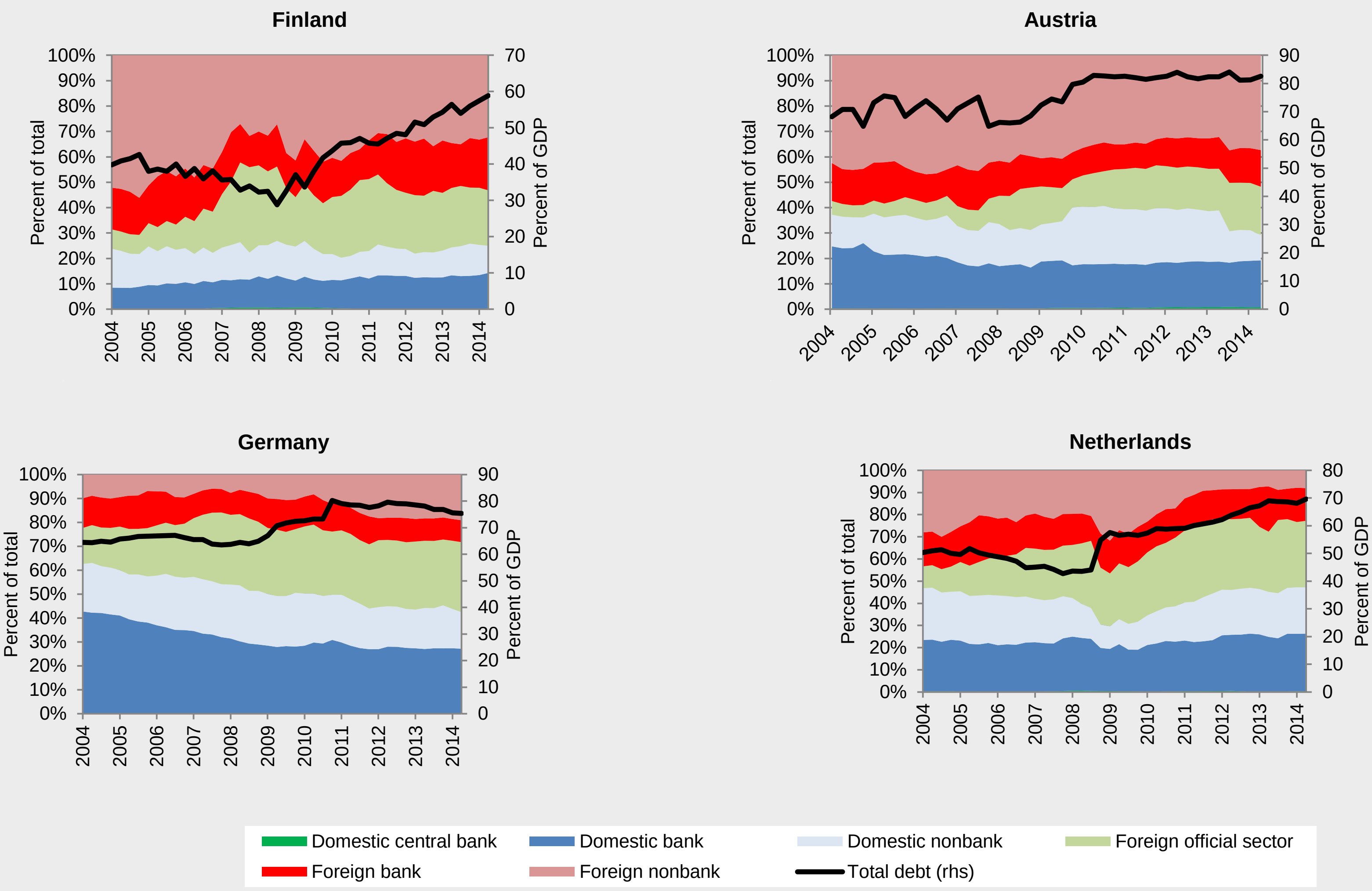
ii. Public sector debt to GDP ratio lower than in other DMs but not stabilized …. Ultimately a redistribution problem





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



Debt (public) overhang
PROGRAMME COUNTRIES

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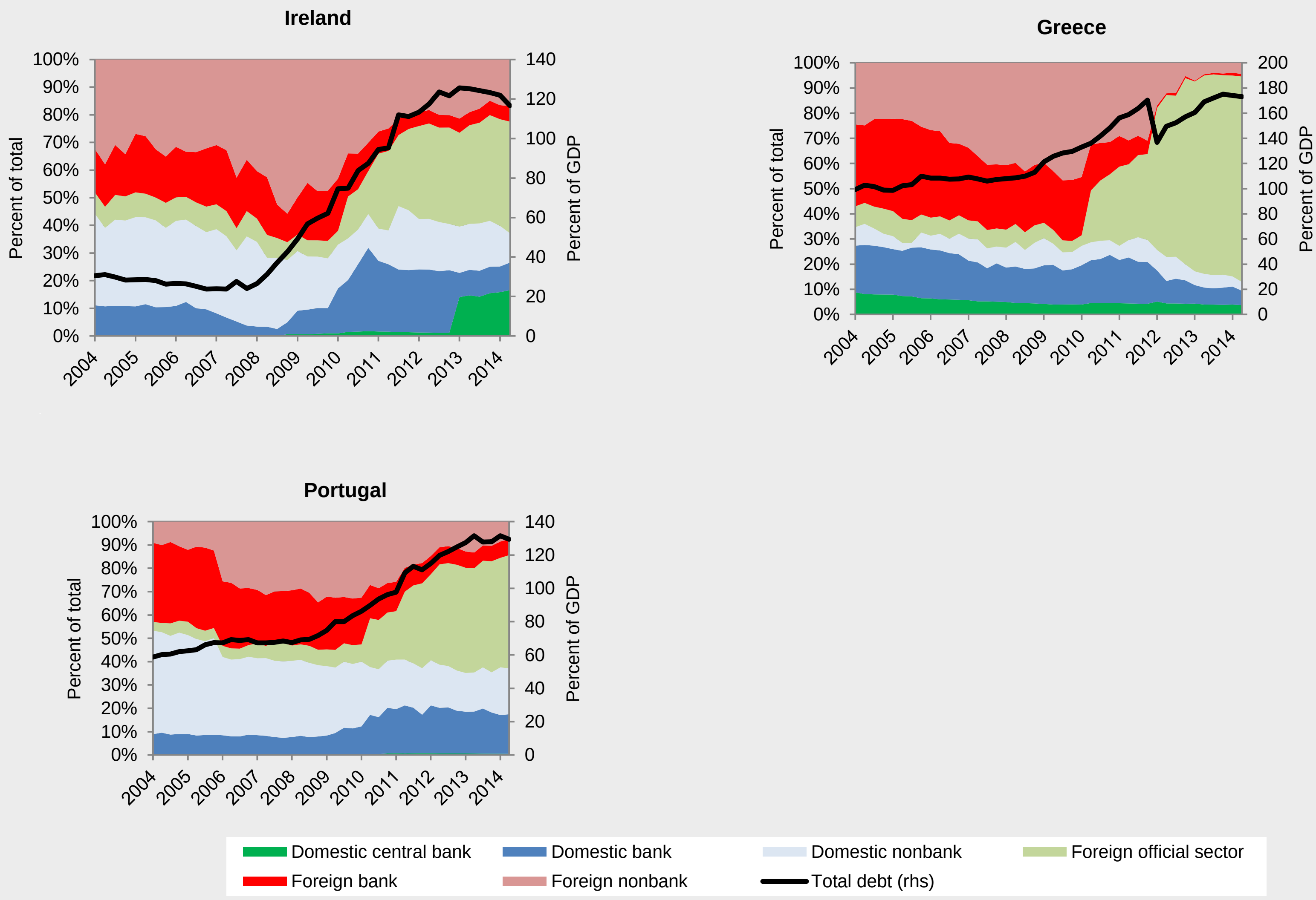

The three issues have to be analyzed jointly

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?

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- Very little action on the fiscal front and on debt overhang is to be expected although a change in he 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 ill 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 redistributional 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

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- 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

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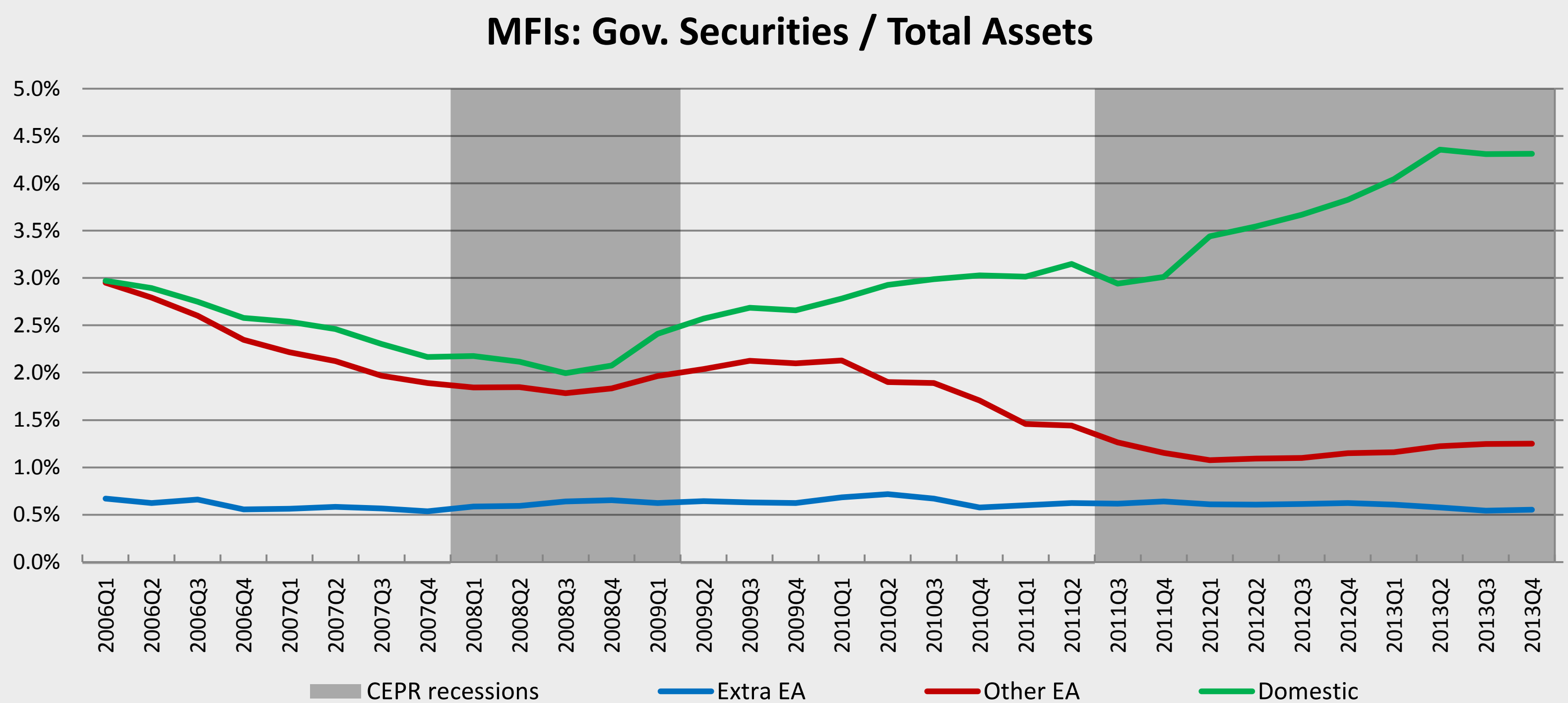
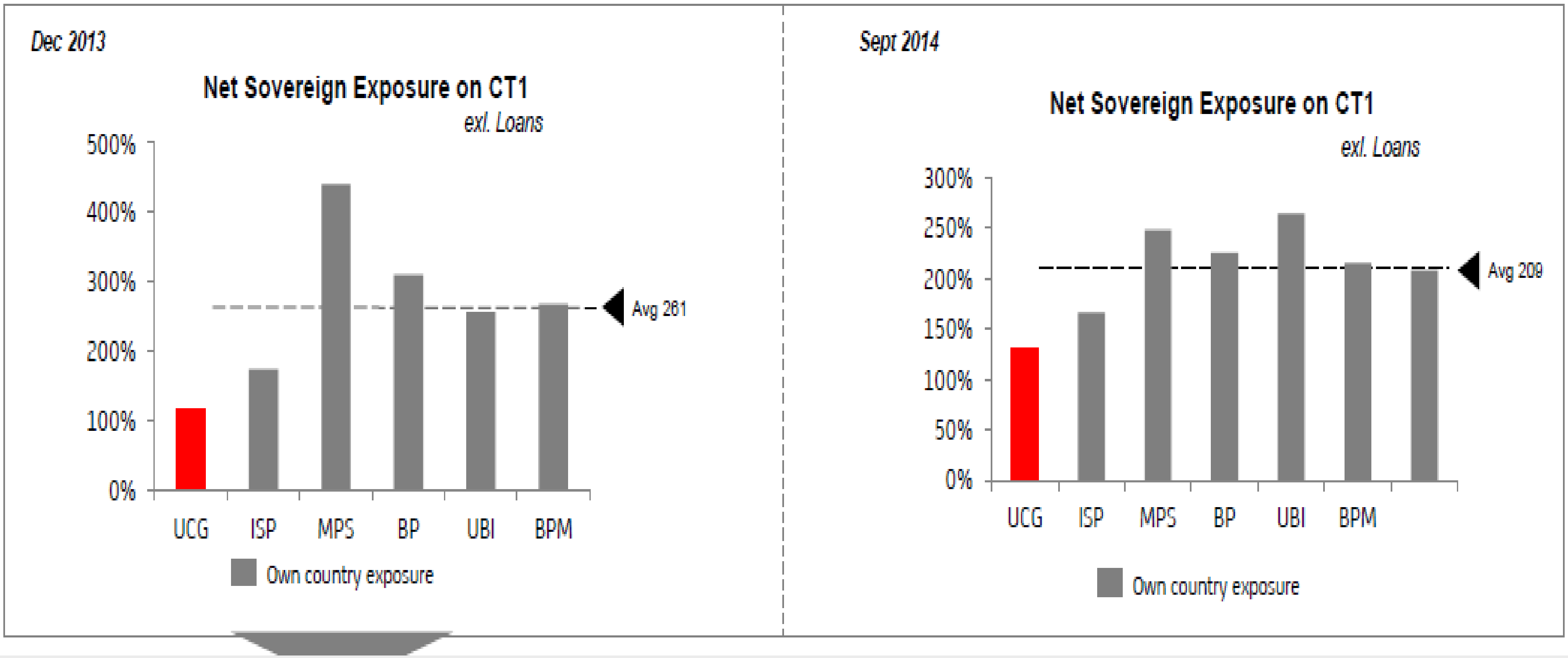


Source: ECB

“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

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	Buying individual securities	Buying a composite security
Without Tranching	1. Buy outright debt from each country 2. Buy only debt from AAA countries 3. Let NCBs buy their own country debt	• Buy a composite security formed by each country debt in fixed proportion (Bastain, 2014)
With Tranching	• First create a senior bond in each country, then have ECB buy the senior bond	• Create a synthetic Eurowide security with a senior and junior tranche, buy senior tranche (Garicano-Reichlin, 2014)

Pros and Cons

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	Buying individual securities	Buying a composite security
Without Tranching	• **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?	• **Pros**: Creates a large, liquid security • **Cons**: Moral hazard and redistribution—security is not a safe asset
With Tranching	• **Cons:** Complex, hard to implement • **Pros:** Incentives and redistribution issues eliminated • **Cons:** But market for junior tranche? Funding costs for peripheral banks	• **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