

A mechanism of self-destruction of the eurozone

Paul De Grauwe

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At the insistence of Germany, the member countries of the eurozone appear to have agreed to introduce a sovereign debt default mechanism. They even seem to be willing to codify this into a new treaty – an extraordinary step.

My contention is that this is a very bad decision that will make the eurozone more fragile by making financial crises an endemic feature of the eurozone.

Before presenting the argument, I want to make the point that the proposed sovereign debt default mechanism is based on a wrong diagnosis of the causes of the debt crisis in the eurozone. The purpose of the mechanism is to reduce the scope for moral hazard: by making it clear to investors that their investments in sovereign eurozone bonds are not guaranteed, these investors will apply more scrupulous risk analyses preventing irresponsible governments from issuing excessive debt. Thus, the proposed mechanism is based on the view that the sovereign debt crisis in the eurozone is the result of irresponsible behaviour of governments that exploited the implicit bail-out guarantee while private investors had no incentive to discipline these governments.

This interpretation of the source of the debt crisis in the eurozone has become popular mainly because it fits the Greek crisis well. It cannot, however, explain the debt crisis involving the other eurozone countries, where the root cause of the debt problems is to be found in the unsustainable debt accumulation of the *private* sectors. From 1999 until 2008, when the financial crises erupted, private households in the eurozone increased their debt levels from about 50% of GDP to 70%. The explosion of bank debt in the eurozone was even more spectacular and reached more than 250% of GDP in 2008. Surprisingly, the only sector that did not experience an increase in its debt level during that period was the government sector, which saw its debt decline from 72 to 68% of GDP. Ireland and Spain, two of the countries with the severest government debt problems today, experienced the strongest declines of their government debt ratios prior to the crisis. These are also the countries where the private debt accumulation was the strongest.

After the crash of 2008, the private debt accumulation in the eurozone forced the governments of the eurozone countries to allow their own debt levels to increase. This was achieved through two channels. The first one consisted of governments actually taking over private debt (mostly bank debt). The second one operated through the automatic stabilisers set in motion by the recession-induced decline in government revenues. As a result, the government debt-to-GDP ratios started

Paul De Grauwe is Professor of Economics at the Faculty of Business Economics at the University of Leuven and Senior Associate Research Fellow at CEPS.

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increasing very fast *after* the eruption of the financial crisis. This increase was necessary to save large segments of the private sector. It had nothing to do with irresponsible governments that failed to be disciplined by financial markets. The reverse is the truth. Financial markets were undisciplined and governments took their responsibility when they saved them.

A sovereign debt default mechanism in the eurozone is not the appropriate response to the debt crisis in the eurozone because it is based on a wrong diagnosis of its origin. More importantly, its implementation is outright dangerous, and will make the eurozone *more* rather than less prone to financial crises. Let me elaborate on this point by introducing an analogy with the Exchange Rate Mechanism (ERM) that existed in the EU prior to the start of the eurozone.

The ERM was a fragile institutional arrangement that led to frequent crises. In the end it could not be sustained and disappeared. The reason for this fragility is well-known. The member countries of the ERM pegged their exchange rates among each other. The understanding, however, was that at any time they could reconsider this peg and devalue their currencies. The availability of this option to devalue their currencies created an unstable environment prone to speculative attacks. Sometimes, there were good reasons for the speculators to expect that one or more countries would devalue their currencies (e.g. because their wages and prices were out of line with the others). At other times these expectations of devaluation would drop out of the blue sky. Whatever the reason, once speculators expected a devaluation, a self-fulfilling dynamics would be set in motion, the end result of which would be that the country involved lost out. This dynamics always had the same ingredients: When speculators expected a devaluation, the central bank of the country concerned had to raise the domestic interest rate. The latter, however, was costly for the domestic economy and for the government budget. As a result, the cost-benefit ratio of keeping the exchange rate fixed increased, leading to a temptation to devalue. As speculators 'smelled' this, they intensified their speculative activities, leading to a further increase in the interest rate and a further deterioration of the cost-benefit ratio of keeping the exchange rate fixed. In most cases this made the devaluation inevitable. In the end the ERM collapsed.

The proposed sovereign debt default mechanism introduces a similar incentive structure for speculators and national authorities as in the ERM. When the member countries of the eurozone solemnly announce (it will be solemn since it will be enshrined in the Treaty) that investors face governments that have the option to apply a haircut on outstanding bonds, two things will happen. First, as the perceived risk of these bonds will increase, the interest rate on these bonds is likely to go up. This is the effect that has been stressed by the President of the European Central Bank, Jean-Claude Trichet. Defenders of the sovereign default mechanism counter this argument by claiming that such a system also gives the national governments stronger incentives to maintain discipline in budgetary matters. The recent increases in the government bond spreads since the announcement of the sovereign debt default mechanism seem to vindicate Trichet.

The second problem, however, is much more serious. This is the ERM problem, which will also become the problem of the eurozone. When governments solemnly declare that in times of payment difficulties they will devalue the government bonds (that's what a haircut means), this will introduce the speculative dynamics in the eurozone that destroyed the ERM. Once investors expect payment difficulties of a particular government, they will sell the bonds, thereby raising the interest rate on these bonds. This is exactly what speculators in the ERM did when they expected a devaluation of the currency: they sold the currency.

This mechanism has already been triggered in the eurozone during the last year and a half, but it has been contained by the commitment of the other countries to provide financial assistance. The declared objective of the proposed sovereign debt default mechanism is to replace mutual financial assistance. As a result, it opens the gates for unrestrained ERM-type speculation. Once the option to devalue becomes the declared policy and replaces mutual financial assistance, the speculative dynamics will become unstoppable as it introduces exactly the same incentive structure as in the ERM: Governments whose bonds are sold face a higher interest rate, which makes the service of

their debt more difficult. This changes the cost-benefit ratio of maintaining full debt service and increases the temptation to devalue the bonds (applying a haircut). Investors ‘smelling’ this temptation will intensify their selling of sovereign bonds, thereby increasing the cost-benefit ratio even further.

I do not want to argue that the proposed sovereign debt default mechanism transforms the eurozone into a system that is identical to the ERM system. Even with a sovereign debt default mechanism, the cost of default (devaluing the debt) in the eurozone is likely to remain higher than the cost of devaluing the currency in the ERM. Nevertheless, by making it easier to devalue sovereign debt, the eurozone moves in the direction of the unstable ERM incentive mechanism. Governments will have a higher incentive to devalue their debt when the sovereign debt default mechanism is in place than when it does not exist. And this can be sufficient for speculators to make a move.

Thus, one should expect that the introduction of a sovereign debt default mechanism will make debt crises in the eurozone more frequent and more lethal. Whether the eurozone can survive such a structural increase in the frequency and intensity of debt crises remains to be seen. I suspect that, if applied, the sovereign debt default mechanism will destabilise the eurozone and ensure its demise.

Under pressure from the German government, which is only concerned about its own reputation, the other eurozone governments seem to have accepted to do what sovereign governments should never do, i.e. to announce that they may debase their own debt. The sovereign debt default mechanism, if implemented, will lead the eurozone governments to downgrade their own sovereign debt. There is no surer path to self-destruction.

It is paradoxical that so many today consider a sovereign debt default mechanism as the formula to avoid future debt crises in the eurozone. Its attractiveness is in my view due to the fact that it promises a solution to the debt problem without having to call upon a solidarity mechanism in the eurozone. Financial solidarity is deemed politically unacceptable in a number of countries. The truth, however, is that a monetary union can only survive if there is a willingness to provide mutual financial assistance in times of crisis. No monetary union can survive without such solidarity mechanism.

The solution therefore is not to implement the sovereign debt default mechanism, which will lead to the demise of the eurozone, but to give a permanent character to the European Financial Stability Facility, or better to transform it into a European Monetary Fund along the lines suggested by Gros & Mayer (2010),¹ including strong enough conditionality so as to reduce the risk of moral hazard.

¹ *How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund*, Daniel Gros & Thomas Mayer, CEPS Policy Brief No. 202, February 2010/updated 17 May 2010.

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E-mail: info@ceps.eu

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CENTRE FOR
EUROPEAN
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Place du Congrès 1 • B-1000 Brussels
Tel: 32(0)2.229.39.11 • Fax: 32(0)2.219.41.51