internal imbalances in the Eurozone

April 20, 2012
one view of the crisis

• Main cause is build up of domestic and financial imbalances leading to “sudden stop’ in cross border financial intermediation

• RER appreciation is, at least partly, an endogenous response to capital inflows

• fiscal imbalances small in comparison to private sector financial imbalances
cross border capital flows were fragile

- mainly interbank and short term

- Fueled and expansion of credit and bubbles
## Euro Area Household Debt Ratios

Percentage of Disposable Income

<table>
<thead>
<tr>
<th>Country</th>
<th>1999</th>
<th>2007</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece(^a)</td>
<td>26</td>
<td>75</td>
<td>49</td>
</tr>
<tr>
<td>Ireland(^b)</td>
<td>113</td>
<td>205</td>
<td>93</td>
</tr>
<tr>
<td>Portugal</td>
<td>95</td>
<td>143</td>
<td>48</td>
</tr>
<tr>
<td>Spain</td>
<td>66</td>
<td>118</td>
<td>52</td>
</tr>
<tr>
<td>Germany</td>
<td>107</td>
<td>95</td>
<td>-12</td>
</tr>
</tbody>
</table>

**Memo:**

<table>
<thead>
<tr>
<th>Country</th>
<th>1999</th>
<th>2007</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>88</td>
<td>122</td>
<td>33</td>
</tr>
</tbody>
</table>
Table 7 - Domestic credit (*) - ratios to GDP

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Ireland</th>
<th>Greece</th>
<th>Spain</th>
<th>Portugal</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>1.06</td>
<td>0.72</td>
<td>0.71</td>
<td>1.00</td>
<td>0.42</td>
<td>0.87</td>
<td>1.10</td>
</tr>
<tr>
<td>2004</td>
<td>1.01</td>
<td>0.76</td>
<td>0.78</td>
<td>1.26</td>
<td>0.62</td>
<td>1.11</td>
<td>1.24</td>
</tr>
<tr>
<td>2008</td>
<td>0.95</td>
<td>0.95</td>
<td>0.97</td>
<td>2.02</td>
<td>0.85</td>
<td>1.71</td>
<td>1.51</td>
</tr>
</tbody>
</table>

(*) outstanding amounts at the end of the period.

Source: National Central Banks
Chart 5

Private Real Consumption Spending

Index: 1999 = 100

Ireland
Greece
Spain
Portugal
Germany
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”)

• Nothing done to compensate for divergent real interest rates (the Walters’critique)
the crisis: a collapse of cross border financial intermediation
Pr. Sinn’s arguments

• A very important point: as a result of the crisis, cross border financial intermediation done through public - rather than private- channels

• Three questions:
  1. should the payment system be used as an instrument for conditionality?
  2. frictions and limits in the payment system equivalent to capital controls? A step back to the 80s.
  3. Macro-economic consequences: a constraint on German exports and capital inflows in Germany
the PSI: a good policy choice?

Benefits

- Eliminate moral hazard
- Reestablish market discipline on sovereigns

 Costs

- Doubts on “OECD “sovereigns willingness to pay
- Solvency liquidity spirals on sovereigns
- Floor on banks funding costs
- Loss of store of value
Chart 5.2 Changes in sovereign and banking sector CDS premia

Sources: Capital IQ, Markit Group Limited, Thomson Reuters Datastream and Bank calculations.

(a) The change is measured from 22 November 2010 to 22 November 2011.
(b) The other countries included, in addition to those labelled on the chart, are Austria, Belgium, France, Germany and the Netherlands.
(c) Banking sector CDS premia are asset-weighted.
(d) Five-year senior CDS premia
what should be done?

• strong micro and macro supervision at the euro area level (more important than surveillance of fiscal policies)
• + resolution mechanisms and funds at the euro area levels
• New stores of values
  – Implicit fiscal transfers: eurobonds-bills?
  – Financial innovation esBies
is the euro a new gold standard?

• No mechanical or institutional constraint on the issuance of (base) money
  – ECB has a regime of unlimited liquidity provision since October 2008 (VLTRO only extended the maturity)

• But no fiscal backing: puts a theoretical cap on the amount of base money

• Unless sufficient capital to substitute for it.

• Two views of a Central Bank’s net worth
  – Buiter: total of discounted seigniorage
  – Sims: must be able to redeem existing money stock with losses < capital