

# **The Euro, the ECB and the European Sovereign Debt Crisis**

Professor Karl Whelan  
University College Dublin  
Presentation at IIEA  
July 14, 2010

# Plan for Talk

1. What “the euro crisis” is and isn’t.
2. The Eurozone Stabilisation Fund.
3. The ECB’s sovereign bond program.

# A Euro-Area Debt Crisis?

<b>Country\Area</b>	<b>Deficit / GDP Ratio</b>	<b>Debt / GDP Ratio</b>
Euro Area	6.6	88.5
UK	12.0	79.1
US	10.1	94.1
Greece	9.3	124.9
Ireland	11.7	77.3
Italy	5.3	118.2
Portugal	8.5	85.8
Spain	9.8	64.9

# The Role of the Euro in the Crisis

- Fiscal crisis often lead to devaluations:
  - Improves competitiveness of export sector.
  - Inflationary effects reduce value of debt relative to nominal tax revenues.
- Greece, Spain, Portugal, Ireland all have serious competitiveness and debt problems.
- But ECB is focused on price stability and these countries cannot devalue inside the euro: This is the sense in which this is “a euro crisis”.

# An Existential Crisis for the Euro?

- Probably not, for now at least:
  - Greece and others are still unlikely to choose to leave the euro.
  - Legal and technical difficulties and consequences of a banking system meltdown likely offset the usual positive effects.
- And even if Greece left, so what? The Euro could carry on without them (Greece didn't join until two years after initial launch.)

# The Decline in the Value of the Euro

- Factors weighing down the value of the euro:
  - Reconsideration of idea that European sovereign debt is risk free.
  - Worries about European banks.
  - Worries about growth given fiscal retrenchment.
- Euro's decline is a consequence of these factors rather than the “existential crisis” .
- Of itself, euro devaluation is *good news* for an economic area with an unemployment rate over 10 percent and below-target inflation.

# The Stabilisation Mechanism

- Two reasons commonly cited for the May 9<sup>th</sup> decision to introduce a contingency bailout fund of €750 billion combined EU and IMF funds:
  - Financial stability
  - Saving the Euro
- The second reason has been overhyped. The first is more key but is a political hot potato.

# Exposure of European Banks to Greece, Portugal and Spain

<b>Exposure to:</b>	<b>Greece</b>	<b>Portugal</b>	<b>Spain</b>
Total	193	240	832
France	78	45	211
Germany	45	47	238

# Financial Stability Rationale

- As with subprime MBS, markets are unsure of exposure of individual banks to sovereign debt: EU stress tests an attempt to deal with this problem.
- Interbank markets have tightened up and bank bond issuance has been minimal over past few months.
- Stabilisation Fund can be viewed as an attempt to “cut the problem off at the pass” by eliminating (or at least managing) sovereign defaults.

# Saving the Euro?

- Common idea that a sovereign default would be “the end of the euro” so the Stabilisation Fund is “saving the euro.”
- But current developments may have potentially negative long-term consequences for euro:
  - EU (and euro) gets blamed for unpopular fiscal adjustments.
  - EU monitoring seen as undermining national sovereignty.
  - Repeated bailouts may be unpopular with Germany. This is may be the real long-run threat to the euro.

# The ECB's Sovereign Bond Purchases

- The ECB has come under political pressure to intervene in the sovereign bond crisis. Its reputation for independence has been undermined by decisions:
  - To allow Greek debt to count as eligible collateral no matter what ratings it has. This happened despite promises of “no special treatment” for any country.
  - To buy government bonds on secondary market. This clearly breaks the spirit if not the letter of the ECB's “no monetary financing” clause.

# Many Unknowns about ECB Program

- The ECB's program is lacks any transparency. We don't know about the program:
  - The composition of the debt securities the ECB is buying.
  - The criteria being used to select bonds to purchase.
  - The ECB's bond purchase strategy during periods of primary issuance.
  - How long the program is going to last and how much may be spent.
- Bond purchases tailing off: €16 billion in first week, only €1 billion last week. Is the program finished? Or perhaps just finished for now?

# The Current Situation

- ECB bond purchase program looking more and more like a temporary stopgap while the Stabilisation Mechanism funds were put in place.
- Borrowing situation has worsened since May 9:
  - Irish ten year bond spread over bunds at 276 basis points (not far off early May levels.)
  - Portuguese spreads at 303 basis points.
- Worries that bank funding problems highlighted in stress tests will spill over to sovereigns (a major issue for Ireland).
- Likelihood of EU-IMF fund being called on is increasing.