A *credible* new economic order for the Eurozone (or even the EU)?
Ramon Marimon

From their genesis, the aftermath of World War II and the ERM crisis respectively, the European Union and the Euro projects have grown out of crisis, out of the sense that alternative paths were worse for everyone. The Euro crisis, now in its second year, may, and should not be, an exception. The March 11-12, 2011 'Pact for the Euro' and the expectations surrounding the European Council of March 24-25, 2011 to finalize it, seem to suggest that once more virtue will arise out of necessity. To see how likely this transformation is, it is worth looking at the confusion that has preceded the pact, and may yet not have resolved itself.

The confusion arises out of the coexistence of three different views, present from almost the beginning of the crisis. I will call them: i) the 'moral hazard' view; ii) the 'together we shall overcome' view, and iii) the 'we shall overcome together, when we all march with the same stride' view. The first is fairly clear, especially to trained economists: if some public or private finances have gone astray, this is the problem of those who took the risks in taken up debts and commitments; rescue solutions only trigger more irresponsible behaviour and deeper crisis. A simple corollary of this view is that the ECB should never engage in buying up sovereign debt of troubled Euro countries (the ECB has lost an excellent economist, as likely future chair, for endorsing similar views).

Those who vindicate the second view often see the problem as a struggle between us (the Europeans) and them (the markets). They stress that what is needed is a clear commitment showing 'them' that we are all in it together and, therefore, that we do not allow a European (restrict it to Eurozone, if you wish) country to fail… or, by extension, the financial sector of a country to fail. A corresponding corollary is that we need a European Rescue Fund (call it EFSF, ESM, or both) with very big pockets; as the blackjack player who follows a winning strategy, which only requires proper counting and big pockets. In the IMF tradition, the Greek and Irish rescue packages have been conditional on austerity plans. Nevertheless, the denial to even consider partial forms of default, or debt restructuring, is rooted on this second view.

The third view came to the forefront later in the crisis, with Merkel as the main proponent (and Sarkozy taking her by the arm). It does not fully deny either of the other two views, but rather emphasizes the European heterogeneity (which, after many years of boom on the periphery, and apparent convergence, has been dramatized by the crisis) and does not want to transform a rescue into persistent redistribution. Therefore, it postulates the need to take a more global view and first resolve the differences. In its decaffeinated version – after the efforts of Van Rompuy not to reach an agreement, especially with the second view – this is the vision that has inspired the 'Pact for the Euro.

It is easy to see virtues in any of these views. The first, by reminding us that any insurance or rescue mechanism is subject to *moral hazard*, and therefore in designing the mechanism one must take this into account; the second, by emphasizing that *commitment* is a key element in making a policy - even more so a rescue operation - credible, and by implicitly acknowledging that a fair amount of commitment is embedded in the European Union and, in correspondence, that the union must also be committed to its members; the third, by taking a broader view of the problem and focusing on the need to undertake pending reforms, in order to improve competitiveness and grow.

It is also easy to see why these views are flawed and can lead to non-credible proposals. For example, almost all advanced economies would have unsustainable levels of debt if they had to systematically refinance them at very high interest rates - say 10 year bonds above 7%, which is below the current cost for Greece, Ireland and Portugal. However, these very high interest rates for debt refinancing are the reflection of two factors: the risk of default (which can certainly be exacerbated by speculation) and the fact that non-contingent debt is a very inefficient financing mechanism (which calls for speculative attacks at times of refinancing, similar to the ERM speculative attacks). The '*moral hazard'* view disregards these endogenous factors - beyond the control of the borrower - and, therefore, proposes inaction when support is justified and needed. In fact, the same establishment of a first European Stabilization Mechanism, on May 10 2010, to rescue Greece shows how this view leads to a non-credible proposition for the Eurozone.

This rescue was a triumph for the supporters of the '*we shall overcome'* view, who think that recognition of any need for partial default, or debt renegotiation, calls for contagion. However, non-credible rescue plans are more likely to create contagion. In fact, market interest rates for Greece and Ireland's debt are back at the levels of the days when they were 'rescued' and it is increasingly recognized that even the 'rescue fund' rates – between 5% and 6% - may not be sustainable, given their current growth prospects. Unfortunately, decreasing these rates further below the market rates seems unfeasible. Leaving aside the expected general increase on interest rates due to the oil-price shock, the reason such further flexibility may not be possible is that either there is an implicit subsidy and redistribution from lenders (who could get better returns for their savings) to borrowers, or the new rates are the price of almost risk-free bonds. The former is politically unfeasible, the latter requires much better rules on how these countries' liabilities are settled, which takes us back to 'drawing the lines': recognizing partial default, or debt renegotiation, with the corresponding seniority for 'rescue fund' loans.

Not surprisingly, beyond avoiding a major collapse, the current rescue packages, with their plans more for austerity than growth, have not resolved the crisis and are generating more resentment than gratitude in recipient countries, and more resentment than satisfaction in 'donor countries'. In fact, not being a credible resolution for larger countries, such as Spain, has had the positive effect of wakening up Spaniards to the need to confront reforms. It is in this context that the third view has taken the stage: to make, as a condition for further action (i.e. further develop and fund the ESM-EFSF), a broader agreement on a 'competitiveness plan' with a range of measures. Among the listed measures, one is unavoidable: to have a better regulation and transparency to deal with the banking crises. Another measure is the old 'cry wolf' of the Eurozone: to reinforce debt limits – possibly in the national constitutions -- with more strict sanctions. The other measures are reasonable and can encourage competitiveness and even, in some cases, the conducting of joint policies, for example, the design of an optimal monetary response to an external oil price shock is different depending on whether salaries are indexed or not. Regarding most of these measures, in going from its original pure vision to the 'Pact for the Euro' there has been a move from "let's solve our differences" to "let's promise to solve them." In summary, a historical exercise in 'community peer pressure' (never to be dismissed), but is it a credible plan to resolve the Euro crisis?

I have a serious doubt, for three reasons: the exercise seems to miss the point, confuses the roles, and doesn't draw the lines. It misses the point in that the strength of the European Union - even more so of the Eurozone - does not lie in periodically making promises for 2010, 2020,… 2050, but on the fact that the union is long-term partnership in which there are potential gains for all the partners. That is, the issue is not to pass a set of exams - with often ill-defined questions and answers that are difficult to assess - but to relate future gains or losses to current actions, in a way that there is no more redistribution across countries or regions than the one commonly agreed upon (as with the old structural funds). It confuses the roles, in making the European Union, or the Eurozone, responsible for the specific measures that countries have to take in order to be more competitive and grow. Not only does this raise issues of democratic accountability, but it is a perverse mechanism: used by weak governments to justify needed reforms, it removes their burden of finding and implementing reforms, and it is a source of citizens' resentment against the European project.

More importantly, in this second year of the Euro crisis, it doesn't draw the lines, or at least not yet. There is a very important role for the European Stabilization Mechanism, which is to transform non-contingent debt liabilities (often short-term) into long-term state-contingent contracts; that is, to confront the 'maturity mismatch' problem (and defuse the speculation gambles in debt-refinancing times), by setting rules of future payments conditional, for example, on whether the country is in a recession, etc. One can build on long-term dynamic contract theory to design these contracts and see how they can be implemented as debt-renegotiations, etc. It also requires a non-trivial exercise of assessing expected returns and liabilities, as well as default scenarios. That is, to draw the lines on existing debts of which a part is sustainable without a persistent subsidy, which in turn requires an assessment of the expected returns of different policies and reforms. This must be a professional exercise, better done with independence from political pressures, should result in statements (of an independent EFSF?) such as: Greece may or may not reform their pension system, it is up to them; here is the different amount of credit (or implicit interest) they can get under the different scenarios. Furthermore, this line of credit could improve in the future as Greek net liabilities diminish. There are elements in the current discussion, regarding the EMS, which point in this direction (although even the recent proposal of the EEAG Report ignores this aspect of long-term contracting). Unfortunately the political rhetoric is not this one: it is a welcome reasonable plan, but not a credible one.

Ramon Marimon San Domenico di Fiesole, March 14, 2011

Director of the
Max Weber Programme
European University Institute
Chair of the
Barcelona Graduate School of Economics
Professor of Economics, EUI & UPF-CREi,
CEPR & NBER

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