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CEPS Policy Brief

Thinking ahead for Europe

CENTRE FOR EUROPEAN POLICY STUDIES

No. 230/January 2011

A less punishing, more forgiving approach to the debt crisis in the eurozone

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Introduction

The debt crisis that hit the eurozone last year forced European leaders to develop new solutions to deal with the crisis. These solutions have been dominated by the idea that sanctions should be imposed everywhere in the system. Thus, European leaders are tightening up the Stability and Growth Pact (SGP) and are imposing stiffer sanctions on governments that do not obey the rules. Bondholders who have the temerity to buy government bonds will face sanctions in the form of haircuts when governments get into payment difficulties. The financial rescue mechanism aimed at providing liquidity to distressed governments carries punitive interest rates. Thus Ireland was subjected to an interest rate of close to 6% for the financial assistance it received from the EFSF.

In this paper I argue that too much emphasis was put on designing punishment mechanisms to deal with the crisis, and to prevent future ones. I will then ask the question why so much emphasis was put on punishment. Finally, I will argue that a greater role should be given to forgiveness, and I will discuss what that means in practice.

In order to analyse whether punishment is the right approach, it is useful to make a distinction between the proposed means of punishment of governments and the punishment of private market participants. Let us concentrate on the latter first.

Punishing private agents

The threat of punishment of private market participants leads to two problems. First, it works only when these agents know they are doing something wrong that is subject to punishment. If they are not aware that they are committing an offence, the threat of punishment will not discipline them. During the good years prior to the crisis, few people realised that they were doing something wrong that would lead to punishment. Private investors were blinded by euphoria and did not see the risks. Bankers took excessive risk because they massively underestimated it. This underestimation had two dimensions. First, bankers underestimated the risk on their own balance sheets and second, they did not take into account the systemic risks they created by over-leveraging. They were driven to do this by the sense of euphoria that infused the bubble and boom periods and that blinded almost everybody, including the supervisors, from seeing the risks. So having the punishment would not have changed their behaviour.

For the same reason, introducing tighter punishments and penalties to be applied in the future will not prevent crises. In the future, agents will do things that may lead to a crisis without being aware that they are doing something punishable. This is likely to happen with the next bubble, when doom and gloom has dissipated and euphoria takes over again.

The second problem with punishments is that they lead agents to run for cover when punishment is imminent. This running for cover is easy in financial

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markets. Investors just sell. But if this selling is done collectively, it triggers the crisis that the threat of punishment was supposed to avoid. In other words, punishment has very little disciplinary effects on financial markets, because if investors are quick enough they know they can avoid punishment. In addition, this running for cover can in fact trigger a crisis where none would have occurred without the punishment scheme.

This idea can be applied to the proposed bail-in mechanism that will be attached to future sovereign bond issues in the eurozone. At the insistence of Germany, the European Councils of October and December 2010 decided to make future financial assistance to eurozone governments conditional on making sovereign bondholders pay in the form of haircuts. Thus, eurozone governments have announced that sovereign bondholders will be punished in the future for the sins of the sovereigns.

This announcement has a double effect. First, it makes sovereign bonds riskier and therefore increases the interest rate. Second, and more importantly, it destabilises the government bond markets in the eurozone for the reasons explained above. The threat of punishment now hangs over the sovereign bond markets in the eurozone, which will have the effect of regularly inducing bondholders to run for cover. They will do this each time they expect future payment problems in one of the eurozone governments. But this running for cover will in turn make a default crisis more likely. When investors sell their bonds, the interest rate goes up, thereby increasing the risk of default, which in turn triggers more selling. This self-fulfilling mechanism will make the government bond markets more fragile and volatile. In fact this has already happened since the decisions made by the European Council in October and December 2010 (see De Grauwe, 2010) where this fragility is compared with the fragility of the ERM that existed prior to the start of the eurozone). Thus, the idea derived from moral hazard thinking that somebody must be punished has a disastrous effect. Instead of solving a problem, it creates a new one.

Punishing governments

The other major solution proposed by the European leaders is to tighten up the SGP, i.e. to have a stronger punishment scheme for governments. This prescription is based on the same moral hazard thinking and will certainly not solve the debt crisis. It even risks making it worse.

There are two reasons why tightening the rules of the SGP is the wrong answer to the sovereign debt crisis. The first one is that with the exception of Greece, the other eurozone countries (Ireland, Spain) were not pulled into a debt crisis because of an excessive public debt accumulation prior to the crisis. The government debt crisis in most eurozone countries has nothing to do with undisciplined government behaviour prior to the crisis, but with excessive risk-taking by the private sector. If the tighter SGP rules now being implemented had been applied before the crisis, they would not have made a difference in most of these countries (with the exception of Greece). Governments like Ireland and Spain would have passed these tighter rules with flying colours; yet they would not have escaped the subsequent crisis.

The second reason why the tighter SGP rules will not work has to do with the political economy of these rules. As long as budgetary policies (spending and taxation) remain vested in the hands of national governments and parliaments, the political responsibility for the decisions about spending and taxation rests with these national governments and parliaments. The latter face political sanctions by national electorates. Neither the European Commission nor the other members of the Council face political sanctions for the measures they impose on one member country. The principle of “no taxation without representation” lies at the heart of democracy. The SGP has been an attempt to short-circuit this principle, by giving powers to individuals and institutions that do not face the political consequences of their actions. Such an attempt has to fail and happily so.

This is also the fundamental reason why the French and German governments decided in 2003 to ignore the then prevailing fiscal rules. They were urged by the Commission to overhaul their spending and taxation decisions. But the Commission did not face the sanctions of the French and German electorates; the French and German governments did. Each time such a situation occurs in the future (and provided the countries concerned are sufficiently large and powerful) it is the European Commission that will lose the battle.

The European policy-makers believe that the Stability and Growth Pact can be made to work by stiffening the rules. But, surely, stiffer rules and sanctions will not help to salvage the SGP, which is deeply flawed because it disregards elementary political principles.

Bad design of financial assistance

The idea that punishment should be part of the cure to the debt crisis has also infected the design of the financial assistance in the eurozone. The EFSF that was instituted during the Greek debt crisis in May 2010 has been forced to provide financial assistance to Greece and Ireland at punitive interest rates. The interest rate applied to the Irish loans now amounts to almost 6%. This high interest rate has a very unfortunate effect. First, by charging this high interest rate it makes it more difficult for the Irish government to reduce its budget deficit and to slow down debt accumulation. Second, by charging a risk premium of about 3% above the risk-free rate that the German, Dutch and Austrian governments enjoy, the EFSF signals to the market that there is a significant risk of default, and thus that the Irish government will not succeed in putting its budgetary house in order. No wonder that financial markets continue to harbour their distrust and also charge a high-risk premium. All this, in a self-fulfilling way, increases the risk of default. It is quite sad that the EFSF that was created to solve a problem contributes to creating one.

The intelligent approach to financial assistance consists of using a policy of the carrot and the stick. The stick is the conditionality, i.e. an austerity package spelled out over a sufficiently long period of time, so that economic growth gets a chance. Without economic growth, debt burdens cannot decline. The carrot is a concessional interest rate that makes it easier for the country concerned to stop debt accumulation. A low interest rate also expresses trust in the success of the package – trust that financial markets need in order to induce them to buy the government debt at a reasonable interest rate. I will come back to this point.

This intelligent approach was not followed. Why is this? Why has the idea that punishment should meted out become so important in the design of mechanisms to deal with the crisis? My answer is that the punishment idea has been much influenced by the idea that the crisis was caused to a large extent by moral hazard.

Is the debt crisis the result of moral hazard?

Moral hazard can be defined as additional risk-taking by agents who believe they are insured against the risk they take. Applied to the sovereign debt crisis in the eurozone, moral hazard means that some governments have issued too much debt in the past, expecting other governments to bail them out. In the context of the banking crisis, moral hazard arose when bankers were taking excessive risks also because they expected governments to bail them out.

There is a strong popular perception today that the core of the sovereign debt crisis is moral hazard. This is especially the case in Northern Europe. Many well-known economists in these countries have stressed the irresponsible behaviour of governments of peripheral countries as the root cause of the crisis and have warned that providing financial assistance will induce these governments to remain irresponsible (see Sinn, 2010). This view has dominated the popular press in countries like German and the Netherlands. As a result, the popular sentiment in these countries has very much turned against financial assistance for 'irresponsible governments'. This popular sentiment has been very influential in shaping the official German and Dutch policies. It is therefore important to once again analyse the question of whether the debt crisis is the result of moral hazard.

Let's consider the debt problems of Ireland and Spain (I'll turn my attention to Greece later). The government debt ratios in these two countries declined dramatically prior to 2007. When the bank crisis erupted, the governments of these countries were forced to rescue the banks and to sustain economic activity. The effect was that the government debt exploded in these countries. Under no stretch of the imagination can one interpret these events as being the result of moral hazard. The Spanish and Irish governments did not increase their debt because they expected to be bailed out by Germany or any other country. They did this because any government responsible for the welfare of its people would have done the same. There was no other available option except to let the economy and the market system in these countries implode.

Proponents of the moral hazard diagnosis may object here, by noting that even if the governments' actions were not driven by moral hazard, the latter was at the core of the banking crisis that forced the governments to intervene. Thus, ultimately the cause of the crisis is moral hazard: banks took excessive risks because they expected to be bailed out by their respective governments. This interpretation does not make sense either. It is true that bankers took excessive risks. But not because in the back of their mind they had this idea that their governments would rescue them. Top management of the banks could not possibly have hoped that governments would bail them out, as such a bailout operation could have cost them their heads. As argued earlier, they took excessive risk because, for various reasons, they massively underestimated it.

What about Greece? No doubt, there was a lot of irresponsible behaviour of successive Greek governments. But to think that these governments were spending excessively because they expected Germany to bail them out is far-fetched. It had everything to do with a weak political system that fell prey to pressures of domestic interest groups trying to obtain part of government largesse. In this process, politicians like bankers and many others, were swept up by the euphoria produced by (unsustainable) growth rates. The latter created the perception that the sky was the limit.

Surely there was misbehaviour of many actors in this drama. When interpreted in the light of moral hazard, it leads to the conclusion that punishment is necessary because it has the salutary effect of changing incentives. It teaches a lesson that should prevent those who have sinned from sinning again. And it teaches a lesson to the others who have not sinned that bad behaviour will be sanctioned.

The need for forgiveness

Too much emphasis has been put on the idea that governments and private market participants should be subjected to sanctions. I have argued that these sanctions will not work in preventing future crises. Worse, when applied to private market participants (e.g. sovereign bond holders), these sanctions will trigger crises more often than they will prevent them. When applied to the design of financial assistance, these sanctions make it more difficult to stop the debt accumulation, thereby prolonging the crisis.

The solution of the debt crisis must be sought not in systematic punishments of governments and private market participants. More emphasis should be put on a willingness to be forgiving. The main reason is that this is in the interest not only of the debtor but also of the creditor nations. Let me develop this point further, beginning with the figures presented in Table 1. I show the primary surplus that is needed to stabilise the government debt ratios in different problematic eurozone countries. Let us assume that the debt level these countries aim to stabilise at is the likely level that will be reached at the end of 2011. The interest rate that is applied in this calculation matters a great deal. I use two opposite scenarios. In one scenario I apply the present punitive interest rate used by the EFSF, which is close to 6%. In the second scenario, I assume that the EFSF would apply a 'gentle' interest rate, i.e. 3.5%, which is the interest rate paid by Germany on its debt plus some 'gentle' risk premium of 0.5% (so as to ensure that the creditor nations do not lose out). Thus, this scenario takes the view that the appropriate interest rate is the one that is approximately free of default risk.[1] In both scenarios I assume a zero growth rate of GDP. Thus, I assume away any improvement of the debt ratio coming from economic recovery.

The contrast between the two scenarios in Table 1 is striking. When the punitive interest rate is used (6%), the fiscal effort needed to stabilise the debt ratio is considerable, leading to the question whether these problem countries will be able or willing to make this effort. In the second scenario using the gentle risk-free interest rate, the fiscal effort required to stabilise the debt ratio is considerably reduced. Countries like Ireland, Portugal and Spain are clearly capable of making that effort, and thus they are capable of avoiding default, making the gentle interest rate applied to lending to these countries a self-fulfilling one, i.e. one that avoids default. It is unclear whether this also holds for Greece, where we see that applying the gentle interest rate will still require a considerable fiscal effort in that country. In addition, in the case of Greece, this effort stabilises the debt ratio at 145% of GDP, which can be considered to be unsustainable in the long run. Thus for Greece other solutions will have to be considered, i.e. debt restructuring.

Table 1. Primary surplus needed to stabilise debt ratios

		6.0%	3.5%
debt ratios			
Greece =	145	8.7	5.1
Ireland =	110	6.6	3.9
Portugal =	90	5.4	3.2
Spain =	70	4.2	2.5

The previous calculation illustrates that there are several possible equilibria. There is a nasty equilibrium. This is the equilibrium obtained in the punitive scenario with a high interest rate that in a self-fulfilling way increases the default risk in all countries concerned and thus keeps the interest rate high. There is a gentle equilibrium in which the lower interest rate reduces the fiscal effort needed to stabilise the debt ratio. By having a greater probability of success, this scenario leads to a lower default risk. The gentle interest rate produces a gentle equilibrium with a low interest rate. This gentle equilibrium is in the interest of both the debtor and the creditor nations.

Achieving this gentle equilibrium, however, is only possible if the creditor nations commit themselves to providing liquidity. They have the means to do so. The only possible obstacle is a political one. It will require convincing the German, the Dutch (and a few other) populations that it is indeed in their national self-interest to commit themselves to financial assistance.

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[1] These interest rates are of course hypothetical. The actual interest rate on the outstanding debt of these countries today is different. The point is that interest rates on the debt would tend to converge to the interest rates set by the EFSF. Thus in Table 1 we look at the long-run solvency requirement under these two interest rate scenarios.

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