



VNIVERSITAT DE VALÈNCIA

Investidura com a Doctor "Honoris
Causa" per la Universitat de València a
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Discurs d'acceptació

València, 30 novembre de 2012

The eurozone as a morality play

Mr. rector, colleagues, students and friends.

LET ME FIRST EXPRESS MY FEELINGS OF GRATITUDE and joy for being here with you today receiving such a great honor of Doctor *Honoris Causa* from your University. The degree you bestow on me is not only a great honor, it also signals to me and to many of my colleagues in this and in other universities how important the search for truth is.

So in a certain sense what we celebrate here today is this constant effort to find the truth that I and many of my friends and colleagues have been engaged in.

It will be no surprise to you that I want to lecture on the crisis in the Eurozone; a crisis that if not contained soon will endanger the fabric of the European Union.

It is no exaggeration to state that there is a deep cleavage between the North and the South of the Eurozone. The cleavage is not only economic: a relatively prosperous North

that up to now has not been affected much by the sovereign debt crisis; and a troubled South (including Ireland) where the debt crisis has hit with full force, pushing countries into a bad equilibrium that is characterized by high interest rates, budgetary austerity, increasing unemployment and economic recession.

Parallel to this economic cleavage, there is a deep divide in the nature of the analysis provided by economists of the causes and the remedies of the sovereign debt crisis. The view of the causes and the remedies of the crisis that prevails in Germany and its satellites, has two ingredients. First, on the diagnostic side there is the conviction in the North of Europe that governments' profligacy that led to excessive deficits and debts is to be blamed for the crisis. Second, on the remedies side the Northern view is that punishment should be meted out to these governments so as to signal to them that they should not try "to sin again".

The "Northern diagnosis" of the crisis may apply to Greece, it does not do so for most other Eurozone countries, in particular not to Spain. Prior to the crisis, the government debt to GDP ratio was declining in most Eurozone countries. Debt to GDP ratios started to increase after 2007 when governments were forced to save the banking system and to sustain economic activity (by allowing automatic budget stabilizers to do their work). Instead of blaming these governments, "Northern analysts" should congratulate them

for having saved the banking system and much of the private economy. The high budget deficits and debts inherited from that episode are testimonies of the public service provided by governments.

A diagnosis that blames governments for the crisis is almost surely not the one that provides the correct remedies. The insistence that governments should be punished for their bad behavior by tough austerity programs has had the effect of bringing the Eurozone to the brink of a new recession. This will not help to reduce budget deficits and debts. Invariably, recessions increase government deficits and debts, thereby offsetting a large part of the effects of budgetary austerity.

This being said, the levels of government debts and deficits are too high and should decline over time. The point is that the Northern analysis has the effect of imposing tough austerity too quickly and on too many countries at the same time. This leads to a deflationary spiral that is pushing the Eurozone into a double-dip recession. Rarely has an analysis been so influential and unhelpful in solving a crisis. Why has Northern Europe be gripped by such an unhelpful diagnosis of the crisis?

One reason is that too many analysts in Northern Europe see the crisis as a problem of moral hazard. Many well-known economists in these countries have stressed the irresponsible behavior 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. This view has dominated the popular press in countries like Germany, Finland 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, Finnish and Dutch policies. But is the crisis the result of moral hazard?

Take the cases of Ireland and Spain. The government debt ratios in these two countries declined dramatically prior to 2007. More than in other countries 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. With 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 since 2007 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 thing. There was no other valuable option except letting 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 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. They took excessive risks because the euphoria during bubble years prevented them from seeing risks. The euphoria in turn was generated by financial markets that lacked any disciplinary mechanism, and by an absence of supervision as the supervisors were gripped by the same euphoria. Moral hazard had almost nothing to do with this.

Moral hazard thinking in Northern Europe has now degenerated into a morality play in which there are good and bad countries. The good countries should not assist the bad ones. Doing so would reward bad behavior. Punishment is necessary. The facts are that if in the South private agents took too much risk prior to the crisis, it must also be true that the creditors from the North were equally reckless in giving so much credit to borrowers they should have expected would have payment difficulties. It takes two to tango. For every reckless debtor there is a reckless creditor.

So we must stop playing a morality game in the Eurozone. Responsibilities of the disaster are shared by the North and the South.

The moralistic attitude is the single most important obstacle to resolving the crisis. This moralistic thinking also has the effect of introducing distrust and hostility between member countries. As long as this distrust exists no solution of the Eurozone crisis is possible.

So, let's set aside this moralistic attitude and think practically of the ways the crisis can be solved. I see three major areas in which action is necessary.

The first area has to do with the role of the ECB. First, the ECB should step in to stop panic and fear from undermining the stability of the Eurozone. The ECB is the only institution that can prevent market sentiments of fear and panic in the sovereign bond markets from pushing countries into insolvency. As a money creating institution it has an infinite capacity to buy government bonds.

On September 6, 2012 the ECB finally recognized this point and announced its "Outright Monetary Transactions" (OMT) program, which promises to buy unlimited amounts of sovereign bonds during crises. This was a great step forwards and has had the effect of reducing the existential fears that existed in the Eurozone.

Thus, the ECB has made the right decision. However, the credibility of the program suffers because of continuing

vehement criticism especially in Germany. Many arguments continue to be voiced against the view that the ECB should be a lender of last resort in the government bond markets. Some of them are phony, in particular the inflation risk argument. Others should be taken more seriously. There is the moral hazard risk. I argued that moral hazard risk has been exaggerated. However, in this case we should take it seriously. When the ECB provides unlimited support in the government bond markets it may create incentives for governments to reduce their efforts at reducing debts and deficits. This risk, however, should be taken care of by separate institutions, in particular the European Commission, aimed at controlling excessive government debts and deficits. These are in the process of being set up (European Semester, Fiscal Pact, automatic sanctions, etc.). This disciplining and sanctioning mechanism then should relieve the ECB from its fears for moral hazard (a fear it did not have when it provided 1,000 billion to banks at a low interest rate in the context of the LTRO program at the end of 2011 and early 2012).

The continuing fierce criticism against the notion that the ECB should be a lender of last resort in the government bond markets explains why the ECB attached a number of conditions to its OMT-program. These conditions are likely to reduce the effectiveness of that program. First, the ECB will restrict its bond purchases to bonds with a maturity of 3

years or less. There is no good economic argument to impose such a restriction. In fact, it may even increase the fragility of the sovereigns. These will now have an incentive to issue bonds with shorter maturities than they would have done otherwise, making them more vulnerable to liquidity crises.

Second, the ECB has attached as a condition to the use of the OMT-program that the countries concerned apply to the ESM which may then subject these countries to additional austerity programs. This creates the problem that countries are pushed further into a recession as a condition to obtain relief from the ECB. It is difficult to understand the economic logic of such an approach. It is in my view the result of the moralistic approach to the problem that is very popular in the North of Europe and that wishes countries applying for support to be punished first for their sins.

The second area of action has to do with macroeconomic policies. The European Commission should take the lead in changing the nature of macroeconomic policies in the Eurozone. Countries experiencing deficits in the current accounts of their balance of payments have no other possibility than to continue austerity, however, the European Commission should allow these austerity programs to be spread over a longer period. While the European Commission travels to the deficit countries and preaches austerity, it should also go to the countries with a surplus on their current accounts and urge them to stop trying to

balance their government budgets when the Eurozone risks moving into a recession. The European Commission's message should be that budget deficits in these countries are good for them and for the system.

It is my contention that the asymmetry in the macroeconomic policies in the Eurozone whereby the Southern European countries are forced into violent austerity programs while the North of Europe refuses to offset this by expansionary macroeconomic policies is the cause of the double dip recession in which the Eurozone is now pushed into. This recession now constitute the single largest risk for a breakup of the Eurozone. As countries will be pushed further into a recession, despair will be intensified leading to uncontrollable social and political reactions.

Finally, a budgetary union and a banking union are key ingredients of a sustainable monetary union.

Budgetary union, however, is a long-term prospect. There is little prospect for achieving it quickly, because it implies a fundamental transfer of sovereignty from the nation states to European institutions. What can be done relatively quickly, however, is the issue of common Eurobonds. This approach has the merit of signaling to the market that irreversible steps towards budgetary union are being taken today, thereby reducing the existential fears that destabilize the Eurozone. Clearly many problems will have to be overcome to launch Eurobonds but this approach has the merit of starting a

process that is unavoidable if one wishes to maintain the euro.

The same can be said about the banking union. Such a banking union is important to make the monetary union sustainable. It makes it possible to cut the “deadly embrace” between the banks and the sovereign. When banks are in trouble, the sovereign also gets into difficulties. Conversely, when the sovereign is defaulting, the banks are pushed into insolvency also. This is one of the problems Spain suffers from today. A banking union allows cutting the link between the national government and the banking system.

A banking union, like a budgetary union, however, requires a large transfer of sovereignty to European institutions. The latter must be given the power to supervise the banks. It must also be given the resources to intervene in crisis times.

These are the three components of any program to save the euro. The details of such a program can differ, but the broad outlines cannot be varied much. Whether such a program can find the necessary consensus among the European political leaders remains to be seen.

Such a program can only work if there is trust between the member-countries of the Eurozone. Northern European countries must trust that Southern European countries are serious about reducing their debt and deficit levels. Southern European countries must trust the Northern European

countries that these have no intention to dominate them. Without mutual trust no further steps towards transfer of sovereignty is possible. And trust can only be established if one is willing to set aside the moralizing analysis that has prevailed in the last few years, and that leads to the view that some countries have been virtuous and others sinful. The Eurozone is not a morality play.

We should act quickly because the level of trust between the member-countries is declining fast. It is my conviction that it is not yet too late.

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