CONDITIONAL EUROBONDS AND EUROZONE REFORM

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• **Reduce** the Euro-area policy focus on fiscal austerity.

• **Switch** to a focus on improving **competitiveness and productivity** (hence growth).

• **Simultaneously** promote **fiscal decentralisation** and **sensible fiscal policy** with national incentives.

• **Achieve all this** through **rules-based risk spreads** for individual countries’ Eurobonds.

INTERNAL IMBALANCES

• Despite spotty improvements, internal imbalances in the common currency area remain a major problem:
  o divergent fiscal discipline;
  o profound differences in labour market, credit, and housing institutions;
  o past failures in financial regulation have left a burden;

• This is visible in divergences in:
  o competitiveness, government, and private debt to GDP ratios, balance of payments deficits, housing market experiences.
• Fundamental issue to resolve:
  o Eurozone lacks the democratic institutions for a fiscal union. Fiscal union without draconian centralisation may pose dangers of perverse incentives.
• Create the right incentives:
  o mixture of carrots/sticks to enable the poorly performing economies to return to economic growth and avoid a future existential crisis;
  o discourage moral hazard;
  o arrive at a fair distribution of burden sharing between taxpayers in different countries and holders of sovereign and bank bonds.
• *Conditional* eurobonds:
  
  o Eurobonds with a collective underwriting guarantee which eliminates the country risk faced by investors;
  
  o Administratively set spreads determine the annual side-payments the riskier countries (Ireland, Italy, Portugal, Spain) pay into a common fund.
  
  o Spreads would compensate the taxpayers in less risky countries for their risk in underwriting the bonds of the riskier countries.
• Conditional eurobonds with risk premia based on economic fundamentals could:
• Create the incentives for the fundamental structural reforms still outstanding.
• Limit the country sovereign debt risk faced by investors (other than in the special case of Greece).
• Avoid the ‘transfer union’ feared by Germany.
• **Conditional eurobonds:**

  o All new borrowing would be in the form of eurobonds. Only countries not under a troika –supervised programme permitted to issue eurobonds.

  o The spreads would be set conditional on a set of clear performance targets ratified by a new European monetary and fiscal authority (EMFA).

  o As economic fundamentals improve, fiscal authorities know that borrowing costs will decline.
• Current spreads of 10 year bond yields relative to Germany have been depressed below economic fundamentals by QE programme.
• Market signals also worked badly in previous years:
• Before 2009, markets paid far too little attention to underlying fundamentals.
• Between 2009 and 2013, markets were distorted by panics, fear of euro-area break up and fluctuations in risk appetite.
• Policy makers don’t know how to interpret the signals.
Create strong incentive for the right reform priorities.

This makes conditional eurobonds quite different from conventional eurobonds.

Kopf (2011) and Gros (2011): conventional eurobonds suffer from incentive problems, creating the risk of a future, even larger crisis.
Model for 10-year yield spreads relative to Germany needs to take account of:

- Inattention before 2007
- Growing attention to fundamentals from 2007 to 2010
- Temporary amplification in market panics and falls in risk appetite
- Effect of QE from late 2014

Model in

http://www.inet.ox.ac.uk/files/publications/ukmfeat4.pdf

updates OXREP

https://ideas.repec.org/a/oup/oxford/v29y2013i3p610-645.html
• DATA
  o Economic fundamentals data: quarterly frequencies.
  o Panel model with quarterly data on spreads in 10-year sovereign bond yields relative to Germany for 9 other euro area countries.
  o Omit Greece: market did not have a realistic assessment of its fundamental data until 2010.
  o Include Ireland and Portugal: up to the quarters preceding their bailouts (in 2010Q2 and 2010Q3).
  o Terms of the rescue packages supervised by the ‘troika’ affected spreads. Ireland then included again for 2014Q1 observation.
• STRUCTURAL CHANGE

- **PHASE 1**: beginning in 2007Q3:
  - Linked with the drying up of money markets, initially triggered by losses in money market funds, partly invested in sub-prime linked securities.

- **PHASE 2**: beginning in the second half of 2009 with full ‘attentiveness’ being reached by the end of 2010.
  - Triggered by increasing worries about sovereign debt and imbalances (dramatised by Greece).
• STRUCTURAL CHANGE
  o The two phases are handled by a linear combination of two dummy variables making a smooth transition from zero to one between mid-2007 and the beginning of 2009 and from then to the last quarter of 2010.
  o Rising attentiveness:
• OVERREACTION OR AMPLIFICATION

  o **First**: by introducing sensitivity to global risk appetite.
  o **Second**: by use of dummy variables to capture euro-area specific ‘alarm’.

• The *alarm function* is influenced both by stated policy of the ECB and other euro area policy makers and by ECB interventions in the sovereign bond markets.

• The model thus includes a time-varying scale factor consisting of ‘attention’ plus ‘alarm’ which amplifies the scalar function of the basic economic drivers of each country’s long-run spreads relative to Germany.
A NEW ECONOMETRIC MODEL

1. ‘Longterm’ solution for the yield spreads can therefore be defined by
   \[ y_{it} = f(x_{it})(attention_t + alarm_t) \]  \hspace{1cm} (2)
2. Attention=1 from 2010Q4; steady state value of alarm=0.
3. In a post-2010 steady state, we have
   \[ y_{it} = f(x_{it}) \]
4. Slightly augmented partial adjustment model for the quarterly change in spreads captures the dynamics well.
5. Speed of adjustment: 25% per quarter; so that around 70% of the adjustment is complete after a year.
• OVERREACTION OR AMPLIFICATION
  o Estimated value of \((attention_t + alarm_t)\) shown; includes plot evaluated when index of global risk appetite is zero.
  o Scale/volatility of amplification: more than 3-fold exaggeration of the underlying fundamentals, end-2011.
• Competitiveness measured by unit labour costs
• Gov’t debt/GDP, linear and non-linear, so very high debt/GDP has larger effects on spreads
• Private debt/GDP
• Fall-out from housing market crises, worse for countries with previously high hp growth
• Short-term news on growth and inflation - all relative to Germany.
Comparing actual & fundamental spreads for Italy
Composition of fundamental spread for Italy

SYRI – fundamental spread
COMP – competitiveness
DEBT – government debt/GDP
PDEBT – private debt/GDP
NEWS – effects of change in growth and inflation rates
HPF – asymmetric house price dynamics
Comparing actual & fundamental spreads for Spain
Composition of fundamental spread for Spain

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How do these fundamentals affect future growth?

- Remarkable findings from a 9-country panel model (with fixed effects) for 2 years ahead growth rate of real GDP relative to Germany:
  - Competitiveness, 2-year lag
  - Gov’t debt/GDP has +’ve growth effect for moderate debt, -’ve for very high debt, 2-year lag
  - Private debt/GDP has –’ve effect, 1-year lag
  - Current year hp growth has +’ve effect but overwhelmed by –’ve effects of appreciation in previous 2 years
Inflation in previous 3 years has negative effect, reinforcing story about competitiveness.

Tendency for partial reversal of high growth rates in previous 3 years.

All highly statistically significant effects.
Policy implications

- Competitiveness and low relative inflation really matter: emphasis on labour and product market reforms, productivity, wage restraint.

- Powerful housing market overshooting effects and negative effects of high private debt/GDP: good financial regulation and macro-prudential policy are crucial.

- Fiscal austerity is bad for growth except for extreme levels of govt debt/GDP.

- For a growth promoting strategy, the weights on the economic fundamentals driving yield spreads overemphasise govt/debt, except for extreme levels.
Conclusions

- A new European monetary and fiscal authority (EMFA) could set weights on the four fundamental economic factors driving risk spreads on 10-year bond yields combining econometric evidence from models for spreads and models for relative growth rates.

- These ‘shadow prices’ would incentivise governments (and prudential regulators) to promote reform agendas for improved competitiveness and credit and housing market stability, and avoiding excess govt debt – without a central fiscal authority.
Change policy, in the absence of eurobonds with risk spreads…

- Current **overemphasis** on fiscal austerity – better a general fiscal expansion (but for the highest govt debt/GDP economies)

- ‘QE for the people’ (http://www.voxeu.org/article/combating-eurozone-deflation-qe-people) or explicit monetary financing of government spending is appropriate in a deflationary world in which the euro-area, with its large trade surpluses, is sucking demand out of the world economy.

- Within the euro-zone, need to reward governments and unions promoting labour and product market reform.