CONDITIONAL EUROBONDS AND EUROZONE REFORM

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OENB workshop 'Towards a genuine economic and monetary union',

Vienna, 10-11 September, 2015

- <u>Reduce</u> the Euro-area policy focus on fiscal austerity.

- <u>Switch</u> to a focus on improving competitiveness and productivity (hence growth).

- <u>Simultaneously</u> promote fiscal decentralisation and sensible fiscal policy with national incentives.

- <u>Achieve all this</u> through rules-based risk spreads for individual countries' Eurobonds.

- Early version in 2011 http://www.voxeu.org/epubs/cepr-reports/resolving-eurozone-crisis-time-conditional-eurobonds

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

- This is visible in divergences in:
- 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.

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- *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.

o Create strong incentive for ***the right reform priorities*** .

o This makes conditional eurobonds quite different from conventional eurobonds.

o Kopf (2011) and Gros (2011): conventional eurobonds suffer from incentive problems, creating the risk of a future, even larger crisis.

o Model for 10-year yield spreads relative to Germany needs to take account of:

o inattention before 2007

o Growing attention to fundamentals from 2007 to 2010

o Temporary amplification in market panics and falls in risk appetite

o Effect of QE from late 2014

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

- STRUCTURAL CHANGE

o *PHASE 1*: beginning in 2007Q3:

o Linked with the drying up of money markets, initially triggered by losses in money market funds, partly invested in sub-prime linked securities.

o *PHASE 2*: beginning in the second half of 2009 with full 'attentiveness' being reached by the end of 2010.

o 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:
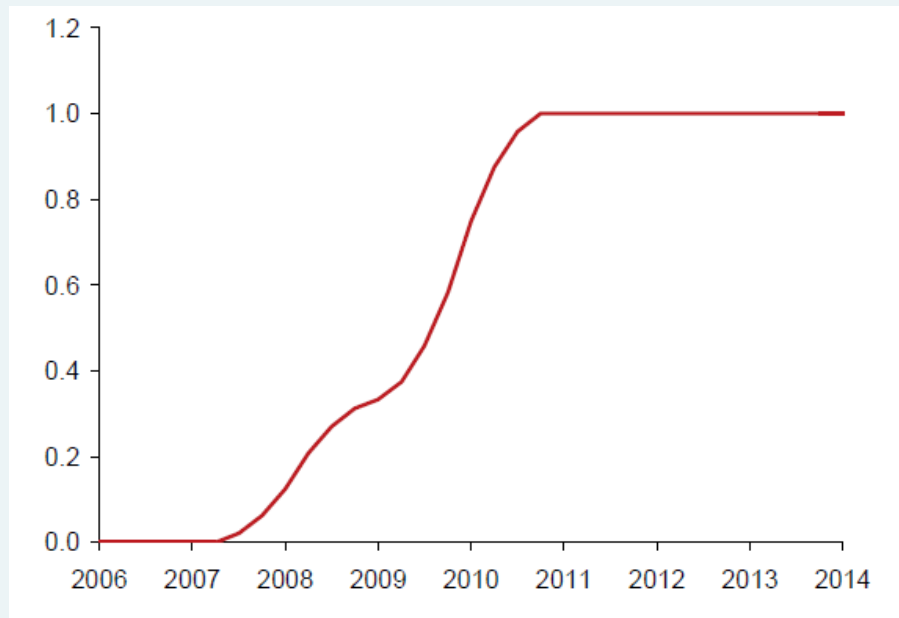
- OVERREACTION OR AMPLIFICATION

- First: by introducing sensitivity to global risk appetite.
- 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.

o 'Longterm' solution for the yield spreads can therefore be defined by

$$y_{it} = f(x_{it})(attention_t + alarm_t) \qquad (2)$$

o Attention=1 from 2010Q4; steady state value of alarm=0.

o In a post-2010 steady state, we have

$$y_{it} = f(x_{it})$$

o Slightly augmented partial adjustment model for the quarterly change in spreads captures the dynamics well.

o Speed of adjustment: 25% per quarter; so that around 70% of the adjustment is complete after a year.

- OVERREACTION OR AMPLIFICATION

○ Estimated value of ($attention_t$ + $alarm_t$) shown; includes plot evaluated when index of global risk appetite is zero.

○ Scale/volatility of amplification: more than 3-fold exaggeration of the underlying fundamentals, end-2011.


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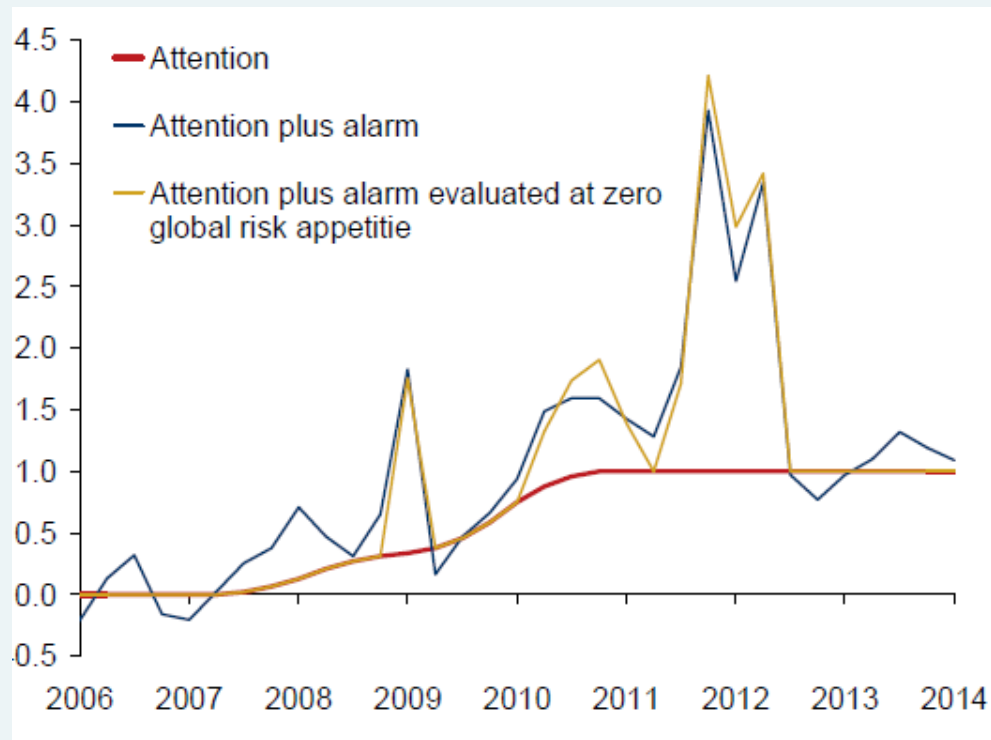
- Competitiveness measured by unit labour costs
- Gov't debt/GDP, linear and non-linear, so very high debt/GDP has larger effects on spreads
- Private debt/GDP
- Fall-out from housing market crises, worse for countries with previously high hp growth
- Short-term news on growth and inflation

   -all relative to Germany.
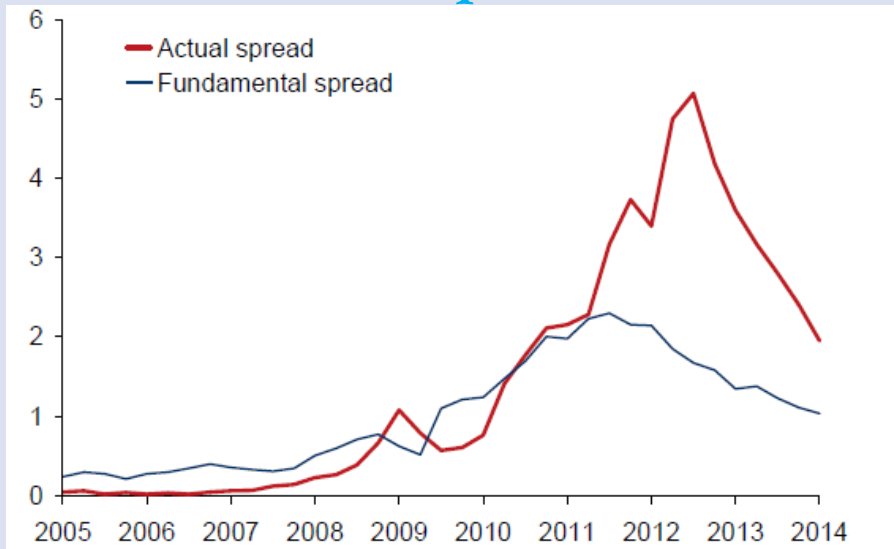
Comparing actual & fundamental spreads for <u>Italy</u>
# Composition of fundamental spread for <u>Italy</u>
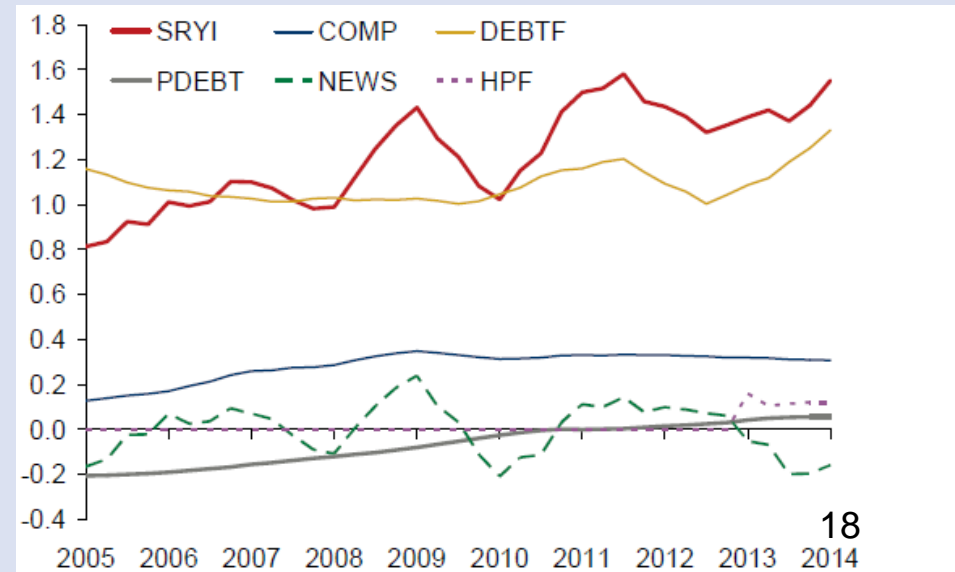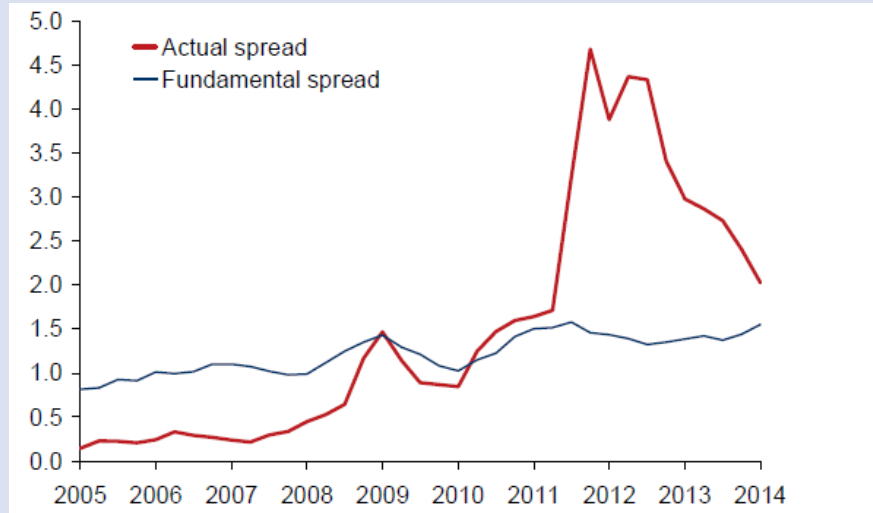
SYRI – fundamental spread
COMP – competitiveness
DEBT – government debt/GDP
PDEBT – private debt/GDP
NEWS – effects of change in growth and inflation rates
HPF – asymmetric house price dynamics

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Comparing actual & fundamental spreads for Spain
Composition of fundamental spread for Spain

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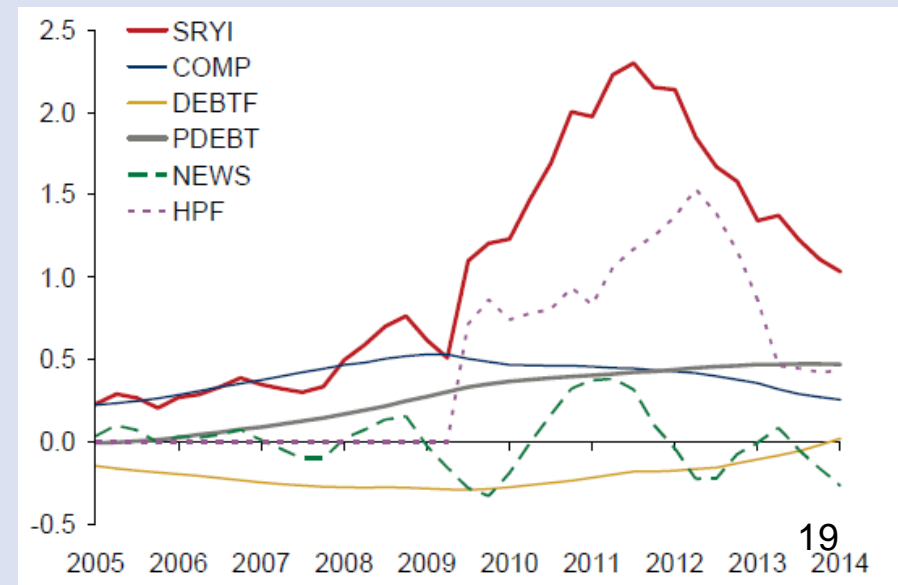
How do these fundamentals affect future growth?

o Remarkable findings from a 9-country panel model (with fixed effects) for 2 years ahead growth rate of real GDP relative to Germany:

o Competitiveness, 2-year lag

o Gov't debt/GDP has +'ve growth effect for moderate debt, -'ve for very high debt, 2-year lag

o Private debt/GDP has –'ve effect, 1-year lag

o Current year hp growth has +'ve effect but overwhelmed by –'ve effects of appreciation in previous 2 years

…..future growth

o Inflation in previous 3 years has negative effect, reinforcing story about competitiveness

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

o All highly statistically significant effects.

Policy implications

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

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

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

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

Conclusions

o 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.

o 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…

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

o 'QE for the people' (http://www.voxeu.org/article/combatting-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.

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