

A policy response to the intra-Eurozone crises

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Twin crises in Europe

- **Balance of payments crisis** (flows)
- **External debt crisis** (stock)

In a **single currency** area (or, impossibility of managed devaluation)

Alternative: public debt restructuring + systemic bank resolution (without external assistance)

Two Stories: ECB 'Credibility' or 'the Greatest Moral Hazard Trade in Human History?'

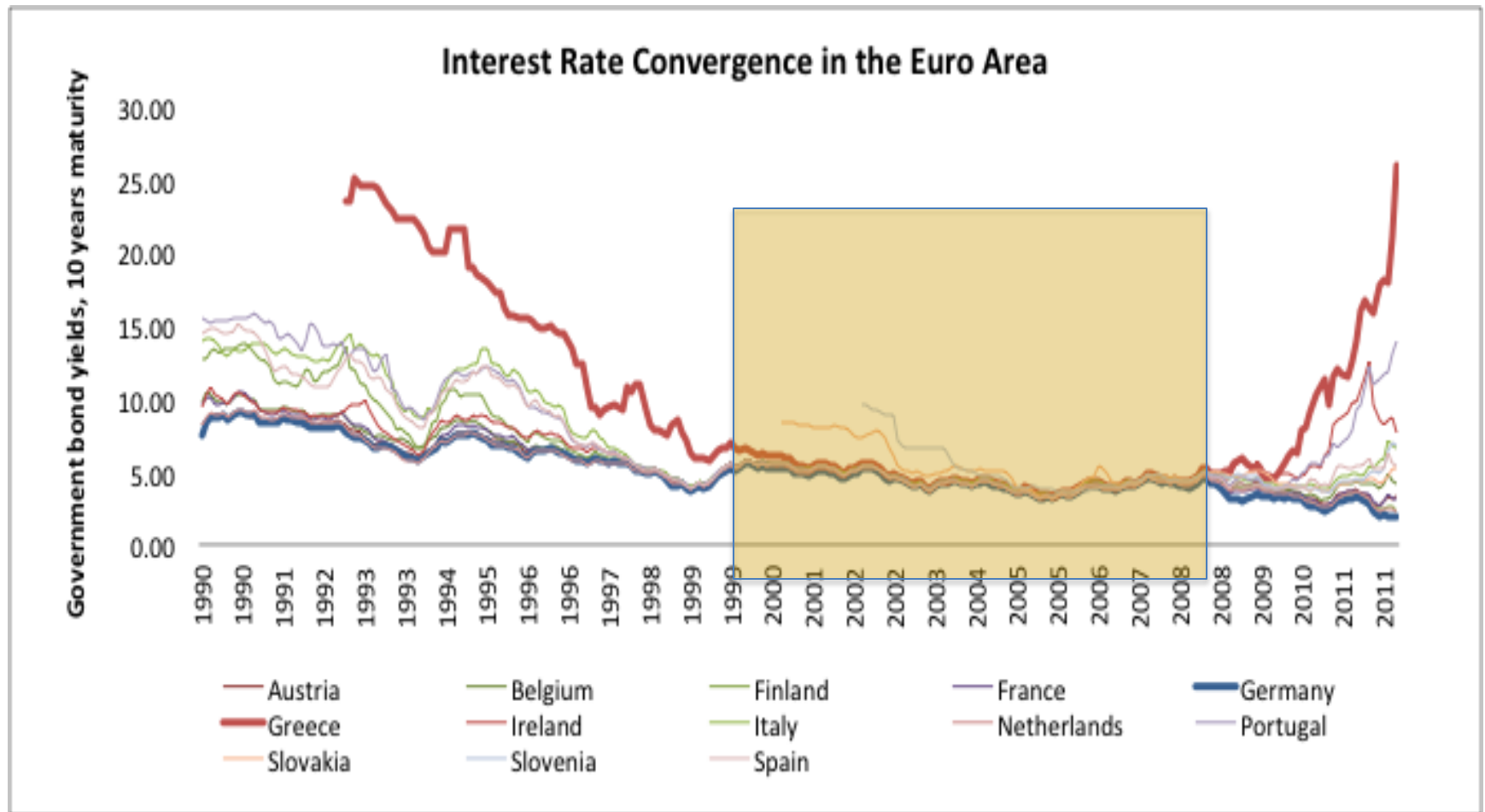


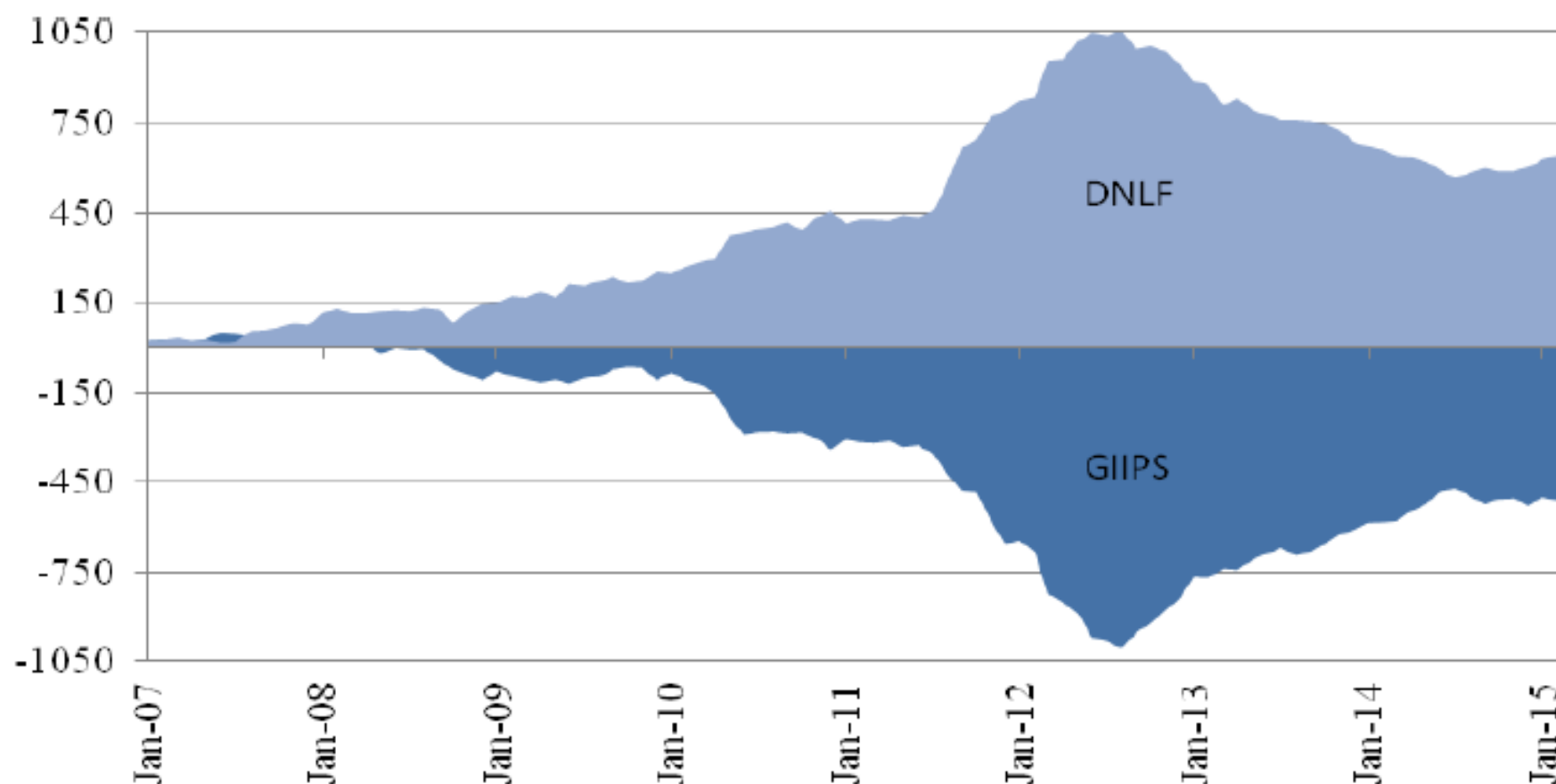
Figure 5. Portugal's net external liabilities (% of GDP)



Source: Bank of Portugal (BoP)

Notes: Position at the end of the period

Figure 3. Evolution of Eurosystem Target2 balances (€billion)



Source: Euro Crisis Monitor, Institute of Empirical Economic Research, Osnabrück University

Notes: GIIPS = Greece, Ireland, Italy, Portugal, and Spain; DNLF = Germany, Netherlands, Luxemburg, and Finland

Versailles agreement after WWI

Reparations of 269 billion marks, for 42 years, 200% of GDP

2 debt restructurations:

1924 Dawes plan,

in 1929 by Young;

Young and Dawes proposed **linking payments to growth**, Europeans did not support, but conceded; US accepted that payments reduction would reflect in diminishing payments for war debts towards the US

(but a **foreign agent** general with powers to enforce the agreement, priority for investors in the Dawes Loan; the gov should **balance the budget** including reparations)

Finally, a reparations **moratorium** was announced by Hoover

Keynes at Bretton Woods



International Clearing Union (with a currency, the “bancor”, all world trade in *bancors*) – correcting the balance of payments

Large supply of credit for deficit countries

Incentives for countries with surplus to expand domestic aggregate demand

Bail-outs during the crisis

- Comparable to IMF's "structural adjustment programs" with no devaluation
- Instead, internal devaluation
- + privatization
- + structural change in flexibility of labor, or wage and working hours flexibility

Debt everywhere

Not so pretty a picture

— United States — *Euro area* — Britain

Government debt
As % of GDP



Central bank assets
As % of GDP



Consumer prices
% change on a year earlier

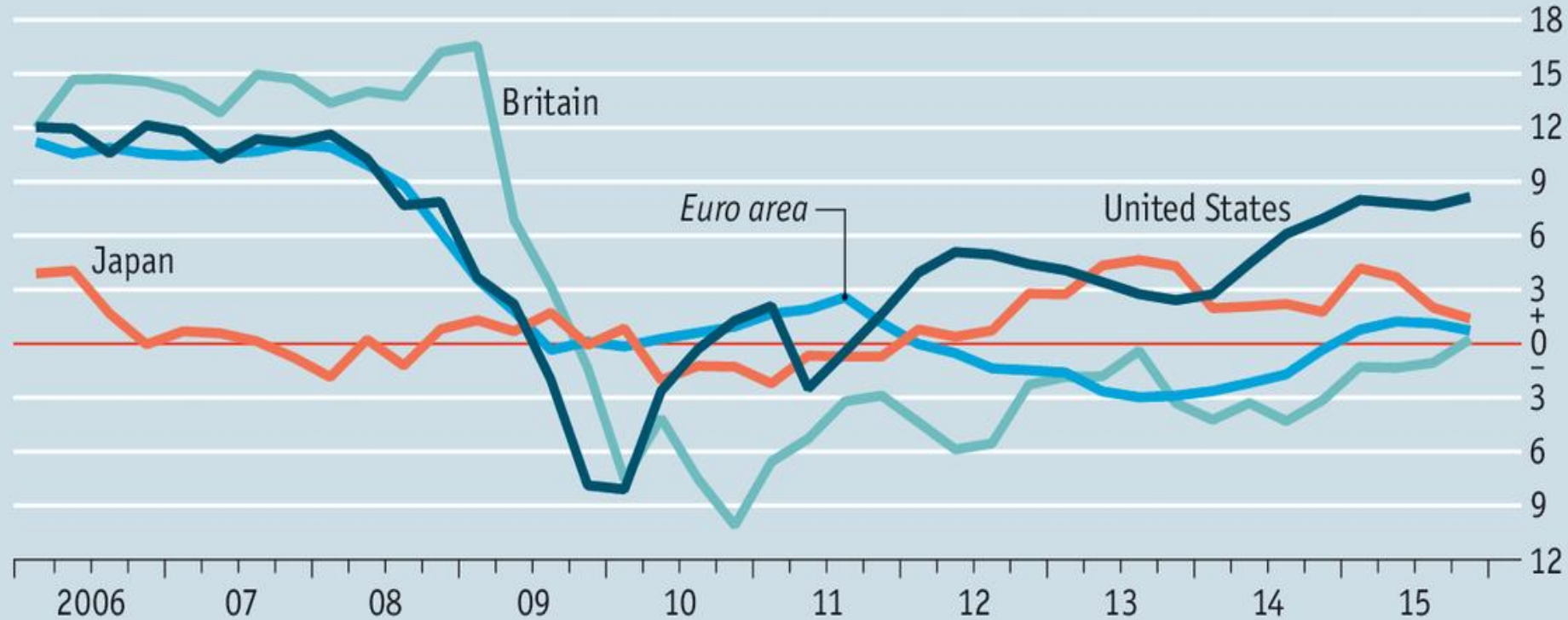


Source: Haver Analytics

No credit

Unwilling to lend

Bank credit to private sector, % change on a year earlier



Source: Haver Analytics



The Draghi Plan



Quantitative Easing:
Monetary emission
for 1 to 2 trillion euros
for the purchase of
financial assets,
including public debt
(in the secondary
market)

Why is the Draghi plan insufficient?

- 1. It is temporary (and what about the large account in the ECB?)
- 2. It failed to deliver on investment.
- 3. It created a wealth effect and augmented the flow of liquidity in the stock market, thus generating bubbles

Then,

Debt restructuring is required.

Table 3. Macroeconomic policy targets of the public debt restructuring and of the systemic bank resolution

	Before		After	
	(€billion)	% of GDP	(€billion)	% of GDP
General Government and State-Owned Enterprise Sector				
Non-consolidated gross debt				
Face value	287	173%	287	173%
Present value	285	173%	136	82%
Gross external debt				
Face value	148	89%	148	89%
Present value	148	89%	67	40%
Resident Monetary Financial Institutions (MFI)				
Aggregated balance sheet	515	310%	429	259%
Capital and reserves	51	31%	68	41%
Other liabilities, of which	464	280%	361	218%
Gross external debt	87	52%	37	22%
Eurosystem loans	51	31%	51	31%
Portugal				
Gross external debt (Face value)	371	224%	320	193%
Gross external debt (Present value)	371	224%	239	144%
Net external debt (Present value)	171	103%	39	24%

Source: Bank of Portugal (BoP), European Central Bank (ECB) and authors' estimates