Curing the eurozone

Politicians may be unwilling to consider it, but the eurozone's problems could be solved through a slight twist on debt monetisation, argues ***Marcello Minenna***

The eurozone crisis is in remission – it has not gone for good. Market participants were reminded of that in late September, when the president of the European Central Bank (ECB) suggested another shot of liquidity for eurozone banks may be needed to keep market interest rates in check.

This, of course, would only be a booster injection – so what might a final cure look like? It would need to be a powerful restorative – reuniting a euro that has fragmented into a host of shadow currencies, while also cutting the ties between nation states and their domestic banks. This would need to be done without stoking inflationary pressure.

I believe it could be done, and this article sketches out one solution – a monetisation of outstanding eurozone debt. It would require a little creativity and a lot of bravery – probably too much of the latter to work in the current climate. That is a shame, because the potential benefits are huge.

The eurozone's problems are, by now, widely recognised. The currency union is only partial – members gave up control of the fundamental tools of economic policy, but retained control of fiscal policy; markets assumed homogeneity between the 17 states, and the steadily accumulating imbalances only became clear when confidence in the project evaporated following the financial crisis (see figure 1).

Each country is now evaluated separately. The more indebted countries, with weak exports, no longer benefit from low interest rates and have to finance themselves at unsustainable levels, without the ability to devalue the currency. One consequence is that each country is characterised by its own interest rate curve, whereas a monetary union is only compatible with a unique interest rate curve (see figure 2). In fact, observing different government interest rates in the eurozone bond markets is like registering different prices for the same underlying asset. Obviously, these differences reflect the perceived probability that each will leave the euro and depreciate in order to avoid default.

If the homogeneity of the eurozone government bonds is assumed, differences in government yields could be described as a shadow exchange rate between, for example, the Italian euro and the French euro, or the Spanish euro and the German euro.

This is more than just a conceptual trick. If the interest rate spread between Italy and Germany is plotted alongside the exchange rate between the old Italian lira and Deutschmark (until they were withdrawn), as well as the credit default swap spread differential between Italy and Germany, one finds surprising similarities (see figure 3).

One of the most dangerous consequences of the dissolution of the unique curve of interest rates is the progressive nationalisation of the debt of peripheral countries. These bonds are confined to the balance sheets of domestic banks that are – more or less – forced to finance their own government. It's a sort of debt nationalisation that offers no benefit to the banks, which are burdened with a deteriorating balance sheet, nor to the government, which would have to support them.

This all contributes to the destruction of the high level of economic integration that had been achieved prior to the crisis. Going to the extreme, at the point when all the debt of each country is nationalised, the euro effectively ceases to exist.

Marcello Minenna, Consob

Exiting the crisis: an alternative proposal of debt monetisation

In the medium to long term, a plausible solution for the eurozone crisis could be via a partial mutualisation of debt, the creation of a basic system of fiscal transfers or, alternatively, a well-planned debt monetisation that should seek to obtain four intermediate results: ease the debt burden of the most distressed countries; bolster the eurozone banking system through a permanent liquidity injection; help the real economy to recover with a monetary stimulus that can be modulated via the banking system in order to reduce inflationary pressures; and – arguably the most difficult – win approval from the core eurozone countries.

To help find favour with the eurozone core, the monetisation should use the GDP, rather than the debt, as the numeraire. In other words, the higher the GDP of a eurozone country, the higher the amount of debt monetised. In contrast, when the numeraire is the debt, monetisation would be proportionate to the size of the burden. This could help win round countries such as France and Germany, which in absolute terms would see far more of their debt paid down.

Monetising eurozone government bonds to a 20% debt-to-GDP level – a total in excess of €2 trillion – means eurozone countries would not have to hold fresh auctions for two years, on average. This would create a firebreak, inhibiting the growth of the yield differential between different eurozone issuers and encouraging convergence to a single, re-established euro curve.

The inflationary effects would be controlled by having the ECB reimburse investors directly as each bond matures, producing a gradual monetisation that would follow the term structure of eurozone government debts. In addition, since the majority of the public debt is held on domestic bank balance sheets, there would be no sudden injection of money into the economy – the funds would, at least temporarily, be held by the banking industry, being gradually released as the debts were paid off.

As stockpiles of illiquid domestic debt shrink at each bank, the vicious circle linking bank and sovereign would be broken – sovereigns would no longer depend on their own banking industry to support their auctions, and banks would be healthy enough not to rely on the valuation of the debt. The interbank funding market could be restored, and sovereign bonds of peripheral issuers would once again be held throughout Europe.

In the end, restoration of the unique curve of eurozone interest rates would allow a return to a more balanced state for the region and the implementation of structural measures that would move it towards stricter economic integration.

During this process of normalisation, it should also be remembered what triggered and amplified the financial crisis – namely excessive risk-taking. A new framework of regulation should be designed that would ensure financial institutions properly measure and disclose probability-weighted risks, hopefully encouraging the design of genuinely valuable financial products. If that happens, we would not just be fixing the problems of the past, but also disarming the next speculative bomb. ■

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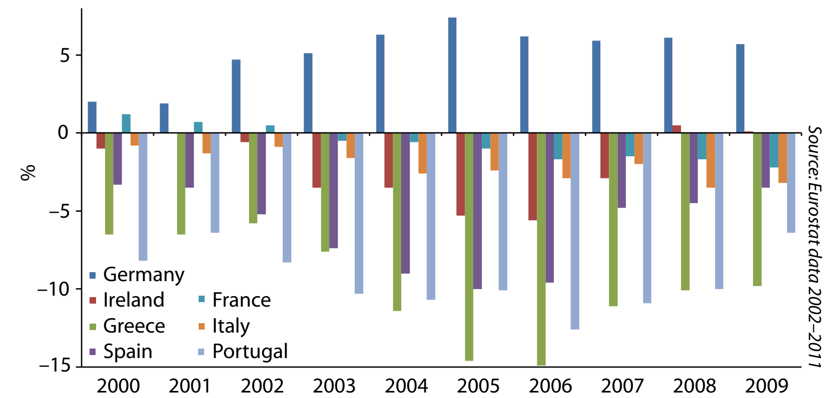
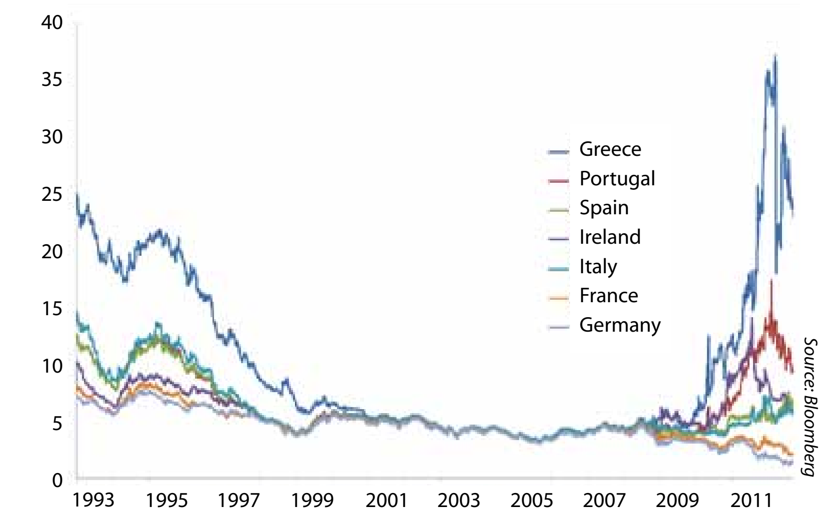
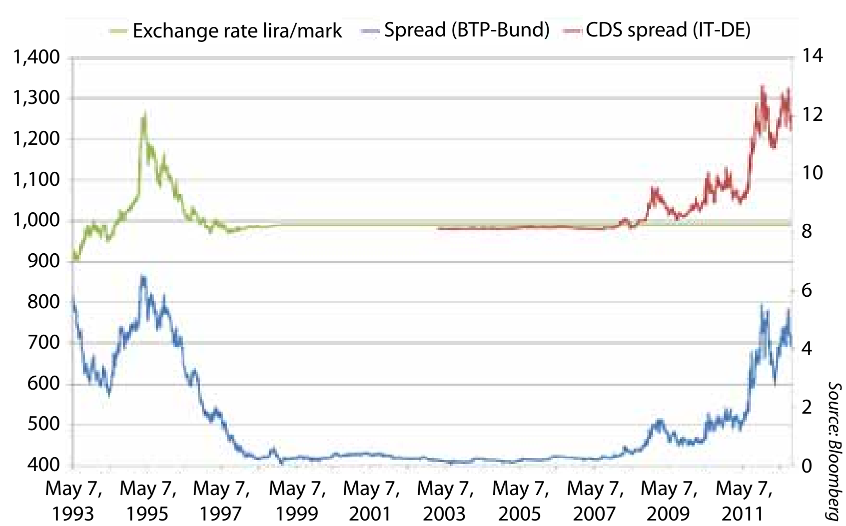
1 Balance of trade for the main eurozone economies



2 The 10-year government bond rate for selected eurozone countries



3 Comparison of the bond spread and exchange rate (real and shadow) between Germany and Italy



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