

Sovereign debt and the euro area

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Abstract

Why a country that borrows in a currency it does not control can face a self-fulfilling run, the doom loop between banks and sovereigns, and what “whatever it takes” changed.

Between 2010 and 2012 Greece, Ireland, Portugal, Spain and Italy paid interest rates that made the arithmetic of The government budget constraint and debt dynamics explosive, then, after a single sentence from the ECB, paid rates that made it benign. Nothing about their fundamentals changed in the week of that sentence. The episode is the clearest demonstration of the multiple-equilibrium logic introduced in Is public debt sustainable?.

Borrowing in a currency you do not issue

A government that borrows in its own currency can always meet a nominal payment: the central bank can create the money, at the cost of inflation. A euro-area member cannot. De Grauwe argued that this makes euro-area members like emerging economies borrowing in dollars: if investors fear default, they sell the bonds, yields rise, the liquidity shortage becomes a solvency problem, and the fear confirms itself. A country with the same debt ratio but its own central bank, the United Kingdom in 2011, paid far lower rates than Spain (De Grauwe, 2011). De Grauwe and Ji later tested the claim and found that the spreads of 2010 to 2012 were far above what fundamentals could explain, and that they collapsed after the ECB’s announcement without any change in those fundamentals (De Grauwe & Ji, 2013).

Definition 1 (Self-fulfilling sovereign debt crisis). An equilibrium in which investors’ expectation of default raises the interest rate to a level at which default becomes optimal, confirming the expectation. It exists only when a lender of last resort is absent or not credible; the same fundamentals also support a low-rate equilibrium.

The diabolic loop

Lane’s account of the crisis adds the second mechanism. Euro-area banks held large amounts of their own government’s bonds. When sovereign yields rose, bank capital fell; weak banks needed public support, which raised sovereign debt; and the rising debt pushed yields up further. Ireland entered the loop from the bank side, with a guarantee of bank liabilities in 2008 that turned private losses into public debt; Greece entered from the sovereign side (Lane, 2012). Brunnermeier and co-authors named the mechanism the diabolic loop and proposed to break it by having banks hold a pooled, tranching European safe asset instead of home sovereign bonds (Brunnermeier et al., 2016).

Whatever it takes

On 26 July 2012 Mario Draghi said that the ECB was ready to do “whatever it takes” to preserve the euro (Draghi, 2012), and in September the ECB announced Outright Monetary Transactions: unlimited purchases of the bonds of a country under a conditional programme. Not one bond was bought under OMT. The announcement alone moved the euro area from the bad equilibrium to the good one, which is what a lender of last resort does: by being willing to lend, it removes the reason to run. The ECB’s Transmission Protection

Instrument of 2022 restated the commitment for the tightening cycle, with the same design of conditional, unannounced-size purchases.

Austerity

The consolidation programmes of 2010 to 2014 became the largest natural experiment on the multipliers of Fiscal multipliers. Alesina, Favero and Giavazzi assembled narrative plans for sixteen countries and found that spending-based consolidations were much less costly in output than tax-based ones, and sometimes nearly costless, while tax-based plans produced long recessions (Alesina et al., 2019). Blanchard and Leigh's forecast-error evidence pointed to multipliers above one during the same years (Blanchard & Leigh, 2013). The two findings are reconcilable: composition matters, and so does the moment. A consolidation in a monetary union at the lower bound, with the partner countries consolidating at the same time, is the worst case for both.

What the episode settled

Three things. A monetary union needs a lender of last resort for governments, or its members carry a default risk their fundamentals do not justify. Banks and sovereigns must be separated, which the banking union has done only partly. And fiscal rules that force pro-cyclical consolidation deepen the recession they respond to; the redesign of those rules is the subject of Fiscal rules and the Swiss debt brake.

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