Erik Jones

The euro versus the markets

The current crisis is certainly not the EU's first. Indeed, in the past, crises have served as catalysts to progress; they have actually spurred integration. Today's leaders are working hard to find solutions to Europe's economic difficulties to keep this particular crisis from turning into a vicious cycle, a destructive spiral that will destroy any remnants of solidarity and bring down the Union itself. They should focus their energies on empowering European institutions to intervene directly in the markets, to discourage short-term speculation and to foster long-term stability.

The June 2012 European Council summit offered a rare display of decisive action by the European Union's heads of state and government. Italian Prime Minister Mario Monti threatened to drag out the summit as long as necessary to win some measure of respite from the markets. German Chancellor Angela Merkel accepted the urgency of the situation and gave her support to more active intervention. In the short term, the European bailout mechanisms will be allowed to purchase sovereign debt in distressed markets like those for Italy and Spain. Over the longer term, the European Central Bank (ECB) will be given explicit responsibility for prudential oversight of Europe's national banking systems so that Europe's bailout facilities can begin to deal directly with individual banks.

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These policy changes are a significant departure from previous practice because they move the European Union ever closer to a more federal arrangement. The price for greater solidarity is more political interference from European institutions and other countries in the budgetary policy and market structures of individual member states.

This is hardly the first choice of any national politician. This fact should be evident in Spanish Prime Minister Mariano Rajoy's unwillingness to see conditions placed on his access to European resources and also in Monti's insistence that Italy can take care of itself. The countries under pressure are not alone in seeking to reassert their independence. Although Merkel has pushed for the creation of strong European institutions, she understands all too well the primacy of domestic politics. The hardliners within her own coalition have been among the loudest voices calling for greater European discipline. Indeed, that is why Merkel has taken such a stark position since the September 2009 elections.

The irony is that domestic German politics is driving the agenda for more European integration. Yet if that agenda succeeds, German domestic politics would presumably become less important. The only way to avoid a contradiction is to assume that Germany will never fall afoul of the new arrangements. That is what the center-right assumed in Germany in the mid-1990s when they called for the negotiation of the Stability and Growth Pact. They never foresaw the possibility that it would be a German government taking the lead in relaxing fiscal constraints, as happened in November 2003. That same faith in German economic competence is what the center-right in Germany assumes today. Should this current crop of politicians prove no more prescient than their predecessors, they could be setting the stage for an even more important crisis of European governance in the future.

A more federal European Union may never be strong enough to control the actions of a powerful member state like Germany. The problem, of course, is that Europe is the only discipline on offer. As numerous commentators have noted, the discipline of the markets has failed: that is how Europe got into this mess in the first place. The failure of market discipline explains why the Greek government was able to borrow as cheaply as Germany despite the country's long reputation of poor fiscal accounting, political cronyism and bureaucratic incompetence. It also explains why the Irish banks were able to borrow so recklessly and why the Spanish commercial real estate sector was able to grow out of control.

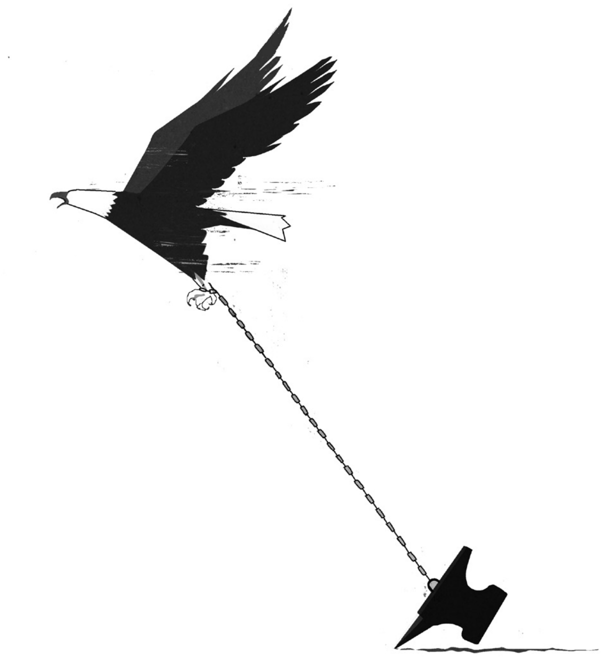
MARKET DISCIPLINE IS KEY. This failure of market discipline deserves more attention than it has been given – first, because market discipline seems to vanish for such long periods of time; second, because when it returns it seems to do so in excess and, in some cases, indiscriminately. The long period of low interest rates across eurozone countries is a good illustration. From 1999 to 2007, Greece could borrow at almost the same rates as Germany, with the other countries ranging somewhere between these two extremes. Once the economic and financial crisis struck the United States in late 2007, however, German interest rates began to sink relative to all other countries. And after the collapse of Lehman Brothers in 2008, the interest rates charged to other countries suddenly began to rise.

The too-easy assumption is that market actors were deluded into a systematic under-pricing of risk. Market participants convinced themselves that Greece was almost as credit-worthy as Germany until the financial crisis showed them the error of their ways. That may be a good description, but it is not an understanding. If market actors were deluded, it is worth considering why that was the case.

The failure of market discipline derives from the enormous volume of information available to market participants. Faced with a wide array of macroeconomic data, ratings, new services, blogs, and other forms of chatter, the biggest challenge "the market" faces is that of filtering the signal from the noise. To do that, market participants rely on models that offer them the promise of maximizing the leverage they can obtain from a restricted flow of information. They look for correlations and causal relationships that they can use to make predictions about how prices will move.

BAD INFORMATION AND A SERIES OF MISSTEPS. The convergence across countries of nominal interest rates on long-term government bond yields in the 1990s rested on a very restricted understanding of what the integration of European capital markets entailed. Bond traders (rightly) assumed that as savings flowed from countries like Germany with relatively saturated investment markets to countries with more abundant opportunities, the relative rates of return across the two different sets of countries would progressively come together. There is nothing surprising in that assumption about convergence; in fact, creating a level playing field in terms of the cost of borrowing across countries within the single market was one of the primary reasons for the liberalization of European capital markets. Moreover, there was some differentiation across countries given the relative size and liquidity of their sovereign debt markets and the assessments of credit-worthiness they attracted from the ratings agencies. But the differences were very small, particularly within the single currency, where there was no exchange rate risk to add into the model.

The changes came when market actors were forced to add entirely new pieces of information into their models. Successive revisions to Greek fiscal data are a good illustration. The Greek government revised its fiscal deficits in October 2008 and again in October 2009. The first time, the markets reacted strongly. Capital suddenly flowed out of Greece and the interest rate differential between Greece and Germany increased dramatically – from 89 basis points (or one-hundredths of one percent) on October 1, 2008 to 165 basis points by October 31 of the same year. The data revision was small, with the government pushing its 2007 deficit up from 2.8% of GDP to 3.5%,



but the fact that Greece was still having problems with its fiscal accounting was relatively new to the markets. Hence, Standard & Poor's downgraded Greece in January 2009, citing the poor quality of Greek government accounts as part of the explanation. The second – and much more famous – revision of Greek government data took place in successive announcements in October 2009. Then, the increase in the deficit was much larger. The Greek government announced on October 2, 2009 that it would need to revise its 2008 deficit upward from 5% of GDP to 5.6%, and on October 21 that the figure would have to increase further, to 7.7% of GDP. Moreover, the European Commission greeted these new numbers with open skepticism, suggesting (correctly) that the Greeks still underestimated the extent of their borrowing. Nevertheless, the market response was muted to non-existent; the spread between Greek and German bonds was just 140 basis points on October 1, 2009 and it was 143 basis points by the end of that month. Capital actually flowed into the country rather than out.

The difference between these two episodes is more than just the familiarity in the markets about the trouble with Greek fiscal accounting. It also stems from comments made in February 2009 by German Finance Minister Peer Steinbrueck, suggesting that no government participating in the euro would be allowed to go bankrupt. Although Greece experienced an outflow of capital from the October 2008 deficit revision through the January 2009 S&P downgrade, that outflow stopped soon after Steinbrueck's remarks. The yield differential between Greece and Germany came back down slightly as well.

The outflow of capital from Greece only started again in earnest once Steinbrueck's commitment was convincingly called into question. At the March 2010 European Council summit, Chancellor Merkel declared that Germany would not support countries in distress until they lost access to private sector finance. Greek bond yields increased immediately after that announcement, and within less than a month the Greek government made a formal request for European assistance.

The possibility and scale of private sector involvement in any debt restructuring within a member state were other variables that the market had to add into their models for filtering information. That came first with the Deauville summit between France and Germany in October 2010 and again during the negotiation of the second Greek bailout in June 2011. According to analysis from the Bank for International Settlements, the Deauville summit precipitated the run in the markets on Irish sovereign debt and so forced that country's government to request a bailout. The increased private sector involvement announced at the June 2011 European Council summit is what focused the attention of the markets on Italy.

WHY MARKETS MAKE BAD PARENTS. What these episodes reveal is how swiftly prices can move once market participants amend their models to include new information. This is a discipline of sorts, but not the kind that psychologists recommend; misbehavior is tolerated for long periods of time until suddenly it is punished with disproportionate force. The fact that all of the countries that have been caught up in Europe's sovereign debt crisis are so different from one another only makes matters worse. It would be easier to understand if each of these countries at least displayed the same kinds of errant behavior. Unfortunately, they do not.

There is no obvious lesson to draw from recent experience that the markets could teach. Greece should manage its fiscal accounts better than it has, but it is unlikely ever to do as well as Ireland did before the near-collapse of its domestic banking system. Spain may be able to limit its borrowing from abroad and yet still not escape the fate of Italy, which finances most of its debt at home. Markets do not seem prone to much compassion either. The fact that the Spanish and Italian governments are both working hard to reform their state institutions has brought little reprieve; once economic performance started to weaken, the pressure in the bond markets returned with a vengeance – which is how Europe arrived at this most recent European Council summit.

Perhaps the mistake is to assume that the markets are a positive influence on politics or society. Sometimes market incentives align with political and social goals; other times they do not. The challenge is to structure markets in order to contain some of the more destructive sudden movements in relative prices. This is the challenge that gave rise to the single currency in the first place.

When Tommaso Padoa-Schioppa wrote his famous report on the completion of the internal European market, he noted at the end that some mechanism must be created to limit the potential for speculation in integrated capital markets. He was careful to laud the potential for greater gains in efficiency that such market integration would entail, but he worried that the periodic impact on exchange rates between countries would be destabilizing and contagious. Hence, he recommended that exchange rates between countries should be irrevocably fixed – and he called upon his colleagues to construct a common currency for that purpose.

Rather than a failure of market discipline, what we are experiencing now is more the weakness of the euro relative to the markets. The single currency is a powerful instrument and yet still insufficient to contain market forces. That is the real lesson to emerge from the European Council summit. The challenge, therefore, is not to discipline governments but rather to discipline – or, better, to focus the attention of – market participants. A strong fiscal union is not the right answer. Market participants may buy into that vision for a while, but they will react strongly should the commitment to intrusive institutions waiver or should the mechanisms for disciplining errant countries fail. By contrast, efforts to empower European institutions to intervene directly in the markets are more constructive. Such institutions help discourage short-term speculation but also foster longer-term stability in trade and investment flows. Europe's citizens stand a better chance of improving their welfare as a consequence.