

Institution: London School of Economics and Political Science
Unit of Assessment: 27: Area Studies
Title of case study: Managing the fragility of the Eurozone
<p>1. Summary of the impact (indicative maximum 100 words)</p> <p>Paul De Grauwe developed and tested the theory that financial markets in the Eurozone can push countries into a vicious circle of economic recession, increasing government debt levels and banking crises in a self-fulfilling way. One of the main policy conclusions of this analysis is that the European Central Bank (ECB) is the only institution that can prevent countries from being pushed into such a vicious circle. This can be achieved by the ECB becoming the lender of last resort in the government bond markets of the Eurozone.</p> <p>After much hesitation the ECB accepted this analysis and decided in September 2012 to become the lender of last resort in the government bond markets of the Eurozone. It called this “Outright Monetary Transactions” (OMT). This decision was of great importance and led to a quick stabilization of the government bond markets in the Eurozone. De Grauwe’s research influenced this policy reform as well as the wider policy debate on reform of Eurozone governance.</p>
<p>2. Underpinning research (indicative maximum 500 words)</p> <p>KEY RESEARCHERS. Following the Eurozone debt crisis that emerged in 2010 and that culminated into a full-fledged existential crisis of the Eurozone during 2011-12, Paul De Grauwe undertook theoretical research which led to the publication of the influential paper “The Governance of A Fragile Eurozone” in 2012 [1]. Professor De Grauwe has been John Paulson Chair in European Political Economy at LSE since early 2012. The empirical tests of the theory were undertaken together with Yuemei Ji of the University of Leuven during 2012 and 2013 [5,6].</p> <p>RESEARCH INSIGHTS AND OUTPUTS. The starting point of the theoretical insights is that when countries join a monetary union they lose the capacity to issue debt in their own currencies [1]. As a result, they cannot give a guarantee to bond holders that the cash will always be available to pay them out at maturity. This lack of guarantee makes the member governments vulnerable to movements of fear and panic that in a self-fulfilling way can create a liquidity crisis. The latter can degenerate into a solvency crisis driving the country into a vicious circle characterized by austerity, a recession and a banking crisis. Economists call this a “bad equilibrium”</p> <p>The conclusion of this theoretical analysis is that the ECB should be a lender of last resort in the government bond markets of the Eurozone so as to give a guarantee to bondholders that the liquidity to pay them out will always be available. In doing so, the ECB can prevent fear and panic from creating liquidity crises and thus stop countries from being pushed into a bad equilibrium. The key element in this lender of last resort function is that the ECB commits itself to buying unlimited amounts of government bonds of individual member states.</p> <p>Since the publication of this paper the research has been focused first on the empirical verification of the theory. Together with Yuemei Ji, De Grauwe found that the government bond rates of a number of Eurozone countries were driven by market sentiments that were unrelated to underlying fundamentals [5,6]</p> <p>De Grauwe also analysed the conditions under which the lender of last resort function of the ECB could be successful. These conditions are that when the ECB commits itself to buying government bonds it should not endanger price stability. It should also do it in a way as to minimize the moral hazard that inevitably arises when it gives a guarantee. Finally, it should recognise that lender of last resort operations have fiscal implications. De Grauwe argued that the ECB can design its lender of last resort operations to meet these conditions [2,3].</p> <p>De Grauwe has stressed that while the Lender of Last Resort function of the ECB is necessary to stabilize the Eurozone it is not sufficient. Other reforms will have to be implemented (e.g. common Eurobond issues, symmetric macroeconomic policies) to make the Eurozone sustainable in the</p>

long run. Much of De Grauwe's research now focuses on the long run conditions for successful governance of the Eurozone. This analysis is also included in the most recent edition of his book *The Economics of Monetary Union* [4], which has been translated into eight languages, including French, Italian, Spanish, Chinese and Japanese.

3. References to the research (indicative maximum of six references)

1. De Grauwe, P., (2012a), The Governance of A Fragile Eurozone, *Australian Economic Review*, vol. 45, no. 3, pp. 255–68. This and earlier versions have 189 citations according to Google Scholar. DOI: 10.1111/j.1467-8462.2012.00691.x
2. De Grauwe, P., (2012b), The European Central Bank: Lender of Last Resort in the Government Bond Markets?, in Allen, F., Carletti, E., Simonelli, S., *Governance of the Eurozone: Integration or Disintegration*, Wharton Financial Institutions Center, FIC Press, pp. 17-28. LSE Research Online ID: 46637
3. De Grauwe, P. (2012c), "How not to be a lender of last resort", *CEPS Commentaries*, 23 March. LSE Research Online ID: 51511
4. De Grauwe, P. (2012d) (9th ed) *The Economics of Monetary Union*. Oxford University Press. LSE Research Online: 46349
5. De Grauwe, P., and Ji, Y., (2012e), Sovereign risk and macroeconomic stability in the Eurozone, *Journal of Common Market Studies*, 50:86, 866-880 DOI: 10.1111/j.1468-5965.2012.02287.x
6. De Grauwe, P., and Ji, Y., (2013), Self-fulfilling crises in the Eurozone: an empirical test, (2012a), *Journal of International Money and Finance*, 34:15-36 DOI: 10.1016/j.jimonfin.2012.11.003

Evidence of quality: publications in top peer-reviewed journals and with a noted academic press.

4. Details of the impact (indicative maximum 750 words)

The impact of De Grauwe's research can be observed at two levels: influencing ECB's highly significant policy decision to become a lender of last resort; and informing the wider policy debate on reforms of Eurozone governance.

Influencing European Central Bank policy:

The ECB decided on 6 September 2012 to become a lender of last resort in the government bond markets of the Eurozone. It accepted the key element that was stressed by De Grauwe, i.e. that it will commit itself to unlimited purchases of government bonds. It labelled this programme "Outright Monetary Transactions" (OMT). The effect of this programme was a quick stabilization of the government bond markets, as predicted by De Grauwe [1].

In his 11 September column, the Financial Times' Chief Economics Commentator Martin Wolf, considered one of the most influential writers on economics - and himself a distinguished economist - noted that this decision "marks belated acceptance of strong arguments made by the Belgian economist Paul De Grauwe, at the London School of Economics" [A].

Indeed, in justifying the decision of the ECB Governing Council, ECB President Mario Draghi used the theory developed by De Grauwe [1] in explaining that "you have large parts of the euro area in a bad equilibrium in which you may have self-fulfilling expectations that feed on themselves... So, there is a case for intervening... to "break" these expectations, which... do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank" [B].

The ECB's decision came after experimenting with the "Securities Market Program" (SMP) - a program of government bond purchases. However, the SMP was explicitly designed to be limited in size and time. De Grauwe warned that the limited nature of the bond purchase program would make it ineffective [1]. This turned out to be correct, and the ECB decided to abandon it.

Another design failure of the SMP was that the ECB insisted on having seniority on the government bonds it acquired in the program. De Grauwe warned that this would lead private holders of government bonds (who had become junior and thus faced future losses) to sell their bonds, forcing the ECB to buy large amounts of government bonds [2]. The ECB dropped its seniority claim on the government bonds acquired under the OMT program. This also suggests that De Grauwe has been influential in shaping policies.

In addition, in 2012 the European Commission (DG ECFIN) proposed that De Grauwe would provide consultancy services to inform the EU on how to deal with the fragility of the Eurozone. More specifically he was asked how the Eurozone design failures which led to the current fragility are to be corrected, focusing on the long run conditions for making the Eurozone sustainable. This research led to a first draft of a paper "Design Failures of the Eurozone. Can they be fixed?" which was presented at a workshop organized by the European Commission on 19th November 2012 (made available by LSE in 2013) [C].

Paul De Grauwe has since 2012 had a similar arrangement with the National Bank of Belgium to help design common Eurobonds, another feature that De Grauwe has stressed will be necessary to correct the design failures in the Eurozone.

On 26 February 2013 Martin Wolf reviewed De Grauwe and Ji's paper [6] and concluded that "By adopting OMT earlier, the ECB could have prevented the panic that drove the spreads that justified the austerity. It did not do so. Tens of millions of people are suffering unnecessarily hardship. It is tragic." [D] Despite these costs, Simon Tilford, Deputy Director and chief economist of the Centre for European Reform, believes that "Paul De Grauwe's academic work has played a crucial role in stabilising the eurozone. In particular, he showed that unsustainable borrowing costs in struggling eurozone economies had little to do with their mismanagement of public finances and a lot to do with the absence of a central bank prepared to act as lender of last resort to governments in times of crisis. His research helped provided the intellectual cover needed by the ECB, and in particular its President Mario Draghi, to face down opponents of a more activist ECB, and take on these lender of last resort functions. The announcement of the ECB's Outright Monetary Transactions (OMT) has provided crucial breathing space for the euro" [E]

Informing policy debate:

A key impact of the research of De Grauwe on the fragility of the Eurozone is on the policy debate, where he has contributed significantly to the quality of evidence and understanding of the major issues facing the governance of the Eurozone. Media and public figures engaged in the policy debate frequently cite De Grauwe's research when discussing the Eurozone crisis. Paul Krugman has referred to De Grauwe's analysis on the fragility of the Eurozone as a new way to analyse a monetary union [F], as well as writing that "Nobody has taught me as much about the euro crisis as Paul De Grauwe, who brought to the fore the crucial point almost everyone was overlooking: the importance of self-fulfilling debt panics in countries that no longer have their own currencies. Now he has a new paper with Yuemei Ji following up on that insight, and offering yet more evidence of the incredible unwisdom of European economic policy" [G].

The need for having a lender of last resort in the government bond markets has also been stressed by Wyplosz [H], Delbecq [I], and Johnson [J], among others. VoxEU, which is probably *the* major policy discussion website, frequently cites De Grauwe's work [H,I]. De Grauwe has also written seven articles posted on VoxEU, with "Panic-driven austerity in the Eurozone and its implications" having over 140,000 'reads' [K]. (The other six articles range from approximately 4,200 to 134,000 reads.)

De Grauwe's proposal to issue common Eurobonds as an instrument for reducing the Eurozone's fragility led to a debate in *The Economist* in July 2012 on "Mutualization of the debt" between him and Professor Ansgar Belke [L]. Moreover, De Grauwe's proposals to strengthen the Eurozone have been discussed in many newspapers, including *Libération*, *Handelsblatt*, *Frankfurter Allgemeine*, *El Pais*, *Publico*, *New York Times*, *Wall Street Journal*, *Repubblica* [e.g. M,N,O], and De Grauwe has explained his views on television and radio in many countries. His youtube video on the Eurozone crisis [P] has been watched by 3,590 viewers.

Martin Wolf believes that "Prof De Grauwe's brilliant work has influenced not only economic columnists, such as professor Krugman and myself, but also many policymakers....All future work on central banking in crises will need to build upon [his] insights. In sum, no economist working in academe or elsewhere has had more influence on the debate on the eurozone crisis than professor De Grauwe" [Q].

5. Sources to corroborate the impact (indicative maximum of 10 references)

All Sources listed below can also be seen at https://apps.lse.ac.uk/impact/case_study/view/68

- A. Wolf, M., Draghi alone cannot save the euro, *Financial Times*, September 11th, 2012. <http://www.ft.com/cms/s/0/e6bb0966-fb41-11e1-87ae-00144feabdc0.html#axzz2qfST05nY>
- B. Draghi, M. President of the ECB, Frankfurt am Main, 6 September 2012. <http://www.ecb.int/press/pressconf/2012/html/is120906.en.html>
- C. "Design Failures of the Eurozone. Can they be fixed?" paper. <http://eprints.lse.ac.uk/53191/1/LEQSPaper57.pdf>
- D. Wolf, M. The sad record of fiscal austerity. *Financial Times*, February 26th 2013. <http://www.ft.com/cms/s/0/73219452-7f49-11e2-89ed-00144feabdc0.html#axzz2qfST05nY>
- E. Statement - Deputy Director, Centre for European Reform. This source is confidential.
- F. Krugman, P. (2012), *End the Depression Now*, Norton, New York. See also: <http://krugman.blogs.nytimes.com/2012/06/24/revenge-of-the-optimum-currency-area/>
- G. Krugman, P. (2013). Paul De Grauwe and the Rehn of Terror. <http://krugman.blogs.nytimes.com/2013/02/22/paul-de-grauwe-and-the-rehn-of-terror/>
- H. Wyplosz, C., The ECB's trillion Euro bet, *VoxEU*, February 2012, <http://www.voxeu.org/article/ecb-s-trillion-euro-bet>
- I. Delbecque, Bernard, The ECB's proportionate response to the Eurozone crisis, *VoxEU*, April, 2012 <http://www.voxeu.org/article/ecb-s-proportionate-response-eurozone-crisis>
- J. Johnson, R., The ECB can save the Euro but it has to change its business model, Institute for New Economic Thinking, <http://ineteconomics.org/blog/inet/paul-de-grauwe-ecb-can-save-euro-it-has-change-its-business-model>
- K. Paul de Grauwe entry on Vox: <http://www.voxeu.org/person/paul-de-grauwe>
- L. The Economist entry <http://www.economist.com/debate/days/view/858/print/all>
- M. Quatremer, J., (2012), La BCE doit racheter de façon illimitée la dette de la zone euro, *Libération*, <http://bruxelles.blogs.liberation.fr/coulisses/2011/11/la-bce-doit-racheter-de-façon-illimitée-la-dette-publique-de-la-zone-euro.html>
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- O. ECB LTRO seen doomed to fail, *Wall Street Journal*, March 23, 2012, <http://blogs.wsj.com/brussels/2012/03/23/ecb-ltro-seen-doomed-to-fail/>
- P. Paul de Grauwe on the Eurozone Crisis: YouTube <http://www.youtube.com/watch?v=Yx1nNNdhrn4>
- Q. Statement - Chief Economics Commentator, *Financial Times*. This source is confidential.