Discussion of “Managing the Euro Area Debt Crisis”, by Bill Cline

Angel Ubide*
D.E. Shaw and Peterson Institute for International Economics

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*Views expressed here are my own and do not represent those of the institutions I am affiliated with

Main conclusions

- “Whatever it takes” and “no Grexit” key decisions
- Periphery is solvent with d/gdp around 100 percent. OMT is key.
- Greece needs further debt relief.
- There was no alternative to fiscal consolidation, and it must continue.
- Country specific OMT better than QE.
- Contingency bond insurance sinking fund.
- Preemptive restructuring a bad idea.

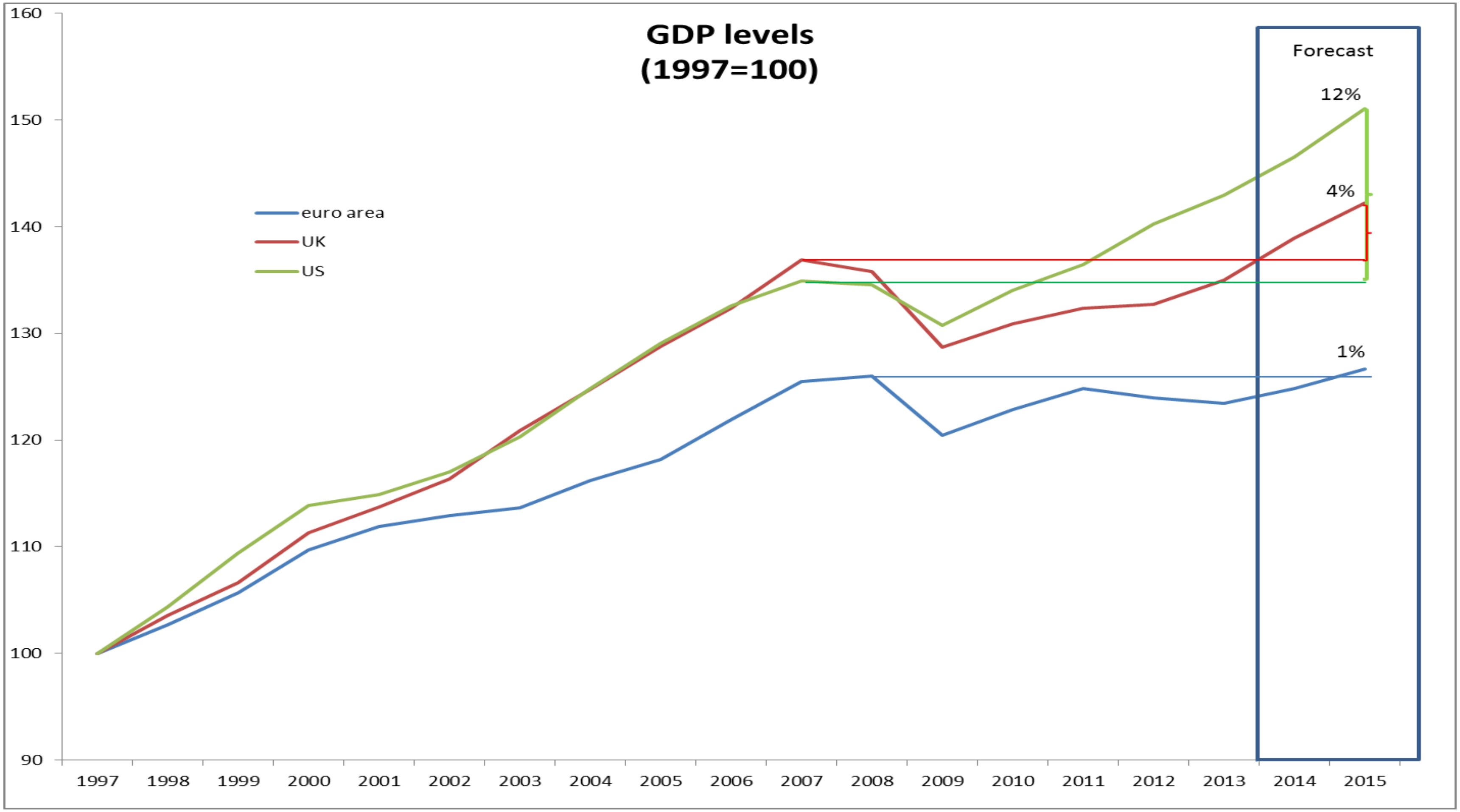
A few agreements

- Crisis self inflicted – Deauville + Grexit. When mistakes corrected (OMT and no Grexit) crisis over.
- Euro area is solvent, contingent on right policies
- Greece needs further debt relief. OSI.
- Preemptive restructuring a bad idea. Imagine Portugal.

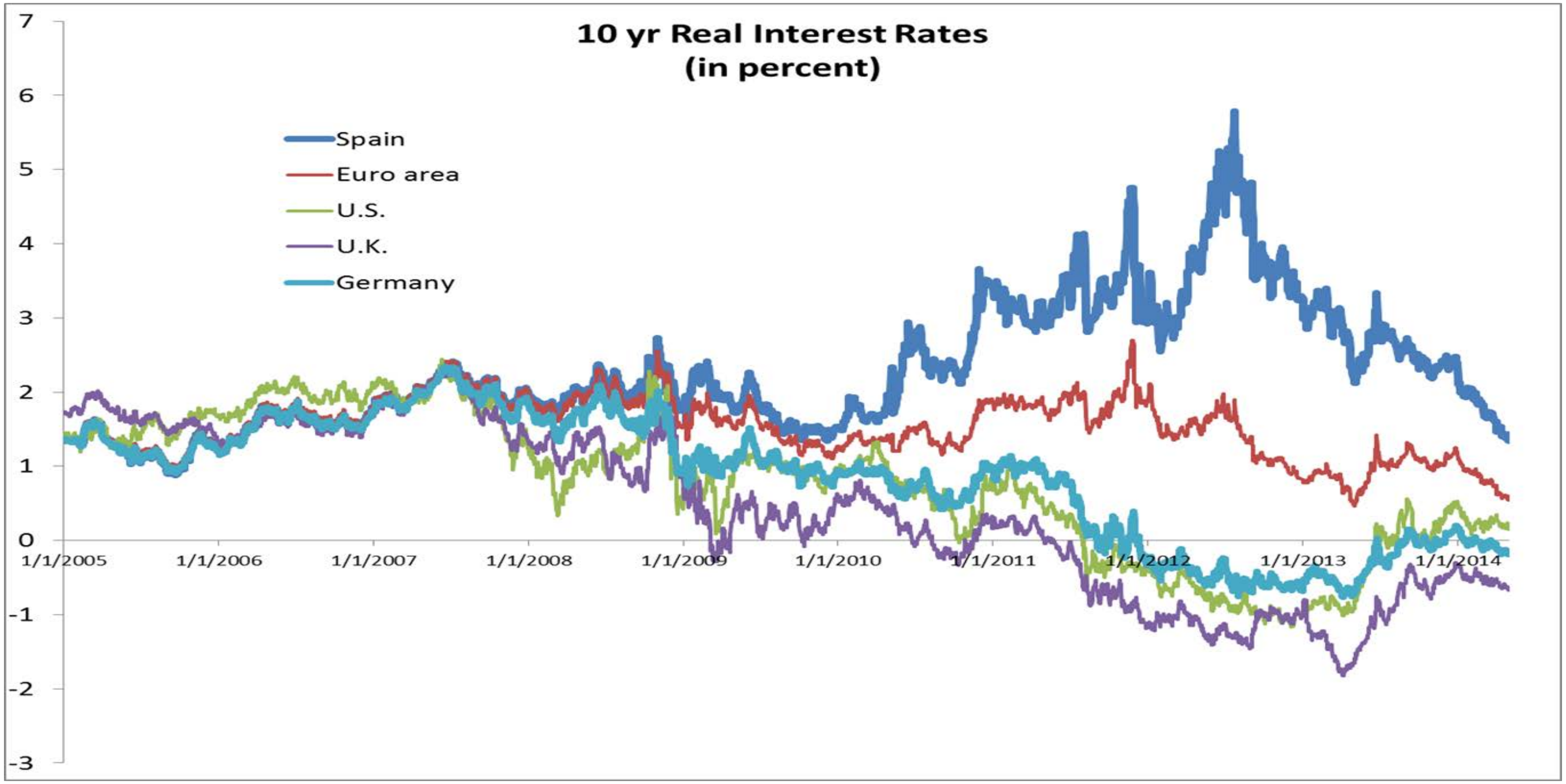
A few disagreements

- Takes ECB as given. Central banks shouldn’t do conditionality.
- Policy mix and sequencing was wrong. First monetary easing, then fiscal consolidation. UK vs Spain
- There can’t be monetary union without risk free assets. Need blue/red eurobonds.
  - ECB can do QE like any normal central bank
  - Banks can hold risk free assets
  - Fiscal policy can be countercylical in recessions

A lost decade, at least

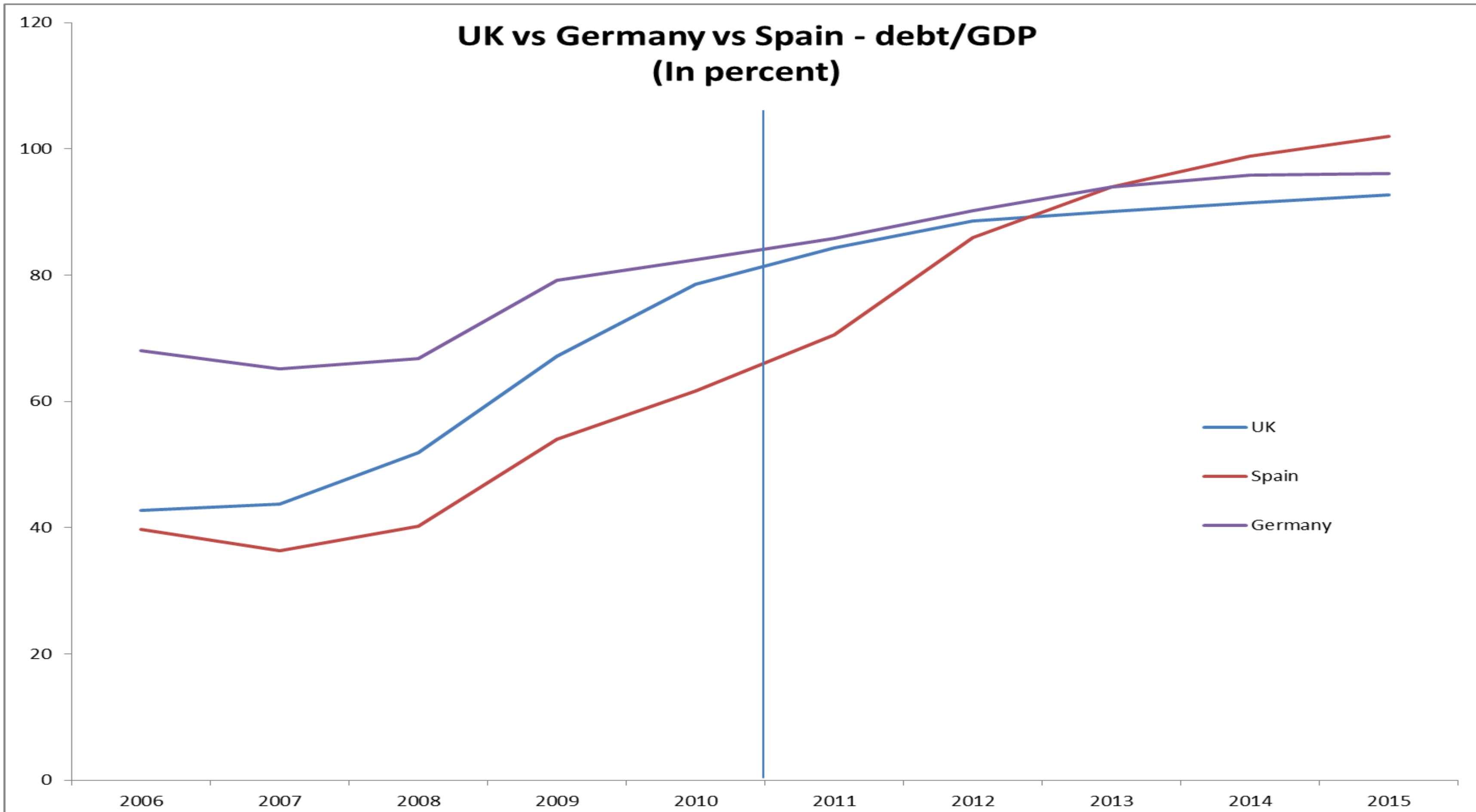


This explains everything

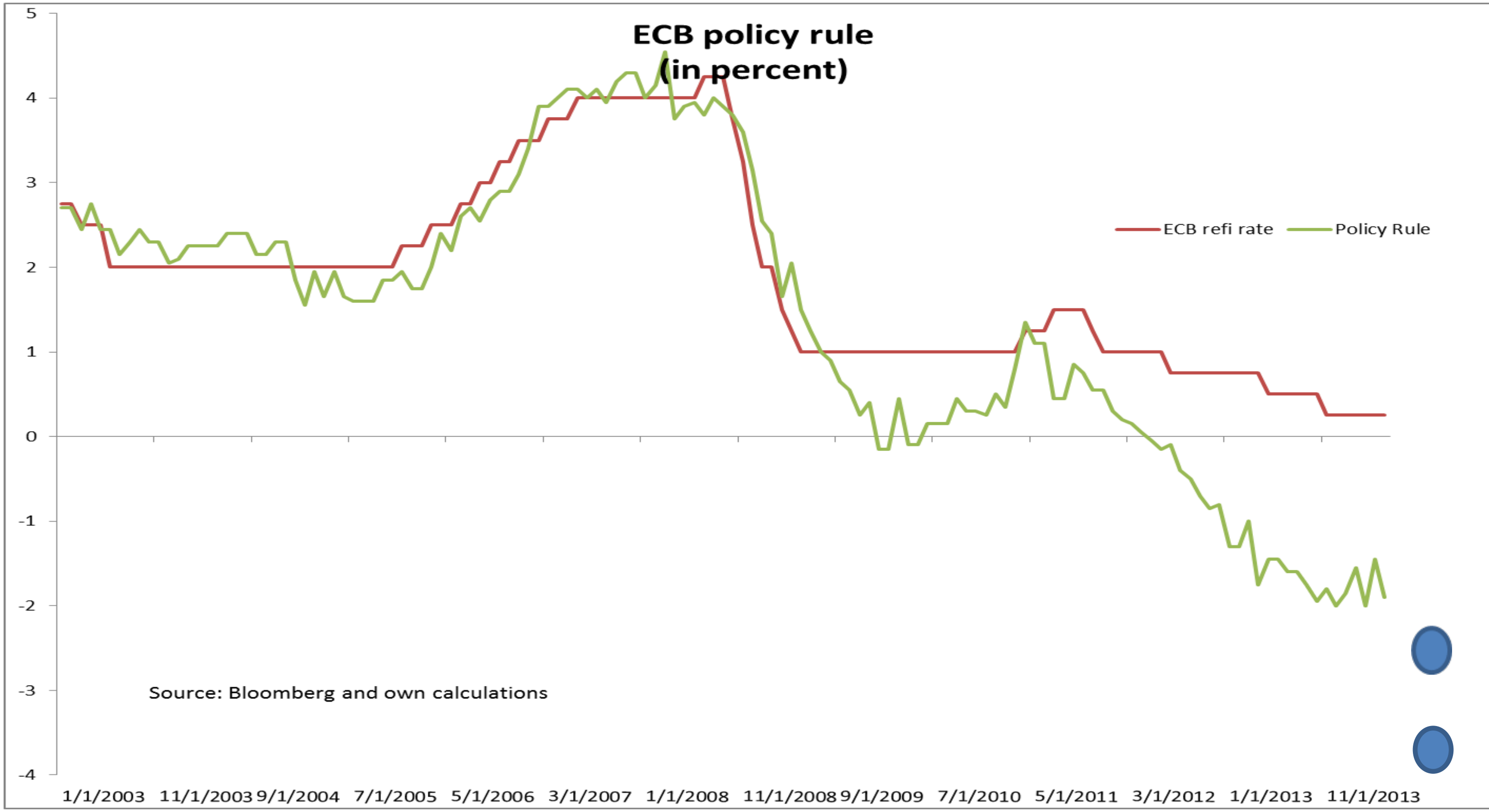


¶ QE in US, UK **and Germany**
¶ Second LTRO ineffective (late 2011), ECB should have done QE.
¶ LTRO passive easing, not active easing.

Similar primary fiscal consolidation, different debt/gdp path



The short run - policy stance too tight



r = 2 + core HICP = [0.5*(core HICP – 2)]+[0.5*2*(7.75-U)] = -1.90
If for post crisis period r*=0 and U*=9, r= -2.65
If for post crisis period r*=0 and U* = 7.75, r = -3.90

The long run - (r-g)

	Long term nominal and real interest rates, spot and forward								
		Germany			Spain			Italy	
	Spot	2yr fwd	5yr fwd	Spot	2yr fwd	5yr fwd	Spot	2yr fwd	5yr fwd
5yr	0.3	0.9	2.2	1.4	2.6	4.4	1.4	2.8	4.6
10yr	1.2	1.7	2.4	2.8	3.5	4.3	2.9	3.7	4.6
Spread vs Ger				1.0	1.7	2.2	1.1	1.9	2.4
				1.5	1.8	1.9	1.7	2.0	2.2
5y inflation	1.2	1.8	2.3	1.2	1.8	2.3	1.1	1.8	2.3
10yr inflation	1.6	1.8	2.3	1.6	1.8	2.3	1.6	1.8	2.3
5yr real	-0.9	-0.9	-0.1	0.2	0.8	2.1	0.3	1.0	2.3
10yr real	-0.4	-0.1	0.1	1.2	1.7	2.0	1.3	1.9	2.3
Potential growth	1.3	1.3	1.3	1.3	1.3	1.3	0.9	0.9	0.9
r-g	-1.7	-1.4	-1.2	-0.2	0.4	0.7	0.4	1.0	1.4

Concluding

- Euro area weaker than before 2007
- Euro area is solvent if right policies implemented.
  - Needs demand policies to prevent deterioration of potential growth
  - Needs right monetary policy stance
  - Needs eurobonds to complete the economic infrastructure
- How to make progress when what is good for the euro area is not good for the politics of Germany.

Thank you