



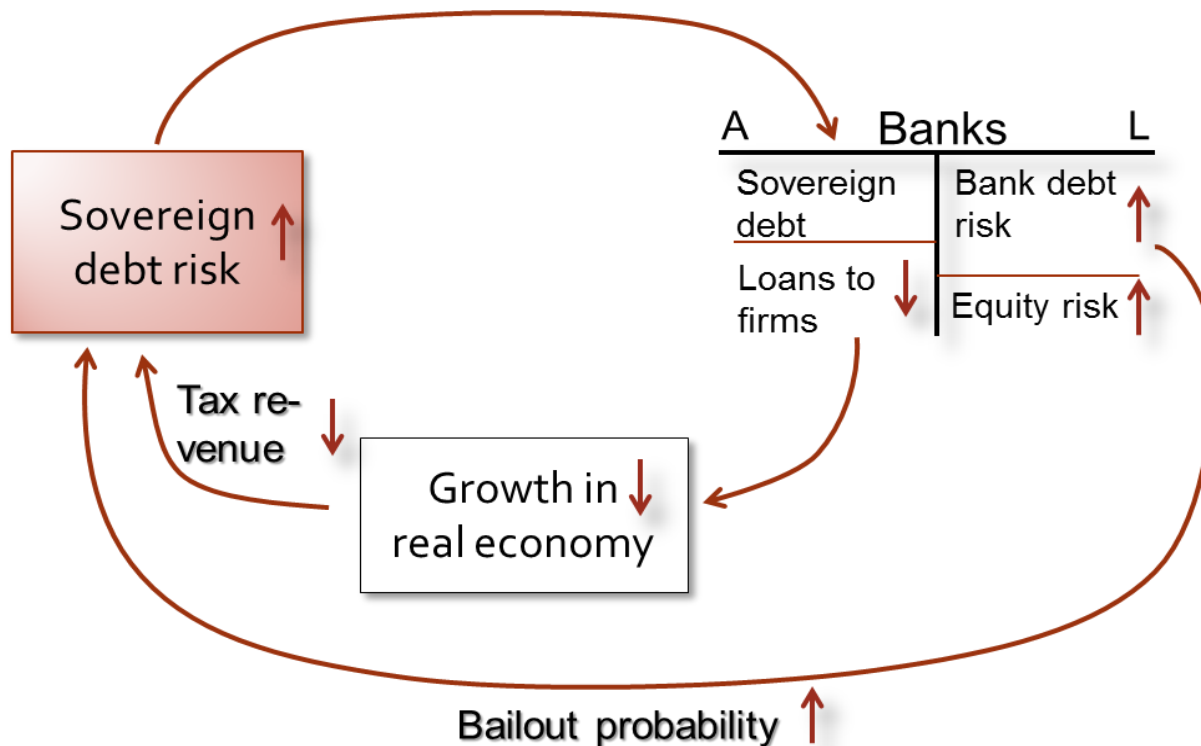
EURO-CRISIS - NBER SUMMER INSTITUTE

MARKUS K. BRUNNERMEIER

Cambridge, July 12th 2012

Problem 1: Diabolic loop

Trigger: **Banking crisis** (Ireland, Spain)
 Fiscal crisis (Portugal, ...)



Problem 2: Flight to safety capital flows

- -2008: all sovereigns were considered safe
almost perfect substitutes = “European Safe Asset”
- 2010-: German Bund remains as safe asset

flight to safety **across borders**

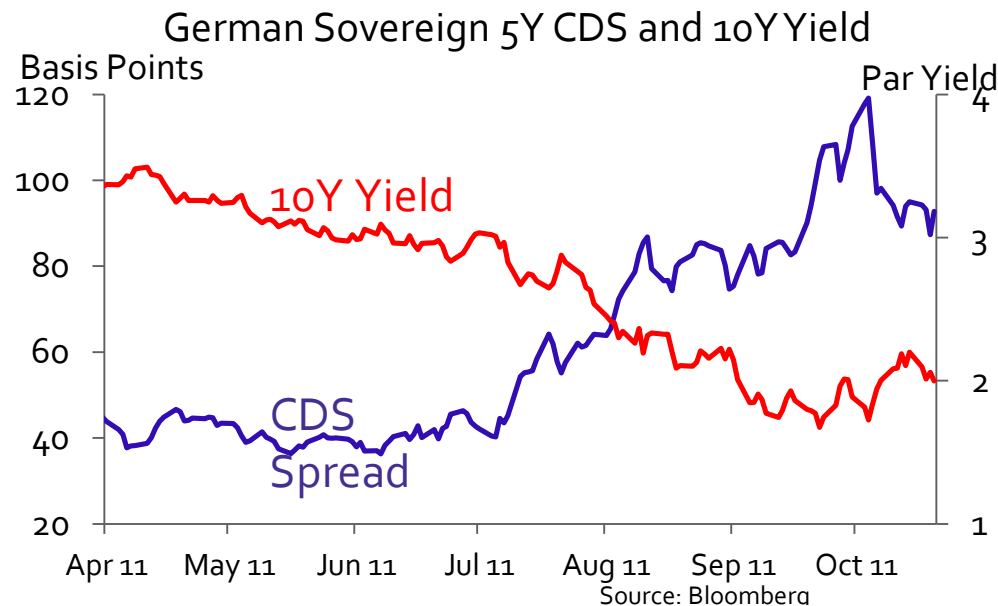


- Value of German debt ↑, Italian/Spanish debt ↓
 - German CDS spread rises, but yield on bund drops (flight to quality)

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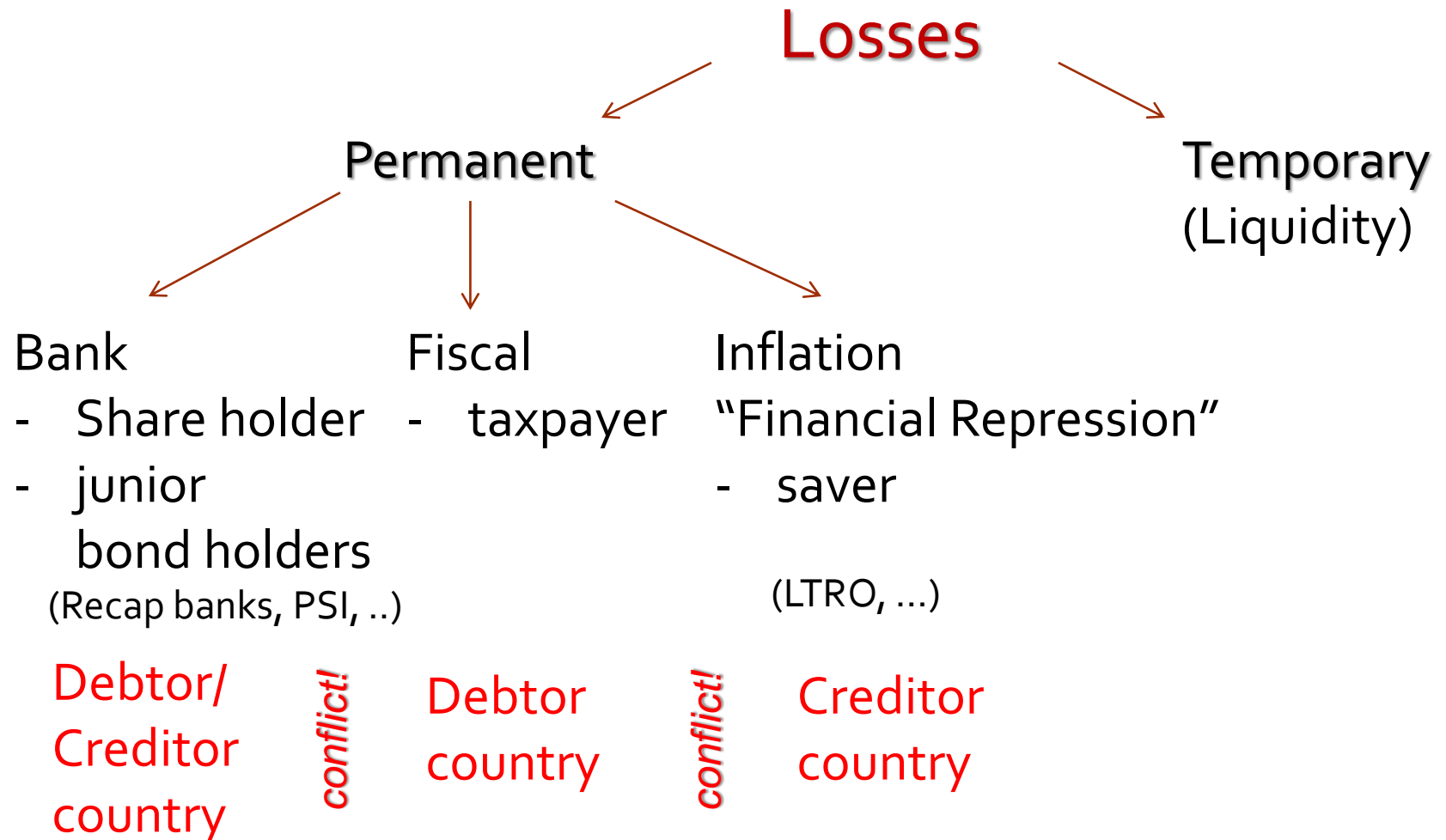
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|| Stock (Legacy) Problems vs. Flow Problems

- “Flow Problem”
 - Competitiveness
 - Fiscal discipline in the future – (fiscal compact, six pack,...)
- “Stock (Legacy) Problem” – resolve debt overhang
 - Transfers to overcome debt overhang problem
 - Who will absorb losses?
 - Eurobonds: “sneaky way” of transfers,
but undermines LR fiscal discipline

Chicken game (leads to delay and uncertainty)!

Chicken game 1: Who absorbs losses?



Chicken game 1

Game 2: new fiscal order

Delay + uncertainty: strangles growth and leads to further losses!

|| Debt mutualization, MH, Politics

Strategy 1: „Alexander Hamilton Strategy“

- Deal: Transfers in exchange for loss of fiscal autonomy
 - Why transfers? Debtor country's tax payers pay bailout
 - GCEE redemption fund: Incentives to reduce public debt

Debt mutualization, MH, Politics

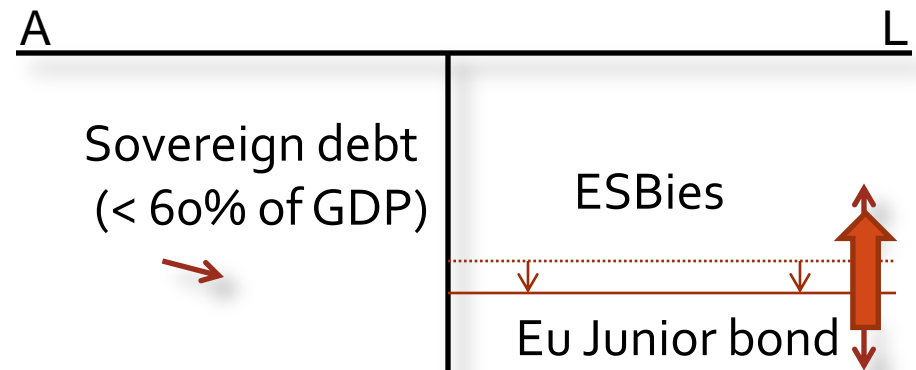
Strategy 1: „Alexander Hamilton Strategy“

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Strategy 1+2: AH + Fait accompli/TINA Strategie

- Eurobonds deep fiscal union
- If not accompanied by strict fiscal union → bigger crisis
 - Eurobills: simply an „entry point “ for Eurobond (in the next crisis)

Flight to safety: in times of crisis



*Flight to safety asset is endogenous
(coordination problem)*

- Today: asymmetric shifts **across borders**
 - Value of German debt decreases
 - German CDS spread rises, but yield on bund drops (flight to quality)
 - Value of Italian/Spanish/Greek... sovereign debt declines
- With ESBies: Negative co-movement **across tranches**
 - Value of ESBies expands – due to flight to quality
 - Value of Junior bond shrinks – due to increased risk
 - Asset side is more stable

Wish list for bond structure

- Preserve full market discipline (+ political discipline)
- Create “European safe harbor asset”
 - Size
 - Small: large movements in price (see e.g. Switzerland)
 - Large: benefits
- Redirect flight to safety capital flows
- Break Diabolic loop b/w sovereign and banking risk
- Flexibility to increase depth fiscal union
- Introduce it soon
- Risk - Reversibility

Comparing different proposals

| | ESBies | Eurobond | Blue-red | Eurobills | Redemption fund |
|--------------------------|----------------------------|--|----------|------------------------|---------------------|
| Market discipline | perfect | Switched off | Limited | Limited exit credible? | limited |
| Safe asset | large | | | small | not in the long-run |
| Flight to safety | redirected | | redirect | swings in yield curve | not in the long-run |
| Diabolic loop | broken | no | broken | only partially | ? |
| Speed | next month | years | | | |
| Risk | reversible | difficult to undo (even after failure) | | | enforced |
| Flexibility | scale up with fiscal union | deep fiscal union needed | | entry into Eurobond | |
| Hidden transfers | none (temporary if needed) | large | | (large) | largest |

|| In sum ...

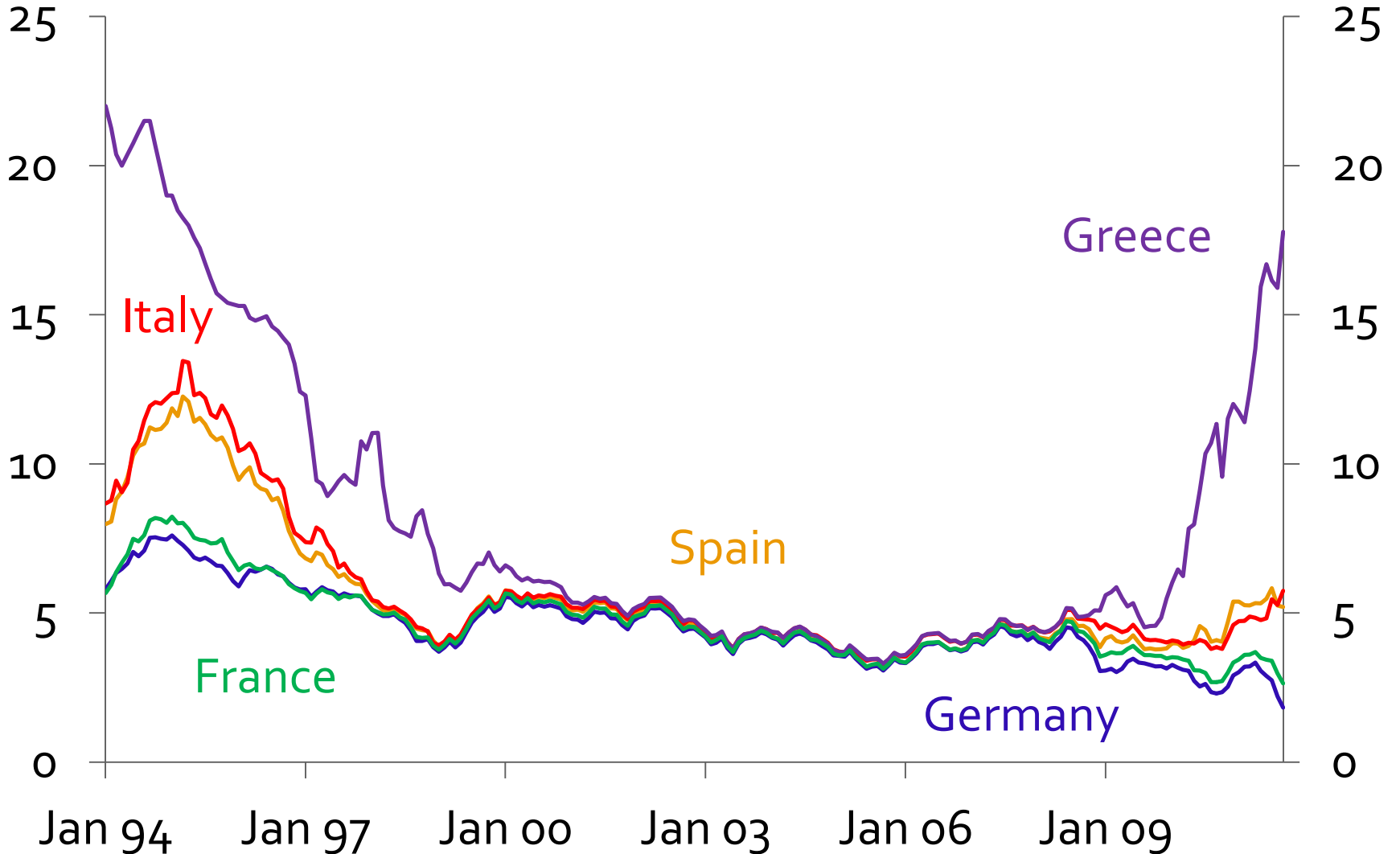
- Create a “European safe harbor asset”
 - “flight to safety” - requires coordination
- Isolate banks from sovereign risk (diabolic loop)
 - LTRO goes in opposite direction
 - “doubling down strategy”
- ESBies are flexible and reversible
 - allow gradual introduction of fiscal union
 - No fait accompli/TINA strategy
- Greece vs. Spain/Ireland/...
 - Fiscal compact
 - Bank regulation
 - European FDIC, bank restructuring,

|| Extra slides

1. Sovereign debt yield (10 years)

Par Yield

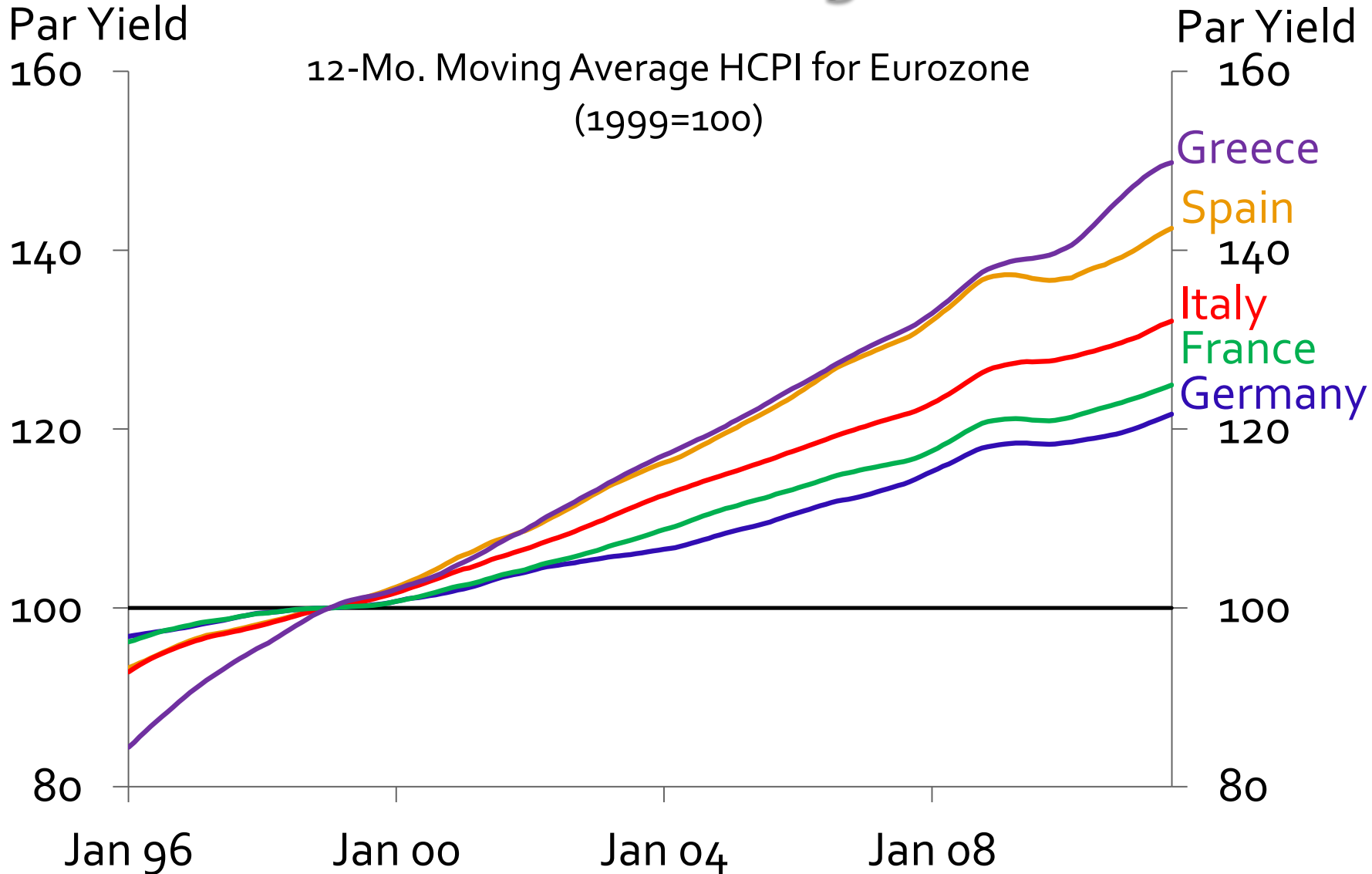
Par Yield



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Source: Eurostat

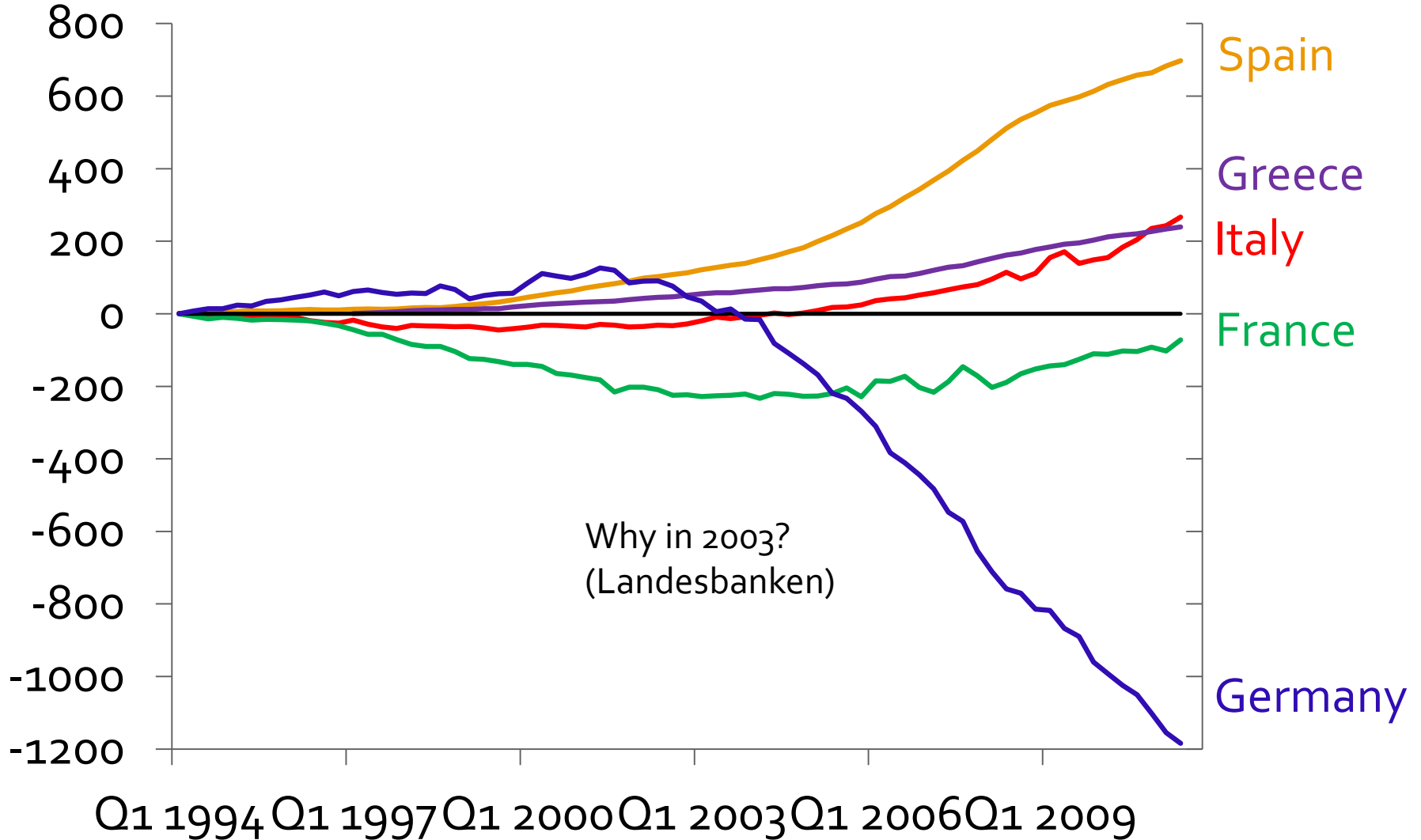
1. Persistent Inflation Divergence



1. Accumulated Net Capital Inflows

€Billion

€Billion



Why in 2003?
(Landesbanken)

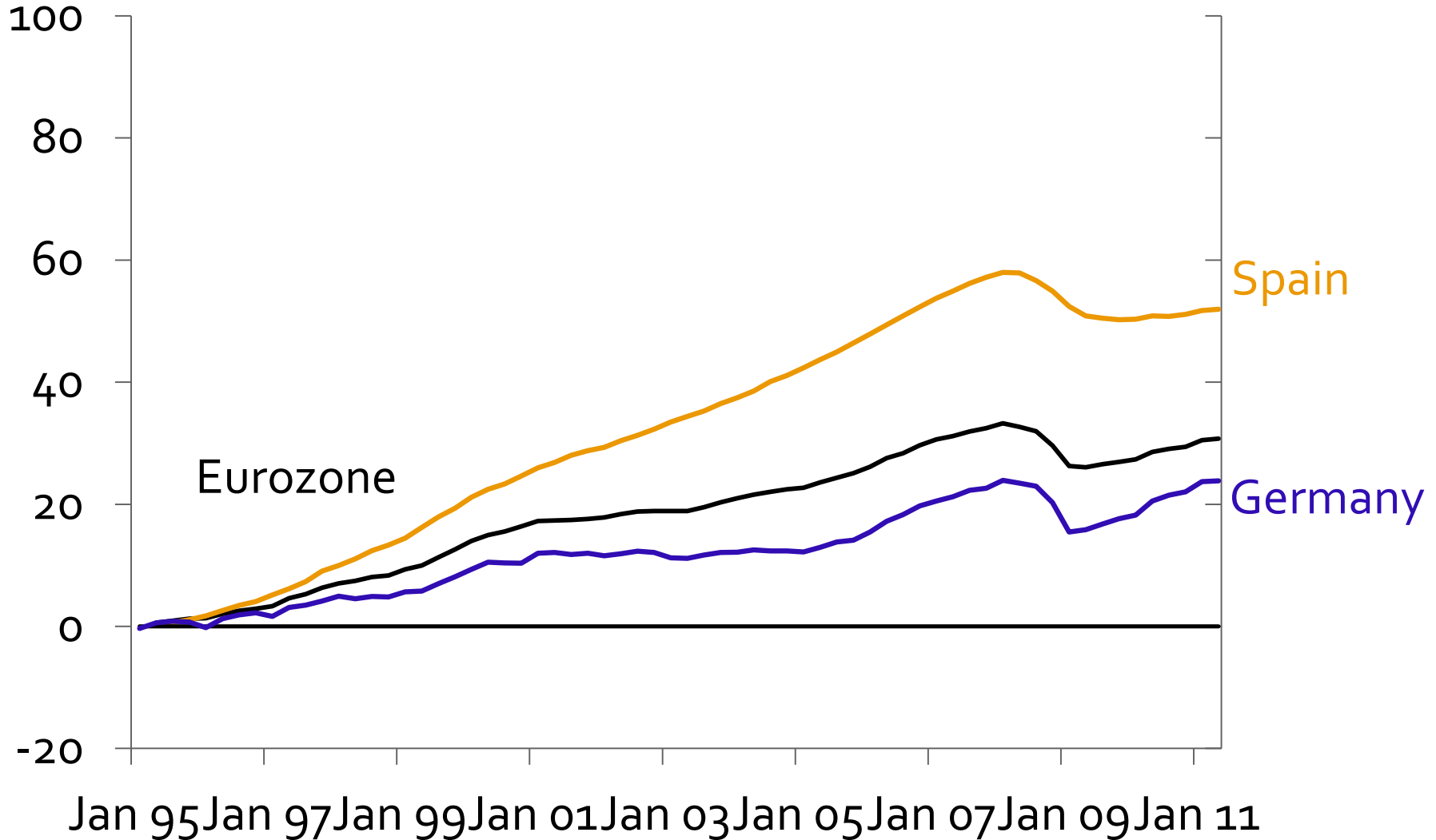
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Source: Eurostat

1. Accumulated GDP Growth

Percent

Percent

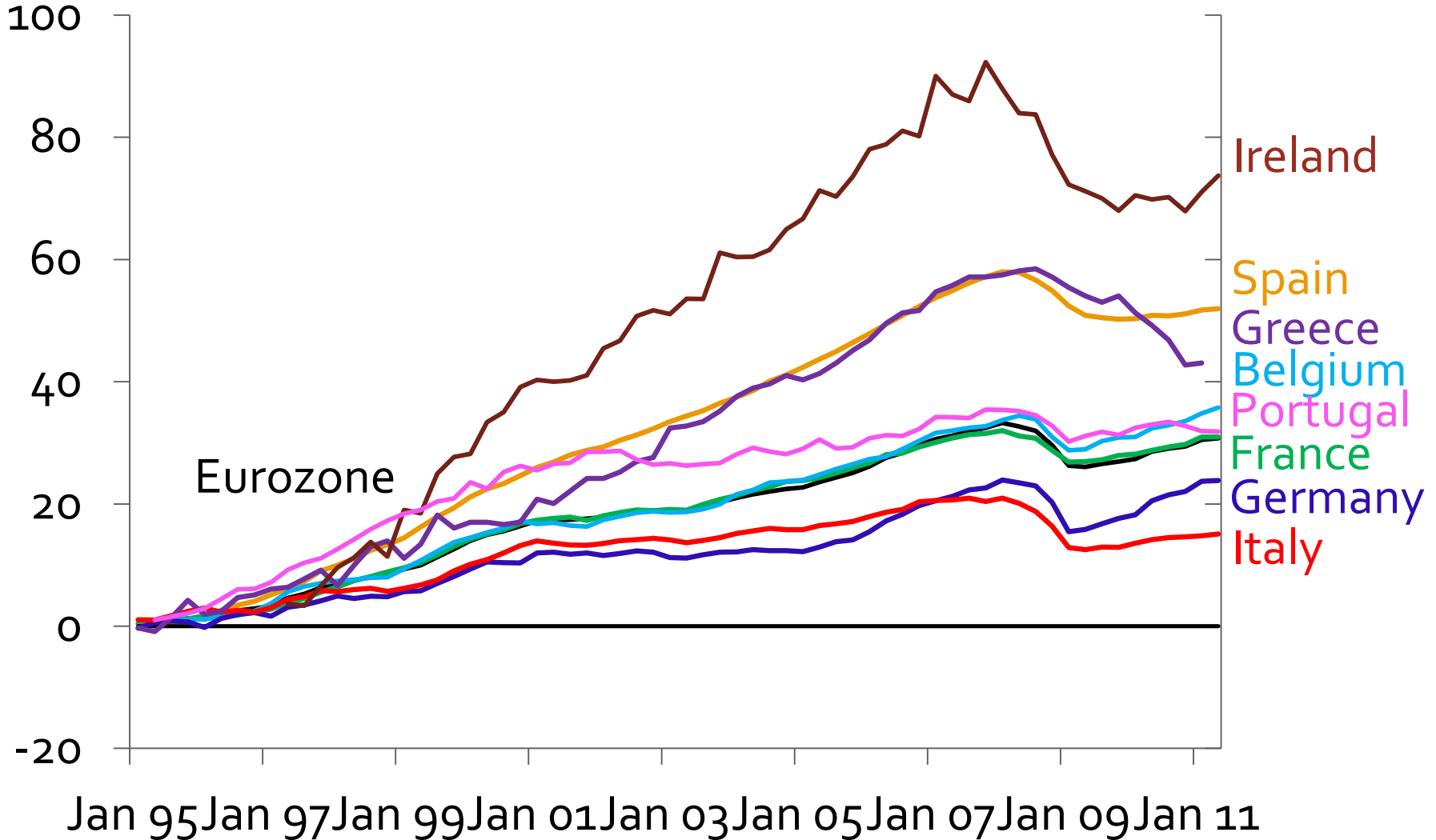


Source: OECD

1. Accumulated GDP Growth

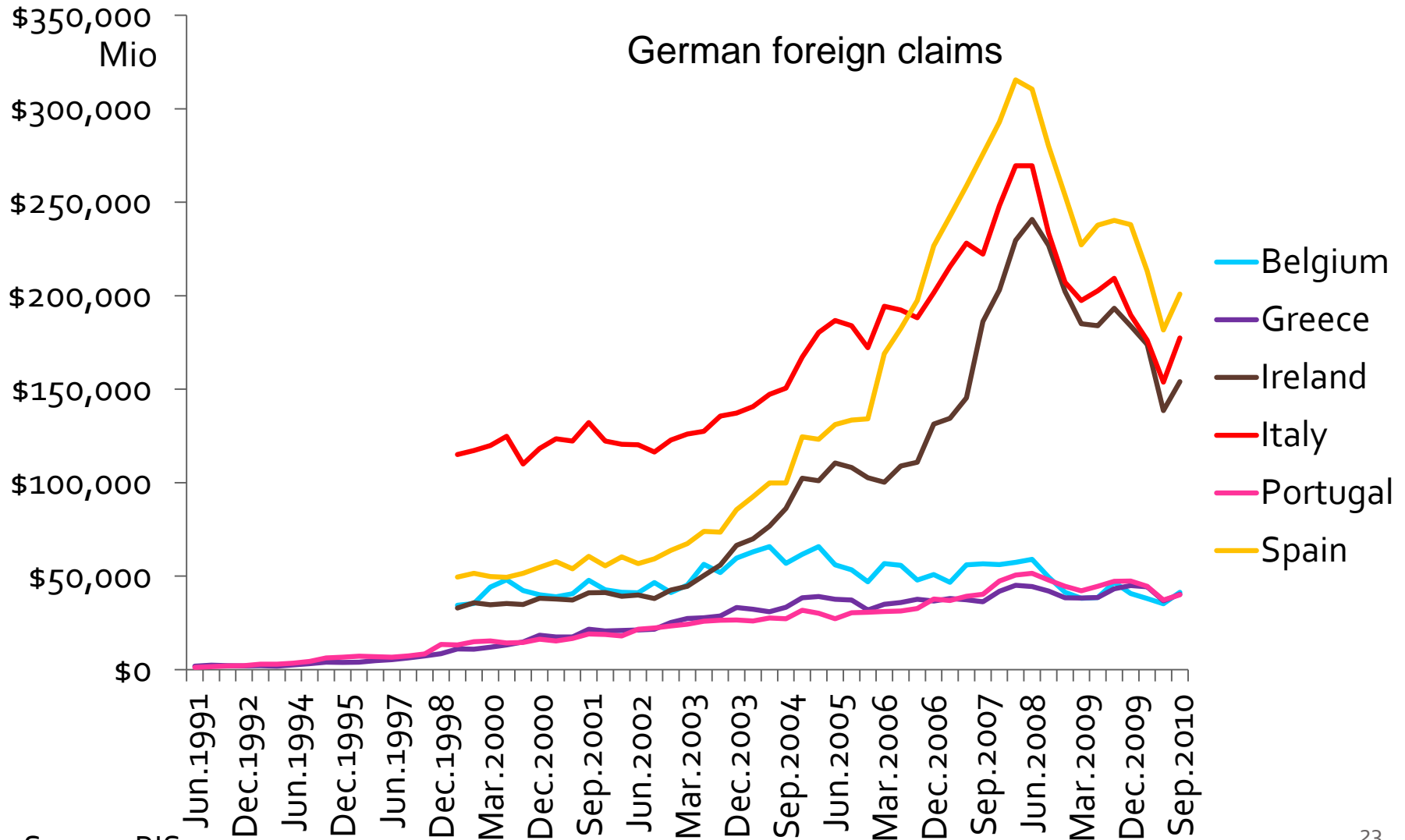
Percent

Percent



Source: OECD

1. Diagnose: b) Flight to safety



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Source: BIS