



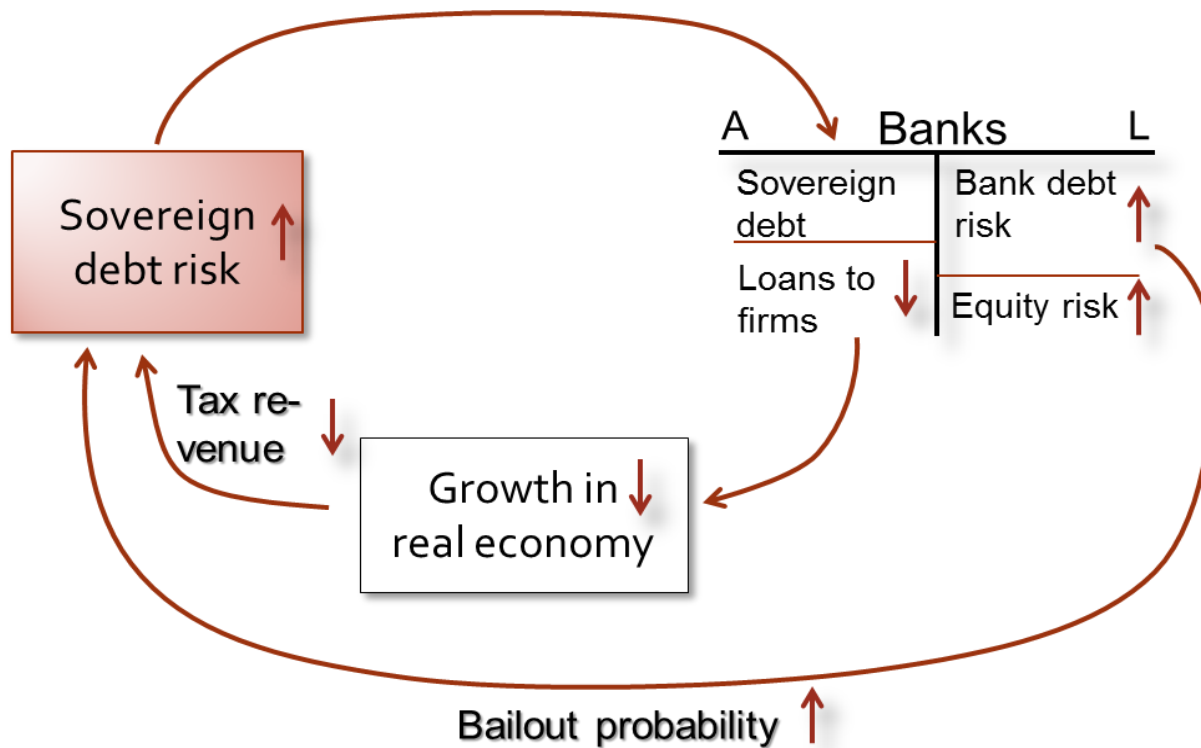
# EURO-CRISIS - NBER SUMMER INSTITUTE

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Cambridge, July 12<sup>th</sup> 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**

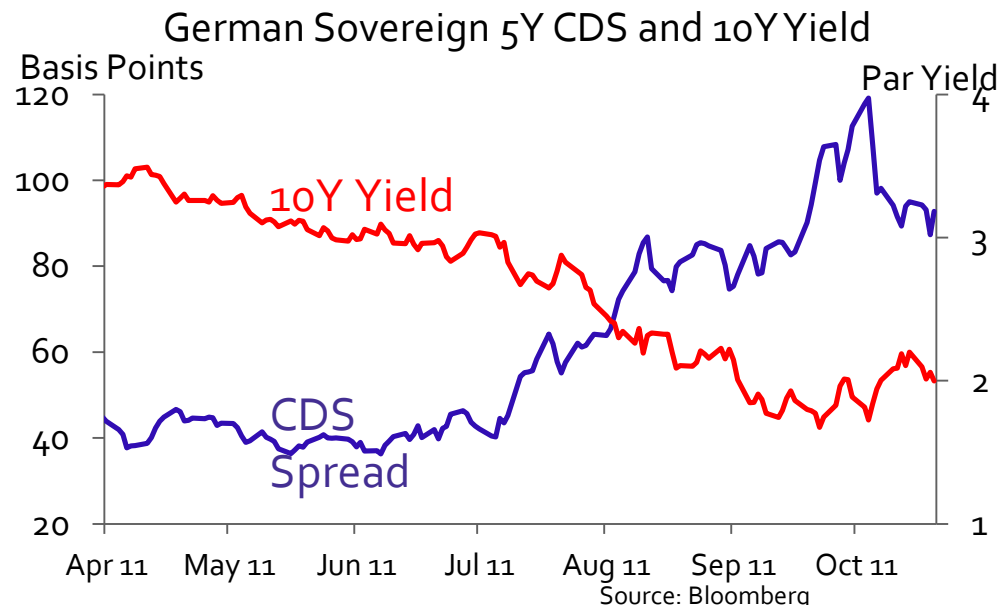


- Value of German debt ↑, Italian/Spanish debt ↓
  - German CDS spread rises, but yield on bund drops (flight to quality)

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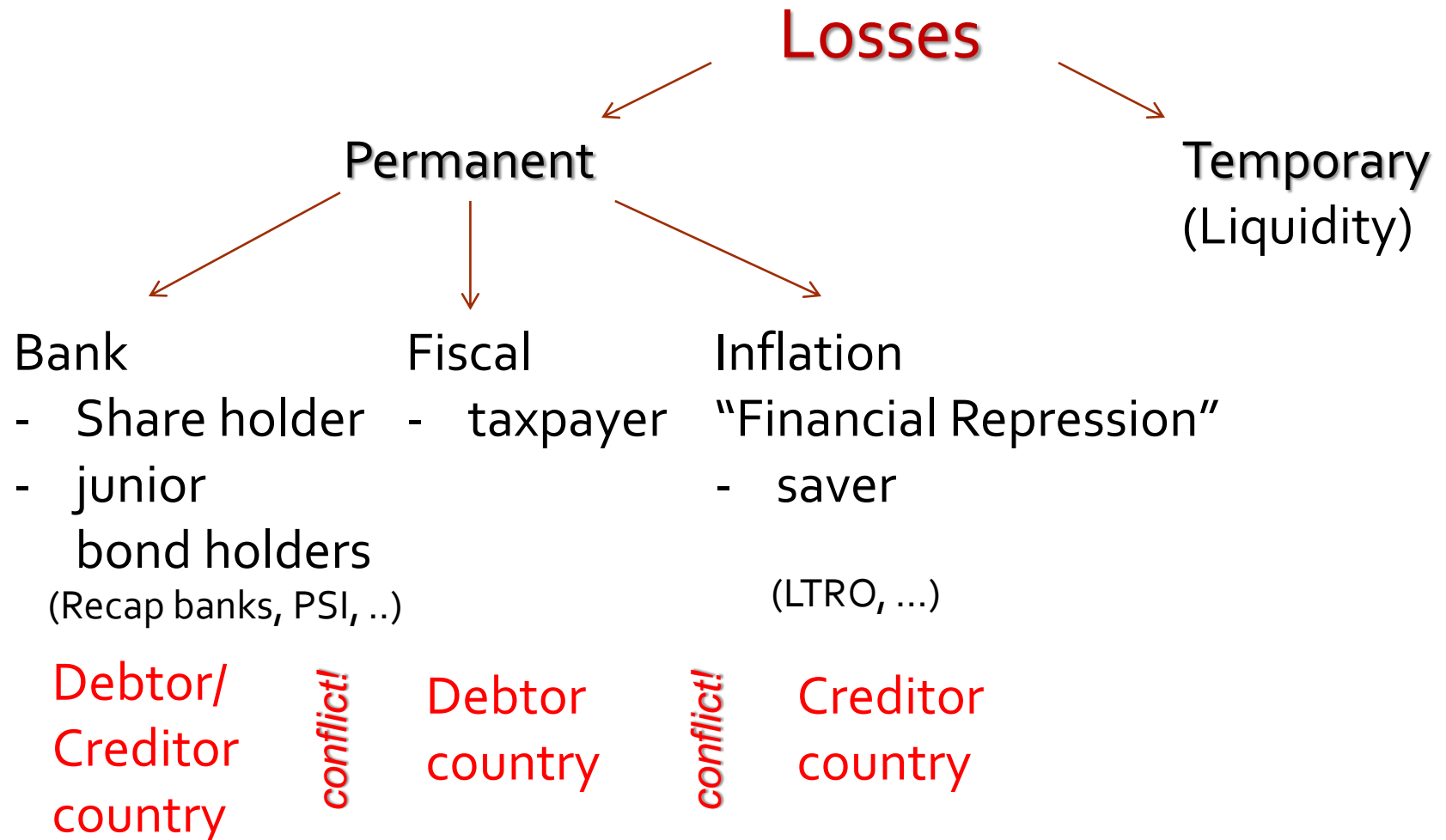
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# || Stock (Legacy) Problems vs. Flow Problems

- “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“

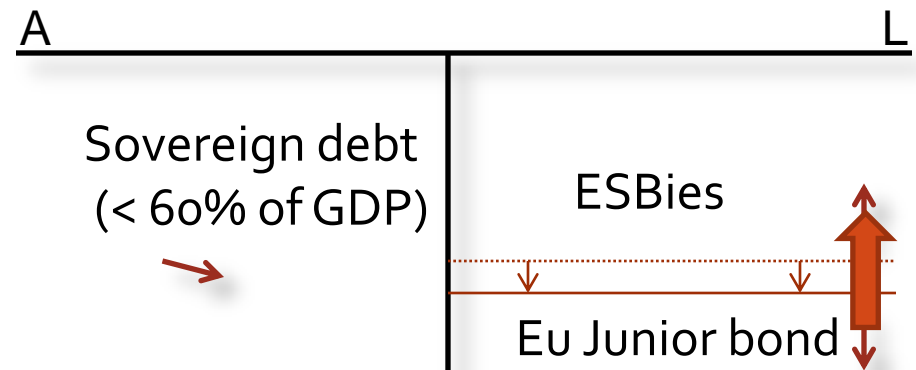
- Deal: Transfers in exchange for loss of fiscal autonomy
  - Why transfers? Debtor country's tax payers pay bailout
  - GCEE redemption fund: Incentives to reduce public debt







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

# || In sum ...

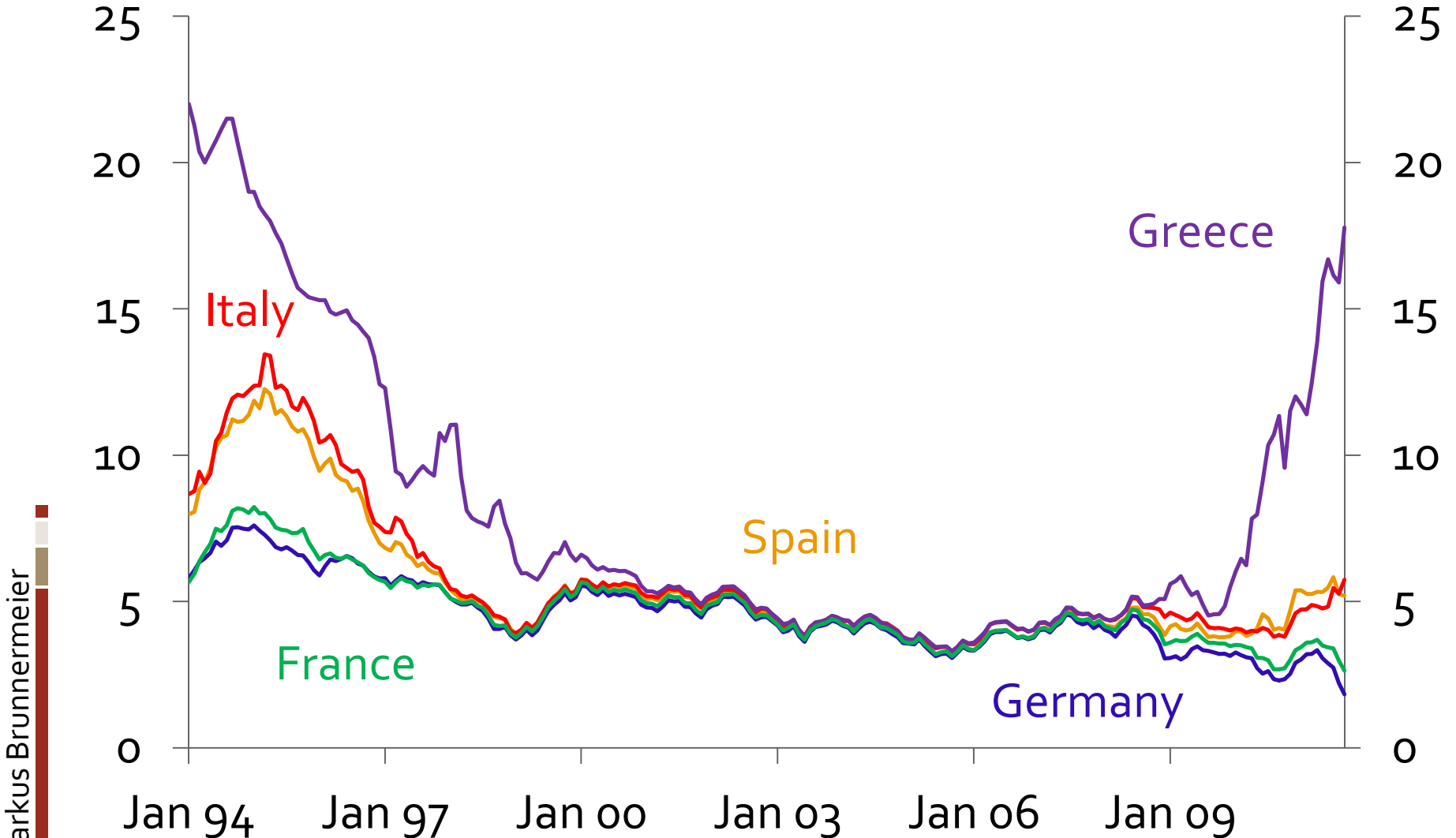
- Create a “European safe harbor asset”
  - “flight to safety” - requires coordination
- Isolate banks from sovereign risk (diabolic loop)
  - LTRO goes in opposite direction
  - “doubling down strategy”
- ESBies are flexible and reversible
  - allow gradual introduction of fiscal union
  - No fait accompli/TINA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

# || Extra slides

# 1. Sovereign debt yield (10 years)

Par Yield

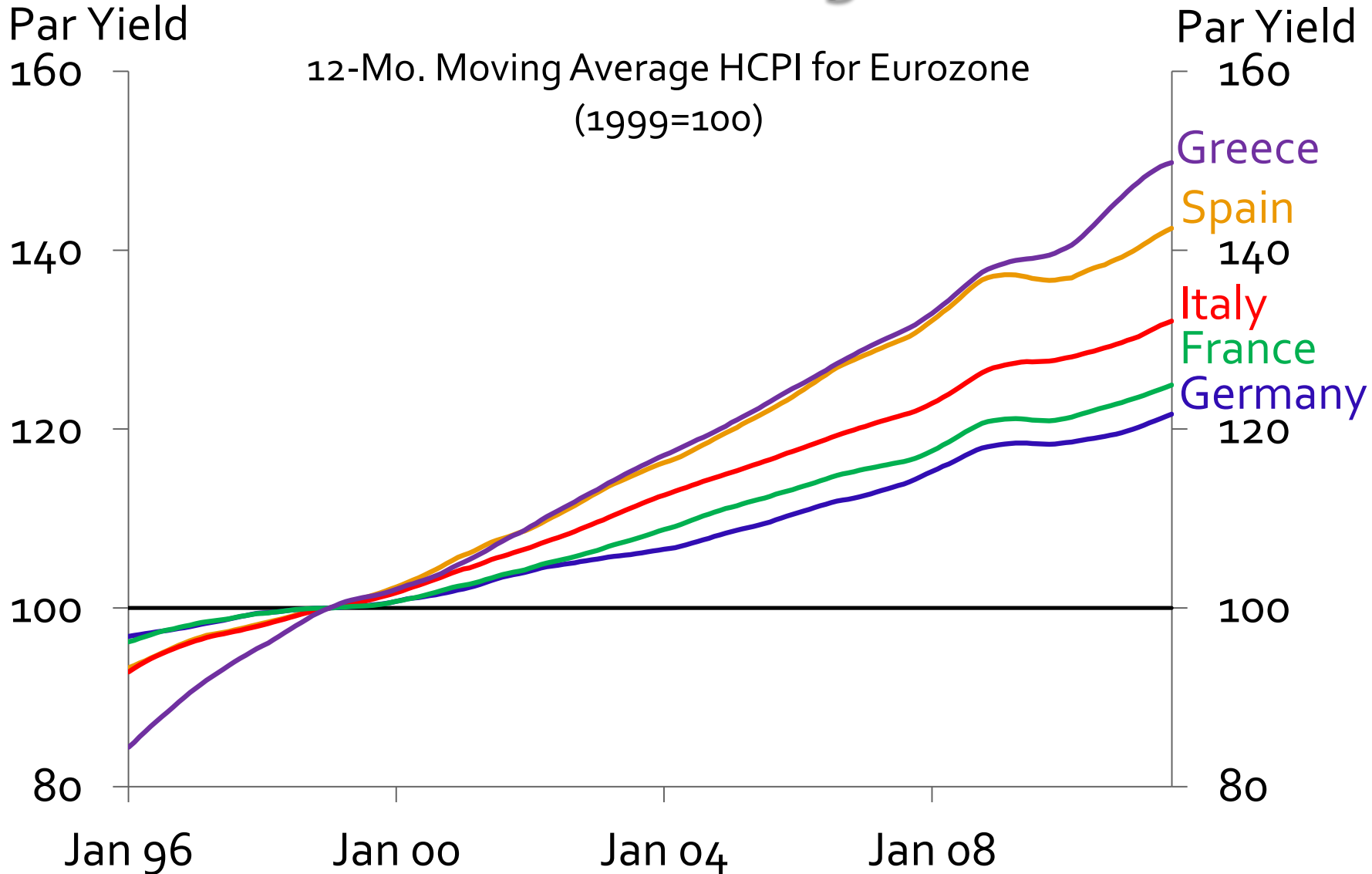
Par Yield



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Source: Eurostat

# 1. Persistent Inflation Divergence

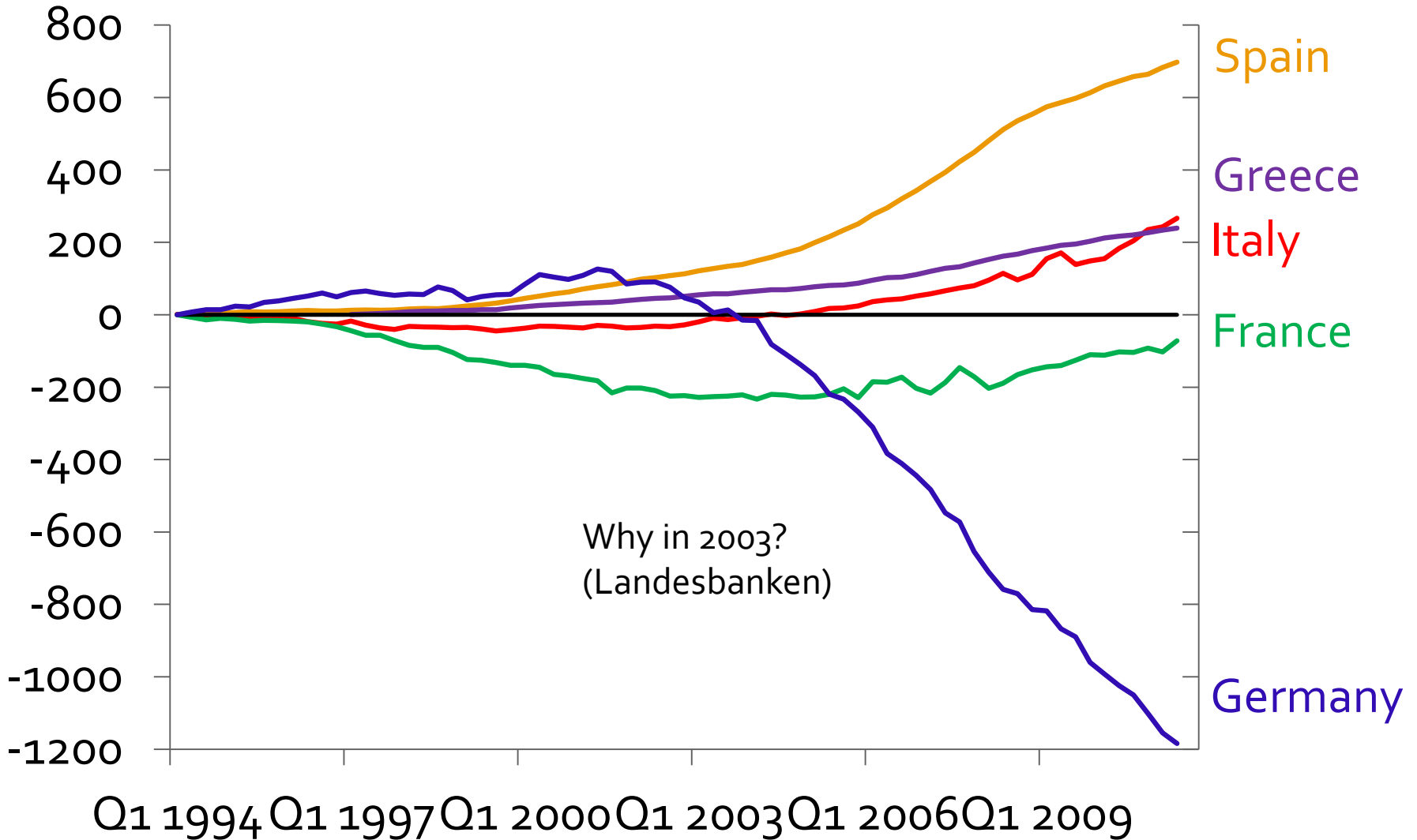




# 1. Accumulated Net Capital Inflows

€Billion

€Billion



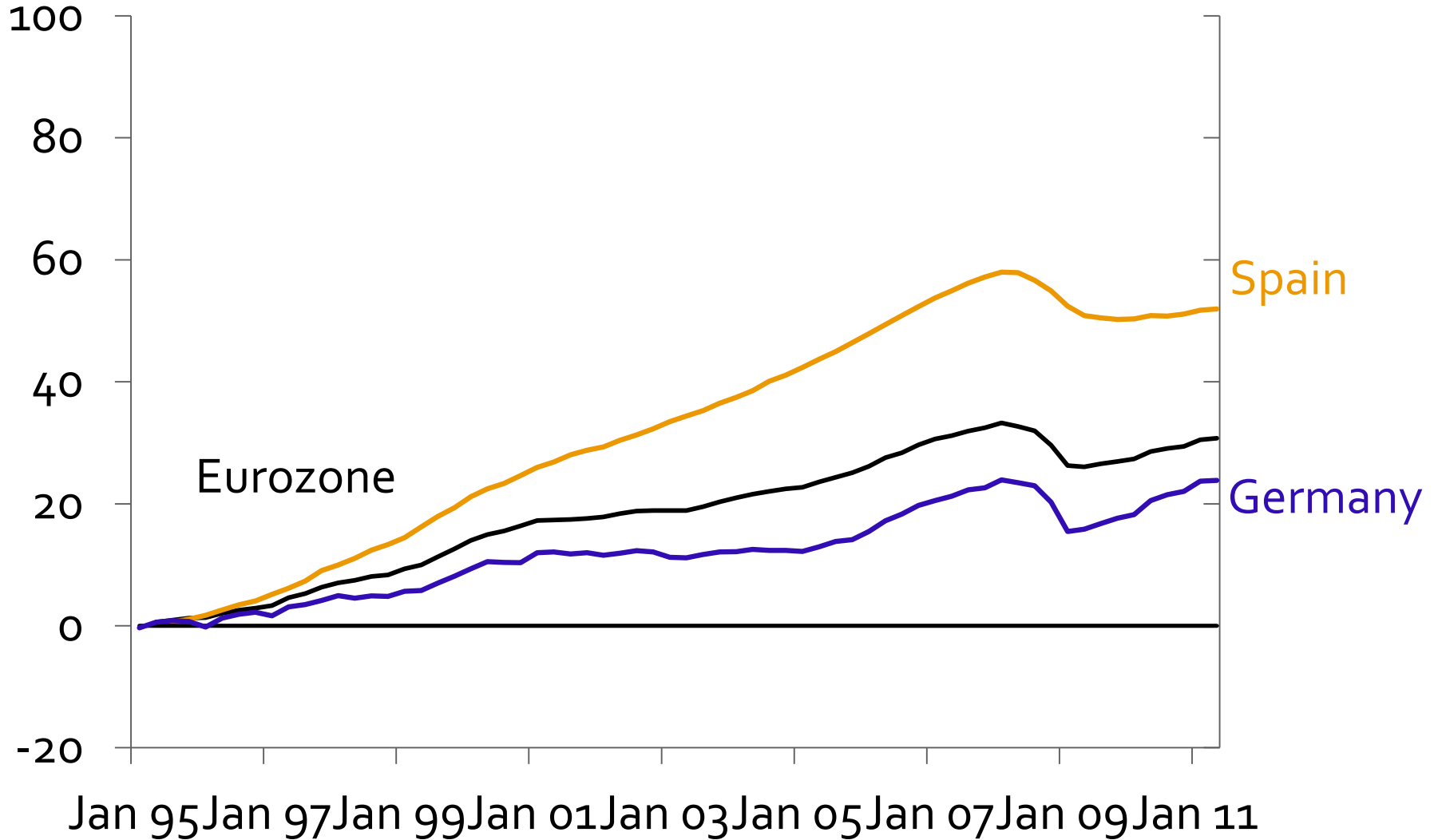
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Source: Eurostat

# 1. Accumulated GDP Growth

Percent

Percent

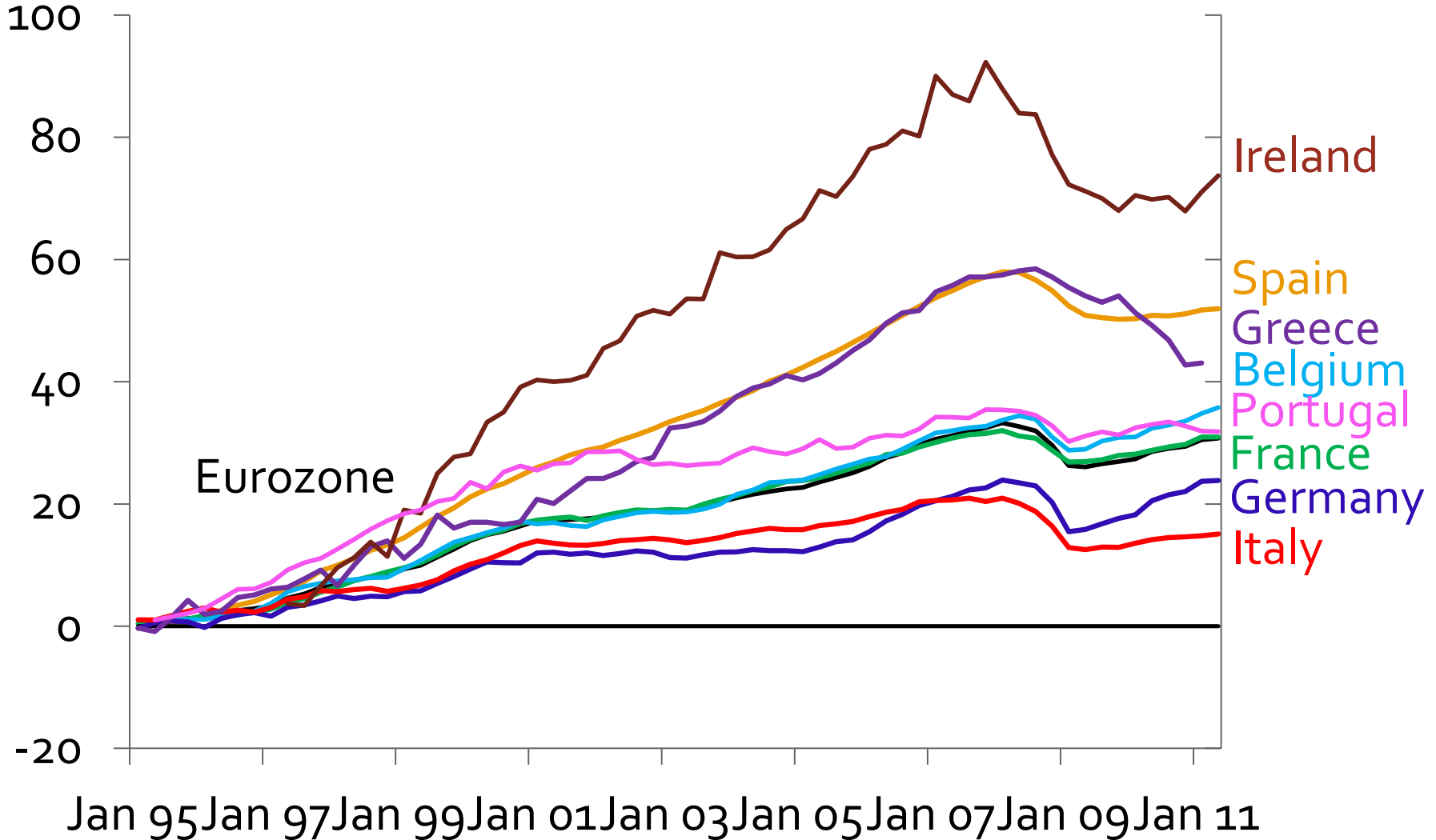


Source: OECD

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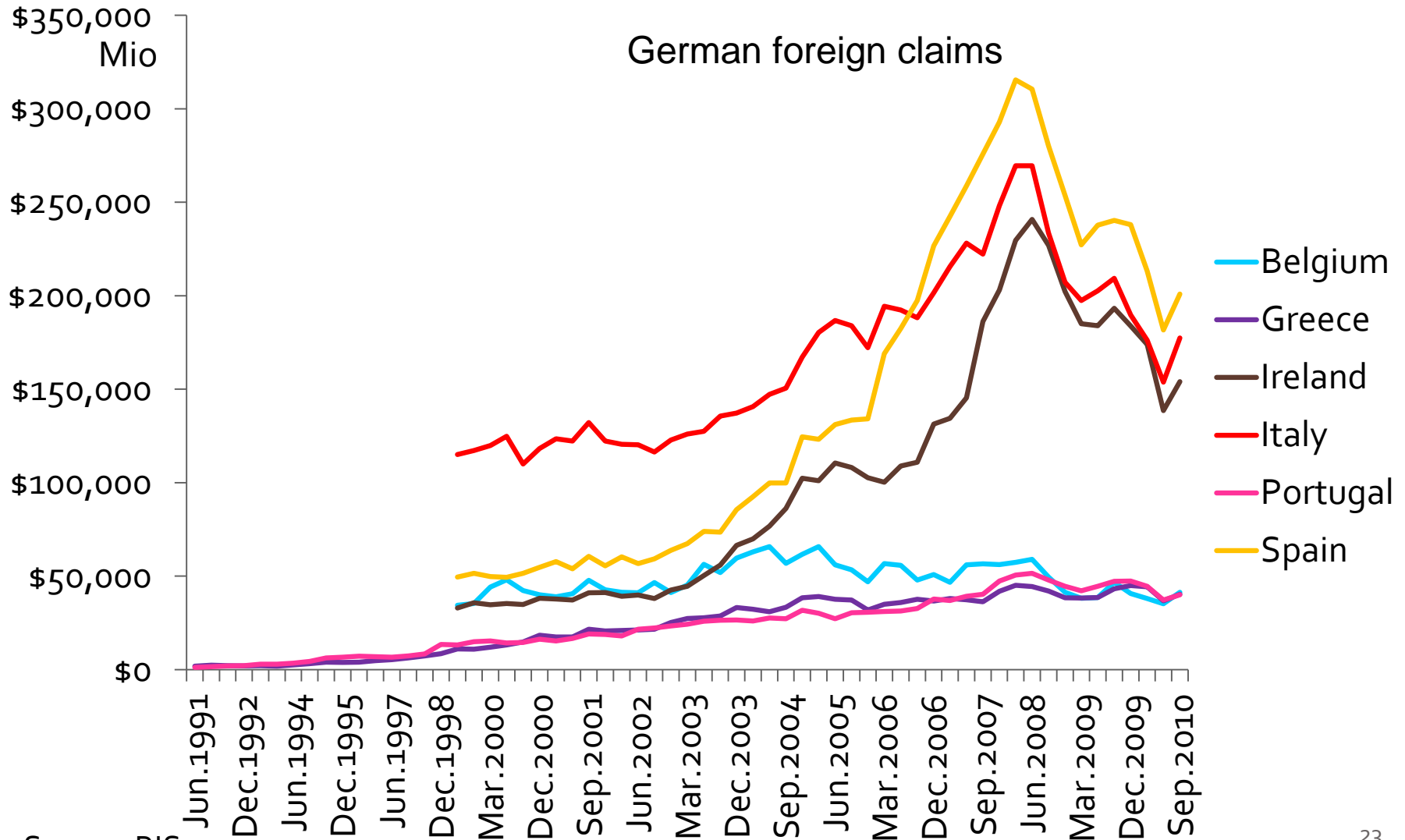
Percent



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Source: OECD

# 1. Diagnose: b) Flight to safety



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Source: BIS