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## America's debt crisis may drag the eurozone down

The temporary agreement to avoid a debt default in the US will produce severe consequences, not only in America but also in the rest of the world, notably in the eurozone.

As long as Barack Obama's administration and US Congress remain in the hands of different parties, they will muddle through, trying to gain time by postponing the fundamental decisions. The deadline for raising the debt ceiling will be pushed forward, but there is no certainty that the worst scenario can be definitely avoided. In fact, the two main actors have an incentive each time to move ever closer to the precipice and try to obtain some advantage by threatening a default.

This is similar to the game of chicken European policy makers played during the eurozone debt crisis, bringing the single currency very close to collapse. Only at the last minute, when the risk of implosion became apparent, did European politicians ultimately decide to create a European Stability Mechanism and to move towards a banking union. The intervention by the European Central Bank, pledging to do whatever it takes to avoid a collapse of the monetary union, calmed the markets but catastrophic risk has not disappeared. It is reflected in the risk premium of some eurozone sovereign bonds.

If the US political authorities continue to follow the same pattern, market participants will have to start pricing in a non-zero probability of a disaster scenario. The memory of Lehman Brothers has not faded away, after all. Tail risk is likely to increase in the near future.

A repricing of risk for Treasuries can be expected to affect a whole range of asset prices, including in other countries. At the global level, international

investors will be induced to further diversify their portfolios, reducing the overweight of dollar-denominated assets in favour of real assets or financial assets denominated in liquid currencies such as the euro.

The incentive to rebalance investors' portfolios may also be influenced by the US Federal Reserve's reaction to the recent deal. Interest rates may remain low for longer and capital may be induced to flow outside the US, chasing higher returns.

Overall, the increased tail risk on US government bonds and the likely reaction of US monetary policy should increase demand for non-US assets. The best rated European sovereigns should benefit from such a portfolio shift. It is less clear, however, that the eurozone as a whole will benefit.

Indeed, the supply of euro-denominated assets is not increasing at the same pace as the global demand. As a result, the euro exchange rate can be expected to further appreciate, continuing the trend of the past few weeks. In fact, the European currency is rapidly heading towards the levels prevailing before the start of the euro crisis. The rising current account surplus of the eurozone, resulting from asymmetric internal adjustment, is further contributing to this trend. This restricts monetary conditions in the eurozone.

On balance, the recent US budgetary events will produce direct and indirect restrictive spillover effects in the eurozone, symmetrical with those the eurozone crisis produced in the US at the peak of the crisis between mid-2011 and 2012. However, eurozone authorities seem less well equipped to deal with these spillovers than the US authorities.

While at the peak of the euro crisis the US authorities flew frequently over the Atlantic to convince European policy makers to get their act together and take the steps needed to complete the institutional framework underpinning the single currency, it is more difficult to imagine Herman Van Rompuy, European Council president, meeting back and forth with John Boehner, speaker of the US House of Representatives, and Mr Obama to convince them they need to reach an agreement on the next debt limit in the interests of the world economy.

Furthermore, while the Fed embarked on various waves of quantitative easing to inundate financial markets with liquidity, avoiding an over-appreciation of the dollar, the ECB's options are more limited. Cutting further the policy interest rate may help divert some of the demand for euro-denominated assets. The acknowledged weakness of the eurozone recovery and the low inflation rate – increasingly distant from the 2 per cent ceiling – provide the necessary justification for such a cut. It would hardly be sufficient, however, to discourage international investors' demand for euro-denominated assets.

If the strengthening of the euro is a result of increased demand for euro assets

by international investors, the only way to counter it – in the absence of capital controls – is to increase the supply of euro assets or to discourage demand. The only institution in a position to do so is the ECB. It could increase overall euro liquidity by operating directly in the markets, which would not be inflationary as long as the liquidity is held by foreign investors for diversification reasons. Alternatively, it could discourage demand for euro liquidity by imposing a negative interest rate on euro deposits held by the central bank.

Either measure would be a significant innovation for the eurozone. However, they may in the end be unavoidable to counteract the unintended consequences of the way the US is managing its debt problems.

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