Exchange rate arrangements: The strange case of Spain and the UK

Martin Wolf
Associate Editor & Chief Economics Commentator, *Financial Times*

Paper presented at the Rethinking Macro Policy II: First Steps and Early Lessons Conference
Hosted by the International Monetary Fund
Washington, DC─April 16–17, 2013

Exchange Rate Arrangements: Spain and the United Kingdom

Martin Wolf[1]

The effort to bind states together may lead, instead, to a huge increase in frictions among them. If so, the event would meet the classical definition of tragedy: hubris (arrogance); ate (folly); nemesis (destruction).

Martin Wolf, *Financial Times*, December 1991

The creation of the euro was among the most revolutionary developments in monetary history. Advanced European economies agreed to replace their national monies with a shared fiat currency, managed by a jointly owned institution, the European Central Bank (ECB). They did this, moreover, without agreeing to any of the other features of contemporary monetary areas, notably mechanisms for fiscal transfers or for common regulation and support of the banking system. In all these respects, the governments of member states remained sovereign, albeit notionally constrained by a set of rules governing fiscal deficits and debt.

A possible justification for this extremely limited institutional infrastructure was that the rules on fiscal policy and the central bank's ability to act as lender of last resort in a crisis would, together, be enough to ensure adequate stability. They would either prevent crises or, if they failed to do so, make them at least reasonably manageable. Another possible justification was the belief that it was essential at least to start. Once the euro area was launched, any failure to prevent or manage severe crises would motivate policymakers to create missing institutions or improve existing ones.

By early 2013, after at least three years of crisis, the institutional framework of the euro area had been shown to be inadequate. The fact that the crisis forced rapid institutional and policy innovations proves that. What had existed before the crisis proved inadequate, but whether a severe crisis would produce the reforms needed to make the euro area able to cope better remains unclear.

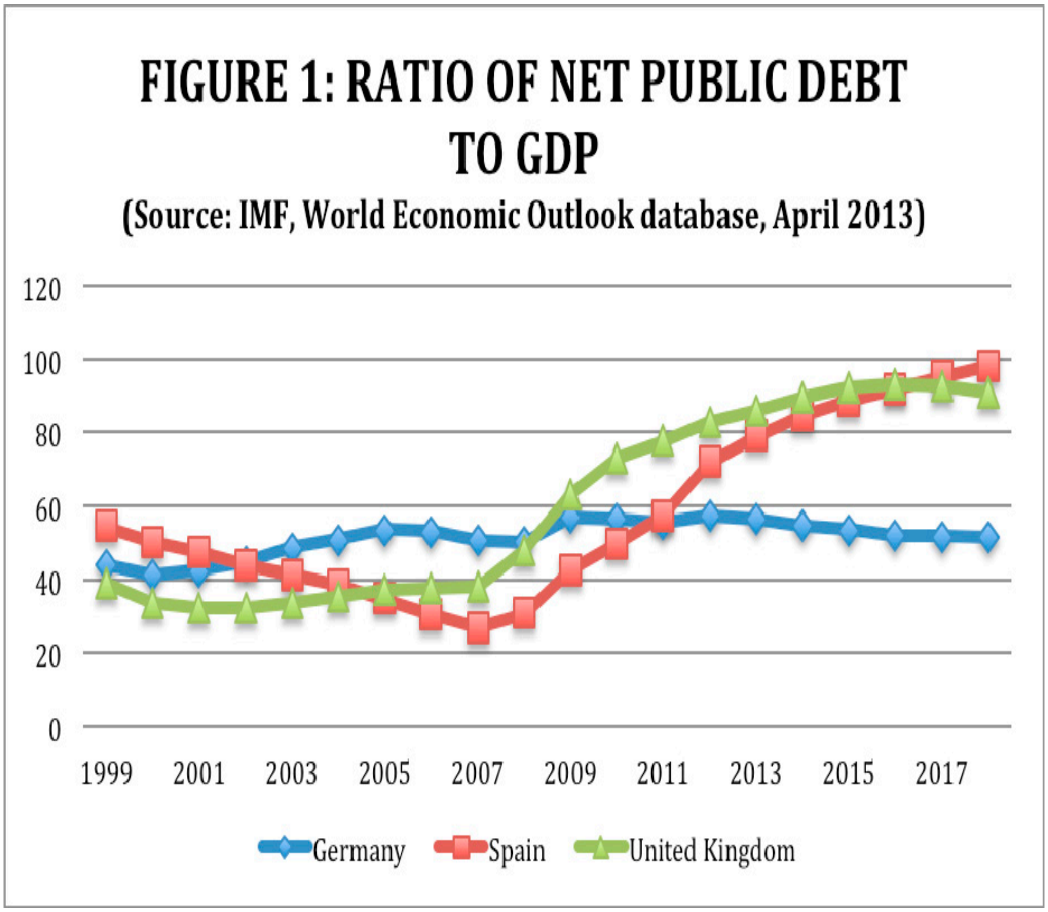
If one is to work out what reforms are needed, one must start by asking what went wrong. This is a topic on which Paul de Grauwe, formerly at the University of

Leuven and now at the London School of Economics, has shed much light in a number of important and illuminating notes and papers.[2] His conclusion is that the euro area simply needs a great deal of reform, particularly in the policies of the central bank. My conclusion is that the euro was a bad idea. Both conclusions might be correct.

Certainly, the loss of sovereignty for the governments of member states has imposed large costs upon them and their peoples. An excellent way to show this is via the contrasting experiences of Spain and the United Kingdom in the crisis. Spain lacks the tools to handle such a big financial crisis with any ease. The United Kingdom does not lack those tools, though it has failed to use them as fully as it might have.

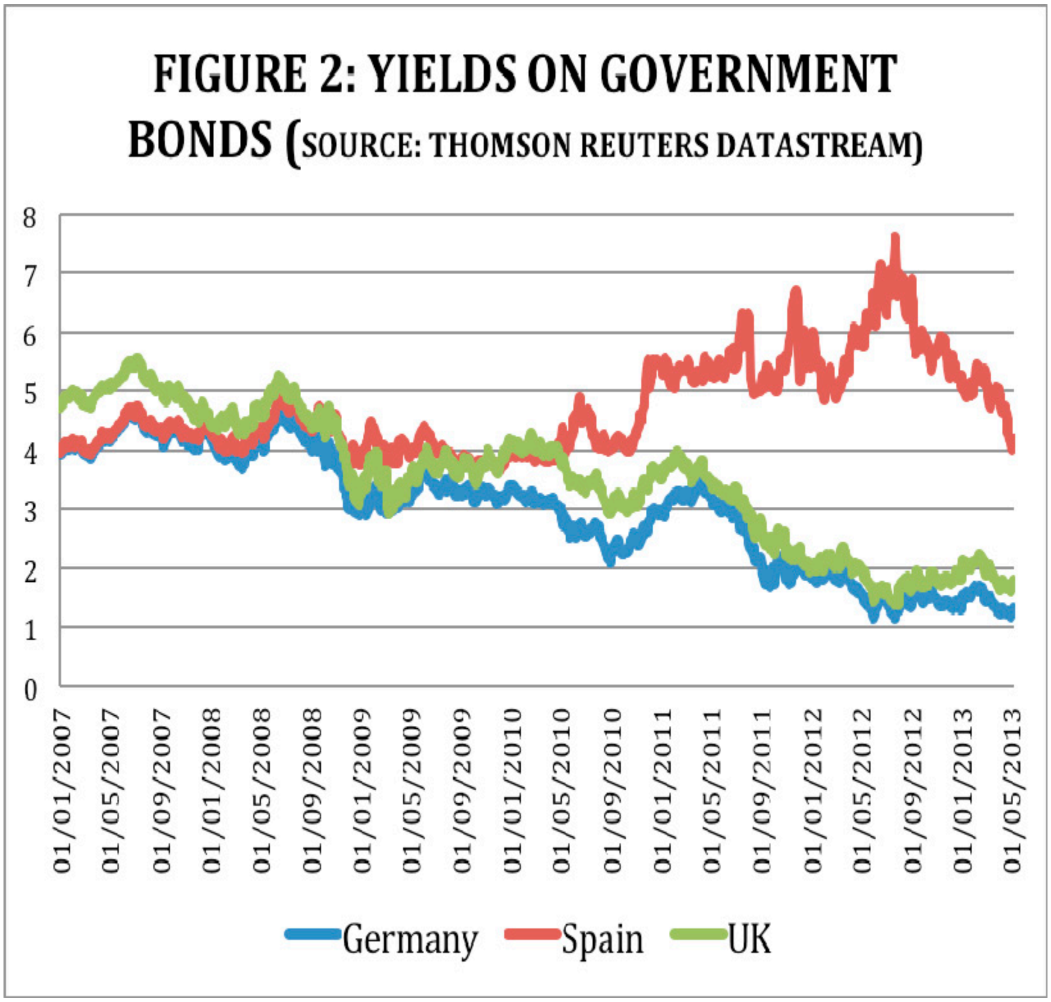
The Contrasting Cases of Spain and the United Kingdom

Spain and the United Kingdom are both crisis-hit countries. Since the crisis, both have been in poor fiscal positions. They also have big problems in their banking industries, though they are not quite the same problem: Spain's is largely debt created by a huge domestic property boom; the United Kingdom's banks have that problem, but they have also been damaged by their global operations. Surprisingly, perhaps, the fiscal consequences of their distinct crises are remarkably similar, as is shown in Figure 1. The expected path of the ratio of net public debt to gross domestic product in these two countries is almost identical.



Source: International Monetary Fund, World Economic Outlook database, April 2013.

For those who think the main determinant of the interest rate on government debt is the public debt burden, the implication is clear: The interest rates on Spanish and U.K. public debt should be quite similar. But they are not. The yield on 10-year U.K. public debt is far more like that on German 10-year public debt than like that on Spanish debt, as figure 2 shows, even though Germany's debt is expected to be under far better control than the United Kingdom's. The divergence between the yields on Spanish and U.K. debt has been very large indeed. This has made it far more difficult for the Spanish government to manage its debt and has adversely affected broader credit and monetary conditions in Spain relative to those in the United Kingdom.



So why should the interest rate difference between the two countries have been so very large? The answer lies mainly in the fact that the United Kingdom is a sovereign country, with its own finance ministry, central bank, and floating currency, while Spain is a subordinate government inside a currency union that has no shared treasury and a supranational central bank (the ECB).

Suppose holders of a government's debt believe that it might be unable to roll the debt over on reasonable terms. They would rationally fear an outright—possibly sudden—default. Creditors cannot seize the assets of bankrupt governments as they can take hold of the assets of companies. This is because national governments are sovereign in their own jurisdictions. So lenders will demand an interest rate that protects them against default risk. But at such an elevated interest rate, the government may be driven into the default that lenders fear, making their prophecy of doom self-fulfilling.

This is the danger of multiple equilibria. Olivier Blanchard, IMF economic counselor, puts it this way:

> At high levels of debt, there may well be two equilibria, a 'good equilibrium' at which rates are low and debt is sustainable, and a 'bad equilibrium' in which rates are high, and, as a result, the interest burden is higher, and, in turn, the probability of default is higher. When debt is very high, it may not take much of a change of heart by investors to move from the good to the bad equilibrium.[3]

Preventing such a shift is one of the jobs of central banks. Thus, a central bank guarantees liquidity in the market for sovereign debt. That hugely reduces the risk of a sudden default. This reduction of liquidity risk increases confidence in lenders. As usual, liquidity and solvency risks are closely related.

The principal reason why interest rates in Spain have been so much higher than those of the United Kingdom is that it had no such lender of last resort. Spanish debt was subject to liquidity risk and so, when liquidity risk looked significant, markets priced the debt accordingly, pushing Spain into a bad equilibrium. The ECB was not believed to be willing or able to ensure liquidity in the markets for sovereign debt of the euro area. In a panic, then, everybody fled to the safest debt—Germany's—causing a big crisis in countries with worse debt positions.

Lessons from ECB Interventions

The plausibility of the view that the biggest problem facing Spain has been the lack of a central bank of its own is strengthened by what happened when the ECB did finally indicate its willingness to intervene in the market for public debt of countries in difficulty. The decline in yields on Spanish debt shown in figure 2 dates almost precisely to July 26, 2012. This is when the president of the ECB, Mario Draghi, told an audience in London that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[4] This statement, in turn, led to the announcement by the ECB on August 2 of "outright monetary transactions" aimed "at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy."[5] Rightly or wrongly, markets concluded that the risk of a sudden outright default on Spanish bonds had greatly diminished. This, in turn, pushed the price of bonds from a bad equilibrium to a better one. As yields fell, the government did, indeed, start to look more solvent, thereby justifying the markets' renewed optimism.

Not coincidentally, the decline from the previous interest rate peak, in late 2011, dates from the announcement by the ECB of its three-year Long-Term Refinancing Operation in early December 2011.[6] But that operation proved unsuccessful in keeping interest rates down. That is why the ECB was driven to adopt the Outright Monetary Transactions program (OMT) in the teeth of opposition from Jens Weidmann, president of the Bundesbank.[7]

Moreover, the same declines occurred in Italy as in Spain, strongly supporting the argument that it is ECB policy, rather than actions by governments, that explains the sharp decline in interest rates on the long-term government bonds of vulnerable countries.[8] The ability of the ECB to trigger such a decline in yields is exactly what De Grauwe predicted. Now that it has become fact, he has analyzed this adjustment in another important article. The point he makes is that these were largely self-fulfilling panics that the ECB has, for the moment, ended.[9]

The crises, then, were in large part the result of allowing government bond markets to operate without grown-up supervision. Fortunately, the grown-ups are back. That is good news for the euro area and the world. A huge amount of unnecessary and ill-timed fiscal austerity has been imposed, just because the euro area did not have a proper central bank. It now has something that is at least a bit more like a proper central bank. It shows.

Why ECB Intervention Did Not Eliminate the Spanish Risk Premium

However, the intervention of the ECB, pleasingly effective though it has been in lowering rates, has not reduced Spanish interest rates to U.K. levels, at least at the time of this writing. Why should that be? One can see two possible sets of explanations.

First, the ECB's OMT program operates under important limitations. The most important one is that the program is not unconditional, albeit in principle it is potentially unlimited. Without conditionality, the ECB could not have obtained internal approval or external consent, above all from the German government, to intervene. Thus, the ECB stated on September 2, 2012:

> A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme.[10]

Another restriction is that the explicit rationale of the program is not to support government debt markets but rather to make monetary policy work effectively. This rationale is ingenious, since it allows the ECB to claim, imaginatively, that the aim of the program is monetary and so within its broad remit, rather than fiscal and so outside that remit. Thus, the ECB announced:

> The Governing Council will consider Outright Monetary Transactions to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme.

As a result, the ECB stated, "Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years." This makes sense for normal monetary policy, but the restriction limits the commitment of the ECB to support the market in sovereign debt.

A second set of explanations for the failure to achieve convergence of long-term interest rates between Spain and the United Kingdom is that the former suffers from a number of handicaps that the latter does not. These include risk of exit from the euro area or of breakup of the euro area, deflation risk, and other economic differences.

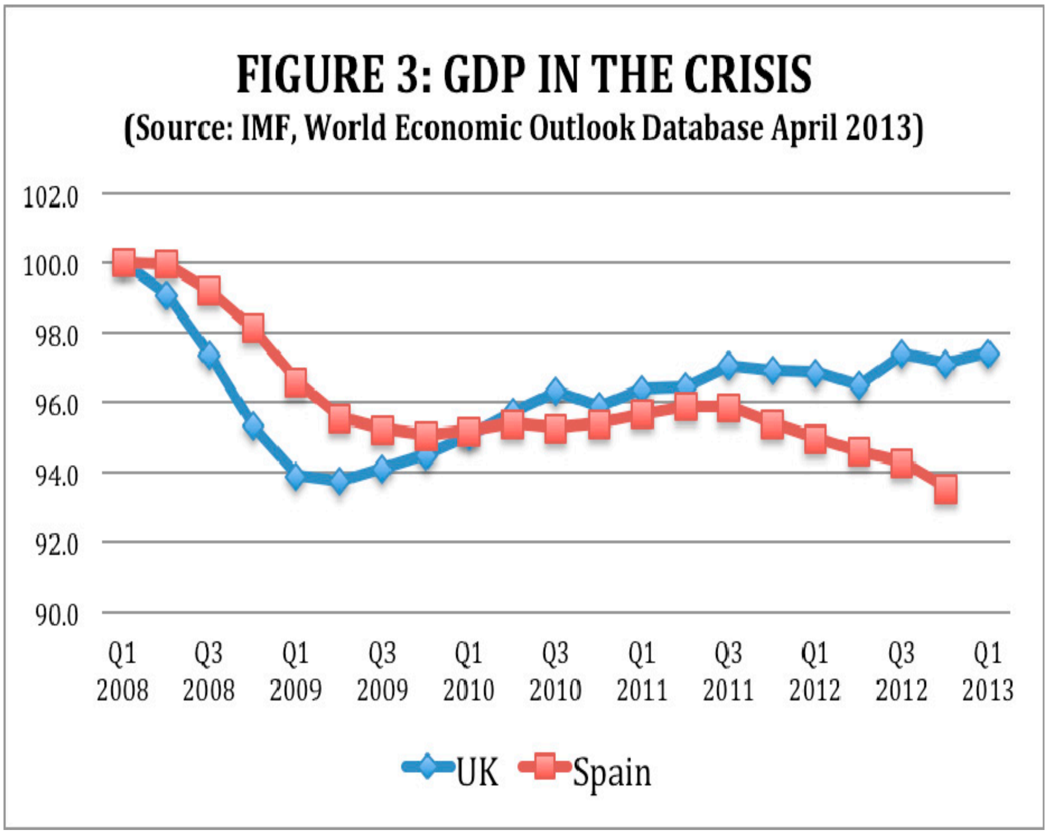
It is impossible for the ECB, or any institution, to eliminate the risk that Spain might leave the euro area or that the euro area might itself break up. So long as that risk continues to exist, investors in Spanish bonds need to take out insurance against the possibility of a sudden and costly redenomination into bonds in a new currency that would then swiftly depreciate. Furthermore, in the event of such a redenomination, it is likely that exchange controls would also be imposed, which creates another risk for investors in Spanish government bonds.

Furthermore, if the euro area were not to break up or Spain were not to exit, Spain would remain vulnerable to deflation risk. Indeed, outright deflation is the mechanism through which external competitiveness is restored inside the currency union. But deflation would raise the real value of Spanish debt, making its debt less sustainable. If the deflation were big enough, the time profile of debt might end up substantially worse than shown in figure 1. This would be particularly true if the deflationary process also inflicted a deeper than expected depression, depressing the denominator still further.

Finally, it seems that Spain's initial disequilibrium was rather larger than that of the United Kingdom. Its current account deficit was 10 percent of GDP in 2007, for example, against 2 percent in the United Kingdom. Consequently, the adjustment Spain needed would have seemed far bigger. Again, Spain's net international investment position was substantially more negative than that of the United Kingdom, making the country more dependent on foreign investors, who are usually, for good reason, more fearful of default than domestic ones are. Spain also had a larger boom in construction than the United Kingdom. For all these reasons, Spain was likely to suffer a longer and deeper recession than the United Kingdom, as indeed has happened. Investors might reasonably suppose that the government of a country undergoing such a deep and intractable slump might not make meeting its debt obligations a priority. In all, investors might reasonably reach the conclusion that Spain was not as good an investment risk as the United Kingdom.

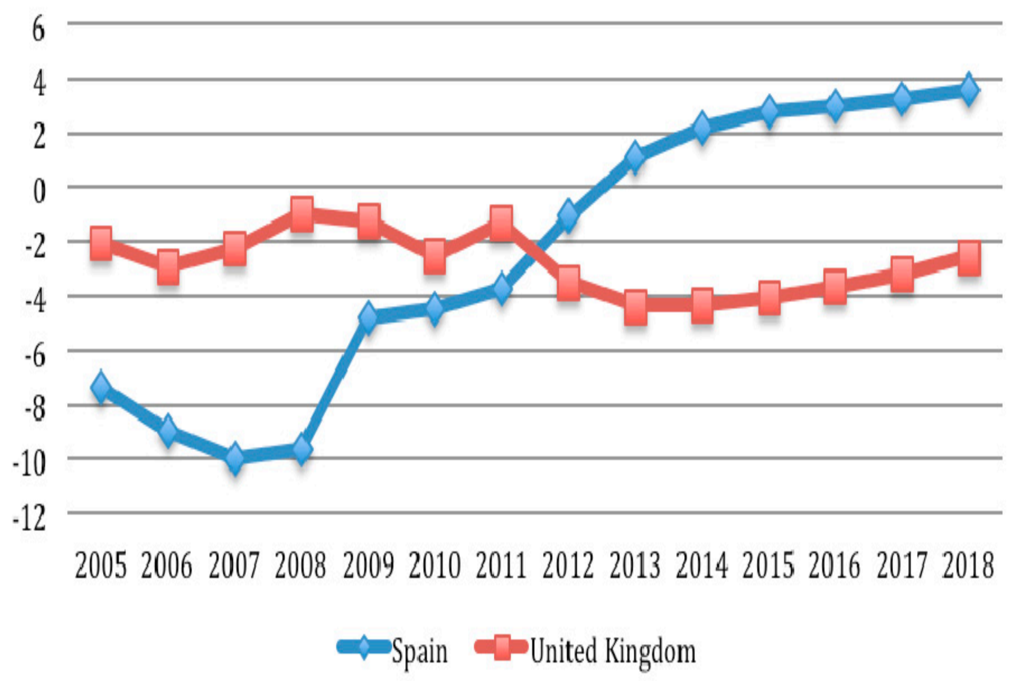
The rating agencies seem to have reached that conclusion. As of this writing, in June 2013, Standard & Poor's rated the United Kingdom at AAA and Spain at BBB-. Moody's rated them at Aa1 and Baa3, respectively. Fitch's rated them at AA+ and BBB. This huge gap between the two countries' ratings may partly reflect the additional and important fact that the United Kingdom has had a longer record of managing its debt well than has Spain. It may also reflect the normal behavior of the rating agencies: "I am your rating agency, therefore I follow you" seems to be their long-standing motto with regard to the market. But the big fact is that the rating agencies downgraded Spain massively compared with the United Kingdom.

Meanwhile, the United Kingdom possessed fundamental countervailing advantages. First, adjustment to a shift in the desire to hold sterling-denominated liabilities has worked, at least in part, via the price of the currency rather than the price of bonds. Such price flexibility reduces the need for quantity adjustments in response to shifts in the desire to hold a country's liabilities. In Spain, instead, a larger quantitative adjustment has been required. This is shown in the scale of the recession, revealed in figure 3, and the size of the current account adjustment, shown in figure 4. From one point of view, Spain's adjustment is impressive. But it is also a powerful indicator of the collapse in Spain's domestic absorption compared with the United Kingdom.



In addition, the United Kingdom has captive savers who need to match the currency of their assets with those of their liabilities. Thus, in a crisis, the U.K. government's liabilities provide a safe haven to such investors, among which will be insurers and pension funds. In the euro area, however, the relevant safe haven is the debt of the German government, in particular, and, to a lesser extent, of other stable creditor countries, such as the Netherlands. Thus, in a crisis, fearful domestic savers will fly toward U.K. government debt and away from Spanish government debt.

FIGURE 4: CURRENT ACCOUNT BALANCES (as a share of GDP)
(Source: IMF, World Economic Outlook database April 2013)



Why the Disadvantages of a Currency Area Are Partly Unavoidable

Nearly all these differences between the United Kingdom and Spain, from the lack of a proper central bank to the scale of the economic disequilibria, derive from the fact that Spain is a member of the euro area while the United Kingdom is not. Membership in the currency area has proved to be a big disadvantage in handling a severe financial crisis. A crucial question is whether, with a different institutional structure, these disadvantages might have been or can be avoided.

To some extent, the answer must be no. The advantages possessed by a country with its own floating currency and central bank are large, at least when handling the contractionary consequences of a huge financial crisis.

Remember, too, that the aim of creating the euro area was to promote internal capital flows. Thus, the huge cross-border flows of private finance that preceded (and then triggered) the crisis were hardly some accidental bug in the system. They were a deliberate feature. Similarly, the euro area was designed, quite deliberately, around the idea of a goal-independent central bank required to focus on price stability and expected not to finance governments directly, whatever happened. Moreover, in a multicurrency union, the only alternative to such a highly independent central bank would have been subordination to a committee of finance ministers. While such an arrangement is conceivable, it would have been extraordinarily ponderous and, in any case, unacceptable to Germany and a number of other member countries. So we have to regard the independence of the central bank and the nature of its mandate as a feature at least of this currency union. As a result, the ECB cannot make an open-ended and unconditional commitment to purchase public debt. A limited or conditional commitment cannot be completely credible and an incompletely credible commitment by the central bank will not shift adverse expectations durably or completely.

Of course, some of these features of the euro area were not logically necessary. Germany might, for example, have had a different philosophy of monetary policy and macroeconomic management. It might have been more like that of the United States. This would have made it easier for the ECB to intervene in sovereign debt markets, as De Grauwe wanted, on a large scale. The difficulties experienced in the currency union would then have been smaller. But the facts that creditor countries would like to restrict the support they offer to debtor countries and that countries in trouble face exceptionally difficult problems in managing the crisis and subsequent adjustment are inherent in almost any conceivable currency union.

Why the Euro Was a Bad Idea

What is the conclusion? It is that there were huge risks in the creation of the euro, some inescapable and some inherent in its design. The nature and extent of these risks has been revealed in the crisis.

Why were people unconcerned about these risks prior to the crisis? A big part of the reason is that many people believed that currency risk was the principal source of crises. This view was certainly consistent with experience in the 1960s, 1970s, 1980s, and 1990s. Consequently, proponents of the euro thought that the elimination of separate currencies would eliminate most of the risks of crises.

Events have proved this view false. Indeed, since 2010, euro area policymakers and economists have discovered that the opposite is true. First, currency risk cannot be eliminated, since there is always the possibility that currencies might be recreated. Second, currency risk will reemerge in other ways, particularly in the form of shocks to the supply of credit and financial and fiscal crises. Finally, when such risks become real, they will inflict huge financial, economic, social, and political pain.

The big lesson the crisis has taught us is that high-income countries embedded in a currency union are more vulnerable to balance-of-payments *cum* financial crises than similar countries with floating exchange rates and their own central banks. The currency union has, in fact, replaced the brief currency crises and exchange-rate realignments of the old exchange-rate mechanism with what now appear to be long-running solvency, employment, and political crises. A more active central bank, willing to push sovereign debt toward good equilibria and away from bad ones, would be a big help. In the course of the crisis, the ECB has become more of such a bank. But for reasons largely inherent in the creation of any currency union and certainly inherent in the euro area, the ECB is not going to act like a national central bank. The question for members to decide is whether the stresses they suffer as a result are worth it.

---

[1] Chief economics commentator, *Financial Times*, London.

[2] See Paul de Grauwe, "The Governance of a Fragile Eurozone," April 2011, http://www.econ.kuleuven.be/ew/academic/intecon/Degrauwe/PDG-papers/Discussion_papers/Governance-fragile-eurozone_s.pdf; Paul de Grauwe, "Managing a Fragile Eurozone," *Vox*, May 10, 2011, http://www.voxeu.org/article/managing-fragile-eurozone; Paul de Grauwe and Yuemei Ji, "Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone," CEPS Working Documents, January 20, 2012, http://www.ceps.eu/book/mispricing-sovereign-risk-and-multiple-equilibria-eurozone; Paul de Grauwe and Yuemei Ji, "Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone," January 23, 2012, http://www.voxeu.org/article/mispricing-sovereign-risk-and-multiple-equilibria-eurozone.

[3] Olivier Blanchard, "Rethinking Macroeconomic Policy," April 29, 2013, http://blog-imfdirect.imf.org/2013/04/29/rethinking-macroeconomic-policy/

[4] Speech by Mario Draghi, president of the European Central Bank, at the Global Investment Conference in London, July 26, 2012, http://www.ecb.int/press/key/date/2012/html/sp120726.en.html.

[5] European Central Bank press release, "Technical Features of Outright Monetary Transactions," September 6, 2012, http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.

[6] European Central Bank press release, "ECB Announces Measures to Support Bank Lending and Money Market Activity," December 8, 2011, http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html.

[7] Michael Steen, "Weidmann Isolated as ECB Plan Approved," *Financial Times*, September 7, 2012.

[8] See Joe Wiesenthal, http://www.businessinsider.com/in-one-chart-heres-why-roger-altman-is-wrong-about-how-the-markets-forced-austerity-on-europe-2013-5; and Paul Krugman, http://krugman.blogs.nytimes.com/2013/05/10/all-about-the-ecb.

[9] See Paul de Grauwe and Yuemei Ji, "More Evidence That Financial Markets Imposed Excessive Austerity in the Eurozone," February 5, 2013, http://www.ceps.eu/book/more-evidence-financial-markets-imposed-excessive-austerity-eurozone; Paul de Grauwe and Yuemei Ji, "Panic-Driven Austerity in the Eurozone and Its Implications," February 21, 2013, http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications.

[10] European Central Bank press release, "Technical Features of Outright Monetary Transactions," September 6, 2012;

http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html