Reponses to the Crisis and Euro Area's Future

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I. KEY ECONOMIC PREREQUISITES FOR THE FORMATION OF AN OPTIMUM CURRENCY AREA WERE PUSHED ASIDE

Some key economic characteristics for an Optimum Currency Area were **expected to adjust endogenously** and conform to the needs of EMU, once the common currency were established. Was this a **POLITICAL HYBRIS**?

- Many economists would say YES,
- while most politicians would say NO, even today after the crisis' wake up call

OCA criteria for the participating countries included:

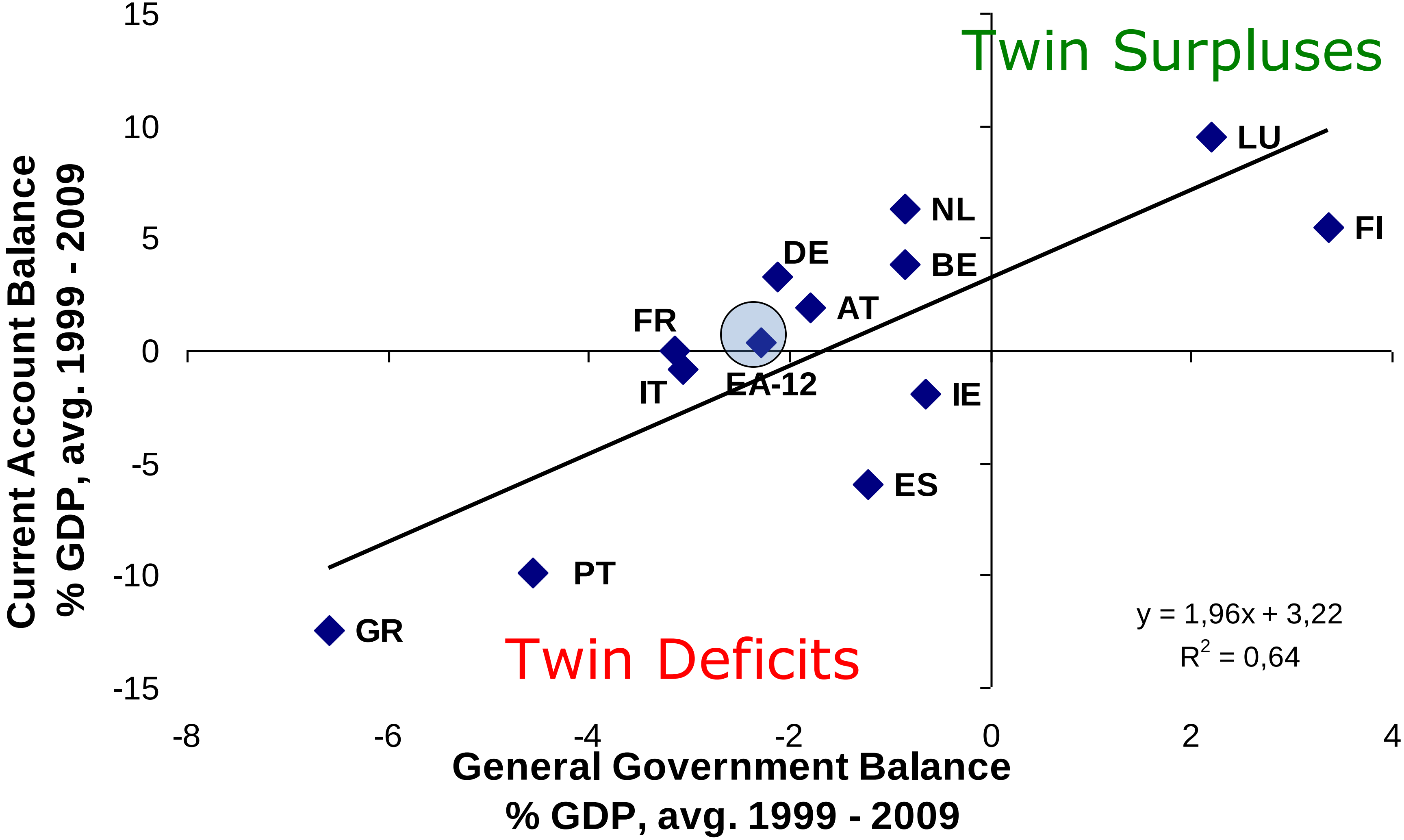
1) **Highly interconnected external trade sectors**
2) **Free cross-country mobility of capital, labor, and products & services**
3) **Adequate degree of uniformity across domestic economic structures and policies**
    a. Common economic policy criteria, synchronization in fiscal policies
    b. Similarity in the structure of the real economy ,e.g. price and labor market flexibility, pension system rules, competitiveness rules, uniform degree of state intervention in the private sector, etc.
    c. Common bank regulation and supervision
4) **Existence of a fiscal mechanism to smoothen the effects of asymmetric shocks,** e.g. on the terms of trade, on size of foreign demand, on asynchronous domestic business cycle developments

I. DIVERGENCES AFTER 1999

- The politicians' earlier hope of endogenous adjustment towards OCA was proven wrong. The very existence of the Euro Area resulted in **absence of market discipline**, which allowed **low interest rates** and resulted in the explosion of private and public debt
  - As money was cheap, banks became over-extended and vulnerable, especially in Spain, Ireland, Germany
  - Real estate bubbles were formed
  - Public Deficits in certain countries went over the 3% GDP limit
- **Structural reforms** represented the only discretionary policy tool to individual country governments post-EMU, yet they **were abandoned**, exactly at the moment they were needed the most: There was no pressure on politicians to perform the reforms as the good times made EMU citizens happy. Hence, a competitive Euro Area North and an uncompetitive Euro Area South emerged.
  - Nominal wages proved sticky and did not allow proper adjustment to external asymmetric shocks
  - In some countries like Greece goods& services prices continued to rise fast relative to the rest of the Euro Area, as oligopolistic structures remained intact
  - Pension systems remained unreformed

I. LARGE EXTERNAL AND INTERNAL IMBALANCES FOLLOWING EMU CREATION

Average annual external and fiscal balance in EA-12 countries before the EMU crisis hit in early 2010



Source: European Commission

I. MORAL HAZARD WORRIES DOMINATED THE RESPONSE TO THE CRISIS

- The crisis revealed **two needs, not necessarily complementary**:
  1) **Need for actions to contain the crisis**
  2) **Need for a better long-run framework, consistent with OCA, which would ensure long-term stability of the euro**
- Academics of all political persuasions agree: **Solve the crisis first and then worry about long-run architecture and adverse incentive problems**
- Yet, **Euro Area politicians chose to focus on redesigning its framework and ignored the need to contain the crisis**
  - When the crisis hit Greece, the country seemed too small to impact the rest of EMU. **Moral hazard reasons and austerity prescriptions dominated the discussions**
  - Markets were particularly irked after the Deauville German-French meeting in October 2010 and its **message that the private sector would pay**, hence interest rate spreads shot up. This message **came 15 years too late at the wrong moment**
  - **Politicians catered to their domestic constituencies and the domestic populist press**, which pained the Greeks as lazy and corrupt, who are taking their money. They confused the EMU imbalances with moral arguments about the Greeks. They **never took decisive actions**, and were thus continuously "**behind the curve**" in their responses
  - The austerity prescription caused even more stress in the South, politics diverged inside the countries, thus driving the countries further apart politically
- At the same time, most **Greek politicians did not understand that this was a regime shift** and not a typical recession, that they would have to carry on with the fiscal and structural reforms. In the crisis both counterparties, Europeans & Greeks, failed

I. EUROSYSTEM: PROVIDED LIQUIDITY SUPPORT … BUT PROVED NOT TO BE A LENDER OF LAST RESORT

- ECB intervened to provide liquidity to the banking system, thus averted the typical *Sudden Stop* in financing, which accompanies a crisis
- Yet, ECB not as aggressive as the Fed, deeply concerned about its independence and of implicit financing of fiscal policy, especially Bundesbank. It intervened massively with LTROs only after Italy was hit by the crisis in the summer of 2011
- SMP and the recently announced OMT are important innovations
- ECB does not act as proper lender of last resort as the ELA mechanism is more costly. **Periphery suffers from restrictive monetary policy**!

Bank Borrowing from the ECB

	EA			Greece		
	a	b	c	a*	b	c
Jun-07	464.6	28,026	1.7	4.3	353.4	1.2
Jun-08	483.0	30,839	1.6	11.6	424.7	2.7
Jun-09	896.8	31,804	2.8	54.0	491.2	11.0
Jun-10	870.4	32,578	2.7	94.3	544.7	17.3
Jun-11	497.5	31,736	1.6	103.1	502.5	20.5
Jun-12	1,260.9	34,177	3.7	135.8	437.6	31.0

(a) Total Lending from the ECB (€bn)

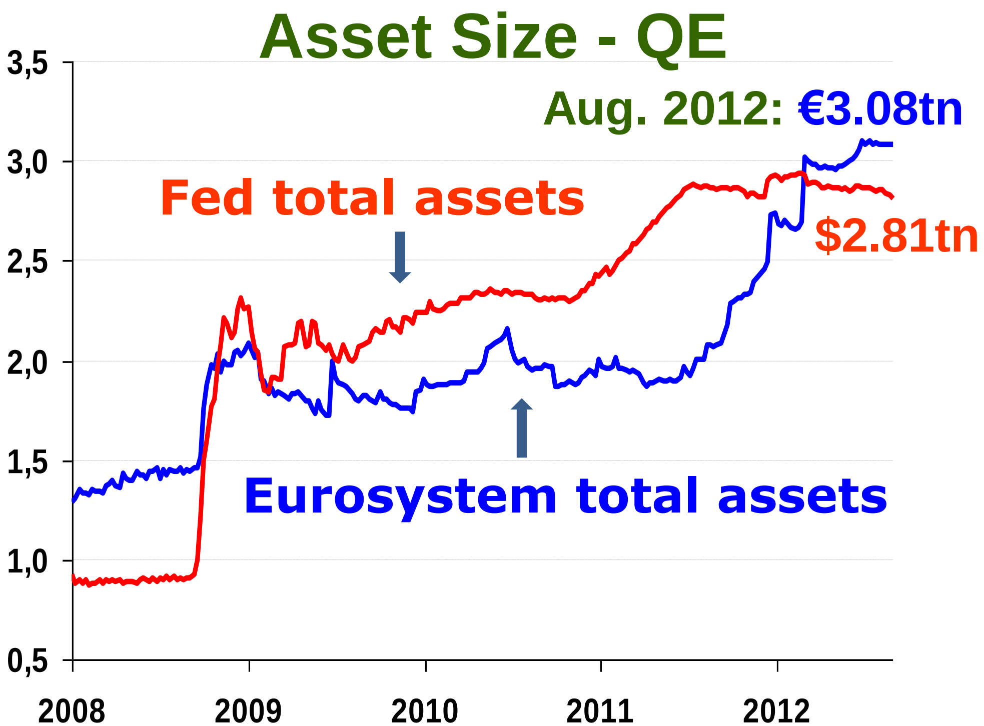
(b) Total Banks Assets (€bn)

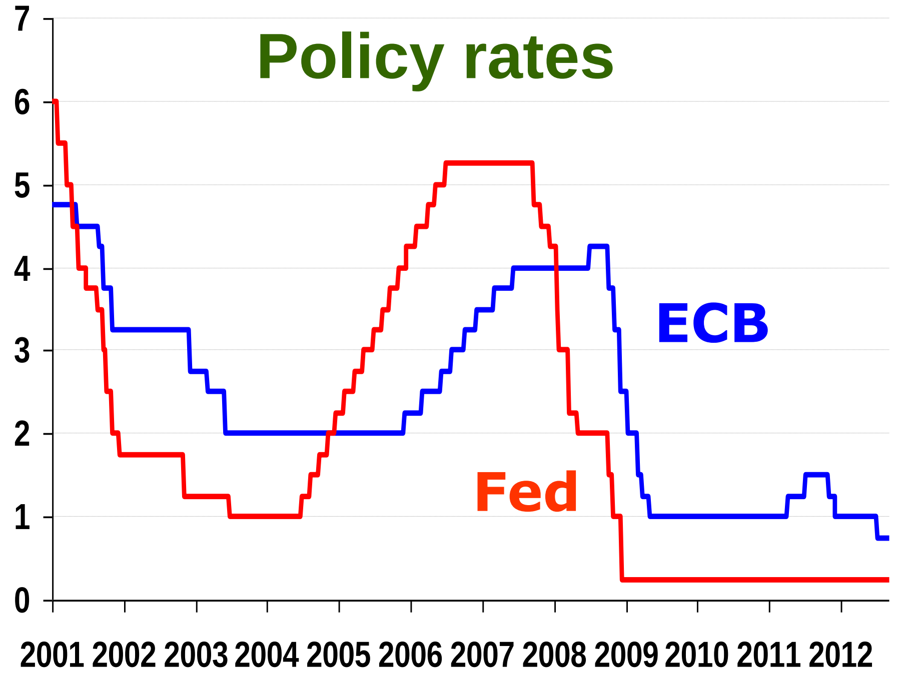
(c) % ratio a/b

* plus lending from the BoG through ELA

I. IN THE PAST, ECB NOT AS AGGRESSIVE AS THE FED, NOW MORE ACTIVE

- ✓ The Fed was more aggressive early on in using Quantitative Easing, yet ECB also expanded aggressively with LTROs in the second half of 2011 after the Italian crisis revealed a great danger to the Euro Area
- ✓ September 2012 announcement of OMT signals radical shift, "will do whatever it takes" by Draghi, yet Bundesbank casts negative vote





I. EVOLVING NEW ARCHITECTURE

- **Fiscal Compact**:
  - Fiscal rule stating GG budgets shall be balanced or in surplus. Annual structural deficit must not exceed 0.5% or 1.0% of GDP depending on the debt-to-GDP ratio.
  - If debt exceeds the 60% reference level, government shall reduce it at an average rate of one twentieth per year as a benchmark
- **Six-pack**, existing fiscal rules running in parallel with fiscal compact
- **Pact for the Euro** (or **Euro**+), addresses issues of competitiveness, employment, financial stability and sustainability of public finances
- **EFSF (ESM)**, currently endowed with €440bn, can issue debt instruments to raise funds for a member country, which has signed an MoU with EC & IMF, in order to:
  - Provide loans to distressed eurozone countries
  - Recapitalize banks
  - Buy sovereign debt, even in primary bond market
- **Single Supervision Mechanism (SSM) for Banks** (EC proposal on 12/9/2012, to begin on Jan 1, 2013 and be fully ready on Jan 1, 2014) by ECB with tasks of:
  - authorizing credit institutions compliance with capital
  - leverage and liquidity requirements
  - conducting supervision of financial conglomerates
- **Euro-bonds & European safe bonds** (have not materialized)

II

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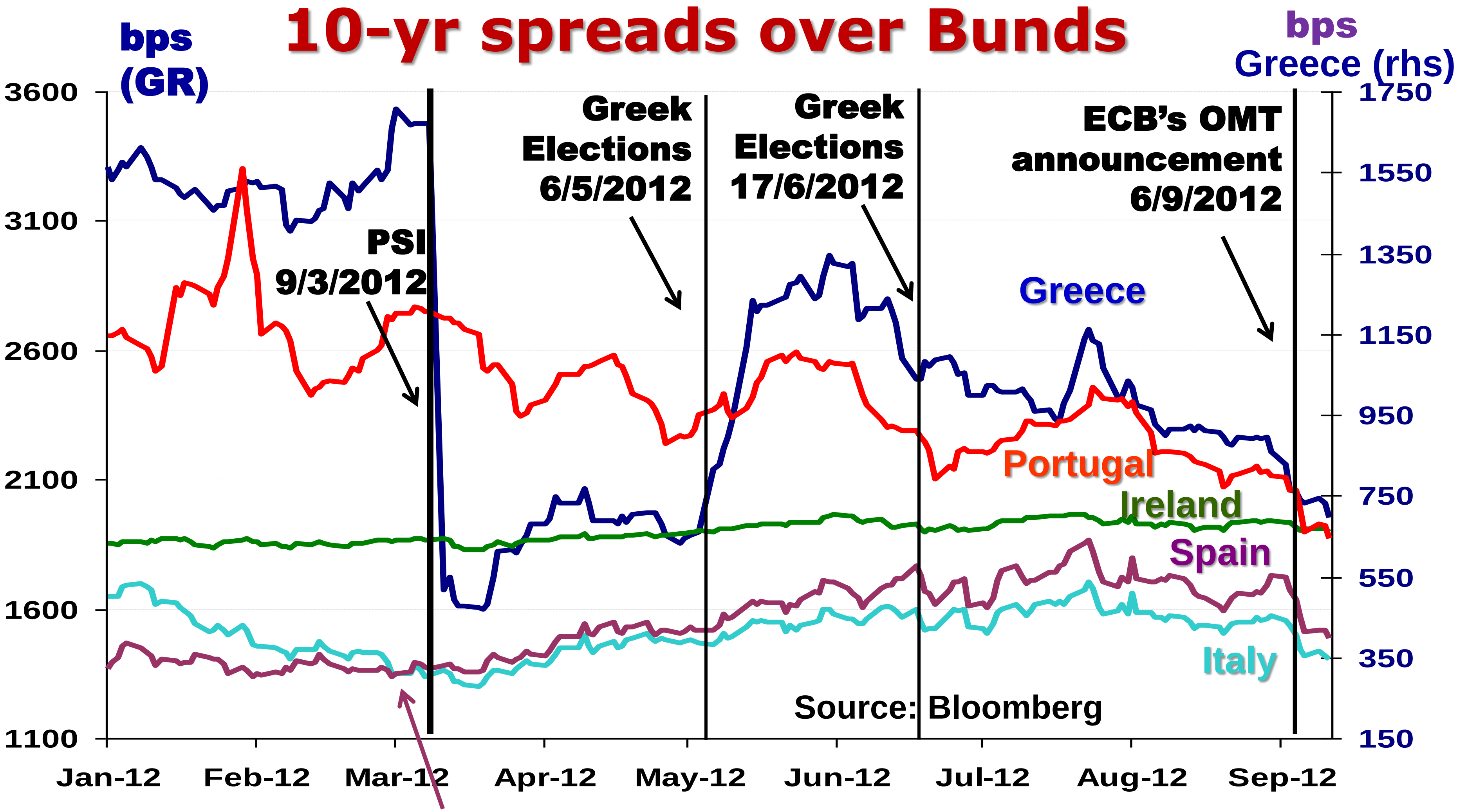
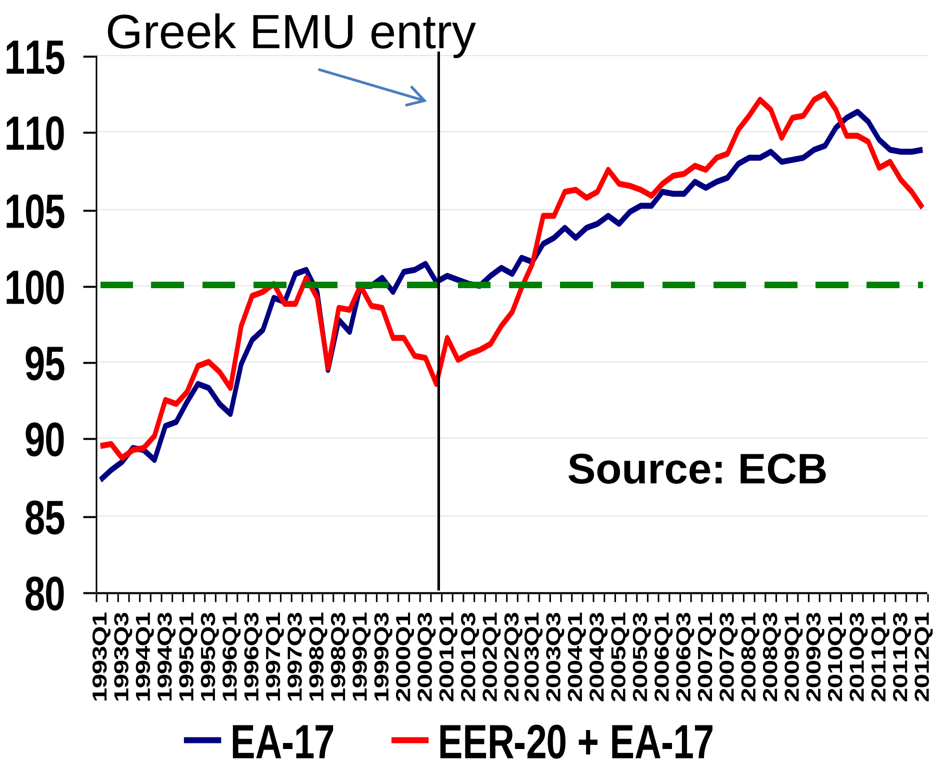
II. GREEK ODDS OF EXIT DECLINED AFTER PSI, INCREASED AFTER MAY ELECTIONS, ARE DECLINING SINCE JUNE



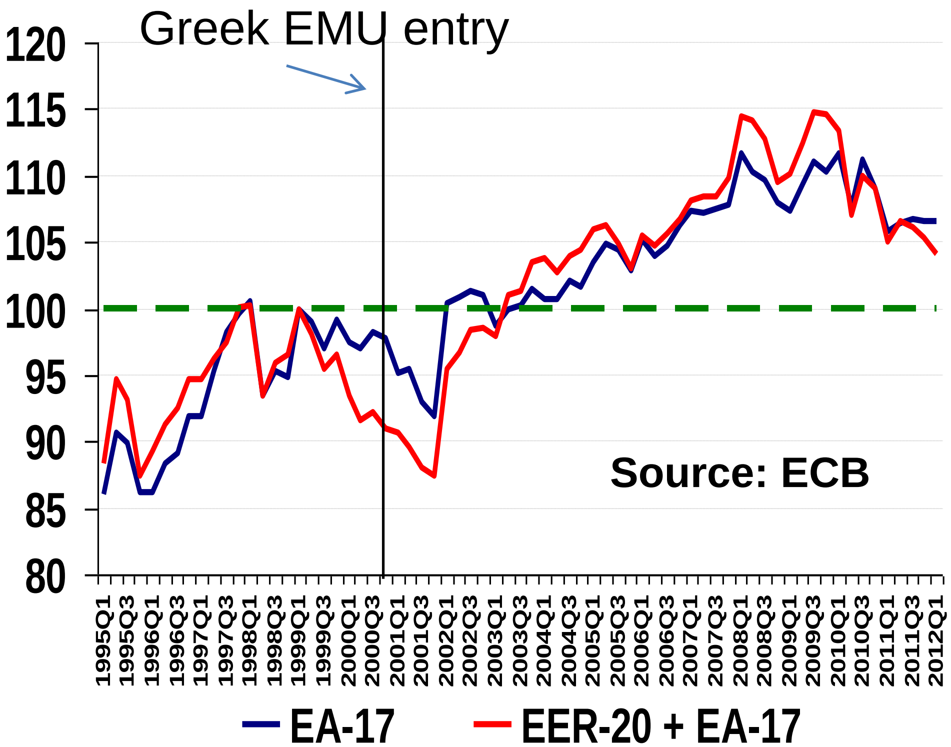
- The larger the spread, the higher the probability of exit
- Worries about Spain outpaced those for Italy in early March 2012
- Watch Greek spreads are measured on the left axis

II. A GRADUAL IMPROVEMENT IN COMPETITIVENESS HAS BEGUN

Real harmonized competitiveness indicator (GDP deflator)



Real harmonized competitiveness indicator (ULC in total economy deflator)



- Yet prices are not falling as fast as wages, which indicates *ceteris paribus* that competition in product and service markets remains a challenge

II. DRASTIC FISCAL CONSOLIDATION OVER 2009-2011 BUT MORE CUTS TO COME

- Over 2009-2011, the primary deficit declined by 8.2pp GDP despite the recession, which is an unprecedented achievement
- Program requires another 5.5 pp GDP reduction in primary deficit until 2014. The size of government is forecast to shrink from 1/2 to 1/3 of GDP
- This type of fiscal contraction risks prolonging the recession beyond 2013

	2009	2010	2011	2012	2013	2014	2015	2020
GDP Growth (%)	-3.3	-3.5	-6.8	-7.1	-2.4	2.5	3.1	2.2
Nominal GDP (€ bn)	232	227	215	201	195	200	208	255

Source: Eurobank Research

Primary Expenditure (% GDP).	48.7	44.4	43.4	43.2	40.4	37.6	35.6	35.8
Primary Balance (% GDP)	-10.6	-5.0	-2.4	-1.0	1.8	4.5	4.5	4.3

Source: IMF Country Report No. 12/57 (March 2012)

General Gov Debt (% GDP)	129.0	144.5	165.2	167.2	176.3	169.6	162.0	125.1
General Gov Debt (€ bn)	299	328	356	336	344	339	337	319

Source: Eurobank Research

- In an optimistic scenario, in which the 9.6% output gap will be eliminated gradually, growth rebounds more strongly from 2014 on, and Debt/GDP in 2020 becomes 109%

II. GREXIT: POOR SOLUTION TO THE EZ CRISIS

Greece

- **Benefits**
  - Independence of monetary & FX policy
  - Possible ability for countercyclical policies
- **Costs**
  - Chance to reform the State and the institutional structure gone
  - EZ fiscal discipline mechanism lost
  - Political gains from EU/EMU membership lost
  - Mafia – type relations will likely prevail
  - Devaluation and inflation with no serious competitiveness gains
  - Default on State debt obligations
  - Likely default on private debt contracts
  - Capital controls and possible exit from EU
  - Significant contraction of GDP and lowering of living standards & a downward momentum, in contrast to CEE countries
  - No financing from EU Structural & Agricultural funds
  - Short-term need for ca financing with IMF as the only provider
  - Introduction of new currency costly, unlike a fixed FX regime or currency board

EZ

- **Benefits**
  - Swift implementation of unification measures (fiscal, financial, political) by remaining EZ countries
  - Minimization of moral hazard issues through tighter controls
- **Costs**
  - Risk of an EZ break up due to contagion
  - Irreversibility of MU destroyed and possibility of future breakup, as EZ resembles a fixed exchange regime
  - Rest of EZ would write-off exposure to Greece's sovereign & banks
  - EZ break up will cause appreciation of the new German currency (i.e. GDP contraction for Germany via the export channel).
  - Political gains from the EU unification will be lost in the case of a euro break-up

II. CONTAGION DIFFICULT TO AVOID

- Contagion can happen (Forbes (2012) through:

  (a) trade, (b) portfolio investors, (c) a wake-up call to re-assess fundamentals (d) financial institutions. I would also add linkage (e) official lending

- Channel (a) is small as EMU exports to Greece represent 0.18% of total EMU exports
- Channel (b) was never a large component in international wealth portfolios
- Channel (c), the wake up call about fundamentals is already present
- Channel (e) is also small, especially since Target 2 is central bank money

	Member states		Eurosystem		Total	
	Bilateral loans	EFSF	SMP	Target 2	€ bn	% GDP
Total	52.9	73.0	34.9	130.0	291.1	3.0

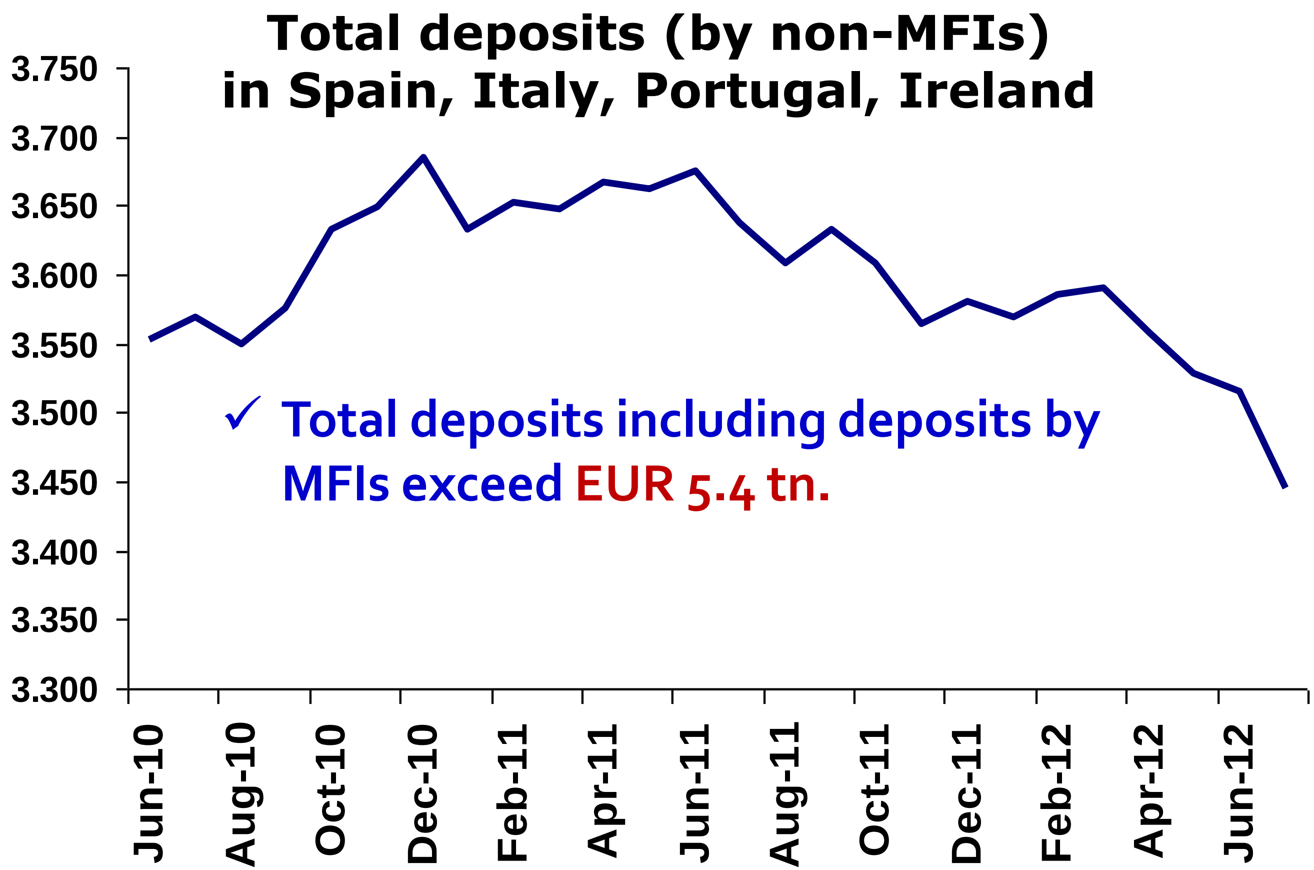
- **Channel (d) is important as fear can easily spread**. The bank direct exposure is small not give a sense of the dimensions of possible deposit withdrawals once fear takes over.

	European banks	France	Germany	Italy	Spain	Sw/land	UK	US
Foreign claims	90473	44353	13355	2186	969	1940	10537	4455
Other potential exposures	29032	6901	3779	1790	417	1406	11825	46231

Source: BIS

II. EMU periphery cannot easily accommodate a deposit withdrawal

- ✓ The size of deposits in countries under crisis overwhelms any type of precautionary buffer.
- ✓ Pray a bank run will not happen: If depositors withdraw 30% of their money, i.e. as much as Greeks have slowly done thus far, this would be a loss of EUR 1.0 tn, a shock that cannot be absorbed even by today's EFSF

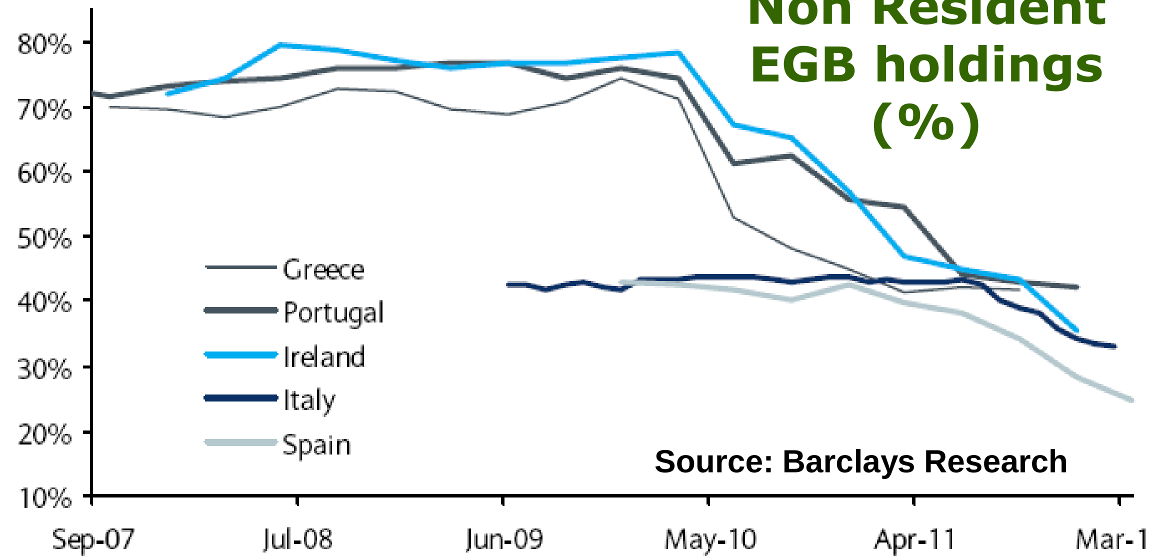


- ✓ A pan-European deposit insurance is not adequate to absorb such a shock. Deposit insurance is designed to handle individual bank insolvencies, not a systemic crisis.

II. SMART MONEY IS LEAVING THE PERIPHERY

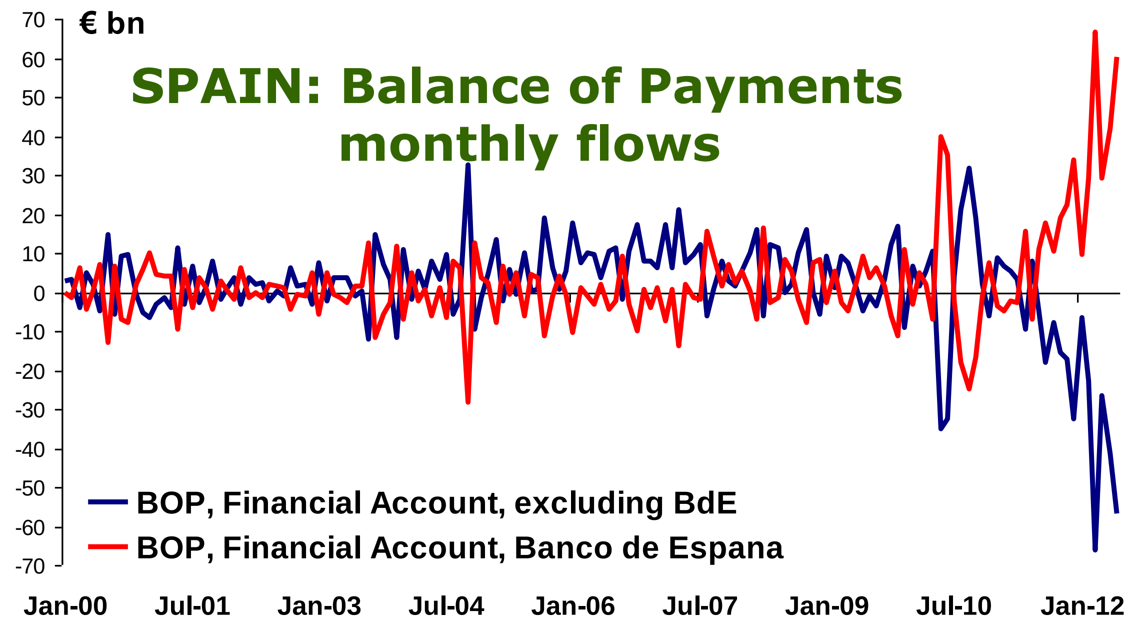
- Smart money usually moves out first, hence notice that **foreign investors have abandoned the government bond market of the European Periphery**
- **Spanish capital outflows since mid 2011**, being replaced by Eurosystem funding
- Capital outflows are the first warning signals of a possible bank run

Non Resident EGB holdings (%)

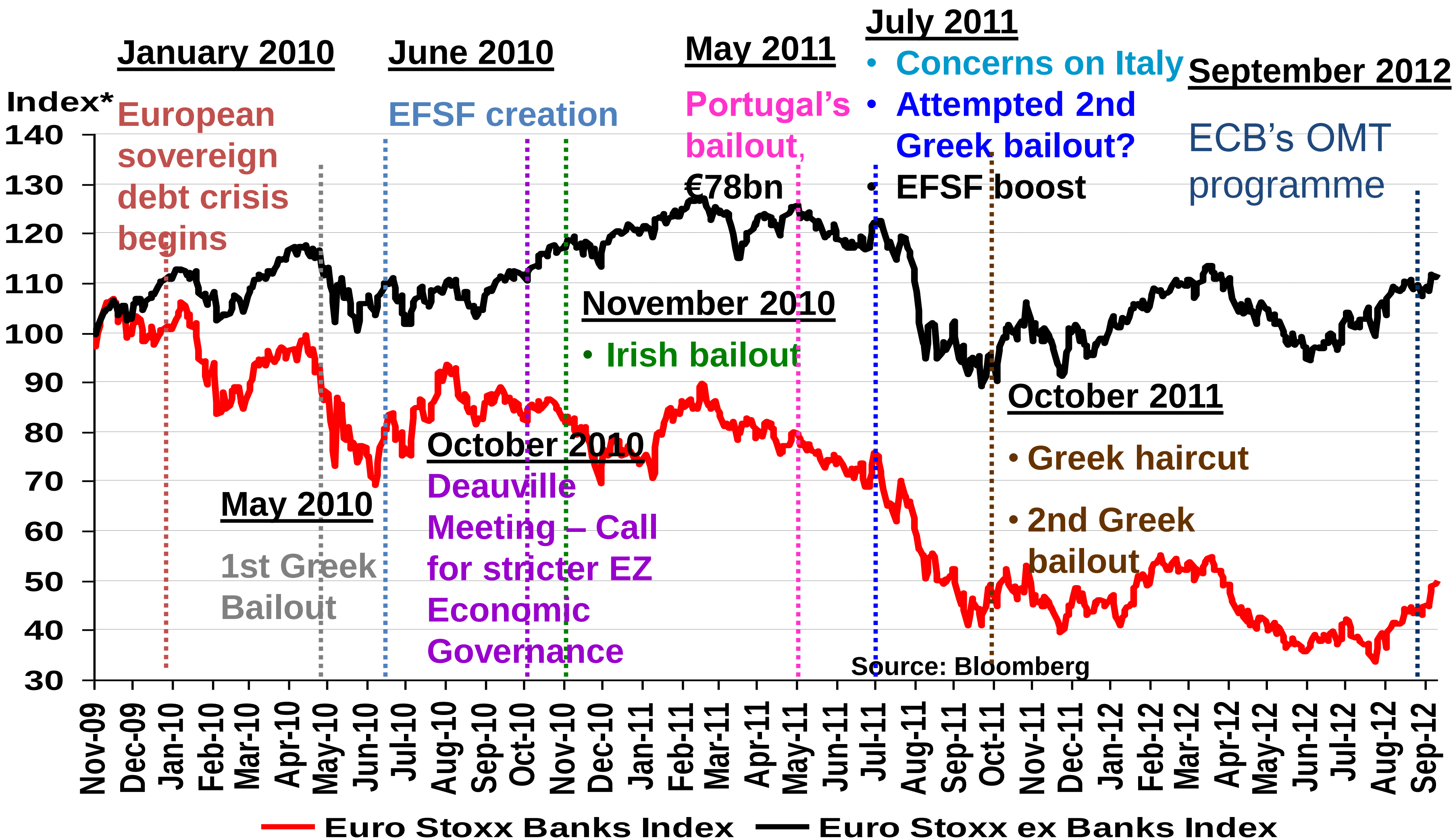


Source: Barclays Research

SPAIN: Balance of Payments monthly flows



II. EURO AREA BANKS ARE VULNERABLE ....



* October 30, 2009=100, first observation: Beginning of November 2009

Capital deficiency € 114.7 bn from (a) stress tests that mark-to-market sovereign bonds, and (b) increase in Core Tier I ratio to 9% from 7%

II. … HENCE A BANK RUN CAN EASILY SPREAD

Euro Area banks & sovereigns are already suffering a confidence crisis. Hence,

- In the **short-run**, given the vulnerability of European banks:
    1. A banking collapse in Greece can lead to a similar bank run in GIIPS, while Greece still remains in the Euro Area and is struggling. GIIPS depositors may fear a **corralito,** similar to Argentina's or, possibly, to Greece's.
    2. ECB is the (only) institution able to control a bank run. Thus far capital outflows in the Periphery have been accommodated by liquidity support from the ECB
- In the **intermediate run**, if Greece were to depart from EMU:
    1. Once the **exit template** is established, individuals and markets will likely ask: "***Which country is next in line?***" A bank run can easily form then. This is perhaps the biggest threat that Greece poses to EMU, namely the **destruction of the irreversibility principle** of EMU membership
    2. **Debt default** (or new restructuring) and **EMU Exit** are two distinct phenomena.
        - ✓ The latter is more serious. Thus Greece cannot be compared to Argentina, whose default did not affect peripheral markets then
        - ✓ Also do not confuse the future reaction to EMU exit with the March 2012 reaction to PSI closure. In March, markets did not respond negatively to the PSI because it was expected and was already priced-in . A Greek EMU exit is not fully priced -in and its consequences are not easily predictable.

III

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III. CONCLUSION: IF THERE IS A WILL, THERE IS A WAY

- In the 1990s, it had been hoped that EMU would speed up the economic and political integration of Europe as OCA requirements would be satisfied gradually
- Yet, the low interest rates and the market euphoria that followed monetary integration, shielded EMU countries from performing the required structural reforms and led to important divergences within EMU
- The crisis was triggered by fiscal concerns, a subset of the divergences
- The political response to the crisis was myopic, driven by moral hazard and other domestic concerns in lender countries, thus unsettling markets and fuelling a subsequent spread of the crisis beyond the Greek border
- For EMU to survive, prerequisites are debt sustainability and structural reforms in individual economies, plus deeper EMU integration: in fiscal policy, in financial market policy and in politics
- Contagion would require massive interventions by the ECB and may not be avoidable as the spread of fear cannot be controlled simply by minimizing banking, asset allocation or trading exposures to Greece
- EMU can easily unravel once the IRREVERSABILITY principle of joining EMU gets destroyed
- Recent Greek achievements in competitiveness improvement and in fiscal consolidation in a hostile macroeconomic environment show that Greece can re-invent its economic paradigm: If there is a will, there is a way

Thank you for your attention

www.hardouvelis.gr