

# Europe in Crisis

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Session 2: **The Economics of the Crisis**

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- I. Euro Area: Many missing ingredients for an Optimum Currency Area
- II. Why did the crisis spread outside Greece?
- III. Need for tighter EMU integration, not just fiscal austerity & competitiveness
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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

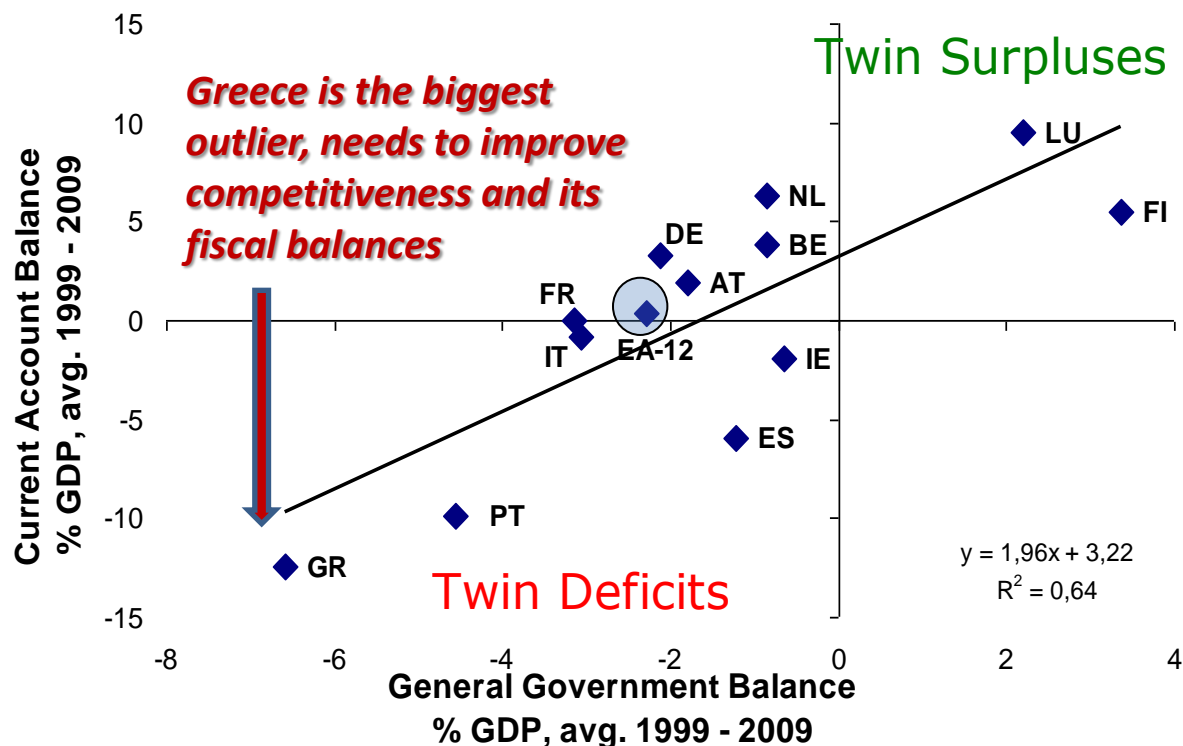
OCA criteria for the participating countries included:

- 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. LARGE EXTERNAL AND INTERNAL IMBALANCES WITHIN EMU FOLLOWING EMU CREATION

- ❖ Political 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
  - Real estate bubbles formed
  - Public Deficits went over the 3% GDP limit
  - Debt criterion was bypassed
- ❖ **Structural reforms** became the only discretionary policy tool post-EMU, yet they **were abandoned**, exactly at the moment they needed the most
- ❖ Hence, a **competitive Euro Area North** and an **uncompetitive Euro Area South** emerged.
  - Nominal wages proved sticky, did not allow proper adjustment to external asymmetric shocks
  - Pension systems remained unreformed

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



Source: European Commission



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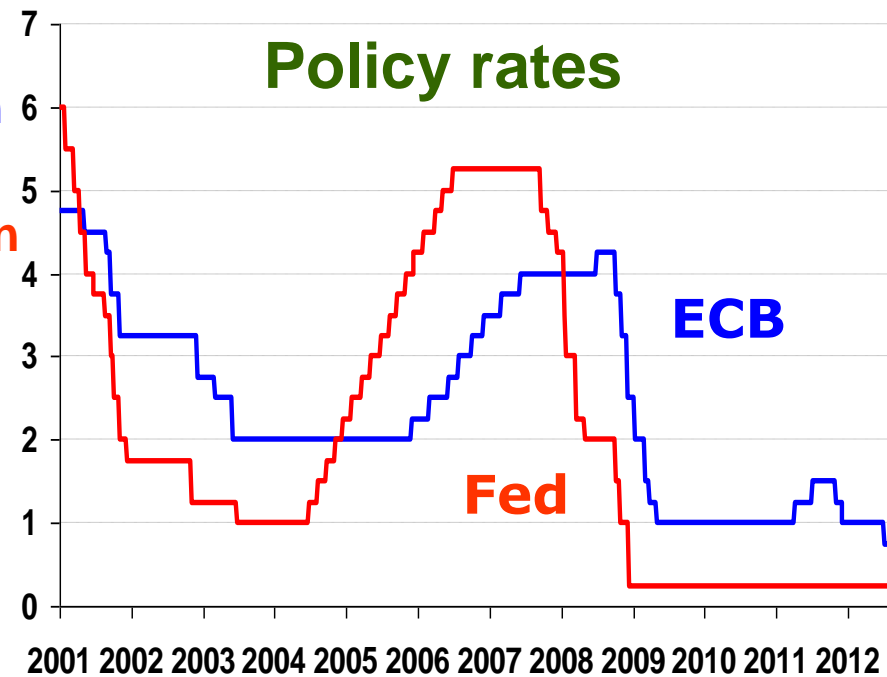
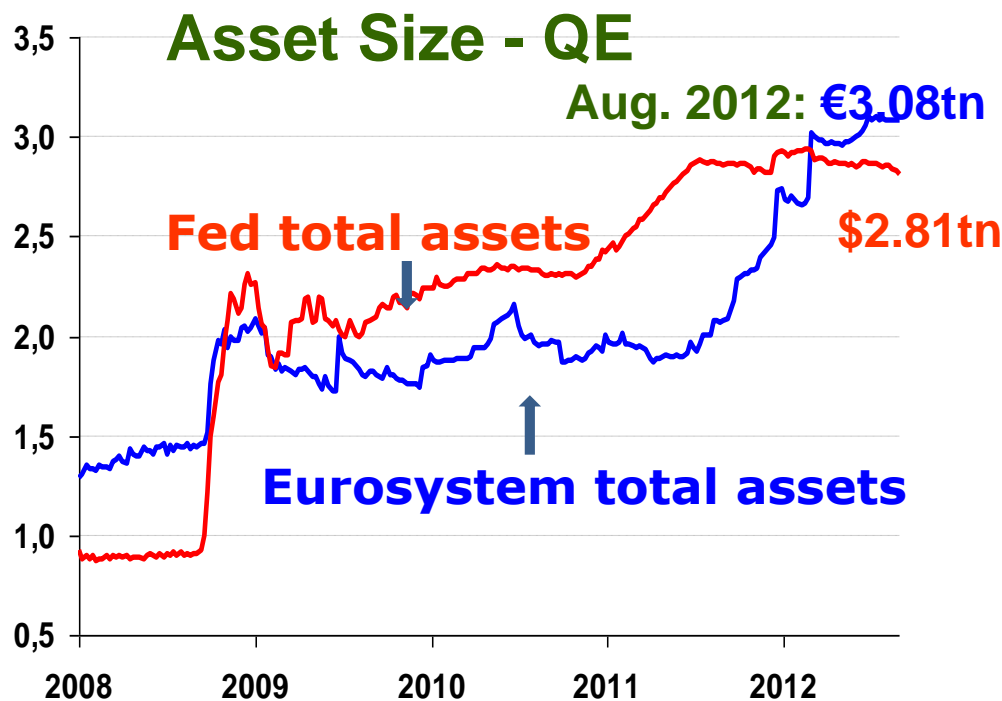


## II. CRISIS MUSHROOMED AS MORAL HAZARD WORRIES DOMINATED THE RESPONSE TO THE CRISIS

- ❖ 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 painted 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. They thought that *“in a year it will be business as usual,”* hence refrained from pushing the reform effort.
- ❖ **It takes two to tango** and in this crisis both counterparties, Europeans & Greeks, failed

## II. ... AND THE ECB DID NOT ACT AS LENDER OF LAST RESORT

- ❖ ECB did provide liquidity (30% of bank assets) and **avoided a sudden stop**, but **responded sluggishly**, as evidenced by a comparison with the FED in (a) QE and (b) Policy rates. Markets did not perceive a strong counterparty in their trading behavior
- ❖ ECB expanded aggressively with LTROs in the second half of 2011 only after the Italian crisis revealed a great danger to the Euro Area; September 2012 announcement of OMT signals radical shift, yet Bundesbank casts negative vote
- ❖ ELA mechanism implies a **restrictive monetary policy** in countries that need it to be expansionary!! E.g., Greek banks pay to the Eurosystem 2% more than German banks





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# III. REQUIREMENTS: DEBT SUSTAINABILITY & COMPETITIVENESS, BUT ALSO NEED FOR TIGHTER UNIFICATION

## ❖ TOWARDS SIMILARITY OF ECONOMIC STRUCTURES

**Pact for the Euro** (or **Euro+**) addresses issues of competitiveness, employment, financial stability and sustainability of public finances: Monitoring and adjusting unit labour costs (ULC); Removing unjustified restrictions on professional services and the retail sector; Improving educational systems and promote R&D, innovation and infrastructure; Removing red tape and improving the regulatory framework (e.g. bankruptcy laws, commercial code); Labour market reforms to promote “flexicurity”; Tax reforms, such as lowering taxes on labour; Aligning the pension system to the national demographic situation; Putting in place national legislation for banking resolution; Developing a common corporate tax base.

## ❖ EU BUDGET NOT ALTERED, YET TIGHTER FISCAL RULES

**Fiscal Compact:** 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

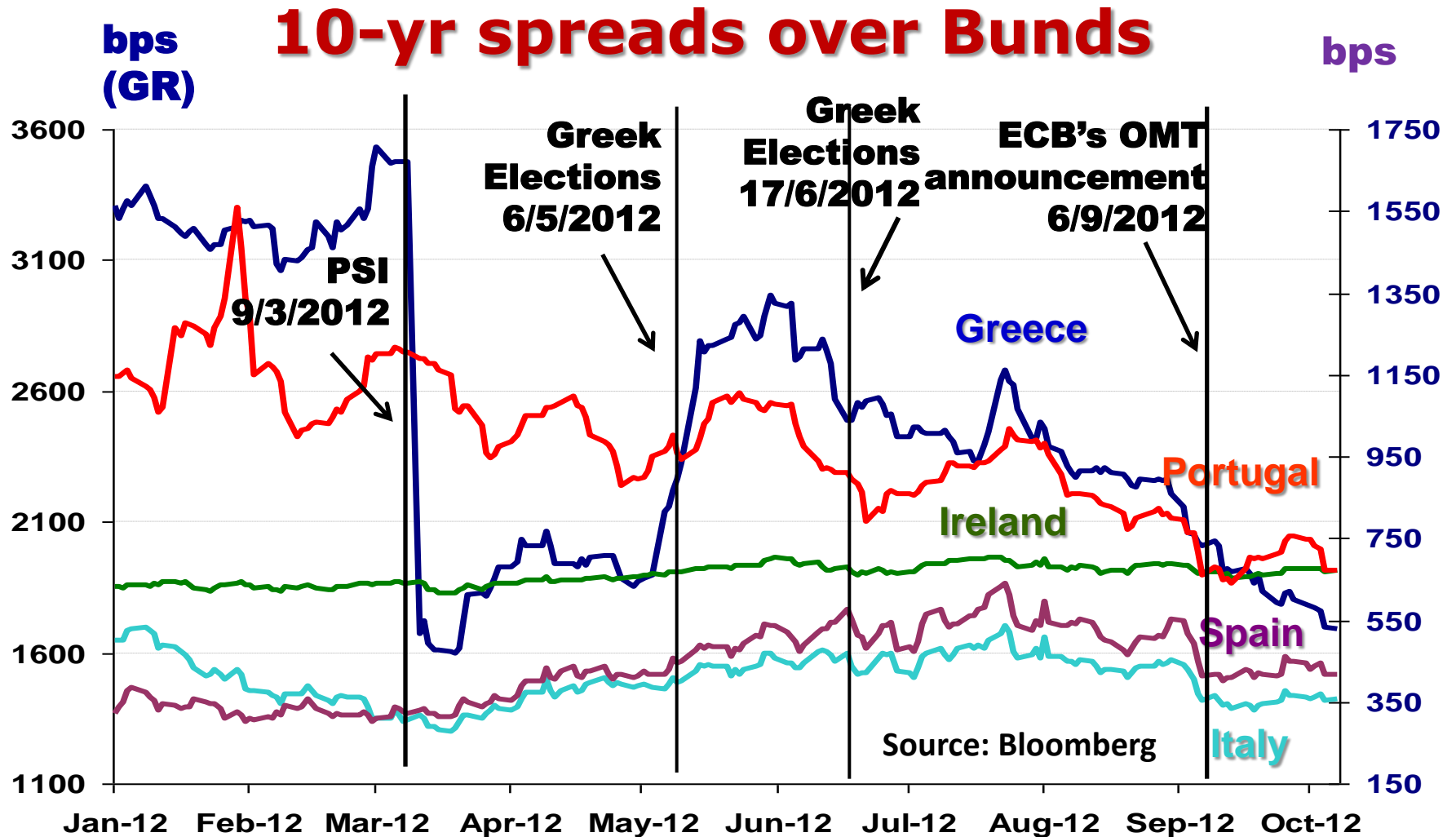
## ❖ STRONGER BACK-STOPS

**EFSF (ESM)**, endowed with €500bn lending capacity, 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

## ❖ SSM (Single Supervision Mechanism) 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. **No common resolution mechanism yet.**

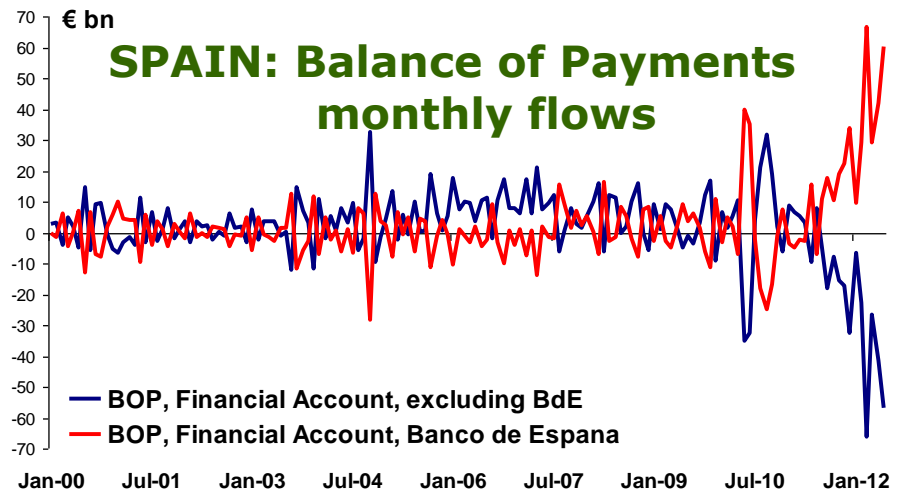
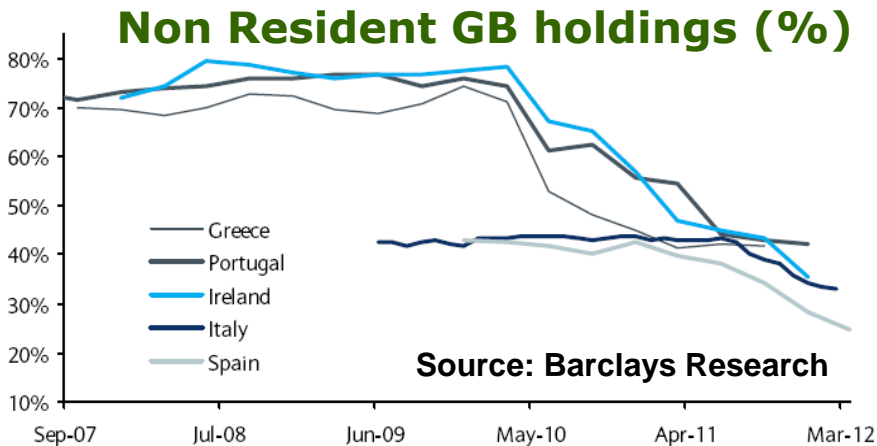
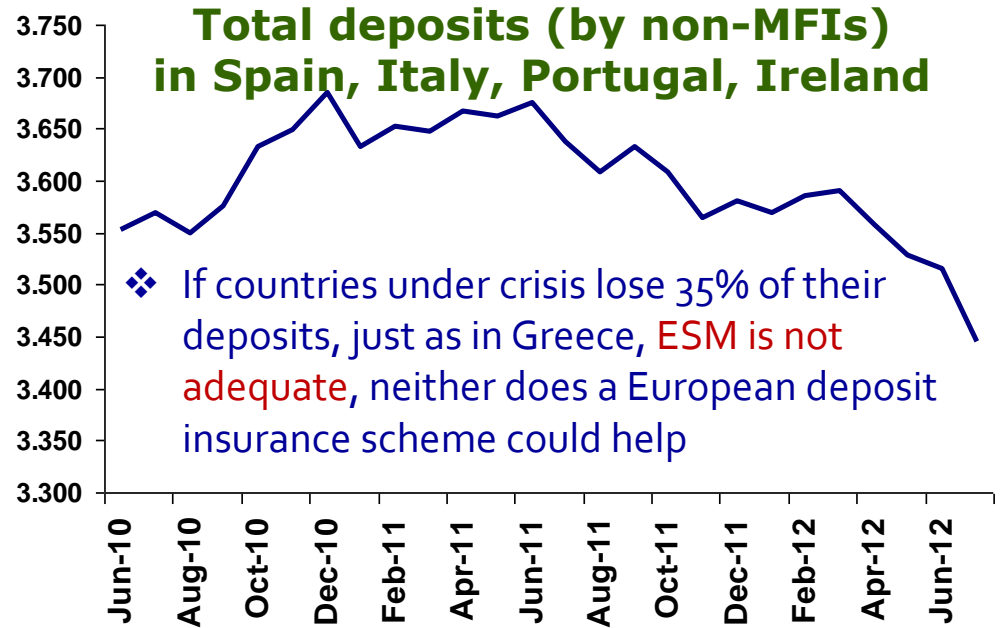
### III. GREEK ODDS OF EXIT DECLINE BUT REMAIN HIGH



Note: Greek spreads are measured on the left axis

# III. IF FEAR SPREADS, IT COULD LEAD TO HUGE BANK WITHDRAWALS IN THE PERIPHERY

- ❖ Smart money is leaving the Periphery, depositors are the last to go
- ❖ **Fear spreads:** In Greek June elections, Spaniards stuck into their TVs
- ❖ A Greek exit would cause a **bank run**,
  - ECB would manage to avoid a financial collapse
  - Yet, **IRREVERSIBILITY PRINCIPLE** destroyed and EMU becomes another fixed exchange rate regime
- ❖ A new **smaller Euro Area** has low probability of success



# IV

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# IV. CONCLUSION: DEEPER INTEGRATION REQUIRED FOR EURO AREA SURVIVAL & STABILITY

- ❖ In the 1990s, it had been hoped that **EMU** would speed up the economic and political integration of Europe; it **did the opposite** as the low interest rates and the market euphoria that followed monetary integration, shielded EMU countries from performing the required structural reforms or reducing their debt, leading to important divergences within EMU
- ❖ The crisis was triggered by fiscal concerns in Greece, a subset of the divergences
- ❖ The crisis moved beyond the Greek border and mushroomed as
  - **moral hazard concerns dominated** the behavior of hardliners, while some countries in crisis did not realize the **regime shift** that was taking place
  - ECB did not act as Lender of Last Resort, although it did avoid a sudden stop
- ❖ For EMU to survive, prerequisites are not only debt sustainability and structural reforms in individual economies, **but also deeper EMU integration**: in fiscal policy, in financial market policy and in politics
- ❖ **Destruction of the EMU institution is not advisable** as it carries significant costs: Inability of individual countries to carry structural reforms, return to inflation, etc.
- ❖ **A two-speed Euro Area is not sustainable** either:
  - A Greek exit would easily trigger **contagion** through **fear**, which would then require massive ECB interventions to stop
  - A Greek exit destroys the **IRREVERSABILITY** principle of joining EMU, thus would herald EMU's prospective unraveling