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Theory and Politics of European Integration

Lecture 8: The Euro Crisis

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Last Lecture

- **Dynamic effects**
  - Trade and growth models
  - Neoclassical growth model (Solow-diagram)
  - Endogenous growth models
  - Transitional vs. permanent growth effects of trade and integration
  - Empirical evidence

Optimum Currency Area (OCA) Theory

- What are the trade-offs?
- Asymmetric shocks and currency areas
- Criteria for an optimal currency area
  - Labour Mobility
  - Trade Openness
  - Diversity of Production
  - Transfers
  - Common Values
  - Common Destiny
- Is the EMU an optimal Currency Area?

The last lecture (*cont.*)

Fiscal Policy and the Stability Pact

- Relevance of fiscal policies in a monetary union
- Limitations of fiscal policies
- Automatic stabilizers vs. discretionary policy actions
- Negative and positive spill-overs:
  the case for policy coordination
- Deficit bias in the EMU
- The No-Bailout Clause in the Maastricht Treaty
- The Stability and Growth Pact
- The 3% and the 60% ceiling and implementation
  via the Excessive Deficit Procedure
- Controversial issues

The EURO Crisis

Diagnosis

- What is the EURO crisis? What are the questions?
- Monetary policies, assymmetric shocks and internal imbalances
- Public vs. private debts
- Has the ECB monetary policy triggered the real estate bubble?
- Why are public debts in a currency union more serious than with national currencies?

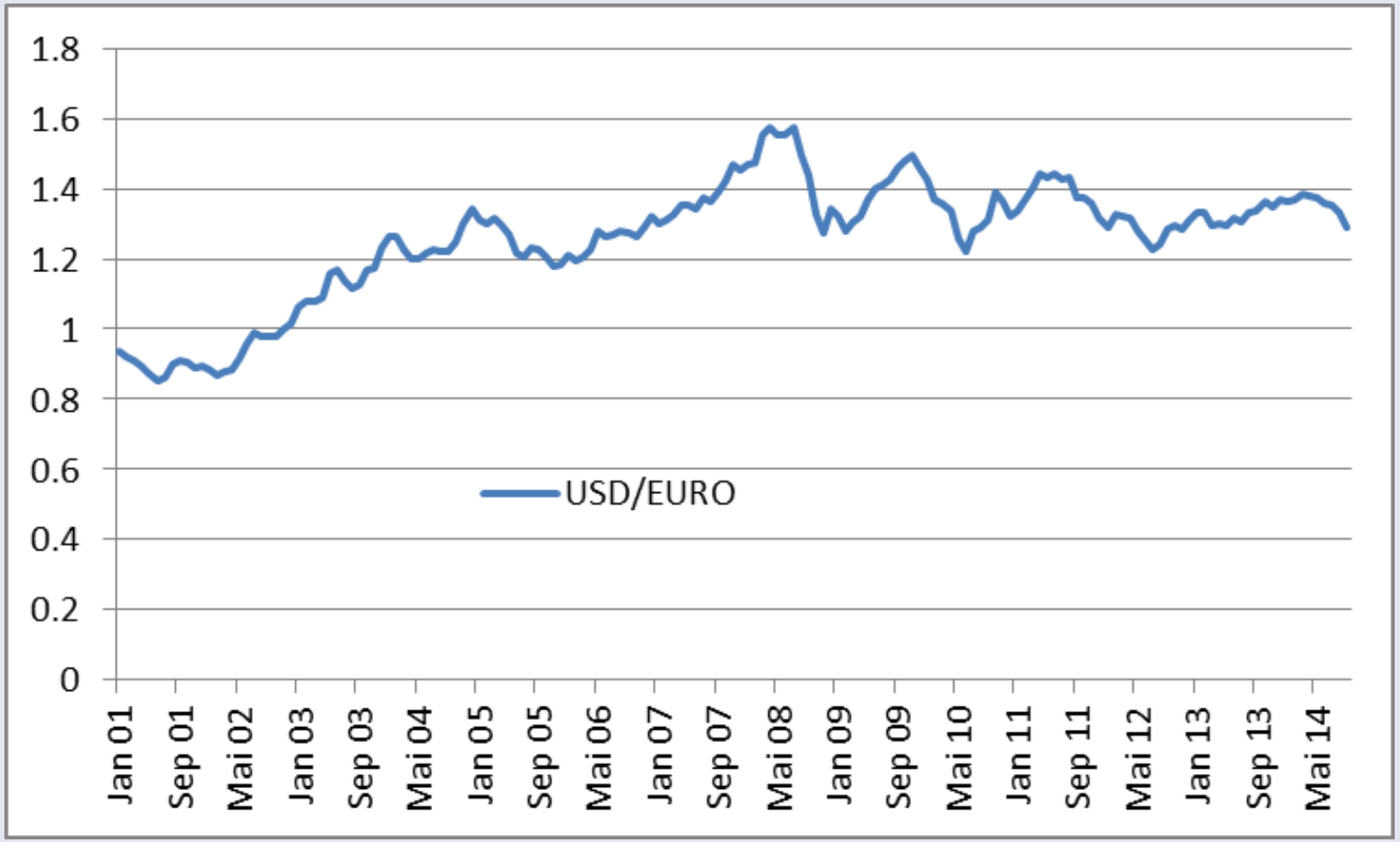
Therapy

- Banking regulation
- ECB: Buying governmental bonds
- Creating a Transfer Union
- State Bankruptcy within Eurozone
- Leaving the Eurozone (“Grexit”)

The EURO Crisis

- The EURO crisis is **no currency crisis** in traditional sense
  - No (dramatic) **depreciation** of EURO
  - No **capital flight** out of EURO zone
  - No **balance of payments crisis** of EURO zone
  - No **inflation**

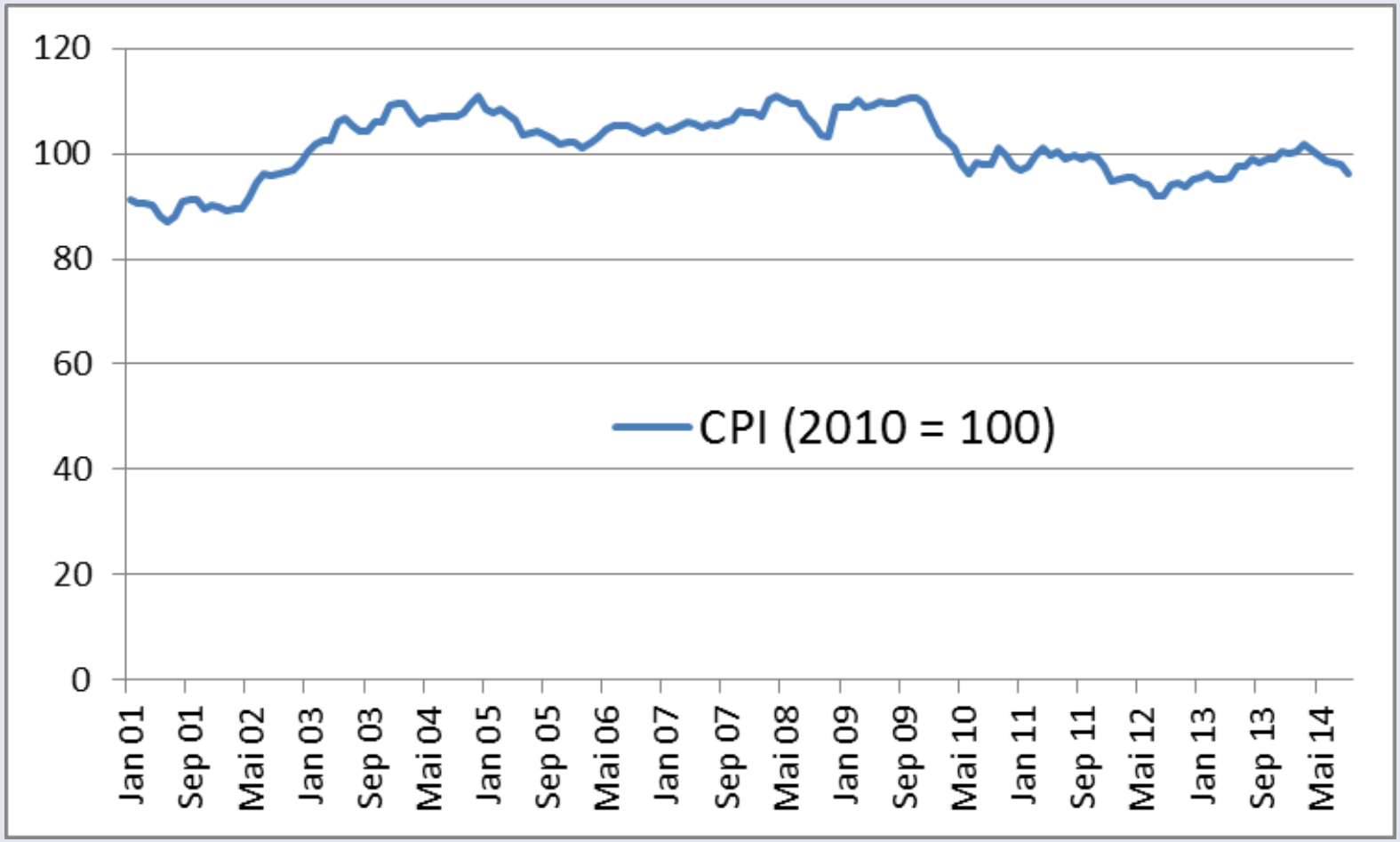
Exchange rate USD/EURO



Source: OECD STAT database.

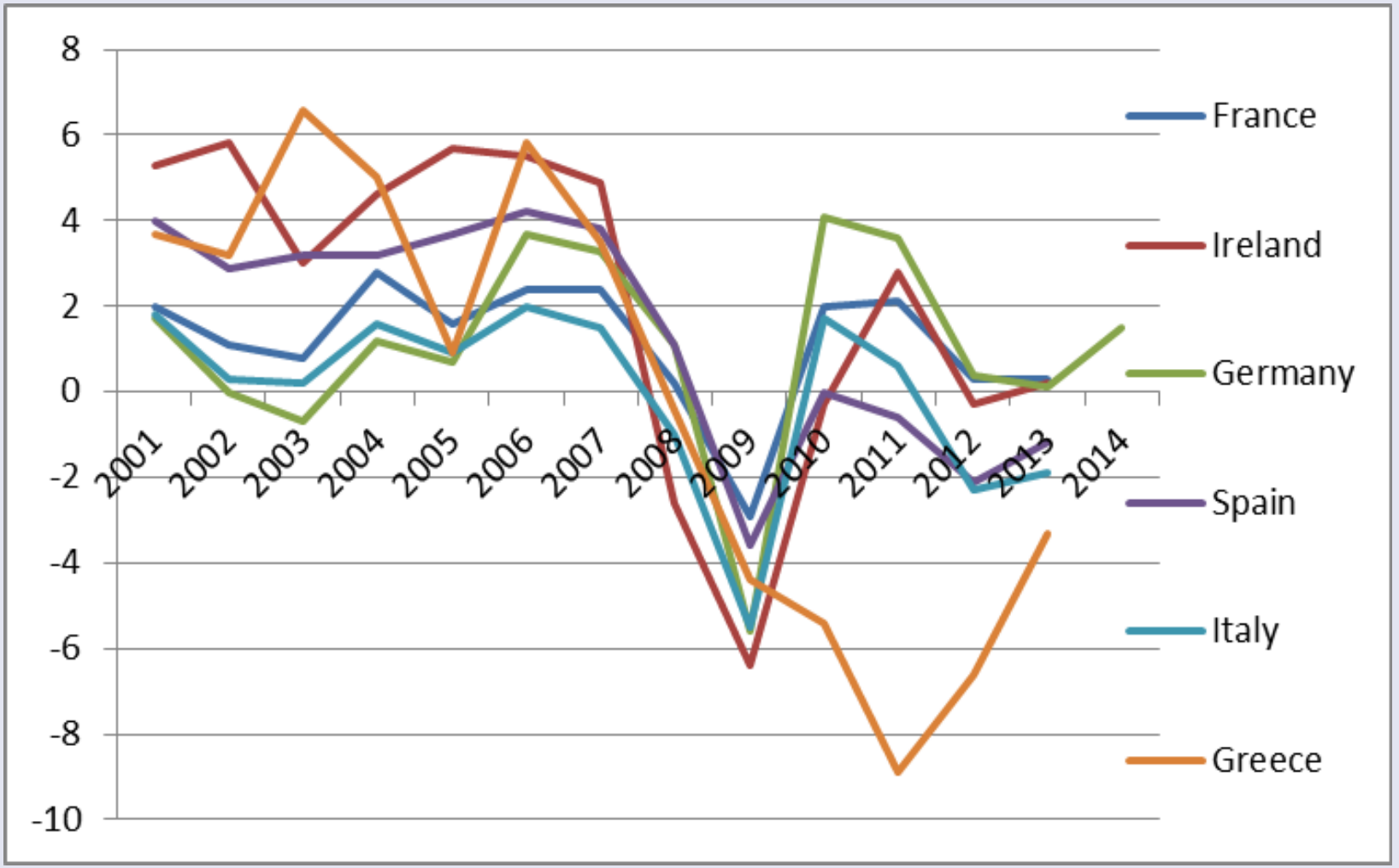
Inflation (Consumer Price Index)

Changes p.a. in %)



Source: OECD STAT database.

Real GDP growth rate in %, 2001-2014



Harmonized unemployment rates (ILO norm) in %, 2001-2014

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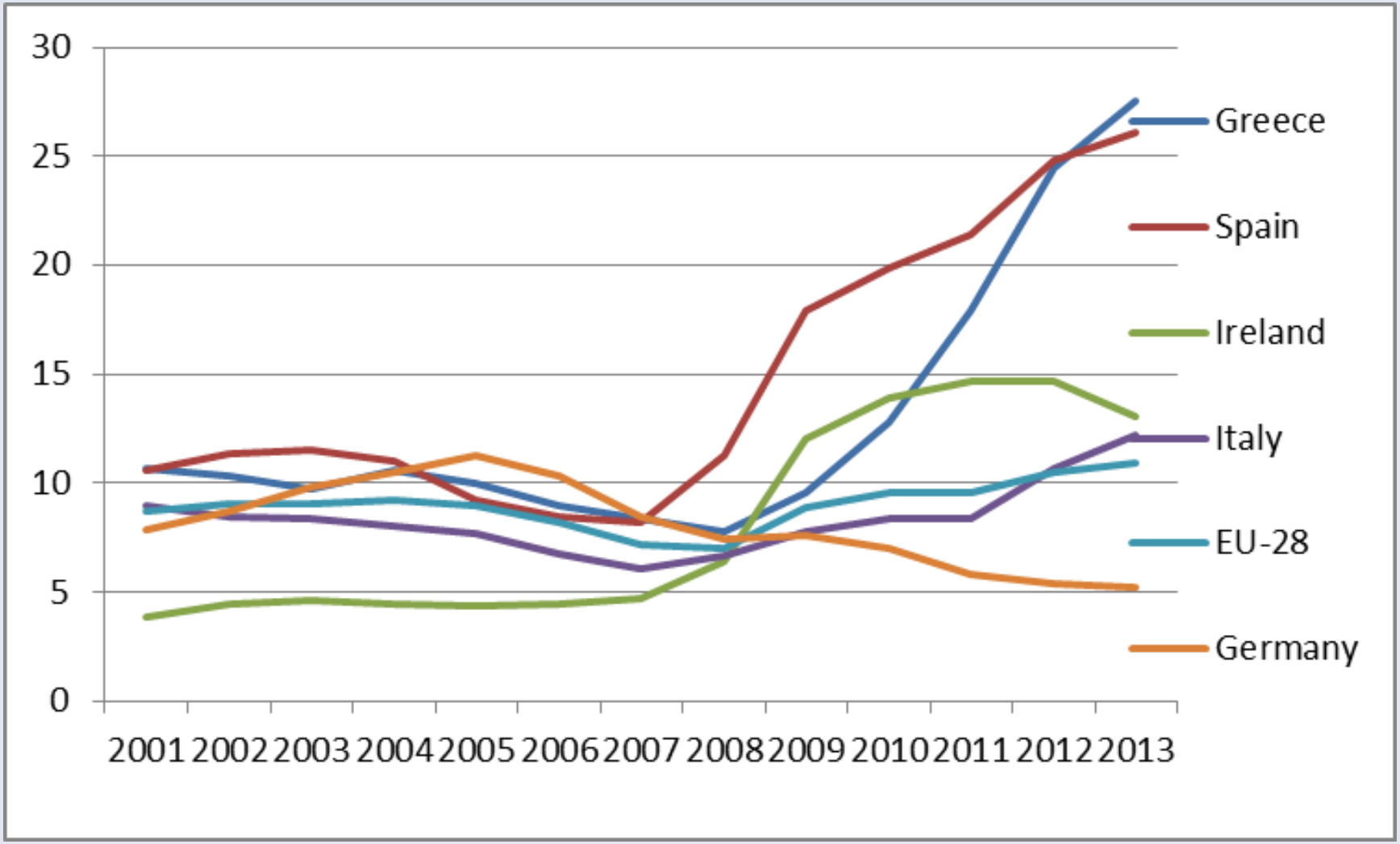


The EURO Crisis

- But:
  - Burst of **real estate bubbles** in many Member States
  - High risks of **bank failures** in private sector
  - **Sovereign debt crisis** of some members of EURO zone (Greece, Ireland, Portugal, Spain, Italy, others?)
  - High **spread** of interest rates within EURO zone
  - Zero growth in the Eurozone and serious recessions in some Member States with high unemployment

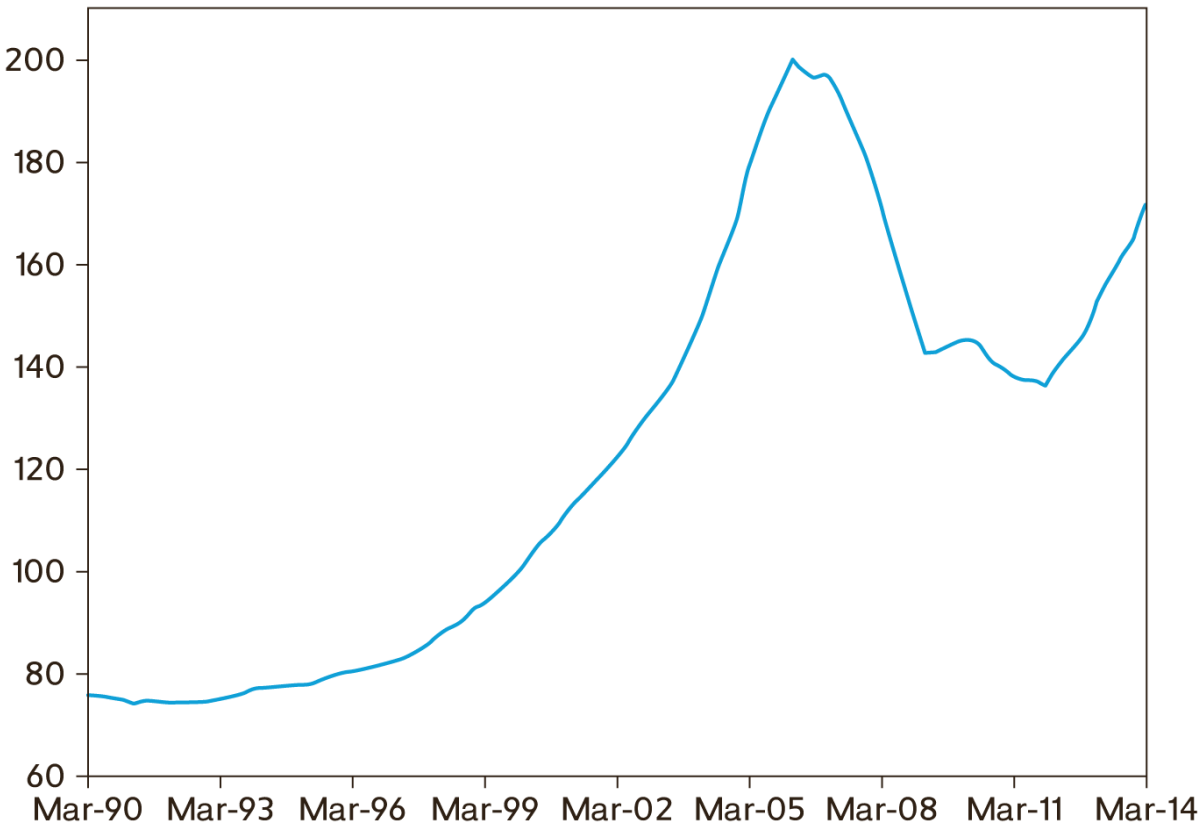
Stage one: the global financial crisis

Following Great Depression, strict regulation was designed to limit risk-taking by banks and financial institutions. The deregulation phase started in the 1980s, followed by a rapid expansion of financial sectors in the USA and Europe:

- banks became active investors:
  - maturity mismatch;
  - currency mismatch;
- banks took major risks, implicitly borne by their governments;
- house mortgages in the US to risky people: **subprime mortgages**, which relied on ever increasing house prices. And these loans were sold to banks, which sold them to other banks (i.e., securitization).

Stage one: the global financial crisis

Housing prices in the USA (Index: January 2000 = 100):



Source: Bank for International Settlements

Spain: Real estate prices (EURO/m^2)

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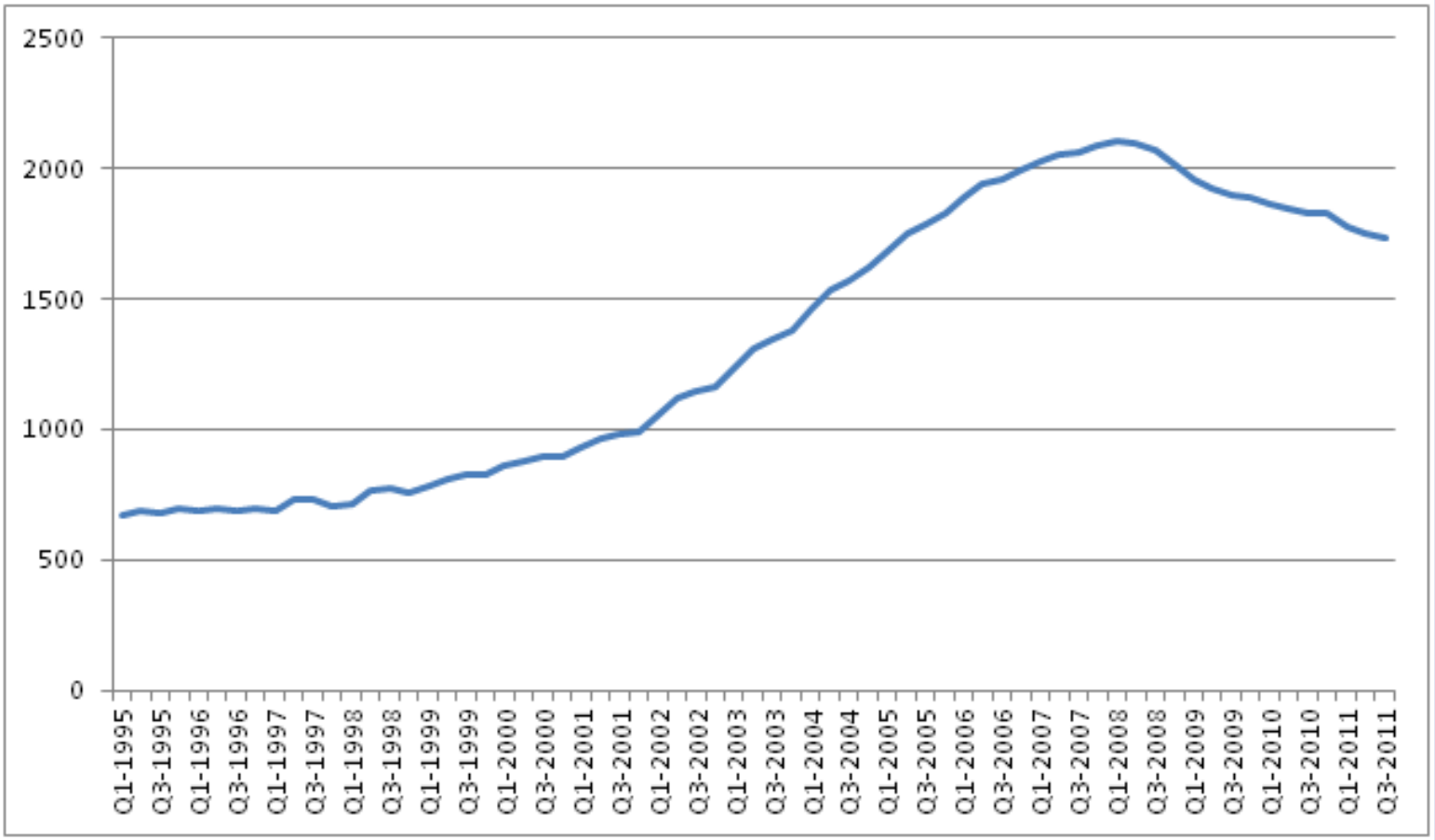

Ireland: Real estate prices (Index: 2003 = 100)

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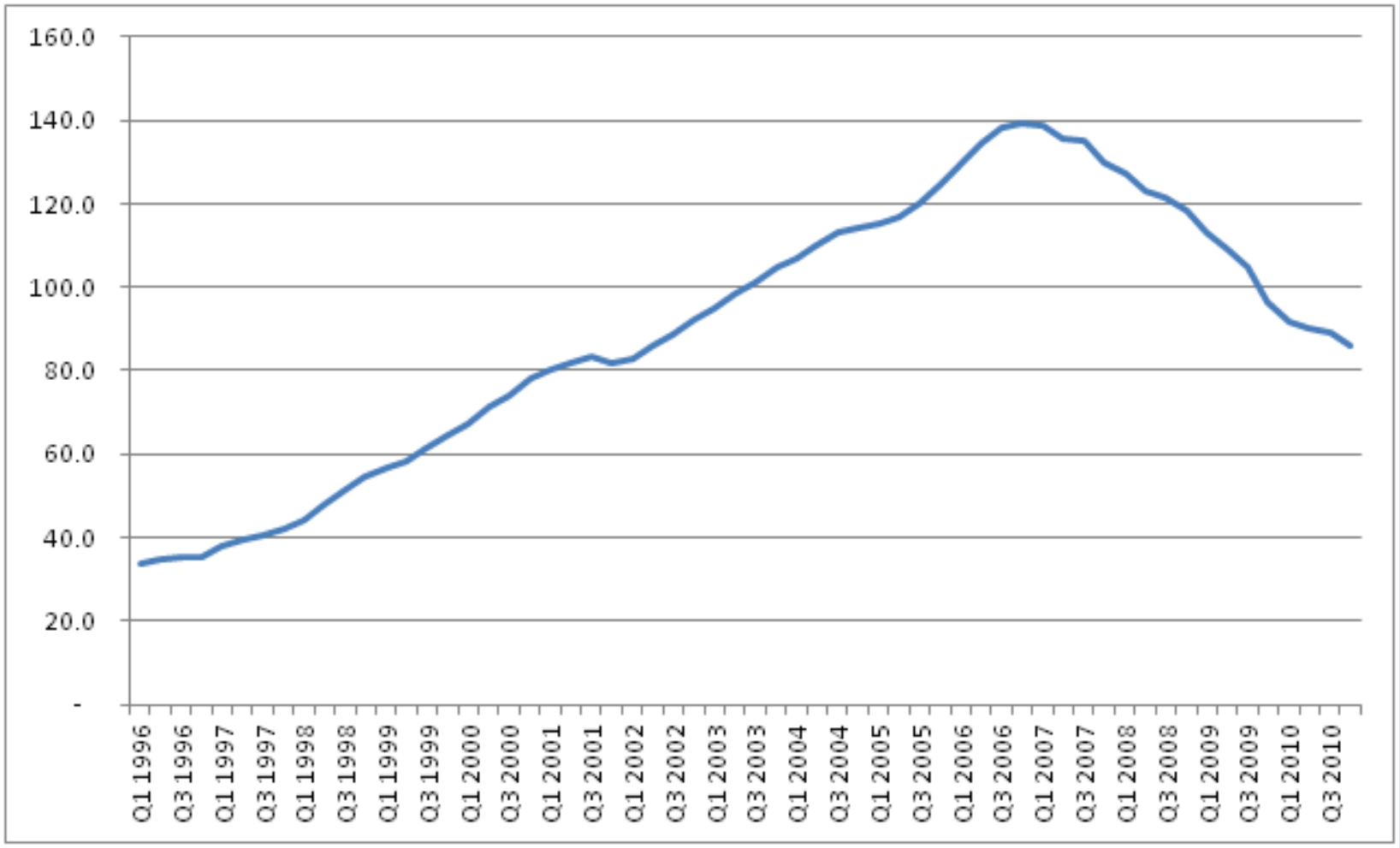
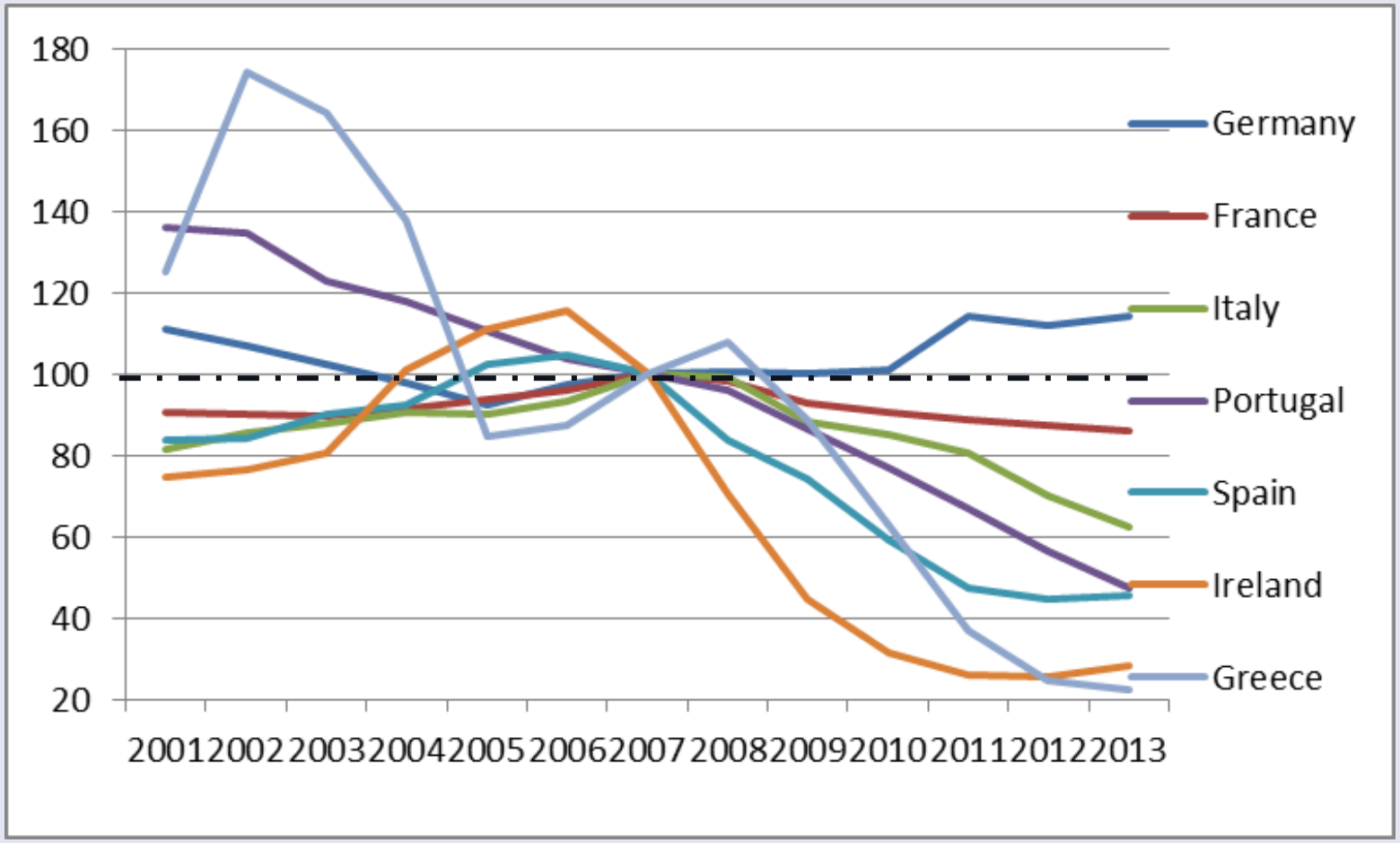
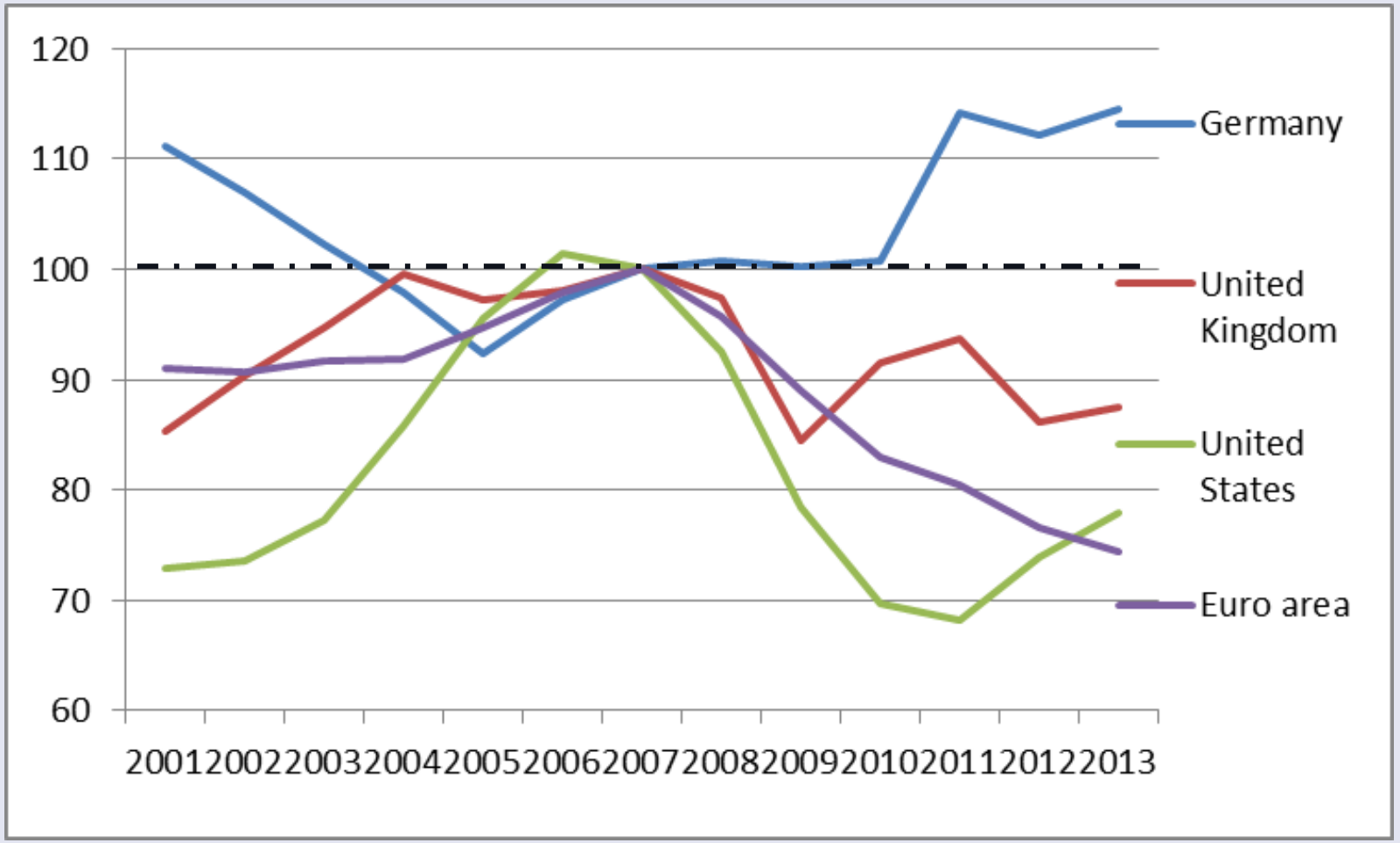


Construction production index (2007 = 100)



Construction production index (2007 = 100)



Stage one: the global financial crisis

- When house prices stopped rising, securities lost their ratings and many of the world's largest banks (especially in US, UK, France, Germany) faced heavy losses.
- April 2007: New Century Financial Corporation (one of the largest US mortgage lenders) declared bankruptcy;
- July 2007: bank Bears Stearns announced that it would stop honoring the commitments of one of its legal entities (SPE);

  → banks grew suspicious of one another and stopped their mutual lending that makes up the interbank market.

  → central banks provided liquidity directly to their banks.
- September 2007 – spring of 2008: several major banks failed;
- 15 September 2008: failure of Lehman Brothers triggered the worst financial crisis since 1929.

Stage one: the global financial crisis

Policy makers (governments and central banks) followed the lessons learned from the Great Depression:

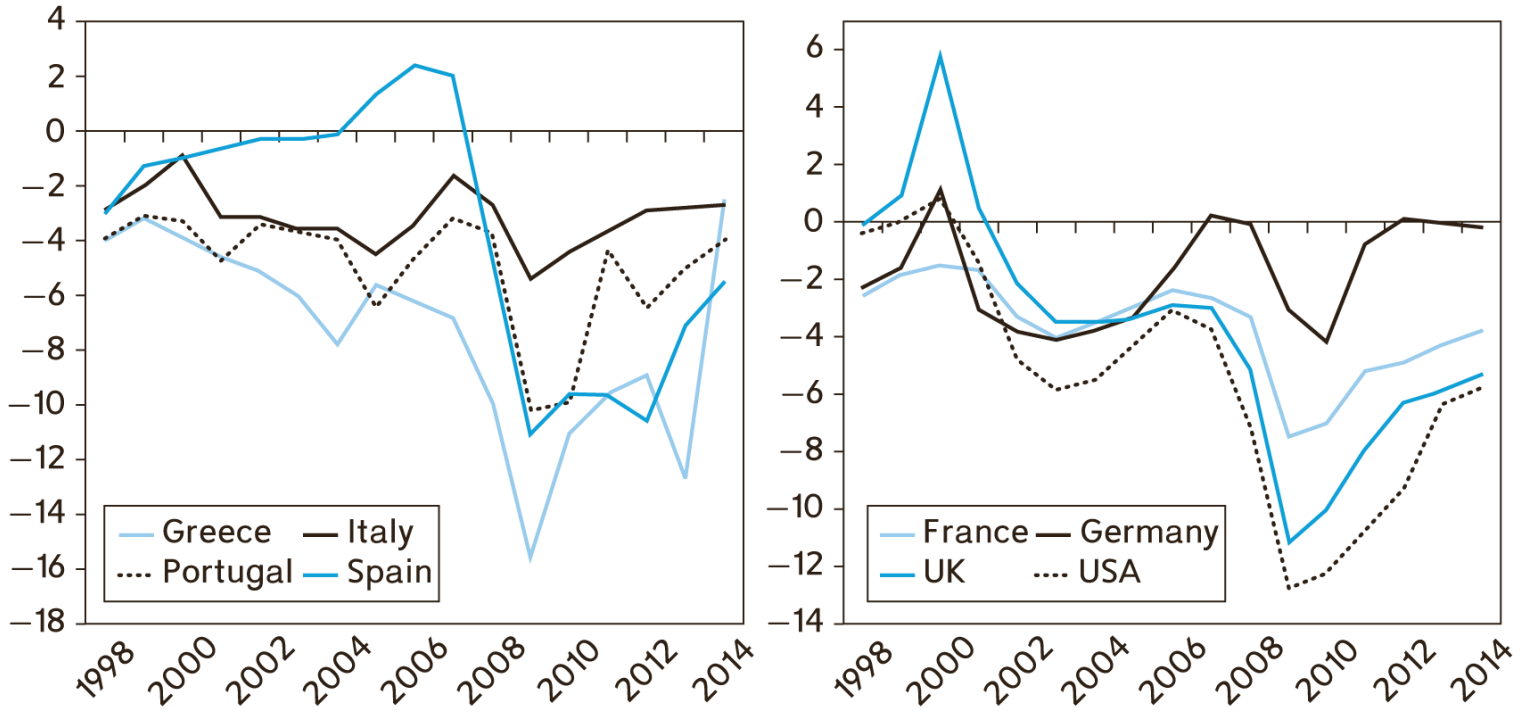
- rescue large financial institutions;
- deep distress in the financial system is soon followed by a profound and long-lasting recession;
- central banks must provide liquidity to the financial system and adopt sharply expansionary policies;
- governments must bail out banks and other financial institutions;
- governments must use fiscal policy to prevent a vicious cycle of recession and large budget deficits.

The London G20 Summit in 2009 called upon all governments to urgently adopt expansionary policies.

Stage one: the public debt crisis

These actions had dramatic impacts on budget deficits (e.g., in 2010, Irish government spent almost 30% of its GDP on bank bailouts).

Budget balances 1993–2014 (% of GDP):



Note: The scale is not the same in both charts.

Source: Economic Outlook, OECD

What are the questions?

- Is the ‘one-fits-all’ monetary policy in the Eurozone the cause of the crisis? What about asymmetric shocks?
- Have soft monetary policies of the ECB triggered the financial crisis, e.g. the real estate bubble?
- Or is banking regulation the problem, i.e. the Eurozone in the same way affectd as, e.g., the US?
- Has the Eurozone created incentives for moral hazard in fiscal policies? Has the Stability and Growth Pact failed?

What are the questions? (*cont.*)

- Is the risk of a sovereign debt crisis and capital flight higher in a Currency Union rather than in the case of national currencies?
- Is state bankruptcy possible in the Eurozone?
- Is it better to move to a transfer union? How?
- Would it help countries to leave the Eurozone?

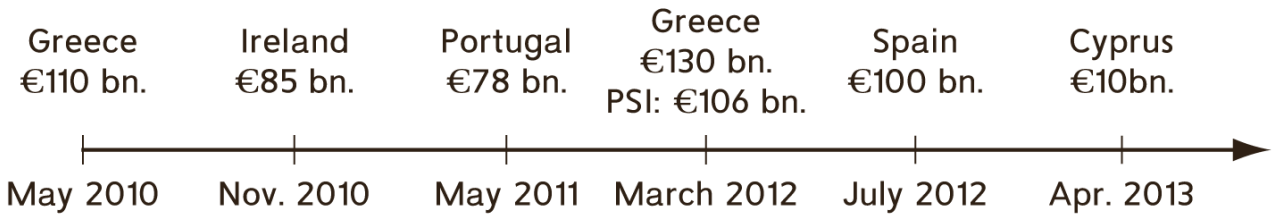
Stage two: the public debt crisis in the Eurozone

- However negative growth and large budget deficits have led to a fast increase in public debts:
  - Financial crisis has led governments to run budget deficits;
  - deficits have led financial markets to worry about the sustainability of public finances.

- Greece:
  - late 2007: public debt at 105% of GDP;
  - late 2009: public debt at 127% of GDP;
  - early 2010: Greek government in desperate situation;
  - May 2010: IMF–EU–ECB (called Troika) rescue operation and creation of European Financial Stability Facility (EFSF);
  - 2011: new package from the Troika (conditional loans).

Stage two: the public debt crisis in the Eurozone

Time line of financial assistance

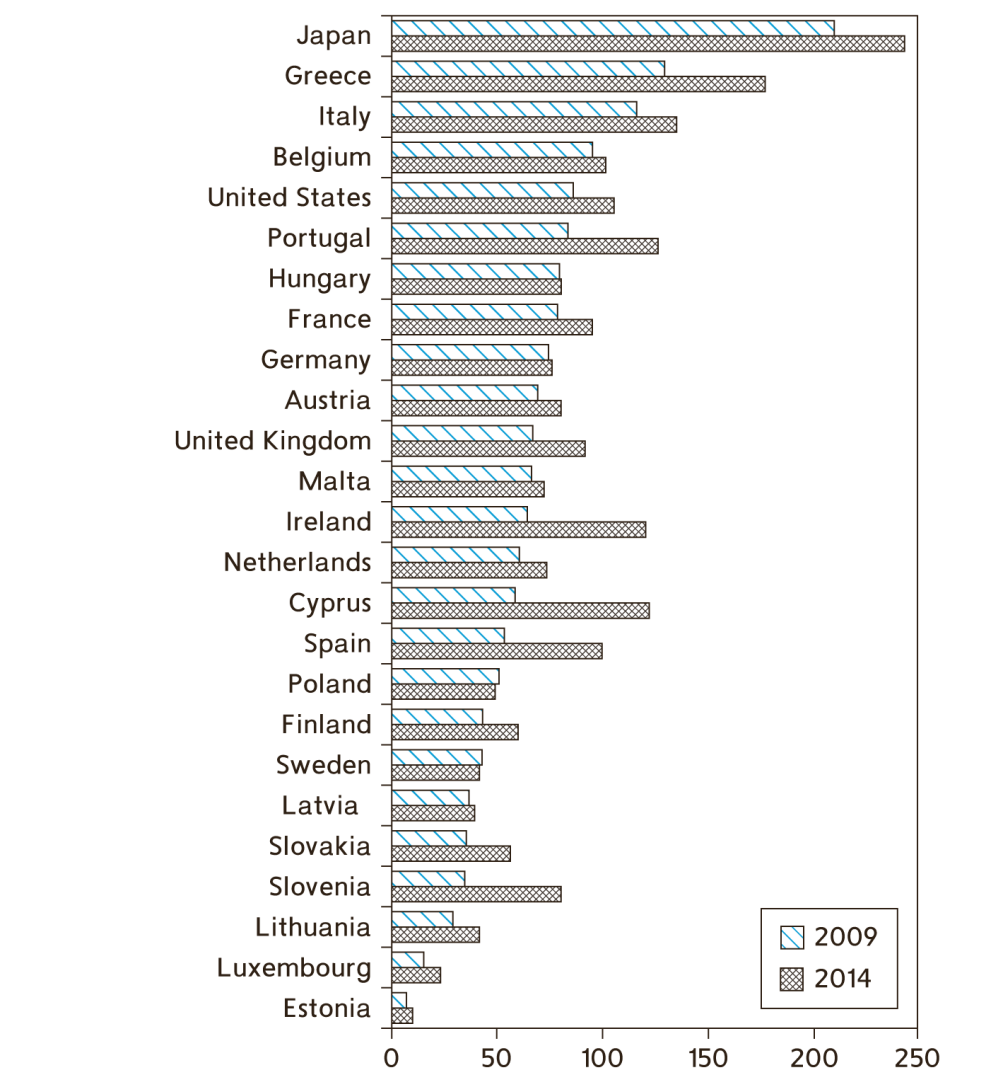


Stage two: the public debt crisis in the Eurozone

- Bailout of Greece in May 2010 was motivated as a way to avoid highly dangerous contagious effects but this goal proved elusive:
  - Ireland received a loan in November 2010;
  - Portugal followed suit with a loan in May 2011.
- Contagion within the Eurozone is highly troubling since public indebtedness is not enough to explain why these countries, and not others, have faced the wrath of the financial markets.
- Possible additional explanations:
  - membership of a monetary union may be a weakness (national central banks cannot help government);
  - no lender of last resort;
  - competitiveness issue;
  - Policy mistakes.

Stage two: the public debt crisis in the Eurozone

Public Debt in 2009 and 2014 (as % of GDP):



Source: AMECO, European Commission

Public vs. private debt

- Conventional wisdom explains EURO crisis by moral hazard of governments in Eurozone
- But: With the notable exception of Greece, (i) public debt has fallen and not increased in Eurozone before the crisis, and (ii) private debt has increased dramatically before the crisis
- Bank debt has increased more than corporate debt
- Thus, banking regulation and moral hazard in private sector might be more underrated in the debate (DeGrauwe 2010)

Government and private debt in Eurozone before the crisis, 1999-2008

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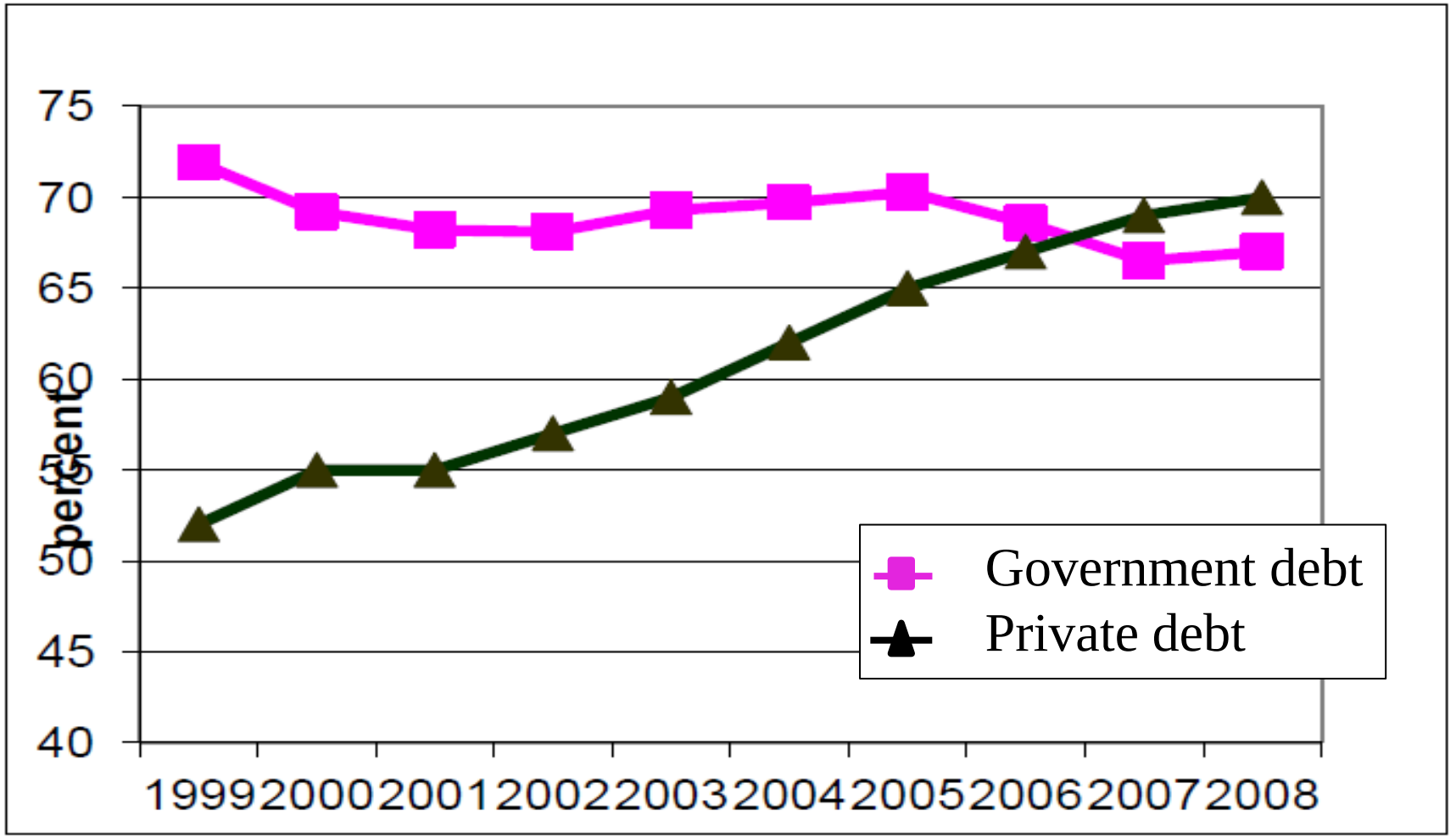
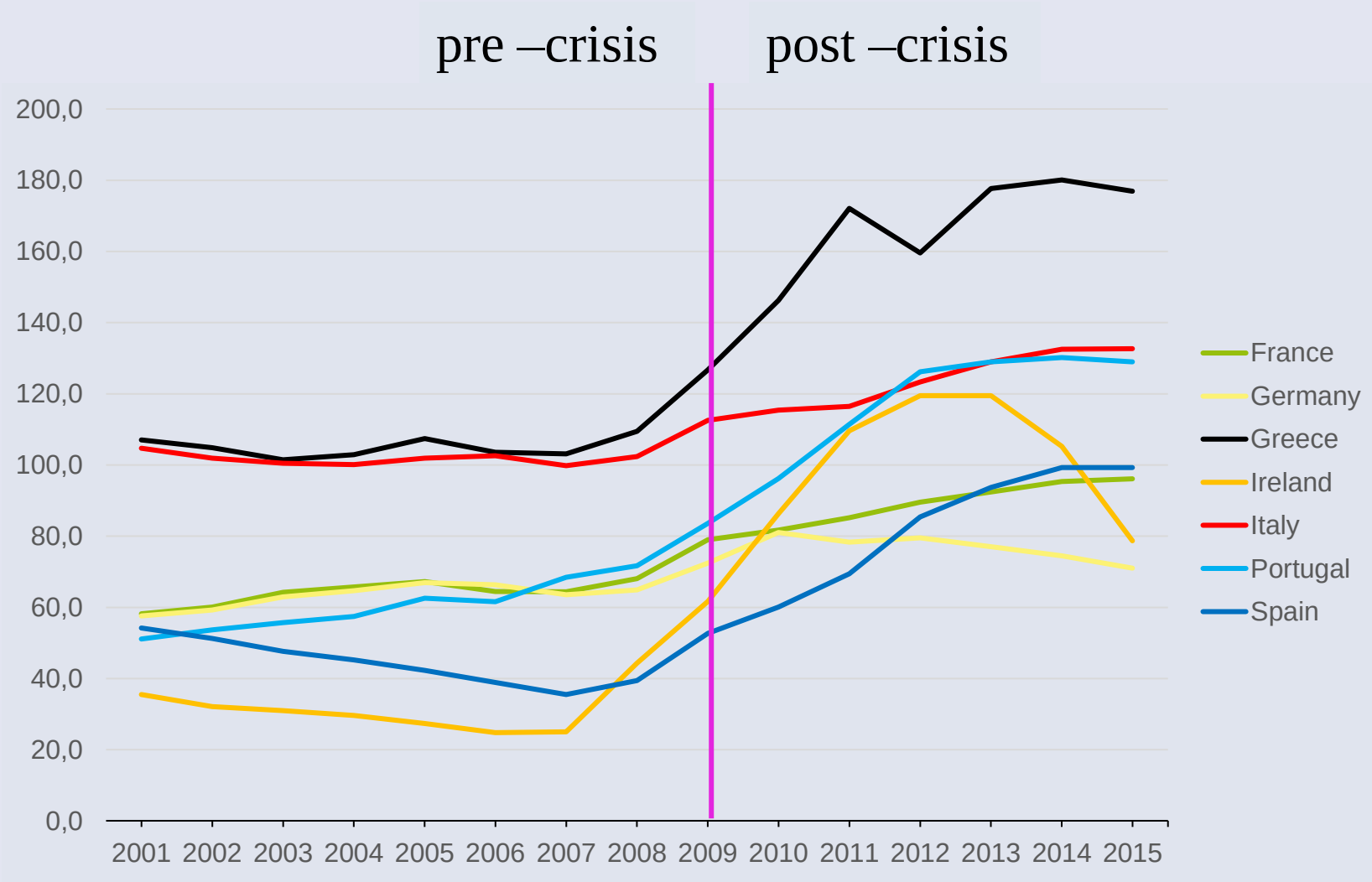


Public debt in % of GDP, 2001-2015



Private debt in % of GDP, 2001-2015

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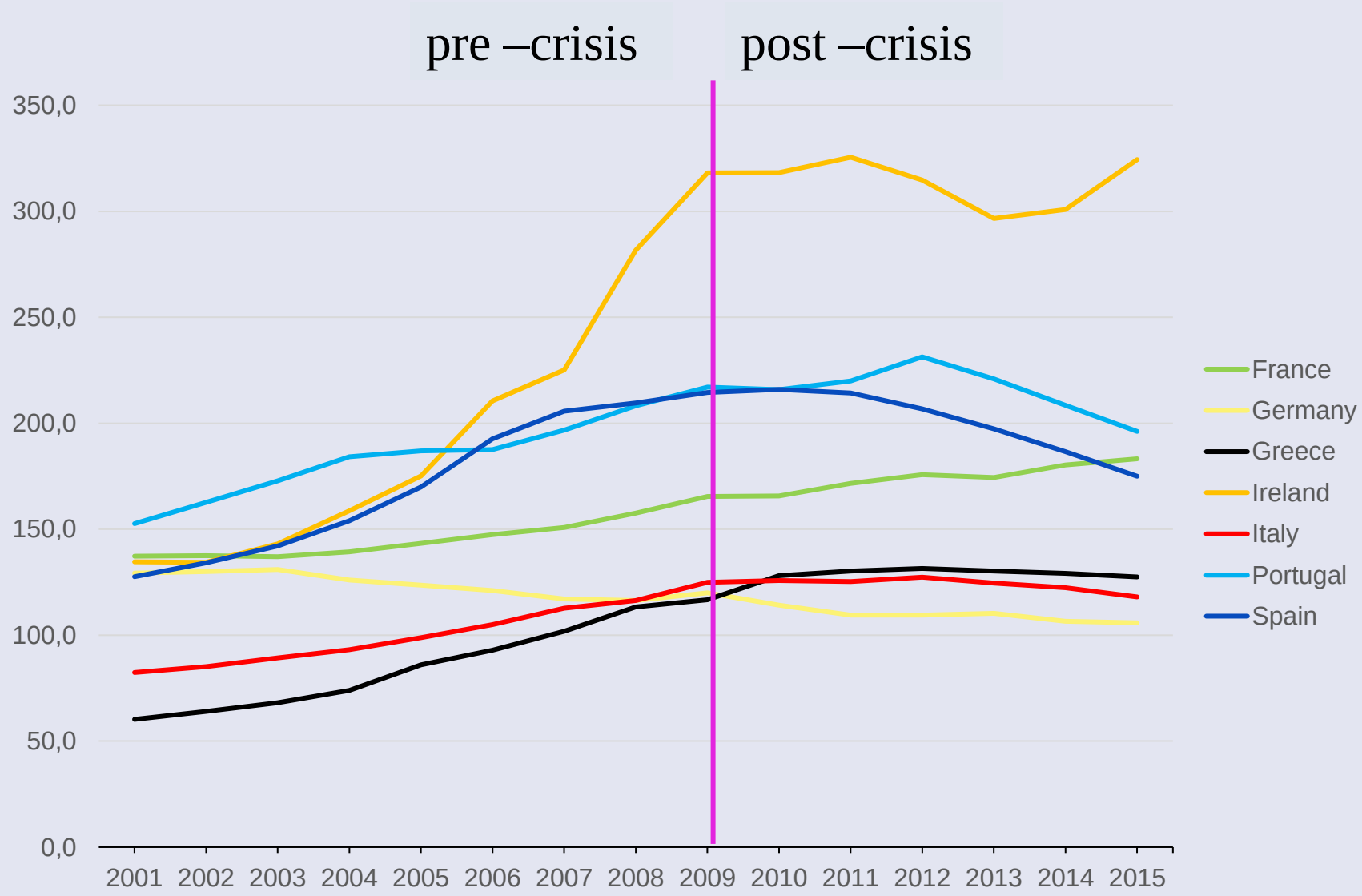

Growth of bank loans in the Eurozone, 2003-2009

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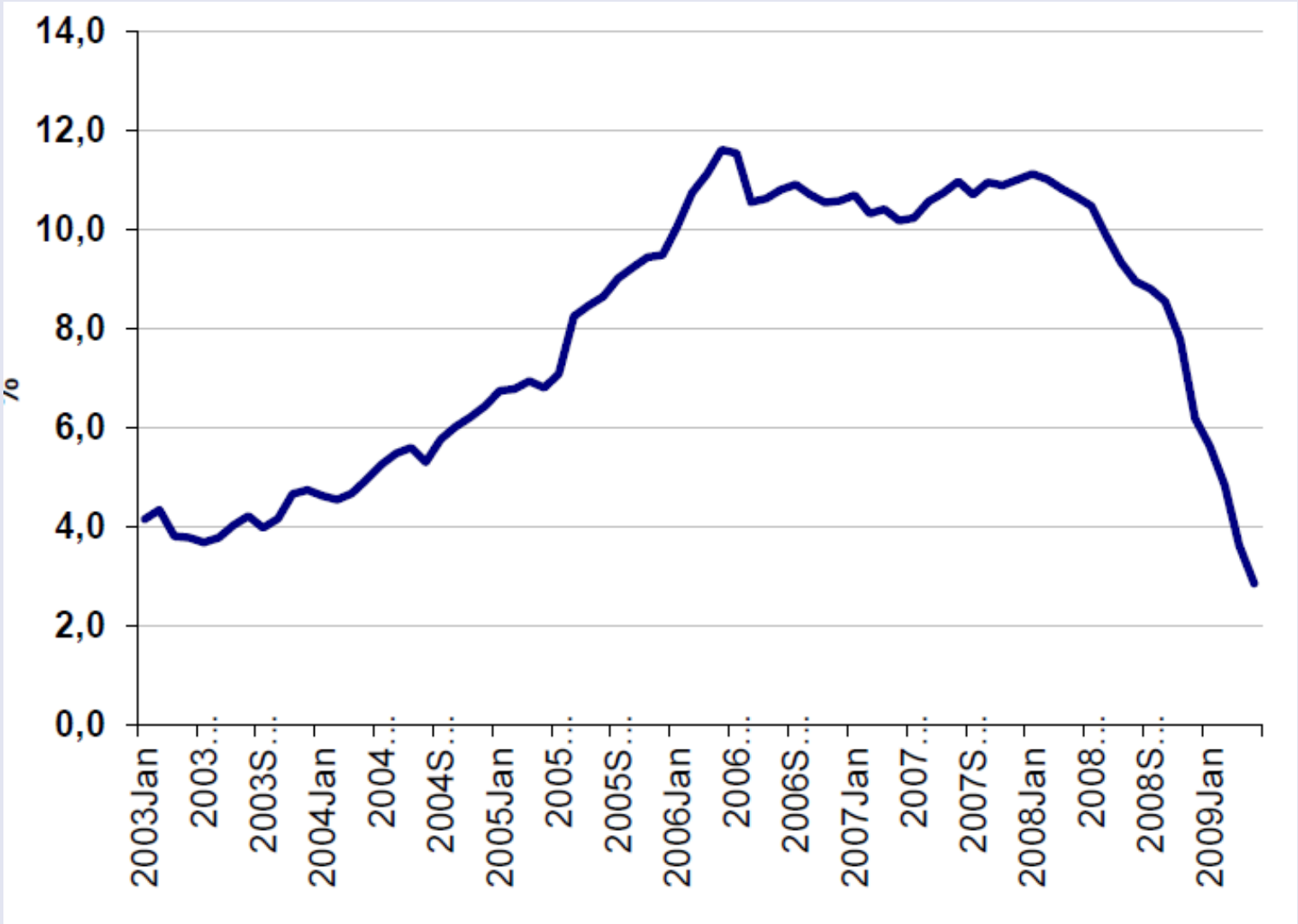


The bottomline I

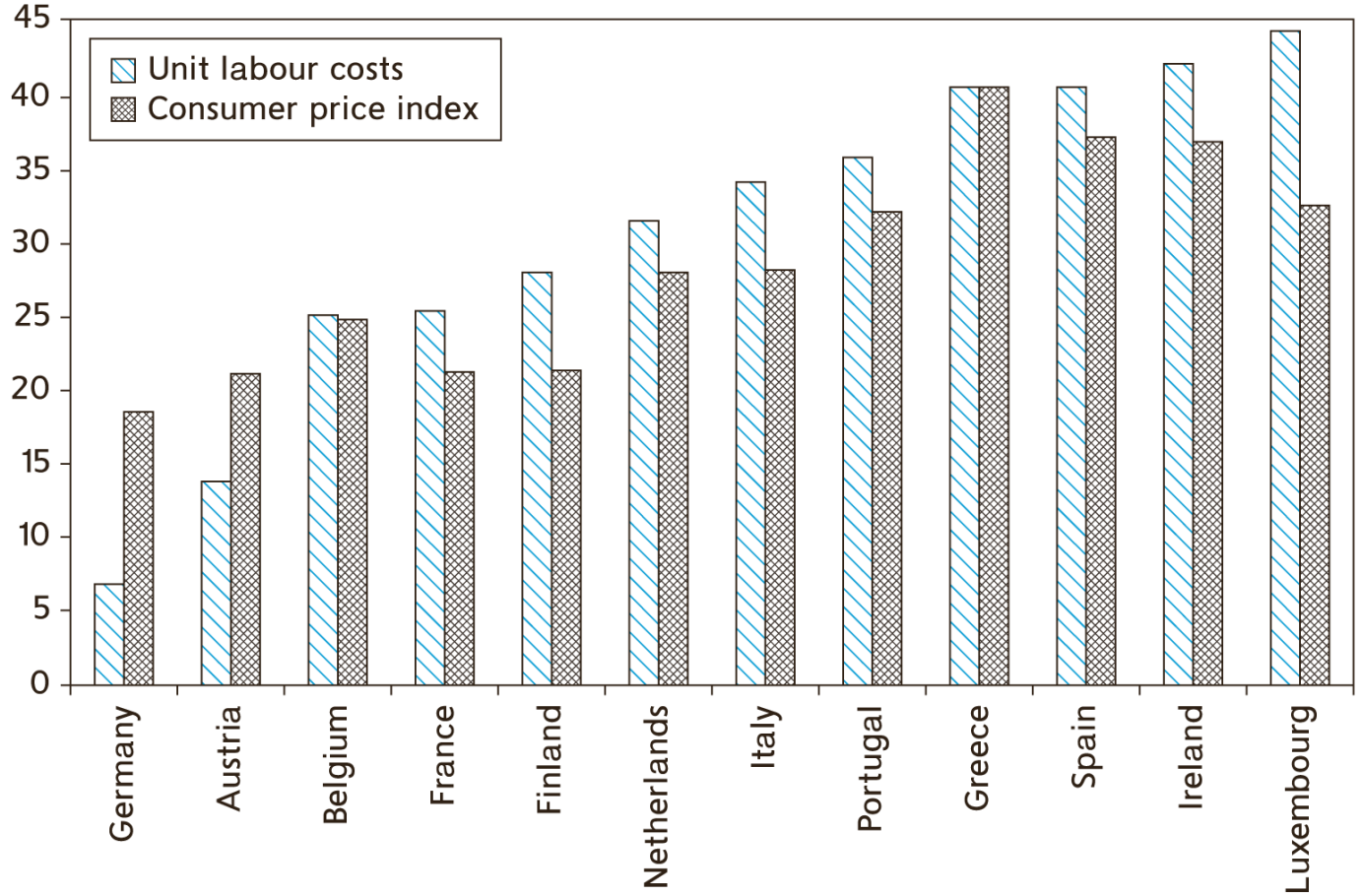
- With exception of Greece, the dramatic increase of private debts (real estate loans) are the first cause of financial crisis
- The crisis of the banking sector forced govern-ments to take-over private debts to avoid systemic failure of financial sector
- This increased dramatically public debts in some countries which had low public debts before
- ‘Great Recession’ increased public debt further through automatic stabilizers and fiscal packages

Wages and current account imbalances in the Eurozone

- If prices and wages are not flexible, different (productivity adjusted) wage developments can create imbalances in current account, which have to be matched by capital inflows
- In theory, a single currency would guarantee a balance of payments equilibrium and in long-term also equilibrium in current account
- In practice, this need not necessarily be the case, since current account imbalances are financed by public transfers in one way or another (see below)

Stage two: the public debt crisis in the Eurozone

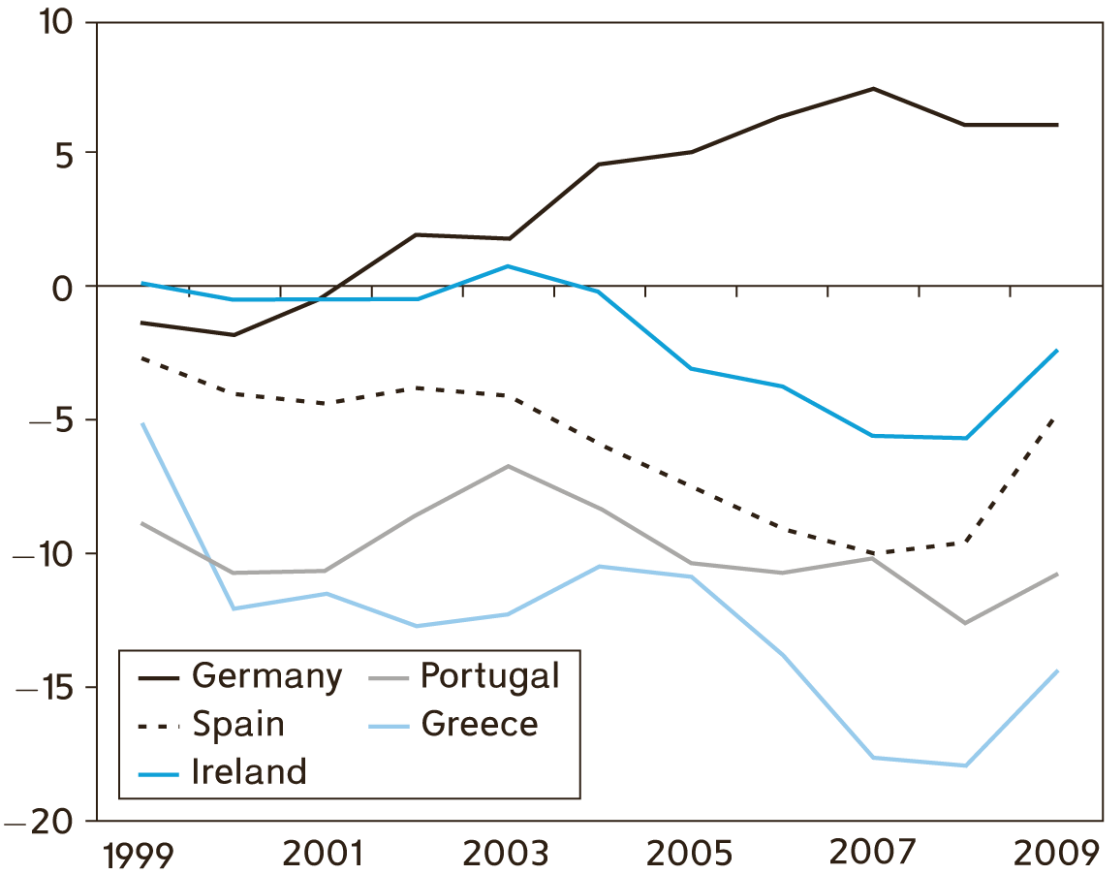
Increases in the unit labour costs 1999 - 2009:



Source: AMECO, European Commission

Stage two: the public debt crisis in the Eurozone

Current Accounts 1999 – 2009 (as % of GDP):



Source: AMECO, European Commission

The bottomline II

- Wage growth has been unbalanced in Eurozone, but (productivity adjusted) real unit labour costs have been much less unbalanced. This suggests that different rates of wage growth reflect different productivity growth patterns

- But: **current account surplus** of **Germany** tended to **increase persistantly and substantially**, while current account of **Greece**, **Portugal** and **Spain deteriorated substantially** in the first place. Meanwhile, under the pressure of structural adjustment, the current account improves there. Still, the development of the current account is a first hint for imbalances within the Eurozone.

Monetary & Fiscal Policies and Asymmetric Shocks

- **Recall:** Optimum currency area theory focuses on asymmetric shocks
- Economic structures between the North and the South might be diverse (manufacturing vs. tourism), but are affected by business cycle shocks in similar way
- The ‘Great Recession’ 2008-09 affected therefore countries with strong manufacturing sectors (export demand shock) as least as much as countries with strong tourism

Implication of a single currency for banks

- In principle, banks should compete throughout the euro area. In practice, many limits to this scenario:
  - good to be known by your banker (information asymmetry);
  - large costs of switching banks;
  - importance of wide branch networks.

- Banks merge, but mostly within countries:
  - regulations remain local in spite of harmonization efforts;
  - cultural differences;
  - tax considerations.

- Early effect:
  - more concentration and less competition;
  - banks could establish branches abroad (but they don’t).

Implication of a single currency for bond markets

- Bond markets deal in highly standardized loans. They used to be segmented by currency risk, which implied interest rate differentials.

- Convergence has happened but is not complete; Interest rates on long-term government bonds.

- The financial crisis changes reversed the convergence extremely.

Implication of a single currency for bond markets

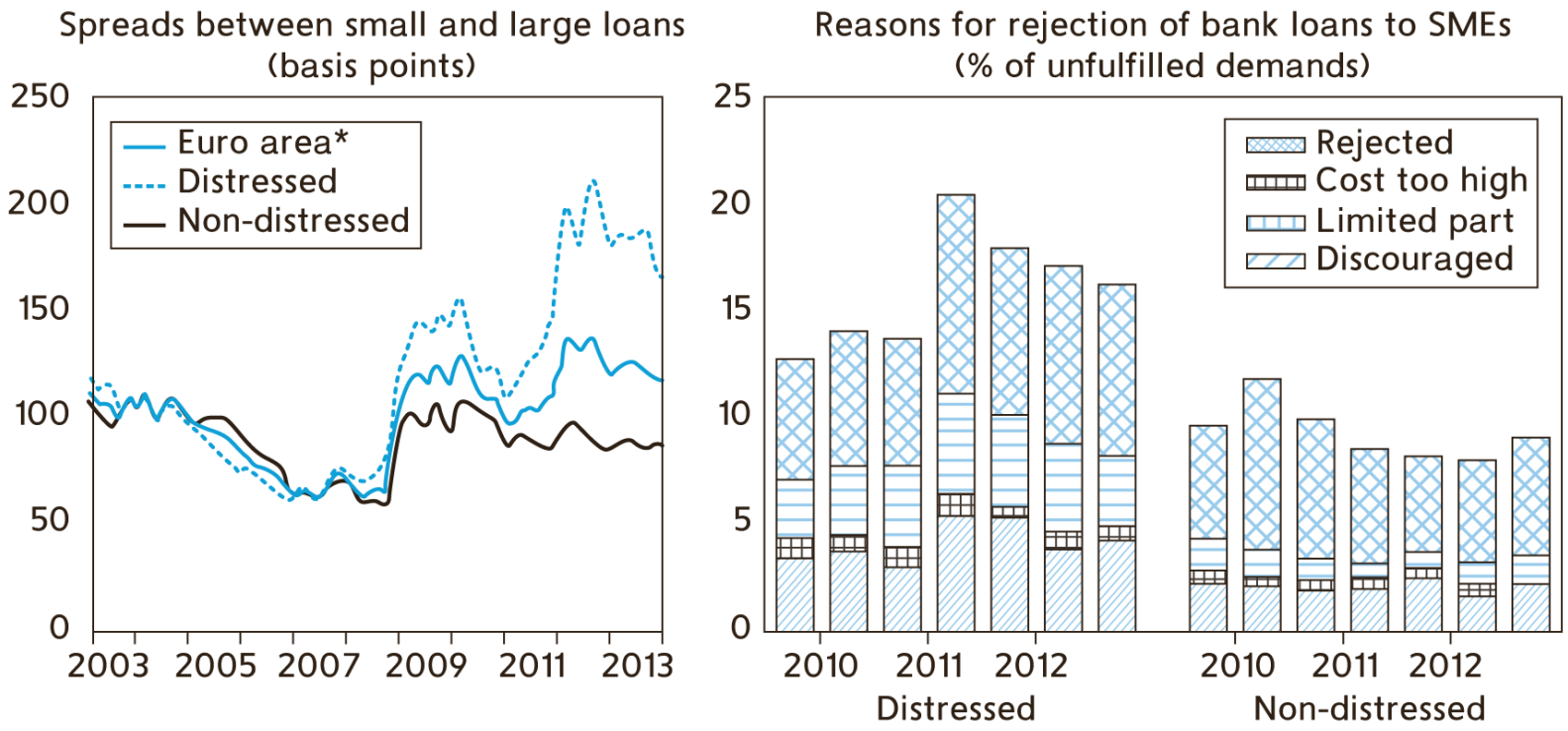
Figure 18.3 Interest rates on long-term government bonds, January 1995–May 2014

Source: IMF

Fragmentation during the crisis

Banks have become increasingly unable to fulfill their key task:

Figure 18.7 Bank loans: interest rate spreads and rejections



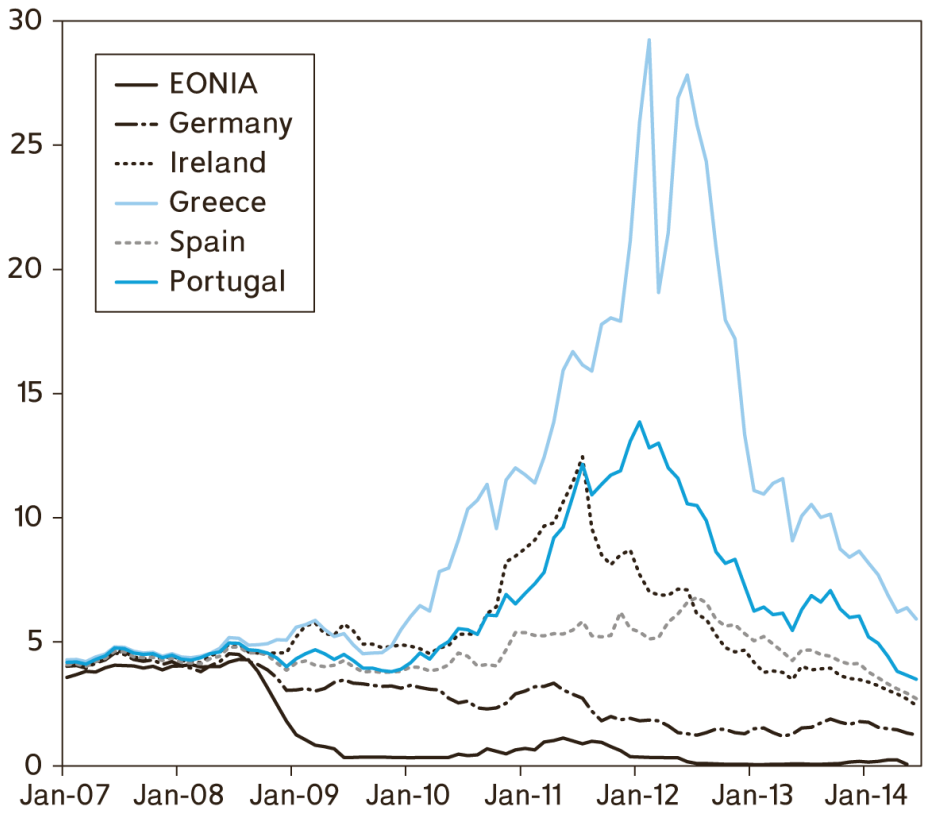
Note: The spreads (interest rate on small loans – interest rate on large loans) are measured in basis points. A basis point is 1/100th of a per cent. Loans for less than €1 million are classified as small.

Source: © European Central Bank, Frankfurt am Main, *Financial integration in Europe*, April 2014, Charts 53a and 55

Fragmentation during the crisis

Monetary policy has stopped “being common”:

Figure 18.10 The ECB policy rate and national interest rates, January 2007–June 2014



Notes: EONIA is the (overnight) rate targeted by the ECB. The national interest rates are the long-term (10-year) rates that most affect credit conditions.

Source: European Central Bank, Frankfurt am Main

Why are governmental debts different in a CU?

Case 1: Investors fear debt default in country with a national currency:

- sells government bonds
- sells the currency on exchange market
- exchange rate drops
- but money stocks remains unchanged
- eventually Central Bank buys government bonds
- this generates inflation and exchange rate depreciation, but no liquidity risk. Only for countries which cannot issue bonds in national currencies.

Why are governmental debts different in a CU?

Case 2: Investors fear debt default of country in Currency Union:

- sells e.g. Greek government bonds
- buys e.g. German government bonds
- EUROs leave Greece, monetary stock contracts there
- Government faces liquidity crisis, i.e. cannot lend money at reasonable interest rate
- There is no channel to create liquidity
- Unless the ECB buys Greek goverment bonds
  (This is what Draghi announced to do in 2012.)

Regulation and supervision in the Eurozone

- Because of ‘market failures’
  - financial markets are regulated
  - and financial institutions are supervised
  - and if necessary a bank resolution has to take place.

- Core principles of regulation are agreed within the ‘Baasel Committee for Bank Supervison’, which brings together regulators from countries with significant banking systems

- A new institution that examines all financial institutions was created in 2009: the **Financial Stability Board**.

Regulation and supervision in the Eurozone

- A single financial market would seem to require a single regulator and a single supervisor. Instead:
  - regulation largely designed at EU level;
  - foster co-operation among national supervisors.
- The financial crisis that hit Europe in 2008 showed that this system was not adequate. For example: decision by Ireland in 2008 to offer full guarantee to deposits and liabilities of six Irish banks forced other countries, which offered limited guarantees, to offer unlimited guarantees to deposits at their own banks in order not to be at disadvantage.
- Crisis led to a task force. The de Larosière Report (2009) showed that:
  - national supervisors did not share information with one another;
  - ECB, tasked with the function of lender of last resort, was not any better informed of the true situation of stressed banks.

Regulation and supervision in the Eurozone

- Following the proposals of the de Larosière Report, the European System of Financial Supervision (ESFS) has been created, which includes **five new institutions**:
  1. European Banking Authority (EBA), which is charged with collecting detailed information on all EU banks;
  2. European Securities Market Authority (ESMA), which brings together all EU bond and stock market regulators and supervisors
  3. European Systemic Risk Board (ESRB), which looks at the overall picture and can issue binding recommendations;
  4. European Insurance and Occupational Pensions Authority (EIOPA), focusing on insurance companies and pension funds;
  5. Joint Committee of the European Supervisory Authorities (ESA), which brings national supervisors together to improve transparency.
- A second step was the creation of the **European Banking Union**

Policy Responses: Bailout

"Bailout Institutions"

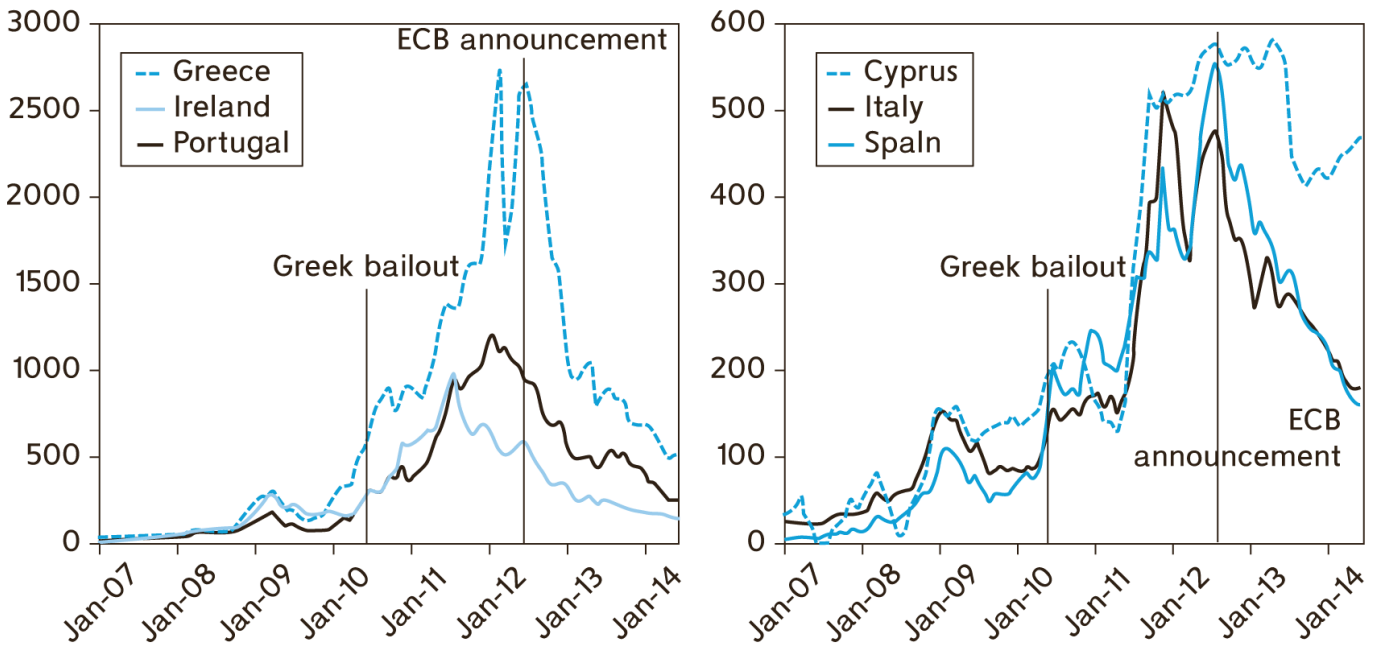
- Creation of the European Financial Stability Fund (EFSF) for availability of financial resources in case of contagion

- Replacement with the European Stability Fund (ESM) in 2012
  - Based in Luxembourg
  - Lending capacity of 500 billion Euro
  - Capital can be increased up to 700 billion Euro

Policy Responses: Bailout

Step increases in interest spreads (below) is due to policy decisions that markets perceived as ‘too little, too late’ (e.g., EFSF).

Interest rate spreads (basis points):



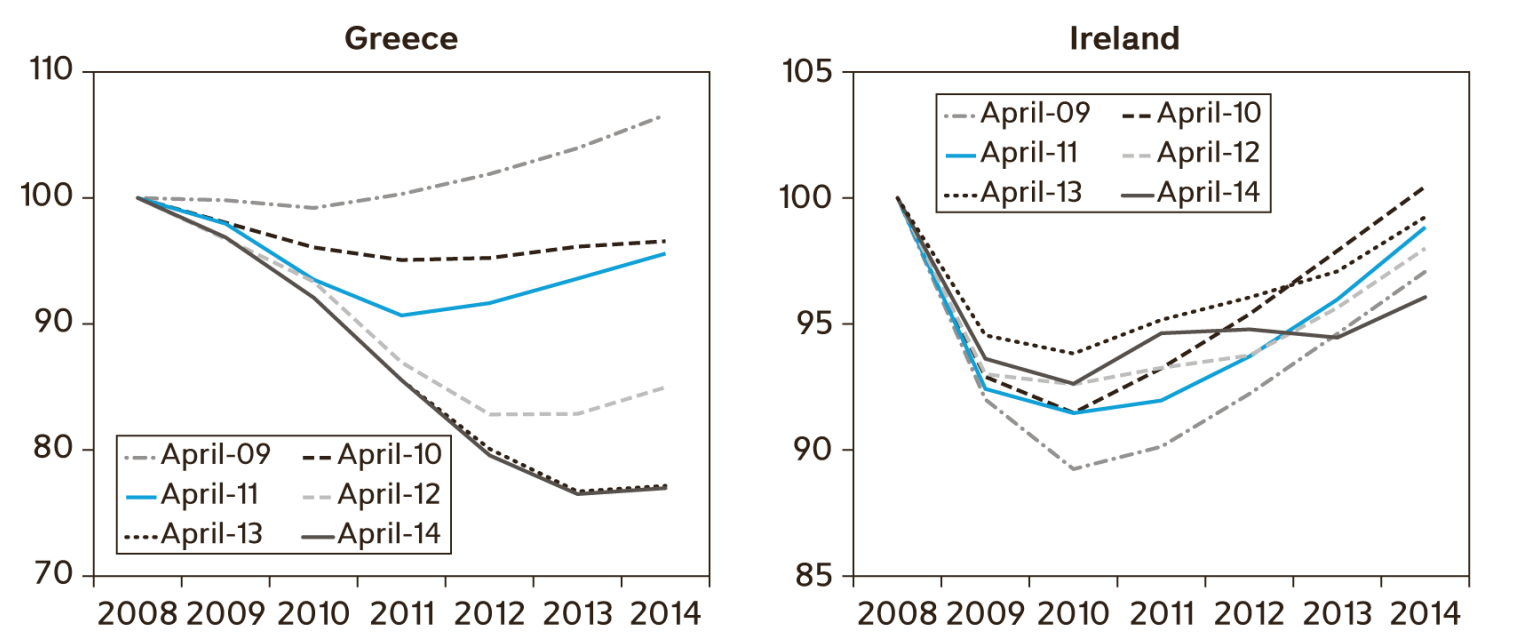
Note: Spreads are measured as the difference between each country’s long-term bond interest rate and the corresponding German rate. A basis point is 1/100th of 1 per cent. The vertical scales are different in the two charts.

Source: International Financial Statistics, IMF

Policy Responses: Fiscal Policy

Fiscal policy strategy: fiscal austerity as a mean to return to economic growth.

IMF real GDP forecasts



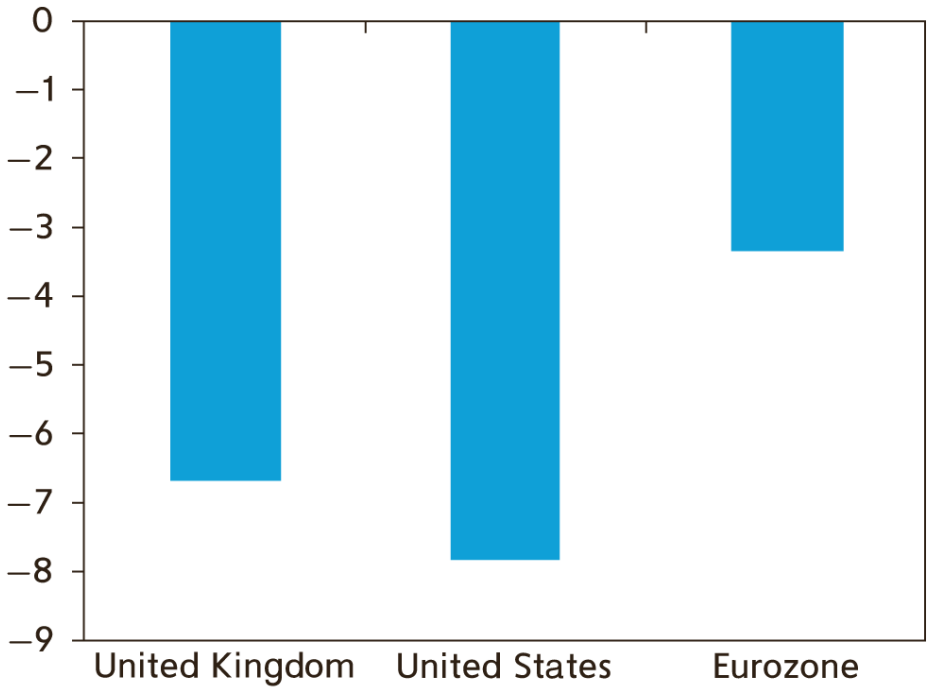
Note: Real GDP is measured as an index normalized to 100 at the time of programme agreement.

Source: Sapir et al. (2014)

Policy Responses: Fiscal Policy

Fiscal policy was much less expansionary in the Eurozone.

Figure 19.10 Cyclically-adjusted budget balances: averages during 2007–2013 (% of GDP)



Source: Economic Outlook, OECD

Policy Responses: Monetary Policy

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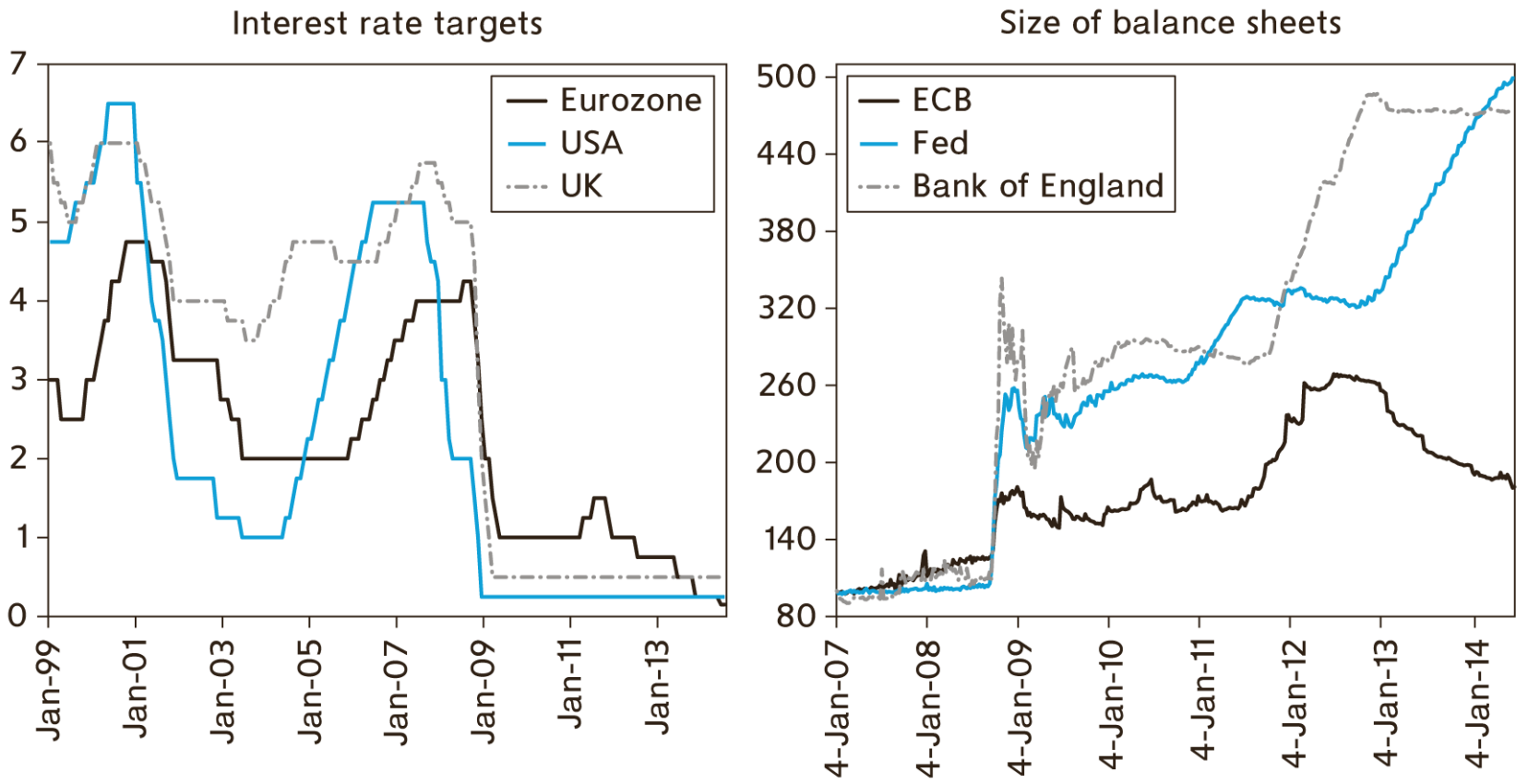
Central banks lend directly to banks → raising balance sheets



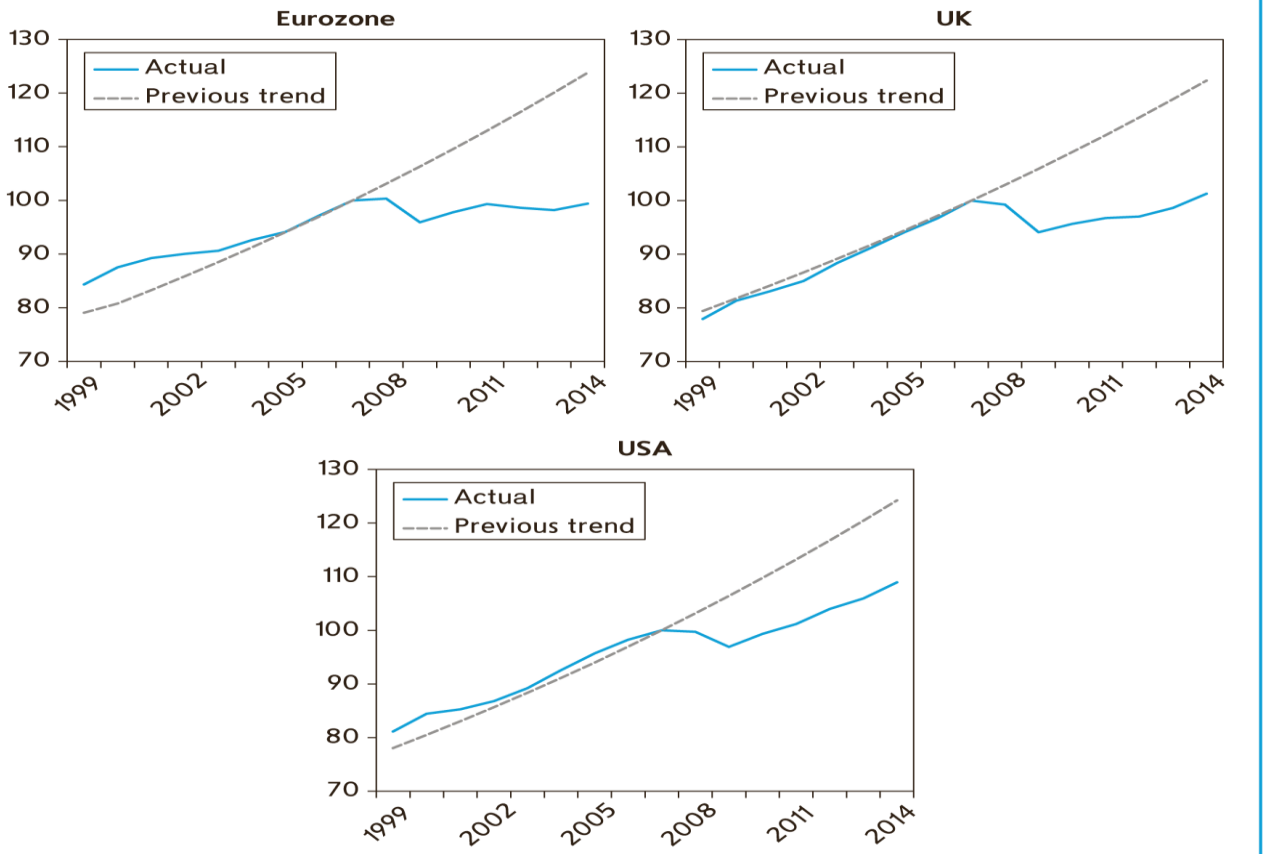
Note: The balance sheet sizes are presented as indices normalized to 100 in January 2007.

Sources: European Central Bank, Federal Reserve Board, Bank of England

The Outcome

GDP growth remains flat in the Eurozone.

Figure 19.12 Real GDP level (Index: 100 = 1999)



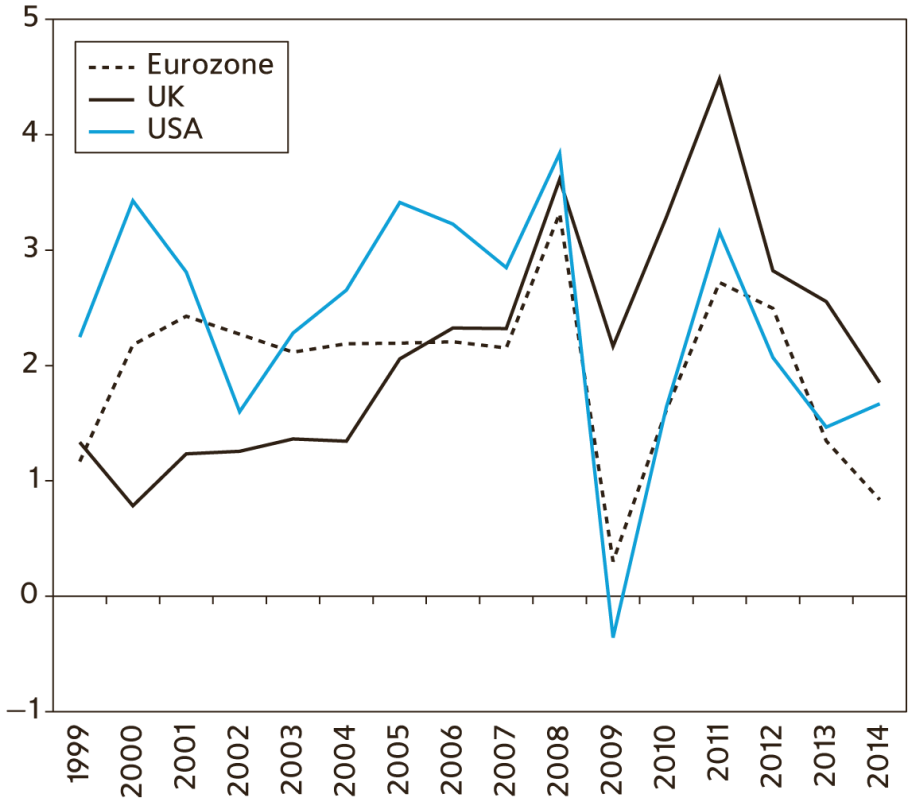
Note: The trend corresponds to the average growth rate observed during 1980–2007.

Source: AMECO, European Commission

The Outcome

Price Stability performance in Eurozone not effective.

Figure 19.13 Inflation rates (% per annum)



Source: AMECO, European Commission

What have we learned from the crisis?

- Fiscal discipline: very high debt creates serious difficulties.
  - limits countercyclical fiscal policy
  - challenges monetary policy independence
  - possibly limits growth
- Eurobonds may have appealing features
  - element of solidarity
  - single Eurobond market might challenge US Treasury Bonds (as international reserves)
  - considered to be save
  - end fragmentation of Eurozone financial market
  - But: politically unfeasible
- Debate on debt restructuring
- Bank fragility
- Governance

Government Bankruptcy in Eurozone

- In principle, there is no reason why goverments of Euro members could not go bankrupt. Similar to private actors
- Risks: Contagion to other countries by forming vicious circle of bad expectations
- Systemic risk by breakdown of banking sector, at least in affected country
- Moderate version: the so-called ‘hair-cut’

Leaving the Eurozone (Grexit)

- Would allow to depreciate currency
- Would not allow solving debt problem by printing money, since debts are issued in EUROs
- Debt default is unavoidable. Risk of systemic failure of financial system and of contagion
- High risk of new default, since it is likely that new debts are not accepted in new currency
- Note that currency depreciation cannot solve long-run structural problems

Banking regulation

- It is largely uncontroversial that the regulation of banks has to be reformed
- But not much is done
- Higher capital demands for banking sector
- Better regulation of derivatives
- ECB branch is in charge of regulation. This is conroversial
- Is complex and beyond this lecture

Will the Eurozone break up?

Yes:

- failure to establish fiscal discipline;
- gap between well-functioning North and badly wounded South;
- many international investors do not believe that the euro can survive (self-fulfilling process).

No:

- breakup would have catastrophic implications;
- new currency would have to be printed and reintroduced;
- no legal procedure for a country to leave the Eurozone;
- deeper problem has been political mismanagement of the crisis.

Exam

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Topics

- Microeconomics of Trade
- Preferential Trade Liberalization
- Scale Economies (BECOMP diagram)
- Trade and Competition Policies
- Dynamics of integration
- Capital and labour mobility
- Macroeconomics of monetary integration
- Optimum Currency Area Theory
- European Monetary Union and Euro crisis

GOOD LUCK!