The euro area crisis: What makes it so intractable?

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Macro-financial crises: General characteristics

- Sudden changes in cost and/or availability of funding ("sudden stops")
  - typically resulting from general reassessment of recoverability of debts
- Spending adjustments triggered with macro spillover consequences
  - public and private investment and consumption
- Losses of actual and potential output; involuntary unemployment; wealth distributional effects

Three prominent causal mechanisms in the build-up

- Exuberant private sector borrowing
  - Often reflecting low interest rates
  - For small country: directly or indirectly (through banking system) from abroad
- Excessive public sector (fiscal) borrowing
- Loss of competitiveness through price/wage changes unmatched by exchange rate developments
  - (associated with build-up of foreign indebtedness through capital inflows)

Canonical crises

- LAC crisis (1982)
  - Caused by excessive accumulation of foreign currency denominated debt, by banks and sovereigns, to fuel property bubble etc.
- ERM crisis (EMS) (1992)
  - Emergence of competitiveness gap (partly triggered by German unification) requires large exchange rate adjustments
- EA crisis (1998)
  - Similar to LAC crisis but less role for fiscal borrowing: more for banks and corporates

The crisis breaks and amplifies through feed-back loops

- Increase in uncertainty causes
  - lower investment and consumer spending
  - lower and diverted flows of funds (credit, deposits)
  - lower asset prices
  - more payments defaults
- Fiscal situation deteriorates due to
  - shrinking tax revenues and growing spending pressures (automatic stabilizers) and
  - socialization of private indebtedness
  - threat to sustainability raises borrowing spreads

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  - shrinking tax revenues and growing spending pressures (automatic stabilizers) and
  - socialization of private indebtedness
  - threat to sustainability raises borrowing spreads → *increasing uncertainty and worsening fiscal situation*

What is the euro area crisis?

- Part of the Global Financial Crisis (GFC)
  - which resulted from a huge build-up of credit in the 2000s
  - and was triggered by the collapse of the US structured finance market in 2007.
- Euro area strand separated from the GFC in 2010
  - with "sudden stops" in Greece, Ireland, Portugal
  - risk premium jumps for Italy and Spain in 2011
  - crisis extended to Cyprus and Slovenia in 2012/3
- Fiscal adjustment and contraction of private spending in these countries saw jumps in unemployment levels and contraction in aggregate output.
- Feedback effects on confidence in other euro area countries

Different euro countries display each of the three canonical features

e.g.

- GR: fiscal
- IE: banks
- IT: competitiveness

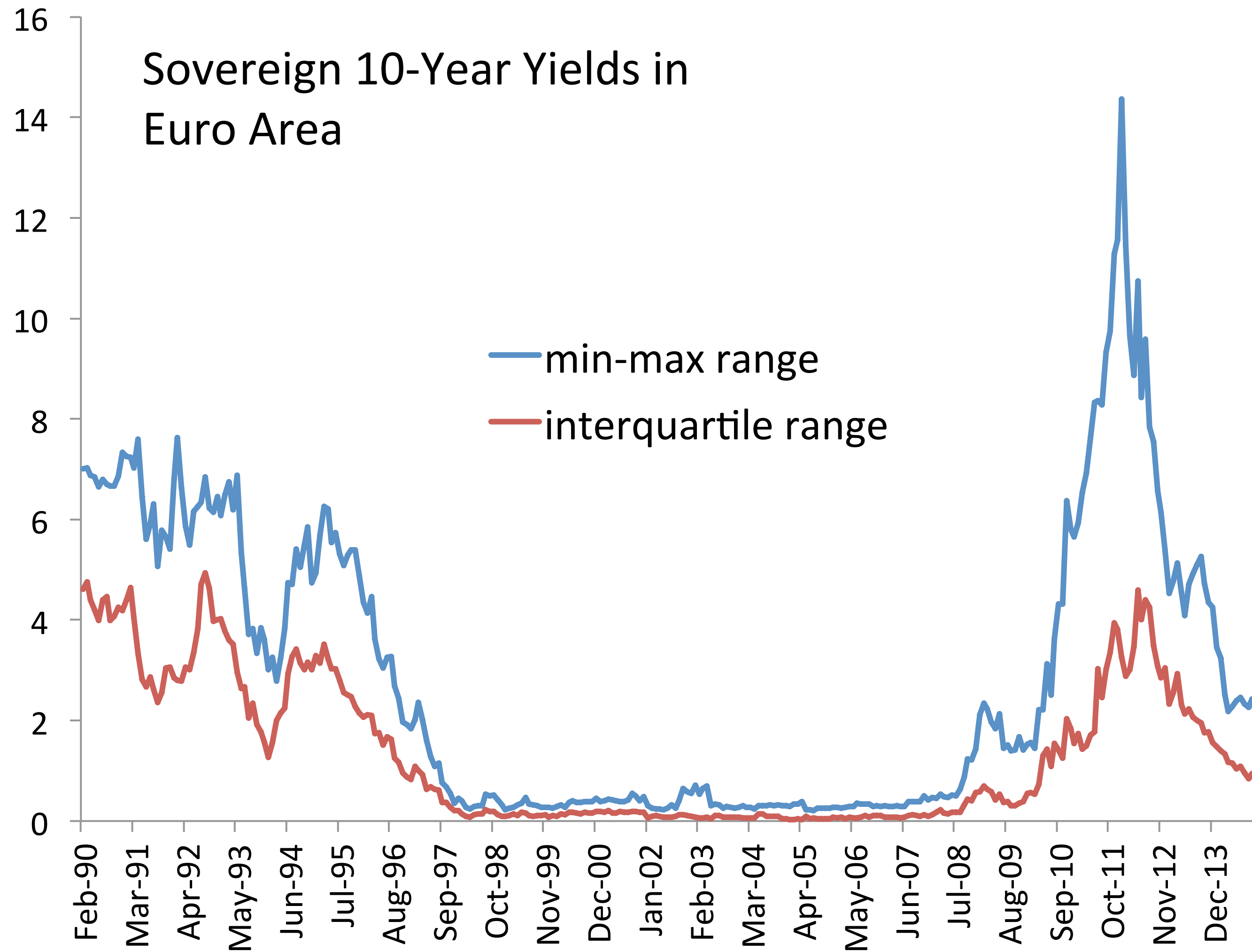
Though as usual each country has mixture of all three:

GR: chronic lack of competitiveness

IE: fiscal deficit emerges even net of bank debt socialisation

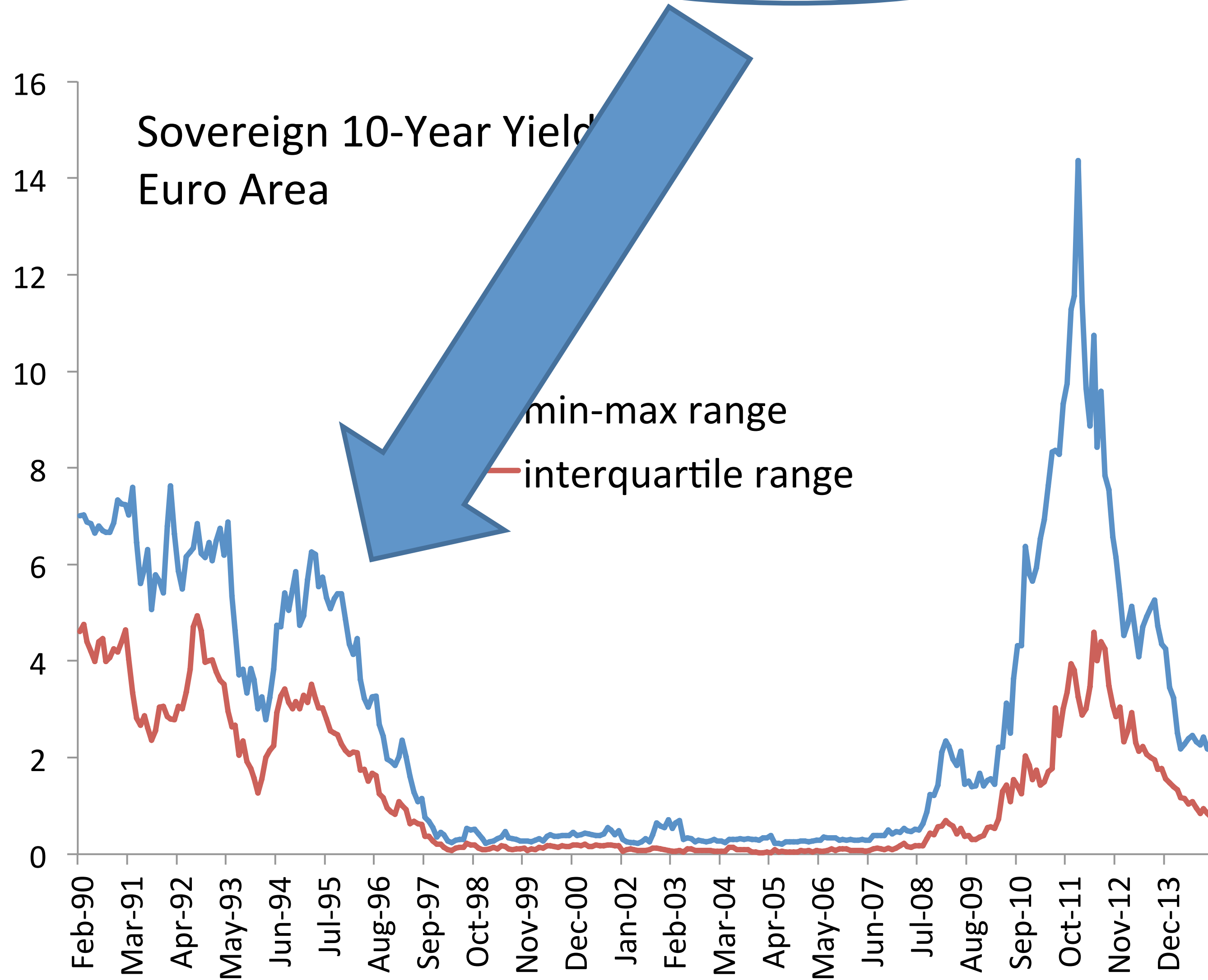
IT: chronic high level of fiscal debt

Yield spread roughly equals exchange rate risk plus credit risk



Source: ECB financial integration indicators

Yield spread roughly equals exchange rate risk plus credit risk



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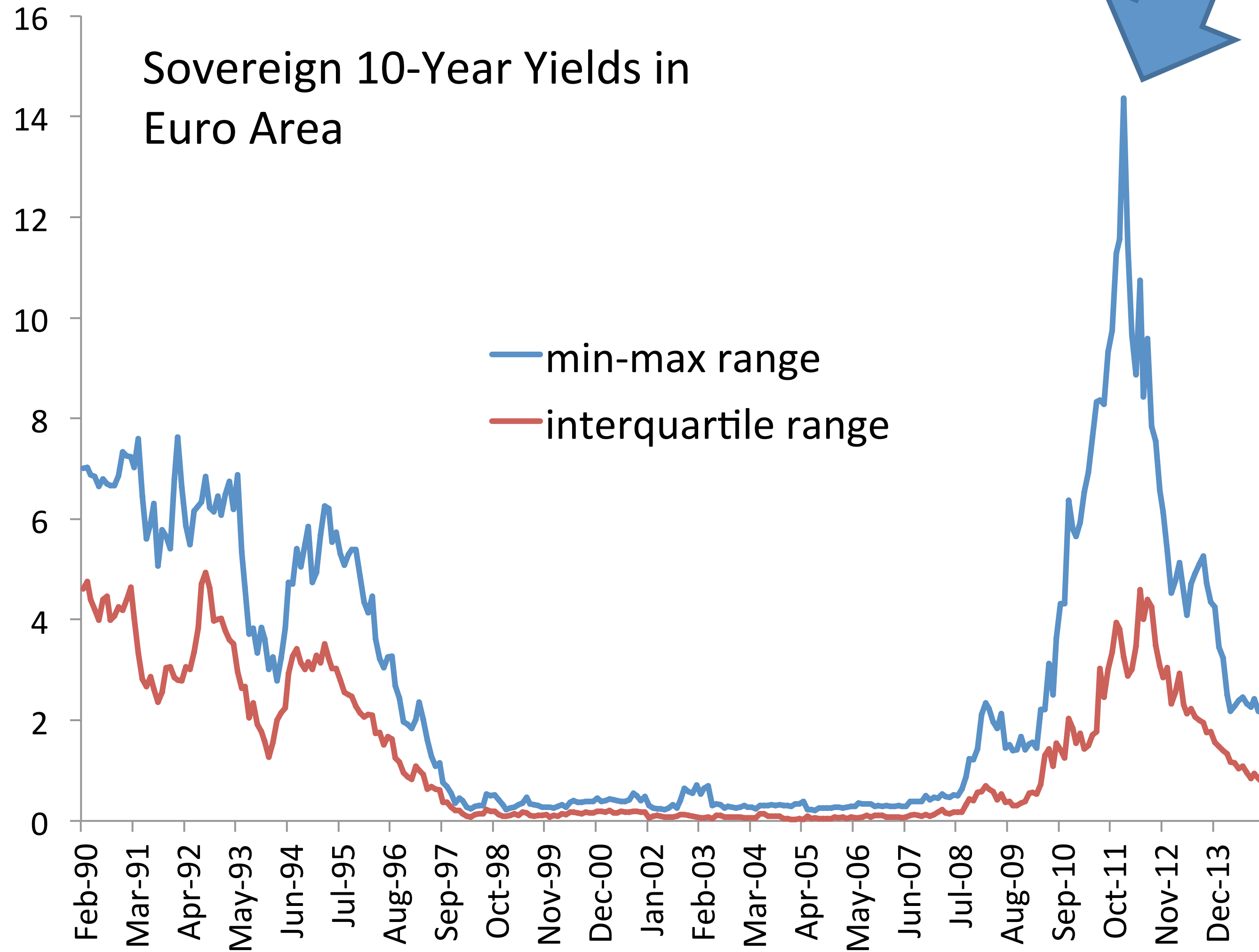

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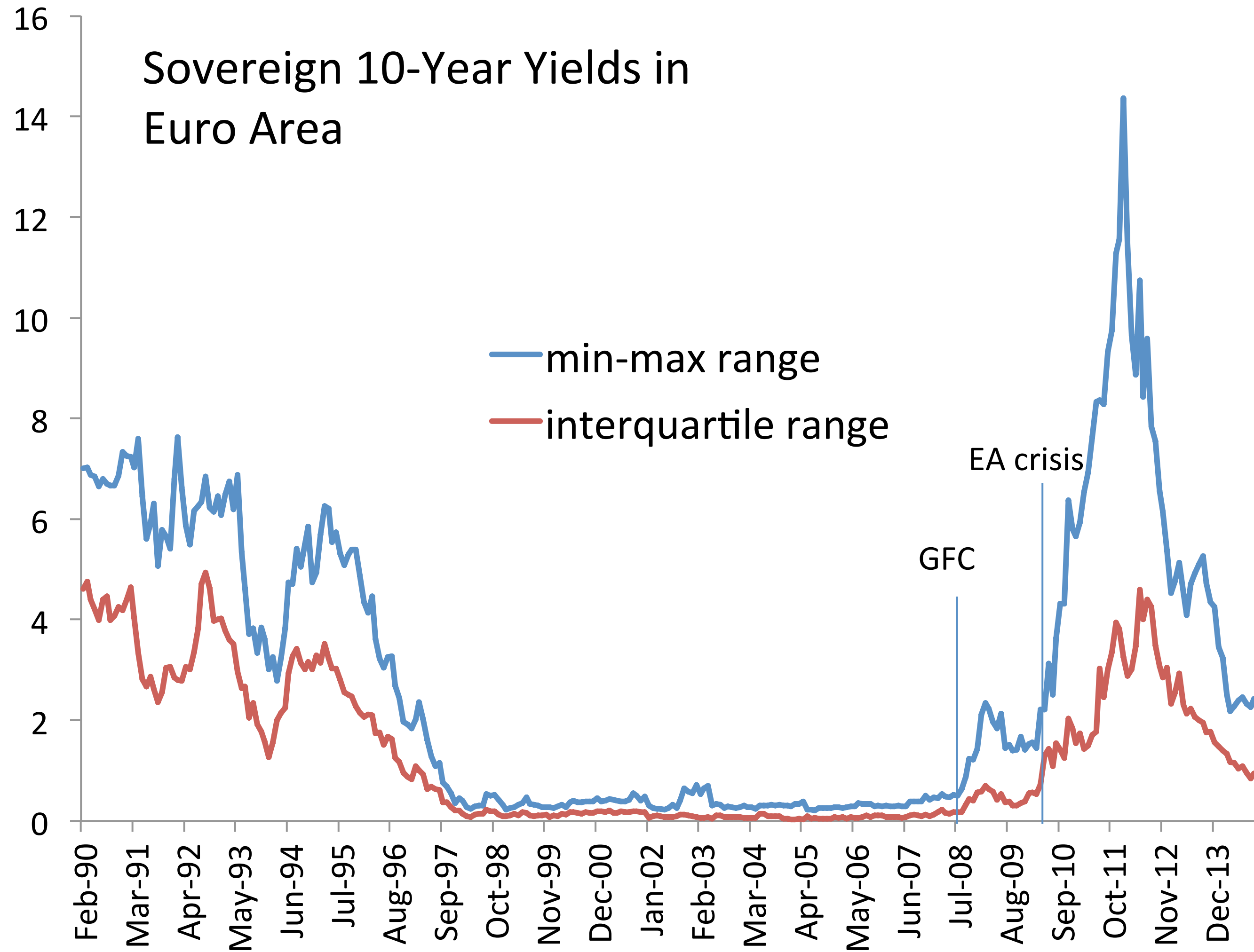


Source: ECB financial integration indicators

Real GDP (2007=100)
110
105
100
95
90
2004
2006
2008
2010
2012
2014 Q2
Euro Area
EU Non-Euro Area
United States
Japan

What's special about the euro area crisis?

Possibility A? Nothing special

Some non-euro countries had similar experiences (e.g. Iceland; Latvia; even UK)

Possibility B? Design flaw

? Amplitude higher because

- Pre-crisis ease of borrowing in euro
- Inability to depreciate currency
- Preclusion of cross-border official transfers resulting in vulnerability (cf. US)
- Brittleness due to "commitment device"

Possibility C? Flawed pre- or post-crisis management

- Weak pre-crisis management (neglect of emerging national imbalances)?
- Implicit cross-country guarantees not honoured?...or ill-advisedly partly honoured?

A: Nothing special?

Partly true:

- In large part it is just a strand of the GFC
- Many euro countries recovered reasonably well

But

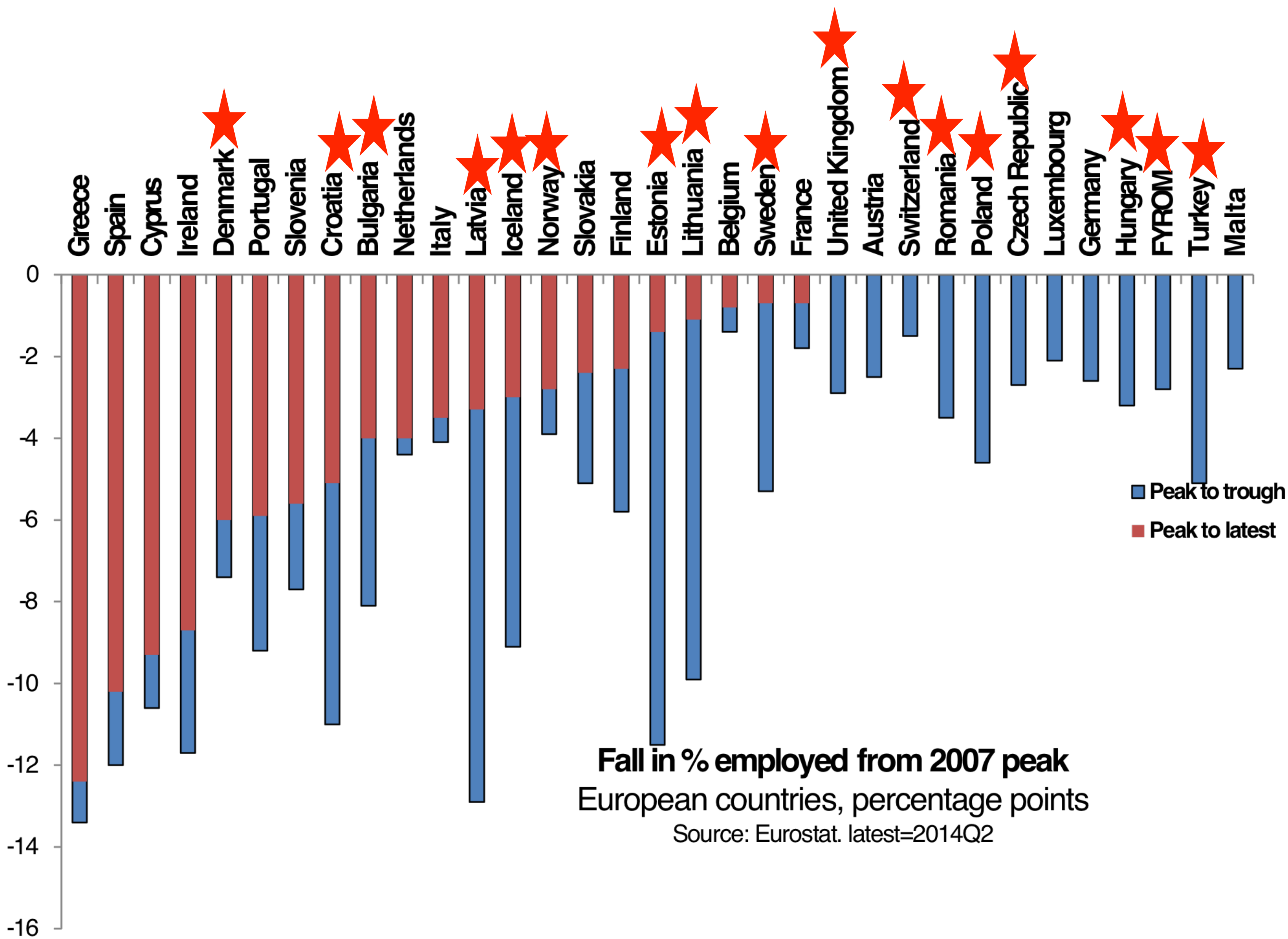
- Problems more protracted and on average more severe than in other countries

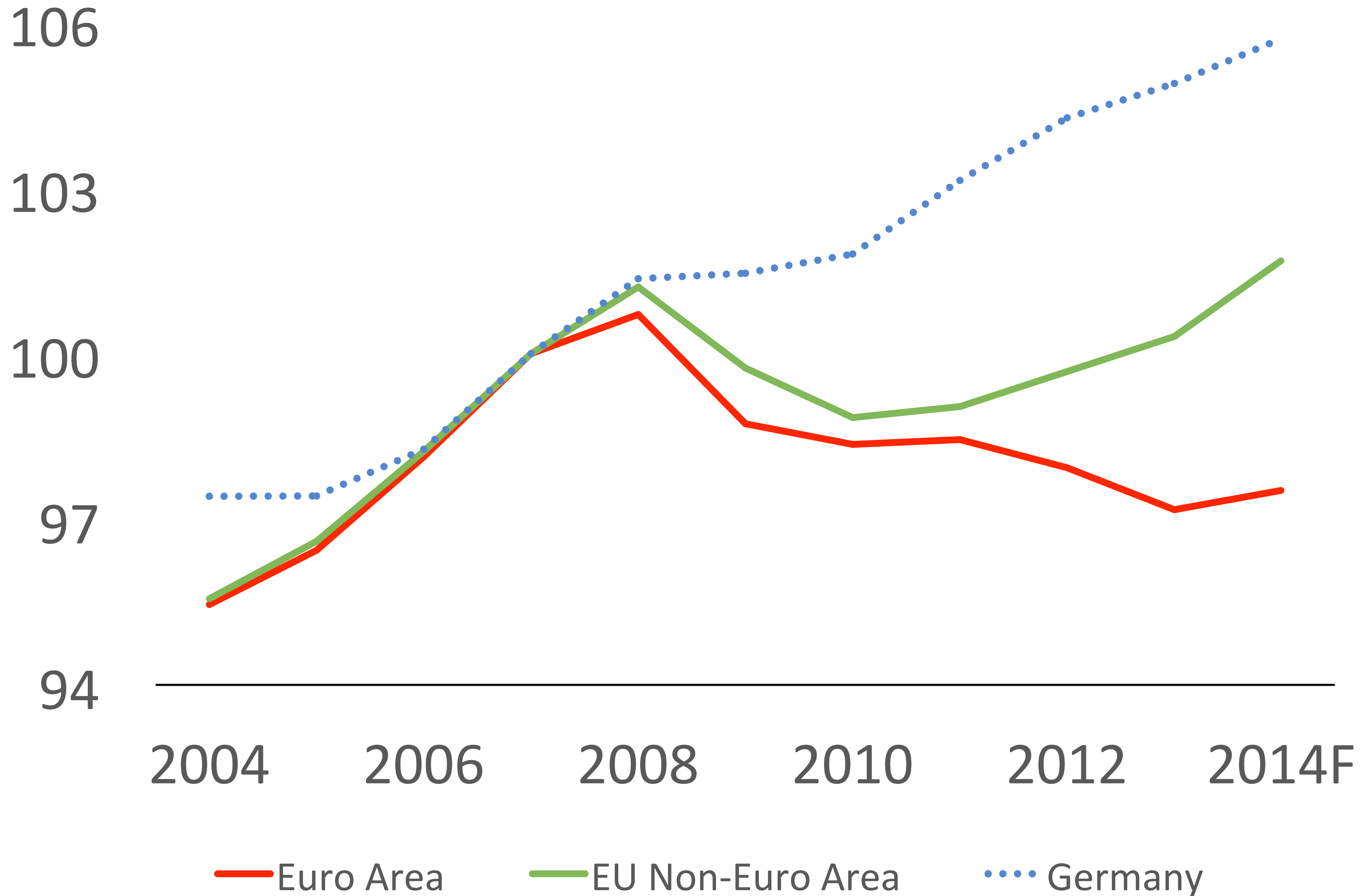
Estimated fiscal cost of bank bailouts: European countries (% GDP)

Country	% GDP	Country	% GDP
Iceland	44.2	Portugal	11.0
Ireland	38.9	Cyprus	9.7
Greece	23.1	Latvia	9.5
Slovenia	18.2	Austria	8.4
Belarus	13.5	Luxembourg	6.9
Netherlands	12.8	Belgium	6.4
Germany	11.9	Spain	5.0
United Kingdom	11.4		

Red indicates non-euro area at time

Source: Bova et al. 2016


Greece
Spain
Cyprus
Ireland
Denmark
Portugal
Slovenia
Croatia
Bulgaria
Netherlands
Italy
Latvia
Iceland
Norway
Slovakia
Finland
Estonia
Lithuania
Belgium
Sweden
France
United Kingdom
Austria
Switzerland
Romania
Poland
Czech Republic
Luxembourg
Germany
Hungary
FYROM
Turkey
Malta
0
-2
-4
-6
-8
-10
-12
-14
-16
Peak to trough
Peak to latest
Fall in % employed from 2007 peak
European countries, percentage points
Source: Eurostat. latest=2014Q2


Total Employment Levels (2007=100)
106
103
100
97
94
2004
2006
2008
2010
2012
2014F
Euro Area
EU Non-Euro Area
Germany

B: Design flaws 1: euro as a capital flow volatility amplifier

- Pre-crisis ease of borrowing in euro?
  - e.g. acceptability of GR debt as collateral
  - But rapid growth in financialization was widespread – almost as easy to borrow in FX as in local currency
- Inability to depreciate currency
  - The decades-long practice of meeting difficulties with currency depreciation no longer available
  - Yet, given structural weaknesses and resilience of *real* wages hard to see that currency depreciation provides much of a medium-term solution

B: Design flaws 2

- Brittle currency arrangement/commitment device?
  - Old fixed but adjustable exchange rate systems had "safety valve" of devaluation.
  - Legal construct of single currency created large break-ip costs as "commitment device"
  - Design of euro was robust to moderate shocks, not so much to large shocks
- Preclusion of cross-border transfers results in vulnerabilities?
  - The no-bail-out rule means that economic and financial power of EU constrained in dealing with crises
  - Result is uncertainty that feeds back onto un-stressed member countries

C: Flawed management 1

- Pre-crisis neglect of emerging national imbalances?
  - EU macro policy focused on new construct: euro area
  - National policymakers no longer concerned with macro
- Post-crisis fiscal and monetary policy could have been more aggressive
  - Though much was done

Long-term bond yield euro area (Germany) vs dollar area (US) mid-2007- early 2017

C: Flawed management 2

Handling of unsustainable debt:

- Implicit cross-country guarantees not honoured…
  - Scale of capital flows had been based on assumption of implicit backing of euro area as a whole.
  - Investors shocked when restructuring of GR and other official debts became a possibility.
- ...or ill-advisedly *partly* honoured?
  - On the other hand, **prompt** restructuring of unsustainable GR debt (consistent with no-bail-out rule) would have avoided build-up of intractable official debt.

This is the big question! Is it the no-bailout rule or its imperfect application that is the problem?

Some commonalities and differences across major international crises

	LAC (1982)	EMS (1992)	EA (1998)	SF (2008)	Euro (2010)	Other GFC
				GFC		
Debt accumulation	✓	✗	✓	✓	✓	✓
Exchange rate issues	✓	✓	✓	✗	✗	✓
Sovereign debt restructuring	✓	✗	✗	✗	GR	✗
Socialization of private debt	✓	✗	✓	✗	✓	✓
Depositor losses (nominal)	CL	✗	TH	✗	CY	✗
Depositor losses from inflation	✓	✓	✓	✗	✗	✗

Source: Based on IMF WPs by Laeven and Valenzia; Das et al.

Conclusion

- The euro area crisis should be seen as one strand of the GFC
- Its cross-country incidence reflects differentially inadequate pre-crisis prevention measures (macro-fiscal and prudential)
- Some elements, including average severity and protracted nature reflect the brittle nature of the single currency under existential pressure of exceptional shock
- And poor handling of unsustainable debt of GR
- Insufficient political solidarity across member states → EU's full economic strength was not deployed