

# Crisis in the EU

- The current euro crisis is considered by many observers as a crisis of government deficits and debt.
- Public debt has been caused by lack of budgetary discipline
- Governments have spent money they did not have
- Budget discipline must be imposed and austerity policies (lower social expenditures, lower wages and higher tax) need to be implemented

- New Fiscal Pact (early 2012)
  - Debt brake (total public debt stock cannot exceed 60 percent of GDP and this condition is to be a part of national constitution)
  - Limited budget deficit
  - The motivation is to impose discipline upon the governments regarding fiscal policies
  - However, the same policy targets have already been around since 1997! (Growth and Stability Pact)
  - The question arises as to why the EU has been obsessed with all these limits on fiscal policy since the start of monetary integration

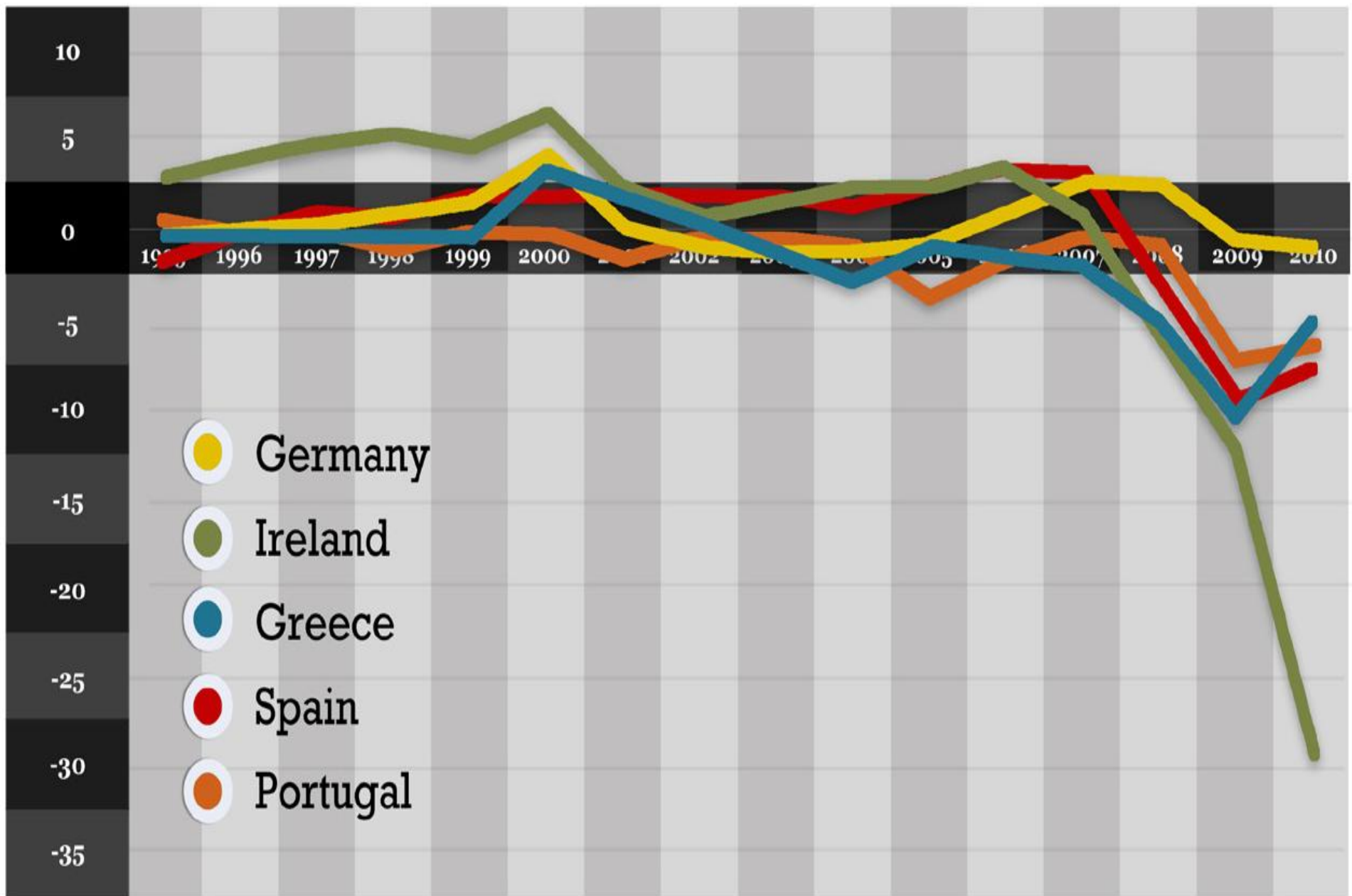
- Euro is a currency to facilitate trade and financial flows among member countries.
  - No exchange rate related risk
- Euro is also considered a world money.
  - It should be accepted as a reserve money by other country groups
- A stable and strong Euro turns out to be the underlying basis of current stage of European economic integration
- Economic policies (monetary and fiscal) in Europe have been designed accordingly

# European Central Bank and European Monetary policy

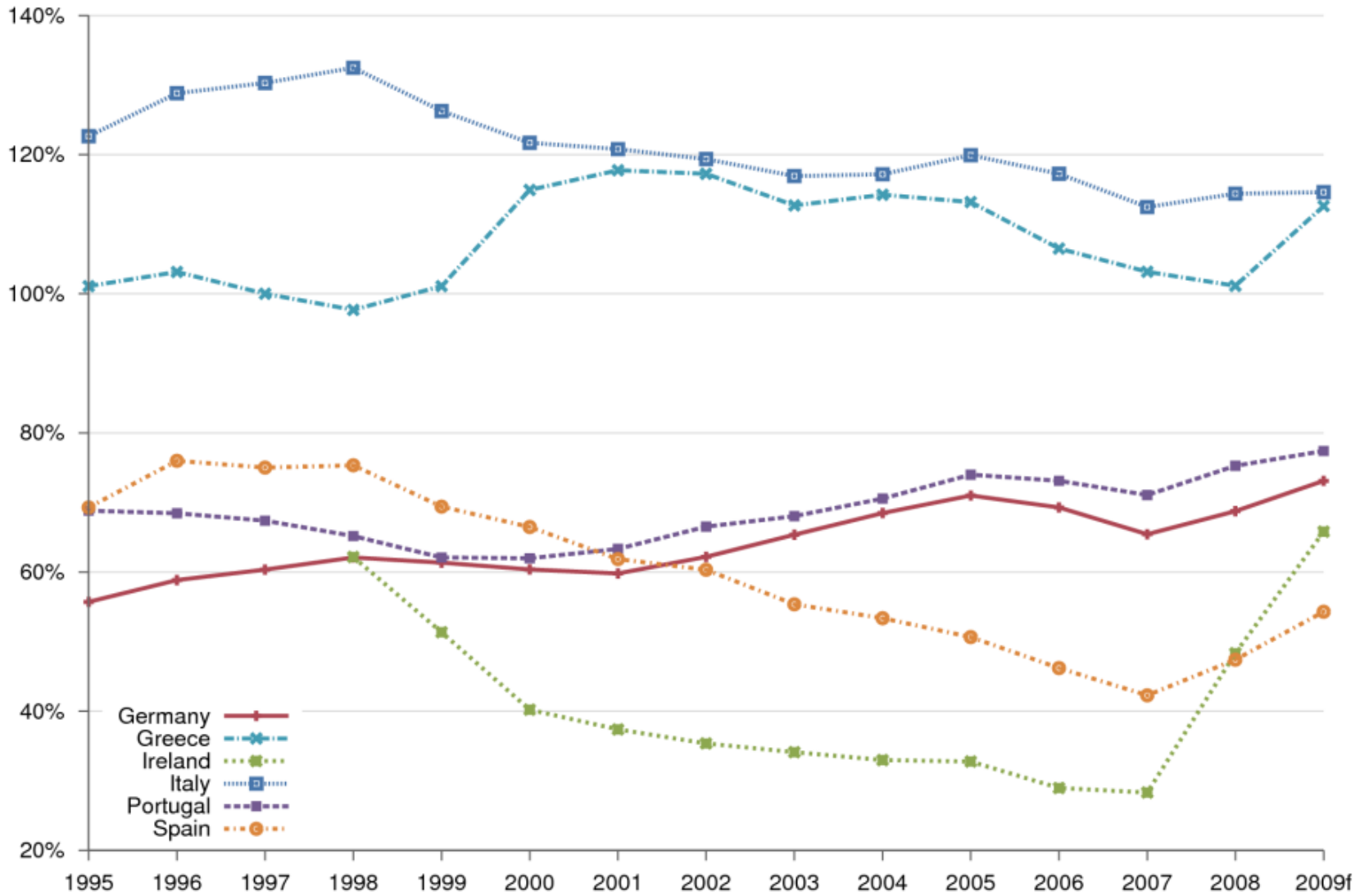
- The ECB was established on 1 June 1998 as the central bank in charge of the single European Currency.
- The primary objective of the European Central Bank is to maintain price stability within the Eurozone, which is the same as keeping inflation low.
- Its main instrument to conduct monetary policy is the short-term interest rate (e.g. Open market operations and repurchasing agreements to change the liquidity)
- Given that the only objective is low inflation, the ECB has a biased policy in favor of price stability rather than full employment
- The ECB is the most independent central bank in the world

- Fiscal policy was shaped by the Growth and Stability Pact, but responsibility for compliance was left to each sovereign state.
  - During the 2000s it relied on the Growth and Stability Pact which stipulated limits for budget deficits and the aggregate national debt (3% and 60% of GDP, respectively)
  - These limits imply that the fiscal policy should be submitted to low inflation policy
  - Rising budget deficit implies loose control and implies danger for Euro as a stable currency
- If there is a common shock to the system, monetary policy has to shoulder the whole burden (lower interest rate to provide the markets with liquidity but no active fiscal policy to deal with low demand)

**Fig. 6 - Government primary balances**

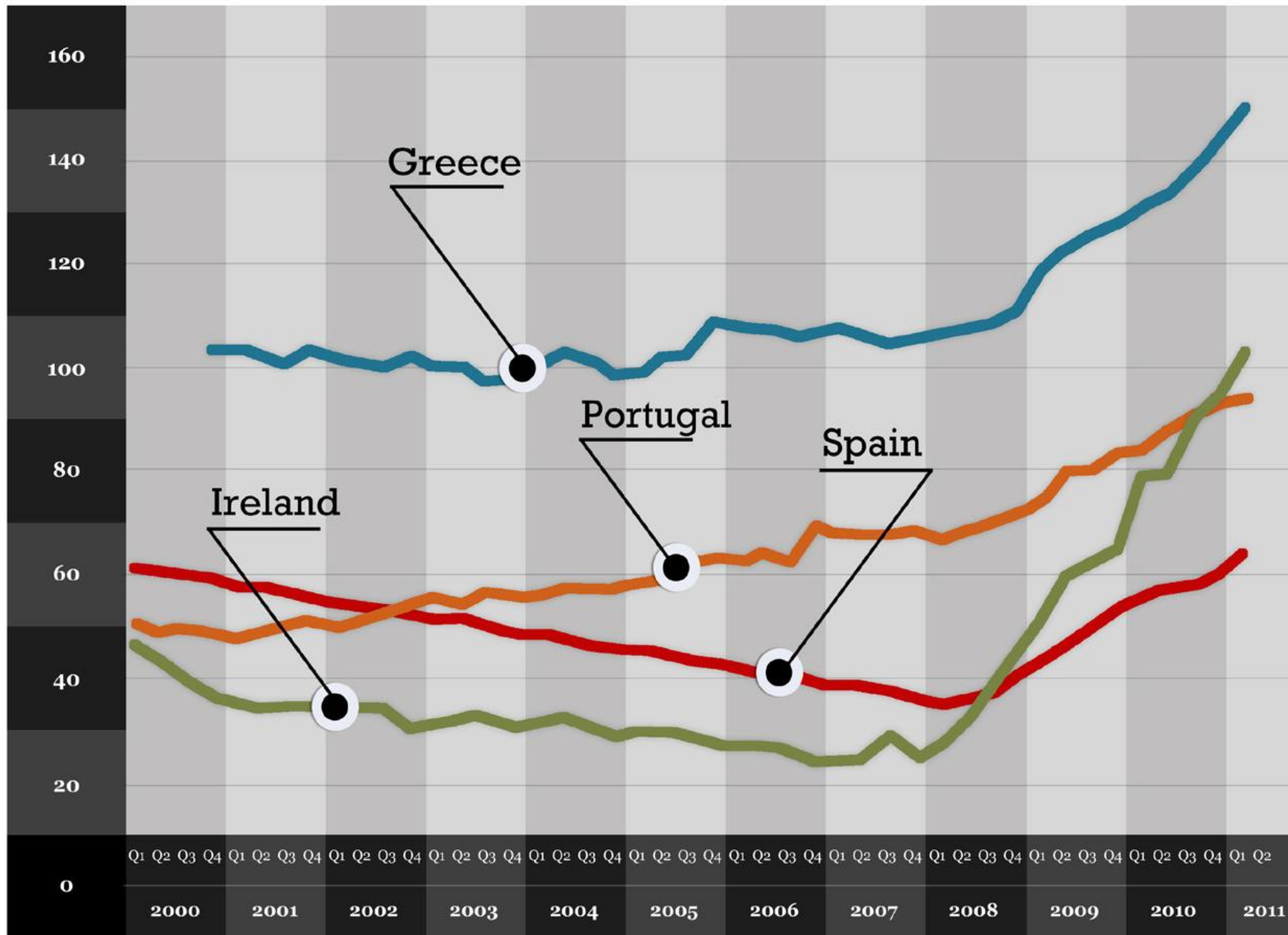


# Public debt





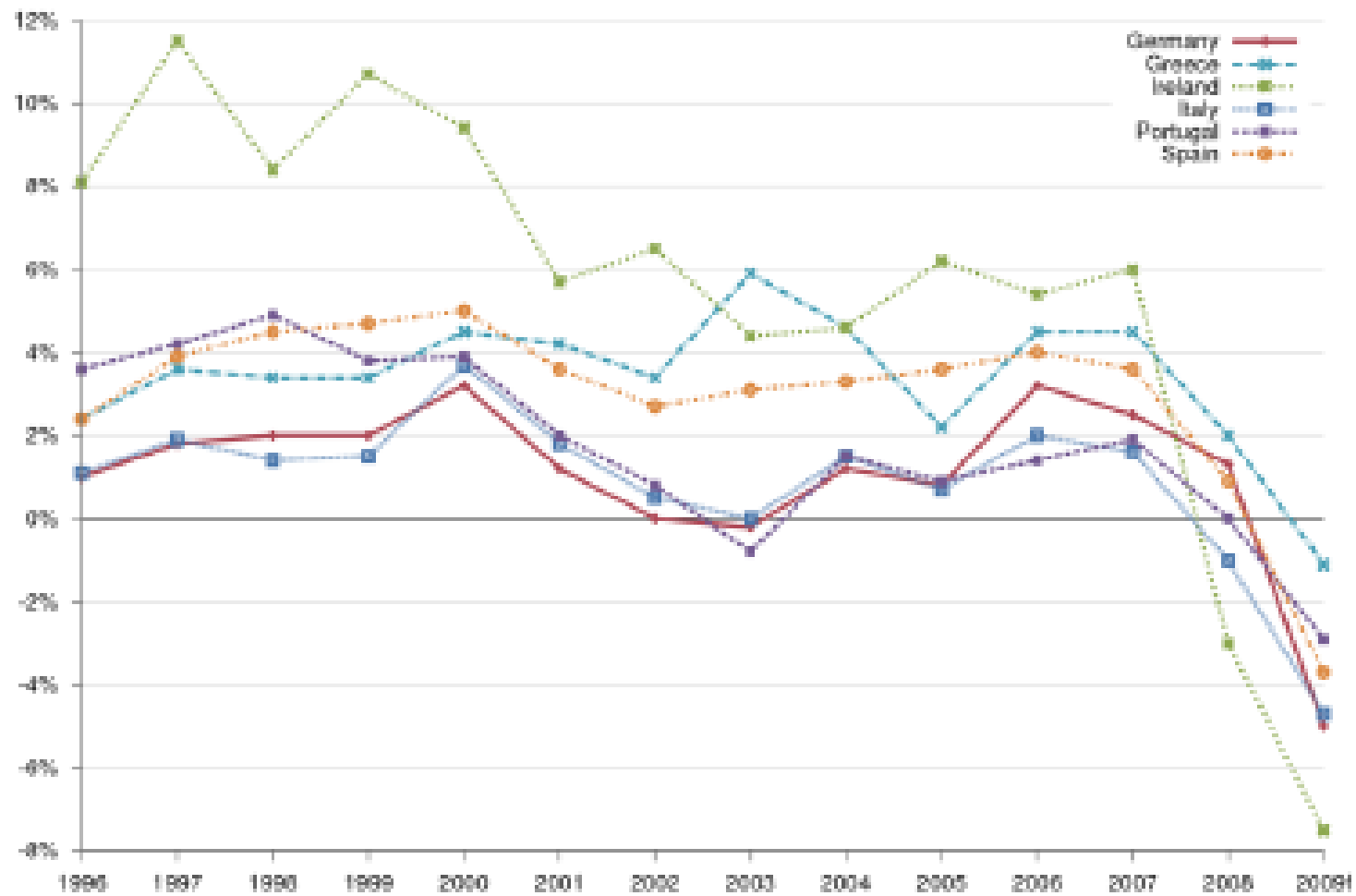
**Fig. 9** - Ratio of public debt to GDP in the periphery



Source: Eurostat

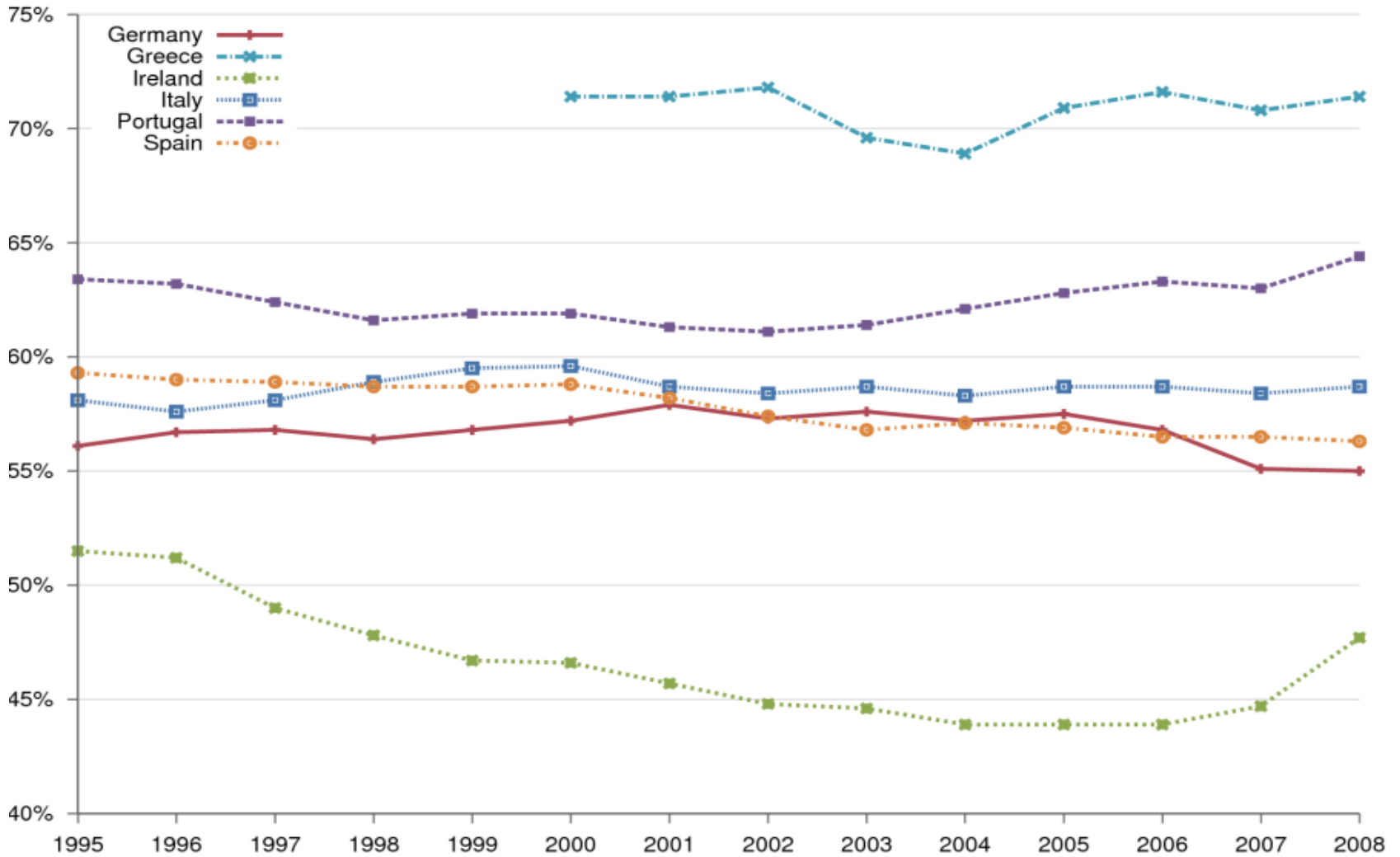
- Rising public debt stock/GDP ratios after 2007
  - the public debt jumped dramatically after governments had bailed out banks. According to official EU sources, 2.3 trillion Euro (= 19,5% of the EU-27 GDP in 2009) were spent in the EU to rescue the financial sector
  - the stimulus programs applied in order to mitigate the consequences caused a second and considerable increase in public expenditure.
- Can austerity policies be a solution?

**Fig. 1 GDP Growth Rates**

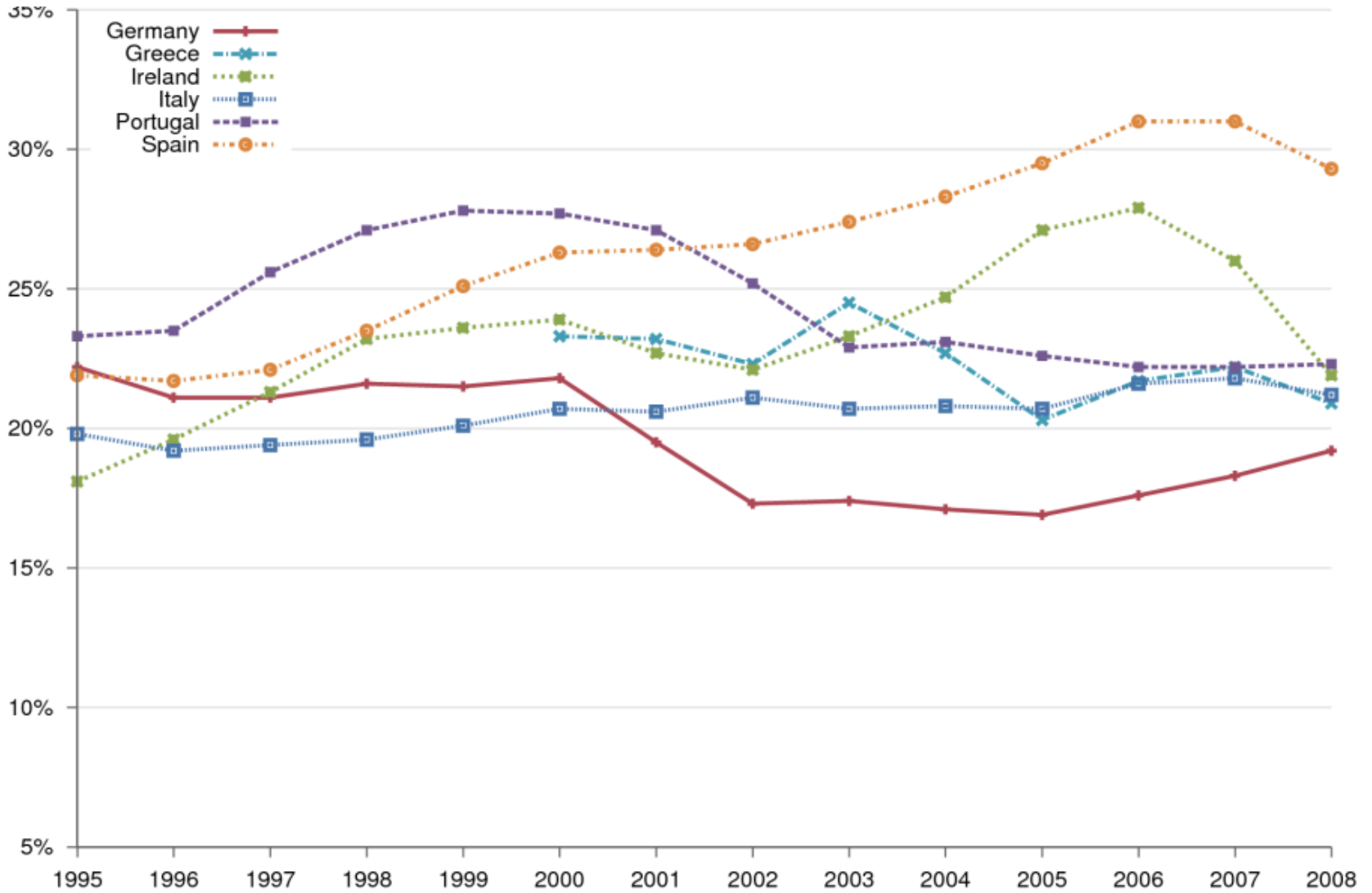


Source: Eurostat

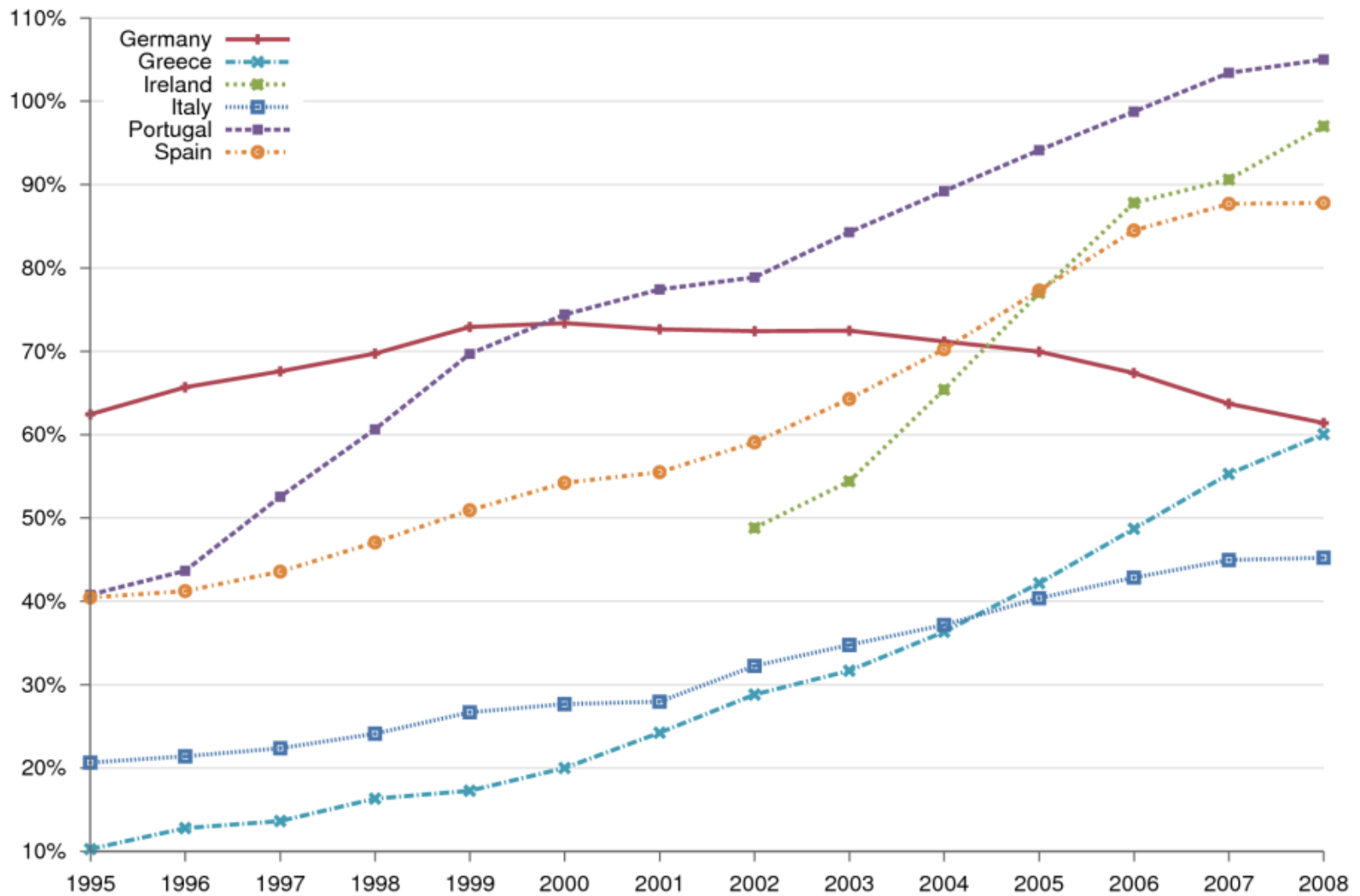
# Consumption



# Investment as a share of GDP

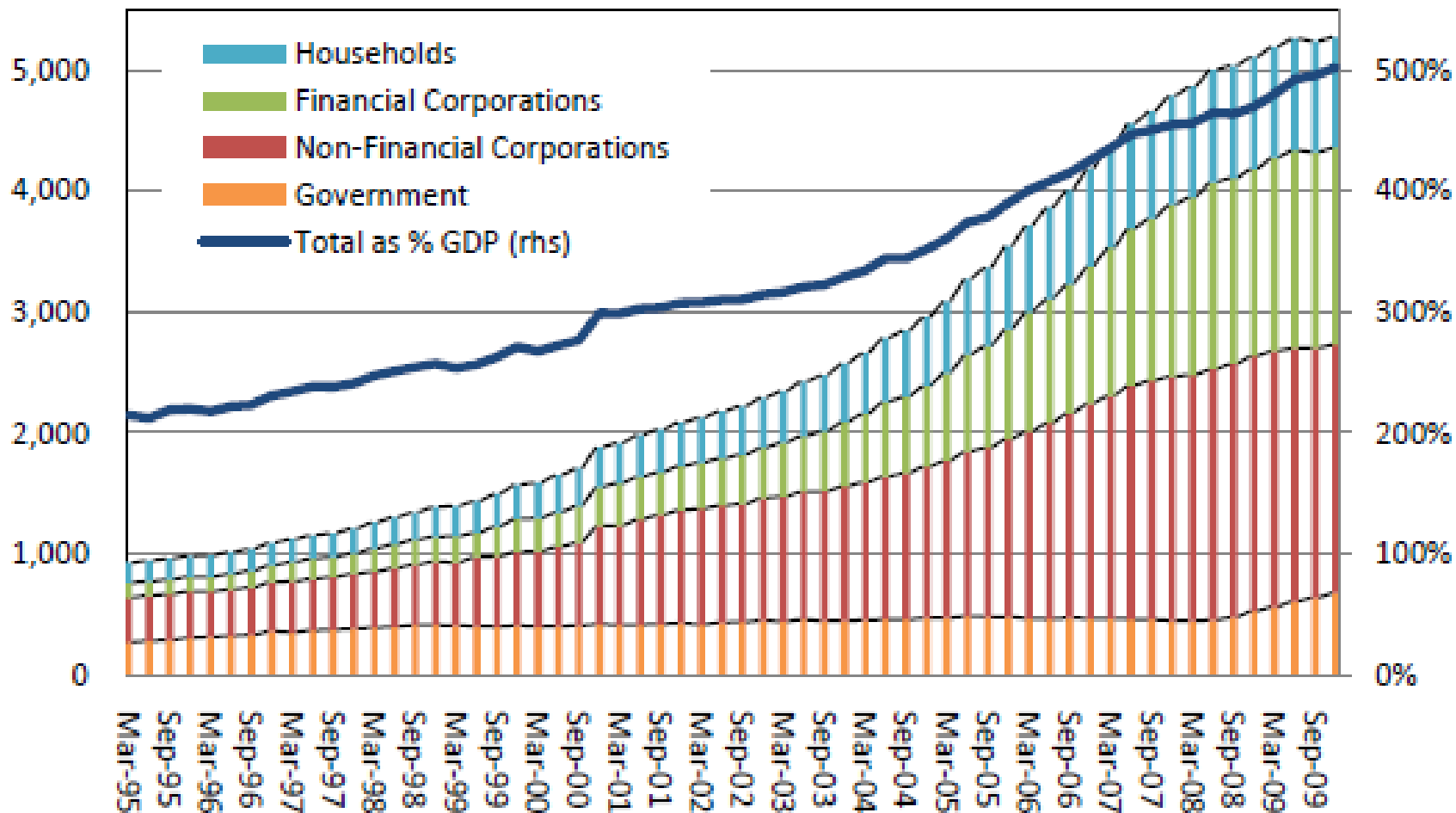


# Household debt



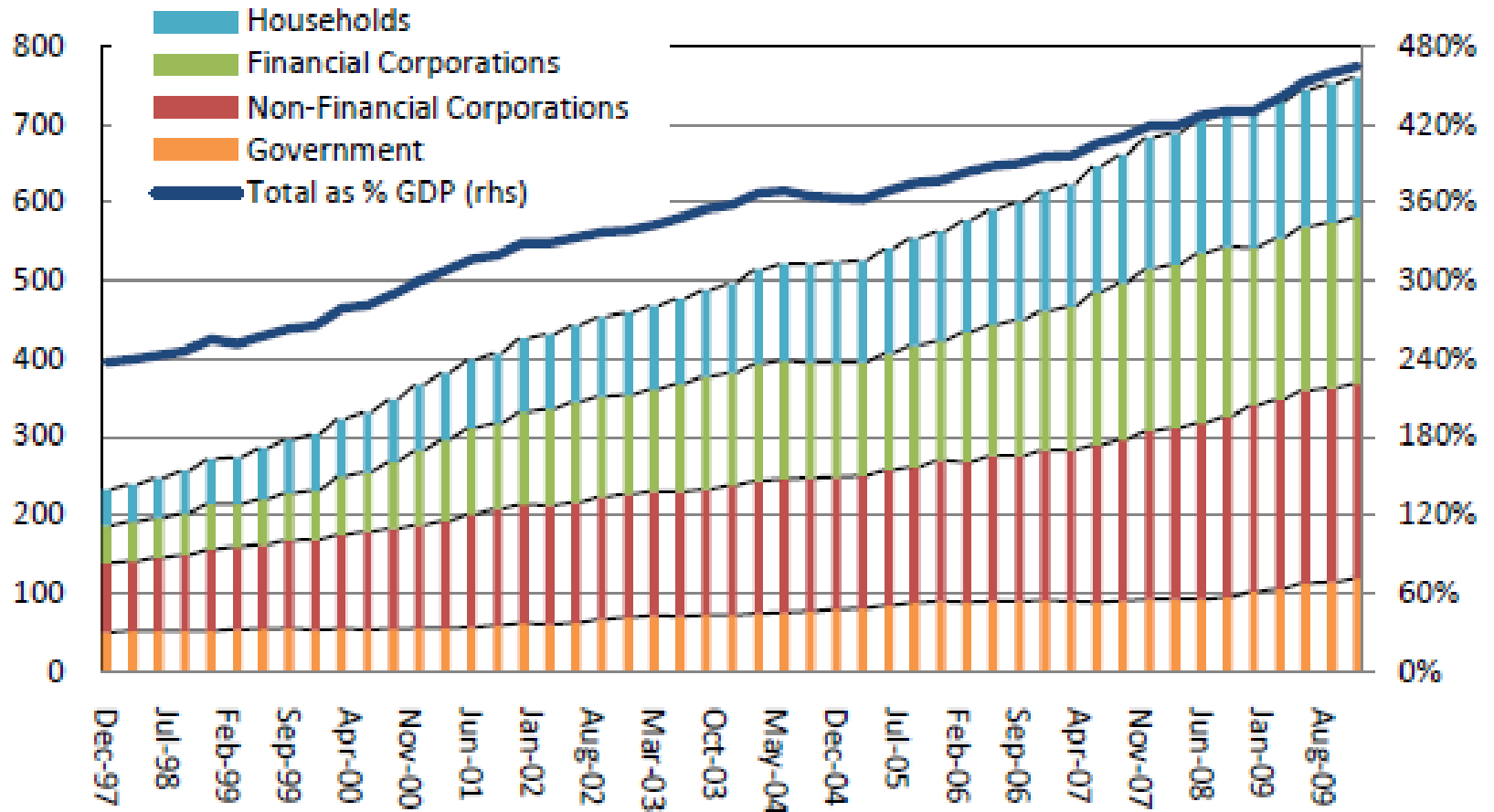
# Figure 10 Spanish debt by sector of issuer

(Euro bn)



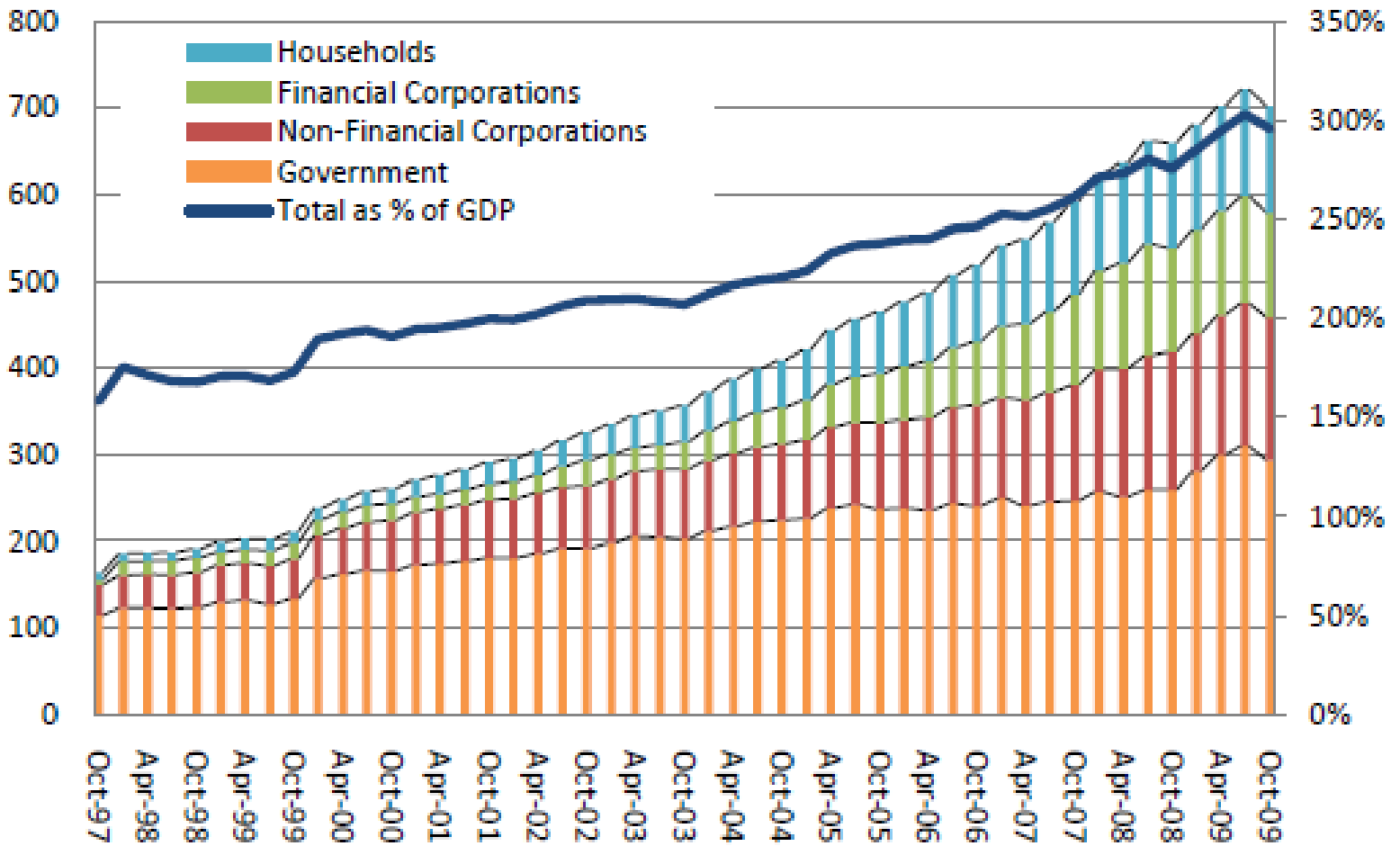
# Figure 12 Portuguese debt by sector of issuer

(Euro bn)

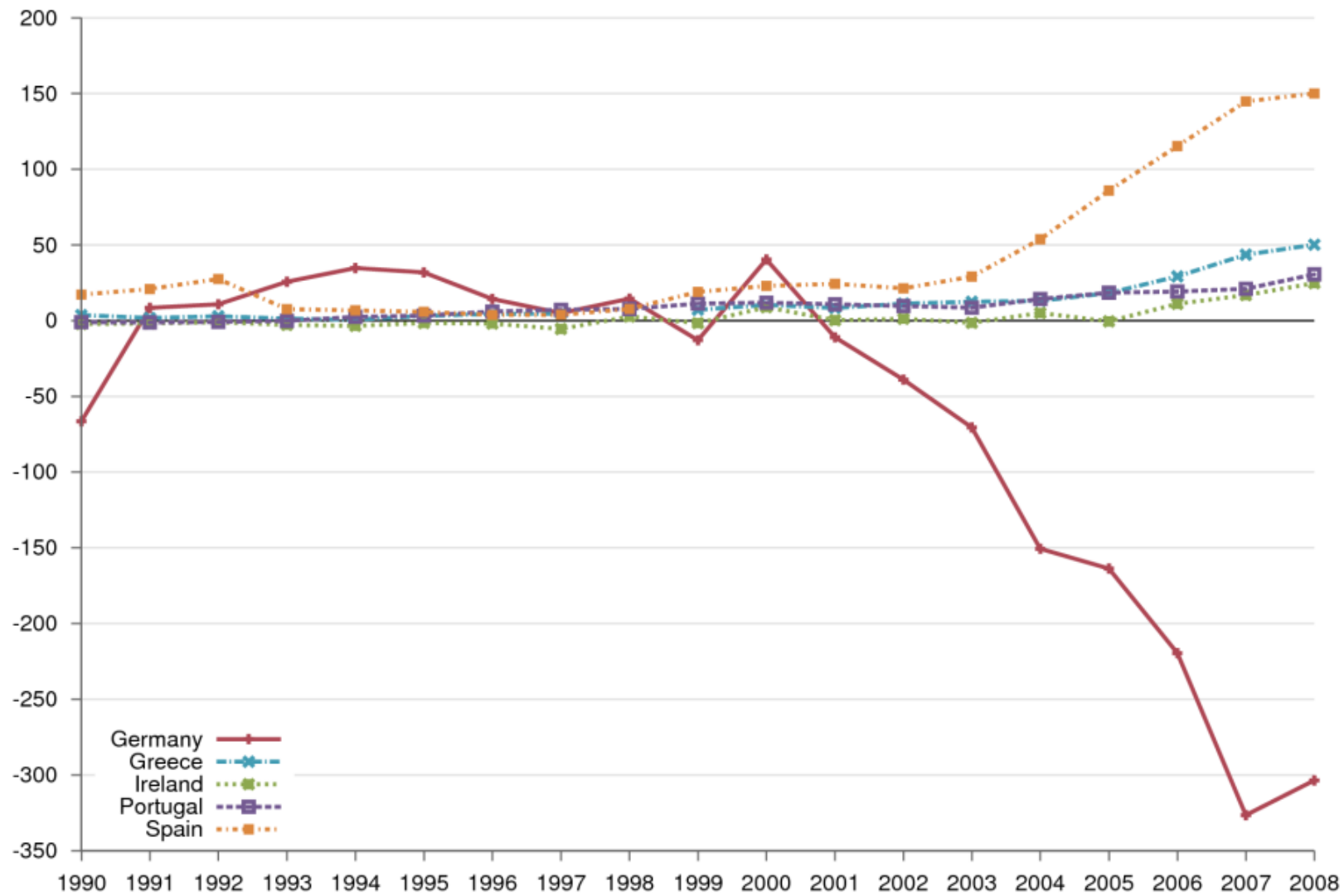




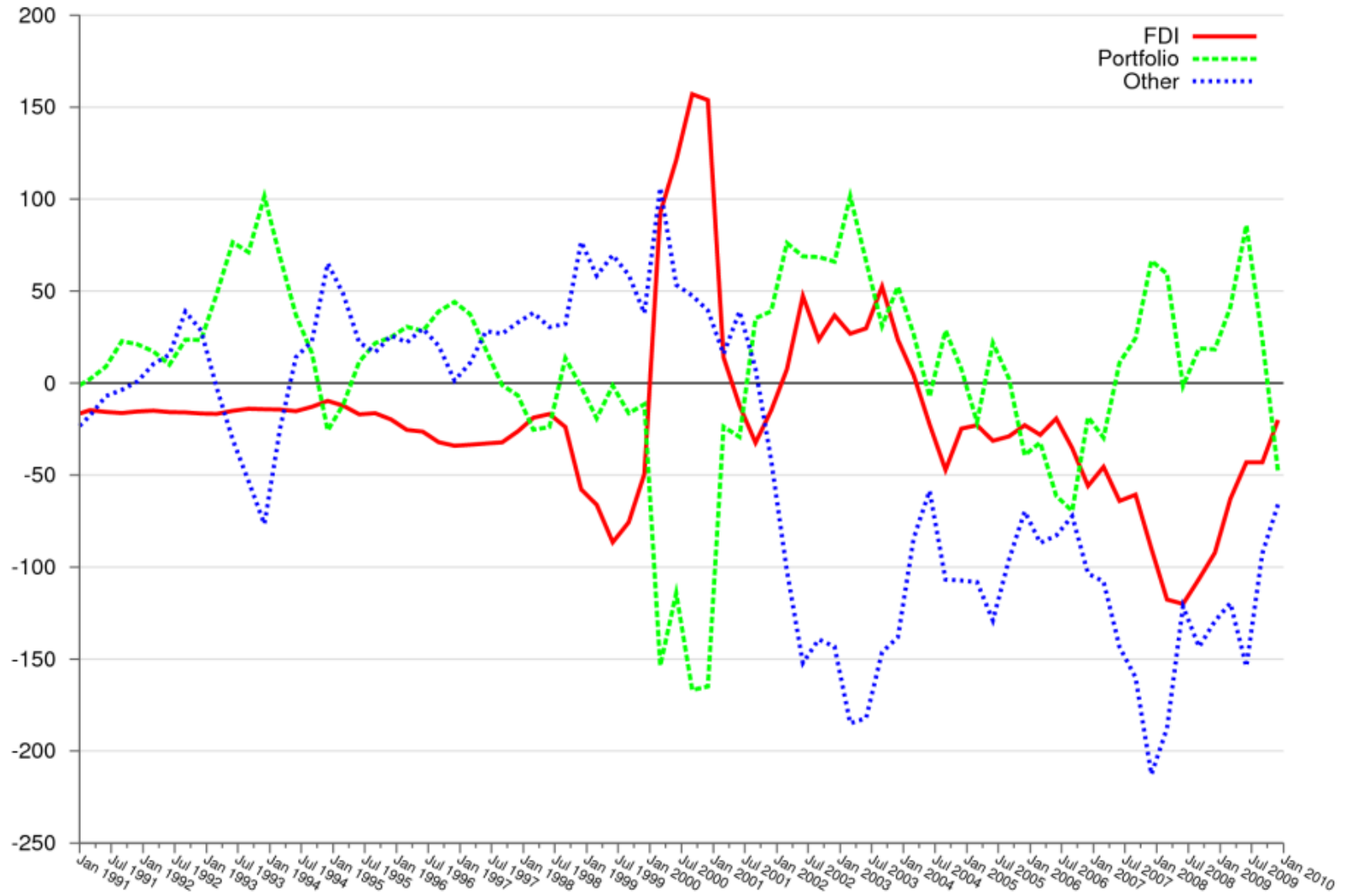
**Figure 14 Greek debt by sector of issuer**  
(Euro bn)



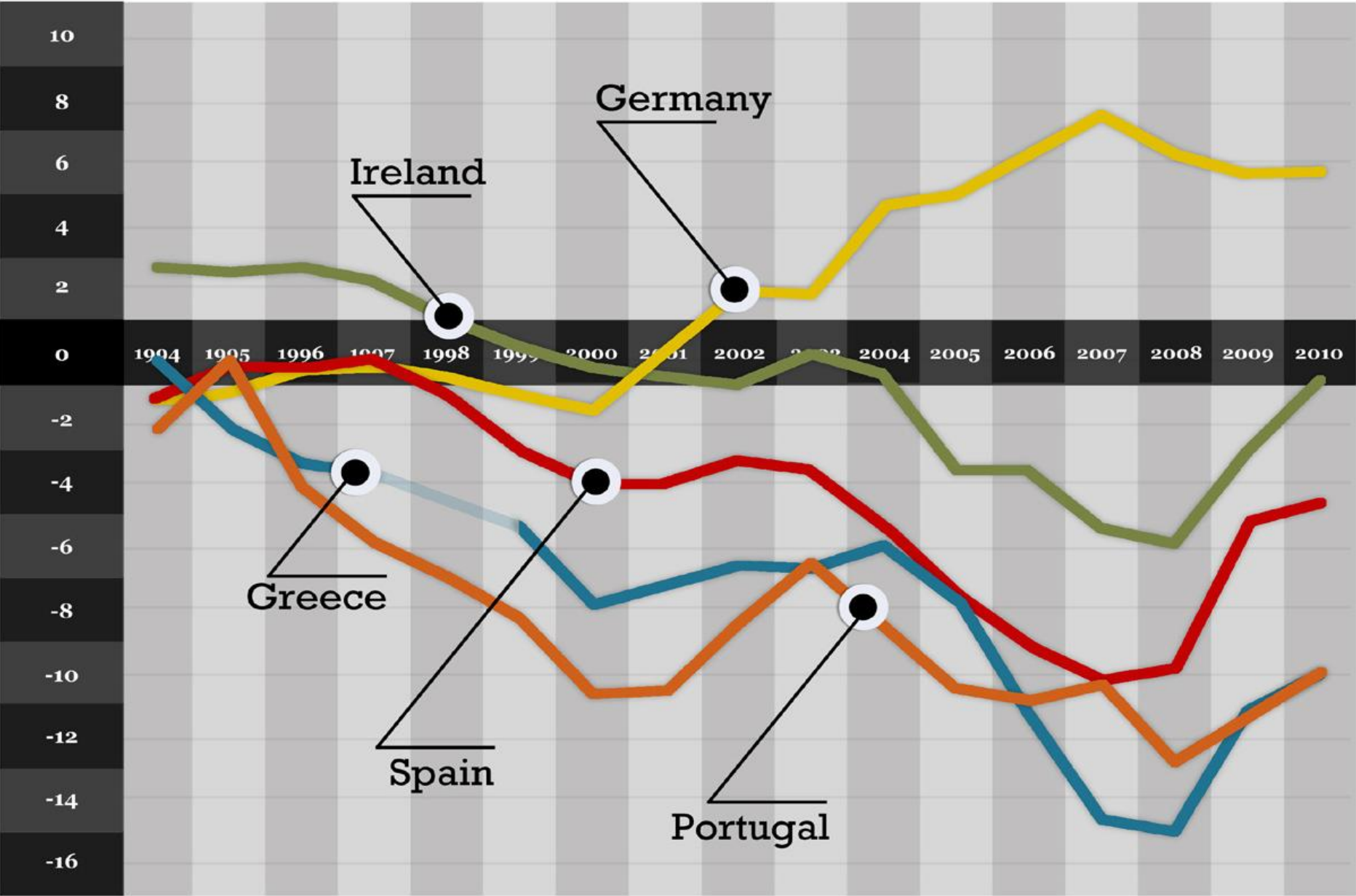
# Financial account



# German Financial Account

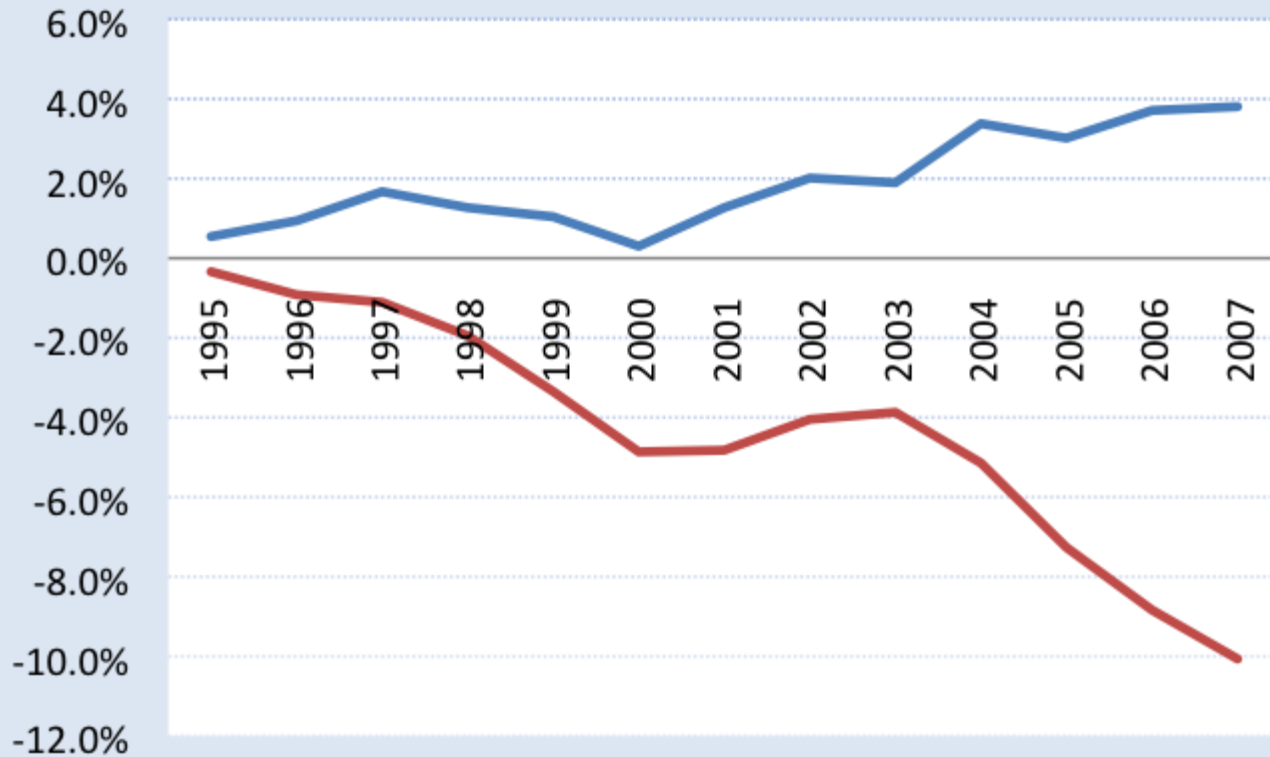


**Fig. 3 - Current account balances as % of GDP**



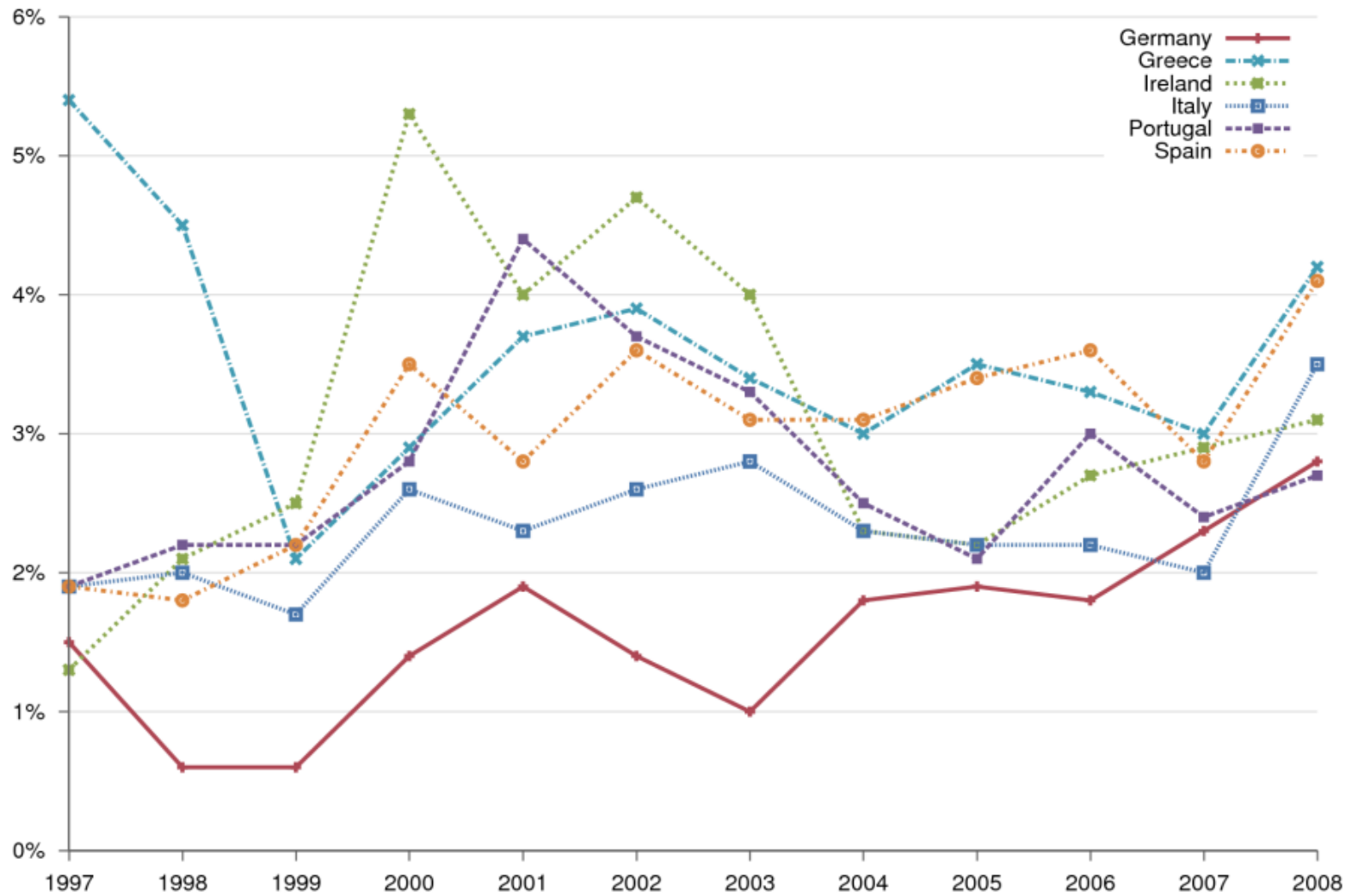
Source: BoPS Yearbook (BPM5)

**Current Account Balance as % of GDP, 1995-2007**

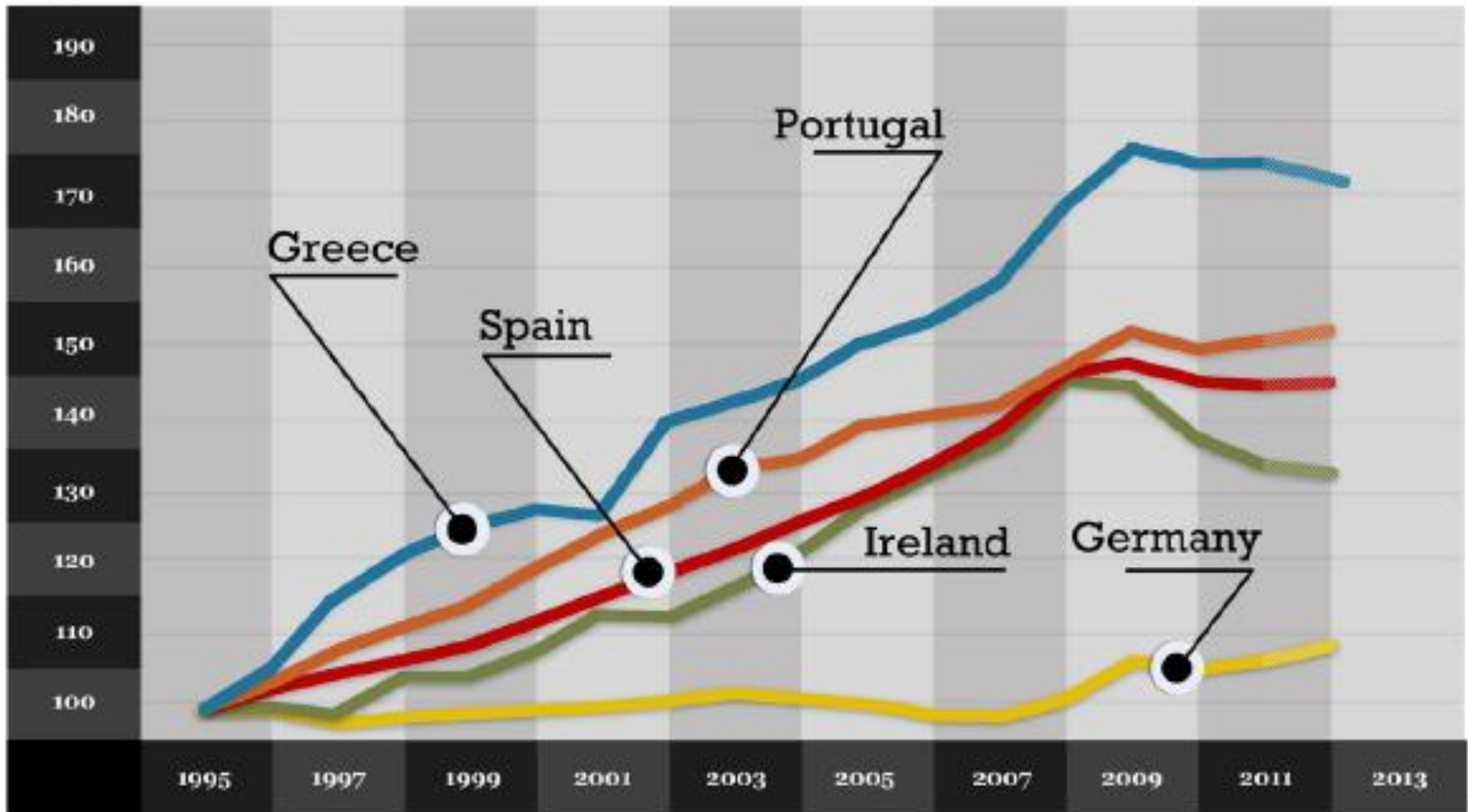


- Eurozone core (Germany, France, Austria, Finland, Benelux)
- Eurozone periphery (Greece, Ireland, Portugal, Spain)

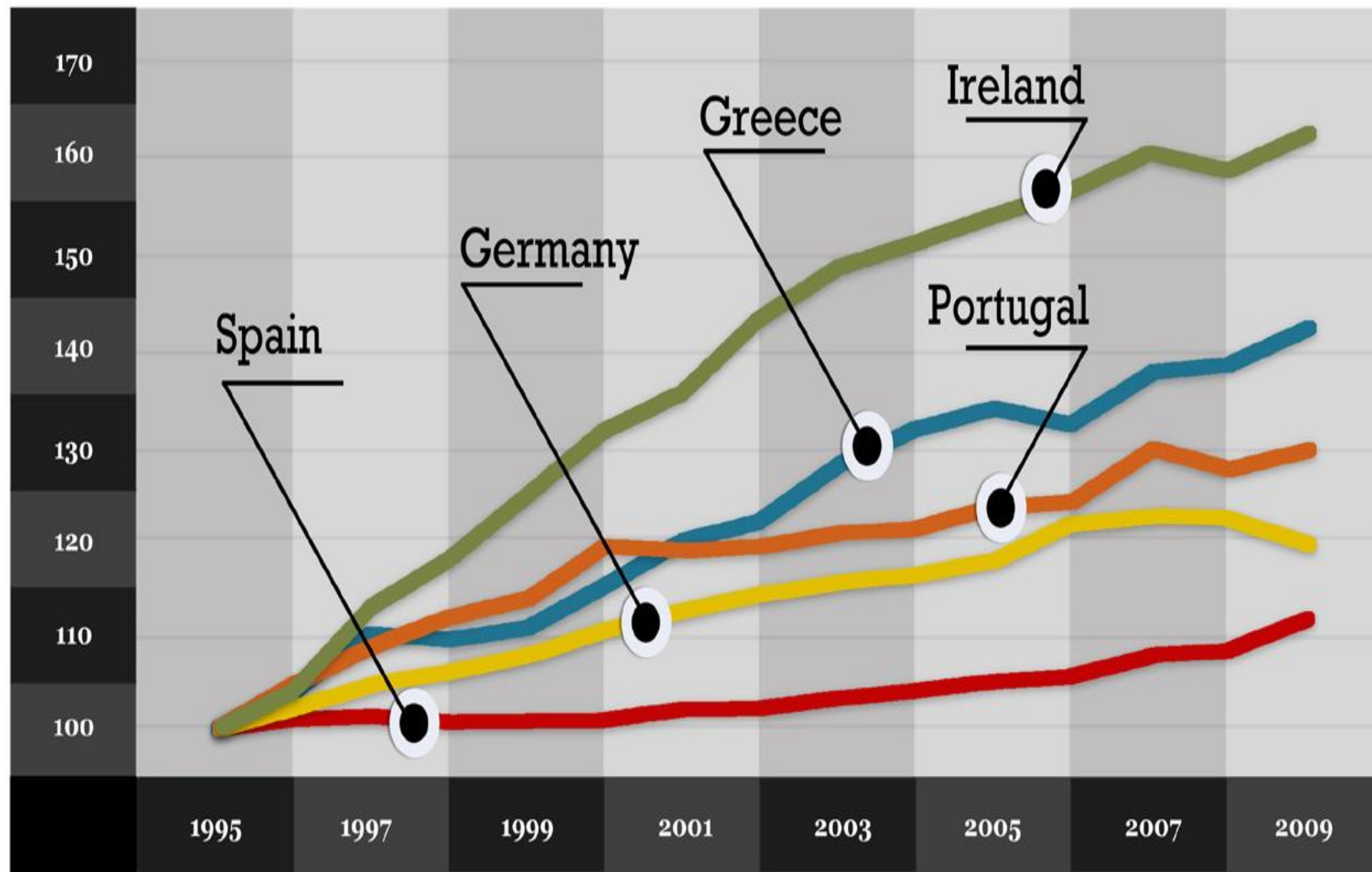
# Inflation



**Fig. 1** - Evolution of nominal unit labour costs



**Fig. 2 - Evolution of productivity growth**



Source: OECD



- It is worth stressing that German gains have resulted mostly from keeping the nominal cost of labour low, i.e., from applying severe wage restraint on German workers.
- Loss of competitiveness led to persistent current account deficits for the periphery, mirrored by equally persistent surpluses for the core, above all, Germany.
- How could Germany have avoided this?
  - Expansionary fiscal policies to stimulate domestic demand (not possible)
  - Lower real interest rates to raise consumption and real investment (given the same interest rate determined by the ECB and lowest inflation in Eurozone, Germany faced high real interest rates)

- Rising current account deficits in the periphery were financed by foreign lending, both private and public, which was easy for much of the 2000s as the ECB kept interest rates low.
- For a brief period cheap credit made peripheral membership of the Eurozone seem successful as rates of GDP growth were generally higher than the core.
- When the crisis of 2007 broke out, however, it became apparent that peripheral success lacked foundations, shown by the divergence in competitiveness.
- The periphery found itself enormously indebted, domestically and abroad, privately and publicly.

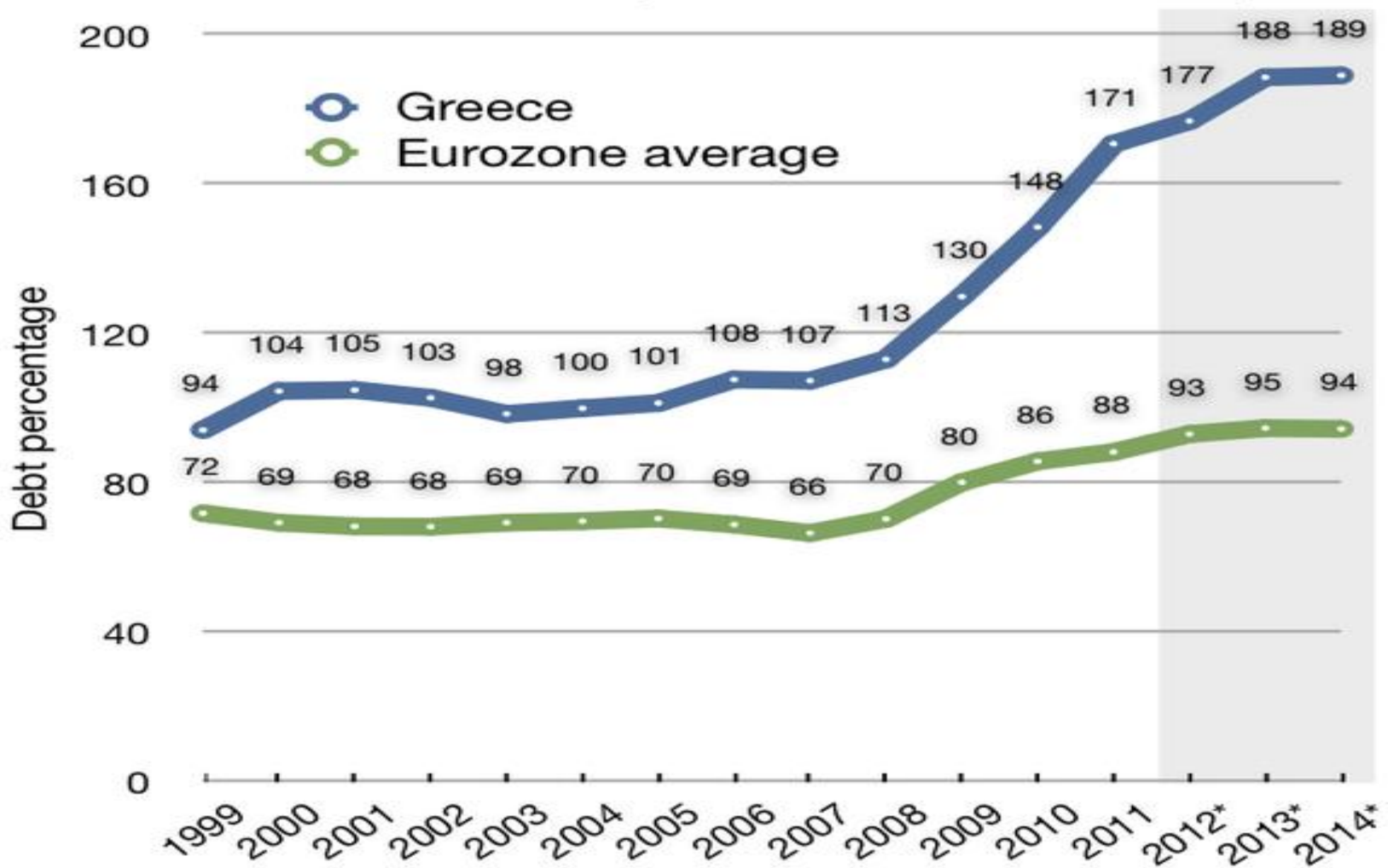
- The collapse of Lehman Brothers in 2008 led to recession in both the core and the periphery of the Eurozone as exports and investment fell. Eurozone states faced falling tax revenues, while attempting to support aggregate demand and to rescue banks. Rising budget deficits followed, the direct result of the crisis and not of state profligacy, even in Greece.
- Escalating budget deficits and unfolding recession led to rapid growth of sovereign debt in the periphery.

# Alternatives

- 1) Austerity
  - Cutting wages, reducing public spending and raising taxes, in the hope of reducing public borrowing requirements.
  - Austerity would probably have to be accompanied by new loans, or guarantees by core countries to bring down commercial borrowing rates.
  - It is likely that there would also be „structural reform“, including further labour market flexibility, tougher pension conditions, and privatisation of remaining public enterprises.

- Problems:
  - Shift of the burden mostly to the working people rather than to the banks
  - Social unrest due to high unemployment
  - Low growth rates based on austerity policies can lead to even higher public debt/GDP ratios.
  - The effect of austerity will be a further deterioration in the Greek economy, and thus a further deterioration in the debt ratio, which in turn requires further policy action of the same self-defeating kind.

## Greek debt compared to Eurozone average



Source: Eurostat  
\*estimates

## • 2) Reform in Eurozone

- Active fiscal policy
  - Abolition of growth and stability pact
- Coordinated wage policy
  - This can improve structural imbalances by enhancing domestic demand and limiting the need for foreign savings
- A European federal state, with an autonomous budget financed by levying its own taxes, would issue federal bonds in order to calm debt markets and undertake bank recapitalisations.
- In theory, it could also allow for European investment policies that might serve to lessen the chronic problems of competitiveness between core and periphery

- Eurobonds

- Debts issued in this way would be guaranteed jointly and severally, thus breaking with the underlying principle of individual sovereign responsibility.
- Eurobonds would entail higher borrowing rates for core countries, above all, for Germany. The higher creditworthiness of the core would act as a subsidy for the periphery
- Eurobond liability would ultimately rest on the public purse of core economies.
- Problems.
  - There is no centralized European state
  - If fiscal discipline was relaxed among member states, there would be a risk that the value of the euro would collapse in international markets.



# Alternatives

- 3) **DEFAULT** and stay
  - default entails rescheduling debt, that is, changing the term, the rate of interest and the face value of debt
  - Creditor-led (haircuts for the creditors) or
- Debtor-led
  - This would certainly mean cessation of payments of interest and principal on public debt, in the first instance. Negotiations with the lenders would then follow seeking final settlement that would involve the cancellation of a large part of the debt

# Alternatives

- Default and Exit from Euro
  - Depreciation of the new domestic currency
    - High inflation (given the high share of imported goods)
    - Problems for banks and non-financial corporations holding foreign liabilities (private foreign debt)
    - Higher competitiveness of export sector
  - Expansionary fiscal policies
  - Public management of financial funds