

What has been going on in the Eurozone since 2009?

Eurozone's dealing with the aftermath of the financial crisis

by

Helmut Wagner



EUSI-conference, Tokyo, December 2011

Content

A) Macroeconomic Development

- (1) Aggregate Outside View
- (2) Disaggregated Inside View

B) Policy Measures

- (1) Measures of Crisis Management
- (2) Assessment of the Crisis Policies
- (3) Strengthening of Governance on the European Level
- (4) Not(-yet)-Chosen Alternatives

C) Prospects of EU-Integration

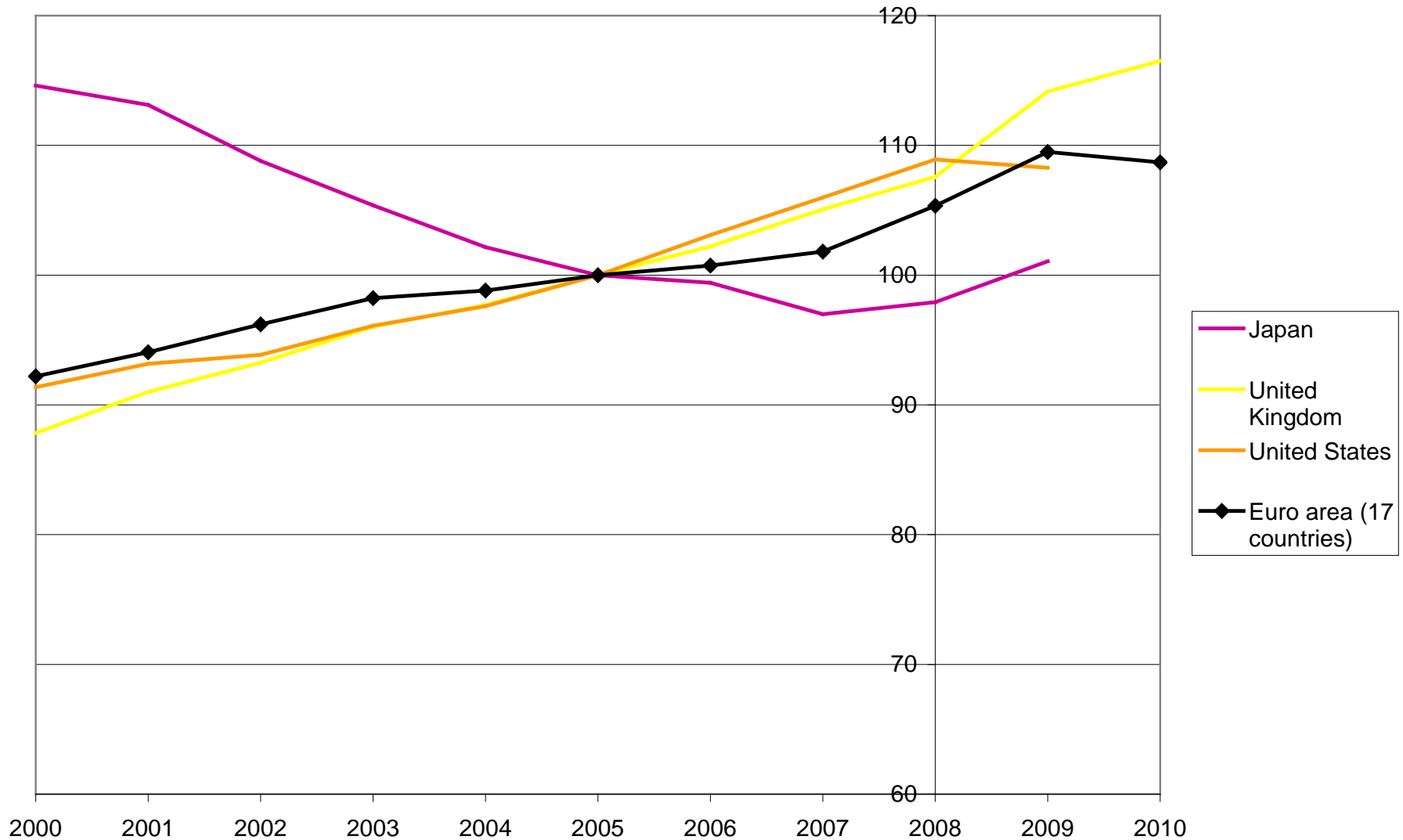
- (1) 3 Scenarios
- (2) Role of Convergence vs. Divergence

D) Conclusions

A) Macroeconomic Development

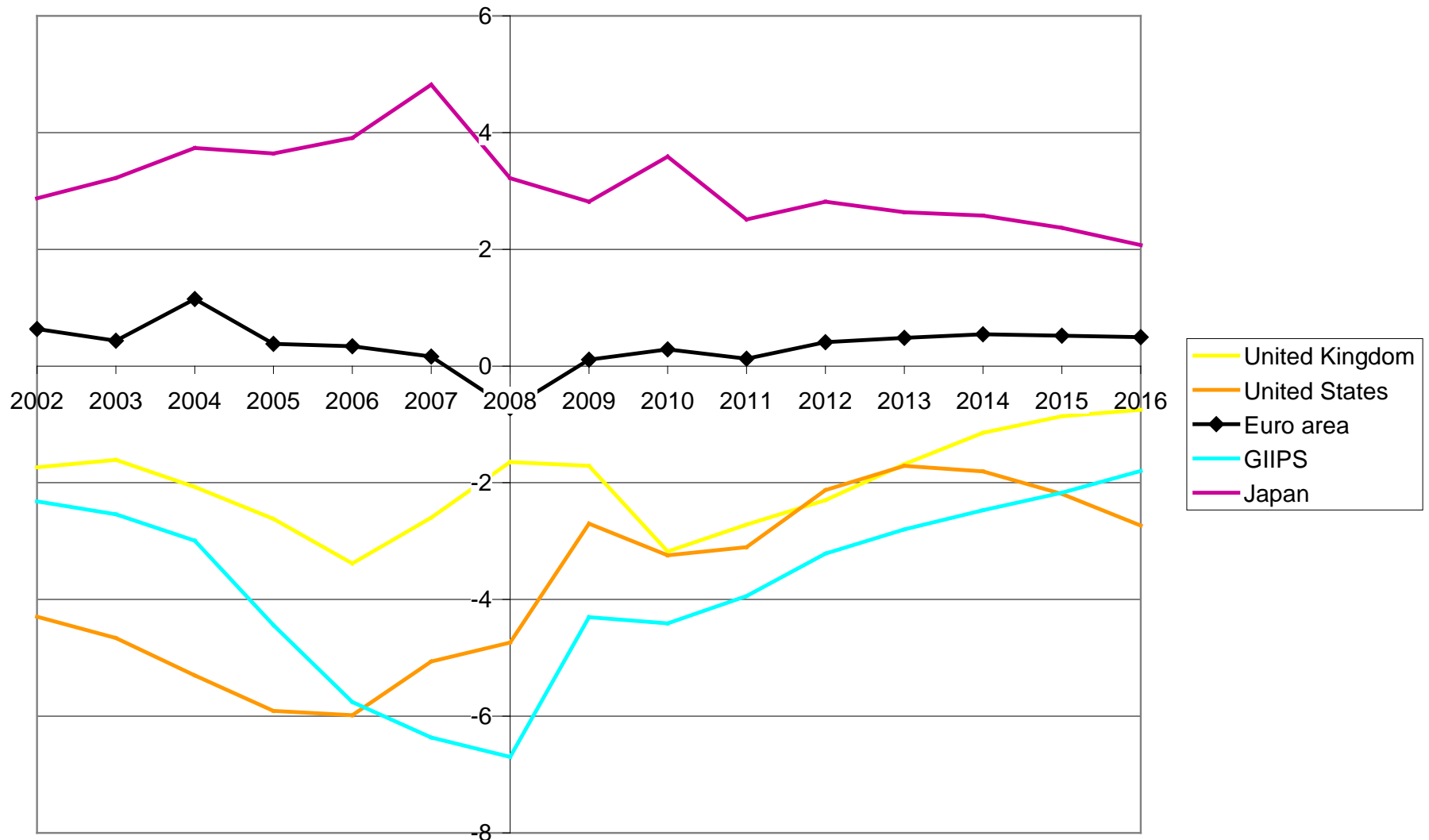
A) (1) Aggregate Outside View

Unit Labour Costs

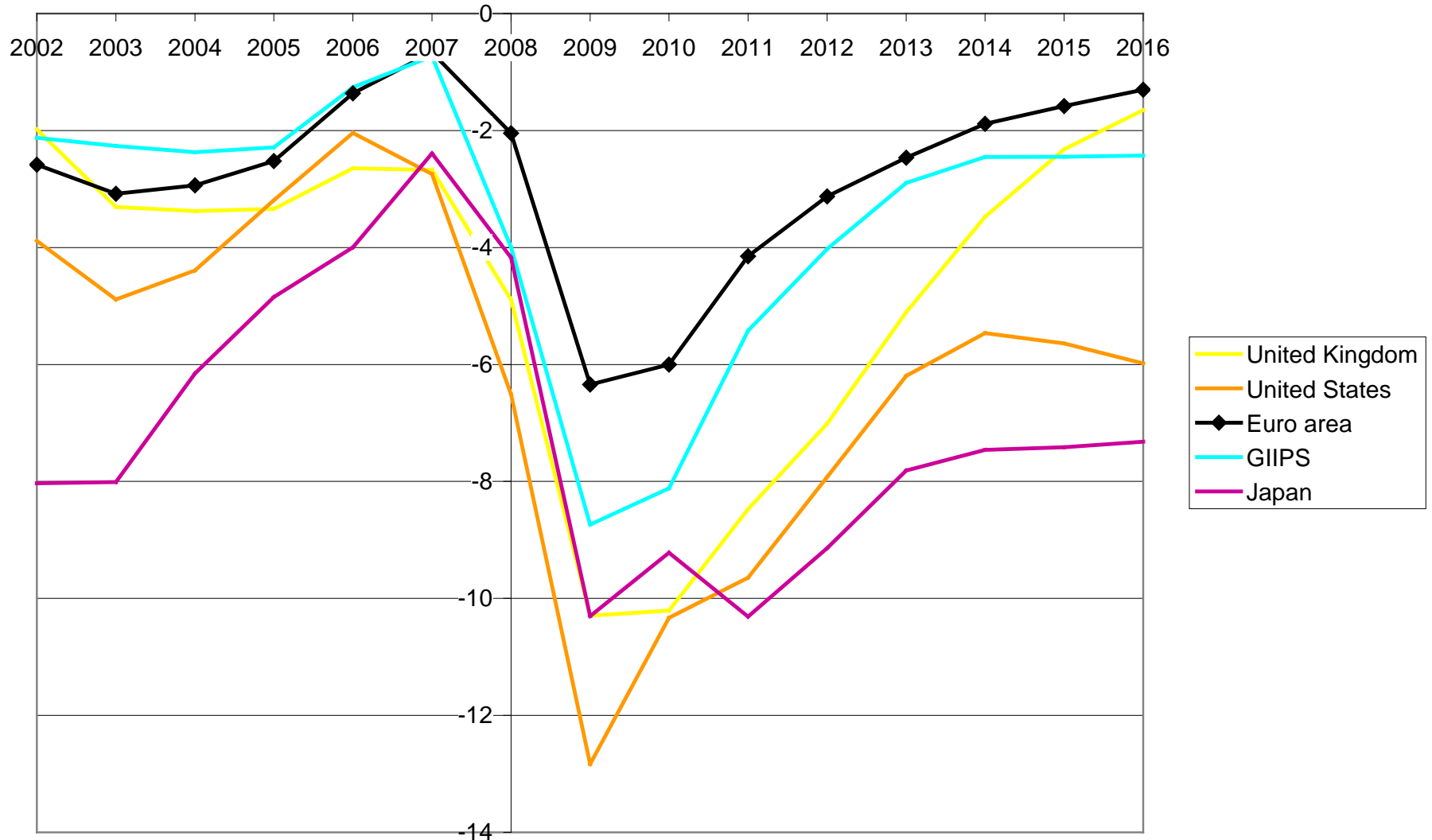


Unit labour costs (annual, total economy), index OECD base year (2005=100). Data source: OECD

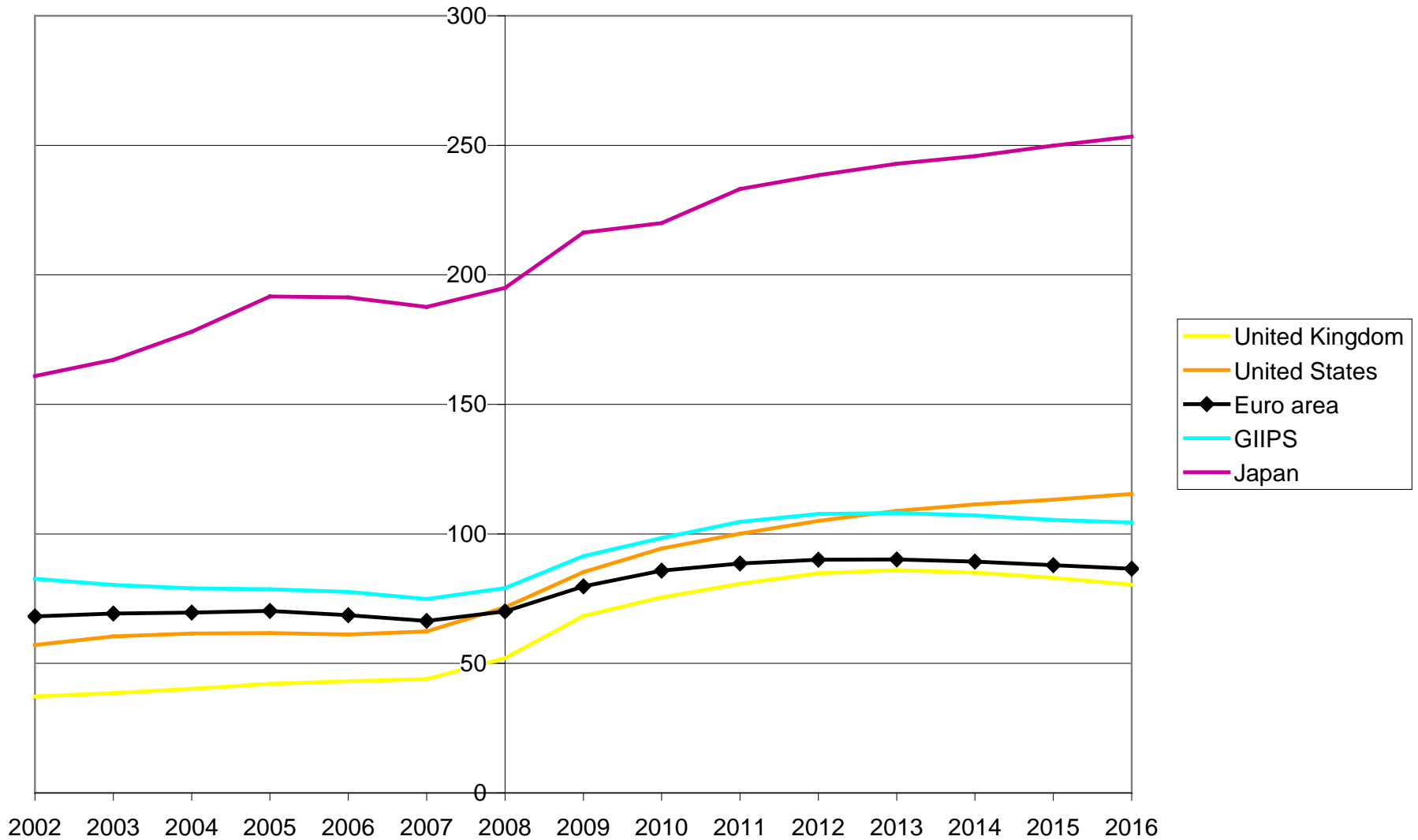
Current Account Balance



Government Deficit



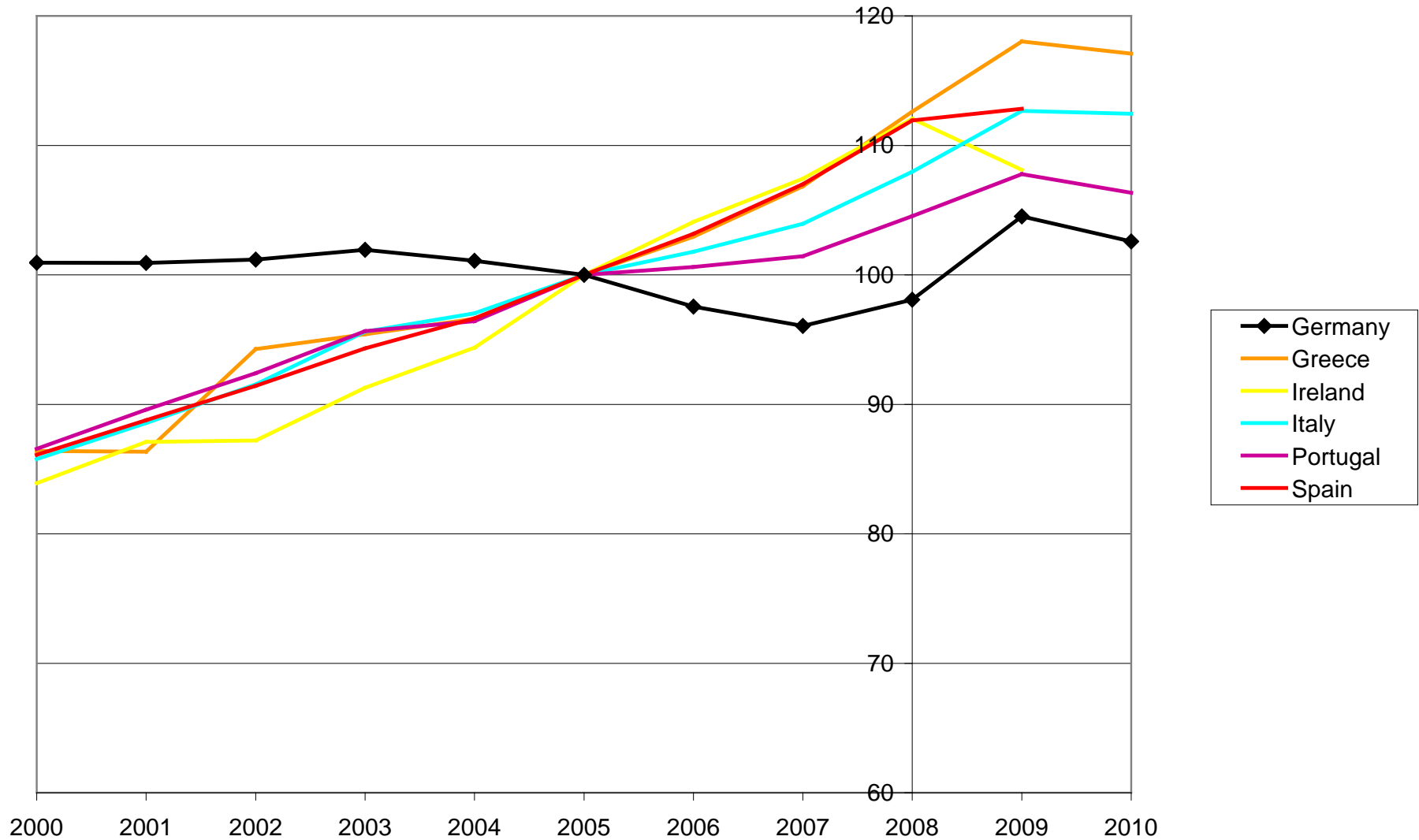
Government Debt



Government gross debt (% of GDP, annual, estimates start after 2010). Data source: WEO Database Oct2011

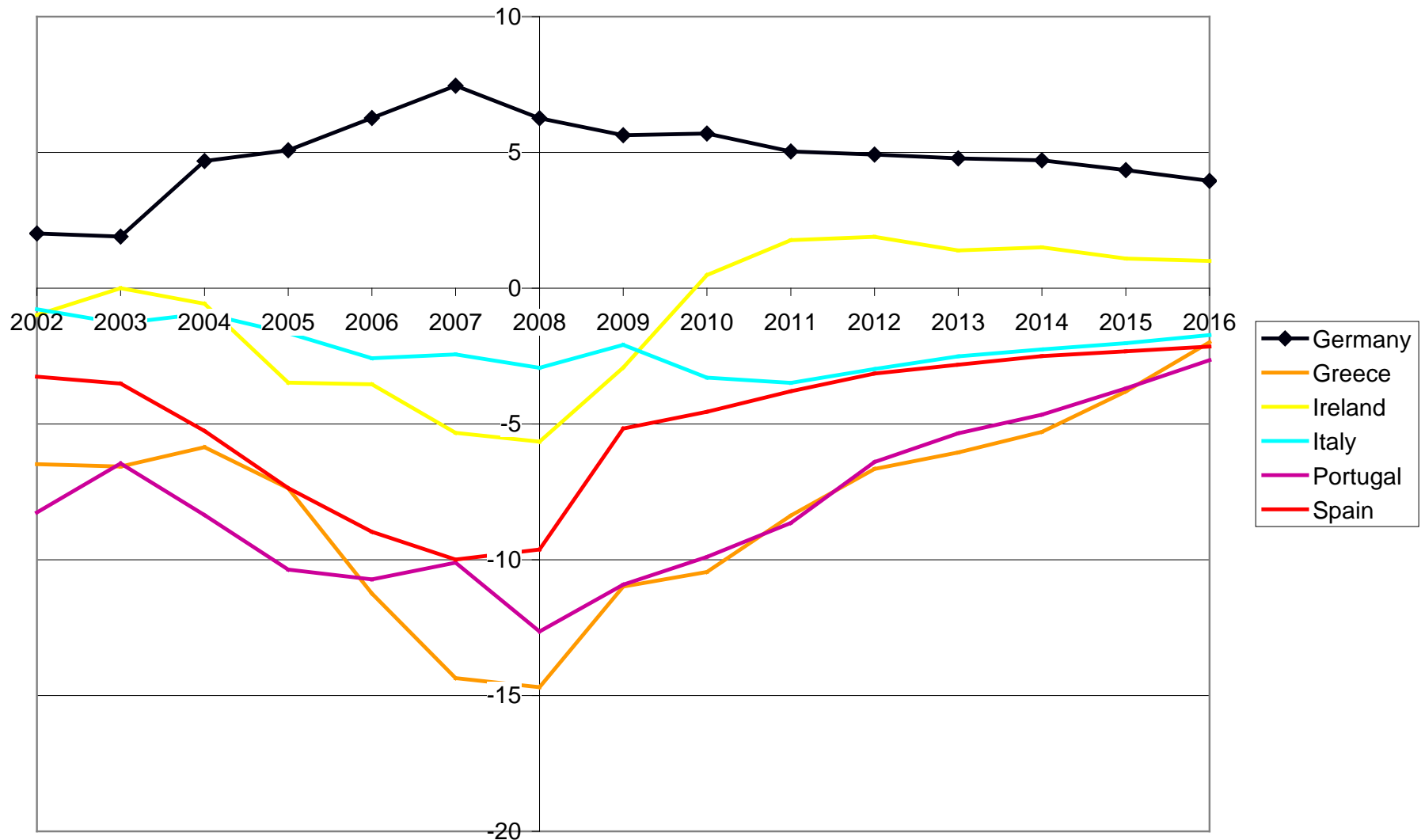
A) (2) Disaggregated Inside View

Unit Labour Costs: GIIPS and DE

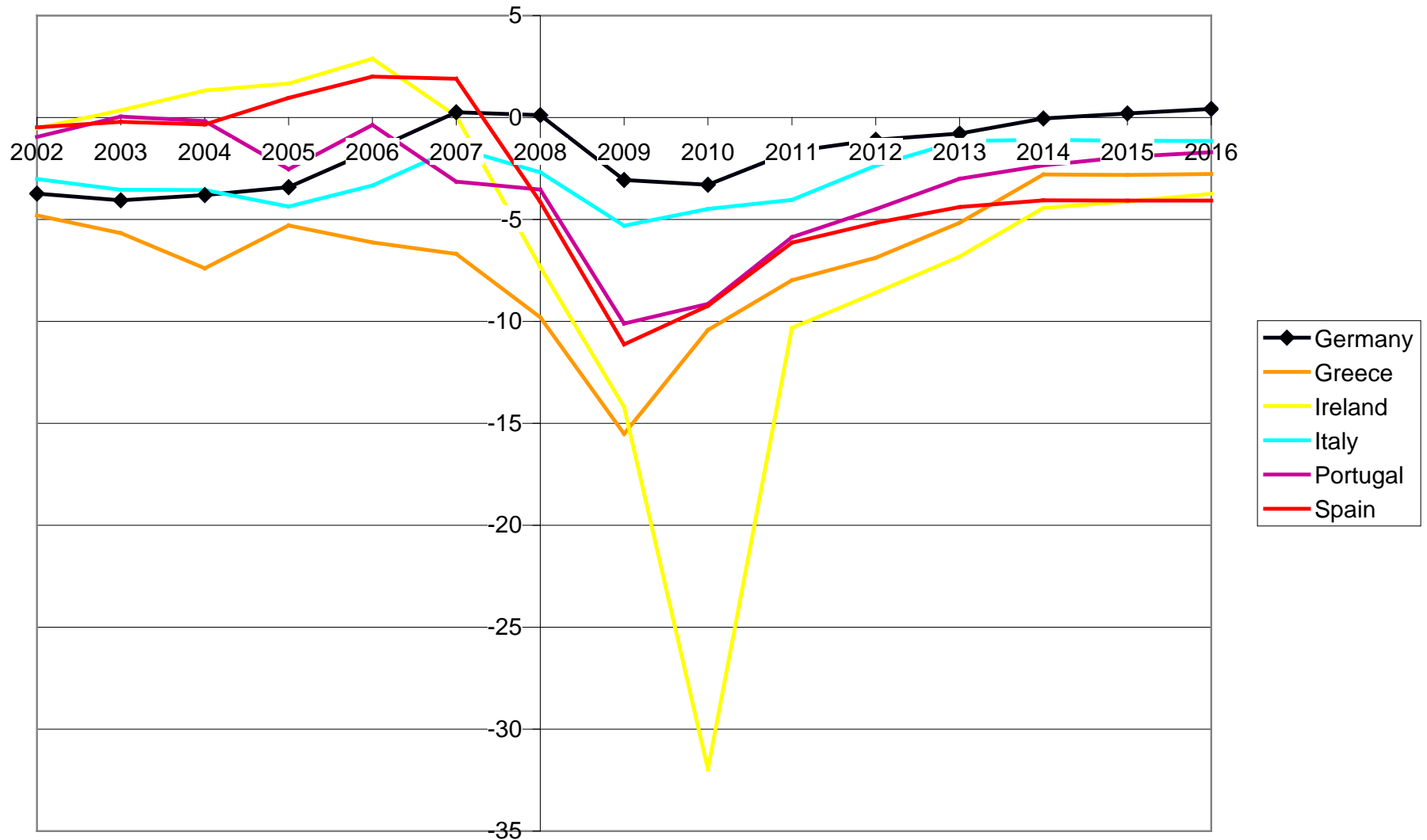


Unit labour costs (annual, total economy), index OECD base year (2005=100). Data source: OECD

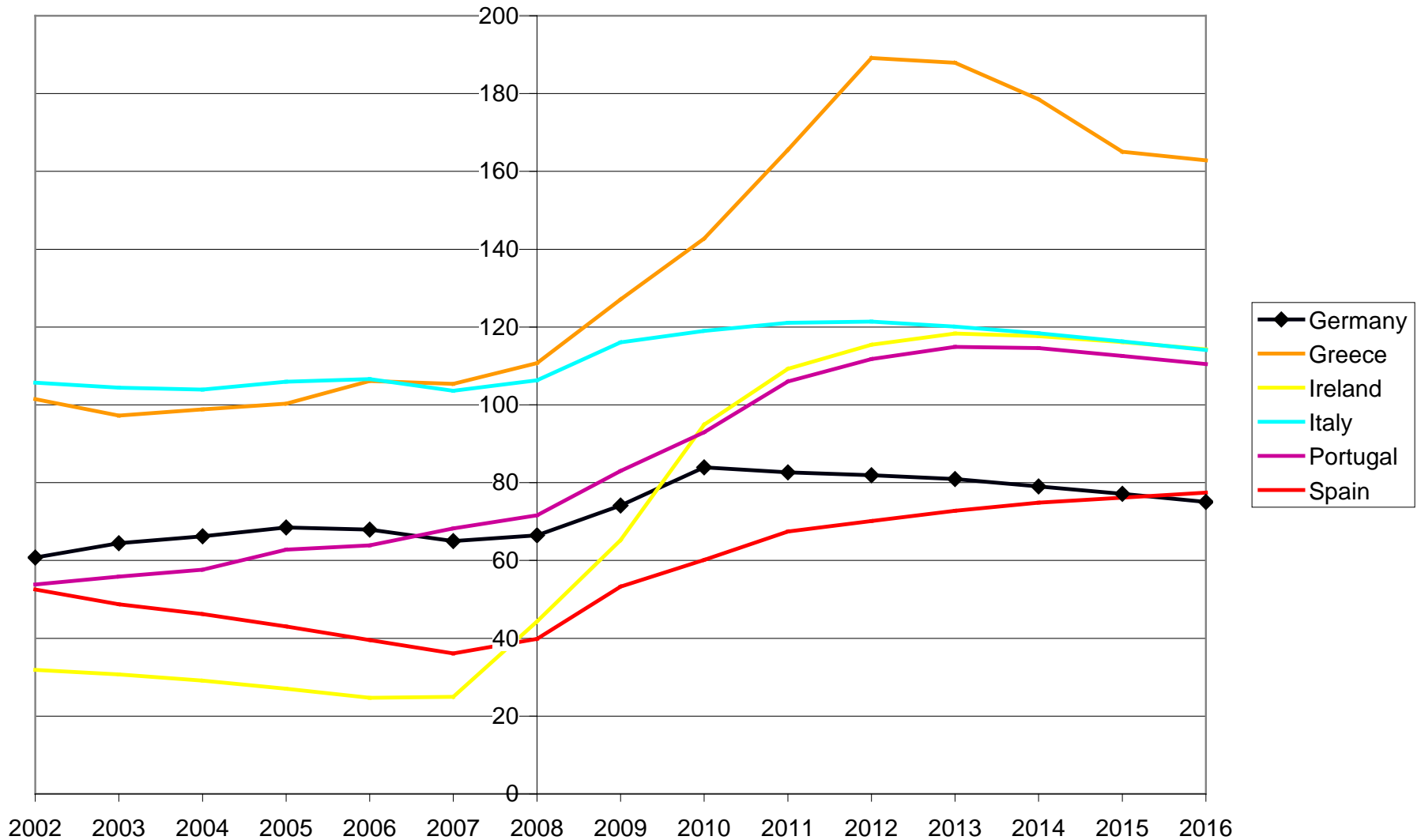
Current Account Balance: GIIPS and DE



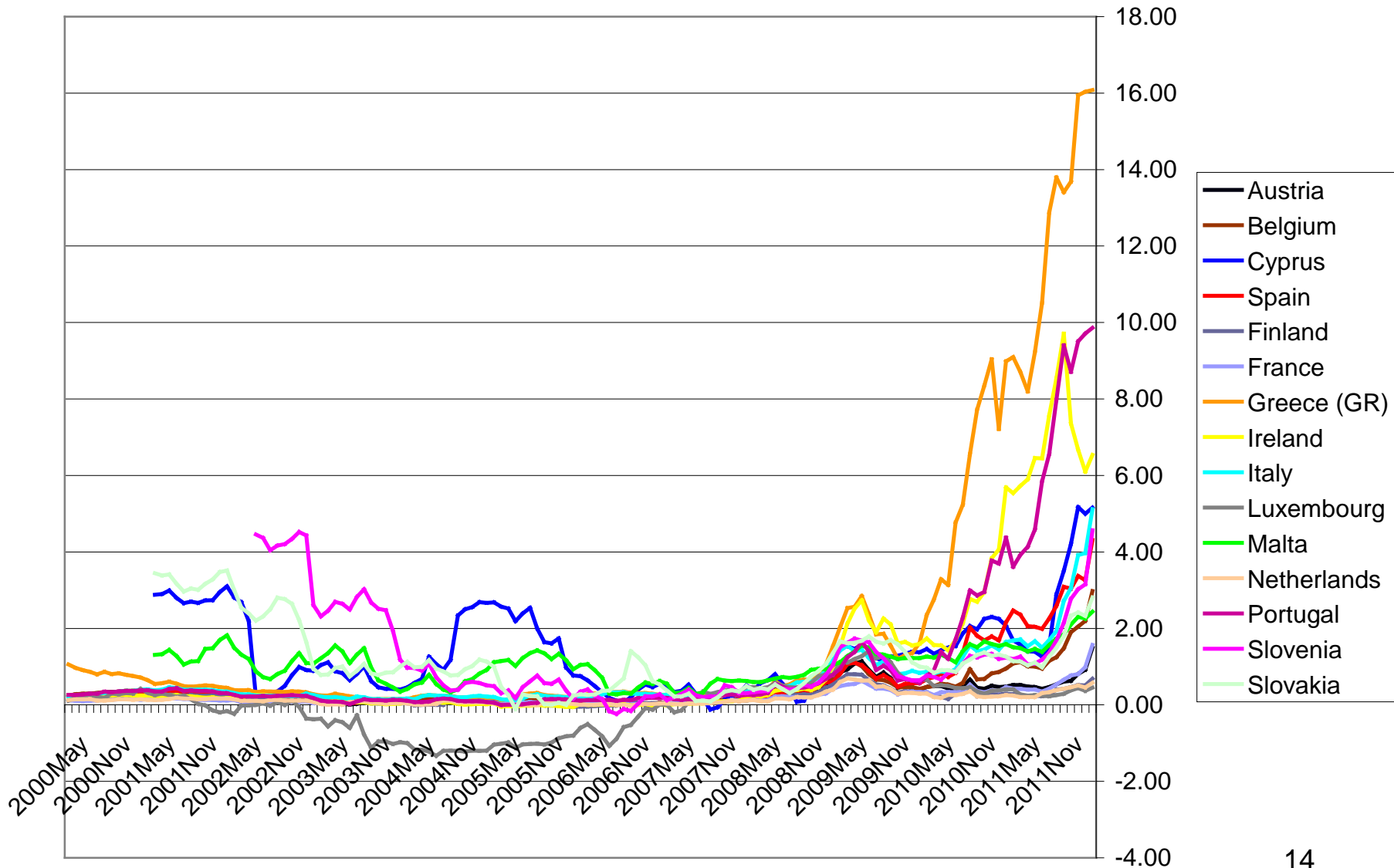
Government Deficit: GIIPS and DE



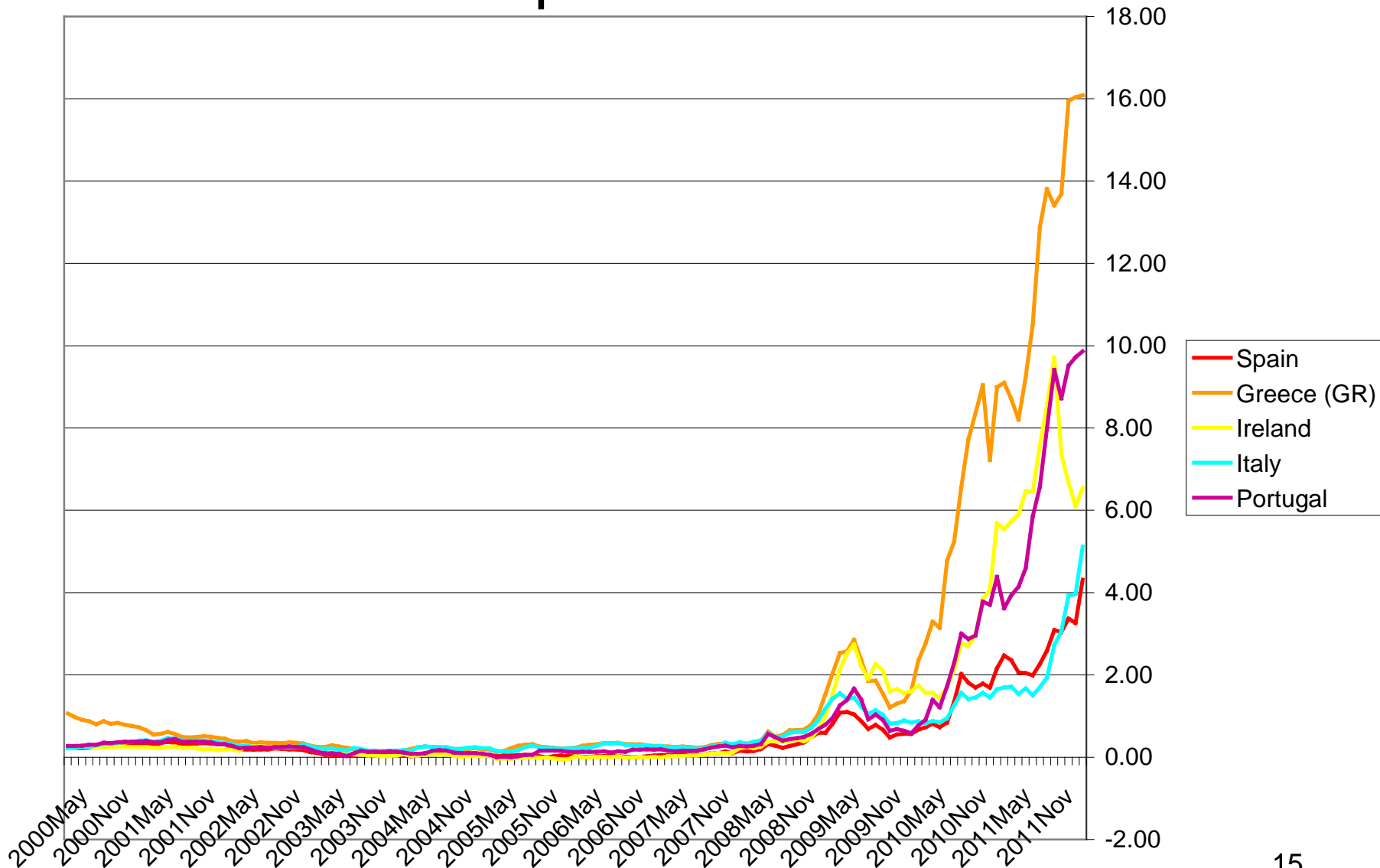
Government Debt: GIIPS and DE



Gov. Bond Yield Spreads: Euro Area (16)



Gov. Bond Yield Spreads: GIIPS



B) Policy Measures to Counteract the Sovereign Debt Crisis in the Eurozone

(1) Measures of Crisis Management

- May2010 last-minute set-up of a loan facility for Greece
2.May2010 amount originally: €110bn bilateral loans
(+ Jul2011 new package of estim. €109bn)
- May-Jun2010 set-up of a [temporary European safety-net](#)
(Ireland: Nov2010, up to €85bn; Portugal: May2011, up to €78bn)
- Oct2011 reforming the safety-net (i.p. increase of resources via leverage)
- guarantees and loans - no financial transfers?
help to reform!
- [propping up of banks](#)

(1) Measures of Crisis Management

- Agreement to set up a permanent European Stabilisation Mechanism (ESM) – so far only in Mar2013
→ fiscal centre, support mechanism for member states
- use of established IMF practice

By now only above actions AND activities by the

- European Central Bank (ECB)
 - suspending the application of the minimum credit rating threshold in the collateral eligibility requirements for member states “in need” (May2010 Greece, Mar2011 Ireland, Jul2011 Portugal)
 - buying of government bonds (from member states “in need”)
 - more expansionary monetary policy
 - coordinated action of 30Nov2011 with BoJ, Fed, BoE et al

(2) Assessment of these Crisis Policies

- Only purchasing of time (*short-term* stabilization policy)
- Scaling up will become necessary; political conflicts probable

Needed:

- structural reforms in the problem countries
and
- governance reform of E(M)U → first steps →

(3) Strengthening of Governance on the European Level: Fiscal Policies

- [Stability and Growth Pact \(SGP\)](#) is being strengthened
- SGP will be supplemented by the [European Semester](#)
- new procedures to avoid excessive disequilibria, i.p. new [“excessive imbalances procedure” \(EIP\)](#) and an [alert mechanism](#) via a scoreboard
- Euro Plus Pact: “stronger economic policy coordination for competitiveness and convergence”
incl. EU member states outside Eurozone
- Europe2020: broad and consistent growth strategy
- improving efficiency

(3) Strengthening of Governance on the European Level: Financial Sector

- reform of financial market regulation:
European System of Financial Supervision (ESFS):
new financial supervision institutions, i.p. for better
macroprudential oversight

European Systemic Risk Board (ESRB):

- European Banking Authority (EBA)
- European Insurance and Occupational Pensions Authority (EIOPA)
- European Securities and Markets Authority (ESMA)
- Joint Committee of the European Supervisory Authorities (ESAs)

(4) Not(-yet)-Chosen Alternatives

- exit/exclusion of Greece from the Eurozone
→ contagion?
- division of Eurozone in North- and South-zone
→ political earthquake in EU? Huge transition costs
- exit of Northern member countries (Germany et al.)
→ political earthquake in Southern member countries;
recession in Northern countries (transition costs)
- Eurobonds + ECB as lender of last resort
(French+ proposal) → moral hazard
- Fiscal union – political union

C) Prospects of EU-Integration

(1) 3 scenarios

- positive: calming down; stabilization
- medium: “muddling through” with recurring crises (developing liability association)
- chaos and breaking up of the Eurozone

medium scenario most likely

(2) Role of Convergence vs. Divergence

Divergence or Convergence

- within Eurozone
- between Eurozone insiders and outsiders
→ reputation effects; development of spreads?
- dependent upon ...
see my 2009 presentation

(2) Role of Convergence vs. Divergence

- Only with convergence a MU can/will be an enduring success. (economic + structural convergence).
- As long as there are wrong incentive mechanisms in the EMU promising unconditional financial support to laggards/drones, there will be divergence or artificial convergence based on financial transfers from rich / more solid member countries. Such artificial convergence however tends to produce systemic sovereign debt crises in the EMU.
- This will be a major topic in my paper for the joint omnibus volume.

D) Conclusions

Conclusions

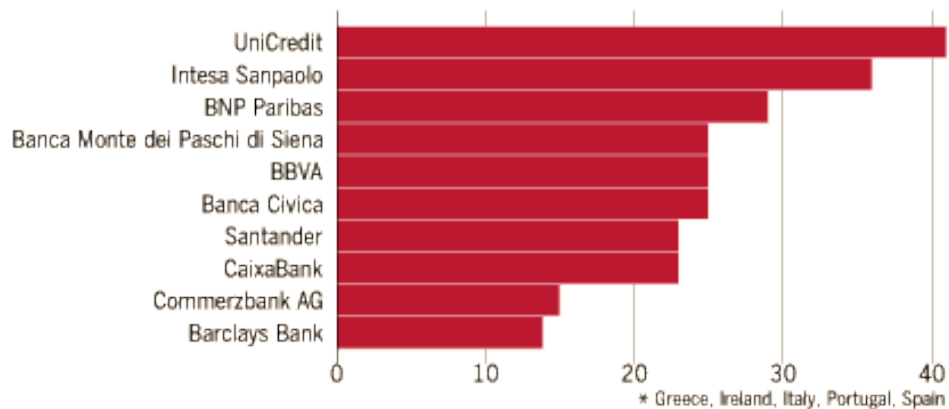
- E(M)U is currently in an impasse: No easy/cheap way out.
 - Probable solution: Eurobonds or ECB as a Lender of Last Resort (“game of chicken” between governments and ECB)
 - Either will lead to moral hazard and unsound finances.
 - Way out?: Deep structural reforms in GIIPS + governance reform of E(M)U. *However*: there are no credible commitments to urgently needed structural reforms in GIIPS; only empty promises. (“War of attrition” between Germany and the GIIPS)
 - Choice between 2 alternatives:
 - A) cheap short-term stabilization with long-term instability
 - B) Expensive short-term-stabilization and long-term stability
- Danger of (B): Could destroy E(M)U: Legitimation Crisis in Transition₂₈

Thank you for your
attention!

Exposure to GIIPS government debt

Lenders on the line

Banks most exposed to peripheral* eurozone debt
First half of 2011 (\$bn)



Source: FT (19.Oct2011): A weekend to save the euro.

Stability and Growth Pact (SGP) Reform

- stronger preventive action
 - member states are required to make significant progress towards medium-term budgetary objectives (MTO)
 - non-interest bearing deposit of 0.2% of GDP imposed on non-compliant member states
- stronger corrective action
 - debt levels above 60% of GDP to be reduced
 - financial sanctions kick in at earlier stage
 - non-compliant member states:
 - non-interest bearing deposit of 0.2% of GDP
 - not refundable fines of 0.5% of GDP maximum
- facilitation of action through majority voting rules

The European Semester (1)

- aim: reinforce the ex ante dimension of economic policy coordination
- how it works: timetable to enhance consistency of policies, covering all elements of surveillance, including fiscal, macroeconomic and structural policies, while keeping them legally and procedurally separate

The European Semester (2)

	Policy guidance for the EU and euro area as a whole				Country-specific guidance			Second half of the year
	January	February	March	April	May	June	July	
			Country reporting					
European Commission	Annual Growth Survey					Policy guidance & possible recommendations		
Council of Ministers		} Debate & orientations					Finalisation & adoption of guidance	
European Parliament								
European Council			Annual economic summit				Endorsement of guidance & possible recommendations	
Member States			Fiscal notifications	National reform programmes & stability and convergence programmes				Adoption of next year's budgets
Continuous: surveillance and, if warranted, recommendations under the preventive and corrective arms of the Stability and Growth Pact								

Excessive Imbalances Procedure (EIP)

- a framework for enhanced and broader macro-economic surveillance for all member states focussing on imbalances
 - preventive arm to avoid the build-up of imbalances
 - corrective arm: strong enforcement mechanisms for euro area members where spill-overs are stronger, interest bearing deposits or fines of 0.1% of GDP, reverse quality majority voting
- broad scope of surveillance
 - external imbalances
 - external positions (e.g. current accounts, net international investment positions)
 - competitiveness developments (e.g. REERs, ULCs)
 - export performance (e.g. export market shares)
 - internal imbalances
 - private sector indebtedness (e.g. credit, debt)
 - assets markets (e.g. housing)

Alert Mechanism

- combination of a transparent review of a small set of indicators (i.e. the scoreboard) with economic analysis
- how it works: scoreboard indicators violating certain thresholds trigger in-depth analysis which will be the basis for policy recommendations
 - indicators: structural indicators from Lisbon process strategy
 - thresholds: distribution over time and across countries, quartiles for upper and lower thresholds, ...
e.g. 3 year average of current account balance may not exceed +6/-4% of GDP

Temporary European Safety-Net

European Stabilisation Mechanism (ESM)

up to €750 provided by

- the European Financial Stabilisation Mechanism (EFSM)
European Commission borrows up to €60bn in financial markets on behalf of the EU under an implicit EU budget guarantee
- the European Financial Stability Facility (EFSF)
special purpose vehicle, backed by guarantee commitments from the Euroarea member states for a total of €780bn → lending capacity of €440bn
- the International Monetary Fund (IMF)
additional funding with the size of 50% of the above loans = up to €250

plus

- possible ECB purchases of sovereign debt