The euro crisis and the EU’s policy response

Zsolt Darvas
Bruegel, Corvinus University, IE HAS
EFTA Parliamentary Committee and EFTA Consultative Committee
Conference
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Christopher Sims: Europe must create a fiscal union to avoid the collapse of its common currency (10 October 2011)

Paul Krugman: The bitter truth is that the euro increasingly looks like it's doomed... and Europe may actually be better off if it collapses sooner rather than later (24 October 2011)

Nigel Lawson: There is a fundamental flaw in the euro … that is that you cannot make a monetary union work... without a tax union. You cannot have a tax union in a democracy unless you have the political union, which is otherwise completely undemocratic ... The whole thing is a nonsense, and the sooner the whole thing can be dismantled in an orderly way, the better. (27 October 2011)
Outline

1. Major reasons behind euro-area problems
2. The EU’s policy response so far
3. What to do to resolve/avoid crises?
4. What are the scenarios?
   • Status quo plus
   • Break-up/Exit from the euro area
   • Fiscal integration
   • United States of Europe
1. Major reasons behind Euro-area problems (1)

Pre-crisis - weak governance & incomplete economic integration:

1. The rules-based Stability and Growth Pact failed
   - High public debt in Greece and Italy at the outbreak of the crisis
2. Sole focus on fiscal issues
   - Unsustainable credit and housing booms in some countries (eg Ireland and Spain)
   - Structural imbalances (eg current account, wage) developed
3. No proper mechanisms to foster structural adjustment
   - Disappointing growth performance in some countries even before the crisis (eg Italy, Portugal)
4. No crisis resolution mechanism
   - Sovereign debt and banking crisis came as a surprise
Paul De Grauwe (2011): EMU’s shockingly fragile

Illustrated by comparison between Spain and the UK
1. Major reasons behind Euro-area problems (2)

The crisis revealed more fundamental problems:

1. Strict no-monetary financing by the ECB/Eurosystem → no lender of last resort (cf. Spain vs. the UK)
   - Sovereign borrowing is like borrowing in a "foreign" currency
2. National bank resolution regimes & large home bias in banks government bond holdings
   - Lethal correlation of banking and sovereign debt crises
3. Interdependence across countries
   - Fall of a "small" country can create contagion, fall of a "large" country leads to meltdown
4. Governance crisis: partial, inadequate and belated responses
   - Lost policy credibility
2. The EU’s policy response so far

- Financial backstop to sovereigns (bilateral loans to Greece, EFSF, EFSM, ESM) → but limited lending capacity
- ECB unlimited liquidity support to banks → very effective, yet the ECB can turn into a bad bank should the banking crisis escalate
- ECB purchase of government bonds at the secondary market → but temporary, limited, and "only to help monetary transmission"
- Strengthened governance, including surveillance (European Semester, assessment of excessive private sector imbalances) → good, may be helpful once the crisis is solved, but won’t solve the crisis
- New institutions for financial stability (eg ESRB, EBA) → but with limited powers
- Stress testing of major European banks → discredited almost immediately
The 26/27 October 2011 Summit – Conclusions

• Five main conclusions:
  1. 50% “Voluntary” haircut for privately-held Greek debt (for a total of €100bn) plus continued official funding
  2. Outline agreement on leveraging the European Financial Stability Facility (EFSF) – two schemes: bond insurance and a fund for foreigners
  3. Bank recapitalisation programme of €106bn
  4. Timetable for Italian reforms
  5. Strengthening euro-area governance
1. The “voluntary” haircut for privately-held Greek debt may not work after all, and public debt is still seen at 120% in 2020
2. EFSF: insurance is the not ideal way to leverage & foreigners are not keen to invest in a fragile euro-area
3. Bank recapitalisation: needed, but wrongly based on the flawed stress-test of July (and may lead to a credit crunch)
4. Timetable for Italian reforms: good, needs to be implemented, but the Italian government collapsed and the nomination of Mr Mario Monti has not (yet) convinced markets
5. Strengthening euro-area governance: still not ambitious enough, and the other four elements above will be decisive
The EU’s policy response – Overall assessment

- With a lot of luck – the strategy might work

- But the strategy does not address the fundamental problems:
  - No lender of last resort for sovereigns
  - Lethal correlation of banking and sovereign debt crises
  - Interdependence across countries
  - Governance crisis

- Markets may deny funding from Italy (and Belgium and Spain) and nobody knows what will come afterwards
3. What to do to resolve/avoid crises?

- Restore lender of last resort for sovereigns
  - ECB
- Break the lethal interdependence of banks and sovereigns
  - Banking federation (centralised regulation, supervision, resolution, deposit guarantee)
  - Limit bank holdings of government debt
  - Eurobond
- Address interdependence across countries
  - Banking federation
- Governance crisis
  - Strengthen centralised decision making instead of inter-governmentalism

- Note: a (limited) budget is needed for a banking federation, but there need not be more redistribution within the euro area

4. Scenarios for the medium/long term

A. **Status quo plus**: governance relying on rules and sanctions (with some improvements)

B. **Falling apart**: reintroduction of national currencies

C. **Fiscal integration**: limiting national fiscal sovereignty and setting-up ‘federal’ functions, such as economic stabilisation, economic risk-sharing and banking resolution/deposit guarantee

D. **United States of Europe**: political integration as well (for dreamers; I do not discuss this option)
4.A Status quo plus?

• With a lot of luck, the current strategy might work

• New governance framework: significant steps, but largely fix current bugs and unlikely the ultimate solution

• Sanctions and too much inter-governmentalism carry risks

• Transition (from the current crisis) is very unclear; time will not solve all issues: banks, solvency of sovereigns, growth, ECB

• Lack of more ambitious plans (separation of banks and sovereigns, higher level fiscal integration, Eurobonds)
4.B Exit or Falling apart?

- Italy is too big to fail: would lead to a meltdown of the euro-area banking system – but Italy’s situation is manageable if borrowing at a ‘reasonable’ interest rate can be restored
- Greece is clearly insolvent, but it is a small country
- An eventual Greek default has no implication for an exit from the euro area
- Benefits from depreciation – unknown, but may not be large
- Greece (and other Southern countries) has an enormous potential to improve the non-price dimensions of its competitiveness (next slide)
- Exit - the “mother of all financial crises” (Eichengreen 2007)
- UBS:
  - weak country exiting would lose 40-50% of GDP (in the first year)
  - strong country exiting would lose 25% of GDP (in the first year)
- Low credibility of the newly stand-alone Greek central bank → much higher real interest rates and high inflation for many years (see also the slide after the next one)
Greece has an enormous potential to improve the non-price dimensions of its competitiveness.

### Structural reform scoreboard, 2003/05 vs 2009/10

**dark green=best, red=worst**

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<thead>
<tr>
<th>Medium Term</th>
<th>Austria</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Netherlands</th>
<th>UK</th>
<th>Greece</th>
<th>Italy</th>
<th>Portugal</th>
<th>Spain</th>
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**Long Term**

| Institutions and contracts   |         |         |        |         |             |    |          |       |          |       |           |         |        |          |         |
| Human Capital                |         |         |        |         |             |    |          |       |          |       |           |         |        |          |         |
| Infrastructure               |         |         |        |         |             |    |          |       |          |       |           |         |        |          |         |
| Innovation                   |         |         |        |         |             |    |          |       |          |       |           |         |        |          |         |

## Selected interest rates in euro-area and non-euro-area countries, April 2011

<table>
<thead>
<tr>
<th>Corporate loans</th>
<th>Household loans</th>
<th>Government bond yields</th>
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<tbody>
<tr>
<td></td>
<td>Up to EUR 1 million</td>
<td>Over EUR 1 million</td>
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<tr>
<td><strong>Euro area</strong></td>
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<td>Belgium</td>
<td>4.5</td>
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<td>Germany</td>
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<td>Greece</td>
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<td>Ireland</td>
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<td>Portugal</td>
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<td>Spain</td>
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<td>Romania</td>
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<td>Sweden</td>
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<td>UK</td>
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Source: ECB except the 2-year government bond yield, which is from Datastream.
4.C Fiscal integration

Sometimes regarded as magic bullet, but what fiscal integration?
- More coordination & more sanctions → *would not be enough*
- Veto power over national budgets, ie partial loss of national sovereignty → *can be helpful after the current crisis is solved*
- More redistribution or transfers → *no*
- Stabilisation instruments (ie when there is a common economic shock) → *yes*
- Risk-sharing (ie when there is an asymmetric economic shock) → *yes*
- Banking federation, ie centralised bank regulation, supervision, resolution and deposit insurance → *yes*
- Central taxing power → *yes (but limited, needed for the above three tasks)*
- Eurobonds → *yes, but with what governance?* *Financed by federal taxes or national contributions? And how to merge existing debt?* *I.e.: Should the federal tax rate be the same in Estonia (8% debt today) and Italy (120% debt today)?
Papers

Darvas, Zsolt (2011) ‘The Greek public debt misery: the right cure should follow the right diagnosis’, opinion piece, 26 October 2011


Darvas, Zsolt (2011) ‘The euro’s last-chance saloon’, opinion piece, 5 September 2011,


Darvas, Zsolt (2011) ‘Debt socialisation' might follow Greek crisis’, opinion piece, 30 June 2011,

Darvas, Zsolt, Jean Pisani-Ferry, André Sapir (2011) ‘A comprehensive approach to the euro-area debt crisis’ Bruegel Policy Brief, 7 February 2011,