European financial crisis, recovery and future prospective

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Good Governance as an essential tool for economic development

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The Council of Europe
European Union
Eurozone
European Economic Area
European Free Trade Association
EU Customs Union
Agreement with EU to mint Euros
Schengen Area

The major grounds for ex ante skepticism among (American) economists

- The euro countries did not meet the criteria of an Optimum Currency Area
  - OCA: Bob Mundell, 1961 (another Nobel Prize).

- Individual members would be hit by individual ("asymmetric") shocks.
  - Lacking the high labor mobility of the US,
    - where workers adjust to unemployment by moving across states,
  - euro members would find it very difficult to abide by a common monetary policy.
  - E.g., when a periphery country suffered a loss in demand, the interest rates set in Frankfurt would be too high for it.

Comments on "The euro: It can't happen, It's a bad idea, It won't last. U.S. economists on the EMU, 1989-2002," by Jonung & Drea. *Euro at 10*, 2009 ASSA mtgs.

5 mistakes made by euro leaders

- **Admitting Greece to the € in the first place,**
  - a country that was not yet ready by the relevant criteria.
- **Pretending to enforce the fiscal criteria.**
- **Allowing Mediterranean countries' bond spreads near 0**
  - helped by investors' under-perception of risk (2003-07)
  - and artificial high credit ratings. But also
  - ECB acceptance of Greek bonds as collateral.

Burying their heads in the sand when the crisis hit in late 2009:

- In early 2010, sending Greece to the IMF was "unthinkable."
- In early 2011, restructuring of the debt was "unthinkable."

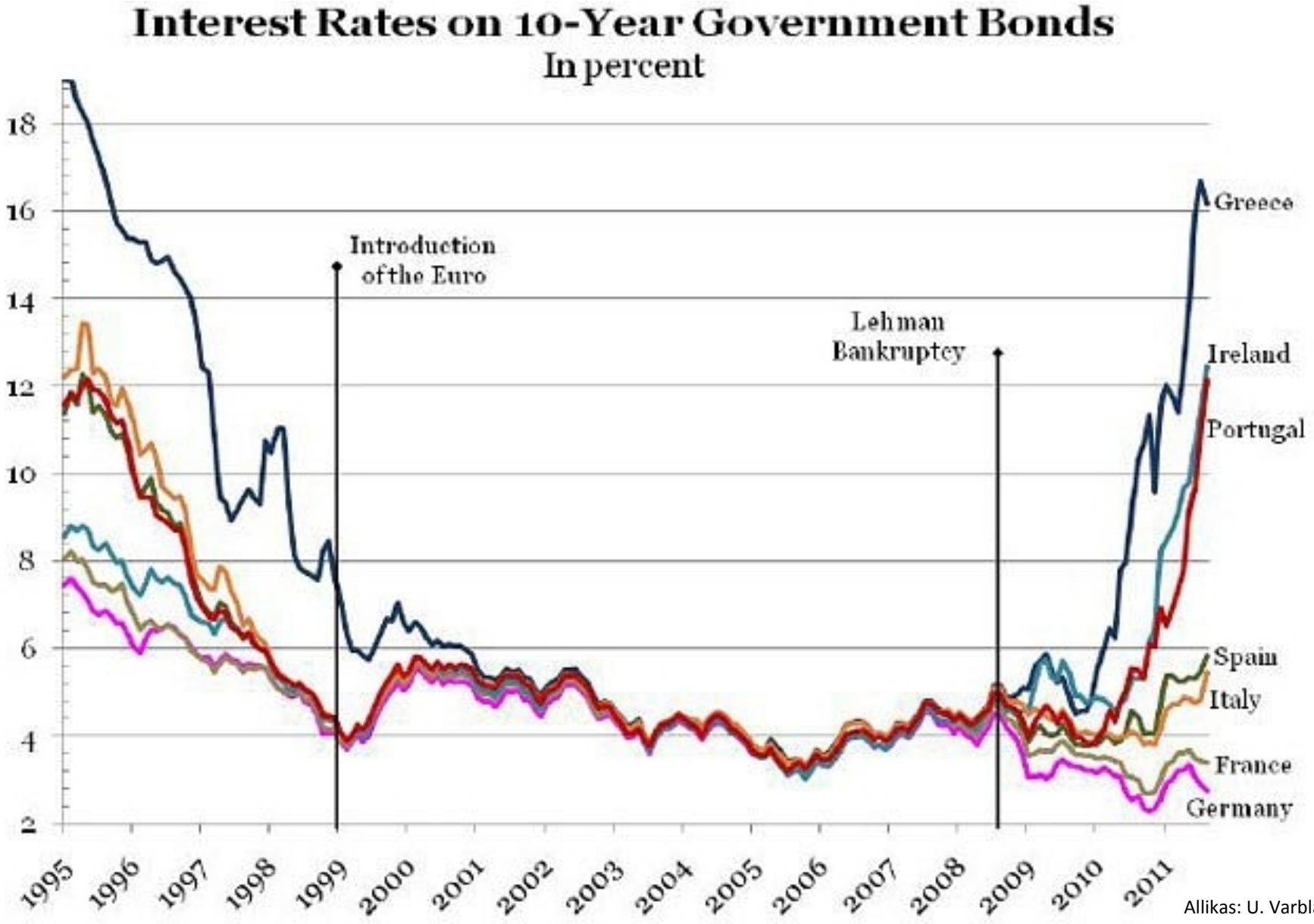
Budget deficit

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Austria	-4	-1.8	-2.4	-2.3	-1.7	0.0	-0.7	-1.5	-4.5	-1.7	-1.6	-0.9	-0.9	-4.1	-4.4
Belqium	-4	-2.3	-0.9	-0.6	0	0.4	-0.1	-0.1	-0.3	-2.7	0.1	-0.3	-1.3	-5.9	-4.1
Spain	-4.8	-3.4	-3.2	-1.4	-1	-0.6	-0.5	-0.2	-0.3	1	2	1.9	-4.2	-11.1	-9.3
Holland	-1.9	-1.2	-0.9	0.4	2	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.6	-5.5	-5.1
Ireland	-0.1	1.1	2.4	2.7	4.7	0.9	-0.4	0.4	1.4	1.6	2.9	0.1	-7.3	-14.3	-31.3
Italy	-7	-2.7	-2.8	-1.7	-0.8	-3.1	-2.9	-3.5	-3.5	-4.3	-3.4	-1.5	-2.7	-5.4	-4.6
Greece	:	:	:	:	-3.7	-4.5	-4.8	-5.6	-7.5	-5.2	-5.7	-6.4	-9.8	-15.4	-10.6
Luksemburg	1.2	3.7	3.4	3.4	6	6.1	2.1	0.5	-1.1	0	1.4	3.7	3	-0.9	-1.1
Portugal	-4.5	-3.4	-3.5	-2.7	-2.9	-4.3	-2.9	-3	-3.4	-5.9	-4.1	-3.1	-3.5	-10.1	-9.8
France	-4	-3.3	-2.6	-1.8	-1.5	-1.5	-3.1	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.1
Germany	-3.3	-2.6	-2.2	-1.5	1.3	-2.8	-3.7	-4	-3.8	-3.3	-1.6	0.3	0.1	-3	-4.3
Finland	-3.5	-1.4	1.5	1.6	6.8	5	4	2.4	2.3	2.7	4	5.2	4.2	-2.6	-2.5
Sloveenia	-1.1	-2.4	-2.4	-3	-3.7	-4	-2.5	-2.7	-2.3	-1.5	-1.4	-0.1	-1.8	-6	-5.8
Cypros	-3.2	-5	-4.1	-4.3	-2.3	-2.2	-4.4	-6.5	-4.1	-2.4	-1.2	3.4	0.9	-6	-5.3
Malta	-8	-7.7	-9.9	-7.7	-6.2	-6.4	-5.5	-9.9	-4.7	-2.9	-2.8	-2.4	-4.5	-3.7	-3.6
Slovakia	-9.9	-6.3	-5.3	-7.4	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8	-7.7
Estonia	-0.3	2.2	-0.7	-3.5	-0.2	-0.1	0.3	1.7	1.6	1.6	2.4	2.5	-2.8	-1.7	0.2
EU (17)	-4.2	-2.7	-2.3	-1.4	0	-1.9	-2.6	-3.1	-2.9	-2.5	-1.4	-0.7	-2	-6.3	-6.2

Government Debt

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Austria	68.1	64.1	64.4	66.8	66.2	66.8	66.2	65.3	64.7	64.2	62.3	60.2	63.8	69.5	71.8
Belqium	127.2	122.5	117.2	113.6	107.8	106.5	103.4	98.4	94	92	88	84.1	89.3	95.9	96.2
Spain	58	59.2	59.4	58.9	57.3	56.9	58.8	62.9	64.9	66.4	63.7	64.2	68.2	79	82.3
Germany	58.5	59.8	60.5	61.3	60.2	59.1	60.7	64.4	66.3	68.6	68.1	65.2	66.7	74.4	83.2
Greece	99.4	96.6	94.5	94	103.4	103.7	101.7	97.4	98.6	100	106.1	107.4	113	129.3	144.9
Ireland	72.7	63.7	53	48	37.5	35.2	31.9	30.7	29.4	27.2	24.7	24.8	44.2	65.2	92.5
Italy	120.2	117.4	114.2	113	108.5	108.2	105.1	103.9	103.4	105.4	106.1	103.1	105.8	115.5	118.4
Luksemburg	7.4	7.4	7.1	6.4	6.2	6.3	6.3	6.1	6.3	6.1	6.7	6.7	13.7	14.8	19.1
Holland	74.1	68.2	65.7	61.1	53.8	50.7	50.5	52	52.4	51.8	47.4	45.3	58.5	60.8	62.9
France	58.3	54.4	50.4	49.6	48.5	51.2	53.8	55.9	57.6	62.8	63.9	68.3	71.6	83	93.3
Germany	67.4	66.1	64.1	62.4	59.4	55.6	52.6	48.8	46.3	43.1	39.6	36.2	40.1	53.8	61
Finland	57	53.9	48.4	45.7	43.8	42.5	41.5	44.5	44.4	41.7	39.6	35.2	33.9	43.3	48.3
Sloveenia	21.9	22.4	23.1	24.1	26.3	26.5	27.8	27.2	27.3	26.7	26.4	23.1	21.9	35.3	38.8
Cypros	53.1	57.4	59.2	59.3	59.6	61.2	65.1	69.7	70.9	69.4	64.7	58.8	48.9	58.5	61.5
Malta	40.1	48.4	53.4	57.1	54.9	60.9	59.1	67.6	71.7	69.7	64.1	62.1	62.2	67.8	69
Slovakia	31.1	33.7	34.5	47.8	50.3	48.9	43.4	42.4	41.5	34.2	30.5	29.6	27.8	35.5	41
Estonia	7.6	7	6	6.5	5.1	4.8	5.7	5.6	5	4.6	4.4	3.7	4.5	7.2	6.7
EU (17)	73.7	73.2	72.8	71.6	69.2	68.1	67.9	69.1	69.5	70.1	68.5	66.3	70.1	79.8	85.3

Allika: U. Varblane



Allikas: U. Varblane

What is the Eurozone Debt Crisis?

- This is also known as Eurozone sovereign debt crisis
- The term indicates the financial woes caused due to overspending by come European countries
- When a nation lives beyond its means by borrowing heavily and spending freely, there comes a point when it cannot manage its financial situation.
- When that country faces insolvency. (Insolvency: when it is unable to repay its debts and lenders start demanding higher interest rates, the cornered nation begins to get swallowed up by what is known as the Sovereign Debt Crisis

Until 2007, German Savings Helped Build Projects in High Growth Areas

Spanish builder borrows for a project

Spanish bank borrows from a German bank in the whole-sale market; lends to the builder

German bank takes deposits from German savers and not finding interesting German investments, lends the money to a Spanish bank in the wholesale market

German saver takes his hard earned savings and puts it into a German bank

What is at risk			
If the project fails the developer loses his equity, but then it is owned by the bank	Once the bank owns the property, losses beyond the equity of the bank are shared with the lenders	Once the bank eats through its own equity, the losses should be shared with lenders	Depositors are usually guaranteed by a deposit fund, which is funded by banks but backstopped by taxpayers (depositors)
2007: 10% equity	2007: 18x leverage (5.6% equity)	2007: 30x leverage (3.3% equity)	Simple example, but not that far from loss (~19% loss)

CARMEL
ASSET MANAGEMENT

The politics of the Eurozone crisis

<u>The origins of the crisis</u>

1. Global financial crisis of 2007-08 triggered by sub-prime mortgage crisis in the US
2. European banks heavily affected, forcing EU governments to step in and bail out their "national" banks
3. Effects on "real economy" leading to a deep recession across the EU (with very few exceptions, such as Poland)
4. Banking crisis (plus recession) triggered sovereign debt crisis in the Eurozone, continously driven by market pressure (channelled via "credit rating agencies")

Greece's Financial Problems

- Since joining the euro, Greece has had higher inflation than other Eurozone members.
- Greece has also increased debt faster than others to finance generous public sector pay, welfare, and retirement benefits, while collecting a lower share in taxes due to widespread tax evasion.
- As a result, Greek goods have become increasingly expensive and uncompetitive, causing loss of market share and further reducing revenues.

More general reasons

- Greece had experienced corruption and spending as its government continued borrowing money despite not being able to produce sufficient income through work and goods.
- Center – periphery problem: Germany exported, Southern Europe imported, cheap loan came from France and Germany, periphery increased expenditures
- General problems (compared with US)
  - Ageing,
  - Low productivity
  - Expensive welfare model
  - Low growth

Debt crises in Europe

- Greece problem, PIIGS

- EU has been dealing with consequences not with reasons

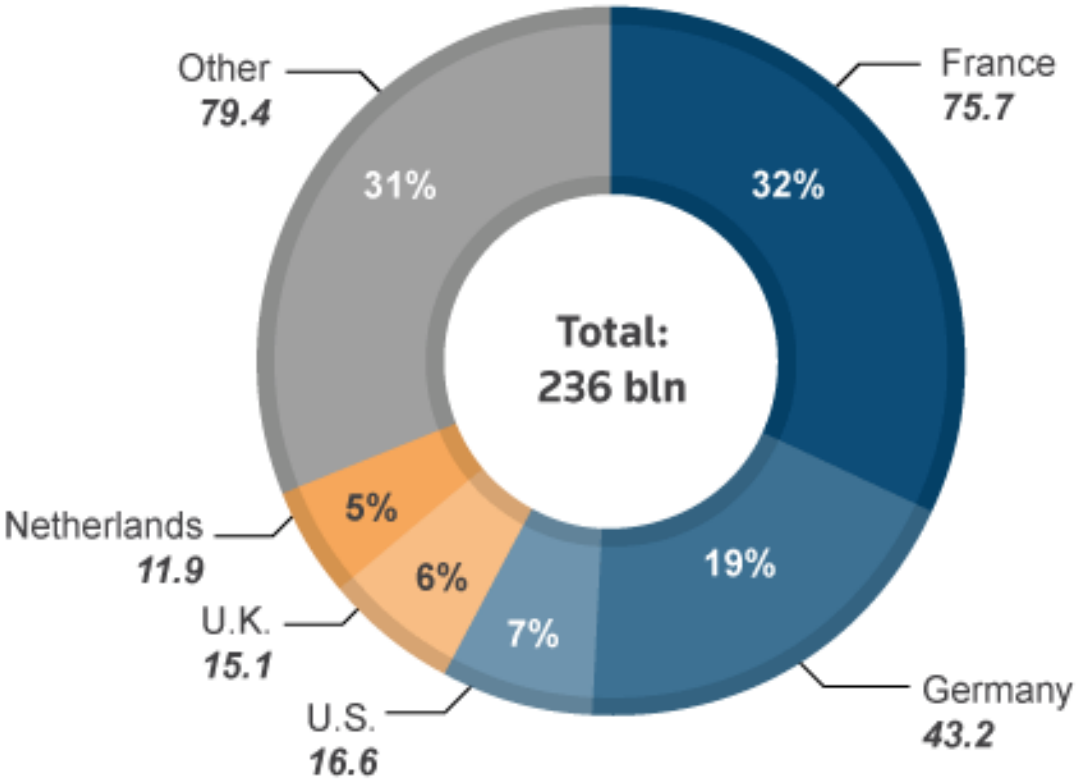
- How much we let market to solve the problem?

- How to motivate countries who follow the fiscal discipline?

- Whom we actually support?

Greece debt in world banks

Bank holdings of Greek sovereign debt by country – $ billions



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REUTERS

Source: Bank for International Settlements

Reuters graphic/Stephen Culp

The politics of the eurozone crisis

Cultural/attitudinal dilemmas

- Fiscally prudent North versus profligate South?
- The spectre of a "transfer union" (or debt union)
- The limits of European solidarity

Institutional dilemmas

- Inadequate decision-making procedures in the EU/Eurozone and various member states (e.g. EFSF ratification process)
- Lack of leadership at the national and European level

Representational dilemmas

- The temporary loss of sovereignty and self-determination
- The rise of populist parties across the EU

-> Can the European political "system" deliver against this background?

The economics of the Eurozone crisis

Main interim measures

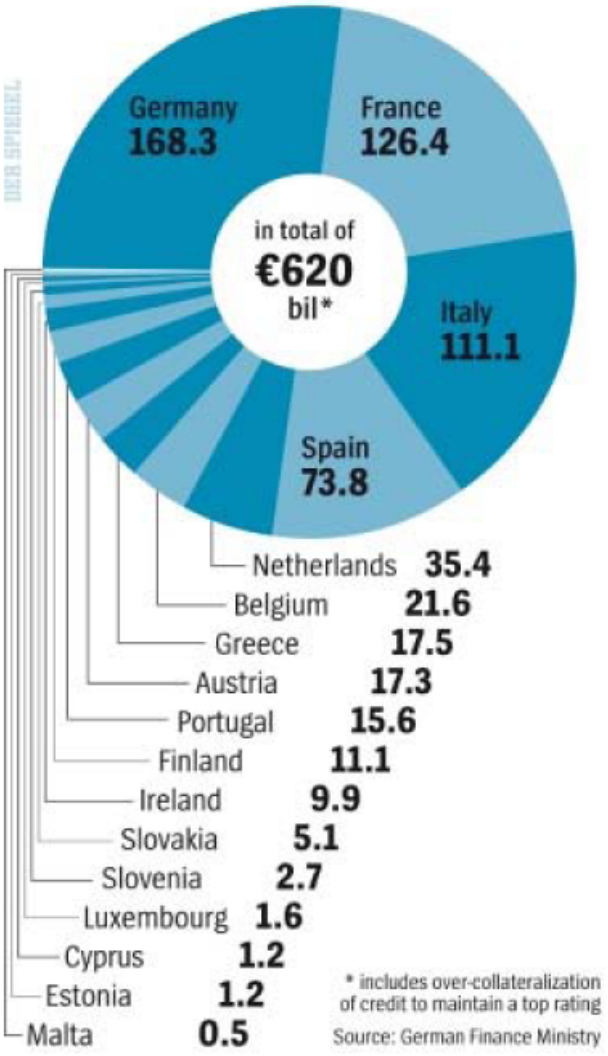
- Bail-out programmes for Greece, Ireland and Portugal
- ECB bond purchasing programmes (mainly for Italy and Spain)
- European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism (EFSM)

A comprehensive resolution package for the short-term

- More powerful EFSF and then permanent European Stability Mechanism (from 2013 onwards)
- Greek debt restructuring plus "haircut" (i.e. debt write-down incl. private sector involvement)
- Re-capitalisation of European banks
- Budgetary surveillance/coordination plus economic convergence programmes (European Semester, EU2020 Strategy, Euro-Plus-Pact; etc)
- A growth and competitiveness plan, in particular for the Southern countries

Liabilities of the Euro-Zone States

Shares in the newly planned European Stability Mechanism (ESM) euro emergency fund set to go into effect in 2013; available capital/ guarantees, in billions of euros.

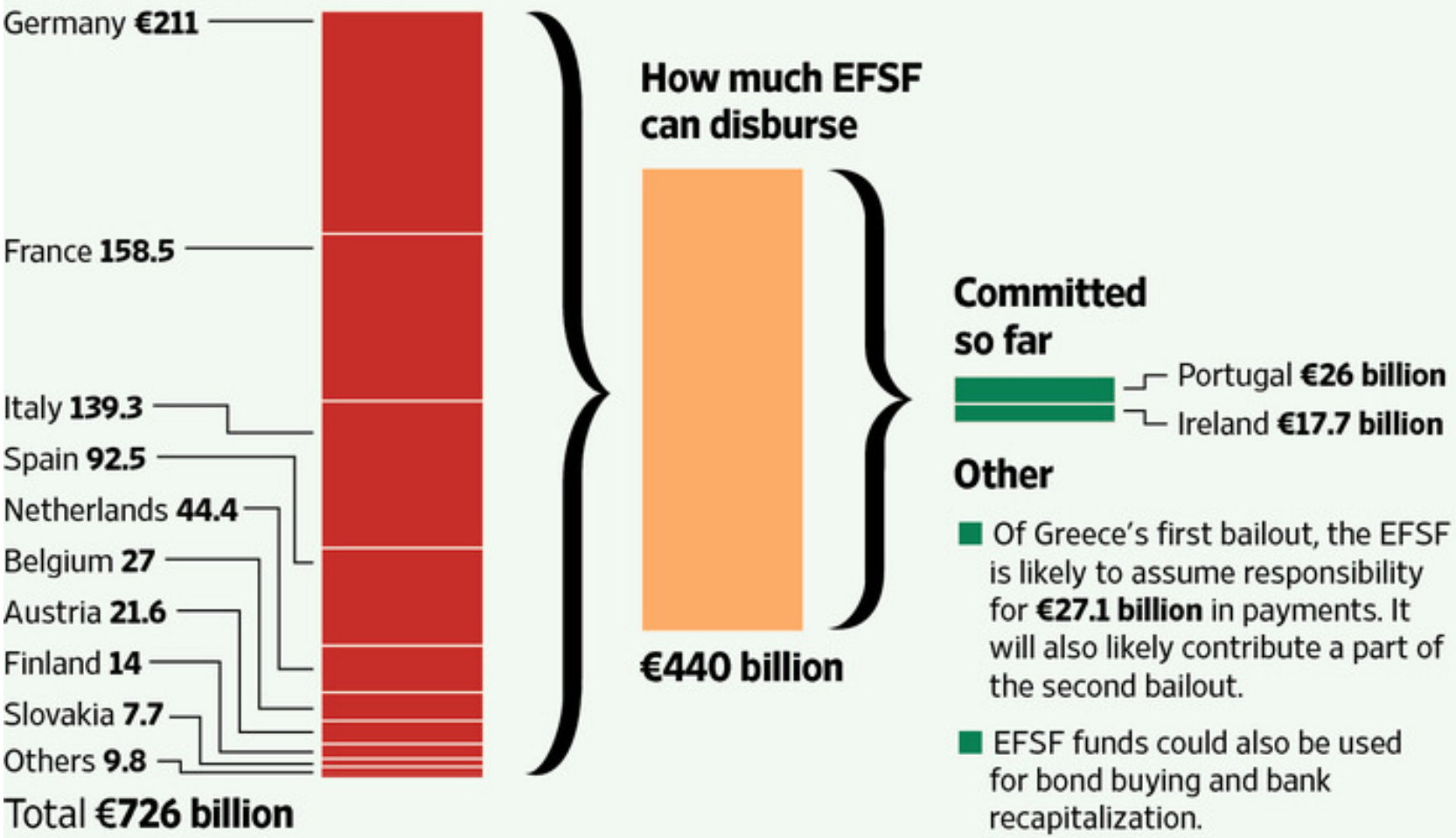


Countries with the lowest government debt levels to pay the most to ESM

Debt % of GDP		ESM % of GDP	
Greece	126.8	**Bulgaria**	16.9
Italy	116	**Romania**	14.1
Belgium	96.2	Latvia	11.1
Hungary	78.4	**Lithuania**	10.9
France	78.1	Hungary	9.9
Portugal	76.1	Poland	9.7
Germany	73.4	**Estonia**	8.6
Malta	68.6	Slovakia	7.4
Austria	67.5	Portugal	7.1
Ireland	65.5	Malta	7.1
Netherlands	60.8	Czech Republic	6.9
Cyprus	58	Slovenia	6.4
Spain	53.2	Greece	6.0
Poland	50.9	Italy	5.6
Finland	43.8	Cyprus	5.5
Latvia	36.7	Spain	5.5
Slovakia	35.4	Germany	5.3
Slovenia	35.4	France	5.1
Czech Republic	35.3	Ireland	5.0
Lithuania	29.5	Finland	4.9
Romania	23.9	Belgium	4.8
Bulgaria	14.7	Austria	4.8
Luxembourg	14.5	Netherlands	4.7
Estonia	7.2	Luxembourg	3.0

Membership Dues

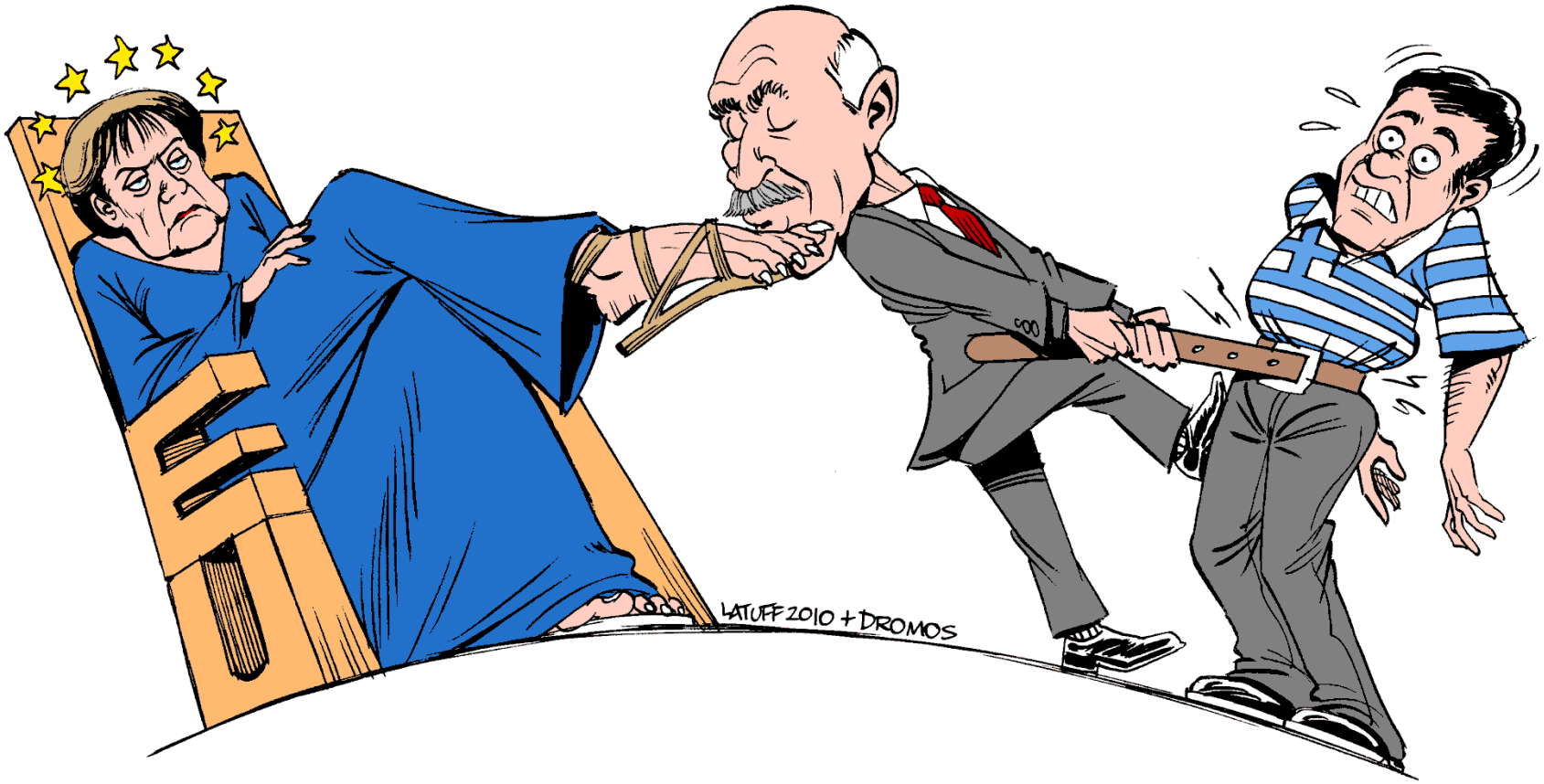
How much each member of the euro zone must contribute to the European Financial Stability Facility, and how the money is being disbursed



Notes: €1 billion = $1.36 billion; contribution numbers don't add to total due to rounding; Source: European Commission

The German view

The Greek view



Strengthening the “E” in EMU

PROGRAMS
Financial assistance for countries in difficulty (but with conditions attached)

BANKS
Strengthen the banking system, including stronger supervision at the EU level

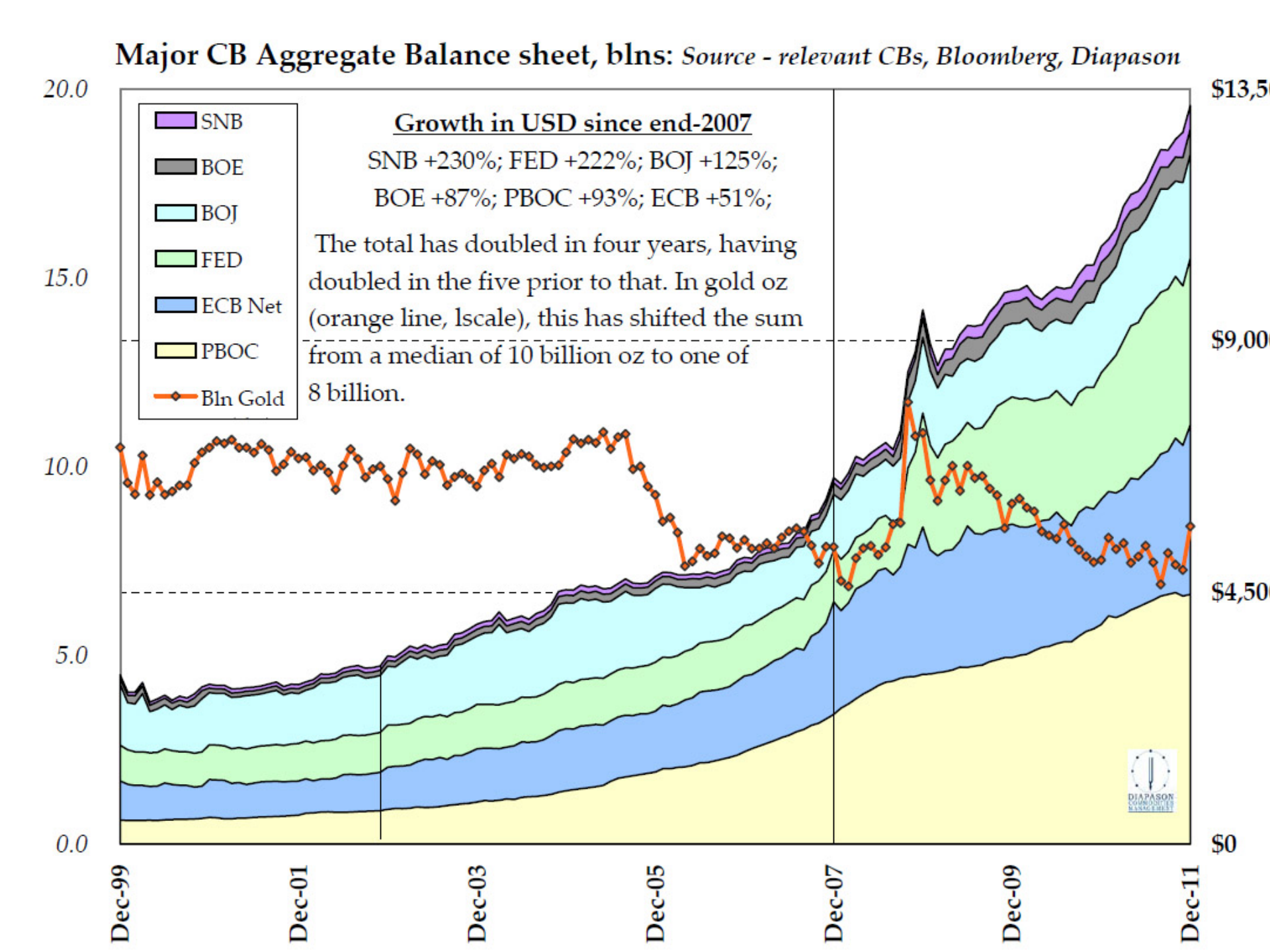
FIREWALL
A permanent mechanism (ESM) to stem the risk of contagion to other countries

RULES
Stronger, more effective fiscal rules and greater coordination of economic policies

GROWTH
Boost growth through “structural reforms” and completing the single market

Potential solutions

- Eurobonds
- ESB will buy bonds of countries in trouble
- Budget cuts
- Joint Economic Government
- EU level bank supervision
- More euros in circulation


Major CB Aggregate Balance sheet, blns: Source - relevant CBs, Bloomberg, Diapason
SNB
BOE
BOJ
FED
ECB Net
PBOC
Bln Gold
Growth in USD since end-2007
SNB +230%; FED +222%; BOJ +125%;
BOE +87%; PBOC +93%; ECB +51%;
The total has doubled in four years, having doubled in the five prior to that. In gold oz (orange line, lscale), this has shifted the sum from a median of 10 billion oz to one of 8 billion.
20.0
15.0
10.0
5.0
0.0
$13,5
$9,00
$4,50
$0
Dec-99
Dec-01
Dec-03
Dec-05
Dec-07
Dec-09
Dec-11

Is it possible to copy experience of Estonia (or Latvia)?

1. Very strong political commitment – introduction of euro
2. Small-scale economy
3. Strong Government
4. Weak trade unions , no demonstrations
5. Flexible labour market

Answer is probably NO

The long-term: economics

Monetary question

•What inflation and interest rate policy in a non-optimal currency zone?

Trade question

•Faced with Asian export dominance and weak(er) US demand, can the euro area as a whole become a 'surplus bloc' if Germany does not balance its current account?

Debt question

•Is debt mutualisation (e.g. through Eurobonds) possible despite the veto of Germany's constitutional court?

More “union”, now and later on…

Political Union

Growth Union

Fiscal Union

Banking Union

The European Union is gradually solidifying