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# Euro Crisis: Causes and Some Solutions

Thomas A McDonnell

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## SUMMARY

The roots of the euro crisis lie in a series of structural flaws in the architecture of European Monetary Union (EMU) including in its design, construction and implementation. Notable design flaws include the absence of a centrally run banking union to accompany currency union, the absence of a fiscal mechanism to soften asymmetric shocks, and the absence of a conditional Lender of Last Resort (LOLR) for sovereign borrowers.

Alongside these design flaws was an inadequate system of surveillance and regulatory mechanisms with too narrow a focus on aggregate Eurozone price stability at the expense of other macroeconomic indicators such as localised credit expansion, financial stability, current account imbalances and economic growth and employment trends.

As a result, destabilising credit flows and the buil-up of regional imbalances within the currency union were allowed to expand unchecked precipitating a debt crisis in the wake of the global credit freeze.


## KEY POINTS

- This NERI inBrief argues that the long-term success and stability of the currency union depends on the implementation of a package of complementary policy reforms to change the union's flawed institutional architecture.
- An important and necessary reform is the creation of a *conditional* LOLR for sovereign borrowers. A conditional LOLR would eliminate default risks by preventing self-perpetuating negative feedback loops taking hold in the sovereign debt market.
- Progress towards a full and genuine banking union with centralized supervisory and resolution powers assigned to an independent banking authority should be expedited. The absence of a banking union generated a 'doom loop' that threatened member state solvency at the height of the crisis.
- Full fiscal federalism is not necessary for a viable and thriving monetary union. However, some apparatus that can countercyclically dampen the negative effects of asymmetric shocks and economic downturns is required.


**Nevin Economic Research Institute (NERI)**

31/32 Parnell Square
Dublin 1
+ 353 (1) 8897722

e-mail: *info@ NERInstitute.net*
Web: *www.NERInstitute.net*

Carlin House
4-6 Donegall Street Place
Belfast
BT1 2FN
Northern Ireland
+ 44 28 90246214


NERI Nevin Economic Research Institute

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## Introduction

The euro crisis was avoidable and the consequence of systemic policy failures in the way EMU was constructed and implemented. The severity of the crisis was amplified by the misdiagnosis of the crisis as a crisis of fiscal discipline, where, Greece apart, it was really a system crisis with its roots in the design flaws of the currency union itself.

The collective response to the crisis has failed to adequately address these design flaws. Policymakers have, in general, failed to learn the lessons of the Great Depression of the 1930s and failed to learn the lessons of previous attempts at establishing and maintaining viable currency unions.

## Currency Union

The single currency was introduced initially in electronic form in 1999, and then in physical form in 2002. A group of sovereign European states chose to abandon their national currencies and transfer control over monetary policy to a nominally independent institution, the European Central Bank (ECB).

According to its proponents, EMU is an indispensable step in the long, slow journey towards integrating the EU economies. The euro was expected to become a global reserve currency which would rival the US dollar and deliver all the privileges that many believe result from that status. The single currency was also expected to become a stabilising anchor for its member economies, providing a degree of protection against the instability of large exchange rate fluctuations, and embedding lower and more stable inflation and interest rates.

As it transpired the early years of the euro were indeed characterised by lower interest rates and, in aggregate terms, by relatively stable prices. However, during its first fifteen years the Eurozone bloc has underperformed in aggregate relative to the US as well as relative to the non-Eurozone members of the EU. This is true if measured in terms of real GDP growth, or in terms of employment performance.

The sheer persistence, severity and seemingly systemic nature of the euro's three crises – the real economy crisis, the sovereign debt crisis and the banking or financial sector crisis - has cast doubt on the inherent stability and coherence of EMU. While an underwhelming and often misguided political response to the three crises certainly didn't help, it has become evident that the architecture and internal inconsistencies of EMU, as constructed, helped to amplify the crisis.

## Instabilities and Weaknesses

The history books are replete with examples of failed currency unions. Perhaps the most famous example of a *de facto* currency union was the gold standard system. Experience shows that systems of fixed exchange rates eventually buckle during times of crisis under the strain of divergences between domestic political priorities and the objectives of the union.

It is uncertain whether the Eurozone will buck the historical trend. Successful and durable monetary unions such as the US and the UK were preceded by, or accompanied, both fiscal and political union. The US and the UK are also characterized by high levels of internal labour mobility, by banking unions with centralized regulation and deposit insurance, by centralized revenue raising powers and by automatic fiscal transfers between regions.

The desirability of the euro was hotly contested in academic and policy circles. In particular there was debate about whether the Eurozone economy qualified as an 'Optimum Currency Area' (OCA). An OCA is defined as a region for which the benefits of adopting a single currency or a fixed exchange rate system outweigh the costs of relinquishing the exchange rate as an instrument of internal adjustment within the region itself. To qualify, a currency union should ideally have labour and capital mobility across the region as well as a risk-sharing system involving automatic fiscal transfers. It is also desirable that member states have similar business cycles.

**Table 1: Average Fiscal and Current Account (CA) Imbalances, 2000-2007**

| | Fiscal balance (% GDP) | | CA balance (% GDP) |
|---|---|---|---|
| **Greece** | **-6.4** | **Portugal** | **-9.4** |
| **Portugal** | **-4.4** | **Greece** | **-8.4** |
| Italy | -3.0 | **Spain** | **-6.0** |
| France | -2.7 | **Ireland** | **-1.8** |
| Germany | -2.4 | Italy | -1.3 |
| Austria | -2.1 | France | 0.4 |
| Netherlands | -0.6 | Austria | 1.6 |
| Belgium | -0.5 | Belgium | 3.0 |
| **Spain** | **0.4** | Germany | 3.2 |
| **Ireland** | **1.5** | Netherlands | 5.4 |
| Luxembourg | 2.4 | Finland | 5.6 |
| Finland | 4.1 | Luxembourg | 10.1 |

Crucially, the Eurozone suffers from three major instabilities: (A) instability from asymmetric economic shocks where no central mechaniasm is in place to offset these shocks; (B) instability from negative feedback loops in the sovereign debt market where no circuit breaker is in place and (C) instability from regional imbalances and the loss of currency devaluation as a means of adjustment.

## Crisis build-up and Response

The proximate causes of the crisis were the sudden unwinding of large current account imbalances that had built up over time combined with the inability of Eurozone policymakers to respond quickly and decisively to the evolving crisis. Table 1 highlights the scale of capital inflows to the Eurozone periphery in the lead-up to the crisis.

When the financial crisis gave rise to a credit freeze in the global economy economies and institutions that had built up large amounts of debt were left exposed. Investors became increasingly reluctant to lend to Eurozone sovereigns as uncertainty increased about the potential for defaults. Markets realized that member states had no LOLR to lean on and might default. This was to manifest in rising bond yields alongside a rapid deterioration in government fiscal balances as growth slowed and then turned sharply negative in 2009.

The inability to devalue in order to restore competitiveness made the recessions in the periphery all the more painful as fiscal consolidation (austerity) and Internal Devaluation (ID) combined to slow demand and reduce nominal GDP. Deteriorating budget deficits, increasing debt burdens and rising risk premiums fed off each other in a toxic loop. Greece, Ireland and Portugal all lost market access in 2010-2011 while Spain came close to losing access.

The Eurozone established a fund called the European Financial Stability Facility (EFSF) in 2010. Its purpose was to preserve the Eurozone's financial stability by providing emergency lending to member states shut out of the sovereign bond markets. It was subsequently replaced by a permanent institution called the European Stability Mechanism (ESM). Access to funding was made conditional on the negotiation of an agreed programme of structural reform in the recipient country combined with an agreed programme of austerity.

The thrust of the official response to the buildup of current account and competitiveness imbalances was to encourage a process of ID and structural reform in the less competitive member states. Crucially, the attempt to restore competitiveness through ID was not balanced by complementary measures to stimulate internal demand and generate internal revaluation in the core countries e.g. by means of policies to inculcate wage increases and higher levels of investment.

Many of the policy responses (e.g. the ESM) were essential stopgap measures to prevent the crisis spiraling out of control. Other innovations such as the Six Pack might, through better surveillance and early warning systems, reduce the frequency of future crises. The ECB's various liquidity supports played a crucial role in preventing the financial system from completely seizing up. However, some aspects of the policy response are problematic or incomplete and when taken as a package the policy response must be considered wholly insufficient.

## Policy Reforms

An important lesson relates to one of the major causes of the euro crisis, namely the lack of a LOLR for sovereign borrowers. When combined with the inability of individual member states to print their own currency this produces the effect that member states can run out of money and become unable to meet their financial obligations. A stable currency union needs a circuit breaker to extinguish the prospect of sovereign default by any member state that demonstrates a willingness to pursue sustainable fiscal policies. This is an essential component of crisis prevention, resolution and long-term macro stability in the Eurozone. As such, an important and necessary reform is the creation of a *conditional* LOLR for sovereign borrowers.

A second lesson relates to the absence of a genuine banking union for the Eurozone. The failure to establish a banking union amplified the crisis by generating credit imbalances across the union, by creating the prospect of bank runs and sovereign bailouts of banks and by generating a 'doom loop' between domestic banks and member state governments that came to threaten member state solvency. A banking union would mean common deposit insurance for all financial institutions and would mean that bank supervision, regulation, and, where necessary, resolution, were all the responsibility of a single central banking authority rather than a host of different national authorities.

A third lesson relates to the absence of a mechanism that can countercyclically respond to asymmetric shocks across the Eurozone. Full fiscal federalism is not necessary for a viable and thriving monetary union. However, some apparatus that can be employed to dampen the negative effects of asymmetric shocks and economic downturns is required. The best way to operationalize this is through a Centralized Insurance Fund (CIF). The CIF could be mandated to automatically provide direct financial support, under strict guidelines, to member state economies operating below their potential output. The CIF would have to be funded from some hypothecated common Eurozone tax.

A fourth lesson relates to a failure of crisis response and policy coordination. There was an overemphasis on short-run discretionary fiscal consolidation, at the expense of employment and other domestic priorities. The consequence was deepening recession and stagnation in the Eurozone periphery. Yet there was a strong argument for countervailing fiscal expansion in the Eurozone core. A fundamental adjustment problem within the Eurozone is the inability of member states to restore competitiveness and unwind current account imbalances through currency devaluation. Instead, member states are forced into economically damaging policies of ID unless more competitive countries adopt inflationary policies of internal revaluation. Much better mechanisms are therefore needed to ensure proper coordination between countries.

Finally, the social element must be restored to economic policy making in the Eurozone. Criucially, the mandate of the ECB should be changed so the employment and unemployment rates are given equal status with inflation.

## References

This NERI *Research inBrief* represents a short summary of NERI *Working Paper* No.32 – '*Understanding the Euro Crisis: Causes and Fixes*.'

McDonnell, T. (2016) *Understanding the Euro Crisis: Causes and Fixes*, NERI Working Paper No. 32. Dublin, NERI.