The Euro Crisis: Causes and Solutions

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What is TASC?

- An independent, progressive think-tank dedicated to promoting equality, democracy and sustainability in Ireland through evidence-based policy recommendations.

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Lessons from Past Monetary Unions

- Successes
  - USA
  - UK
- Failures
  - Latin Monetary Union (LMU)
  - Scandinavian Monetary Union (SMU)
  - Gold Standard
  - Precursors to EMU – i.e. 'Snake in the Tunnel', EMS
- Successful unions have been preceded by, or accompanied by, political union
- Domestic objectives and concerns eventually undermine monetary union in the absence of political union

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The Trilemma

- The chosen macroeconomic policy regime can include at most two elements of the 'inconsistent trinity' of three policy goals (Obstfeld and Taylor, 2004):
  A. Full freedom of cross-border capital movements;
  B. A fixed exchange rate; and
  C. An independent monetary policy (interest rates) oriented towards domestic objectives

  Gold standard supported 'A' and 'B' – abandoning 'C'
  - No expansionary monetary policy; difficult to engage in expansionary fiscal policy

  Bretton Woods supported 'B' and 'C' – abandoning 'A'
  - Capital controls

  Post Bretton Woods entailed 'A' and 'C' – abandoning 'B'
  - Sharp exchange rate movements seen as problematic for the Single Market

  EMU entails 'A' and 'B' – abandoning 'C'
  - Single market (free movement of capital) and abolition of national exchange rates

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A flawed design?

A narrow focus on price stability at the expense of other macroeconomic targets

Fragilities

- Not an optimal currency area
  - No fiscal transfer mechanism for asymmetric shocks
  - Euro zone has no automatic stabilisers
  - No mechanism for offsetting competitive imbalances
- Monetary union without banking union
  - No centralised authority responsible for the supervision, regulation and, if necessary, resolution of financial institutions
  - No FDIC equivalent was installed
- No conditional Lender of Last Resort
  - No circuit breakers against bad equilibriums
  - No debt mutualisation
  - No protocols for debt write-down

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Boom and bust

- Credit inflows to the periphery
  - Homogenous interest rate despite different places on the business cycle
  - Negative real interest rates
  - Failure of supervision and regulation
- Widening of current account imbalances (2000-2007)
  - Wage restrictions in Germany et al
  - Southern countries maintain traditional wage practices
  - The widening gap could not be offset by devaluations as in the past
- 2008 crash
  - Credit freeze replaced large credit inflows
  - Financial crisis forced bank bailouts (debt socialisation undertaken at the national level)
  - Countries affected asymmetrically (with fixed exchange rates and no transfer mechanisms)
- Negative feedback loop sets in as fiscal balances deteriorated
  - Greece, Ireland, Portugal, Spain, Italy et al suffer severe recessions
  - Spiralling interest rates accompanied by deepening austerity
  - Greece in full blown depression

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Scale of the Debt Overhang (end 2011)

- **Government Debt**
  - circa €169 billion (107%)
  - Increasing y-o-y (government balance in deficit)
  - circa €192 billion at end 2012 – 146.7% of GNP
- **Household Debt**
  - circa €185-190 billion (circa 119%)
  - Decreasing y-o-y (household deleveraging)
- **Business Debt**
  - circa €140-150 billion (90-95%)
  - Decreasing y-o-y (deleveraging/write-downs)

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Bank Recapitalisations by the Irish State (€ billions)

	Anglo	INBS	AIB	EBS	BOI	IL&P	Total
2009	4.0 *Exchequer*	0	3.5 *NPRF*	0	3.5 *NPRF*	0	**11.0**
2010	25.3 *Pro Notes*	5.4 *Pro Notes*	3.7 *NPRF*	0.9 *Pro Notes*	0	0	**35.3**
2011	0	0	1 2.7 *Exchequer =3.9* *NPRF =8.8*	0	1.2 *NPRF*	2.7 *Exchequer*	**16.5**
2012	0	0	0	0	0	1.3 *Exchequer*	**1.3**
Total	**29.3**	**5.4**	**19.9**	**0.9**	**4.7**	**4.0**	**64.1**

Fiscal and Competitiveness Imbalances

Fiscal balance		CA balance	
Country	2000-07 ave	Country	2000-07 ave
Greece	-5.4%	Portugal	-9.4%
Portugal	-3.7%	Greece	-8.4%
Italy	-2.9%	Spain	-5.8%
France	-2.7%	Ireland	-1.8%
Germany	-2.2%	Italy	-1.3%
Austria	-1.6%	France	0.4%
Netherlands	-0.6%	Austria	1.6%
Belgium	-0.4%	Belgium	3.0%
Spain	0.3%	Germany	3.2%
Ireland	1.5%	Netherlands	5.4%
Luxembourg	2.3%	Finland	5.9%
Finland	4.1%	Luxembourg	10.6%

'Multiple Equilibria' in a Monetary Union

- Massive and destabilising credit inflows and outflows
  - Persistent mispricing of risk
- No Lender of Last Resort facility for sovereigns
  - 'Multiple equilibria' problem
  - Member states effectively 'Dollarized', albeit with Euros
- Member states downgraded to emerging country status
  - Dollarized Governments can run out of money creating risk of sovereign default
  - As fiscal balance deteriorates in a recession the risk premium increases
  - This creates a progressively worsening feedback loop eventually forcing external assistance or default

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Three Interlocking Crises

1. Sovereign debt crisis
2. Banking crisis
3. Real economy crisis (growth and jobs)
   - All three are manifestations of a wider system crisis
   - All three are interlocking

- Feedback loops
  - Sovereign ↔ Banks
  - Banks ↔ Growth
  - Growth ↔ Sovereign

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Structural Crisis

Over indebtedness (Balance sheet recession)

- Public debt
- Excessive private debt
  - Commercial
  - Household
- Weak balance sheets of banks

All of the above weigh down on consumption, investment and employment

Structural imbalances

- Structural deficits
- Misaligned real exchange rates
- Current account imbalances – competitiveness problems

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The Official Response to the Crisis

A. Sovereign debt crisis:

- Securities Market Programme (SMP)
- Special Purpose Vehicles are created: EFSF/ESM
  (Funding access conditional on 'structural reforms' and fiscal consolidation)
- Fiscal Compact
- Outright Monetary Transactions (OMT)

B. Banking crisis:

- Banking recapitalisation at the national level (socialisation of private debt)
- Cheap liquidity
- Stress tests and increased bank capital ratios
- LTROs

C. Growth and employment crisis:

- Internal devaluation to deal with fiscal and competitiveness imbalances
- No countervailing measures in the core
- Structural 'reform' for programme countries

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Proposed Solutions: Sovereign debt crisis (1)

Goal: Eliminate the multiple equilibria problem for any state showing a willingness to pursue a sustainable fiscal path

The current structure of the ESM is inherently fragile

- To date there is no credible institutional framework which would prevent member state insolvency
- ESM is not an LOLR
- But it is an important crisis stopgap

Medium term solutions?

- Collective action problem means fiscal rules…cannot be ignored
  - Eurobonds are problematic
  - Unconditional LOLR for sovereigns is inappropriate without full fiscal federalism

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Proposed Solutions: Sovereign debt crisis (2)

- Proposal – First Element
  - **Assign Banking Licence to a Special Purpose Vehicle**
    1. ECB would be able to lend to it
    2. Special Purpose Vehicle (SPV) could be the ESM
    3. ESM has a paid in working capital of €80 billion and would be able to engage in purchases of government bonds at future sovereign debt issuances
    4. ESM could then place these bonds as collateral with the ECB in order to maintain its own capital base
    5. The ESM would become a de facto LOLR for sovereigns
  - But what about monetary expansion, particularly in the short-term?
    - A slightly higher level of inflation in the short-to-medium term would actually have advantages

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Proposed Solutions: Sovereign debt crisis (3)

- Basic model has the same old moral hazard risks
  - How can we incentivise sovereigns to employ fiscal prudence?
  - How can we protect against political interference?
- Proposal – Second Element
  - **Guaranteed but 'conditional' lender of last resort**
  - Moral hazard - Different interest rates for sovereign borrowers with the exact interest rate offered by the SPV determined by:
  - Sovereign policy actions
  - Economic context (place in the business cycle)
    - Formula would need to be transparent with the exact interest rate to be offered announced in advance of the auction
    - This would set a ceiling on the yield demanded
  - Political interference? - Precise formula determined annually by the board of governors (transparent and automatic)

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Proposed Solutions: Banking crisis (1)

Goal: Breaking the link between sovereigns and banks, protecting taxpayers and depositors and dealing with capital flight

- **Proposal - First Element**
- A **centralised deposit insurance scheme** along the lines of the FDIC is a necessary component of any monetary union characterised by massive transnational banks
- How should such a scheme be implemented and which institution should have responsibility for managing the scheme?
- Short-term – ECB
- Medium-term – a dedicated European Deposit Insurance Corporation (EDIC) funded by the Euro zone's private credit institutions

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Proposed Solutions: Banking crisis (2)

Proposal - Second element

- **Centralised banking union**
- Centralised supervision and regulation at the Euro zone level with the authority to close down insolvent banks is:
  - A necessary quid pro quo for pan Euro zone underwriting of bank deposits
  - And desirable in any case
- **All** Euro zone banks should automatically be covered
  - Position of non Euro zone banks is less clear
- Bank resolution
  - No liquidity support for insolvent credit institutions
  - Banks should be closed and allowed to fail where shown to be insolvent by mandatory regular stress tests conducted by the ECB/EDIC itself
  - Rules should be clearly defined with transparent protocols.
  - EDIC decisions should be independent of national governments

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Proposed Solutions: Real Economy (1)

Goal: Escaping the Trilemma

- Giving up full freedom of cross-border capital movements is inconsistent with EU membership
- Giving up a fixed exchange rate is inconsistent with Euro zone membership

But…

- At the level of the Euro zone itself we don't have the trilemma problem because the Euro floats against other currencies
- At the Euro zone level we can align monetary and fiscal policies to the goals of employment and growth

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Proposed Solutions: Real Economy (2)

	Target for peripheral regions (weight = 1)	Target for non-peripheral regions (weight = 2)	Overall Target
Inflation (%)	0	3	2
Inflation (%)	1	4	3
Inflation (%)	2	5	4

Proposal – First Element

- Balance of payments and competitiveness crisis:
  - Competitiveness is a relative concept
  - Is there an alternative to internal devaluation?
  - **Differentiated inflation targeting** (temporarily increasing it overall)
  - Fiscal expansion in the core
  - Closer coordination of policy

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Proposed Solutions: Real Economy (3)

- **Proposal – Second Element**
  - Asymmetric shocks and the need to replace lost policy levers
    - Does not imply the need for full fiscal union
- Broad framework

1. **Intergovernmental coordination of policies** to prevent competitiveness imbalances from growing too large
2. **Centralised insurance fund**:
   - Counter cyclical policy lever
   - Funded through a pan Euro zone consumption tax hypothecated for and paid directly to the centralised insurance fund
   - Mandated to run a surplus over the economic cycle

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So…

The monetary union can fail or stagnate.

- But if the correct policies are adopted the Euro zone can be made viable
- **Lessons of history and economic theory**:
  1. Monetary unions must be supplemented by banking unions including trans-national deposit insurance
  2. Monetary union also requires a guaranteed lender of last resort with safeguards against moral hazard
  3. An offsetting centralised fiscal apparatus to combat regional recessions and asymmetric shocks is an important component of successful monetary union

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A Social Compact for Europe?

- What kind of EMU do we want to be part of and to save?
- Supplementing the Fiscal Compact with a Social Compact
- Expanding the list of indicators
- Strategic versus tactical decision making

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