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Monetary cooperation and monetary policy in the EU

The Eurozone crisis

Lecture 5

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The Eurozone crisis

Lecture 5

In this lecture you will learn about:

- The global financial crisis of 2008
- Internal imbalances in the EU and the Eurozone prior to the crisis
- Reactions of the EU to the crisis
- Austerity policies
- Core-periphery divide in the EU and the Eurozone
- Post-crisis perspectives (growth, employment, public finances)

Introduction: Phases of the Eurozone crisis

Impact of global crisis

- Financial crisis (2008-2009)
- Fall in demand (2009)

Crisis management I

- Restoring demand through public spending

Impact: considerable worsening of public finance positions leading to the:

Sovereign debt crisis (2010-2011)

Crisis management II

- Efforts to consolidate public finances, the European Semester
- Austerities (2012-)
- Banking union (2014)
- Changing role of ECB (from strict inflation-targeting to more supportive policy)

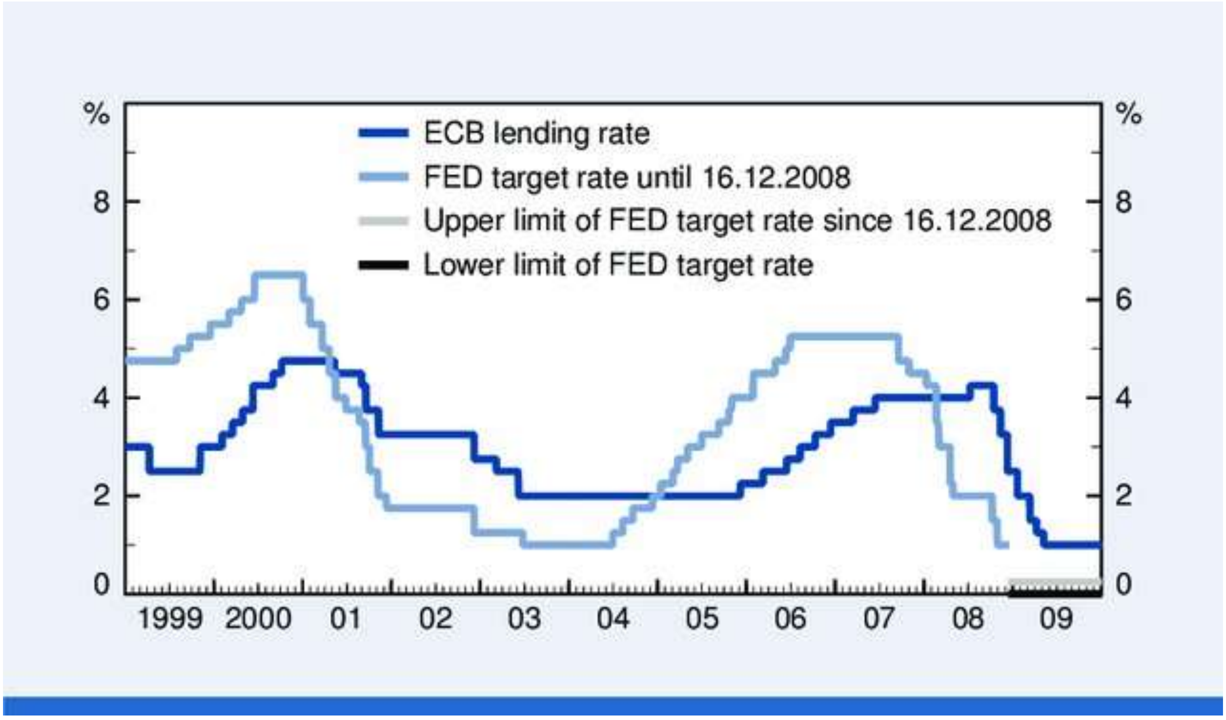
Impact: political crises, high unemployment in many countries, low growth

After 2014: public finances still not sustainable in many countries, political turmoil still not over

The run-up to the global financial crisis of 2008

“Cheap money” in early 2000s → huge pressure on financial actors → weaker and weaker borrowers

Also: **high demand → rising prices**



Source: Gylfason et al. (2010)

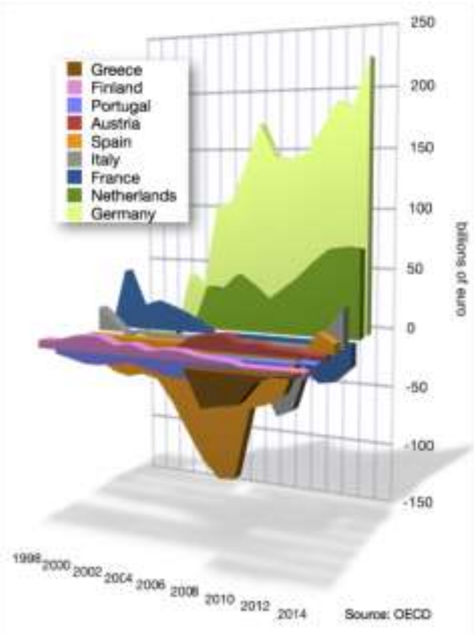
Besides stimulating the economy, **decreasing interest rates** can be used as a crisis management tool as it eases the financing burden of real economic actors through the interest rate transmission channel. However, if a central bank arrives at a crisis with already low (or even 0) interest rate levels, this tool cannot be deployed any longer (→ **zero lower bound**).

The run-up to the crisis in the Eurozone

Internal imbalances prior to the crisis:

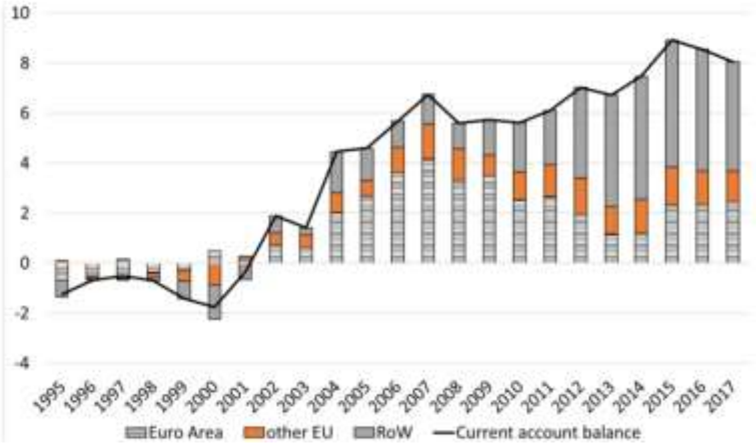
- large-scale **German-led export and investment boom towards the Eurozone periphery** that experienced unprecedented increase in purchasing power, and also of labour cost increase, in the first decade of EEMU
- in the same time, Germany undertook a multiannual national reform programme to restore its competitiveness by restricting labour cost increase and improving labour market flexibility

Current account imbalances (1998–2014)



Source: https://en.wikipedia.org/wiki/European_debt_crisis

German current account, by partner (% of GDP)



Source: Micossi et al. (2018)

The outburst of the global crisis

Too much **risk-seeking**, leading to... **price bubbles**... (mostly real estate: secondary mortgages) ...**bursting** quickly, creating **negative shock-effect**.

Lack of confidence in the markets resulting in... **bank panic** and... **decreasing production**, leading to... **decreasing demand and unemployment**.

September 2008: **Lehman Brothers going bankrupt**.

Too much risk: remaining hidden, due to financial innovations. We can't let all the banks go bankrupt: time for some banking system bailouts. Draining back capital from all around the world, creating liquidity shortage.

First steps in the EU

November 2008: action plan of the European Commission: the **European Economic Recovery Plan**

> *"A comprehensive and ambitious recovery plan is now on the table. The quicker we make it happen, the sooner we will bring the help needed to Europeans today."* José Manuel Durão Barroso (at-that-time President of the European Commission)
>
> Slogan: *"the time to act is now"*
>
> The **"winner" action** is: **quick**, **brave**, **ambitious**, **targeted**, carried out in the **cooperation** of partners, based on **commonly defined objectives**, built on **strengths**, **aimed at restoring demand and trust**

Two key pillars of the plan:

1. A major injection of purchasing power into the economy: this is the way to save hundred thousands of work places.
2. Short-term action should be taken to reinforce Europe's competitiveness in the long term. Key concept: intelligent investment, investing in
   – the right skills for tomorrow's needs
   – energy efficiency to create jobs and save energy
   – clean technologies to boost sectors like construction and automobiles in the low-carbon markets of the future
   – infrastructure and inter-connection to promote efficiency and innovation

Principle: solidarity and social justice → greatest help for those who need it most; social security systems should protect work places

Stimulating demand can only bring long-lasting results if it is accompanied by structural reforms. The economy's adjustment capacity is the key success factor of a rapid recovery.

Strategic objectives:

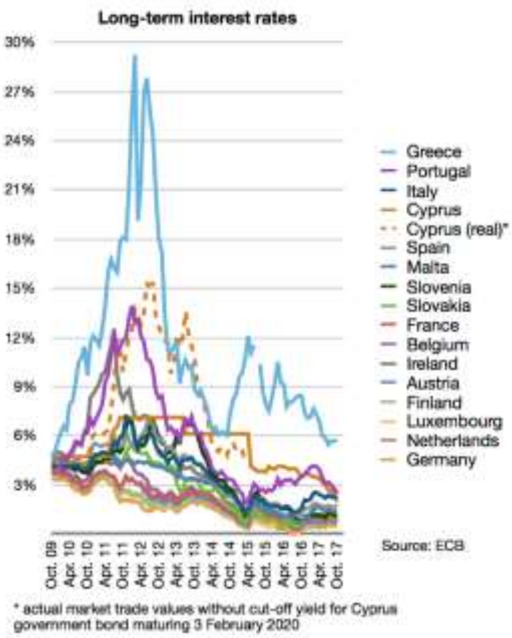
- Quickly stimulate demand and boost consumer confidence.
- Lessen the human cost of the economic downturn and its impact on the most vulnerable.
- Ensure that the European economy is in tune with the demands of competitiveness and the needs of the future, as outlined in the Lisbon Strategy for Growth and Jobs.
- Speed up the shift towards a low carbon economy.

Budgetary stimulus at the member states' level:

- Should be temporary – the medium term objective is balance
- Not all member states were in the same starting position
  - Those that had taken advantage of the good times to achieve more sustainable public finance positions and improve their competitive positions had more room for manoeuvre in the crisis.
  - For those member states, in particular outside the euro area, which were facing significant external and internal imbalances, budgetary policy was essentially aiming at correcting such imbalances.

Consequences:

- Rebound – but one that has proven only temporary
- A second wave of recession (W-shaped crisis)
- Severe deterioration of public finances in the member states
- Investors' trust decreased → state's refinancing became more expensive, in times of crisis…
- Interest rates of long term government bonds: spread increased, periphery experiencing sudden increase

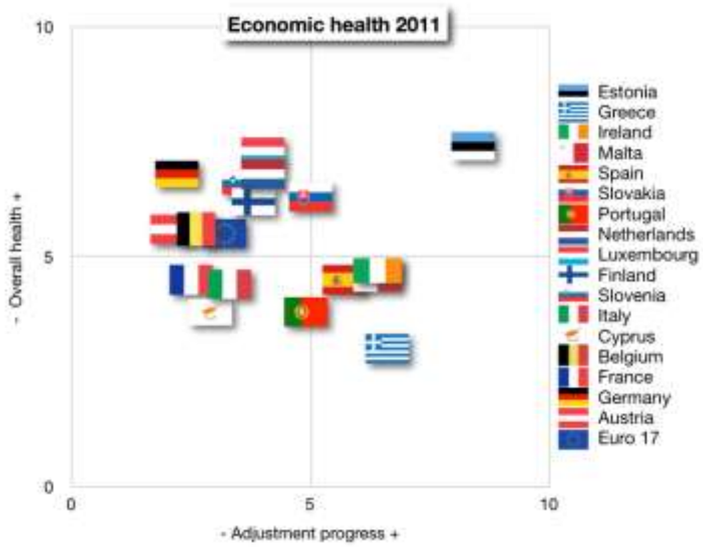


How could restrictive fiscal policies (e.g. austerity policies) become popular among member states?

Because investors lost confidence in poorly performing countries → the interest rates on their sovereign bonds started to rise → investors' trust had to be gained back → consolidation of public finances became necessary.

The **Eurozone became divided** into:

– a **core** coping relatively well with the crisis
– a **periphery** sinking into a deepening sovereign debt crisis



Source: European Commission

There has been **no legal or economic roadmap to exit the Eurozone**. For the Eurozone countries facing severe refinancing difficulties, an exit from the EEMU would have probably meant leaving the EU as well. The consequences would have been detrimental (extreme losses by investors including major European banks), with the risk of uncontrollable events eventually leading to the breakup of the EEMU and even the EU. This way, other solutions had to be found.

International financial assistance to crisis countries

International financial assistance became necessary:

- **European Financial Stability Facility (EFSF)**
- **European Financial Stability Mechanism (EFSM)**
- **European Stability Mechanism (ESM)**

European Financial Stability Facility

These were managed by the **European Commission**, with the participation of the **IMF** and the **ECB** (→ Troika)

European Financial Stability Facility (EFSF)

The temporary fiscal backstop

The **European Financial Stability Facility (EFSF)** was created as a **temporary crisis resolution mechanism** by euro area countries in **June 2010**. It has provided financial assistance to **Ireland**, **Portugal** and **Greece**. The assistance was financed via bonds and other debt instruments on capital markets.

European Financial Stability Mechanism (EFSM)

Pre-2015 support

The **European Financial Stabilisation Mechanism (EFSM)** was created for the European Commission to **provide financial assistance to any EU country experiencing or threatened by severe financial difficulties** using bonds issued on behalf of the European Union.

The EFSM was used to provide financial assistance conditional on the implementation of reforms to **Ireland** and **Portugal** between 2011 and 2014, and to provide short-term bridge loans to **Greece** in July 2015.

European Stability Mechanism (ESM)

Permanent tool

The **European Stability Mechanism (ESM)** was set up as an **international financial institution by the euro area member states to help euro area countries in severe financial distress**. It provides emergency loans but in return, countries must undertake reform programmes (→ **conditionality**).

The ESM replaces the EFSF.

The sovereign debt crisis in the Eurozone periphery

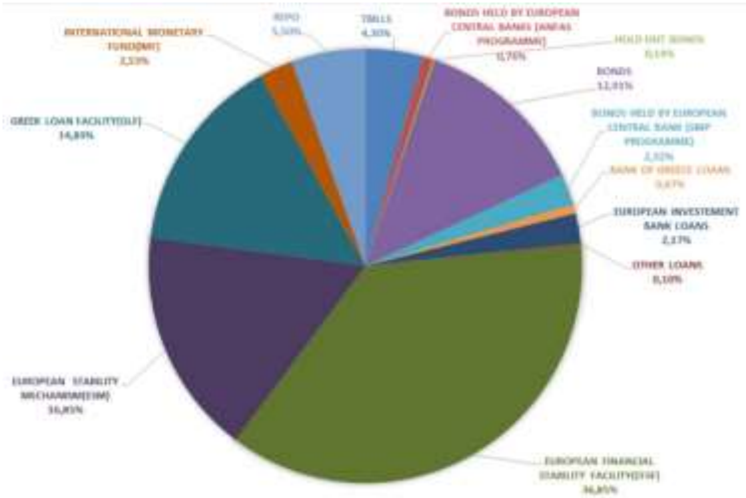
Greece

May 2010: First assistance programme (80 billion EUR until June 2013)

March 2012: Second assistance programme (further 130 billion EUR for 2012-2014, later expanded until 2015)

August 2015: ESM Stability Programme (62 billion EUR over 3 years, until August 2018)

Composition of Greek debt, 2019



Source: http://www.pdma.gr/en/public-debt-strategy/public-debt/composition-of-debt/composition-by-funding-instrument

Ireland

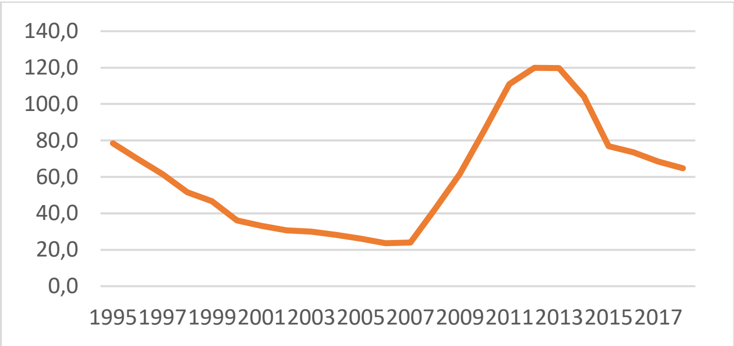
Overheated economy pre-crisis

- outstanding GDP growth rates (>10%)
- high inflation, in EUR
- massive inflow of investment into the country
- intensive deleveraging of national public debt
- belonged to the most competitive countries of the worlds

Crisis

- tremendous fall in GDP
- ca. a yearly GDP spent on bank bailouts
- international financial assistance between December 2010 and March 2014

Ireland's gross national debt, % of GDP, 1995-2018



International financial assistance to Ireland

Source	Amount
EFSM	22.5 bio EUR
EFSF	17.7 bio EUR
United Kingdom (bilateral agreement)	3.8 bio EUR
Sweden (bilateral agreement)	0.6 bio EUR
Denmark (bilateral agreement)	0.4 bio EUR
IMF	22.5 bio EUR

Source: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-ireland_en

Portugal

In the early 2000s the country undertook harsh fiscal adjustment in the framework of the Excessive Deficit Procedure (EDP)

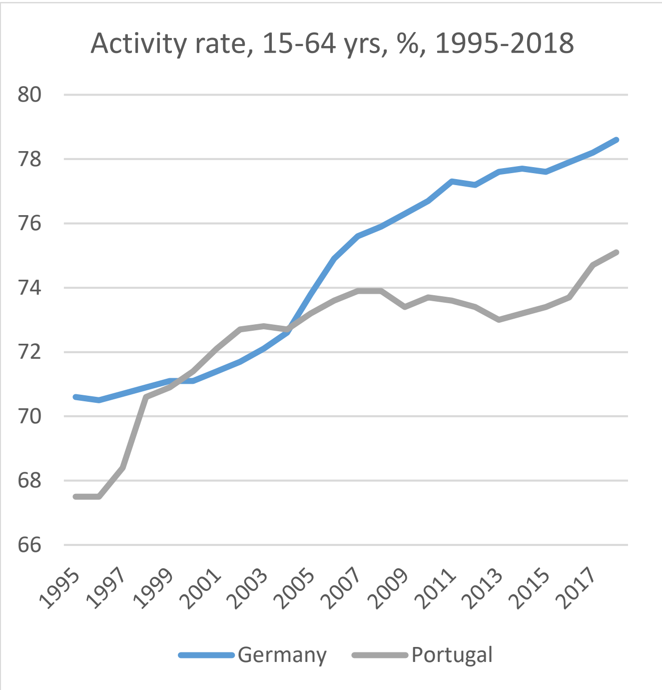
But the expected upswing did not come (austerity policies failed!)

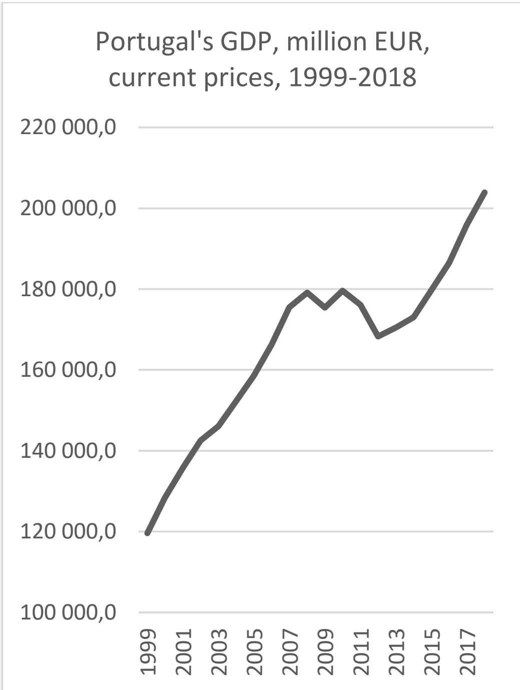
At the outburst of the crisis

- too low activity in the labour market
- underperformance in education indicators
- further structural problems

Crisis

- GDP growth halted
- international financial assistance between April 2011 and December 2014
- the country met all criteria of the creditors and exited from the programme according to schedule





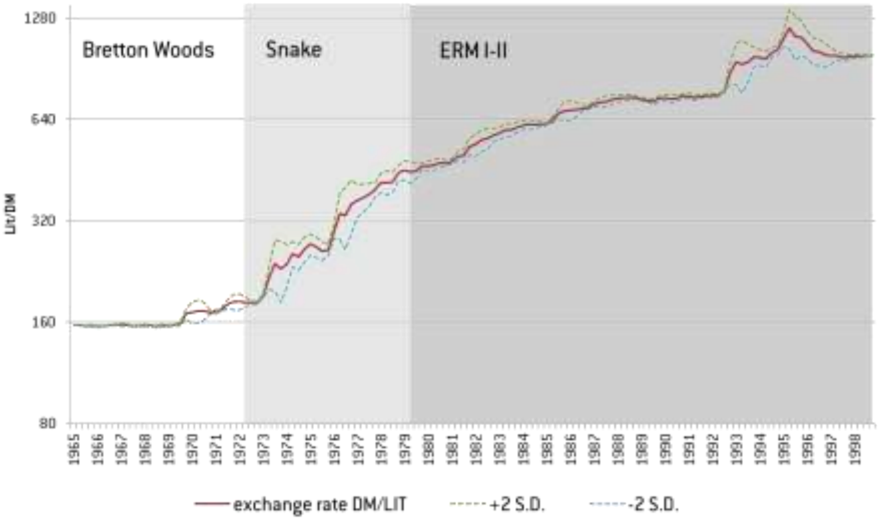
Italy

Gradual depreciation of the ITL from the 1970s onwards

- became a standard ingredient to the national economic policy mix
- one of the main causes leading to the 1993 EMS crisis (the GBP being other one)
-

The Origins of the Italian Sovereign Debt Crisis

ITL/DEM exchange rate, 1965-1998



Source: https://bruegel.org/2017/07/italian-economic-growth-and-the-euro/

1998: ca. 100% debt-to-GDP ratio at euro introduction (the creative interpretation of the Maastricht criterion allowed it)

Relative stability in the first ten years of the euro → the acceptable growth hid the structural problems

Crisis

- dynamic increase in indebtedness, up to 130% of GDP in few years
- “too big to fail” (24% of all Eurozone debt is owned by Italy) → international financial assistance not possible
- large part of Italian debt is held by Italian banks → systemic risk

Source: http://www.telegraph.co.uk/finance/financialcrisis/8880481/Debt-crisis-as-it-happened-November-9-2011.html

Spain

Economic opening from EEC accession (1986) onwards → spectacular development

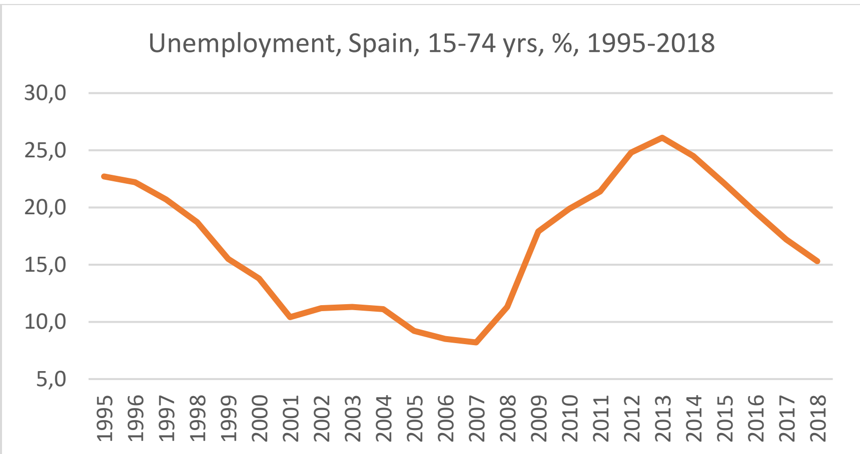
Large support for EU and EUR (all throughout the decades)

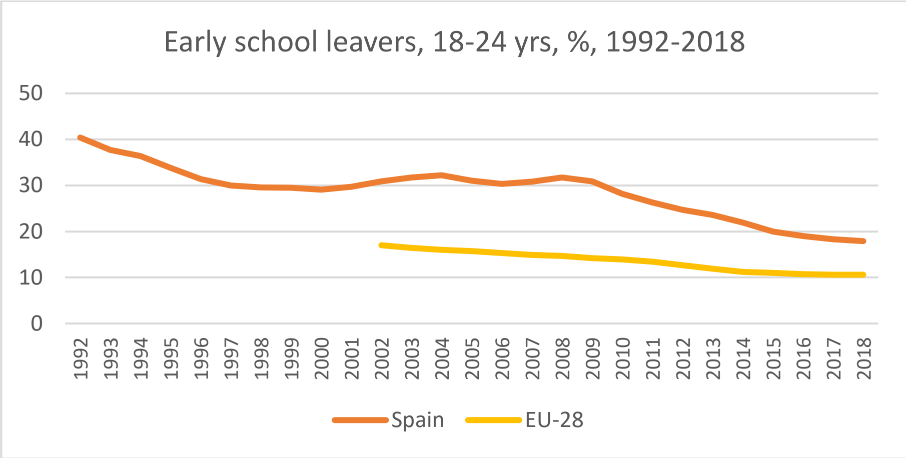
First ten years of the euro: upswing

- massive investment (especially from the EU core)
- debt deleveraging
- structural modernisation, labour market expansion, decrease in unemployment
- construction sector boom hid the structural problems of the labour market

Crisis

- started already in 2007 in the real estate sector
- banking crisis, peaking in summer 2012
- international financial assistance: July 2012, 40 billion EUR, for bank recapitalisation



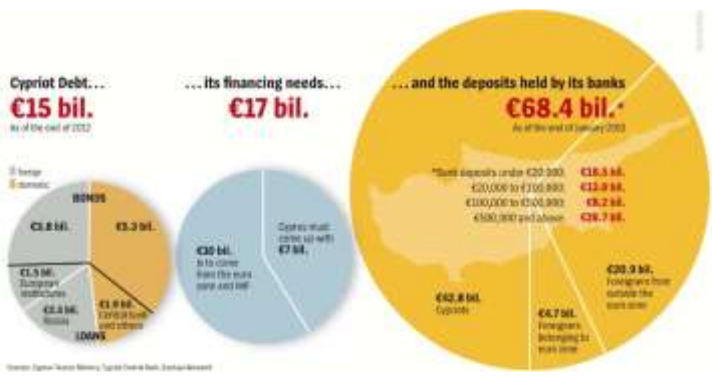


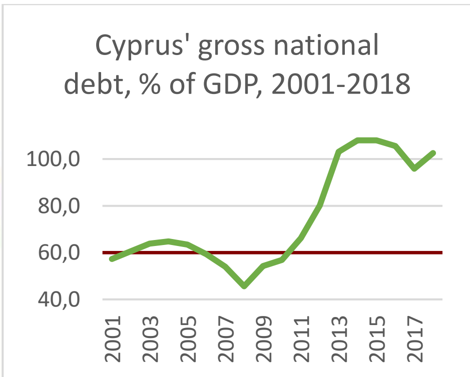
Cyprus

Joined the EU in 2004 and the Eurozone in 2008; quickly became an offshore haven in EUR

Crisis

- reached the country only in 2013
- special case
- international financial assistance: May 2013, 10 billion EUR until March 2016
- ambitious reform programme including regulation of the financial sector with the aim to restore financial stability
- private capital was also involved into crisis management: “haircut” at 100,000 EUR

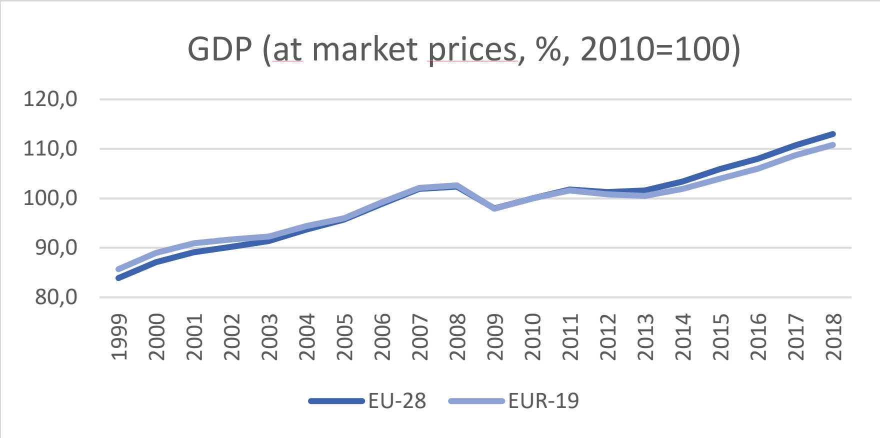




Post-crisis prospects of economic growth in the EU and the Eurozone

Growth

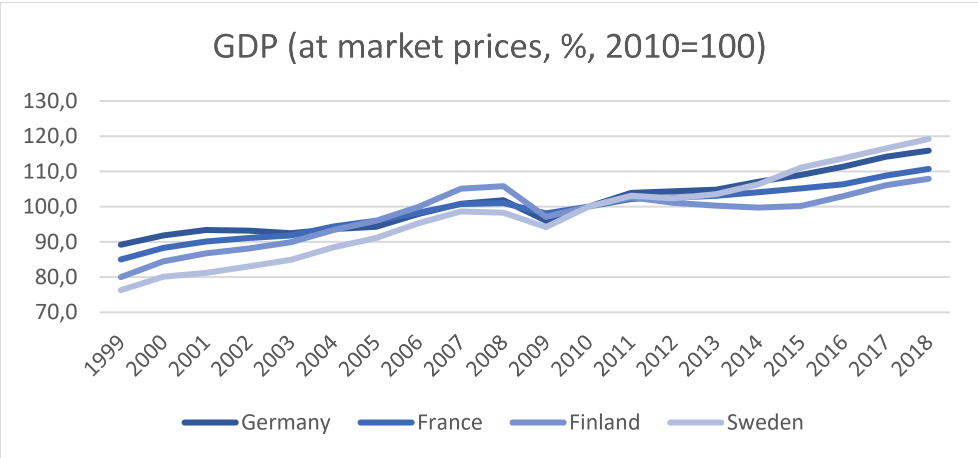
Growth returned in the EU and the Eurozone in 2013

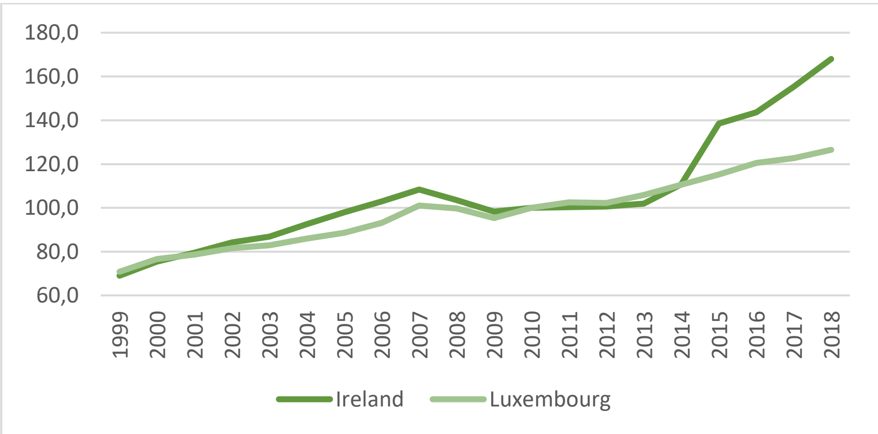


- however, countries have followed different paths

Core countries of the EU: fallback during crisis, back to growth soon after

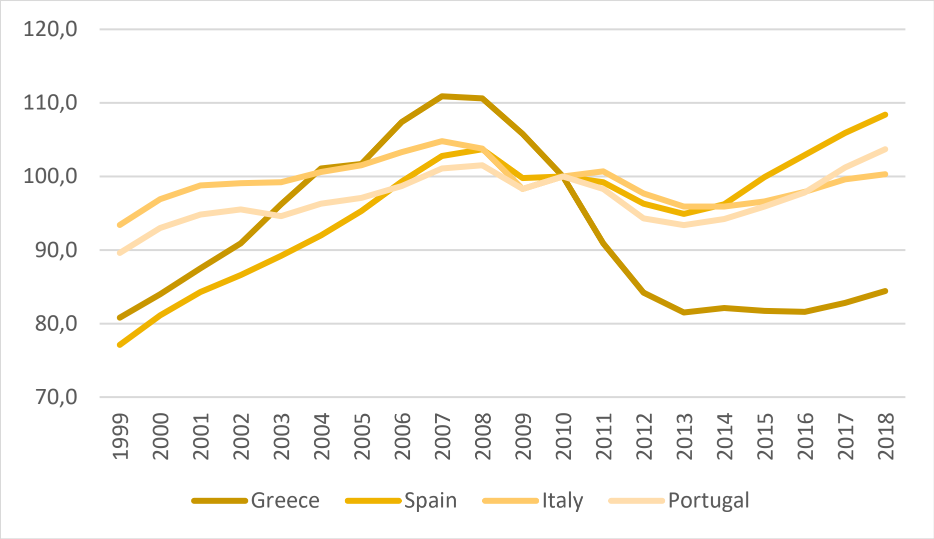
- Ireland: special case





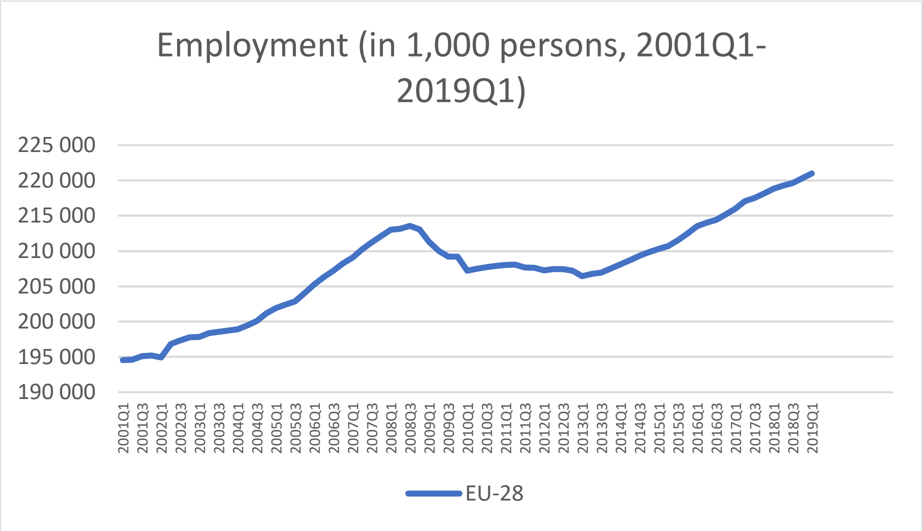
Eurozone Southern periphery: growth problems

- Greece has lost 25-30% of its pre-crisis GDP
- Italy, Portugal: mostly stagnation

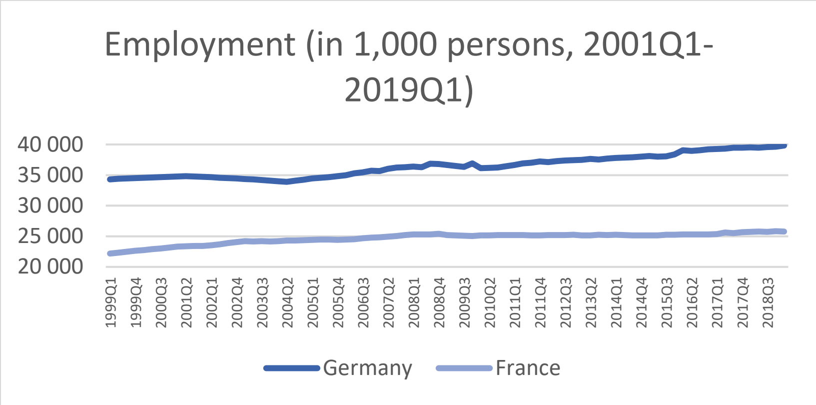


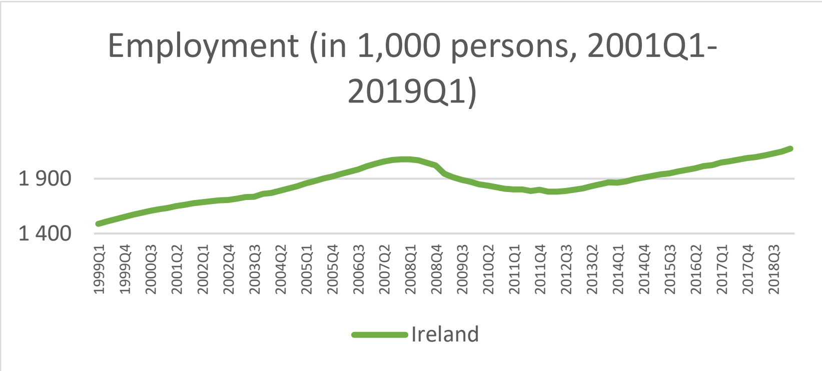
Employment

Employment has been growing again as well since 2014



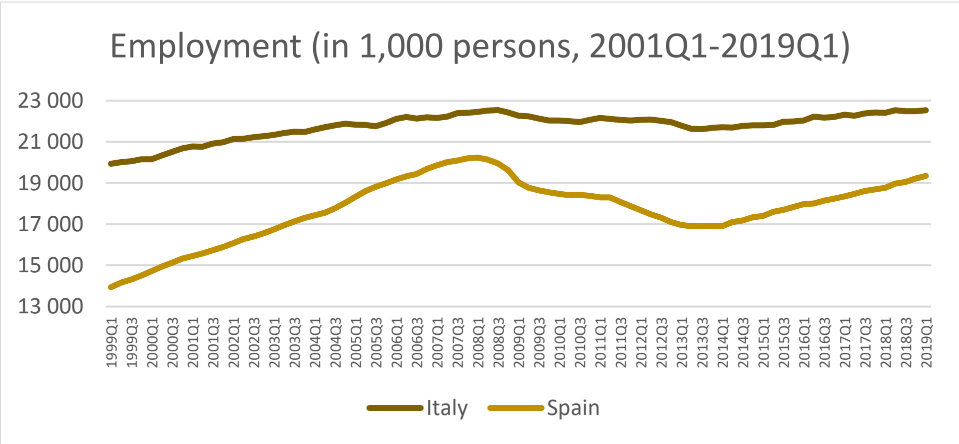
- national varieties

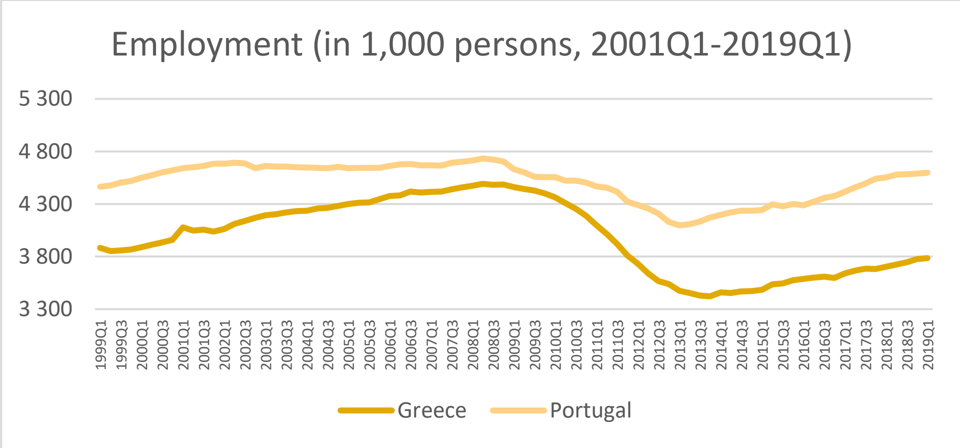




Southern Eurozone periphery:

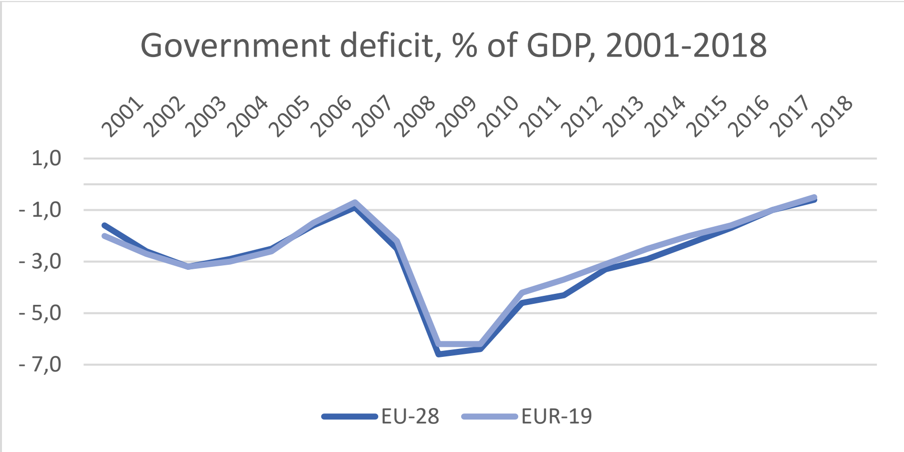
- spectacular growth of labour force pre-crisis (except for Portugal)
- considerable effect of crisis
- hardly reaching pre-crisis levels

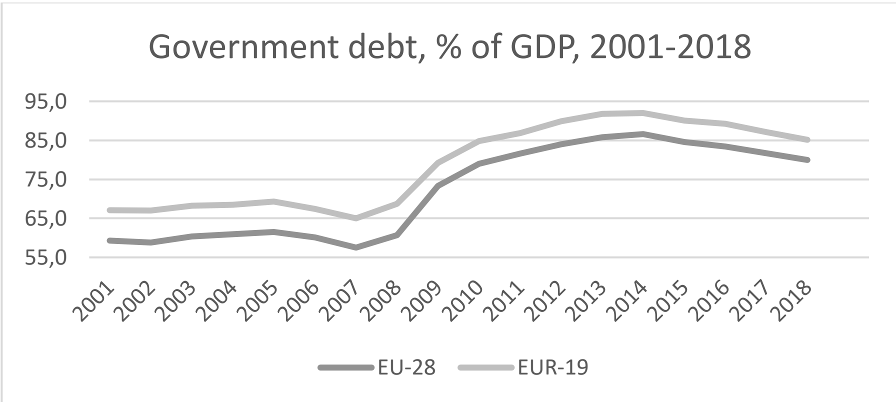




Public finances

Public finance situation post-crisis is not favourable overall





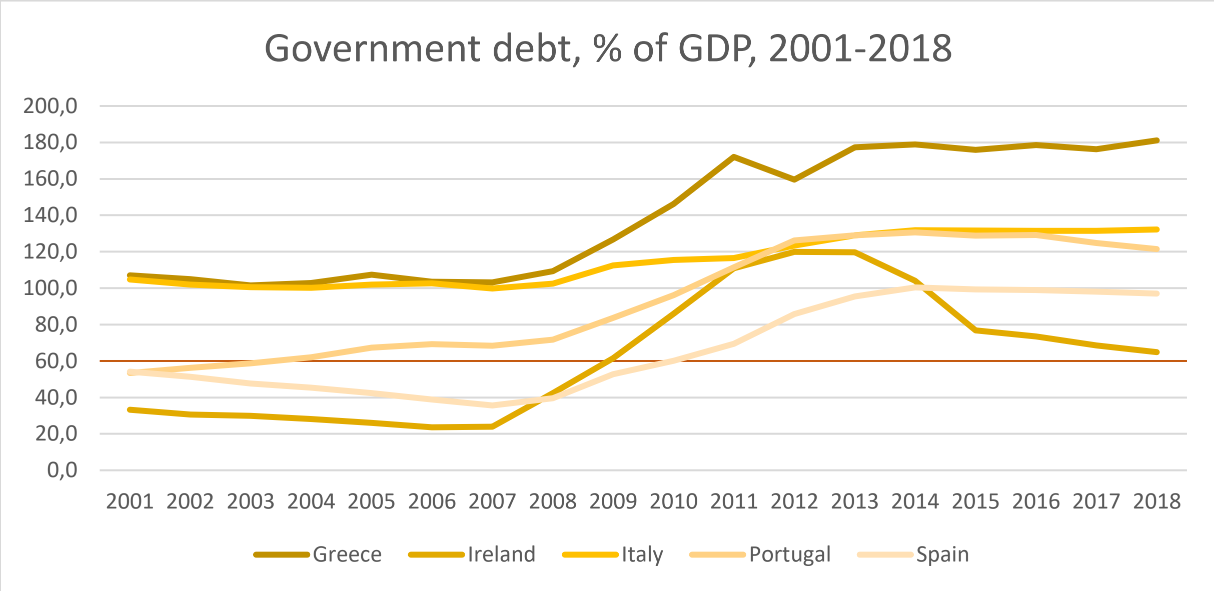
Government deficits

- deteriorated everywhere due to crisis and crisis management

Government debt

- was a minor issue pre-crisis
- became central in the Eurozone crisis

- Ireland, Portugal, Spain: around or below Maastricht threshold pre-crisis
- Greece and Italy: ~100% pre-crisis
- intensive indebtedness everywhere during crisis
- Ireland is most successful in deleveraging its public debt post-crisis (→ very high growth!)
- pre-crisis levels not on the horizon for EU and Eurozone as a whole



Conclusion

The crisis was a 'game changer' for the EU.

Internal structure of the EU has changed considerably.

- core-periphery divide
- core countries: steady performance, coped well with the crisis
- Eurozone periphery: deteriorating performance, long-lasting negative effects of crisis
- Eastern new member states: crisis put a halt to earlier impressive convergence; diverse paths since then

Finding joint ways forward has become more difficult.

- not only because there are 28 (27) various countries
- but because such divergent interests are hard (or impossible?) to reconcile
- this applies to the ECB's common monetary policy in the Eurozone as well

Economic governance: more sophisticated tools but still substantial limitations.

- MIP shows us the problems – but what can we do with them?
- similarly to EDP, MIP is also processing along Council decisions

Questions for self-study

1. What were the general causes of the global financial crisis of 2008?
2. Through what channels could the mortgage crisis of the USA affect the economy of the EU?
3. What caused the financial bubbles in the periphery of the EU?
4. Please describe the internal imbalances developed prior to the crisis.
5. What were the main pillars of the 2008 European Economic Recovery Plan?
6. Why is it unfortunate to raise interest rates during crisis?
7. Which member states could apply stimulating fiscal policies?
8. How could restrictive fiscal policies (e.g. austerity policies) become popular among member states?
9. How can you describe the tendencies of interest rates of long term government bonds between 2009 and 2014?
10. Which are the so-called PIIGS countries? How did the crisis take place in each of these countries? Please describe each case. What about Cyprus? What happened there during the Eurozone crisis? How was the Cyprus crisis solved?
11. How could a sovereign debt crisis evolve in the PIIGS countries?
12. Please describe the core vs. periphery divide in the EU and the Eurozone. In what respects is this internal divide problematic?
13. What was the aim of the different common European crisis management funds? (EFSF, EFSM, ESM)
14. What would be some of the expected results of a Eurozone exit?
15. What are the current prospects of economic growth in the EU and the Eurozone?

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EFSM: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/loan-programmes/european-financial-stabilisation-mechanism-efsm_en

ESM: https://www.esm.europa.eu/about-us/intro

Data: Eurostat