The euro on the brink
‘Multiple’ crises and complex solutions

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European economies’ sovereign debt (as a share of GDP)

Source: IMF WEO September 2011
Introduction

• Europe’s sovereign debt crisis has:
  • exposed the deficiencies in the governance of the EMU;
  • shown the limits of its framework of policy cooperation;
  • exposed the imbalances within Europe;
  • exacerbated the structural weaknesses of its model of growth;
  • emphasised the regional differences - or “two-speed” Europe.

• However, the euro crisis did not develop overnight, but incubated over the years
  • the process of European integration exacerbated existing weaknesses and accentuated divergencies
Greece and Italy

• Greece and Italy were admitted to the EMU with public debt exceeding 60% of GDP that was sanctioned in the Maastricht Treaty in 1992.

• However, Italy, one of the signatories of the Treaty of Rome in 1957 and one of Europe’s largest economies, was deemed necessary to the success of the euro.

• Being about 2% of the total euro area economy, Greece was believed to be too small to have any significant impact on the stability of the currency union.
Greece fiscal deficit (as a share of GDP)

Source: IMF WEO September 2011
*Drop down lines indicate election years
Ireland, Spain and Portugal

• Ireland and Spain suffered from interest rates inappropriate for the pace of their economic growth and/or of credit growth.

• In addition, strong economic growth and potential overheating in Ireland and Spain required countercyclical policy measures to avoid excessive credit growth and build up in property bubble.

• Government interventions in response to the global financial crisis led to the widening of public deficits and debt, even for ‘fiscally virtuous’ countries such as Germany.

• Ireland and Spain, and to some extent Portugal, ended up joining the group of countries with long-term public finance problems such as Greece and Italy.
Ireland fiscal deficit (as a share of GDP)

Source: IMF WEO September 2011
The critical outlook of the euro periphery

• Unsustainable cost of government borrowing
• ‘Two-speed’ Europe: growth and inflation
• Record levels of youth unemployment
The cost of government borrowing

Source: Financial Times
GDP growth and Inflation, Euro Area 2010

Source: Eurostat
Youth unemployment, Euro area, September 2011*

Source: Eurostat

*Germany: August 2011; Greece, Estonia: July 2011
Stress points and spillovers

- Banks’ direct holdings of sovereign debt
- European banks have sizeable exposures to banks in affected countries
- Credit Default Swaps channels
- Cross-country contagion
Banks’ foreign claims located in Greece by European reporting countries, Quarter 2, 2011 (USD Billions)

- Germany, 21.4
- France, 55.7
- Other, 18.4
- Portugal, 10.1
- Netherlands, 4.4
- Italy, 3.7
- Austria, 3.3
- Belgium, 1.7
- Spain, 1.2
- Ireland, 0.8

Source: BIS
European banks’ combined exposure to foreign claims located in affected countries, Quarter 2, 2011

Source: BIS
The long genesis of the euro crisis

• Long-standing problematic fiscal positions, under-performing economies and imbalances are the main causes of Europe’s vulnerability to the global financial crisis and later to the sovereign debt crisis.

• In addition, deteriorating competitiveness of the affected countries clearly manifested (prior to the crisis) in:
  • Unit labour costs
  • Consumer prices
  • Terms of trade / current account balances
  • Real effective exchange rates
Nominal unit labour costs (compensation per employee to real GDP per person employed)

Source: AMECO
Inflation in the euro area (Consumer Prices Index, 1991=100)

Source: OECD
GDP at 2000 market prices (adjusted by terms of trade per person employed)

Source: AMECO

*1000 ECU/EUR- Weighted mean of t/t-1 national growth rates (weights: t-1 current prices in ECU/EUR)
Greece Real Effective Exchange Rate (deflator: unit labour costs in the total economy, 12 trading partners)

Source: Eurostat
Ireland Real Effective Exchange Rate (deflator: unit labour costs in the total economy, 12 trading partners)
EMU ‘on the brink’

• The general consensus is that Greece is now insolvent.

• Indicators of debt sustainability point towards a Greek default:
  • public debt-to-GDP (165.6%),
  • public debt-to-government revenues (about 400%), and
  • benchmark government bond yields (10-year bond yield at about 28%)

• Spreads on Italian (and Spanish) debt are getting close to the point where sustainability issues are raised.

• Credit rating agencies have also warned about the risk of a downgrade to France’s rating owing to French banks’ exposure to a Greek default and their reliance on wholesale funding.

• However, the German fiscal position as well as the growth prospects have kept a lid on its sovereign borrowing.
European Financial Stability Facility

- € 440 billion
  Total EFSF

- € 250-275 billion
  To be leveraged 4-5 times hoping to yield € 1 trillion

- € 150 Billion
  Used to help Ireland, Portugal and Greece

Source: EFSF, Eurostat, EBA, WSJ and Reuters
Private Sector voluntarily write off 50% of its investment in Greek bonds to reduce Greece's debt by €100 billion.

Source: EFSF, Eurostat, EBA, WSJ and Reuters
Banks: European banks recapitalised to raise around € 130 billion by June 2012

Source: EFSF, Eurostat, EBA, WSJ and Reuters
The diagnosis

• The problems – fiscal burden, contagion and lack of growth – are interlinked

• Firstly, root cause of the problems in the eurozone periphery countries is their lack of competitiveness

• Secondly, Europe’s fiscal problems cannot be addressed without a return to growth

• Finally, in its current form the EFSF is simply not large enough to fulfill the stabilisation role
Solution

• If the euro survives in its current form, addressing these competitiveness issues requires:

  • A comprehensive fiscal strategy: that balances the immediate need to support growth with the imperative for a credible medium term plan to reduce deficits and debt

  • Structural reforms: to maximise growth potential in individual countries

  • Maintain competitiveness: reforms that ensure the real exchange rates can adjust with ease
Structural Reforms

1. An effective fiscal coordination mechanism

2. Better balance of responsibilities between surplus and deficit countries within the eurozone for correcting payments imbalances.

• However, it is clear that these are very difficult political problems that test the balance between:
  • member states and the central bodies (the Commission, the ECB and the European Parliament)
  • 17 members of the eurozone and the full 27 members of the European Union
The alternative

• The balance of costs and benefits from membership of the single currency are spread unevenly between its members.

• Nevertheless, the benefits of the EMU membership are large especially for smaller countries.

• Ultimately, if the cost-benefit equation shifts too far, it could force the break-up of the euro, either by forcing out some of its weaker members or by encouraging the stronger members to leave because they are not prepared to accept the consequences for themselves.

• But this would potentially reverse the trend towards greater integration at all levels within Europe and for that reason, it would only come about as a last resort.
• THANK YOU

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