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'Multiple' Crises and Complex Solutions

PAOLA SUBACCHI AND STEPHEN PICKFORD

Abstract

Europe's sovereign debt crisis has exposed the deficiencies in the governance of the European Monetary Union (EMU), and has shown the limits of its framework of policy cooperation. It has its roots in the imbalances within Europe and the structural weaknesses of its model of growth. Most of all, the crisis has intrinsically threatened the political fundamentals of the currency union and greater integration in Europe. This paper discusses the outlook of the euro area, in particular the euro periphery, and assesses the vulnerabilities and stress points. It argues that the factors underlying the current crisis predate the 2007-08 global financial crisis and are a mix of structural problems in some member states and faults in the design of the EMU framework. It identifies that in the short-term, the countries in the euro area have to normalise the access of banks to market funding, convince markets that their public debt is on a sustainable track, and improve their external payments position, whereas in the longer term, the challenge is to improve competitiveness, restore growth, and rebalance the intra-EMU growth pattern. The paper concludes by assessing the chances of the euro to survive in its present form if the necessary structural measures are not implemented.

INTRODUCTION

Europe's sovereign debt crisis, that began in January 2010 and still continues, has exposed the deficiencies in the governance of the European Monetary Union (EMU), and has shown the limits of its framework of policy cooperation. It has its roots in the imbalances within Europe, in the structural weaknesses of its model of growth—with the possibility that the region's potential output has been permanently downshifted—and in the differences within the region—a so-called two-speed Europe. Most of all, the crisis has intrinsically threatened the political fundamentals of the currency union and greater integration in Europe.

The euro crisis did not develop overnight, but incubated over the years and was based on the fact that the whole process of European integration, of which the currency union was the most advanced, though as yet incomplete, element, is mainly driven by politics rather than sound economic principles. Economic theory has always been clear that Europe falls short of the requirements for an optimal currency area.[1] And a monetary union that was not accompanied by a fiscal union could only succeed by putting in place robust governance and strong rules. Yet rules in the euro area have been over many years disregarded for the sake of politics.

Two of the countries that ended up at the centre of the sovereign debt crisis, Greece and Italy, were admitted to the single currency union with public debts well in excess of the 60% of GDP limit that was sanctioned in the Maastricht Treaty in 1992. But the euro project needed critical mass and Italy, one of the signatories of the Treaty of Rome in 1957 and one of Europe's largest economies, was deemed necessary to the economic and political success of the euro. As a result, Italy qualified for EMU membership on the assumption that recent

1. For a detailed discussion on optimal currency area, see Mundell (1961, 1963, 1973a, and 1973b). In addition, for a discussion on Mundell's work, the euro and optimal currency areas see McKinnon (2000).

efforts to put its debt on a reducing path and the drastic drop of its deficit down to the required 3% of GDP were enough to guarantee future fiscal consolidation. As for Greece, its admission to the EMU came during the preparations for the 2004 Olympics when massive investments had boosted economic growth. In any case, accounting for only about 2%[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. This assumption only looked at how inflation in member states affected the inflation figures for the euro area as a whole, and therefore its effect on the conduct of monetary policy. All linkages through the financial and banking system, and the possible spillovers on the real economy, were completely disregarded.

The other countries affected by the present crisis—Ireland, Portugal, and Spain—suffered from interest rates inappropriate for their pace of economic growth and/or of excessive credit growth. Indeed the common monetary policy set by the European Central Bank (ECB) was too loose for them and needed to be offset by suitable domestic policies. For instance, strong economic growth and potential overheating in Ireland and Spain required policy measures to avoid excessive credit growth and to prick the property bubble. This did not happen. Instead, large private sector borrowing, and widening current account deficits, were signals of the building up of large imbalances. In the aftermath of the collapse of Lehman Brothers in autumn 2008 government intervention was necessary in both Ireland and Spain—as well as in the UK—to rescue the banking system. At the same time, the impact of the financial crisis on the real economy and the need to support economic growth required extremely accommodating fiscal policies.

The result of these interventions was 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 (including Greece and Italy). For some of them the banking crisis morphed into a sovereign debt crisis although the fundamental soundness of their fiscal positions, especially in the case of Ireland, could eventually result in an easier path to fiscal consolidation.

The European Council has recently agreed on measures to address some of the weaknesses leading to the crisis. But at the time of writing the crisis is continuing, and this hinders any complete and objective assessment of the situation and the drawing of comprehensive policy recommendations. Nevertheless, it is clear that a number of steps will have to be taken to address the crisis, both the immediate problems and the longer term issues that lie at the origin of the protracted build-up of imbalances within the eurozone. Finally, there are a set of issues about the future governance of the euro area and, to some extent, of the EU as a whole that need to be addressed if the euro is to survive.

It is against this backdrop that the paper discusses possible solutions and assesses the long-term consequences of the crisis. Here we argue that the factors underlying the current crisis in the euro area predated the global financial crisis of 2007-08 and are a mix of structural problems in some member states and faults in the design of the institutional framework that underpins the EMU. A distinction is made between short-term measures that are needed to deal with the immediate crisis and the longer term structural changes that are essential to make the currency union, and more broadly the process of European integration, more sustainable. It is urgent to regain control of events and to restore confidence, as the Greek crisis has spread over other countries while reducing market confidence. However, the immediate priority of restoring confidence and resolving the crisis should not overshadow the other fundamental goal of rethinking the governance and the institutional framework of the European monetary union. Structural measures that address the long-term challenges of rebalancing the euro economy, dealing with regional growth differentials and supporting GDP growth need to be included in the agenda of actions for the future survival and stability of the euro. The crisis has made it clear that rebalancing would be possible only through a substantial shift in the intra-EMU growth pattern. The weakness of all the southern European economies, coupled with the need to rebalance the economy of the eurozone, the constraints imposed by a fixed exchange rate regime within the EMU, and the need for some EMU member states to implement structural reforms in their economies, has shifted the burden of adjustment towards surplus countries. The paper concludes by assessing the chances of the euro to survive in its present form if the necessary structural measures are not implemented.

The paper is organised as follows. Part 1 discusses the outlook of the euro periphery and assesses where vulnerabilities and 'stress points' are. Part 2 looks at the long-standing and deep-rooted causes of the euro crisis. Part 3 analyses possible solutions and concludes.

2. Unless otherwise mentioned, all the data used in this paper are from the International Monetary Fund, *World Economic Outlook*, September 2011 (IMF WEO).

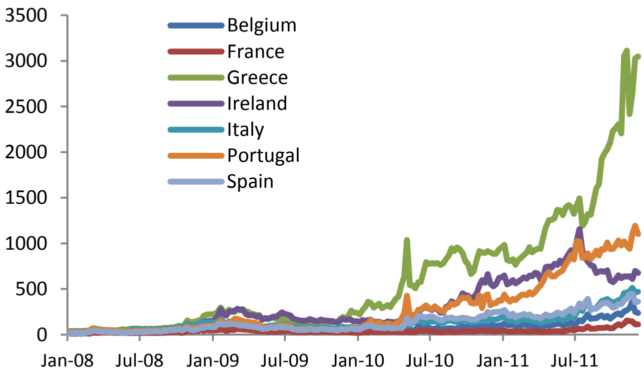
1. THE EMU 'ON THE BRINK'

1.1 THE CRITICAL OUTLOOK FOR THE EURO PERIPHERY

The sovereign debt crisis has widened the divide between countries that are well-adapted to survive and prosper within the monetary union and those which are not. The eurozone's core economies, including Germany, are now key to the single currency area's survival. Countries with problematic debt positions have seen sharp rises in the cost of government borrowing since the crisis erupted and at each critical point in its development (figure 1). Indeed Italian and Spanish bond yields have spiked to unsustainable levels while France's AAA credit rating is increasingly vulnerable.[3] Moreover, a disastrous German debt auction provided the clearest sign that even the strongest eurozone country is not insulated, reconfirming this to be a systemic crisis. Germany failed to attract investors for about 35% of its €6 billion 10-year bund issue at the end of November 2011, suggesting that investors are shying away from the euro area in general, and not just from the countries with unsustainable sovereign positions (Financial Times 2011).

Italy, deemed too big to be bailed out, continues to be the major concern and is subject to the IMF's "enhanced monitoring" of its policies since the G20 Cannes Summit in November 2011. With its 10-year benchmark government bond yields hovering about 7%, recent developments in the country have brought the eurozone to the brink. Although Italy does not pay 7% on all its outstanding debt, the current high levels of yields in the secondary market indicate that interest payments are expected to increase in the near term. Italy's cost of debt servicing is expected to rise by about €30 billion in the next couple of years, which in turn will cost the Italian Treasury 5.1% of GDP in 2012, up from 4.2% in 2011, and anticipated to rise to 5.6% in 2013 (See Donovan 2011).

FIGURE 1. THE COST OF GOVERNMENT BORROWING (spread over German bunds, basis points)



Note: Based on 10-year government bond yields.
Source: *Financial Times*.

Short-term financing from European mechanisms (in particular, the European Financial Stability Facility, EFSF[4]) and the IMF has allowed Greece to continue meeting its immediate financing needs. But this has only provided short-term relief, and has not addressed the structural fiscal problems. And in the absence of these further fiscal actions market sentiment has remained very negative. Greece is still far away from being able to access capital markets and achieve financing from private investors.

The general consensus is that Greece is now insolvent. Indicators of debt sustainability, such as public debt to GDP (165.6%), public debt to government revenues (about 400%), and benchmark government bond yields (10-year bond yield at about 30%), all point towards a high likelihood that the country will be unable to honour its obligations. Financing alone is only likely to lead to further withdrawals of private capital, until the point is reached where all Greek debt is owned by other European governments, either directly or through European institutions (including the ECB and EFSF). In July 2011, private bank creditors had agreed to accept a voluntary debt rescheduling, calculated to be equivalent to a 21% haircut. But the decision of the European Summit at the end of October 2011 to seek write-downs of at least 50% on private debt recognizes the scale of restructuring needed in order to return to a more sustainable position for Greece.

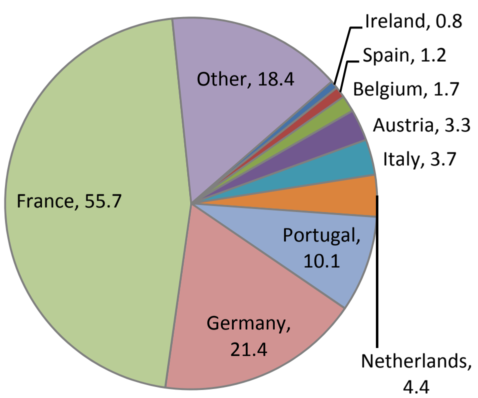
3. Rating agency Standard & Poor's (S&P) have already downgraded France by one notch to AA+, whereas Fitch Ratings have placed France's AAA credit ratings outlook on 'negative' due to deepening political, financial, and monetary problems within the eurozone. Moody's maintains a stable outlook for France; however, it has warned that the country's outlook is at risk. Explaining what prompted the downgrades of European sovereigns in general, S&P stated "the policy initiatives that have been taken by European policymakers in recent weeks may be insufficient to fully address ongoing systemic stresses in the eurozone. In our view, these stresses include: (1) tightening credit conditions, (2) an increase in risk premiums for a widening group of eurozone issuers, (3) a simultaneous attempt to delever by governments and households, (4) weakening economic growth prospects, and (5) an open and prolonged dispute among European policymakers over the proper approach to address challenges." For further details, see Standard and Poor's 2012.

4. On January 16, 2012, S&P lowered the long-term issuer credit rating on the European Financial Stability Facility (EFSF) to AA+ from AAA.

1.2 Stress Points and Spillovers

The pressure for a resolution of the sovereign debt crisis is not only on the countries directly involved, but on all the eurozone member states. With banks across Europe holding large amounts of the debt of countries in the euro periphery, the sovereign debt crisis has the potential to generate large spillovers to private financial institutions and a huge shock to the financial system. According to the Bank of International Settlements' (BIS) consolidated banking statistics, the total foreign claims (for the second quarter in 2011) on Greece alone amounted to US$120 billion for all the banks in European reporting countries (figure 2). The amount, a rough indicator of the direct and indirect exposure of private banks to the sovereign debt crisis in Europe, shoots up to about US$2.2 trillion when foreign claims on Ireland, Italy, Portugal and Spain are included (with Italy and Spain accounting for about 68% of the total).

Figure 2. Foreign Claims on Greece by Banks in European Reporting Countries, Q2-2011 (US$ billions)

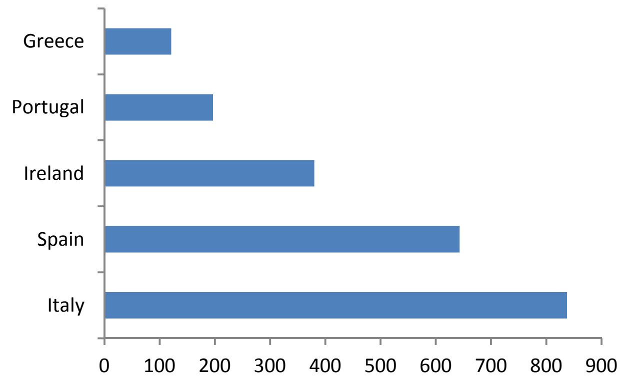


Source: Consolidated Banking Statistics, Bank for International Settlements.

Markets have already responded to this potential deterioration in fiscal positions by raising the spreads on sovereign borrowing. Spreads on Italian debt and to a certain extent Spanish debt remain unsustainable over the long run; and credit rating agencies have also responded with downgrades and/or warnings of further downgrades due to the increased risk of fiscal liabilities arising from the eurozone's sovereign debt crisis. In addition, French banks' credit ratings were downgraded also due to investor concerns about the eurozone crisis and their reliance on wholesale funding (See Daneshkhu and Alloway 2011). As captured in figure 2, along with banks in France, some banks in Germany too have sizeable exposures to foreign claims located in Greece. Germany's fiscal position as well as its growth prospects have kept a lid on its sovereign borrowing until now; however, global risk aversion could drive the market demand away from German bunds (as observed in late November 2011).

As indicated in figure 3, European banks' exposure to foreign claims located in Greece is only the tip of the iceberg, when compared to their exposure to foreign claims in Spain and Italy. This suggests debt sustainability concerns in these two countries could potentially cause a meltdown in the European banking sector, spark cross-country contagion, and threaten the very existence of the single currency.

Figure 3. European Banks' Combined Exposure to Foreign Claims Located in Affected Countries, Q2-2011 (US$ billions)



Source: Consolidated Banking Statistics, Bank for International Settlements.

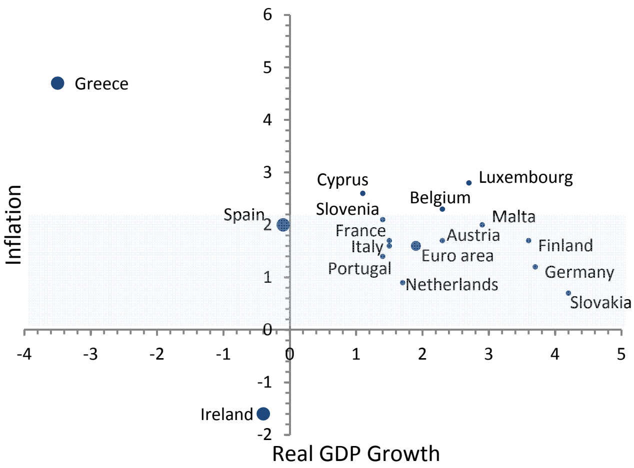
1.3 A 'Two-Speed' Europe?

The concept of a 'two-speed' Europe is used to distinguish between those countries that can live within the constraints imposed by the single currency and those which cannot.[5] Greece and Ireland, but also Spain, Italy, and Portugal, are countries with problematic debt positions[6] and are out of synch in terms of growth and inflation. These are countries at the euro periphery not only because of their geographical distance from the euro core, but also because of their conceptual distance from Germany's economic model (figure 4). While Greece, Ireland, and Spain, and to some extent Italy, Cyprus, and Portugal, stand out in terms of GDP growth and inflation, Finland, Germany, and Slovakia score well on both terms.

5. This, however, does not necessarily imply that problematic countries should leave the EMU. Certainly they need to implement the necessary adjustments and resolve the mismatch.

6. It is important to acknowledge that the Spanish government debt is estimated to be 67.4% of GDP, much below its peers. However, the vulnerabilities in the Spanish banking sector could spill over to the public balance sheet.

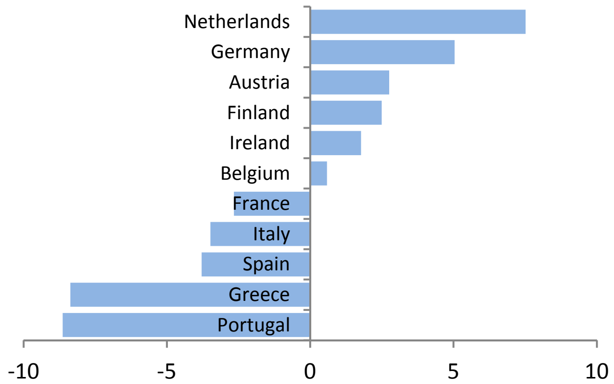
FIGURE 4. GDP GROWTH AND INFLATION, EURO AREA AND INDIVIDUAL MEMBERS, 2010 (percent)



Note: Inflation is based on the Harmonized Index of Consumer Prices (HICP).
Source: Eurostat.

Moreover, current account imbalances within the euro area also highlight the concept of a two-speed Europe. Although the eurozone, taken as a whole, runs a modest current account surplus (estimated to be 0.1% of GDP in 2011), the figure masks large underlying imbalances. Excepting Ireland, all other European economies facing severe fiscal crisis are running a current account deficit, reflecting their lack of export competitiveness. However, the surpluses run by northern European economies more than make up for the deficits in other parts of the euro area (figure 5).

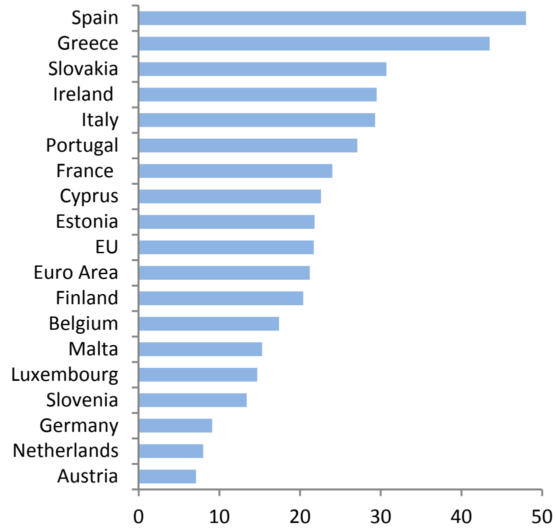
FIGURE 5. CURRENT ACCOUNT BALANCES, EURO AREA MEMBERS, 2011 (% GDP)



Source: IMF WEO, Estimates for 2011.

The euro periphery's growth problems translate into high unemployment rates. Again, Greece, Spain, and Italy have deeply rooted unemployment with high percentages among the young and with significant regional differences—especially in Italy. The latest labour market figures show youth unemployment in Spain and Greece fast approaching 50%, at 48% and at 43.5% respectively (figure 6). The figures in Ireland and Italy, at around 30%, are not only signs of economic malaise, but they also highlight an area of possible social tension and conflict. German youth unemployment, running at 9.1%, underscores the stark difference within the euro area and reinforces the concept of a two-speed Europe.

FIGURE 6. YOUTH UNEMPLOYMENT, EURO AREA (percent)



Notes: Unemployed aged 15-24 years old as a percent of the total labour force (both employed and unemployed) in that age group. Sept. 2011, except Germany, August 2011; Greece, Estonia: July 2011.
Source: Eurostat.

The challenges for the countries in the euro periphery, and indeed for the existence of the euro itself, are a mix of urgent priorities and long-term measures. In the immediate future, with the exception of Greece, they have to convince markets that their public debt is on a sustainable track. They also have to normalise the access of banks to market funding and to improve their external payments position. The latter should be helped initially by deleveraging and the slowdown (and, in some cases, contraction) in economic activity. In the longer term, the challenge is to restore growth and to improve competitiveness.

2. THE LONG GENESIS OF THE EURO CRISIS

2.1 THE MORPHING OF THE GLOBAL FINANCIAL CRISIS

In the aftermath of Lehman Brothers' collapse in the last quarter of 2008 it seemed possible that the global financial crisis could have a selective impact on Europe, affecting only those countries exposed through their banking and financial systems. For instance, the United

Kingdom, Ireland, and Spain, having gone through substantial housing booms, were particularly affected by the credit crunch. Similarly, the new member states in eastern and central Europe that had experienced strong foreign capital inflows and domestic credit booms on the back of loans denominated in foreign currencies, such as euros or Swiss francs, found themselves at the centre of the financial crisis (Subacchi 2011).

Excessive credit growth fueled by foreign capital flows not only created imbalances that became unsustainable in the aftermath of the Lehman collapse, but also facilitated the transmission of the crisis from the United States to Europe. When the US financial and banking system clogged up, foreign capital flows dried up. Struggling parent banks cut back funding to their local subsidiaries through tightened credit or higher costs of borrowing. The pressure on local currencies took its toll, regardless of whether countries had floating exchange rates or currency pegs to the euro. A few western European banks (based primarily in Sweden, Belgium and Austria) had a particularly high percentage of loans to Eastern Europe and funded much of the Baltic's credit-fueled growth.[7]

All these countries saw early and sharp contractions in investment and private consumption as businesses and consumers were starved of credit. Gross investment declined by 12% in Spain and almost 20% in the UK in the final quarter of 2008; in Ireland the corresponding figure was 37%. They also witnessed a deceleration in private consumption from the beginning of 2008: from the peak of the crisis in 2008 to its trough, private consumption fell by 34% in Ireland, 21% in Spain, and 15% in the UK. In comparison, the figures for France and Germany were 0.7% and 2.8%, respectively. In the final quarter of 2008, Irish GDP had contracted by about 9% year on year—the most serious recession in the EU.

Then, in late 2008, the crisis began to have a wider effect on the real economy through the trade system. It dragged the world economy into the worst recession since 1929. Countries with a large export sector, such as Germany and Japan, which up to then had been almost unscathed by the crisis, were severely hit by a sudden and sharp drop in their exports. Although the severity of the downturn varied considerably within the region, in 2009 the world economy in aggregate recorded the worst contraction since the Great Depression, with GDP falling by 0.7%. In Europe the recession was even worse, with a contraction in GDP of 4.2%.

Policy intervention required both monetary and fiscal measures to bail-out troubled banks and to support weakening economies. The banking sector was the main recipient of government and central bank money to ensure that credit flows were not frozen and so to avoid a possible banking collapse. Troubled financial institutions were supported through capital injections, guarantees, or partial nationalisation. The UK was one of the earliest to respond, nationalising troubled mortgage lender Northern Rock in September 2007 after it suffered a bank run.[8] As the crisis deepened in 2008, more countries were pressed to support their troubled banks, with the major recipients being UBS (Switzerland), Fortis (Benelux), ING (the Netherlands), RBS (UK) and Loyds TSB (UK). These measures ensured that a more severe crisis was contained, yet spiraling bad debts from the east remained a problem for some time.[9]

Interventions in support of the real economy were also massive even in countries such as Germany that were reluctant to risk a further deterioration of their fiscal position. The size of the stimulus packages varied across Europe from 3.8% of GDP in Spain to 0.2% of GDP in Sweden.

Fiscal interventions alongside falling tax revenues and the impact of automatic stabilisers resulted in an increase in debt-to-GDP ratios among European economies from a pre-crisis average of around 61% (59% in 2007 and 64% 2008) to as much as 74% in 2009. For some countries, the fiscal position deteriorated more rapidly and widely than for others, because of a number of factors including high pre-existing levels of debt (Italy), large current spending with little scope for 'easy' cuts and efficiency gains (Greece), a rapid drop in GDP growth and consequent impact on fiscal revenues (Spain and Portugal), and a large bank bail-out (Ireland). Given the pattern of public indebtedness, problems seemed to be concentrated in countries that had fast but unsustainable growth in the pre-crisis years or had pre-existing critical fiscal positions, or both (table 1). With the exception of Ireland, these countries were concentrated in southern Europe.

7. For some of the most exposed countries, including Sweden and Belgium, loans to emerging European markets represented as much as 30% of GDP; in the particular case of Austria, this figure was a staggering 70%, including more than 30% of the country's total banking assets (IMF, 2009; Arvai et al., 2009).

8. It was the first in the UK since the 19th century.

9. A major Austrian bank that was heavily exposed in the region was nationalised as late as December 2009.

TABLE 1: SOVEREIGN DEBT, EURO AREA

(% OF GDP)

Euro Area	2010	2011
Finland	48.4	50.2
Spain	60.1	67.4
Netherlands	63.7	65.5
Austria	72.2	72.3
France	82.3	86.8
Germany	84.0	82.6
Portugal	92.9	106.0
Ireland	94.9	109.3
Belgium	96.7	94.6
Italy	119.0	121.1
Greece	142.8	165.6
International comparison		
United Kingdom	75.5	80.8
United States	94.4	100.0
Japan	220.0	233.1

Source: IMF WEO September 2011.

The worst, however, had still to come, with Greece's deep-rooted fiscal problems becoming unmanageable and spilling over to the private sector. The first critical point was in May 2010 when the European Council, together with the IMF, put together €750 billion in emergency funding. By then Greece's spiraling public debt had generated a serious crisis in confidence. What had been mistakenly thought to be an isolated and relatively insignificant episode, given Greece's relatively small weight, was sending shockwaves through the entire European banking and financial system. As the risk of contagion from Greece to other countries with critical fiscal positions rapidly increased, investors started to worry about it spreading to other European economies. This led to a vicious cycle of widening sovereign spreads, differentials in credit rates, difficulties for refinancing, and higher borrowing costs (see figure 1).

2.2 THE BUILDING UP OF IMBALANCES

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. The sequence of events is clear and unmistakable.

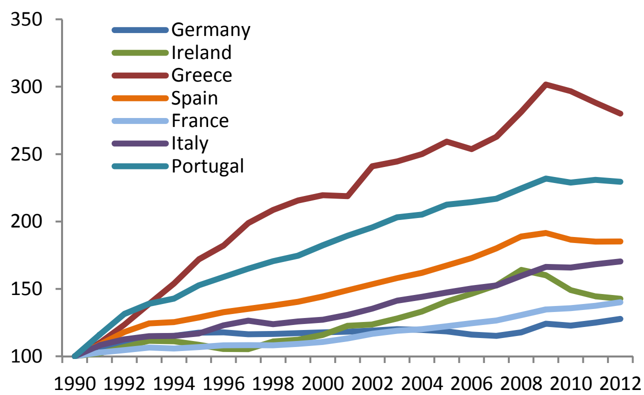
Below-trend GDP growth and lack of economic dynamism predate both the global financial crisis and the sovereign debt crisis. During the 1990s, when the US was experiencing strong productivity growth[10] and China was beginning to flex its economic muscles, the European economy was growing on average around 2% per year (although this rose closer to 3% by the latter part of the decade).

If Europe's overall performance was disappointing in the pre-crisis years, there were, however, cases of strong growth. Spain managed to grow at an average rate of 3.8% from 1997 to 2007. Similar examples of high growth were registered in central and eastern Europe. The Polish economy grew at an average rate of 4.5% over the same period, while the three Baltic economies grew at 6.5–8% (reaching around 10% in 2005–06).

But this outstanding performance proved to be unbalanced, either because growth tended to be concentrated in a few sectors or because it was fueled by strong foreign capital inflows. In the case of Spain, nearly 20% of GDP was in some way related to real estate or construction, and one-sixth of the workforce was employed in it (Martin Torres 2009). In the years preceding the crisis, Spain had the largest housing sector in the EU, with 900,000 housing starts recorded in 2006; between 2000 and 2007, the average house price grew by 134% (an annual average rate of 13%). Over the same years, Spain experienced a widening of its current account deficit from 3.9% in 2000 to 9.9% in 2007 (Martin Torres 2009).

All countries that in one way or the other have been hit by the sovereign debt crisis—Greece, Ireland, Portugal, Spain, and Italy—have a common problem of competitiveness. Using nominal unit labour costs as a proxy for competitiveness, all these countries, and especially Greece and Portugal, saw a strong increase in labour costs since 1990 and as a result experienced a deterioration of their competitiveness against Germany (figure 7).

FIGURE 7: NOMINAL UNIT LABOUR COSTS (1990=100)

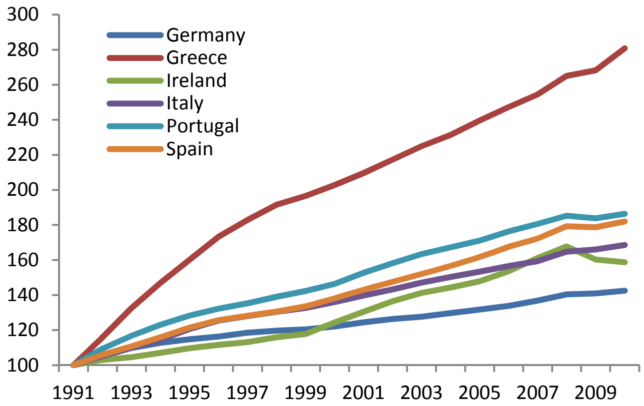


Notes: Compensation per employee to real GDP per person employed.
Source: European Commission, Directorate General for Economic and Financial Affairs, Annual Macro-economic Database (AMECO).

10 US business sector total factor productivity (TFP) growth averaged about 1.6% per year from 1996 to 2004 (and annual labour productivity growth averaged 3.2%) after a poor performance in the late 1980s and early 1990s, when annual TFP growth averaged 0.4% between 1987 and 1995.

Growth in consumer prices is another sign of imbalances and differentials in competitiveness between southern European countries (plus Ireland) and Germany (figure 8). In the case of Ireland and to some extent Spain, inflation above the ECB target was partly a reflection of strong economic growth. In the years 2001-2005, according to the OECD, the average inflation rate for Ireland and Spain was 3.5% and 3.2% respectively, compared with 1.5% in Germany. But high inflation in Greece and Portugal was more a reflection of inefficiencies and distortions in the labour market and in the services market. Greece's inflation rate was on average above 3% throughout the 2000s, while it was around 5% in the years 1996-2000.

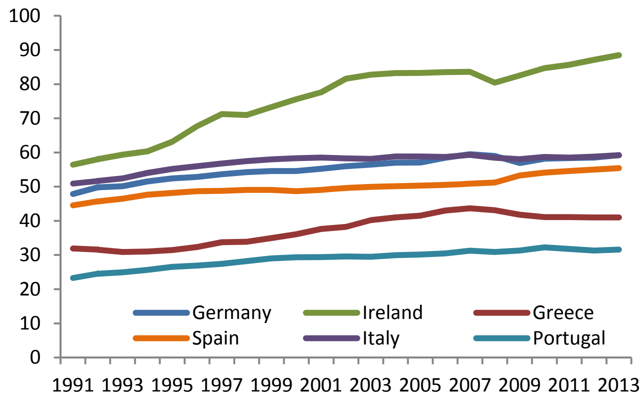
FIGURE 8: CONSUMER PRICE INFLATION (1991=100)



Note: Based on consumer price indices.
Source: OECD.

Poor competitiveness reflects in differential GDP growth, with the growth dynamics of Greece and Portugal trailing well behind that of Germany (figure 9).

FIGURE 9: GDP AT 2005 MARKET PRICES (1000ECU/EUR)



Notes: Adjusted by terms of trade per person employed. 1000 ECU/EUR- Weighted mean of t/t-1 national growth rates (weights: t-1 current prices in ECU/EUR)
Source: AMECO

Poor competitiveness also has had a direct impact on current account imbalances. In 2010 the current account deficits of Greece and Portugal were 10.5% and 9.9% of GDP. The comparison with the 5.9% US current account deficit in 2006, when it was at its peak and deemed unsustainable, shows the extent of the challenge that the reduction of these deficits poses. Spain and Italy need also to address their current account deficits, although at 4.6% and 3.3% respectively they are more manageable than those of Greece and Portugal. The deficits of the euro periphery are mirrored by the large surpluses of the euro core. In 2010 Germany had a surplus in its current account of 5.7% of GDP, while the Netherlands had an even higher surplus of 7.1%.

It seems clear that underlying economic imbalances have offered a fertile ground for the financial crisis to develop on the back of the shock waves of the US banking crisis. Excessive leverage and problematic fiscal positions provided further fuel to the deepening of the crisis.

Greece displayed all the symptoms of imbalance. Along with a large current account deficit, high inflation and low growth, the long standing problems with public finances, that go back to the 1980s (box A), the inappropriate monetary policy stance, and the removal of the exchange rate risk that came with EMU membership resulted in excessive leverage in the private sector as well. The household net savings rate as a percentage of disposable income was in negative territory throughout the 2000s until 2008 (the most recent data available). Greece epitomises the failure of several governments' attempts to manage public finances and the spillover into the private sector.

In the case of Ireland, on the other hand, it was the unsustainable credit growth and the rise of property prices that infected the public sector. If the Greek crisis can be classified as a typical public finance crisis (the origins of which predate EMU membership), the Irish crisis has its origin in the disconnect between the Irish economy's pace of growth, the building up of imbalances in the banking sector, and the monetary policy stance that prevailed in the currency union (box B). The Irish government, however, failed to mitigate the impact of low interest rates by not implementing fiscal and regulatory measures that could act in a countercyclical manner to offset the expansionary impact of the EMU membership and the general overheating of the economy in the run up to the crisis (Honohan 2010; Regling and Watson 2010).

Box A
Greece: Deep-Rooted Twin Deficits

Although Greece's GDP comprises a mere 2% of the eurozone's total, the country's sovereign crisis has been sending shockwaves much bigger than was initially thought possible. Indeed, despite long-standing fiscal problems and modest economic performance, Greece was admitted to the EMU on the assumption that it was too small to create significant problems for other Member States. Experience from the last couple of years shows how wrong that assumption was.

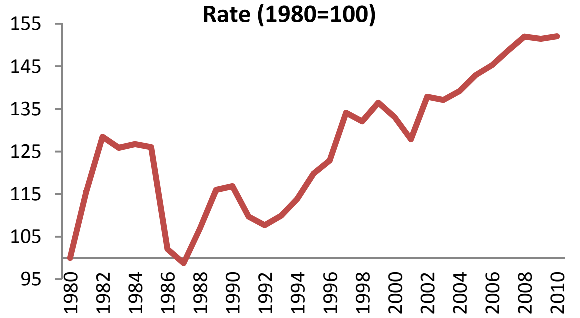
From the early 1980s to the mid-1990s, the Greek economy featured modest GDP growth, double-digit inflation, and persistent budget deficits, leading to accumulation of high levels of debt. Between 1980 and 1994, inflation averaged about 19% per year. It was only in the late-1990s, in anticipation of EMU membership, that inflation was substantially reduced. In addition, inflation-based indexation of wages set off a vicious cycle of wage and consumer price inflation. This led to a sustained increase in nominal unit labour costs, eroding the Greek economy's competitiveness (figure A-1) and pushing its current account to persistent deficits.

Greece has had long-standing public finance problems. Over the last 20 years public debt has been around 100% of GDP, even during the run-up to EMU membership in the late 1990s. Though a tighter fiscal policy helped reduce the deficit, the country never managed to achieve fiscal surpluses to substantially reduce its gross debt. Even during the benign economic period in the 2000s, the country not only failed to bring down the debt level, but also ran chronic budget deficits (figure A-2).

Greece's budget cycle is inseparably linked to the electoral cycle as indicated by the vertical lines in figure A-2, and so the political system is unable and unwilling to undertake the necessary reform measures to achieve the much-needed fiscal correction. An attempt at fiscal consolidation was initiated in May 2004 within the EMU's Excessive Deficit Procedure (EDP), but was mismanaged.

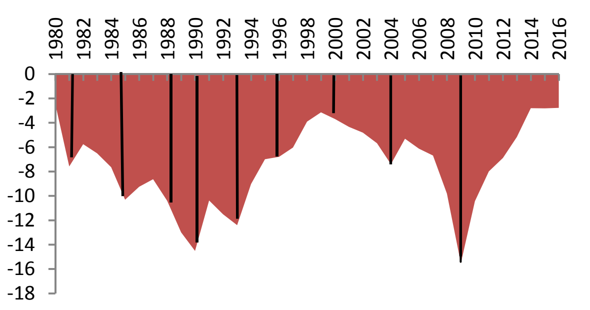
In October 2009, the then-new government discovered a larger-than-expected hole in the public account which led it to revise the deficit figure up to 12.5% of GDP. This brought about a loss of credibility for the country and a substantial spike in the cost of government borrowing. Burdened with unsustainable bond spreads in April 2010, the Greek government sought help from the EU. In May 2010, Greece became the first euro area country to receive a bailout as the EU and IMF announced a €110 billion rescue programme while imposing austerity measures on the country. Though there was a temporary reduction in its borrowing costs, the country soon slid into a social crisis. With no respite to its sovereign debt woes and a political deadlock stalling further assistance, Greece's debt concerns have sparked cross-country contagion. The country's public debt was 143% of GDP in 2010, and is projected to be 165.6% in 2011. The future of the Greek economy remains unclear.

Fig. A-1: Greece's Real Effective Exchange Rate (1980=100)



Notes: Deflated by unit labour costs in the total econom; 12 trading partners.
Source: Eurostat.

Fig. A-2: Greece's Fiscal Deficit (% GDP)



Note: Vertical lines indicate election years.
Source: IMF WEO Sept. 2011.

Box B
Ireland: A Banking Crisis Spilling Over to the Public Sector

During the 1990s Ireland's dynamic economy became a symbol of economic success. Between 1991 and 2000 GDP growth averaged 6.8% per year and the Irish population experienced a dramatic rise in living standards. Fiscal consolidation in the late 1980s, as shown in figure B-1, was a significant factor in creating a stable macroeconomic condition in the country. In addition, structural reforms in the late 1980s, in particular the wage agreements between unions, employers, and the government, ensured moderation in wage inflation. Ireland became a destination for foreign direct investment (FDI) and began to reap the benefits of the EU single market.

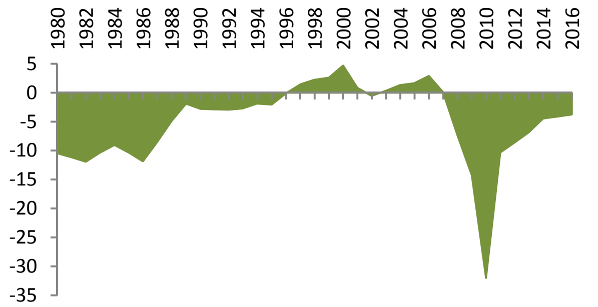
With the economy operating at full employment from the mid-1990s, however, wages began to rise, competitiveness began to erode, and the current account balance was pushed into deficit in the 2000s. In addition, the EMU-wide monetary policy proved to be too loose to suit the Irish economy while financial market integration and the elimination of currency risk within the EMU made cross-border bank funding widely available, improved Irish banks' access to wholesale funding markets (such as the euro-denominated London market), and increased competition between domestic and foreign banks in the domestic market (Regling and Watson 2010).

All this generated excessive credit growth, a significant rise in household indebtedness, and rapid increases in property prices. Between 2003 and 2006, households' gross debt-to-income ratio increased from 124.9% to 187.3% and nominal house prices rose an average of about 12% per year. Asset concentration risks in the construction sector, heavy reliance on short-term wholesale foreign borrowing, and increasing loan-to-value ratios were identified as failures of both regulators and the banking community (Honohan 2010). Furthermore, Irish competitiveness deteriorated rapidly during the 2000s, as indicated by the rising real effective exchange rate (figure B-2).

The global financial crisis of 2008 resulted in a 'hard landing' with the Irish banking system absorbing severe losses. In late September 2008, after the economy had slid into recession and the property bubble had burst, the Irish government guaranteed all deposits and some debt instruments of the six domestic banks. The guarantee shifted the problem to the government's balance sheet. Despite a prudent fiscal stance throughout the 1990s (but with current expenditures growing from 2001) Ireland ended 2010 with a fiscal deficit of 32% of GDP (figure B-1) while public debt had jumped to 95% of GDP (projected at 109% in 2011) from only 25% in 2006.

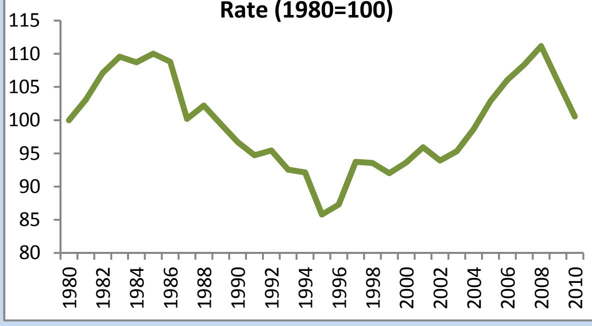
The significant increase in the Irish sovereign spread over the German bund, questions about Ireland's ability to service its debt, and fears of contagion to other troubled countries resulted in a joint EU and IMF financial assistance of €85 billion in November 2010. In recent months, the Irish economy seems to have turned a corner with a modest export-led recovery. However, the downside risks from the sovereign debt crisis in Europe and the possible effect of the large fiscal correction remain major concerns.

Fig. B-1: Ireland's Fiscal Deficit (% GDP)



Note: Vertical lines indicate election years.
Source: IMF WEO Sept. 2011.

Fig. B-2: Ireland's Real Effective Exchange Rate (1980=100)



Note: Deflator is unit labour costs in the total economy, 12 trading partners.
Source: Eurostat.

3. Solutions

3.1 In the Short-Term . . . A Lender of Last Resort

Addressing the euro crisis has been an exercise requiring political and diplomatic skills—which have not always been sufficiently in evidence. Economic and financial solutions that have needed to be implemented rapidly in order to respond to market pressures and growing distrust have often been overturned or postponed because of political priorities and considerations. Despite repeated assurances that keeping the monetary union stable and cohesive was Germany's objective,[11] until late 2011 German Chancellor Angela Merkel seemed to be taking a political stance that was inconsistent with that objective. The insistence on involving the private sector in Greece's bail-out in order to avoid moral hazard, even if correct in principle, triggered an adverse market reaction and resulted in contagion spreading to Italy. Merkel's more conciliatory approach, helped by a change of government in both Italy and Greece,[12] should make it easier to deal with the crisis and limit contagion.

However, such a change might have come too late as the chances of avoiding the breaking up of Europe's monetary union are now higher than just a few months ago. Allowing the sovereign debt crisis to spill over to Italy has turned the crisis into one that threatens the survival of the single currency. With Italy now on the brink, the whole approach to crisis resolution has fundamentally changed, as it now involves complex solutions dealing with the governance of the whole monetary union. But complexity has not been matched by clarity. Indeed, the key question of whether Italy will be able to refinance the €114.1 billion[13] of its debt early in 2012 is still unanswered and still depends on whether investors believe that Italy is on track toward achieving fiscal consolidation without undermining growth.[14]

Most of all, there is a disconnect between the 'reaction time' of EU decision making—and the national politics that underpin it—and market expectations. So far, the policy response has focused on complicated solutions, negotiated between many countries that require long-term implementation. How long markets are prepared to wait before completely stopping investing in euro area countries remains to be seen. Even if the disorderly break-up of the monetary union has not been fully priced in by financial markets—and indeed the euro has been remarkably resilient[15]—contingency plans to deal with the scenario of a breaking up of the European Monetary Union are openly discussed in the private sector. Without suggesting that euro zone policy-makers should do the same—an option which could trigger a massive confidence crisis—nonetheless there should be more focus on crisis resolution measures that deal with short term priorities.

The need remains for a financial safety net to support Europe's banking system and for firewalls around problematic countries to avoid the spread of contagion. The December 9, 2011 agreement[16] at the European Council for a provision of €150bn for the IMF[17] is a good start, but surely not enough to support Italy. However, this provision as well as the EFSF are not large enough to withstand the impact in the event of of Italy's partial default. The Italian debt, at €1.9 trillion, is too large and a

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11. "Nobody should take for granted another 50 years of peace and prosperity in Europe. They are not for granted. That's why I say: If the euro fails, Europe fails." German Chancellor, Angela Merkel, Speech to the German Parliament on 7 September 2011.

12. Both Italy and Greece have resorted to technocratic governments to see them through the crisis. In Italy, Mario Monti, a former European Commissioner, took the helm of the interim government until 2013. Meanwhile in Greece, after days of negotiations between political parties, in early November 2011, Lucas Papademos, a former European Central Bank vice president, was named head of an interim government until the elections in February.

13. The figure refers to the total amount of bonds reaching maturity in the first three months of 2012.

14. In an interview with the *Financial Times* , Italy's Prime Minister Mario Monti stressed how growth-promoting policies are the necessary complement to fiscal rigour if market confidence has to be restored (Financial Times 2012).

15. The euro has remained remarkably resilient since the onset of financial crisis in early 2010. Since January 2010, the currency has traded between 1.2 and 1.5 dollars per euro. However, there are growing pressures on the value of the common currency as observed by the recent developments in the foreign exchange market.

16. On 9 December 2011, the European Council agreed to enhance ex ante fiscal surveillance and the solidity and credibility of budgetary processes in the euro area. More importantly, it agreed on a treaty among 26 governments to support recommendations that the European Commission makes in the framework of the Excessive Deficit Procedure, leading to greater automaticity of sanctions and to adopt a balanced budget rule at the constitutional or equivalent level, and to recognise the jurisdiction of the Court of Justice to verify its transposition. Furthermore, to ensure the financial stability of the euro area, the leaders agreed: 1) that the European Stability Mechanism (ESM) should enter into force in July 2012 instead of July 2013; 2) private sector involvement in the Greek debt reduction programme will remain a unique one-off case; 3) urgent decisions in the ESM can be taken by qualified majority; 4) the adequacy of the combined ceiling for the EFSF and ESM of €500bn will be reassessed in March 2012; and 5) the euro area and other member states will confirm in 10 days whether they can provide up to €200bn in additional resources to the IMF, through bilateral loans, to ensure it has adequate resources to deal with the crisis.

17. Though member states were expected to confirm the provision of up to €200billion in additional resources to the IMF, the failure to ensure British participation meant that the target had to be revised to €150billion.

debt write-down as the one decided for Greece at the end of October 2011 would have substantial implications for the health of Italy's private creditors, in particular the country's banking system as well as banks in other eurozone countries. Many of these banks are already struggling to raise significant amounts of capital and so to restore their capital to the levels estimated by the European Banking Authority (EBA) as needed to protect them against adverse shocks. A 'debt event' in Italy would require government interventions in many countries in Europe to inject capital into their banks at a time when governments already face substantial fiscal pressures. The EFSF could provide the necessary financial safety net if it was large enough to fulfill this role. But so far all talks on additional financing by stronger eurozone countries or from outside Europe (the IMF or the BRICs) have not resulted in any substantial improvement.

It is essential to reduce Italy's debt servicing cost, and in the absence of other solutions the ECB could provide short-term assistance by acting as a fully-fledged lender of last resort. This would mean intervening decisively in support of troubled countries' bonds while the crisis continues; and eventually agreeing to an expansion of its statutory role to become a 'market maker and stabiliser' for the bonds issued by member states. In recent months the ECB has continued to intervene in support of both sovereign bonds and the banking sector. However, it has always made clear that this was not the default mode. In order to restore market confidence it is now necessary that the ECB agrees to provide support for as long and on as sufficient a scale as is needed.

3.2 A Plan for Growth in the Longer Term

In this paper we argue that Europe's sovereign debt crisis is multi-faceted and even if the outcome is similar for all countries—a critical fiscal position that markets deem unsustainable—restoring fiscal health should not be a 'one size fits all' policy goal, but should be assessed and achieved within the specific context of each country. Not only does a 'one size fits all' approach ignore features and conditions that are peculiar to each country, but also indiscriminate fiscal strategies with the ultimate goal simply to balance the budget can have very adverse effects on economic growth (at least in the short term). Lack of growth, in turn, seriously hinders fiscal consolidation because of its effects on tax revenue and welfare spending. Thus, in the longer term Europe's fiscal problems can only be sensibly addressed with a return to growth—both to avoid the debt dynamics that could put fiscal consolidation plans at risk and to generate the necessary political support for difficult policy decisions.

This is clear in the case of Greece, where the implementation of public expenditure cuts and tax increases has already contributed to strong falls in output, which in turn are making the fiscal challenges even greater. Strong public opposition and the recent change of government following the decision—subsequently reversed—of holding a referendum on the austerity measures is an unambiguous sign of the difficulties facing the country in addressing these challenges. Indeed, the autumn forecast by the European Commission projects a substantial increase in gross debt as a share of GDP—from 162% in 2011 to 198% in 2013—while GDP growth remains in negative territory in both 2011 and 2012—at -5.5% and -2.8% respectively.[18]

As we discuss in this paper, a root cause of the problems in the eurozone periphery countries is their lack of competitiveness within the single currency union that has exacerbated current account imbalances and slowed growth. In addition, simultaneous fiscal consolidation by all parts of the eurozone has magnified the adverse effects on growth. Small open economies can minimise the contractionary effects of domestic fiscal consolidation if their trading partners are able to substitute external demand for domestic. But eurozone countries have much stronger trading links with other eurozone members, and the eurozone as a whole is a large and relatively closed economy with substantial interconnections between its constituents. So for each country within the eurozone, its own fiscal efforts are not only affecting domestic demand, but external demand is also weakening.

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

- a shared solution where euro area member states with critical fiscal positions implement credible medium-term plans to reduce deficits and debt while euro area member states with current account surpluses take measures to reduce their surpluses;
- a more structured approach to fiscal transfers between richer and poorer countries within the currency area;
- structural reforms to maximise growth potential in individual countries;
- reforms that make it easier for countries to maintain competitiveness within the single currency, in particular to ensure that real exchange rates can adjust.

3.3 Rebalancing the Euro Economy

There is a fundamental contradiction between the two equally important and necessary goals of fiscal consolidation and economic growth, especially within the constraints imposed by the fixed exchange rate regime in the euro area. Given the limited time frame imposed on the eurozone by financial markets, fiscal consolidation can only be achieved through a painful process of domestic deflation. Under the right circumstances this process is a way to increase competitiveness; it is indeed the process

18. See, European Commission, "European Economic Forecast-Autumn 2011," *European Economy* 6, 2011 (provisional version), http://ec.europa.eu/economy_finance/eu/forecasts/2011_autumn_forecast_en.htm.

that Germany went through in the years 2003-2007 in order to achieve the adjustments in the real exchange rate necessary to compete in a fixed exchange rate regime. However, the size of debt reduction for countries such as Greece and Italy, and to some extent Spain and Portugal, requires measures of fiscal austerity that would seriously damage growth and threaten social cohesion. The solution is then to generate an intra-euro rebalancing where the burden of adjustment is shared between deficit and surplus countries.

3.4 Structural Reforms

In the long term, if the euro is to survive, the design flaws and the political tensions that the current crisis have exacerbated will have to be addressed.

One major flaw in the design of the single currency that is widely recognised is the lack of an effective fiscal coordination mechanism. The Stability and Growth Pact (SGP) has proved to be ineffective in both offering a benchmark for measuring member states' fiscal performance and providing surveillance on critical situations and mitigating action. In addition, its design is structurally flawed as it only considers each member state's fiscal policy, and not fiscal policy for the eurozone as a whole.[19]

It is now clear that the EMU cannot be successful without a degree of fiscal union—a mechanism for formulating fiscal policy at the union level—and a mechanism for making fiscal transfers from more competitive to less competitive regions within the currency area. A credible system of sanctions for excessive deficits in individual countries would also be necessary in order to avoid free-rider problems. The EU as a whole does allow limited fiscal transfers through the structural and cohesion funds. But these are primarily intended to encourage convergence between the poorer and richer regions, not to compensate for the loss of monetary sovereignty.

Effective fiscal coordination would also help avoid the current self-reinforcing nature of fiscal policy-making within the eurozone, which is magnifying the contractionary effects of simultaneous fiscal consolidation.

Another related issue is the balance of responsibilities between surplus and deficit countries within the eurozone for correcting payments imbalances. As at the global level, the responsibilities are placed much more on the deficit countries than on the surplus countries. But within a monetary union, with shared responsibilities and shared interest in ensuring that the union flourishes, it should be easier to rebalance those responsibilities. One mechanism could be to link fiscal transfers directly to balance of payments surpluses and deficits (the eurozone equivalent of Keynes' original notion for taxing balance of payments surpluses and deficits).

19. Fiscal policy coordination in the sense of avoiding spillovers and promoting peer review in order to detect problematic situations before they become unmanageable was not a main concern in the minds of the architects of EMU. The SGP was designed as an instrument to provide a measure to control and reprimand fiscally problematic countries like Italy. It is ironic that the SGP was breached by Germany itself (together with France) in 2003. The previous year Portugal was reprimanded, but not fined for having had a deficit of more than 3% of GDP.

3.5 Conclusion: The Alternative

Without these changes, both to deal with the current crisis and to address some of the underlying problems which prevent the eurozone from effectively coordinating its policies, it is hard to see the euro surviving in its current form. The balance of costs and benefits from EMU membership is spread unevenly among its members. And the strains, both economic and political, placed on individual countries on living within the constraints of the single currency are substantial.

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 be a 'nuclear option,' and would potentially reverse the trend towards greater integration at all levels within Europe. For that reason, it would only come about as a last resort. Nevertheless, unless further changes are made to the structure of the single currency to put it on a sustainable footing, it may still come to pass.

Despite the difficulties, the benefits of membership in the euro are large. Its members are able to trade with each other without facing currency risk, and the economic costs of currency conversion are eliminated. Also, many of the periphery countries have enjoyed substantially lower borrowing costs, and they have had significant political benefits from membership.

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