



Euro Zone Crisis: Diagnosis and Likely Solutions

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Abstract

This policy brief provides a short guiding tour to the euro zone crisis. It looks at the current situation, the context conditioning the solutions to the situation, how we got here, and the possible way out. The latter section outlines a set of minimum steps required to make the euro sustainable.

The situation

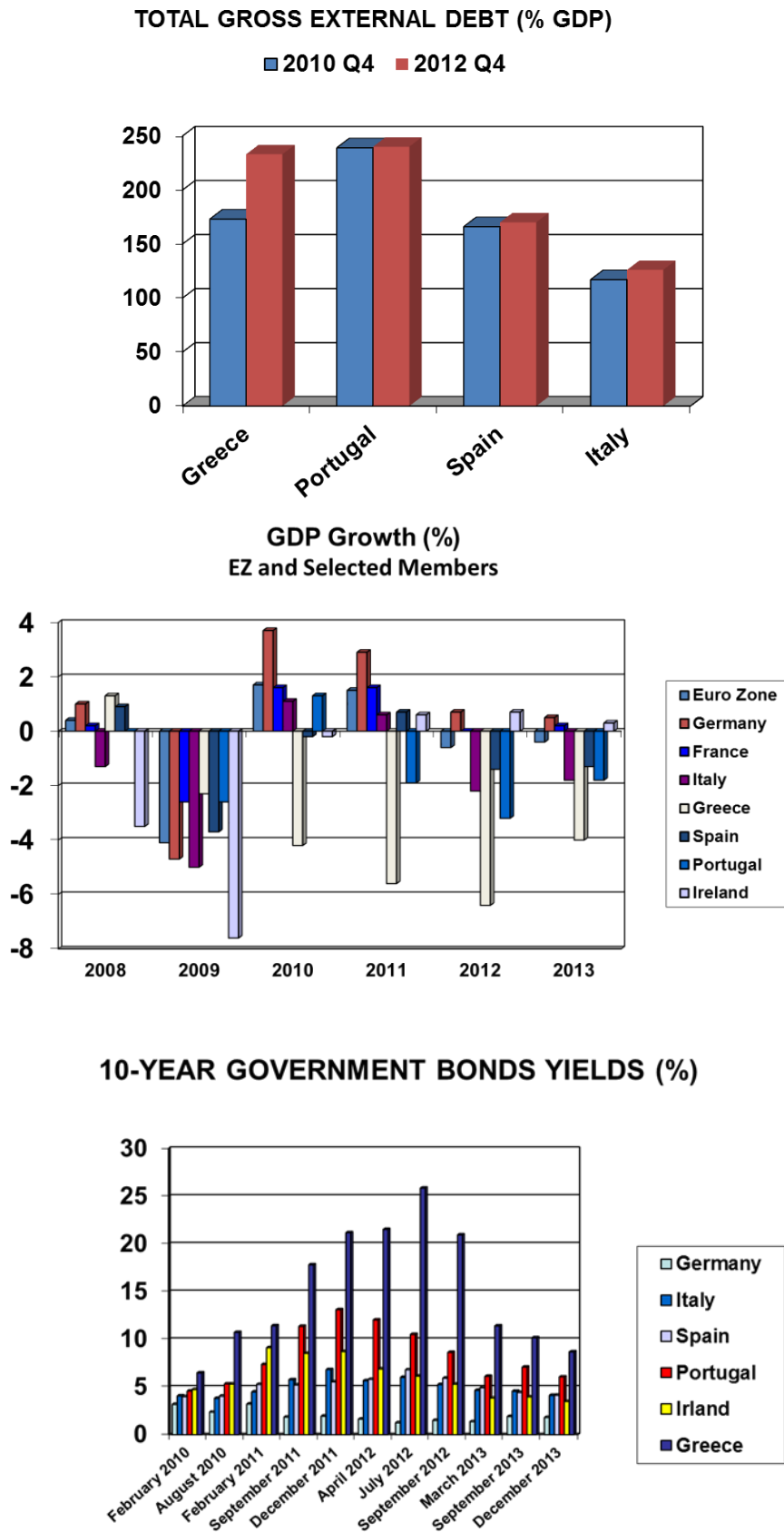
Southern euro countries are in a situation of vulnerability due to three factors: their high debt levels, their eroded competitiveness and their difficulties to restart growth. Together, these factors generate a vicious circle which is difficult to exit and which can even degenerate into a self-fulfilling economic downward spiral.

The reason is that deleveraging and price adjustment to regain competitiveness takes time and requires austerity, leading to output losses or stagnation. And with weak or negative growth, the debt-to-GDP ratio worsens, calling for additional austerity measures which further weaken growth and the debt position. Progressive deterioration of the debt position leads to higher default risk premiums, which again worsen the debt position. Unless stopped, this self-reinforcing process can lead to debt deflation and stagnation, or eventual loss of access to financial markets, leading to bankruptcy and deep recession.

Greece, Ireland, Portugal and Cyprus lost market access and had to be rescued. Spain and Italy experienced heavy market pressure during 2011-12, with increasing risk premiums that were only put under control when the European Central Bank stepped in and made clear its intention of acting as a lender of last resort in the sovereign debt market.

Risk premiums have been decreasing over the last months. But the euro zone situation in early 2014 is still one characterized by an indebted, uncompetitive and stagnant south.

Figure 1 – Debt; Growth; Risk Premiums



Source: BIS, EC and ECB

The context

In its efforts to deal with this difficult economic legacy, the south operates in a context that leaves very limited room for policy support, making the adjustment even harder. Two key elements frame the adverse working context of debtor countries. On the one hand, they have a highly constrained toolkit for macroeconomic stabilization. On the other, their productive structure is especially vulnerable to intense global competition from emerging markets. Let us turn to discuss these issues.

The macro stabilization toolkit of a stand-alone country includes interest rate and exchange rate tools, the fiscal stand at federal and/or national levels, and, of course, market stabilization via price and quantity adjustments. The latter tends to be painful, and can be partially offset by the former monetary and fiscal tools.

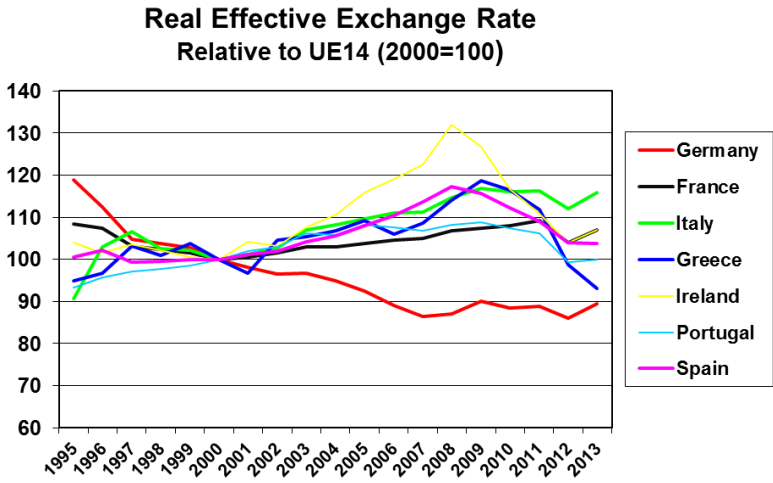
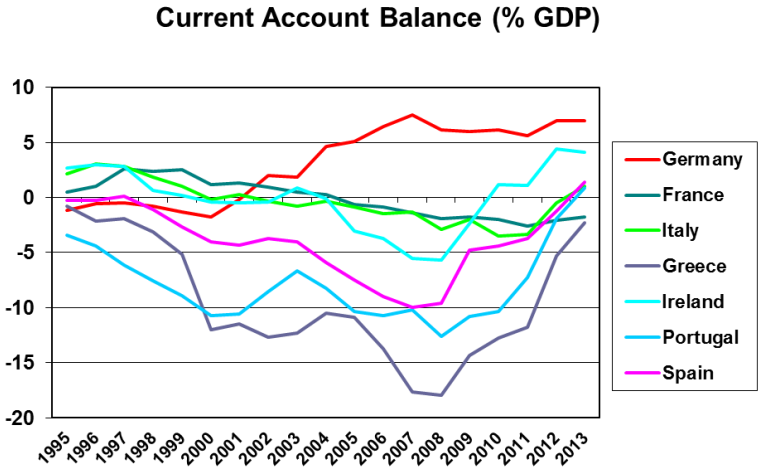
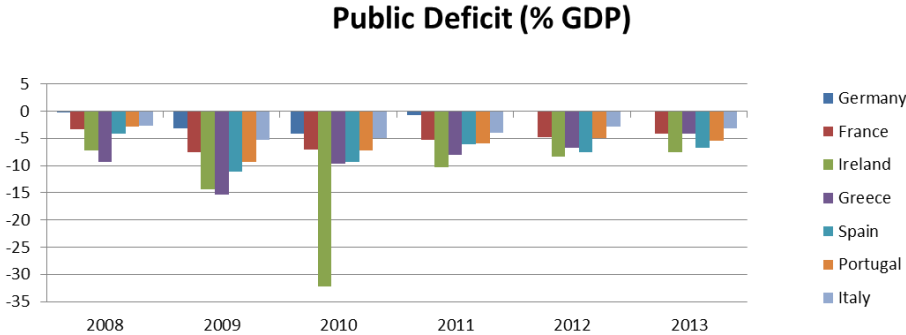
In contrast to a stand-alone country, a euro zone member's own too-kit consists of the national fiscal stand and market adjustment. There are three important constraints embedded in this stabilization kit. First, the fiscal level is incomplete, since there is no federal level for Euro-zone-wide fiscal actions and cross-country risk-sharing. Second, member countries lack own interest rates and exchange rates that can be adjusted to fit domestic macroeconomic needs, thus limiting their ability to counteract macroeconomic hardship. Third, members have lost the capacity to issue debt in a currency that is under their own control, a fact that makes sovereign defaults possible, thereby making countries prone to sovereign crises, since they promise to pay something they may run out of. Sovereign crises are precisely what we have seen since 2010, which demonstrates the consequences of having a central bank that cannot effectively perform the role of lender of last resort in order to eliminate the risk of outright sovereign default.

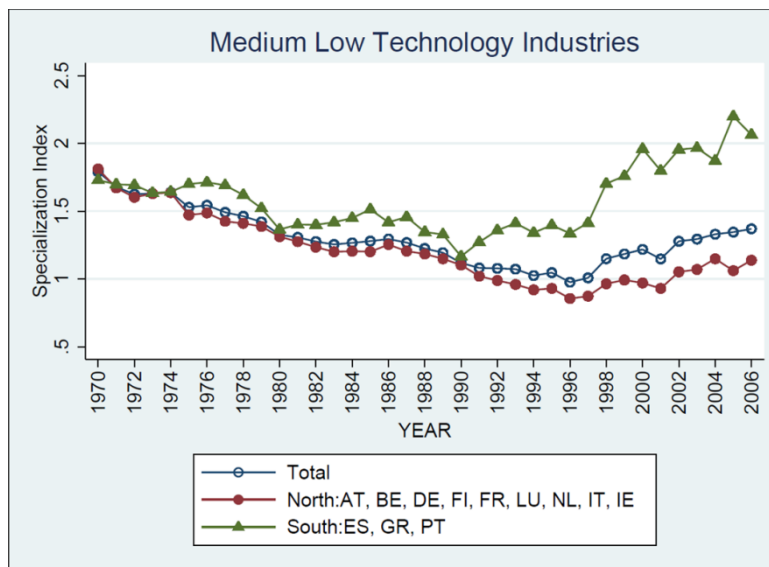
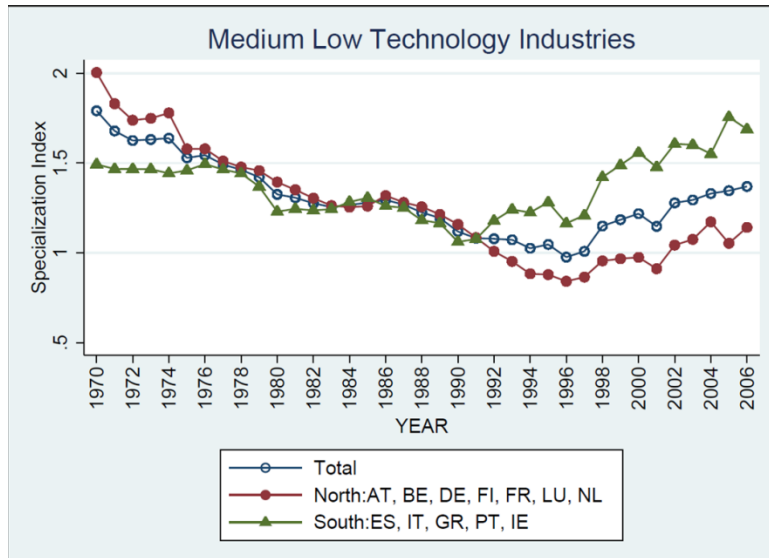
To summarize, the south is facing economic hardship without having its own offsetting monetary tools, with limited and conditional support from the European Central Bank, without federal fiscal support, and with national fiscal policy in an austerity mood. This means that macro adjustment is basically being left in the hands of the market. And this is happening in a context also characterized by market rigidities, banking sector segmentation and debt run risk.

The second key context element is the sectorial structure of southern countries. As it turns out, since the introduction of the euro, their sectorial economic activity has tilted to the middle-low technology side rather than to the middle-high. This kind of specialization makes the south more vulnerable to emerging market competition. Additionally, it makes the lack of a full-fledge stabilization toolkit even more costly in a context characterized by a euro-wide

macroeconomic policy that favors a strong euro and by the lack of clear progress in euro-wide risk-sharing institutions, such as a banking union or further fiscal integration.

Figure 2 - Fiscal Austerity; Painful Market Current Account Correction; Price Adjustment; Specialization Indicators





Source: EC and Ballabriga & Villegas

How did we get here?

The decision to start the preparation for the adoption of the euro was formalized in 1992. It was a political decision. The early 1990s were times of European integration euphoria. A number of relevant pro-European politicians were in power and the disintegration of the Soviet bloc brought the issue of German reunification. To a large extent, the reunification of Germany and the single currency decision run in parallel. It was a way of seeing the reintegration of Eastern Germany as part of a more general push to foster European integration.

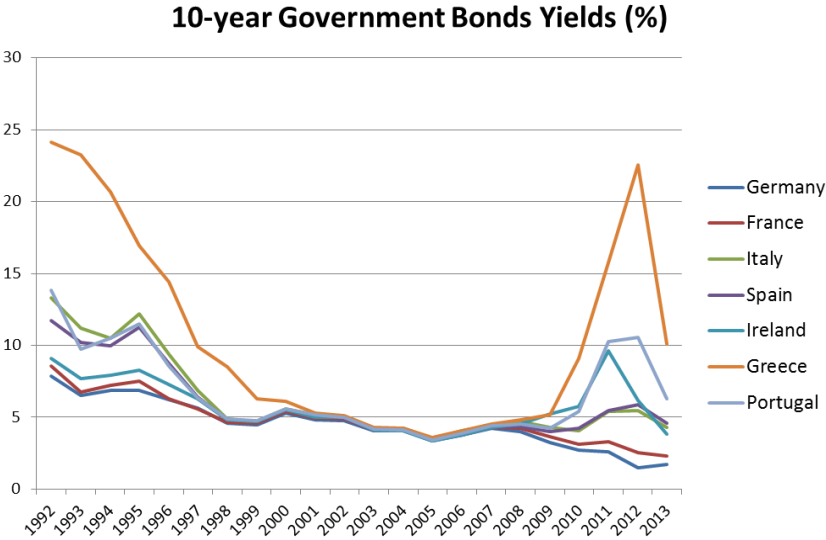
But this political optimism was an obstacle to a careful assessment of the potential economic consequences of the decision to adopt the euro. In fact, the economic foundations of the euro were fragile: a set of diverse countries in terms of productive structures, regulatory

frameworks and macroeconomic policy traditions, which could hardly be defined as an optimal currency area, decided to form a monetary union. A transatlantic economic debate was prevalent during the 1990s, with some prominent American economists claiming that the euro could end up being more a source of friction and division than an element for further integration. But the European side downplayed the risk, presenting the single currency as the natural step to complete the single market, and arguing that the euro zone would become a proper currency area along the way.

So the euro project started. And it did so as a plain monetary union, with just some limited fiscal coordination embedded in the so-called Stability and Growth Pact and a non-bail-out clause stating that no country would be rescued by neighbor members. No prospects of a fiscal or even a banking union were in sight.

Given the strong political will and optimism, the market trusted the euro project. Once the euro was introduced, financial markets treated member countries as equally risky, providing financial resources at a single interest rate which was historically low for peripheral countries. In fact, the introduction of the euro set the stage for a surge of cross-border lending-borrowing among member countries, neglecting country risk differences. Ten years later, Europe found itself split into creditors and debtors, and the euro crisis was unleashed.

Figure 3 – Long Term Interest Rates in the Euro Zone



Source: EC

The way out

The crisis has revealed some key institutional flaws of the euro architecture and has left a large debt overhang. The way out of the crisis requires finding a sensible solution to these

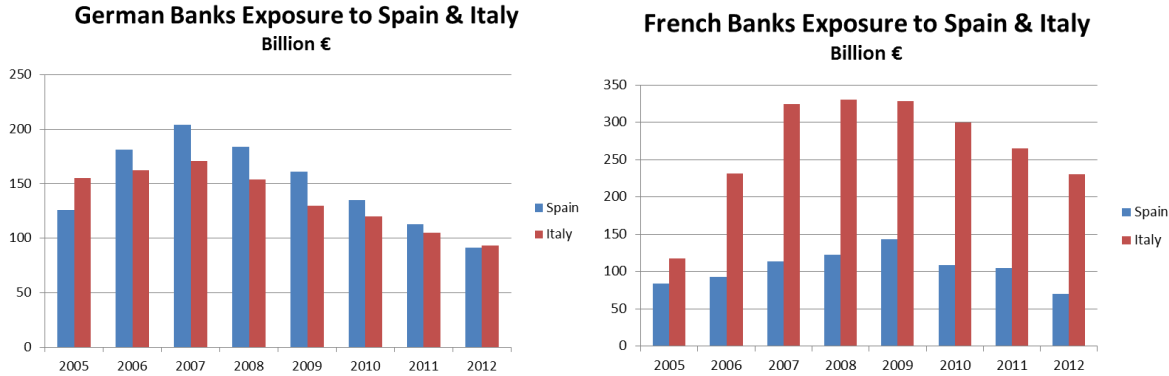
political economy problems. And to be sensible, the solution must take into account how we reached the current state of affairs. Let us look at the relevant aspects of this debate.

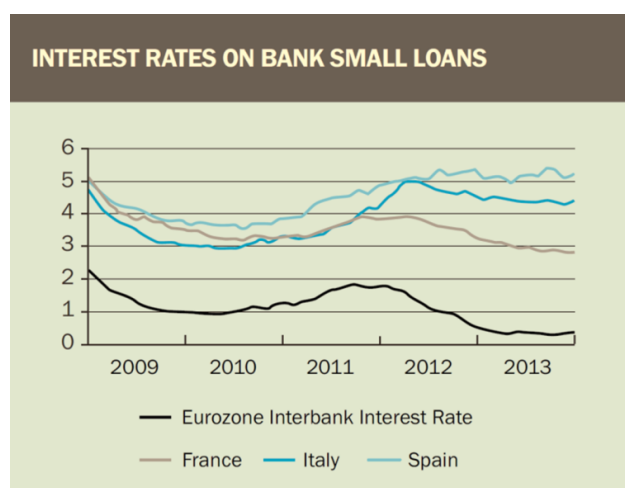
There are three structural institutional flaws that the crisis has highlighted as especially harmful. The first is the lack of significant progress in national structural reforms. The second is the lack of a banking union. The third is a central bank which cannot effectively perform the crucial role of lender of last resort.

One of the main reasons why structural reforms are important for a country that belongs to a monetary union is that they provide an avenue to a lubricated market mechanism which can at least partially make up for the loss of monetary stabilization tools the membership of a monetary union entails. Lubricating the market means eliminating obstacles to competition, which then delivers the wage and price flexibility and labor mobility that allows for the smoothing out of economic fluctuation through the market adjustment buffer. The so-called Lisbon Agenda 2000-2010 was the European institutional instrument put in place to promote national structural reforms. It did not work. Only as a reaction to the current crisis have some member countries started to accelerate some of these reforms. But there is still a long way ahead.

The lack of banking union has been highly damaging. Without effective euro-wide banking supervision, it first contributed to the misallocation in the south of credit from the north, both in size (bubbles) and targeted sectors (low-middle tech). And once the crisis erupted, it led to banking fragmentation, with northern banks reducing exposition to the south and the south left with a credit crunch due to its zombie banks. This in turn led to the risk of a destructive sovereign-banking loop, as illustrated by the case of Spain, which was forced to borrow European funds and rescue part of its banking system in order to stop the loop.

Figure 4 - Northern Banks' Exposure to the South; Credit Rate Differentials





Source: BIS and IMF

The design of the European Central bank (ECB) is another important institutional fragility. In contrast to the Fed or the Bank of Japan, the ECB was designed as an institution protected against sovereign bankruptcies. That is, potential sovereign bankruptcies could not lead to ECB negative net worth. In practice, this means that the ECB is not supposed to have euro members' sovereign debt in its asset portfolio. But this has two important implications. First, the ECB cannot regularly buy public debt issued by member states; and second, it lacks the necessary fiscal backing to guarantee price stability in the event of capital loss generated by potential non-performing assets. The latter implication has not yet been activated. But the first has been highly visible, as risk premiums reflected the increasing market fear of an actual sovereign default in a context where the central bank does not have its hands free to buy public debt, and so cannot kill default risk by always being ready to buy debt as a last resort.

Improving the market adjustment mechanism, making steady and credible progress toward banking union, and guaranteeing the commitment of the ECB to buy unlimited debt of sovereigns that are arguably solvent at default-free interest rates are lines for immediate progress to the way out of the crisis. However, the implementation of these or similar proposals requires as a precondition a solution for the debt overhang, a burden that is weighing too heavily and which the south is unlikely to successfully manage on its own.

There are three possible solutions to the debt problem. First, continuing along the path of a long and painful wage-price adjustment and deleveraging process in the south. Second, considering the implementation of a more aggressive monetary policy to boost euro zone demand. Third, consider an exceptional (never again) debt write-down.

It is unlikely that each of these solutions will work on its own. The first would highly likely end in eventual default. The second would generate high political tensions due to the sharply

different conceptions with regard to the proper role of the ECB. The third would shift an excessively heavy burden to the north. Therefore, the most sensible solution is a combination of all three, which would essentially amount to sharing the debt burden.

Why share the burden? If one looks back and makes a brief account of euro events, one observes facts such as the following: the monetary union sprouted from a European political seed; it was designed too fast with important flaws in its initial institutional architecture; it brought short term benefits to the south but also to the north, which kept its industrial base competitive and strong; and it has been characterized by systematic breaches of its basic rules, namely its fiscal pact and its non-bail-out clause, the latter of which was breached to save northern banks from southern default.

The unavoidable conclusion of this equation is that the euro crisis is a European collective responsibility, and thus that it is morally just that the consequences and potential solutions be shared collectively. Debt sharing requires collective fiscal resources. Progress in banking union requires collective fiscal resources for the deposit guarantee and the resolution funds. Achieving a central bank able to act as an effective lender of last resort requires some collective fiscal resources to provide fiscal backing to the ECB.

This set of collective actions constitutes a minimum requirement for a sustainable euro. Will they be undertaken? The answer may hinge upon the collective ability to deal with the consequences of the initial partial debt write-down. This write-down will create a moral hazard problem in the south and a corresponding reluctance in the north to restart the game – unless it is fully convinced that the outcome will not be renewed set of rescues. It is therefore crucial that the write-down be presented as what it should be: a once-and-for-all event justified as the result of an unprecedented historical experiment that uncovered mistakes which will never be made again.

With the debt clock reset to sustainable levels, correcting past mistakes will require a new fiscal pact that shifts fiscal responsibility to member countries and a new non-bail-out clause that will need to be made credible through eventual painful country defaults.

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**For further information on ESADEgeo's Position
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