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Eurozone crisis: debts, institutions and growth

The Eurozone crisis is much more than a sovereign debt crisis. It calls into question the whole architecture of economic policy, from monetary policy to macroeconomic surveillance and sanctions. Beyond the short-run urgencies, EU members need to come out with a clear view of what kind of coordination device they want to invent. There are several routes forward, but failing to select one could contribute to marginalizing the Eurozone in the global economy.

How we got there

The deep crisis the Eurozone has experienced since 2009 is not just a side effect of the global crisis. True, the global crisis has had a strong impact on government debt-to-GDP ratios, inflating the numerator while the denominator was negatively impacted. However, the seeds of the crisis are to be found in the Eurozone construction itself: a monetary union with no fiscal federalism and weak government coordination. Three elements proved key in this respect:

♦ First, the benign attitude of European partners towards cumulative macroeconomic imbalances in some Member states.

♦ Second, the failure of the Stability and Growth Pact (SGP) to foster fiscal sustainability. In some member states, this failure was related to fiscal profligacy while in others, fiscal discipline proved partially flawed.

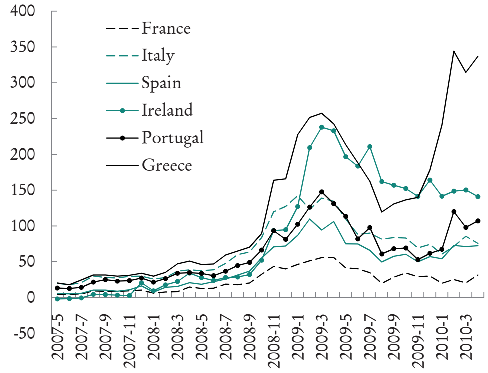
♦ Third, the lack of a provision in the Treaty for sovereign insolvency. The authors of the Treaty had well understood that insolvency from one Member state would put the monetary union at risk because sovereign bonds were to be disseminated within the European integrated financial system: to avoid a financial crisis, there would be strong pressure on partner countries for a bail out, and on the ECB for monetization. To avoid both, bail out and monetization were (almost) proscribed in different articles of the Treaty. But no provision was taken for the way to deal with a sovereign insolvency: the very possibility of insolvency would supposedly be excluded through the enforcement of the SGP.

The Greek sovereign debt crisis found European partners unequipped and it took several months for them to come with solutions (as evidenced in Figure 1, sovereign spreads started to widen in late 2008). Having rejected a pure IMF solution, they had no other choice but to circumvent the Treaty. Together with the IMF, they extended loans to Greece and then established the European Financial Stability Facility, a special purpose vehicle designed to provide financing to troubled countries against conditionalities, for a three-year period. On May 10, the ECB also stepped in through outright purchases of troubled government bonds. Admittedly, EU partners did not bail out Greece, but just provided loans that are to be repaid; as for the ECB, it did not buy government bonds directly from the troubled states, but on the secondary market, and it was careful to sterilize its interventions. Still, it is difficult to deny that at least the spirit of the Treaty has been violated.

The EU-IMF 3 and 9 of May schemes will provide loans at fixed interest rates in order to ensure that fiscal adjustments are not absorbed by skyscraping debt service. After the plan is over, the different countries will hopefully display healthier public finances that will allow them to raise money at reasonable rates on the bond market. The problem with this scheme is that historical experience suggests that large fiscal adjustments take much more than a couple of years, and that they generally involve exchange-rate adjustments. Hence, the nervousness of the markets which doubt large fiscal adjustments being feasible over a short period especially without a devaluation.

Today, three major issues are under scrutiny: 1/ the continuation of the sovereign debt market despite rising concern that the sovereign debt of some countries could need restructuring over the next couple of years; 2/ a plan for coordinating adjustment policies in the medium term without killing the seeds of growth; 3/ a longer-term framework of economic governance or integration that will ensure further structural convergence across euro countries.

Figure 1 – Euro area government (10-year) spreads (in basis points)



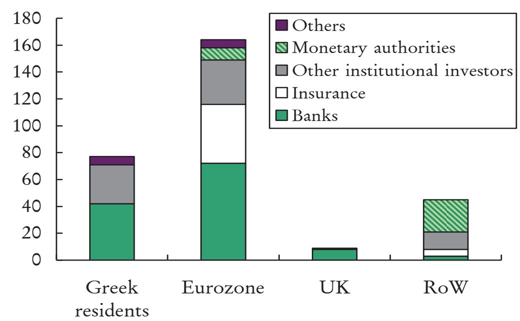
Source: Thomson Datastream.

The continuation of the sovereign market

The bulk of Greek, Irish, Italian, Portuguese and Spanish government bills and bonds are held by non-residents, especially by financial institutions in euro area countries (see Figure 2 in the case of Greece). Detailed estimates reported by European banks suggest that, although a Greek default or restructuring could be absorbed,[1] a default or restructuring extended to several countries would likely trigger a second bank crisis. For example, according to the Bank of International Settlements,[2] total bank exposure of France and Germany to Greece, Portugal, Ireland and Spain, including direct debt holdings and exposure through branches, represents around 15% of their GDP.

Hence, even very limited haircuts on several troubled government debts would put the Eurozone's still fragile banking system at risk. This means that in the worst-case scenario, the amount needed to recapitalize banks could be large enough to downgrade French and German government signatures. To face this difficult situation, two different routes were initially available.

Figure 2 – Estimated Greek government securities holdings at end Q3 2009 (€ bn)



Source: Barclays Capital.

The first option consisted in organizing the sovereign default of the smallest, most troubled countries in such a way that it would not spread over large countries. This was a perilous route as there are many contagion channels. One possibility would have been to create one or several "bad banks" or dedicated funds that would have offered exchanging the bonds of some troubled countries for claims on the fund, with a significant haircut, thus acting as a backstop against capital losses.[3] The problem with such scheme would be its financing. Relying on contributions by SGP-infringing countries, would likely prove insufficient in the short run.

The second route was that governments take swift action to cover the refinancing needs of troubled countries before these needs become unbearable. This was the choice made by the EU council on May 9 2010, with the creation of a special purpose vehicle to raise funds in order to help troubled countries to meet their refinancing obligations at reasonable cost. However it took a month before the governments could reach an agreement on the way this scheme would be financed, delaying its operational start.

Given the urgency of the situation, the ECB also stepped in on 10 May 2010 and decided to act as a "buyer of last resort". There were two main reasons for the ECB to get involved. Firstly, it was necessary to unclog some of the bonds markets so that these bonds could be valued in banks and other financial institutions books. Secondly, this was a way for the ECB to signal its willingness to exert its responsibility of Eurozone's financial stability. Thus the ECB bought for close to €40 bn of three troubled countries' debt in the first four weeks of its purchasing operation, with significant haircuts.

The U-turn operated on May 10 has raised a number of concerns. As long as growth remains subdued and the amount of slack in the economy is large, the risk for inflation is unlikely to materialize.[4] A more serious concern is the deterioration of the ECB's balance sheet. Given the limited amounts involved,[5] the risk is not so much that of a capital loss by the ECB and subsequent needs for recapitalization than that of moral hazard, European banks being keen to transfer risk at no cost to the central bank. De facto, the ECB is playing the role of a bad bank. Because it is now market maker, it could at a later stage participate in a partial default arrangement. The loss then incurred would depend on the negotiated haircut compared to the price the bonds were purchased.

ECB's intervention will not have large, long-run implications if such intervention remains limited. Being independent, the ECB was able to act much faster than governments. But this strength could become a weakness should governments find debt monetization much more comfortable than a large bailout. De facto, no government intervention on the secondary market has been decided so far.

1. For instance, a 50% haircut on Greek debt (which is the average size of restructuring that took place in previous countries), and assuming Greek debt holding by banks have been halved between 2009 Q3 and the date of restructuring, the loss would amount to €4 bn for the French or German banks, which is manageable.
2. BIS, "Detailed tables on provisional locational and consolidated banking statistics at end-December 2009", Monetary and Economic Department, April 2010.
3. D. Gros & T. Mayer, How to deal with sovereign default in Europe: Create the European Monetary Fund now!, *CEPS Policy Brief* No. 202, 17 May 2010.
4. The fact that bond purchases have been sterilized may not be the crucial feature here since the ECB has simultaneously reopened its fixed-rate, illimited allotment refinancing operations. See G. Tabellini, "The ECB: Gestures and credibility", *Vox*, 26 May 2010.
5. Less than €40 bn during the first month, amounting to 0.4% of Eurozone's GDP, to be compared with a cumulated 14% of GDP in the UK and 12% in the US. See P. Meggyesi, "How lite is the ECB's QE-lite?", J. P. Morgan Global FX Strategy, 4 June 2010.

Kick-starting fiscal adjustment without killing the seeds of growth

The fiscal restrictions announced as of May 2010 pile up to 7% of GDP in Greece, 3% in Ireland, 2.5% in Portugal and Spain in 2010 (Table 1). These are very large amounts for these countries, but given still expansionary or neutral fiscal stances in other Eurozone countries, the aggregate tightening will be very limited in 2010 (see bottom line of Table 1). In 2011, the group of adjusters will be joined by all Eurozone countries, although at a more moderate pace. Although the process of drafting the 2011 budget is still at an early stage, currently it can be anticipated that the additional amount of fiscal tightening in 2011 would be around 1% of GDP.

The IMF review of past adjustments,[6] suggests that successful adjustments on average lasted seven years, relied heavily on spending cuts (especially in the wage bill and social expenditures), and were supported by declining interest rates and/or a depreciating currency. The current episode is different in the sense that countries in the euro area cannot devalue vis-à-vis their main trading partners who also are in the euro area, and interest rates are already at record low. The fiscal adjustment thus runs the risk of engineering a severe contraction. To avoid this, the euro area should find ways of 1/ engineering an internal devaluation for those countries in need of strong adjustment, 2/ getting the support of euro area and the rest of the world demand, to compensate somewhat for the decline in internal demand.

Table 1 – Euro area fiscal tightening announcements as of May 2010

	Discretionary tightening (change in fiscal stance, including one-off measures, % GDP)			
Reference year	2010	2011	2012	2013
Austria	-0,5	0,2	0,5	0,5
Belgium	0,7	0,5	0,5	0,5
Finland	-1,0	0,2	0,0	0,0
France	0,0	0,6	0,6	0,6
Germany	-1,5	0,4	0,2	0,2
Greece	7,0	4,0	2,0	2,0
Ireland	3,0	2,0	1,5	1,0
Italy	0,5	0,8	0,4	0,4
NL	-1,0	0,7	0,7	0,7
Portugal	2,5	3,1	1,5	1,5
Spain	2,5	2,9	2,0	2,0
Others	0,3	0,5	0,5	0,5
Euro area	0,2	1,0	0,7	0,7

Source: Barclays Capital, based on updated national stability programmes and governments announcements post 9 May.

In an analysis of Portugal, Blanchard (2007)[7] suggested that, in a monetary union, lost competitiveness could still be recovered through internal devaluation. He suggested that a large cut in nominal wages and in the prices of non-tradable goods would induce a reduction of all prices and revive competitiveness. An internal devaluation would rely on a simultaneous change of all prices in Greek-law contracts, including debt contracts. Such a change would raise difficult legal issues. The alternative is a decade of deflation. In the latter case, the cost could still be mitigated through (i) a weak euro, which would raise price competitiveness vis-à-vis non-Eurozone countries, and (ii) higher inflation in other Eurozone countries. The latter point is likely to be non-consensual, core-euro countries being keen to favor price competitiveness as a key element of their exit strategies.

Finally, the cost of fiscal adjustment in periphery countries can be reduced by the lack of monetary policy tightening and by limited fiscal tightening in those countries where fiscal adjustment is less urgent. The timing of monetary tightening will depend on the evolution of inflation. Because inflation in turn will depend on the output gap, too early monetary tightening is unlikely to be a concern (should the ECB hike interest rates, this would be related to fast recovery). On the fiscal side, things are different in particular due to the introduction of national fiscal rules: core-euro countries will unlikely weigh the situation of periphery countries when they decide to reduce their own deficits. Still, some coordination could be organized around the composition of receipts and expenditures, and on demand-friendly structural reforms.[8] On the receipt side, spreading the effort across the different tax bases (rather than, as has already started, relying on VAT hikes) could help reviving domestic demand. On the spending side, preserving public investment in infrastructure and education would be key to help recovering a dynamic potential growth path.

The way forward: economic governance and integration?

At the onset of the euro, economists warned that it would be difficult to run a single currency without a federal budget, or more labour market flexibility, or marked divergence in the economies' competitiveness. The Stability and Growth Pact substituted for budgetary integration. The Lisbon agenda and Broad Economic Policy Guidelines (BEPG) were introduced with a view of fostering labour and product market flexibility, thus enhancing countries' competitiveness. Yet, both the SGP and the Lisbon Agenda turned out to be weak instruments.

So far, the enforcement of the SGP has relied on fines, while the BEPG and Lisbon agenda have relied on peer pressure. Both enforcement devices have shown their limitations. This suggests two different routes that could possibly be combined:

♦ *Tighter sanctions*: without going as far as depriving a member state from its voting rights, sanctions could target EU support more directly (suspension of CAP or structural funds support) rather than asking troubled governments to pay a fee (and ultimately having the fee socialized through rescue schemes). Sanctions could also be swifter, e.g. starting before the 3%-of-GDP deficit bound is actually breached, with fast implementation, contrasting with the present delay of three years included in the SGP;[9]

6. IMF, "From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies", Fiscal Affairs Department, 10 April 2010.
7. O. Blanchard (2007), "Adjustment within the euro. The difficult case of Portugal", *Portuguese Economic Journal*, vol. 6(1), pages 1-21, April.
8. See IMF, Article IV consultation discussions with euro-area countries, 7 June 2010.
9. The decisions taken by the Eurogroup on 7 June 2010 to "upgrade" the SGP point to this direction.

♦ *Incentives*: while they have proved efficient in the run-up of EU and EMU membership, incentives are curiously absent from the coordination system in the Eurozone. Those countries that carry out fiscal adjustment programmes could be rewarded *e.g.* by easier channeling of CAP or structural and cohesion funds for investment, as the adjustment measures are being implemented.[10] Another way of providing incentives could be to allow countries to issue common eurozone bonds (or guaranteed bonds) up to a certain threshold of debt, as suggested by Delpla and von Weizsäcker (2010).[11] Debt in excess to the threshold would not benefit from the scheme, and the risk premium attached to them would provide an incentive to adjust public finances.

As for surveillance itself, it is now widely recognized that focusing on public finances while disregarding private sector's leverage proved wrong: Ireland and Spain, which perfectly complied with the SGP, fell in deep fiscal trouble during the crisis. Consistently, there is some consensus to broaden the scope of surveillance to intra-Eurozone competitiveness, private leverage, asset-price bubbles, *etc.*[12] For surveillance to bite more, the current organization must be amended. Two directions are possible: further integration or decentralized coordination as is the case for competition.

Recognizing the failure of the rule-based surveillance mechanisms, a natural avenue could be to move towards further integration. The proposal by the Commission, endorsed by the Eurogroup on 7 June 2010, to have national budgets reviewed before they are examined by national parliaments, points to this direction. Ideally, such an ex ante coordination would carefully consider not only the aggregate amounts, but also the composition of the budgetary policy. De facto, it would tend towards more federalism, where countries would be ready to amend their economic policy in line with the "common welfare". Given the loss of sovereignty this would involve, surveillance could no longer remain a technical exercise in the hands of the Commission; strong involvement by the Eurogroup would be needed. Consistent with further coordination of the decision-making, a financial backing system in case of crisis or difficult times could be made permanent, which would potentially involve transfers across Eurozone partners.

The problem is that the crisis does not seem to have increased the appetite of member countries for more centralization. As argued by Pisani-Ferry (2010),[13] the integration route is not the only way forward: "It is perfectly possible to imagine an alternative scenario where budgetary discipline would result from a combination of institutional reforms at domestic level and market forces." This second route would be more akin to the European mechanism of financial surveillance (or competition policy). A common European framework could be set-up for processes and institutions. For instance, in each country, an (independent) Committee would review the short-term (cyclical) adequacy of the budget, the long term sustainability of the public finances, but also (as is the case for the Swedish Fiscal Committee[14] the employment and growth developments and subsequent government policy proposals. Each national Committee would in turn report not only to the national parliaments, but also to a European Fiscal Committee that would evaluate and communicate on the aggregate result, with the technical assistance of the Commission. Thus each member state would remain free to implement its policies, but there would be an official and publicized assessment of its fiscal stance, and more largely of its economic policy, at the national level and with implications for the euro as a whole. Such less-demanding coordination could maybe find its way more easily in national political arenas and gain the "ownership" that SGP and BEPG have been lacking during the first decade of the euro.

*Agnès Bénassy-Quéré & Laurence Boone**
beatrice.postec@cepii.fr

10. For instance, the co-financing requirement could be reduced for those countries carrying out large adjustments, as a way to encourage them to preserve investment spending.
11. J. Delpla & J. von Weizsäcker, "The blue bond proposal", *Bruegel Policy Brief*, 6 May 2010.
12. For instance, not all Eurozone countries experienced housing-price bubbles prior to the 2008-09 crisis. Those, like Spain, that experienced them could have taken action through the taxation and/or regulation of mortgages. The failure of the Spanish government to take action could have been pointed out and sanctioned, since it had a potential for spillovers on the rest of the Eurozone through the banking sector and a sudden stop in growth.
13. J. Pisani-Ferry, "What went wrong in the euro area? How to repair it?", *Panel discussion on policy co-ordination in the euro area*, Brussels Economic Forum, 6 May 2010.
14 See L. Calmfors, "The Swedish fiscal policy council – Experiences and lessons", *Conference on Independent Fiscal Policy Institutions*, Budapest, 18-19 March 2010.
* L. Boone is Chief economist for France at Barclays Capital.

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EDITORIAL OFFICES
Centre d'études prospectives
et d'informations internationales
9, rue Georges-Pitard
75015 Paris
Tél. : 33 (0)1 53 68 55 14
Fax : 33 (0)1 53 68 55 03

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Agnès Bénassy-Quéré
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CHIEF EDITOR:
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La Documentation française
124, rue Henri Barbusse
93308 Aubervilliers Cedex
Tél. : 01 40 15 70 00

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