SAPIENZA
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European Economic Integration
EPOS – Master in Advanced Economics
Giovanni Di Bartolomeo

Euro crisis Baldwin&Wyplosz's view

Class overview

1. Global financial crisis
2. Public debt crisis
3. Policy response

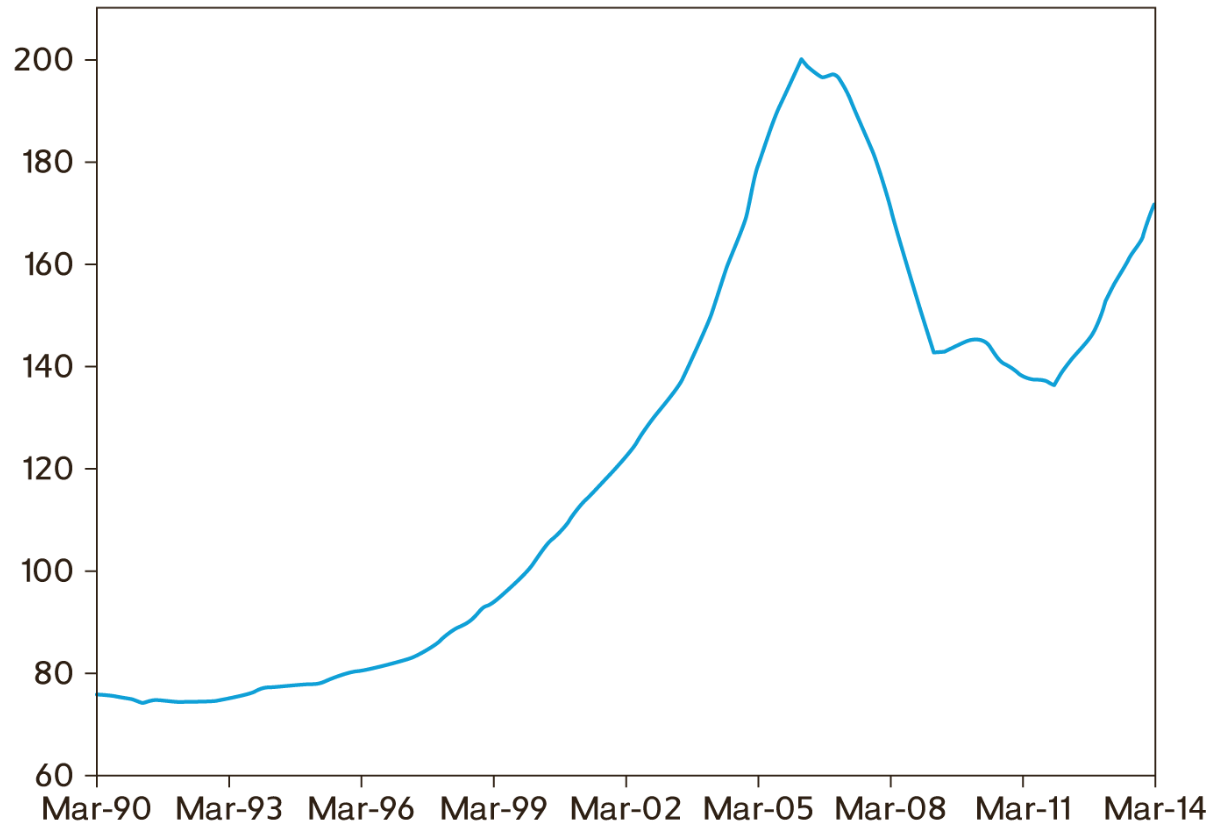
- Slides are largely based on Baldwin-Wyplosz's ones (textbook)

Stage one: the global financial crisis

- Following Great Depression, strict regulation was designed to limit risk-taking by banks and financial institutions. The deregulation phase started in the 1980s, followed by a rapid expansion of financial sectors in the USA and Europe:
  - Banks became active investors:
    - maturity mismatch;
    - currency mismatch;
  - Banks took major risks, implicitly borne by their governments;
  - House mortgages in the US to risky people: subprime mortgages, which relied on ever increasing house prices. And these loans were sold to banks, which sold them to other banks (i.e., securitization).

Stage one: the global financial crisis

Housing prices in the USA (Index: January 2000 = 100):

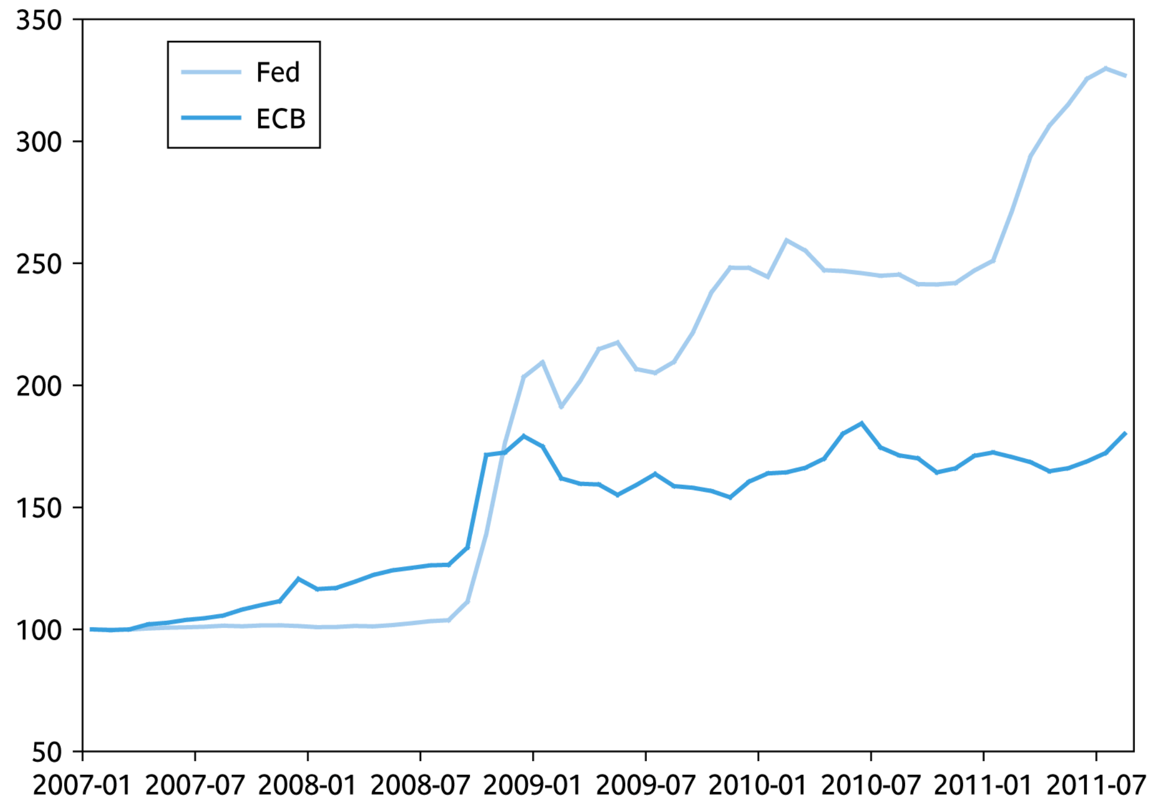


Stage one: the global financial crisis

- -When house prices stopped rising, securities lost their ratings and many of the world's largest banks (especially in US, UK, France, Germany) faced heavy losses.
- April 2007: New Century Financial Corporation (one of the largest US mortgage lenders) declared bankruptcy;
- July 2007: bank Bears Stearns announced that it would stop honoring the commitments of one of its SPVs;
  - → banks grew suspicious of one another and stopped their mutual lending that makes up the interbank market.
  - → central banks provided liquidity directly to their banks.
- September 2007 – spring of 2008: several major banks failed;
- 15 September 2008: failure of Lehman Brothers triggered the worst financial crisis since 1929.

Stage one: the global financial crisis

- Assets of central banks (Index: January 2007 = 100):

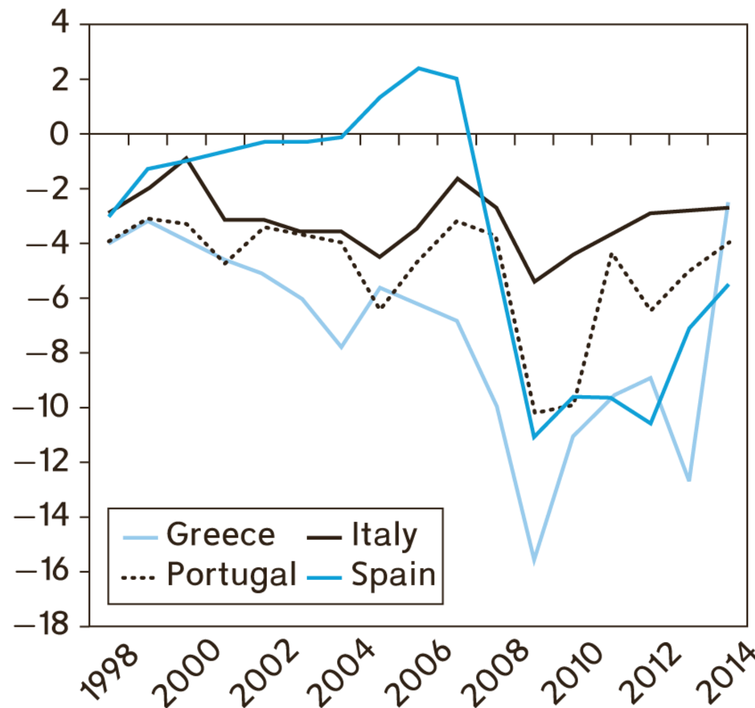


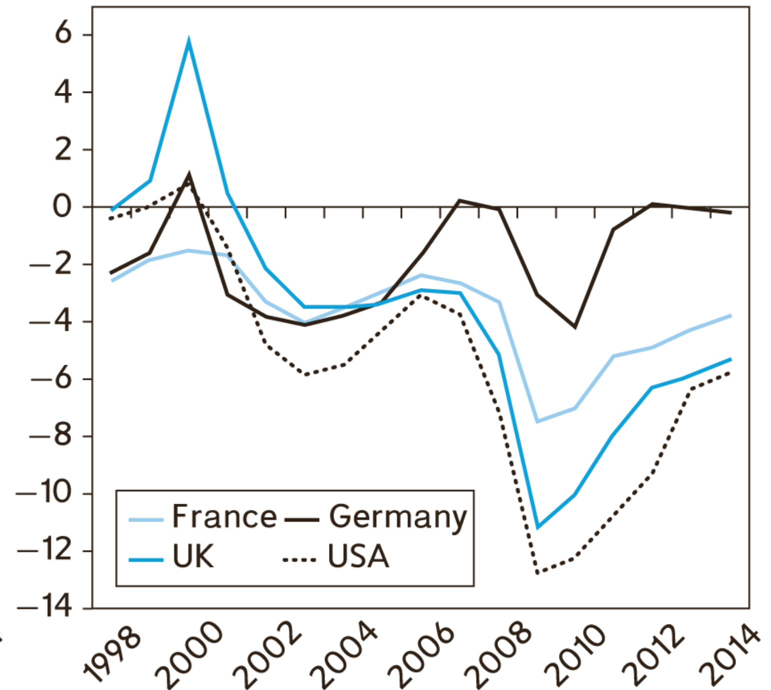
Stage one: the global financial crisis

- Policy makers (governments and central banks) followed the lessons learned from the Great Depression:
  - rescue large financial institutions;
  - deep distress in the financial system is soon followed by a profound and long-lasting recession;
  - central banks must provide liquidity to the financial system and adopt sharply expansionary policies;
  - governments must bail out banks and other financial institutions;
  - governments must use fiscal policy to prevent a vicious cycle of recession and large budget deficits.
- The London G20 Summit in 2009 called upon all governments to urgently adopt expansionary policies.

Stage one: the public debt crisis

- These actions had dramatic impacts on budget deficits (e.g., in 2010, Irish government spent almost 30% of its GDP on bank bailouts).
- Budget balances 1993–2014 (% of GDP):





Note: The scale is not the same in both charts.

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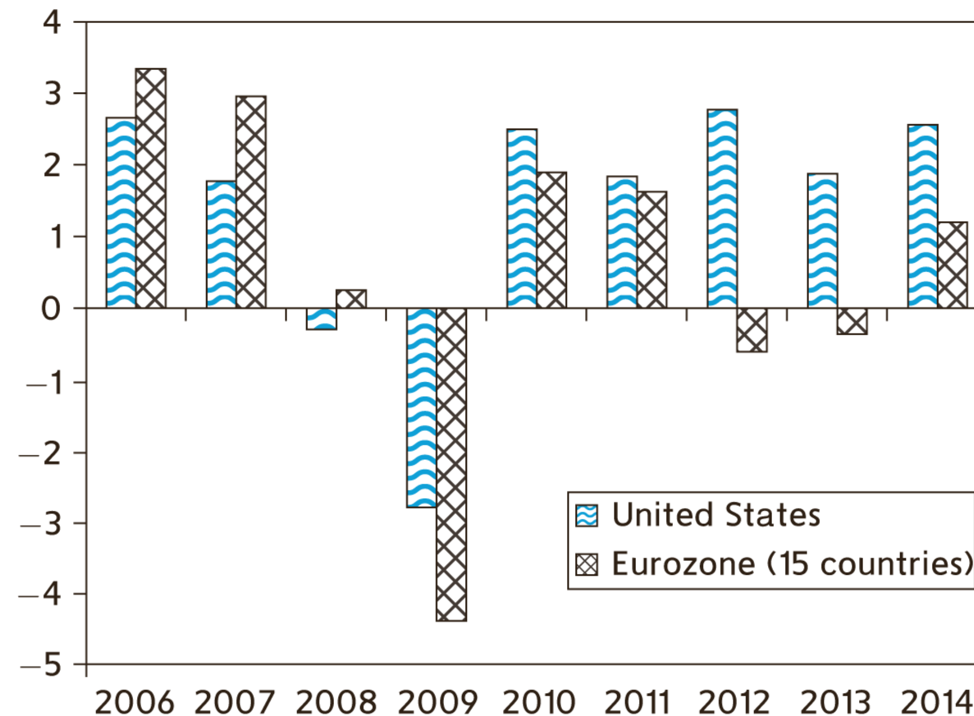
Stage two: the public debt crisis in the Eurozone

- The recession has been deep but relatively short-lived!
- GDP growth 2006–14:



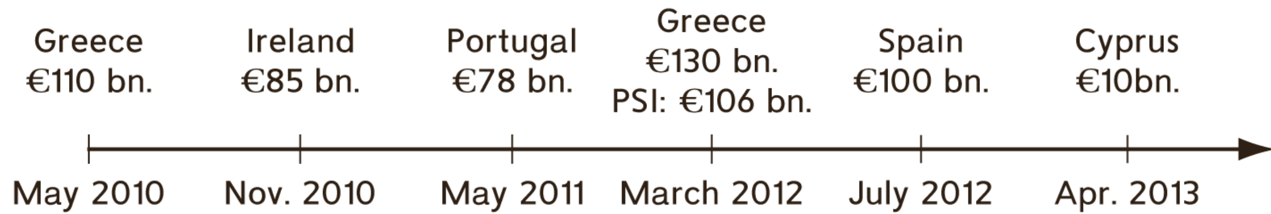
Notes: Forecasts for April 2014. The EU15 refers to the Eurozone excluding Cyprus, Estonia, Lithuania and Slovakia.

Stage two: the public debt crisis in the Eurozone

- However negative growth and large budget deficits have led to a fast increase in public debts:
  - Financial crisis has led governments to run budget deficits;
  - deficits have led financial markets to worry about the sustainability of public finances.
- Greece:
  - late 2007: public debt at 105% of GDP;
  - late 2009: public debt at 127% of GDP;
  - early 2010: Greek government in desperate situation;
  - May 2010: IMF–EU–ECB (called Troika) rescue operation and creation of European Financial Stability Facility (EFSF);
  - 2011: new package from the Troika (conditional loans).

Stage two: the public debt crisis in the Eurozone

- Time line of financial assistance



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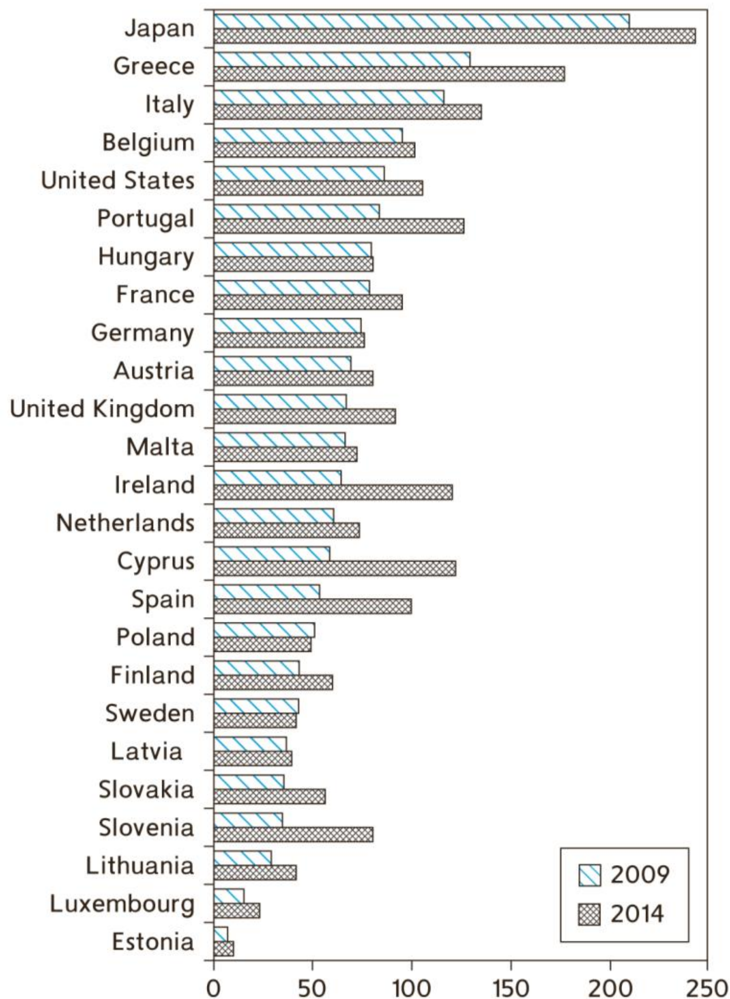
Stage two: the public debt crisis in the Eurozone

- Bailout of Greece in May 2010 was motivated as a way to avoid highly dangerous contagious effects but this goal proved elusive:
  - Ireland received a loan in November 2010;
  - Portugal followed suit with a loan in May 2011.
- Contagion within the Eurozone is highly troubling since public indebtedness is not enough to explain why these countries, and not others, have faced the wrath of the financial markets.
- Possible additional explanations:
  - membership of a monetary union may be a weakness (national central banks cannot help government);
  - no lender of last resort;
  - competiveness issue;
  - Policy mistakes.

Stage two: the public debt crisis in the Eurozone

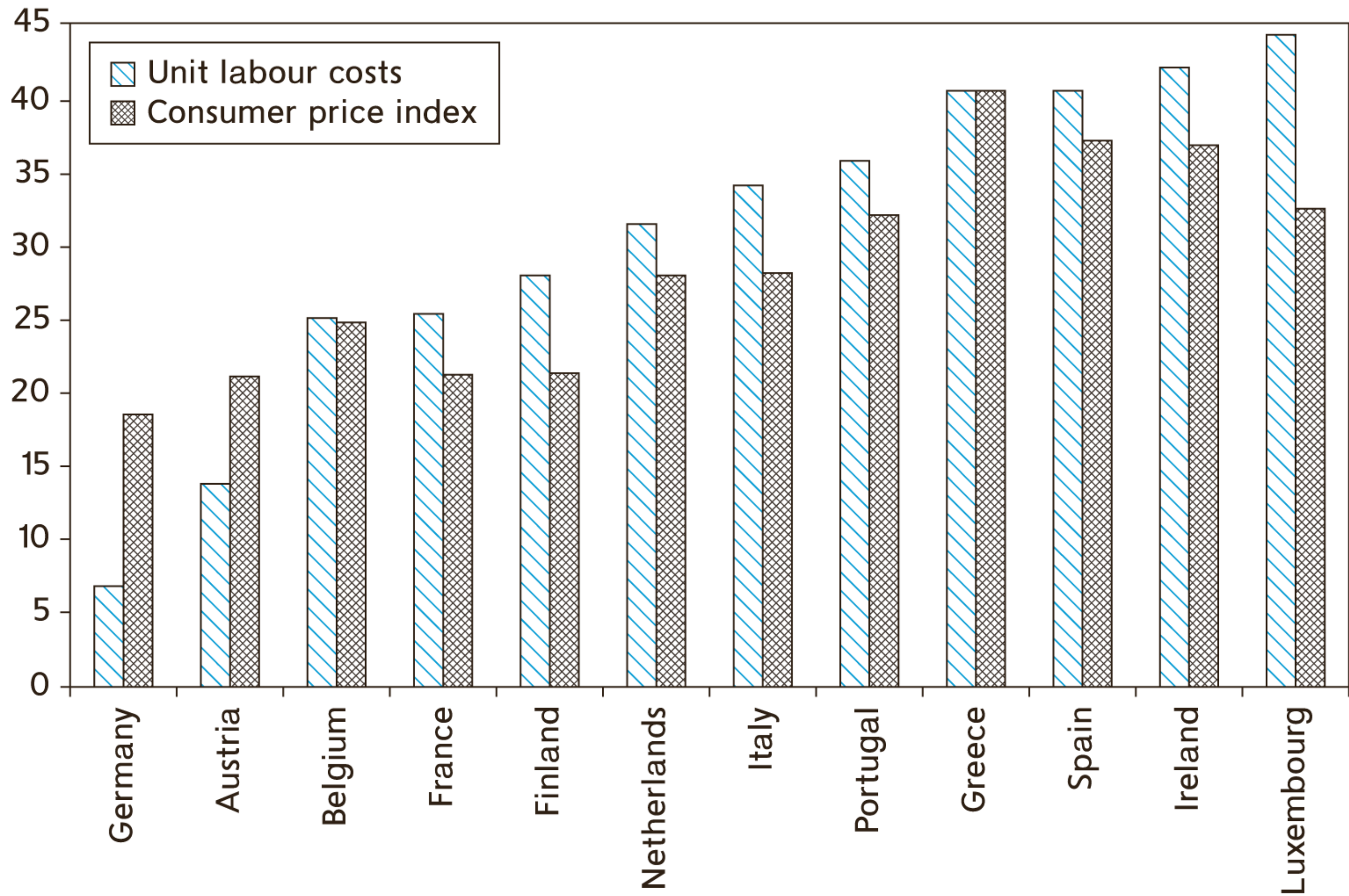
- Public Debt in 2009 and 2014 (as % of GDP):



Source: AMECO, European Commission

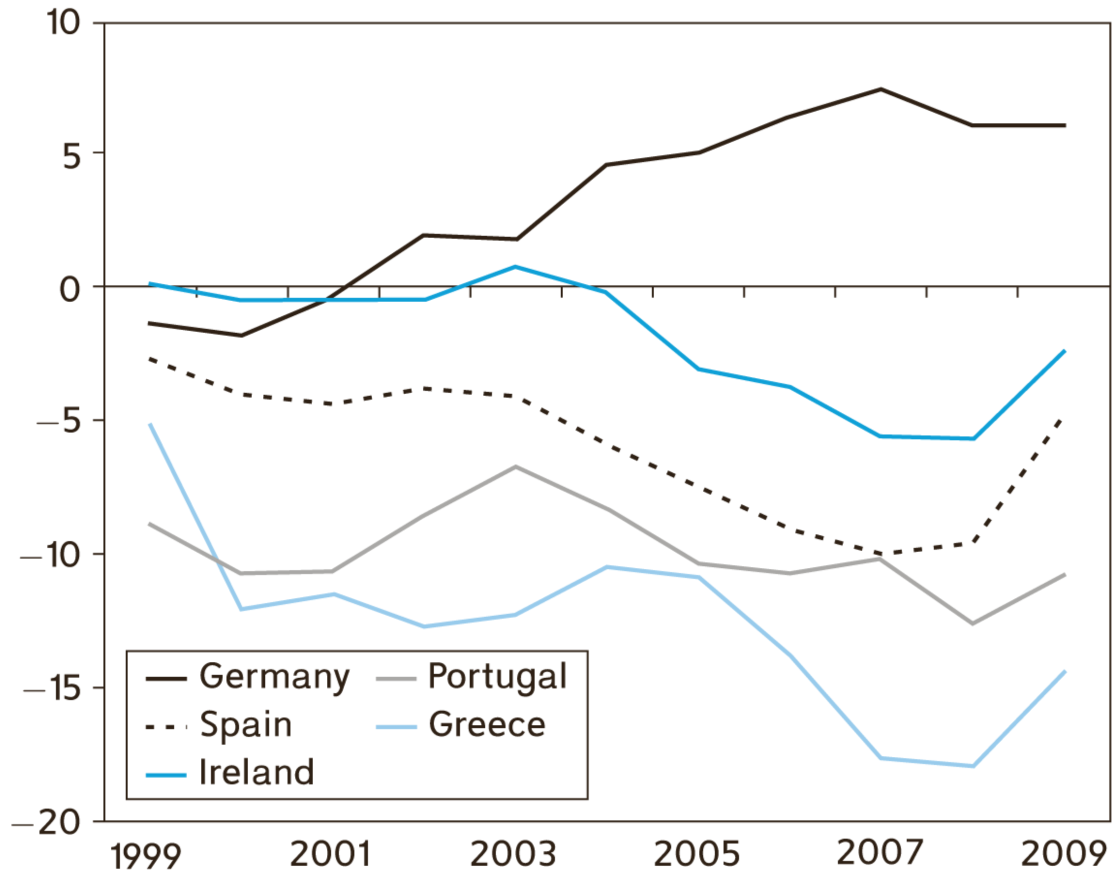
Stage two: the public debt crisis in the Eurozone

- Increases in the unit labor costs 1999 - 2009:



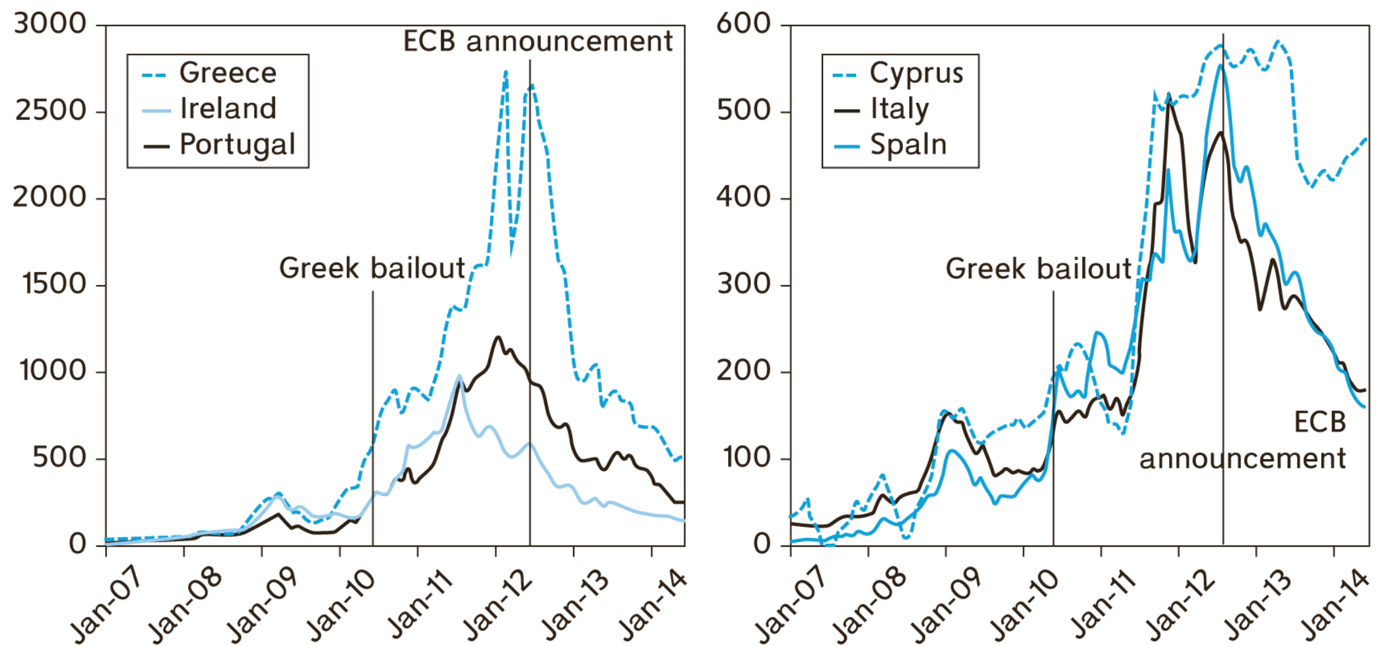
Stage two: the public debt crisis in the Eurozone

- Current Accounts 1999 – 2009 (as % of GDP):



Policy responses

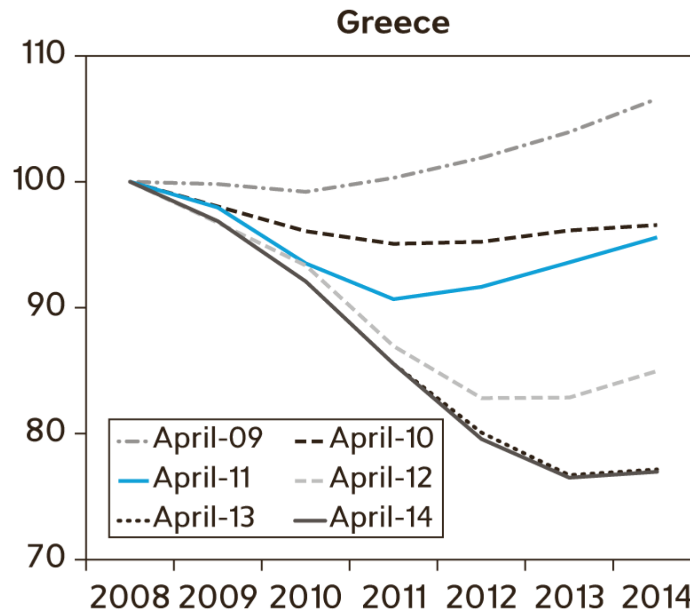
- Step increases in interest spreads (below) is due to policy decisions that markets perceived as ‘too little, too late’ (e.g., EFSF).
- Interest rate spreads (basis points):

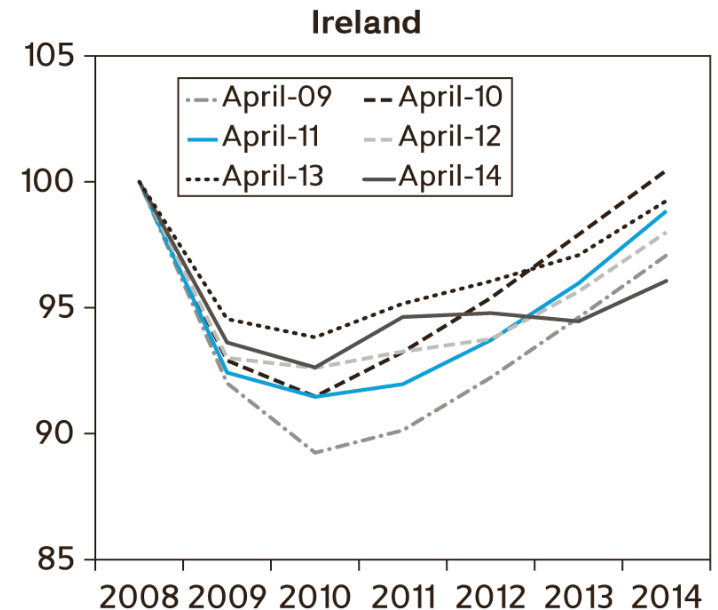


Note: Spreads are measured as the difference between each country's long-term bond interest rate and the corresponding German rate. A basis point is 1/100th of 1 per cent. The vertical scales are different in the two charts.

Policy responses

- Fiscal policy strategy: fiscal austerity as a mean to return to economic growth.
- IMF real GDP forecasts

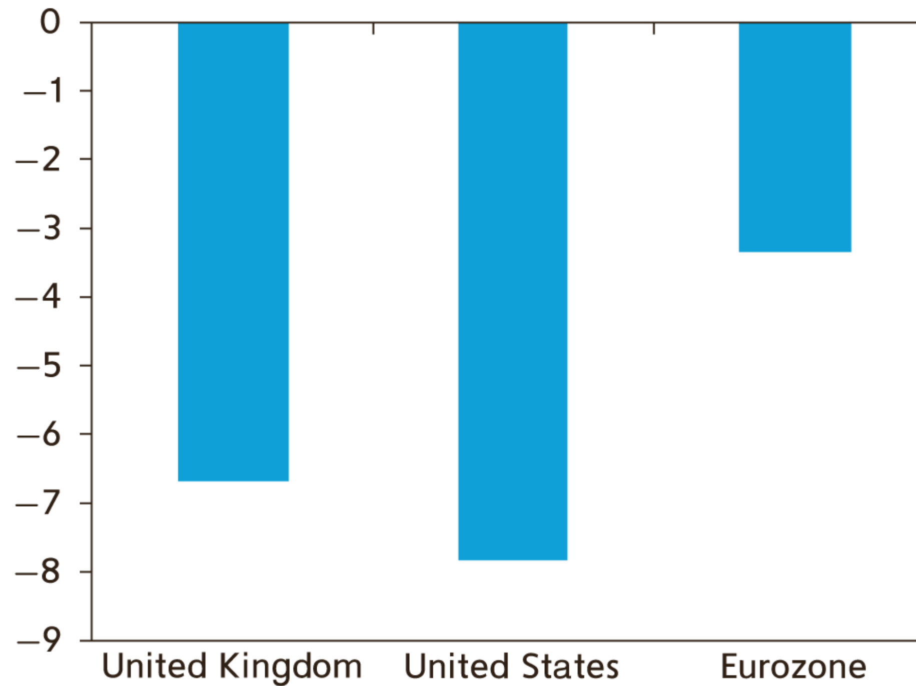




Note: Real GDP is measured as an index normalized to 100 at the time of programme agreement.

Policy responses

Fiscal policy was much less expansionary in the Eurozone.



Policy Responses

- “Bailout Institutions”
  - Creation of the European Financial Stability Fund (EFSF) for availability of financial resources in case of contagion
  - Replacement with the European Stability Fund (ESM) in 2012
    - Based in Luxembourg
    - Lending capacity of 500 billion Euro
    - Capital can be increased up to 700 billion Euro

Policy Responses

- Monetary Policy

Interest rate targets

Eurozone
USA
UK

0 1 2 3 4 5 6 7

Jan-99 Jan-01 Jan-03 Jan-05 Jan-07 Jan-09 Jan-11 Jan-13

Size of balance sheets

ECB
Fed
Bank of England

80 140 200 260 320 380 440 500

4-Jan-07 4-Jan-08 4-Jan-09 4-Jan-10 4-Jan-11 4-Jan-12 4-Jan-13 4-Jan-14

Note: The balance sheet sizes are presented as indices normalized to 100 in January 2007.

The Outcome

Eurozone

130
120
110
100
90
80
70
1999 2002 2005 2008 2011 2014

Actual
Previous trend

UK

130
120
110
100
90
80
70
1999 2002 2005 2008 2011 2014

Actual
Previous trend

USA

130
120
110
100
90
80
70
1999 2002 2005 2008 2011 2014

Actual
Previous trend

The Outcome

What have we learned from the crisis?

- Fiscal discipline: very high debt creates serious difficulties.
  - limits countercyclical fiscal policy
  - challenges monetary policy independence
  - possibly limits growth
- Eurobonds may have appealing features
  - element of solidarity
  - single Eurobond market might challenge US Treasury Bonds (as international reserves)
  - considered to be save
  - end fragmentation of Eurozone financial market
  - But: politically unfeasible
- Debate on debt restructuring
- Bank fragility
- Governance

Will the Eurozone break up?

Yes:

- failure to establish fiscal discipline;
- gap between well-functioning North and badly wounded South;
- many international investors do not believe that the euro can survive (self-fulfilling process).

No:

- breakup would have catastrophic implications;
- new currency would have to be printed and reintroduced;
- no legal procedure for a country to leave the Eurozone;
- deeper problem has been political mismanagement of the crisis.