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

EU sovereign debt crisis: Different views

Class overview

1. Two narratives
2. Bailout
3. Unbalances

Slides based on Stiglitz 2010/Frankel 2013/Alessandrini *et al.* 2014

EU sovereign debt crisis

- Two narratives:
  - Country's fault
  - EU system fault

EU sovereign debt crisis: Country's fault

- Countries of the periphery "misbehaved"
- Excessive borrowing (public or private)
- Rigid labor and product markets
- Low productivity growth (e.g., in Portugal)

Structural drawbacks

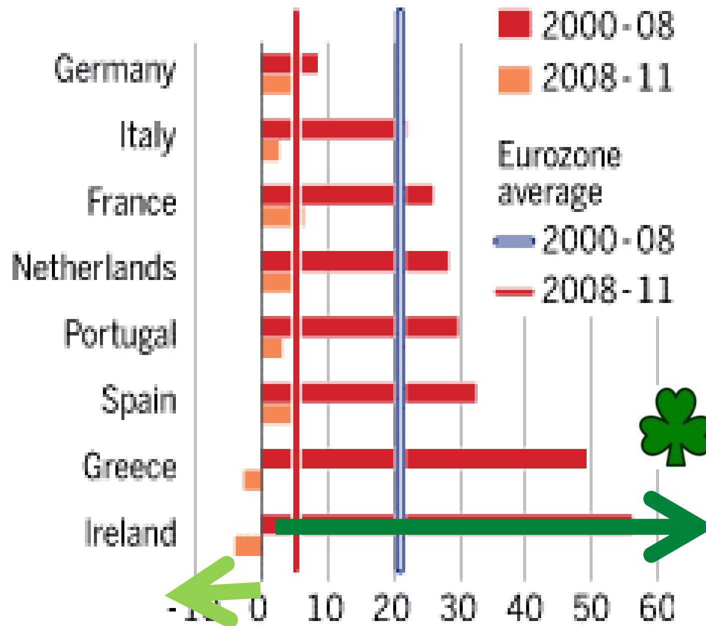
- The **competitiveness** problem
  - inability to devalue (& loosen money)
- The **fiscal** problem, in particular, moral hazard,
  - As fiscal policy is primarily at the national level.
  - Well-anticipated by architects of Maastricht

    Pushed by German taxpayers afraid they'd have to bail out Club Med, they produced Maastricht criteria, No Bailout Clause, SGP, & successors. All failed, from the first day, continuously up to today. Greece is the worst example
- The **banking** problem,
  - Bank supervision was kept at the national level
  - It received very little discussion at Maastricht.

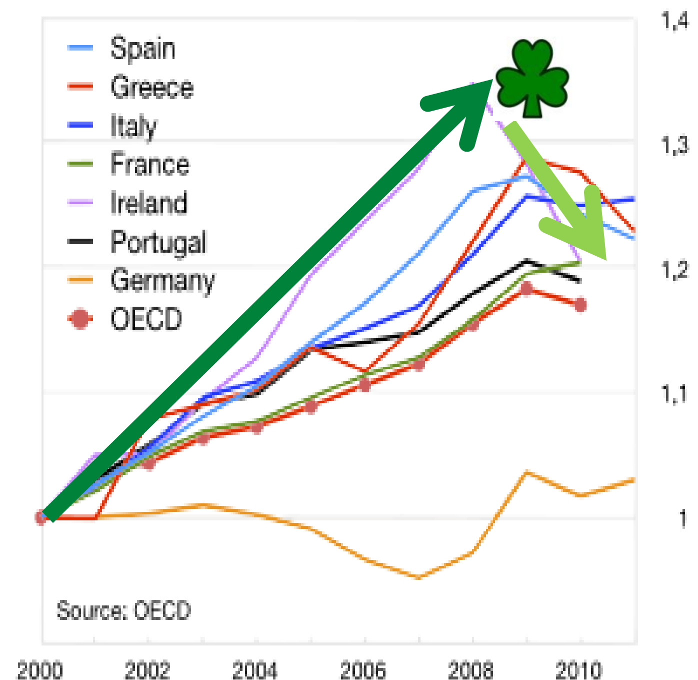
Competitiveness

- During the euro's first decade, wages & ULCs rose faster in the periphery than in Germany.

Eurozone wages growth



Changes in unit labor costs



During 2008-11 (only) a fraction of the wage gap was reversed

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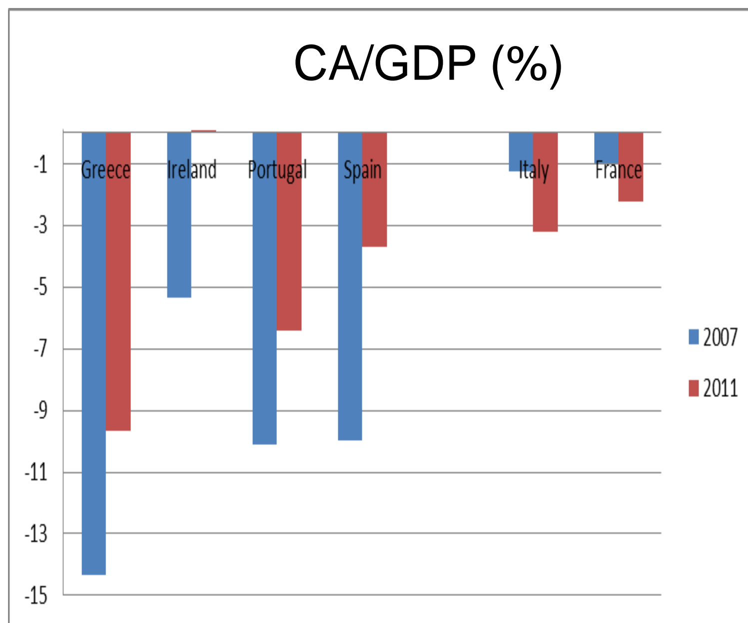
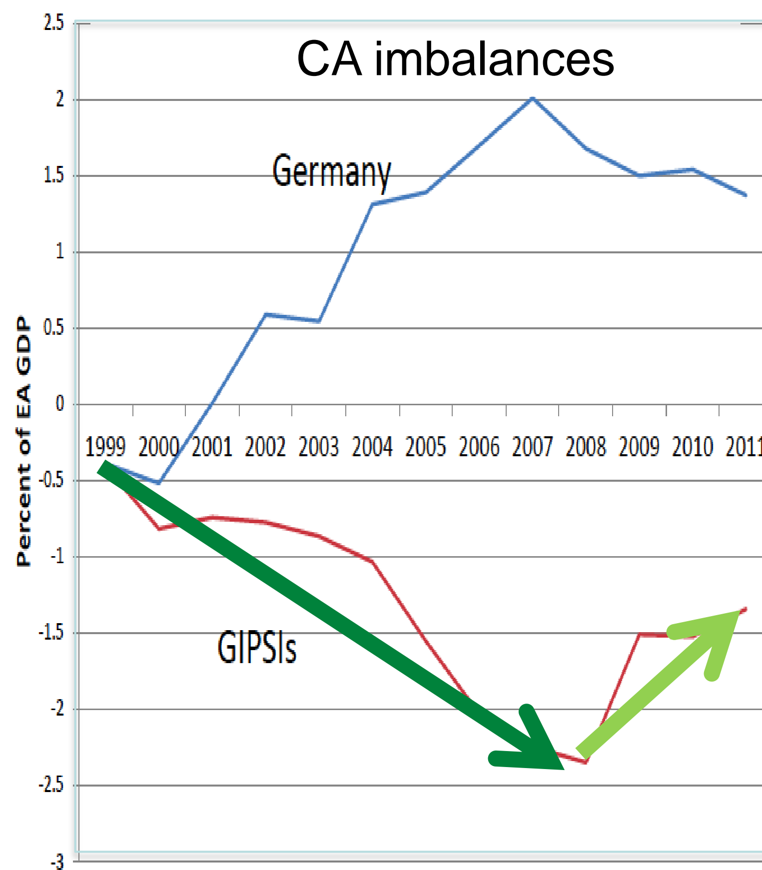
Current account deficits in periphery

- Huge current account deficits in periphery countries up to 2007 were seen as benign reflections of optimizing capital flows, instead of warning signals.





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Fiscal moral hazard

High debts → the ECB must have been seen as standing behind them.

bp
1'600
1'400
1'200
1'000
800
600
400
200
0
-200

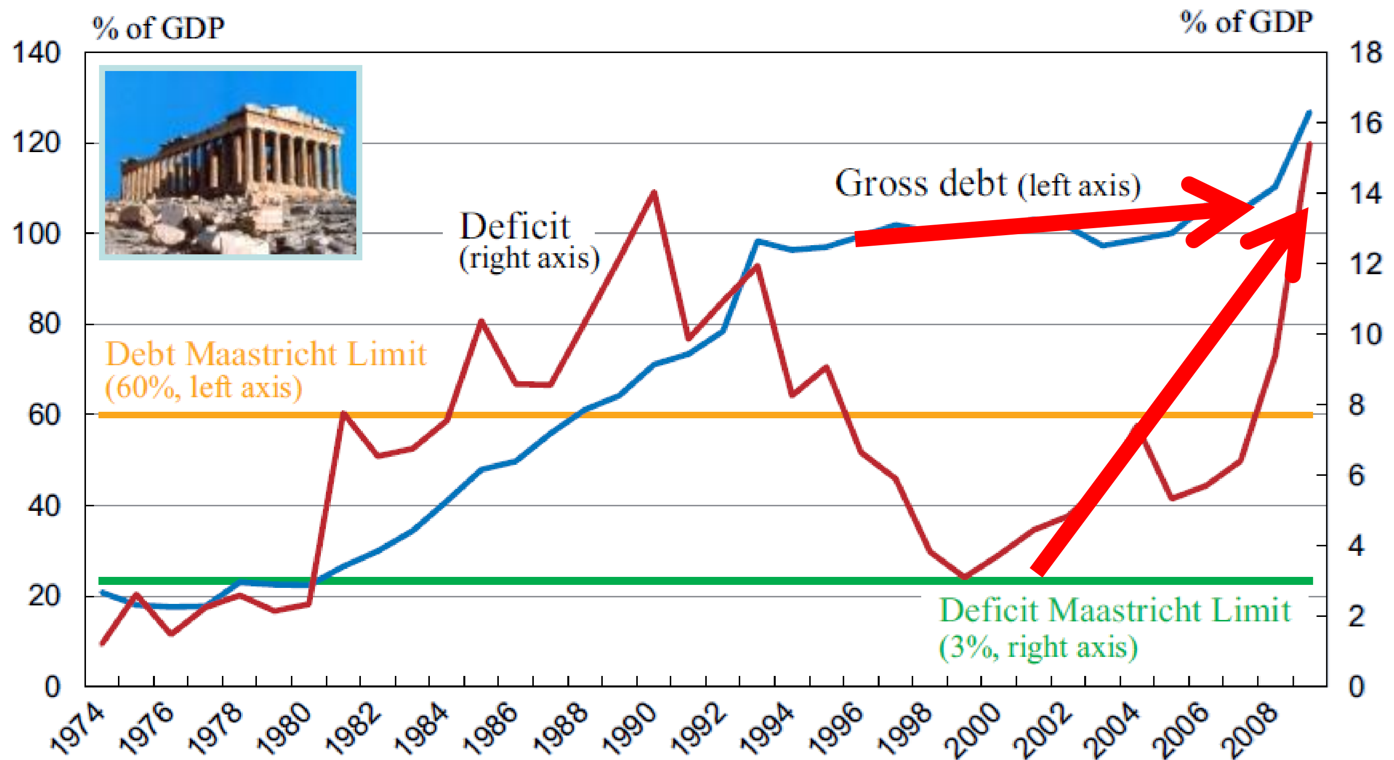
euro birth

Greece
Ireland
Portugal
Spain
Italy
France

91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12

Greek gross debt and budget deficit

The Greek budget deficit in truth had never come below the 3% of GDP ceiling. Nor did the debt/GDP ratio (≈100%) ever decline in the direction of the 60% limit.



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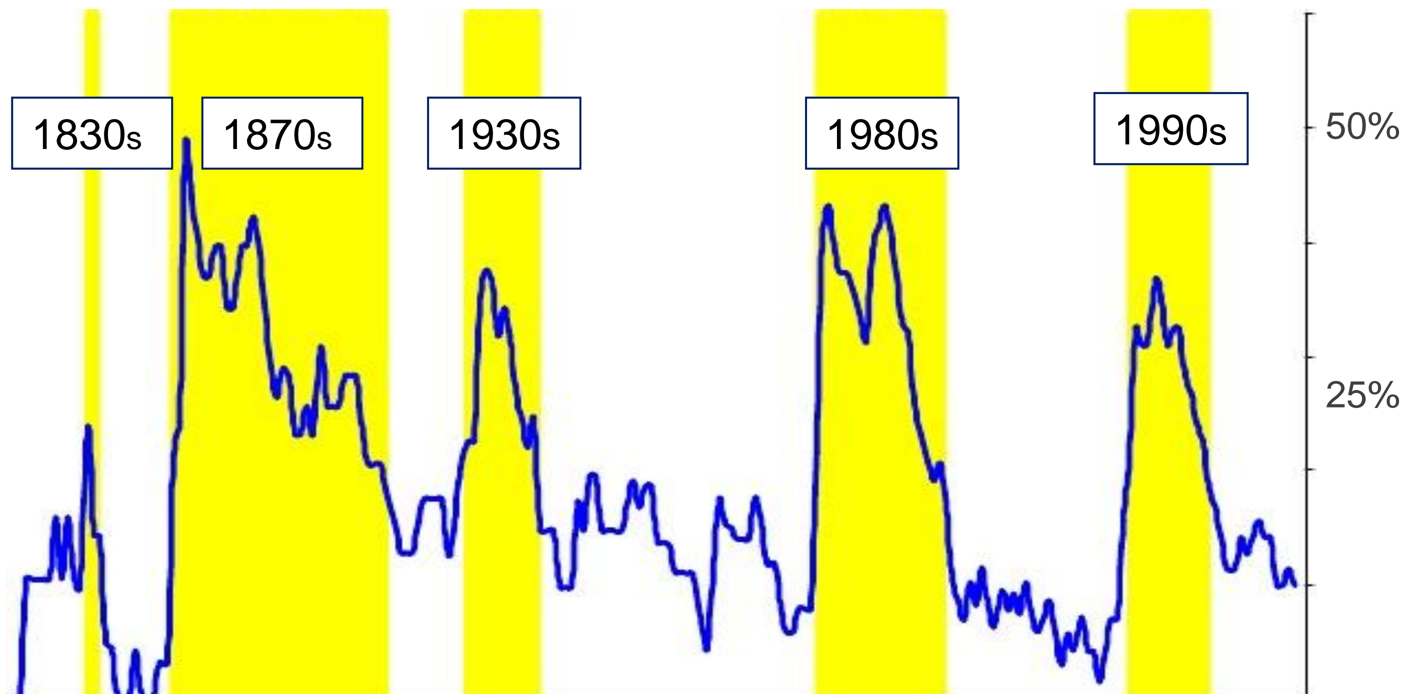
Countercyclical fiscal policy?

- Even though many Emerging Market countries learned from the sovereign debt crises of the 1980s & 1990s, e.g., learned to run countercyclical fiscal policy, leaders in Euroland failed to do so.
- They thought a sovereign debt crisis could never happen to them.
  - even after the periphery countries violated the deficit & debt ceilings of Maastricht and the SGP.

Sovereign external debts

- Sovereign external debt: 1800-2009, % of countries in default or restructuring

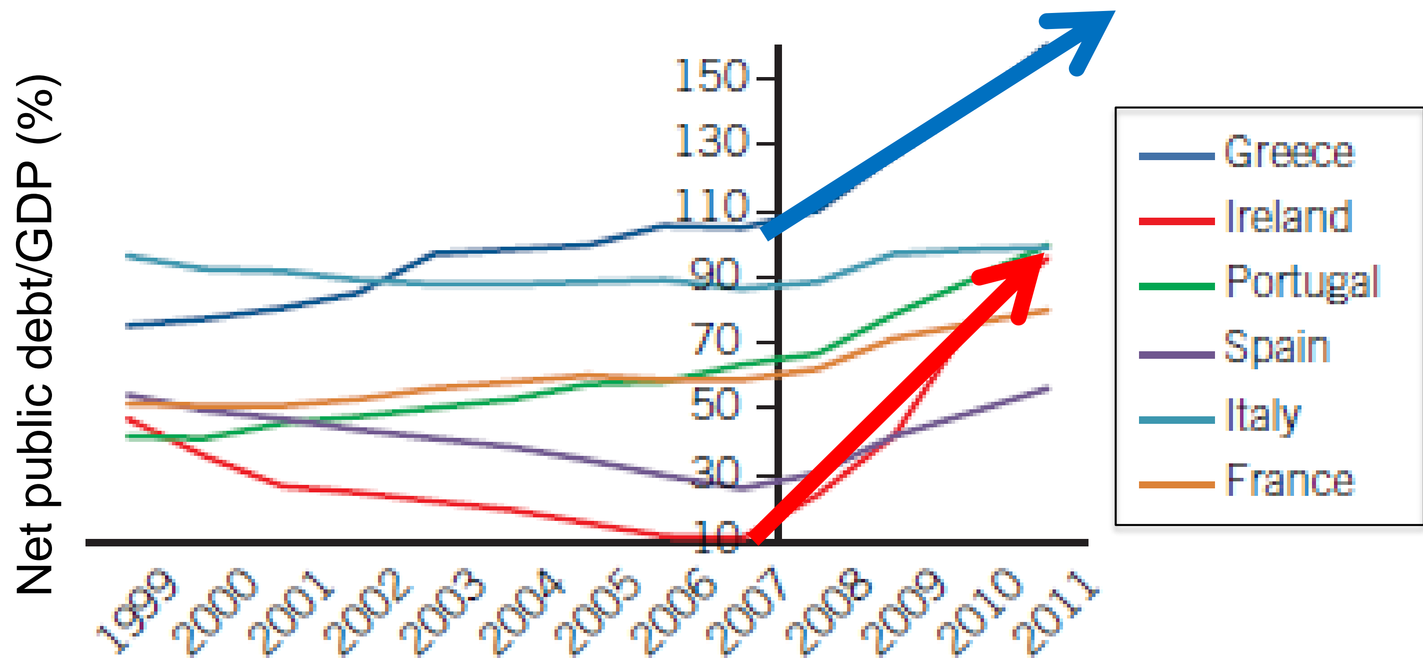


But Reinhart & Rogoff remind us: sovereign default is an old story, including among advanced countries

(*This Time is Different*, updated in "From Financial Crash to Debt Crisis," 2010)

Debt/GDP ratios in the periphery

- Debt/GDP ratios have been rising sharply, as high interest rates & declining GDP overpower progress on reduction of primary budget deficits.



Possible paths forward

- The **competitiveness** problem:
  – Bleak: The periphery must tough out internal devaluations.
- The **fiscal** problem:
  – hardest of all.
  – Germany is right on moral hazard (long run), but wrong about "expansionary fiscal contraction" (short run).
- The **banking** problem:
  – Encouraging moves in 2012, → banking union.
    - Unlike fiscal union, one can imagine Europeans having moved to supra-national supervision even if not part of monetary union.

EU sovereign debt crisis: EU system fault

- The euro zone is an incomplete economic union, whose structural faults got exposed when hit by external financial shock
- Lack of banking and fiscal union
- Imbalance between single currency and multiple sovereigns/fiscals
- Absence of common legal order and bankruptcy regime

Some relationships

- National accounts
- $Y = C + I + G + N - X$
- $Y + NI = C + T + S$
- It follows $S - I = (G\text{-}T) + CA$
- $C + I + G + N - X = C + T + S - NI$
- $(S-I) + (T-G) = CA$
- If
  - $S-I<0$ Private savings deficit
  - $T-G<0$ Government deficit
  - $CA<0$ Current account deficit
- $CA = N - X + NI$

A fundamental identity

- The fundamental identity in any open economy:

$$S - I = G - T + CA$$

- This identity links external imbalances and private financing imbalances to the government's fiscal imbalance.
- It shows how imbalances on the right hand side can lead to a banking crisis in the private sector;
- and/or how an external imbalance, even in the absence of fiscal irresponsibility, can lead to an accumulation of public debt, capital outflows and a financial sector liquidity crisis, in which private debt is replaced by public debt.

Example

- Starting from and equilibrium and recalling that:

$$S - I = G - T + CA$$

- If a CA deficit appears for any reason (CA<0), then either
  – a budget deficit has been to run G–T>0, or
  – private savings must fall S–I<0.
- to restore equilibrium in the economy.
- But since private saving tends to rise and investment tends to fall in a recession (S–I)>0, the likely outcome is that the government budget deficit rises: G–T>0.

Financial crisis → Bank crisis

- Starting from: (S–I) = (G–T) + CA
- If the private sector is carrying too much debt, it will be the first to deleverage in a downturn (i.e., (S–I)↑) – creating a banking crisis because savings rise to reduce that debt.
- This causes a loss of liquidity in the banking system and a potential banking crisis, which leads to even larger fiscal deficits to rebalance economic activity and to replace savings in banks (i.e., (G–T)↑).
- At that point, excess private debt becomes excess public debt.

$$S–I > 0 \rightarrow G–T > 0$$

Financial crisis → Sovereign debt crisis

- Excess private debt → excess public debt.
- Demand for assets/bonds in problem countries will collapse, especially in a currency union like the Euro Area where asset sales can be sent to low-risk countries (Germany, Finland, or the Netherlands) without cost or exchange rate risk.
- Government bonds in the problem countries are then no longer capital risk free, especially if a bailout looks unlikely or too small.
- The expected value of 1€ held in one place is not the same as its value in another, leading to a run on the deposit base in the problem economy and increased borrowing costs.

Low interest rates

- How did the private sector get indebted in the first place?
- If an economy enters an era of historically low interest rates (a global savings glut, or on joining a more disciplined currency zone), then savings will fall with the start of an asset bubble or domestic credit boom (US, UK, Ireland) which turns S-I negative.
- This is no problem if, and as long as, the credit bubble produces a matching trade deficit (CA<0) to provide liquidity to the banks.
- Hence the distribution of debt matters and this needs to be recognized.

Fiscal irresponsibility

- Poor macroeconomic fundamentals and current account deficits can easily translate into fiscal deficits and a crisis in the banking sector, even if there has been no fiscal irresponsibility (Ireland, Spain).
- Fiscal irresponsibility (Greece) simply adds to the fiscal deficits already implied.
- It is therefore sufficient to model these links for a given fiscal program, responsible or not.
- The key point is that they can cause unsustainable build-ups in sovereign or private debt, irrespective of the degree of fiscal responsibility.

EU Current Accounts 1999–2009 (% of GDP)

(S-I) + (T-G) = CA

North
S-I > 0
CA > 0

South
S-I < 0
CA < 0

10
5
0
–5
–10
–15
–20
1999
2001
2003
2005
2007
2009
Germany
Portugal
Spain
Greece
Ireland

A summary

- Starting from: (S–I) = (G–T) + (CA)
  - North: (S–I>0) = (G–T) + (CA>0)
  - South: (S–I<0) = (G–T) + (CA<0)
- Fiscal irresponsibility: G–T>0
- Financial bubble I>S
  - North: (S–I<0) = (G–T<0) + (CA>0)
  - South: (S–I<0) = (G–T) + (CA<0)
- Financial crisis S↑↑ (deleveraging)
  - North: (S–I>>0) = (G–T>0) + (CA>0)
  - South: (S–I>0) = (G–T>>0) + (CA<0)
- Debt crisis!!!

The dissolution of the euro? (Stiglitz)

- The circumstances of different European countries are markedly different, both with respect to fiscal and trade deficits and with respect to debt
- Limited "solidarity" to share burden of adjustment
  - Without exchange rate and interest rate mechanisms, there is a need for large fiscal assistance
  - What is required may be more than those who are capable of providing it are willing to give

EU government debts

General government consolidated gross debt as a percentage of GDP, 2009 (Eurostat)

140
120
100
80
60
40
20
0

Germany
Greece
Ireland
Italy
Portugal
Spain
United Kingdom

Current account balances

Current account balance, percentage of GDP, 2010

08
06
04
02
00
-02
-04
-06
-08
-10
-12

Germany
Greece
Ireland
Italy
Portugal
Spain
United Kingdom

Source: IMF, *World Economic Outlook*, April 2010

The dissolution of the euro?

- Inconsistent macro-frameworks
- Focus has been on countries with too high deficits as the “problem”
  - Concerns are legitimate
  - Especially as one focuses on long-term problems (aging of population)
  - These long-term problems have continued to fester, but the crisis has diminished the ability of countries to deal with them
  - Markets have recognized this

Surpluses are the problem

- But equally, countries with too high trade surpluses are a problem
  - Surpluses mean that they are producing more than they are consuming
  - Contributing to an insufficiency of aggregate demand
  - Imposing macro-economic costs on others
- Keynes recognized this
  - Wanted to impose tax on surplus countries
  - Part of original Bretton Woods initiative
  - US refused

Trade deficits and surpluses

- If euro were set so that on average, Europe has a trade balance, if part (Germany) has a trade surplus, others have trade deficit
- Trade deficit requires financing (may be hard to get) and contributes to weak national aggregate demand
- If exchange rates were flexible, they would adjust to "punish" trade surplus economy, equilibrate system
  - US is complaining that China is not adjusting its currency, contributing to global imbalances
  - The euro in effect is doing the same for Germany

Three alternatives (Stiglitz)

1. Europe finishes the euro agenda
2. The euro comes to an end
3. Muddling through/brinkmanship

Europe finishes the euro agenda

- Germany recognizes the problem
- Europe establishes an effective fiscal and macro coordination framework
- … and it works

The euro comes to an end

- Weak countries do a cost-benefit analysis and decide that the costs exceed the benefits
  - Market fundamentalist philosophy (underling much of the EU project) is viewed as wrong
  - Can legitimately blame lack of sufficient solidarity to make project successful
- Strong countries decide it is not worth subsidizing weak countries
    - Probably myopic view
    - Germany would find it hard to maintain surpluses
    - Critical part of its economic model

Muddling through/brinkmanship

- Strong countries provide just enough assistance and critical level of conditionality (enforcement of conditionality) to keep euro together
- But because the money is provided reluctantly, late, and in minimal amounts with maximum conditionality, overall costs may be higher than if an effective program were designed initially
- Especially because judgments will differ—some market participants will think amount insufficient
- Resulting in higher interest costs

The Implication

- Europe and the world are likely to be going through a period of high volatility
  - – Confidence in sovereign bond markets of certain countries will not be easily restored
- Which in itself will contribute to weak recovery
- Managing risk will be especially difficult
- Market opportunities based not just on underlying economics, but on political judgments

Stiglitz's view

- Remedying the institutional deficiencies that were apparent at the creation of the euro would be the best course of action
- But it is not clear that this will be the course undertaken
- At least until all other courses have been tried