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The euro area crisis: a view from the North

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Editorial

On 23-24 May 2013, the Bank of Greece organised a conference on "The Crisis in the Euro Area", in Athens.

The papers and commentaries presented at the conference addressed many important issues related to the functioning of the euro area. Our hope is that these contributions will help improve understanding of the nature of Europe's monetary union, the underpinnings of its crisis, and the changes that are needed so that crises will be prevented in the future.

The papers examined two main sets of issues. One group of papers, adopting a union-wide perspective, assessed the aspects of the euro area's institutional architecture that, with the benefit of hindsight, may have contributed to the crisis, and the policy responses to the crisis at the union level. A second group of papers focused on developments in three crisis countries -- Greece, Ireland, and Portugal.

The papers presented at the conference, with their discussions, will be published in the *Journal of Macroeconomics.*

Here we present the paper by Seppo Honkapohja (Bank of Finland) with its discussion by Dimitris Malliaropulos (Bank of Greece).

THE EURO AREA CRISIS: A VIEW FORM THE NORTH

Seppo Honkapohja
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Abstract

The paper provides an overview of the sovereign debt crisis. I first consider the build-up of the crisis. I then discuss policy choices when a financial crisis erupts and assess the adjustment processes in the crisis countries, including alternatives to policies of austerity. Finally I take up institutional improvements that can help in resolving the current crisis and avoiding a future one. These include the banking union and the strengthened Stability and Growth Pact and related institutional rules. Current high levels of public and private debt together with still weak bank balance sheets are a major unsolved problem.

Keywords: financial crisis, sovereign debt, European integration

JEL Classification codes: E62, E65, F36

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1. Introduction

The global financial crisis has now lasted nearly six years. Naturally, it strongly influenced euro area economies and for some countries - notably Ireland and Spain - it triggered a banking crisis as real estate prices started to fall. These banking crises in turn contributed to the sovereign debt crises in these two countries.

The term euro crisis usually refers to the sovereign debt crisis. It has a shorter duration of about three and half years right now. Its start can be timed to autumn 2009, when after Greek elections new information was announced about the much higher public deficits than had been told before. The interest rate on Greek bonds began to rise hugely as a result. A similar, though less drastic rise in the long-term government bond of Ireland and Portugal rates began a few months later in the beginning of 2010. The rates for Spanish and Italian long-term bonds followed suit in the summer of 2010. The most recent crisis country is Cyprus, for which the interest rate as indicator of an acute crisis began to rise quickly in the early summer of 2011.[1]

The sovereign crisis in each country has some unique characteristics. For Ireland and Spain, a big part initiates from the real estate bubble that led into a major banking crisis. Government finances in these two countries appeared to be in good shape before the crisis. Portugal and Italy are more general cases of economic weakness: slow growth, some overheating, a dearth of reforms and debt problems. Greece had huge problems of overheating and persistently very high deficits.

I will not focus in any depth on the individual countries in this paper, though I mention examples and counter-examples here and there. My goal is to consider more general aspects of the euro crisis. I should add that I do not aim for a comprehensive coverage, so that my discussion is necessarily selective focusing on key dimensions of the euro crisis.[2] In particular, I will not cover banking developments and issues in detail as they are discussed by Vitor Constâncio (2013), Vice President of ECB.

First I consider the main aspects of the build-up of the crisis. The emergence of a boom-bust cycle is clearly an important characteristic. It is useful to consider

[1] I will not discuss the Cyprus case further, as it is still evolving and the picture is not fully clear at present.
[2] For a broad overview of the euro area crisis see Mongelli (2013).

developments up to and including the boom and, in particular, whether there were "design faults" in the euro system. Did the euro system contain adverse incentives and opportunities for its members thereby contributing to the build-up of the crisis? A different matter is the problems in the implementation of the agreed rules and procedures in the euro area and the EU. They contributed to the crisis but the significance is harder to assess. There are also the issues about the role of national policies before the crisis. It is worthwhile to inquire about the reasons for the Northern or "high-rated" countries avoiding the crisis.

The second part of my discussion is about the crisis itself. What kinds of policy choices are available when a financial crisis erupts? What is the present stage of the adjustment processes in the management of the crisis? Are there realistic alternatives to the current policies?

Third, I will focus on the future and consider mechanisms that can help in resolving the current crisis or help avoiding a future crisis. The banking union is a crucial development. What can banking union accomplish if it is successful? Another improvement is the strengthened Stability and Growth Pact (SGP) and related institutional rules and procedures. Both the banking union and improved governance of EMU and EU are useful for the longer term build-up of the political and fiscal systems in Europe. The "legacy problem" is a key open issue in the crisis management and resolution of the current crisis. By this I mean the existing very high levels of public and private debt together with still-weak bank balance sheets. Different ways for dealing with this very difficult problem have been suggested. While this topic may in principle be kept separate from longer term plans for the euro area, some suggested ways of resolution have implications for the structure of the political union.

2. The build-up

Many accounts have already been written about the build-up of the euro crisis and the reasons for the crisis. I will not attempt to provide a comprehensive overview. My discussion emphasizes two key elements in the start and pre-crisis years of the euro area.

First, creation of the euro area led to virtual disappearance of interest rate differentials between members of the euro area despite the fact that there were major heterogeneities between the countries. Figure 1 shows the interest rate differential for 10-year government bonds between Germany and the crisis countries (excluding Cyprus). Figures 2 and 3 show the public deficits and public debts for the crisis countries and the euro area. Nearly complete convergence of the interest rates to German levels took place despite the very different situations of public finances. This convergence of interest rates was even used as a selling point for euro membership![3]

[Insert Figure 1]

[Insert Figure 2]

[Insert Figure 3]

The convergence of interest rates shows that market assessments about public finances of the crisis countries were clearly problematic. The interest rate differentials between countries were very small for a long time and did not reflect the differences in underlying public finances. The early ECB practice of treating public debt of different countries equally as collateral may have been a contributing factor (e.g. Buiter and Sibert 2005; Ullrich 2006); although it is less clear on what basis the ECB could have differentiated its collateral practice. The convergence of interest rates seemed incompatible with the "no-bail-out clause" of the EU Treaty, and has been interpreted as evidence that the no-bail-out clause was never perceived fully credible. There is probably some truth to this view, but it does not fit well together with the subsequent spread dynamics. In particular, if investors expected Greece to be bailed out, why did the spreads increase from 2009 onwards? Did something suddenly restore the credibility of the no-bail-out clause, and if so, what was it?

There are good reasons to believe that the low spreads were to a large part just a manifestation of the more general mispricing of risk that characterized the years leading to the financial crisis – a bubble not unlike the subprime bubble. This interpretation succeeds better in explaining the widening of spreads from early 2009 onwards. Spring

[3] See for example European Economy (1990), p.11 and Daniels (1998).

2009 was a time of a wholesale re-pricing of risk of financial assets and flight to quality. It was also a time when the full impact of the great recession on public finances was becoming visible. Hence, the liquidity and the solvency of sovereign issuers became an issue, and there were good reasons to start differentiating between strong and weak sovereigns.

Returning to the run-up to the crisis, the convergence of interest rates to low levels provided incentives for countries and private agents in the GIIPS countries to borrow a lot. There was little incentive to improve public finances. Increased private borrowing led to current account deficits and there was little ability or willingness for countries to keep the situation under control. The current account deficits emerged in the early years of the euro system while the public deficits were accentuated only later when the boom ended. This is indicated in Figure 4 by the counter-clockwise loops in current account - public deficit space. The current account problems indicating increasing private debts became clearly visible early in 2002-3, whereas public deficits started to worsen only when the boom was ending in 2008-9.[4]

Figure 4: current account deficit and public deficit in the GIIPS countries in 2002-2012.[5]

These counter clockwise loops in Figure 4 can be contrasted with the current account and public finance dynamics in the high-rated euro members (details not shown). The current account and public deficit of Austria, Belgium, Finland, France, Germany and the Netherlands would look very different from the dynamics in Figure 4. Current accounts remained mostly in surplus and the analogous loops appear only for some countries and any loops are quite small. This observation illustrates one aspect of the heterogeneities between euro countries that widened in the early years of EMU.

Another part of the increasing heterogeneity after the start of the euro is evident if one considers the export performance of the euro area countries (details are not shown). The average of exports to GDP ratios for the crisis countries did not increase after the

[4] See Dellas and Tavlas (2012) for a discussion of the Greek case and the lack of an internal adjustment mechanism to current account deficits. They argue that investors' assessments of Greece were relying on a sovereign bailout.
[5] Note that the arrows indicate the starting year 2002 for each country.

start of the euro area. In fact, there was even slight decrease in this ratio. It has started to increase only after the recession from 2009-2010. For the high-rated countries the exports to GDP ratio gradually increased until the Great Recession hit in 2008-9 after which there was a recovery.

Northern countries carried out necessary adjustments in the early years of the EMU or even before its start. These countries were cautious and did not respond to the adverse incentives from low interest rates. My own country, Finland is a good example. Finland had gone through a severe financial crisis in the first half of 1990's.[6] Private consumers, businesses and the government were all cautious in the years before the current crisis as they still had the 1990's in their memory. The Finnish economy ran both current account and public finance surpluses just before the start of EMU and during its early years. (Another factor for the surpluses was the partly funded mandatory pension system which was investing its large surpluses abroad; this supported a large capital outflow during the first decade of the euro).

Germany is a different example. German unification was a very costly process for the Western parts of the nation. A lengthy adjustment process in Germany had to be carried out in the early years of the euro system. This can be seen from Figure 5 showing the unit labour costs for the high-rated countries. Figure 6 shows the unit labour costs for the five crisis countries Greece, Ireland, Italy, Portugal and Spain. Unit labour costs are a widely used indictor for cost competitiveness (other indicators could be used instead). Again the contrast is remarkable and illustrates the heterogeneity between the two groups of countries.

[Insert Figure 5]

[Insert Figure 6]

One must also mention social cohesion and strength of the democratic and civil society. They have been and continue to be important characteristics of the Northern

[6] Norway and Sweden also experienced deep financial crises in the beginning of 1990's. These three crises were among the "Big Five" crises in advanced economies before the current crisis as listed by Reinhard and Rogoff (2008). The main cause for the Nordic crises was in a failure to manage the earlier financial liberalization process during the 1980's. See Honkapohja (2009, 2012) for overviews of the management of the Nordic crises and of the problematic financial liberalization processes. The Finnish crisis was the deepest of the three, see Honkapohja et al (2008) and Jonung et al (2009).

countries. The important role of the civil society stems from relatively well-educated population, high morale for paying taxes, relatively efficient public sector, low levels of corruption and other strong institutions.[7]

3. Some design faults

Though current accounts and competitiveness problems were not the underlying cause of the current crisis, they are a very important link in the process. In the early years of EMU it was thought that current accounts are largely unimportant and balance-of-payment crises were thought to be impossible. This is seen, for example, in the 2006 and 2007 country reports of international organizations for Greece and Ireland, see the Appendix for some quotes. The reports acknowledged external deficits and an improving fiscal situation for Greece and did not see need for strong corrective action. For Ireland property price risks were noted but strong public finances and a well-supervised financial sector were praised. No alarms were sounded.

Traditionally, a balance-of-payments crisis involves a currency crisis and some concluded that a common currency area cannot have a balance-of-payments crisis. The sovereign debt crisis has shown that this view was mistaken. Balance-of-payments crises can indeed take place in a currency union as a run on the sovereign.[8] In fact the latter shares many key characteristics with the traditional Latin American or Asian debt crises. The key common element is a variant of the familiar 'original sin': the sovereign is indebted in a currency the issuance of which it cannot control. The lack of control over the currency of debt makes the sovereign vulnerable to self-fulfilling panics. Hence, rather than offering protection from balance-of-payments crises, membership in a monetary union can in some circumstances make its members vulnerable to them.

The lack of attention on the current account was clearly a major design fault in the euro system. Sufficient attention to the external imbalances that, in large part, reflected

[7] The importance of political and social institutions for economic development is well argued in the recent book by Acemoglu and Robinson (2012). An overview of the so-called Nordic model and comparisons to other European countries is in Andersen et al (2007). Gylfason et al (2010) discusses how Nordic countries weathered the current crisis.
[8] The run on the sovereign also created difficulties for foreign funding of banks in the crisis countries.

private sector indebtedness would have provided a good warning signal. Current account deficits were visible much before the boom period. It is remarkable that the first versions of the SGP made no reference to monitoring external imbalances.

A different problem in the early years of EMU was the lax implementation of the SGP. The events leading to the 2003 reform of the SGP were clearly unfortunate. They signalled lack of respect for policy coordination and missing willingness to carry out the required adjustments. When coupled with the lack of market discipline with respect to public finances and the associated low interest rates, this weak implementation set the tone for a permissive attitude toward avoidance of agreed rules. However, in my opinion the 2003 events were probably not a decisive fault. Some countries that subsequently faced the sovereign debt crisis met both the pre and post 2003 SGP rules.

A much more serious problem has been the complete downgrade of the no-bail-out clause in the Maastricht treaty. The clause had problems of time inconsistency and moral hazard that were not addressed. In principle, this clause is still in force, but events during the crisis have de facto turned it into a dead principle. The role of no-bail-out clause must be clarified in the future.

Another important failure in earlier policies has been the far from sufficient completion of the EU single financial market programme (e.g. see Obstfeld 2013). Progress with it was slow for a long time as strong national interests made it difficult to proceed speedily. In particular, financial supervision and regulation remained at the national level and plans for an integrated financial supervisory mechanism have emerged only recently. This last failure turned out to be serious given the fast growth of banking and finance, which was part of similar global trend and also encouraged by the creation of the euro area.

4. Adjustment and policies in the crisis

A basic lesson from the Nordic and other financial crises is that once the crisis has erupted, only hard choices for economic policy remain. The crisis is bound to have major macroeconomic effects in the form of a recession and consequent rise in unemployment.[9] A country in a financial crisis must adjust downward one way or other. The policy choices are about trying to find a least damaging way forward, given the economic, financial and political constraints.

The choices about downward adjustment are extraordinarily difficult in the euro crisis, because the euro area and the EU are by their nature much more complex institutions than a single country. What does optimal or least damaging policy mean in this context? There is no clear objective function for such entities in contrast to the case of a single country - assuming that one can formulate an objective function for a country. Policy issues in the euro area and the EU take form of a complicated game, whereas a single country can usefully be thought as one decision maker.[10] It is thus not surprising that, in my view, the policies during the euro crisis are probably best characterized as "coping forward more or less satisfactorily" rather than a clear attempt to reach in some sense optimal adjustment.

The crisis countries have been going through the painful downward adjustment. I will next give a short commentary of these processes as an overview. Figure 7 shows the development of GDP levels for Greece, Ireland, Italy, Portugal, and Spain. In terms of GDP, Ireland appears to have turned round with modest positive growth since 2011 after the decline of 10.7 percent from the peak in 2007Q4 to the through in 2009Q4. Greece has seen a long decline in the level of GDP from late 2008 onward and the decline continues at present. The latest forecast by EU Commission (Spring 2013) suggests that a turnaround is taking place this year with return to some positive growth in 2014. The other three countries experienced a decline in GDP levels during the Great Recession in

[9] These costs have varied from crisis to crisis and country to country. In the Finnish crisis GDP declined about 13 percent from peak to through and unemployment rose from about 3 to about 16-17 percent according to the latest comparable data from the Statistical Office. (Note that there are different data series for unemployment and the data has been revised somewhat over the years. GDP data has also been revised over time.) The Spanish crisis in 1977 is a very different case as there was no decline in GDP but unemployment increased a lot. Figures 14.3 and 14.4 in Reinhard and Rogoff (2009) give illustrations of the varied macroeconomic real impacts of major financial crises.
[10] Countries have multiple power groups but at least they typically have a single executive and a sovereign legislature.

2008-9 with a turnaround and levelling-off in 2009-10 but then a plunging back to decline in late 2010 or 2011.

[Insert Figure 7]

Figure 8 shows the external balances of the crisis countries. Current account deficits have gotten smaller, but only Ireland has managed a current account surplus (since 2010). Italy, Portugal and Spain are not far from achieving a surplus. The Greek external deficit has more than halved during the recession but the country still has quite a way to go with current account deficit per GDP at about 5 percent in 2012.[11] Part of this development is due to the low levels of economic activity, but with the exception of Italy, the countries have also achieved improvements in cost competitiveness. This is indicated by the levels of unit labour costs (ULC), see Figure 6 above. For Greece and Ireland the adjustment in ULC has been around 10 and 20 percent, respectively. Portugal and Spain have had declines in ULC in the 5-10 percent range thus far.

[Insert Figure 8]

Public debt to GDP ratios are still increasing for all five crisis countries. The countries differ in terms of public deficits as illustrated by Figure 9. Italy has had a slowly improving primary surplus (as percent of GDP) since 2011. Portugal and Greece are not far from achieving primary balance this year. For Ireland and Spain primary deficits are forecasted to be in the 2-3 percent range for 2013 and these deficits are getting smaller. It must be remembered that achieving primary balance does not suffice for actual reduction in public debt to GDP ratio. A surplus of a few percentage points is needed.

[Insert Figure 9]

In summary, the five crisis countries are currently in the middle of adjustment, with Ireland having largely turned round, except in public finances. The adjustments have been and continue to be painful with high and rising unemployment rates, see Figure 10. Understandably, political tensions run high and not surprisingly ways to avoid the

[11] This is according to the EU Commission data. There is also data on current accounts constructed by the Bank of Greece (and used e.g. by IMF) in a different way. The latter data gives clearly lower figures for current accounts deficits. For example, see Dellas and Tavlas (2012).

austerity are frequently pondered by both laymen and some professional economists. Are there alternatives to the present policies?

[Insert Figure 10]

5. The austerity debate: comments

Tightening of fiscal policies has undoubtedly been a factor in the downward adjustments and negative growth rates for the crisis countries. Some commentators in the ongoing debates have argued that this tightening is having a surprisingly strong impact on growth, on the basis of the analysis by Blanchard and Leigh (2013) and others.[12] But is it the case that the effects of fiscal tightening are surprisingly large at present or is some other factor responsible for negative surprises in growth? A study done in the European Commission (2012) suggested that fiscal vulnerabilities, which in the crisis lead to steep increases in borrowing costs and tightening of borrowing conditions were the main reason for the surprisingly large negative effects on GDP of the current fiscal adjustments.

The potential significance of negative impact from government bonds rates on growth arises from the correlation between costs of private borrowing with the rates on sovereign borrowing. High rates on sovereigns have led to high interest rates to private borrowers, which has dampened private sector activity. Interestingly, the phenomenon of dampening of private investment and consumption as a result of very high interest rates also took place in the 1990's financial crises in Finland and Sweden.[13]

The results in EU Commission (2012) were criticized because changes in sovereign interest rates are likely to be endogenous with respect to GDP growth. While the possibility of endogeneity makes it difficult to interpret the results, there are ways to assess the significance of this problem. Ikonen et al (2013) reconsider the EU commission study and re-estimate the relation between forecast errors in GDP growth,

[12] The austerity measures have been widely discussed in different forums. Much of the discussion is about Europe, but debates are active also in the United States of America. For examples, see De Grauwe and Ji (2013) and Krugman (2013).

[13] The difference is that in Nordic crises high rates for the private sector funding was caused by extremely high short-term rates due to the defense of the fixed exchange rates.

forecasted fiscal stance and sovereign bond yields using instrument variables for the sovereign borrowing costs. The sovereign interest rate for 2010-2011 is instrumented by three strictly exogenous variables: actual government deficit to GDP ratio in 2009, average sovereign CDS price at the end of 2009 and the sovereign rating at the end of 2009. These variables explain nearly 80 percent of the cross-country variation in sovereign bond yields during the crisis.

Table 1 presents the results of a note by Ikonen et al (2013). It is seen that the forecast of fiscal stance is statistically insignificant whereas the instrumented value of the change in sovereign bond yields has a statistically significant negative effect on growth surprises (forecast errors).

Table 1: GDP growth forecast errors and forecast of fiscal stance revisited

Constant	0.97*	(0.54)
Forecast of fiscal stance	-0.28	(0.39)
Fitted value of change in sovereign bond yields	-0.56**	(0.21)
R^2	0.67	
Growth forecast error = $\alpha + \beta$ forecast of fiscal stance + γ fitted value of change in sov. yields + ε		
Change in sov. bond yields = $\gamma_0 + \gamma_1$ sov. rating + γ_2 sov. CDS spread + γ_3 headline fiscal deficit + ε		

Note: Figures in parentheses are standard errors. * and ** denote significance at 10 % and 5 % levels, respectively. Real GDP growth forecast errors are cumulative for 2010–2011 (EC spring 2010 forecast). Forecast of fiscal stance is the change in structural balance (% of potential GDP) for 2010–2011 (EC spring 2010 forecast). Change in 10-year sovereign bond yields refers to the period between end-2009 and end-2011 (source: EC). EC winter 2013 forecast is the source for the 2009 headline fiscal deficits (% of GDP) and Bloomberg for end-2009 S&P sovereign long-term debt ratings. Sovereign CDS spreads are calculated as 2009 Q4 averages (source: Blanchard and Leigh (2013), German Figure is used for Luxembourg). Sample: 16 euro-area countries (Estonia excluded).

The results can be interpreted as describing reassessments of sovereign risk that took place since 2009.[14] Recall from section 2 that markets evidently misperceived the sovereign risks in the relatively calm years preceding the crisis since the interest rate

[14] I acknowledge that Table 1 gives the results of a single regression and it would be worthwhile to investigate the issues in more detail.

differential of the crisis countries relative to German rates remained very low for many years. When the sovereign debt crisis began to take hold, the markets made reassessments and interest rates on the vulnerable sovereigns began to rise rapidly. This impacted negatively on economic growth, so that the changed market assessments moved the economies to very undesirable equilibrium through a large extent self-fulfilling dynamics as suggested by De Grauwe and Ji (2013). The dynamics was probably initiated by indicators of the fiscal situation in the crisis countries.

I now come to the issues about alternatives to present policies. One line of thought admits that a fiscal consolidation and deleveraging process is necessary and cannot be avoided but argues that the speed of adjustment in the crisis countries should be altered. In principle, this approach would have positive effects though the magnitudes of multipliers in the crisis economies are difficult to assess. Difficulties in private sector financing, high unemployment rates and limited openness of the economy probably tend to increase the multiplier, whereas responsiveness of interest rates to changes in fiscal policy in crisis countries works the other way.[15] Moreover, a slower pace of adjustment would provide some help with the problems of social and political cohesion. The challenge for this line of thought is the question of finding the funds or keeping the cost of additional financing low for a more gradual fiscal adjustment?

The countries relying on an EU-IMF program do not have access to market finance.[16] Re-negotiating an existing program is fraught with difficulties, not least because of the current populist political debates in the countries providing the financing for the current programs. The rates on government bonds have declined a lot since August 2012 for crisis countries that have access to financing from the markets. The decline is a very welcome development. For example the Spanish 10-year rate has declined from 6.6 (August 2012 average) to 4.2 percent in May 2013 (average May 1-16) and that of Italy from 5.8 (August 2012 average) to 3.9 percent in May 2013 (average May 1-16). Ireland and Portugal, which have been in the EU-IMF programs, have also

[15] The argument about relatively high multipliers at lower bound of the interest rate does not apply to the crisis countries.
[16] Ireland has raised private financing since the summer 2012 and Portugal has also begun to return to market financing.

seen big declines in the interest rates and these two countries have begun to raise finance from the market (see footnote 15).

I must, however, emphasize the risks in a reversal or major slow-down of the current fiscal adjustment as additional borrowing from the market might well raise the interest rates on these countries. It is possible that there is a little bit of flexibility in designing the time path for fiscal adjustment but these countries would have to proceed very carefully. More generally, it is important to ask whether a crisis country commits to a systematic adjustment program and does not view the easing of the current programme or other plan as a chance to avoid the adjustment. I do not want to make a judgment in this respect but want to emphasize that a country would have to convince either the markets or other financiers.

A related suggestion has been that the highly rated euro countries should have more expansionary fiscal policies. This idea is of course technically possible, including financing of the additional government spending in fiscally strong countries. Yet there are other questions. The very low policy rates and rates on sovereign bonds of the highly rated countries probably mean that the multipliers are somewhat larger than in normal circumstances where interest rates respond to fiscal changes. Nevertheless, magnitudes of the fiscal multipliers may not be all that large. As the degree of openness of crisis countries is often small, the benefits from less stringent fiscal policy in the highly rated countries would probably be limited. In addition, one must note that the fiscal situation of the stronger countries is not that good and these countries do not appear to show much willingness to such policies.

A second, more radical line of thought about alternatives is to ask whether it is possible to avoid the downward adjustment altogether by defaulting on the existing debt and thereby creating room for less tight fiscal policy. This could happen without exit from the euro or in conjunction with an exit. A default would probably necessitate a quick balancing of the public deficit via additional austerity measures which would imply a further downward movement in GDP and living standards. The degree of new austerity depends on whether external financial assistance continues to be available after such a default. Such assistance was given after the restructuring of the Greek sovereign debt in 2012, but forthcoming assistance is not necessarily evident.

If a default took place in conjunction with exit from the euro, then monetary financing of public deficits by using a new national currency is in principle an alternative financing option but it would make the new currency quite fragile. Such an exit might also imply that international funding for the country would be greatly reduced or cease altogether. Resulting additional austerity again means a further downward movement in GDP and living standards. The exiting country would also have to introduce tight capital controls to minimize a likely run on its banks. There is also the additional issue of external deficits, as after exit new international financing for the country would not be forthcoming for some years. An exiting country with a current account deficit would have to adjust downward immediately to achieve external balance. Altogether, it is clear that the likely developments for a crisis country after an exit from the euro would make the downward adjustment partly chaotic and a deepening of the recession would take place.

In summary, it is very likely that policies have not been optimal and indeed a concept of optimality is difficult to define for the euro area. The economic, political and legal constraints for the current institutions were not designed for management of a sovereign debt crisis. Instead, I would say that by and large macroeconomic policies in the euro crisis can best be thought of as "muddling through" (or coping forward more or less satisfactorily). The adjustments necessarily involve reductions in living standards, so it is easy to point out how current policies have adverse consequences. It is much harder to come up with well-defined alternative policy programs and present a careful analysis why such alternatives would be superior.

6. Going forward

Governance of EMU was designed without attention to the possibility of a sovereign debt crisis. Above I have also noted the existence of some other design faults. Responses to the global financial crisis and the euro crisis as its latest stage have made it necessary to introduce new EU and EMU level institutions and procedures to deal with the crisis. This response has two principal parts. Day-to-day management of the ongoing crisis initially relied on ad hoc agreements as it took some time to create a systematic framework is for governing the current crisis is now largely in place. The other part, improvement in the economic and fiscal governance of the euro area and its member countries is more focused on the future, so that a more resilient EU and euro area is gradually formed to weather future crises. The latter development is currently far from complete.

The framework for managing the ongoing crisis can be said to comprise of three elements.

First, the most important element is the policies in the crisis countries. As was reviewed above, the processes for adjusting back to competitiveness and achievement of external balance and fiscal sustainability are ongoing but they are not complete. This adjustment implies adjusting to lower levels of domestic expenditure and living standards with associated costs in terms of unemployment. Structural measures to mitigate the consequences of unemployment are very important but they are made difficult by the downward adjustment. They also take time to be effective.

Second, provision of finance by IMF and EU through ESM and its predecessors for the adjustment has been a second important part of the short-term crisis management. This bridge financing clearly helps but it is no substitute to the policies by the crisis countries. Without this financing the adjustment processes in the crisis countries would have been much harder and possibly chaotic.

Accommodative monetary policy, including unconventional measures by the ECB has been a third element in the crisis management. Very low interest rates, the full allotment liquidity provision to banks and the OMT play a part in the ongoing crisis management to mitigate the consequences of the downward adjustment.

Improvements and reforms of the euro area and more generally the EU institutions with a medium to long term view are a second development stimulated by the crisis. There are two notable areas of development and one open problem.

Let me begin by briefly noting the ongoing plans to establish the banking union. I will not go into details since Constâncio (2013) covers the subject in this volume. However, I want to stress two points. The establishment of the banking union is essential for improving the functioning of the EU single financial market. As I noted earlier, the financial crisis made it painfully clear that lack of a common financial supervisory and bank resolution mechanisms was a major omission in the EU programme for single financial market. The second point worth stressing is that the lack of a banking union was one element in the build-up of financial imbalances within the euro area. Though the build-up first took place largely in the private sector, the financial crisis tied together the sovereigns and the banking systems. The European banking union can enable a weakening of these difficult inter-linkages between the banks and the sovereign.

Improvements in the economic and fiscal governance of the euro area countries are the second element in the attempt to build a more resilient EU, euro area and the member countries in the future. Let me list the main changes without going into details.[17] Surveillance of national policies and tighter policy coordination has been improved by the "European Semester". The so-called "six-pack" of legislative measures includes stronger enforcement of the Stability and Growth Pact and the excessive deficit procedure and the debt criterion, fostering reforms of national fiscal frameworks, and the macroeconomic imbalances procedure to screen external and internal imbalances for member countries. The "two-pack" for tighter surveillance procedures and for improving confidence in financial markets is currently under negotiation. All these are useful additions to the EU governance structure, but one should be realistic about how much they can attain. In the end, whether they lead to better outcomes will depend on implementation, and effective implementation will always be constrained by the particular political context.

[17] See, for example, Mongelli (2013) and ECB (2013) for overviews and discussion of the reforms.

The intergovernmental Treaty on Stability, Coordination and Governance in the EMU, which came into force in the beginning of this year, is somewhat different in its approach. Its first part, the "fiscal compact", is meant to transpose balanced budget rules and an automatic correction mechanism into national laws. There is some hope that bringing fiscal rules into national laws and under the scrutiny of national courts may lead to more effective implementation. The Treaty also contains additional measures for economic policy coordination and convergence, including further governance structures.[18]

When completed, the banking union and the strengthened economic and fiscal governance structures will no doubt provide an improved institutional framework for economic and economic policy in the euro area and the EU as a whole. Naturally, they remain untested until major shocks hit the system sometime in the future. As I emphasized earlier, good implementation of the rules and institutions is going to be crucial for the resilience of these new institutional structures. The past record of the EU is not good in this respect.

An open problem in the longer-term resolution of the euro crisis is the legacy problem: What to do the existing high levels of sovereign debt? Reduction of public debt to GDP ratios via gradual deleveraging from over 100 percent to more manageable levels will take a long time, possibly several decades.[19] Let me use Ireland from the 1980s as an example as shown in Figure 11. It took Ireland twenty years to reduce the debt ratio from about 125 to 25 percent.

Figure 11: Public debt to GDP ratio for Ireland and Greece in 1970–2010.

A variety of proposals have been made about solving the problem of high public debts via some other means than the slow debt reduction process. A non-exhaustive list of suggestions ranges from establishment of European Fiscal Union, issues of Eurobonds,

[18] Fiscal Compact can also be viewed as an element for the long run fiscal framework for the euro area. The main competing models are a US-style system with an operative no bail-out clause for lower levels of public administration and the more federalist Germany model. For example, see Henning and Kessler (2012), and Wyplosz (2012) for discussions of fiscal governance in Europe and the comparisons to existing federal fiscal systems.

[19] Slowness of the debt reduction processes is well known from economic history. For example, after WWII it took 30 years to reduce the debt ratio from about 90 to 25 percent in the western world. See Reinhart and Sbrancia (2011).

transformation of EFSF/ESM into a European Monetary Fund issuing fixed-rate Eurobonds, drastic debt write-off to gradual debt reduction funds. These proposals all have several difficulties. One difficulty is that they imply complicated and possibly drastic redistributions of sovereign liabilities among different countries. Thus it is very difficult to find unanimous agreement among the euro area members. A second difficulty is that to control for moral hazard, Eurobond proposals typically involve strict rules, the credibility of which in times of stress is questionable.

I want to conclude by drawing your attention to the recent lack of focus in the basic mission of the EU, namely increased economic integration and international trade. Economic integration and trade between countries is a key source for positive growth and improving well-being in the EU to which we all want to return. As noted earlier, past performance in economic integration and trade has not been satisfactory as indicated by increasing heterogeneities among the euro countries. In my opinion, it would be important to find new dynamism and initiatives here. Recent suggestions for deepening of the EU single market in different areas are one option. Establishment of a Transatlantic Trade and Investment Partnership would be another growth-enhancing development.

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Appendix

Figure 1: Interest rate differential between Germany and the GIIPS countries from 1995-2012 for 10-year government bonds

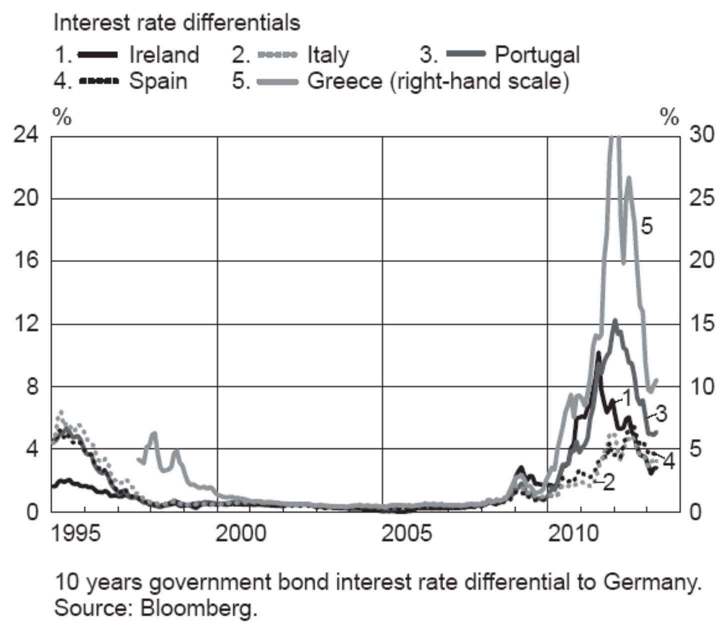


Figure 2: Public deficits to GDP ratio for the GIIPS countries and Euro area average, 1998-2012.

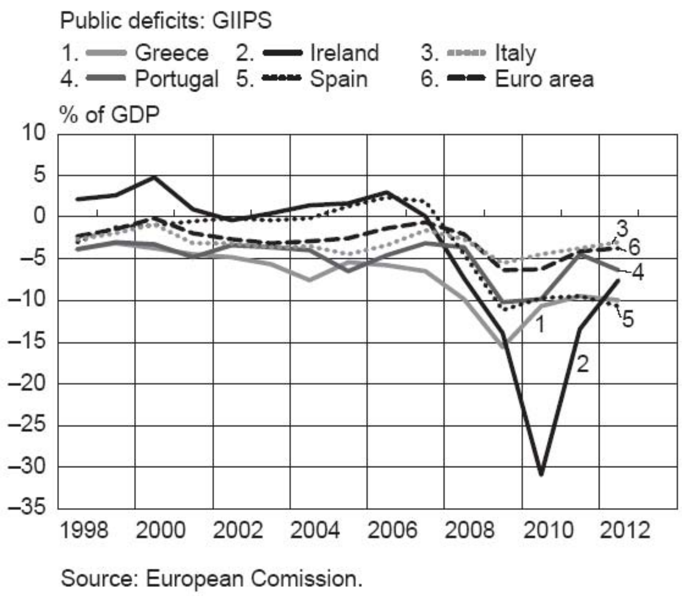


Figure 3: Public debt to GDP ratio for the GIIPS countries and euro area average, 1998-2012.

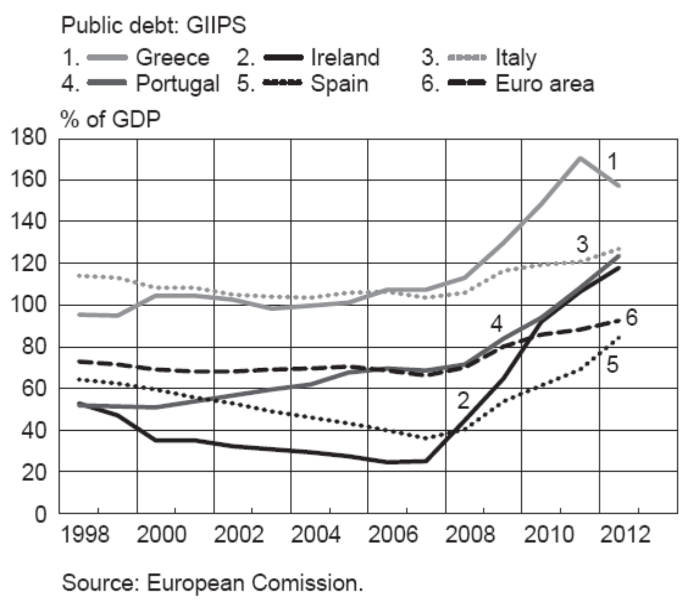


Figure 4: Current account deficit and public deficit in the GIIPS countries in 2002-2012.

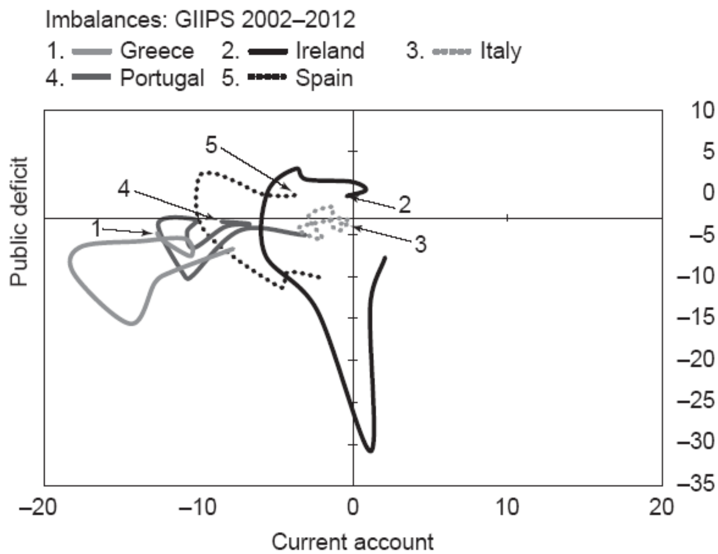

Imbalances: GIIPS 2002–2012
1. Greece 2. Ireland 3. Italy
4. Portugal 5. Spain
Public deficit
Current account
10
5
0
–5
–10
–15
–20
–25
–30
–35
–20
–10
0
10
20
1
2
3
4
5

Figure 5: Unit labour costs in Belgium, Finland, France, Germany, and the Netherlands for 1999-2012.

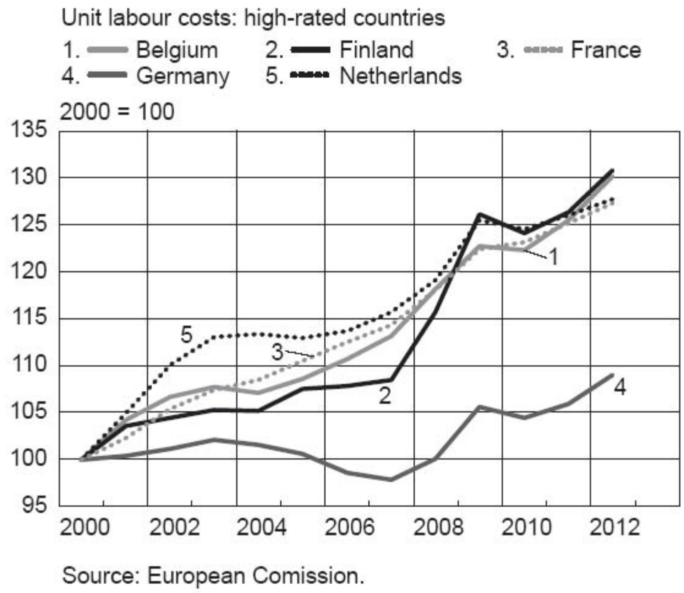


Figure 6: Unit labour costs in the GIIPS countries for 1999-2012.

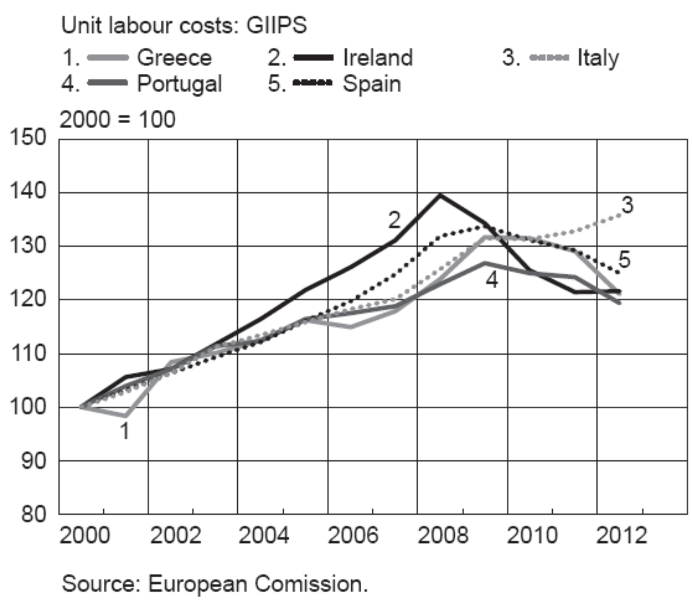


Figure 7: Levels of GDP for the GIIPS countries in 2000-2012.

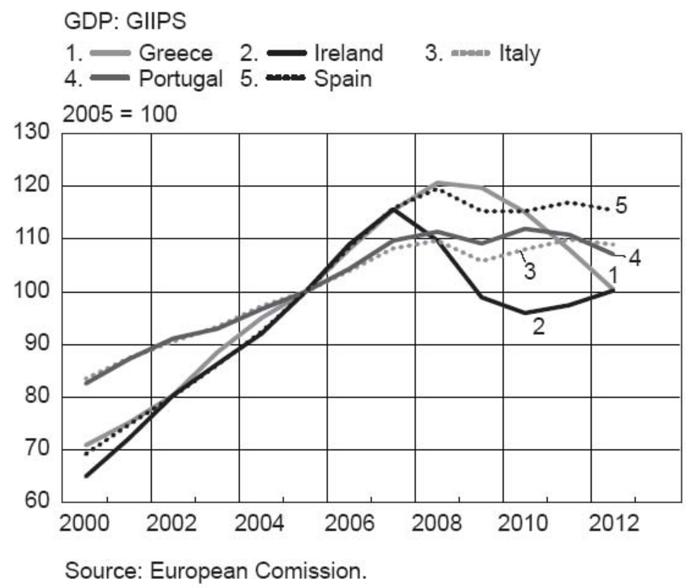


Figure 8: Current account balance per GDP for the GIIPS countries in 2000-2012.

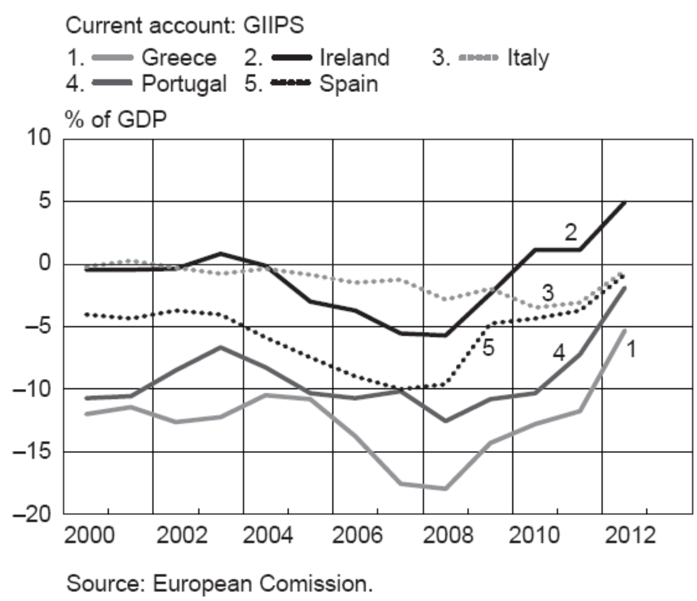
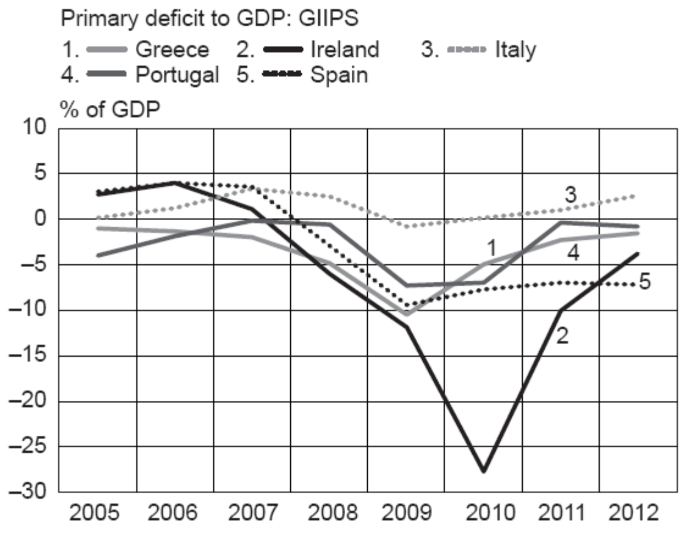
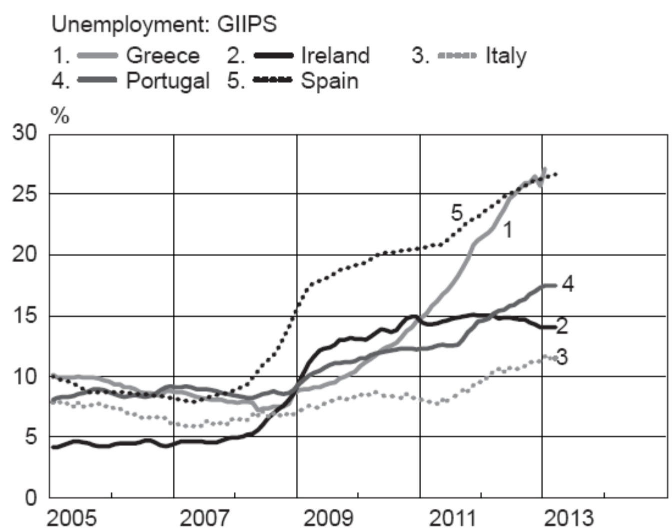


Figure 9: Primary deficit to GDP in the GIIPS countries in 2005-2012.



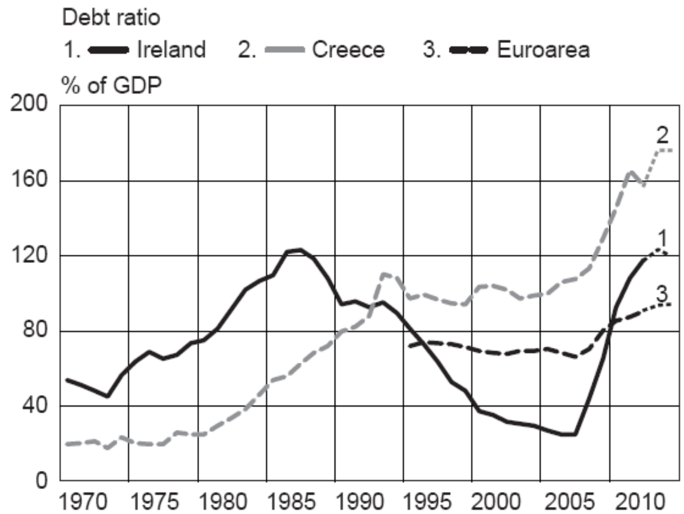
Source: European Comission.

Figure 10: Unemployment in the GIIPS countries in 2005-2012.



Source: Eurostat.

Figure 11: Public debt to GDP ratio for Ireland and Greece in 1970–2010.



Sources: Eurostat and European Commission.
Forecast spring 2013.

Assessments on Greece and Ireland in 2006-2007

Greece

IMF, Article IV report, Dec 2006:

- ” *Significant fiscal consolidation was put in place in 2005–06, but further deficit cuts are needed.”*

- “*Vulnerabilities have developed in the form of very high credit growth, persistent inflationary pressures, eroding competitiveness, and an unsustainably large current account deficit.”*

OECD, Country report, May 2007):

- *“Losses in competitiveness may ultimately undermine growth performance.”*

- *“The clearest sign of macroeconomic tension is an increase in the current account deficit.”*

- *“There has been substantial [fiscal] consolidation since 2004.“*

Ireland

IMF, Article IV report, June 2006:

- *“concentration of lending in property-related sectors… banks’ reliance on wholesale funding…”*

- *”Economic policies have been in line with Fund policy advice.”*

- *”Financial system continues to perform well, but rapid credit growth is a vulnerability.”*

- *“Regulatory and supervisory framework has been strengthened in line with the recommendations of the 2000 FSAP.”*

OECD, Economic survey, March 2006

- *“The fiscal position is healthy.”*

- “*House prices may have overshot fundamentals to some extent, although this does not imply that they will fall significantly.”*

Discussion

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Seppo Honkapohja's paper provides an accurate and well-balanced analysis of the causes of the euro crisis, focusing on the impact of the euro on macroeconomic imbalances between euro area countries and on design faults of the monetary union, which have contributed to the buildup of the crisis. It further provides an assessment of adjustment policies in the countries hit by the crisis and the response of EMU to the crisis.

My discussion will focus on three issues: 1. the role of the no-bail out clause, 2. the cost of austerity and the related debate on the fiscal multiplier and 3. external adjustment and the role of competitiveness.

First, on the role of the no-bail out clause. The paper argues that the "complete downgrade" of the no-bail out clause in the Maastricht treaty was to a large extent responsible for the abolition of interest rate differentials in the euro area despite major heterogeneities between the countries. Though it is difficult to disagree with this assessment, one should not overlook that it was not the downgrade of the no-bail out clause per se which contributed to the buildup of the crisis but the fact that the no-bail out rule was time-inconsistent. As such, it failed to solve the double moral hazard problem for the sovereigns and financial markets. What had been overlooked in the Maastricht treaty is that moral hazard is not created by the possibility of a bail out but by the *incentive* of EMU to bail out a member country. This incentive was expected and has proven to be high, given the risk of contagion when one member of the union (Greece in early 2010) lost access to market financing.

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Moreover, the lack of credibility of the no-bail out clause does not fully explain why markets were so willing to refinance debt of fiscally weak countries in the first place. An alternative interpretation is that markets did not at the time think that public debt of these countries was unsustainable as their fundamentals appeared to have undergone a regime shift due to the launch of the euro. The decline in interest rates, combined with high growth rates of GDP, made the debt-to-GDP ratio of these countries to appear sustainable. What markets may have not realized was that the fundamentals of these countries would suddenly change to the worse when markets stopped refinancing their debt, triggering destabilizing debt dynamics (see Gros 2012).

The credibility of the no-bail out clause was further undermined by (what one could call) the "impossibility trilemma" of "no bail out", "no debt restructuring", "no exit from the euro", which characterized the initial response of the euro area to the sovereign crisis. Markets knew that this trilemma was impossible to hold and they expected that, due to the fear of contagion, a bailout of Greece was probably the least costly option for the euro area.

My second comment relates to the cost of austerity and the debate on the size of the fiscal multiplier. Many observers have argued that the cost of austerity for fiscally weak euro area countries has been excessively high due to the higher size of the fiscal multiplier in a recession. Critics of this view suggest that the surprisingly strong impact of fiscal consolidation on growth was not the result of fiscal tightening per se but the result of the steep rise in borrowing costs and a tightening of credit conditions due to the fiscal crisis (see European Commission (2012)). The truth lies probably somewhere in between, i.e. both fiscal consolidation and the deterioration of credit conditions are important factors in explaining the depth of the recession. There is no doubt that credit conditions have played an important role in deepening the recession during recent episodes of fiscal consolidation in the euro area. In addition to a significant increase in borrowing costs for the private sector, the sovereign debt crisis has led to a liquidity squeeze. This was the result of several factors including the drying up of bank funding and deposit flight, the rise in NPLs, deleveraging of banks and the tight inter-linkage between banks and the sovereign.

It is difficult, however, to control for the effects of endogeneity in standard regressions. Ikonen et al (2013) uses instrumental variables such as lagged sovereign ratings, budget deficits and CDS spreads to control for endogeneity of sovereign interest rates. Since sovereign ratings and CDS spreads are forward looking variables and react to changes in expectations about both the future stance of fiscal policy and real output, using such variables as instruments may lead to downwardly biased estimates of fiscal multipliers because the control variables take up part of the effect of the explanatory variable on GDP forecast errors.[21]

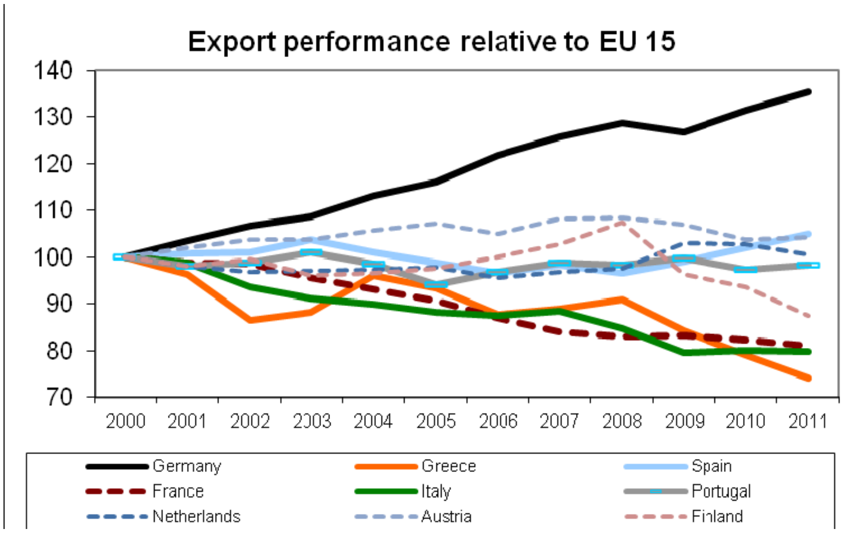
My final comment relates to current account imbalances and the role of relative prices. The loss in competitiveness and the accumulation of external debt in the years of EMU was one of the major imbalances leading to the crisis. I agree with the view that, over longer periods of time, export performance is related to competitiveness.[22] When we look at individual countries, however, it is difficult to distinguish a clear pattern between North and South. Figure 1 plots the performance of exports relative to EU15 for selected countries. Greece, Italy and France have suffered the biggest loss, Germany has over-performed by a large margin, whereas all other countries performed more or less similarly. It is difficult to distinguish a clear pattern between Northern and Southern euro area countries.[23]

[21] This may explain why the results of Ikonen et. al. (2013) do not differ significantly from the results of the European Commission (2012) study.

[22] Anastasatos and Malliaropulos (2013) find in a cross section of 19 countries that over longer periods of time, a 1% increase in cost competitiveness is related to a 0.8% increase in exports relative to trading partners.

[23] Seppo Honkapohja's Figures 5 and 6 also suggest that, with the exception of Germany, there is no evidence that ULCs have increased in Southern countries more than in Northern countries.

Figure 1. Export performance relative to EU15.



Source: Eurostat Ameco. Exports of goods and services at 2005 prices: Performance relative to the rest of the former EU-15: double export weights (series code: OXGSQ)

This brings me to my final point: the deterioration in the competitiveness of the South is to a large extent related to the increase in relative labor costs and prices of non-tradables ("internal" exchange rate) and, secondarily, to the increase in unit labor costs in the export sector ("external" exchange rate).[24] This development has harmed competitiveness by drawing resources away from the tradables' sectors, thereby reducing the export sectors' productive capacity and fueling inflation. As a policy implication, it follows that economic adjustment in these countries requires an adjustment in relative wages and prices between the tradables' and the non-tradables' sector and not a generalized deflation, i.e. "internal devaluation".

[24] See Anastasatos and Malliaropulos (2011) for an application to Greece.

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