



The Euro Crisis: a View from the North

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**Views expressed are my own and do not necessarily reflect
those of the Bank of Finland.**

Outline

- ◆ Build-up of the crisis
- ◆ Some design faults
- ◆ Adjustment and policies in the crisis
- ◆ The austerity debate: comments
- ◆ Going forward

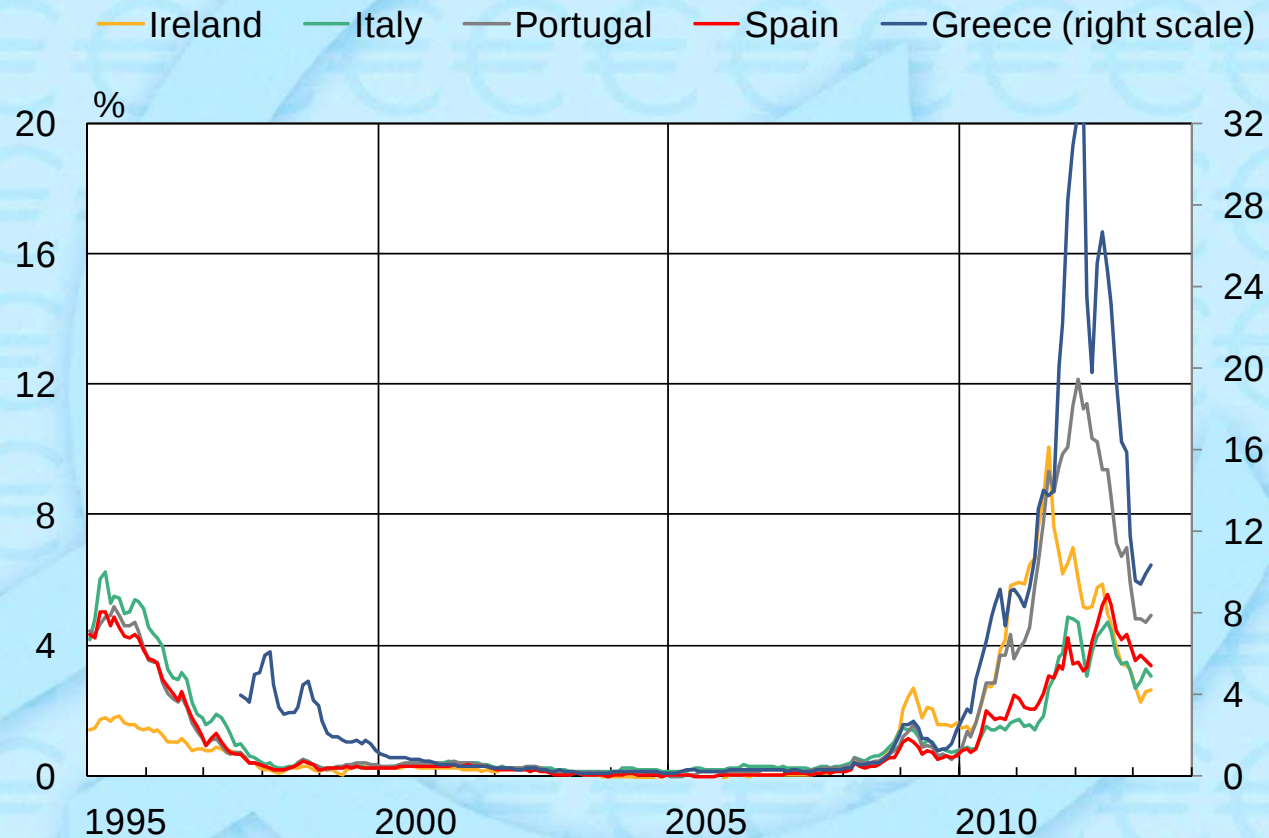


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1. Build-up of the crisis

Fig. 1: Disappearance of interest rate differentials (before 2008)

Interest rate differentials



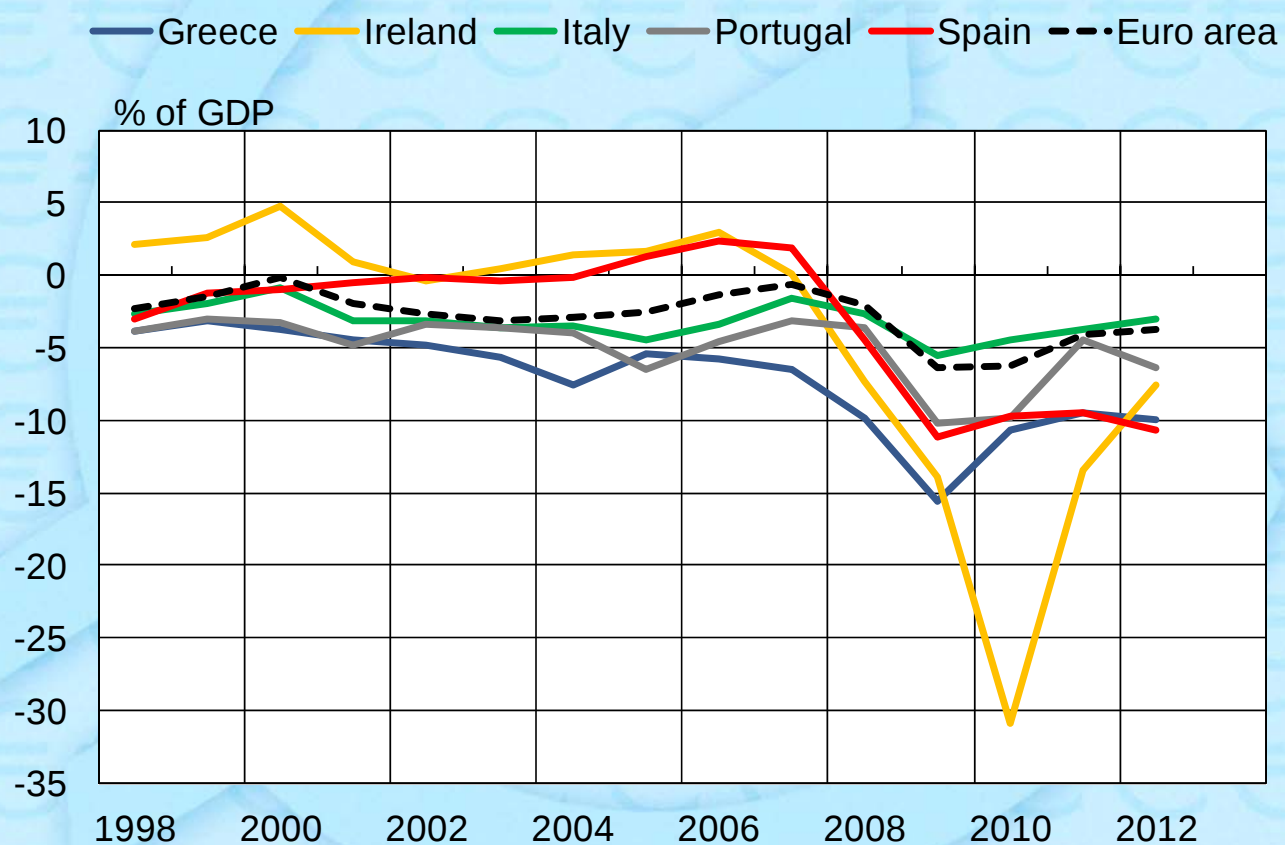
10 years government bond interest rate differential to Germany.

Source: Bloomberg.

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Figure 2A: Public deficits

Public deficits: GIIPS

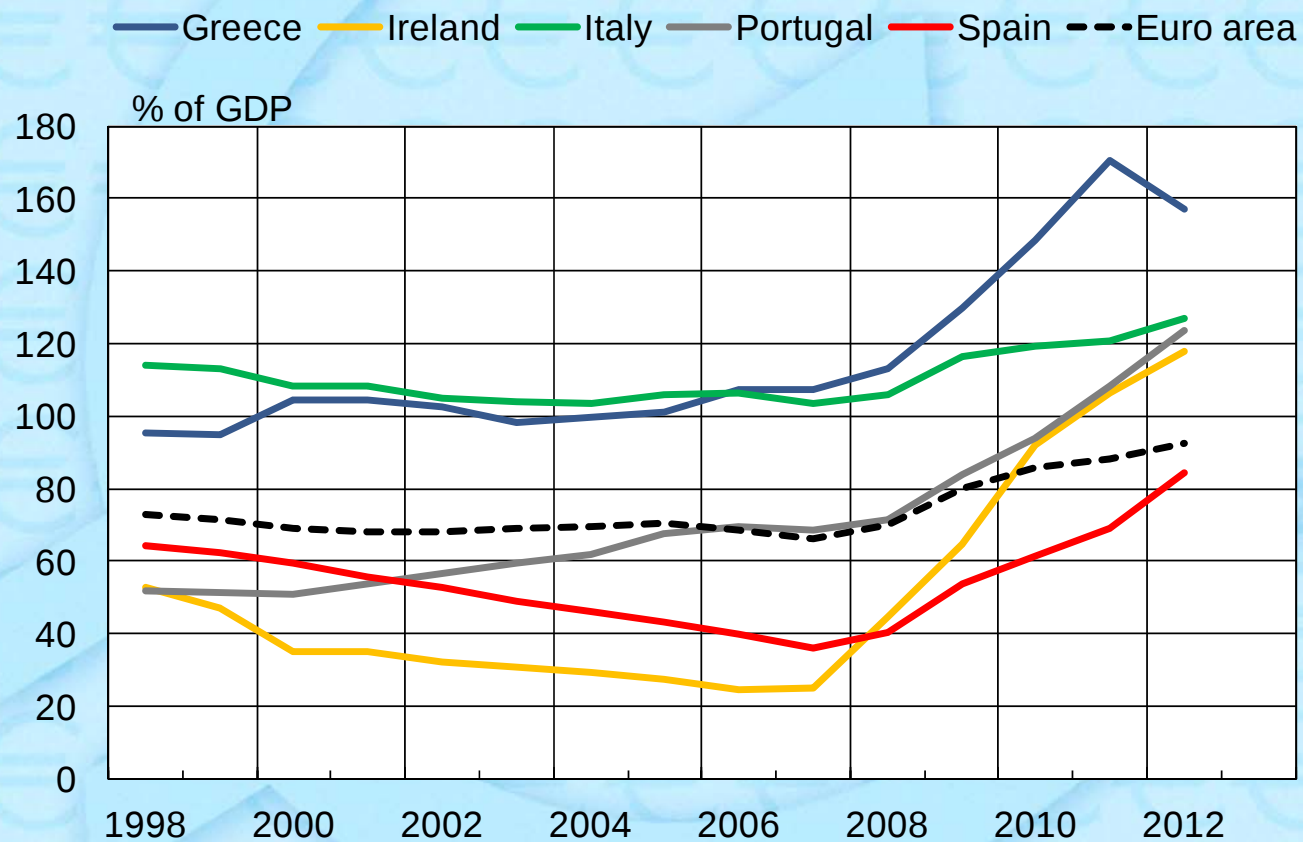


Source: European Commission.

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Figure 2B: Public debt

Public debt: GIIPS



Source: European Commission.

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Figure 3: Current account and public debt dynamics, GIIPS countries

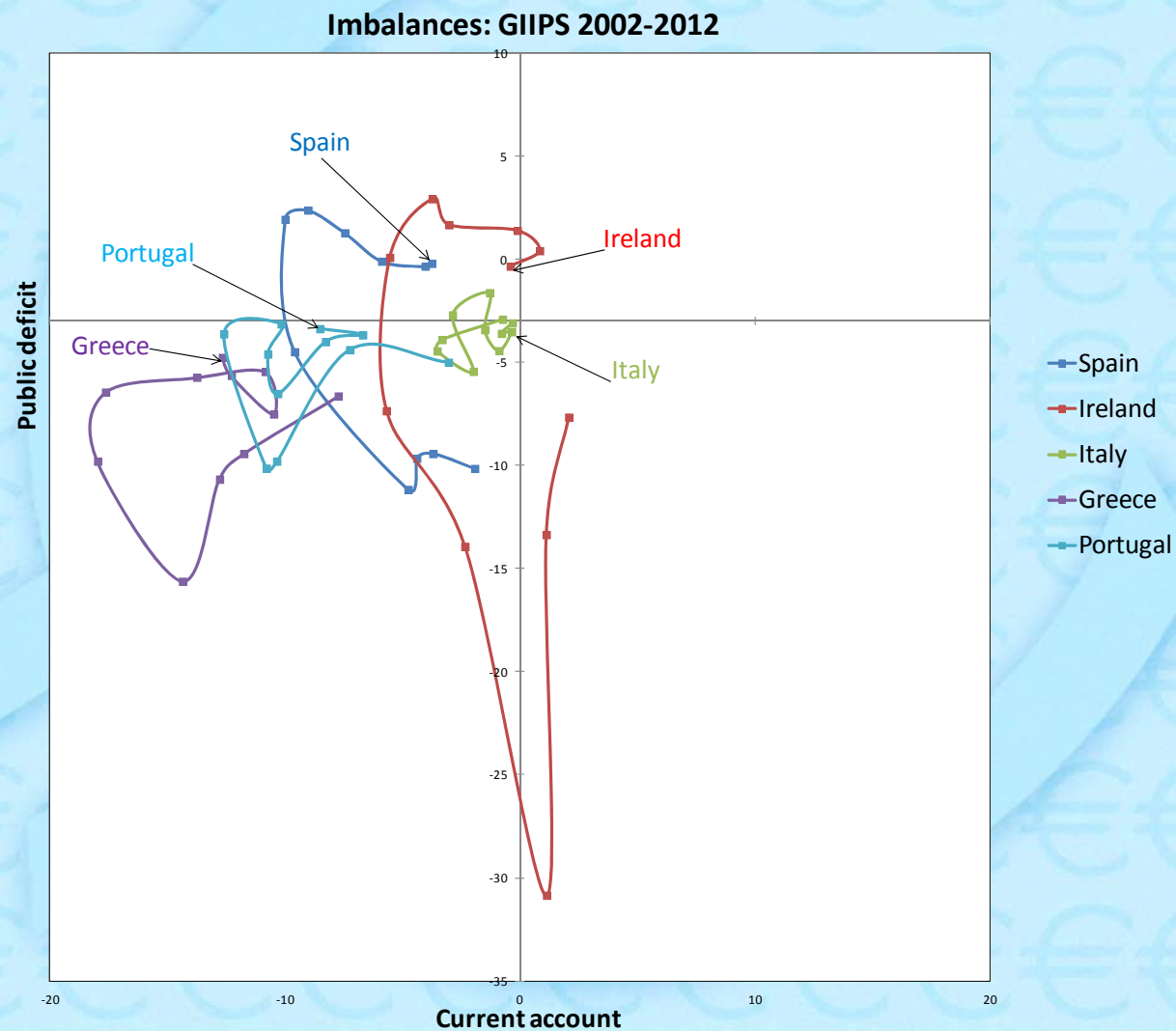


Figure 4: Current account and public debt dynamics, high-rated countries

Imbalances: High-rated countries 2002-2012

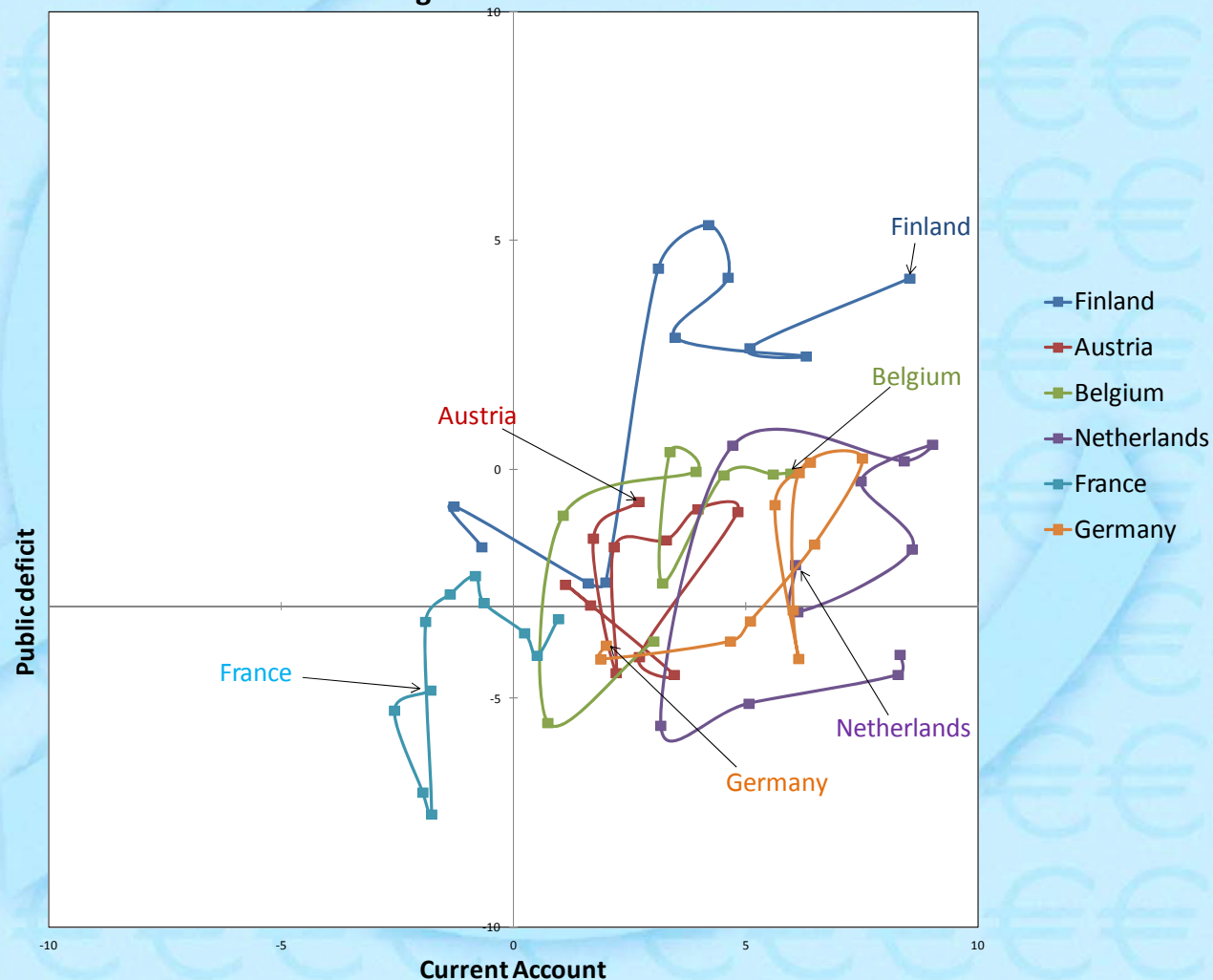
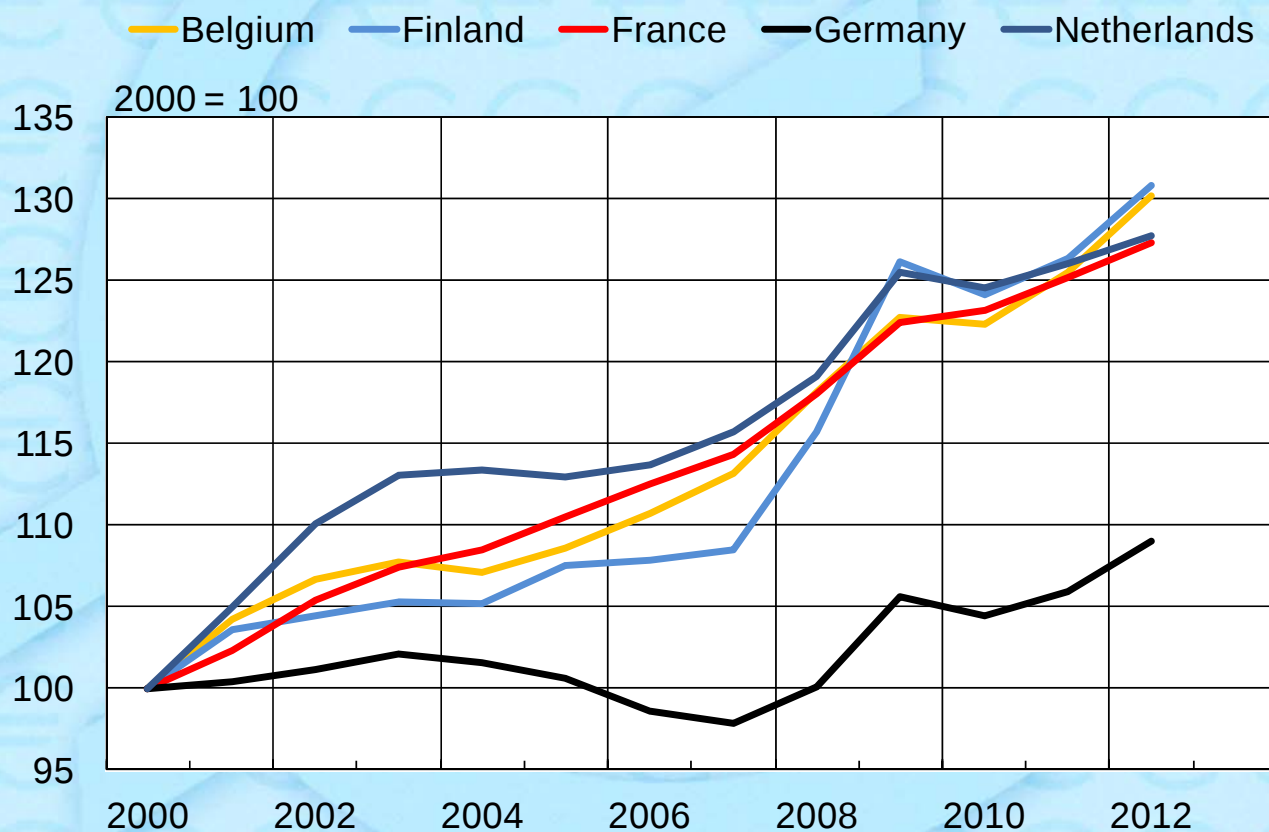


Figure 6: Unit labor costs for selected high-rated countries

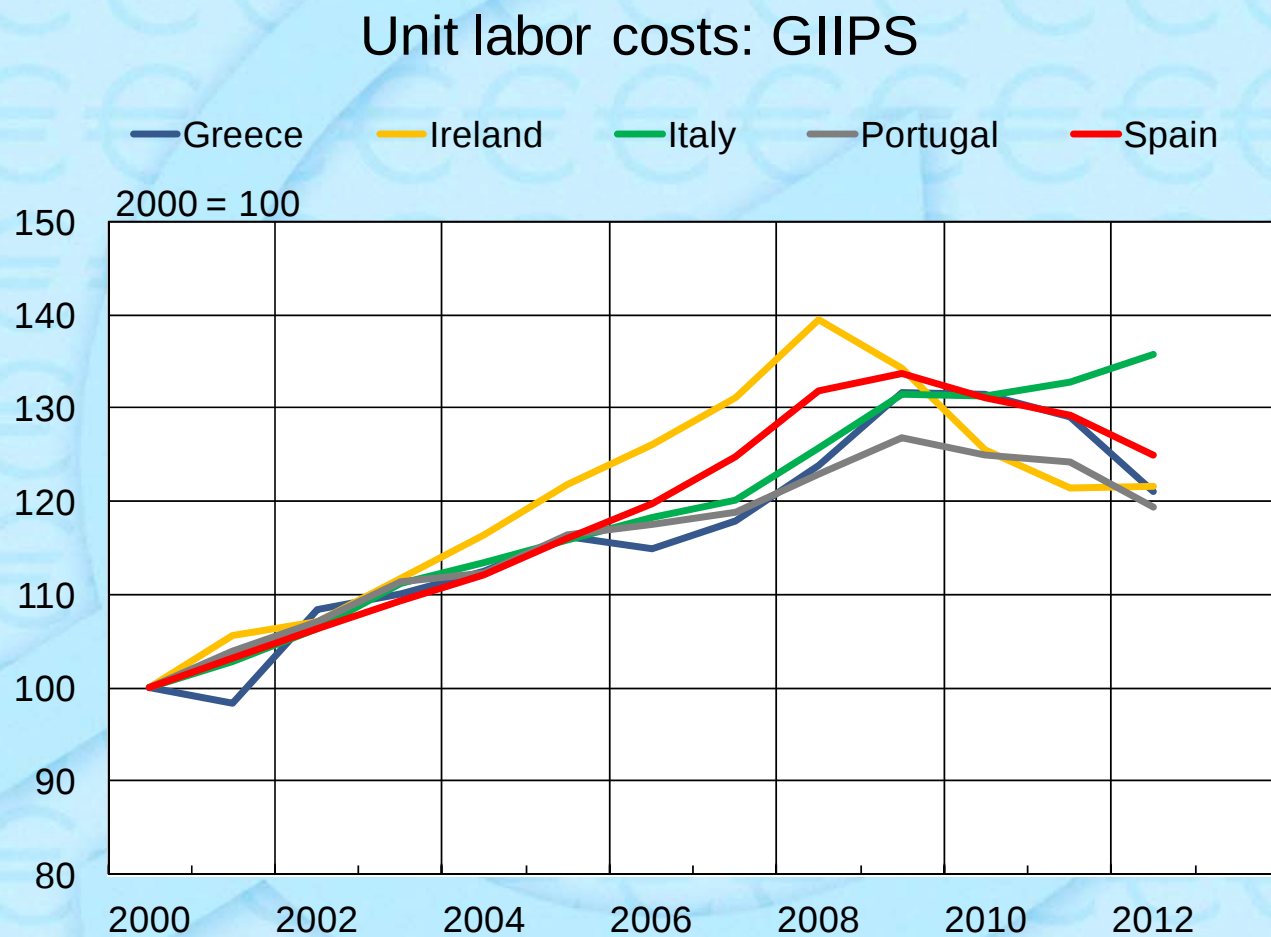
Unit labor costs: high-rated countries



Source: European Commission.

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Figure 7: Unit labor costs for GIIPS countries

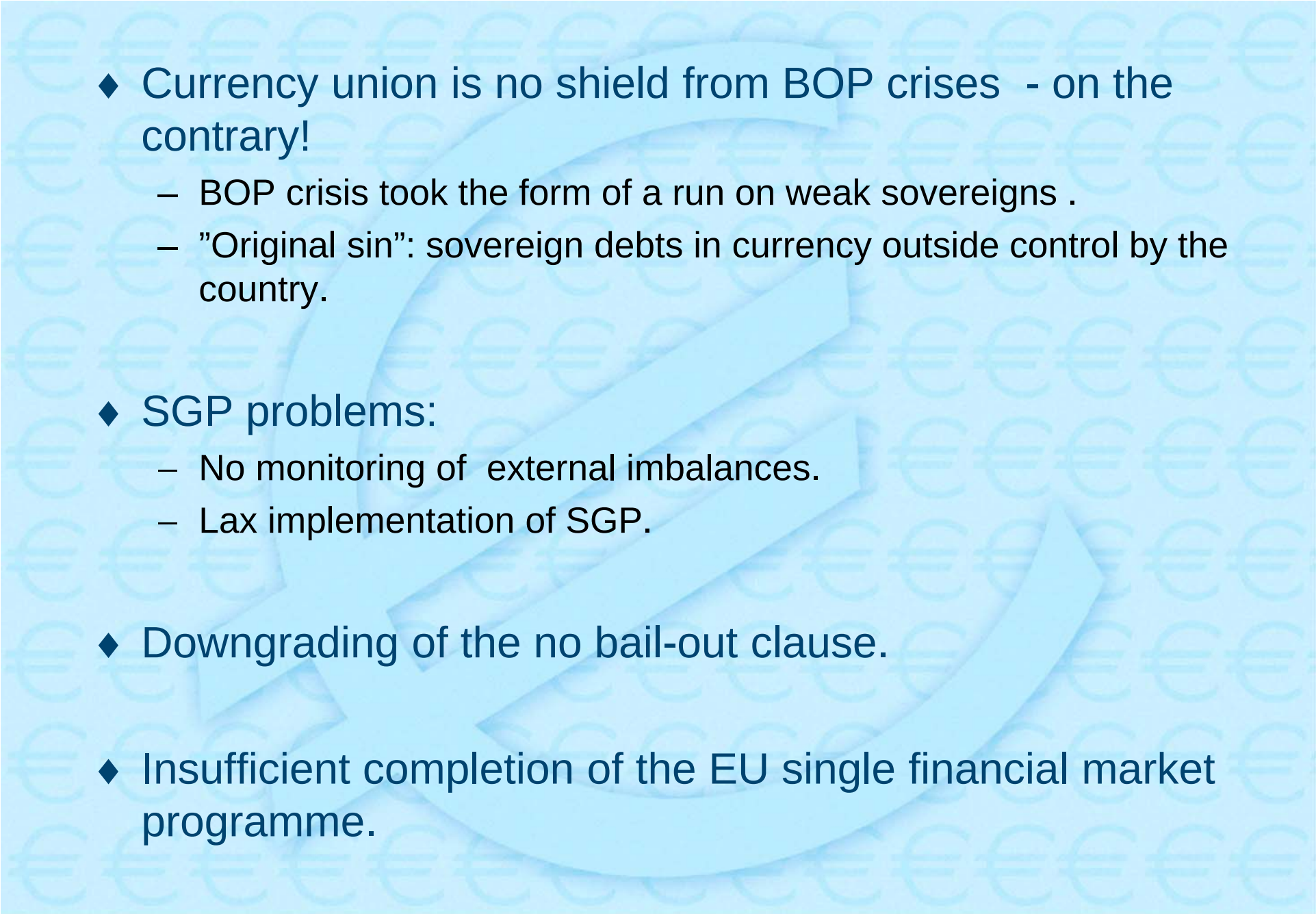


Source: European Commission.
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2. Some design faults

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- ◆ Currency union is no shield from BOP crises - on the contrary!
 - BOP crisis took the form of a run on weak sovereigns .
 - "Original sin": sovereign debts in currency outside control by the country.
 - ◆ SGP problems:
 - No monitoring of external imbalances.
 - Lax implementation of SGP.
 - ◆ Downgrading of the no bail-out clause.
 - ◆ Insufficient completion of the EU single financial market programme.



3. Adjustment and policies in the crisis

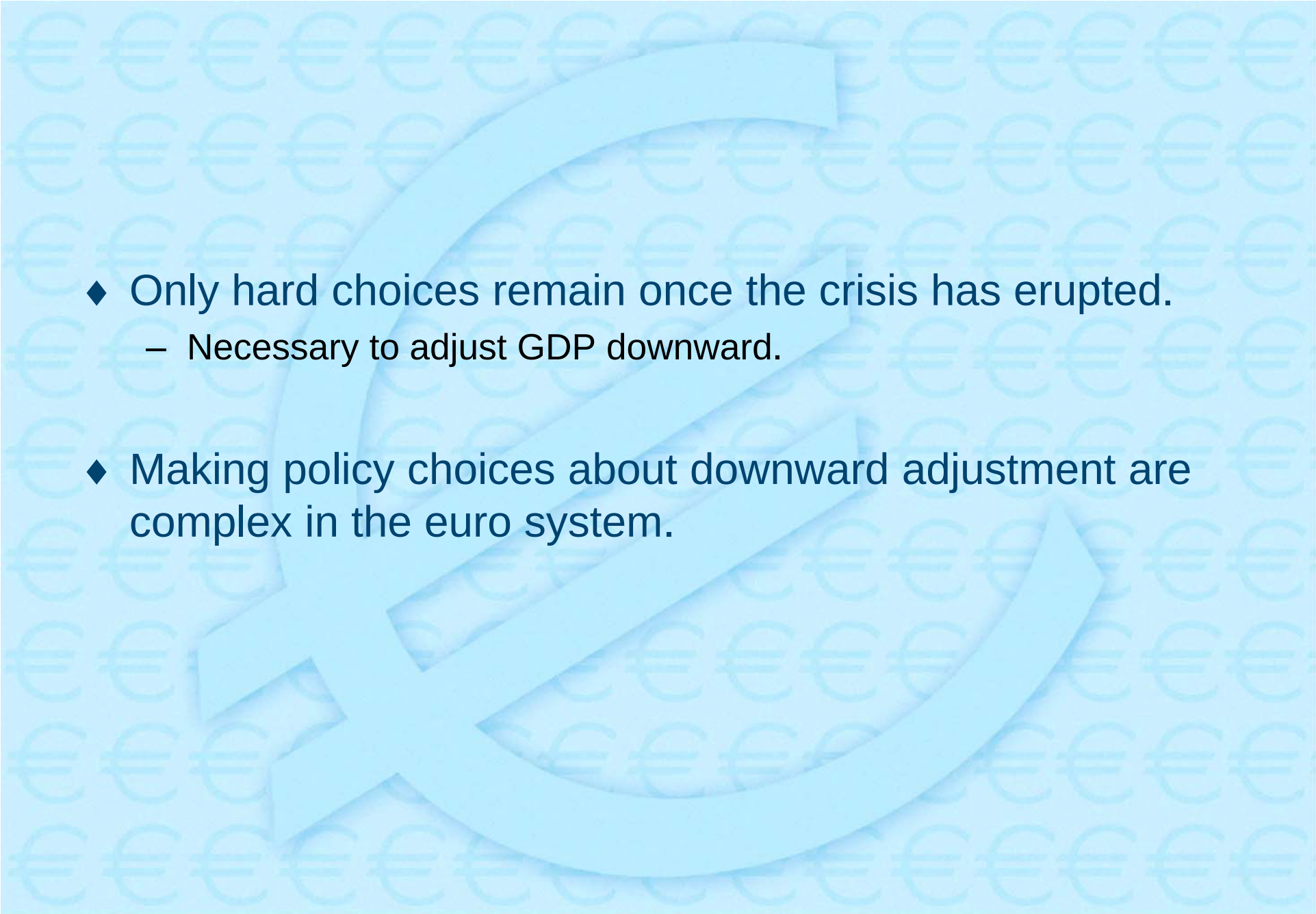
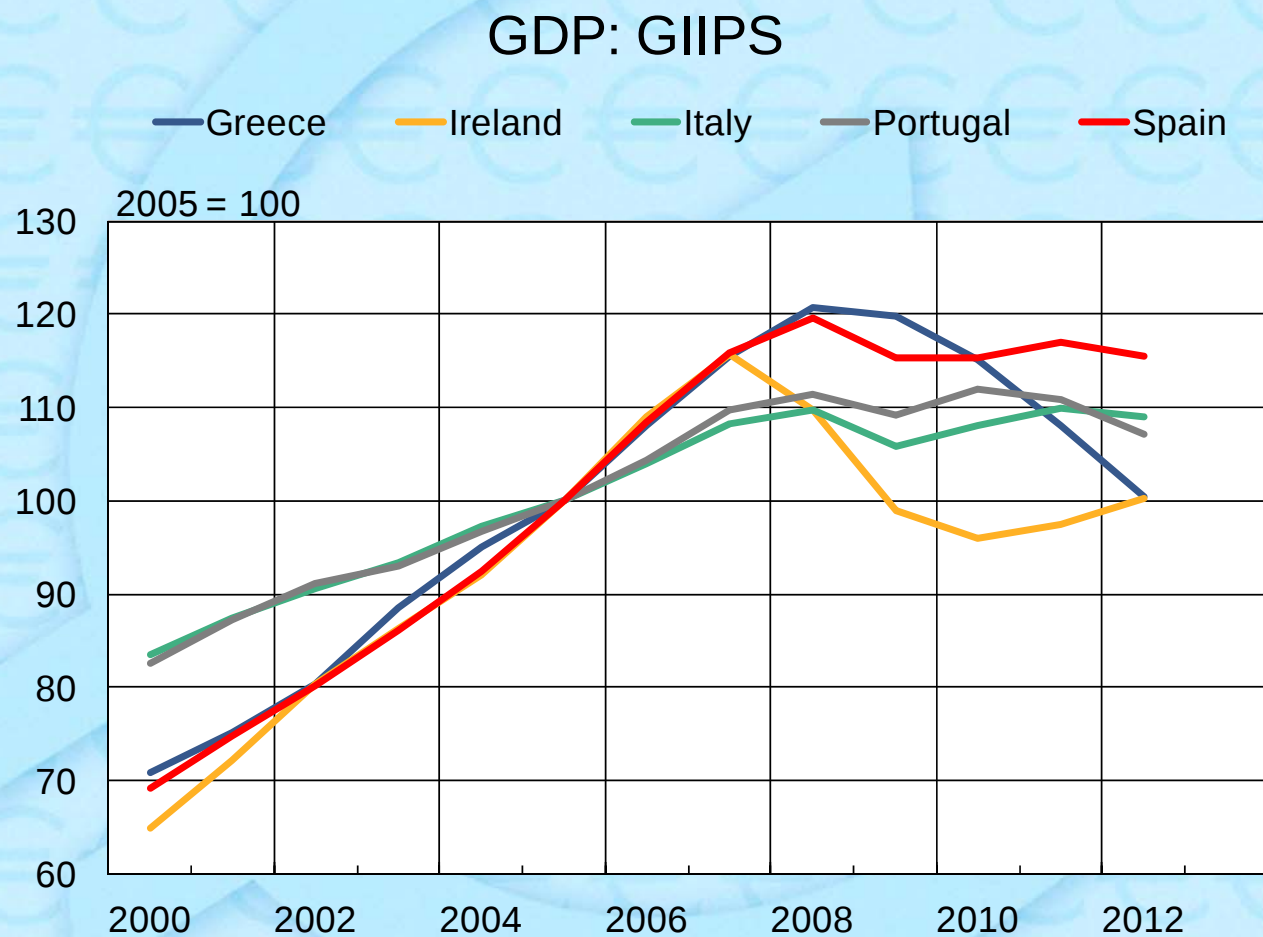
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- ◆ Only hard choices remain once the crisis has erupted.
 - Necessary to adjust GDP downward.
 - ◆ Making policy choices about downward adjustment are complex in the euro system.

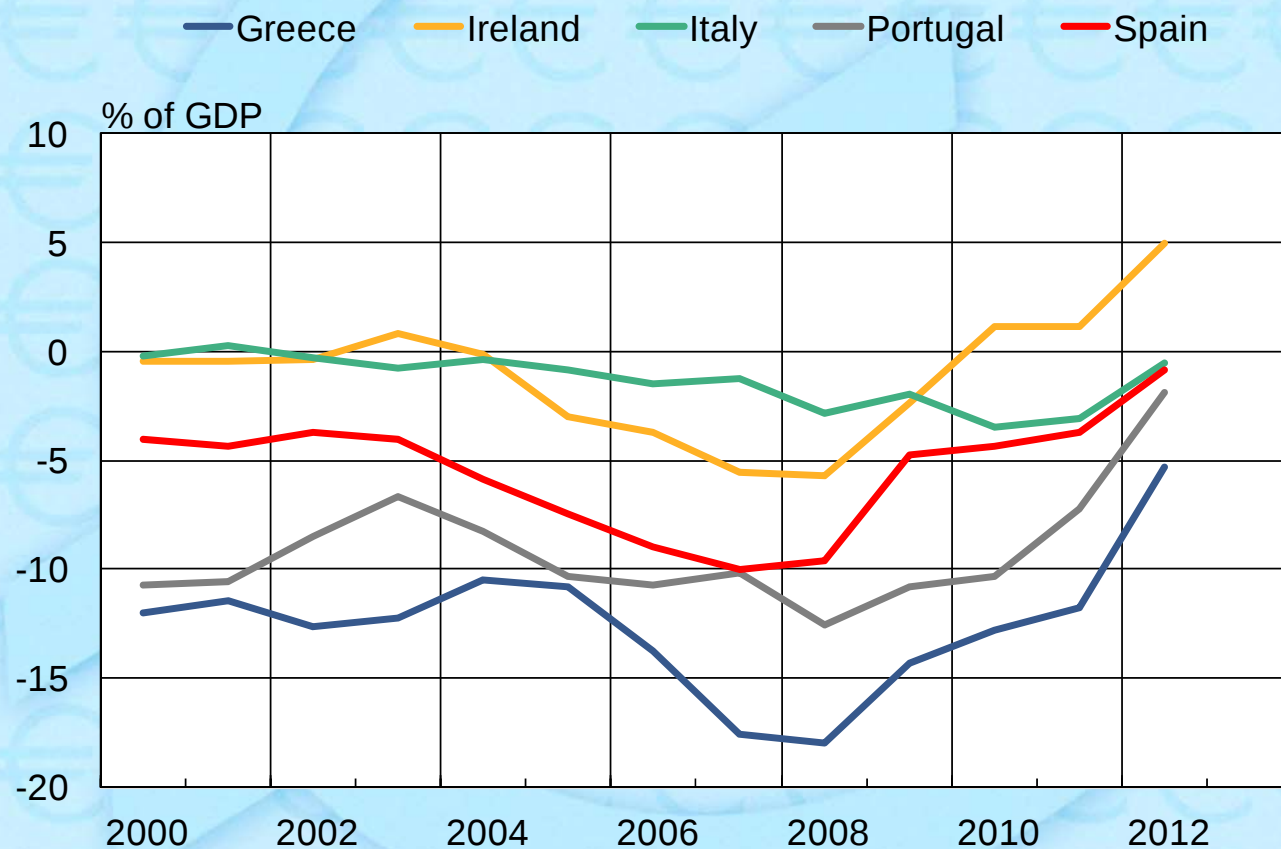
Fig. 8: GDP declining, except for Ireland



Source: European Commission.
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Fig. 9: Current accounts in still deficit, except Ireland

Current account: GIIPS

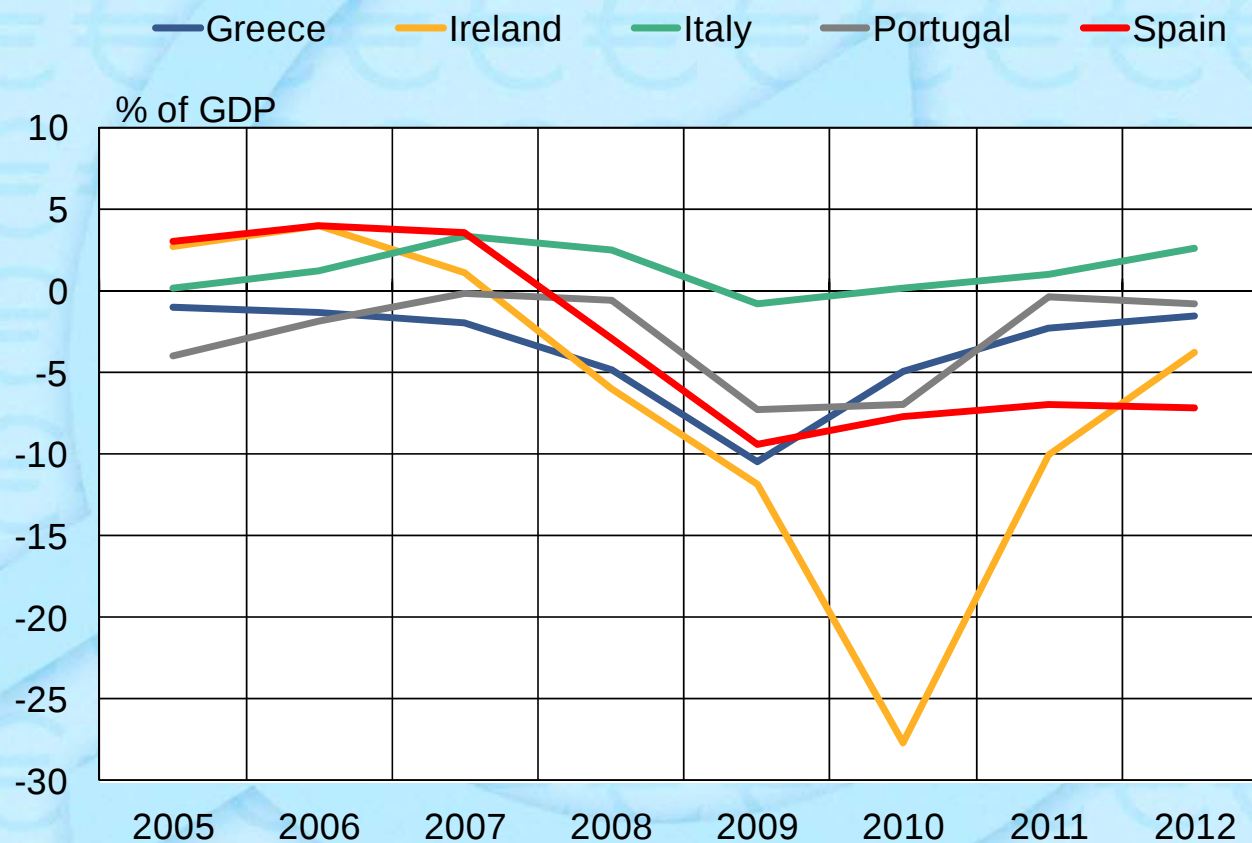


Source: European Commission.

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Fig. 10: Primary balances improving

Primary deficit to GDP: GIIPS

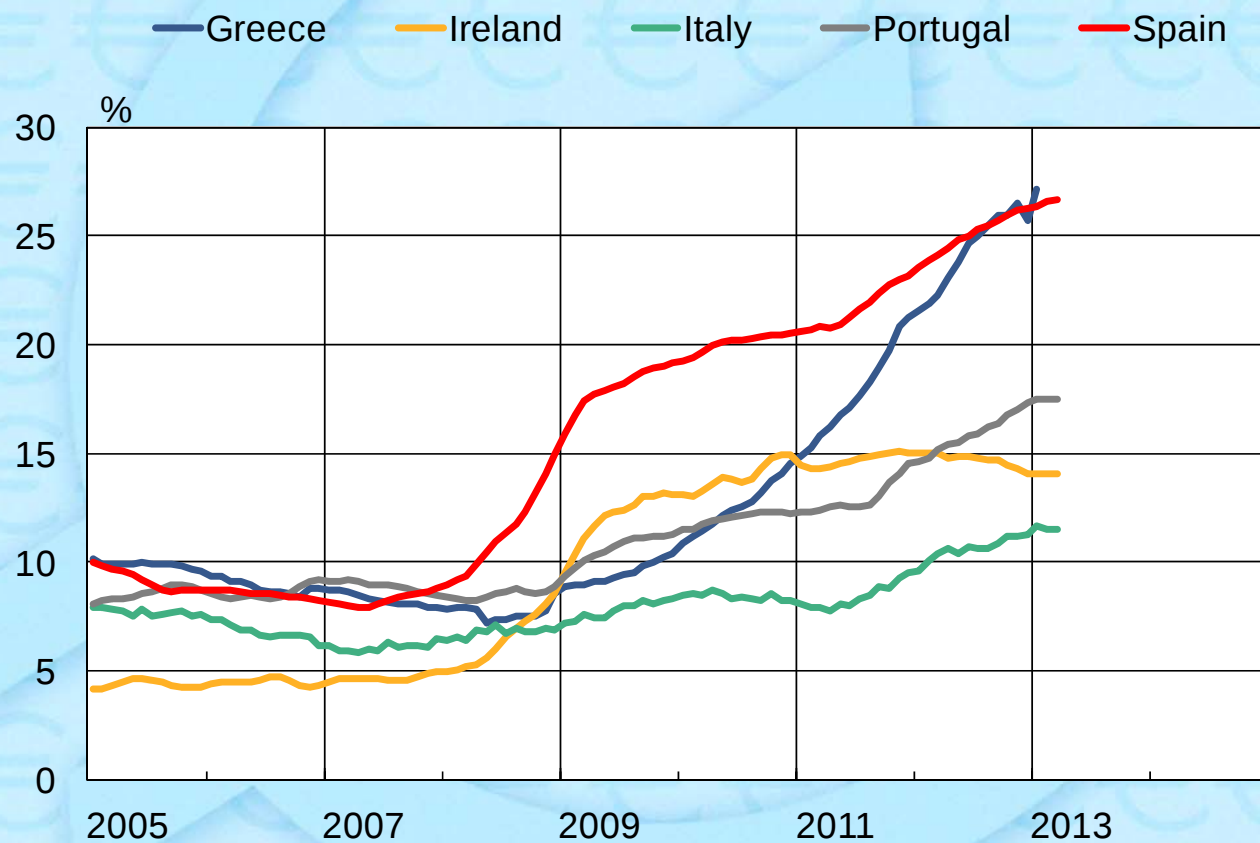


Source: European Commission.

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Fig. 11: Rising unemployment

Unemployment: GIIPS



Source: Eurostat.

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4. The austerity debate: comments

Table 1: GDP growth forecast errors and forecast of fiscal stance, estimation with instrument variables

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

◆ Alternatives to present policies:

(1) Slower speed in adjustment:

- Finance for countries in EU-IMF programmes?
- Other countries: risk of increasing rates with major slow-down or reversal in adjustment.

(2) More expansionary FP in high-rated countries:

- Limited impact?
- Public finances of Northern countries are not that strong.
- Political willingness in Northern countries?

(3) Defaulting on existing debt (and possibly exit from euro).

- Quick balancing of public deficit and CA
=> additional austerity, capital controls, possibly fragile new currency.

5. Going forward

- ◆ Two principal parts in the policy response.

- (1) Crisis management.

- Policies in the crisis countries.
 - Provision of bridge finance by IMF and EU (ESM).
 - Accommodative monetary policy by ECB.

- (2) Improvements in economic and fiscal institutions and governance.

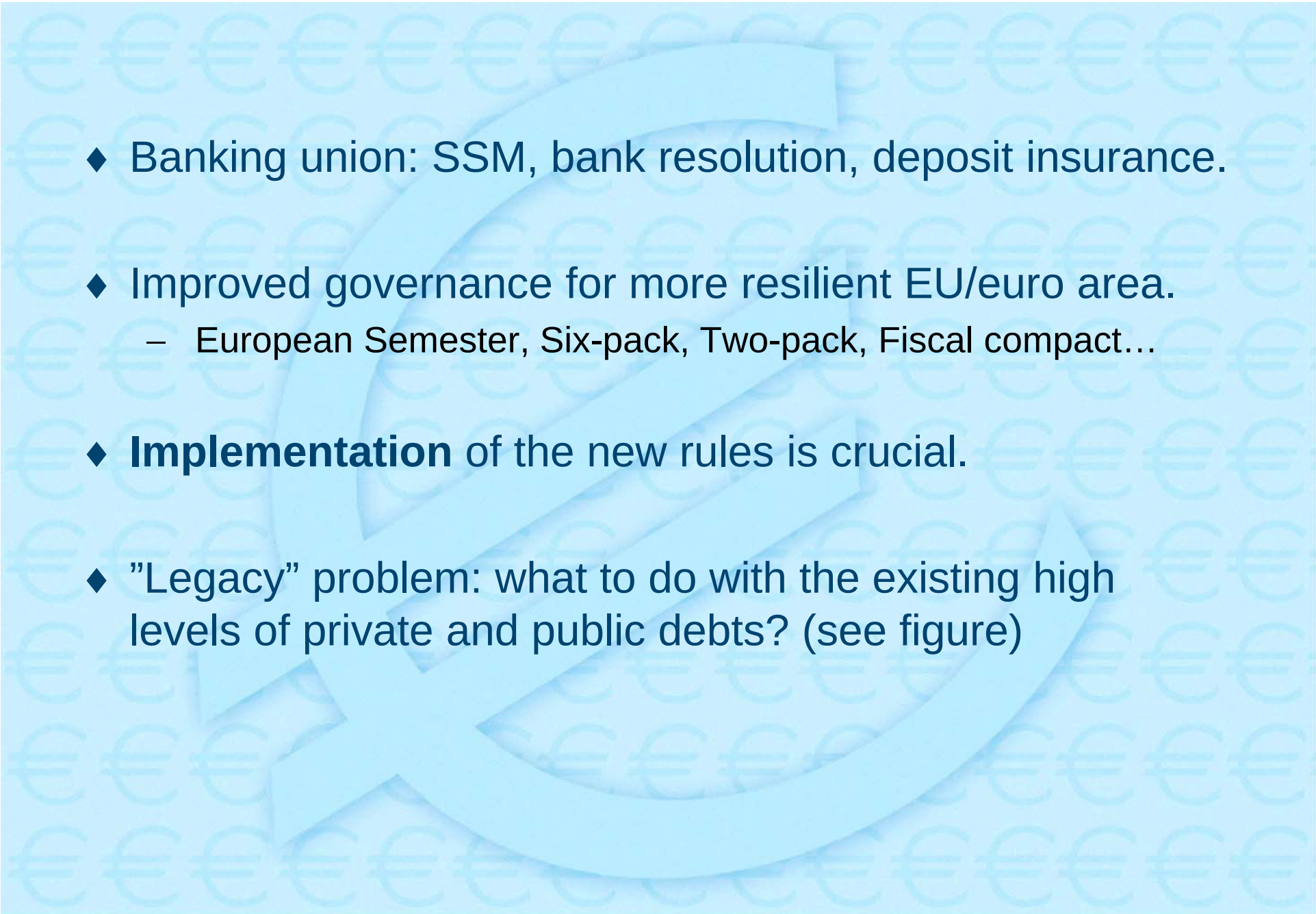
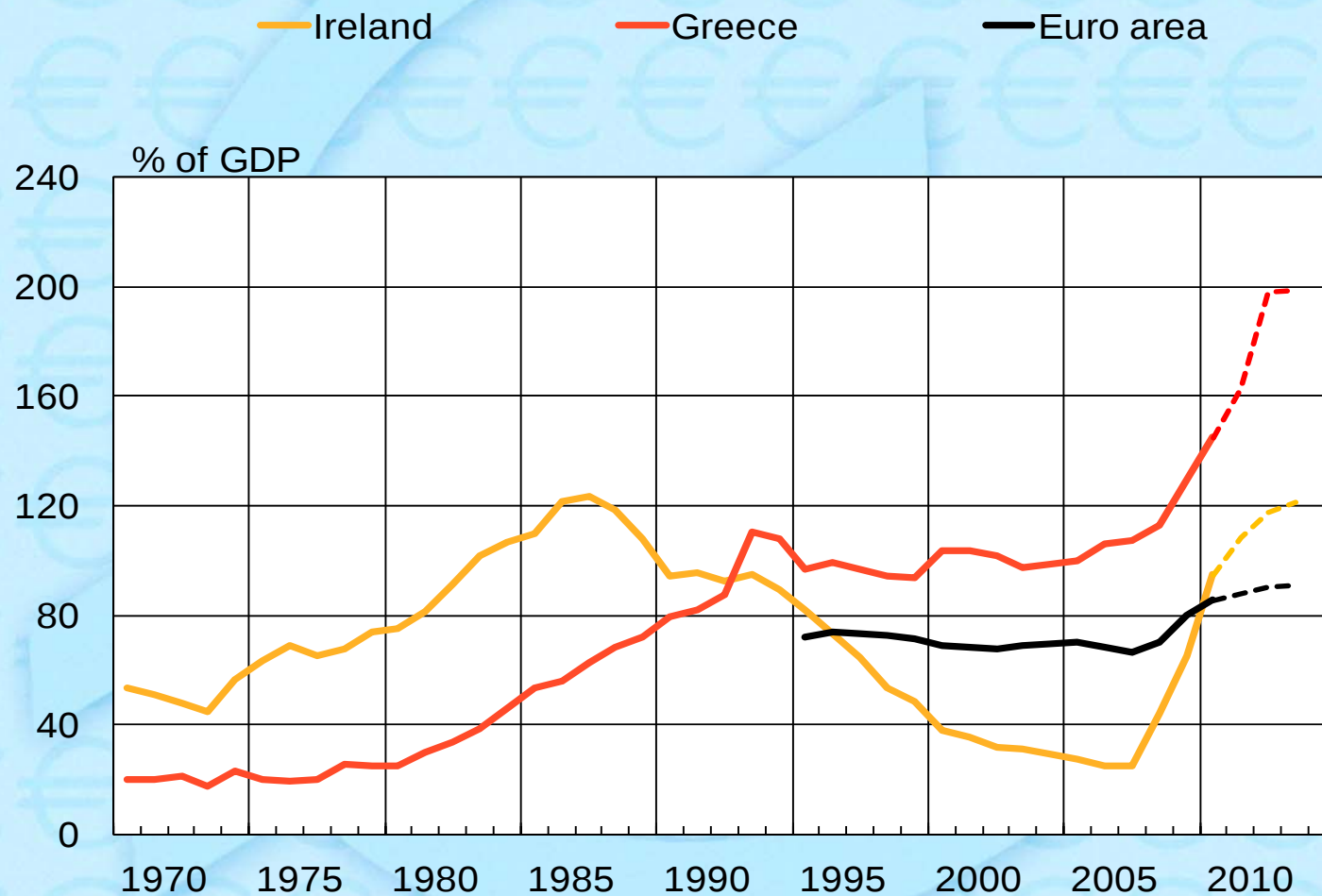
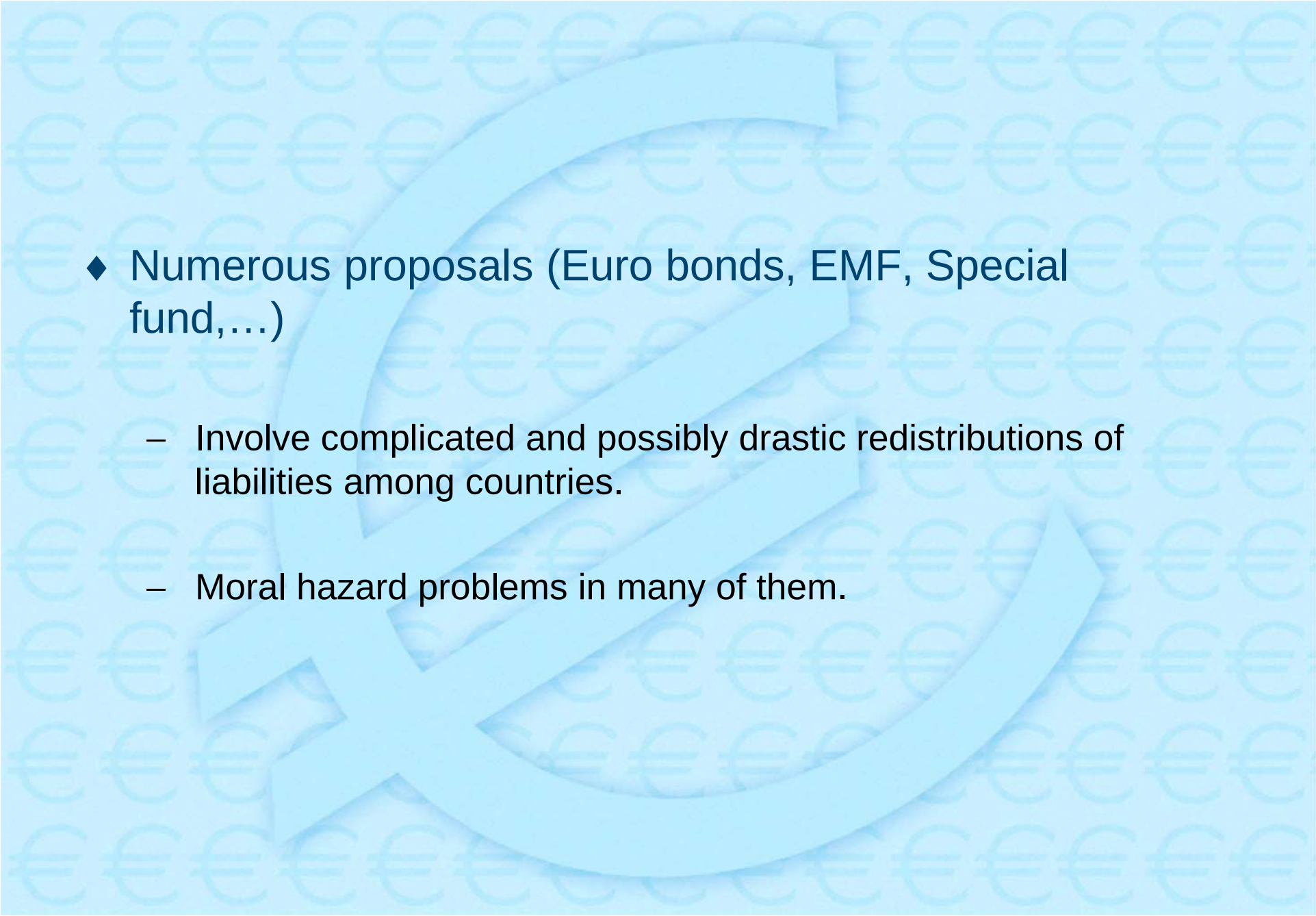
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- ◆ Banking union: SSM, bank resolution, deposit insurance.
 - ◆ Improved governance for more resilient EU/euro area.
 - European Semester, Six-pack, Two-pack, Fiscal compact...
 - ◆ **Implementation** of the new rules is crucial.
 - ◆ "Legacy" problem: what to do with the existing high levels of private and public debts? (see figure)

Figure 12: Greek and Irish public debt ratio 1970-2011



Sources: Eurostat ja European Commission. Forecast autumn 2011.

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- ◆ Numerous proposals (Euro bonds, EMF, Special fund,...)
 - Involve complicated and possibly drastic redistributions of liabilities among countries.
 - Moral hazard problems in many of them.