EZ Crisis: A Consensus Narrative

These slides are taken from “Rebooting the Eurozone: Step 1 – agreeing a crisis narrative”, CEPR Policy Insight No.85

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Today’s situation:  
EZ Crisis: a long way from recovery

The Eurozone Crisis is far from finished…

- Lacklustre growth and bleak economic prospects
- “Jobless Europe” for the youth
- Extremist views and nationalistic tendencies

…fragilities and imbalances are still present.

- Non-performing banking loans
- Feedback loops between banks and the sovereign via debt holdings
- Risky interest rate normalization
The causes of the EZ crisis

The core reality

EZ crisis as a ‘sudden stop’ crisis

• Abrupt end of capital flows $\rightarrow$ slow growth $\rightarrow$ increased public debt and deficit $\rightarrow$ public debt crisis

EZ Crisis amplifiers

• No lender of last resort
• No devaluation possibilities
• Vicious feedback cycle between banks and government
• Predominance of banking financing
• Rigid labor and product market
EZ crisis: a consensus narrative

Plan of lecture

- Building up problems
- Triggers of the crisis
- Phase one: failed bailouts and contagion
- Phase two: contagion spreads to the core
- Denouement
Building up problems

- Sharp drop in borrowing costs and the disappeared spreads
- Critical intra-EZ imbalance
  - Current account deficits
  - Investment versus saving
  - Competitive imbalance
- Public debt build up (not the driving force!)
- Private debt build up
  - EZ banks’ cross-border lending
  - Crisis prelude
Sharp drop in borrowing costs and the disappeared spreads

Source: OECD online database with author’s elaboration.
German long-run interest rates fell in line with global trends

Source: OECD online database with author’s elaboration.
Critical intra-EZ imbalance
current account imbalances

Peripheral EZ members generally ran current deficits while Core members generally ran current account surpluses.
Critical intra-EZ imbalance

Saving and investment imbalances

GIIPS generally saved less and invested more than average while Core EZ nations generally saved more and invested less than the average.
Critical intra-EZ imbalance
Public debt fell in most EZ nations

Government debt ratios improved for most EZ nations (especially Ireland and Spain) but Portuguese and Greek debt burdens soared
Critical intra-EZ imbalance
Bank debt rose rapidly in some EZ nations

Rapid accumulation of bank debt was a problem especially in Ireland, Spain, Italy and France
House prices rose in the GIIPS more than in the US while Germany’s fell.

Note: 1999 Q1=100.
Source: OECD online database. House price indices in real terms.
Total landing from core countries’ bank to the periphery (billion euros)

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Portugal</td>
<td>26</td>
<td>110</td>
<td>320</td>
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<tr>
<td>Ireland</td>
<td>60</td>
<td>348</td>
<td>481</td>
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<tr>
<td>Italy</td>
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<td>Greece</td>
<td>24</td>
<td>141</td>
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<tr>
<td>Spain</td>
<td>94</td>
<td>613</td>
<td>554</td>
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<tr>
<td>GIPS</td>
<td>204</td>
<td>1,212</td>
<td>495</td>
</tr>
<tr>
<td>Total</td>
<td>463</td>
<td>2,033</td>
<td>340</td>
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</tbody>
</table>

Note: EZ core is Germany, France, Austria, Belgium and the Netherlands
Prelude and Phase One of the Crisis in EZ Periphery

Note: The spreads are the difference between national 10-year government bond yields and those of Germany, in percentage points.
Source: OECD online database with author’s elaboration.
## Summary of pre-crisis imbalances

<table>
<thead>
<tr>
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<tbody>
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<td>Portugal</td>
<td>-96</td>
<td>-36</td>
<td>44%</td>
<td>262%</td>
<td>72</td>
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<td>Greece</td>
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<td>-47</td>
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<td>173%</td>
<td>109</td>
<td>9.9</td>
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<tr>
<td>Spain</td>
<td>-60</td>
<td>2</td>
<td>121%</td>
<td>296%</td>
<td>39</td>
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<td>Ireland</td>
<td>-21</td>
<td>14</td>
<td>464%</td>
<td>783%</td>
<td>43</td>
<td>11.6</td>
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<tr>
<td>Italy</td>
<td>-8</td>
<td>-26</td>
<td>85%</td>
<td>235%</td>
<td>102</td>
<td>1.8</td>
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<tr>
<td>EZ</td>
<td>-2</td>
<td>-17</td>
<td>94%</td>
<td>335%</td>
<td>69</td>
<td>0.0</td>
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<tr>
<td>France</td>
<td>6</td>
<td>-23</td>
<td>180%</td>
<td>395%</td>
<td>68</td>
<td>-2.9</td>
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<tr>
<td>Austria</td>
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<td>-19</td>
<td>305%</td>
<td>379%</td>
<td>69</td>
<td>-3.2</td>
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<tr>
<td>Germany</td>
<td>27</td>
<td>-19</td>
<td>18%</td>
<td>316%</td>
<td>65</td>
<td>-4.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>47</td>
<td>-5</td>
<td>83%</td>
<td>392%</td>
<td>92</td>
<td>-1.1</td>
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<tr>
<td>NL</td>
<td>48</td>
<td>-5</td>
<td>-9%</td>
<td>375%</td>
<td>55</td>
<td>2.8</td>
</tr>
<tr>
<td>Finland</td>
<td>61</td>
<td>33</td>
<td>101%</td>
<td>197%</td>
<td>33</td>
<td>-4.9</td>
</tr>
<tr>
<td>Lux'g</td>
<td>98</td>
<td>23</td>
<td>-577%</td>
<td>2367%</td>
<td>14</td>
<td>5.5</td>
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</tbody>
</table>

Note: ‘Excess’ inflation is the nation’s cumulative inflation rate minus that of the EZ average.
Source: OECD online database with author’s elaboration.
Triggers of the crisis

- October 2009: Greece budget deficit unmasked
- Six-moth attempt of ‘self rescue’ – failed
- Greece trapped into a public debt vortex
  - Debt loop
  - Austerity loop
Phase One: failed bailouts and contagion

- Failed bailouts - Greece’s borrowing cost continued to soar
- Contagion in the periphery
  - Public debt vortexes: Portugal
  - Bank debt vortexes → public debt vortexes: Ireland

Figure: Prelude and Phase One of the Crisis in EZ Periphery
Phase Two: contagion spreads to the core

- Mismanagement of the bailouts give rise to a general fear
- Pro-cyclical fiscal tightening further stoking contagion
- Self-feeding panic: Good equilibrium, bad equilibrium
Fiscal policy turned pro-cyclical from 2010

Note: Inspired by Carrot and de Castro (2015) with author’s elaborating using IMF WEO data.
### Pro-cyclical fiscal policy, 2010 to 2014

<table>
<thead>
<tr>
<th></th>
<th>% of own potential GDP</th>
<th>bill EUR</th>
<th>share of EZ swing</th>
<th>share EZ 2014 GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2010 to 2014 swing</strong></td>
<td></td>
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<tr>
<td>Greece</td>
<td>7%</td>
<td>14</td>
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<td>2%</td>
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<td>Italy</td>
<td>2%</td>
<td>28</td>
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<td>16%</td>
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<td>Portugal</td>
<td>9%</td>
<td>17</td>
<td>5%</td>
<td>2%</td>
</tr>
<tr>
<td>Spain</td>
<td>5%</td>
<td>53</td>
<td>16%</td>
<td>11%</td>
</tr>
<tr>
<td>EZ</td>
<td>4%</td>
<td>340</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Austria</td>
<td>1%</td>
<td>2</td>
<td>1%</td>
<td>3%</td>
</tr>
<tr>
<td>Belgium</td>
<td>0%</td>
<td>2</td>
<td>0%</td>
<td>4%</td>
</tr>
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<td>Finland</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>2%</td>
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<td>France</td>
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<td>108</td>
<td>32%</td>
<td>29%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1%</td>
<td>1</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2%</td>
<td>15</td>
<td>5%</td>
<td>6%</td>
</tr>
</tbody>
</table>
Phase Two: contagion spreads to the core

Spreads started to rise for Belgium, France and Austria – as well as Italy and Spain

![Graph showing spreads and bailout events]
Denouement

- Agreement on Banking Union and the Fiscal compact
- Draghi’s “whatever it takes”

Figure: Yields converged again after Draghi’s intervention
Proximate causes, and causes of the causes

Proximate cause
- Sudden stop in inter-EZ lending
- Loss of independent monetary policy after euro adoption

Cause of the cause
- Policy failures that allowed the imbalance to get so large
  - Failure to control national debt
  - Failure to control excessive bank leverage
- Lack of institutions to absorb shocks at the EZ level
- Failings in real-time crisis management
Concluding remarks

This essay has identified proximate causes, the causes of the proximate causes of the RZ crisis and provide and crisis narrative.

How we got here…

• Fundamental design flaws of the EMU

…the way ahead

• Lots of suggestions, no consensus
• Both on where to go, and on how
• We need a systematic rethinking how to get Europe working again
The End