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 → slow growth → increased public debt and deficit → 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

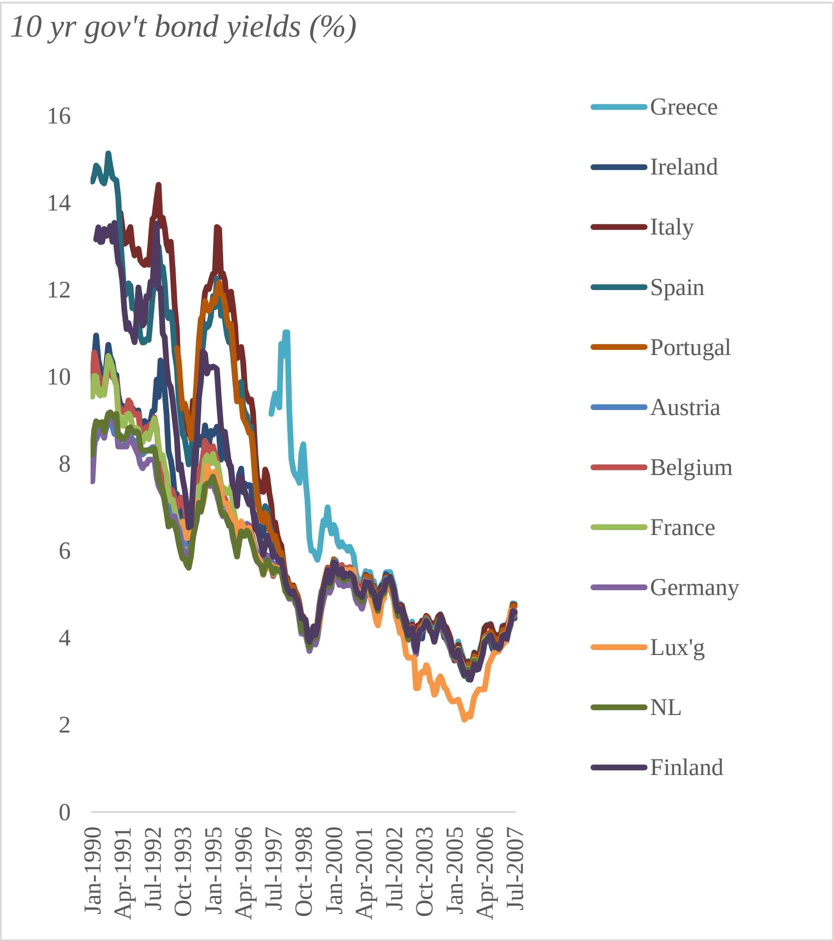
Plan of lecture

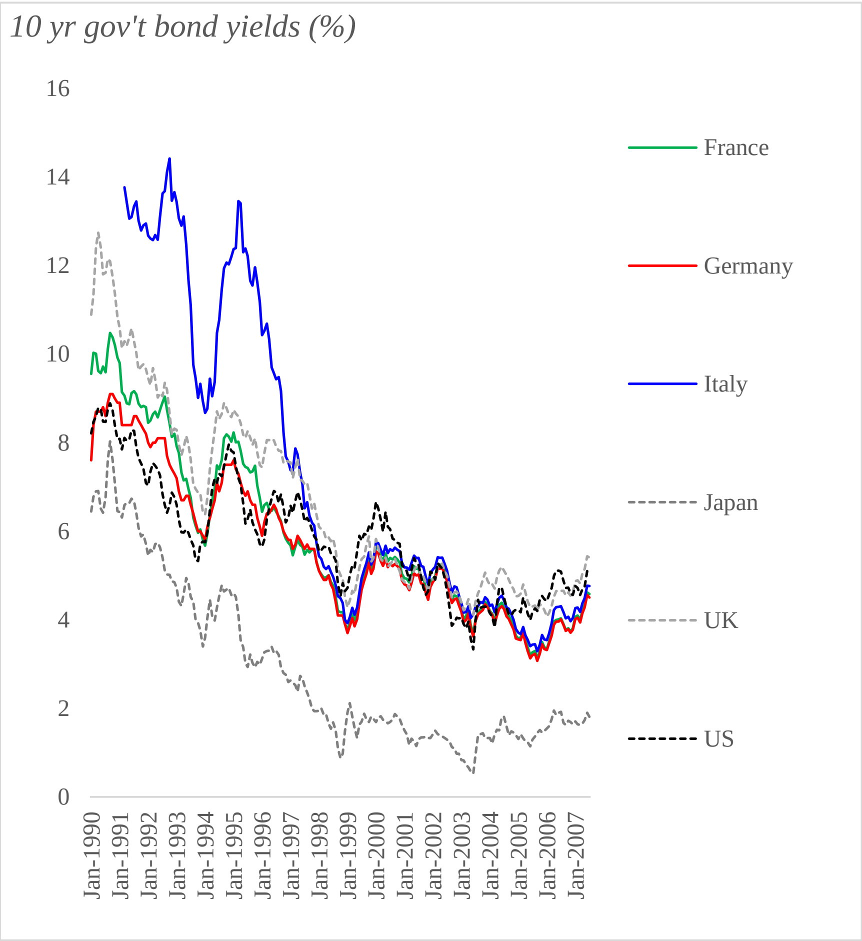
- Building up problems
- Triggers of the crisis
- Phase one: failed bailouts and contagion
- Phase two: contagion spreads to the core
- Denouement

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

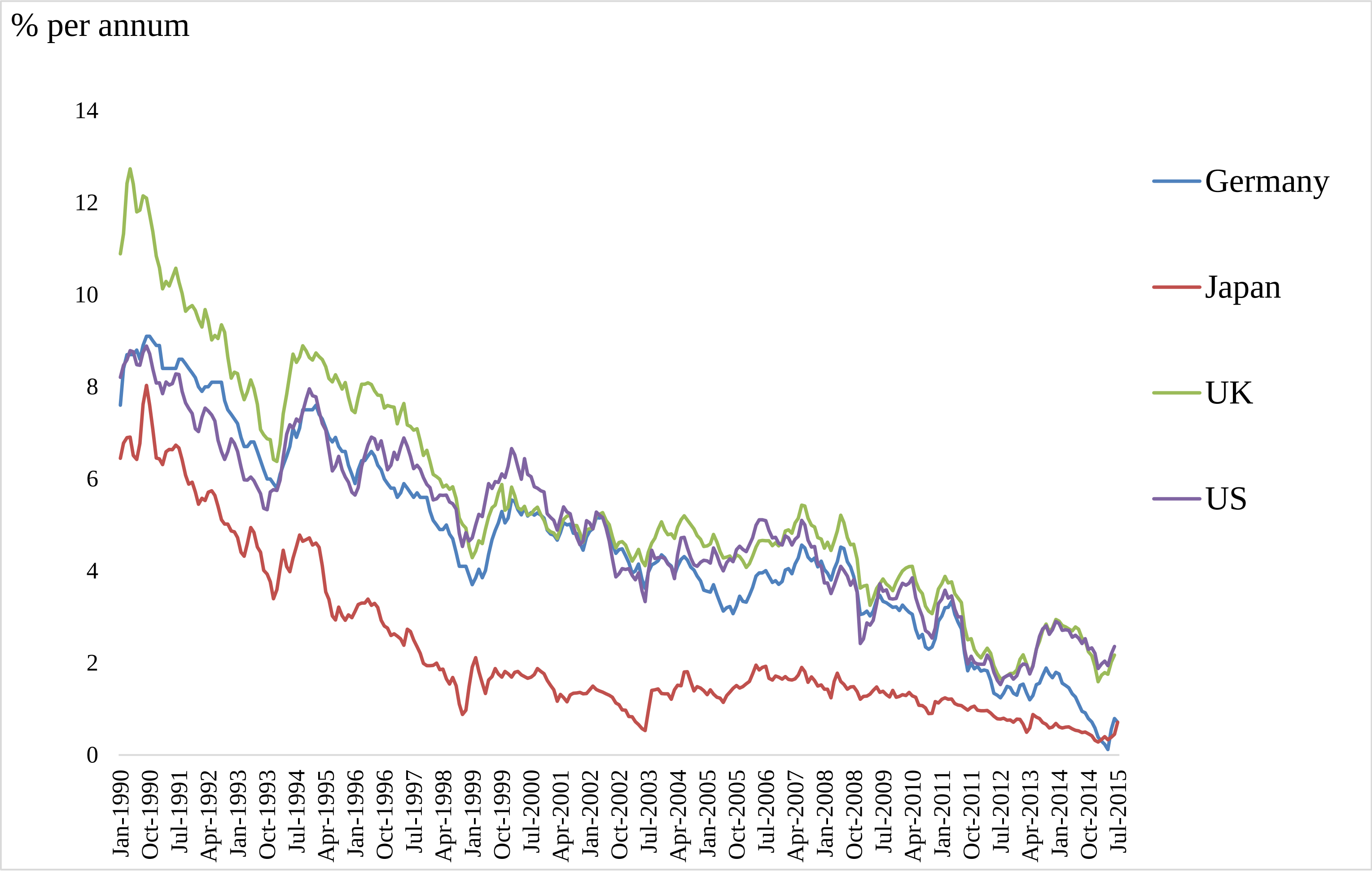
Sharp drop in borrowing costs and the disappeared spreads





Source: OECD online database with author's elaboration.

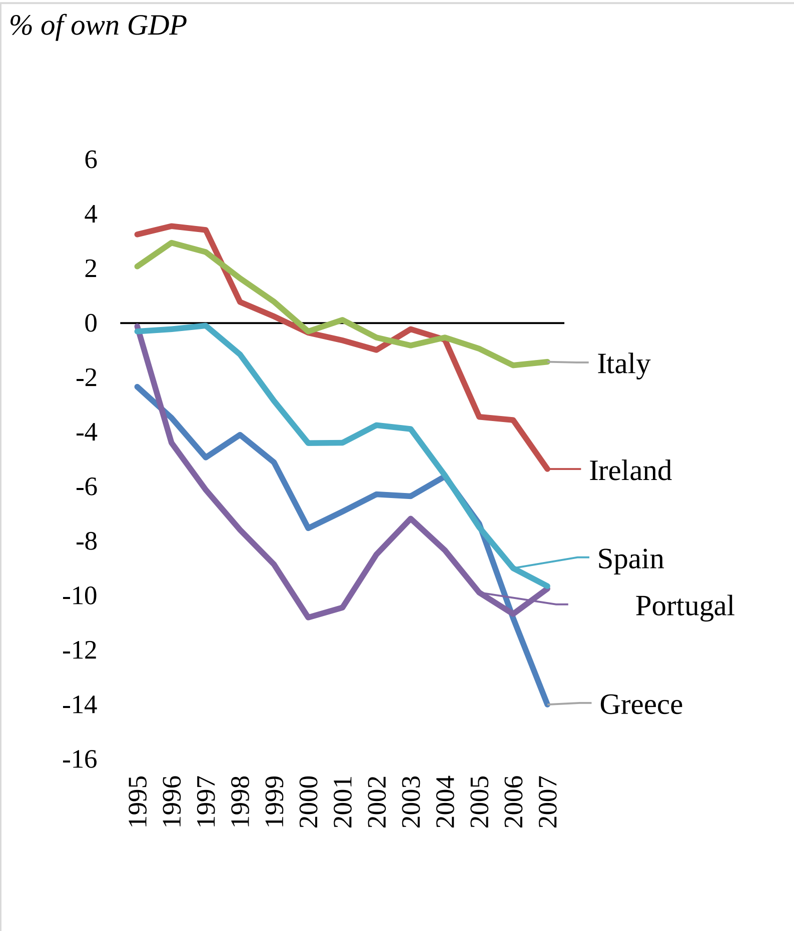
German long-run interest rates fell in line with global trends

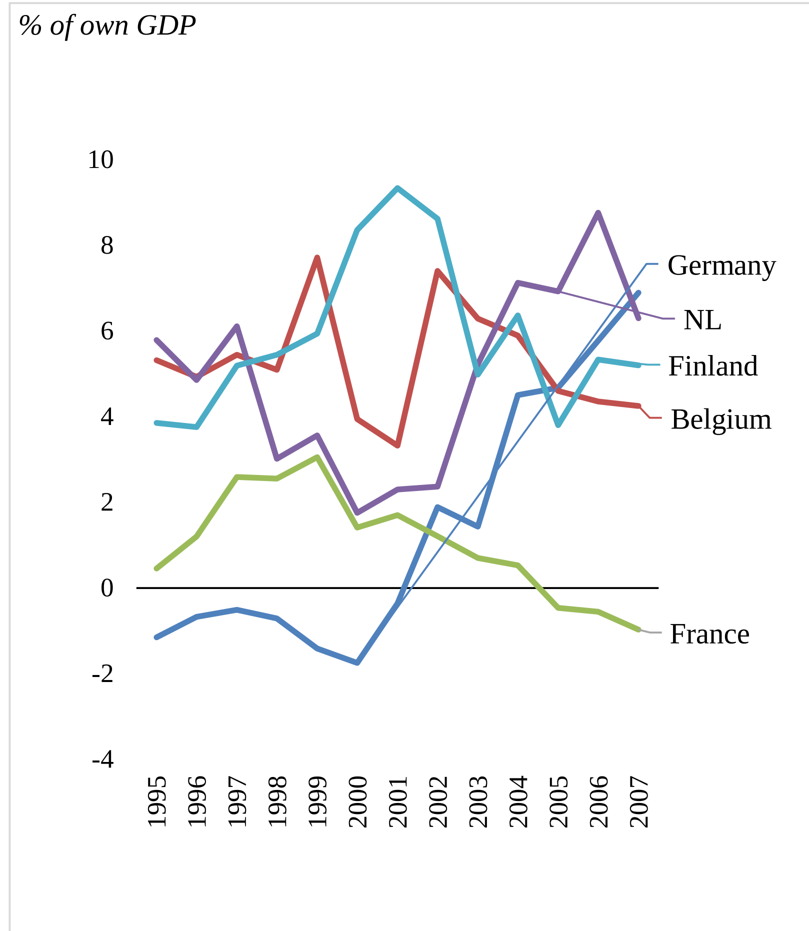


Source: OECD online database with author's elaboration.

Critical intra-EZ imbalance

current account imbalances

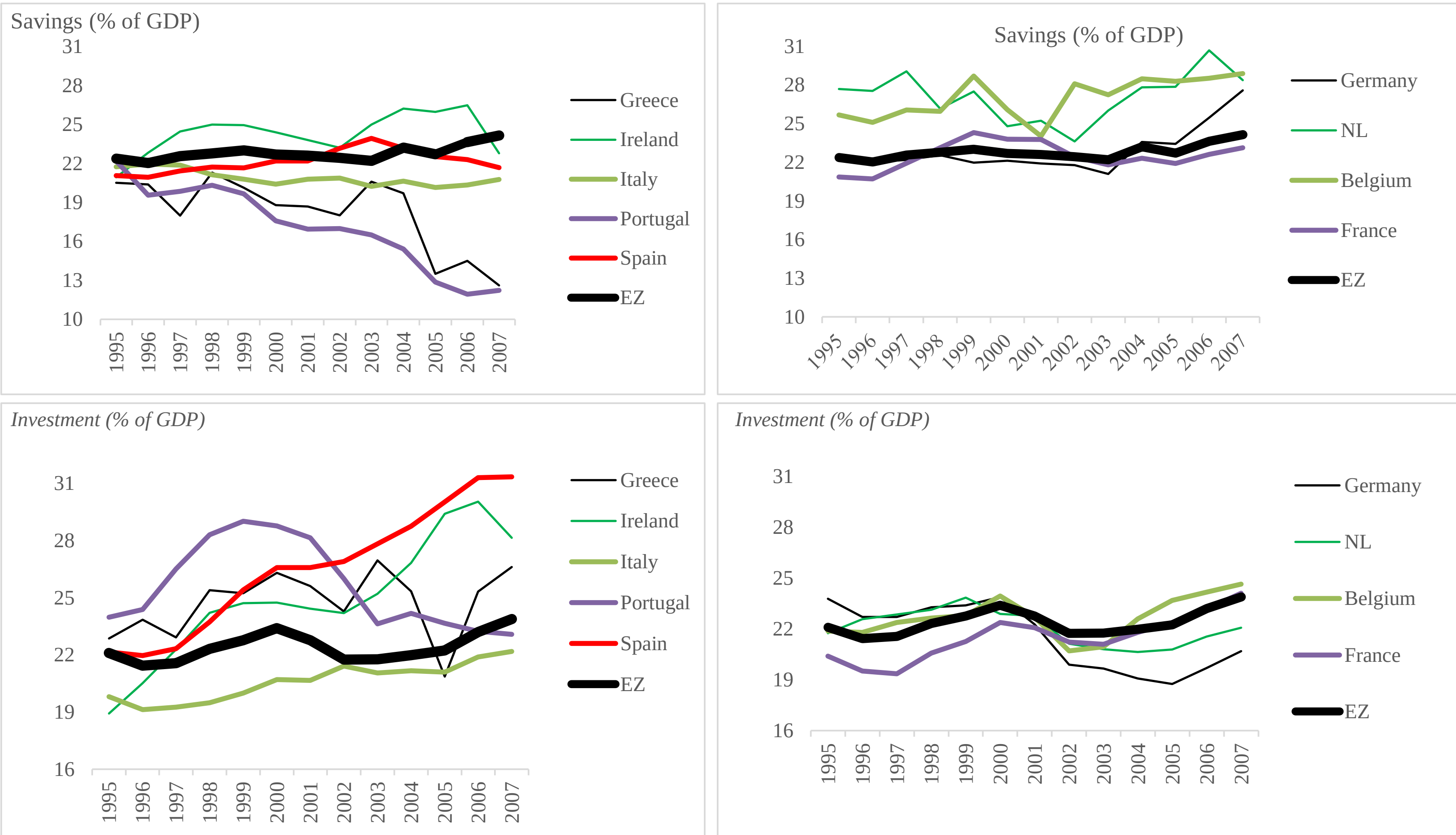




Peripheral EZ members generally ran current deficits while Core members general ran current account surpluses

Critical intra-EZ imbalance

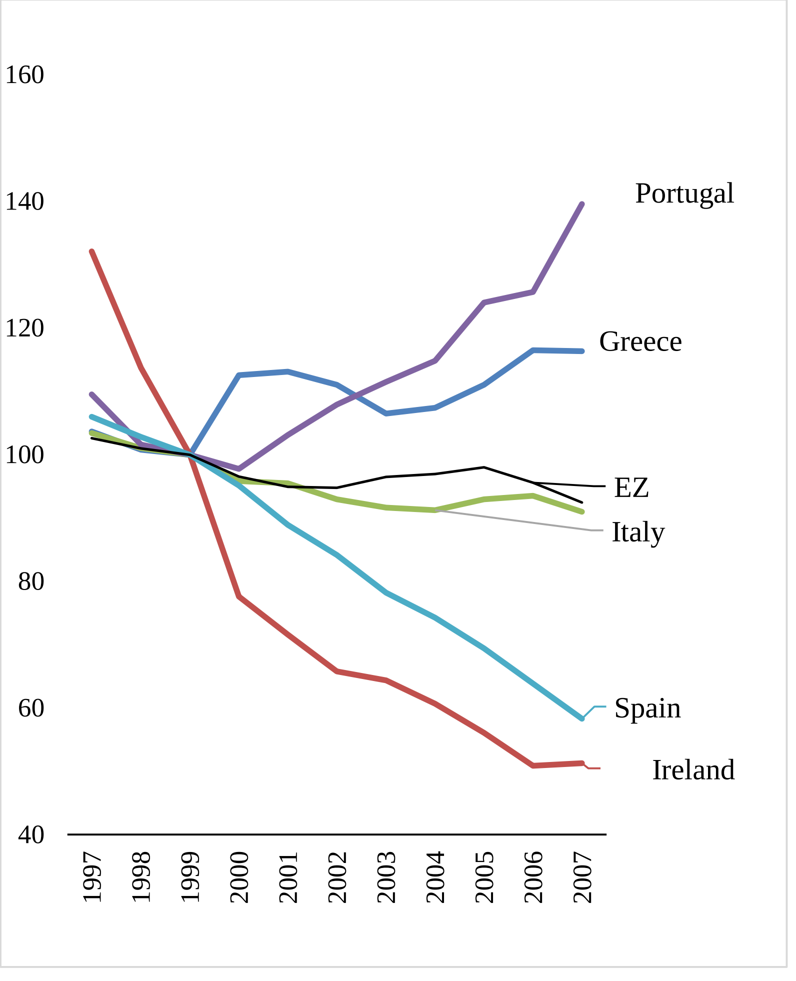
Saving and investment imbalances

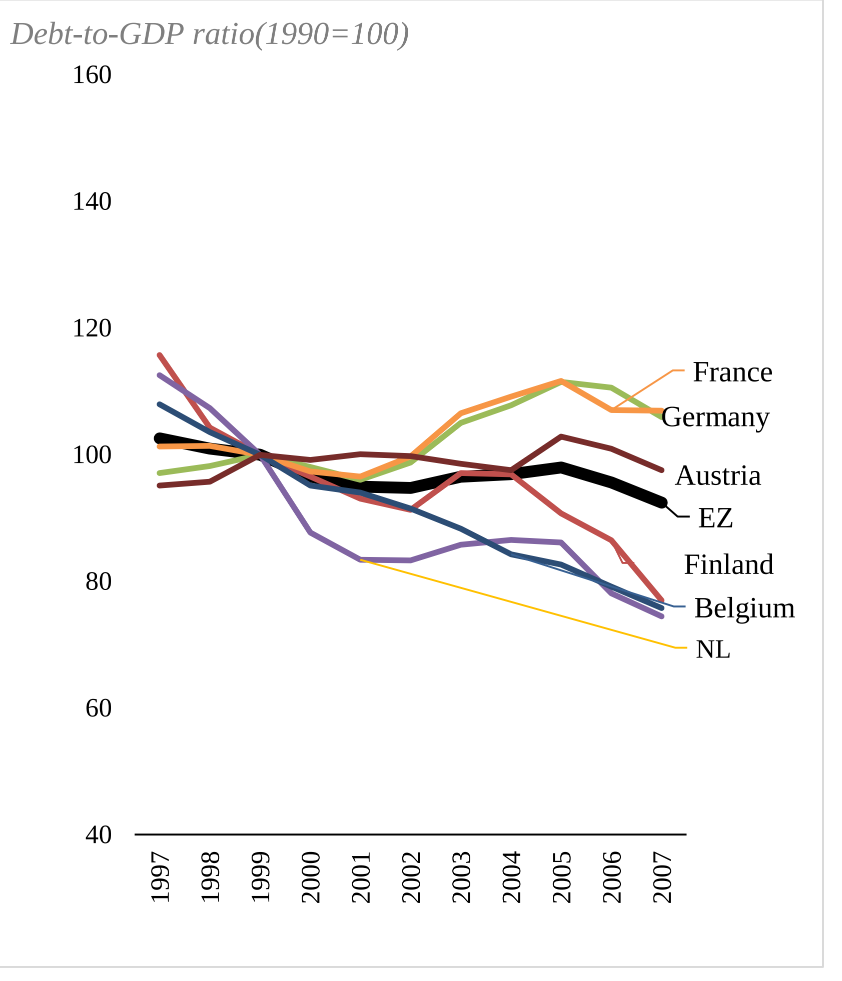


GIIPS generally saved less and invested more than average while Core EZ nations generally saved more and invest less the average

Critical intra-EZ imbalance

Public debt fell in most EZ nations

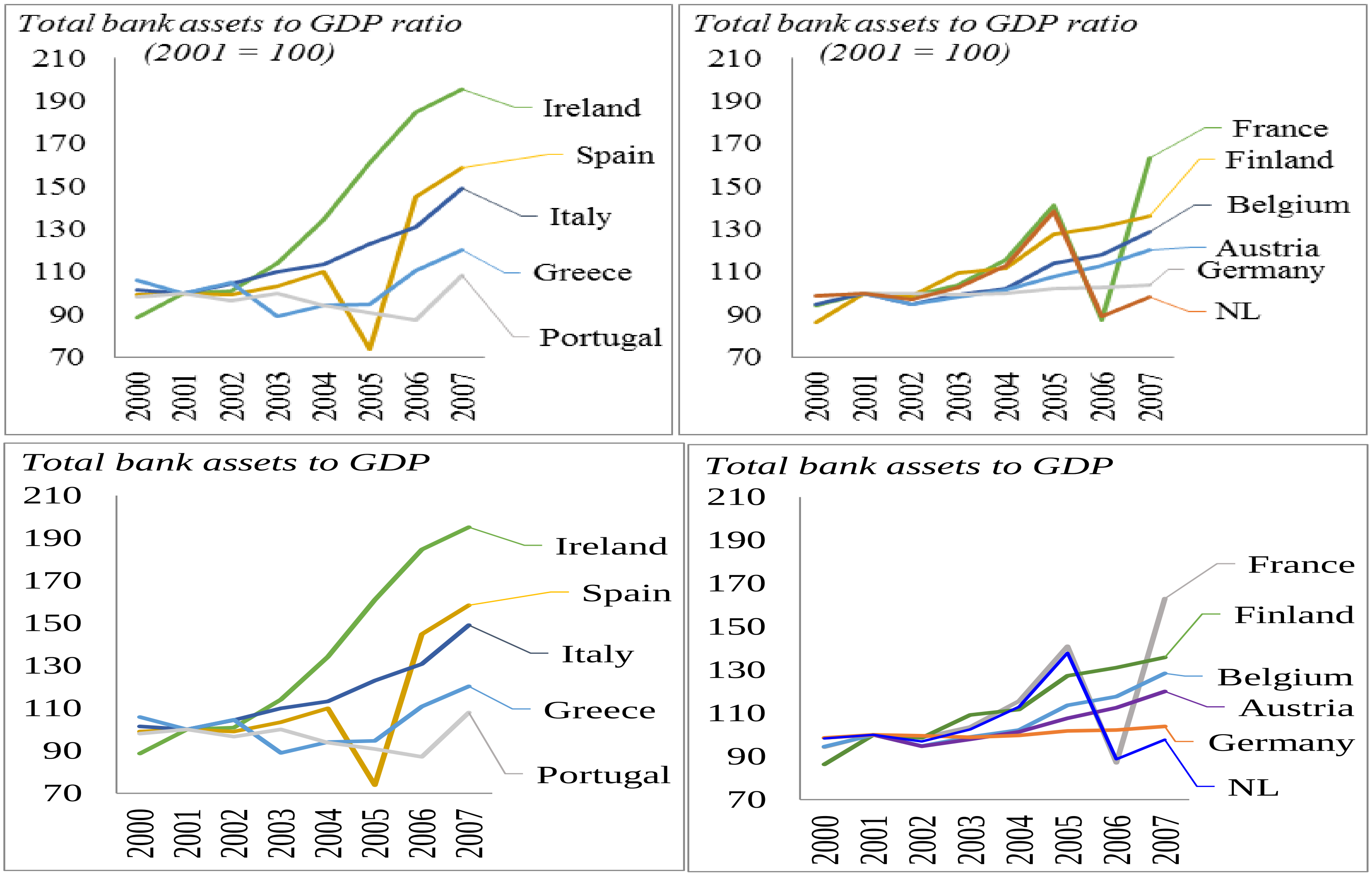




Government debt ratios improved for most EZ nations (especially Ireland and Spain) but Portuguese and Greek debt burdens soared

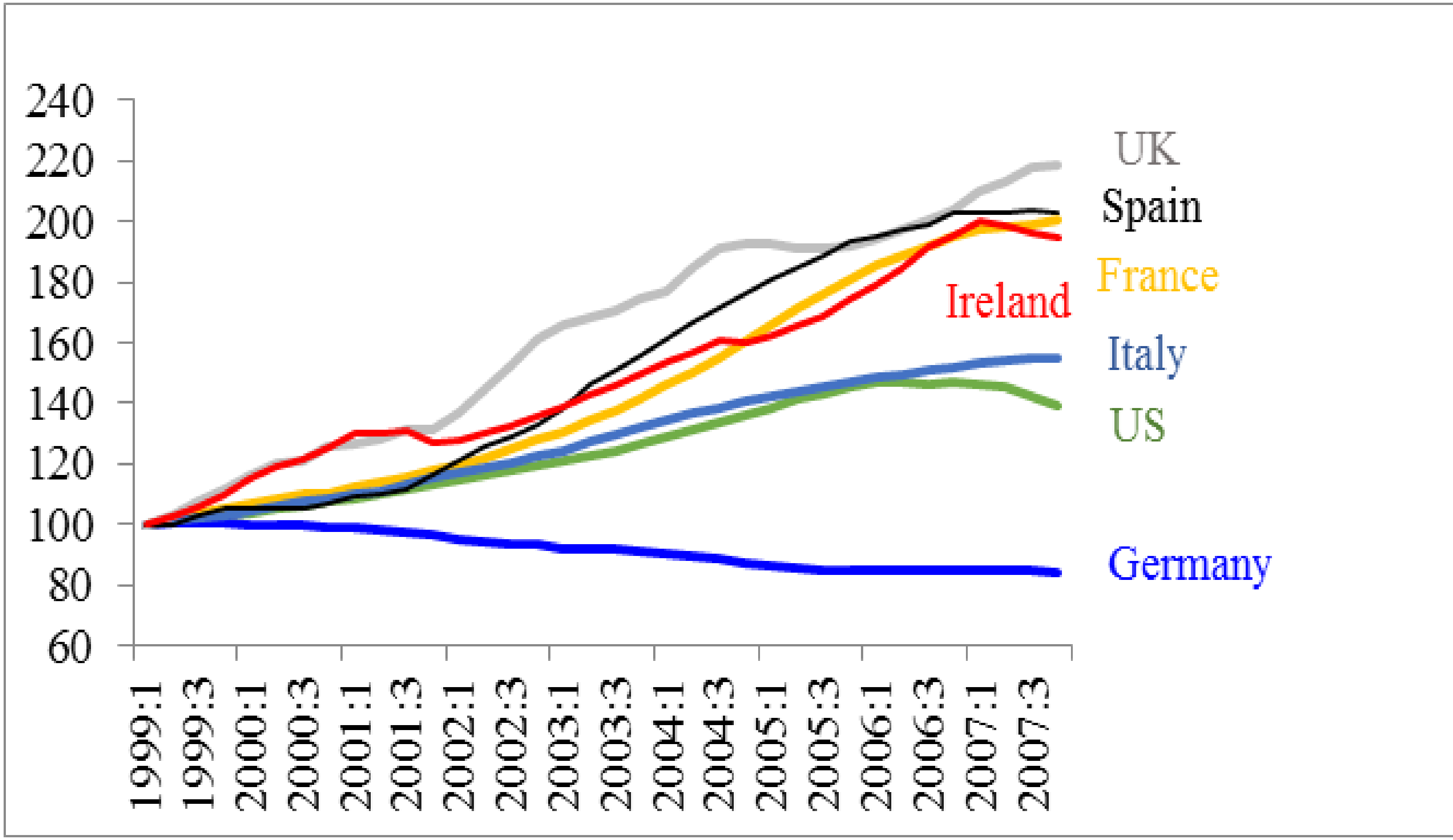
Critical intra-EZ imbalance

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.

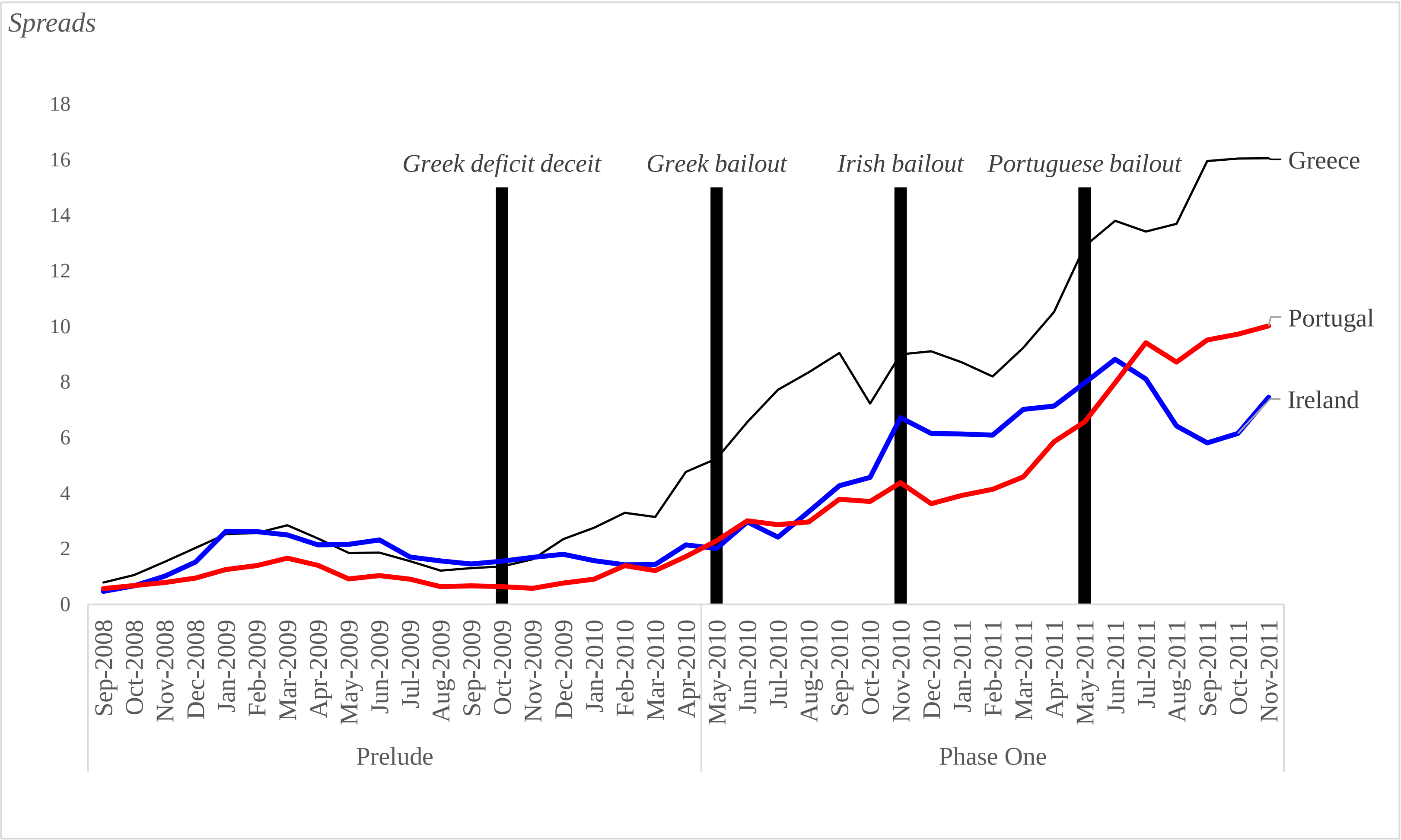
Source: OECD online database. House price indices in real terms.

Total landing from core countries' bank to the periphery (billion euros)

	1999 4th quarter	2009 4th quarter	% change 99-2009
Portugal	26	110	320
Ireland	60	348	481
Italy	259	822	217
Greece	24	141	491
Spain	94	613	554
GIPS	204	1,212	495
Total	463	2,033	340

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 bound yields and those of Germany, in percentage points.
Source: OECD online database with author's elaboration.

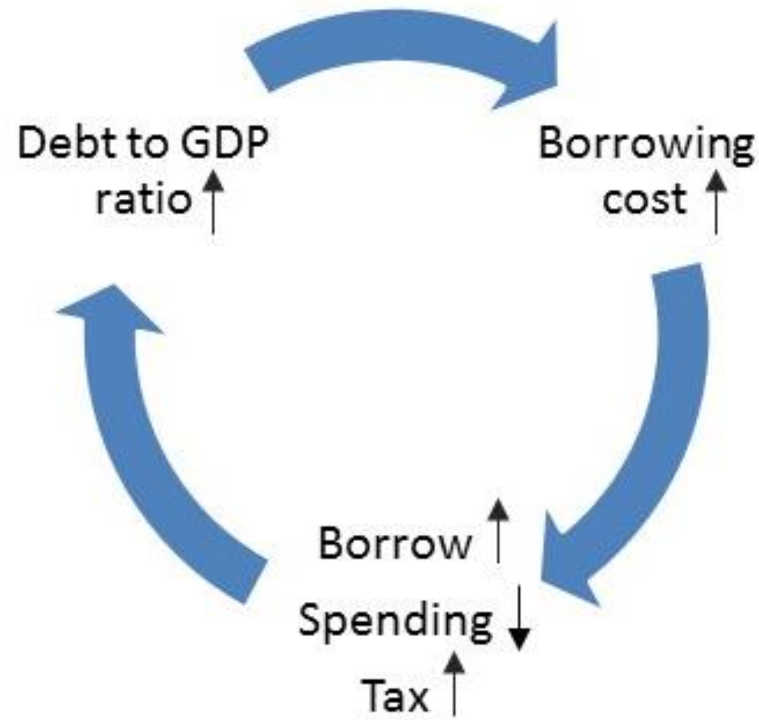
Summary of pre-crisis imbalances

	1999 to 2007 (% of own GDP)		Bank assets (% of GDP)		%	
	Cumulative current account balance	Cumulative budget deficit	2000 to 2008 increase (p.p.)	Bank assets, 2008	Debt-GDP ratio, 2008	Excess inflation (1999-2007)
Portugal	-96	-36	44%	262%	72	7.5
Greece	-84	-47	36%	173%	109	9.9
Spain	-60	2	121%	296%	39	9.2
Ireland	-21	14	464%	783%	43	11.6
Italy	-8	-26	85%	235%	102	1.8
EZ	-2	-17	94%	335%	69	0.0
France	6	-23	180%	395%	68	-2.9
Austria	16	-19	305%	379%	69	-3.2
Germany	27	-19	18%	316%	65	-4.8
Belgium	47	-5	83%	392%	92	-1.1
NL	48	-5	-9%	375%	55	2.8
Finland	61	33	101%	197%	33	-4.9
Lux'g	98	23	-577%	2367%	14	5.5

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

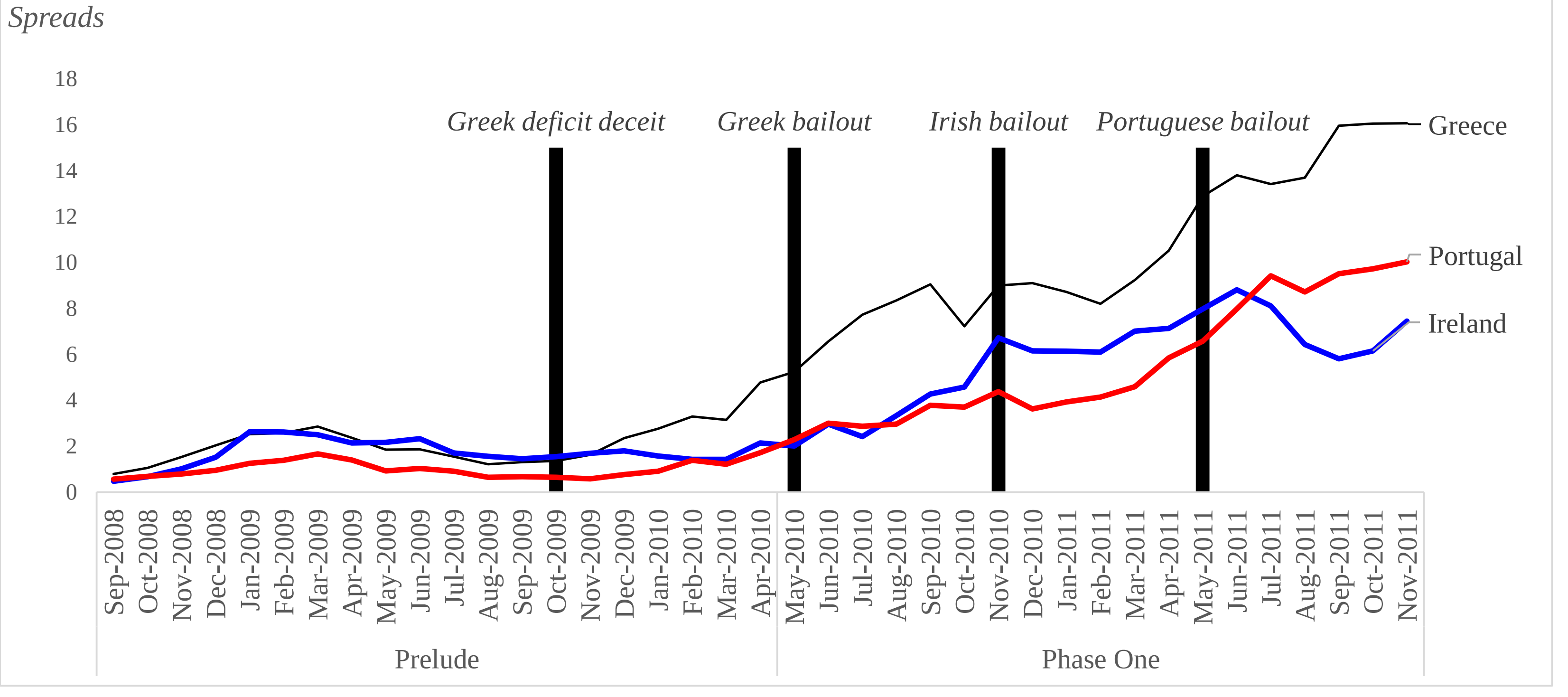
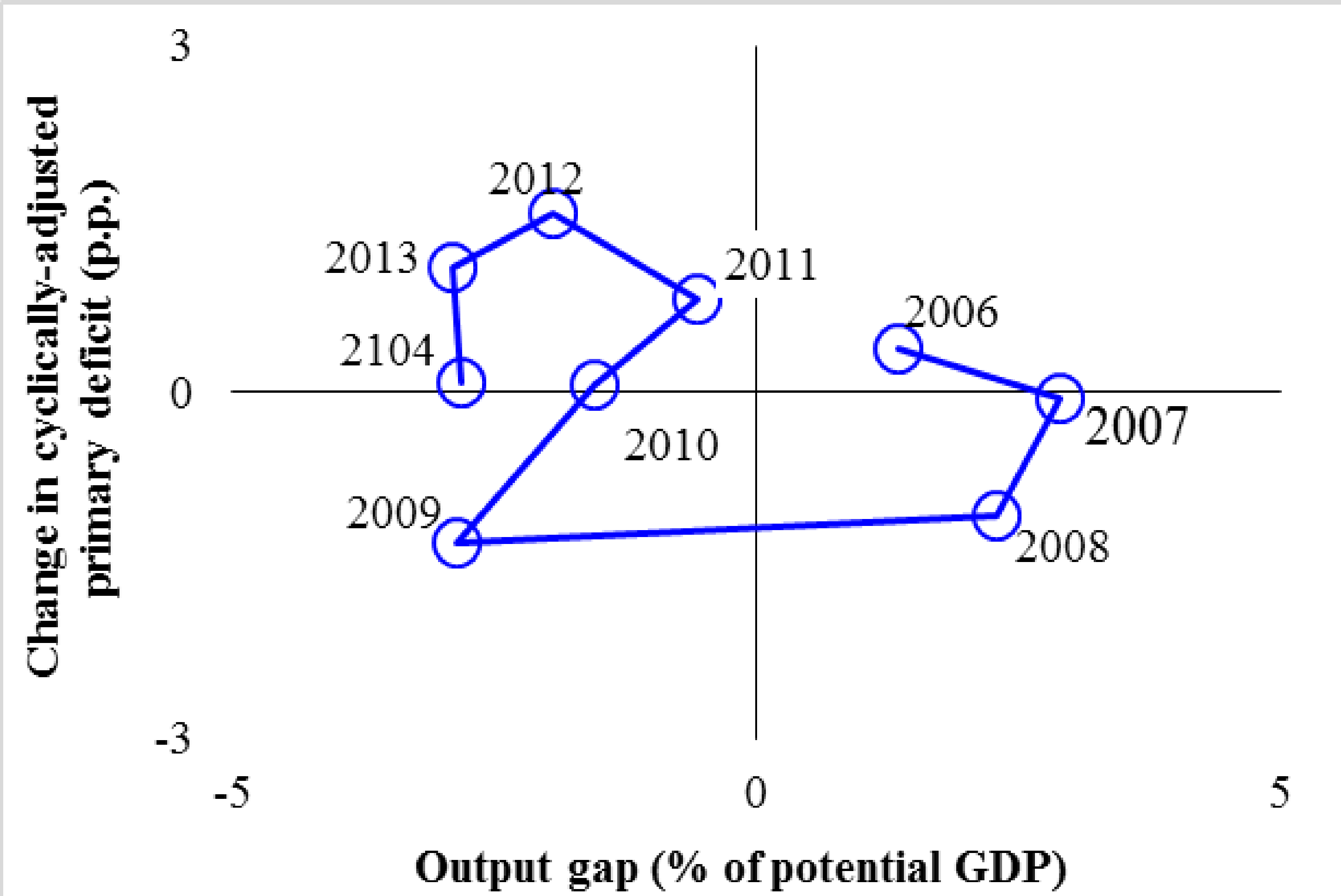


Figure : Prelude and Phase One of the Crisis in EZ Periphery

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



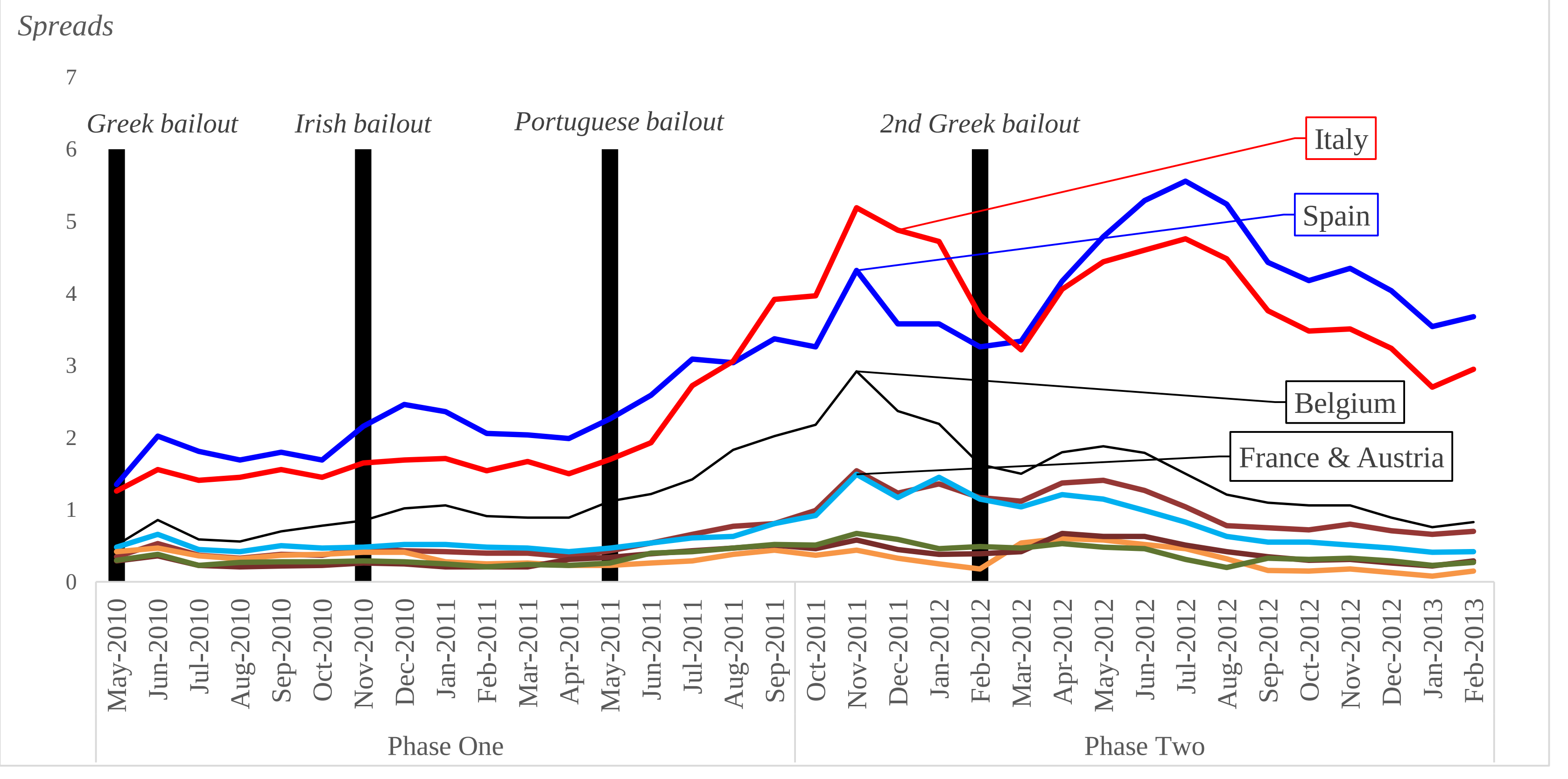
Note: Inspired by Carrot and de Castro (2015) with author's elaborating using IMF WEO data.

Pro-cyclical fiscal policy, 2010 to 2014

	% of own potential GDP	bill EUR	%	%
	2010 to 2014 swing	2010 to 2014 swing	Share of EZ swing	Share EZ 2014 GDP
Greece	7%	14	4%	2%
Ireland	28%	49	14%	2%
Italy	2%	28	8%	16%
Portugal	9%	17	5%	2%
Spain	5%	53	16%	11%
EZ	4%	340	100%	100%
Austria	1%	2	1%	3%
Belgium	0%	2	0%	4%
Finland	0%	0	0%	2%
France	2%	46	13%	21%
Germany	4%	108	32%	29%
Luxembourg	1%	1	0%	0%
Netherlands	2%	15	5%	6%

Phase Two: contagion spreads to the core

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



Denouement

- Agreement on Banking Union and the Fiscal compact
- Draghi's "whatever it takes"

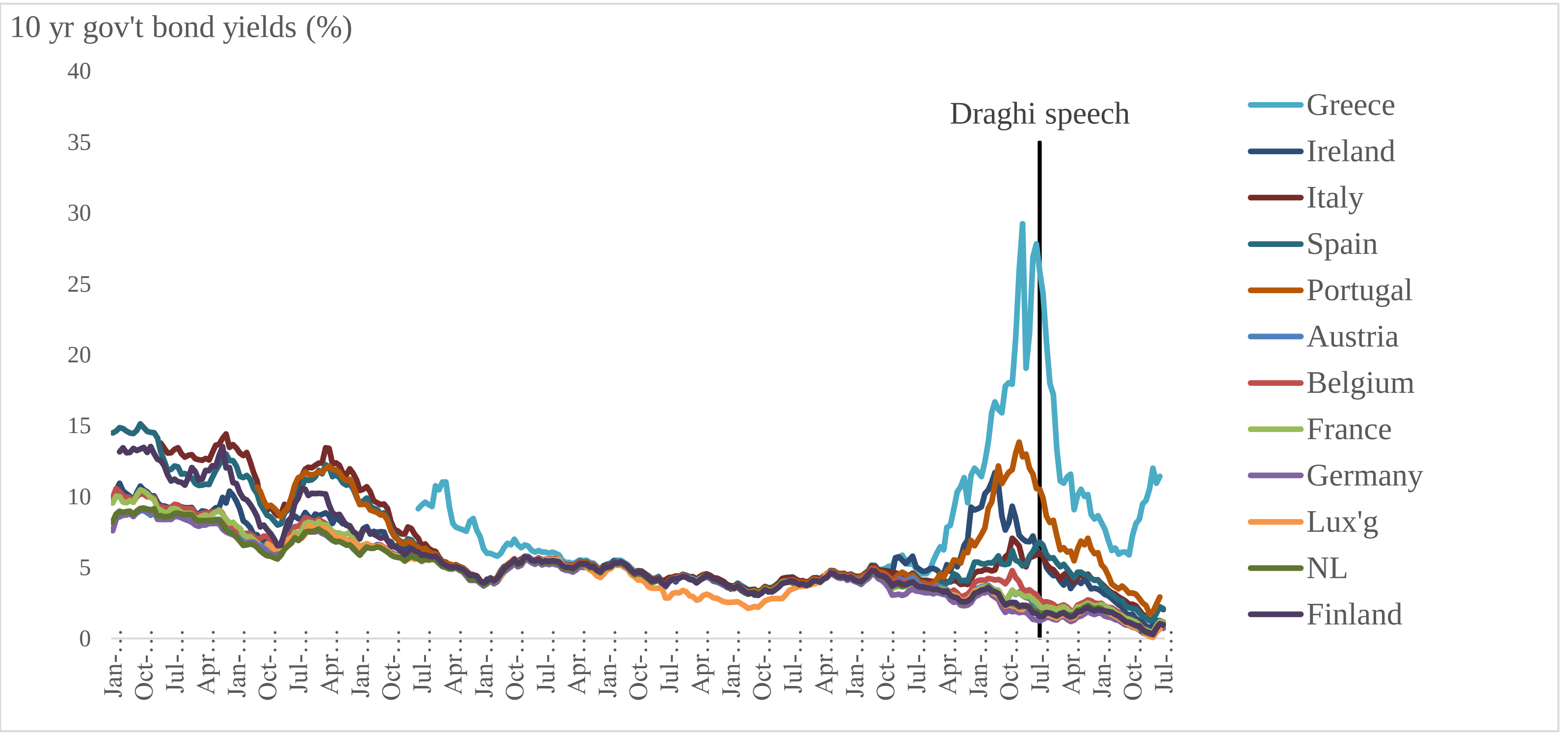


Figure: Yields converged again after Draghi's intervention

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