

# International Monetary Economics: The Euro Crisis

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# The Euro Area in Crisis

- A few years ago it was common to hear global economic policy makers and journalists remark on what a great success the Euro was.
- Today's top FT headline was "Businesses Plan for Possible End of Euro."
- How did we get here?
- This is a very complex subject and I can't do justice to it in the time we have today.
- I'll focus my comments on:
  - ① Why sovereign default is a big issue for various Eurozone countries.
  - ② How debt crises traditionally evolve.
  - ③ Why the crisis has moved on from Greece to other countries, particularly Italy.
  - ④ Issues related to euro exit.
  - ⑤ Current policy options.

# The Euro and the Debt Crisis

- The story of for each country in difficulty in Euro area is a little different but the trigger for the crisis was the massive and unexpected loss of output by the 2008/2009 global recession (most Euro area countries are not yet back to pre-recession output levels).
  - 1 Some countries (e.g. Greece and Italy) had poor fiscal records even during the good times but the impact on their debt of the large recession moved their debt burdens up to dangerous levels.
  - 2 Other countries (e.g Ireland and Spain) went through large housing boom and bust cycles and the loss of housing-related revenue and jobs and the costs of saving banking systems threatened fiscal sustainability.
- What binds these countries together is their inability to use some of the key policy tools often used when a country is in crisis:
  - 1 Monetary policy is set by the ECB and these countries have no separate exchange rate. So they cannot devalue their currency to boost growth via stronger exports and weaker imports.
  - 2 They cannot get their national central bank to directly purchase their debt because this is against Eurosystem rules.

# Three Responses to Debt Crisis

- There is a large literature on debt crisis and how they end.
- Traditionally, countries with very high debt-GDP levels reduce them in one of three ways:
  - 1 **High Rates of Nominal GDP Growth:** It is rare to see countries actually pay down large amounts of nominal debt. Instead, debt ratios come down mainly through high growth in the denominator, i.e. nominal GDP. In many cases, it is high rates of inflation that drives this growth.
  - 2 **Financial Repression:** Governments can pass laws that force banks or pension funds to hold their debt even if it carries a low rate of interest. See the Carmen Reinhart article linked to on the website.
  - 3 **Default:** This can mean anything from a large write-down of the principal on sovereign debt owed to an extension of the maturity.
- The countries with debt problems in the Euro Area cannot rely on high nominal growth (conditions are poor for real GDP growth and the ECB will not consider high inflation). And financial repression measures are generally inconsistent with free movement of capital required by EU law. That leaves the third option—default.

# Greece and The EU

- By early 2010, the bond market was unwilling to lend to Greece and most analysts believe a Greek default was inevitable.
- Rather than let Greece default in 2010, the EU and IMF provided large amounts of new loans.
- By Summer 2011, the EU had decided that Greece's private sector debt would be "restructured" with a 21 percent reduction proposed in July, quickly replaced by a 50 percent reduction in October.
- Because the EU, IMF and ECB will not take "haircuts" on their Greek debts, the European Commission calculates that Greece would still have a debt-GDP ratio of 120 percent by 2020, even after years of fiscal austerity.
- At some point, despite all negatives involved, Greece may decide that euro membership isn't worth giving up the various "heterodox tools" (exchange rate depreciation, printing money, financial repression) that are traditionally used to solve debt crises.
- While previously claiming it was inconceivable anyone could leave the Euro, Merkel and Sarkozy's recent "ja" or "nein" ultimatum to the Greeks shows that they are now willing to consider this option.

# The Crisis Moves to Italy

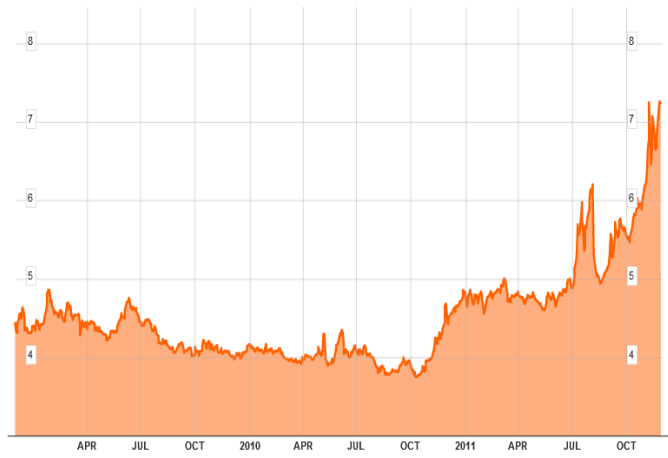
- Sovereigns are like illiquid banks that rely on the confidence of their creditors to keep operating. Their reputation as good credits relies on their ability to tax their citizens. However, at any point in time, most government revenue is pre-allocated to various spending programmes and there are usually severe political limits on the size of tax increases and spending cuts that can be implemented at any point in time.
- This means that even governments that are not running deficits are reliant on the confidence of the bond market to continue rolling over their existing debts, while those running deficits are even more reliant on bond market sentiment.
- We discussed back in Part 14 how sovereign bond markets can quickly close when the perceived probability of default increases from very small to four or five percent. The funding cost then makes the debt unsustainable and suddenly the market closes and default quickly becomes inevitable.
- Once it became clear that the EU would allow default on Greek bonds held by the private sector, these dynamics were set in train for Italy.
- The next slide, taken from Peter Boone's recent presentation at TCD summarises this process well.

## Italy's Dangerous Situation



**Ceteris Paribus, Italy needs an additional 6% GDP primary surplus to keep debt stable !**

# Italian Ten Year Bond Yields



## Too Big to Fail? Too Big to Save?

- Italy has almost €2 trillion in public debt, equivalent to about 20 percent of Euro area GDP.
- An Italian default would cause huge disruption throughout the global financial system. It would likely trigger further knock-on sovereign and bank defaults.
- Many Italian banks would be insolvent. If the Italian government had to use public funds to recapitalise them, then the necessary haircut on the default would need to be bigger.
- The strains in the system caused by such a default may well trigger a decision by Italy to leave the euro, redenominate its debt in lira, and have its central bank allow it to roll over the debt.
- Can this scenario be prevented?
- The current EFSF bailout fund is not large enough to fund Italy: Next year, it will take about €300 billion to fund Italy's maturing debt and deficit. The EFSF only has about €250 billion left.

## Leaving the Euro: Logistics

- Can a country actually leave the euro? The euro is intended to be fixed and irrevocable, so there is no official legal way to leave.
- See the ECB legal working paper on the website. Leaving the euro likely involves reneging on Treaty commitments and those leaving the EU altogether.
- If people expect that the new currency will be worth less than the old one, then they will likely pull their money out of domestic banks and look to send it abroad. To some extent, this is already happening in Greece and elsewhere. But an official pre-announced plan to leave would cause chaos.
- An exit would likely work as follows:
  - ▶ It would occur over a weekend.
  - ▶ Banks would not re-open the following Monday and payment systems would be shut down.
  - ▶ A law would be passed redenominating all deposit accounts.
  - ▶ When ATM machines start working again, they would dispense euro notes with a new stamp to indicate they they're not euros, they're drachmas, liras, whatever. And, within a week or two, new notes would be dispensed replacing the stamped euros.

# The End of the Euro: The Mother of All Crises?

- If one country left, it is likely that investors and depositors would anticipate that others would also leave.
- To prevent massive outflows of capital, these countries may need to impose capital controls.
- It would be difficult to re-establish the euro as a common currency after restrictions have been put in place that prevent euros moving from one country to another: An Irish euro would no longer be the same as German euro.
- Financial chaos is likely to ensue. The meaning of financial contracts denominated in euro would be completely uncertain. There would be large-scale defaults as creditors with lira and drachma assets may be unable to pay back foreign liabilities previously denominated in euro.
- While the world would pull through in the end, the resulting uncertainty would likely make Lehman Brothers look like a tea party.

# ECB Bond Buying and Leveraged EFSF

- One policy that would ease the possibility of default in Italy and elsewhere is a decision by the ECB to create money to buy new government bonds.
- However, the ECB is legally forbidden from purchasing bonds directly from government.
- It can purchase bonds on the secondary markets and is doing so in small quantities with its Securities Markets Programme. In large quantities, this could be a “nod and wink” way of financing governments as participants at primary debt issues quickly sell their bonds to the ECB.
- But the ECB does not want to do this because they worry about their reputation for independence and about the potential inflationary consequences. They have been supported in this stance by Germany.
- An alternative option is to use the EFSF's remaining €250 billion to cover losses for private investors buying government bonds, i.e. “leveraging the EFSF”. This is the current official policy but it seems unlikely to produce enough bond-buying power to solve the debt crisis.
- And the IMF simply does not have enough lending capacity to bailout Italy, Spain etc.

# EFSF As a Bank or ECB-to-IMF Loans?

- Two options that are currently being resisted by the ECB but which would at least avoid them directly purchasing bonds:
  - ① **EFSF as a Bank:** Give EFSF a banking licence. It could then buy government bonds, use these bonds as collateral for loans with ECB, then use the ECB-loaned funds to buy more bonds. In this fashion, the EFSF bank could quickly be leveraged up to €2 trillion or €3 trillion or whatever it takes. (The Euro area assigns Euro-denominated sovereign bonds a zero risk weight, so there's really no limit.)
  - ② **ECB-to-IMF:** The ECB loans money to the IMF, which then provides it to peripheral countries provided they agree to IMF monitoring of adjustment programmes.
- As of now, the ECB are resisting these options. Will they blink and if so when? Perhaps when an Italian bond auction fails.
- There are lots of possible outcomes but I don't have time to go through them all. Gavyn Davies's graph from his FT column (on the next page) gives a good sense of the different possibilities.

# Gavyn Davies's Graph

