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The euro crisis and the responses to it: Missing the point?

*Stefan Ederer**

Introduction

In the past two years the world economy experienced a patchy but relatively strong recovery. In the European Union, however, the upturn was markedly weaker than in the rest of the world. Buoyant exports to the fast-growing emerging economies led to a strong upswing in several countries of the EU (particularly Germany, but also Austria, Netherlands, Czech Republic, and Slovakia) and conveyed the impression that the financial and economic crisis of 2008/09 was over. It seemed that the crisis continued only in some 'peripheral' countries with high government debt, mainly in Southern Europe.

This perception was thoroughly misleading. The financial crisis had not been overcome, but evolved into a crisis of confidence in public finances. It severely dampened economic growth and impeded a self-sustaining recovery in the euro area. The deeper roots of the euro crisis consist in the macroeconomic imbalances within the monetary union, the public aid for the financial sector and to some extent also the high levels of public and private sector debt. The crisis in the euro area has worsened substantially during the past months and is currently the largest risk for the world economy. All attempts of EU governments to solve the crisis have failed so far. This article does not deal with the deeper causes of the euro crisis, but focuses on recent developments.¹ It discusses the key mechanisms underlying the crisis and the policy responses until now. Finally, it looks into the cornerstones of a promising strategy to solve the crisis.

The euro crisis so far

In spring 2010 it became evident that the actual Greek government debt was higher than previously assumed. As a consequence, yields on Greek government bonds increased dramatically. In May the member states of the Euro area, the EU commission and the IMF decided upon a support package for Greece amounting to € 110 billion. At the same time the European Financial Stability Facility (EFSF) was established with the potential to provide loans of up to € 440 billion to illiquid countries. Based on a multilateral agreement,

¹ For a discussion of the causes and underlying developments of the euro crisis see Niechoj and van Treeck (2011).

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a company registered in Luxembourg was founded with the purpose to issue bonds and pass on the proceeds to member states in the form of loans. Each member state guarantees a share of these bonds corresponding to its quota in the ECB's equity capital. The EFSF was intended to operate for three years. It was planned to be replaced by the permanent European Stability Mechanism (ESM) in 2013.

In November 2010 and May 2011 respectively, the EFSF provided loans for Ireland and Portugal after their government bond yields had also risen dramatically and the two countries were essentially cut off from capital markets. All loans were subject to conditionality implying reform packages which included public spending cuts, tax increases and a set of measures aiming at structural changes in labour and product markets. The loans are disbursed in several tranches, all of which are preceded by an assessment of the respective country's progress by the EU, the ECB and the IMF (Troika).

The rescue packages and the establishment of the EFSF failed to restore the confidence of investors to an extent which would have permitted government bond yields to start decreasing. These measures only temporarily prevented an escalation of the crisis. Since the summer 2011 the crisis has significantly worsened both in terms of its scale and its pace. In July 2011 Italian and Spanish government bond yields started to rise. For the first time the crisis threatened to spread to the larger economies. As a reaction EU governments gave up the belief that the crisis was limited to some peripheral countries and implicitly accepted its systemic and European dimension. They approved a reform of the EFSF which augmented its capacity. As only six member states of the Euro area had a triple-A rating at that time and these countries provided guarantees for 58 per cent of the loans, the lending capacity of the EFSF at its inauguration had amounted to only € 250 billion instead of the € 440 billion originally envisaged. The EU governments consequently decided to increase its financial firepower to € 780 billion by raising the liability of each member state to 165 per cent of its individual quota. The credit volume which the EFSF could therefore provide without losing its triple-A rating increased to € 440 billion. Furthermore, the EFSF's room of manoeuvre was enlarged. Before that, the EFSF could provide loans to member states on the basis of an agreement only after their formal application for support. Since then, the EFSF has also been entitled to buy government bonds in the secondary market and to support the banking system indirectly by providing loans to member states. The upgraded EFSF came into effect in October 2011 after its ratification by all member states. Simultaneously with the reform of the EFSF, the EU governments approved a new rescue package for Greece. It had become clear that the expectations with respect to economic growth and budget targets had been far too positive, and Greek yields had soared to record heights again in spring. Within the framework of the second rescue package, EU governments envisaged a voluntary contribution of private investors to the reduction of Greek debt for the first time. However, the rescue package of July 2011 was never implemented, because the situation continued to deteriorate and new measures had to be taken.

The situation eased only temporarily. Shortly after the July summit, Italian and Spanish bond yields started to rise again. The ECB acted as a lender of last resort and bought government bonds to prevent further increases in yields. In August and September the crisis

spread to the banking sector. Share prices of European banks fell dramatically. The ongoing discussion about a haircut in Greece and its potential consequences for banks severely damaged the confidence in the stability of the financial system. The interbank market dried up completely, because banks were no longer willing to lend to each other.

Following extensive political debates, in particular in Germany and Slovakia, the decisions of the July summit were eventually approved by all national parliaments at the beginning of October 2011. At the same time, however, it became evident that yet again these measures were not sufficient to stabilise confidence and solve the crisis. The speed of escalation had increased threatening to overwhelm policy makers. In October, after mounting evidence indicated that Greece would miss its budget targets due to the deteriorating economic performance and the political debate about economic reforms in Italy intensified, government bond yields increased again in several countries. At the end of October, further measures were announced at a series of crisis summits. These measures included a target for equity capital of systemically relevant banks, the call for a »voluntary« hair cut of private investors amounting to 50 per cent of the net present value of their Greek bonds as well as a plan to leverage the EFSF. The second rescue package for Greece was augmented to € 130 billion, € 30 billion of which should serve as guarantee for the remaining debt after a 50-per cent haircut of privately held Greek government debt. Thus, the debt to GDP ratio in Greece was expected to decline to 120 per cent until 2020. The two rescue packages for Greece would amount to a total of € 195 billion.

As before these decisions failed to restore the confidence in public finances in the euro area. In January government bond yields of Greece, Portugal, and Ireland remained at astronomic levels and those of Italy and Spain were close to the seven per cent benchmark. In France, Belgium, Slovenia, Austria and other countries yields increased markedly at the end of 2011, albeit from a low level. At the end of November, the rating agency Moody's threatened to downgrade 87 European banks. Standard & Poor's changed its outlook for 15 countries to negative at the beginning of December, and actually downgraded 11 countries, including France and Austria in January. On December 8th and 9th, the governments of the euro area decided to sign a new treaty for a »fiscal pact« by March 2012. The objective of this pact is to implement even stronger rules for fiscal planning and monitoring. In addition, central banks from the EU and other countries are to extend a loan of € 200 billion to the IMF. The launch of the permanent ESM is to be brought forward to July 2012.

The details of some of these measures are still to be elaborated. Negotiations of the Greek government with representatives of private creditors about a potential haircut started in November 2011 and should have been finalised by January 2012. Until then, however, no agreement was reached. Details of the plan to leverage the EFSF are also left to be decided. Two options are under discussion (see below). However, rumours that this plan is dead and will not be implemented at all are already circulating. The reaction of investors to all these decisions has been weak so far.

No political solutions so far

As these developments clearly show, the political solutions that have been adopted until now have obviously failed. The measures that have been taken by the EU governments have not been adequate or far-reaching enough to solve the crisis or even to contain it to some smaller countries in the periphery. Most probably the latest measures will also fail to stabilise the situation. The main reason for this failure is that the mechanisms underlying the crisis apparently have not yet been entirely understood by European policy makers and have consequently not been addressed properly.

The euro crisis manifests itself as a combination of sluggish economic growth, high private and public debt, a highly vulnerable financial system, increasing uncertainty, and inadequate political solutions. These factors reinforce each other in several feedback loops and induce a downward spiral spreading from one country to the next. In particular, there are mutually reinforcing effects between investors' confidence and government debt as well as economic growth. High government debt and high budget deficits combined with negative economic prospects provoked a loss of investors' confidence in the solvency of governments. As a result, demand for bonds in the secondary markets declined and the yields increased. If bond yields remain elevated for some time, interest payments of the respective government will increase, because new bonds can only be issued at a higher interest rate. However, high interest payments lead to a deterioration of fiscal solvency. If government debt subsequently increases, confidence of investors will deteriorate even further. A liquidity crisis (a temporary lack of liquid financial means to finance public debt) will thus turn into a solvency crisis.

To avoid an explosion of their debt, governments of the affected countries have tried to improve their budget balances implementing massive austerity programmes. Greece, Ireland, and Portugal were obliged to commit to drastic measures in return for rescue loans. Italy, Spain, France and other countries of the euro area also decided on extensive consolidation measures. Compared to the previous year the government's primary balance improved in 2010 by 5.5 per cent of GDP in Greece, by 2 per cent in Spain and by 1.5 per cent in Portugal. In Ireland the deficit increased dramatically in 2010 due to the rescue measures for the banking sector, but is expected to decrease from now on. In the four years from 2009 to 2013 primary balances are planned to improve by a total of 6.5 per cent of GDP in Spain, by 10 per cent in Ireland and Portugal, and by 12 per cent in Greece. The austerity measures appear especially drastic in the light of recent economic developments. Between 2007 and 2010 GDP decreased by 10 per cent in Ireland, by 7 per cent in Greece, by 3 per cent in Spain and by 1 per cent in Portugal. According to the European Commission's forecast (European Commission 2011a) GDP in Greece will be 14 per cent below the level of 2007 in 2013. In Ireland (-6 per cent) and Portugal (-5 per cent) the decline of GDP compared to the pre-crisis peak is also substantial.

The measures which were agreed in the austerity programmes aim primarily at an immediate reduction of public expenditures and an increase in taxes (European Commission 2010, 2011c and 2011d). However, hikes of value added tax and income tax, cuts in public sector salaries and jobs, and pension cuts directly reduce the income of private households

and dampen consumption. As a result, aggregate demand and economic growth weaken. Indeed, the set of measures contains a variety of structural reforms which are supposed to enhance growth. However, they are only effective in the long run, if at all. Offsetting measures to stimulate aggregate demand were not part of the packages. Slower economic growth produces lower tax revenues and higher expenditures. Consequently, targets for budget balances are not met and new austerity measures are taken. Greece and several other countries have already reported that they exceeded the planned budget deficit in 2011. The drastic austerity measures have started to reach the limits of acceptance by the public. Strikes and protests regularly occur in many crisis countries. In late 2011, the Greek and Italian governments were replaced by cabinets of experts which rely on a broader majority in parliament. It remains to be seen whether they will be able to implement further measures.

The feedback loop between confidence in public finances and the real economy produces a downward spiral, in which the crisis in the affected countries worsens further and further. As a consequence, the uncertainty for consumers and firms increases. Consumption and investment are dampened weakening total demand even further. The pro-cyclical reaction of the rating agencies enhances these developments and accelerates the downward spiral. As we have seen, the rescue packages and the corresponding reform programmes have not yet succeeded in restoring investor confidence. It is highly unlikely that Greece, Ireland and Portugal will return to the capital markets any time soon. Further rescue loans may become necessary.

Because of its underlying mechanisms the crisis can in principle affect any member state of the monetary union. The probability that investors lose confidence in the solvency of a government is the higher, the more negative the economic prospects of the country, the higher its debt and the less stable its financial system. The longer the crisis continues and the more it accelerates, the higher the risk of contagion. After Greece, Ireland and Portugal, the crisis threatens to spread to Italy and Spain, but also to Belgium, France and Slovenia. There is a serious danger that even in the »core« of the euro area one country after another will get under pressure. Only Germany has benefitted from the crisis so far. German government bond yields had decreased since the spring 2011 reaching record lows in autumn. The measures taken so far have not been sufficient to stabilise the crisis. Their adoption was preceded by lengthy and intensive discussions, which were to a large extent held publicly. With the propagation of the crisis, new measures were discussed which had been vehemently opposed before (e.g. a haircut in the case of Greece). The solutions were never perceived as final and comprehensive by the general public, which seriously undermined the confidence of private households. The ongoing discussion and the lack of a credible solution also led to the spread of the crisis to other countries.

The euro crisis requires a comprehensive solution

A comprehensive solution of the euro crisis needs to take the mechanisms of the crisis and the flaws of the current measures into account. It consists of three main pillars:

1. A European solution

In 2010 total government debt in the euro area amounted to 85 per cent of GDP. This ratio is not higher than that of the USA, the UK or Japan. Nevertheless, yields on 10-year government bonds are lower in those countries than in the euro area. One explanation for this paradox is that the USA, the UK and Japan have central banks which would step in and supply the market with liquidity in the case of a crisis. By contrast, the member states of the European Monetary Union issue debt in a currency they cannot control. Firstly, they no longer have national central banks, which could assume the role of a lender of last resort. Secondly, in a monetary union liquidity can easily flow to other countries. The risk of a liquidity problem turning into a solvency crisis is therefore much higher (De Grauwe 2011a). The joint and several liability of all Euro area member states would thus immediately stop the uncertainty about the solvency of individual countries and prevent a further spreading of the crisis.

The EFSF is a first step towards such a European solution. Its function is to issue bonds and pass on the proceeds in the form of loans to those member states which are affected by a liquidity crisis. Its current design has two major flaws. Firstly, its size is too small to be credible as a mechanism to prevent a crisis. Its lending capacity amounts to € 440 billion of which € 140 billion are already committed to Greece, Ireland and Portugal. As an increase of the contributions of each member state seems unrealistic politically, the EU governments intend to leverage the capacity. Two options are currently being discussed: The first one would establish a co-investment fund (CIF), in which the EFSF and other individual countries, primarily outside the EU should engage. The second option proposes that the EFSF guarantees 20 per cent of newly issued bonds (‘insurance solution’). Both options are thought to enable the EFSF to raise the credit volume. There are serious doubts, however, that these solutions would work. The willingness of private investors and other countries to contribute to a CIF will probably be limited unless the euro area countries provide further guarantees. The insurance solution could possibly reduce yields of newly issued bonds. In case of a deep crisis of confidence, however, it would probably fail (Gros 2011). The easiest way to leverage the EFSF would be to provide it with a bank licence, so that it can borrow from the ECB to purchase government bonds (Gros/Mayer 2011). Nevertheless, this solution is no longer discussed, because it implies a de facto financing of government debt by the ECB.

The second flaw of the current design of the EFSF is that each country only guarantees its debt up to a certain quota. Countries which have already been bailed out cannot extend guarantees. In the case of a further spread of the crisis, the lending capacity of the EFSF would shrink. Furthermore, the EFSF’s rating and consequently the amount it can borrow in financial markets depends on the quota of the countries which still possess a triple-A rating. The loss of a country’s triple-A rating would ultimately lead to the reduction of the lending capacity of the EFSF. After Standard & Poor’s downgrade of several countries in January 2012, only three countries still enjoy this agency’s triple-A rating. Other rating agencies have also threatened to follow the example of Standard & Poor’s. Without increased guarantees or a bank licence, the EFSF could therefore become ineffective very soon.

A different possibility of a European solution would consist in the issuance of euro bonds which would be guaranteed jointly by all member states of the euro area. The European Commission (2011b) has recently proposed three variants of euro bonds (‘stability bonds’), which differ with respect to the form of the guarantee (joint/pro-rata) and the extent of substitution of national debt (complete/in part). The most comprehensive version envisages a complete Europeanisation of government debt. All member countries would jointly guarantee all outstanding bonds. The risk of insolvency would be distributed evenly across the whole euro area. Consequently, all countries would pay the same interest rate for public debt.

Issuing this kind of bonds would create a large and highly liquid market for government debt, which would be backed by the whole economic power of the euro area. This market would probably be highly attractive to international investors and would enjoy a status similar to the market for US government bonds. The stability bonds would most probably receive the highest rating. The current high-yield countries would benefit from markedly lower interest rates. Ultimately, a high liquidity premium of such bonds might also reduce interest rates for Germany and other low-yield countries. The most serious problem with the issuance of such stability bonds, however, would be moral hazard. If all countries jointly guarantee euro area debt, the incentives of one country to get indebted at the expense of another is high. Thus, an additional mechanism would be necessary to limit the issuance of new government debt. Another downside of this scheme is that its implementation would take time. Several years could pass until all national debt is owed jointly.

The second version of stability bonds envisages a joint guarantee up to a certain limit. It is very similar to the proposal elaborated by the Belgian Bruegel Institute (Delppla/von Weizäcker 2010 and 2011). The authors propose a limit for the issuance of euro bonds of 60 per cent of GDP (‘blue bonds’). All debt above this limit would remain the liability of national governments (‘red bonds’). Red bonds would be seen as inferior to blue bonds. All the advantages of the first type of stability bonds also apply to this scheme, albeit only for the jointly guaranteed bonds. The risk of red bonds would increase significantly and consequently raise their interest rate. This would have the additional effect that countries with high public debt would pay a higher marginal interest rate than now, which could reduce incentives to get indebted, at least in the long run.

The first two variants of stability bonds would stabilise the confidence of investors, reduce yields and ensure the solvency of countries. Politically, such a solution seems highly unlikely as it would require a change of the EU treaties. The proposal of the EU commission, however, contains a third variant, which envisages a pro-rata liability. This solution is very similar to the EFSF in terms of its construction. Nevertheless, the volume of such a stability bond solution would be much higher amounting to up to 60 per cent of GDP. It could probably be implemented without changing the EU treaties and would therefore represent a quick solution. As the guarantees of each member state would be limited, the expected advantages in terms of higher liquidity and lower risk would be markedly less significant than for ‘real’ euro bonds. Nevertheless, the yields could be reduced significantly for the current high-interest countries. Germany and other low-interest countries, however, would most probably face higher interest rates. The actual level is currently discussed controversially.

The German ifo institute (Berg et al. 2011) assumes that the interest rate for such euro bonds would be a weighted average of the interest rates of the individual member states. This would raise the interest rate for Germany by 2 per centage points. As government debt in relation to GDP in the euro area as a whole is about the same level as in France, the common bonds would probably receive a similar rating. This would increase the German interest rate by 0.5 per centage points.

In its last report the German Council of Economic Experts (Sachverständigenrat 2011) proposed a 'debt redemption fund'. This solution would combine the joint liability for government debt with a mechanism to reduce it. According to this proposal, all member states' debt in excess of 60 per cent of GDP would be transferred to the fund. The member states would jointly guarantee this debt, but it would remain the liability of the individual member states. Each country would commit itself to liquidating its debt in the fund according to a consolidation path over a period of 20 to 25 years. The joint liability would give high-interest countries some breathing space. However, the proposal is intended as a temporary solution. After the redemption of the debt, the fund would be liquidated.

The possibility of introducing euro bonds is currently not considered by European governments. So far the reformed EFSF has not assumed its new responsibilities either. In summer 2011 therefore the ECB had to step in and buy government bonds on a large scale. The bond purchasing programme has been continued since then. However, the ECB leaves open for how long and to what extent this programme will continue. In November the ECB announced that its weekly purchases would be limited to € 20 billion. In the public debate, however, the ECB is increasingly asked to buy government debt without limit. If the ECB announced an expansion of its bond-buying programme to limit interest rate increases, this would be highly credible due to its unlimited liquidity reserves. Such an announcement would reduce uncertainty and probably reduce the need for actual intervention, compared to the current situation (De Grauwe 2011b). However, neither euro bonds nor a stronger intervention of the ECB were discussed at the summits in December 2011 and in January 2012.

2. Measures to stabilise the economy in the short run

A sustainable solution of the euro crisis will only be possible, if the economies of the member states return to growth. In the light of the current global slow-down, which is caused primarily by the euro crisis, this means that the automatic stabilisers should not be weakened or counteracted by spending cuts. Therefore, deficit targets should be abandoned. Budget consolidation has to be achieved via expenditure paths which are not affected by business cycle volatility. These paths should show a flatter slope, which would imply raising stabilising expenditures in the present and postponing the planned austerity measures. The repercussions for other economies have to be taken into account. This would make it possible to support weak economies without fiscal transfers: Countries with more fiscal room for manoeuvre could make a higher contribution to the stabilisation.

3. Measures to stabilise government debt in the long run

Public and private debt in the euro area have reached a level making the economy more prone to financial crisis. The higher the debt level, the more unstable the financial system will be. This is explained by the erratic behaviour of financial investors. In the long run, it is necessary to reduce the debt to GDP ratio. Therefore, higher expenditures in the short run should be combined with measures to reduce expenditures in the long run. Such measures should aim at increasing the efficiency of the economy and could include reforms of public administration as well as the pension and health systems. Tax reform, in particular a reduction of taxes on labour combined with an increase of taxes on property, would be an option. All these measures, however, need to be examined thoroughly before their implementation and would take some time to become effective. Governments should accept initial costs and expect benefits only later.

A joint European guarantee for government debt via euro bonds would increase the incentives to issue more debt. A higher degree of fiscal coordination is therefore necessary to mitigate these incentives. It should be complemented by stronger controls of imbalances with respect to the trends of unit labour costs, inflation, asset prices, credit etc. as is envisaged in the reinforcement of the Stability and Growth Pact (‘six-pack’). In the long run a genuine fiscal union as in the USA would also be an option.

To truly overcome the crisis, however, the euro area countries also need to address its underlying causes. This would mean a significant reduction of the macroeconomic imbalances, which were built up before the financial crisis of 2008/09 and which have persisted since. This would only be possible, if wage moderation were abandoned in Germany on the one hand and wages increased more slowly in Southern Europe on the other hand (Ederer 2010, Niechoj/van Treeck 2011). Without a reduction of these imbalances, the peripheral countries will not be able to return to the sustained economic growth which is necessary to stabilise their debt.

Conclusions

The financial and economic crisis of 2008/09 transformed itself into a crisis of confidence in public finances of the euro area countries and in the ability of their political institutions to solve it. It has escalated markedly during the past few months and is currently the biggest risk for the global economy. The measures taken by EU governments so far have not been sufficient or appropriate to solve the crisis. This article tries to elucidate the mechanisms at work behind the crisis. Furthermore, it presents the cornerstones of a comprehensive solution to the euro crisis, which directly addresses these mechanisms.

As recent developments show, a first requirement for the stabilisation of confidence in public finances would be a joint liability for government debt, at least up to a certain level. This could be achieved via an enlargement of the rescue fund, by issuing euro bonds or via the supply of liquidity by the ECB. As a second step the feedback loops between the crisis of confidence and the real economy must be cut. Instead of implementing more and more

austerity measures, the economy needs to be stabilised by raising expenditures. Coordinated Europe-wide efforts would increase the impact of these measures. Thirdly, the government debt level should be stabilised by implementing long-term measures. The joint liability for euro bonds makes it necessary to reduce incentives for further debt increases at the expense of other countries.

These measures require a distinctive change of strategy to solve the crisis. Instead of focusing on the debt and budget figures and trying to restore investor confidence by adopting debt brakes and fiscal pacts, European governments need to properly address the mechanisms of the crisis. If the crisis is not solved soon, a break-up of the EMU cannot be ruled out. This would send large shock waves through the financial system, massively damage confidence in the solvency of public finances of the euro area member states and dramatically increase the uncertainty for private households and firms. Such a shock would seriously damage the real economy of the euro area.

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