

## Why Has Euro Crisis Management Been So Hard?

EUI E-book on *Institutions and the Crisis*

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The euro crisis began in 2010 as a fiscal crisis in Greece and a banking crisis in Ireland, two small countries which together made up about 4 percent of euro area GDP. IMF-EU programs backed by the ECB were meant to quickly address the underlying fiscal and financial problems and prevent contagion. Instead, the crisis spun out of control. By early 2011, it had reached Portugal; by the third quarter of 2011, Italy and Spain. By 2012, the entire euro area was in recession. Even after it began to recover, in 2014, aftershocks of the crisis continued to haunt the euro area. After a government opposing EU- and IMF- sponsored adjustment came to power, Greece almost exited the euro in 2015. Most recently, a government coalition crystalizing anti-EU sentiment in Italy poses a serious, perhaps existential, challenge to the euro and the EU. With similarly polarized views in other countries, it looks like the euro crisis may be perpetuating itself indefinitely (or until the euro collapses).

Why was it so difficult to bring the euro crisis under control, and why do we continue to suffer from its legacies today, after more than eight years? Part of the answer surely has to do with the extent of private and public debt problems accumulated in the boom years – in some countries, on top of high pre-existing levels – and the magnitude of the external financial shock that hit the euro area in 2008-09, triggering a deep recession. But the United States and other advanced countries were similarly affected by the 2008-09 financial crisis and recovered much more quickly. Among 37 countries listed as “advanced” by the IMF, 32 suffered negative growth in 2009, but only 11 – nine members of the euro area, plus neighboring Sweden and the Czech Republic – suffered a double dip recession, with negative growth in 2012. Hence, the full answer must surely include the struggle of euro area institutions – defined broadly to include the European Commission, the ECB, political institutions such as the Eurogroup of finance ministers, and national authorities – to develop a coherent and effective crisis response.

This essay explores three reasons why European institutions found it so difficult to manage the crisis, all of which are specific to the euro area setting.<sup>2</sup> First, managing a center-periphery crisis in a currency union setting poses specific challenges. It took European institutions time to understand and address them. The second reason was a collective action problem caused by creditor-debtor conflict of interests. The third reason, finally, reflects an intellectual and

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<sup>1</sup> I am grateful to Olivier Blanchard, Mitu Gulati and Jean Pisani-Ferry for insightful comments on an earlier draft.

<sup>2</sup> These reasons are not meant to be exhaustive. For example, a frequent criticism is that euro area authorities were slow to force banks to recognize losses and raise capital, delaying the recovery (see the April 2013 and April 2014 issues of the IMF’s *Global Financial Stability* report). This criticism is directed primarily at national authorities managing their own economies, and it is not clear that membership in the currency union had much to do with this particular set of policy choices (a similar criticism, although to a lesser extent, was directed at the UK).

political failure, namely, the transposition of creditor-debtor conflicts to a setting – the debate about euro area reform – where these conflicts could and should have been avoided.

### **Learning to manage an international financial crisis inside a currency union**

Compared to systems of pegged exchange rates, which European countries had experimented with in the 1980s and 1990s, currency unions are much more resilient because the payments system linking member central banks (called “Target” in the euro area) can accommodate unlimited capital flows between members. A currency union is equivalent to a fixed exchange rate regime combined with permanent and unlimited central bank swap lines, at pre-determined rates, between the members of the regime. Official balance of payments support of the kind that the IMF has traditionally provided is hence unnecessary: unlimited access to such support is an automatic privilege of membership. Perhaps reflecting this reasoning, the EU’s Balance of Payments Facility, created in 1988 to allow EU members to adjust to balance of payments disequilibria, excluded Euro area members from 2002 onwards.

However, the consequences of capital flow reversals go beyond the balance of payments. “Sudden stops” in capital flows can prick credit bubbles, expose underlying private debt problems, and precipitate a collapse of credit and investment through financial sector channels. In severe cases, they can trigger banking crises. They can also lead to sovereign debt crises: via tighter financing conditions, spillovers from banking crises, and through the impact of a recession on government finances.

As it turned out, these implications of capital flow reversals not only continued to be possible in the euro area, they also became harder to manage. As Europe discovered after the collapse of Dexia in late 2008, pre-crisis financial integration, partly induced by currency union, can make the resolution of banking crises more difficult. The same is true for the management of fiscal crises: currency union sovereigns are exposed to self-fulfilling debt runs, since they lack national central banks that would normally be able to backstop their liquidity (De Grauwe 2011). With Italy and Spain on the brink of losing market access in 2011 and 2012, a construct needed to be found that allowed the ECB to assume this role within the legal constraints posed by its prohibition of monetary financing of governments.

European institutions responded to these challenges – incrementally, and punctuated by mistakes and setbacks, but they eventually got it right.<sup>3</sup> The first step was the creation of temporary facilities – the European Financial Stability Facility (EFSF) and the ECB’s Secondary Market Programme (SMP) – to lend to crisis-hit sovereigns and stabilize government bond markets, respectively. This was followed by a blueprint for creating the ESM, designed specifically to deal with sovereign debt crises inside the euro area. Mistakes and setbacks included the design of the SMP, a limited-volume program subordinating private bondholders; the design of the first Greek program; the Deauville announcement linking the creation of the ESM to “private sector involvement” (PSI); and the initial decision to “haircut” depositor in

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<sup>3</sup> For accounts of the crisis response, from different perspectives, see Pisani-Ferry (2014) and Bastasin (2015).

Cyprus. Most of these mistakes were later reversed or at least contained, albeit at considerable cost; but some, like the catastrophic Greek program, caused permanent damage.

The backdrop for some of these mistakes was a conflict of interests – in particular, the desire to minimize any redistribution benefiting the crisis countries, a topic taken up below. Others simply reflected a lack of experience in managing financial crises. The Deauville announcement is a case in point. The principle that unsustainable debt ought to trigger a debt restructuring “involving” private creditors is commonsensical (even tautological), and the idea that the euro area should have a procedure for doing so was sound. But the communication was terrible. Markets interpreted the PSI announced at Deauville not as a rarely-to-be-used feature of the European financial architecture that would be erected after the crisis (as it was presumably intended), but as a signal that the official sector would insist on debt restructuring in the crisis that was just beginning to unfold.

The crisis was contained only after the ECBs announced the “Outright Monetary Transactions” (OMT) program, plugging the most threatening hole in the crisis resolution architecture of the euro area – the inability to stop a self-fulfilling run on the debts of a member state. The period of experimentation and ad hoc institution-building was over, but it took two and a half years – from April 2010 until September of 2012.

### **A “chicken game”: crisis resolution in the presence of distributional conflict**

The resolution of debt crises involves a trade-off between fiscal adjustment, official financing, and debt restructuring. How this trade-off is resolved has significant distributional implications. Fiscal adjustment goes at the expense of the debtor country. Official financing puts the resources of official creditors and their shareholders – referred to as the creditor countries – at risk. Debt restructuring goes at the expense of private creditors, and so reduces the direct drain on public resources. But it also creates financial stability risks in both debtor and creditor countries, as private creditors may be systemically – and politically – important.

As a result, while creditor and debtor countries have a shared interest in resolving the crisis quickly, their interests conflict on *how* to resolve it. In the euro crisis, debtor countries wanted moderate fiscal adjustment, ample official financing and – in the case of Ireland – a bail-in of senior bank bondholders. In contrast, creditor countries wanted as much fiscal adjustment and as little official financing as possible (preferably on penalty terms, one of the several mistakes of the initial Greek program). They were also opposed to restructuring bondholders, in Ireland and initially in Greece, both because the ECB feared that this would set an adverse precedent and lead to contagion and because some of the banks holding bonds had tight connections to their respective governments.

This resulted in an incentives structure prone to gambles for redemption – postponing debt restructuring to see if it could be avoided altogether. Incentives faced by debtor and creditor countries also shared some of the features of the “game of chicken”, in which accommodation by at least one side is necessary to avoid catastrophe, but each side prefers the other to do the

accommodation.<sup>4</sup> In the case of the euro area crisis, as in the game of chicken, outright catastrophe – in the sense of disorderly default and euro area exit – was avoided. Instead, one of the two equilibria predicted by the game of chicken prevailed – namely, deep fiscal adjustment, and too little debt restructuring. Debtor countries agreed to crisis resolution strategies that accommodated the preferences of the creditor countries.

Apart from being inefficient, this equilibrium created problems that went beyond what is captured in the (static) chicken game. First, even where fiscal adjustment worked in the sense of eventually engineering a return to capital markets, it contributed to a sense of unfair treatment in the debtor countries. Europe helped them avoid catastrophe, but on harsh and seemingly self-serving terms. Second, in one case – Greece – excessive fiscal adjustment and the failure to undertake meaningful reform exacerbated the economic collapse, led to a debt restructuring that was too little and too late, and created a political backlash that generated a new crisis in 2015.

Neither debtor nor creditor countries can be blamed for trying to resolve the crisis on their terms. There was a genuine conflict of interest. This said, the creditor countries and the institutions advising them and setting the terms of the adjustment – the European Commission and the IMF – should have realized that pushing the debtor countries too far risked undermining the crisis resolution strategy in both economic and political terms. More than eight years after the agreement on the first program, in Greece, Europe is still suffering the consequences.

### **Euro area reform through the prism of redistribution**

The third reason why the euro crisis dragged on and crisis-related political fault lines became increasingly cemented was that the distributional conflict created by the crisis infected attempts to reform the long-term financial architecture of EMU. This created costs by shackling institutional design – for example, defining the ESM as an “ultima ratio” institution that can be activated only in the face of a threat to the euro area as a whole, rather than pre-emptively and proportionally. It also stopped more ambitious reforms, such as the completion of banking union. And it contributed to a continuing anti-euro backlash in both creditor and debtor countries.

In the public opinion of creditor countries, plans for more risk sharing across EMU members – proposed by the European Commission and countries such as France, Italy and Spain – are now

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<sup>4</sup> The game of chicken has its name from a game played by two trucks on a collision course, in which the first driver to “chicken out” (i.e. to accommodate by swerving to avoid collision) loses the game. There are no equilibria in which both sides accommodate, or both fail to accommodate. Failure to accommodate by both sides would lead to collision, which any of the two sides would prefer to avoid by swerving. Accommodation by both sides is not an equilibrium either, since each side would prefer to win by not accommodating. Hence the two equilibria of the game involve one side accommodating but not the other. In the context of the euro crisis, accommodation by a debtor country can be interpreted to mean to accept ambitious fiscal adjustment, while accommodation by the creditors would have meant a larger financing envelope or an early acceptance of debt restructuring.

widely viewed as attempts to create a regime in which virtuous, better performing countries would pay for the sins of past and future crisis countries. In the debtor countries, lack of progress on euro area reform has been widely interpreted as a sign that the creditors were unwilling to show solidarity, instead forcing the “south” to engage in austerity policies and other forms of self-harm. Both narratives lead to the same conclusion: that the euro is a threat to democracy, either because it forces countries to take actions against the will of their electorates (a familiar argument in Italy) or because it creates contingent fiscal commitments, through a growing number of institutions that mutualize risk, forcing elected representatives to surrender fiscal control (a frequent line of argument in Germany). The creation or rise of populist parties such as Syriza, the AfD, the Lega, or Five Star is directly linked to these narratives.

However, the premise on which these arguments are built – that more risk sharing in the euro area boils down to more north-to-south transfers – is incorrect. Unlike crisis resolution, successful institutional reform in the euro area does not entail an inherent distributional conflict. Depending on how risk-sharing institutions are designed, the alleged trade-off between risk sharing and good incentives may not exist. This is clear from the fact that insurance arrangements are commercially viable, which could not be the case if they were to lead to systematic transfers from the insurer to the insured. Although insurance can give rise to moral hazard, this can be contained through the design of the insurance contract, which ensures that insurance is beneficial for all contracting parties. By transposing features of insurance contracts such as deductibles or experience-rated contributions to euro area risk sharing arrangements such as euro area deposit insurance or unemployment insurance, it would be possible to significantly lower risk in the euro area without creating a “transfer union” (see, among others, Gros 2013, Gros 2018, Bénassy-Quéré et al. 2018, and Véron and Schnabel 2018).<sup>5</sup>

Two recent papers, by Bénassy-Quéré et al. (2018) and Berger et al (2018), take this argument a step further. They argue that, far from leading to “transfer union” and undermining incentives, well-designed risk sharing arrangements are in fact *needed* to rule out transfer union, because without them, the no-bailout-rule is not credible. When debt restructuring leads to significant domestic euro area disruptions, even creditor countries will be in favor of bailouts. Hence, debt restructuring is unlikely to happen even when it is efficient ex ante, and when the chances that bailouts will succeed are low.<sup>6</sup>

Unfortunately, governments across the euro area – particularly creditor country governments – have failed to distance themselves from the idea that risk sharing in the euro area necessarily entails (systematic) redistribution. Some governments, notably in Germany, are in fact guilty of actively promoting the idea. The German government has traditionally rejected both European deposit insurance and fiscal risk sharing, claiming that this would lead to moral hazard. Even

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<sup>5</sup> See Gros (2013), Gros (2018), Bénassy-Quéré et al. (2018) and Véron and Schnabel (2018).

<sup>6</sup> This argument is not new: Gros and Meyer (2010) advocated the creation of a “European Monetary Fund” on the grounds that “Market discipline can only be established if default is possible because its cost can be contained.”

reinsurance was viewed as an unacceptable “further mutualization of risks”.<sup>7</sup> Little wonder, then, that many German voters have bought into the idea that any form of additional euro area risk sharing runs counter to the German interest. By promoting the idea that more risk sharing will likely lead to north-to-south redistribution, the German government has given intellectual respectability to the arguments of Eurosceptics and done a disservice to German and European interests.<sup>8</sup>

More surprisingly, the proposition that meaningful euro area risk sharing is possible without systematic transfers has also been under attack from the opposite end of the political spectrum. Commentators such as Münchau (2018a) and academics such as de Grauwe and Ji (2018) have taken the view that *only* full risk mutualization will make the euro area safe, in the form of a jointly and severally guaranteed “Eurobond.” Proposals to create euro area safe assets that avoid mutualization (see Brunnermeier et al, 2017 and Leandro and Zettelmeyer 2018 a,b for a survey) are derided as a euro area version of the “CDO scam of the subprime years”, and the Bénassy-Quéré et al. (2018) proposals to reconcile risk sharing with good incentives as “astonishing for its lack of ambition” (Münchau 2018a,b). These commentators agree with the intellectual premise of the Eurosceptics, namely, that risk sharing inevitably implies redistribution at the expense of countries with track records of fiscal prudence. The only difference is that they view redistribution of this type as an acceptable price to pay for a successful euro area, whereas northern Eurosceptics do not.

## Conclusion

The euro crisis was difficult to bring under control in part because managing a debt crisis inside a currency union posed new challenges that took time to understand and address, and in part because debt crises create conflicts of interests that turned out to be particularly pernicious in the euro area context. These conflicts delayed or prevented effective crisis resolution and created a legacy of resentment and distrust between debtor and creditor countries. They also contributed to the view that meaningful euro area risk sharing necessarily has redistributive consequences, at the expense of countries with track records of fiscal prudence.

Although wrong, this view is hard to dispel, in part because it has attracted support both from opponents of any risk sharing at the level of the euro area and from proponents of full risk mutualization. Reform of the euro area financial architecture that seeks to avoid permanent redistribution is rejected by one side because it is viewed as a ploy that will ultimately lead to mutualization through the back door, and by the other because it lacks mutualization through the front door. It is hard to see how meaningful reform – with or without redistribution – can succeed in such circumstances.

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<sup>7</sup> German non-paper on banking union, 8. September 2015, [http://blogs.ft.com/brusselsblog/files/2015/09/Nonpaperfinal\\_20150910091345.pdf](http://blogs.ft.com/brusselsblog/files/2015/09/Nonpaperfinal_20150910091345.pdf)

<sup>8</sup> Very recently, there are signs that the German position may be shifting. Germany’s new finance minister, Olaf Scholz, has recently endorsed the idea of a European unemployment reinsurance mechanism, albeit one based on loans rather than transfers. See <http://www.spiegel.de/international/germany/interview-with-finance-minister-olaf-scholz-a-1211942.html>

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