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The 2010 European Economic Crisis

Diagnosis, Response, and Longer-Term Implications

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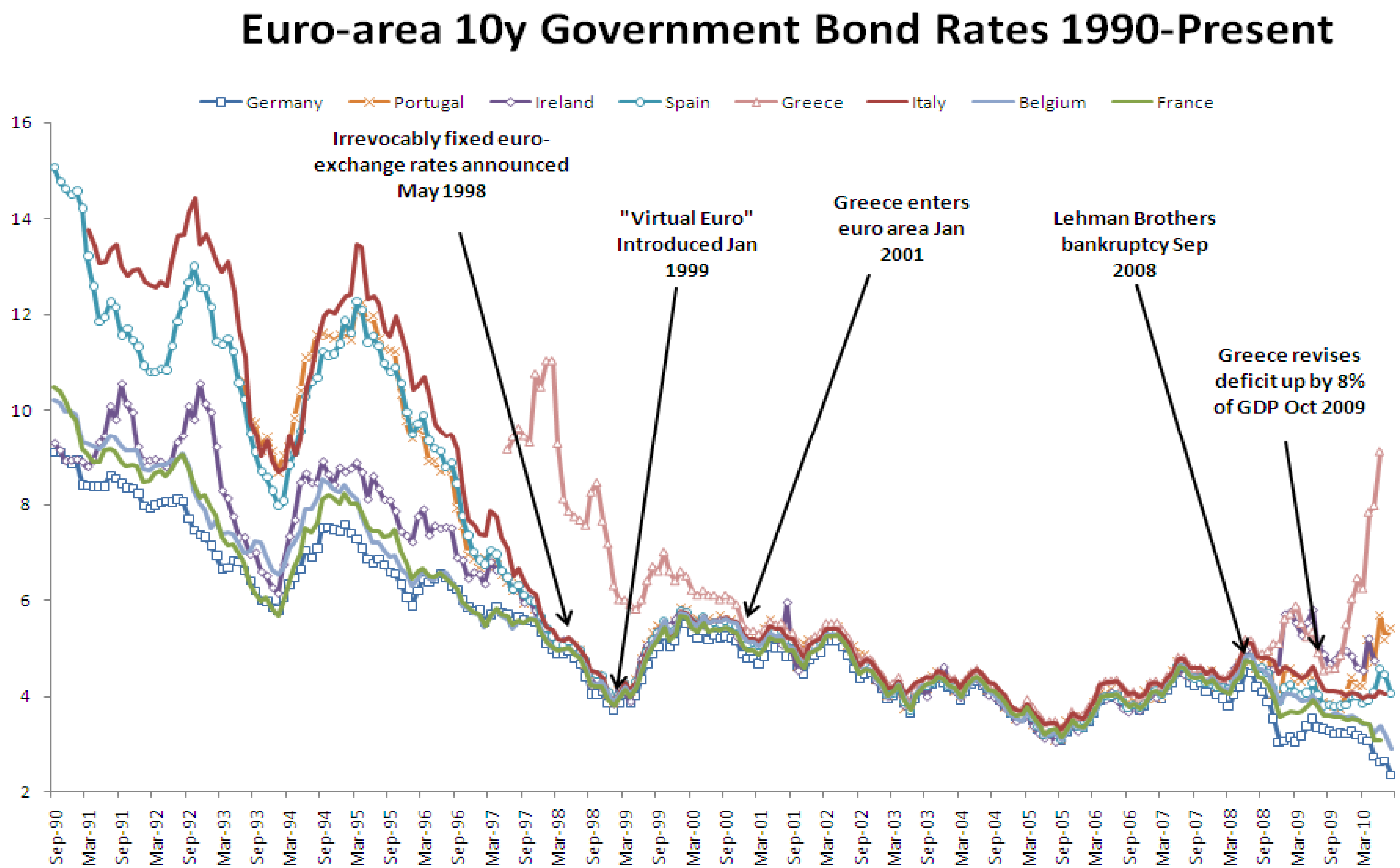
The EMU Crisis Diagnosis



Note: Belgium 6y or longer maturities. *Source: Datastream*

The EMU Crisis Diagnosis

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Design Flaws, BoP, or Fiscal Crisis?

No agreement exists regarding the cause of the European debt crisis.

1) Design Flaws (Milton Friedman): The result of a flawed construction of a monetary union not being reasonably close to an OCA, i.e. without labor mobility or a central transfer mechanism/fiscal union?

2) Balance of Payment: The result of a loss foreign financing for excessively large current account deficits, arising from competitiveness divergences, i.e. German wage compression?

3) Fiscal: The result of unsustainable fiscal policies/growth strategies, which markets ignored for ten years and then suddenly woke up to when the real estate/construction growth model collapsed?

In my opinion, it was mostly 3), although 2) played an unhelpful role.

The EU Crisis Management Process

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Amateurish and Easy to Point Fingers, BUT:

1) No institutional experience in Brussels/national capitals in communicating in "real time" with financial markets (first 2 a.m. moment for the EU!)

2) Very hard to coordinate 27 countries in multilayered regional group + a genuinely independent ECB + EC (NO message disciple possible)

3) Numerous EU policy U-turns all "in the right direction"

    i. Starting at "small number (~€10-15bn) with no IMF involvement" (February)
    ii. Ending at "BIG number (€750bn) with 100% IMF conditionality" (May)
    iii. ECB from absent (as in Eastern Europe) to pan-European lender-of-last-resort
    iv. Years late, some improvements in bank transparency with stress tests

4) TARP was initially rejected by US House and was widely criticized at the time but proved beneficial.

Europe's "Grand Bargain" in Early May 2010

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1) ***ECB Agrees to:***
   I. **Purchase government/private bonds in secondary market**
   II. **Accept any government (and guaranteed) bonds as collateral (April)**
   III. **Guarantee the liquidity of any eurozone credit market as a "lender of last resort" through its balance sheet**
   IV. **Despite sterilized interventions, ECB has expanded its own mandate significantly beyond "Bundesbank Legacy" (and overcame unanimity on controversial issue)**

2) ***EU (Eurozone) Member States Agree to:***
   I. **Provide bailout funding for EFSM/EFSF (e.g. *ad hoc crisis-only euro-bonds*)**
   II. **Implement dramatic and politically painful austerity measures**
      a) **For Southern left-wing governments, a "Nixon goes to China" moment**
   III. **Agree to a strengthening of the broader SGP framework**
   IV. **Accelerate pro-growth structural reforms in labor markets and social systems**

<u>In sum: The "cyclically adjusted pragmatism in Europe" proved much higher than expected pre-crisis</u> .

(Not a lot of tea parties being thrown)

Who Pays for "Europe's Response"?

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- In extremis, Germany and France pays over 50% of the total direct cost (excl. IMF).
- The political challenge of approving "bailouts" of a scale surpassing TARP to "other countries" should not be underestimated.
- Precedent for bailouts introduces large-scale political and economic moral hazard into the EU.
- Unsurprising that longer-term response focuses on limiting moral hazard

Maximum Potential "Bailout Liabilities", €bn

	Total	Germany	France
EFSF (120% share)	440	147	111
EFSM (EU Budget Share)	60 (+35)	19	15
Greece Program	80	22	17
ECB SMP (Sep 24th 2010)	61.7	17	12
	676.7	205	155
Scaled to U.S. GDP Levels		*872*	*826*
Addendum			
Via IMF; Greece Program	30	2	2
Via IMF; Anticipated Future Participation	250	15	12

Source: ECB; EU Council; Commission; IMF

The Eurozone “New Normal”

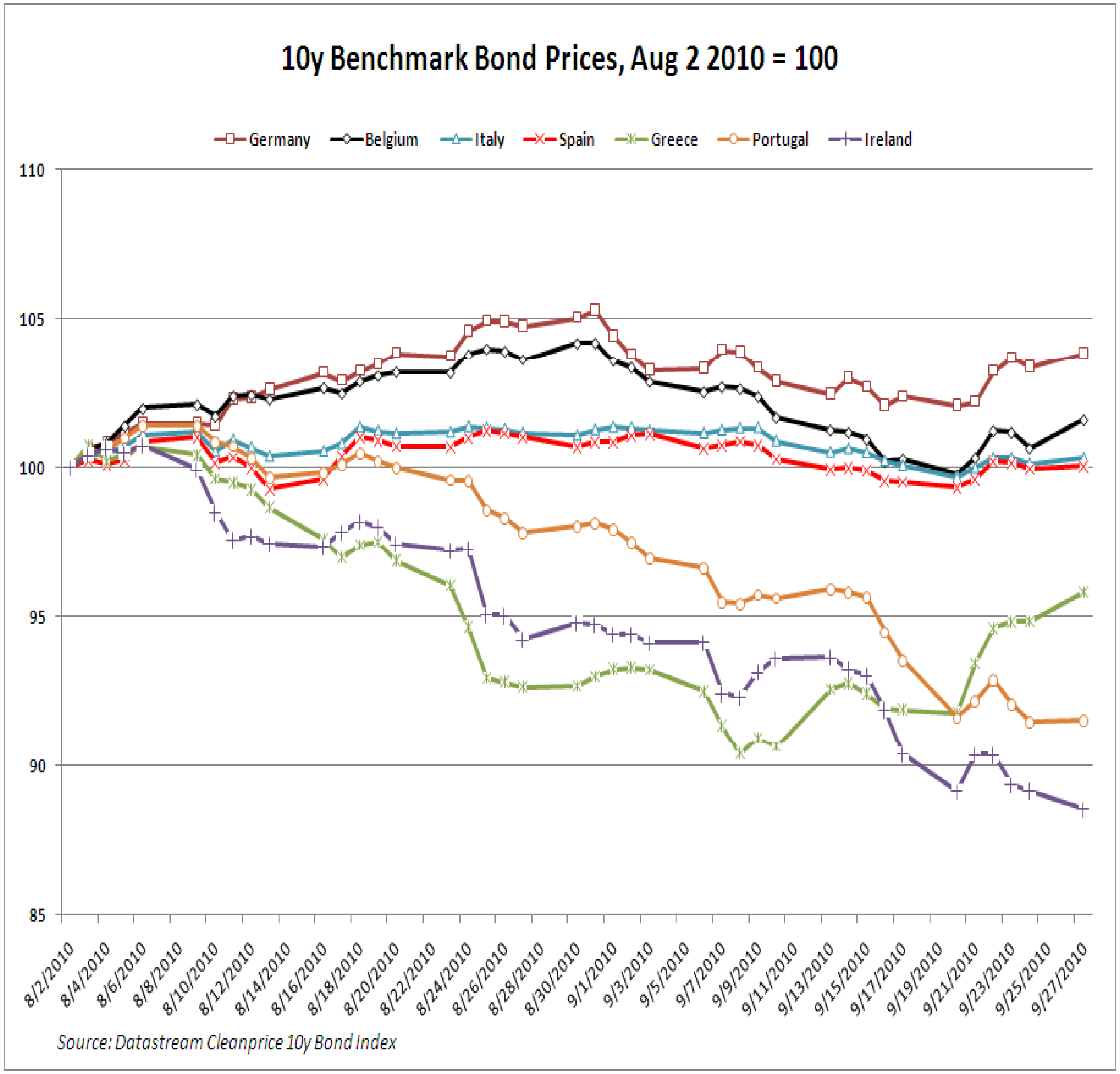
- Portugal, Ireland, and Greece in the “market crosshair”

- Deficient policies now met promptly by “default premia”

- The problematic periphery right now consists of only small countries (might change again in the future).

- Small states likely to be bailed out with the help of IMF using ~€100bn in ESFM like Hungary (€6.5bn), Latvia (€3.1bn) and Romania (€5bn)

- Unlike the EFSF, §122.2 in TEU does not expire.

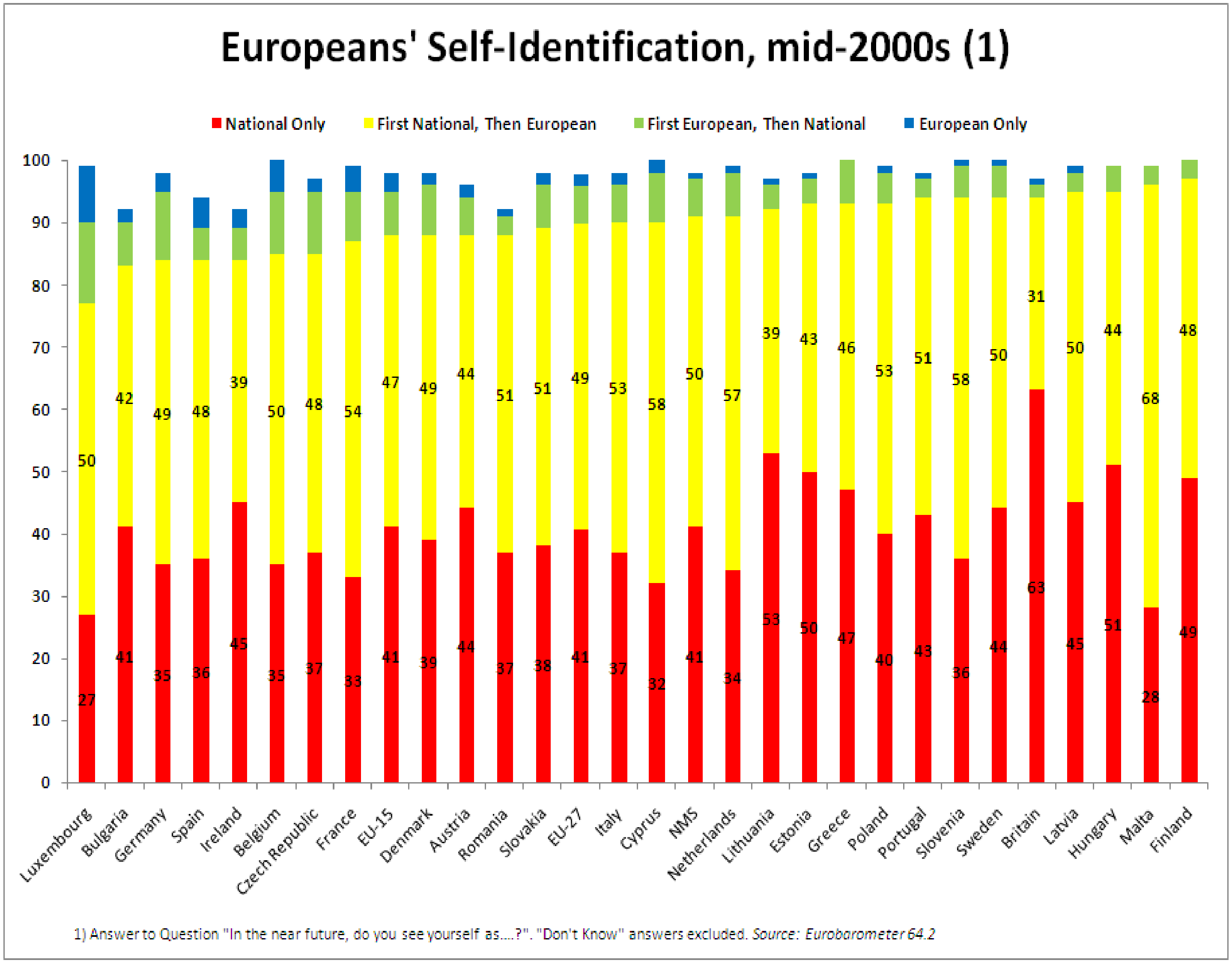


Some Political Considerations Regarding the Longer-Term Response

- Prohibitively high political barriers to "fiscal union" (or a Treaty change)

- Germany's "euro-asset safe-haven status" means huge empowerment in EU decision-making

- Populism partly a result of "economic consensus" on austerity/structural reforms (center-left abandons "loony left policies")



The Longer-Term Political and Institutional Response

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1) The "Greek demonstration effect" has (so far) made austerity electorally popular.

2) New European Commission SGP Reform Proposals (Sep 29)
   I. SGP Preventive Arm; public expenditure to grow below MTO GDP
   II. SGP Corrective Arm; >60% debt cut by 1/20 for 3 years (debt levels are back!)
   III. "Reverse Voting" – QMV to vote against "quasi-automatic sanctions"
   IV. 0.2% of GDP in potential fine
   V. "Excessive Imbalance Procedure"; Peer pressure + 0.1% of GDP in potential fine for euro-zone members (likely asymmetric enforcement for deficit countries)

3) "Moral Hazard" in the EU to be controlled at multiple levels
   I. IMF program-like conditionality on all bailouts
   II. A more credible SGP focused on quasi-automatic sanctions
   III. (Possibly) a eurozone "Orderly Debt Restructuring Mechanism", e.g. an SDRM

4) Eurozone exit remains crazy, but countries won't rush to join prematurely.

5) Long-term challenge is the "end of automatic EU economic convergence in the periphery" (suggests, too, that ECB monetary policy will remain quite accommodating for some time to avoid pushing peripherals over the edge).