

# Can the European Monetary Union (EMU) Be Rescued?

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Bilbao, July 2010

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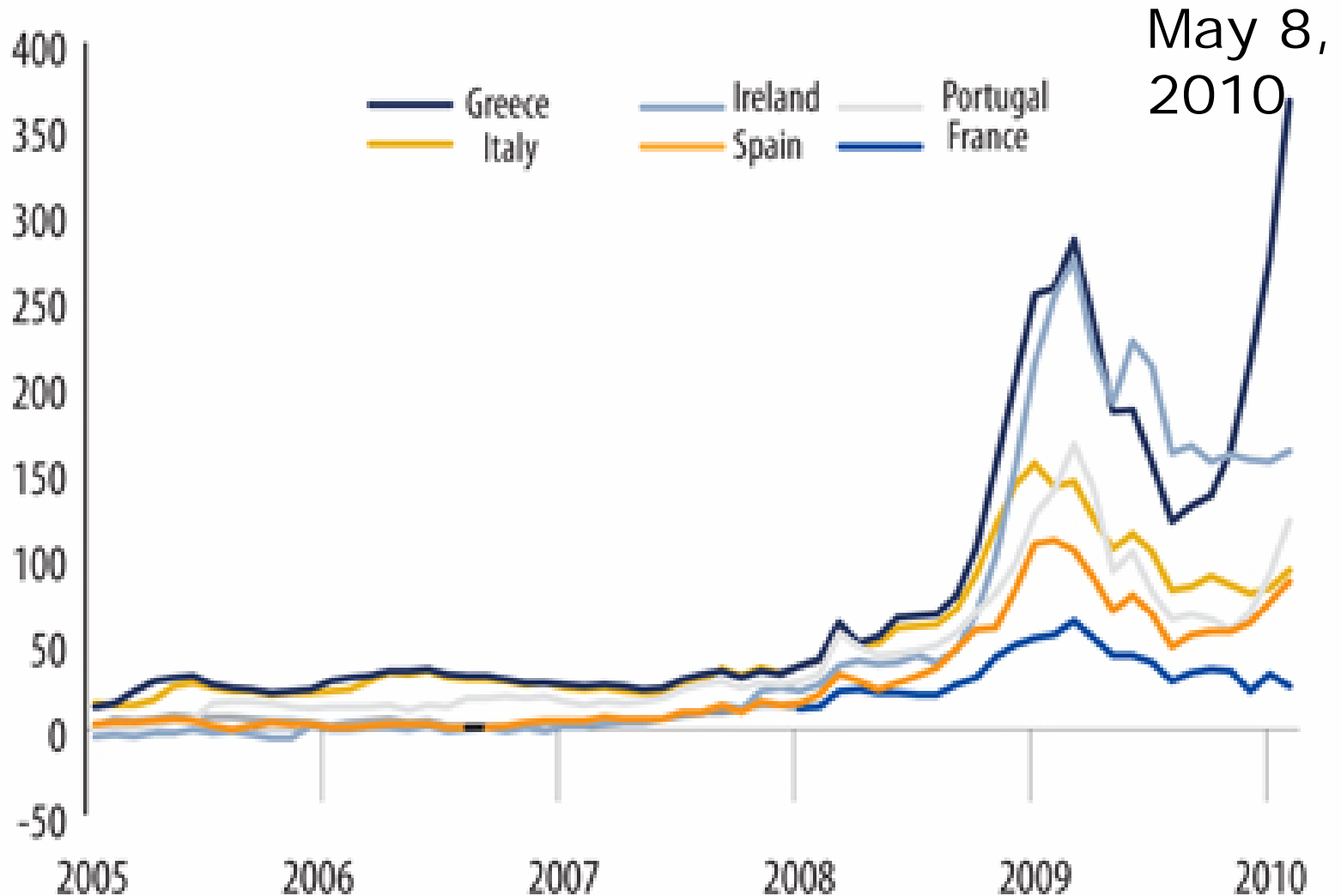
# 1 Is EMU at risk?

- Risk of debt crisis of some members (sovereign and private debt) – aftershock crisis
- Solvency risk for GR and others not unlikely
- Contagion risk for European creditor countries or other non-EMU countries
- € bn 750 protection scheme from May 9 is short-term relief for max 3 years, lack of robust reforms will be anticipated by markets
- Depreciation of € harms UK and US economies
- Divergence of wages, current accounts and budgets within Euro-area unsustainable
- EMU can break down or run into deflation/stagnation

# 10-Year Government Bond Spreads to German Bund

Sources: IMF, Bloomberg

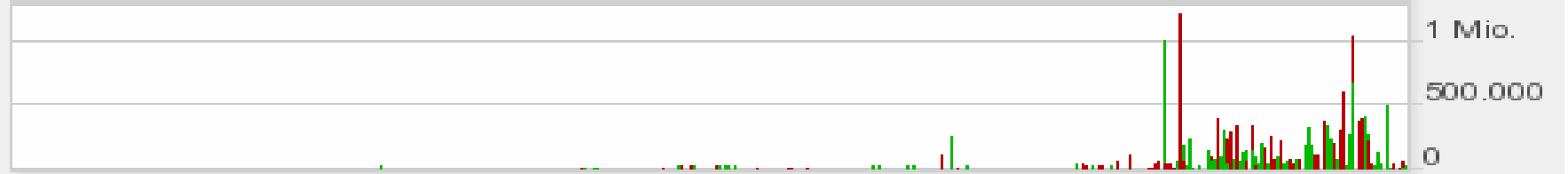
Basis Points



■ Griechenland EO-Bonds 2005(15)  
■ Bundesrep.Deutschland Anl.v.2005(2015)



Volumen



## Sovereign Bonds Yield 10 June 2010, 5 years maturity

(spread vis à vis Germany in %-points)

- **Greece**                    **8.77 (7.29)**
- Germany                    1.48
- Italy                        3.84 (2.36)
- Spain                      4.60 (3.12)
- Ireland                    4.33 (2.85)
- UK                         2.31 (.83)
- Brazil                     3.70 (2.22)

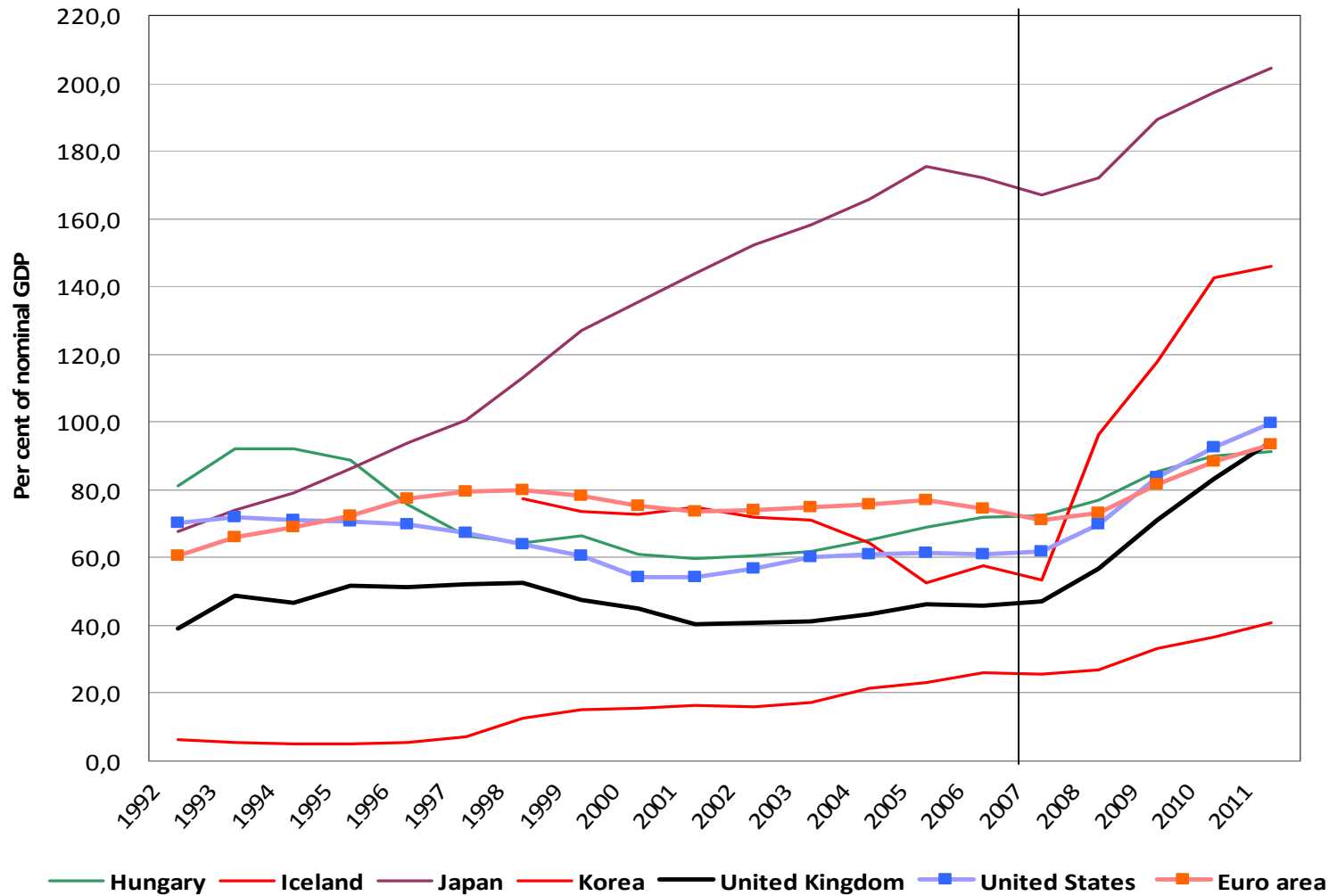
The bail-out has slowed but not stopped investor flight from Europe's periphery  
May 20th 2010 From *The Economist*



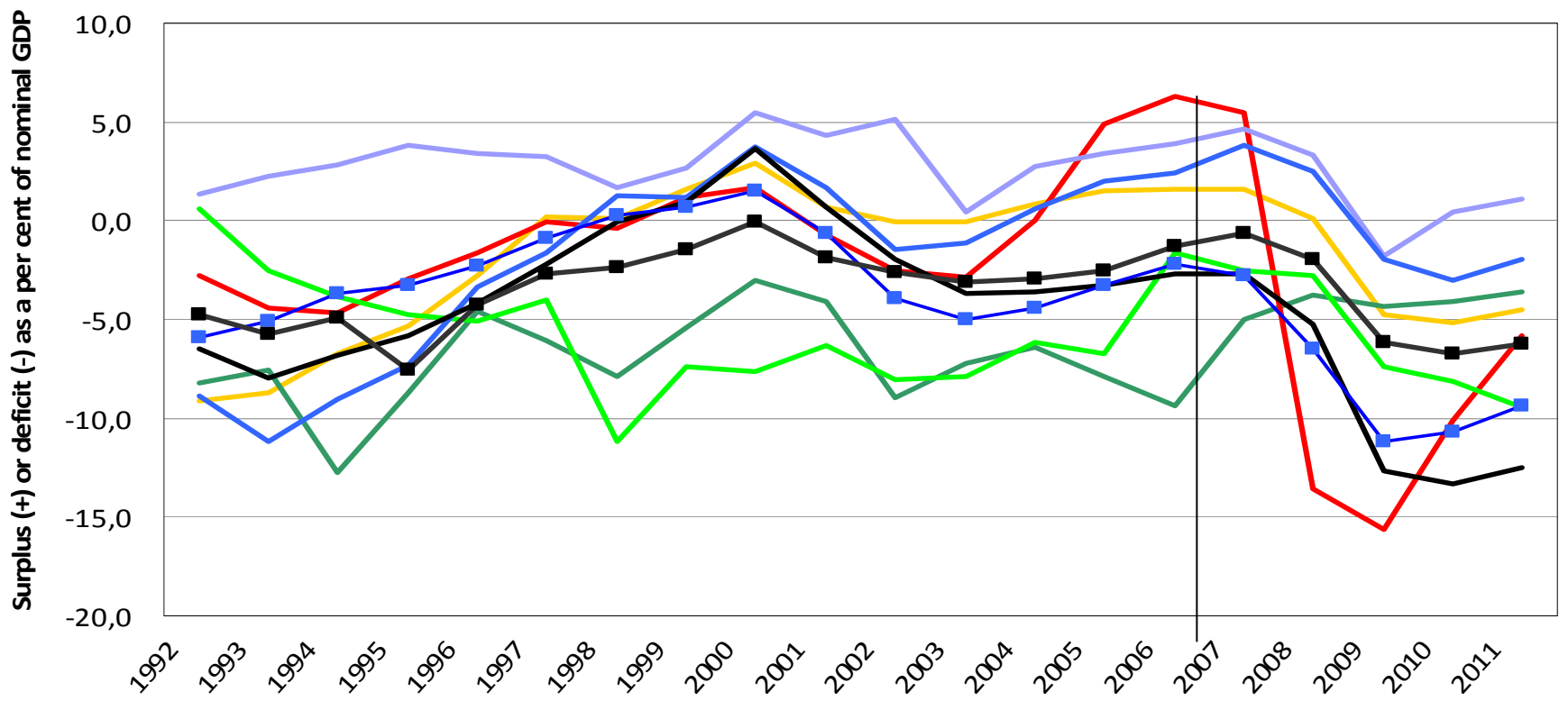
## 2 Cause I: „Grand Recession“ aftershock

- During and after „Grand Recession“ sovereign debt in OECD hiked by ~ 20-40 % points debt/GDP
  - Bank bailout
  - GDP ↓ → tax revenues ↓
  - Stimulus packages
- With low interest rates, debt service is still low
- With inflation fears, rising interest rates (exit from monetary easing) can trigger debt default
- Premature exit from fiscal stimulus could suffocate recovery
- Weakest OECD countries would be hit

## Debt to GDP ratio in selected OECD countries



# Budget Deficits in % of GDP in Selected OECD Countries



- Canada
- Hungary
- Iceland
- Japan
- Korea
- Sweden
- United Kingdom
- United States
- Euro area

### 3 Causes II: „PIIGS“ countries

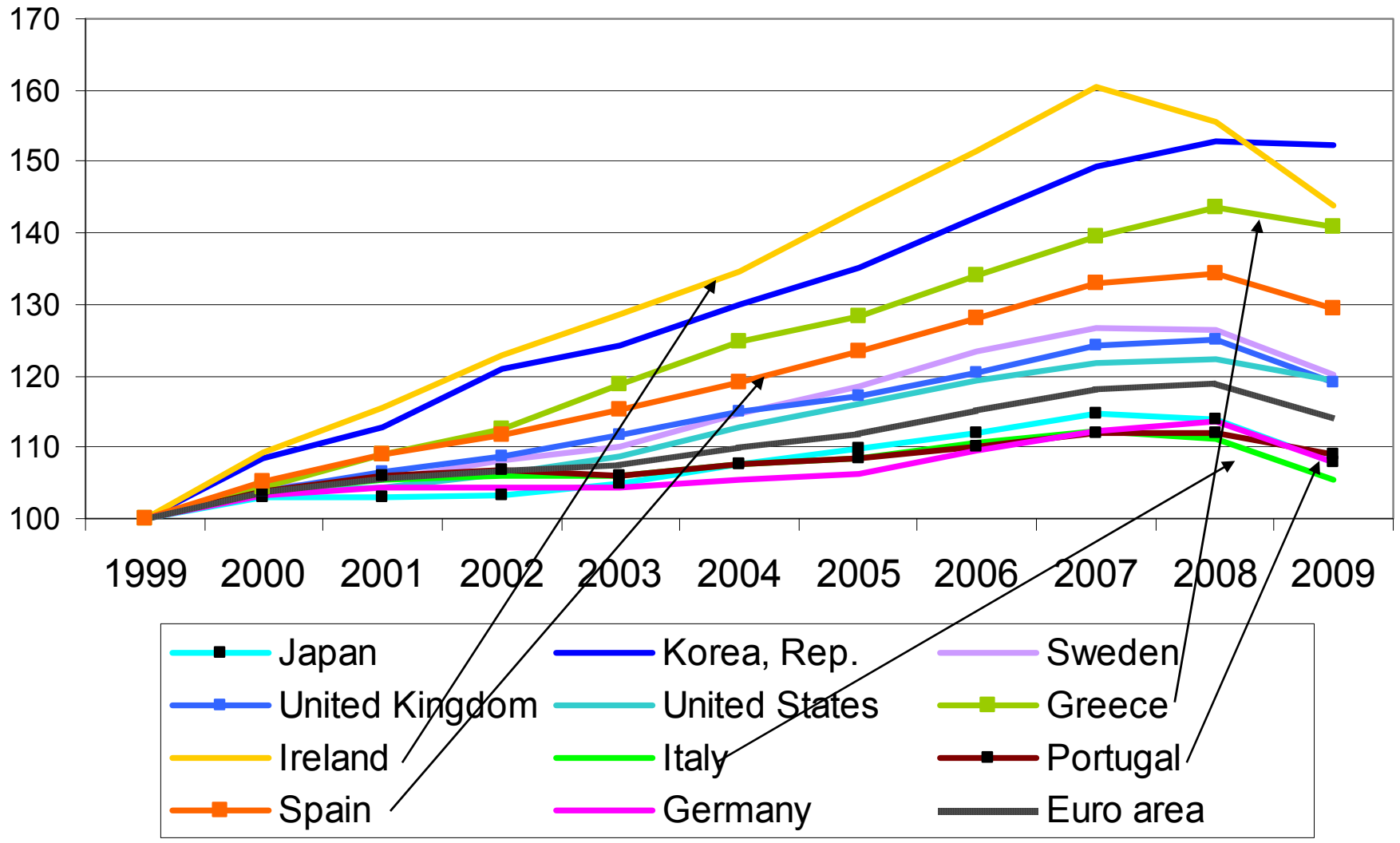
- Above average budget deficits, debt/GDP, current account deficits, stronger rise in unit labour costs (ULC), higher inflation ...
- countries differ considerably: high growth in Ireland, Greece, Spain, not in P and IT
- Sole focus on budget deficits and sovereign debt misleading
- Increasing private sector external debt
- External debt worse than domestic debt although both in € → country risk premium

## Main causes of debt in PIIGS

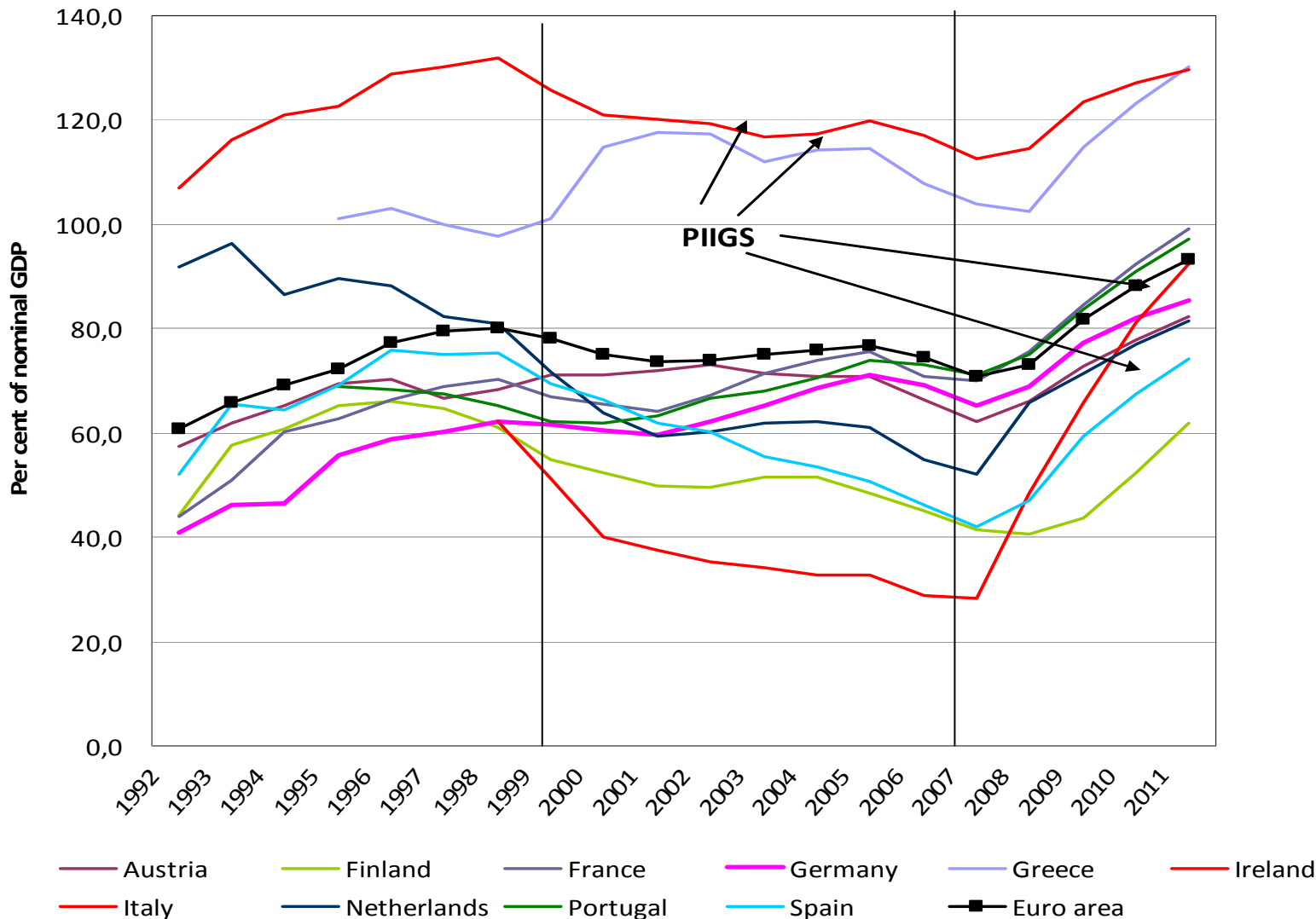
- Main cause of deterioration in debt: grand recession
- Moral hazard: EMU members benefited from AAA rating of all sovereign debt
- Too high inflation, current account, wage increases – was no subject of concern as long as EMU average looks fine
- Spreads enlarged by uncertainty and panic

Note: 3 of the PIIGS are very small (6% of eurozone GDP) → forbearance

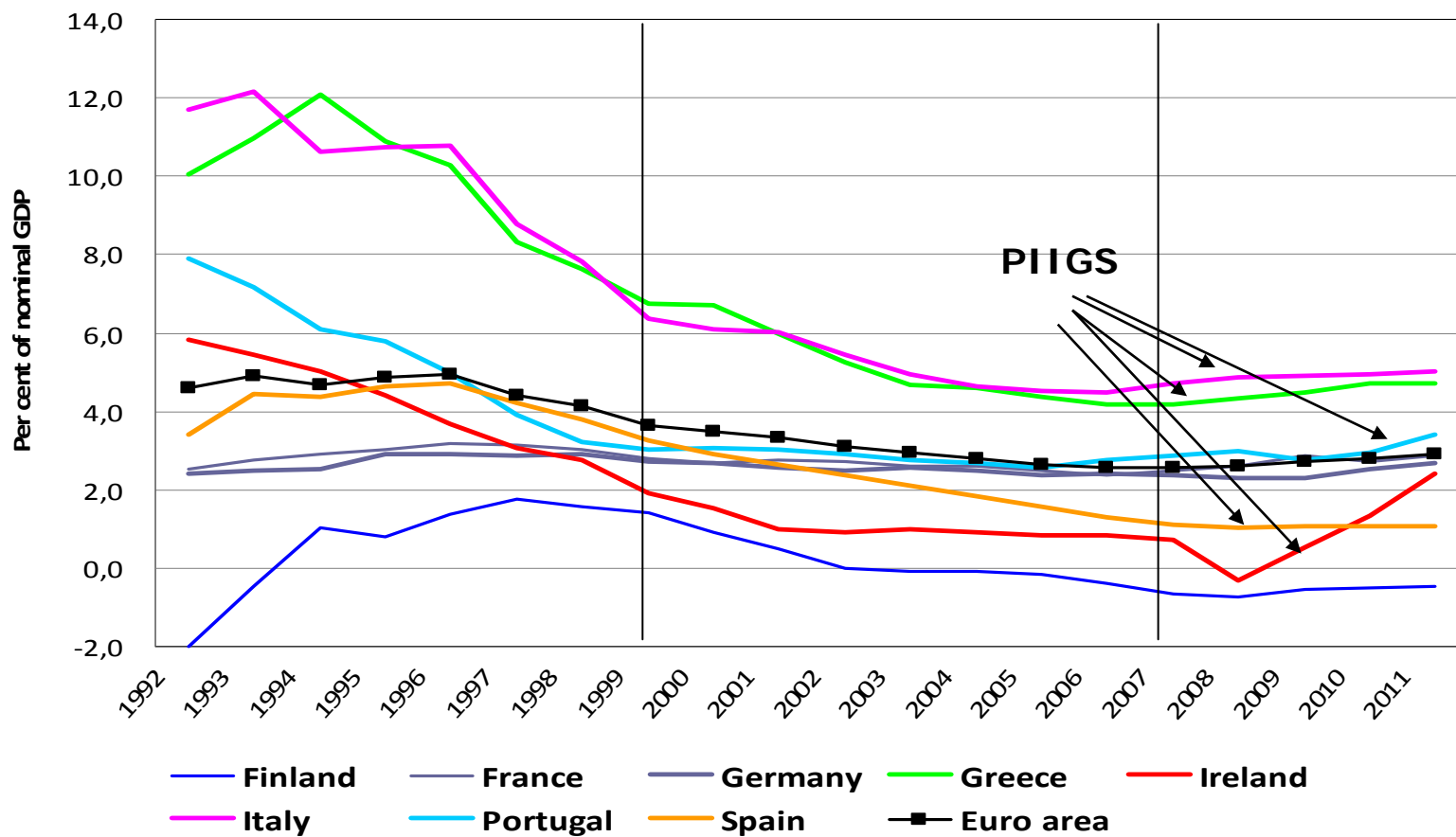
### GDP growth 1999-2009 (1999=100)



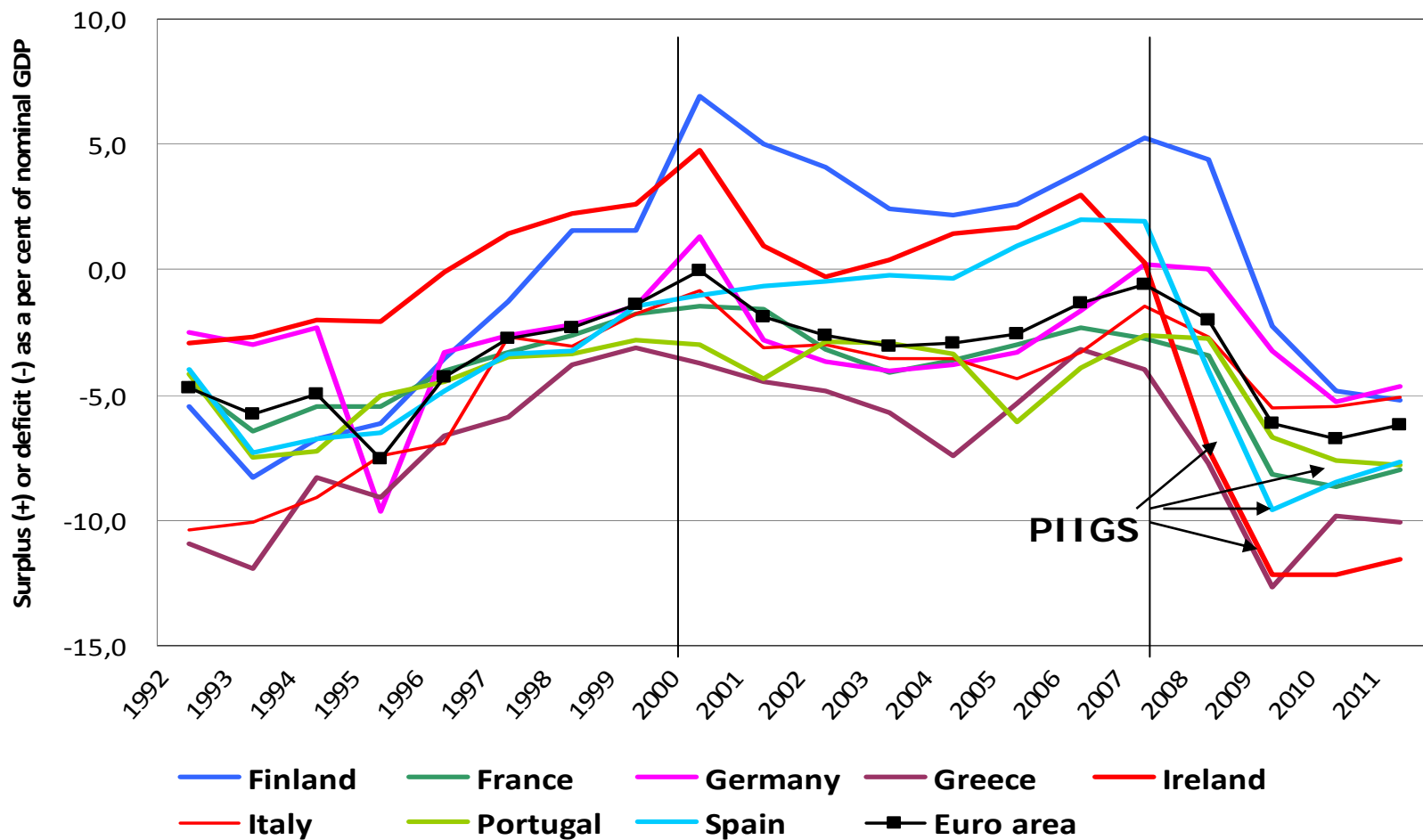
# Debt to GDP ratio in Euro area countries



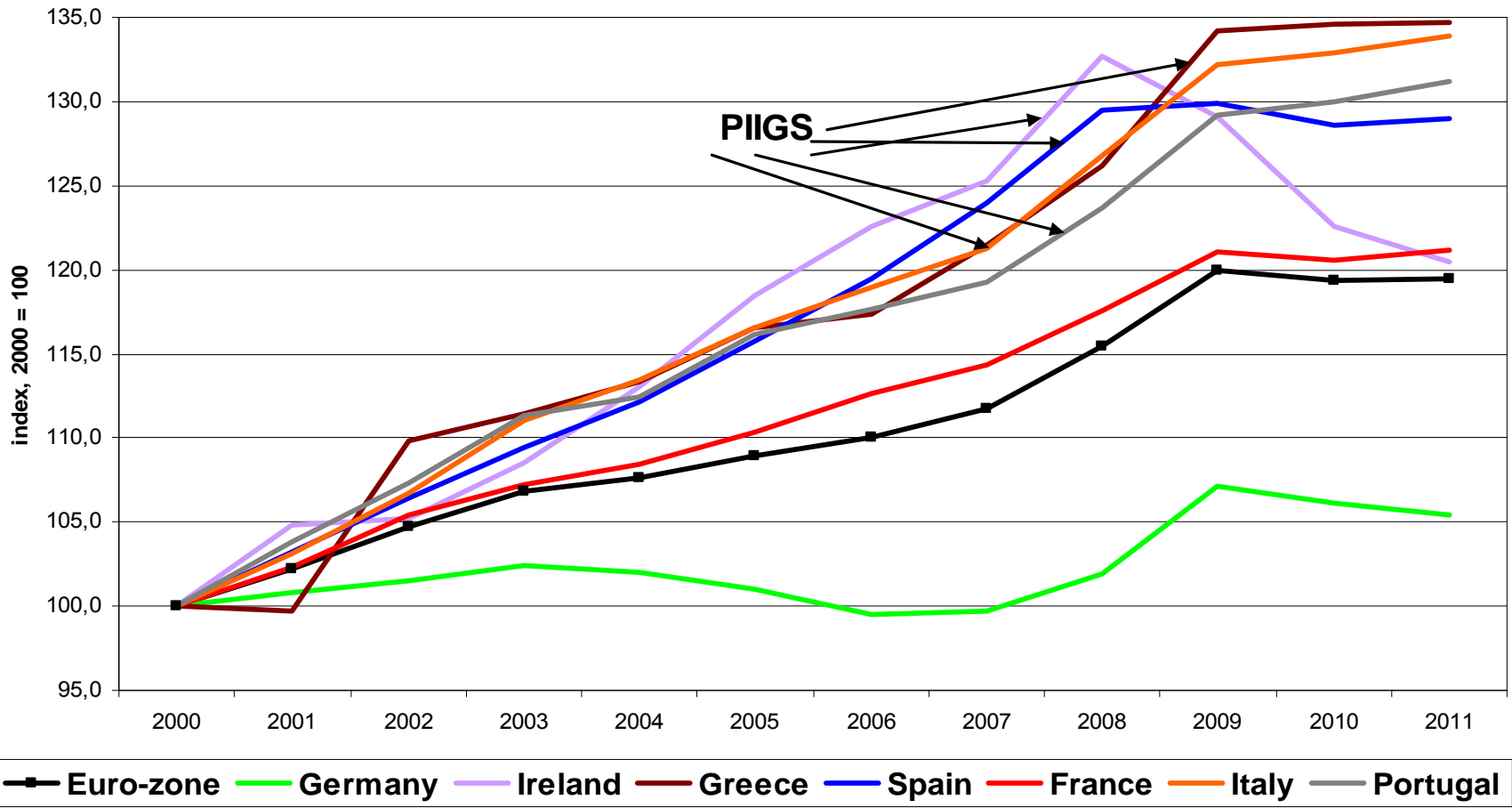
## General government net debt interest payments in selected Euro area countries (% of GDP)



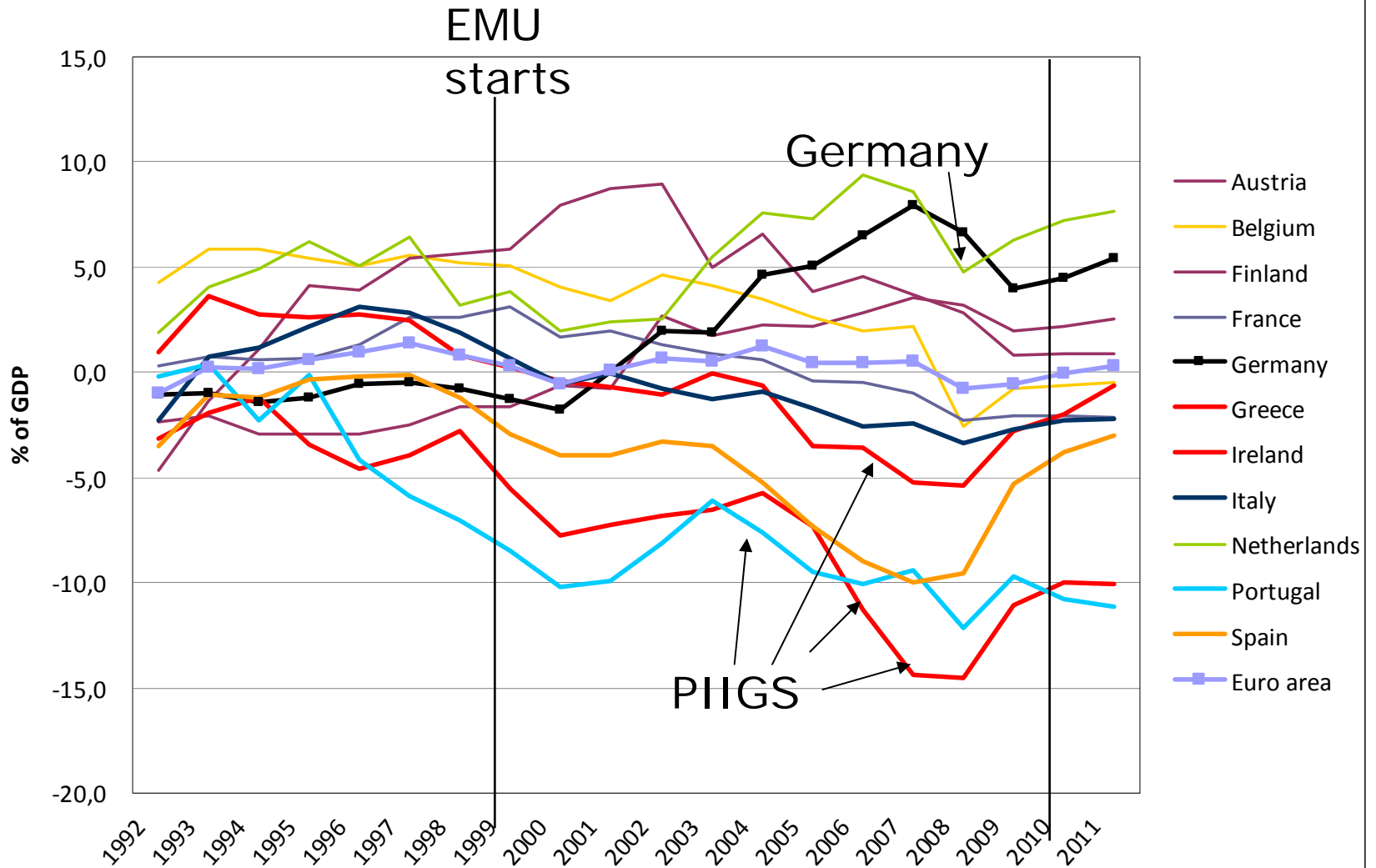
## Budget Deficit in % of GDP in Euro Area



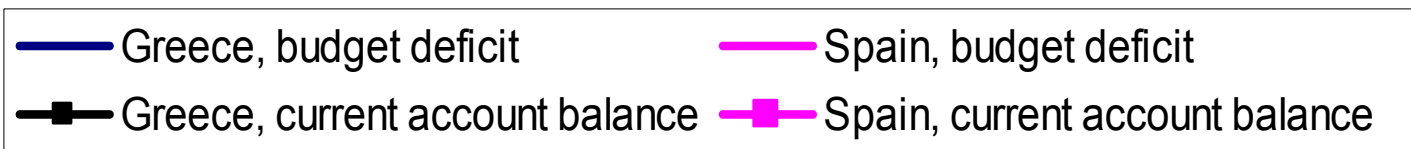
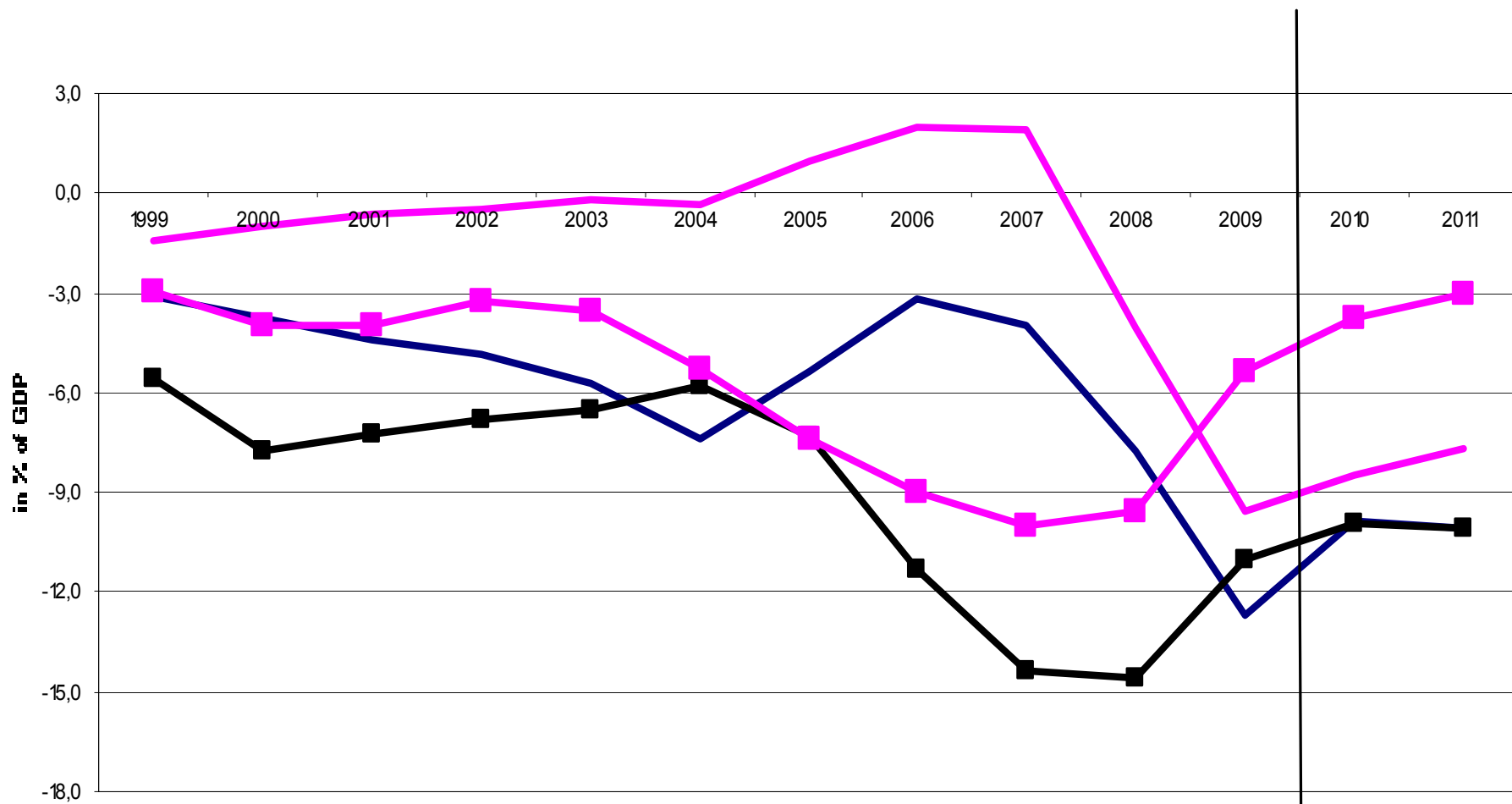
# Unit Labour Costs (ULC) 2000-2010 in the Euro Area



# Current account balances as a percentage of GDP



# Greece and Spain: budget and current account balances in % of GDP



## Impact of PIIGS countries on Euro-zone (in % of Euro-zone)

Country (c)	$\Delta D_c / \Sigma \Delta D$ Eurozone	$D_c / \Sigma D$ Eurozone	$GDP_c / \text{Eurozone GDP}$
Greece	5.7	3.9	2.6
Spain	20.8	7.9	11.7
Italy	14,3	24.9	17.0
Portugal	2,7	1.8	1.8
Ireland	4,1	1.5	1.8
Eurozone	100	100	100
<b><math>\Sigma</math> PIIGS</b>	<b>47.7</b>	<b>40.0</b>	<b>34.9</b>

D debt,  $\Delta D$  budget deficit,  $\Sigma \Delta D$  total budget deficit in euro area,  $\Sigma D$  total debt in euro area

## Countries prone to sovereign debt default

	2010 (est.)	2009	2009	2009	2000-2010
	D/Y	$\Delta$ D/Y	CAB/Y	i x D/Y	ULC growth*
<b>Euro-area</b>	<b>97,4</b>	<b>-6,1</b>	<b>-0,6</b>	<b>2,8</b>	<b>19,4</b>
Greece	123,3	-12,7	-11,1	4,5	34,6
Spain	67,5	-9,6	-5,3	1,1	28,6
Italy	127	-5,5	-2,7	4,9	32,9
Portugal	90,9	-6,7	-9,7	2,8	30
Ireland	81,3	-12,2	-2,8	0,5	22,6
benchmark	60,0	-3,0	-3,0	3,0	22
UK	83,1	-12,6	-2,6	2,4	
U.S.	92,4	-11,2	-3	1,6	
Japan	197,2	-7,4	2,5	0,9	

D debt, Y GDP, CAB current account balance, i interest rate, ULC unit labour costs

Yellow: way beyond benchmarks

## 4 Cause III: speculation

- Popular view, but simplifying
- Speculative attack on Greek bonds with naked short selling unlikely, better evidence needed
- Fundamental problems do exist, uncertainty whether Greece is in liquidity or solvency crisis  
→ uncertain capacity to bear interest burden
- Even „stabilizing“ speculation is exuberant → panic
- Spreads cannot be explained fully by fiscal deficits or other „fundamentals“ → contagion, risk perception ↑, increased vulnerability of lenders, panic

## 5 Causes IV: European trade imbalances

- Divergent economic development, esp. in labour costs, competitiveness indicators and current accounts in EMU
- Since EMU's CAB is +/- 0, most of the imbalances are within EMU
- Germany, Netherlands, Austria and Finland are surplus economies, but Germany has ULC increases of 6.2%, Greece 41.1% p.a. (2000-2010) – differences cumulate
- Germany: quasi real undervaluation, PIIGS: quasi real overvaluation
- Deficit AND surplus countries generate imbalances

- Germany + 3 practice fiscal and wage austerity  
→ lower growth → lower imports
- No corrective market mechanisms in competitiveness divergence
- Until 2007, no currency risk in lending to „PIIGS“ → underpricing of country risk → over-lending + over-borrowing
- Current account balances unsustainable
- ... but self-reinforcing
- „Endogenous divergence“ instead of convergence

## 6 Reform scenario: rectifying EMU architecture

- EMU institutional setting not aligned to strong economic linkages between member countries
- Partly destabilising rules of EMU (e.g. fiscal policy, no-bail-out clause)
- Single capital markets cannot properly assess risks of capital flows
- Missing rules – additional rules necessary
- EMU works below its potential: improvement of sub-optimal currency union
- EMU is a low growth area with Achilles' heels (no convergence mechanisms)

- a) **Remedial action:** „no bail-out clause“ is explosive device for EMU, must be abandoned → solidarity without moral hazard
- b) **Preventive action:** avoidance of excessive budget deficits; current account imbalances; inflation differentials → prevent real depreciation competition
- c) **Growth enhancement** → counter-cyclical fiscal policy
- d) **Reform of SGP**
- e) **New forms of economic governance:**  
Economic Government

## 6.1 Proposal A: Dealing with over-indebtedness

Replace € 750bn rescue package in 2013:

- Liquidity & solvency crisis provisions → „European Monetary Fund“ (EMF)
- Insolvency rules for overindebted EMU-members (sovereign & private debt), involve creditors
- EMF can offer long-term preferential loans to indebted nations with conditionality, ECB stabilises bond prices; EMF can issue Euro bonds
- Mitigation of speculative downward/upward exuberance → proactive anti-speculation policy, should deter speculative attacks and panic

## 6.2 Proposal B: Preventive measures

### Fundamental overhaul of SGP:

- additional convergence criteria must be fulfilled by EMU-members, apart from 3% deficit: inflation +/- 1.0% from target inflation; spreads on gov't bonds +/- 2% from average; current account deficit +/- 3%
- In case of deviation, obligatory adjustment packages
- Surveillance of deviating members, monitoring, obligation for adjustment
- financial penalties as contributions to EU budget: inflation/deflation tax; capital inflow/outflow tax
- make orderly exit from EMU possible

[Additional entry criterion for EMU access (current account balance)]

## 6.3 Proposal C: Counter-cyclical fiscal policy

- Growth enhancing fiscal policy in EMU needed
- All members should be *obliged* to practice rule-based counter-cyclical fiscal policy – with sanctions
- Centralized counter-cyclical fiscal policy by EU budget in case of symmetric shocks to counter EU-wide output-gaps
  - gradual widening of EU budget up to x % of EU-GDP
  - relocation of some national expenditure to EU
  - option for issuance of Euro bonds by EC
  - broadened EU-tax base, own EU-tax
- Rules-based cooperation with ECB

## 6.4 Proposal D: EMU Economic Government

- „Open coordination method“ of governance has failed
- New ECOFIN Government: elected by both EMU Council of Governors and EU parliament (EMU members only)
- Tasks:
  - + monitor compliance with New SGP
  - + conduct macroeconomic policy for EMU according to proposals A, B and C
- Requires EMU-members' Constitution, independent from Lisbon Treaty
- Deepens European integration within EMU
- Towards „Two Speeds European Integration“

## 7 Conclusions

- The crisis we have is not a Greece or „PIIGS“ crisis – but an EMU crisis
- ... existence of EMU is at risk
- To assure credibility, timely EMU reforms necessary
- Deficit and surplus countries are inter-linked
- Deepening European integration, i.e. centralised economic policy in EMU: European Government
- Simple fiscal tightening is counter-productive, if not complemented by growth strategy
- Quantum leap in European integration is needed to let EMU survive