



# The Eurozone crisis: Causes and implications

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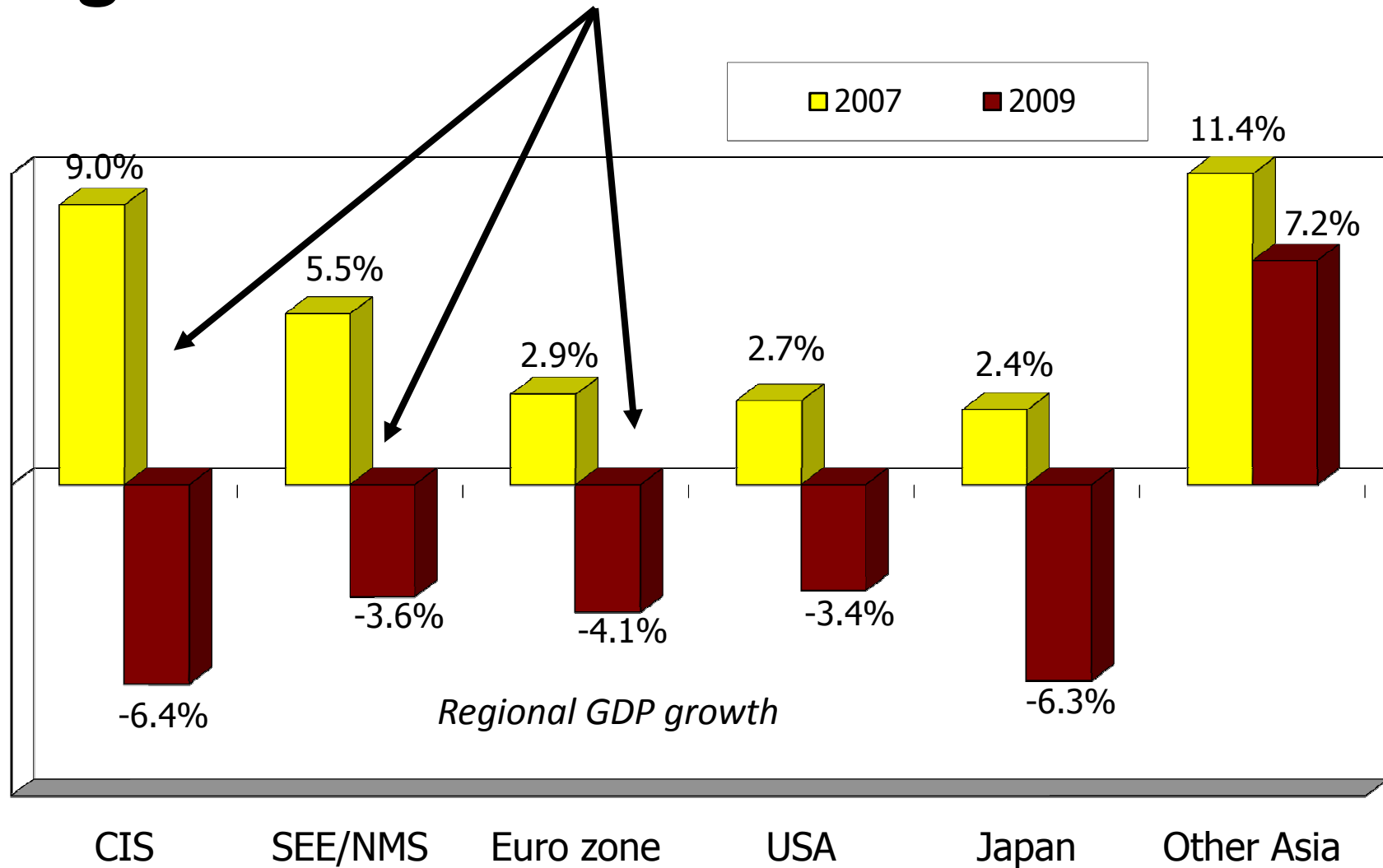
# The good news, and the bad . . .

- Good news:
  - The Eurozone will probably not break up
  - Some crisis outcomes could be good:
    - A weaker Euro
    - EU fiscal reform
- Bad news:
  - Europe is in for serious economic trouble
    - Best medium-term growth outcome: stagnation
    - European countries without the Euro also affected
    - Collateral damage could be global
  - Risks of very bad outcomes are non-trivial:
    - A horrific financial/economic crisis in Europe
    - Break-up of the EU

# **. . . The misunderstood, and the not yet fully appreciated**

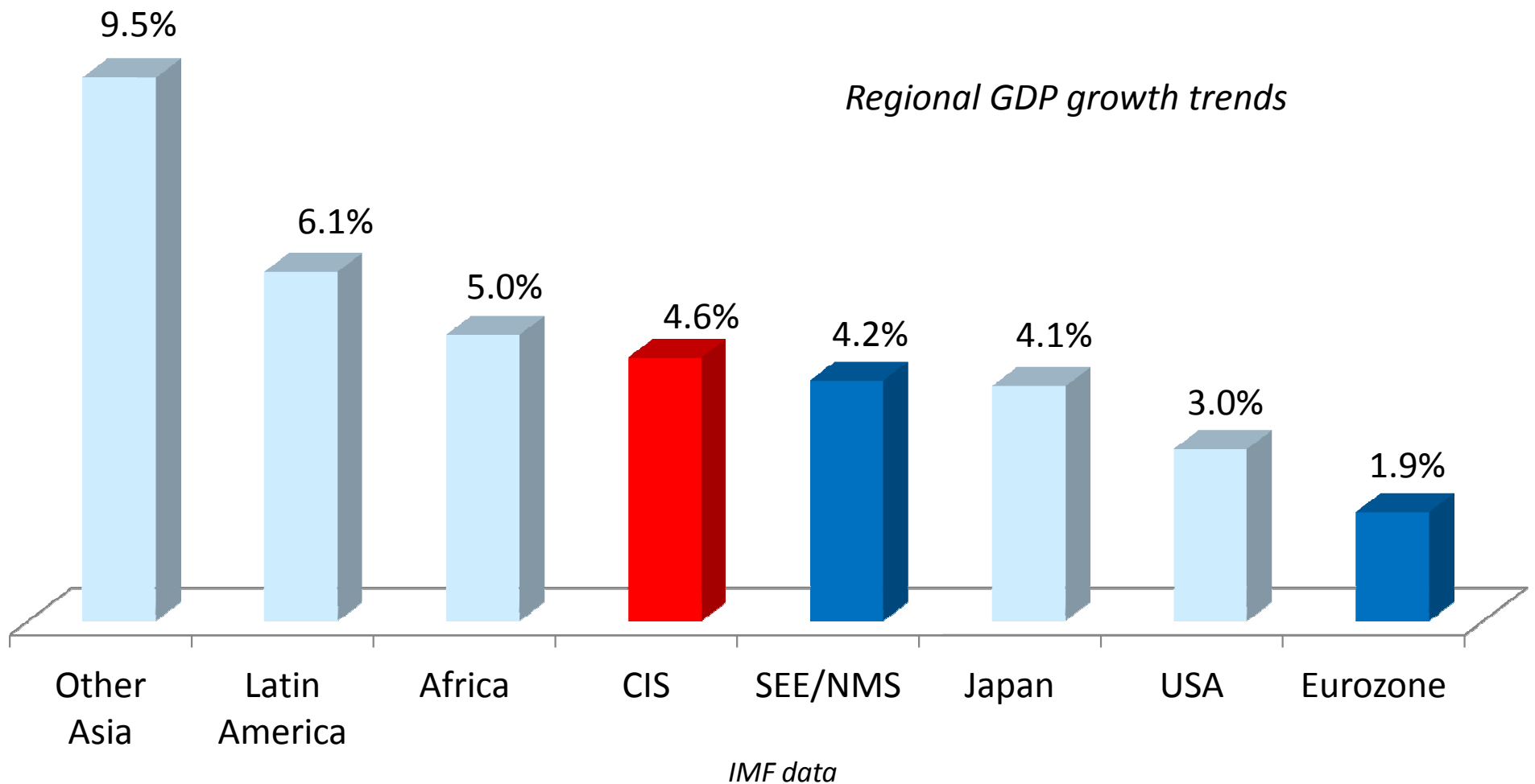
- What's misunderstood:
  - It's not about the common currency
  - It's about fiscal policy and debt
- What's not fully appreciated:
  - Europe will be a source of global financial instability and contagion for years to come
  - The soft power of the “European anchor” (linked to EU accession, integration) will weaken
  - Rebalancing of the global political economy, away from the “north” towards the BRICS, will accelerate
  - An important source of core funding for the UN, global governance will shrink

# Europe took a big hit from the global financial crisis in 2008-2009



IMF data

# Recovery in 2010— relatively weak

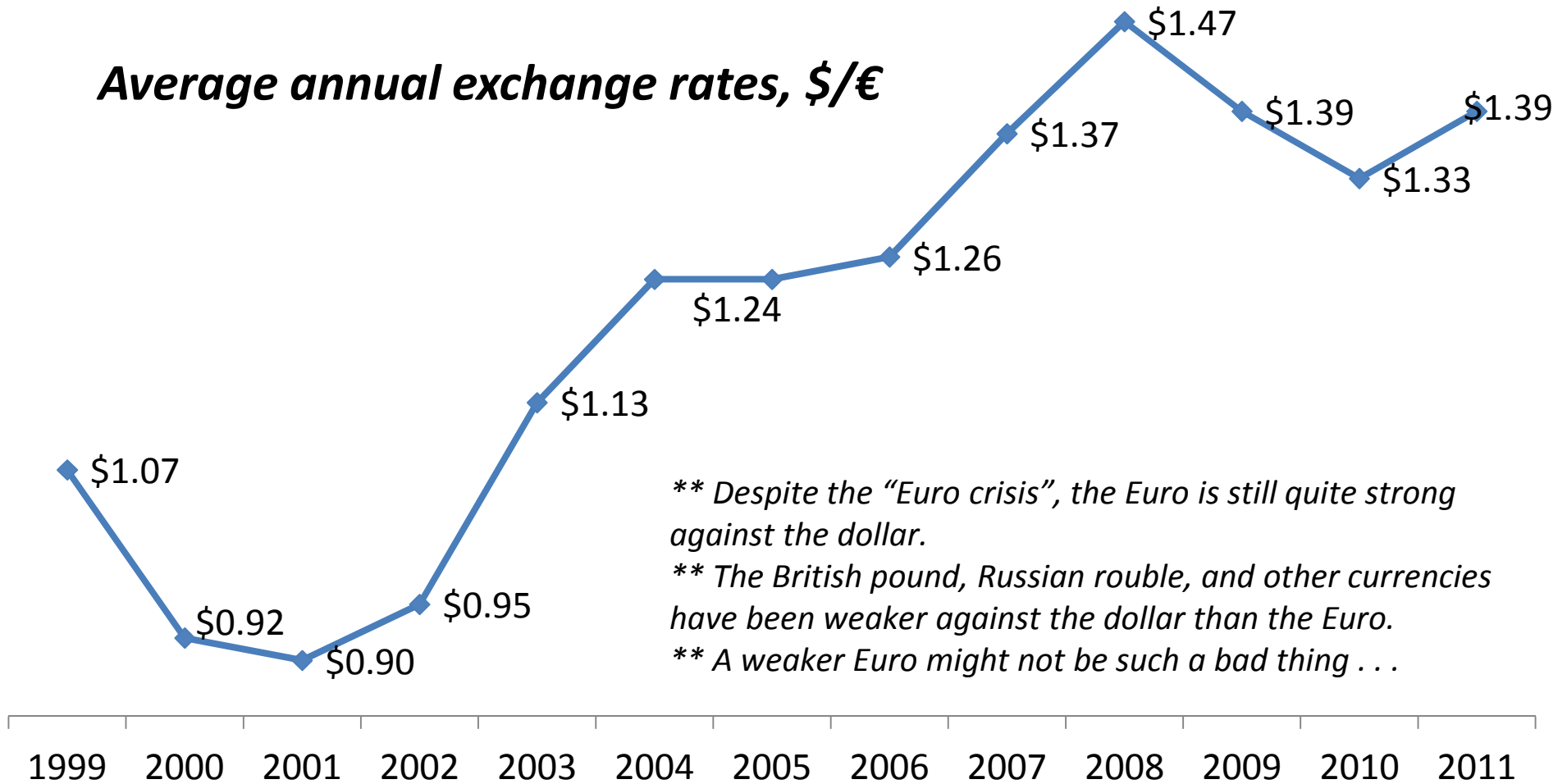


# Whence comes the Euro?

- Euro was introduced in 1999:
  - Part of 1991 Maastricht Treaty that formed the Economic and Monetary Union (EMU)
  - “Cash” Euro introduced in 2002
- Economics:
  - Allows Europe’s monetary policy to be managed by European Central Bank
    - By contrast, there is no European fiscal policy
  - Reflection of deep financial integration
- Politics: Euro has symbolized a united, prosperous Europe

# How has the Euro fared? Not so badly . . .

*Average annual exchange rates, \$/€*



*\*\* Despite the "Euro crisis", the Euro is still quite strong against the dollar.*

*\*\* The British pound, Russian rouble, and other currencies have been weaker against the dollar than the Euro.*

*\*\* A weaker Euro might not be such a bad thing . . .*

*ECB data, UNDP calculations.*

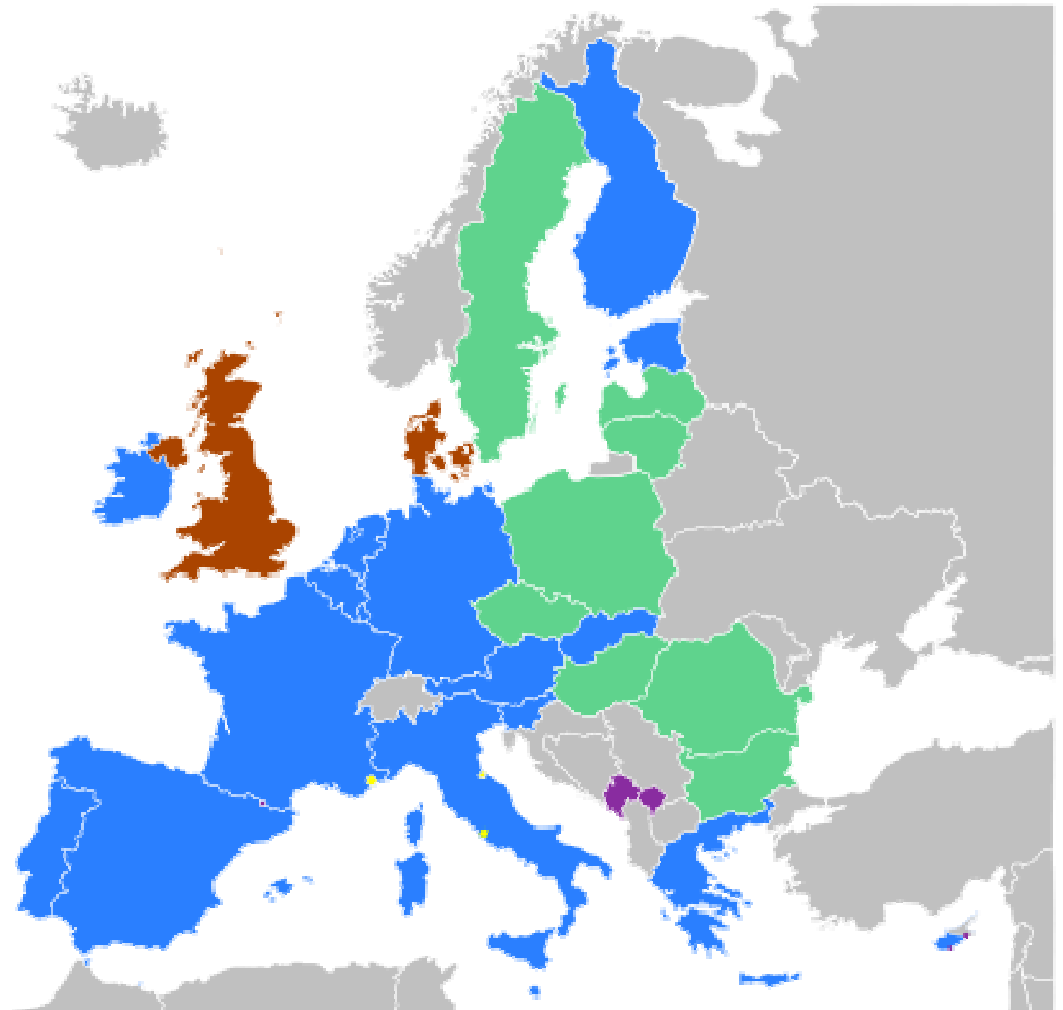
# Most EU countries have adopted, or must adopt, the Euro



- Only Denmark, the UK have “opt outs”
  - There are no legal provisions for withdrawing from the Eurozone
- To enter the Euro zone, “convergence criteria” for financial stability must be met
  - Fiscal deficits: 3% of GDP
  - Public debt: 60% of GDP
  - These also apply after membership (“Stability and growth pact”)

# Eurozone today—17 members

- 1999: Austria, Belgium, Finland, France, Germany, Italy, Ireland, Luxembourg, Netherlands, Portugal, Spain
- 2001: Greece
- 2007: Slovenia
- 2008: Cyprus, Malta
- 2009: Slovakia
- 2011: Estonia

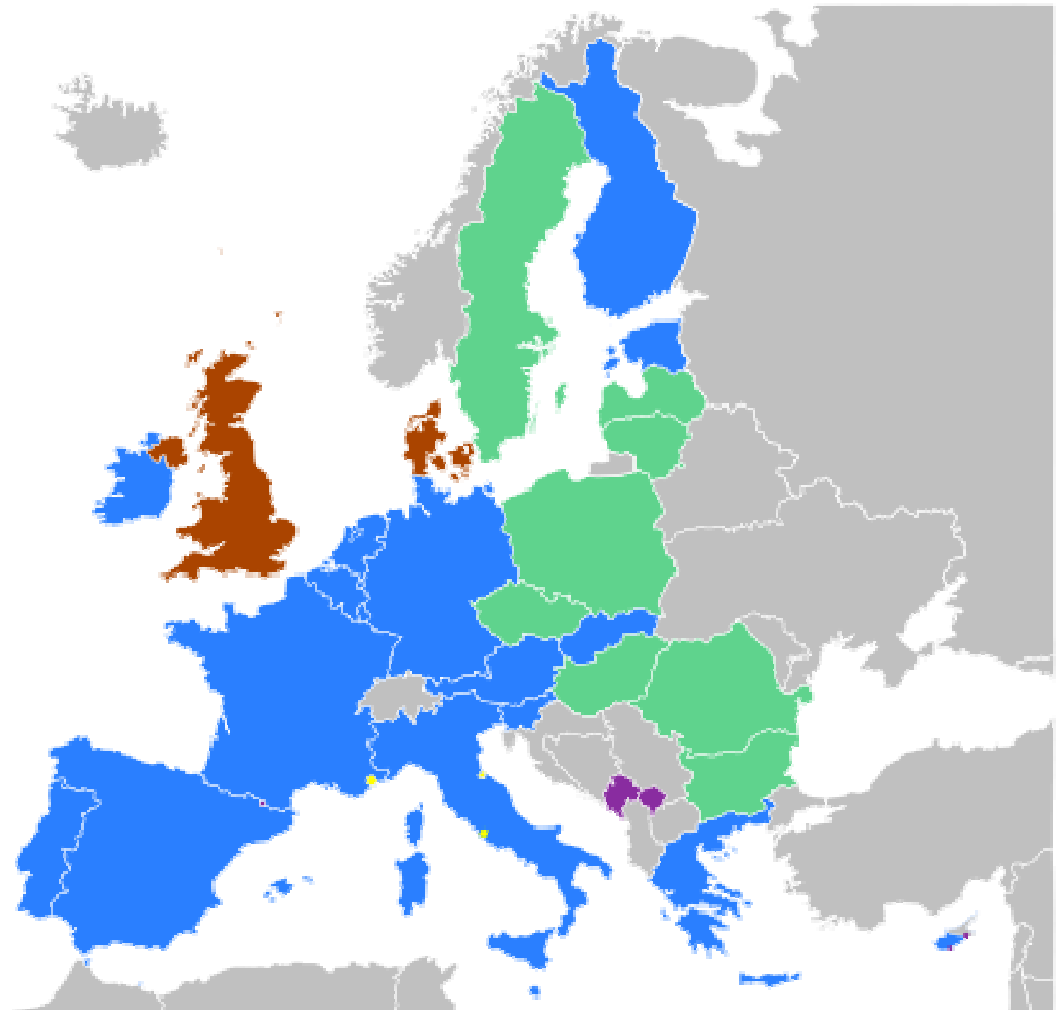


# What are the economic benefits of a monetary union?

- Reduced exchange rate risks
- A single currency:
  - Promotes trade within a monetary union, by
    - Lowering transactions costs
    - Reducing uncertainty
  - Prevents balance-sheet mismatches
    - When Iceland's krone depreciated sharply against the Euro in 2008, its banks—which had borrowed in Euros and made loans in krone—collapsed
    - These mismatches kept the Baltic states, Bulgaria, Croatia, FYRoM from devaluing their currencies, thereby magnifying their 2009-2010 recessions

# Additional benefits of a monetary union

- Before the Euro, most of Europe was “tied to the Deutsche mark” anyway
- For transition economies, adopting the Euro can serve as an “anchor” promoting macroeconomic, financial stability
  - This is why Kosovo, Montenegro have the Euro



# Downside of a monetary union?

- Loss of independent monetary, exchange-rate policies
  - But for most EU countries, *de facto* policy discretion was very limited before the Euro
  - This is true today for:
    - Croatia (and Macedonia) with Euro pegs
    - BiH, Bulgaria, Lithuania with currency boards
- Loss of ability to improve competitiveness via devaluation/depreciation
  - But most EU countries concluded that this benefit is of limited importance, because of:
    - “Competitive devaluation” syndrome
    - High inflationary pass-through of devaluation

# Additional downsides of a monetary union

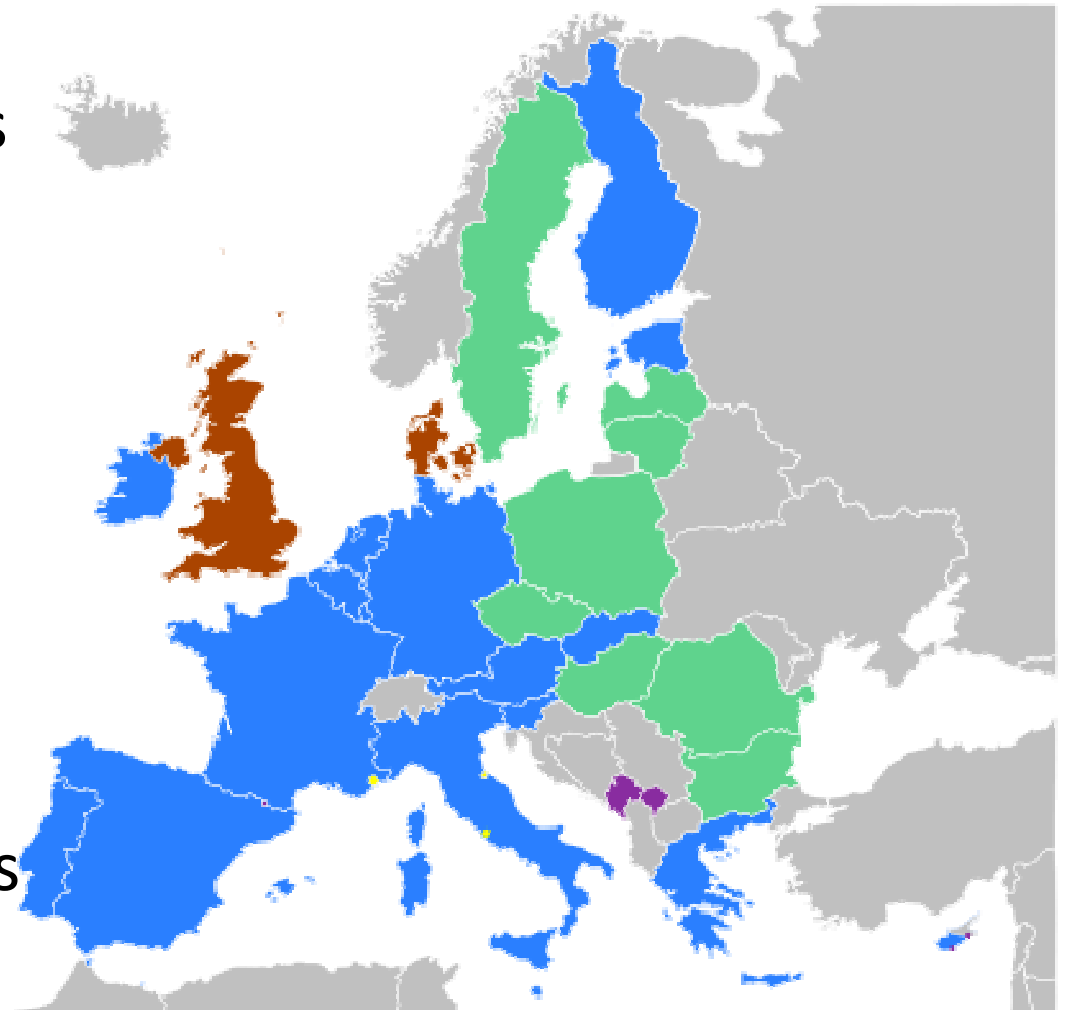
- Challenges of the Stability and Growth Pact:
  - Maastricht created a European Central Bank— but not a European Ministry of Finance
  - Weak sanctions for violators
  - Discretionary fiscal policy is limited
  - All the burden is put on monetary policy
- Productivity/competitiveness issues have to be addressed by non-monetary tools:
  - Fiscal transfers from rich to poor countries/regions (e.g., cohesion funds)
  - Wage, price, labour market flexibility — “internal devaluation” (“Europe 2020”)

# These risks are now playing out in the Eurozone

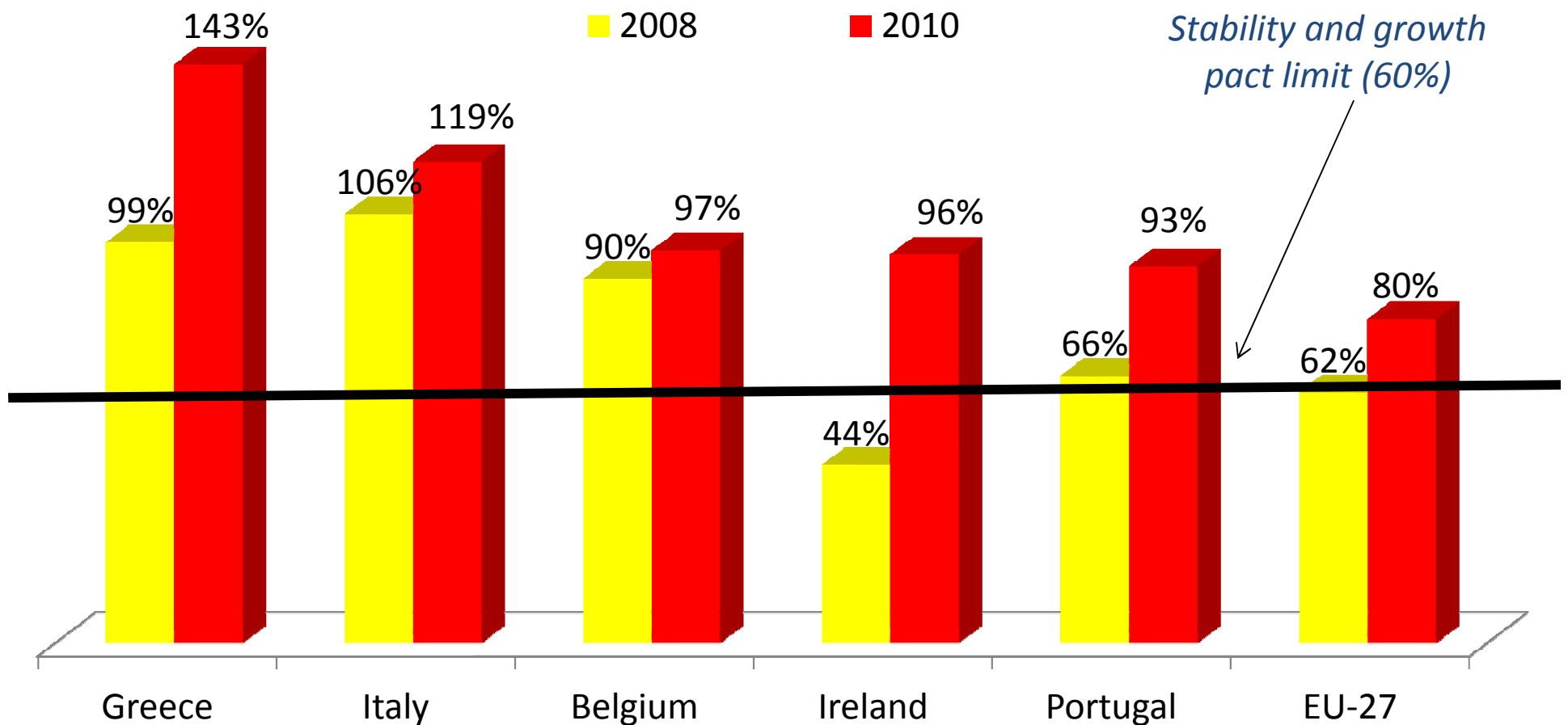
- Stability and growth pact has not been observed (no European minister of finance)
  - High budget deficits, public debt have resulted
- Improvements in competitiveness require painful internal devaluations:
  - Fiscal transfers from rich to poor countries/regions (e.g., cohesion funds) are too small to have major macro impact
  - Within the EU, wages are relatively inflexible, labour is relatively immobile
- Result: intra- , inter-state political tensions

# Eurozone's challenges today

- Two key problems:
  - Debt and deficits
  - Lost competitiveness
- They are not problems of the Eurozone as a whole—they're:
  - Problems of individual countries (PIIGS) . . .
  - . . . That are spread to other EU countries via the Eurozone



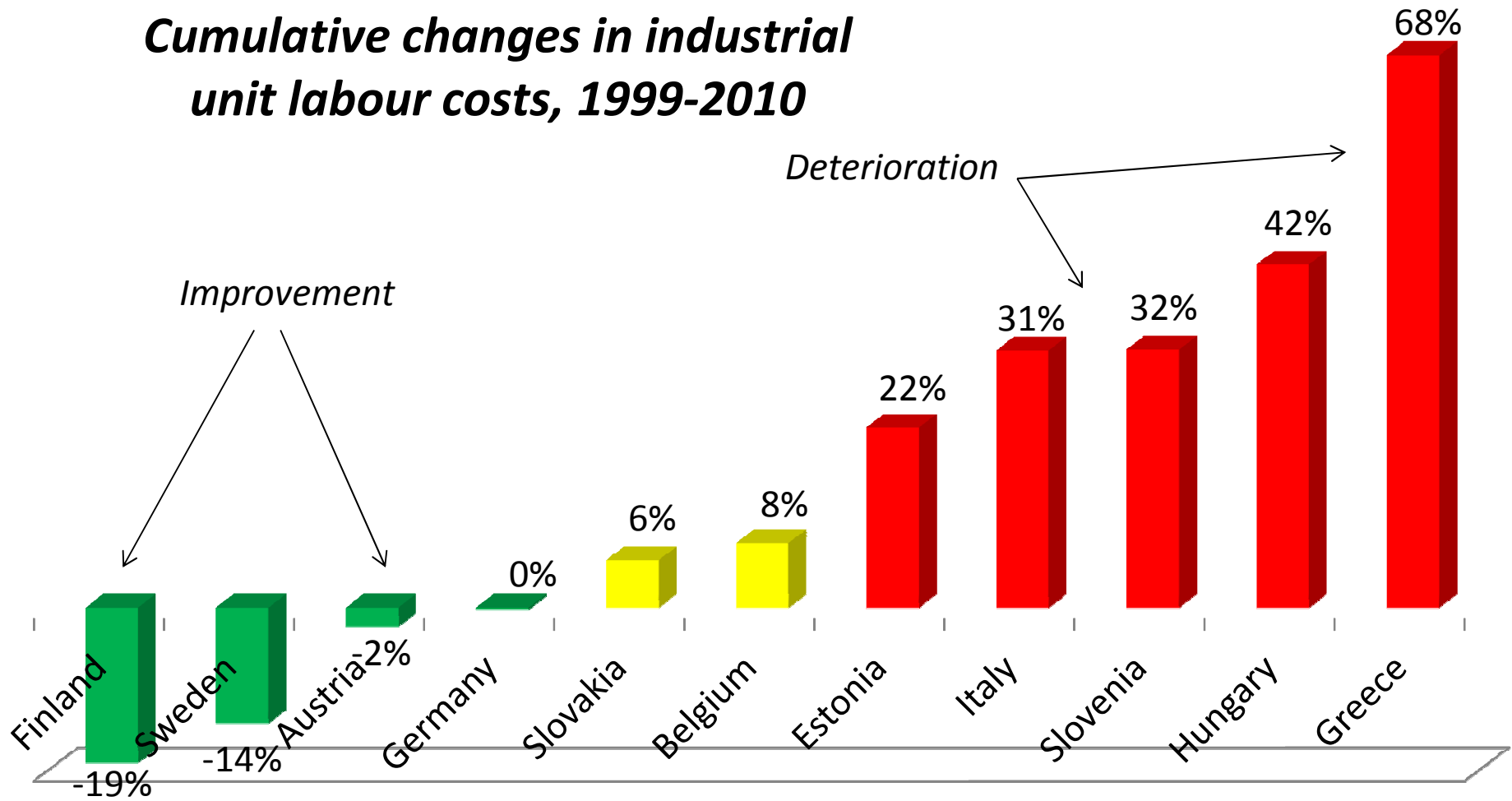
# “PIIGS” and friends: Bank bailouts, other spending boost public debts



*Gross public debt as share of GDP. Eurostat data.*

# Competitiveness trends

*Cumulative changes in industrial unit labour costs, 1999-2010*



OECD data, UNDP calculations.

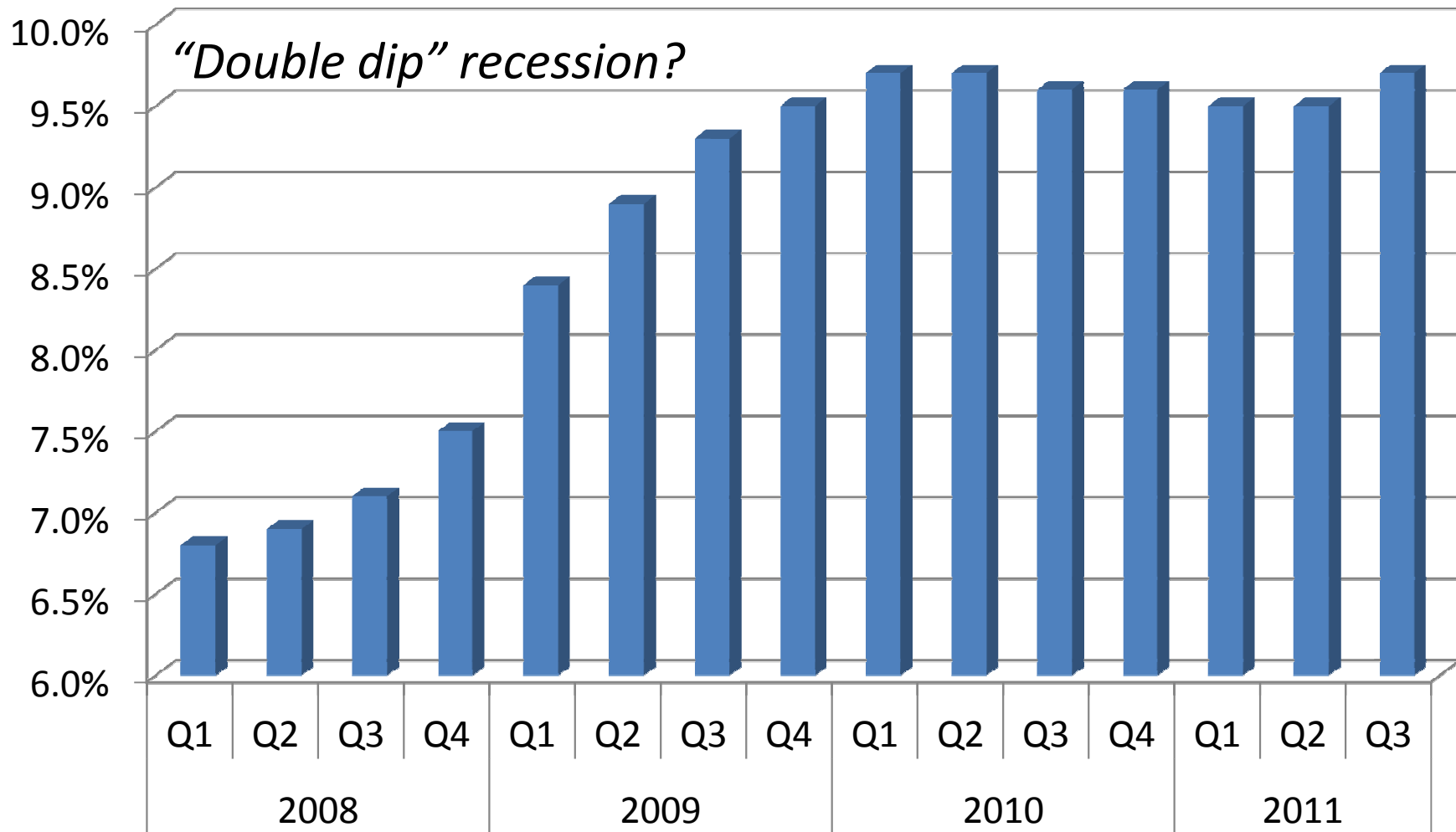
# Fiscal risk implications

- Greece, Ireland, Portugal:
  - Have lost access to international capital markets
  - Can't refinance their state debt when it comes due
  - Now getting bail-outs by the IMF, European Financial Stability Facility
- Greece: “Voluntary” public debt restructuring
- What if Spain or Italy loses access to the markets?
  - Do the IMF, EFSF have enough “fire power”?
  - It's not clear . . .
- There's not much “fiscal space” left in the Euro zone, to respond to recessionary conditions

# Financial sector risks implications

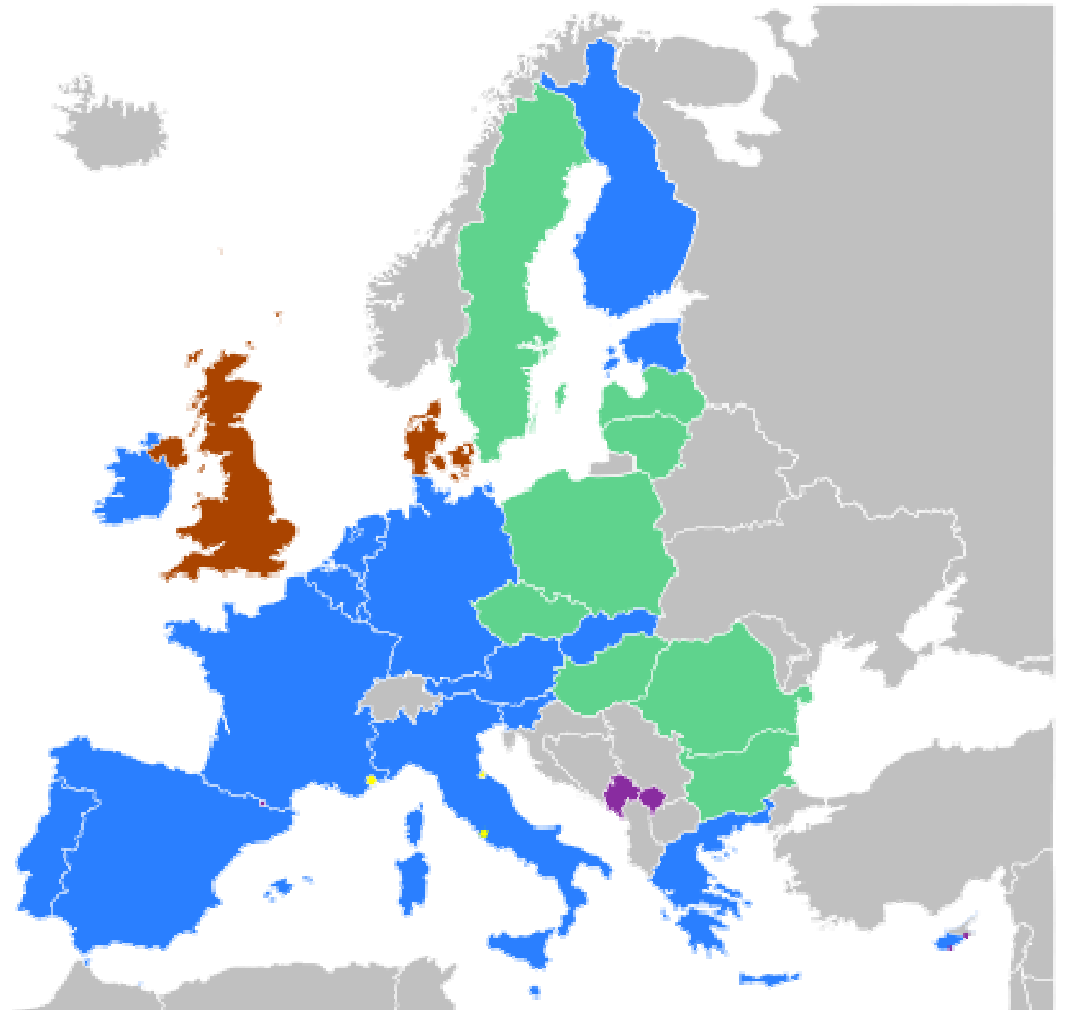
- Financial institutions that own Greek debt are taking “haircuts”
- Many of these banks:
  - Lost money:
    - In the pre-2008 real estate bust . . .
    - . . . During the global financial crisis
  - Need to raise new capital for their own sustainability
- Result: money, credit conditions are tightening, exacerbating recessionary tendencies
- The ECB is buying PIIGS (and other countries’) sovereign debt on secondary markets
  - If more “haircuts” come, the ECB might be threatened
  - Who would bail out the ECB? BRICS?

# Social implications: EU-27 unemployment rate isn't falling



# If things are so bad in the Eurozone, why not leave?

- Legally—it's virtually impossible
  - Can't leave EMU without leaving EU
  - There's no provision for leaving the EU
- Presumably, a country that wants to leave would have to negotiate this with each of the other 26 member states . . .



***“Treaties are like roses and young girls. They last while they last”—Charles de Gaulle***

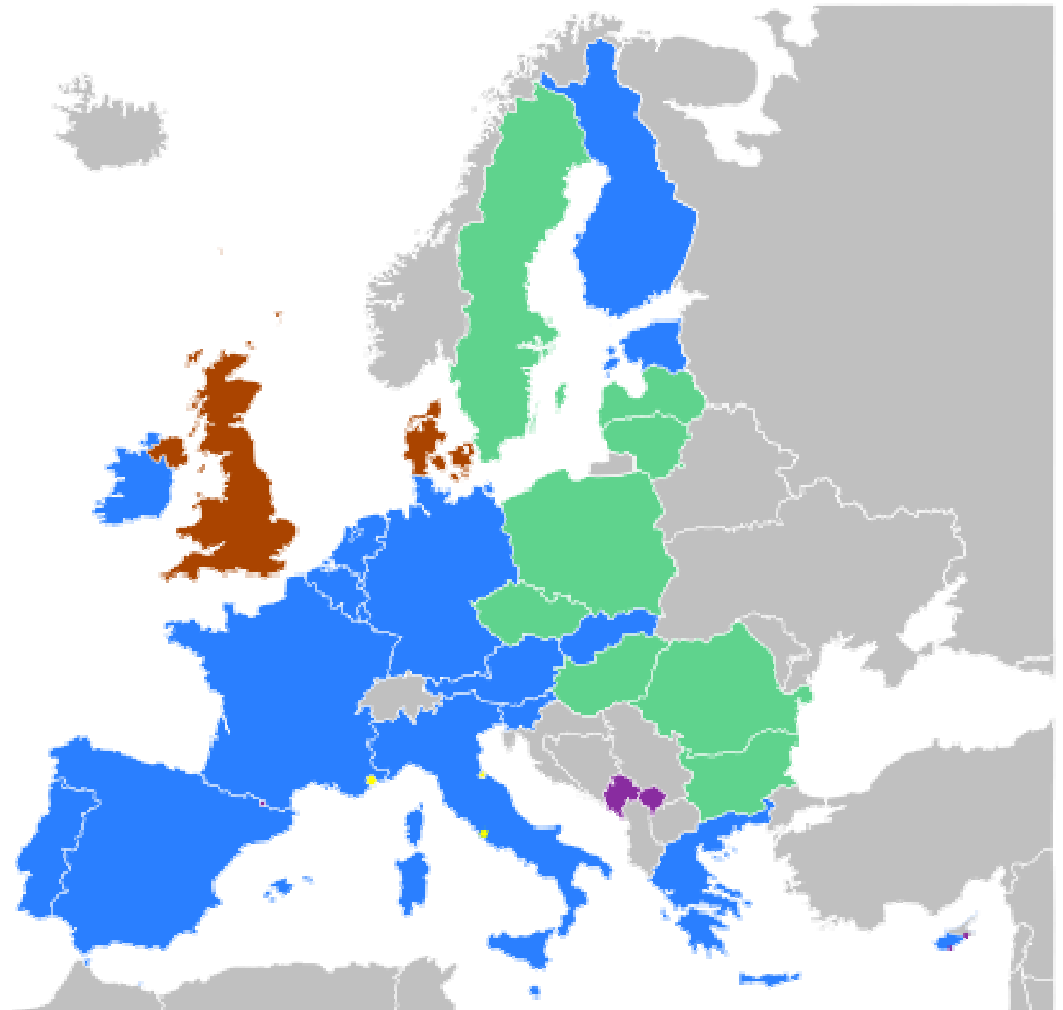
- Why not leave anyway?
- Different possible scenarios
  - If Greece left the Eurozone, it could:
    - Reintroduce a national currency, regain control of its monetary and exchange rate policies, and
    - Devalue, to restore competitiveness
  - Or Germany (perhaps with some likeminded northern European countries) could:
    - Introduce a “new Euro” or “Northern Euro”
    - The “neuro” would appreciate against the Euro, helping to restore Eurozone competitiveness (for the PIIGS)

# **Either scenario risks a European (possibly global) financial meltdown**

- A country preparing to leave the Eurozone would face massive capital outflows
- After leaving, it would face a:
  - Huge devaluation, high inflation, and bankruptcies
  - Multi-year legal nightmare while its Euro-denominated contracts get renegotiated (in various national courts)
  - In short: Its financial system would collapse
- This would be a disaster for creditors as well
  - “Northern” European banks, governments could lose access to finance as well
  - Massive contagion: the good go down with the bad (“mutual assured financial destruction”)

# Europe faces a Hobson's choice

- Optimistic scenario:
  - Slow (or no) economic growth for 2-3 years
  - Financial instability
  - Socio-economic tensions
  - Weakening of EU's
    - Cohesion
    - Vitality
    - Soft power
- Pessimistic scenario:
  - Financial collapse
  - Global financial contagion
    - Euro is a global reserve currency



# Implications for the “wider neighbourhood”



- To the EU: Slower export growth
- From the EU— slower growth in:
  - Foreign investment
  - Remittances
- Outcomes:
  - Slower growth in:
    - GDP
    - Consumption
  - More poverty, social exclusion
  - Less interest in EU accession, integration

# “Don’t worry, be happy”

- Worst-case scenarios are unlikely to happen
- Euro’s current problems could:
  - Strengthen the EU fiscal system
  - Boost competitiveness
- For many countries, its still better to be in the Eurozone than to be out
  - Many are tied to the Euro anyway
  - Adopting the Euro removes balance-sheet mismatches
  - BiH, Bulgaria, Croatia, FYRoM, Latvia, Lithuania
  - Downside: Have to finance bailouts
- Exceptions: Czech Republic, Denmark, Poland, Sweden, Turkey, UK—for two reasons
  - Relatively large domestic markets minimize inflationary pass-through; or
  - Not so much borrowing in Euros