

EUROPA IN CRISIS

HET CENTRAAL
PLANBUREAU OVER
SCHULDEN EN
DE TOEKOMST VAN
DE EUROZONE

COEN TEULINGS e.a.

'Een *must* voor iedereen die wil meedenken over de toekomst van het eurogebied, misschien wel de grootste economische en politieke uitdaging van de laatste vijftig jaar.' – *Arnoud Boot, hoogleraar ondernemingsfinanciering en financiële markten aan de UvA*



Centraal Planbureau

Europe in crisis

George Gelauff

ECU'92 Lustrum Conference
Utrecht

23 February 2012

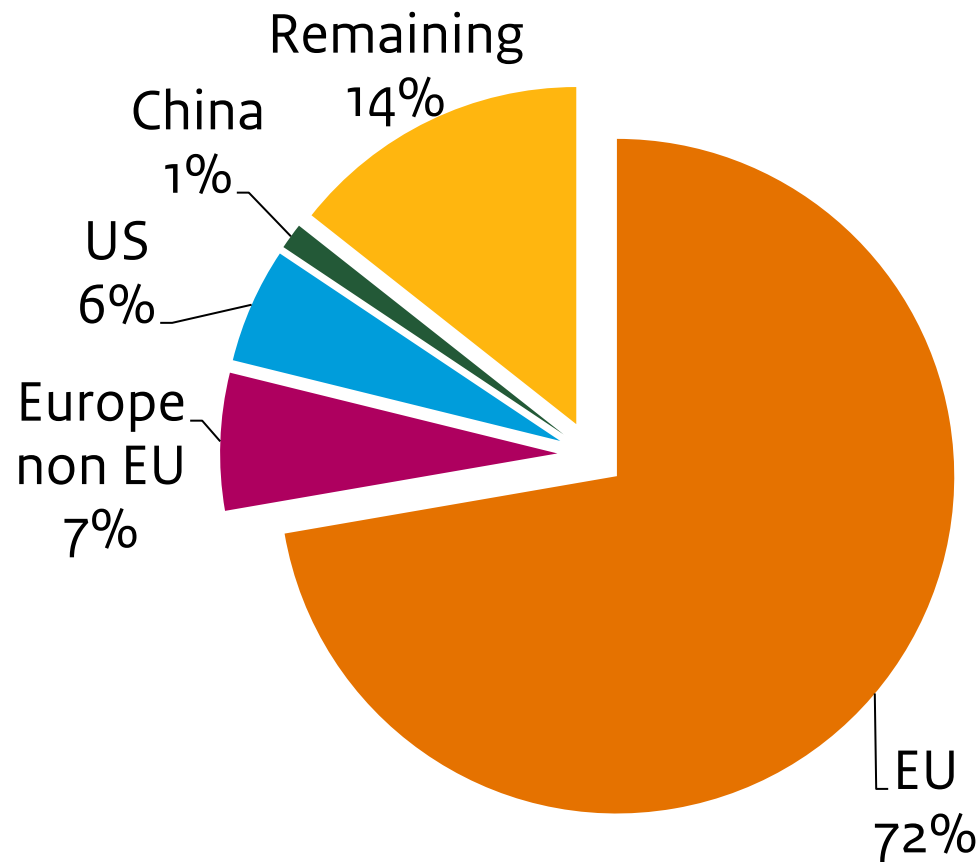


Menu

- Costs and benefits of Europe
- Banks and governments
- Monetary Union and debts
- Germany
- Conclusion



Europe largest export market for the Netherlands





Benefits of the internal market

- Four freedoms, free movement of:
 - goods, services, capital and people
- National income 4-6% higher by internal market
 - more trade, competition and innovation
 - increase in scale
 - restriction of the power of national champions
- Single European market provides one month's salary
 - €1500 to €2000 euro per year



Monetary union: advantages and disadvantages

- Advantages
 - lower transaction costs: more trade
 - better risk spreading: more investment
 - one central bank: lower inflation especially in Southern countries
- Disadvantages:
 - no adjustment through the exchange rate
- Absorbing shocks
 - simpler with synchronised business cycles
 - factor mobility (labour, capital)
 - wage flexibility
 - budgetary transfers



Advantages and disadvantages of the EMU

- Direct costs setting-up EMU: 1% GDP (once-only)
- Advantages of introduction of the Euro less clear
 - Baldwin: 5% more trade
 - at the most one week's salary
- Costs of abolishing the Euro enormous
 - legal costs: in which currency will claims be recovered?
 - appreciation of Northern European currency, loss of competitiveness
 - large problems for the banks
 - loss on assets for pension funds (and others)



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Financial integration increased

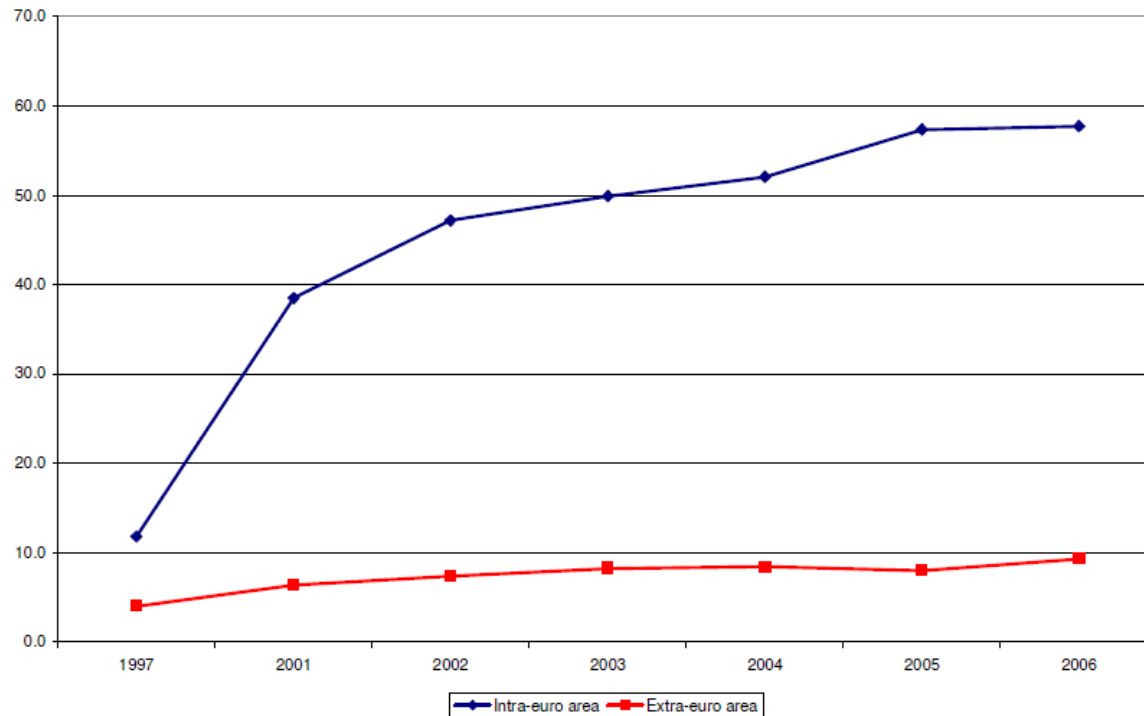


Figure 3: Cross-Border Ownership of Euro Long-Term Debt. Note: . Source: European Central Bank's *Financial Integration Indicators* database.

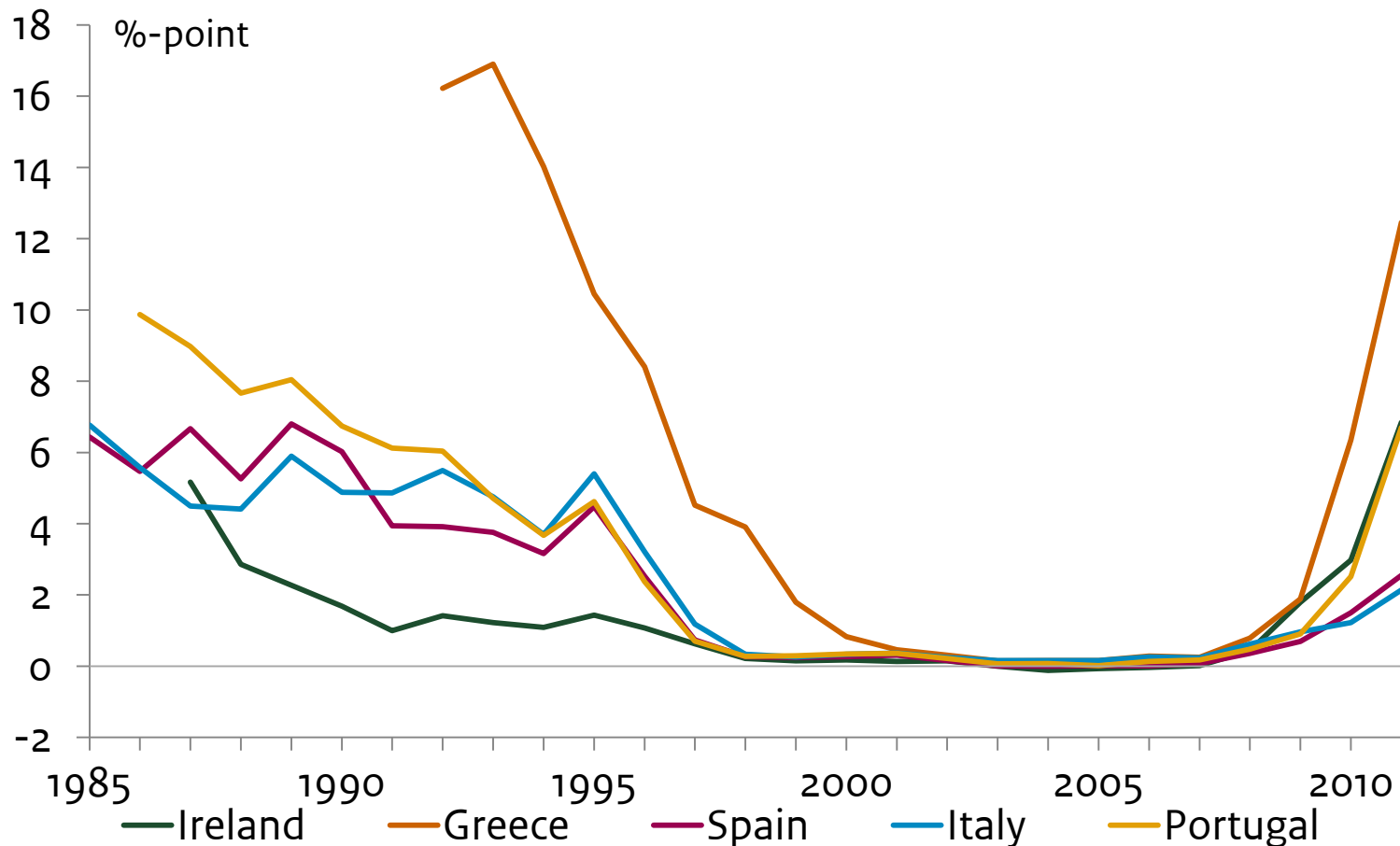


Discrepancy after introduction of the euro

- Financial market risks more and more international
 - savings at foreign banks (Icesave)
 - bank loans in other EU countries (real estate)
 - cross-border interbank loans
 - banks hold more government debt of other countries
- National supervision
 - takes into account only national interests
 - no influence on foreign banks
 - coordination difficult in times of crisis



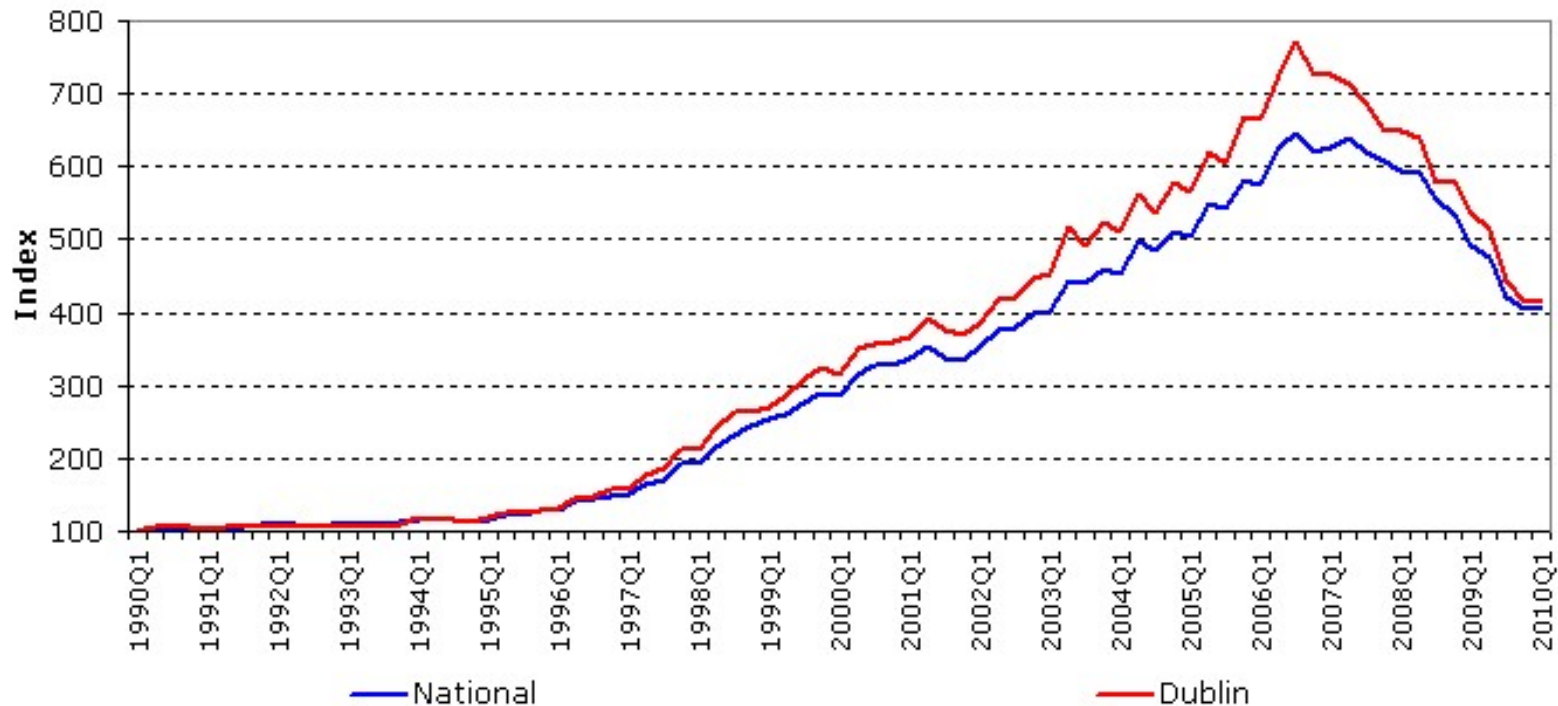
Interest rate convergence and divergence





Housing market bubble Ireland

Ireland House Prices (March 1990 = 100)



Source: Central Statistics Office Ireland

www.macrobusiness.com.au



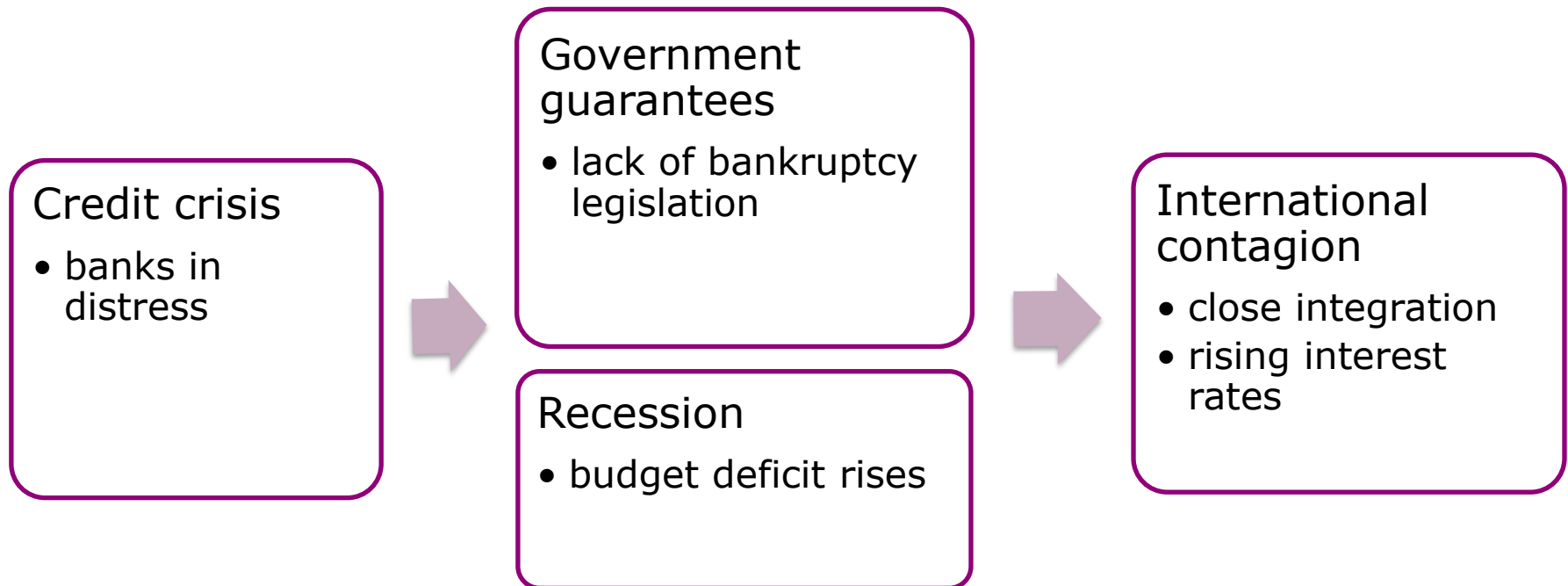
Convergence and financing of a bubble



- Much is still unknown
 - why do banks take so much risk?
 - what is the role of the supervisor?
 - why on real estate?



Divergence: the bubble bursts

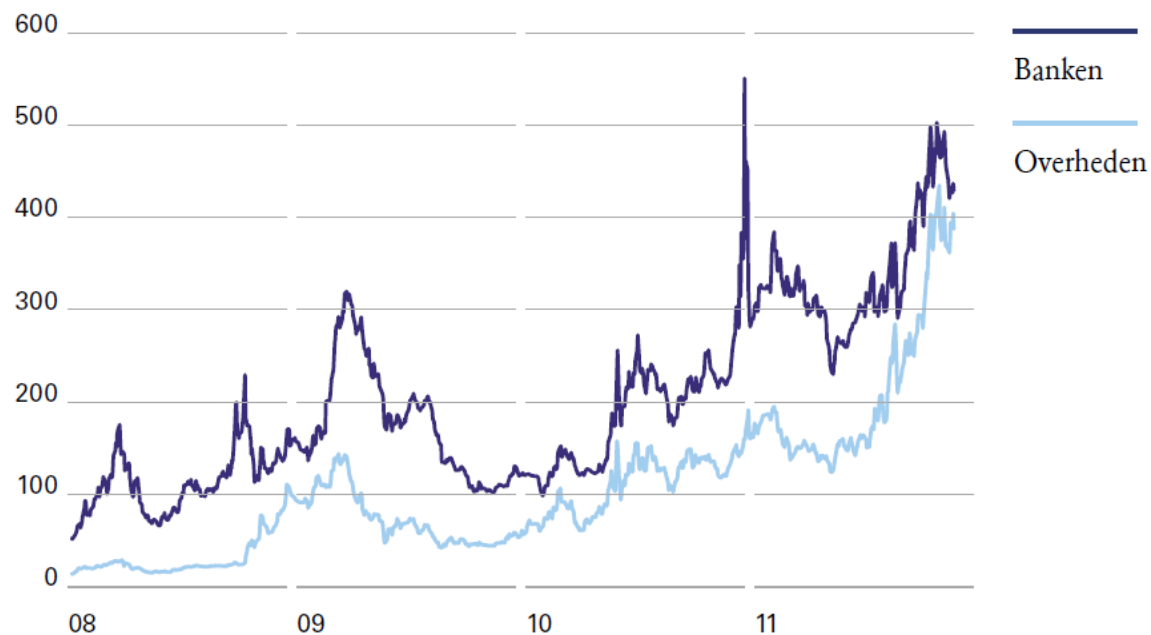




Banks and governments entangled

Grafiek 1 CDS-premies in het eurogebied

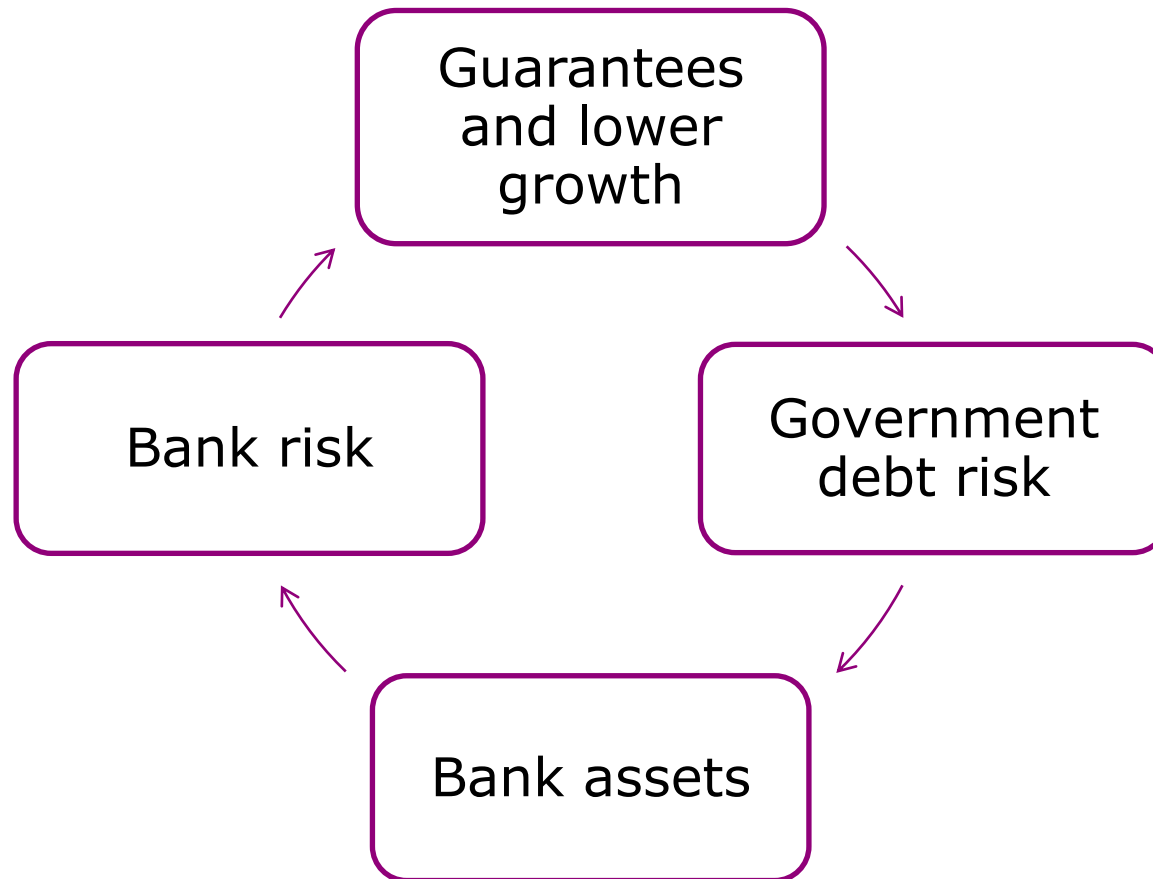
5-jaars CDS-premies, in basispunten, 1-1-2008 t/m 19-10-2011.



CDS-premies van overheden betreft het naar bbp gewogen gemiddelde van de individuele lidstaten.
Bron: Thomson Datastream en IMF.

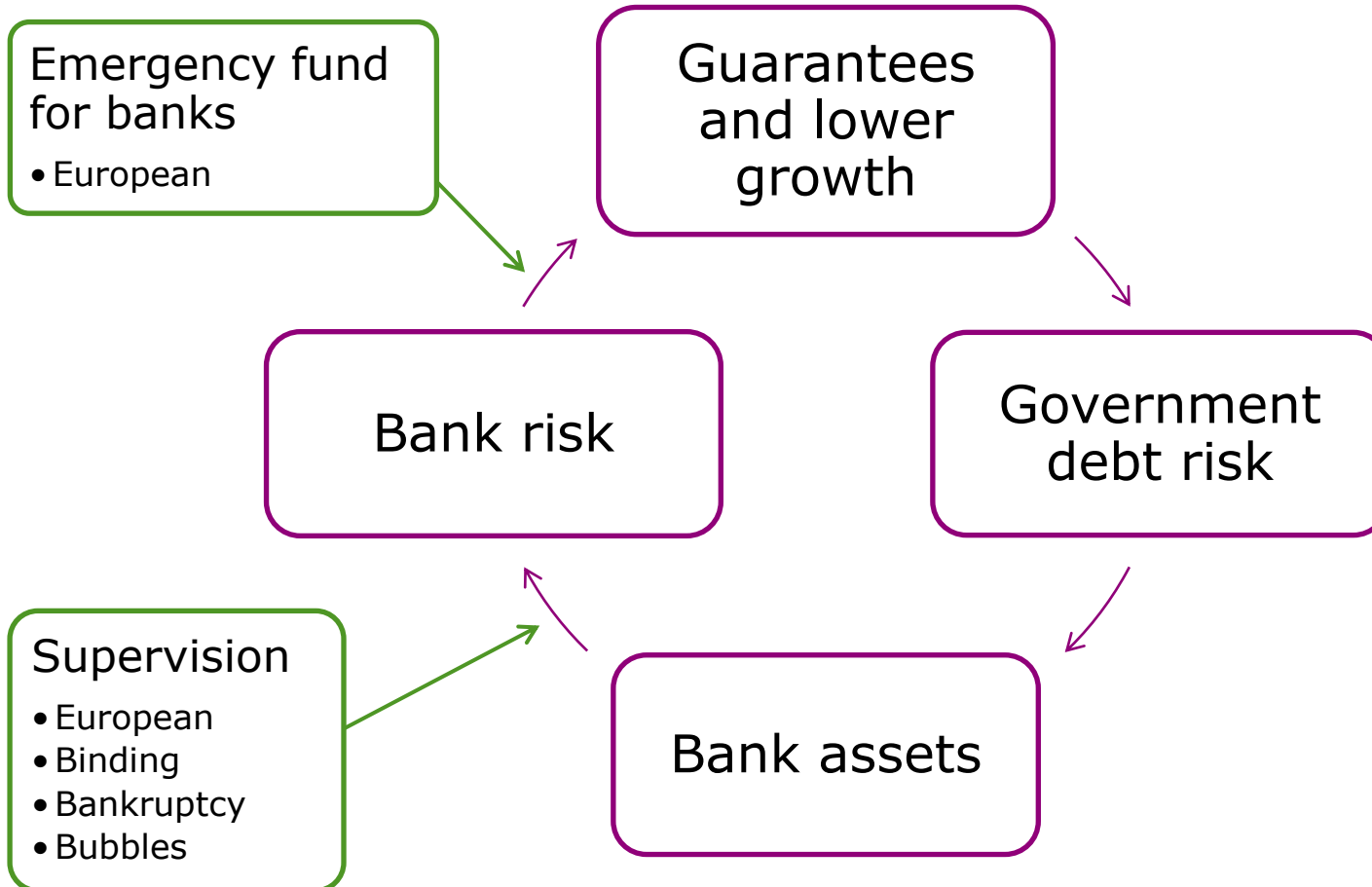


Suffocating embrace





Institutional reforms: banks





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Monetary union: budget policy

- No union: budget discipline by the market
- Budget risks within the union
 - countries with high debt put pressure on ECB: more inflation
 - financial problems: contagion to other countries
- Budget discipline in EMU
 - Stability and growth pact: deficit and debt rules
 - > violated by Germany and France in 2003
 - Fines for offending
 - > Portugal gets no sanctions in 2002
- No bailout clause in Maastricht Treaty
 - credibility?



Why does monetary union work in US en not in EU?

- United States
 - large federal budget (20-30 cent per \$), high federal debt
 - small budget for states, low debt of individual states
 - strict budget rules in constitutions of the states
 - *Federal Deposit Insurance Corporation*
- Europe
 - small federal budget (1 cent per Euro)
 - large budget (40-50 cent per Euro) and high debt member countries
 - hardly binding constitutional budget rules
 - national deposit insurance systems

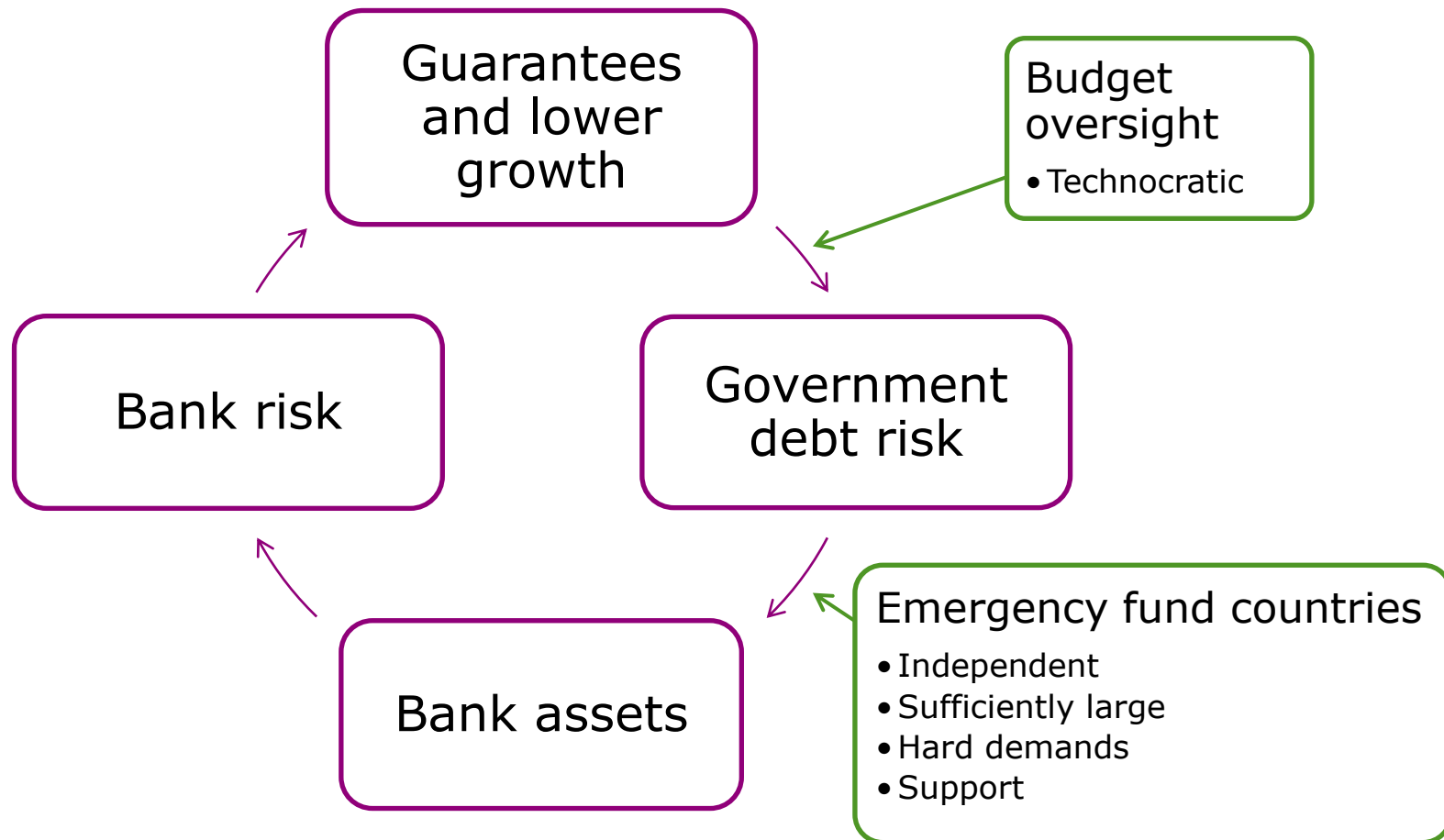


Debt crisis

- Liquidity problems
 - Austerity
 - Structural reforms: increase growth rates
- Solvency problems
 - Debt restructuring and partial write-off
- Difference not always clear
 - Forecasts: achievable cutbacks, expected growth, etc
 - Self-confirming panic in financial markets
 - > rising interest rates lower the chance of paying of debt
 - > contagion to other countries
 - Emergency fund (lender of last resort) for countries needed



Institutional reforms: governments





In practice: too little too late

- Support by EU + IMF
 - Greece, April 2010: €30 bn; May 2010 €110 bn
 - EFSF, May 2010: €440 bn = €250 bn effective
 - Ireland, Nov 2010: €85 bn
 - EFSF, March 2011: €780 bn = €440 bn effective
 - Portugal, April 2011: €78 bn
 - Needed according to economists: €1500 to €2000 bn
- ECB buys Greek, Italian and Spanish public loans
 - chance of political pressure: undermines independence
 - budget policy = distribution: requires democratic legitimacy
 - risk of default: at the cost of ECB payments to Member States



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Pillars of the German social market economy

1. Democracy and control of power of the government
 - Constitutional Court
 - Bund and Länder share power

2. Embed the market in rules
 - without ad hoc interventions

3. Price stability
 - independent central bank

4. Safety net
 - Social security



German dilemmas

- First political integration, next economic integration
 - pillar 1: democracy
- No integration: preferences about fiscal policy too different
 - subsidiarity

- No Transferunion with transfers within Europe
- But Germany is a Transferrepublik with transfers among Länder
 - economists: undermines fiscal discipline

- Euro crisis: high costs for Germany
- But leaving the Eurozone leads to a new Great Depression



German dilemmas, continued

- Constitutional Court: EFSF not in conflict with the Constitution
 - actions require approval of Bundestag budget committee
- EMS may be in conflict with the constitution
 - pillar 1: protection of citizens and democracy
 - But less power to handle the crisis entails a risk for citizens
- ECB has to be independent
- No transfer of sovereignty to Europe: ECB lender of last resort
- CDU/CSU and FDP
 - austerity in debtor countries
- SPD and Bündnis 90/Die Grünen
 - European safety net for debtor countries, bank regulation

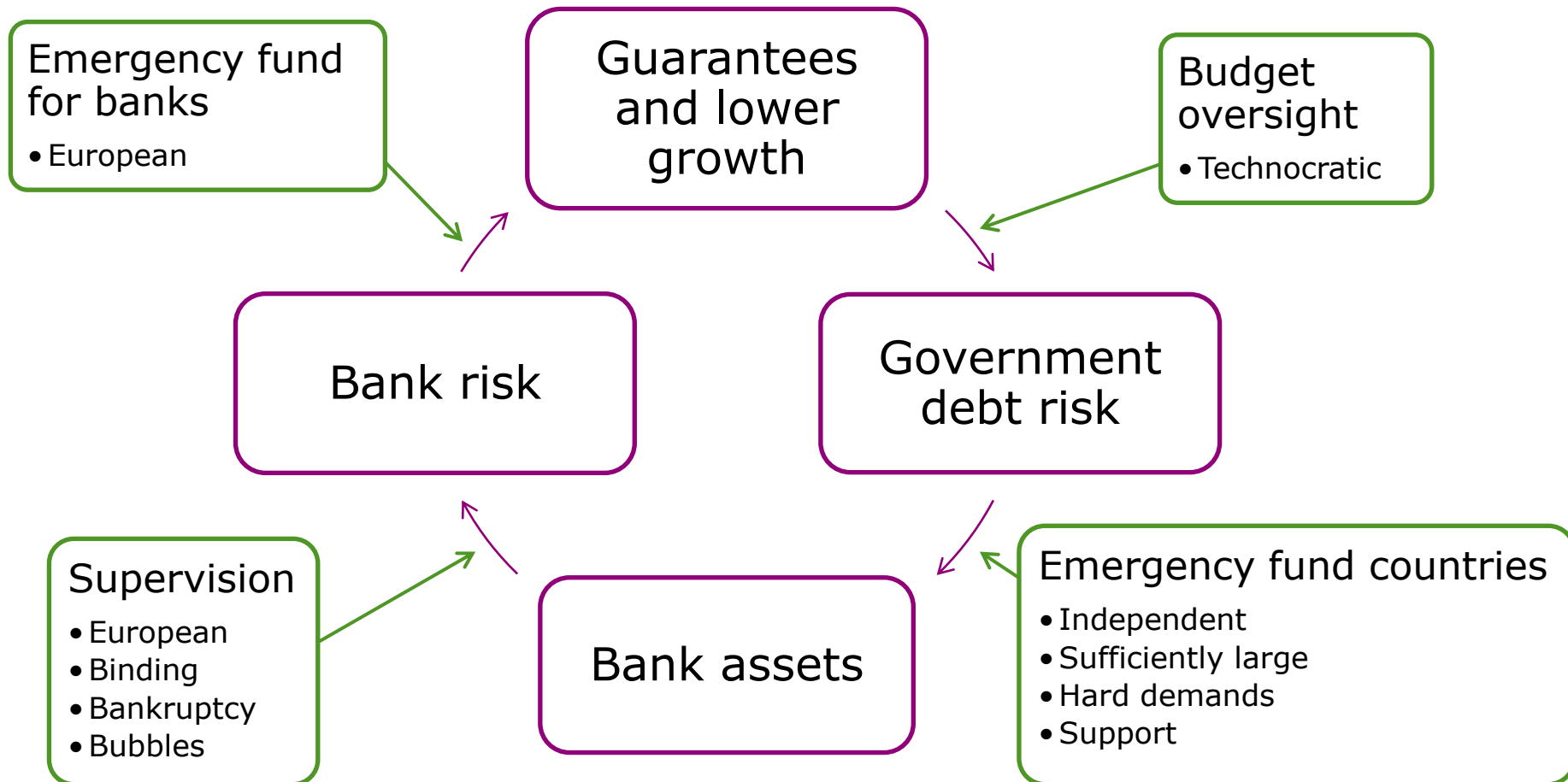


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Institutional reforms: banks and governments





Long-run: transfer of sovereignty needed

- Monetary union only works with sufficient federal power
- Transfer of sovereignty on 4 points
 1. European bank supervision
 2. European emergency fund/deposit guarantee system for banks
 3. Preventative European supervision of national budgets
 4. European emergency fund for countries with liquidity problems
- No role for the ECB in budget oversight and emergency fund



Short term policy: expand emergency fund

- Eurocrisis continually affecting new countries
- That puts further pressure on growth in 2012
- Growth slowdown is now important source of higher deficits and debt
- Crisis is now self-sustaining
- Therefore: stop contagion

- Creditworthiness of reform programs, especially Italy
- Effective expansion of emergency fund needed: “*The Big Bazooka*”
- Germany must take the lead as the largest country
- The Netherlands also important due to of good starting conditions
- Credible commitment from EU-leaders crucial