

THE EURO AREA CRISIS: A SHORT HISTORY

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EXECUTIVE SUMMARY

”WITHOUT A SHARED
DIAGNOSIS, FINDING
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More than half a decade has passed since the start of the euro area crisis yet there is still no consensus on the fundamental economic and political questions: What caused the crisis, and what explains its exceptional severity and duration? Without a shared diagnosis, finding common answers is hard.

In this policy paper, Jörg Haas and Katharina Gnath argue that the most widely shared explanations of the crisis have an important element in common: they point to the importance of debt imbalances in the euro area, be they private or public. From this starting point, it is possible to create a coherent account of the roots of crisis and the contagion effects.

The authors give an overview of the four main phases of the crisis:

- **Divergence.** Abundantly available credit, combined with weak political and economic adjustment mechanisms in the currency union, led to the emergence of large imbalances in the euro area. The global financial crisis of 2008/9 triggered the euro area crisis, but divergence was the underlying cause.
- **Fire-fighting.** The euro area had to build a crisis management framework almost from scratch. The resulting delays, a weak role of the European institutions, and a constrained monetary policy hampered the crisis response.
- **Structural change.** European policymakers were ultimately able to reform important parts of EMU. The reform efforts focussed on a rule-based system of crisis prevention, on limited mutual insurance in times of crisis, and on breaking the bank-sovereign nexus.
- **The situation today.** The euro area is still in a dangerous position. Expansionary monetary policy faces increasing criticism, high debt levels leave very little space for fiscal policy, and public support for solidarity is low. A debate on the fundamental reform of the currency union is needed while the relative calm lasts, not during the next market panic.

TABLE OF CONTENTS

1. No solution without shared diagnosis	3
2. The emergence of imbalances	4
3. European fire-fighting	6
4. Structural change	7
5. The situation today	8
ON THE SAME THEMES...	10

1. No solution without shared diagnosis

Open questions. There is a sense among European policymakers that Europe's Economic and Monetary Union (EMU) is not sustainable in the long run. However, since the decision in 2012 to create a partial banking union, reform progress has been imperceptibly slow. Widespread Euroscepticism among the population plays a role, as do divergent national interests. But more importantly, agreeing on a solution is virtually impossible without first agreeing on the problem that needs to be solved. After more than half a decade of crisis, there is still no consensus on the fundamental economic and political questions: What caused the crisis, and what explains its exceptional severity and duration?

” THE THREE
APPROACHES POINT TO
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Competing narratives. There are three widely shared explanations of the outbreak of the crisis:

- *Excessive public debt.* Many EMU member states did not conduct sound fiscal policies and failed to adhere to the Stability and Growth Pact. When growth slowed, some of them lost their market access because their sovereign debt position was considered unsustainable.
- *Diverging competitiveness.* In the run-up to the crisis, incomplete and sheltered markets let unit labour costs rise rapidly in those countries that would later be hit hard by the crisis, while costs remained almost unchanged in other EMU members, notably Germany. Without the possibility of a currency devaluation, this led to unsustainable current account imbalances and ultimately to a sudden stop in external financing.
- *Weak regulation of the financial sector.* When the euro was introduced, the euro area “core” started lending large amounts of money to the “periphery”. Once external funding dried up in the uncertainty that followed the financial crisis of 2008/9, oversized banks had to be bailed out by their governments, burdening them with debt.

Key role of imbalances. Contrary to what is often implied, there is no need to choose between these three approaches. In spite of their differences, they all share one important element: they point to the importance of debt imbalances in the euro area, be they private or public. From this starting point, it is possible to create a coherent account of the roots of crisis and the contagion effects.

2. The emergence of imbalances

Credit shock. The inception of EMU reinforced a broader trend experienced across the advanced economies: It helped spread the availability of cheap credit. In spite of the no-bailout clause (Art. 125 TFEU), interest rates dropped sharply in the euro-area periphery. The capital flows led to increases in wages, growth and inflation in the countries concerned. However, contrary to expectations at the time, the additional capital failed to raise productivity. Instead, it fuelled asset bubbles in the non-traded sector in a number of countries. In other countries, governments took the opportunity to issue more debt.¹

Weak adjustment. Why were the euro area economies unable to adjust timely and smoothly to the emerging imbalances? As a monetary union within a heterogeneous economic space, EMU lacked the typical adjustment mechanisms that are common at the national level.

- A *fully integrated market* with far-reaching mobility of goods and labour could have forced wage adjustments in line with productivity (the “real exchange rate channel” of adjustment).
- A *coordinated economic policy* could have enabled strong anti-cyclical fiscal policies.
- A *common budget* could have acted as an “automatic stabilizer”, thus leading to more balanced growth rates and smaller inflation differentials.

At the same time, the euro area no longer possessed the adjustment instruments that are available to countries with a currency of their own.

- A *currency devaluation* would have restored competitiveness and slowed down investment and consumption.
- A *monetary policy* tailored to the cyclical position of the economy would have normalised inflation.

In short, membership in a monetary union stripped the national governments of their traditional adjustment channels, but did not provide a viable replacement at the European level. As a result, the euro area economies started to drift apart.²

Effects of monetary policy. Since the European Central Bank (ECB) sets one nominal interest rate for the entire currency union, it entrenched the emerging imbalances further. For high-growth, high-inflation countries such as Spain and Ireland, the real interest rate was too low, and provided fuel to an already overheating economy. For low-growth, low-inflation countries such as Germany, the real interest rate was too high, depressing growth and investment. Instead of mitigating economic volatility, monetary policy exacerbated it (the “one size fits none” problem).³

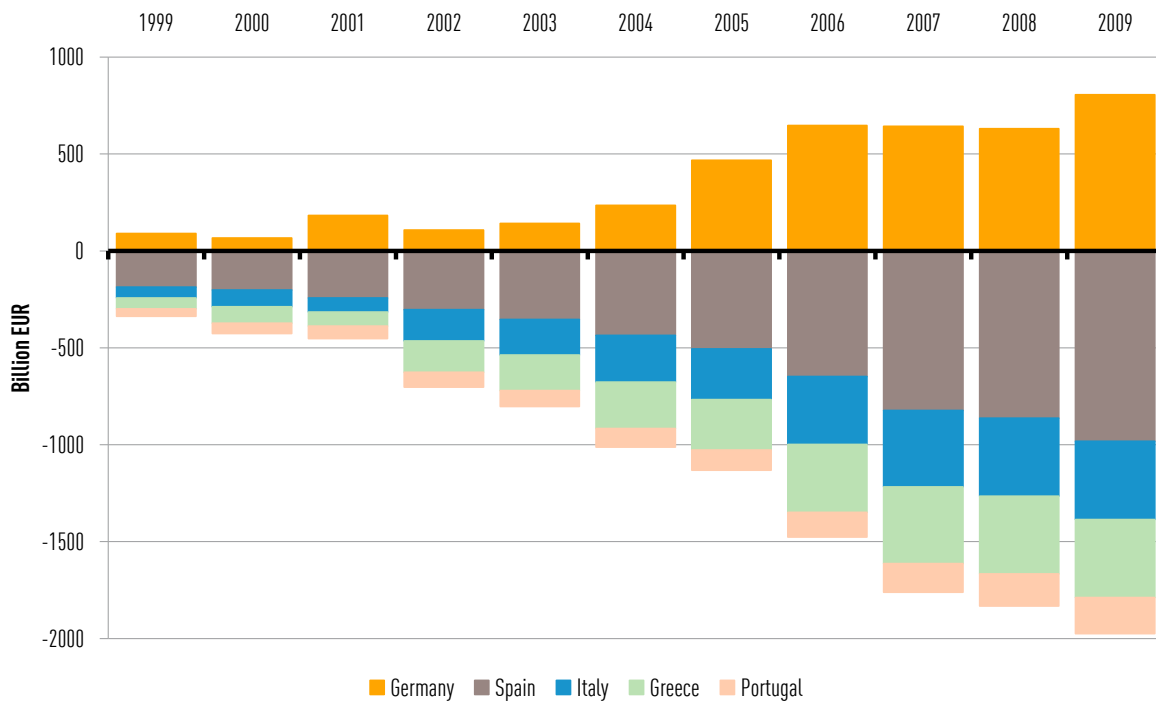
Growing imbalances. Over the years, the capital-importing periphery accumulated a large amount of external debt, while the assets of the capital-exporting core grew steadily (see figure 1). The EMU architecture was not suited to stop this trend and member states’ desire to remain in charge impeded meaningful coordination. This was especially visible in weak national budgetary processes and bank supervision. While there was some debate about lacking compliance with EMU’s budget rules, the simultaneous build-up of private imbalances did not raise any flags among European policymakers. It is important to note that the problems of the euro area started almost with its introduction when imbalances began to build up. The crisis played out as it did because of the divergence prior to it.

1. *The Eurozone Crisis. A Consensus View of the Causes and a Few Possible Solutions.* Edited by Richard Baldwin and Francesco Giavazzi, 2015. <http://voxeu.org/content/eurozone-crisis-consensus-view-causes-and-few-possible-solutions>. Allard, Céline, Petya Koeva Brooks, John C Bluedorn, Fabian Bornhost, Katharine Christopherson, Franziska Ohnsorge, and Tigran Poghosyan. *Toward a Fiscal Union for the Euro Area.* IMF Staff Discussion Note, SDN/13/09, 2013. <https://www.imf.org/external/pubs/ft/sdn/2013/sdn1309.pdf>.

2. Enderlein, Henrik, Peter Bofinger, Laurence Boone, Paul De Grauwe, Jean-Claude Piris, Jean Pisani-Ferry, Maria João Rodrigues, André Sapir, and António Vitorino. *Completing the Euro. A Road Map towards Fiscal Union in Europe (Report of the “Tommaso Padoa-Schioppa Group”).* Notre Europe Studies & Reports, No. 92, 2012. <http://www.delorsinstitute.eu/011-3317-Completing-the-EuroA-road-map-towards-fiscal-union-in-Europe.html>.

3. Enderlein, Henrik. *One Size Fits None*, Central Banking XVI, no. 1: 24–28, 2005.

FIGURE 1 ► Net assets abroad of selected euro area countries from 1999- 2009



Source: Eurostat (net international investment position), authors' calculations.

The collapse. The large capital inflows that were needed to maintain the status quo dried up when the euro area was hit by the crisis of 2008/9 and the discovery of falsified Greek budget deficit figures increased mistrust in the financial markets. At the same time, expenses grew rapidly as countries tried to stabilise their economies and to rescue failing banks. Suddenly, the euro area members were confronted with two unexpected problems:

- *Self-fulfilling insolvencies.* Since the euro area members were liable for debt in a currency that they did not directly control, they were perceived as vulnerable. Interest rate premiums on sovereign debt from countries with large current account deficits increased sharply. The resulting increase in debt refinancing costs raised doubts about the solvency of the countries in question, even if their public debt levels had initially been low.⁴
- *Bank-sovereign nexus.* Doubts about the solvency of governments hurt the capital buffers of banks already weakened by the financial crisis. The required bail-outs in turn increased the public debt burden.⁵

4. Corsetti, Giancarlo, and Luca Dedola, *The Mystery of the Printing Press: Self-fulfilling Debt Crises and Monetary Sovereignty*, CEPR Discussion Paper No. DP9358, 2013.

5. Fratzscher, Marcel, and Malte Rieth. *Monetary Policy, Bank Bailouts and the Sovereign-Bank Risk Nexus in the Euro Area*. European Economy Discussion Paper 009, September 2015. http://ec.europa.eu/economy_finance/publications/eedp/pdf/dp009_en.pdf

3. European fire-fighting

An empty toolbox. The crisis struck EMU almost entirely unprepared. When the potential for contagion among euro area countries became clear, EMU had to build a crisis management framework from scratch. A crucial concern was that far-reaching risk-sharing would lead to moral hazard. While this was a legitimate worry, it meant that precious time was spent on debating fundamental questions concerning the legality of rescue efforts and institutional competences.

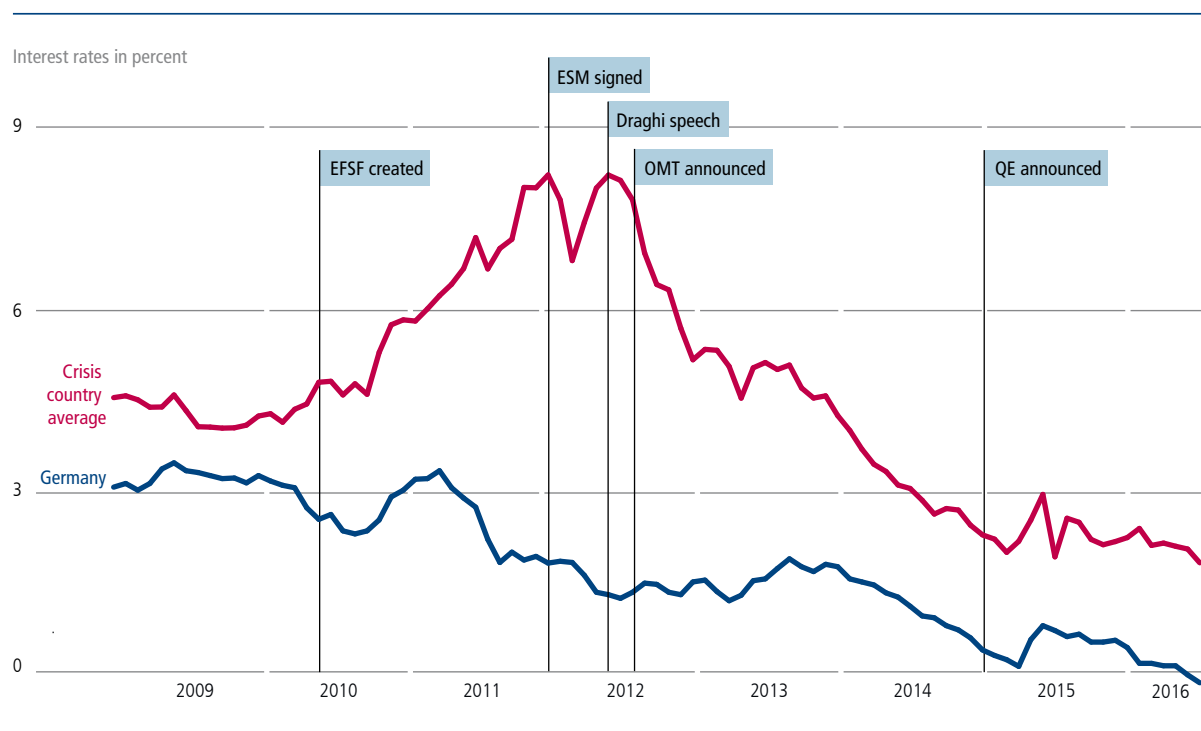
” THE RESCUE
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Too little and too late. The resulting delays deepened the crisis. Uncertainty in the financial markets about whether or not the no-bailout clause would be enforced damaged banks' balance sheets and government finances.⁶ When the rescue programmes were finally implemented, they helped most investors but too late to avoid lasting damage to the economy of the crisis countries.

Weak supranational politics. From the beginning, intergovernmental politics dominated the crisis negotiations. The European level was left out of crucial decisions, and debates over conditionality and austerity were often charged with moral overtones. Since the resulting framework (the European Financial Stability Facility (EFSF), and its successor, the European Stability Mechanism (ESM)) was vulnerable to vetoes from individual member states, it could not put a definite end to the crisis. A lack of democratic oversight on the euro area level would become important as the crisis dragged on and the assistance programmes did not lead to the fast economic recovery that had been initially expected.⁷

Constrained monetary policy. Since the political reaction to the crisis was weak, much of the burden of stabilisation rested on the shoulders of the ECB. However, the central bank had no clear mandate to undertake the necessary steps. Any support to individual countries was very controversial. Consequently, the ECB's monetary policy was initially conservative compared to the measures taken by the US Federal Reserve and the Bank of England. When the ECB finally decided to become a de facto lender of last resort to euro area governments in 2012 (by announcing its willingness to engage in Outright Monetary Transactions), it provided decisive relief. At the same time, it attracted renewed criticism and legal challenges for engaging in quasi-fiscal policy.

6. Shambaugh, Jay C. "The Euro's Three Crises." *Brookings Papers on Economic Activity*, Spring 2012. http://www.brookings.edu/~media/Projects/BPEA/Spring%202012/2012a_Shambaugh.pdf
7. Dawson, Mark. "The Legal and Political Accountability Structure of 'Post-Crisis' EU Economic Governance." *JCMS: Journal of Common Market Studies* 53, no. 5: 976-993, 2015.

FIGURE 2 ► How EMU stabilisation efforts influenced interest rates on long-term government bonds

Notes: The figure shows interest rates on long-term government bonds (percentages per annum; period averages; secondary market yields of government bonds with maturities close to ten years) and major EMU stabilisation efforts. Crisis country average shows the average for Greece, Ireland, Italy, Portugal and Spain, weighted by the ECB capital key (five-year average as of 2014). No data for Greece in July 2015.
Source: ECB, authors' calculations.

Source: Enderlein, Henrik, Enrico Letta et al. (2016). *Repair and Prepare: Growth and the Euro after Brexit*. Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut - Berlin, and Jacques Delors Institute, p. 17.

4. Structural change

Reform efforts. In spite of numerous obstacles, European policymakers have ultimately been successful in reforming several important parts of EMU. The reform efforts focussed on a rule-based system of crisis prevention, on limited mutual insurance in times of crisis, and on breaking the bank-sovereign nexus.

Greater control. Measures designed to improve EMU crisis prevention mostly rely on tighter or additional rules, embedded in the European Semester. The emphasis was shifted to greater control of national budget policy. Two sets of EU legislation (the “six-pack” and the “two-pack”) as well as the intergovernmental Treaty on Stability, Coordination and Governance (Fiscal Compact) have made it easier to punish violations of the budget rules and introduced a debt brake at the national level. Furthermore, the scope of the rules has been enlarged: Imbalances in the private sector and wage costs are now subject to European supervision (Macroeconomic Imbalance Procedure), and can also lead to sanctions.

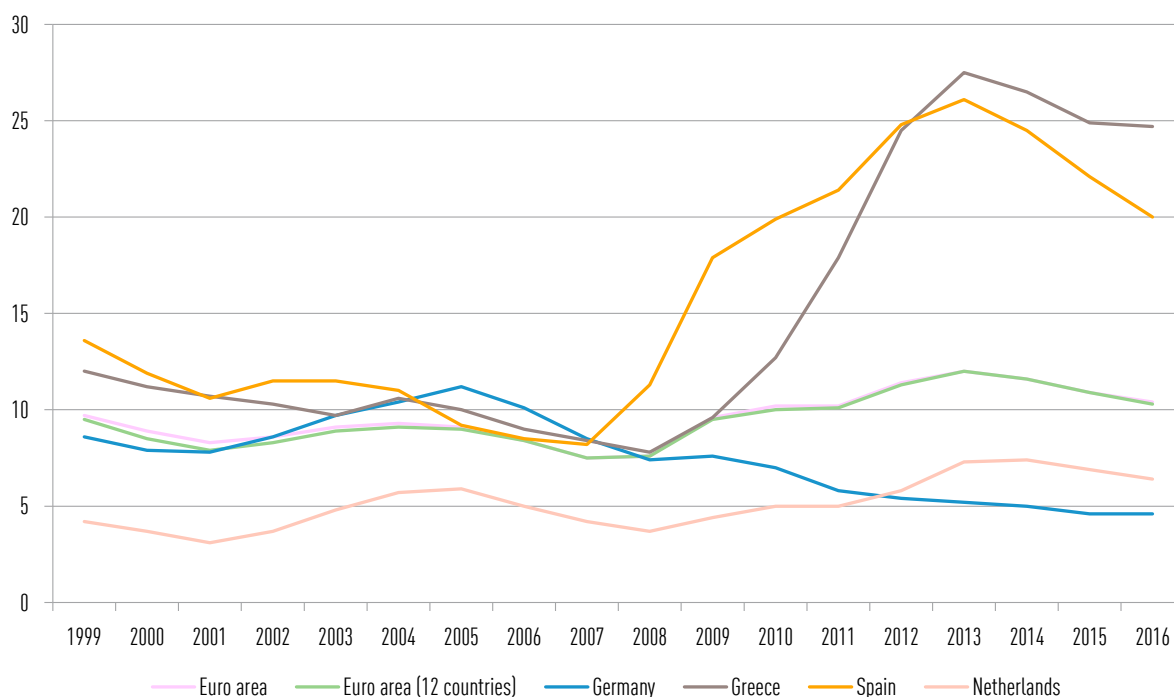
Mutual insurance. The new European crisis management system has a limited mutual insurance component. The temporary EFSF and its permanent successor, ESM, came close to the idea of common liability for debt. However, the way in which the ESM functions is still rooted in the old Maastricht model. The member states (and not the European institutions) control the disbursements and there is an upper liability limit. Furthermore, loans to countries in financial distress are made available only for a limited period and only in return for the implementation of budget cuts and structural reforms.

Steps towards a banking union are another important building block in the euro area's new crisis management system. The establishment of the Single Supervisory Mechanism, the involvement of creditors in bank restructuring costs, and the creation of a Single Resolution Mechanism will likely make it possible in future to reduce the impact of a banking crisis on government finances and thus the potential for contagion within the eurozone.

5. The situation today

Partial success. The combination of rescue programmes, steps towards a banking union and an accommodative monetary policy has ultimately been able to stop contagion and bring down risk premia, but the economic and financial situation in the euro area remains fragile. Countries that were at the centre of the crisis paid a high price in terms of economic prosperity. Many have lost their savings. Benefits were cut. Unemployment rates are at staggering levels. The weak recovery is undermining support for the common currency and the euro, and mistrust among EU member states is high.

FIGURE 3 ▶ Unemployment rates in selected euro area countries from 1999- 2009



Source: AMECO, authors' calculations.

Incomplete EMU. The history of the crisis can be boiled down to two components: an architecture prone to imbalances and weak crisis management capacity at the European level. It is not clear that these weaknesses have been addressed sufficiently. Market integration and the banking union are still incomplete, the EU's new economic governance framework (the European Semester) has not been able to strengthen coordination decisively, and the ESM in its current form is not an instrument that can take decisive action against an unfolding debt crisis. Investment and potential growth has also been reduced by the crisis, affecting the euro area's chances of recovery. In terms of growth, the euro area has gone through seven bad years and GDP levels have only returned to pre-crisis levels in late 2015.

Ready for the next crisis? Europe finds itself in a very dangerous position. Expansionary monetary policy faces increasing criticism, high debt levels leave very little space for fiscal policy, and public support for solidarity in EMU is low. At the same time, the euro area economies are modernising only slowly due to reform fatigue and low investment quotas. Should a new crisis strike, the margin for error is very small. In this situation, relying on an improvised institutional framework seems irresponsible.

Start reforming today. A debate on reform is needed while the relative calm lasts, not during the next market panic. The euro area needs to reinforce its crisis management instruments so they become faster, more credible and democratically accountable. It also needs to demonstrate that growth in Europe is a priority in response to challenges such as Brexit and the refugee crisis. It should agree on a common plan for investments that pave the way for future growth and on an agenda of coordinated reforms that completes the Single Market.⁸

8. For more details on the reform priorities, see Enderlein, Henrik, Enrico Letta, Jörg Asmussen, Laurence Boone, Aart De Geus, Pascal Lamy, Philippe Maystadt, Maria João Rodrigues, Gertrude Tumpel-Gugerell, António Vitorino (2016). *Repair and Prepare: Growth and the Euro after Brexit*. Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin, and Jacques Delors Institute; available from 20 September 2016 on www.strengthentheeuro.eu.

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