Global Financial Systems: Stability and Risk

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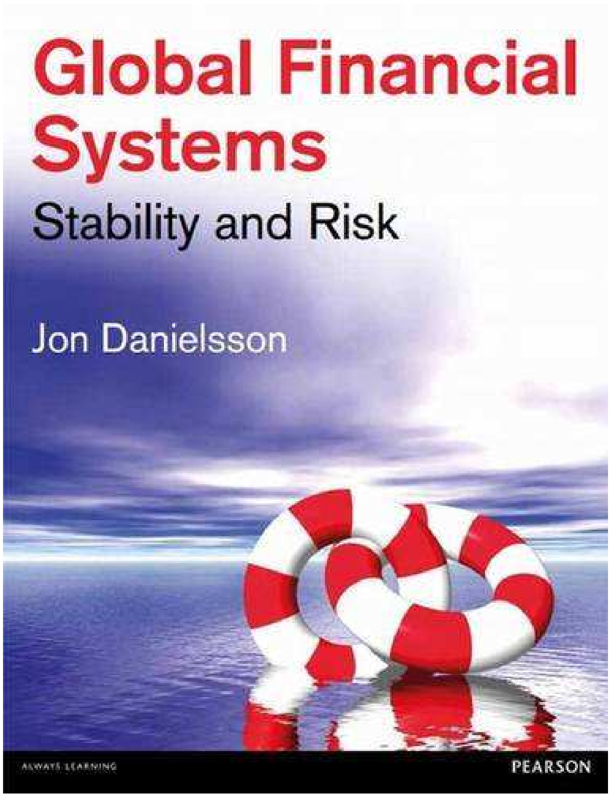

These chapters contain the latest developments on the European crisis, financial regulations and current challenges in financial policy. The latest version can be found on the book website www.globalfinancialsystems.org.

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Introduction

The focus of this book is on how the world's financial system functions, the various policy choices governments have and how the system has built–in vulnerabilities leading to crises. Financial crises have been our constant companion from the very first time human beings created a financial system. This means that over time, we have accumulated deep knowledge and understanding of the economic forces enabling such crises. This experience shows that financial crises are all fundamentally the same, only the details differ. This is why financial crises are so hard to prevent and so costly to fight. Every time we are faced with new details that enforce age old vulnerabilities.

Any printed book that focuses on current events runs the risk of being out of date before the print is dry, and my book is no exception. For this reason, I decided early on to create these special chapters, only be published on–line and updated frequently, so that obsolescence could be mitigated.

Comments are more than welcome, and if you find any mistakes or have suggestions for improvements, please let me know and I will incorporate your comments into the next release, acknowledging your contribution.

London
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GLOSSARY

BU banking union. 445

EC the European Commission is the executive body of the EU responsible for proposing legislation, implementing decisions, upholding treaties and the day–to–day running of the EU. 434, 435, 438, 451

ECB the European Central Bank is the central bank of the euro zone. 433, 434, 436, 438, 446, 448, 451, 452

EDIS European Deposit Insurance Scheme. 438

EFSF the European Financial Stability Facility is a vehicle set up by euro zone members to finance bailouts. 437, 452

EFSM the European Financial Stabilisation Mechanism is a vehicle off the European Union to provide bailouts. 437

EP European Parliament. 445

ERM European exchange rate mechanism. 448, 449

ESM European Stability Mechanism. 437

EU European Union. 434, 438, 444–446, 452

GDP gross domestic product. 436, 441, 443, 446, 447, 450

IMF International Monetary Fund. 434, 437, 440, 449–452

OECD Organisation for Economic Co–operation and Development, a Paris based international organization. 451

OMT Outright Monetary Transactions. 447

QE quantitative easing. 438

SME small and medium–sized enterprise. 441

UK United Kingdom. 444, 448, 449

WWII Second World War. 444

CONTENTS

CHAPTER 20

THE EUROPEAN CRISIS

The global financial crisis that started in 2007 originated within the financial system, as discussed in Chapter **??** (the ongoing crisis: 2007–2009 phase), it reached its peak in the second part of 2008, and by 2009 it looked like the crisis was over. However, for parts of Europe the worst was yet to come, since soon afterwards a sovereign debt crisis erupted, strongly affecting the European economies and spilling over to the rest of the world.

The crisis started when Greece was unable to meet its sovereign debt obligations in 2010, eventually receiving a bailout. It was followed in short order by Ireland, Portugal, Spain and Cyprus all being bailed out as well. However, while the crisis is often referred to as a *sovereign debt crisis*, that term is a misnomer, because just as important are the banking and the growth crisis, as well as the political crisis.

We might just as well just call the crisis the *European crisis*, or even the *euro zone crisis*. However, those terms are also not strictly correct since only some European countries have been seriously affected while others have enjoyed positive economic performance throughout.

The European crisis reached its peak in 2012. At that time, the European authorities took the necessary steps to stop the crisis, manifested in an announcement from European Central Bank (ECB) president Mario Draghi in July 2012:

> "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

Here, Draghi is speaking with the full backing of the key European governments and the European Union (EU). This speech marked a key turning point. From that point, speculation about a break–up of the euro zone receded and the economic situation stabilized.

Three different bodies have come together under the name of *Troika* in fighting the crisis:

Definition 20.1 (Troika) *Most bailout loans have been jointly provided by the International Monetary Fund (IMF), the European Commission (EC) and the ECB, who took a lead role in evaluating, choosing and supervising the implementation of the bailout packages and required reforms, whilst also providing advice. These three entities came to be known as the* Troika*. This term has recently fallen out of favor.*

Links to other chapters

This chapter makes use of important concepts from Chapter **??** (banking crises), which also relate to the concepts of Chapter **??** (liquidity) and Chapter **??** (bailouts). The role of the ECB in the crisis was discussed in Chapter **??** (the central bank), and the role of the IMF was developed in Chapter **??** (the Asian crisis). Bank runs and deposit insurance Chapter **??** (bank runs) and probability of default, presented in Chapter **??** (credit markets) are concepts relevant to this chapter. The first part of the crisis was analyzed in Chapter **??** (the ongoing crisis: 2007–2009 phase).

Key concepts

- Monetary union
- Common market in banking services
- Banking crises
- Sovereign debt
- Growth crisis
- Political crisis
- Deposit insurance
- Crisis resolution

Readings for this chapter
Due to the recent and ongoing nature of the crisis, there are few general papers that conclusively analyze and draw conclusions from the crisis. General overviews of the crisis are provided by **?** and **?**, while its political aspects are covered by **?**. Thorough descriptions and analyzes of the problems faced by the countries in crisis and details on the financial assistance and stabilization programs are provided by the EC.

20.1 Overview of the crisis

The European crisis started with the Greek bailout in 2010, as seen in the timeline in Figure 20.1. However, as so often is the case with crises, the underlying problems started long before. While there are several causal factors, perhaps the most important is the monetary union followed by the common market in banking services.

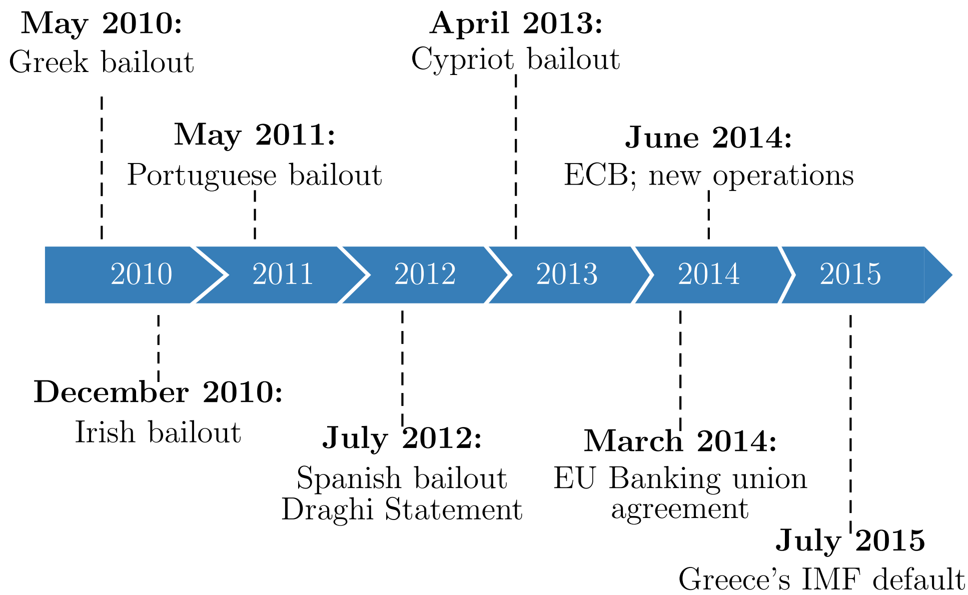


Figure 20.1: Timeline of the crisis

Convergence of interest rates

The general market perception before the crisis was that loans to euro zone sovereigns were all somehow backed by all the members, so that regardless of the underlying structural problems, loans ended up carrying the same interest rate, as seen in Figure 20.2.

The history of convergence in bond yields goes back to the Maastricht Treaty, see Section **??**, after which European sovereign bonds became seen as essentially interchangeable, so that there was little difference in rates paid by the strongest and weakest members. Market participants seem to have assumed that government bonds of the weakest members were backed by the stronger members, explaining anomalies such that when in 2003, Italy had a debt level of 97% of GDP, compared to 38% in Germany, the spread on Italian 10–year bonds was less than 20 basis points.

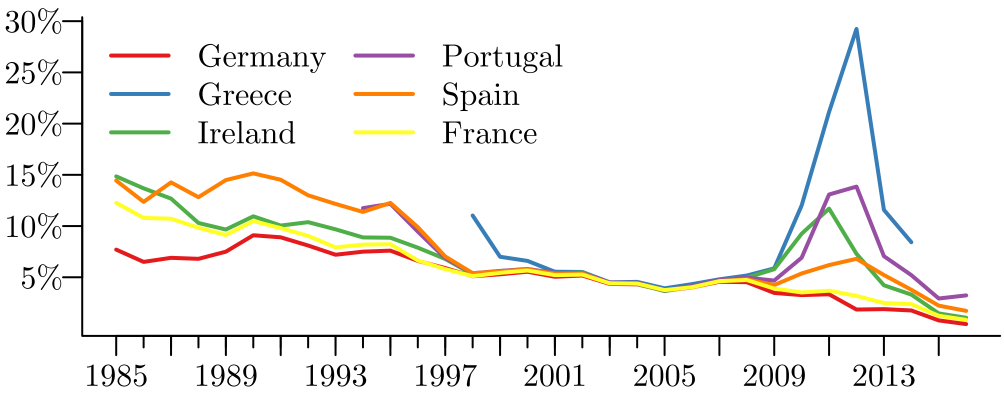


Figure 20.2: Selected European long–term bond rates (annual max).

Datasource: ECB

Only some members of the euro zone have been seriously affected by the crisis as seen in Figure 20.5. By far the worst affected is Greece, having seen its GDP drop by a quarter, followed by Italy which fell back into recession in the first half of 2014 and is still in a fragile state (see Section **??**). By contrast, Germany has shown moderate growth across the crisis period, as have some other euro zone members like Austria and Belgium.

Financing the sovereign bailouts

The initial motivation for providing support to the crisis countries was the belief that the affected states were facing a liquidity crisis, not a structural or a solvency crisis. Once the need for liquidity was acknowledged, all the European countries had to agree on both the size of the financial assistance packages and the structure of the funding.

If the problem facing the crisis countries is really just liquidity shortage, a particular type of crisis response is called for: Liquidity support (see Chapter **??** (liquidity)). In particular, the experience from the Asian crisis, (Chapter **??** (the Asian crisis)) and the theoretic discussion in Chapter **??** (liquidity), indicates that the size and credibility of a liquidity support package needs to be very large, with immediate availability. In other words, a liquidity support package has to demonstrate "*shock and awe*".

The inability of the Troika to provide sufficiently large packages led to avoidable repeated crisis events, with Greece requiring three bailouts. However, while liquidity played an important role in the crisis, structural problems seem to be even more important. In that case, bailing out countries risks removing the pressure for implementing structural reforms. Therefore, the objective of a rescue package should not just be to increase the confidence of investors, but also to implement reforms so that a country can sustainably grow and meet its obligations.

Box 20.1 (European financing programs) *The crisis led to the development of two euro zone financing programs: The European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (ESFM). The EFSF and the EFSM were transformed into the permanent European Stability Mechanism (ESM) in October 2012.*

In 2013, the IMF criticized its own performance concerning the Greek first bailout, especially the lack of sustainability in the level of public debt and the importance of spreading the burden of adjustments across different sections of the society in order to gain popular support and credibility. The report also underlined the importance of being more critical about official data from sovereign governments. In a 2016 report, the IMF commits to continuing support for Greece, while admitting that the country is still in need of more IMF support to overcome the current economic turmoil.

The handling of bank failures

One of the most dangerous aspects of any banking crisis are bank runs, and following the experience of the widespread runs in the Great Depression, most countries have taken measures to prevent runs, most importantly deposit insurance, discussed in Chapter **??** (bank runs). The run on Northern Rock in 2007 demonstrated the importance of high quality and credible deposit insurance schemes, and consequently, the integrity of the deposit insurance scheme in Europe became the first order priority, especially in the critical fall of 2008. Before the crisis, minimum deposit insurance in Europe was around €21,000, and it could take considerable time for depositors to receive those funds. Now, minimum deposit insurance is €100,000, and most countries will pay it out quite quickly.

In June 2015, a report published jointly by the presidents of five EU authorities (including the ECB, the EC and the European Parliament) suggested the creation of a European Deposit Insurance Scheme (EDIS) by mid-2017. The EDIS would consist of a re-insurance system, complementary to the pre-existing national schemes. It would also be financed through ex-ante risk-based fees charged on participating banks in all member countries of the banking union.

Box 20.2 (Who pays?) *Early on in the crisis, the European governments decided the taxpayers should shoulder the entire burden of bailouts, shielding creditors. Reasons for this were as follows:*

First, *governments thought the eventual amounts would not be too large and recoverable and that there might be unacceptable disruptions in the financial markets, especially after the near–shutdown of financial markets caused by collapse of Lehman.* Second, *there were systemic and political concerns about individual creditors like vulnerable banks and insurance companies.*

The "taxpayers pay all" position was only ever seen as an emergency measure and over time became increasingly unpopular, with increased emphasis on burden sharing with shareholders and creditors.

How the ECB contributed to the banking fragilities

The constitution of the ECB (in)directly contributed to increasing fragilities in the European banking sector. Under EU law, the ECB was forbidden to directly finance member countries. The ECB actively encouraged European banks, and particularly Greek banks, to increase their holdings of their country's government bonds to prop up the country's debt, as presented in table 20.1. In other words, the ECB encouraged a quantitative easing (QE) program by the backdoor. It was not until March 2015, in the context of its newly implemented QE program, that the ECB started outright purchases of German and Italian bonds. But with the key difference that risk was being transferred to commercial banks rather than being taken by a state entity as European banks accumulated risky Greek bonds.

20.2 Four crises in one

Although sovereign debt is at the heart of the crisis, only some member states of the euro zone have excessive debt levels. Instead, it is the confluence of four interrelated crises — banking, debt, growth and politial — that come together in the European crisis, as depicted in Figure 20.3. The common factor is the interconnectedness of European economies due to the common market in financial services and especially the common currency, as discussed in Chapter **??** (sovereign debt crises). The common currency prevents countries from responding individually and optimally to the crisis, handicapping monetary policy as a crisis-fighting tool, leaving only fiscal policy, internal devaluation and structural adjustments. However, fiscal policy cannot easily be used in many cases because of high debt levels and falling fiscal revenues.

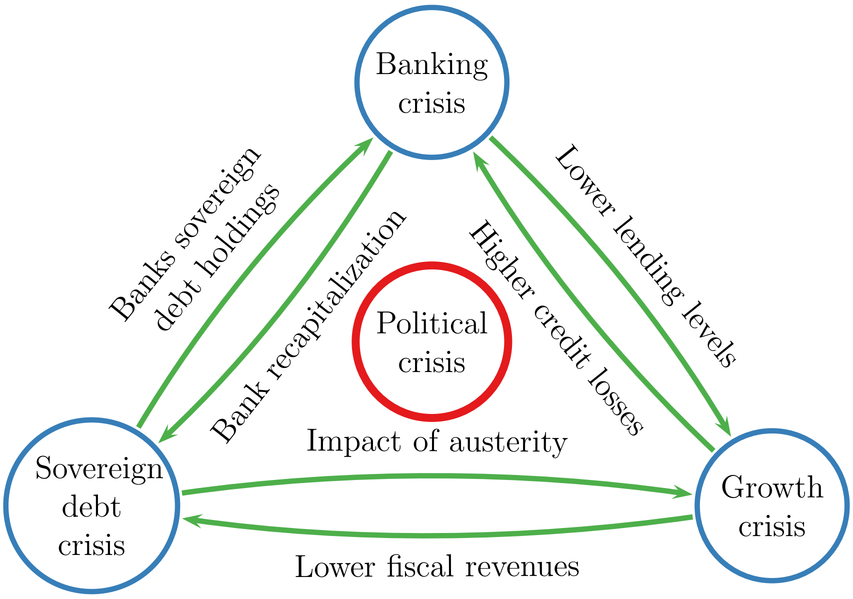


Figure 20.3: Relationships between the crises

20.2.1 The sovereign debt crisis

The European crisis first became visible when some member states were unable to meet their sovereign obligations and had to be bailed out by the Troika. However, public debt levels in Europe and the euro zone are not out of the ordinary on the global scale. Figure 20.4 shows the debt of selected countries, and while some member states are amongst the most indebted, many have averages similar to non-European developed countries, and some enjoy very low debt levels.

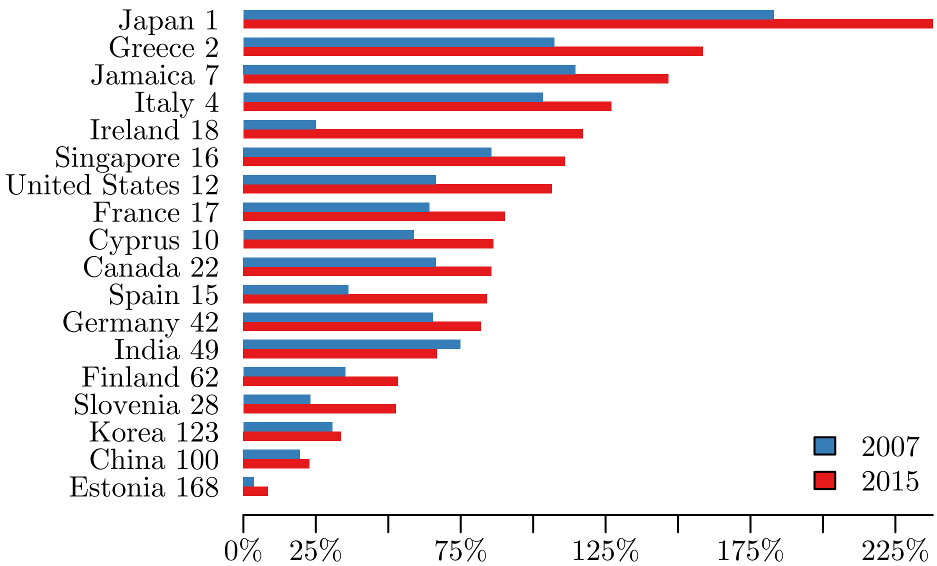


Figure 20.4: Gross debt of selected countries and global rank out of 173 countries, 2007, 2015

Datasource: IMF

Furthermore, a country's debt levels may be seen as safe when economic conditions are benign, but if the environment turns, the same debt level quickly becomes unsustainable. That is what happened to some European countries. See the discussion in Section **??** on debt intolerance.

The business and credit cycle

Rapid credit growth has throughout history been a powerful indicator of upcoming financial crisis (see e.g. **?**), and the European crisis is no different. In the boom years before a crisis, credit grows rapidly, but is increasingly directed to unprofitable investments, often in real estate. Eventually, the level of credit becomes unsustainable and a crisis ensues.

In the case of Europe, this was fueled by international capital flows. Prior to the crisis, the countries on the periphery borrowed large amounts from the core countries. In Spain and Ireland, these funds went largely into real estate, while in Greece most financed public spending. When the collateral for these loans fell in value in Ireland and Spain, the banks were hit by the large amount of non–performing loans deteriorating their capital levels and threatening their solvency.

20.2.2 The banking crisis

Due to its colonial history and substantial cross-border trade, Europe has always had more than its fair share of large internationally active banks and the global banking crisis, discussed in **??**, affected Europe especially strongly. As noted in Table **??** and Figure **??**, Europe's banks and banking systems are very large compared to GDP.

With the establishment of the common market, European banks took full advantage of the new opportunities to expand across Europe. Funding costs converged across the Union and exchange rate risks as well as previous market-based restrictions on lending activity were eliminated. Core countries intermediated savings throughout the euro zone, giving rise to increasing interconnectedness and interdependence, thereby creating stronger channels for contagion. As noted by **?**, by 2006, European banks had on average 26% of their activities in European countries other than their home country, with some reaching 70%. Furthermore, as noted in Section **??**, the European banks were active in mediating funds between American savers and borrowers, creating vulnerabilities that were hard to detect.

Inevitably, any failure of a sizable European bank was likely to adversely affect several member states. Unfortunately, regulations did not keep up with the international operational scope, and national governments were often responsible for supervising both the domestic and international operations of their banks, whilst ultimately being responsible for the fallout from their failures.

The periphery nations attracted large amounts of capital in a short period of time, increasing investment and consumption. For example, net foreign liabilities of the Irish banking system increased from 10% of GDP in 2003, to 55% in 2007, while the corresponding numbers for Spain are 35% to 65%.

Since the crisis, European banks in core countries have been retrenching away from the crisis countries, adversely affecting small and medium–sized enterprise (SME) lending in those countries and hence holding back recovery.

There are two different explanations for the banking crisis. In some countries, the banks were the culprit, with excessively loose lending without adequate standards, insufficient regulatory oversight and high levels of leverage. In other cases, the banks were more prudently run and regulated, but fell victim to the sovereign debt crisis, partly because they placed too much faith in the risk-free status of government debt. The first category includes Ireland and Spain, but also Belgium, Germany, France and Denmark, while Italy and Greece fall into the second, with Portugal leaning that way as well.

20.2.3 The growth crisis

Underpinning the banking and debt crises is a deeply rooted structural problem in many European countries, which are increasingly seen as uncompetitive globally. While this is a long–running problem, it has become especially problematic after the crisis started, since these countries have experienced anaemic growth post 2007.

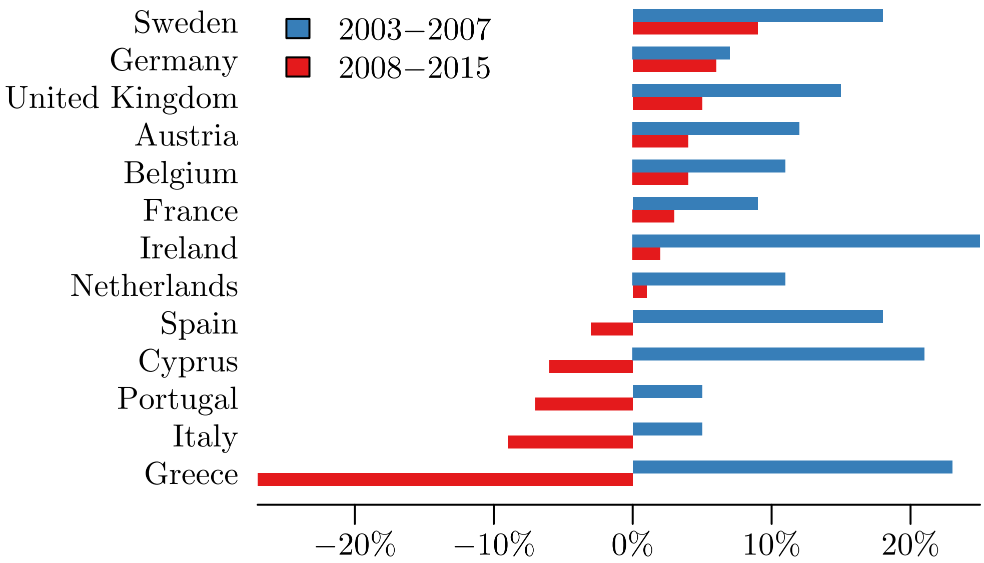


Figure 20.5: Economic growth

Datasource: Eurostat

The structure of the European economy changed significantly with the rise of Asian economies. The former European low cost–producers, like Italy and Portugal, faced new competition, especially from China, and failed to implement structural reforms to maintain competitiveness.

Before the introduction of the Euro, those countries tended to use currency devaluations as the main mechanism for maintaining price competitiveness, being unwilling to match government revenues with expenditures, consistently increasing sovereign debt levels. This is problematic for high debt countries not the least because a slowdown in GDP growth will contribute to increasing debt/GDP ratios, all else equal, leading to a vicious feedback loop.

There are two main reasons for this. *First*, as a country's economic situation deteriorates, the revenues from taxation also decrease. As a result, the fiscal deficit grows larger, contributing to increased debt levels (or constraining debt repayment), unless the decrease in revenues is offset by a decreases in expenditure. *Second*, as the growth prospects of an economy appear negative, investors become more wary of the capacity of the sovereign to repay their debt, and start asking for higher interest rates to compensate for the higher risk. When the rating agencies assess the quality of sovereign debt, one of the criteria they use is growth prospects. This exacerbates the negative feedback loop.

The uneven distribution of growth across member states contributes to the problem. Any country suffering large current account deficits is accumulating debt, and becoming increasingly vulnerable to changes in capital flows. Even though such debt is private, there is always the chance that the sovereign will have to take some of this private debt onto its own balance sheet, as often happened in this crisis.

While countries with large current account deficits are most at risk, those with a current account surplus are not immune either, both because their economic activity is highly dependent on demand from abroad and they often hold the debt of the high current account deficit countries. Large — and even small if over a long period of time — differences in growth patterns can therefore create instabilities within a currency union, unless they are countered by some balancing effect such as the migration of labour to wealthier economies, or internal subsidies. This in turn contributes to a deepening of the crisis. It is for this reason that it is difficult to maintain a currency union without some transfer mechanisms.

20.2.4 Political crisis

> "There are no new issues in economic theory with Europe and the Euro [...] the difficult thing is the politics."
> Thomas Sargent (2011)

The three economic crises are well understood, and whilst there are disagreements as to what economic track to take to solve the crisis, many of the conflicting proposals are individually sensible. What is lacking is the political capacity to achieve a coordinated response to the crisis.

The original motivations for creating the EU were never economic. The EU was created in the 1950s because European leaders believed that the best way to prevent another war was European integration. In this, the generation that decided on and implemented the monetary union and the common market in banking services, was the last generation of European leaders directly affected by the Second World War (WWII). For them, the political reasons dominated the economic. This meant that key issues were swept under the carpet, as noted in Section **??**, leaving institutional flaws that are now at the root of the European crisis. Politics has therefore not only become the main factor in preventing a resolution of the crisis, but also a direct cause.

The Union mainly faces two political challenges:

Decision lags

Whilst there are many clear economic advantages from greater integration like a common market and the coordination of policies, this also has created multiple layers of decision-making. That increases the amount of bargaining frictions as well as political differences between nations and lengthens the policy-making process. For an overview of European decision-making, see Figure 20.6.

These frictions have significantly impacted the resolution of the crisis in Europe and explain why the euro zone was not able to react as swiftly as nation states, such as the US or the UK have. In any nation state, the government can directly address economic problems, and in a crisis can react very quickly.

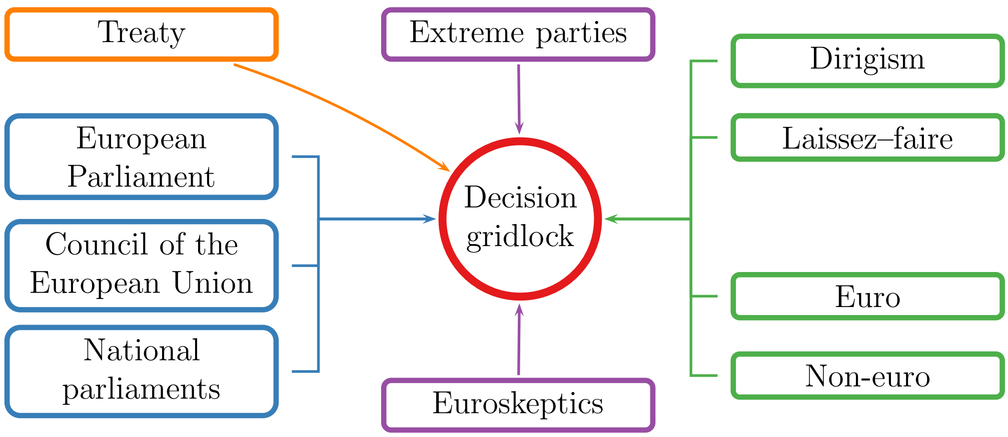


Figure 20.6: Politics

By contrast, passing a simple law in the EU requires the EU to submit a bill to both the European Parliament (EP) and the Council of the EU representing the governments of all 28 members, all catering at the same time to their national electorates. Therefore, for future crises, it is important to have the necessary set of rules and resolution mechanisms in place prior to a crisis. A concerted effort to achieve this has been made in the rules concerning banking union (BU); however as indicated in Box 20.2 there must be some doubts as to whether this has been entirely achieved.

Balance of power

One can also define the euro zone loosely as two opposing camps, crisis and non-crisis countries. The non-crisis block includes countries such as Germany, Belgium, the Netherlands, Luxembourg, Finland and Austria, while the second block was composed of countries like Greece, Italy, Ireland, Spain, Portugal and Cyprus. When a country exits the bailout process, and hence ceases to be a crisis country, it often takes a very strong position against other countries in crisis. This became very clear in the attitudes of Ireland, Spain and Portugal towards Greece. The reason is that the political justification for undergoing the crisis resolution process and the accompanying austerity is only validated if the crisis ends. Therefore, the austerity becomes seen as the necessary condition for ending a crisis, and consequently other countries who as unwilling to do the same become seen as irresponsible.

Both set of countries have a position that gives them some leverage in bargaining. Obviously, if the crisis countries refuse the conditions imposed by the non-crisis countries, they face the risk of not receiving aid. However, if non–crisis countries fail to reach an agreement on the terms of the financial assistance, and let the countries in crisis fail, they would themselves be severely impacted by these failures. That could happen for several reasons, for example if their own banks get into difficulties or the the currency unit is threatened.

Several observations may have tilted the balance in favour of the non-crisis countries. *First*, as providers of the loans, a failure to reach an agreement has a less severe impact on their economies than on the economies of the recipients and they are generally adequately placed to bail out their own banks if required. *Second*, the way the crisis was seen by the electorate of the respective countries. The revelations about Greece's fiscal mismanagement and misreporting of their budget deficits made the Southern countries appear economically irresponsible. It became difficult both for crisis countries to impose conditions and for Northern countries to accept them. *Lastly*, the elites of the indebted countries see joining the EU as having been beneficial and consequently fear being kicked out.

20.2.5 The relationship between the crises

The key feature of the European crisis is that all three economic crises (banking, growth and sovereign debt) feed into each other, as illustrated in Figure 20.3. Initially, the banking crisis affected sovereigns. Both Ireland and Spain had fiscal surpluses prior to the crisis, and decreased their debt to GDP ratios. But as the banking crisis struck, bank recapitalizations and guarantees quickly demanded large amounts of financing, increasing deficits and the accumulation of public debt, at the same time as the recession lowered tax incomes, further exacerbating the deficit. Countries hit by a banking or sovereign crisis are likely to implement austerity programs to curtail deficits and increase confidence in the markets, either because they themselves believe this to be good policy or because they are forced to do so by their creditors.

The constitution of the ECB is strictly opposed to suffering losses from providing credit to the crisis countries. Therefore, like any creditor, it is naturally inclined to demand implementation of policies it sees as maximizing its chance of recovery.

	Italy	**Portugal**	**Spain**	**Germany**	**Total euro zone**
January 2012	6.8	4.6	6.3	3.5	4.6
February 2014	10.2	7.4	9.5	4.6	5.8

Table 20.1: Own government debt as percentage of bank assets
Data source: ECB

While the European banking sector is retrenching into the core, the banks are hoarding pre-dominantly domestic sovereign bonds with help from the ECB liquidity programs, see Table 20.1. There is an important distinction between holding domestic government bonds and the bonds of other euro zone member states.

20.3 Internal devaluation and structural reforms

The crisis has not affected all European countries equally. Following the crisis, severely-hit members of the euro zone were unable to devalue their currency to inflate their debt away. Therefore, they usually resorted to internal devaluation to maintain their competitiveness and support their economic activity. They were also required by non-crisis countries to implement structural reforms and austerity measures, which were usually contested by local populations and had severe domestic political costs.

Box 20.3 (The crisis debate: (Ir-)Rationality?) *While there are many competing hypotheses on the cause of the crisis, some commentators look for an explanation in the irrationality of financial markets, using arguments similar to those in the Asian crisis of 1998, see Section* **??***. For example,* **?** *see the pre-crisis rate convergence as the norm with the crisis-spread as a divergence. While they accept that fundamentals matter, they recognize that collective movements of fear and panic can have dramatic effects on spreads.*

In their view, market agents panicked, demanding irrationally large yields. They find that the spread on a country's bond, relative to German yields, was highly correlated with the degree of the austerity, which had a further negative impact on GDP growth and hence were counterproductive in reducing debt levels. Therefore, the commitment to unlimited support via the Outright Monetary Transactions (OMT) in 2012 provided necessary calming to panicking markets.

An opposite conclusion is reached by **?** *who argue that the loss on Greek bonds proved that market participants were not panicking and that spreads were correlated with the underlying fundamentals.*

Ultimately, the irrationality arguments are not convincing for the same reasons we did not find them convincing as explanations for the Asian crisis (Section **??***).*

20.3.1 Internal devaluation

An obvious way to increase the competitiveness of a country is to devalue its currency. The option to devalue is not open to individual euro zone members since they do not have control over their currency, and is disliked by those who seek to join the euro, because the associated commitment not to devalue is expected to reduce financing costs and increase financial stability. The main alternative is internal devaluation, i.e. lowering domestic factor costs through targeted government policies so that domestic prices decrease. The end result of internal devaluation is thus similar to a currency devaluation. An important early case is the Hartz reforms in Germany during the mid-2000s, and several European crisis countries, including Ireland and Spain have done the same, to varying degrees.

The Baltic countries (Latvia, Lithuania and Estonia) also carried out internal devaluation in response to the dramatic decrease in external demand they faced as a result of the 2008 crisis. At the time, these countries had their currency pegged to the euro as part of the European exchange rate mechanism (ERM)–II mechanism, and were candidates for accession to the euro zone. Hence they were determined to show that they could handle the crisis without the need to devalue their currency. They successfully managed to reduce labour costs, although this came at the expense of a significant drop in output, high unemployment and lower standards of living. This has led some commentators to reject the idea that the Baltic countries were a successful example of internal devaluations.

However, this is often quite difficult, especially in countries with unreformed labour markets. The UK experience between 1925 and 1931 of an overvalued currency was almost continuous labour strife and recession.

One possible way to ease the process of internal devaluation would be to generate a euro zone-wide controlled inflation, thus lowering the real wages for the countries concerned. Countries such as Germany, however, are strongly opposed to such a solution and action beyond the pursuit of a 2% inflation target seems to be outside the scope of the ECB.

20.3.2 Structural reforms

Internal devaluation can have negative implications in the long–run as much as in the short–run if not complemented by effective structural reforms. Non-crisis countries have demanded structural reforms as a condition for the bailout packages. Common examples include the liberalization of services and utility sectors or changes in the wage-bargaining system in order to increase productivity and reduce labour costs.

The labour market in the periphery countries is often singled out as being especially in need of reform, and some countries have already attempted some policy changes. Examples include Italy's labour and product market liberalization in 2011 and 2012 and Spain's labour market reforms. However, any such reforms are strongly resisted by vested interests. Reforms are often painful in the short–run, and, if any, beneficial effect is only realized in the long–run. For nations with high unemployment, removing obstacles for firing employees can lead to further unemployment in the short–run, especially for low–skilled labour, in a situation where the social needs are already desperate. Therefore, reforms require a broad political agreement, which can be difficult to achieve in countries that are experiencing a harsh recession.

It is unclear whether poorly paid workers can expect to benefit much from these kinds of reforms because the worsening in their bargaining position may easily outweigh any gains in the wealth of the economy as a whole. What is clear, however, is that they tend not to believe they will benefit and the rise of populism, anti-globalization and anti-EU sentiments are the result.

20.3.3 The austerity debate

Central to the resolution of the European crisis is the notion that austerity is necessary. A country is supposed to sharply curtail government expenditures and increase taxes, turning a deficit into a surplus. Applying such a rigor would then lay the foundations for future economic prosperity. Austerity finds some support in standard economic theory, but most mainstream economists are skeptical. The main support comes from the uniquely German economic school, *Ordoliberalism*.

The notion of austerity is highly controversial, Northern European policymakers are strongly in favor, as is the IMF, but others are more skeptical.

Not surprisingly, austerity measures have come under strong criticism, as voiced by Paul Krugman as early as 2010, which has since grown into a wider academic debate, see for example **?** or **?**. The austerity debate has strong echoes to the Great Depression (Chapter **??**). At that time, countries on the gold standard, such as the UK, suffered from recession until they devalued their currencies, and became competitive. Under this argument, structural reforms were not needed, simply a realignment of prices, achieved by devaluation. Similar effects were at work during the ERM crisis in 1992, discussed in section **??**.

Critics

The critics find the austerity measures to be too stringent, severely impacting efforts to revive GDP growth. They maintain that cutting government expenditure during a recession will aggravate the downturn and therefore be counterproductive. A decreasing level of GDP would counteract any efforts to reduce the debt/GDP ratio through debt reduction, and result in a decrease in living standards (through higher taxes or lower levels of public services and transfers), with no improvement in debt sustainability. In this, government spending is assumed to have a positive multiplier effect, where a change of one unit in government expenditures would affect GDP by more than one unit.

In normal times, government expenditures might crowd out private investment, but in times of crises, the multiplier might be much higher. This is backed up by evidence from the Great Depression where the rapid increase in government expenditures by the incoming Roosevelt administration from 1933 is seen as key in helping the US escape from the Depression. Therefore, economic stimulus is then better than austerity. Ideally, the exchange rate should be adjusted to make these countries more competitive, considering the negative experiences of the UK currency overvaluation between 1925 in 1931. However, since the majority of the euro zone countries is not in a recession, that is difficult to justify.

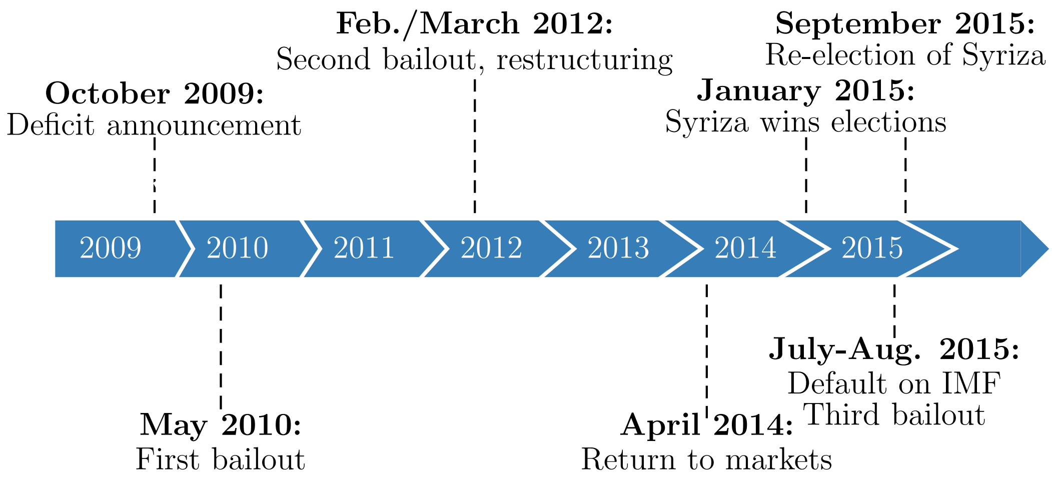
Proponents

The proponents of austerity counter with two main arguments. *First*, that the stimulus multiplier is quite low, since the stimulus uses resources that could otherwise be used for more productive uses by private firms — the crowding out effect. In addition, any stimulus might just lead to increased savings if seen as temporary. *Second*, any increase in government debt might simply encourage lenders to demand higher interest rates, which in turn would drag down growth. Therefore, credible fiscal adjustments are seen as necessary to make the debt sustainable and keep interest rates low. This might be relevant for some of the countries in difficulty, such as Portugal, Spain and Italy, but not for Greece given the ownership, maturity and interest rate of its debt. The austerity proponents have praised the strict austerity measures undertaken in Latvia, especially as these were accompanied by the highest GDP growth rate in Europe.

The IMF has historically been a strong proponent of austerity policies, but did admit they might have gone too far in the case of Greece, finding in a

2013 report that "Greece's recent experience demonstrates the importance of spreading the burden of adjustment across different strata of society in order to build support for a program". More recently, the Fund also advised France to slow the pace of austerity, though insisting on rebalancing the revenue side and the expenditure side (?). However, the EC reacted to these criticisms by pointing out that the fiscal policy strategies that were being carried out were in line with other international organizations (such as the IMF and the OECD), and that the EC's position was generally more flexible and less one-sided than commentators believed.

20.4 The Greek crisis



Every European crisis country has, at least for the moment (there are worries about Portugal), overcome its main difficulties, except Greece. When it adopted the euro in 2001, Greece did not comply with convergence criteria imposed under the Maastricht Treaty. But the entrance of Greece in the euro zone implied that it shared the same monetary policy as wealthier countries such as Germany or France, through the authority of the independent ECB and the use of the same currency. This caused the risk perception by international investors to decline and Greek interest rates to converge to those of wealthier countries. This gave the government the opportunity to improve its debt levels and finance structural reforms, but it chose not to. Instead, it took advantage of reduced interest rates to increase debt substantially, while economic growth was hindered by administrative barriers, protected oligopolies and corruption.

The spark starting the Greek crisis occurred when a newly elected Prime Minister revealed that the previous administration had falsified financial data and that public debt and budget deficit were actually much higher than initially announced. At that time, the benefit of being in the euro zone became a hindrance, as Greece could neither devalue nor use the central bank to monetize the debt. When it became clear that Greece could no longer meet its debt obligations in 2010, it got the first rescue package worth €110bn from other euro zone members and the IMF, conditional on strict austerity measures.

This soon proved insufficient, and Greece received a second bailout in 2012, accompanied by a private sector haircut, and a third bailout in 2015, after defaulting on its IMF obligations in 2015. The government implemented two new austerity packages as a condition for the third bailout, including higher and more uniform VAT, increased corporate tax rate and pension reforms.

The option of a *Grexit*, meaning that Greece leaves the EU, has been raised, but is not under discussion any more. Many Greek citizens fear that by leaving the euro zone, the country would also lose the discipline and the anchor of the monetary policy as conducted by the ECB. Even though the latter has been accused of managing poorly the European sovereign debt crisis, it is still regarded by a major part of the Greek population as more competent than national politicians in managing domestic economic affairs. Despite being elected on a populist platform including renegotiation or repudiation of European debts, Syriza has in fact proved willing to maintain the status quo.

Box 20.4 (Who owns the Greek debt?) *The composition and ownership of the Greek government's debt has changed following the rescue packages. First, the ownership shifted from private to official creditors. At the end of 2013, official creditors represented 94% of total loans and 89% of total securities both owned by non-residents. Second, euro zone members owned 60% of the Greek debt through the EFSF and the Greek Loan Facility. The IMF holds roughly 10% of the Greek debt, the ECB 6% and Greek banks 3%. Among euro zone members, Germany is by far the largest creditor, through the EU bailout fund but also through its national banks.*

20.5 Summary

This chapter provided an overview of the many aspects of the European crisis. The central element of the crisis is the presence of feedback loops between the three economic crises (growth, banking, sovereign) and the political crisis. The crisis, however, only directly involved a relatively small part of the Union with the rest having done well economically.

Bibliography