

# 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

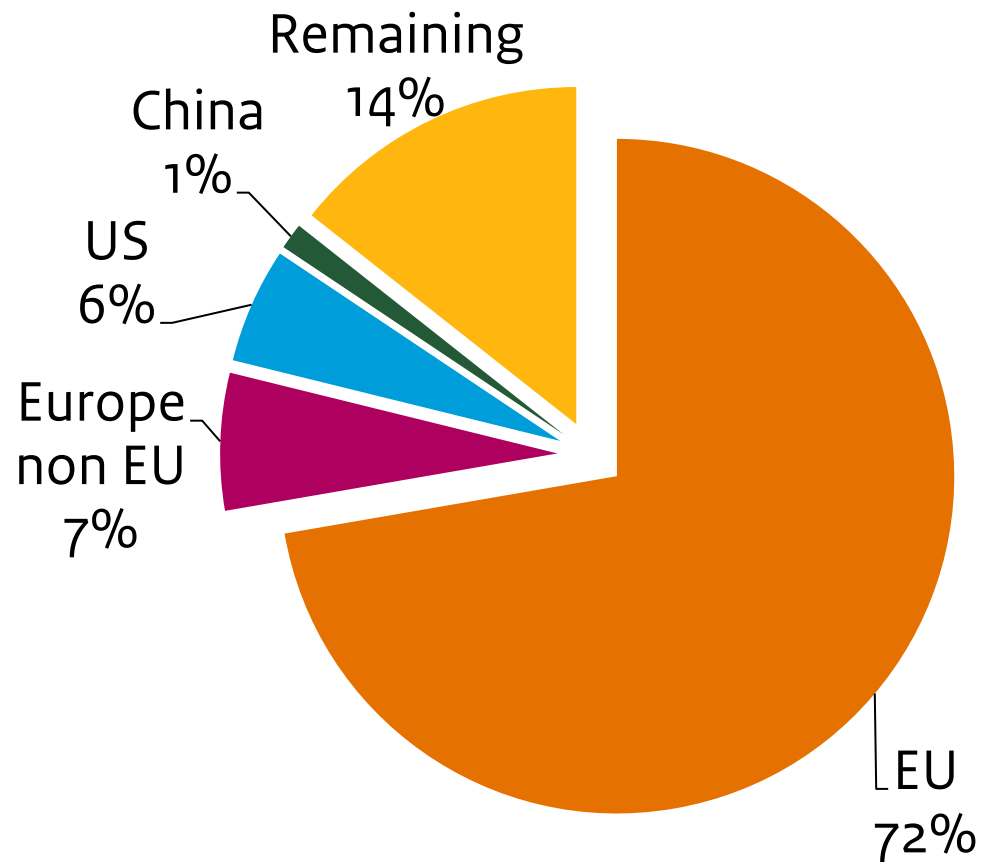


# Menu

- Costs and benefits of Europe
- Banks and governments
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# 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

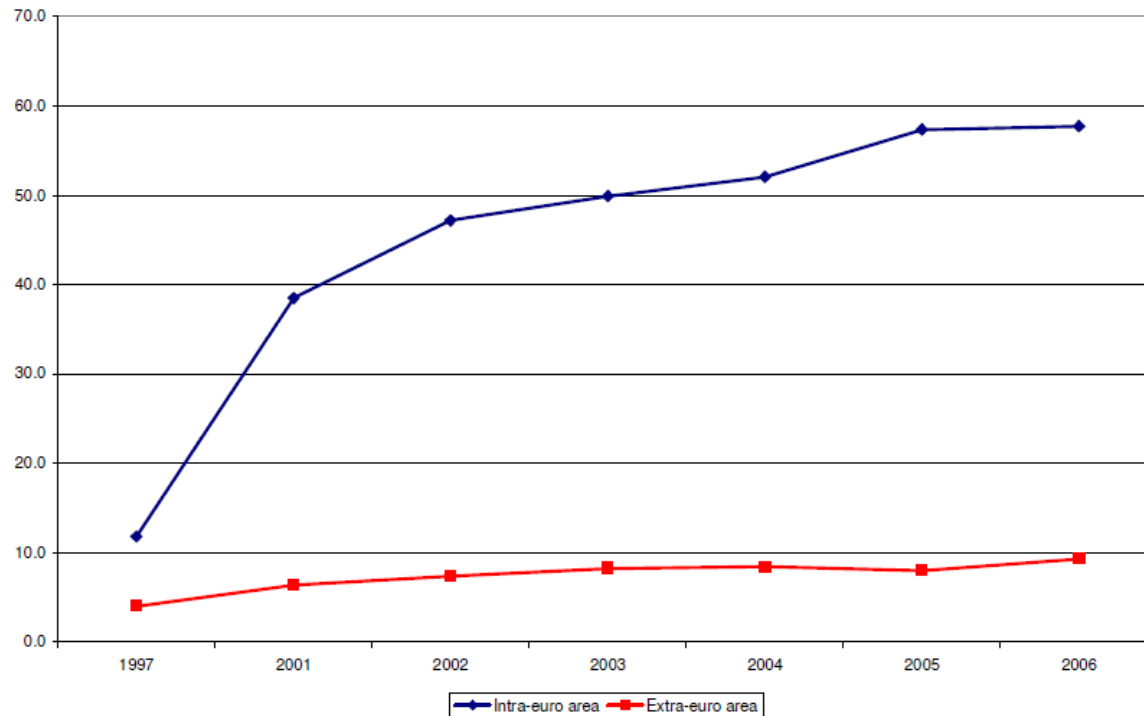


Figure 3: Cross-Border Ownership of Euro Long-Term Debt. Note: . Source: European Central Bank's *Financial Integration Indicators* database.

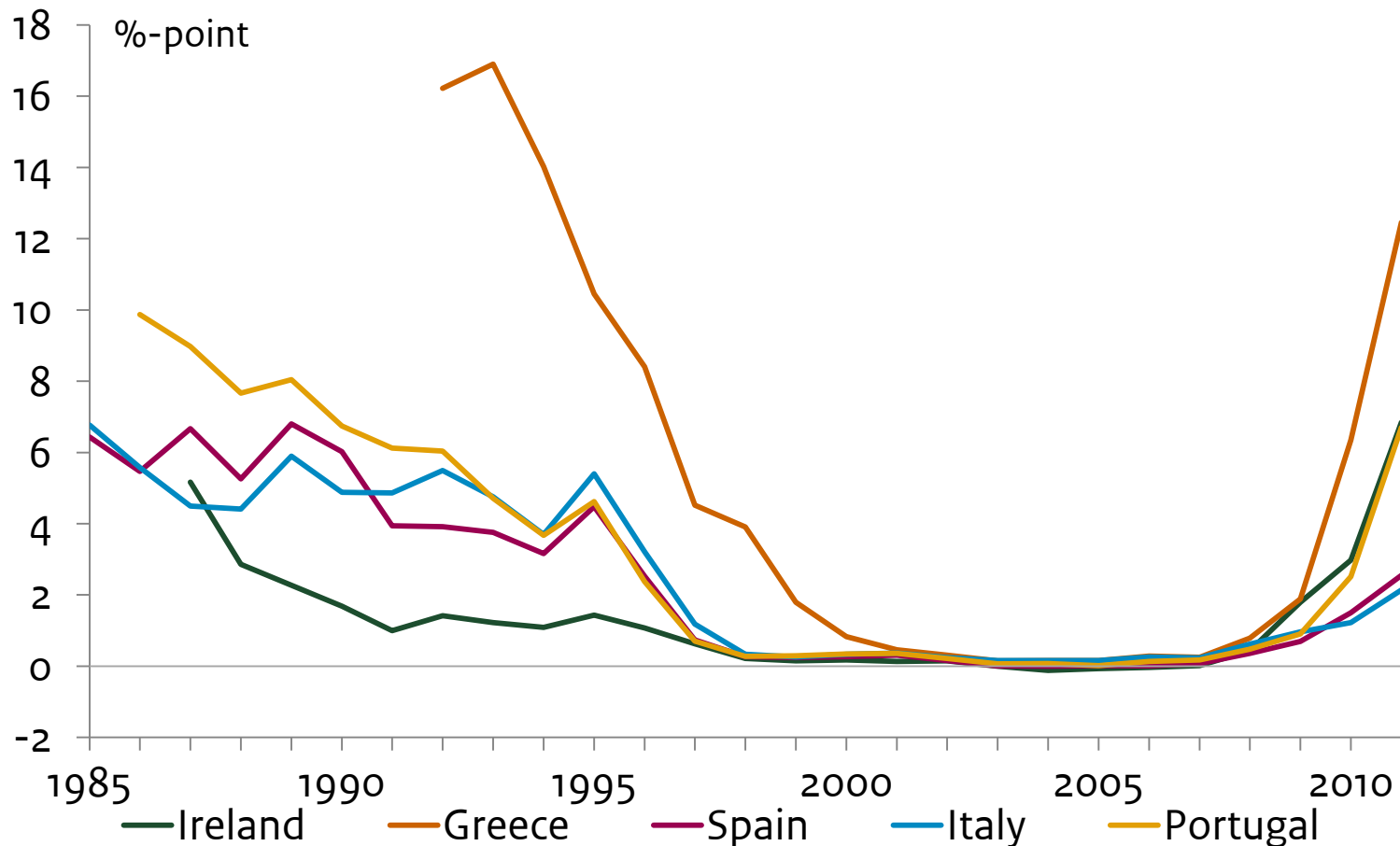


## Discrepancy after introduction of the euro

- 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



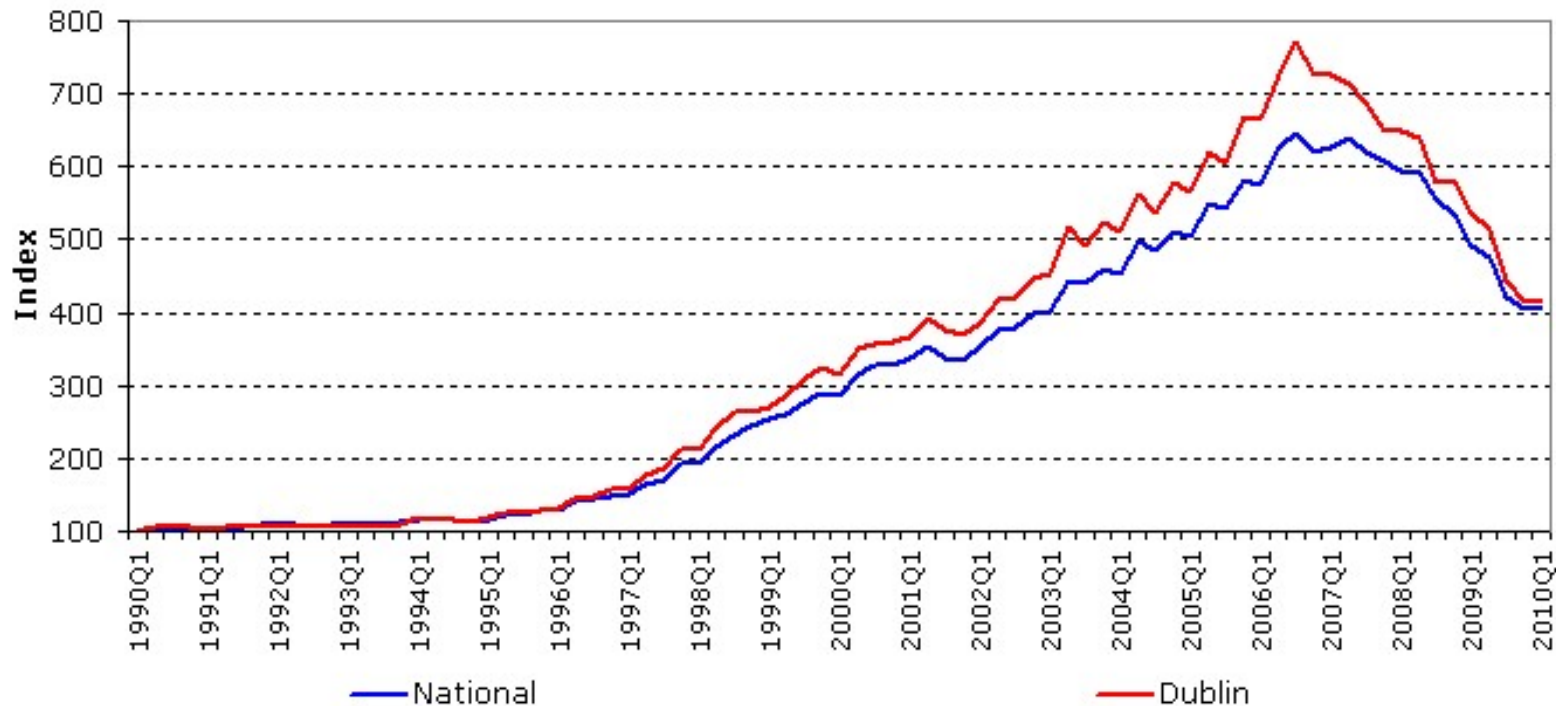
# Interest rate convergence and divergence





# Housing market bubble Ireland

Ireland House Prices (March 1990 = 100)



Source: Central Statistics Office Ireland

[www.macrobusiness.com.au](http://www.macrobusiness.com.au)



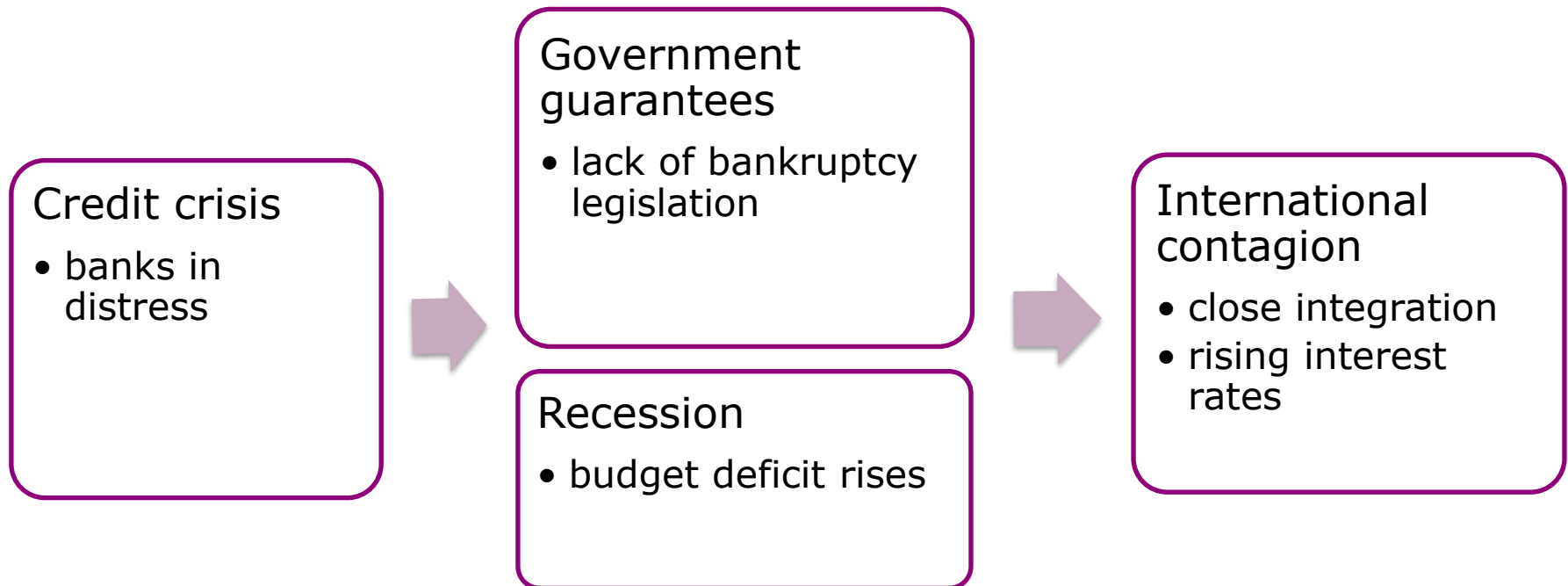
# Convergence and financing of a bubble



- 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

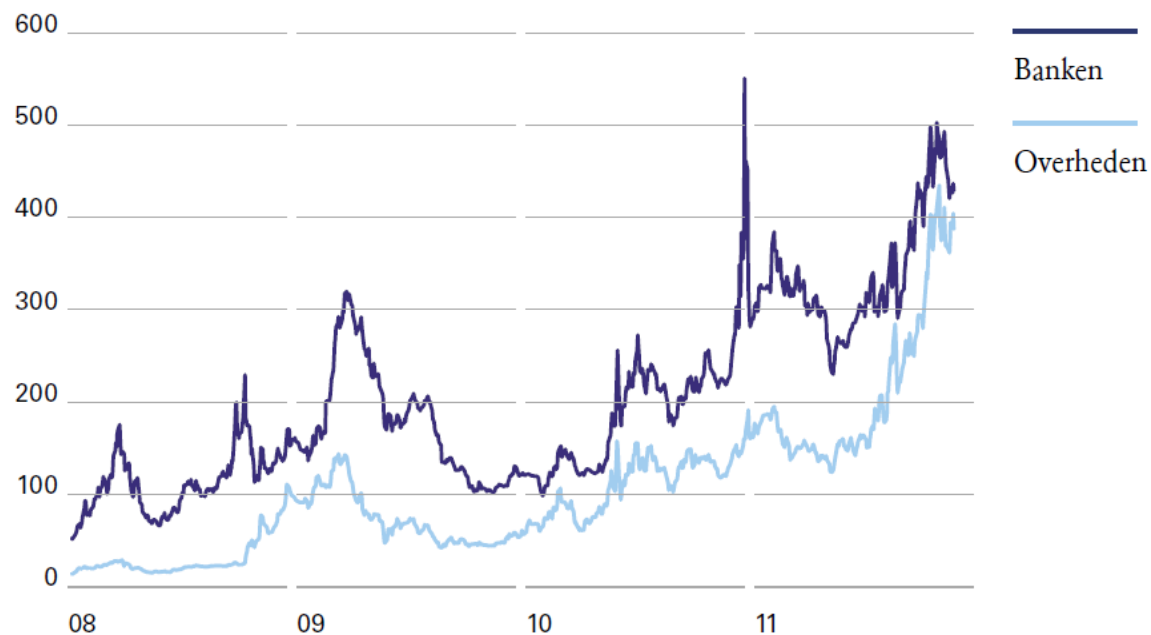




# Banks and governments entangled

## Grafiek 1 CDS-premies in het eurogebied

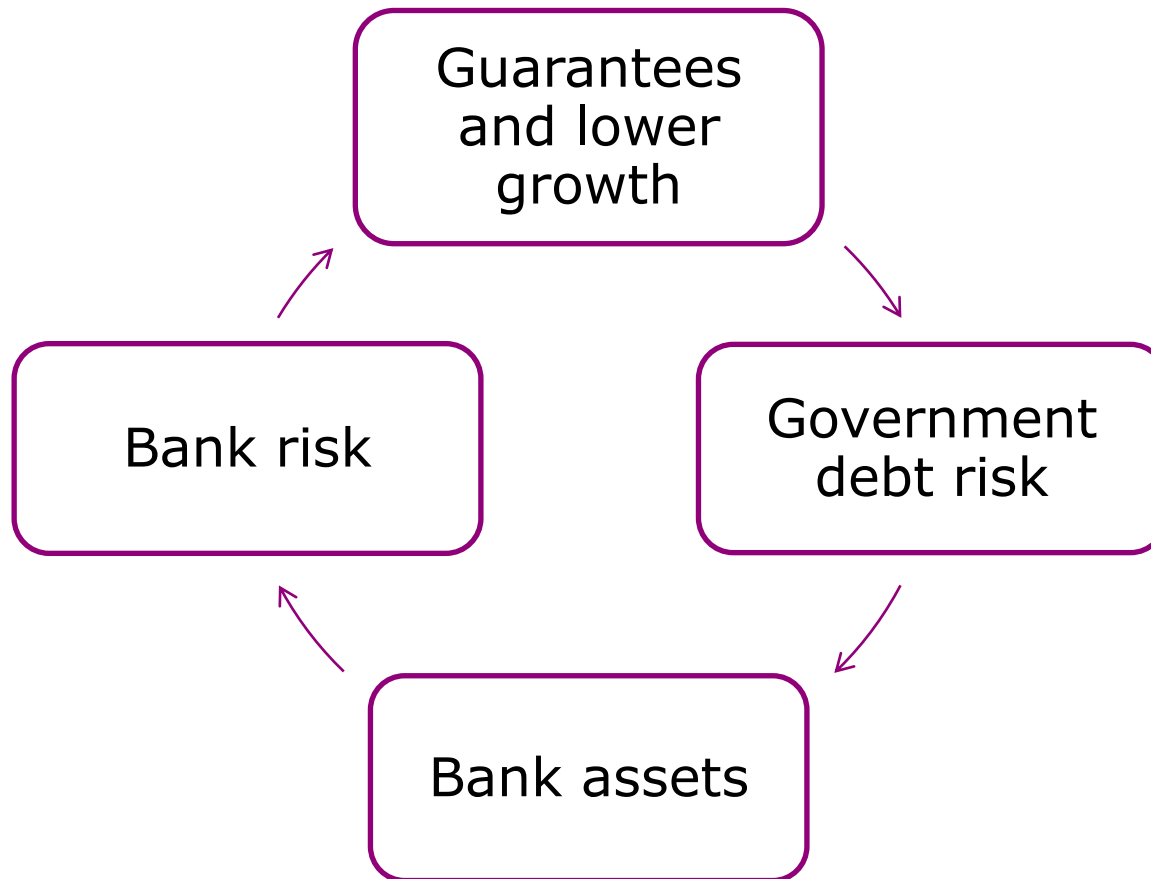
5-jaars CDS-premies, in basispunten, 1-1-2008 t/m 19-10-2011.



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

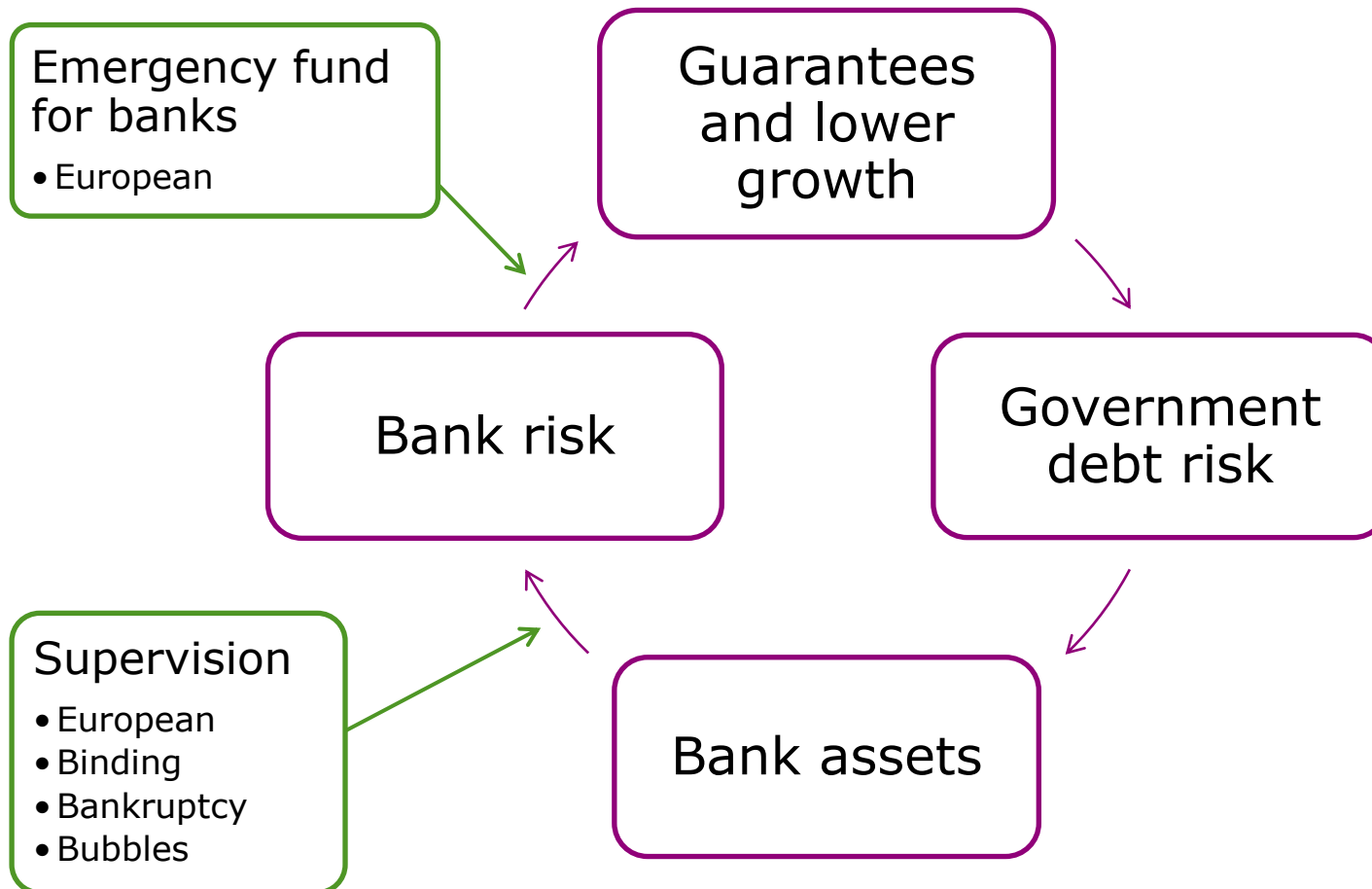


## Suffocating embrace





## 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

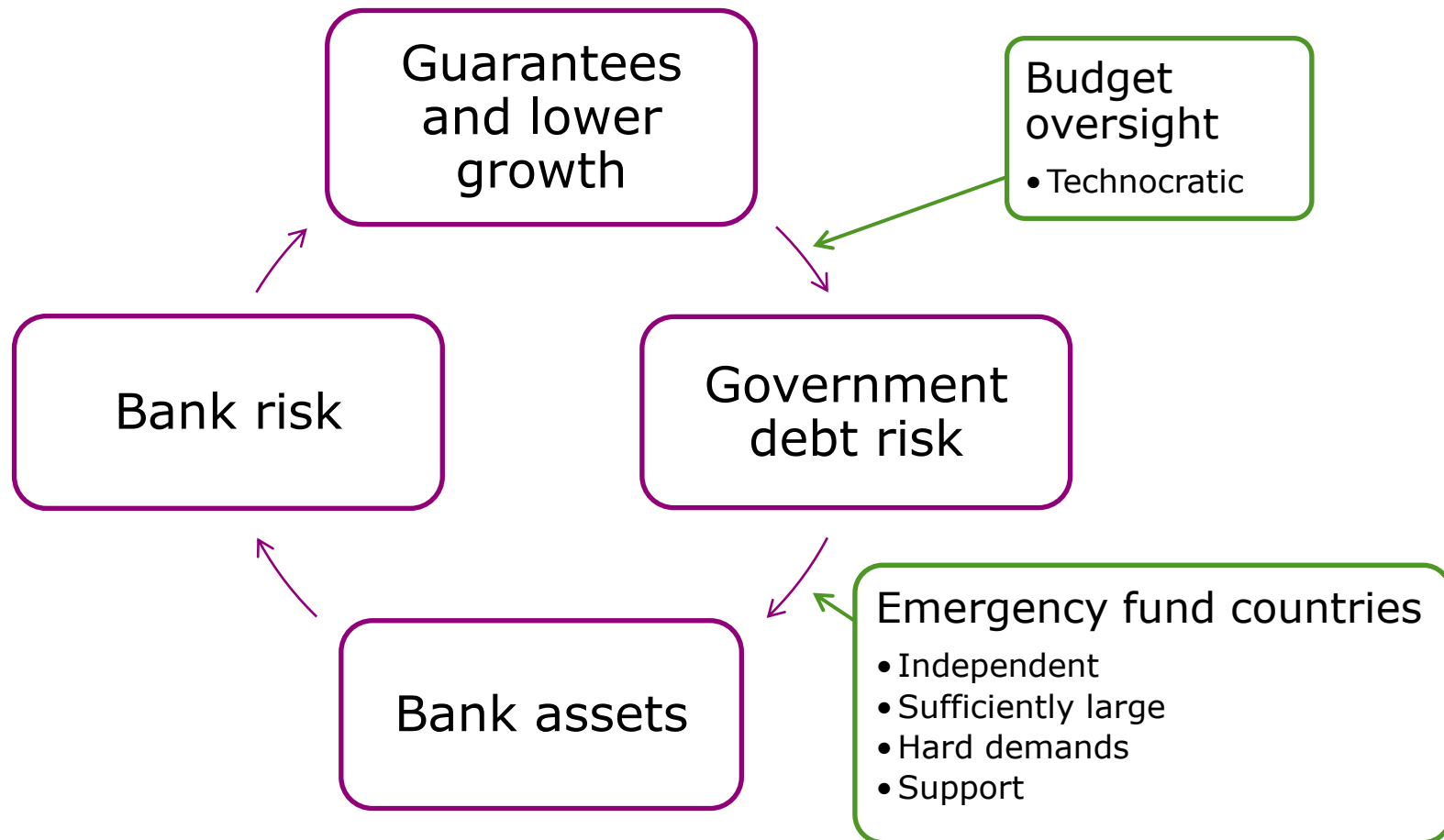


## Debt crisis

- 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

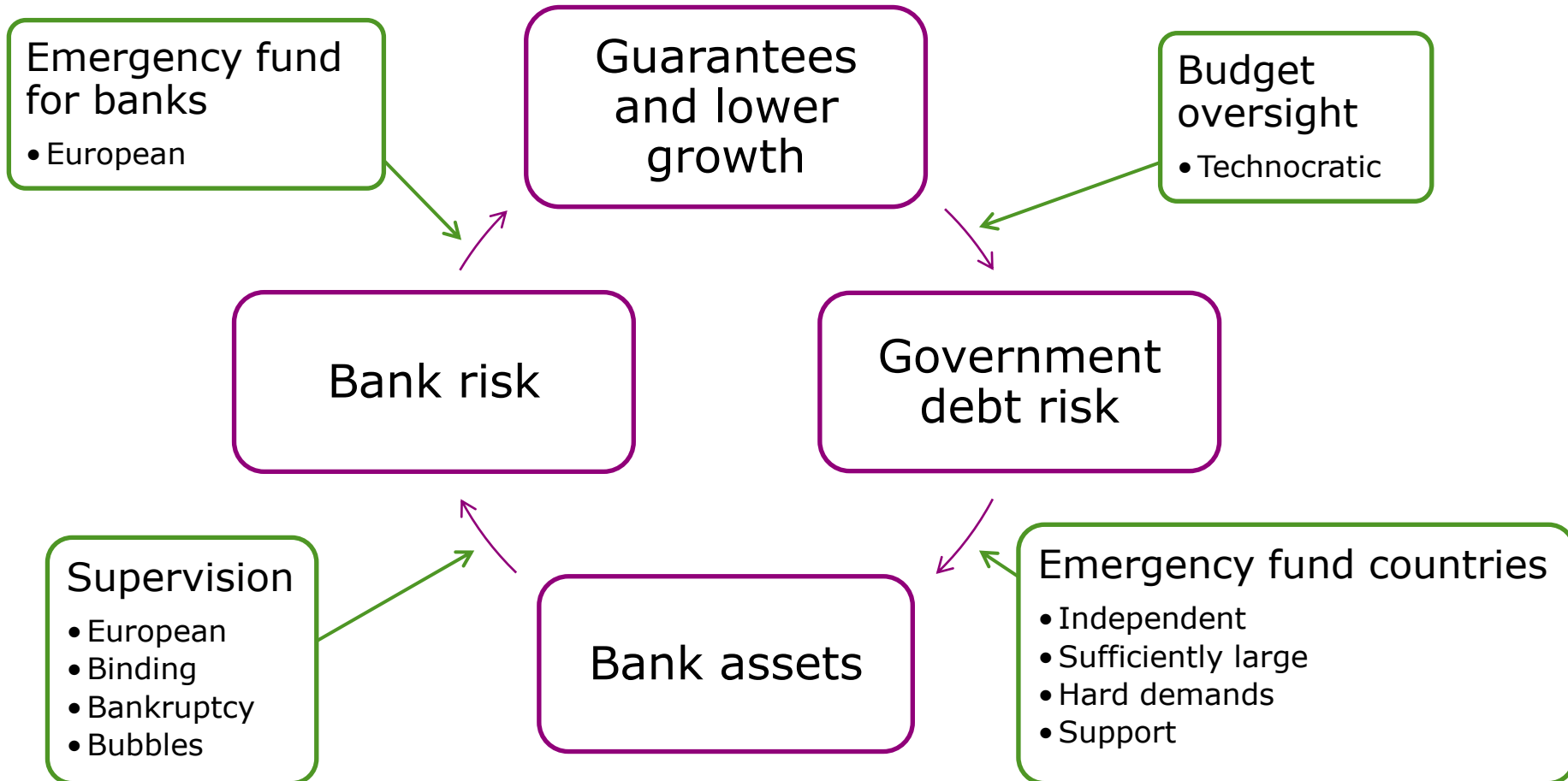


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# Institutional reforms: banks and governments





## 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