

Crisis Management in the euro area and EU: what worked, what did not?

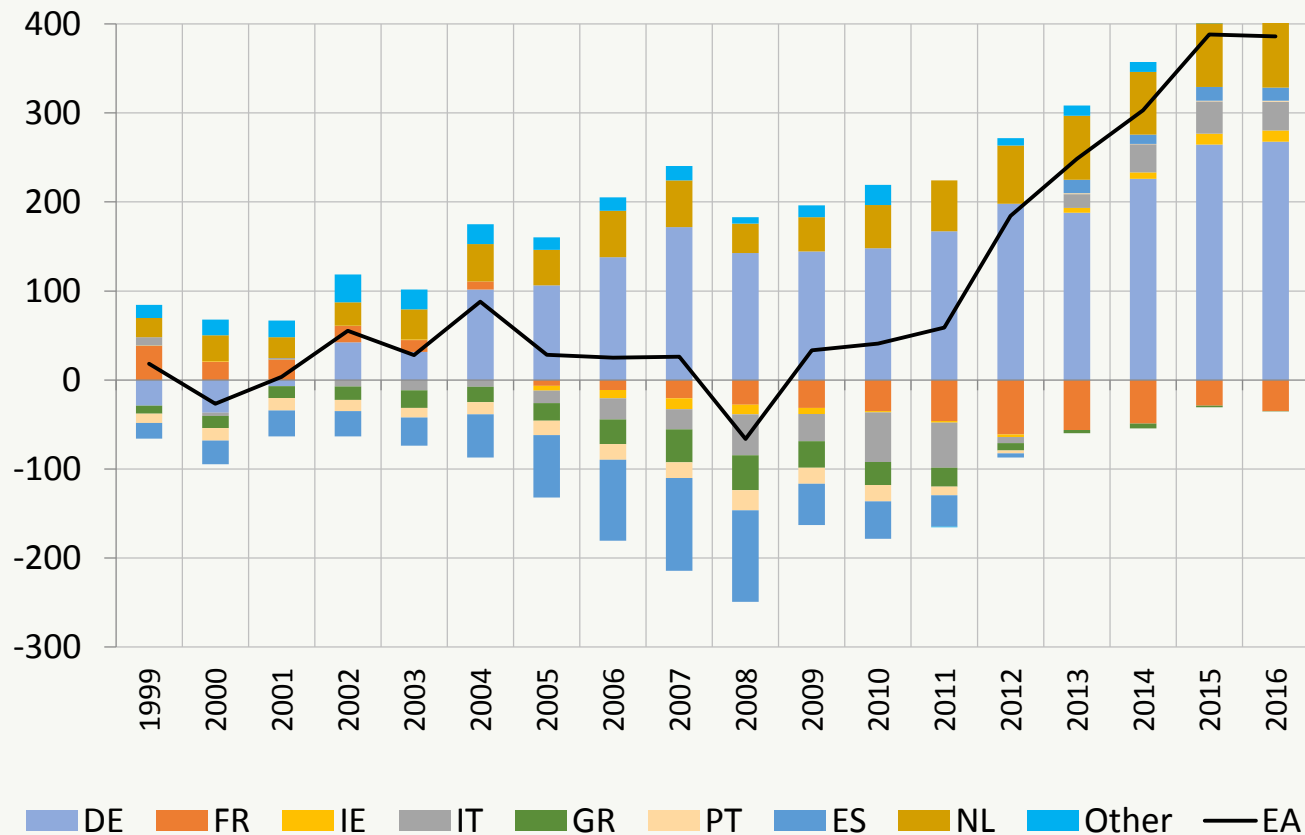
Guntram Wolff, Bruegel
September 14, 2016, Budapest

Outline

- Buildup of imbalances in the euro area
- The crises in Greece, Ireland, Portugal and Cyprus
- ESM/OMT
- Fiscal compact and fiscal rules
- Towards a fiscal union in the euro area
- Multispeed-Europe

Buildup of imbalances in the EA

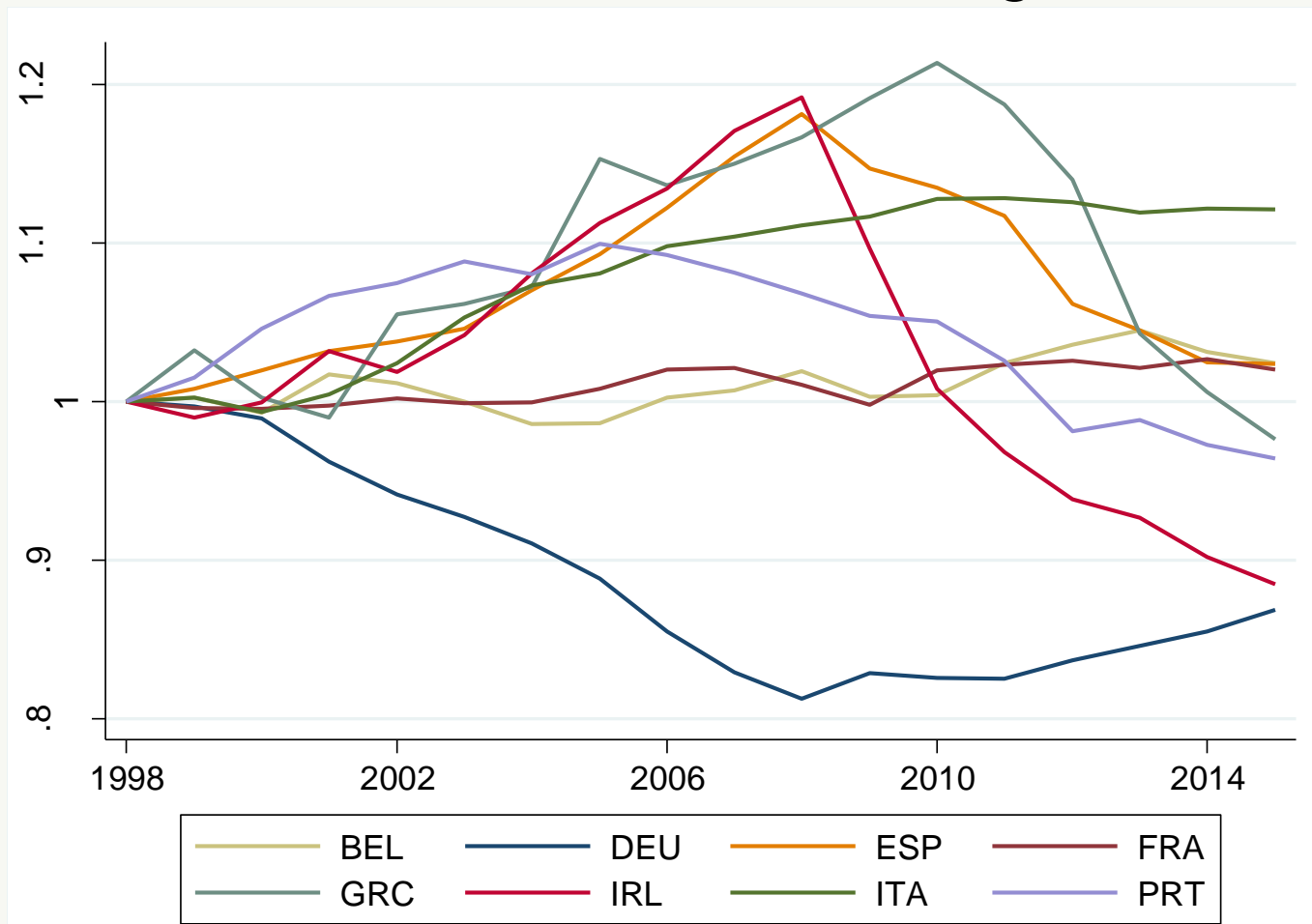
- Current account balance (in EUR bn)



Source: Bruegel based on AMECO (EFCIN)

Buildup of imbalances in the EA

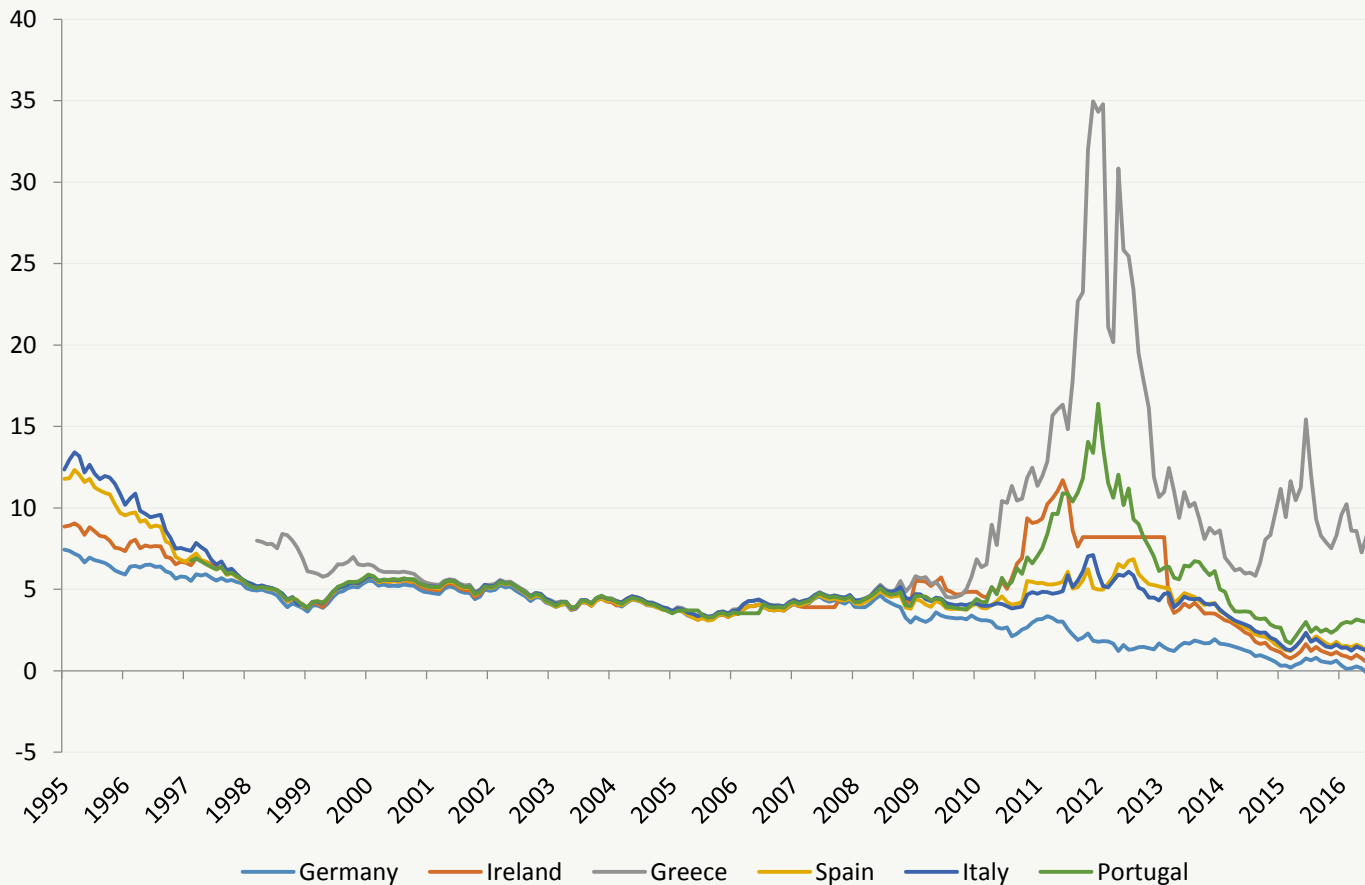
- ULC-based real effective exchange rates



Source: Bruegel based on AMECO (EFCIN)

Buildup of imbalances in the EA

- 10-year sovereign yields



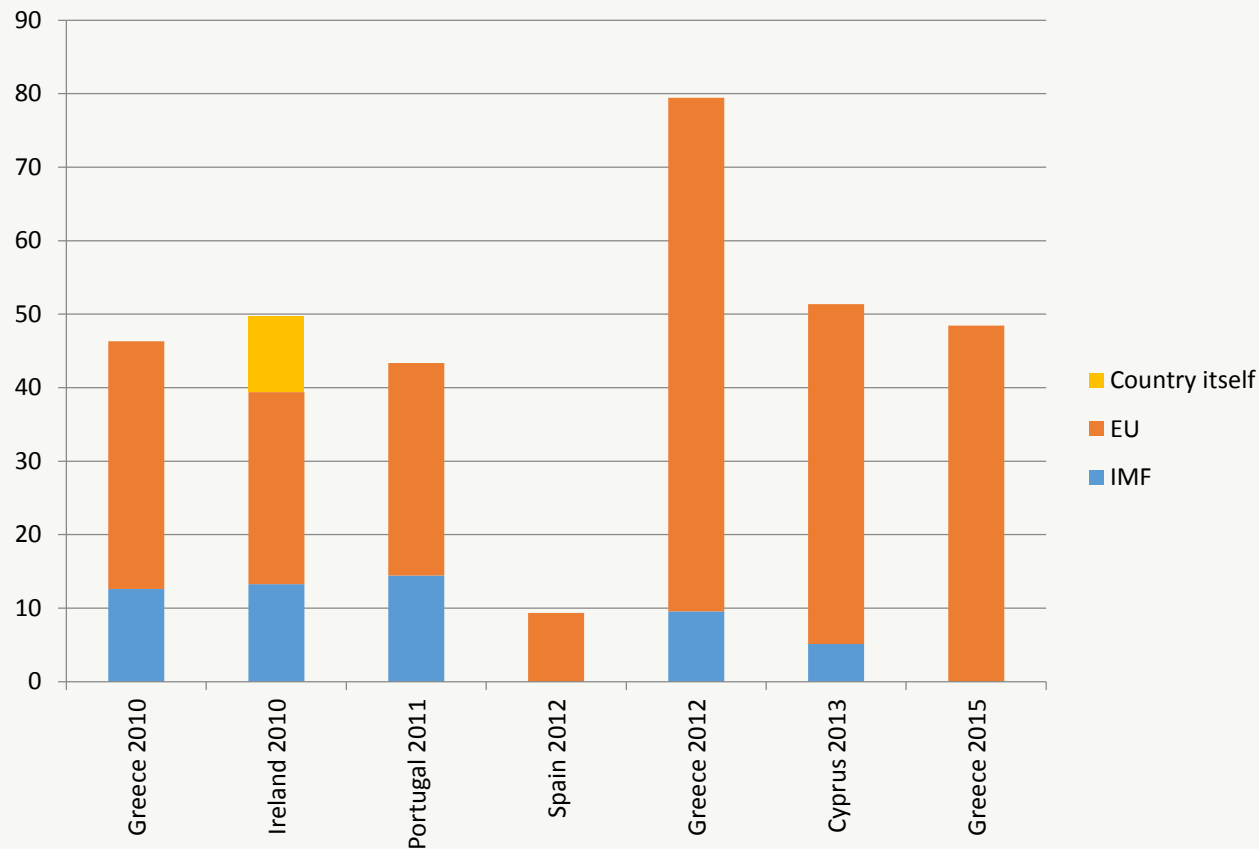
Source: Bloomberg

Distinctive aspects of Troika programmes

- **Very large imbalances:** accumulated in the pre-crisis years
- **Absence of an European Union/Euro Area crisis management framework** when the crisis erupted
- **Very large financing** to the government (by the IMF and various EU funds) and liquidity provision to banks (by the ECB)
- **No possibility of currency devaluation** to quickly regain competitiveness & **no stand-alone central bank**
- **Unprecedented Troika arrangement**, with three institutions operating under different rules and mandates

Size and composition of financial assistance programmes

- In % of previous year GDP

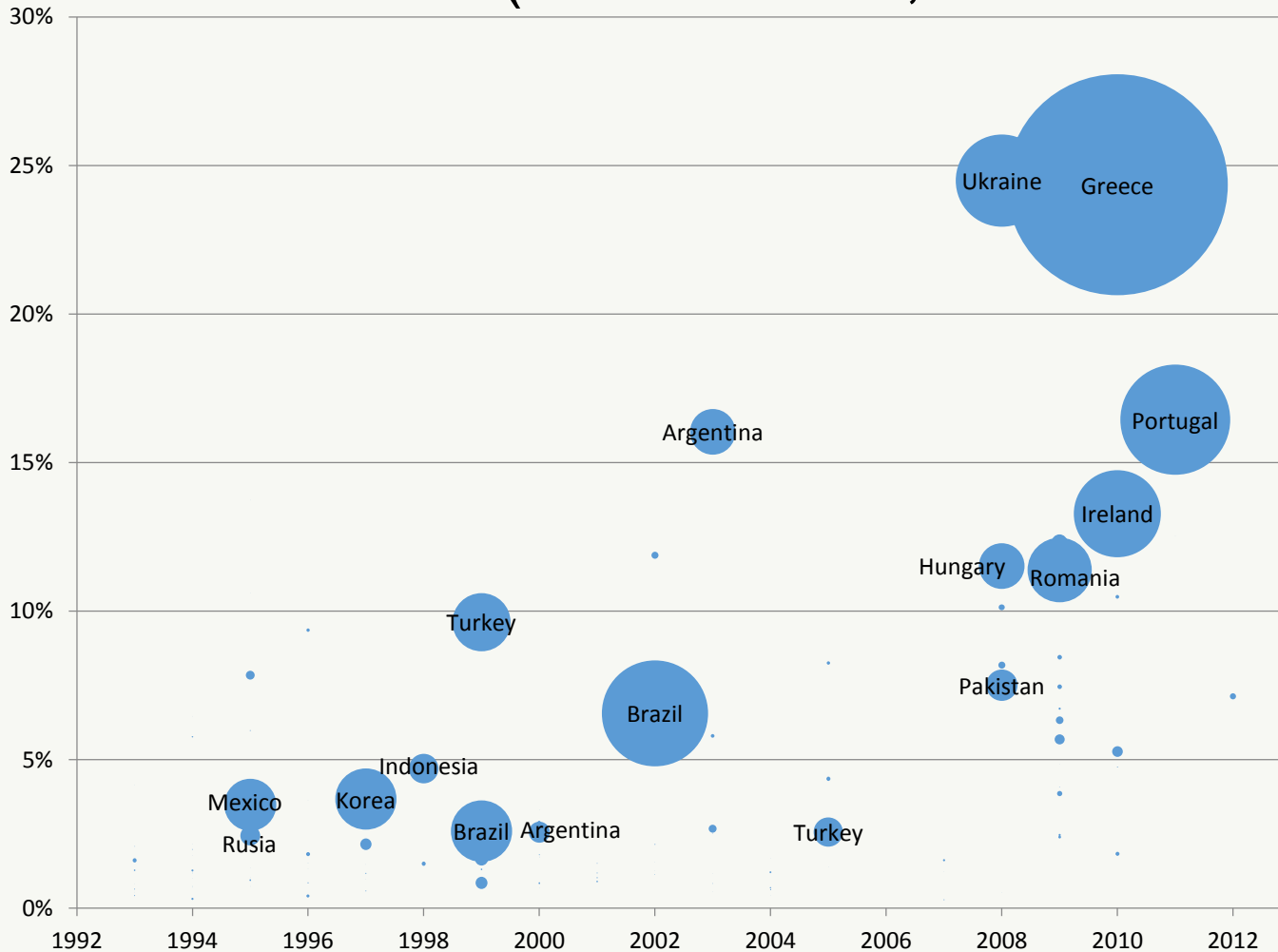


Sources: ECFIN, AMECO (ECFIN)

Note: committed amounts. There is overlap between the first and second Greek programmes. EU includes all kinds of European Union facilities. 'Other external' includes the World Bank and EBRD.

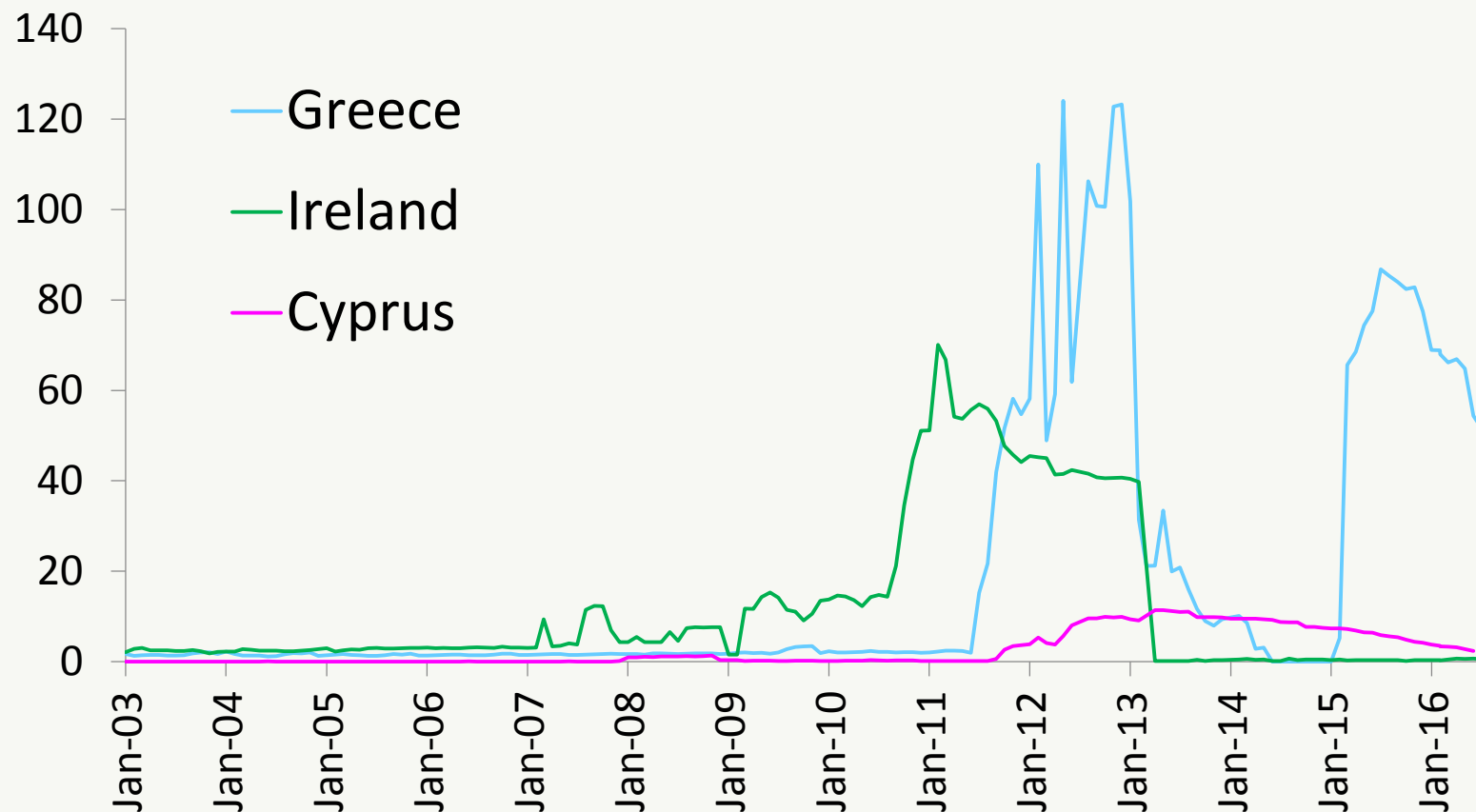
In historical perspective

- Size of IMF loans (in % of GDP, 1993-2012)



Source: Pisani-Ferry et al (2013)

Use of Emergency Liquidity Assistance (ELA) by banks (EUR bn)



Sources: national central banks.

Note: ELA is provided by a national central bank, after obtaining authorisation from the ECB Governing Council. Data for Portugal is not available.

Criterion 1: Creating conditions to regain market access

▪ **Greece: unsuccessful**

- Greece issued some bonds in 2014 at a relatively high rate of 4.9% at 5-year maturity, it was not able to issue further bonds
- I doubt that Greece will be able to return to market at the end of the third financial assistance programme

▪ **Ireland: very successful**

- Ireland repaid the IMF early in 2014-15 because market rates were so much lower, saving about €1.5 billion in interest
- current 10-year government bond spread to Germany is only 45 basis points

▪ **Portugal and Cyprus: successful**

- but relatively high spread to Germany, about 300/350 basis points; see next slide

Criterion 2: Compliance with conditionality under various headings

▪ **Fiscal consolidation:**

- adopted in all four programme countries (the largest by Greece) → deviations impossible as funding was external

▪ **Financial sector reforms:**

- measures broadly implemented, but high share of non-performing loan (especially in Greece and Cyprus) signal problems

▪ **Growth-enhancing structural reforms:**

- Ireland and Cyprus: healthier structural conditions before the crisis
- Greece and Portugal: can an adjustment programme fix long-lasting weak structural conditions?

Criterion 3: Expectations vs Outcomes

- **Greece: disaster**
- **Ireland: great success**
- **Portugal: worse than expected**
- **Cyprus: better than expected**

Projections vs outcomes

	Greece		Ireland		Portugal		Cyprus	
	Program projection	Actual (IMF WEO)	Program projection	Actual (IMF WEO)	Program projection	Actual (IMF WEO)	Program projection	Actual (IMF WEO)
Date	May-10	Apr-16	Dec-10	Apr-16	Jun-11	Apr-16	May-13	Apr-16
Period*	2009-2015 cumulated		2009-2015 cumulated		2010-2015 cumulated		2012-2015 cumulated	
Real GDP (% change)	1.2	-22.6	11.9	18.7	3.8	-4.6	-11.3	-6.8
Inflation (% change)	5.4	5.5	2.4	2.3	12.2	7.3	3.8	-1.4
Period	2015		2015		2015		2015	
General Government Balance (% of GDP)	-2.0	-4.2	-4.8	-1.6	-1.9	-4.4	-5.3	-1.7
Current Account Balance (% of GDP)	-1.9	0.0	-0.5	4.5	-2.7	0.5	-0.9	-5.1
Unemployment (%)	13.4	25.0	10.7	9.4	10.8	12.4	18.7	15.3
General Government Debt (% of GDP)	140.0	178.4	123.0	95.2	112.9	128.8	125.7	108.7

Notes: *The reference period is determined by the year before the programme started. Sources: IMF country reports at the inception of the programme and World Economic Outlook database April 2016.

Disagreement within the Troika: the Greek example

- IMF staff (and many independent economists) concluded Greek public debt is not sustainable and therefore debt restructuring was needed
- Major European creditor countries did not have consensus about how to help Greece. Political cycles in EU creditor countries influenced the stance on Greece. Significant share of Greece's debt was owed to banks of other EU countries which had weak balance sheet that time.
- IMF staff conceded, debt was not restructured in 2010, IMF changed its exceptional access criteria to be able to finance Greece
- Debt was restructured only in 2012, after the negative downward spiral of the economy intensified
- Question: how much more would one have been able to restructure in 2010 compared to 2012?

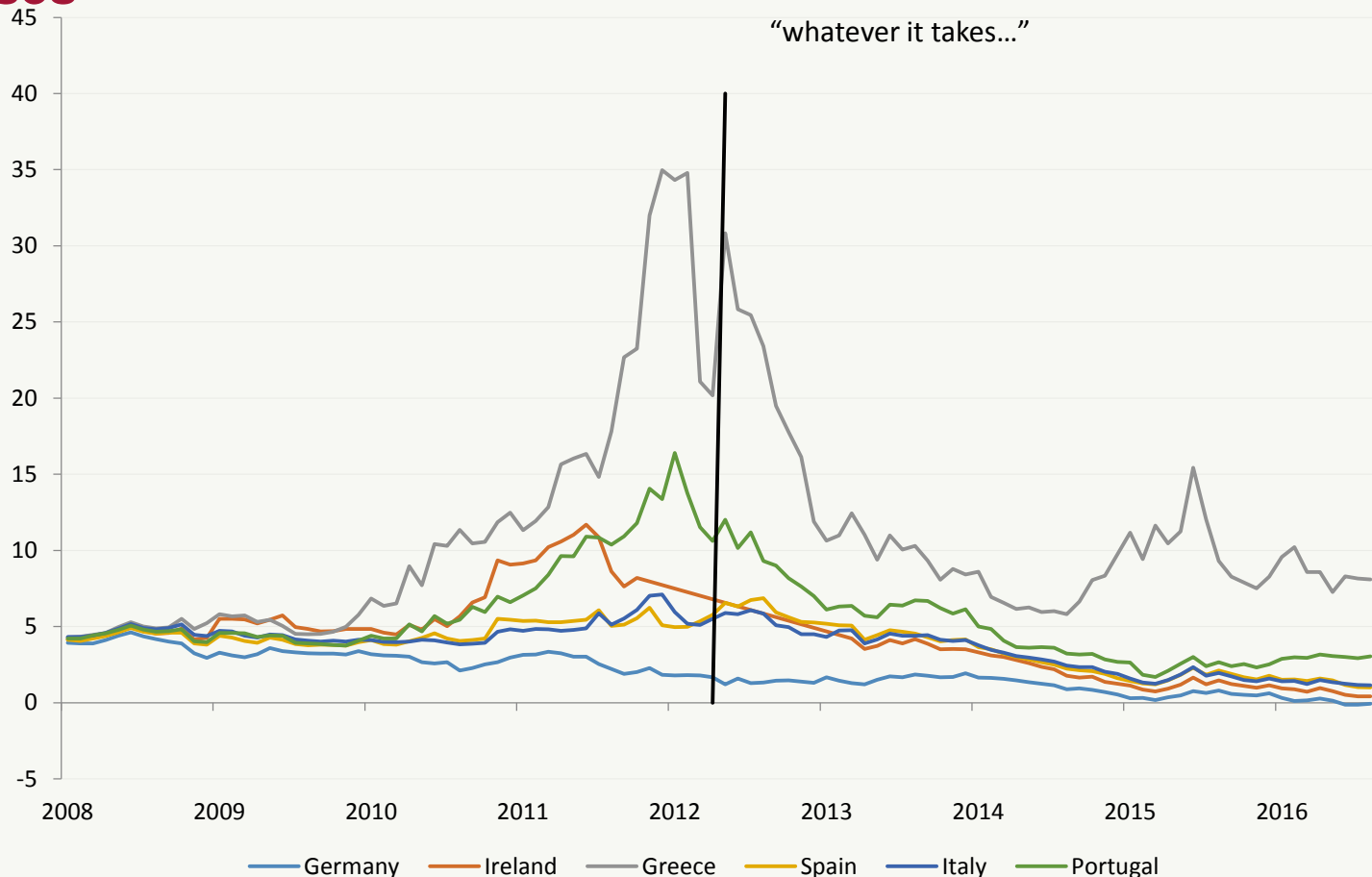
- The debate on debt restructuring now continues but it would involve official sector creditors. Question on credibility of no-bailout clause and huge political issue.

Disagreement within the Troika: the 2010/2011 Irish example

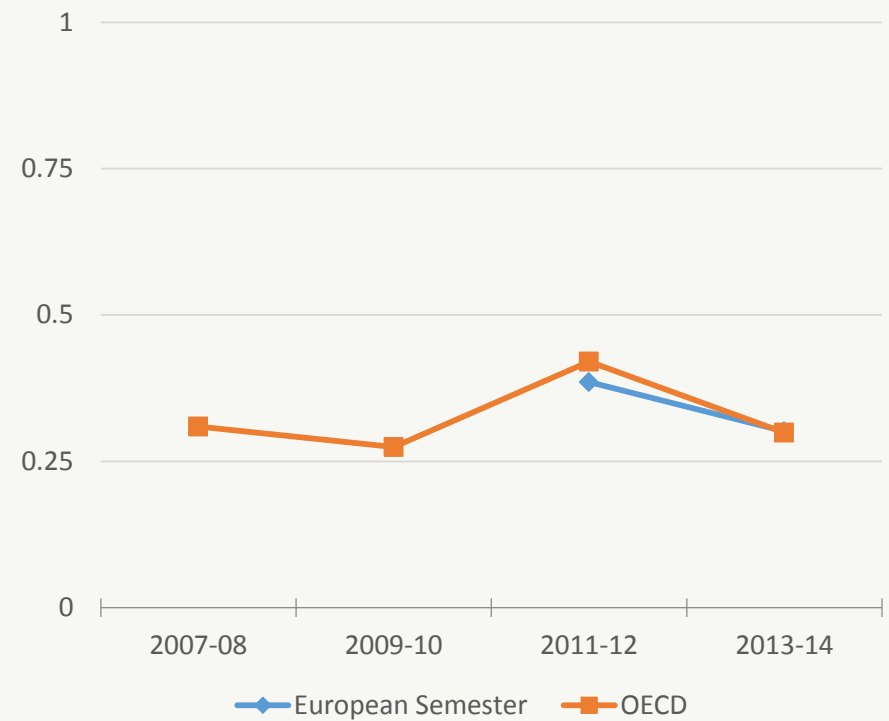
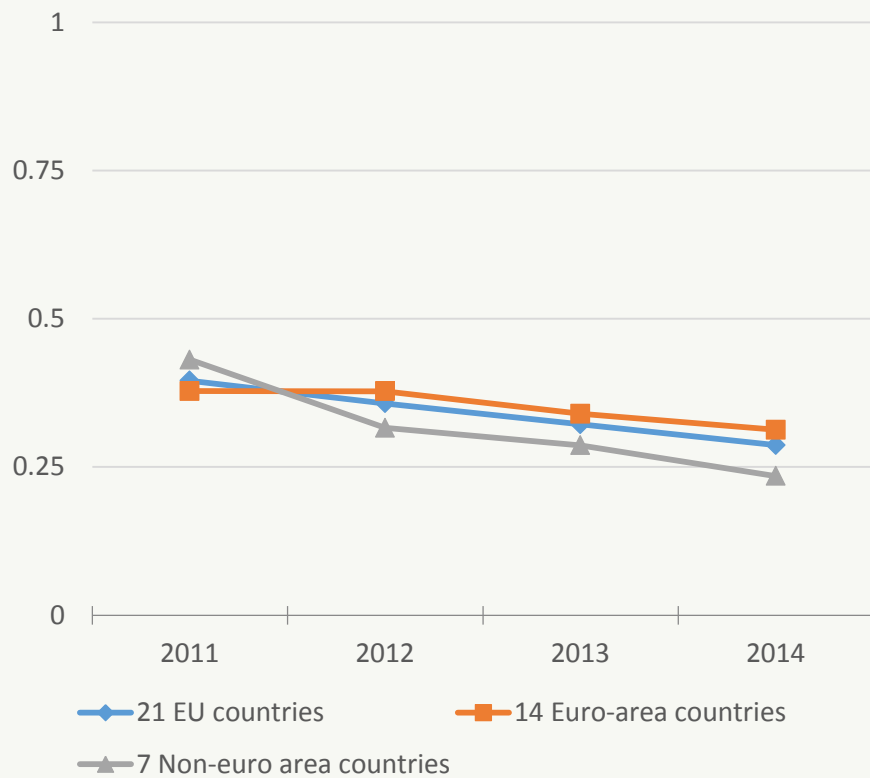
- IMF staff wanted to impose losses on senior bank bondholders. Potential benefit to Irish taxpayer of about €10 billions (~6% of GDP)
- The ECB (and US treasury) expressed opposition, motivated by the fear from destabilising senior bank bond markets in the euro area.
- IMF conceded, senior bank bond was not bailed-in
- However, the episode left a sense of unfairness against Ireland that played a big role in later enabling a financial restructuring known as the “promissory notes transaction”, which was beneficial to Ireland.

OMT announcement: sovereign yields

- **Key feature: OMT requires ESM programme with unanimity**
- **Of great importance as a tool to prevent self-fulfilling liquidity crises**



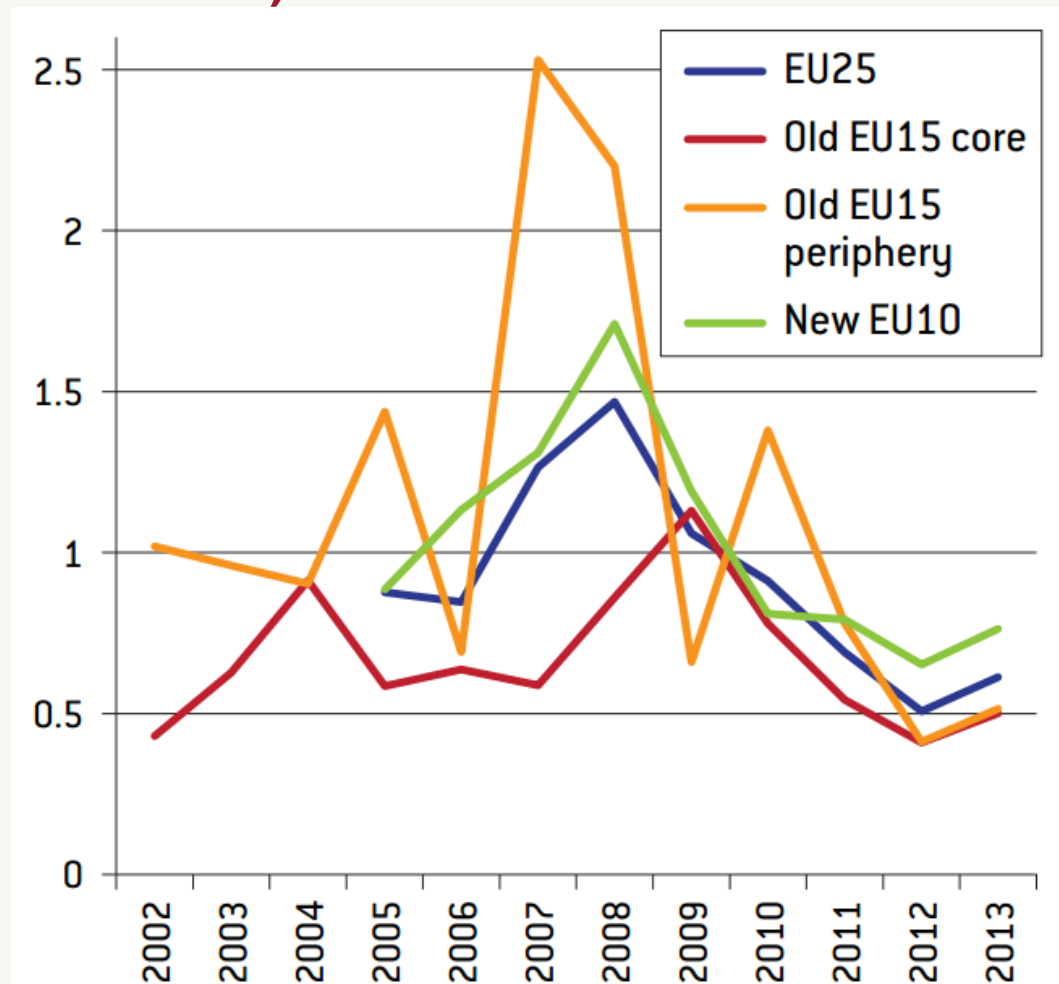
The poor implementation of EU policy recommendations:



Source: Darvas and Leandro (2015)

Fiscal rules and measurement problems:

- Average one-year revision in EC estimate of change in structural balance (in % of GDP)



Source: Claeys et al (2016)

Key remaining problems

- **Low inflation and still rather slow recovery**
 - Fiscal stance
 - Persistent structural problems
 - Euro area imbalances
- **Credibility problem of the current fiscal framework**
 - Lack of implementation feeding lack of trust
 - Low effectiveness of rules to achieve stabilisation and sustainability
- **Remaining banking problems**
- **Downward shift in global and European productivity growth?**
- **Funding of European public goods**
 - Migration/border controls
 - Security
 - Climate policy

3 steps forward

- **A: Finish banking union and establish more credible no-bailout clause with full national responsibility**
 - Minimum for stability -> financial centralisation as paradoxical precondition for fiscal decentralisation and no-bail-out clause
 - Once established, less intrusive fiscal surveillance
 - But no mechanism for absorbing large shocks, nor area wide fiscal stance, no European public goods
- **B: Add small fiscal capacity to fund certain European public goods, pan-European investment, mechanism to absorb large shocks**
 - EU budget spending review for public good funding, but additional resources may be needed
 - Helps with large shocks if countries lose market access
 - No area-wide fiscal stance other than through coordination, important role for stronger countries
- **C: Analytical benchmark: stronger fiscal centralisation**
 - Would allow central functions to be provided centrally: allocation, stabilisation and redistribution
 - But not likely, perhaps not even desirable given heterogeneity of preferences and large differences in living standards.

Brexit or how to deal with greater diversity

- **Need for “Brussels” to accept and accommodate greater diversity**
- **EU is political project, free movement of workers is core aspect of that political project...**
- **...but it must be possible for non-EU countries to be closely economically integrated without free movement**
- **... and without the same level of supranational political integration that the EU has achieved.**
- **...how could such a collaboration be structured? My proposal of a continental partnership with Jean Pisani-Ferry, Norbert Röttgen, André Sapir and Paul Tucker.**

Conclusions

- **Europe has managed and overcome many very intricate crises in recent years but important problems persist**
 - ESM/OMT very important
 - First steps in banking union crucial
- **Of central importance that national policy makers continue reforms to improve productivity performance and address inequality issues**
- **But especially monetary union is still fragile in its construction and not everything can be achieved by national policies.**
 - Address fiscal dimension of banking union
 - Centralise some functions, decentralise others
 - Address fiscal stance for area as a whole, achieve more symmetric adjustment
- **Need for EU to focus on growth policies (single market) and on public goods with benefits for citizens**
- **Need for EU to accept different speeds of integration**
 - Needs stronger core
 - And less integrated outer circle

Thank you!

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References

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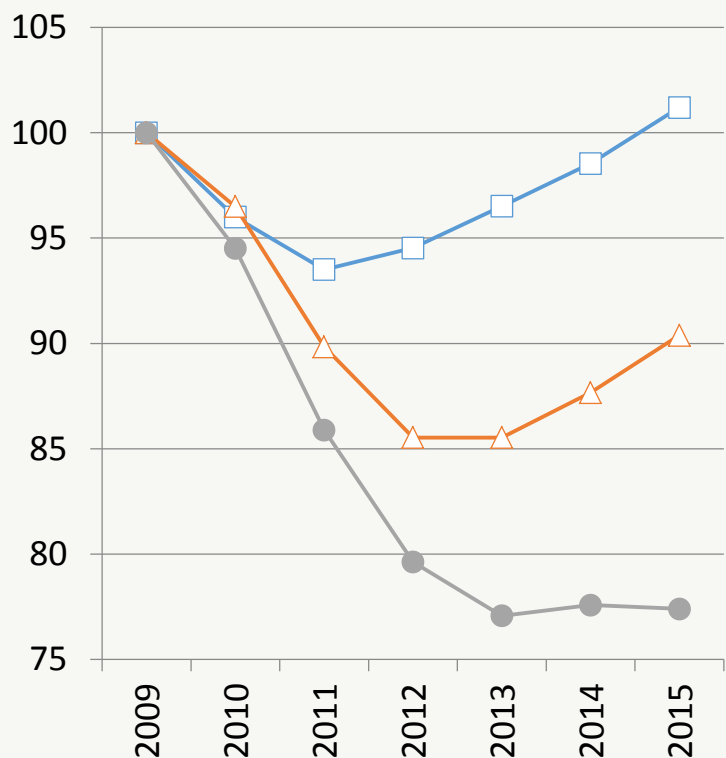
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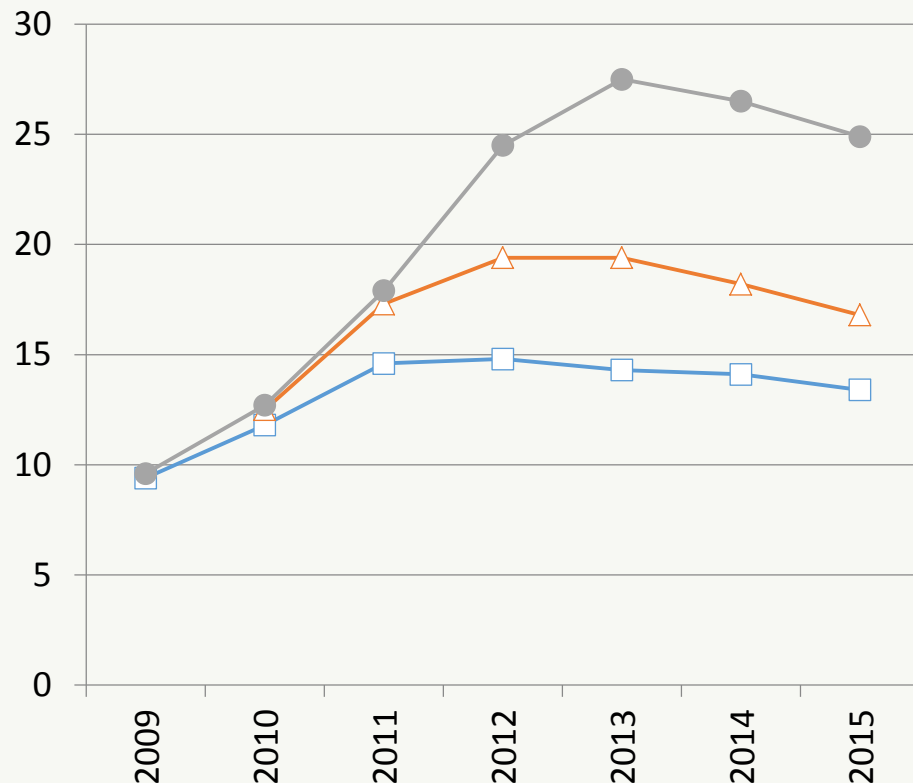
Greece: GDP and unemployment projections vs outcomes

GDP at constant prices (2009 = 100)



- 1st programme assumption (May 2010)
- △— 2nd programme assumption (March 2012)
- Actual

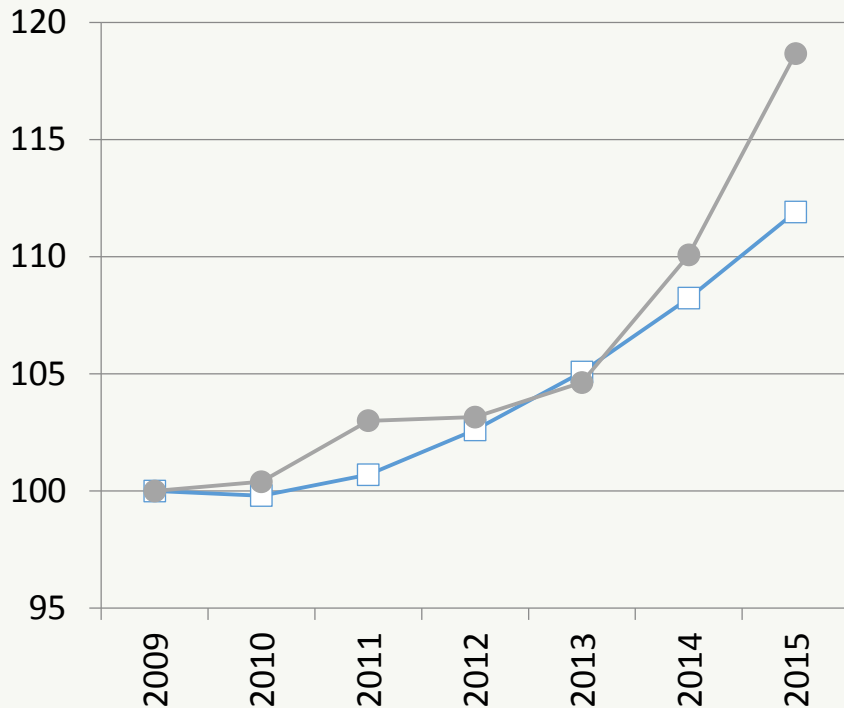
Unemployment rate (%)



- 1st programme assumption (May 2010)
- △— 2nd programme assumption (March 2012)
- Actual

Ireland: GDP and unemployment projections vs outcomes

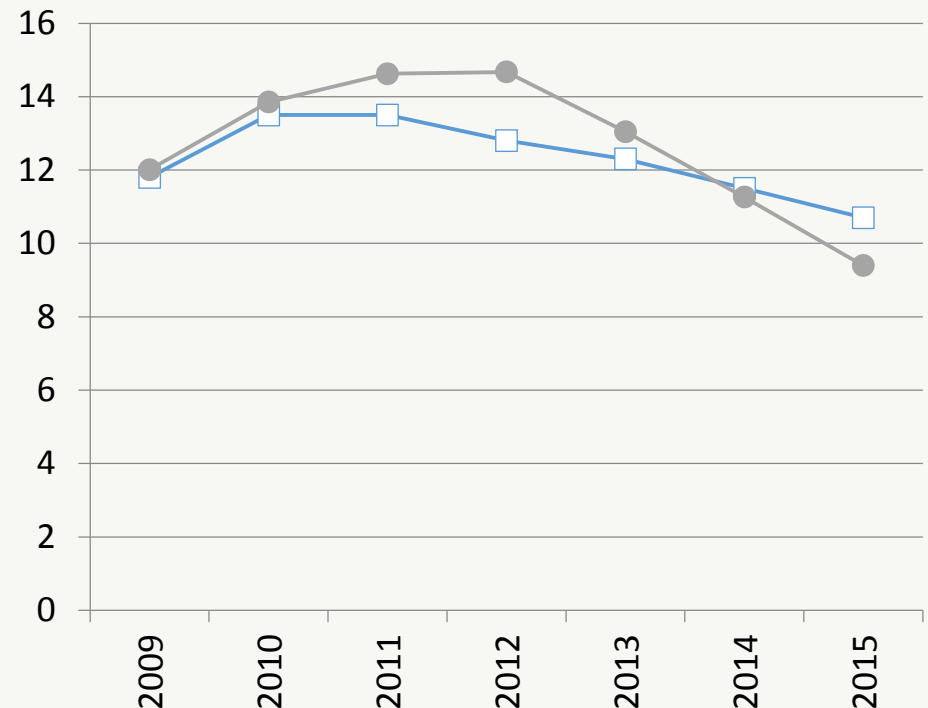
GDP at constant prices (2009 = 100)



—□— programme assumption (Dec 2010)

—●— Actual

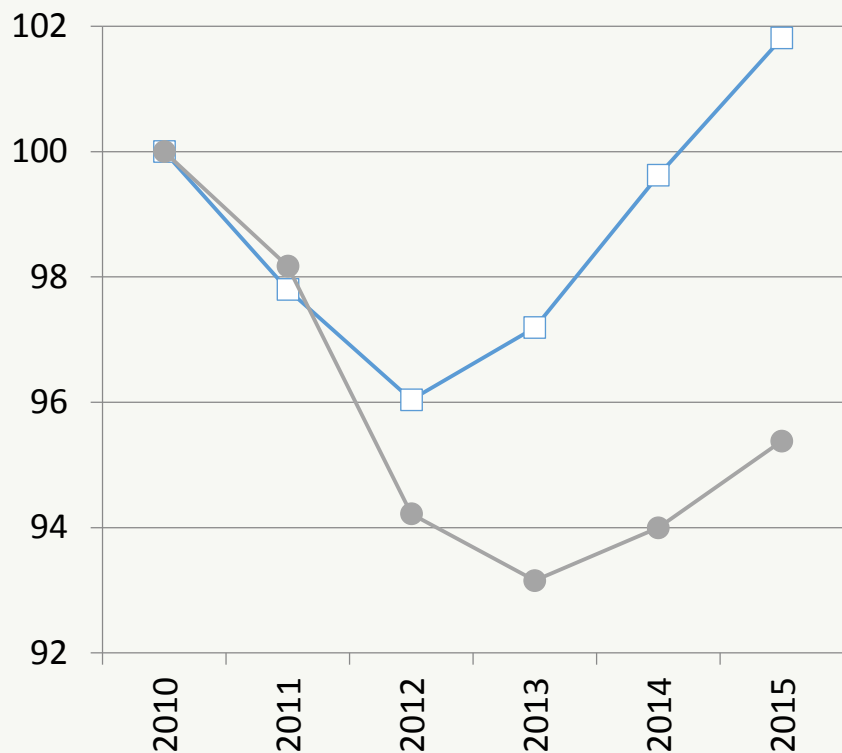
Unemployment rate (%)



—□— programme assumption (Dec 2010) —●— Actual

Portugal: GDP and unemployment projections vs outcomes

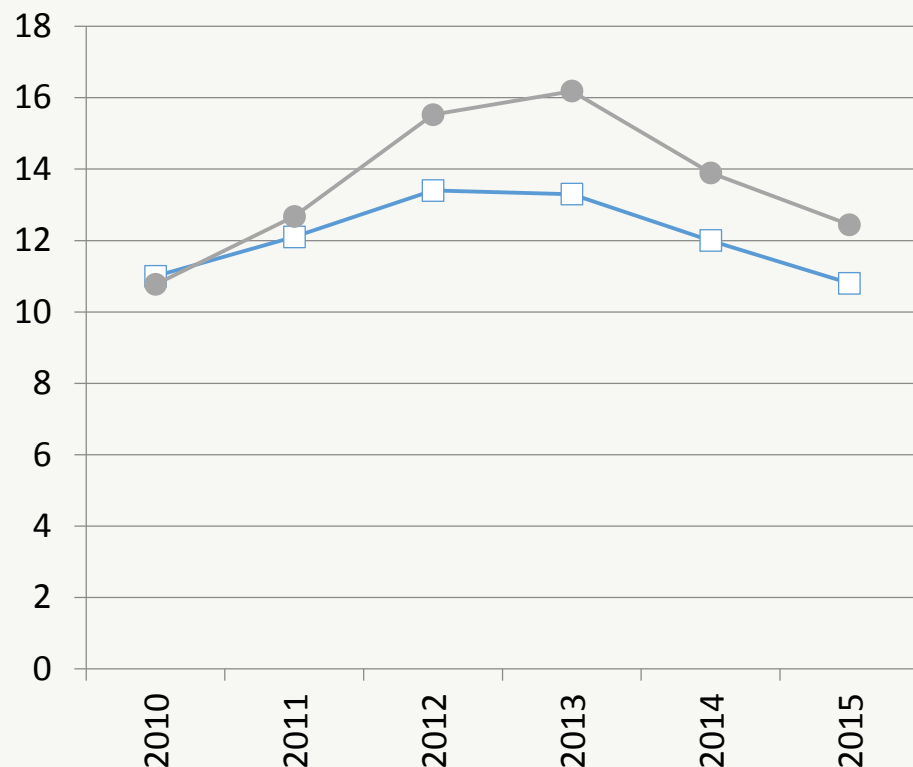
GDP at constant prices (2010 = 100)



—□— programme assumption (June 2011)

—●— Actual

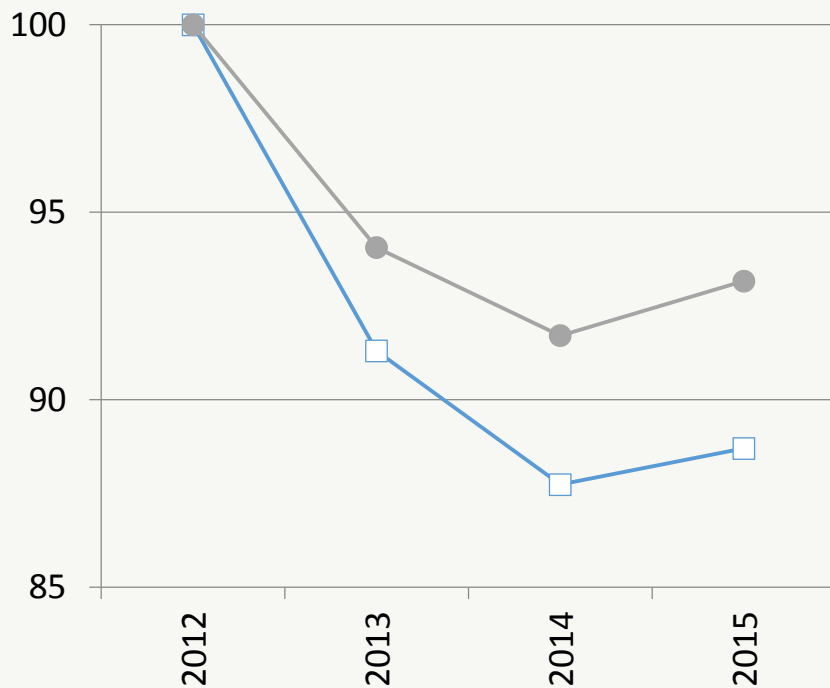
Unemployment rate (%)



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Cyprus: GDP and unemployment projections vs outcomes

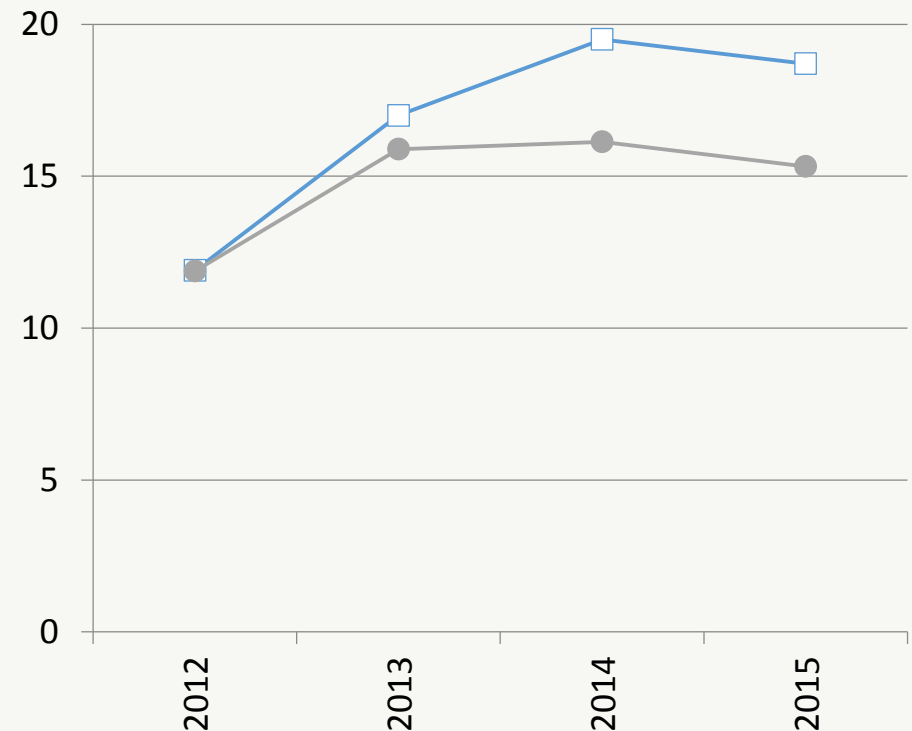
GDP at constant prices (2012 = 100)



—□— programme assumption (May 2013)

—●— Actual

Unemployment rate (%)



—□— programme assumption (May 2013) —●— Actual