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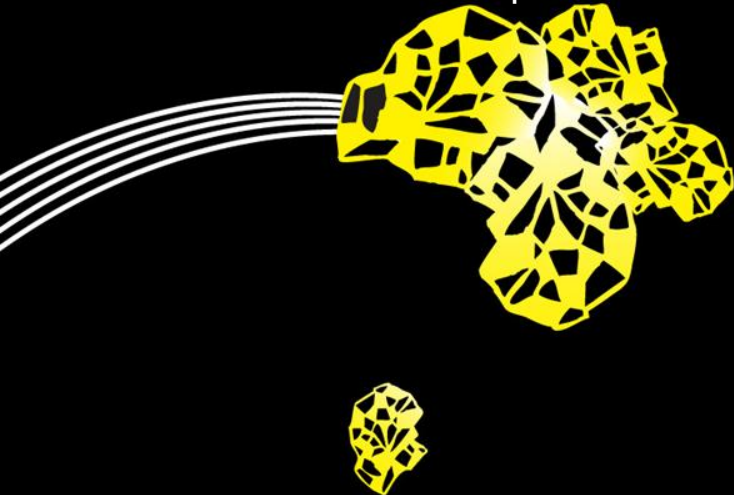


The Euro Zone Crisis: Causes, Consequences, Exit Strategies

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Overview

- Getting into the crisis
- Dealing with the crisis
- Getting out of it
- Choices
- Discussion

Getting into the Crisis

- **Dual Crisis**
 - Banks
 - Countries
- **Banking Crisis**
 - Trading in sub-prime mortgages
 - Bought up through securitised financial products
- **Sovereign Crisis**
 - Trading in sub-prime country debt
 - Bought up through bond markets in the euro zone

Getting into the Crisis

- **Banking Crisis**
 - Banks illiquid or insolvent
 - State aid required:
 - Recapitalisation
 - Restructuring (bad banks)
 - Nationalisation
 - State aid approved by European Commission:
 - Article 345 exemption for severe economic disturbances
 - Threat of general financial collapse: Dec . 2008, Dec. 2011

Getting into the Crisis

- **Sovereign Debt Crisis**
 - **Sub-prime countries in the euro zone**
 - Possible collapses on a regular basis
 - General loss of confidence in periphery:
 - Downgrades by credit rating agencies
 - Underlines that previous rules didn't work
 - **State borrowing to inject into the banking sector**
 - Plus state guarantees of further bank debt

Getting into the Crisis

- **Exacerbating factor 1: Sub-prime crisis in the US**
 - Collapse of financial instruments that banks use for cash
 - American banks cashing in European, global investments
 - American portfolio managers seek to sell the weakest links

- **Exacerbating factor 2: Speculation on state debt**
 - Question: what is the risk of default?
 - Political risk analysis first targets national state capacity
 - Then targets EU institutional capacity

Dealing with the Crisis

- **Crisis Management**
 - Monetary Policy
 - Stabilisation mechanisms

- **Crisis Prevention**
 - Fiscal policy (fiscal compact)
 - Fiscal union
 - Regulation of financial markets

Dealing with the Crisis: Crisis Management

- **Monetary Policy**
 - ECB provides liquidity
 - ECB coordinates with 5 other key central banks
 - ECB buys government bonds of countries in trouble
 - (on secondary markets—primary market purchases illegal)
- **Stabilisation mechanisms**
 - Emergency loans to besieged national governments
 - Money provided by euro zone member states, IMF
 - Tied to rules of fiscal policy

Dealing with the Crisis: Crisis Prevention

- **Fiscal policy (Stability & Growth Pact, Fiscal Compact)**
 - Stronger controls on government borrowing
 - Penalties for non-compliance
 - Administration of programme countries receiving aid
- **Fiscal union**
 - Non-existent: no transfer of money from creditor countries to debtor countries
- **Regulation of financial markets**
 - Restrictions on speculation
 - Regulation of banks, to prevent repeat collapses

Dealing with the Crisis: Crisis Prevention

- **Regulation of Financial Markets**
- New bodies in January 2011:
 - **European Systemic Risk Board (ESRB)**
 - European Central Bank + 3 New Authorities:
 - European Banking Authority (EBA)
 - European Securities and Markets Authority (ESMA)
 - European Insurance and Occupational Pensions Authority (EIOPA)

Dealing with the Crisis: Crisis Prevention

- **Problems with regulation prevention powers:**
- **Member state interference** in Authority work already apparent:
 - Poor quality of EBA stress tests
 - Stress tests: would banks survive a big disturbance?
 - Ignore possibility of a Greek default
 - Some German banks refuse to participate

Getting out of the Crisis: What kind of Exit Strategy?

- **Restoring financial stability**
 - In the financial market sector
 - In the state finance sector

- **Ensuring growth and employment**
 - Unemployment very high
 - Youth unemployment (to 25) double regular unemployment
 - How to generate growth without government stimulus?

- **Returning to the single market (?)**

Getting out of the Crisis: What kind of Exit Strategy?

- **Restoring financial stability**
 - **In the financial market sector**
 - Continued state aid for as long as the crisis lasts
 - Locks in relationship of national governments and national banks
 - **In the state finance sector**
 - Balancing budgets over time
 - Fiscal compact is a massive experiment in changing human nature
 - It might work, but at what cost?

Getting out of the Crisis: What kind of Exit Strategy?

- **Ensuring growth and employment**
 - Unemployment very high
 - Youth unemployment (to 25) double regular unemployment
 - How to generate growth without government stimulus?
 - Europe's answer is private capital / return to single market:
 - Attracted by privatisation, de-regulation, structural adjustment programmes
 - Europe 2020 Programme (international competitiveness)
 - Means exporting to Asia, America
 - Compensates for lack of ECB, deficit macroeconomic stimulus

Getting out of the Crisis: What kind of Exit Strategy?

- Overall growth and employment affected by
 - Monetary policy
 - Fiscal policy
 - Fiscal union
 - Regulation of banks
- All stress the elimination of money in the economy over the next generation (deleveraging)
- **Generation of economic decline in Europe, if we're lucky**
- **Generation of economic instability if we're not**

Getting out of the Crisis: What kind of Exit Strategy?

- **Institutional Requirements to prevent economic instability**
- Lender/Creditor of Last Resort
- Fiscal transfer to support LLR/LCR
- Political authority supporting fiscal transfer
- Reorganisation / supervision authority at EU level

- **All are lacking due to political obstacles:**
- The US has far worse problems, but survives better because it has these

Choices

- **Must all banks that get into trouble be bailed out?**
 - Not necessarily: separation of big investment banks from small retail banks and credit unions can work well. Also in NL.
 - State aid can focus on saving deposits of normal individuals

- **Must governments that get into trouble be forced to pay back 100%?**
 - Not necessarily: others, including the United States, have defaulted
 - Fiscal compact without fiscal union a recipe for depression
 - Is terminating Greek democracy an acceptable means of getting money back?

Discussion

What's on your mind?