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EURO-ZONE CRISIS: PAST TRENDS, CURRENT DEVELOPMENTS AND PERSPECTIVES

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Abstract

After its launching in 1999 and rather successful decade-long performance, the euro-zone entered in 2010 into its first and extremely profound crisis. The crisis has been dragging on for almost four years and there isstill a lot of work to be done in order to reach a comprehensive and sustainable solution.

The main objective of the article is threefold. Firstly, to present the main design failures of the original institutional structure of the euro-zone and its economic governance, secondly, to analyze the process of the euro-zone crisis management from its ad-hoc approach in 2010 to a more systematic approach applied over the recent 3 years, and thirdly, to discuss the key elements for a sustainable resolution of the euro-zone crisis. Looking in a more medium-term perspective, the solution of the euro-zone crisis is associated with an appropriate switch of the policy mix it applies. On the long-run, the resolution of the euro-zone crisis depends on the stabilisation of the public finances and, more specifically, on the reduction of the public debt level.

***Keywords**: euro-zone crisis, crisis management, design failures, prevention mechanism, sustainable resolution*

JEL Classification: F36, G01, G18

Introduction

This paper is composed of three parts. The first part represents the original institutional structure of the euro-zone with its design failures and highlights two important inadequacies. The first one is a failure to introduce an appropriate fiscal arm of the newly designed monetary union. The second represented design failure of the euro-zone's institutional structure, as designed in the Maastricht Treaty, is the non-existence of a debt resolution mechanism. The process of the euro-zone crisis management from its ad-hoc approach in 2010 to a more systematic approach applied over the recent 3 years is analysed in the second part of the paper. The third part discusses the main elements for a sustainable resolution of the euro-zone crisis.

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Original institutional structure of the euro-zone and its design failures

Building of the euro-zone crisis has been to a significant extent a result of inadequacies or design failures of its original institutional structure and economic governance. Two of these inadequacies / design failures have been of particular importance.

The first one was a failure to introduce an appropriate fiscal arm of the newly designed monetary union. It is well known under the optimal currency area theory that a monetary union needs to be strongly supported by a common fiscal policy, or, at least, by an instrument enabling fiscal transfers to those geographical areas of the monetary union that have been affected by an asymmetric shock (see, for example, Baldwin and Wyplosz, 2006 on this subject).

As there was no appetite of the EU Member States to establish a full-fledged fiscal arm of the newly created monetary union at the time when the Maastricht Treaty was negotiated, a "second best solution" known as the Stability and Growth Pact (SGP) was put in place. SGP was, in fact, the key crisis prevention fiscal instrument of the euro-zone. Unfortunately, it had two main deficiencies. *Firstly,* it was based under an assumption that all eurozone member states would "keep their houses" in fiscal order with public finance deficits below 3 percent of GDP and public debts below 60 percent of GDP. *Secondly,* SGP was inadequately managed. A clear example of this problem was the 2003 weakening of the SGP by several member states including Germany, the engine of the eurozone creation and main SGP proponent. Making the SGP rules more flexible had been a major blow to the credibility of the eurozone's economic governance.

The second design failure of the eurozone's institutional structure, as designed in the Maastricht Treaty, was a non-existence of a debt resolution mechanism. The architects of the original eurozone had namely been of an opinion that under an assumption of a good functioning of the SGP, there would be no need for establishing such a mechanism. The logic was roughly as follows. If member states would stick to the GDP rules, then it is reasonable to expect that none of members would enter into a crisis. If nobody would enter into a crisis, then there is no need to create a special debt management and resolution mechanism. The Maastricht Treaty went even a step further. Under the so-called "no bail-out" provision of this Treaty, no member of the euro area would be assisted if in a default situation. The experience with the recent crisis has shown that in the context of fragile financial markets, the danger of a financial meltdown of one or several Eurozone member states has made this "no bail-out" clause unrealistic (Pisani-Ferry, 2010).

In addition to these two main design failures, eurozone's economic governance was associated with several other weaknesses. For example, the eurozone had a very unreliable system for monitoring the statistical data provided by the member states to Eurostat, the EU's statistical agency. Another fundamental problem was the so-called "it is all fiscal" indicating an implicit assumption that fiscal indiscipline of one, or several member states, may be the main cause for the crisis in the entire euro area (Pisani-Ferry, 2010). While Greece is an example of a county that entered into the current crisis primarily due to its fiscal weaknesses, there are some other eurozone member states, where the building up of the crisis had been a consequence of reasons that go beyond the narrowly defined fiscal indiscipline. The growing balance of payment imbalances among its member states is another systemic problem of the eurozone that has been revealed during the recent years.

Ad-hoc management of the eurozone crisis

The eurozone crisis broke out in Greece in May 2010 and spread to Portugal and Ireland by the end of that year and in early 2011. Even though the country-specific causes of the crisis had varied to a certain extent from one country to another, with the fiscal mismanagement, being the most prominent in Greece, the weakened international competitiveness in Portugal and the financial sector problems in Ireland, the end result was the same. In all the three cases, spreads on their government bonds increased to unprecedented level and consequently the three countries lost their access to funding from international financial markets.

The response of the eurozone policy makers on the Greek crisis has, in fact, established precedence for eurozone crisis management. Even though a bankruptcy of the country was at that time one of the possible options, it was removed rather quickly from the table. Why? The main reason seems to be a judgement that bankruptcy "costs" of all eurozone member state, not only in economic, but also in political terms, would simply be too high. As a consequence, the decision was taken that the Greek problem had to be solved. Bearing in mind the fact that the euro-zone had at that time no crisis resolution mechanism, the member states had to design in rush an entirely new one.

What have been the ingredients of the "Greek package" agreed by eurozone leaders in May 2010? The package consisted of three main elements. The first one was a classical stand-by arrangement where the eurozone members and the IMF provided financial assistance in exchange for Greece's commitment to implement a drastic programme of fiscal and more generally economic adjustment. Under the financial part of this stand-by arrangement, the eurozone member states committed to provide €80 billion of bilateral loans, with the allocation among them according to their respective capital shares in the ECB, and the IMF to provide the remaining €30 billion. The volume of the bail-out was supposed to be sufficient to cover Greece's financial needs in case it would have no access to international financial markets over the following 3-year period.

As the crisis threatened to spill over to other eurozone members, especially Ireland, Portugal, and Spain, the EU leaders were forced to agree – within the framework of the Greek arrangement – about another important line of defence. They agreed to create a temporary crisis resolution mechanism in the form of the €440 billion intergovernmental facility made up of eurozone member state guarantees. The 3-year duration facility named the European Financial Stability Facility (EFSF) obtained a triple-A rating from the key rating agencies in the summer of 2010.

As the funds from the €110 billion stand-by arrangement for Greece and the funds under the €440 billion firewall financial package were not operational at the time of their adoption and as contagion of the Greek syndrome was spreading to other eurozone countries, it was only the ECB that had instruments available to intervene immediately and thus to prevent Greece and potentially some other eurozone members from a sovereign default. It is within this context that ECB announced a decision to commit itself to directly purchase government bonds on the secondary market.

The post-May 2010 developments have clearly shown that financial markets were not convinced by the reaction of the eurozone leaders to the outbreak of the Greek debt crisis. The contagion spread to those other peripheral members of the eurozone that were considered by financial markets as being the most financially vulnerable. The first in line were Portugal and Ireland and, to a lesser extent, also Spain.

Though different in terms of domestic policy measures required for each of the countries, the bail-outs for Portugal and Ireland were in conceptual terms very similar to the Greek arrangement. Similarly as there, the packages consisted of a stand-by arrangement designed in cooperation between the debtor country and the "troika". The arrangements had a strong policy adjustment programme component that was supported by the financial assistance of the eurozone member states (roughly two thirds of the total) and the IMF (the remaining one third of the total). There was, however, one important difference between the Greek financial package and the packages for Ireland and Portugal. While in the case of Greece financial assistance of the eurozone member states was provided in the form of bilateral loans, in the other two cases the eurozone's funding portion was provided through the newly created EFSF.

In conclusion, the *ad-hoc* management of the eurozone sovereign debt crisis was successful in preventing its collapse which would undoubtedly have devastating consequences on the whole EU integration process. By bailing-out Greece and later Ireland and Portugal, the EU and especially eurozone members, bought a limited period of time for addressing the systemic weaknesses of the European monetary union. Financial markets have perceived the bail-outs as an acceptable short-term response to the crisis, but with clear expectations that the eurozone would put in place and operate a comprehensive crisis prevention and management system.

Systemic management of the eurozone crisis

Phase one: Crisis focused on peripheral members (May 2010 – summer 2011)

The strategy for a systemic reform of the eurozone implemented in the period between May 2010 and the summer of 2011 had *de-facto* two components. On the one hand, it was aimed at strengthening substantially SGP as the eurozone's key crisis prevention mechanism. On the other hand, the strategy was aimed at putting in place an entirely new crisis management and resolution mechanism, as it was missing in the original eurozone institutional architecture.

As far as SGP reform is concerned – the eurozone's crisis prevention mechanism – it had gone in two directions. With respect to its substance, the reform was focused on broadening the economic policy framework. In contrast to the first ten years of the euro, when public finance discipline dominated the policy agenda, the current crisis has demonstrated very clearly that the European monetary union with price stability, as the only objective of its central bank, cannot function properly without a broader macroeconomic coordination among the member states. In the legislative package known as “six pack” – it was finally adopted in early autumn 2011) – the public finance dimensions were complemented by more general macroeconomic surveillance issuers. In future, non-fiscal imbalances and weaknesses will be addressed much more systematically, especially the ones associated with the international competitiveness of national economies and the stability of their financial sectors.

Another area where major adjustments of the crisis prevention mechanism were badly needed is related to enforcement of the SGP provisions. The experiences with SPG implementation over the decade prior to the crisis had shown very clearly that peer pressure among the ministers of finance within the ECOFIN was simply not a sufficient guarantee for proper SGP functioning. The reform introduced through the so-called “reverse majority rule” was a step into the right direction. Under this arrangement, a decision, initiating sanctions against an individual member state, can be taken much more automatically than before. Under the new rules, the ECOFIN has a possibility to reject a proposal of the European Commission only by a qualified majority.

As far as crisis management and resolution mechanism is concerned, it has already been mentioned that the eurozone's original institutional structure had no mechanism of that kind. It is because of the systemic deficiency that the eurozone member states had no other alternative when faced with the Greek crisis and its contagion to other eurozone counties, but to create in a rush an *ad-hoc* temporary arrangement. As the €440 billion EFSF was envisaged to expire within 3 years, the December 2010 European Council decided to establish a permanent crisis management institution. In spring 2011, the conceptual features of the institution called European Monetary System (EMS) were agreed and its articles of agreement were drafted. The main objective of the institution with the lending capacity of €500 billion and total subscribed capital of €700 billion is, *firstly*, to assist the eurozone countries that are unable to refinance their sovereign debt on the markets, and *secondly*, to prevent various kinds of contagions. ESM started with its formal operations in October 2012 and it also took over all the EFSF obligations.

There is no doubt that the reforms designed and implemented in the period May 2010 – summer 2011 strengthened the eurozone's institutional infrastructure and governance. However, these reforms failed to address at all or addressed only marginally a number of issues that were at that time crucial for putting the eurozone back on a sustainable path. Three of these issues deserve special mentioning.

First, similarly as the emerging countries' debt crisis of the 1980s, also the euro-zone crisis was treated at the beginning as a liquidity crisis that could be managed well with a provision of additional liquidity. As the time passed by, it was becoming increasingly obvious that some of the indebted countries, Greece in particular, were not just illiquid but also insolvent. This meant that restructuring of the debt with its partial writing-off was a precondition for an indebted country to start a sustainable recovery.

Secondly, another big problem of the eurozone's crisis management has proved to be the undercapitalised banks. In contrast to the US, where large amounts of public funds were used to stabilise banks in very early stages of the crisis, the European approach in this area was much more hesitant. In the period before the summer of 2011, it was the official position in Europe that banks were sufficiently capitalised and that the member states were ready to recapitalise individual institutions and accelerate bank restructuring, where appropriate. This position was broadly supported by the results of the stress tests of European banks implemented by the European Banking Association and published in early summer of 2010 and 2011.

And thirdly, the debt crisis of the peripheral eurozone countries cannot be effectively resolved without implementing a development strategy ensuring a return to economic growth, based on structural improvements and sustainable public finances.

To conclude, the period between May 2010 and the summer of 2011 was, in fact, a crisis of relatively small, peripheral countries of the eurozone. In spite of the numerous positive developments made for systemic fixing of the eurozone throughout this period, this had not been sufficient to prevent the crisis spreading to the very core of the eurozone. The markets had perceived reforms, done in this phase, as simply not bold enough, as not sufficiently consistent and too slow. The policy approach of doing just enough to avoid the immediate collapse, but not to establish firm foundations for a resumption of financial markets' confidence, had compromised the policy makers' credibility and, at the same time, caused spreading of the crisis into the core eurozone countries.

Phase two: Crisis entered into the core of the eurozone and transformed itself into a systemic crisis (since summer 2011)

With the debt contagion spreading to Italy and Spain, and to a lesser degree to France, and consequently to banks holding large portions of these countries' debt, the eurozone debt crisis entered into a new and much more dangerous phase in August 2011 (Baldwin, 2011). Its main characteristic was that the crisis moved from the periphery of the eurozone into its very centre and that it had threatened to become a serious systemic crisis that would endanger the very existence of the eurozone and would represent a serious threat to the overall global financial stability.

In the autumn of 2011, it became increasingly possible that some large, core eurozone member states may need to be bailed-out. At the same time, it became obvious that the firewall put in place in the form of EFSF and ESM in the previous phase of the crisis – it had proved to be appropriate response for bailing-out relatively small eurozone members – is simply not an appropriate instrument for addressing debt problems of core member states the public debt of which is equivalent to around €600 billion, in the case of Spain, or even €2.000 billion, in the case of Italy. The existing instruments were simply not sufficient to deal with the crisis of this magnitude.

There is another characteristic of this phase of the eurozone crisis. In contrast to the previous period, when the crisis was actually a sovereign debt crisis only, it had been transformed into a combination of a sovereign debt and banking crises. We were witnessing a vicious circle, where the sovereign debt crises, through the deterioration of the bank portfolios,was causing a fall of their share values, with risk downgrading and default-insurance prices increasing. All these factors had triggered a banking crisis and requested large, new bank recapitalisations. As private funds available for bank recapitalisation were rather scarce if they existed at all, there was no other funding source but the public funds coming either from national budgets and/or from the reformed EFSF. Additional funding needs for bank capitalisation had a strongly negative impact on the already weakened public finances of the eurozone member states, and this had contributed to their further downgrading and thus to increased probability for sovereign debt problems.

In the autumn of 2011, the policy makers of the eurozone were *de-facto* faced with the need to introduce much bolder and comprehensive policy measures than ever before, if they wanted to save the euro. Furthermore, these measures would have to be introduced rather quickly and in a manner that would not address only immediate dangers, but would also deal with some of the longer-term challenges. By non-acting very decisively at that very moment, eurozone's policy makers would in fact decide for a more or less controlled dissolution of the eurozone in the current form, with strongly negative consequences for the EU, as a whole.

Being pressed with this enormous pressure, the eurozone member states embarked on a strategy, whereby the troubled member states were divided into those that are insolvent and the ones that are illiquid. Once this division was done, then separate treatment has been applied for each of the two groups.

In the case of insolvent countries, Greece is no doubt within this category, it was necessary to continue with the two arm strategy, whereby financial assistance to be provided in the form of fresh money and appropriate debt restructuring arrangements, including debt write-off, was accompanied with the implementation of domestic policies, aimed at creating conditions for economic growth, based on structural reforms and sustainable public finances. For countries within this group, an organised exit from the eurozone was not considered a taboo any more.

The second Greek package from March 2012 followed precisely this logic. Its backbone was again a stand-by arrangement where the country's commitment for continuation of reforms was accompanied by fresh funds provided by the eurozone and IMF public funds and by over 50 percent write-off of the country's debt towards private creditors.

In the case of illiquid countries, a completely different approach has to be taken – countries of this group should be given an unlimited, but temporary liquidity support. A conceptually clear solution for addressing the problem of illiquid eurozone members would thus be that the ECB systematically performs the "lender of last resort function" on the sovereign bond market, not just occasionally and from time to time, as has been the case since the beginning of the crisis in May 2010.

Even though ECB still does not perform the "lender of last resort function" for the eurozone members, it has still made a significant step forward towards this function in the autumn of 2011. In line with the Draghi's "whatever it takes" announcement, ECB initiated implementation of several unconventional policy measures, aimed at providing additional liquidity into the eurozone banking system. With an easier access of banks to its liquidity, ECB has significantly influenced the sovereign bond spreads at which they are traded on international financial markets.

ECB was willing to embark on this route, only in exchange for a much stronger commitment of the eurozone member states, *firstly*, to consolidate further their public finances and especially to stabilise their public debt positions, and *secondly*, to recapitalise their still undercapitalised banking sector. With respect to further stabilisation of their public finances, the eurozone member states agreed about the so-called Fiscal Compact. The Compact, having the legal form of a treaty – it entered into force at the beginning of 2013 – aims to strengthen fiscal discipline in the eurozone through the "balanced budget rule" and the automatic correction mechanism. It requires the national budgets of the member states to be in balance or in surplus. This goal will be deemed to have been met if their annual structural government deficit does not exceed 0.5% of nominal GDP (European Council, 2013).

The Fiscal Compact is a clear recognition of the fact that monetary union cannot be sustainable without a well-functioning fiscal arm. Even though, there is a consensus among the euro- zone member states, that sensible public finances at the country level area necessary condition for a well operating fiscal arm of the monetary union, it is becoming more and more obvious that this is not sufficient. The arrangement has been strongly and rightly criticised on two lines. *Firstly*, it is considered to be overly based on public finance restrictions, with excessively negative implications on economic growth. And *secondly*, the arrangement follows the "one fits all" logic and does not recognise the fact that the current eurozone crisis is at least as much a fiscal crisis as it is a lance of payments crisis. If this is the case, then adjustments have to be done, not only in current account deficit countries, but also in countries with current account surpluses, especially in Germany.

In addition to more close to "lender of last resort" function of the ECB associated with the Fiscal Compact commitments of the member states, there are two other developments that have contributed to the stabilisation of the eurozone in 2012 and 2013. One is the beginning of the actual operation of the ESM as the permanent crisis management and resolution mechanism. The mechanism was tested for the first time when Spain and later on Cyprus asked for the assistance to be provided to their more and more troubled banking sectors.

Another factor contributing to the long-term stabilisation of the eurozone was the mid-2012 European Council decision to create a banking union and the process of its actual establishment over the period of the last year and a half. This decision was taken in order to break the vicious circle of sovereign and debt crisis and to prevent fragmentation of the eurozone financial market, accompanied with strong renationalisation of financial flows. The banking union of the eurozone will consist of three main components with their actual introduction being at the very different stages of implementation. The first pillar – single supervisory mechanism – is well underway with ECB to start performing the role of the eurozone banking supervisor in the autumn of 2014. At the December 2013 European Council, some key features were articulated also with respect to the banking union's second pillar, called 'single resolution mechanism'. This highly complex mechanism is planned to become operational at the time when ECB with take over its single supervisory role. As far as the third pillar of the eurozone's banking union is concerned – an appropriate deposit guarantee scheme – it is not envisaged at this stage to create a single supranational deposit guarantee scheme. The priority for the time being is to reach an agreement on a common network of national deposit guarantee schemes (European Commission, 2013).

Where do we stand today – December 2013 – in managing the eurozone crisis. Due to the strengthened efforts of the member states and especially due to significantly adjusted monetary policy of the ECB, the immediate danger of the eurozone's dissolution has been removed and several important systemic improvements of its institutional structures have been made. They include significant strengthening of the crisis prevention mechanism, as well as, introduction of the ESM, as a permanent crisis resolution mechanism. In spite of these positive developments, there is still a lot of work to be done for the euro to be put on a long-term sustainable path. The current status of the eurozone's systemic reforms can, thus, will be summarised as "the work in progress".

Elements for a sustainable resolution of the eurozone crisis

Over the recent months, ECB has done a lot for managing the euro-zone crisis, but the Bank is still far away from the full-fledged “lender of last resort” role. In the future, the ECB as the eurozone’s central bank,will have to be ready to buy public debt of those member states experiencing liquidity crisis in a similar way, as this has been traditionally performed by central banks in countries with their own currency.

Looking in a more medium-term perspective, the solution of the euro-zone crisis is associated with an appropriate switch of the policy mix it applies. For the time being, the crisis is wrongly treated as primarily a fiscal crisis of the “southern” countries. Consequently, the policy mix applied is strongly focused on austerity and on structural reforms in these countries, with a high price to be paid by these countries,in terms of their growth and employment. This policy mix is not inappropriate only in economic terms, but is also becoming socially unacceptable and explosive in political terms. What is needed, is to address the crisis rightly, i.e., as a combination of fiscal and balance of payments crises, with the adjustments to be done both in the “southern” and in the “northern” countries. Adjustment of the “south” must be based on the resumption of economic growth and with fiscal consolidation stretched over a longer period of time (too fast fiscal consolidation and internal devaluation kill growth) and with further competitiveness enhancement measures. On the other hand, adjustment of the “north” should be oriented towards increased public investment and spending, including fiscal transfers to the countries of the “south”.

On a long-run, the resolution of the eurozone crisis depends on the stabilisation of the public finances and more specifically on reducing of the public debtlevel. There are five major options for reducing unsustainable public debt to more sustainable levels (Paris and Wyplosz, 2013): (i) budget surpluses (typically a process that lasts very long), (ii) sales of public assets (typically not sufficient in volume), (iii) classical debt restructuring (firewalls simply too small), (iv) debt write-offs (associated with political problems in creditor states), and (v) debt monetisation. I share the view of the two authors that none of the five options is appealing, but that the last one is the “least bad” among all of them, under an assumption that certain preconditions, though very difficult ones in their substance, are met.

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