The euro crisis. A tale of divergences

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(*) The views expressed here do not necessarily coincide with those of Banco de España or the Eurosystem

OUTLINE

• Two issues
  • Update of economic situation and perspectives
  • Progress in crisis management and prevention

• Under a very specific light:

  Divergence, n.
  1. The act of moving away in different direction from a common point;
  2. A difference between conflicting facts or claims or opinion

  Economic
  The ones you see

  Political Economy
  The ones you perceive
ECONOMIC DIVERGENCES WITHIN THE EURO AREA. Growth dynamics and internal adjustment

- Euro area double dip, with large divergences
- Internal demand slump is very severe in periphery, in core it is stagnant

**Evolución del PIB Real**

**Demanda Interna, Importaciones, Exportaciones y PIB Variación 2008-2012**
**ECONOMIC DIVERGENCES. External adjustment**

- Extremely sharp in periphery. Spain > 10 pp GDP
- Limited, insufficient in core

**Global imbalances adjustment, G-20 & euro area**

- Less than average surplus reduction
- More than average deficit reduction
- Regression line
- Improve surplus
- Worsen deficit

**ECONOMIC DIVERGENCES. Internal devaluations**

- Competitiveness adjustments have been remarkable.
  - Spain has recovered more than 70% of previous loss
- …at a high cost. Productivity <<< employment loss, rather than wage restraint (there’s too)
ECONOMIC DIVERGENCES. Indebtedness

- Easy financing leads to excess indebtedness in the periphery
  - But not only (NL), not always (IT)
- Reduction in denominator –income/wealth- limits the process of deleveraging

ECONOMIC DIVERGENCES. Fiscal adjustment

- Fiscal consolidations feasible in the core
- But extremely difficult and risk of becoming self-defeating in the periphery
ECONOMIC DIVERGENCES. Financing

- Financing stress on sovereigns and overall
  - Lead to extreme divergences.
- Reflecting a massive capital reversal... to the core

FINANCIACIÓN DEL TESORO TIPOS DE INTERÉS A 10 AÑOS

ECONOMIC DIVERGENCES. The role of ECB

- Liquidity provision through TARGET alleviates the strains.
  - Unconventional policies are decisive
  - Sort of international reserves
- But the capital draught remains

Net Balance with the Eurosystem / Target [bn €]
POLITICAL ECONOMY DIVERGENCES

EMU fragile foundations

- Economic
  - Disparities in economic structures
  - Markets are procyclical, no discipline
  - EMU shock destabilizing
- Institutional
  - Imbalances dismissed
  - Failure of fiscal discipline framework
  - Implications financial integration dismissed
  - Lack of crisis management mechanisms

→ Euro crisis

CRISIS PREVENTION
(the long run/ end point)

Deep institutional reform
More integrated Europe

Closely interlinked

Economic rationale
- Refoundation
- Moral hazard

Political rationale
- Bargain core-periphery

DIVERGENCE

CRISIS MANAGEMENT AND RESOLUTION
(the short run)

Rescues & backstops v Adjustment

POLITICAL ECONOMY DIVERGENCES. Crisis management and resolution

- Traits and patterns
  - Slow, dubitative response. Discordination, cacophony, undecisiveness
  - Sharing of responsibilities gives way to shirking of responsibilities
  - Increasing credibility gap.
  - Painful adjustment with little return so far
  - Back and forth from the brink
  - Action is only under pressure

- Outcome
  - The extension of crisis has not been contained: GR, IE, PT, SP-b, CY, … SL?
  - Increasing strains among actors
  - Disproportionate role of ECB, relative to national governments
  - Credible backstops are evasive
  - Some remarkable bright spots:
    - Regain access to markets, reduction of financing costs
    - Progress in resolution schemes: ESM, successor of EFSF
POLITICAL ECONOMY DIVERGENCES. Crisis prevention

- Deepening of crisis fosters institutional reform
- Two stages
  - Reaction to first wave of crisis (2010-2011) << fallout from small economies
  - Reaction to second wave of crisis (2012-) << contagion, redenomination risks
- Multiples areas of action
  - Fiscal discipline
  - Macroeconomic surveillance
  - Financial surveillance and supervision
  - Political underpinnings: more integration
- …but one is spared:
  - The ECB mandate: just price stability
  - Does not prevent, policy hyperactivity

### An overview of the euro crisis

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POLITICAL ECONOMY DIVERGENCES. Wrap-up

- **Key elements**
  - The EU response is subordinated to the intergubernamental decisions
  - Divergences in the interpretation of the crisis
    - Discrepancies in allocation of responsibilities
    - Moral hazard concerns compound with reluctance to support by core
  - Thus, creditor countries dominate the process. Commission and debtors follow
  - Dynamics between management, resolution and prevention determined by bargaining process
- **Divergences**
  - **Intertemporal.** The urgency (M&R) lags behind the priority (prevention). Backtracking, too
  - **Leadership.** ECB leads short-term response. Relatively, governments drag their feet
  - **Keys to resolution** …beyond the ECB realm (under actual basis-mandate, euro arch)
  - **Internal** incumbent governments lose social support
  - **External** increasing strains among partners

CONCLUSIONS

- **Divergences provide a key to interpret the euro crisis**
  - Intersection of economic and political divergences have generated powerful negative feedbacks
- **Explains that the crisis is being much worse and extended than…**
  - Anticipated
  - Could and should have been
- **Is progress in management catching up with these divergences?**
  - Prevention proceeds at the speed of light
  - Interaction of management and prevention is falling into place = progress
  - But the economic and political divergences are not decreasing, overall
- **The jury is still out**
ANNEX. Comparison with Latam. External Adjustment

Graph 3. Current Account

Latina America and financially stressed countries

Euro Area

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<th>Year</th>
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<th>Financially stressed Euro Area (b)</th>
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<td>1980</td>
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% GDP, simple average (c)

Source: IMF (WEO October 2012)
(a) Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
(b) Financially stressed Euro Area: Greece, Italy, Ireland, Portugal and Spain
(c) The grey bars show crises in Latin America. The orange, global crisis of 2008.
ANNEX. Comparison with Latam. Financing

**Gráfico 1. Flujos financieros brutos**

**Gráfico 2. Países de la Zona Euro con tensiones financieras**

**Fuente:** FMI (IFS) y Datastream
(a) Argentina, Brasil, Chile, Colombia, México, Perú y Venezuela
(b) Grecia, Italia, Irlanda, Portugal y España
(c) Excluido "pasivos otra inversión, autoridades monetarias"

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ANNEX. ECB RESPONSE

**Standard monetary policy response:**

- Reduction of interest rates and provision of liquidity
- **Non-standard measures**
  - Fixed rate full allotment, extension of maturities, extension of collateral eligibility,
  - Currency swaps
- **New programs to address impaired transmission of monetary policy**
  - Covered Bonds Program (CB)
  - Securities Market Program (SMP)
- **Additional liquidity measures**
  - Two Longer Term Refinancing Operations (LTRO) with a maturity of 3 years each
  - Reduction in the reserve ratio to 1%
  - Further increases in collateral availability (including new assets like bank loans).

**The silver bullet?**: Outright Monetary Transactions (OMT, unlimited purchases of sovereign bonds in secondary markets)