The Sovereign Debt Crisis in the European Union

A critical perspective at the "official view" of the facts

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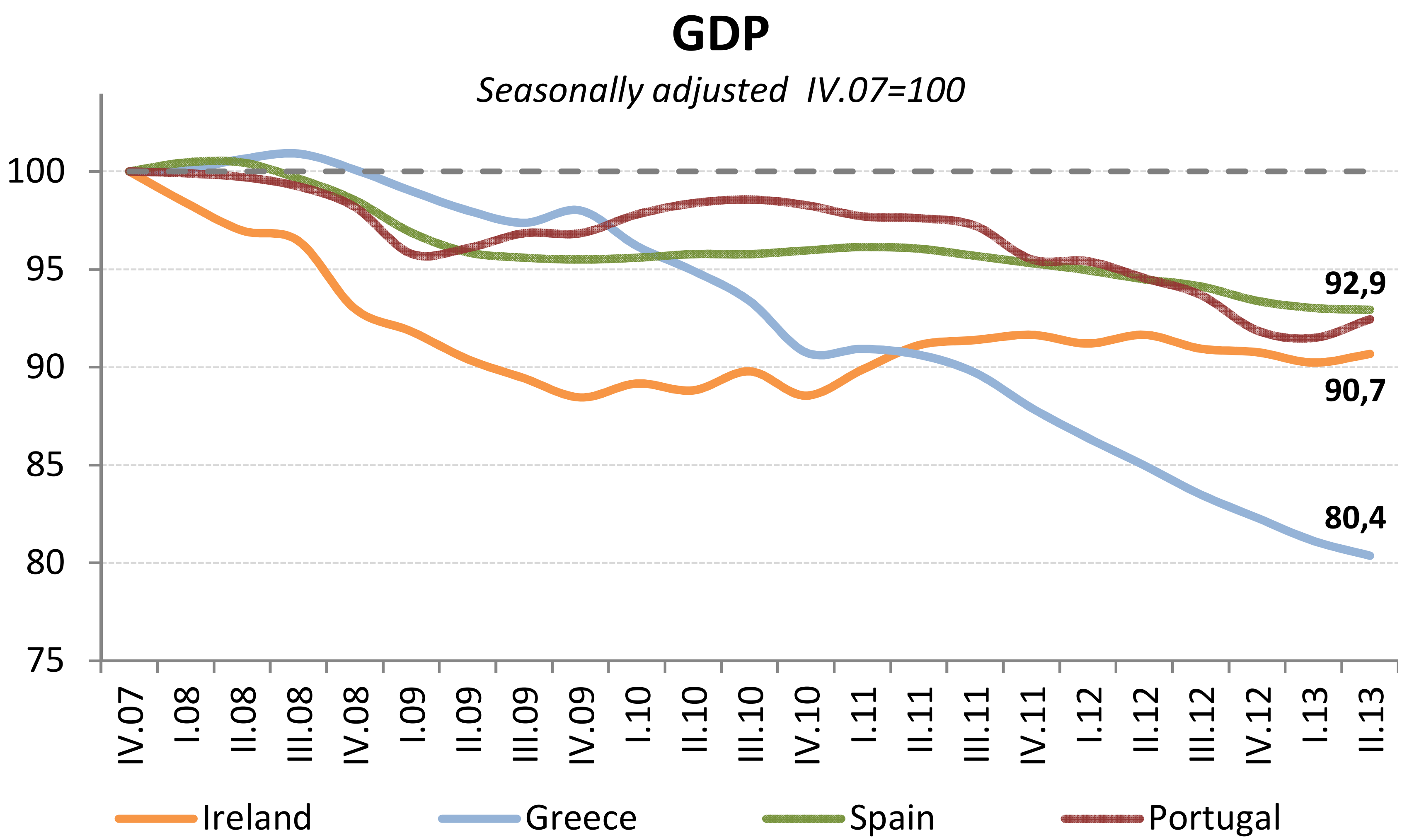
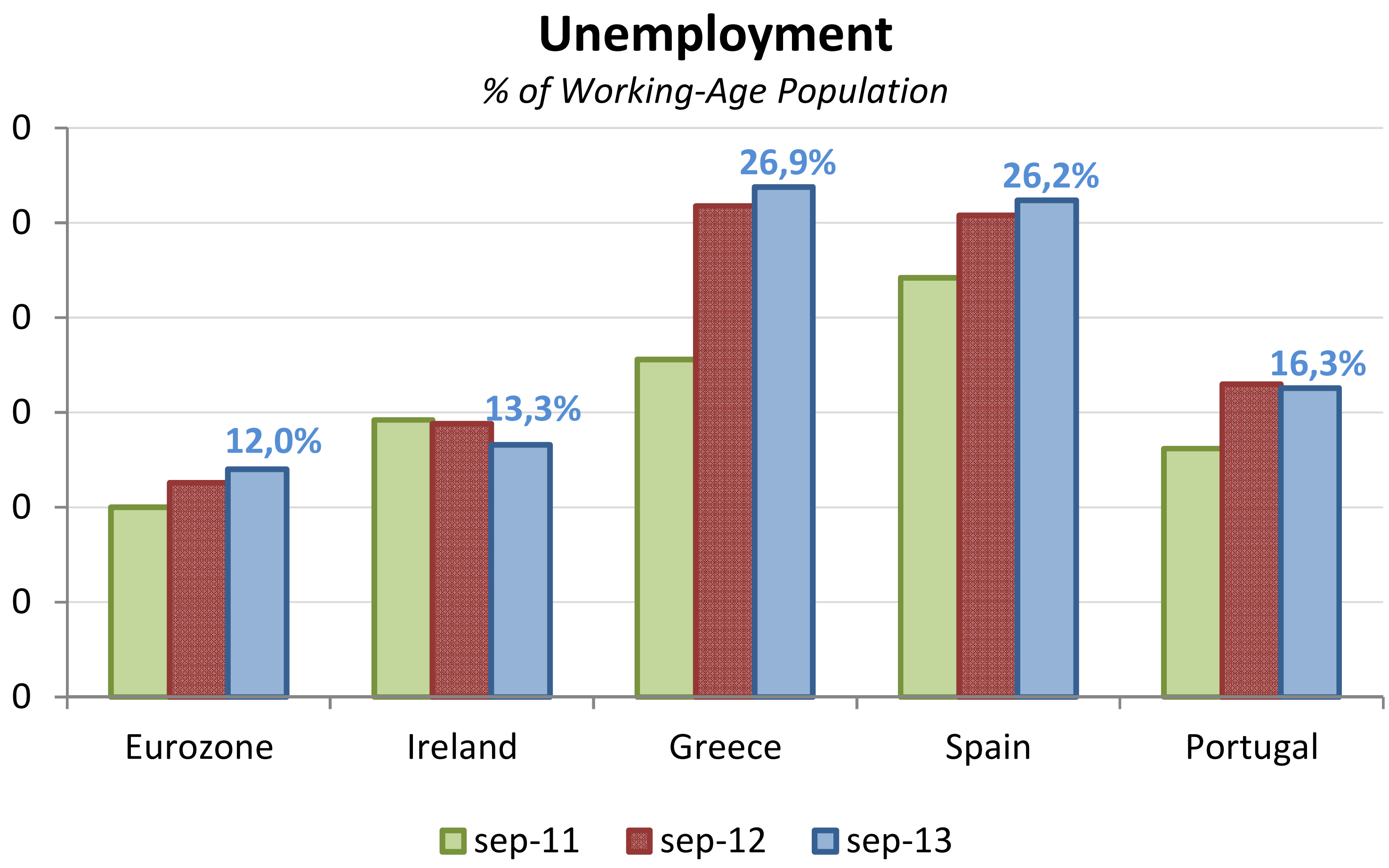
1) The “Official View” (OV) of the facts

The GDP of the Peripheral Countries (PCs) of the European Monetary Union (EMU) is below the pre-crisis level after falling steadily for several years.



Source: Eurostat.

Even though five years have passed since the crisis began, there are still more de 19 million people unemployed in the EMU. Greece and Spain, two of the most affected countries, have over 25% of unemployment.



Source: Eurostat.

The “Official View” of the facts:

- It is a crisis of confidence, whose root is in the fiscal indiscipline of the PCs.
- Although the government had to intervene with countercyclical policies and rescues to the private sector, the problem was that at the beginning of the crisis their debt level was alredy high.
- The PCs’ high public debt levels are perceived by the financial markets as a signal of insolvency and vulnerability.
- This causes massive withdrawals of investors (*flight to quality*), triggering a speculative attack which results in increases of their costs of borrowing.

Policy recommendations:

- Austerity measures (aka “fiscal consolidation”).
- Its objetive is **to reduce the debt to GDP ratio**.
- However, since this coefficient is composed of two components closely connected to each other, for the austerity measures to work it is neccesary that the cut in public expenditures leads to a reduction of the public debt *greater* than the contraction of GDP.
- This masks an additional assumption: ***the fiscal multiplier has to be less than 1*.**

Assumptions behind the fiscal multiplier:

The final result of the fiscal contraction will depend on the combination of four mechanisms:

a) Keynesian mechanism: automatic reduction of effective demand due to the cut in public spending.

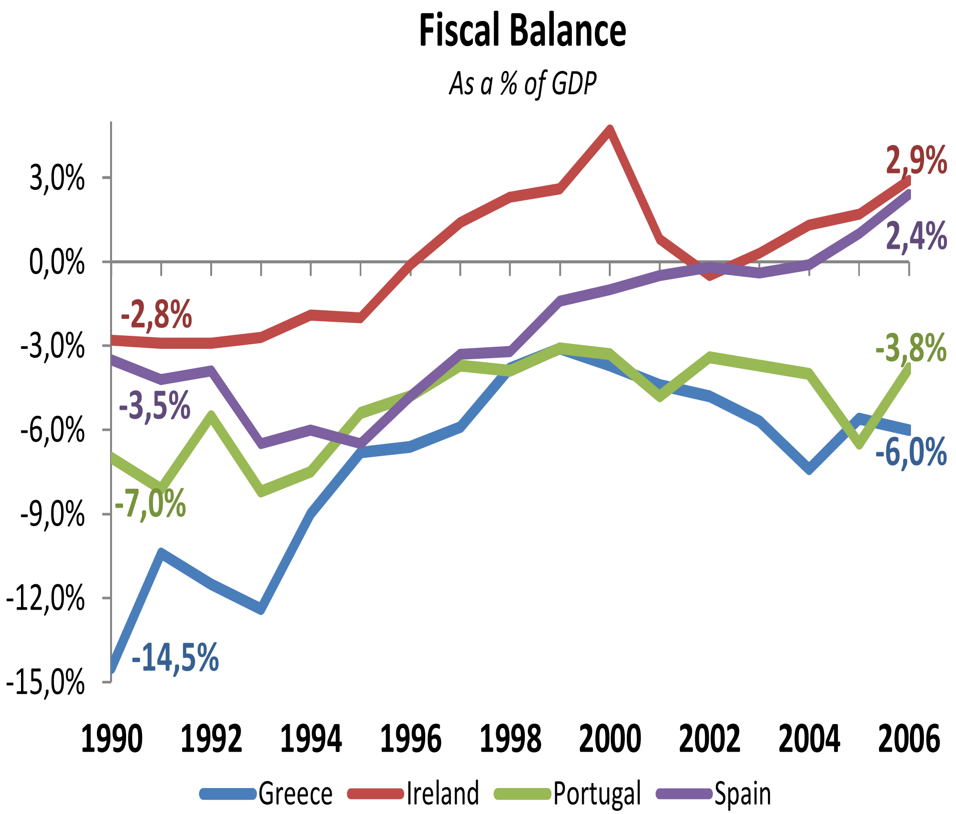
b) "Crowding out" effect: lower interest rate, more private demand.

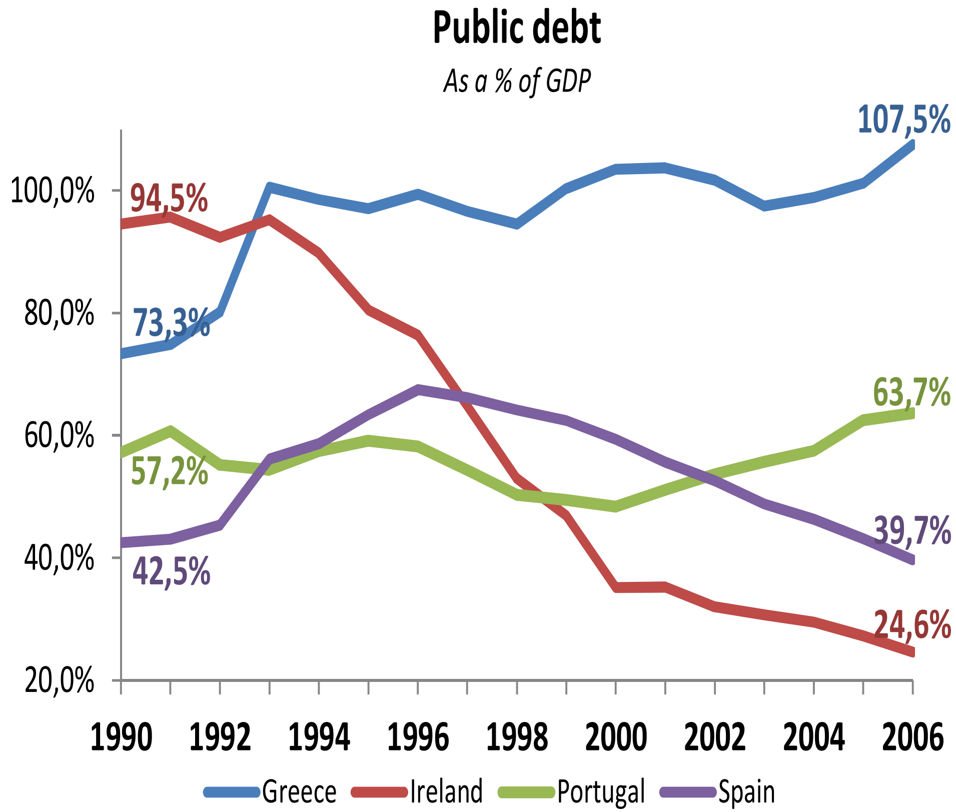
c) Ricardian equivalence: less taxes tomorrow; hence more consumption today.

d) Competitiveness effect: increase in net exports, as imports fall because of higher income elasticity and export grow as a result of the fall in costs (salaries).

2) Empirical evidence and double failure of the OV

With the exception of Greece, all PCs had a low public debt level before the crisis started.



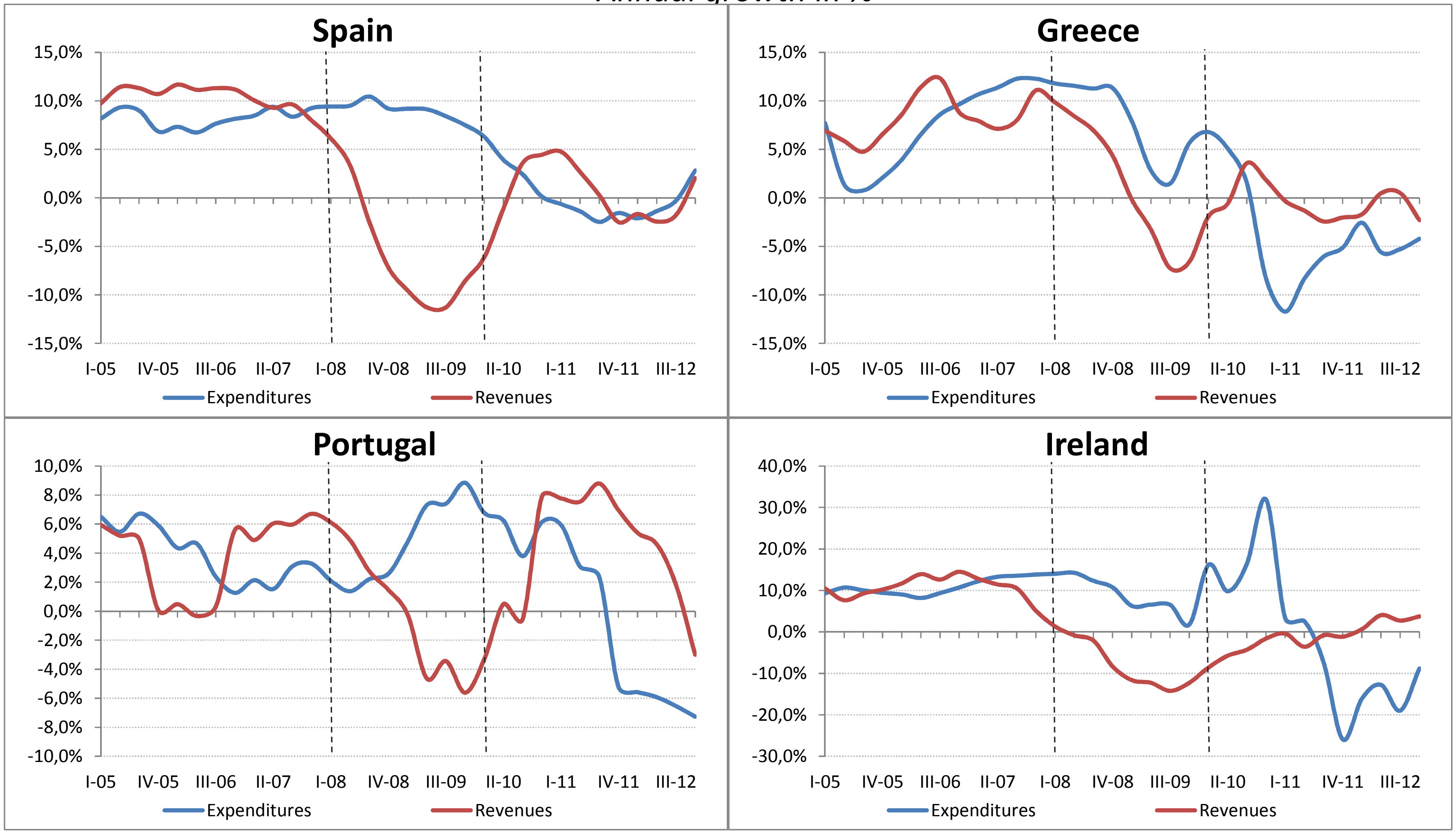


Source: Eurostat.

When the crisis broke, all PCs applied countercyclical fiscal policies (rescues and automatic stabilisers, mainly) which deteriorated the fiscal balance.

Expenditures and Revenues

Annual growth in %

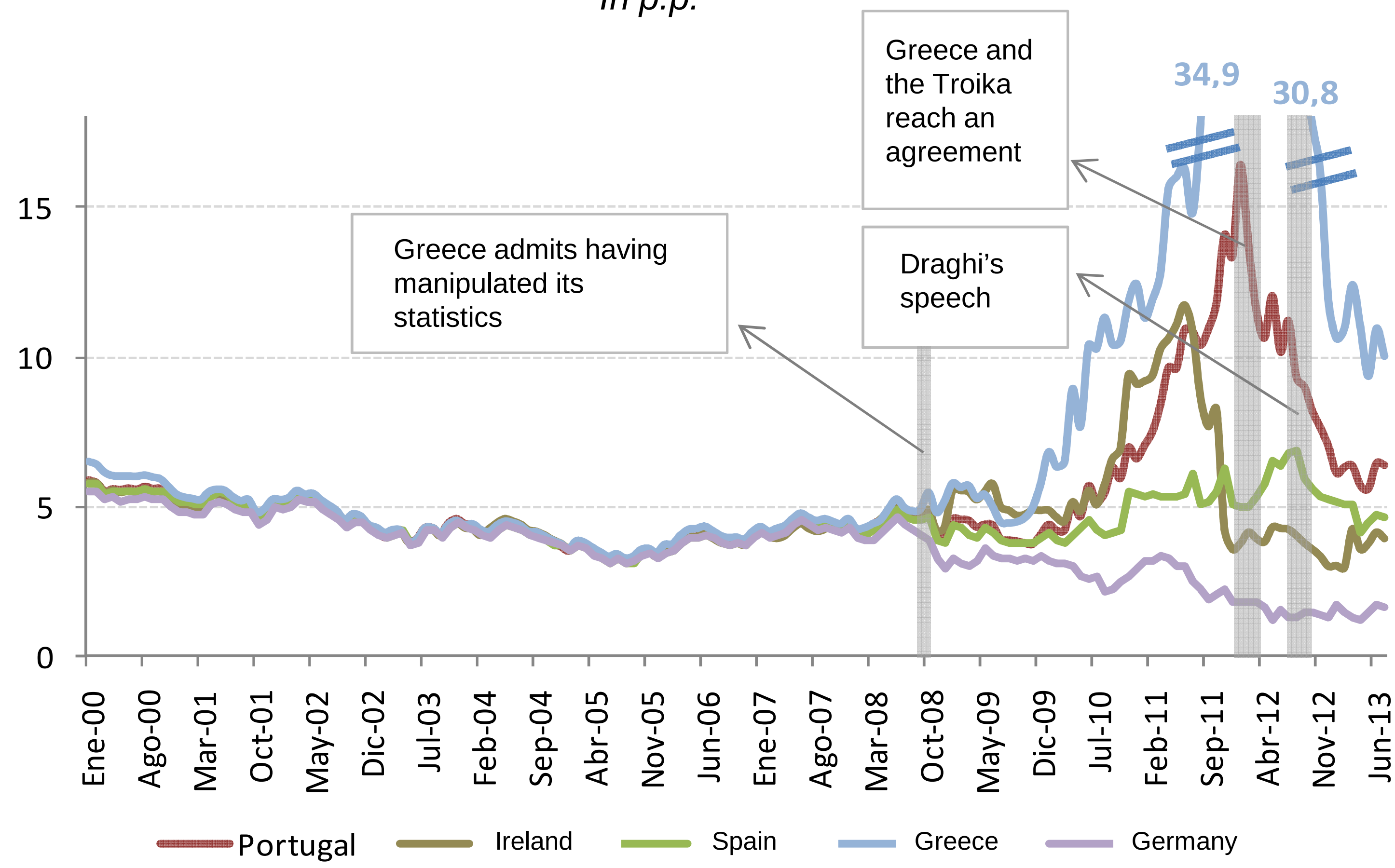


Source: Eurostat.

Nevertheless, these keynesian policies only lasted untill late 2009, when it was detected that Greece was manipulating its statistics. This generated panic in the markets, which triggered the risk premia of the PCs. From this, the answer of the OV was to apply fiscal austerity.

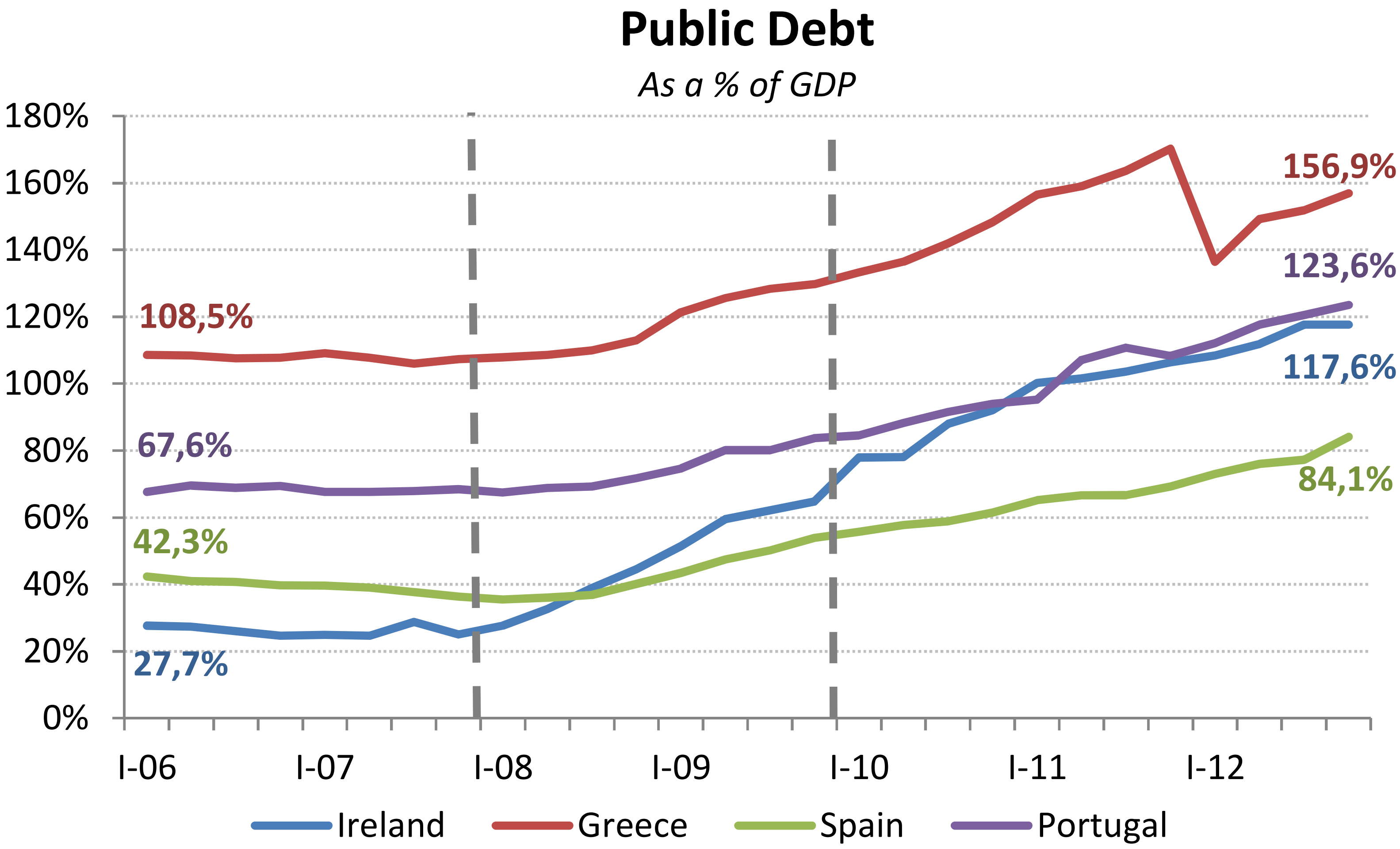
CDS for 10 years

In p.p.



Source: Bloomberg.

However, contrary to what the OV proclaimed, the austerity measures applied in the PCs were a complete failure: not only they were extremely recessive but they also affected negatively the government revenues. Both things **made the public debt to increase**.



Source: Eurostat.

The OV's failure can be found in their approach to fiscal austerity: **the assumptions made are not seen in the real world**.
The dynamics of the debt to GDP ratio (D/Y) has to be analysed in terms of both elements, debt and GDP:

$$\Delta D = (G - T) + I_d$$

$$\therefore \downarrow D \Longleftrightarrow \downarrow G > \downarrow T \qquad = i^*$$

But this by itself does not assure the D/Y will fall, for that to happen it is also neccesary that:

$$\downarrow D > \downarrow Y$$

$Y = C + I + G + (X - M)$ $\quad \therefore \downarrow G$

→ $\uparrow$ C (Ricardian Equivalence)
→ $\uparrow$ I (Crowding out effect)
→ $\uparrow$ X – M (Competitiviness effect)

The Baltics' "success":

Baltics rapid recovery after applying austerity measures was shown by the OV as being evidence of a successful internal devaluation.

However, there are 3 fundamental elements which are usually omitted in the analysis:

- ❖ The provision of funds from Sweden, whose financial system was deeply integrated with the Baltics.
- ❖ The use of various funds given to all members of the EMU (Cohesion fund, Agricultural fund, etc.) which represented more than 4% of their GDP in 2009.
- ❖ It was income-elasticity (and not price-elasticity) which explained the recovery in exports.

3) The Structural View (SV)

The "Structural View" of the facts:

- The causes of the crisis are related to the external imbalances generated since the creation of the EMU.
- The introduction of the single currency meant the loss of the monetary autonomy and the rate of exchange determination. This imposed severe limitations on the member countries to deal with the structural differences between them.
- The control of these key policy tools passed to the European Central Bank, whose sole objective was to monitor the rate of inflation.
- Thus, its roots should be found in the very architecture of the EMU.

The OCA theory

In order to understand the EMU's process of creation and its architecture, we should look into the evolution of the discussion around the theory of Optimum Currency Areas (OCA):

- ***Pioneering phase***: Here, the main requirements that an OCA must meet are established.
- ***Cost-Benefit phase***: The mayor costs and benefits of being part of an OCA are assessed in order to estimate wheter or not the monetary union is convenient.
- ***OCA's revaluation phase***: Discussion are renewed and new contributions are made, leading to a "new" OCA theory.

The Pioneering phase

This phase began with the seminal work of Mundel (1961), where the author proposed the conditions that a region must meet to adopt a single exchange rate. From this, several authors made contributions and ended delineating the characteristics to be met by an AMO. The main were:

- Prices and wages flexibility
- Factors mobility
- Financial integration
- High degree of comercial openness
- Similar rates of inflation
- Fiscal transfer mechanism between countries

The Cost-Benefit phase

The main **benefits** are:

- Reduction of the monetary costs of transactions.
- Increasing comercial and financial flow of goods.
- Access to more open and transparent financial markets.

The main **costs** are:

- Loss of monetary policy.
- Loss of exchange rate policy.

The OCA's Revaluation phase

During this phase a clear position in favor of economic integration is adopted. Various contributions helped in this regard:

- The monetarist critique significantly weakened the importance given to monetary policy as a key policy tool.

- In contrast, financial capitals gained much more relevance as an alternative tool for correcting imbalances.

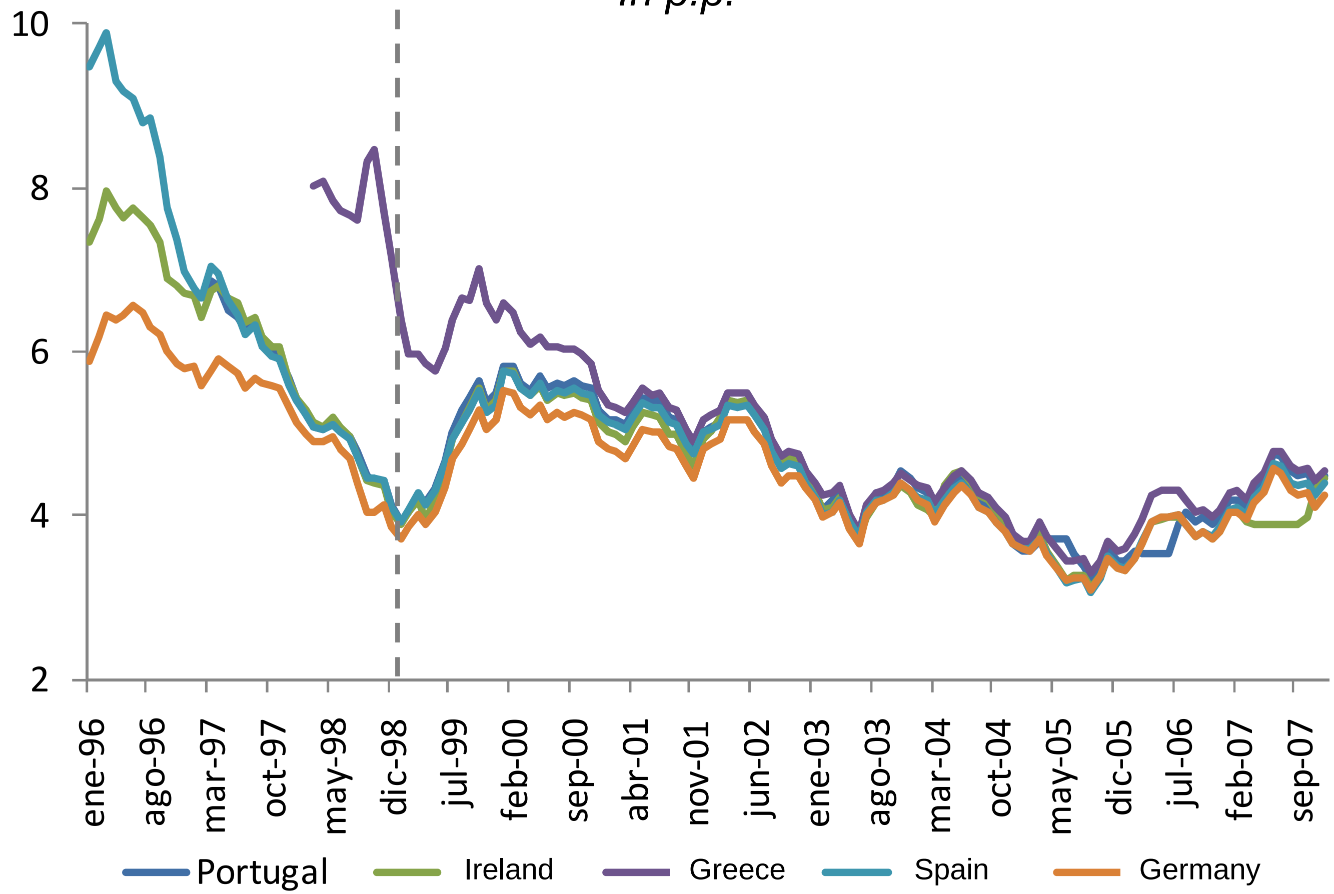
- Inflation became the key variable to monitor and its eficacy in controlling it became associated with "credibility".

So what we see is a clear reivindication for adopting a monetary union, since the new contributions tended to downplay the costs of losing monetary sovereignty.
Moreover, **all these contributions were incorporated into the design of the UM**.

At first, the theory seemed to hold: EMU countries grew at an accelerated pace and the PCs' interest rates aligned with those in the core countries. This was due to the fall in the risk perception associated with the supposed strength of the EMU.

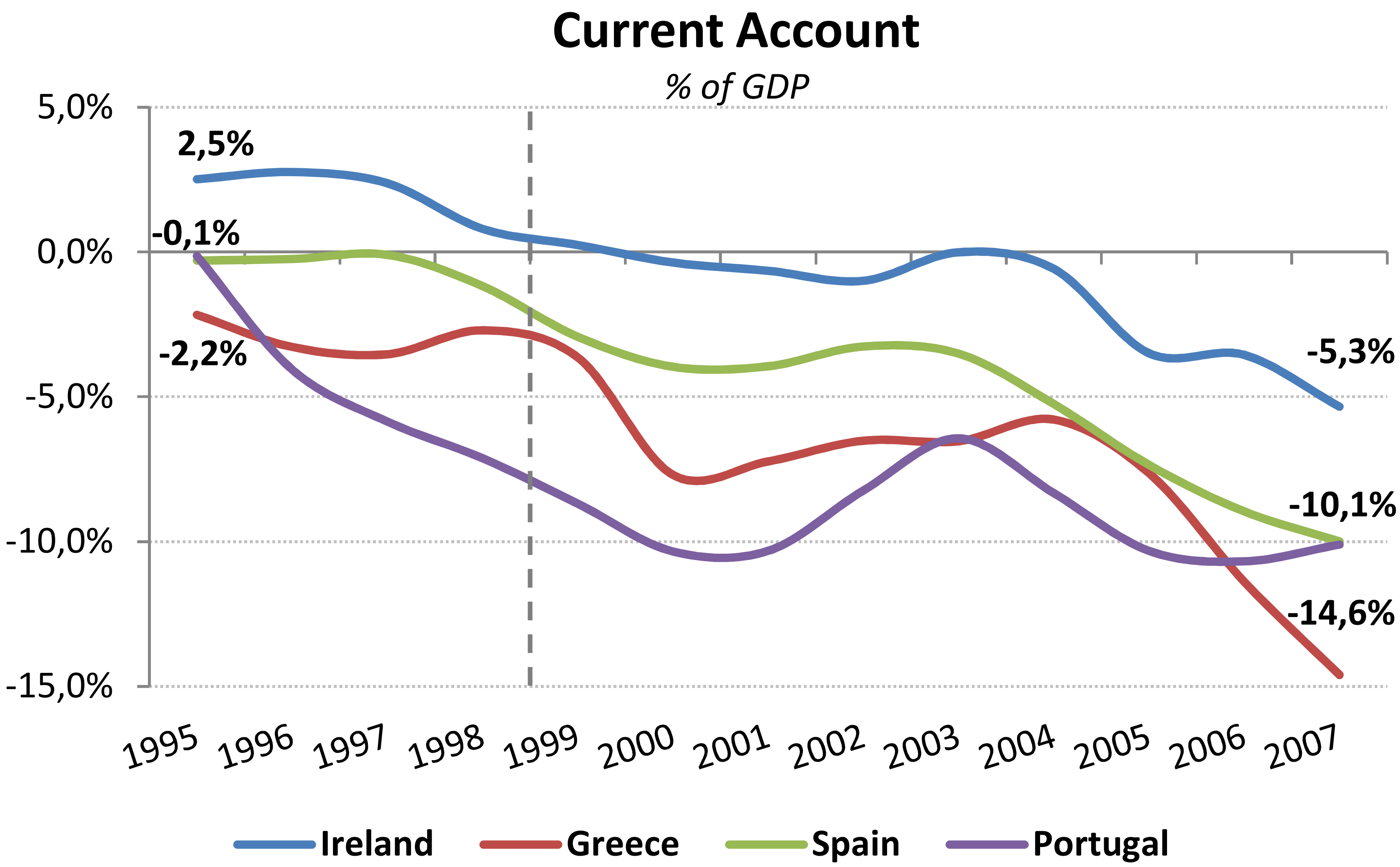
CDS for 10 years

In p.p.



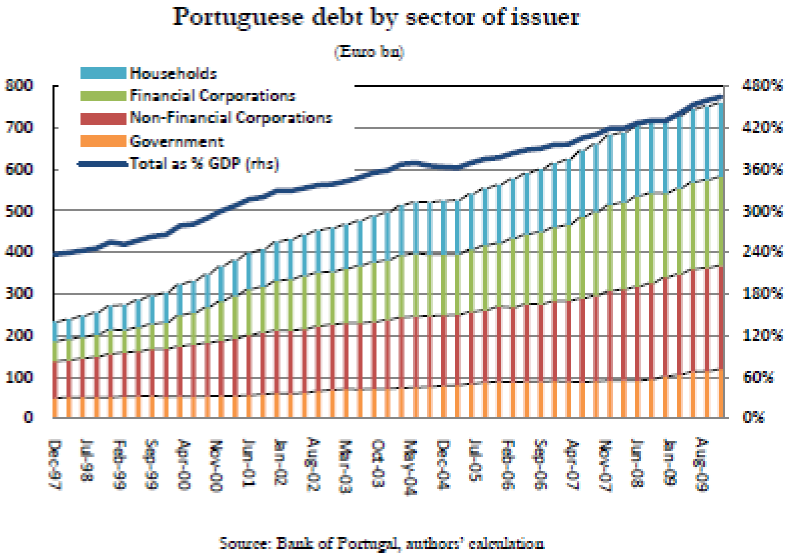
Source: Bloomberg.

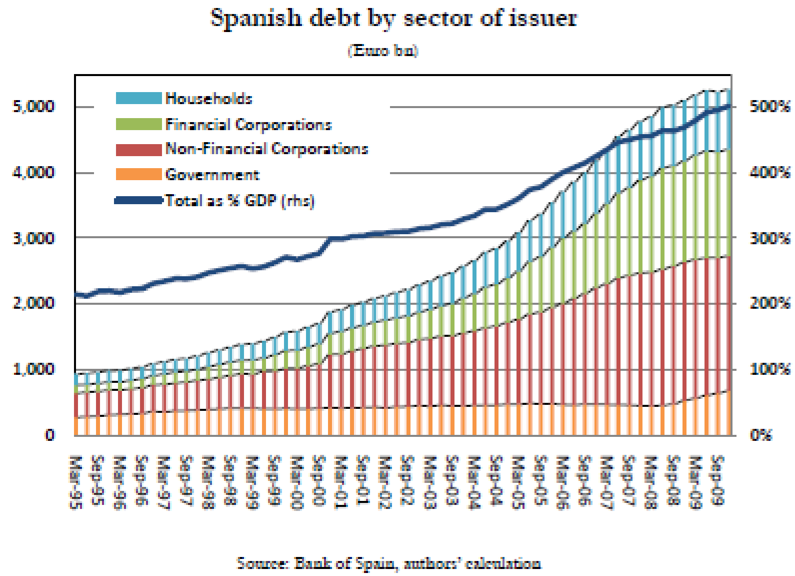
This encouraged massive inflow of capitals, which financed the growing current account deficits. The steady deterioration observed reflects the incapacity of the PCs to correct these imbalances.

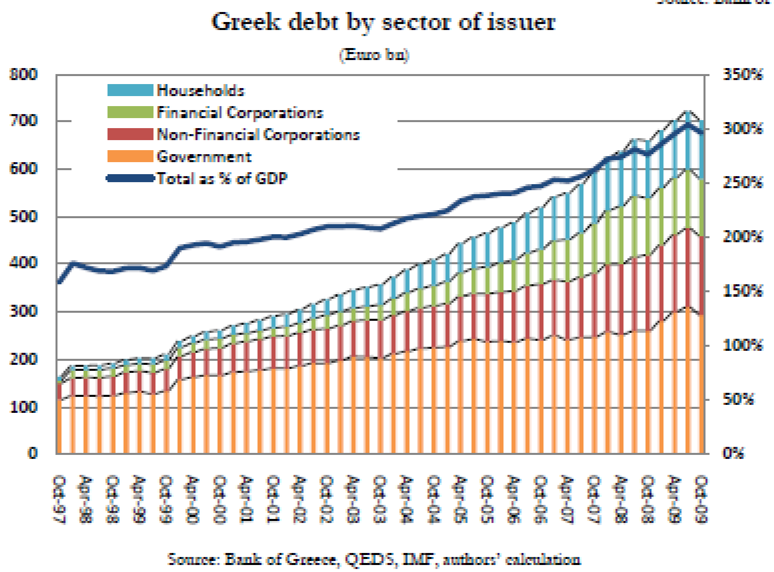


Source: Eurostat.

The lower cost of funding also meant an acceleration in domestic credit, generating a remarkable accumulation of debt; which, unlike what was postulated by the official view, **was mostly of a private nature**.

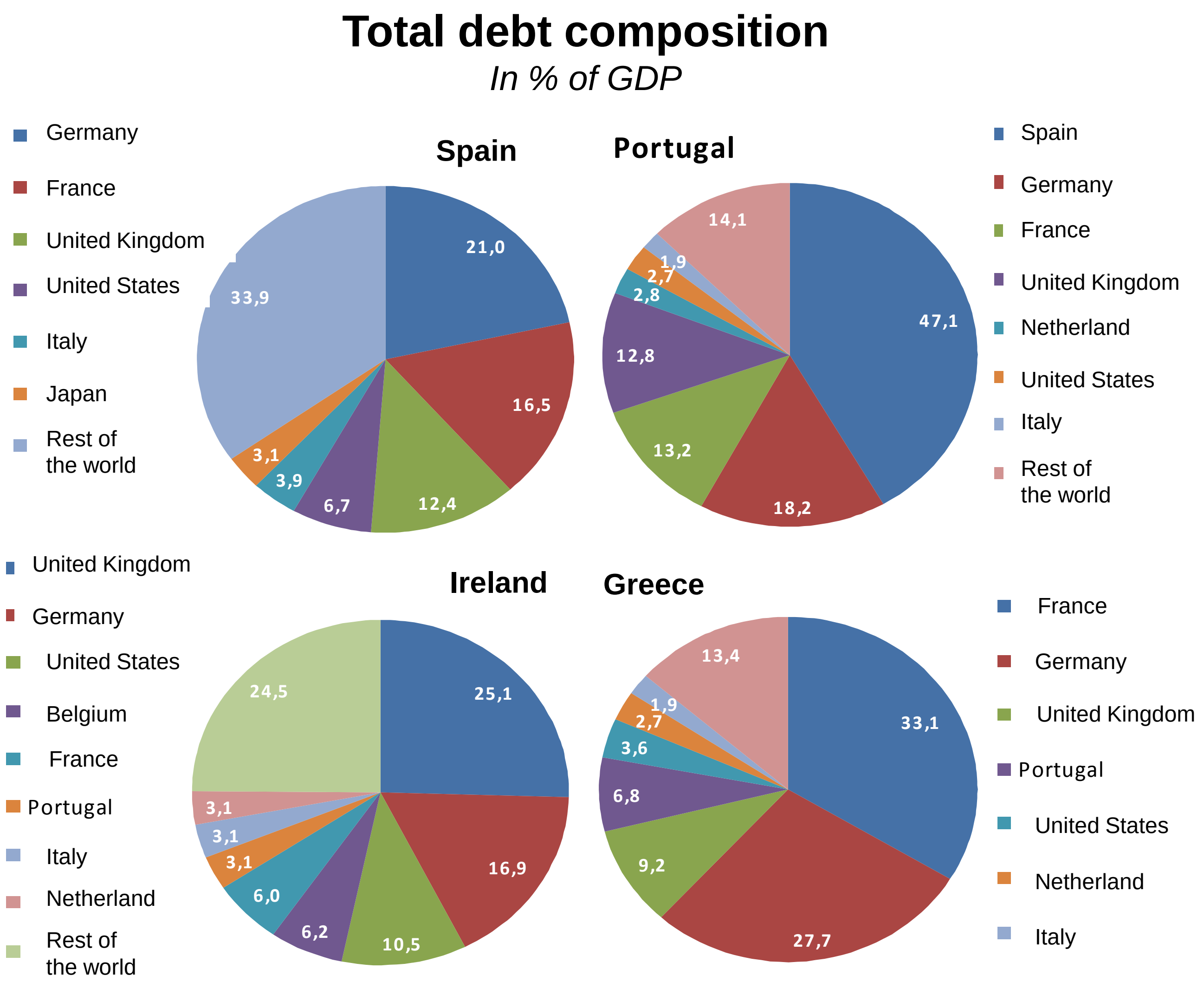






Source: Lapavitsas et al (2010).

Moreover, the main lenders of the PCs' debt were the core countries of the EMU, which revealed the high financial interdependence that prevailed prior to the outbreak of the crisis.



Source: Bank for International Settlements.

Conclusions

- The explanation provided by the **official view**, associated with fiscal profiglacy is merely a superficial reading of the facts.
- Because of that, fiscal austerity only aggravated the situation.
- In contrast, the **structuralist view** identifies the root causes of the crisis on the very design of the EMU.
- Money should not be seen only as a medium of exchange but also as a unit of account and a means of payment determined by the government.
- The waiver of sovereign monetary policy, coupled with trade and financial liberalization, led to the accumulation of external imbalances that resulted in a disproportionate increase in private debt, which was the ultimately cause of the European debt crisis.

Thank you very much.

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