

Is the EMU Crisis over? A view from the South

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Crisis prevention: what caused the Eurozone crisis and where are we now?

- Financial instability, no joint supervision: progress (SSM; SRM) but not yet there (inadequate banking union-proc)
- Public debt: worse off (2009-14: ESP from 60% to 110%; POR 90% to 140%; IRE: 70% to 130%; GR 140% to 190%)
- Budget deficits (GR): better monitoring, prevention & correction; SGP; emphasis on structural budget balance
- Uncoordinated economic policies and current account imbalances: improvements, European Semester; MIP; CA convergence; but...
- Lack of crisis resolution mechanism and sovereign lender of last resort: ESM, but...

Crisis reaction and policy mix (1)

What should have been done	What was done
Aggressive monetary easing by the ECB	ECB activism (ELA, SMP, LTRO, TLTRO). But interest rates higher than other CBs, monetary transmission mechanism broken, OMT too late, no QE
Fiscal consolidation emphasizing medium-term	Fiscal consolidation front-loaded, expenditure-based, amplifying recession; Policy mix procyclical, accentuating recession → further fiscal target slippage
Structural reforms at national level	National structural reforms came late, insufficiently supported by EU
Countercyclical stimulus at Eurozone level	Almost no countercyclical EA policies (investment & effective demand weak); simultaneously restrictive fiscal policies; EIB inadequate
Leaps of integration (fiscal, banking, economic) in the EMU	Muddling through; buying time for national adjustment to deliver: always behind the curve

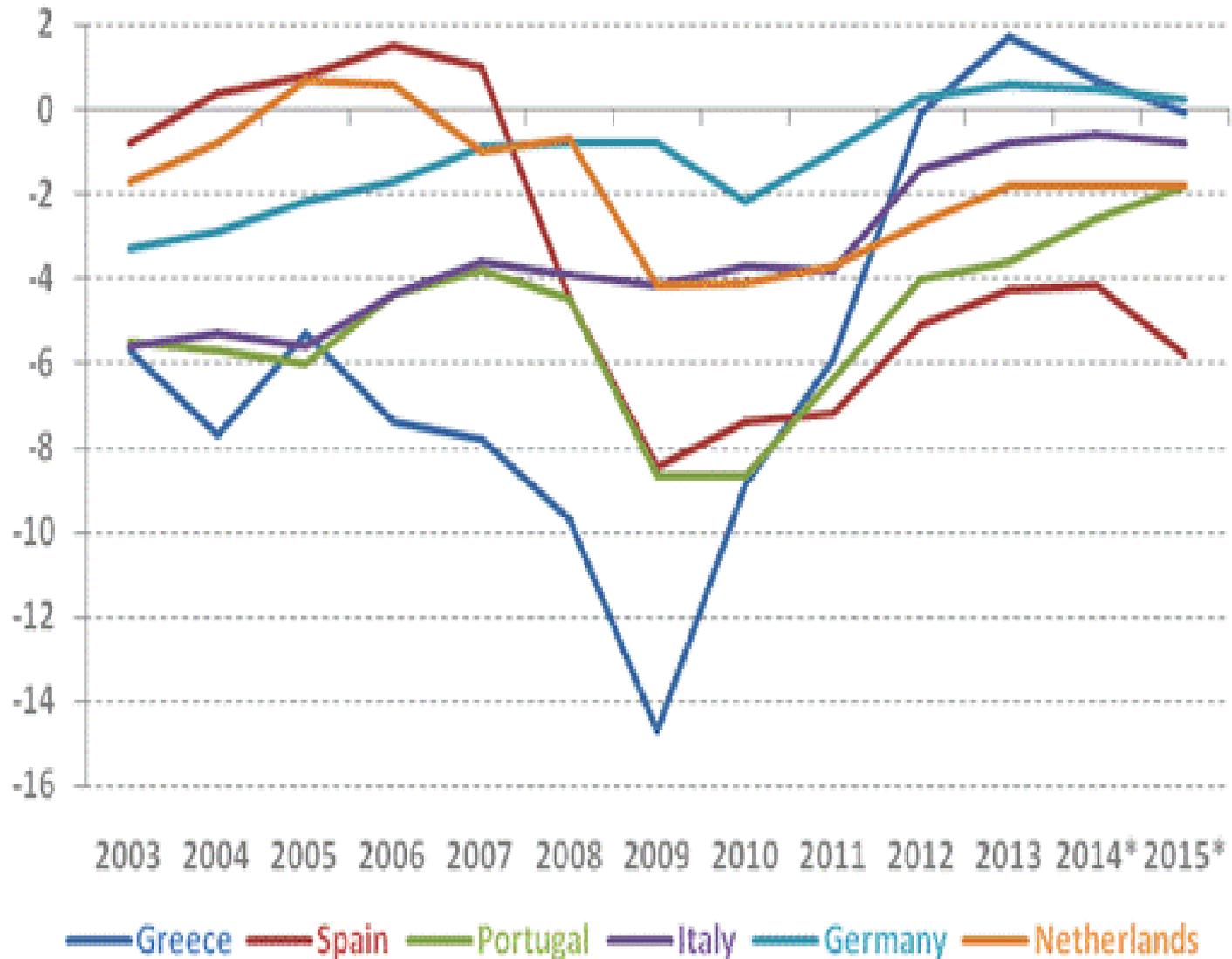
Crisis reaction and policy mix (2)

What should have been done	What was done
Some policy leeway – some breathing space	All policies for S restrictive (fiscal, incomes, monetary) –procyclical austerity
Coordinated debt relief if needed	Debt reprofiling for Greece in 2010 rejected. Debt restructuring 2012
Backstop and assured Eurozone membership	“Will do whatever it takes” never uttered by Eurozone partners. Caveats and footnotes. Grexit risk/ country risk from 2010 to fall 2012 cancelling adjustment
Treated crisis mainly as Eurozone systemic, institutional and policy crisis	Crisis treated as the sum of national crises resulting from Southern “laxity” (in case of Greece true) instead of the systemic EMU crisis that it mainly was
Break bank-sovereign contagion	Intensified bank-sovereign doom loop
Progress to deeper integration, “genuine” EMU	Important steps made but not enough given the scope and systemic depth of the crisis

Is the crisis over? Yes...

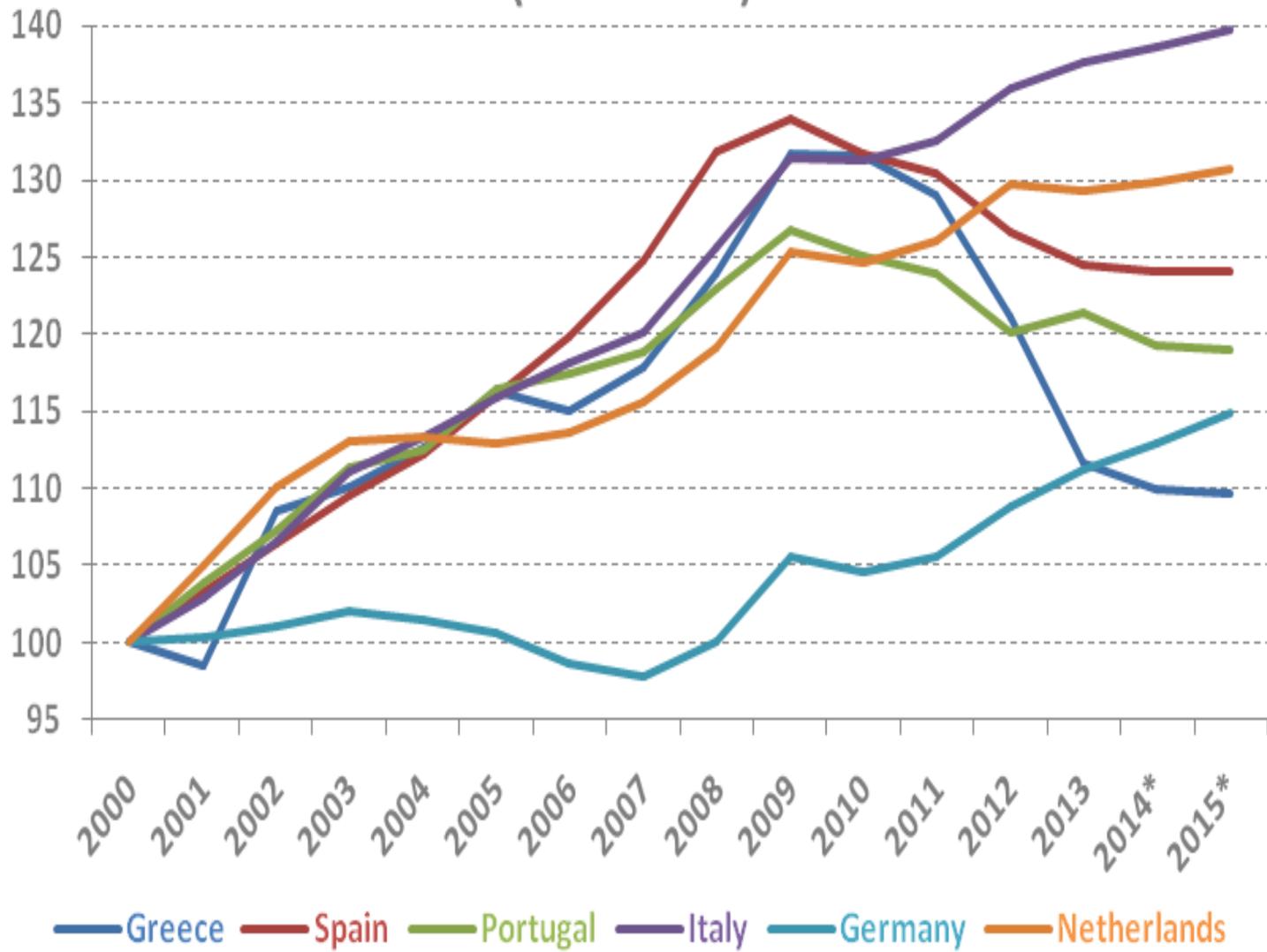
- Worst of debt crises is over
- Program countries are back in the markets
- Peripheral spreads declining (10Y: GR 4.6; POR 2.3; ITA 1.4; ESP 1.3; IRE 1.0)
- Large deficits eliminated
- Troika programs close to completion (IRE & POR ended; Greece nearing)
- Speculation on Euro breakup has diminished
- Deepest recessions are over; (weak) positive growth outlook for 2014
- Large adjustment implemented

Structural Balance, share of GDP (%)



Source: European Commission (*forecasts)

Nominal Unit Labor Cost, Total Economy (2000=100)

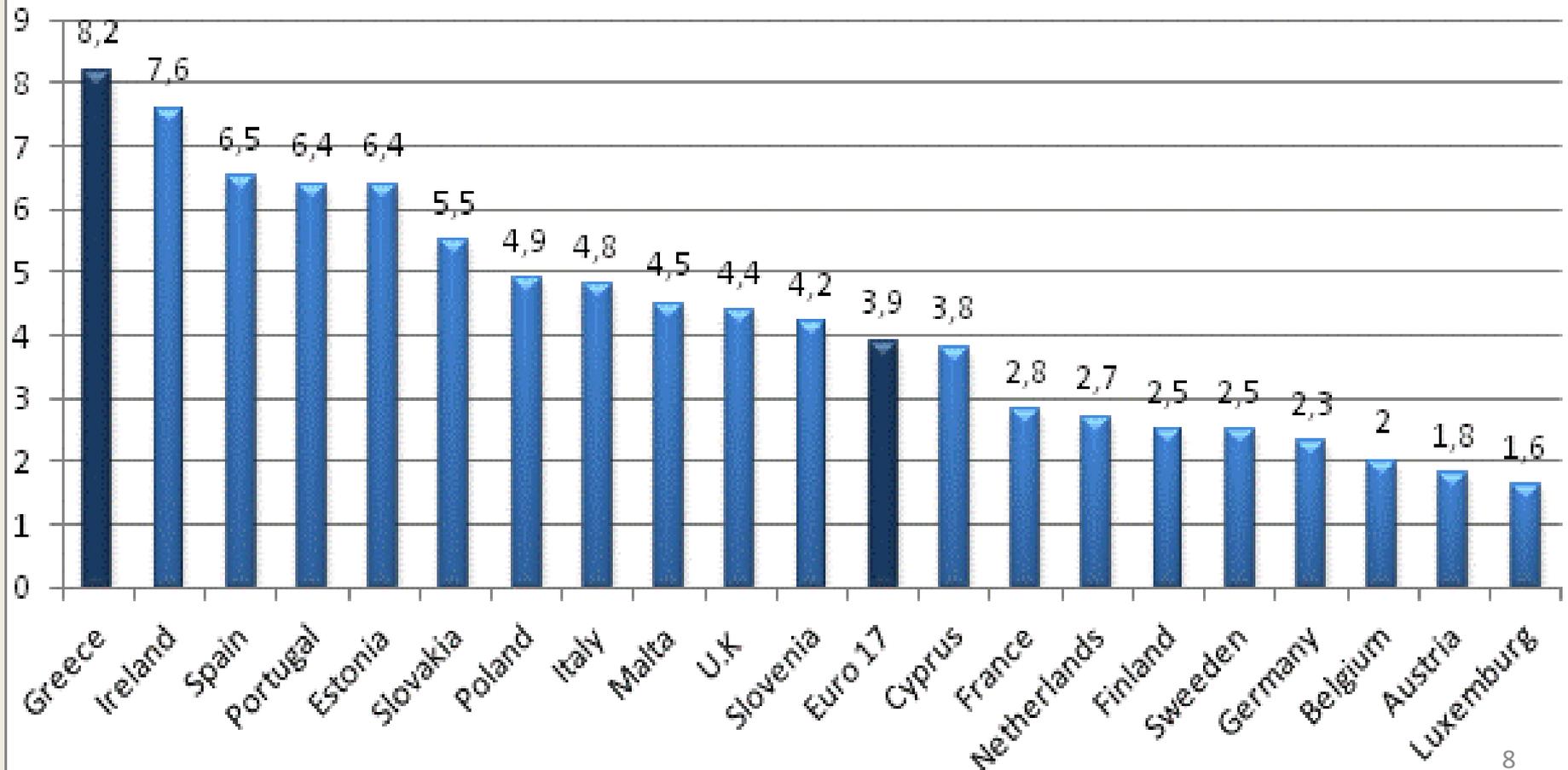


Source: European Commission (*forecasts)

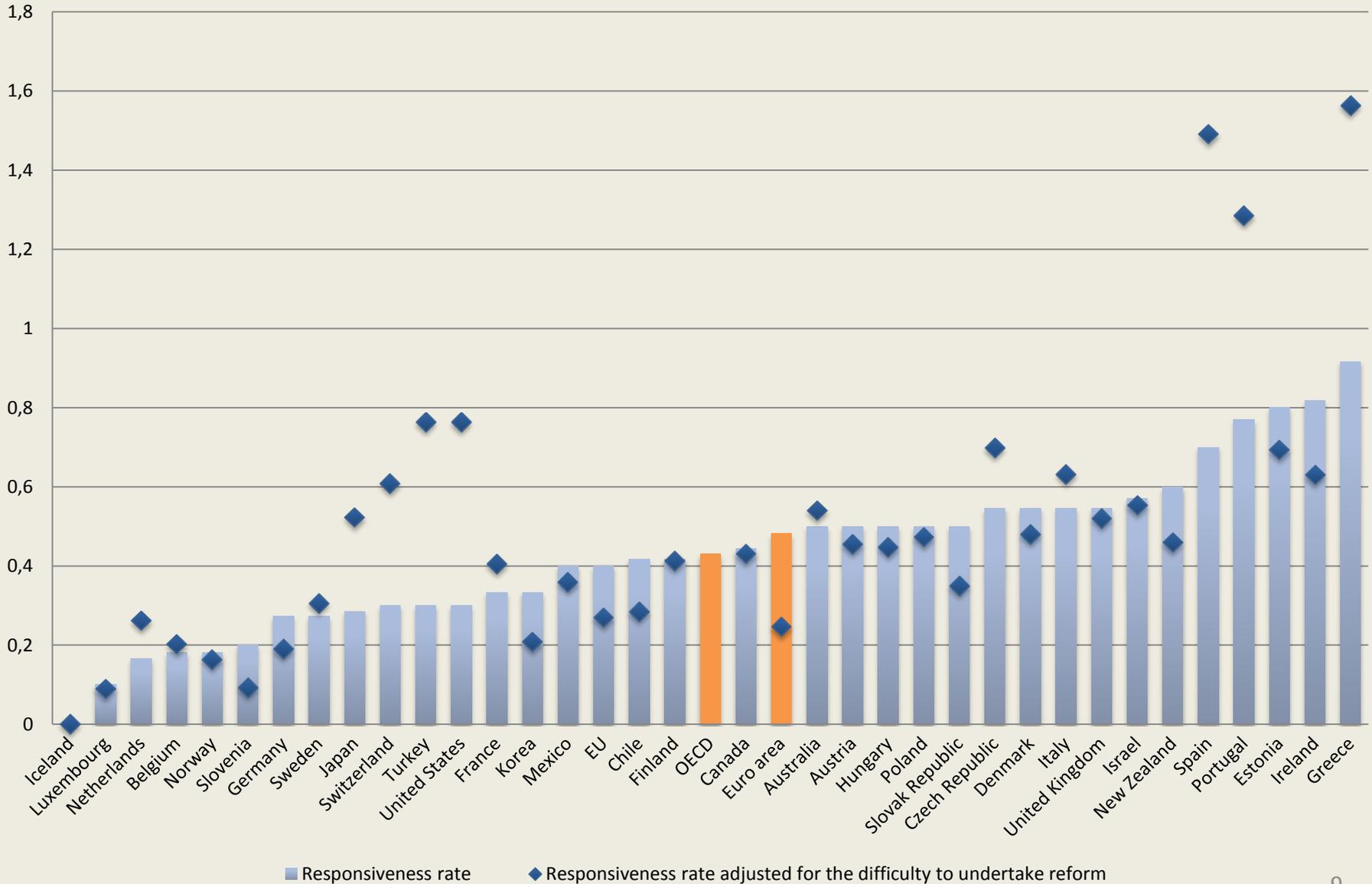
Source: Berenberg Bank & the Lisbon Council, *The Euro Plus Monitor: Spring 2013 Update*, based on Eurostat, ECB, European Commission, OECD and Berenberg calculations

Note: The total score is the average of the four subscores for external adjustment, fiscal adjustment, labor cost adjustment and reform drive, all on a scale of 10 (best) to zero.

Overall Scores in Adjustment Progress



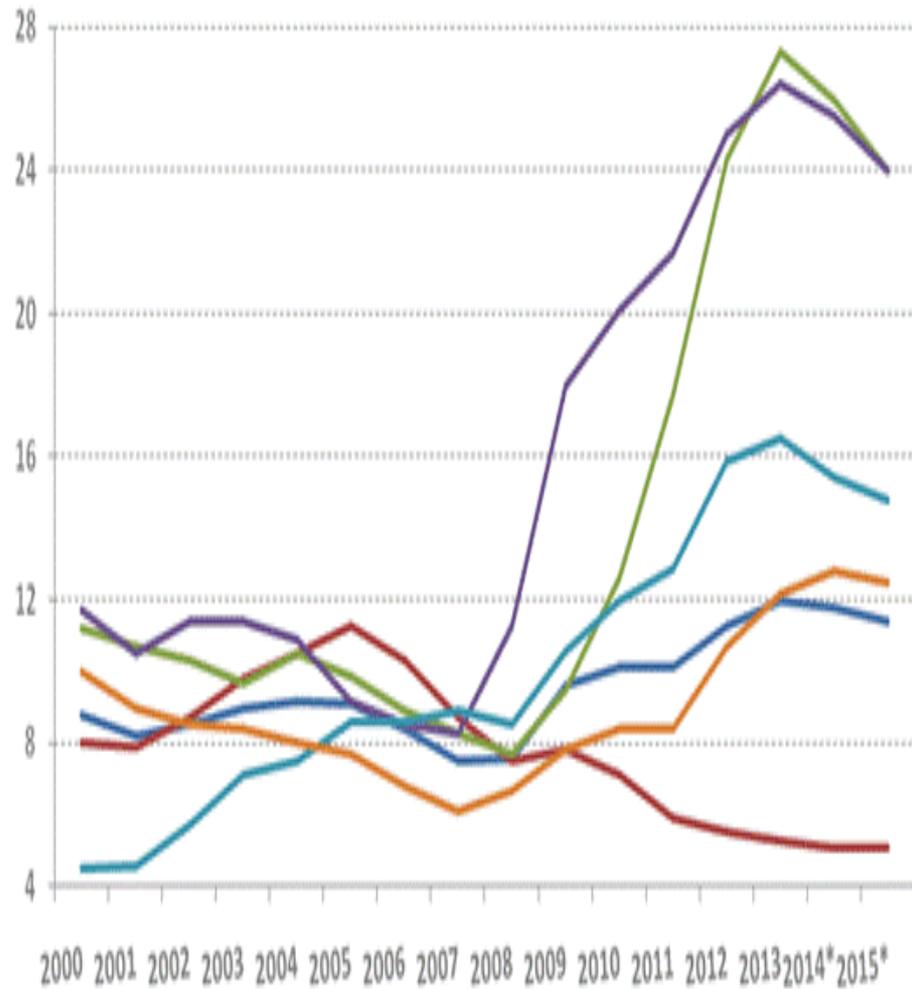
Responsiveness to Going for Growth recommendations across OECD countries, 2011-12



Is the crisis over? NO

- Debt crisis; bank crisis; economic crisis; confidence crisis
- Huge socioeconomic costs of austerity
- Unemployment, large income losses, rising poverty and inequality
- Sociopolitical tensions, new democratic deficits
- Eurozone fragmentation
- Polarization core / periphery (FR in the middle)
- Euroscepticism, anti-Europeanism & extremism
- The enduring effects of the crisis

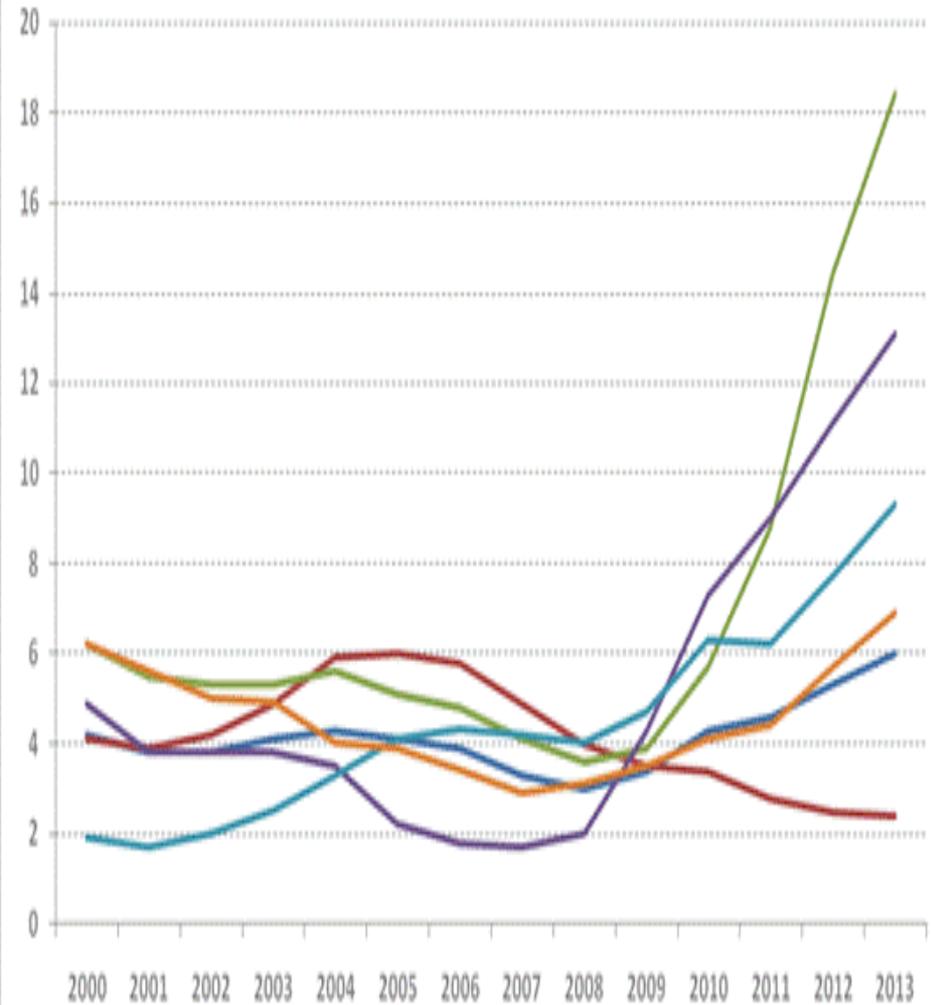
Unemployment (%)



— Euro Area (18) — Germany — Greece — Spain — Portugal — Italy

Source: European Commission (2014), *=Forecasts

Long-term Unemployment (%)



— Euro Area (18) — Germany — Greece — Spain — Portugal — Italy

Source: Eurostat (2014)

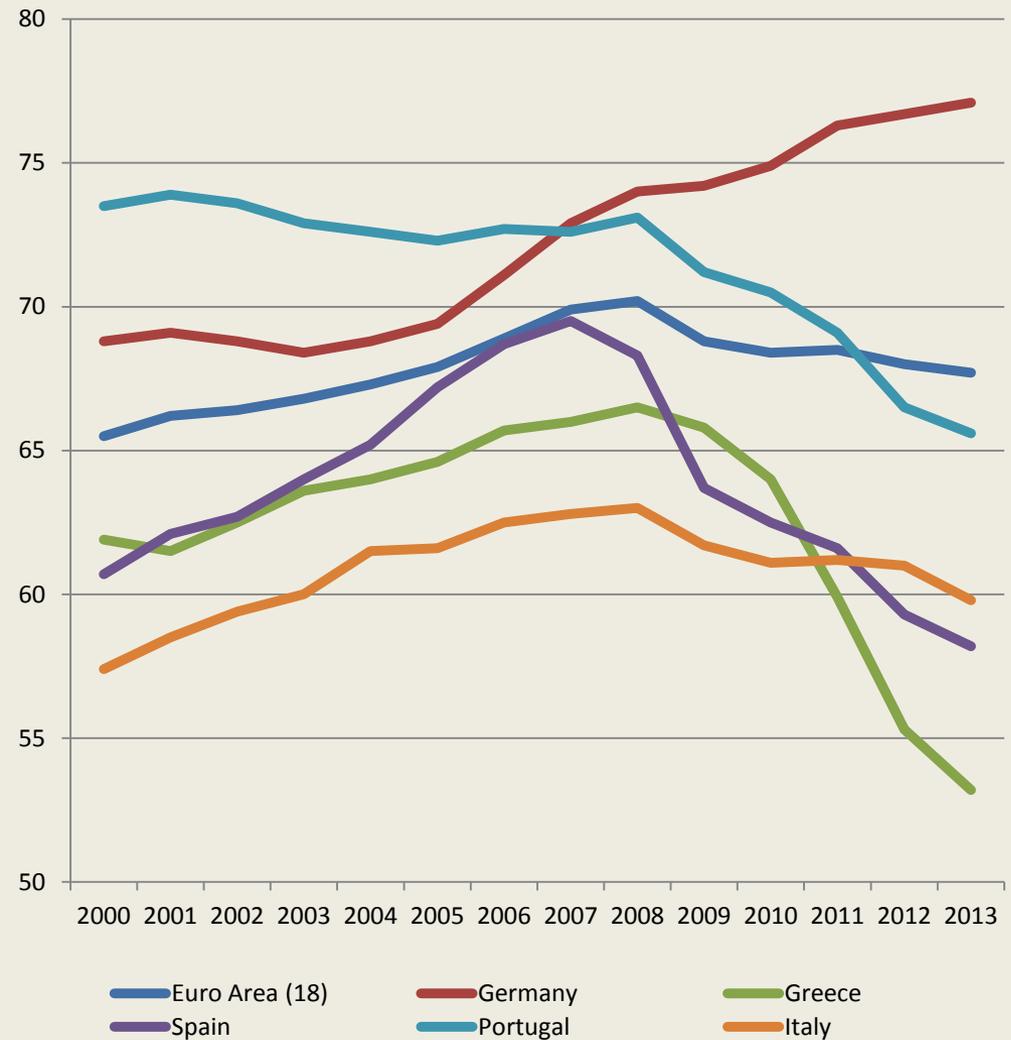
Sharp decline of the Employment Rate

The number of persons aged 20 to 64 in employment / the total population of the same age group

**EU 2020 target:
75% by 2020!**

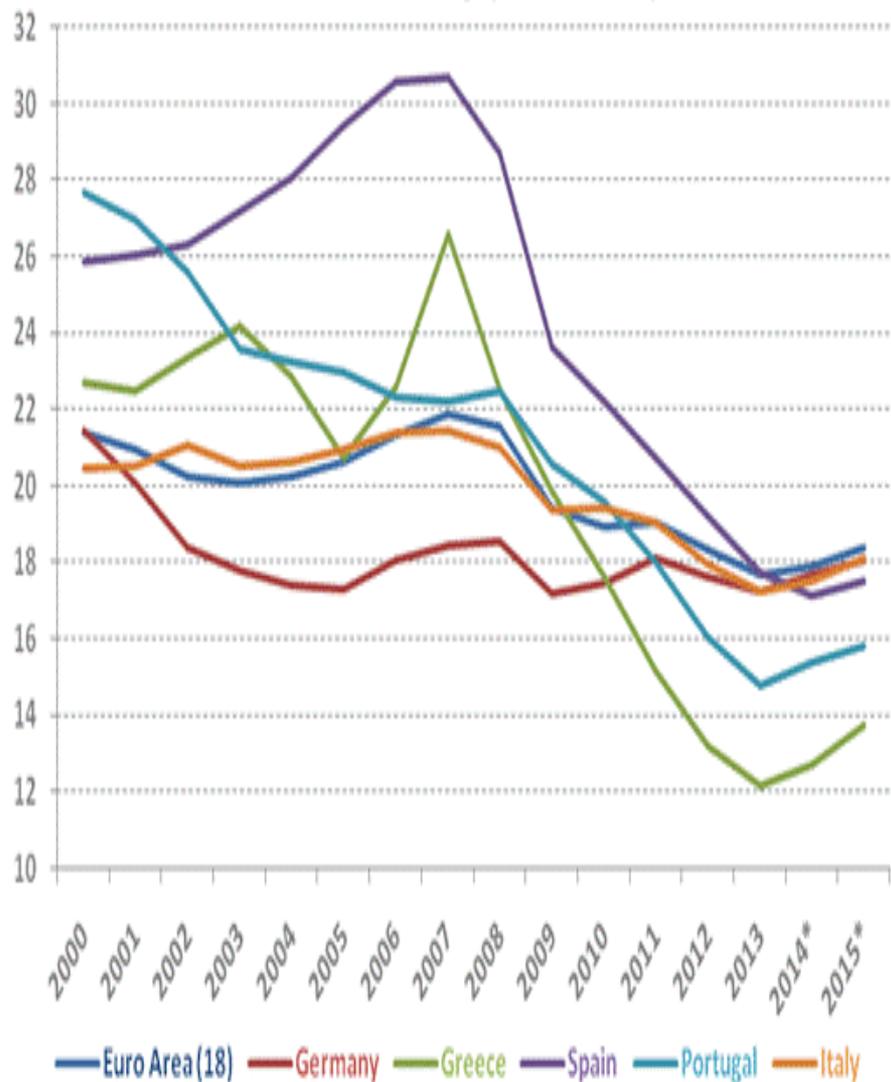
* Employed population consists of those persons who during the reference week did any work for pay or profit for at least one hour, or were not working but had jobs from which they were temporarily absent.

Employment Rate (%)



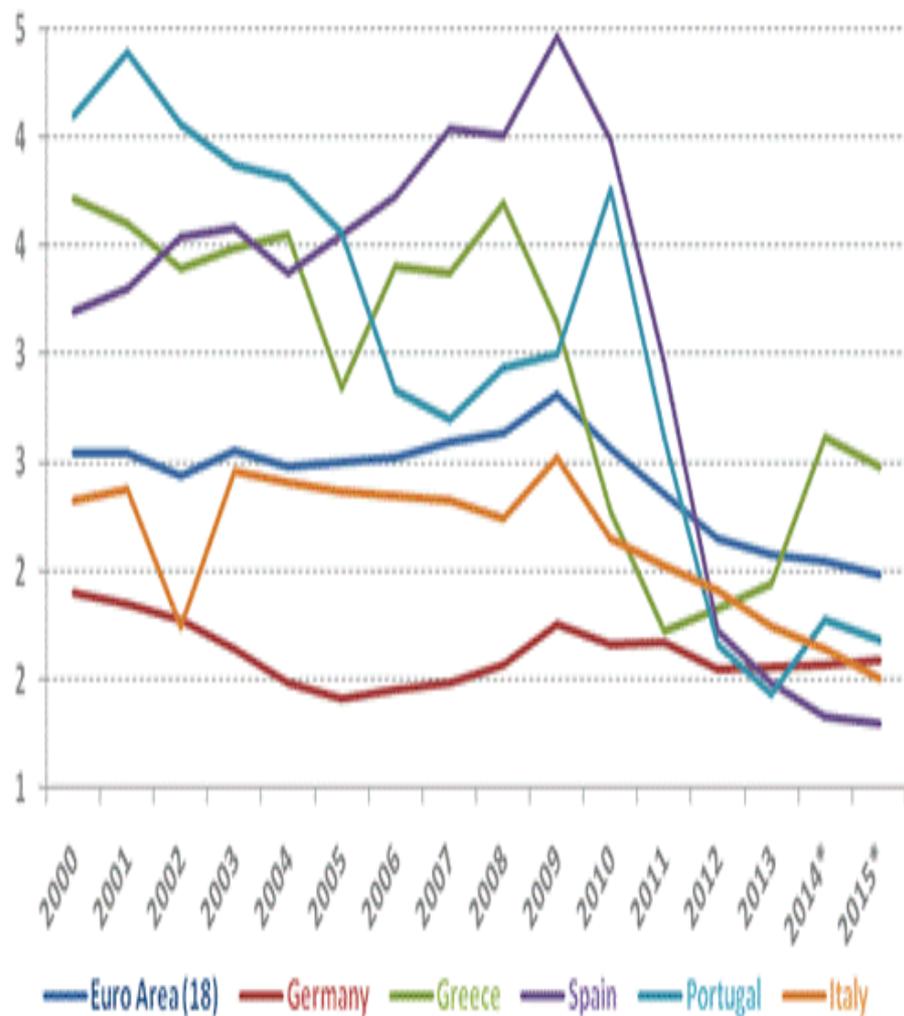
Source: Eurostat (2014)

Gross Fixed Capital Formation, Total Economy (% of GDP)



Source: European Commission (2014), *=Forecasts

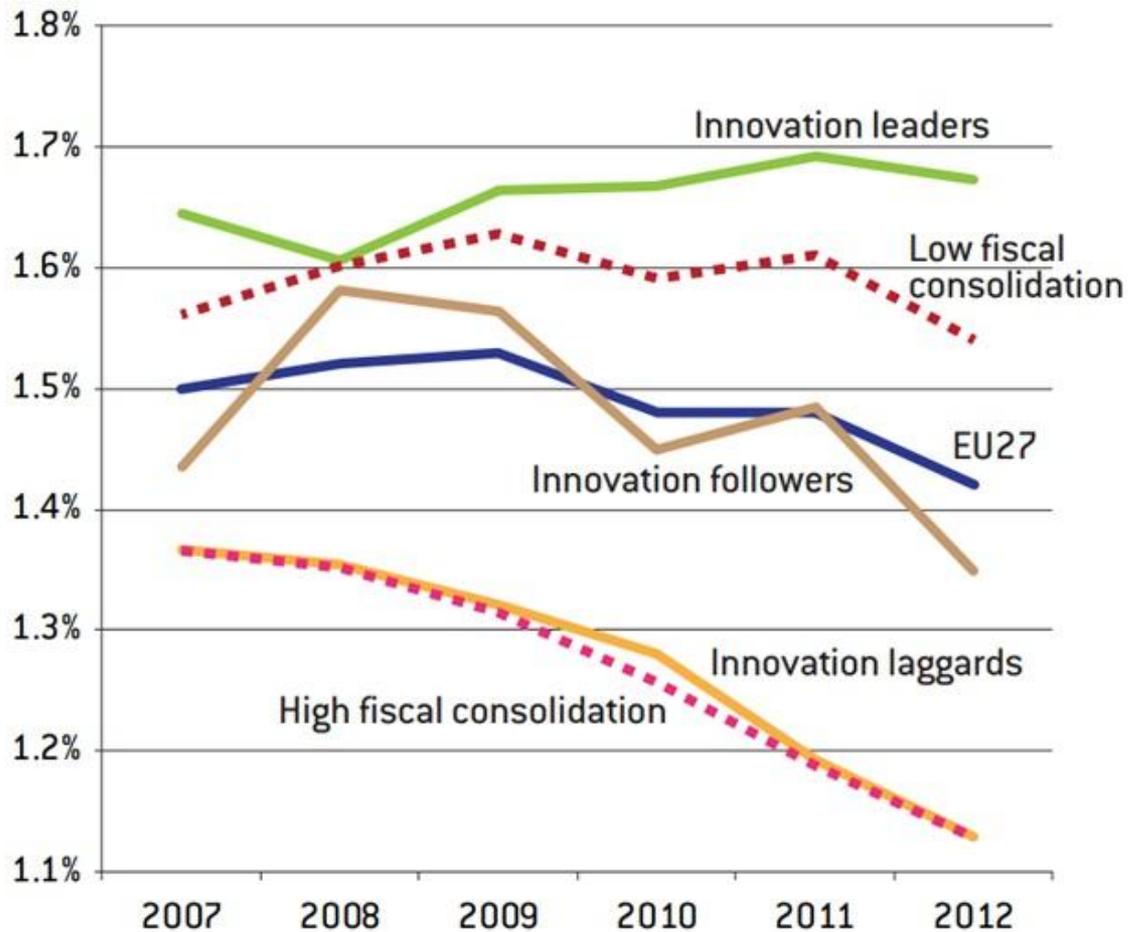
Gross Fixed Capital Formation, General Government (% of GDP)



Source: European Commission (2014), *=Forecasts

Government R&I Expenditure

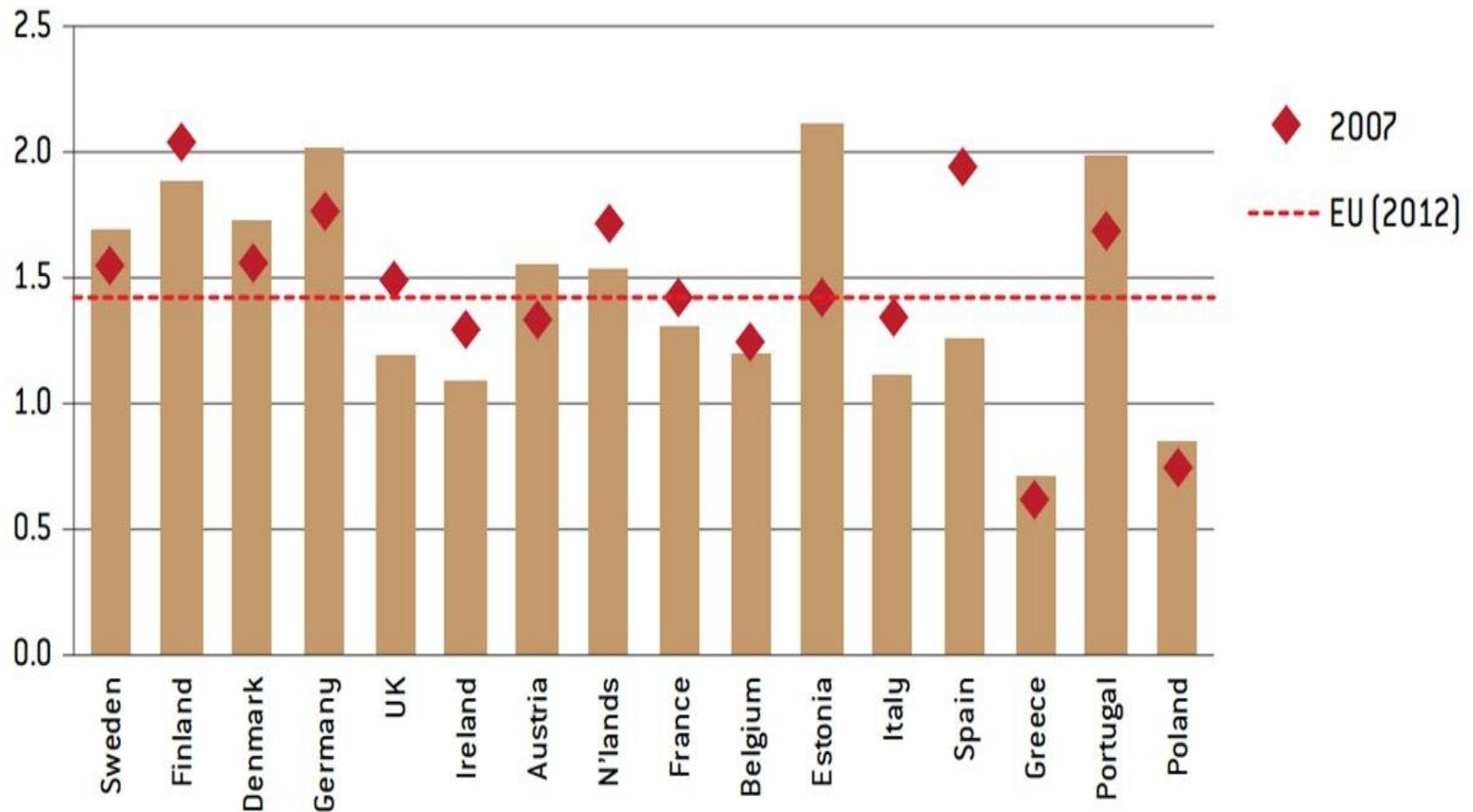
(Government Budget Appropriations or Outlays for Research and Development as % of Government Expenditure)



Source: Bruegel (2014)

Government R&I Expenditure, 2012 relative to 2007

(Government Budget Appropriations or Outlays for Research and Development as % of Government Expenditure)

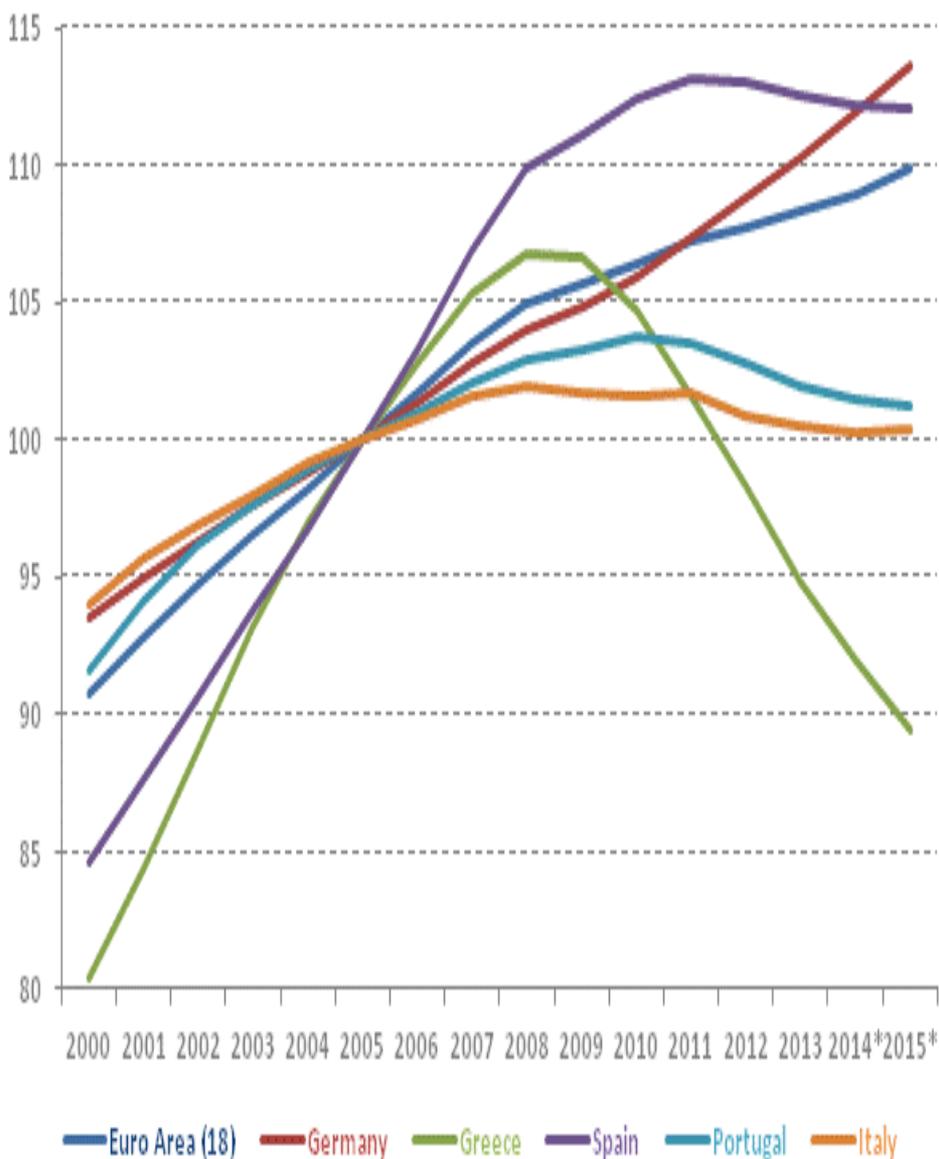


Source: Bruegel (2014)

Potential GDP has shrunk

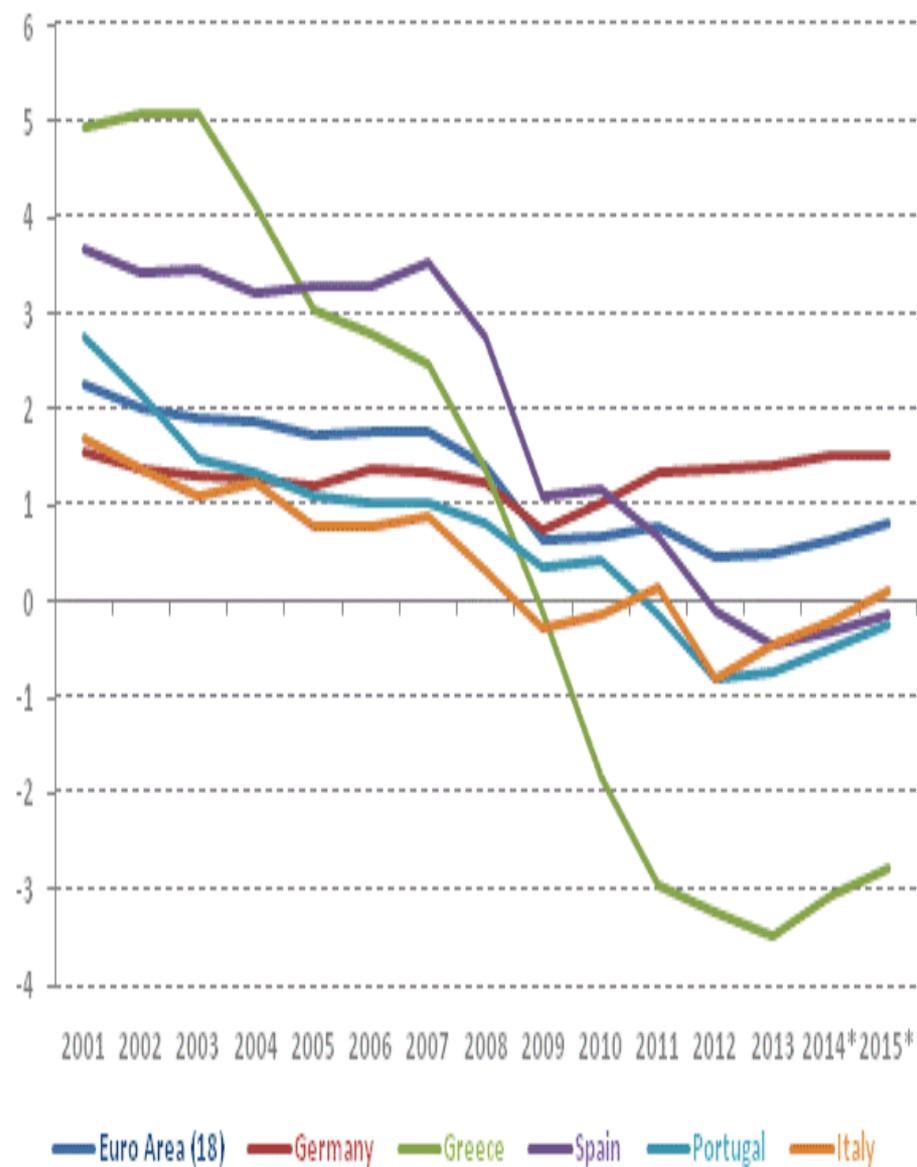
- The level of output that an economy can produce at a constant inflation rate.
- Although an economy can temporarily produce more than its potential level of output, that comes at the cost of rising inflation.
- Potential output depends on:
 - the capital stock
 - the potential labour force (which depends on demographic factors and on participation rates)
 - the non-accelerating inflation rate of unemployment (NAIRU),
 - and the level of labour efficiency

Potential GDP, 2005 market prices (2005=100)



Source: European Commission (2014), *=Forecasts

Potential GDP Growth Rate (%)



Source: European Commission (2014), *=Forecasts

Investment gap (DIW)

Durchschnittliche Investitionslücken

in Prozent des BIP

	1999-2013	1999-2007	2010-2013
Euroraum-18	0,1	-0,3	1,5
<i>Deutschland</i>	3,2	2,5	4,7
<i>Niederlande</i>	1,5	0,7	3,4
<i>Finnland</i>	1,3	1,6	1,2
<i>Belgien</i>	-0,9	-0,6	-1,0
<i>Frankreich</i>	-0,1	0,6	-0,7
<i>Österreich</i>	-0,4	-1,0	0,6
<i>Italien</i>	0,0	-0,4	1,0
<i>Griechenland*</i>	-0,9	-2,7	2,8
<i>Portugal</i>	0,3	-1,5	4,3
<i>Spanien</i>	-3,6	-5,1	0,2
<i>Irland**</i>	0,7	-3,4	7,5
<i>USA***</i>	-2,4	-3,0	0,5
<i>Japan****</i>	-1,4	-2,2	1,6

What should be done (1): Fix the Eurozone building

- Key challenge: restore confidence in capacity of institutions (national and EU); Turn EMU again into win-win
- Fiscal integration; joint budget control *for* some joint debt management; debt redemption fund
- Banking integration: real backstop
- Fiscal capacity for the Eurozone; stabilization fund for asymmetric shocks
- Greater risk-sharing

What should be done (2): Investment and employment stimulus

- Urgent employment support against cyclical unemployment over certain level
- Investment stimulus
 - New Marshal Plan?
 - EIB?
 - EIB bonds purchased by ECB?
 - National investment spending, exempt from deficit rules?

Conclusion

- Over the last 4 years, the economies of the Eurozone periphery have implemented adjustment of often unprecedented scale.
- Under the optimistic scenario, stabilization, shrinking deficits, and structural reforms will allow the Eurozone peripherals to shift to a strong and sustainable growth rate.
- However, the positive effects of adjustment are offset by the more enduring consequences of austerity: unemployment and decline of the employment rate, disinvestment, erosion of the productive base.
- Austerity has not only taken a heavy toll on incomes, economies and societies in periphery.
- It threatens to create lock-in effects and vicious circles of prolonged stagnation and high unemployment.
- If that were the case, its effects could be devastating for cohesion, integrity and longer-term viability of the Eurozone and EU project.

*Kalo kouragio...**

** Bon courage (Olli Rehn in Athens, 2010)*