EC245 – INTERNATIONAL FINANCIAL INSTITUTIONS AND POLICY

"Why did current account imbalances build up between countries of the euro zone after the introduction of the single European currency? Explain the policy measures advanced by the European Central Bank (ECB), the European Union (EU) and the International Monetary Fund (IMF) to bring an end to the euro zone crisis, and critically assess their effectiveness."

1. Introduction

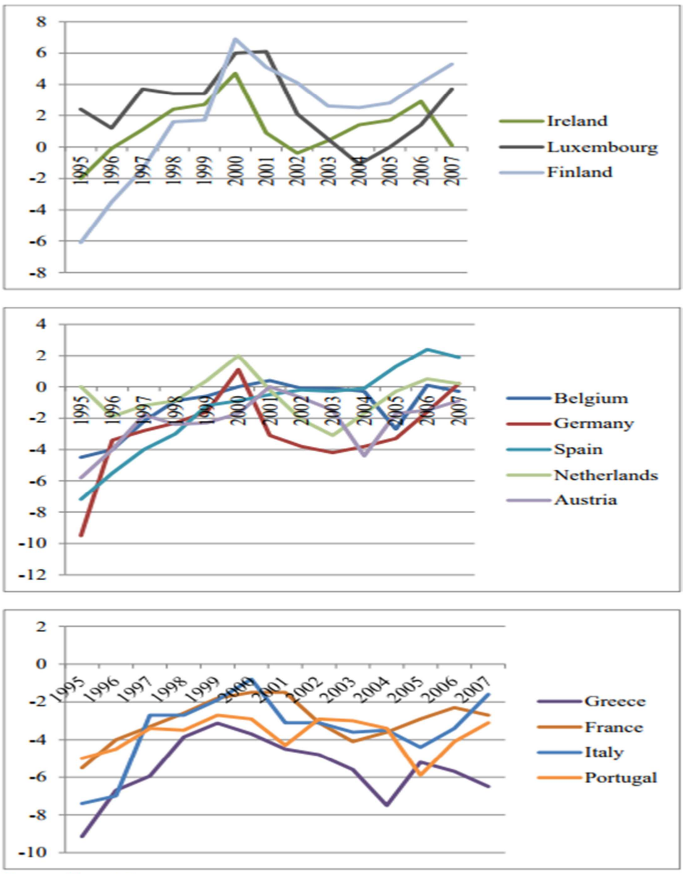
With the end of the Second World War, The need for stability and economic development was immense, and with the establishment of the European Coal and Steel Community in 1951, arguably sparked a chain of events that now became the European Union. The first step towards cooperation that was necessary to create a governing body to oversee economic and political policies was first seen during the creation of the OEEC which was formed by 16 nations who weren't influenced by the Soviet Union. The European Economic Community (EEC) initially was to bring about economic integration, including common market and customs union, and achieved a single market in 1993. This allowed free movement of capital, goods, services, and people within the EEC. Some of these establishments provided a framework for the Maastricht treaty, which formally established the European Union. In section 2, I have talked about causes of the current account imbalances, section 3 is about policies measures taken to bring an end to the euro, and section 4 is the bailout programme of Greece.

2.1 Stability Growth Pact

The creation of the Economic and Monetary Union (EMU) was another step forward in the process of economic integration. The benefits of economic integration was immense with coordination of economic policy makings between Member States, the usage of the single currency, an independent monetary policy ran by the European Central Bank (ECB). However within the framework of the EU lie several structural problems which include "the rules, regulations and institutions that govern it – is to blame for the poor performance of the region, including its multiple crises."

The first problem that arose was fiscal moral hazard. As Buiter, William, Corssetti, Giancarlo & Roubini, Nouriel stated, "They put fiscal and debt limits at the heart of the Maastricht criteria for entry (3% of GDP and 60%, respectively), and adopted a No Bailout Clause meaning no member states should not be liable, nor assume the commitments or debts of any other member states. Furthermore, the Stability and Growth Pact (SGP) was agreed, however it was this pact that played a crucial part in the causes of the Eurozone debt crisis. To illiterate, the basic premise of the pact was to enforce budgetary discipline to Member States, but the key point is the two conditions that the member states have to respect: Annual government budget deficit should not exceed 3% and Debt/GDP ratio should be no more than 60%. The fiscal deficit limit was subject to the Eurozone averages of 1990, as given growth and inflation assumption, the European policy-makers believed the Debt/GDP ratio could be held constant at 60% with an annual deficit of 3%. Given this, it was pretty clear that no countries would be able to uphold these criteria, as figure 1 shows that at some point between 1995 to 2007, all Eurozone countries, except Luxemburg and Ireland had deficit levels exceeding 3% of GDP.

Figure 1: Budget deficit



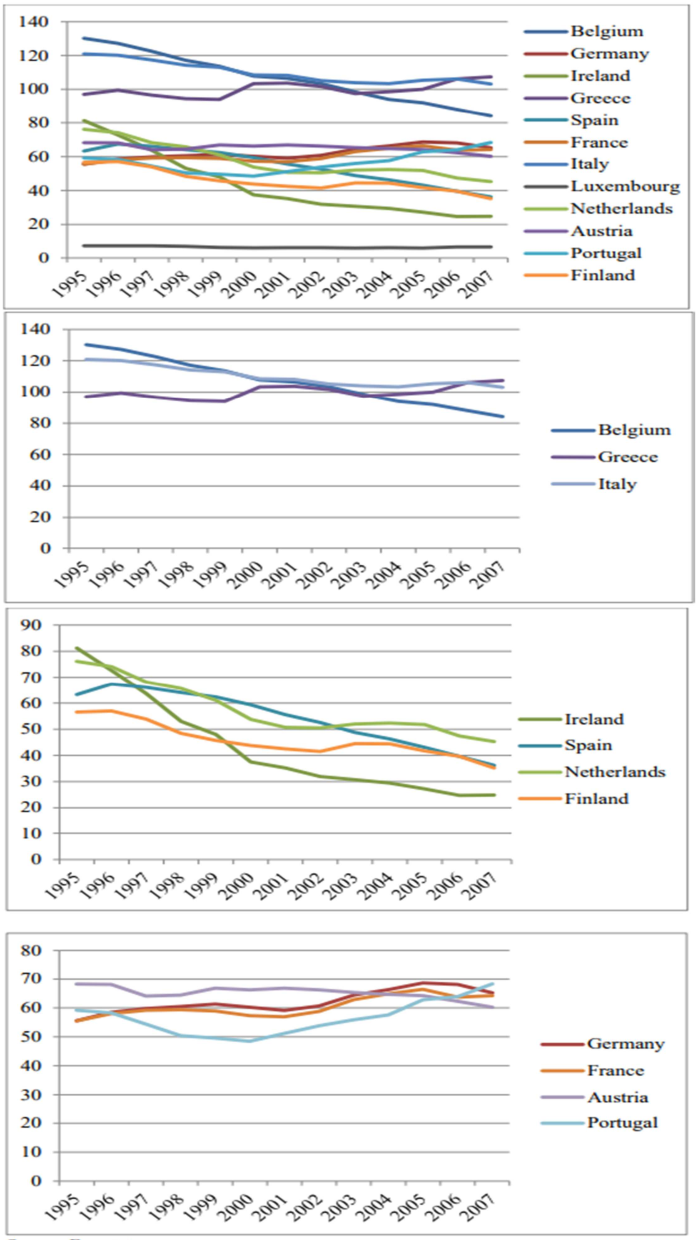
Source: Eurostat

What's noticeable about the graph is that Ireland had held surpluses for mostly the entirety of the period and so respected the 3% budget deficit, but was later affected severely by the sovereign debt crisis. Germany and Spain made efforts to have fiscal surpluses, however still remained deficit countries. Nevertheless, their deficit levels reached the 3% criteria by 1998.

What's even more surprising is that France who's considered a core member in the EU also had a high level of deficit, and despite lowering its deficit to meet the requirements to enter the Eurozone, had increased its deficit after 2001.

Another key criteria defined in the SGP was the debt levels as a percentage of GDP. Several categories were outlined by the European System of Accounts that would contribute to the general government gross debt, which were: Currency and deposits, loans, and securities. Figure 2 shows the Eurozone countries Debt/GDP levels.

Figure 2: Government gross debt as percentage of GDP



Source: Eurostat

Overall, the trend of the government gross debt of the Eurozone countries has been decreasing during the time period. At the start of 1995, Greece, Belgium and Italy had very high debt levels, and what's apparent is that Belgium and Italy made substantial improvements over the years, thus justifying that they were actively reducing their debt to satisfy the Maastricht criteria. Greece on the over hand, instead of decreasing had increased their debt levels by 10% over the time period.

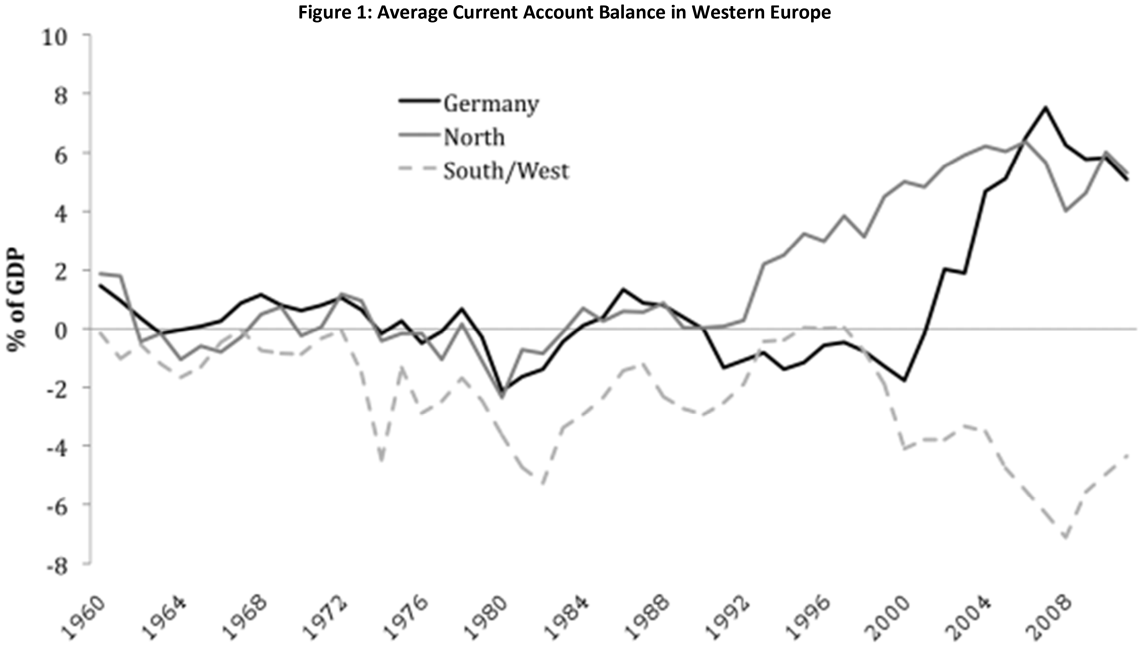
2.2 European Central Bank

Since the introduction of the Euro in 1999, the member states gave control of monetary policy to the European Central Bank (ECB), which sets interest rates to the Eurozone. Some countries, such as Germany and France had slow growth, and so the ECB set low interest rates. However, this was too low for booming countries such as Ireland and Spain, which contributed to the real estate bubble. Furthermore, as member states have no power over monetary policy, they are more prone to adverse economic shocks and are unlikely to adjust due to the fact that the control over policy instruments is held by the ECB, and countries experiencing these economic shocks would see a decrease in tax levels and an increase in social spending placing pressure on public finance. Unlike other countries such as the UK or USA, there is no mechanism at the central level to transfer funds as “automatic stabilisers” to help with recovery shocks. The sense of powerlessness is created as it leaves Eurozone members in a predicament when there are too few policy levers available to tackle the economic shock, which adds to the overall instability of the system, whilst heightening economic crises.

2.3 Trade and Current Account Imbalances

According to De Grauwe (2010), the origins of current account imbalances and the European sovereign debt crisis had been linked to random shocks, while Berger and Nitsch (2010) argued that the rising intra-European current account imbalance was due to the introduction of the Euro in 1999. I would like to bring up the fact that evidence has shown that after the European integration, the current account surplus in Northern Europe matches comparatively to the high current account deficit in Southern Europe. How we classify these two groups is determined by intertemporal preferences. In Northern Europe (Belgium, Denmark, Finland, Germany, Netherlands, Austria, Sweden, and Switzerland) the preferences for price stability, tight fiscal policy stances, high investment, and export driven growth, while Southern and Western Europe (Spain, France, Portugal, Greece, Italy, UK) preferences for high consumption, inflation, net capital imports, and expansionary fiscal policy stances. Figure 1 shows the current account balances of the Eurozone countries, and what’s to note is Germany being listed both separately and part of Northern Europe due to the fact it played a crucial role for current account

Figure 1: Average Current Account Balance in Western Europe



Source: European Commission AMECO database

imbalances in Europe.

As trade integration was a mutual interest by both groups after the European integration, it allowed Southern and Western European markets who were more consumption orientated to be exposed to the export-orientated countries in Northern Europe. With economies of different countries growing at different speeds, countries such as Spain, Ireland, and Greece were importing more due to their economies growing strongly, and this resulted in a large trade deficit which in the end had to be funded by high levels of public and private borrowing. With a huge trade deficit, it caused these countries to become less competitive internationally, especially in terms of Labour and wage costs.

2.4 Impact on German unification

The reunification in the short term led to a positive aggregate demand shock for West Germany, leading to a boom. This caused an increase in demand for capital investment in the east, and combined with the reduction of the money supply to counteract its high inflation had caused the interest rate to increase. High inflation, high interest rate and a reduced money supply unwillingly made the government to raise taxes. Debt in turn increased from 41.8% GDP in 1989 to 64.2% in 2003, and the current account went from a surplus in 1989 to a 3.1% deficit in 1991. As Sachverständigenrat (2005) pointed out, it is uncertain to a particular degree as to how the western stagnation had associated with the reunification. It could be due to government debt that caused consumers to alter their wealth, thus causing growth to stagnate as consumer spending decreased (Carlin and Soskice 2006).

With the knowledge of knowing how the reunification had an effect on the economy of Germany, it also impacted Europe as a whole as well. With the rise of the interest rate, it inevitably led to a crisis for the European Exchange Rate Mechanism (ERM) who was the predecessor of the EMU. The Deutschemark required a revaluation with the ERM due to its high interest rate, and as a result devalued other ERM currencies. This disrupted the growth of other European countries as they tried to counteract by attempting to maintain the existing exchange rate as they were afraid of a loss of deflationary credibility; however was not successful as they were forced to devalue due to speculative attacks in 1992.

2.5 Level of competitiveness in the EMU

Since the creation of the ECB, member states no longer have control over revaluation of the currency to reduce the economic impact over a fall in competitiveness globally. Therefore, nominal exchange rate movements had to be replaced by wages (De Grauwe, 2009: 41; Carlin, 2012: 13). Throughout the first years of the EMU, the southern countries registered with high inflation and so were unable to restrain wage growth. According to De Grauwe (2009:40), the average year-over-year inflation of southern Europe went above the ECB 2%, while Germany's inflation rate was around 1.5%.

The ECB's "one size fits all" interest rates couldn't really be applied to the Eurozone, as it was too loose for southern countries while restrictive for northern countries. The effect of low real interest rates had two effects in the south. Firstly, it led to higher consumer and investment demand in the sheltered sectors where it had no foreign competition pressure at all, and so the increase in this non-tradable sector increased the upward pressure on wages. Secondly, a low real interest rate produced a massive sum of budgetary savings for the southern governments. With these two effects in mind, it caused wage setters in the sheltered sector to adjust the wages and so increase it above the Euro area average. As Carlin (2012) pointed out, rational wage setters in both sectors (exposed and sheltered) should have set wage convergence within the ECB inflation target and productivity growth. Johnston and Hanké (2009) and Hanké(2013) provided evidence, reporting that the nominal wage growth and labour productivity laid above the EMU average in Portugal, Spain, and Italy. Similarly Johnston (2012: 348) reported that Italy, Spain, and Portugal showed wage growth in sheltered sectors exceeding those in exposed sectors between 1999 and 2007.

The increase in budgetary savings considerably raised the public sector wages, which the led to a wage mark-up in these economies. International competitiveness as a whole for southern countries were threatened as there was an increase in employment and wage in sheltered sectors, meaning that as they are not pressured by foreign competition, there was no reason for competitiveness, thus causing a huge current account deficit in these countries. On the other hand, Germany increased its competitiveness by restraining wage mixed with pattern-bargaining (Carlin, 2012: 6). Several studies shows that pattern bargaining are correlated with lower public sector wage growth and thus higher overall wage moderation (Johnston, 2012; Traxler and Brandl, 2012).

3.1 Policy decisions of the ECB- LOLR & LTRO

As the ECB became the lender of last resort (LOLR), they can provide banks with unlimited liquidity to prevent bank runs, reducing the motion of a liquidity crisis. One of the main arguments of why ECB shouldn't become a LOLR in the sovereign bonds market was that it would lead to inflation. However, this was put down as in early 2012, the ECB designated around €1 trillion of liquidity support to the Eurozone banking system in name of the LTRO program. The Long Term Refinancing Operation is a cheap loan scheme for European banks to help ease the Eurozone crisis. As Kang (2015:5) stated, the LTRO provided short term liquidity support to help maintain credit lines. As the banks use their own sovereign debt as collateral, it allows demand for bonds to increase and lowers yields. As a result, Spain and Italy have taken a loan to help lower their yields as the selling of bonds from investors had lowered the price of the government bonds. The reduction of the interest rate, alongside the increase in liquidity support of banks can spur consumption and investment, as banks would be able to lend.

3.2 Policy decisions of the ECB-OMT

Outright Monetary Transactions is a program under the ECB in which operates in secondary sovereign bond markets, aimed at safeguarding an appropriate monetary policy transmission and the singleness of monetary policy (ECB Press release, 2012). For a Eurozone government to be eligible for OMT, four conditions must be met. Firstly, the state needs to have received financial aid from the bailout funds (ESM) in the form of either macroeconomic support or precautionary credit lines. Secondly, an MOU must be signed (Memorandum of Understanding) and must be in compliance with the OMT purchases. Thirdly, the state must have complete access to private lending markets. Fourthly, once the pre-conditions have been met, and the government bonds interest rates are found to be distressed by the time they gained complete control of the private lending markets will finally allow the state to purchase government bonds that have between 1-3 year maturities. The IMF is involved to design country-specific conditionality and monitoring the program. Only Portugal and Ireland were eligible for OMT support, however as none of them met the 4th condition, no OMT had yet been activated by the ECB.

4. Bailout Program for Greece

Fiscal disaster had hit Greece, as the budget deficit never was below the 3% Maastricht Criteria, nor did its debt/GDP ratio decline towards the 60% ceiling, but instead hovered around the 100% mark (see figure 2). As a result to the debt crisis, confidence fell and the government saw a wide spread of bond yields , as well as an increasing in cost of risk insurance on credit default swaps.

The Greek government issued a series of austerity measures to counterattack the sovereign debt crisis, which became the First Economic Adjustment Programme which began from May 2010 to June 2011. Eurozone countries and the IMF agreed to a three year €110 billion loan, paying 5.5% interest. As a result of this, credit rating agencies immediately downgraded Greek government bonds to a lower standard. The aim of this measure was to limit the budget deficit. The second Economic Adjustment Programme once again is an MOU, in which Euro area leaders agreed to extend Greek loans payments from 7 to 15 years and agreed to reduce the interest to 3.5%. An additional €109 billion support package was given to help improve the economy. The Greek government had a total of 14 austerity packages to this date, requesting more loans to help improve the economy and living standards.

5. Conclusion

Europe had been divided into two country groups since World War II due to different ideologies regarding fiscal and monetary policy as well as intertemporal preferences. While these philosophies exacerbated the current account imbalances; other factors crucially also played a role in the making of the Eurozone Crisis, notably the structural problems of the EMU. Since the creation of the EU, there were no mechanisms regarding dealing with a fallout of insolvency crisis, or sovereign debt crisis due to the fact that they lacked financial resources. The financial crisis, and Eurozone debt crisis has put forward major and successful policies that allowed the Eurozone countries to recover, noteably the OMT and LTOR. This in turn reinforced and reformatted the EU framework.

6. References

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