Special Report 2012/05

Why is the euro crisis not ending? *(part 1)*

In the first part of this series, we will show that fiscal indiscipline is not at the root of this crisis. This is why the current policy prescription (fiscal austerity) has not been the silver bullet most hoped for. In part 2, we propose a number of steps the European policymakers can take in order to end the crisis. All it takes is a little bit of imagination and a lot of willingness.

Have we misdiagnosed the crisis?

What happens if a doctor misdiagnoses a patient? In that case, the wrong medication is prescribed and this, in the best outcome, will not cure the disease while it may even have very damaging, if not fatal, consequences for the patient. Arguably, the same is true for an economy. Wrong macro policy recommendations will not help an economy and may even seriously harm it.

So how have the European leaders, who are acting as economic doctors in the region, faired so far? Have they come up with policy recommendations for the beleaguered periphery countries of the eurozone (Greece, Italy, Ireland, Portugal and Spain; GIIPS) that enables them to reach higher economic prosperity in the long-term? Or are they pushing them deeper into a hole with no bright prospects? To answer this question we need to correctly diagnose the problem. Only then can we come up with policy recommendations that can potentially end this crisis (see part 2, Rabo Special Report 12/06).

How did we get into this mess?

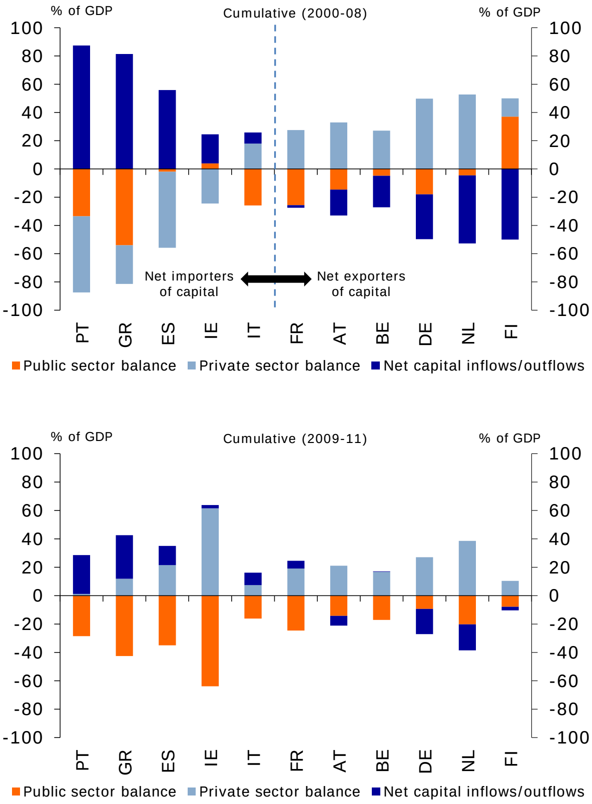
The German version of the story, which has sort of become conventional wisdom, can simply be summarised in two words: *fiscal indiscipline*. The policymakers in Berlin, who dominate the policy agenda in the euro area, are convinced that fiscal profligacy got us into this mess and therefore a return of prudent fiscal policy is our way out.

Is this diagnosis correct? The short answer is: no. Of course, fiscal irresponsibility was a problem in Greece, Portugal and, to a lesser extent, Italy. Governments in these countries had been running sizeable (structural) deficits in the run up to the financial crisis in 2008/09. But Spain and Ireland were the poster children for responsible fiscal policy before the crisis. Both countries continuously posted large budget surpluses in the years leading to the crisis and their debt-to-GDP ratios in 2007 were among the lowest in the euro area (Ireland: 25%; Spain: 36%).

So why did all these countries experience a debt crisis? The answer is widening macroeconomic imbalances within the region. As figure 1 illustrates, the private and/or public sectors of the GIIPS were living way beyond their means since joining the euro area (total expenditure in the period 2000-08 exceeded total income by 87%, 81%, 56%, 21% and 8% of GDP in Portugal, Greece, Spain, Ireland and Italy, respectively). This ‘extravagant’ lifestyle was largely sponsored by net savers (e.g. Austria, Finland, Germany and the Netherlands), which were willing to export huge amounts of capital to these countries in the go-go years. The result was a rapid accumulation of external private and public sector debt in the GIIPS in a very short time-span. Since most of the capital inflows into the periphery were either consumed (especially in the case of Greece and Portugal) or invested in unprofitable projects (e.g. housing markets in Ireland and Spain), these imbalances were clearly unsustainable.

As we now know, this feast ended as soon as the financial crisis made landfall. Falling asset prices, incomes and credit availability combined with a surge in jobless rates led to extreme private sector frugality. *All* countries in our sample started running private sector surpluses in 2009-11. Given the negative feedback loop between private sector saving and economic activity, governments judged that the expansion of their own balance sheets was necessary to stave-off a depression-like scenario. So once the private sector had to be bailed out, private sins became public problems. Ireland was a classic example of this. The country's debt-to-GDP rose by an eye-watering 38.5%-points due to its support for the financial sector.

Figure 1: Sectoral financial balances

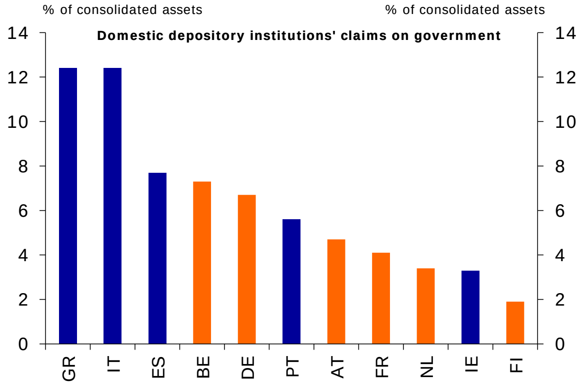


Source: Reuters EcoWin, Rabobank

But this Keynesian policy amounted to a 'Pyrrhic victory' for some sovereigns as they themselves came under the spotlight. Market participants realised that not all governments had the fiscal space to rescue their economies without bringing their own solvency into question. The result was an eventual loss of confidence in sovereign bonds of all the GIIPS and an ensuing rise in interest rates. As such, the rise in sovereign risk in the GIIPS started creating problems for the banking sector given large exposure of banks to their own governments (see figure 2).

The negative feedback loop between banks and sovereigns, whereby their respective weaknesses reinforce each other, is causing a lot of headache for the GIIPS. Banks' funding costs are rising (for those that even have access to the international capital markets) owing to higher perceived sovereign risk[1]. Conversely, weaker banks raise potential bailout costs and this increases sovereign risk. Thus far, the policy prescription to end this vicious feedback loop is to force both banks and governments to repair their balance sheets at the same time.

Figure 2: Home bias in the banking sector



Source: IMF

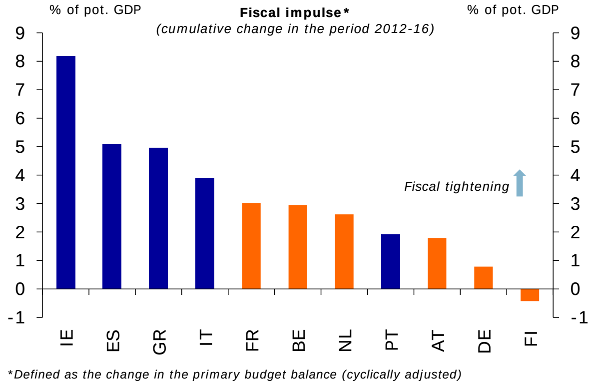
Current policy prescription

Banks in the GIIPS have already been shedding assets for a while now amid concerns about sovereign's solvency, weaker economic growth, and tighter regulatory environment. Yet they are expected to deleverage even more going forward to withstand adverse shocks. According to the IMF, 58 EU-based banks will shrink their combined balance sheet by as much as EUR 2,000bn (or almost 7% of total assets) through end-2013. This will lead to reduced loan supply in the eurozone. The

[1] Banks are hit through four potential channels. First, increases in sovereign risk cause marked-to-market losses on banks' government bond holdings (trading book). Second, falls in the market prices of sovereign bonds reduce the value of the collateral that banks can use to secure wholesale and ECB funding, and can trigger margin calls from counterparties. Third, rising sovereign risk reduces the funding benefits that banks derive from government guarantees. Fourth, sovereign downgrades often flow through to lower ratings for domestic banks, which further raises their funding costs.

GIIPS are expected to face the biggest cutbacks in credit. As regards the sovereigns, the GIIPS would need to push through further austerity measures in the coming years (see figure 3). This process is now being formally enforced by the the Fiscal Compact[2] (see Rabo Macro Comment 12/14 for details).

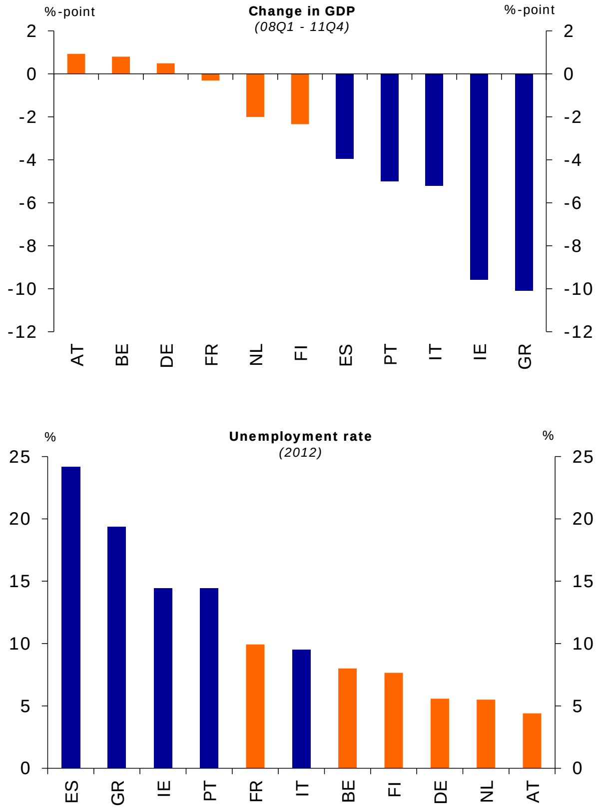
Figure 3: Austerity is the only game in town



Source: IMF, Rabobank

Sadly, the simultaneous domestic private and public sector deleveraging has pushed the economies of the GIIPS deeper into the red (see figure 4, top panel) and if the recent history is any guide, economic pain will not go away until the deleveraging process comes to an end. This will undoubtedly place an enormous strain on the periphery's social fabric given high and rising jobless rates (see figure 4, bottom panel). To ease the pressure on sovereigns and banks, the European leaders decided to combine the bailout funds (ESM and EFSF) so that their firepower would amount to EUR 700bn. This did not help alleviate market fears because the gross financing needs of Italy and Spain alone would be around EUR 1900bn until end-2014. This is not even taking account of the contingent bailout costs arising from banking sector losses.

Figure 4: Divergent recoveries



Source: Reuters EcoWin, IMF

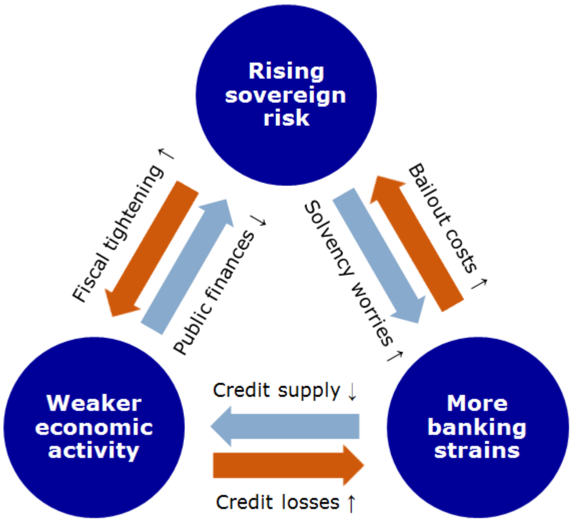
Given the lack of a strong firewall, the European Central Bank (ECB) pumped around EUR 1trn into the European banking sector (in two phases; December 2011 and February 2012) as part of its 3-year long-term refinancing operations (LTRO). This certainly helped ease financial conditions in the region and helped pull the most liquidity-constrained European banks back from the brink. However, the LTRO magic seems to be waning recently. Government bond yields of Spain and Italy are once again on the rise as market participants realised that their weak fiscal fundamentals have not been appropriately addressed by ECB's massive liquidity injection. The LTRO was a temporary sticking plaster that only bought some time. Even worse, by encouraging banks to stock up on domestic government debt, the LTRO loans have reinforced the pernicious links between weak banks and weak sovereigns.

Against this backdrop, the GIIPS have found

[2] In broad terms, the European governments will be obliged to follow so-called 'medium-term budgetary objectives' (MTO), which aim to guarantee debt sustainability by demanding that every country reports a structural budget deficit of at most 0.5% of GDP. Meanwhile, the fiscal pact explicitly requires member states to gradually reduce their debt ratios to achieve the 60% target. Failure to comply with this will trigger an Excessive Deficit Procedure (EDP) even if the country meets its 3% deficit criterion.

themselves in a very uncomfortable position, whereby deleveraging by banks and sovereigns is acting as a considerable drag on economic activity and that, in turn, is resulting in weaker public finances and rising non-performing loans in the banking sector. Obviously, this means more balance sheet repair is required, which only adds insult to the injury. The negative sovereign-bank-growth feedback loop seems to be getting worse and there is no end in sight.

The sovereign-bank-growth feedback loop



To break away from this vicious loop, the European leaders have called upon the GIIPS to carry out much-needed structural reforms so that aggregate demand gathers some strength. But will this work? There are reasons to be sceptical. Scholars that studied reforms conclude that their positive impact on the economy is subject to long lags. Country experiences, such as New Zealand, Germany and the UK, illustrate that reforms can take years and sometimes decades before translating into higher growth (for a survey of studies see IMF, 2011). Empirical cross-country evidence carried out by the IMF (2004) corroborates this conclusion.

What's more, reforms can sometimes increase the pain even more in the short-run. For example, research shows that in many cases, labour market reform has initially led to higher unemployment as workers are shaken out of unproductive employment. Moreover, by upsetting the established status quo, such reforms can raise uncertainties about income/job prospects for the 'protected' group. This may cause them to postpone spending which, at least in the short term, can add to downward economic momentum. So structural reforms are certainly needed, but we cannot expect them to come to the rescue in the short-term.

Bottom line: The European leaders have come up with the wrong diagnosis of the problem facing the GIIPS (fiscal indiscipline as opposed to widening macroeconomic imbalances) and are now prescribing the wrong medicine that pushes these countries only into a more precarious position and in the meantime keep the euro-exit discussion alive. Forcing the governments in the GIIPS to carry out harsh austerity measures while asking their banks to boost their capital buffers is doomed to fail if economic growth fails to pick up. Indeed, there is a high risk that some periphery countries will eventually opt for a disorderly sovereign default. Even a subsequent exit from the eurozone is not entirely unthinkable.

To avoid such a scenario, a comprehensive solution is required to end the adverse sovereign-bank-growth feedback loop. In part 2 (see Rabo Special Report 12/06) we will come up with a number of macro policy measures that achieves this goal.

May 2012

Shahin Kamalodin (+31) 30 - 2131106)
S.A.Kamalodin@rn.rabobank.nl

www.rabobank.com/economics

References

IMF (2004). Fostering Structural Reforms in Industrial Countries. *World Economic Outlook April*.
IMF (2011). Italy: Selected Issues. *Country Report No. 11/176*.