Summary of European Debt Crisis

- Why was the Euro created?
- What was the immediate effect of Greece on joining the Euro?
- What happened in Greece that showed there was a problem?
- How did this effect Greek debt?
European Debt Crisis

- First we’ll talk about specifics:
  - Timing of events
  - Scale of the economic impacts

- Then we’ll discuss the way forward:
  - What can the Eurozone do to end the crisis?
  - Can/should the Euro be maintained?
History of the Euro

- Framework set in the Maastricht Treaty (1992)
- Officially came into existence on Jan 1, 1999
  - First an accounting currency
  - Became legal tender on Jan 1, 2002
- Originally had 14 members
- Now has grown to 27 countries over the years
- Now second most traded currency in the world
European Union vs. Eurozone

- The EU is not the same thing as the Eurozone
- There are countries in the EU that don’t use the euro (e.g., the United Kingdom and Poland)
- But all countries in the Eurozone are in the EU
- With some exceptions, countries joining the EU have to make a plan to join the Eurozone
- Kosovo and Montenegro adopted the euro as their currency without being EU members
Purpose of the Euro

- The Euro is designed to integrate the European economy
- As a large number of relatively small countries (compared to the US and China) they had little international power
- Would like to be a single, powerful economy
- Requires:
  - Firms that can easily operate between countries
  - Uniform trade policy
  - Fixed exchange rates between countries
- Having a unified currency does all of those things
Requirements of the Euro

- In order to join the Euro, countries must meet several requirements:
  - Debt to GDP ratio < 60%
  - Budget Deficit to GDP ratio < 3%
  - Inflation Rate < 2.5%
  - Interest Rates < 4.81%
  - At least 2 years a member of the European Exchange Rate Mechanism (band around Euro)

- Also, after joining must maintain standards

- … that part didn’t happen
Prior to the Crisis

- Period from Euro adoption to crisis (2002-08):
  - Low international interest rates
  - Real estate bubbles in many countries
  - Rising budget deficits in many EU countries
  - Internationalization of debt: e.g., France owned Greek debt with value equal to 14% of Greek economy
- Also many good things, such as large increases in within-EU trade and business activity
- More within-EU migration, education programs
Catalyst for the Crisis

- Before the Euro, many of these countries had very different inflation rates, and interest rates
- After the Euro, interest rates all converged:
  - Investors perceived Euro-debt to be one thing; as good from Germany as from Greece
- A new government took over in Greece and reported that the previous government had been under-reporting the budget deficit
  - Instead of 3% of GDP, more than 12% of GDP
- Interest rates on Greek debt spiked, and broke the parity that they had before
Yields on Government Bonds

Eurozone and UK 10-year Government Bond Yields
January 1993 to October 2011

Source: European Central Bank Statistical Data Warehouse

- Germany – black
- France – blue
- Italy – magenta
- Spain – orange
- Ireland – green
- Portugal – brown
- Greece – red
- UK – purple

- Euro introduced
- Lehman collapse

Graph showing the interest rates of different countries over time.
Contagion

- Once this happened in Greece, investors became worried about international debt
- Uncertainty spread about the value of these debts
- Because their economies are all inter-connected, had real effects as well
  - Reductions in trade and supply chain disruption
- Panic spreads to debt for several other countries
Several countries that were in particularly tenuous financial positions were very vulnerable:
- Portugal
- Italy
- Ireland
- Greece
- Spain

Later, other places also had problems, including Cyprus and even France.
Effect of the Great Recession

- The Great Recession, which started in the US, had a small effect on the EU at the beginning.
- However, the drop in growth exposed problems in several economies:
  - Ireland: Huge banking sector hit hard
  - Spain: Major housing bubble burst
  - Greece: Huge public sector deficits
  - Italy: High debt/GDP ratio
  - Portugal: Huge government spending
Response to these Problems

- The European Central Bank (ECB) and IMF coordinated a series of public sector bailouts.
- That is, they lent to the governments to finance their deficits.
  - Too expensive or too difficult to borrow in normal financial markets.
- Popular press: Basically a transfer of money from Germany to the indebted countries in Europe.
  - Financing at a subsidized interest rate.
How should they have responded?

- These debts were incurred at the country level
- Should the Eurozone have responded at all?
- What would have happened if some of those countries defaulted on their debts?
- Why is it in Germany’s interest to worry about Greece?
- In the future, how does the way this crisis is handled affect the behavior of member countries?
Spreads on Government Bonds

PIIGS Bond Spreads over German Bonds
(January 1, 2008 to present)

- Greek Bailout
- Irish Bailout
- Portuguese Bailout
- Greek Bailout II
- Greek Bailout III

Source: Norge Bank, Bloomberg
Example: United Kingdom

- The UK is not on the Euro but is a member of the EU and trades *a lot* with Eurozone members.
- Their debt/GDP ratio was a little below average of other EU members.
- Government spending over GDP was about average (or a bit below).
- The UK economy was hit hard by the recession:
  - Big increase in public sector debt
  - Big loss in GDP
Example: United Kingdom

- … but there hasn’t been a sovereign debt crisis in the UK
- No increase in interest rates relative to Germany
- No need for an international bailout
- This despite a “double dip” recession

Source: Thomson Reuters Datastream
How did the UK avoid a crisis?

Nearly 30% devaluation of the British Pound against the Euro at the time of the crisis
Why would that devaluation be helpful in avoiding the crisis?

What would have happened if Greece was not a part of the Eurozone when the crisis hit?

Is this the same thing as if Greece were to exit the euro now?
Sargent’s Comparison

- Nobel Laureate Tom Sargent sees a parallel between the EU today and the USA in the 1790s
- The US states had accumulated large debts to fight the Revolutionary War
- Several states were near bankruptcy
- The federal government was weak under the Articles of Confederation
  - Unified currency
  - Central government had no power to tax
  - Reliant on individual states
US Solution to Debt Crisis

- The Constitution of the United States was a grand bargain that ended the debt crisis.
- All debt was taken on by the federal government.
- The federal government gained (essentially) all power to tax.
- Debt crisis ended immediately.
- Later during the 1840s, another state debt crisis, but the government didn’t bail them out.
  - Why?
Parallel to US Experience

- What would this solution look like if implemented in Europe?
- What are problems with implementing this in Europe?
- Likely to happen?
Current Situation

- At this point, the debt crisis is essentially over for everywhere except for Greece
  - No end in sight for Greece
  - Greece is in the middle of a Great Depression
- However, there is still high unemployment in many countries
  - Especially youth unemployment
Debt Levels

Spreads

http://markets.ft.com/Research/Markets/Government-Bond-Spreads
Exchange Rate

https://www.google.com/finance?q=CURRENCY%3AEUR&ei=0h5mVpOeEJWgjAHK27PACg