How Will the Eurozone Emerge from the Crisis?

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European Crisis: Historical Parallels and Economic Lessons
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Introduction

- Stability and growth pact was designed to ensure that Eurozone countries were fiscally responsible
- Basic elements are 3% deficit and 60% Debt/GDP ratio
- How well has it worked?

Convergence criteria

Inflation rates

- Cannot exceed 1.5 percentage points above average of the three member states with the lowest inflation rates

Government Finance

- **Annual government deficit:** Deficit-to-GDP must be close to or be under 3% except for exceptional cases
- **Government debt:** Gross debt-to-GDP ratio cannot exceed 60%. If not achieved, then the ratio must be diminishing and approaching the reference value.

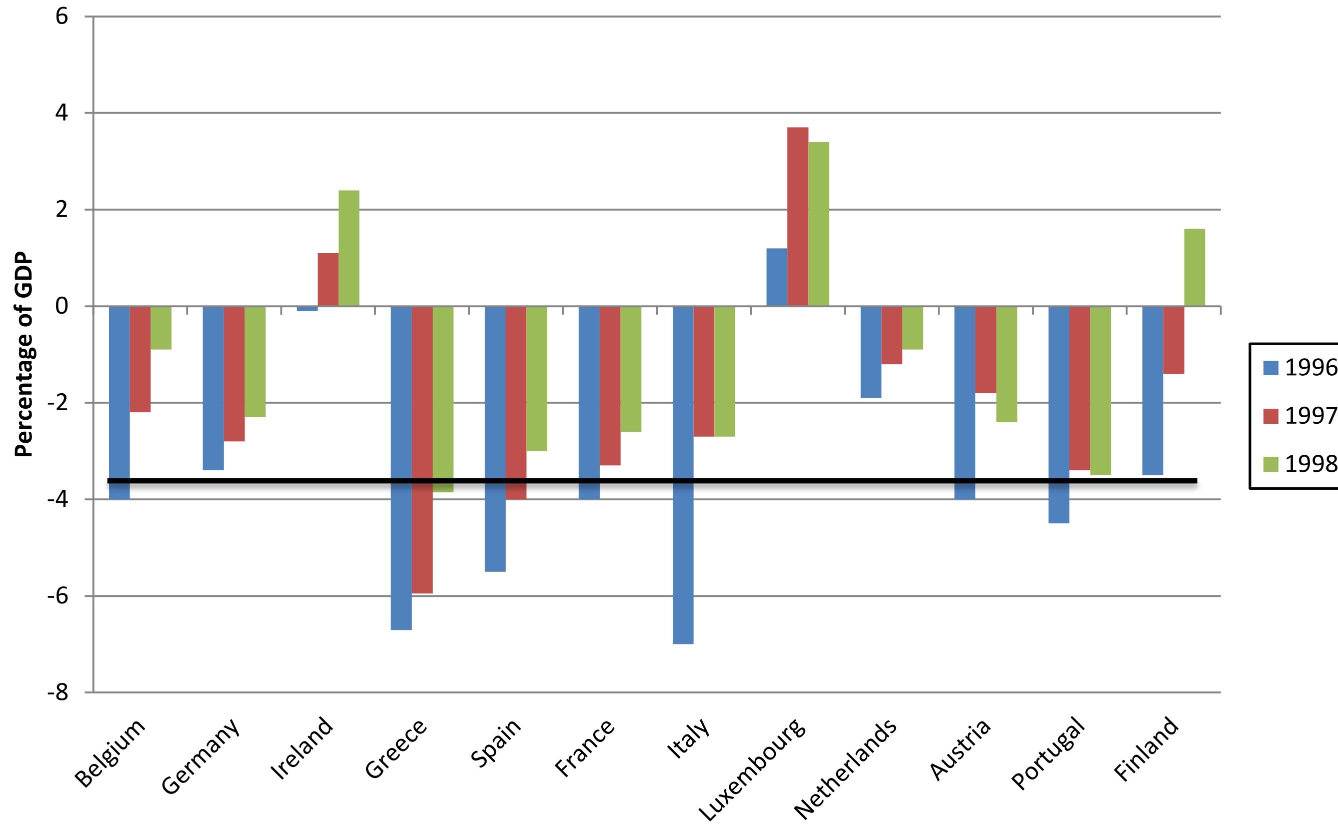
Exchange Rates

- Joined the exchange-rate mechanism (ERM) under the European Monetary System (EMS) for two consecutive years and cannot devalue currency during the period

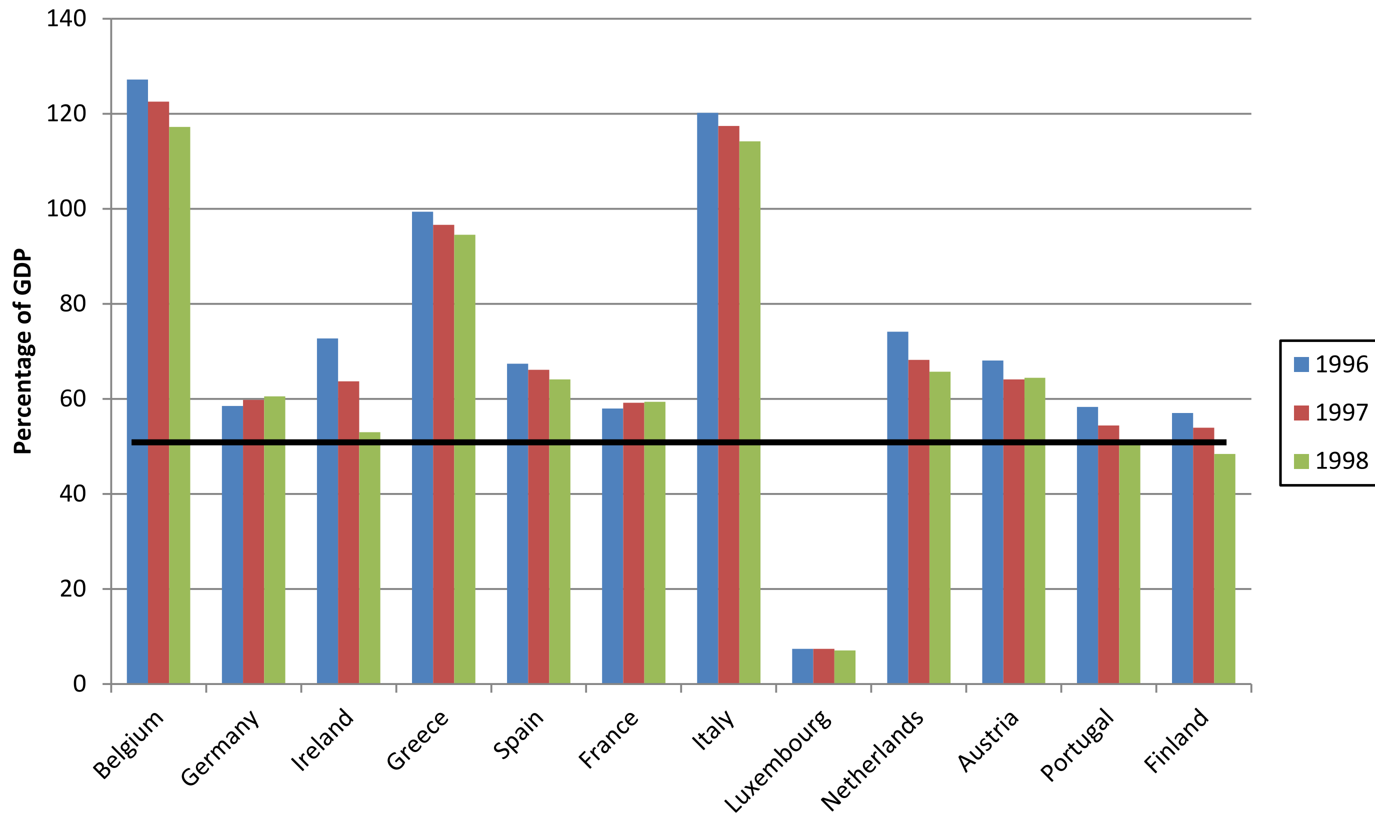
Long-term Interest Rates

- Nominal long-term interest rate cannot exceed 2 percentage points above average of the three member states with lowest inflation

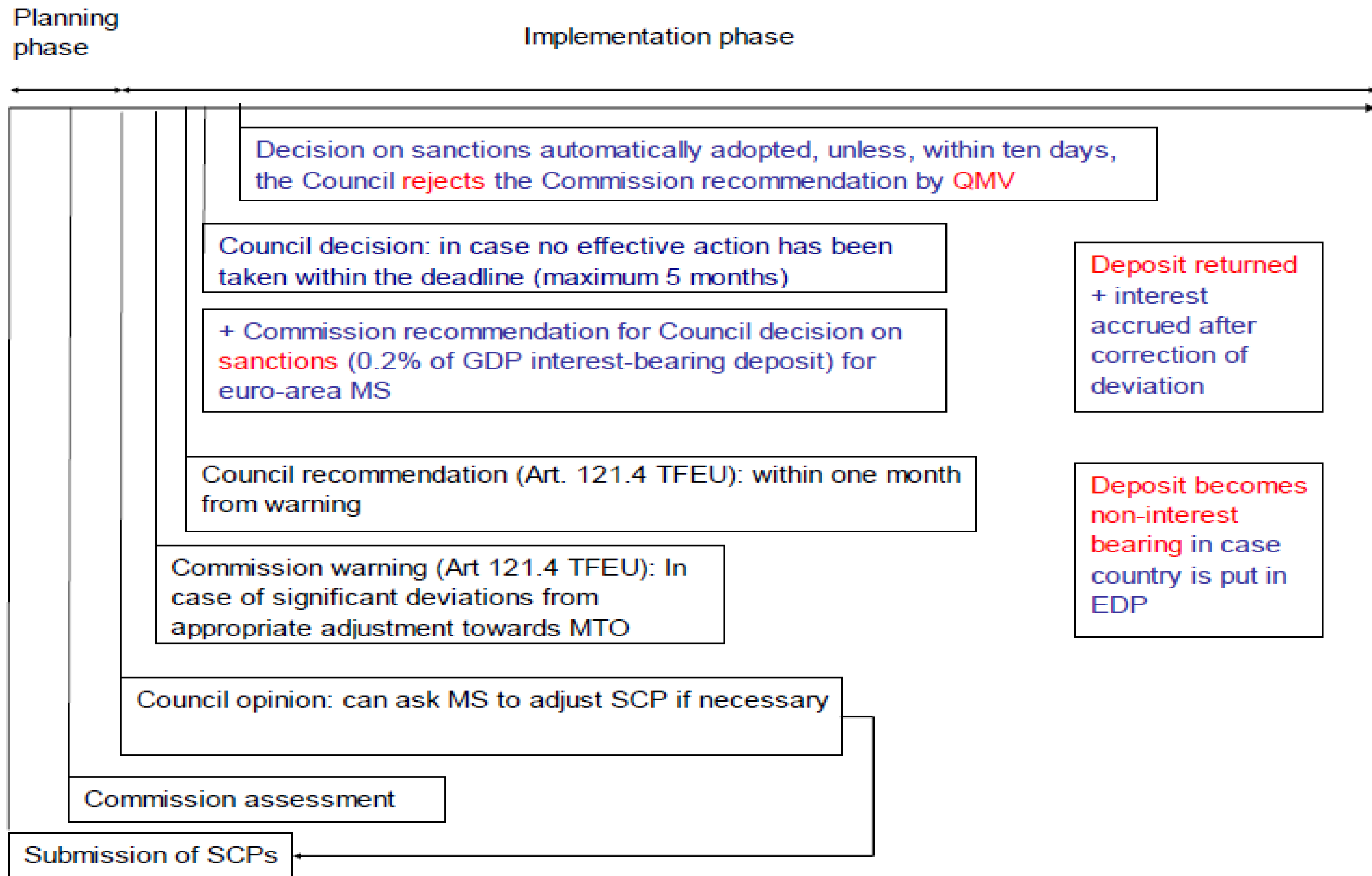
Government Surplus/Deficit, three years prior to entry to Eurozone



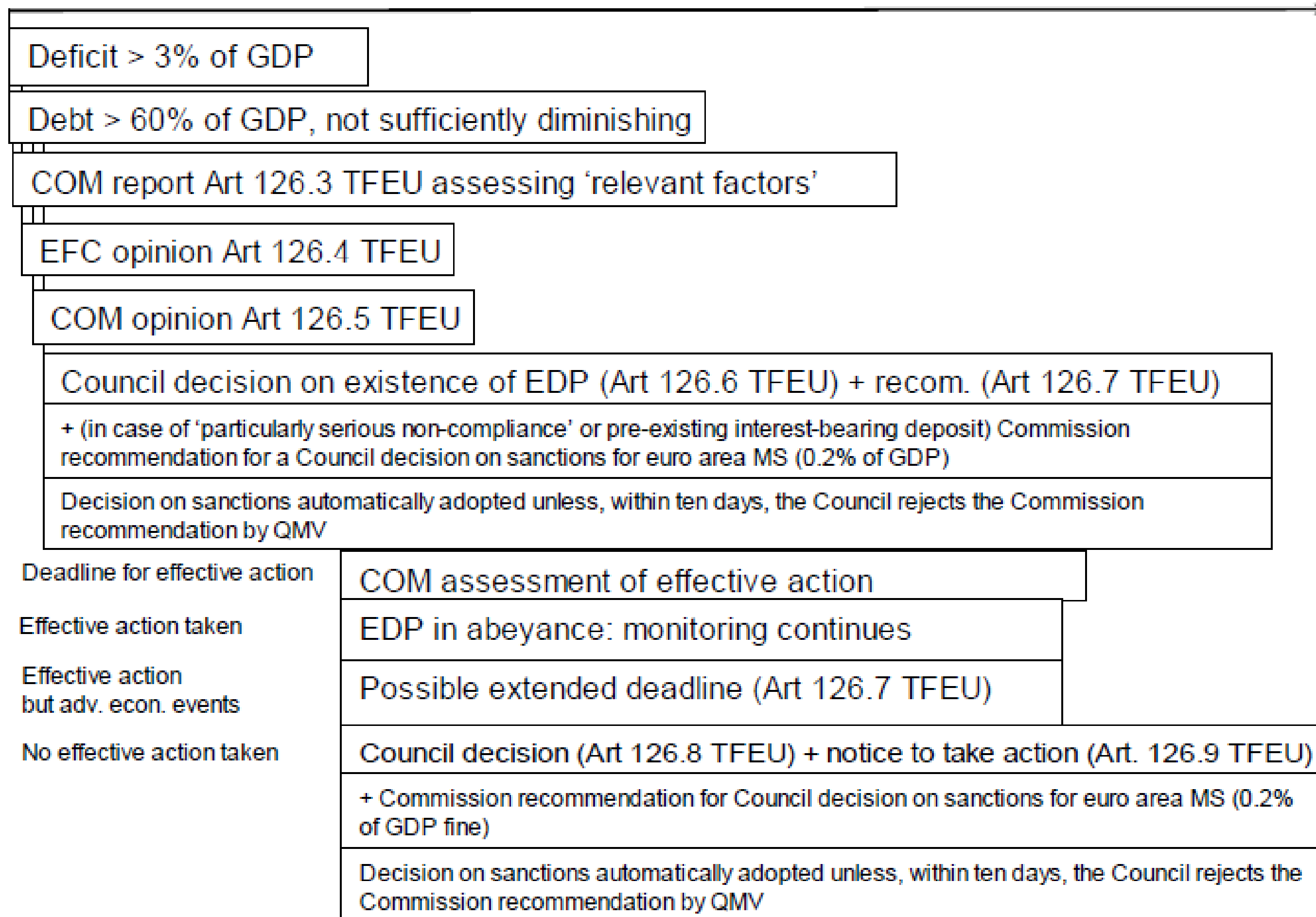
Gross Government Debt, three years prior to entry to Eurozone



Preventive arm processes



Corrective arm processes



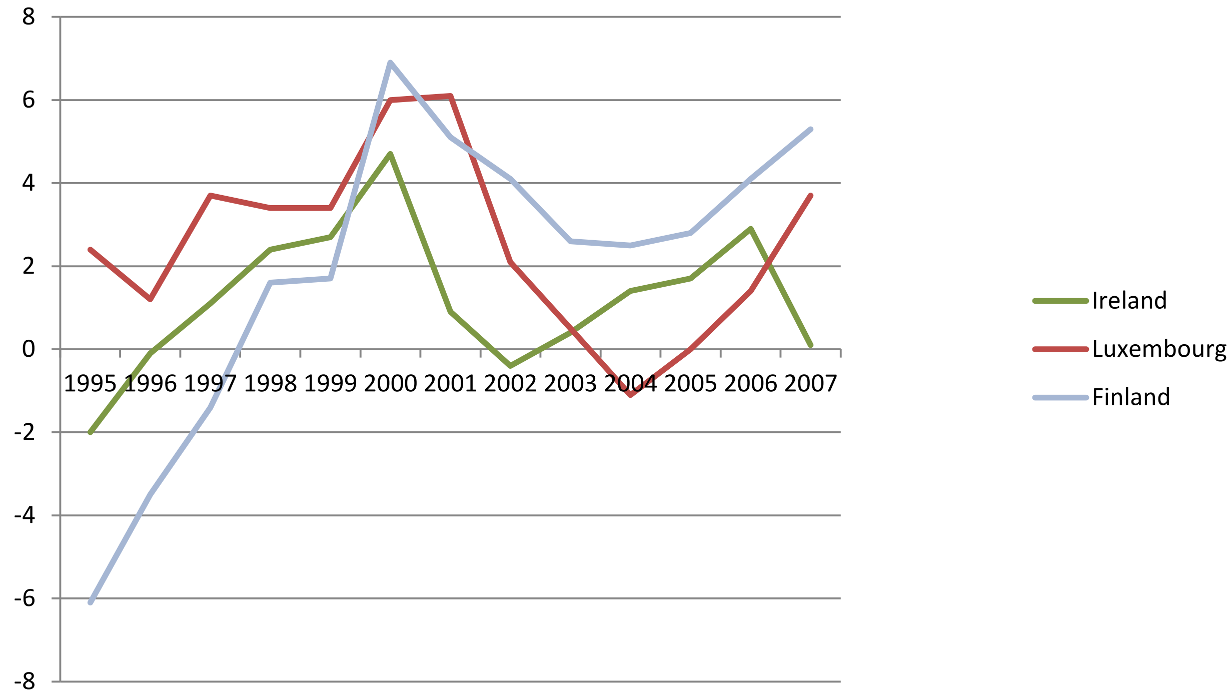
Did the system work?

- 2002-2003: Germany and France had problems meeting the SGP deficit rules
- November 2003: The EC presented evidence to ECOFIN that Germany and France had not taken adequate steps to reduce excessive deficits
- Political pressure from these countries led to the suspension of the pact in December 2004
- No country was penalized

2005 reform of pact

- Loosened escape clauses
- Lengthened deadlines for taking action
- Expanded circumstances for longer adjustment periods

Eurozone government surplus/deficit 1995-2007



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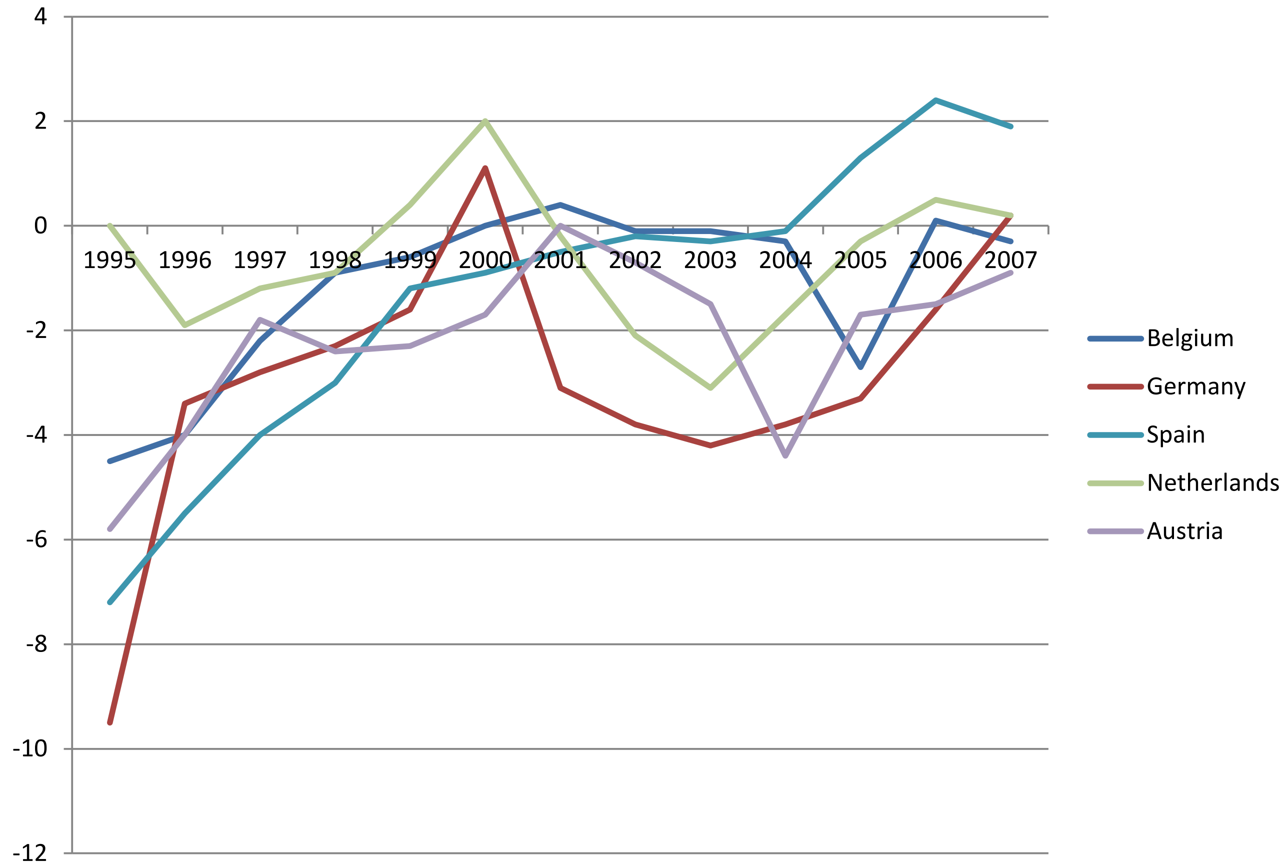
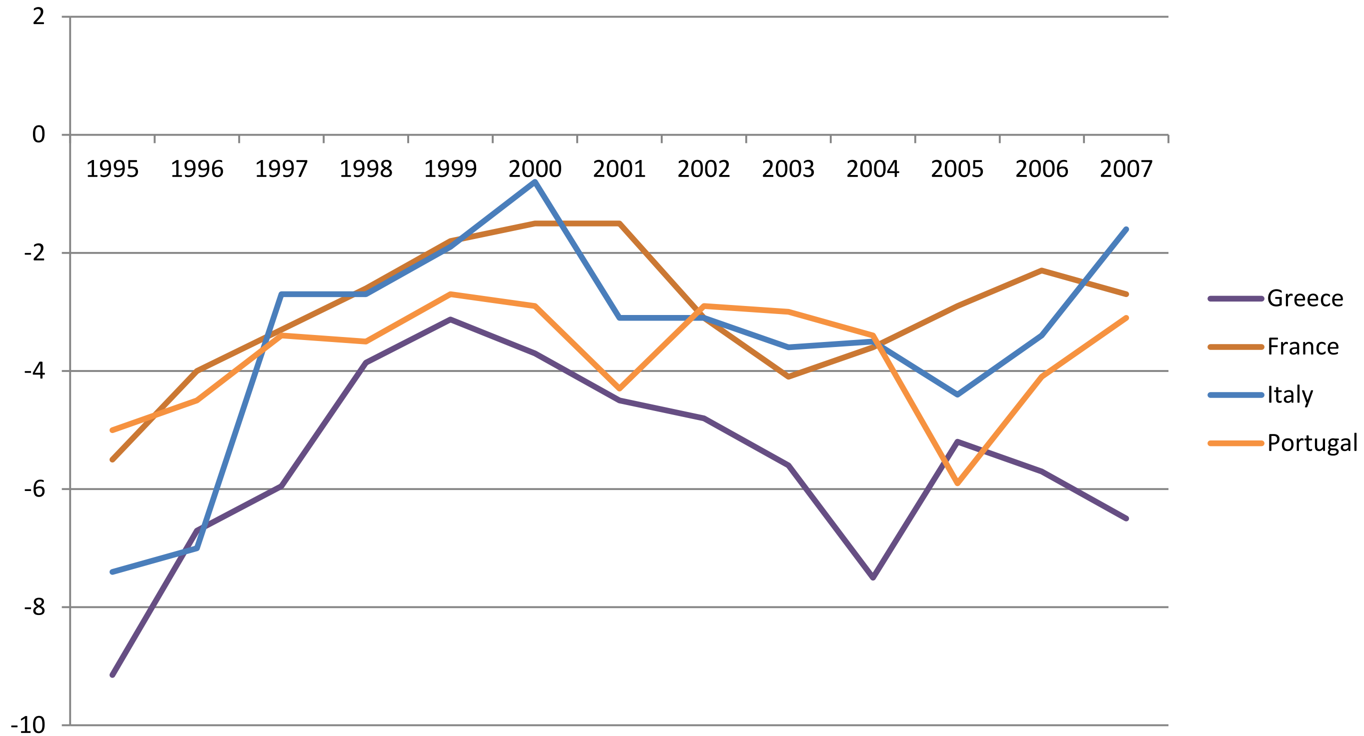


Eurozone government surplus/deficit 1995-2007



Violations before the crisis

- All countries except Luxembourg and Ireland violated the 3% deficit rule
- A number of countries increased debt/GDP ratios particularly Greece
- No countries were penalized for violations
- Comparing other OECD countries with Eurozone countries suggests SGP did not have much marginal effect in terms of enhancing fiscal discipline after the establishment of the euro

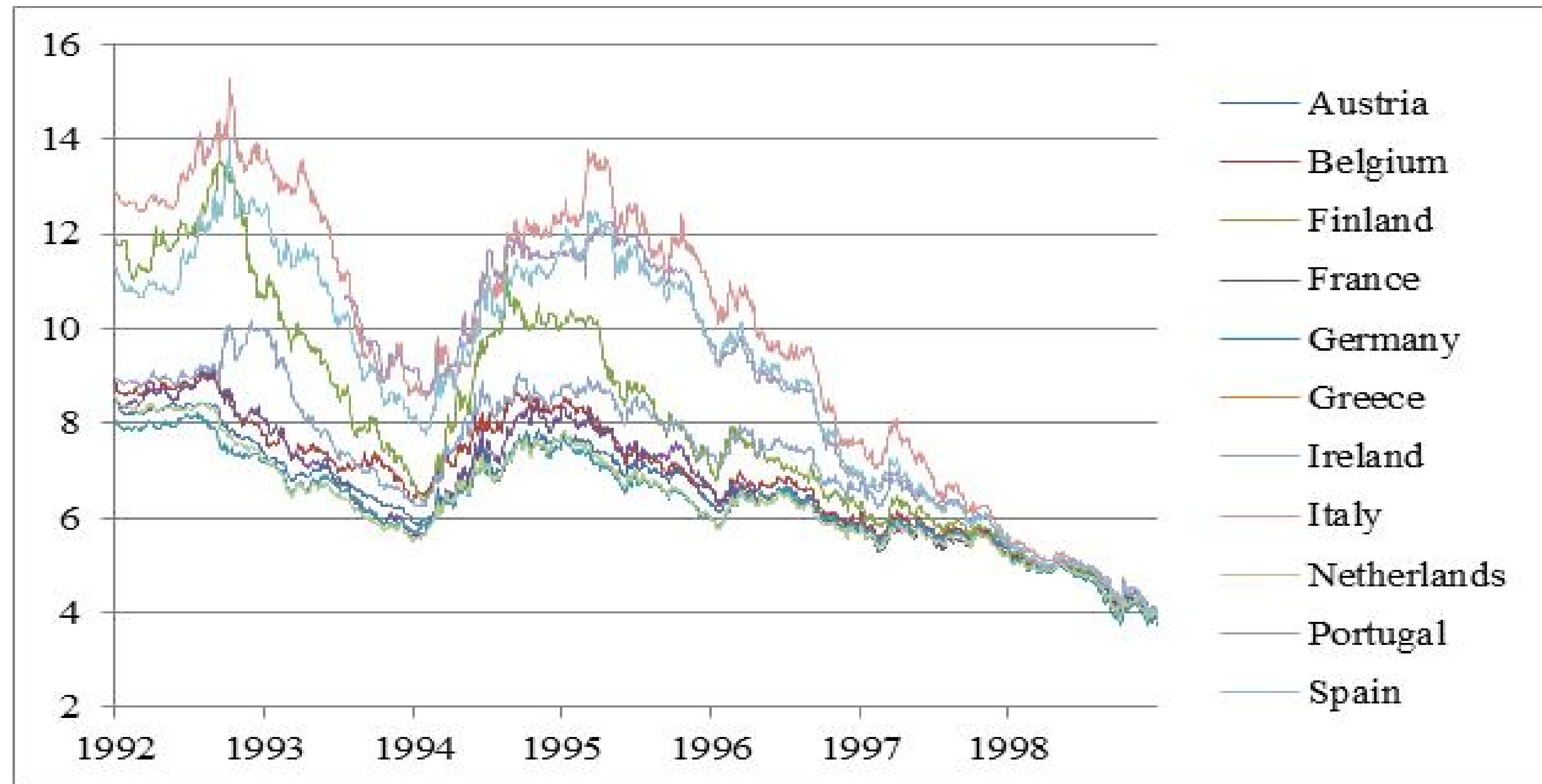
Violations after the crisis started

- After the crisis most countries violated the SGP both in terms of the 3% deficit rule and the 60% GDP rule
- Currently only 4 countries in the EU satisfy the SGP criteria 3% [60%]

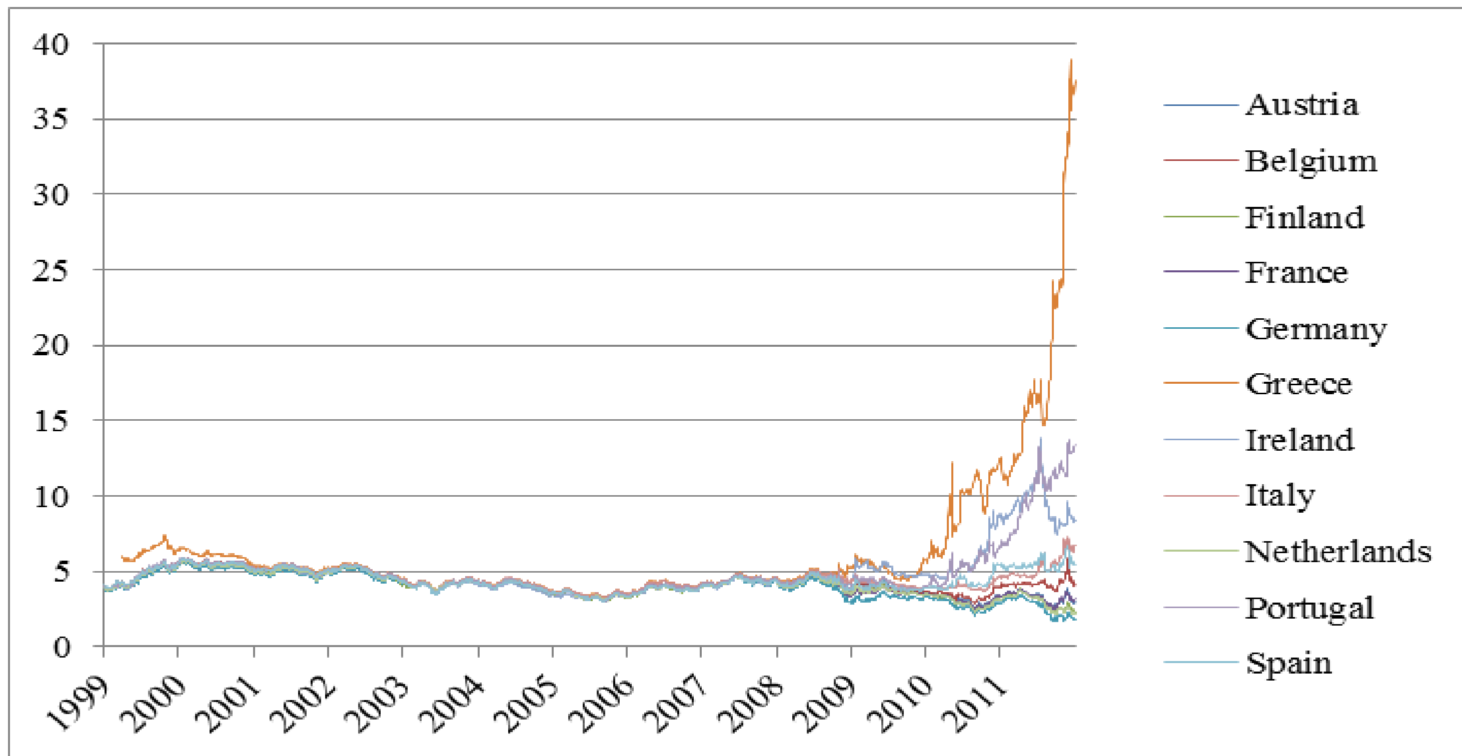
  Denmark -2.6 [49.3]
  Estonia 0.2 [6.1]
  Luxembourg -1.1 [18.5]
  Finland -2.5 [47.2]
  Sweden 0.2 [37.0]

- No countries were penalized

Market discipline before the euro: 10-year Government Bond Yields for EU-12 (1992-1999)



Market discipline after the euro: 10-year Government Bond Yields for EU-12 (1999-2011)



2012 reforms: Fiscal Compact Treaty
The "Six-Pack"

Fiscal Policy

- Regulation: Strengthening of budgetary surveillance and coordination of economic policies
- Regulation: Speeding up and clarifying the implementation of the excessive deficit
- Regulation: Effective enforcement of budgetary surveillance in the euro area
- Directive: Requirements for the fiscal framework of the Member States

Macroeconomic Imbalances

- Regulation: Prevention and correction of macroeconomic imbalances
- Regulation: Enforcement action to correct excessive macroeconomic imbalances in the euro area

2012 reforms: Sanctions and penalties

Trigger of the sanction	Sanction	Adoption
Failure to take action in response to a Council recommendation	Interest-bearing deposit (as a rule 0.2% of GDP)	RQMV
Existence of an excessive deficit, where interest-bearing deposit already made or there is serious non-compliance	Non-interest-bearing deposit (as a rule 0.2% of GDP)	RQMV
No effective action in response to Council recommendation to correct excessive deficit	Fine (as a rule 0.2% of GDP)	RQMV
Persistence in failing to put into practice recommendations from the Council to correct excessive deficit	Fine (0.2% of GDP + variable component, up to 0.5% of GDP)	QMV

Alternative reforms

- Given past history it seems unlikely that the new Treaty will be effective
- Basic problem is that the shocks during the crisis were much larger than anticipated and the Treaty does not deal with booms and busts, e.g. Ireland and Spain
- Austerity measures do not appear to be working
- Transfers between countries are one way to deal with the shocks but these are politically difficult at the moment

Alternative reforms

Introduce two formal mechanisms

1. Sovereign default within the Eurozone

2. Temporary exit from the Eurozone and reentry after recovery when the SGP criteria are met

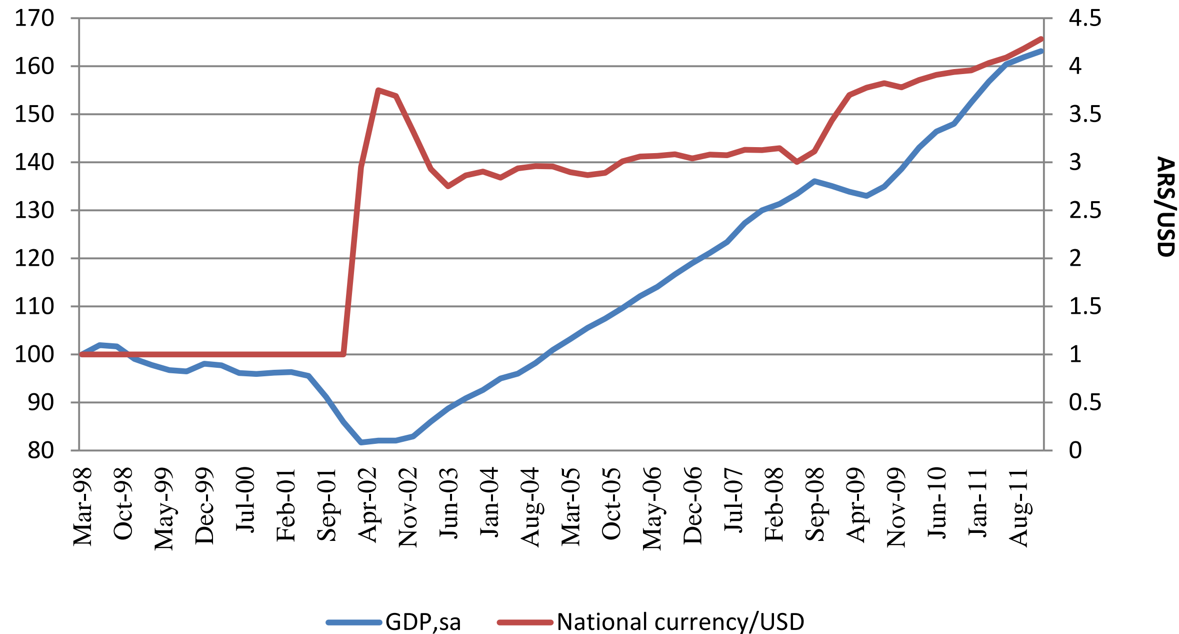
These changes would provide strong incentives for markets to impose discipline on countries

Alternative reforms

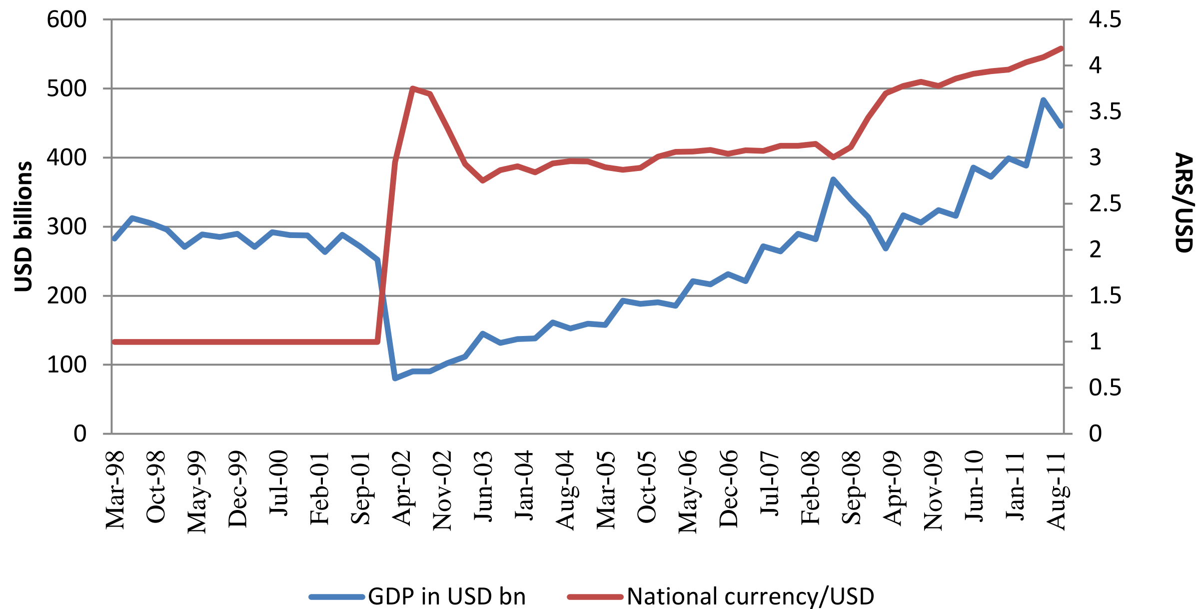
1. The Greek default in March 2012 provides a good example of how default can occur without drama and help the situation. Unfortunately, it was too little too late.

2. Argentina provides an example of how exchange rate adjustment can help an economy grow

Argentina, Normalized GDP



Argentina, GDP in US $'s



Alternative reforms

- Other examples such as Finland and Sweden in the early 1990s, Korea in 1997 and 2008 as well as the success of countries leaving the gold standard in the 1930s (Eichengreen and Sachs 1985) show the efficacy of exchange rates in promoting growth

- Current austerity policies are very costly in terms of growth and unemployment, particularly among youths

- Default within the Eurozone and temporary exit provide shock absorbers for countries and have the potential to be more efficient than current policies

Korea, Normalized GDP