The crisis of the euro-zone:

EMU structural imbalances, the sovereign debt crisis and the response of the EU

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Main points:

- The global financial crisis was an unprecedented blow to the global economy whose consequences still need to be fully appreciated.

- The last phase to date in the unfolding of the crisis was the outburst of a sovereign debt crisis in the Euro area, first in Greece, in May 2010, then in Ireland at the end of November 2010, and finally to all the members of the so-called PIIGS group (including Portugal, Ireland, Italy, Greece and Spain).

- In this presentation the run on the sovereign debt of the ‘PIIGS’ group of EU Member States is analysed within the context of the structural asymmetries of the Economic and Monetary Union with the to identify the impact of the crisis on the future of the EMU and of the PIIGS within it.

- Far from having been socialised among the members of the euro-zone and of the EU through the adoption of a real common fiscal policy and the attribution to the European Central Bank of its natural role as lender of last resort, the burden of the costs of the crisis was inflicted on the weakest countries of the system through austerity and internal devaluation. It remains to be seen if this is a price worth paying in exchange for fiscal stability.
The global financial crisis was an unprecedented blow to the global economy whose consequences still need to be fully appreciated.

Scholars identify five different stages in the unfolding of the global financial crisis. The first stage is the collapse of the US subprime mortgage market. This spilled over into the credit market with a credit crunch that led to a third phase, represented by the liquidity crisis. The fourth phase was represented by the commodity price bubble and the fifth one by the demise of investment banking in the US.

Eventually, the decision to pump an enormous amount of public money into the global financial markets avoided the global financial catastrophe. But the financial crisis had already spilled over into an economic crisis, with Ireland being the first eurozone country to technically enter into recession in September 2008. In only two years, the world as a whole experienced a GDP reduction of 6 per cent, from 5.2 per cent to -0.8 per cent, the sharpest ever recorded in history.

In the euro-zone GDP fell even more sharply, recording an incredible loss of 9% from 3.8% in 2007 to -5.2% in 2009 (Figure 1).
GDP changes in the eurozone 2000-2012
Real GDP loss 2007-2010

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<th>2007</th>
<th>2008</th>
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<th>2010</th>
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<tr>
<td>Euro area (17 countries)</td>
<td>3</td>
<td>0.4</td>
<td>1.9</td>
<td>5.2</td>
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<tr>
<td>Ireland</td>
<td>-4.3</td>
<td>-3</td>
<td>-0.4</td>
<td>1.9</td>
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<tr>
<td>Greece</td>
<td>-3</td>
<td>-3.3</td>
<td>-3.5</td>
<td>3.5</td>
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<tr>
<td>Spain</td>
<td>-3.7</td>
<td>0.9</td>
<td>-0.1</td>
<td>1.7</td>
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<tr>
<td>Italy</td>
<td>-2.9</td>
<td>1.5</td>
<td>2.4</td>
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<tr>
<td>Portugal</td>
<td>2.9</td>
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PIIGS Real Exchange Rates: 2000-2012
Who could stop the run? The ECB as the saver of last resort

However, in the wake of the collapse of Lehman Brothers in October 2008, the ECB started a novel mode of monetary policy relying not only on conventional measures, such as interest rate cuts, but also on ‘non-standard measures’. These included ‘enhanced credit support’ and ‘securities markets programs’. Such measures configured a new role for the ECB as ‘hidden/modern lender of last resort’ or, as referred to in some scholarly interventions as ‘intermediation of last resort’. The enhanced credit support relies on (a) increasing the share of liquidity supplied at its long-term refinancing operations (LTROs) relative to its regular main refinancing operations (MROs); and (b) increasing the maturity structure of its LTROs. Most importantly, all of the ECB’s re-financings would be conducted on a ‘fixed-rate full allotment’ basis, rather than a variable rate tender format, as used before. In other words, contrary to normal practice, financial institutions are allotted the full amount of liquidity that they want at the prevailing interest rate, which was and still is very low.

Moreover, the program allowed the Eurosystem to accept assets that had become illiquid in financial markets (notably mortgage-backed securities) as collateral in its refinancing operations. In its operations, the Eurosystem provided cash loans against the security of these assets. Finally, the Eurosystem increased the number of counterparties eligible for Eurosystem operations from 140 to around 2000 and started protecting the counterparties’ anonymity to avoid domino effects.
Who could stop the run? The ECB as the saver of last resort

The second non-standard component of the ECB’s response to the crisis, together with enhanced credit support measures, was the launch in May 2010 of the Securities Markets Programme (SMP). This allowed the Eurosystem to buy both private and public euro area debt. Given the constraints of the provisions of the Treaty on the Functioning of the European Union, Eurosystem purchases of government bonds were strictly limited to secondary markets and fully sterilised by conducting liquidity-absorbing operations. They were also capped to a weekly limit which made the appetite of the markets even greater as they knew that by overcoming the limit by just a tiny bit they could make a huge profit. However Draghi’s announcement on 6th September 2012 that the SMP was superseded by the Outright Monetary Transactions (OMT) allowing for the unlimited purchase of bonds of struggling countries in secondary markets finally stopped the financial markets from going short on the sovereign debt of the PIIGS. The ECB finally became the “saver of last resort” by making it impossible for market speculation to run against the weakest Euro-zone countries’ sovereign debt. Of course, this is subject to conditionality, which implies that Member States willing to benefit from the OMT have to agree to the implementation of a full or precautionary ESM macro-economic adjustment programme. Also the IMF should be involved in the elaboration and monitoring of country-specific conditionality. Moreover the Governing Council of the ECB maintains the right to initiate, continue and terminate OMT with full discretion. In addition to these measures, the Eurosystem continues to provide liquidity in foreign currencies, most notably in US dollars.
Conclusions: Towards a Europe of Solidarity?

- The crisis of the sovereign debt in the periphery of the eurozone seems to have been the consequence of the combined effect of the global financial crisis and the structural asymmetries that had affected the EMU from its establishment.

- Overall, the European Union does not seem to have been particularly well-equipped to cope with the financial crisis, nor does it seem as yet to have the political will and capacity to truly move forward in the necessary process of political and fiscal integration.