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# Eurozone crisis and its impact on Moldova

**Workshop at the Institute for Economy, Finance and Statistics**

German Economic Team Moldova / Berlin Economics

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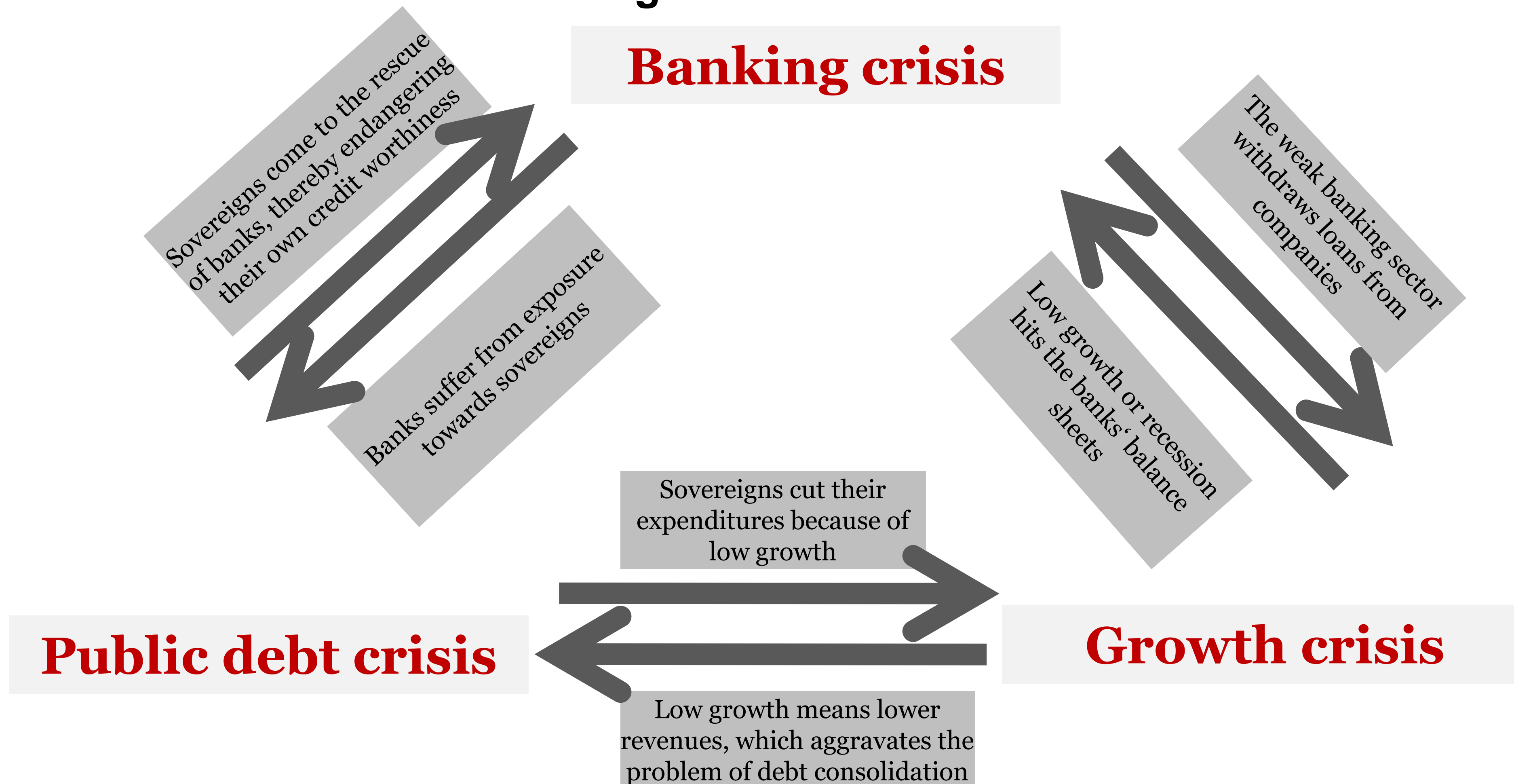
# The Euro crisis = An ugly combination of public debt, banking and growth crisis




Source: IMF, BE

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# Chronology of the financial crisis

Source: BE

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A. Causes for the Euro crisis

B. What has been done so far to combat the Euro crisis?

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D. Impact on Moldova

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# A. Causes for the Euro crisis

1. High public debt in some member countries

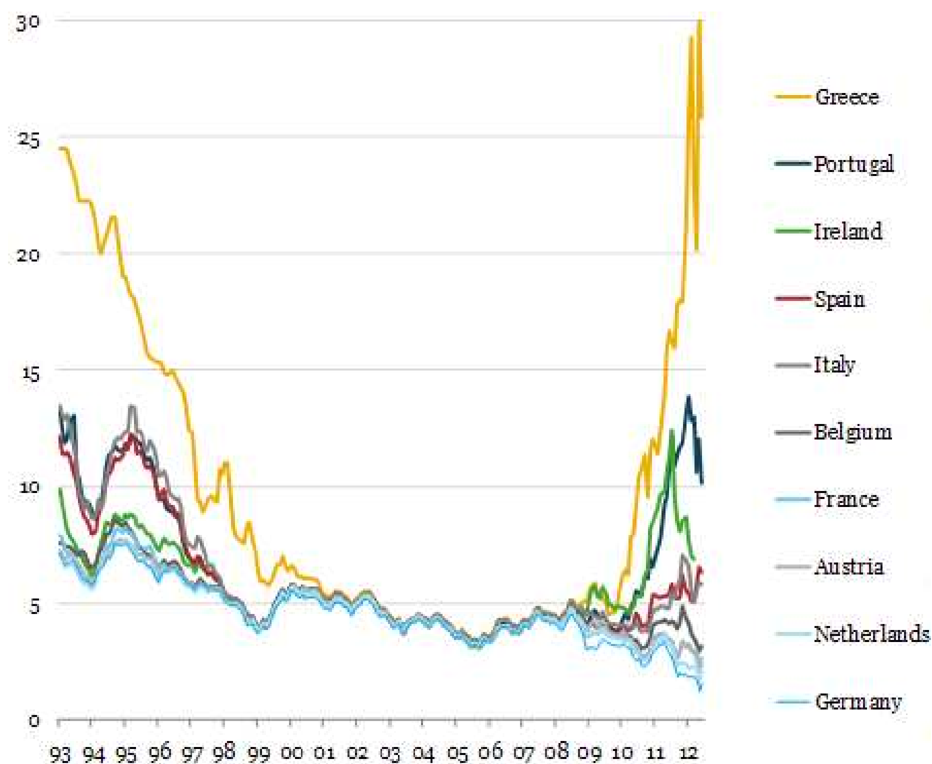
2. High private debt in some member countries

3. Loss of competitiveness in some member countries

4. At the level of the eurozone: Lax implementation of fiscal rules and absence of tools to support distressed member countries

# Reasons for high public debt: Lax fiscal policy taking advantage from lower interest rates

**10 year gov bond yields**

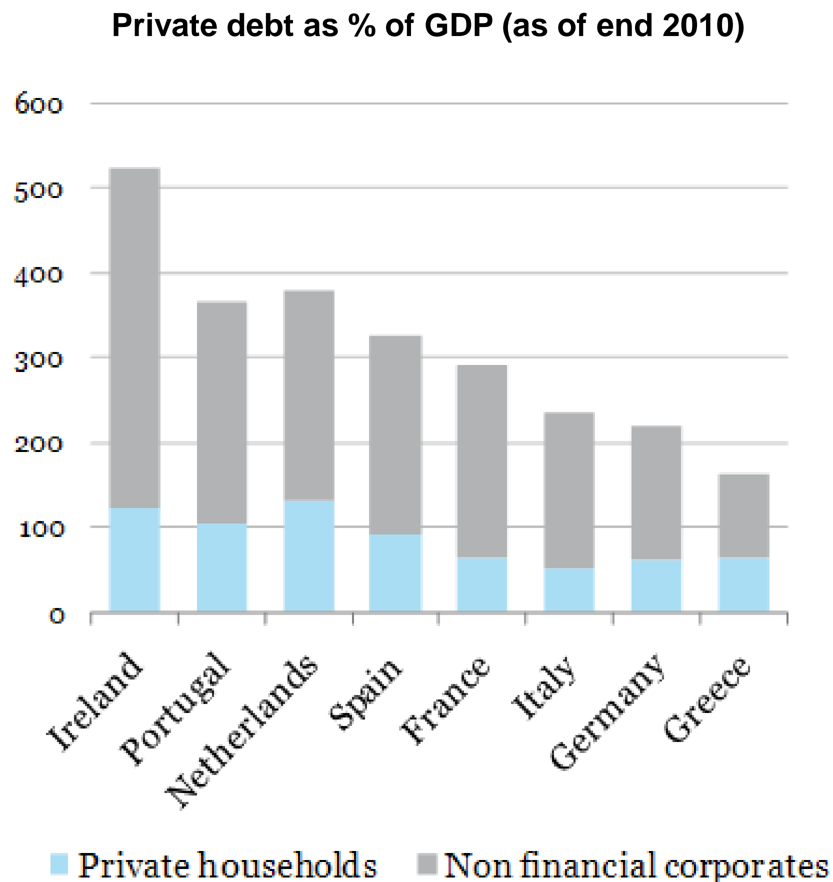



Source: Eurostat, Bloomberg

- As interest rates went down significantly prior to the start of the eurozone, some governments took advantage of the lower interest rate burden to increase spending and public debt
- Actually, no risk was assigned to bonds from Greece, Portugal and Italy in the period of 2001 to 2007, even though the fiscal problems were well known
- Thus, bond markets failed to act as vigilantes in 2001 to 2007
- Since 2008/2009 investors differentiate once again, as they did in the 90ies

# High private debt: Sharp increase

**Private debt as % of GDP (as of end 2010)**



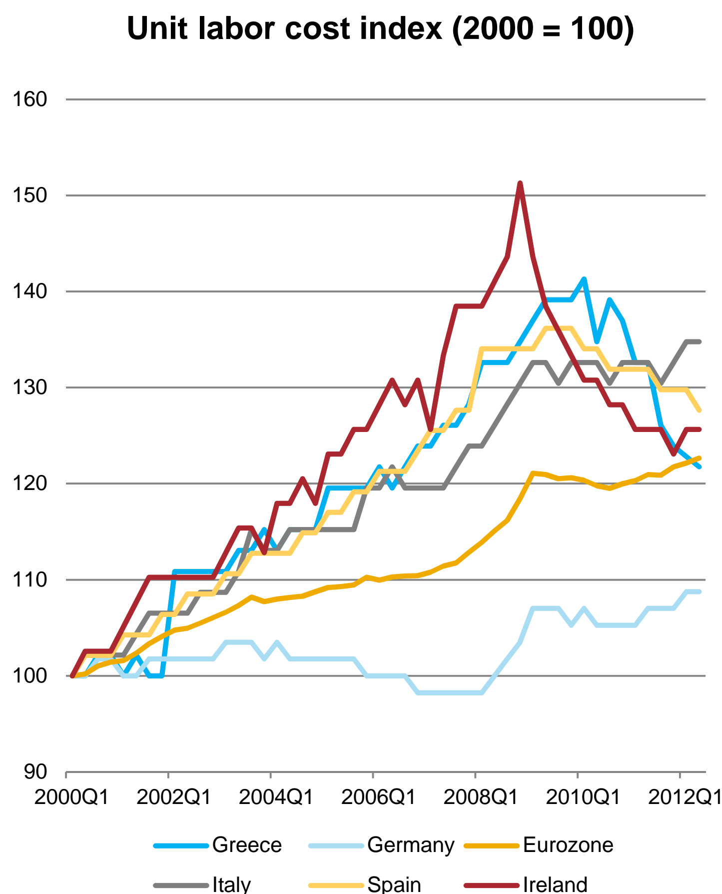

Source: Deka

- Not only public, but also private debt created significant risks
- Private debt rose sharply, especially in Ireland and Portugal
- However, both regulators and markets were not worried about events
- Regulators: No setting of alarm bells
- Banks and markets: No risk differentiation and thus very low interest rates

Relationship public-private debt

- Greece and Ireland are two extreme cases:
  - While Ireland had the highest private debt ratio of the countries listed here (in comparison to GDP), it‘s public debt was one of the lowest
  - In Greece the reverse issue is true: The private debt ratio is the lowest of the countries listed here, while the public debt ratio is the highest
- Note that Italy has relatively low debt, too

# Loss of competitiveness due to a significant increase of unit labour costs

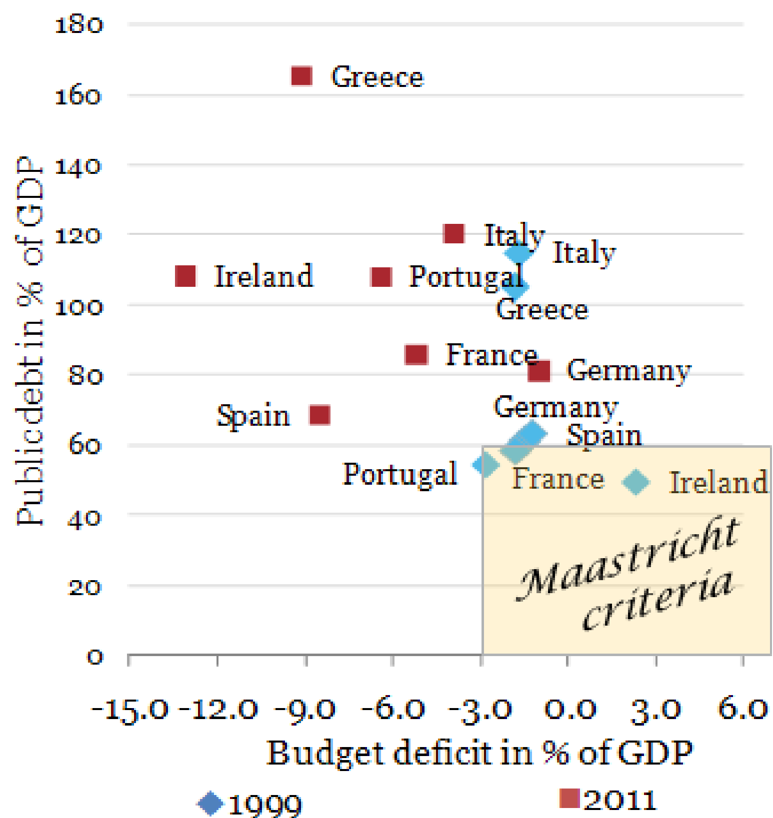



Source: Bloomberg

- In Ireland unit labour costs increased most. Interestingly, labour costs came down significantly after the eruption of the crisis, showing that the labour market is quiet flexible
- In Greece, the labour cost evolved with similar dynamism as in Ireland, without having been accompanied by a corresponding positive development of the economy
- Spain and Italy (were labour costs even increased during the crisis) are faced with similar problems
- In Germany unit labour costs went down, partly due to Chancellor's Schröder “Agenda 2010”
- Before EMU: Loss in competitiveness in Southern countries regained through devaluation
- Since EMU: Exchange rate as an instrument of national policy does not exist anymore; thus, devaluation not possible anymore

# On the <u>level of the eurozone</u>: Lax implementation of fiscal rules and absence of tools to support member countries

**Budget deficit and public debt 1999 and 2011, in % of GDP**




Source: ECB

- To compensate for the flaws of the construction of the eurozone (amongst other things no political or fiscal union, limited labour mobility, no banking union), the founders of the eurozone defined the <u>Maastricht criteria</u>:
  - Budget deficit limit of 3% of GDP
  - Public debt limit of 60% of GDP
- However, only a few countries fulfilled these criteria at the start
- Most prominent countries not to fulfil these criteria: Italy and Greece
- Thus, fiscal rules existed and they were not bad, but they were not applied or implemented
- <u>On top</u>: The monetary union foresaw no tools for supporting member countries in financial distress

# B. What has been done so far to combat the Euro crisis?

1. Adjustment programs in some member countries
2. New measures to regain confidence
3. The role of the European Central Bank
4. The role of fiscal policy of the eurozone
5. Decision on a common banking supervision

# Adjustment programs (IMF-like programs) in some member countries: Austerity and reforms

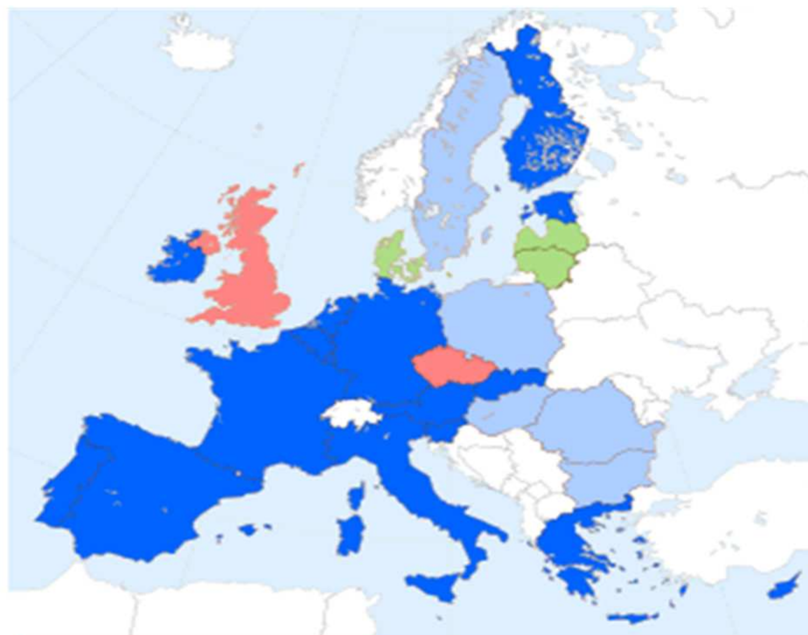
Overview of adjustment programs in member states (as of October 2012)

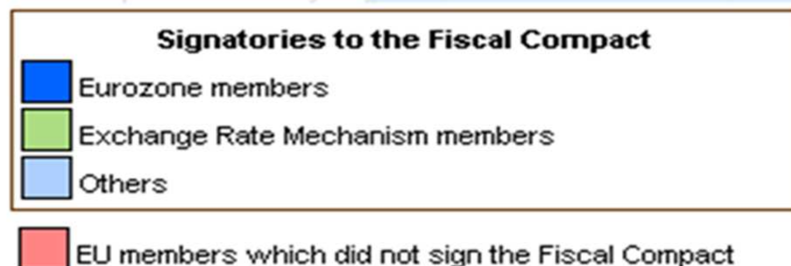
| | Greece | Ireland | Portugal |
|---|---|---|---|
| **Period covered by EU assistance** | Assistance available up to December 2014 | Assistance available up to December 2013 | Assistance available up to July 2014 |
| **Financial instruments** | EFSF; Bilateral loans from the euro-area Member states | EFSF; EFSM; bilateral loans from the UK, Sweden and Denmark, Irish reserves | ESFS; EFSM |
| **Amount granted by the EU** | Up to € 197.6 bn | Up to € 45 bn | Up to € 52 bn |
| **Total size of the assistance (including other lenders)** | € 244 bn (48 bn from IMF) | € 85 bn (22,5 bn from IMF) | € 79.5 bn (27.5 bn from IMF) |
| **Number of instalments under EU assistance** | Up to 23 instalments | Up to 12 instalments | Up to 12 instalments |
| **Amount disbursed so far** | € 148.6 bn (13 instalments) | € 54.8 bn (7 instalments) | € 614 bn (5 instalments) |
| **Main areas of policy conditionality** | * Fiscal consolidation<br>* Fiscal governance and reporting reform<br>* Reform of the public wage system<br>* Pension reform<br>* Financial sector regulation and supervision reform<br>* Other structural reforms (related to Europe 2020 agenda) | * Fiscal consolidation<br>* Labour market reform<br>* Public administration and taxation reforms<br>* Energy sector liberalisation<br>* Financial sector regulation and recapitalisation<br>* Other structural reforms (related to Europe 2020 agenda) | * Fiscal consolidation<br>* Banking sector recapitalisation and deleveraging<br>* Prudential Capital Assessment Review<br>* National Recovery Plan to mitigate adverse effects on growth<br>* Labour market reform<br>* Other structural reforms (related to Europe 2020 agenda) |

Source: European Commission, IMF

# New measures to regain confidence: The Fiscal Compact

Countries which agreed to comply with the Fiscal Compact



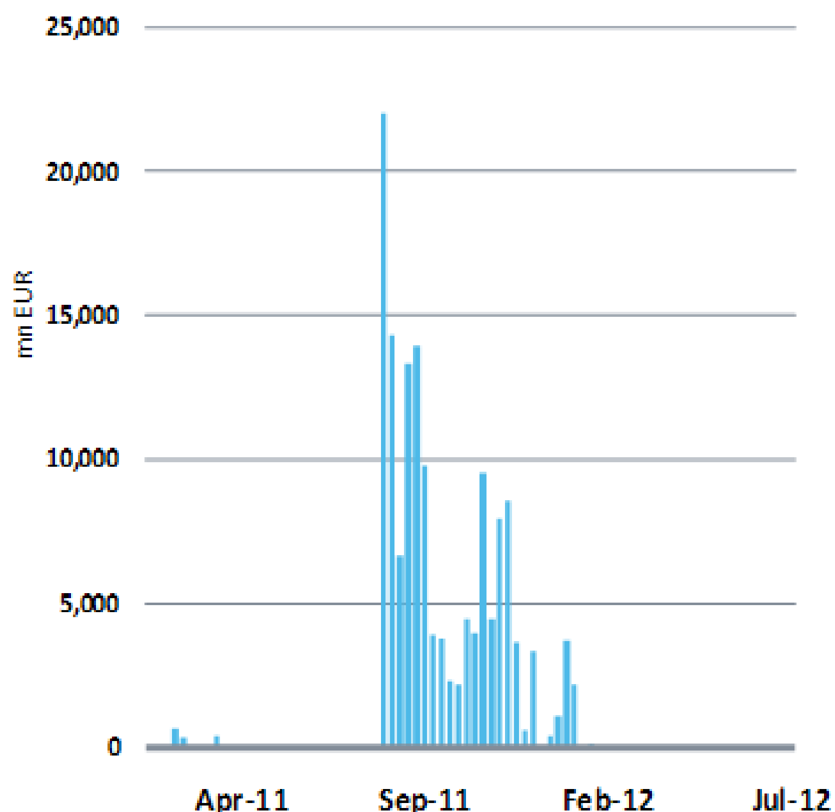



EU members which did not sign the Fiscal Compact

Source: Wikipedia, European Commission

- While signed by almost all EU countries (exceptions: UK and Czech Rep.), some member states have still to ratify the Fiscal Compact
- Germany: President signed respective law immediately after positive decision by Constitutional court on September 12th
- The Fiscal Compact is planned to be implemented on January 1st 2013
- The core element of the Fiscal Compact is a debt limit, which has to be introduced in the legal system of each country
- In particular: No structural budget deficit exceeding 0.5% of GDP
- Markets so far seem not too impressed with the concept
- **Own view:**
  - Anchoring of prudent fiscal policy
  - Long-term effect
  - Very important measure, which shows that the eurozone is changing

# The role of the ECB: Purchase of government debt

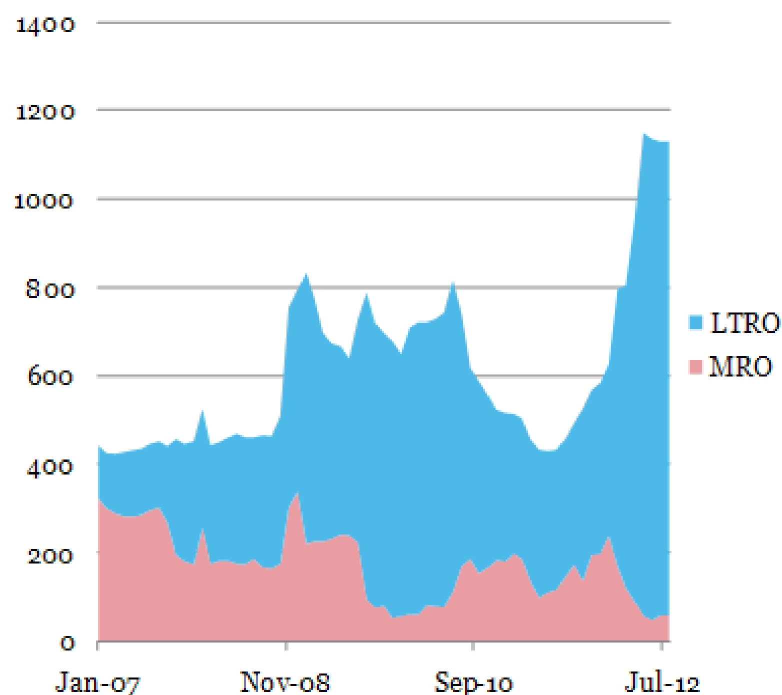



Source: IMF, Bloomberg

- ECB: Purchases of gov bonds of troubled countries on the secondary market (more than EUR 200 bn), followed by a hot public debate
- Pro purchases: Central banks US, UK & Japan are heavily engaged in those transactions
- Contra purchases:
  - Implicit monetisation of public debt
  - Quality ECB's balance sheet suffers
  - Liquidity injected creates asset price bubbles and increases the risk of inflation
- 6th Sep 2012: ECB announces that it will restart buying short-term gov bonds (1y-3y) "Outright Monetary Transactions (OMT)" without ex-ante limits
- Conditions: Adjustment program in place, EFSF/ESM also engaged in purchases of bonds
- **Own view**:
  - Purchase of gov bonds certainly not ideal
  - But: Fiscal tools at the level of the eurozone still not working properly
  - Thus: Purchases of gov bonds as an emergency measure until proper fiscal tools are in place

# The role of the ECB: Long term refinancing operations (LTRO)

Refinancing operations (RO) ot the ECB, in bn EUR




**LTRO = Long term RO;**

**MRO = Main (short term) RO**

Source: IMF, Bloomberg

- Normal times: ECB provides liquidity to the market through short term repo transactions
- Duration: 2 weeks to a maximum of 3 months
- Crisis times: Extension to up to 3 years
- Reason: Funding problems of banks, recently especially in Spain, Italy and France
- Currently: Eurozone banks refinance more than EUR 1,100 bn through the ECB, almost three times the amount of 2007
- LTRO partly used by banks (especially in Spain) to buy gov bonds; significant interest rate spread
- Impact: First risk premiums down, but after a few months effect vanished
- **Own view**:
  - Ambiguous instrument
  - Who is targeted? Banks or sovereigns?
  - If sovereigns: Right instrument?
  - On top: Additional risks for banks and adverse sovereign-bank-link increases

# Eurozone fiscal policy: New instruments had to be created

Original architecture of European Monetary Union (EMU):

- No eurozone fiscal tools foreseen to support distressed countries
- And: No IMF-type institution within the EU or the EMU to rescue countries

As Greece got in trouble:

- Bilateral loans from Euro members
- Setting up of a troika, consisting of EU Commission, ECB and IMF

Thus: Need to create new instruments and institutions to support countries in need

But: Huge time pressure, since Euro crisis in place; not an easy task

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# Overview of new instruments: EFSM, EFSF and ESM

| | EIB | EFSM | EFSF | ESM |
|---|---|---|---|---|
| Full name | European Investment Bank (in place before crisis) | European Financial Stabilisation Mechanism | European Financial Stability Facility | European Stability Mechanism |
| Legal Foundation | International Financial Institution | Supranational administrative body | Private company | International Financial Institution – multilateral lending institution |
| Mandate | EU's long term lending institution | Provide financial assistance to countries in difficulty | Provide financial assistance to countires in difficulty | Provide financial assistance to countires in difficulty |
| Shareholders | 27 EU member states | 27 EU member states | 17 euro-zone member states | 17 euro-zone member states |
| Contribution key | According to their economic weight | According to their economic weight | According to their share in the ECB's capital | According to their share in the ECB's capital |
| Support to bondholders | Explicit and irrevocable obligation for EIB's sharehlders to pay their own share of the callable capital | EU's budget and ultimately explicit and unconditional guarantee of the 27 members | Explicit, irrevocable and unconditional guarantee of the members | Explicit, irrevocable and unconditional obligation to pay the share of callable capital |
| Preferred Statuts? | Yes, preferred creditor status / access to ECB's liquidity | No | No | Yes, preferred creditor status, but junior to IMF |
| Lending capacity | Outstanding loans and guarantees are capped at 250% of the subscribed capital and reserves | EUR 60 bn, EUR 11.5 bn still at disposal | EUR 440 bn (EUR 192 bn are already committed to Ireland, Portugal and Greece | EUR 500 bn |
| Instruments | Loand and guarantees for loans | Loans and grants | Loans, precautionary credit lines, bonds purchases | Loans, precautionary credit lines, bonds purchases |

Source: European Commission, BNP

# Common supervision of banks

- EU summit end June 2012: Decision to centralise banking supervision in the eurozone
- September 2012: European Commission submits proposals for a single European supervisory mechanism

Background:

- Intention of providing direct financial support from eurozone to Spanish banks
- But: Eurozone has no direct influence on Spanish banks, since banking supervision is still a national matter („incomplete monetary union“)
- Thus: Eurozone would provide the money, but have nothing to say; not acceptable
- Decision: Direct financial support to banks, but only after direct influence in form of a common banking supervision is in place, probably under the ECB
- Planned completion of common regulatory framework: January 2013 (rather ambitious)
- **Own view**: Common supervision makes sense, but many questions remain
- In particular: First step towards a banking union, incl. common deposit guarantee scheme and common bank resolution institution? Or only common supervision?

Source: European Commission, BNP

# C. What has to be done?
# Possible solutions to the Euro crisis

1. Short term stabilisation measures

2. Long term stabilisation measures

# Short term stabilisation measures

**Voluntary debt restructuring (same face value, but longer maturities with credit enhancements)**

**Pro**

Reaching the target of a sustainable debt level faster

Lessening the burden of tax payers

**Contra**

Risk of an acceleration of capital flight

Negative effects on balance sheets of financial institutions

**Leveraging government bond issues through EFSF or ESM guarantees**

**Pro**

Should help Spain an Italy to maintain market access

Disciplinary function of markets would be maintained

**Contra**

The firepower of EFSF and/or

ESM is not endless

# Long term stabilisation measures: A banking union

As of now: Banking sectors are a national, not an eurozone issue; no common policy

Possible measure: Creation of a banking union, consisting of 3 elements

i. Deposit guarantee scheme

ii. Single eurozone supervisor of banks

iii. Common resolution fund

**Own view:**

- A banking union would strengthen the yet incomplete monetary union
- However, the goal of banking union is quite ambitious, given significant differences in regulation and structure of banking sectors throughout the eurozone
- Also distributional aspects between member countries need to be addressed

# Long term stabilisation measures: Stronger fiscal integration

- For a monetary union to work properly, a certain degree of fiscal integration is required
- This is especially true for EMU, given the rather low labour mobility between countries
- How does this work? Negative economic shocks to single members are partly absorbed by other members through common fiscal instruments; in such a way, the likelihood of strong macroeconomic misbalances is reduced
- How stronger fiscal integration? How more risk sharing?
  - Eurobills: Eurozone securities with short term maturities
  - Eurobonds: Eurozone securities with long term maturities
  - Increase of transfers ("transfer union")
  - Rescue funds
- **Own view**:
  - A higher degree of risk sharing makes sense
  - Common debt would help to reduce current pressure on sovereigns
  - But: Incentives to keep up reforms and fiscal consolidation have to be maintained
  - Key question: How to create more stability without reducing incentives for reforms?

# D. Impact on Moldova

- As stated in the beginning, the Euro crisis is a very complex phenomenon consisting of
  - public debt crisis,
  - banking crisis and
  - growth crisis
- Each component has potentially its own implications for Moldova:
- Public debt crisis: More difficult for lower-rated sovereigns like Moldova to access int. capital markets; however, as Moldova does not issue bonds on international markets, this has practically no impact
- Banking crisis: Eurozone banks are cutting back cross-border lending in order to improve their balance sheets and concentrate on home markets. Since some Eurozone banks are active in Moldova, this can have an important impact
- Growth crisis: Recessions in many Eurozone countries lead to
  - Lower remittances to Moldova and thus lower demand for goods
  - Lower exports from Moldova to these countries
  - Thus: Strong impact on Moldova
- **To sum up**: Growth crisis matters most to Moldova, followed by banking crisis

# E. Final thoughts

- Euro crisis is a very complex phenomenon consisting of
  - Public debt crisis, banking crisis and growth crisis
  - On top: Adverse links between these crises
- Since the appearance of the crisis a lot has been done
- In particular: Fiscal consolidation in the eurozone much more successful than in US
  (US: Expected budget deficit 2012 = 7.8% of GDP, public debt to GDP = 101.5%)
  (Eurozone [aggregate]: Expected budget deficit 2012 = 3.2% of GDP, public debt to GDP = 91.8%)
- However, this has not been enough to settle the issue; a worsening cannot be excluded
- But a worsening of the crisis would have a very negative impact on the world economy
- Any solid, long-term solution to the crisis needs to achieve 2 very different goals:
  - Financial stabilisation, i.e. better access to debt markets in the short term
  - Continuation of fiscal consolidation and reforms in the short and long term
- Key problem for finding “the” solution: As soon as more financial stability is achieved and sovereign risk premiums drop, the pressure on reforms falls immediately
- Consequently: Solving the problem with one big shot might not be possible
- Instead: Need to implement a number of consecutive steps (step by step approach)

# Outlook: Eurozone seems to be at a crossroads

Scenario 1: Strong Euro

- Crisis is used to improve economic policy and strengthen eurozone architecture
- Result: Stronger Euro than before, since weaknesses of the past put aside

Scenario 2: Weak Euro

- Eurozone institutions (ECB, ESM) are used to monetise national gov debt
- Result: Higher inflation and weaker Euro

Scenario 3: No Euro

- No compromise between core and peripheral countries on how to solve the crisis
- Break-up of monetary union, with unknown consequences

**Own view:**

- Scenario 1 would be our preferred scenario
- Scenario 3 rather unlikely (in the medium term), because of high cost of break up

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