The Euro Area Crisis: Politics over Economics

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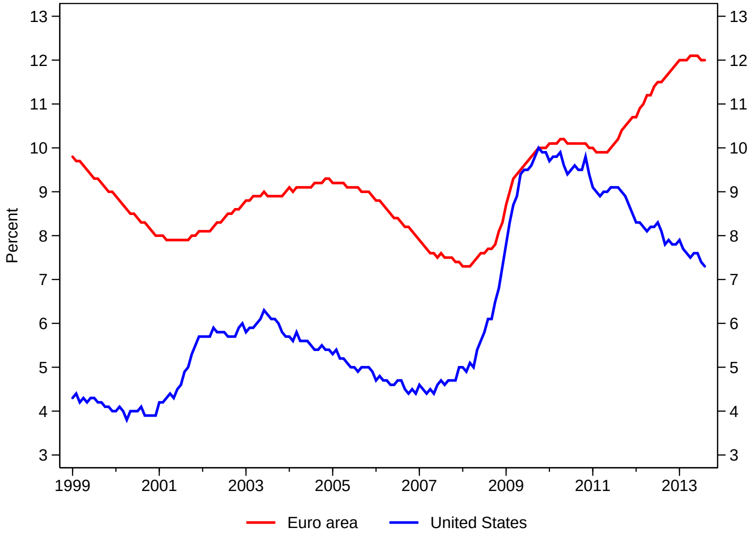
Unemployment in the US and the euro area



What crisis?

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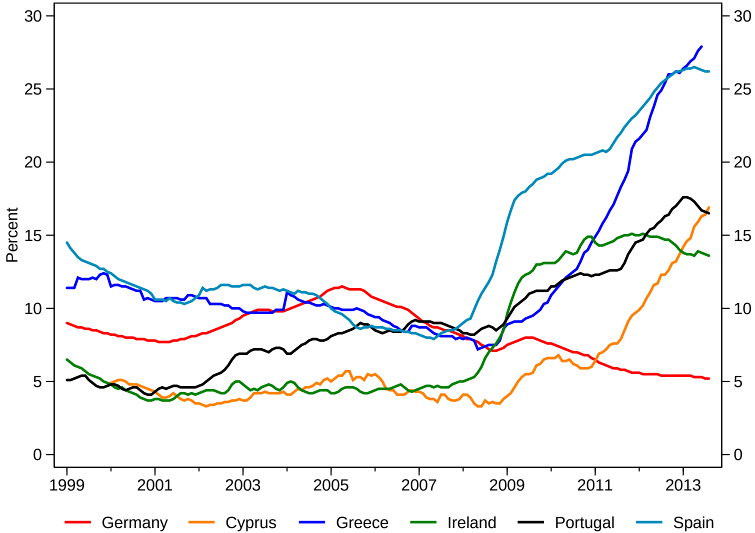
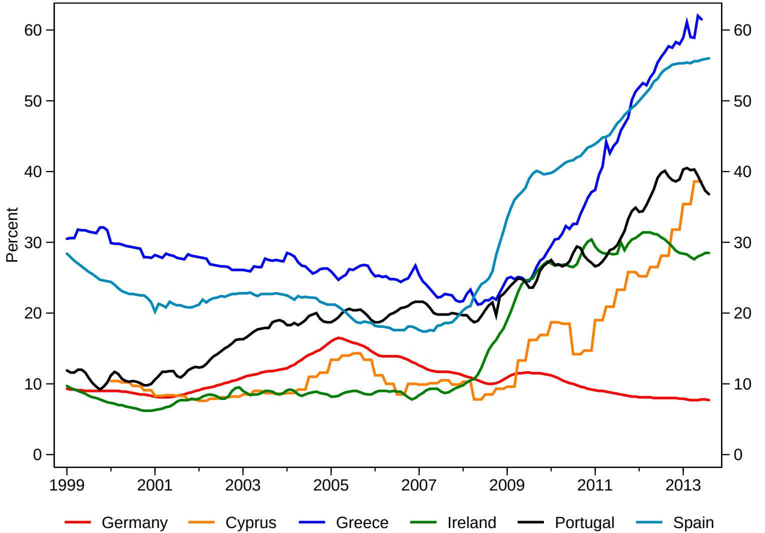
The disintegration of the euro area economy



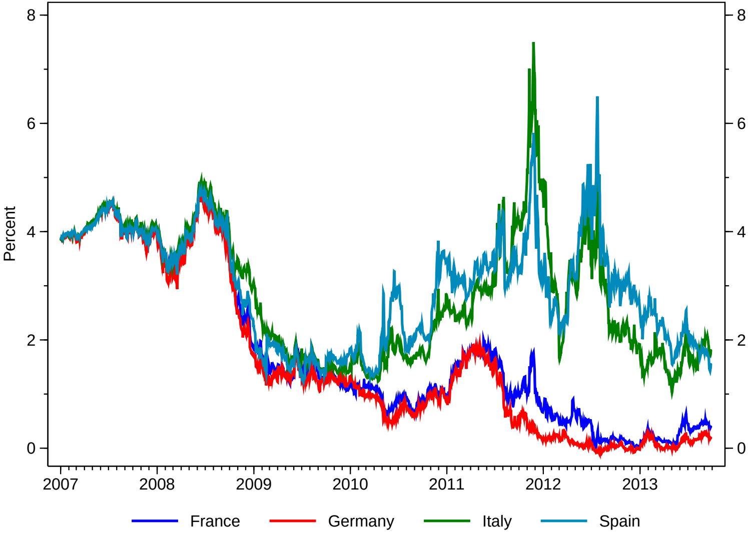
Unemployment rate: Germany vs program countries

A lost generation in the making



Youth unemployment rates

The disintegration of euro area sovereign markets



- Yields on two-year sovereign debt

Why is the euro project crashing to earth?

- Is the problem in Europe a "fiscal" problem, a "competitiveness" problem, a "banking" problem, etc?
- Alternatively, are these symptoms of a deeper flaw that cannot be solved with technical arguments?
- Flawed narratives can mislead policymakers.
- Dealing with symptoms while the underlying causes make the problem worse may lead to irresponsible complacency.

Crisis mismanagement: Two examples

- October 18, 2010, Deauville:
  Decision to introduce credit risk in what used to be considered "safe" government debt.

- March 16, 2013, Brussels:
  Decision to introduce credit risk in what used to be considered "safe" bank deposits.

Unique and exceptional blunders?

- Why the haphazard decisions?
- One explanation is that the blunders we have repeatedly observed during the crisis reflect incompetence. If so, this could be corrected with more enlightened advisers.
- Another explanation is that these blunders are a predictable manifestation of the decision making process. If so, a correction may not be feasible.

How could things get so bad?

- The euro was incomplete by design.
- No crisis management mechanism in place.
- The success of the euro rested on the belief or hope that if and when a crisis erupted governments would work together towards completing the project.
- This belief proved misplaced.

Political constraints and incentives

- Europe is not a federal state—there is no single government that can enforce solutions.
- Solutions on key issues that may involve adjusting the Treaty, require unanimous agreement by governments of the member states.
- But governments of member states must face their own electorate and some element of any solution may be unpopular to the electorate in some state.
- Election cycles vary from state to state and at any given moment some government may prefer to postpone decisions or misuse a problem for local political gain.

How could things get so bad?

- Mismanagement of the crisis by euro area governments damaged sovereign markets of euro area member states perceived to be "weak".
- As a result, some euro area member states face much higher government bond yields than countries with worse public finances that are not in the euro area.
- Holdings of government bonds by banks weakened the capital position of banks in member states perceived to be weak.
- Negative feedback loop between banks and sovereigns continues to damage the economies of several euro area member states.

October 18, 2010: Deauville

- Agreement between French and German government to introduce the Private Sector Involvement (PSI) doctrine.
- Remarkably, other governments subsequently went along, despite objections and warnings by the ECB.
- Whenever a euro area member state faced liquidity pressures (not necessarily solvency concerns), the imposition of losses on private creditors would be demanded before euro area governments agreed to provide any temporary assistance.
- Message to potential investors: Euro area sovereign debt should no longer be considered a safe asset with the implicit promise that it would be repaid in full.

Deauville implications

- The introduction of credit risk in euro erea sovereign debt raised the cost of financing for euro area governments perceived to be relatively weak.
- The first casualty was Ireland that lost access to markets within a few weeks. Portugal followed a few months later.
- The PSI doctrine also generated the adverse feedback loop between sovereigns and banks that has been driving weakness in the periphery since then.
- Although it was a blunder for the euro area as a whole, the PSI doctrine proved beneficial to Germany, suggesting an adversarial approach to the crisis was taking hold among the member states.

The role of European Institutions

- Ideally, european institutions (European Commission, ECB) should serve the interests of Europe as a whole, defend fundamental rights, equal treament for all.
- In practice, because Europe is a loose confederation, european institutions do not have the authority to solve the problem.
- The attempt to preserve the euro at all costs creates a risk that the role of european institutions may become counterproductive.
- European institutions may be politically captured by the governments of specific member states that could misuse the crisis for local political gain.

Are solutions available?

- The most obvious threat remains the adverse feedback loop between sovereigns and banks.
- This can be solved by creating a banking union in the euro area.
- Concern about the survival of the euro brought governments close to an agreement that could have solved the crisis in June 2012.
- June 29, 2012—EU Summit: Significant progress in improving governance, setting up a banking union to break "the vicious circle between banks and sovereigns."
- Since OMT governments have backtracked on the most critical elements of the banking union, ensuring continuation of crisis.

Euro Area Summit Statement: 29 June 2012

"We affirm that it is imperative to break the vicious circle between banks and sovereigns. . . . We affirm our strong commitment to do what is necessary to ensure the financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise markets . . . "

Key elements needed to “break the vicious circle”

- Common banking supervision
- Common deposit guarantee scheme
- Common resolution mechanism

Towards a Genuine Economic and Monetary Union

"This report lays down the actions required to ensure the stability and integrity of the EMU and calls for a political commitment to implement the proposed roadmap. The urgency to act stems from the magnitude of the internal and external challenges currently faced by the euro area and its individual members."

December 5, 2012

Herman Van Rompuy, President of the European Council
Jose Manuel Barroso, President of the European Commission
Jean-Claude Juncker, President of the Eurogroup
Mario Draghi, President of the European Central Bank

Why was this solution not implemented?

- It was blocked by the German government once the OMT was introduced by the ECB and the immediate threat to the euro subsided.
- For over a year, the German election in September 2013 had become a constraint on action.
- Elements needed to make progress unpopular in Germany and opposed by German banking interests.
- Solving the crisis in 2012 by making real progress towards a banking union would have compromised the Chancellor's reelection so progress was blocked.

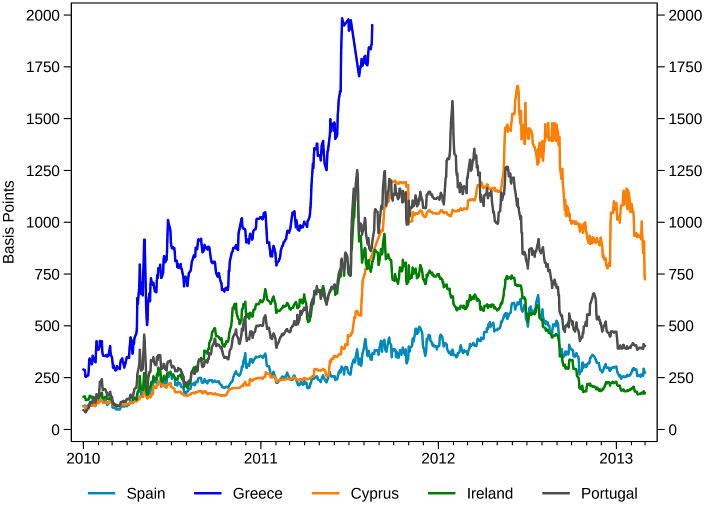
Can solutions be implemented?

- Europe has many presidents but no individual who can take a presidential decision.
- Effectively any government can veto anything of substance that is necessary to move forward.
- Some governments use their veto power to leverage the flawed construction of the euro to serve local short-sighted political interests regardless of the cost to Europe as a whole.
- Europe has no institution that can enforce the common good over local political interests.
- European institutions appear powerless to avert predictable blunders.

Latest blunder? Cyprus

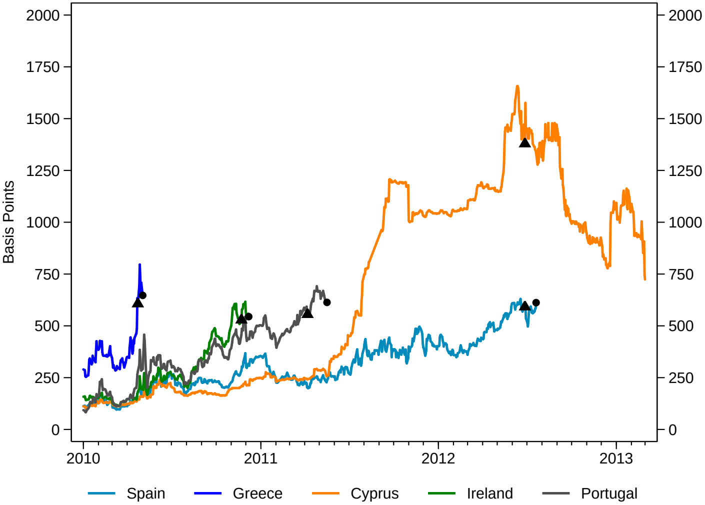
- Cyprus: 0.2% of the euro area, entered euro in 2008
- Large banking system with large Greek exposure
- Stable currency and finances before euro entry
- Problem: Communist government was in power for five years right after euro entry: March 2008—February 2013
- The problem in Cyprus started with the Cypriot government. First came overspending, then the politics of the Cypriot election in February 2013.
- It ended badly as a result of the politics of the German election in September 2013.

Could one see the Cyprus crisis coming?



- Five-year CDS on sovereign, as of end February

The delay that made Cyprus unique.



- Markers show when assistance was sought and agreed.

How did the crisis reach Cyprus?

- Communist government lost access to markets in May 2011 after two years of unsustainable increases in public expenditures.
- It opted to ignore all warnings and obtain financing through a bilateral loan from Russia to last through the February 2013 election.
- In October 2011, it agreed with the PSI plan to impose 25% of GDP capital loss on banks from exposure to Greece.
- Starting in May 2012, in coordination with the bank supervisor (central bank), it run the February 2013 presidential campaign on a “blame the banks” platform.

The contribution of the central bank

- Started investigations against banks with selective defamatory leaks to press.
- Started decribing the banking model in Cyprus as "casino banking."
- Forced banks to book accounting losses and took steps to exaggerate capital needs of banking system to divert attention from fiscal problems of the government.

The February 2013 election in Cyprus

- The coordinated campaign succeeded in creating the image that the banking system was so severely undercapitalized that if the government provided the capital, as was done in previous cases, then, according to standard IMF analysis, government debt could be deemed unsustainable.
- This set up a bad outcome in March 2013, right after the Cypriot election.
- Although communist party lost the election, the problem remained.

The September 2013 election in Germany

- The delay in finalizing a program for Cyprus pushed it into the German election cycle.
- How could elections in any single state matter for a program in another state?
- Because each state has veto power that can be exploited whenever another euro area member state might need assistance.
- EU member states not in the euro area do not face the threat that another member state would misuse its veto power in a similar manner because they are not bound together by the common currency.

Why did the German elections matter so much?

- The Chancellor's party (CDU) has needed support from its main opposition party (SPD) to pass legislation on Europe.
- Support of earlier programs was secured by SPD.
- Getting closer to elections, the SPD signaled a tougher stance to create political cost to the government.
- This became a major issue when German press and some German politicians started claiming that helping Cyprus is equivalent to "giving away German taxpayer money to Russian oligarchs" who have deposits in Cypriot banks.

Headlines in Germany

SPIEGEL ONLINE

11/05/2012 06:41 PM

Bailing Out Oligarchs

EU Aid for Cyprus A Political Minefield for Merkel

By Markus Dettmer and Christian Reiermann

The EU is likely to bail out the banks of tiny member state Cyprus with 10 billion euros of credit. But a secret German intelligence report reveals that the main beneficiaries of the aid would be rich Russians who have invested illegal money there. It's a big dilemma for Chancellor Angela Merkel.

A solution for the German government

- Any solution had to be structured so as to be an effective response to the SPD arguments and avoid political costs.
- This could be achieved if losses were imposed on depositors (preferably "Russian oligarchs")
- Ideally, for the German government, a solution should inflict permanent damage to the financial sector in Cyprus.
- This could be justified using the "casino banking" description that the communist government and central bank had used in Cyprus during the election campaign.

The domination of local politics

“[A]nyone having their money in Cypriot banks must contribute in the Cypriot bailout. That way those responsible will contribute in it, not only the taxpayers of other countries, and that is what's right.”
Angela Merkel, March 16, 2013 (remarks at a German election rally, quoted in eKathimerini, March 17, 2013)

"We don't like this business model and we hope it is not successful ... In the case of Cyprus we have leverage that we don't have with other tax havens.”
Wolfgang Schaeuble, April 5, 2013 (Reuters)

The eurogroup blunder on March 16, 2013

- Eurogroup decided to impose haircut on all deposits, insured and uninsured, in all banks regardless of capitalization, to replenish capital and solve problem.
- The proposal was contrary to any known framework and violated basic EU principles and was rejected by parliament in Cyprus
- Subsequent eurogroup meeting on March 25 changed program to protect insured depositors but impose greater damage to banking system, while violating fundamental EU principles.

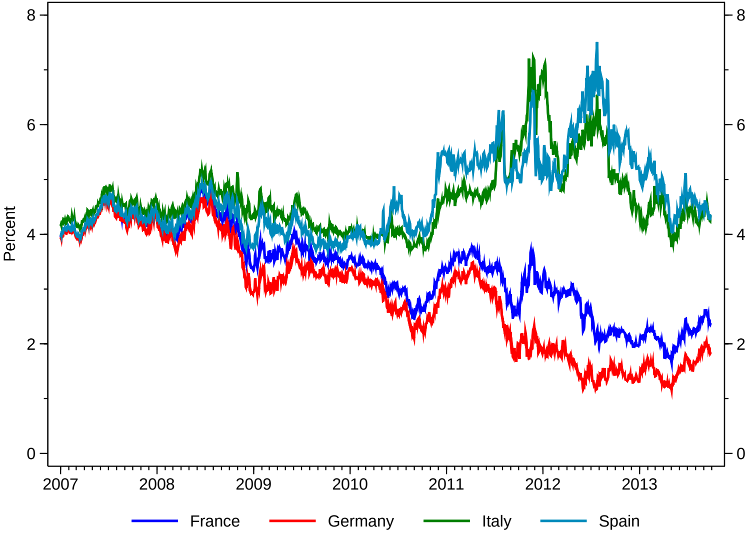
Consequences?

- Much like the Deauville blunder, the solution the German government imposed on Cyprus was risky for the euro area.
- The introduction of credit risk in deposits added to pressures on banks in the periphery.
- But the strategy paid off handsomely for the German Chancellor in the September 2013 elections.

Is a solution to the euro area crisis feasible?

- Can a solution to the euro area crisis pass the political feasibility test?
- Unlikely without fundamental political reform in Europe.
- Is political reform presently feasible?
- Unlikely with the current configuration of leaders and governments.

Can the euro area survive?



- Yields on ten-year sovereign debt