Report based on the panel

"The Euro Crisis:

How it all started and where it might lead"

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Carleton University

Speakers:

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Introduction

Carleton University's Centre for European Studies, and the Friedrich Ebert Foundation offered a briefing about the unfolding Euro crisis to a very attentive audience on February 9, 2012 at Carleton University. The explanations and analyses provided by Carleton's Professor Hurrelmann, and Ottawa University's Professor Leblond, were enthusiastically received by the event's attendees who, given the topic's complexities, undoubtedly regretted the briefing's end.

The audience at this event consisted of Ottawa-based government officials, business leaders, academics, as well as students. Given the overwhelming media coverage the Euro crisis has attracted, it is unlikely that the attendees were hearing about this issue for the first time.

This report will highlight the explanations, arguments and analyses provided by Professor Leblond and Professor Hurrelmann during their respective presentations, and will discuss the main themes emerging from the discussion with the audience.

"The Euro Crisis: How and Why It Happened"

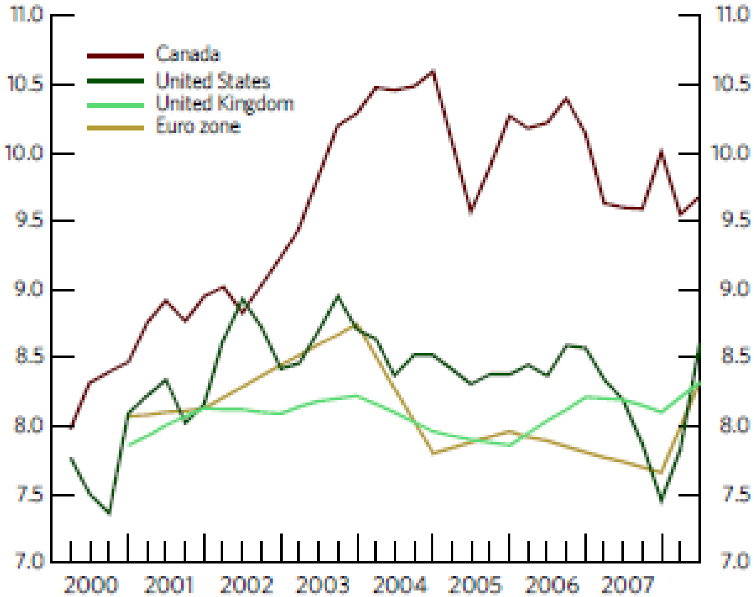
presented by Professor Leblond, Graduate School of Public and International Affairs, University of Ottawa

In the short time allotted to him, Professor Leblond provided a very detailed explanation of the causes and context associated with the Euro crisis. He noted that the Euro is not the cause of the current crisis per se and instead, the origins of the crisis lie in the global financial and banking crises as well as in political and economic problems that existed before the creation of the Euro.

<u>Banking Crisis Meets Debt Crisis</u>

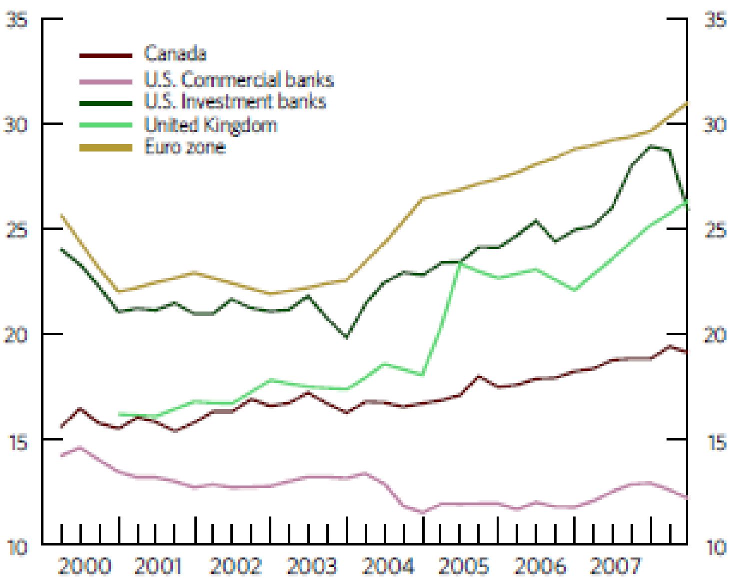
The Euro crisis has its origins in the banking crises of 2008-2009 and the ensuing debt crises of the past two years, specifically the debt crisis in Greece that started at the end of 2009. The banking crises preceded, and largely shaped, the current debt crises experienced by many European Union (EU) Member States. As a precursor to these crises, European banks were closer in similarity to American banks than to Canadian banks in the sense that they were more leveraged and held less capital, as can be noted from the graphs below.

Chart A
Tier 1 Capital-Adequacy Ratio
Tier 1 capital as a percentage of risk-weighted assets



Sources: Bloomberg and bank financial statements

Chart B
Banking Sector Leverage
Assets as a multiple of capital



Sources: Bloomberg and bank financial statements

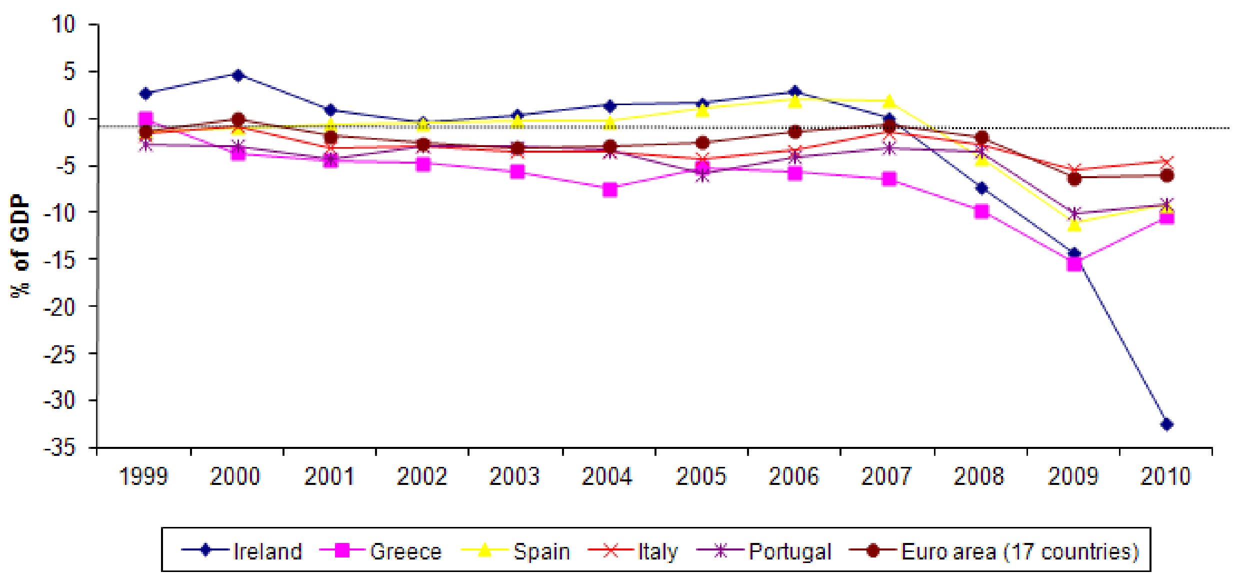
Source: Bank of Canada, Financial Stability Report, December 2008, p. 24.

As the graphs demonstrate, EU banks were already quite vulnerable before the banking crises began, holding too much debt relative to equity. The (global) banking crises started in the summer of 2007 with the collapse of several hedge funds (American as well as European) that were invested in sub-prime mortgages in the United States (US). Many European banks also overextended loans and mortgages to households and subsequently had to significantly cut back on their lending in response to the deteriorating economic conditions and people's inability to pay their debts. As a result, both the credit markets and the economy were paralyzed.

At the end of 2008, the cost of lending between banks was very high and they could no longer finance themselves. Central banks, including the European Central Bank, had to intervene and replace the frozen inter-bank system. A number of banks had to be bailed out by their respective governments. This forced some governments to have to borrow money for the bailouts and to stimulate the economy, given that they were receiving less tax revenue as a result of higher unemployment and the lower profitability of businesses. This, in turn, left financial markets worried about the growing sovereign debt that resulted.

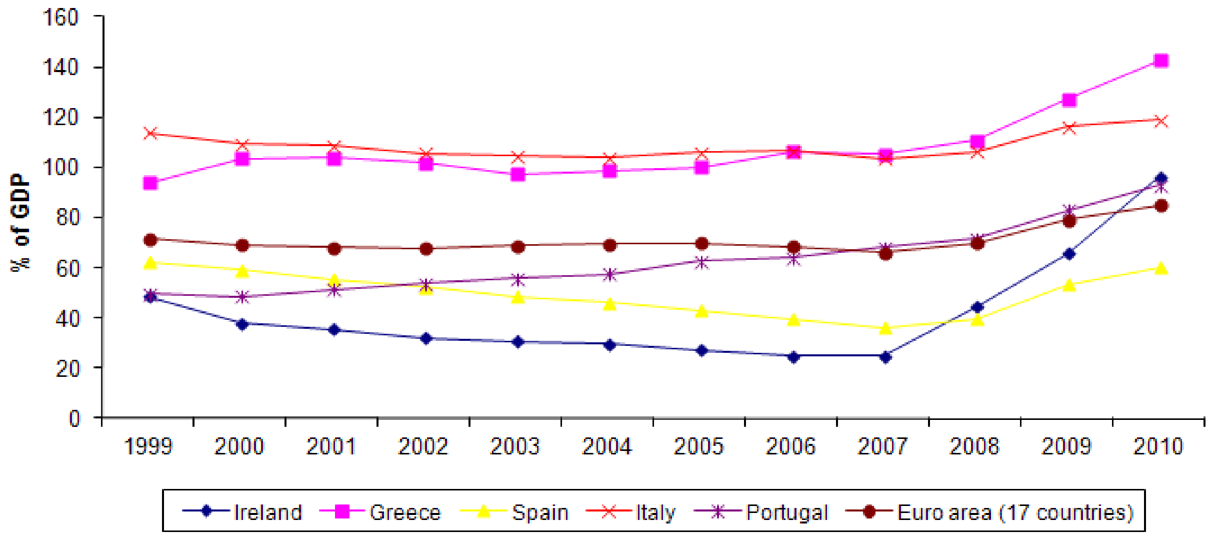
With the exception of Greece, high debt-to-GDP ratios were not the main reason for the debt crisis that struck the Euro zone. In fact, many countries, such as Spain and Italy, were either decreasing their debts, or stabilizing them, prior to the banking crisis, as can be seen from the graphs below.

Fiscal Deficit as % of GDP



Source: Eurostat

National Debt as % of GDP



Source: Eurostat

As the graphs show, many EU countries had budgets that were nearly balanced before the global financial crisis broke out. This data does not support the argument that these Euro zone countries were living beyond their means due to unsustainable welfare spending. The sharp increase in debt following the banking crisis in some states, such as Ireland, represents the cost of bailing out the banks. Some countries were able to address the situation better than others. For example, Italy did not significantly increase its debt because it avoided any fiscal stimulus to boost its economy during the slowdown.

Unfortunately, investor panic ensued, affecting Greece and Portugal, which had seen their public debt increase in spite of relatively good economic conditions before the crisis. These countries were no longer able to finance their debt in financial markets and, as a result, required bail-outs from the EU and the International Monetary Fund (IMF). These countries' relatively uncompetitive economies only intensified the gravity of the problem, as did their inability to devalue their currencies because of their membership in the Euro zone.

Prof. Leblond noted that one must be cautious not to treat the Euro zone as a single entity with respect to this crisis. Different Member State economies possessed varying levels of debt and competitiveness. Therefore, Prof. Leblond advised that the chosen response measure(s) should depend on the nature of the problem(s) in each country. On the one end of the continuum are countries like Ireland, which have competitive economies and high debt levels resulting from the mitigation of the banking crisis. The crisis in Ireland represents a typical banking crisis model that can be resolved by temporarily "tightening the belt". On the other end of the continuum are Greece and Italy, with weak, uncompetitive economies that took advantage of low EU interest rates while borrowing during good economic times. These countries represent a typical debt crisis model, which is more difficult to remedy.

Ireland's banks were highly exposed and consequently assumed a very large amount of debt, while the country's economy was viewed as quite competitive, which is a positive sign to forward-looking financial markets. It is not surprising that investors showed greater concern for Greece and Italy due to their competitiveness problems. In Greece, the crisis was compounded by heavy government borrowing; slowed external demand for Greek products/services; and higher interest rates resulting from the country's increasing risk profile which made debt financing more expensive. This all culminated in a sudden halt of investment flows from sovereign bond investors to Greece, Ireland and Portugal, financially crippling these countries and requiring government bail-outs as well as significant austerity programs. Through a contagion effect, investors began to demand higher returns on Italian and Spanish sovereign debts, though this did not result in a need for bailouts. In response, these countries were nevertheless forced to adopt fiscal austerity measures as well as structural reforms in order to reduce budget deficits and improve economic competitiveness.

Prof. Leblond noted that austerity measures, aimed at decreasing the level of debt, must be squared with a restructuring of the economy to make it more competitive. Achieving these two goals simultaneously is very difficult given the negative relationship between austerity and economic growth. This difficulty is compounded when several interdependent economies are pursuing these policies at the same time.

<u>Who's to Blame?</u>

Professor Leblond avoided identifying a sole culprit responsible for the Euro crisis, and instead pointed to the diverse actors who share in the blame. The causes of the crisis include banking regulations in some EU countries, which allowed real estate bubbles to form and permitted excessive lending. The governments of Greece, Italy, and Portugal, who did not address competitiveness issues within their economies, were also among the guilty. Less apparent actors include sovereign bond investors who should have differentiated between the quality of Greek bonds and other, healthier bonds within the Euro zone prior to the crisis. France and Germany also played a role in delegitimizing effective action through their noncompliance with the Stability and Growth Pact's requirement to keep deficits below 3 per cent of GDP in 2003. Despite the diversity of actors involved in this crisis, Professor Leblond ultimately believes the Euro will survive, albeit badly bruised.

<u>What does it mean for Canada?</u>

Fortunately, Canada has been largely unaffected by the Euro crisis because its banks had little exposure to Euro zone sovereign debt. The impact of this crisis on Canada will likely be indirect, mainly in the form of reduced EU demand for Canadian goods and services. On the bright side, Canada is now one of few countries with a triple A credit rating and can therefore finance its deficit and debt relatively cheaply. This will make it easier for the Canadian government to balance its budget.

“Keeping the Euro Alive: The EU’s Response to the Debt Crisis”

presented by Professor Hurrelmann, Department of Political Science, Carleton University

Professor Hurrelmann used cleverly coined terms to analyze the management of the Euro crisis, while summoning his predictive powers to assess how this crisis may impact EU integration. Prof. Hurrelmann’s presentation was organized in three parts. (1) First, he examined the governance of the Euro crisis, including short-term responses to the crises and long-term measures aimed at preventing the recurrence of future crises, and he identified some key players involved in EU crisis governance. (2) He then looked at the economic and political effects of these interventions within the EU. (3) Finally, he offered two potential scenarios European integration may follow after the Euro crisis passes. The insights he has imparted are summarized into three main themes below.

Euro Zone to the Rescue

The Euro zone’s short-term response measures to this crisis have included the following:

- “Life support” in the form of bailouts for Greece, Ireland, and Portugal. These bailouts were provided jointly by the EU Member States and the IMF and were conditional on harsh austerity. Simultaneously, steps were taken to write down the Greek debt to bring it closer to what is considered a more sustainable level (120% of GDP).

- “Vaccination” plans to establish temporary bailout funds such as the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). These will later be replaced with a larger permanent bailout fund called the European Stability Mechanism (ESM) to reassure investors of the availability of bailout funds in the future and to prevent the contagion from spreading across the Euro zone.

- “Immune system boost” in the form of the recapitalization of banks through cheap credit from the European Central Bank (ECB). This measure was aimed at supporting banks, which might be affected by the sovereign debt write-down.

In addition, a number of long-term measures were adopted to prevent the recurrence of future crises. These measures were aimed at strengthening the coordination between the fiscal and economic policies of Euro zone members, given that monetary policy is controlled at the supranational EU level. Prof. Hurrelmann noted that the coordination mechanisms provided by the Stabilisation and Growth Pact were no longer adequate. The new measures go beyond EU monitoring of Member States’ fiscal balances and as far as the monitoring of current account balances.

- The “Six-pack” package of measures includes stricter monitoring of national economic policies and intensification of sanctions for excessive deficit and debt levels.

- The Fiscal Compact introduces binding ceilings for national debt levels and further strengthens the use of sanctions, however is not supported by the UK and the Czech Republic.

Conversely, the response measures that have been avoided consist of: Greek default and a possible Euro zone exit for the country; pooling of Euro zone borrowing through jointly issued Eurobonds; and buying up of national debt by the lender of last resort - the ECB. This first scenario would result in significant economic and political turmoil in the whole Euro zone, while the latter two options (opposed by Germany and some other EU Member States) would require richer European countries to commit to ongoing transfers to the poorer ones and would call for significant revisions to EU Treaties.

<u>Who's the Puppet Master?</u>

The EU's governance of this crisis has been largely dominated by Germany, whose provision of significant bailout money has provided it with a primary role. French President Sarkozy has supplied legitimation to the unified response through his cooperative approach toward German Chancellor Angela Merkel. The European Council has emerged as the core decision maker, supported by influence from the European Central Bank. The EU's supranational institutions like the European Commission and the European Parliament have yielded little influence in devising the immediate response to the crisis as it required prompt action. However, Prof. Hurrelmann sees a greater role for these institutions in developing long-term measures dealing with the crisis. The time sensitive nature of this crisis has left the process lacking democratic accountability, which is not uncharacteristic of EU governance.

<u>Looking into the Magic Crystal Ball</u>

Professor Hurrelmann identified two possible scenarios for the EU's future: <u>stabilization</u> and <u>disintegration</u>. The former consists of Italy, Spain, and Ireland regaining competitiveness, while Greece and Portugal receiving long-term support. This would be supplemented by deeper economic policy coordination within the EU. People would become more accepting of this supranational actor as economic growth increased, thus restoring output-based legitimacy in the EU. The second scenario involves disintegration resulting from austerity-induced recession in most Member States, coupled with an intensification of anti-EU sentiment. This could possibly lead to pressure for a Euro zone exit in some countries, which would reduce the Euro zone to a Northern core of states surrounding Germany. The scenarios outlined exclude the possibility of the Euro's demise, and do not predict a significant deepening of economic policy coordination at the supranational level. Professor Hurrelmann identifies stabilization as the most likely outcome, while placing importance on the upcoming elections in Greece and France, which have the potential to change the direction of this crisis.

Discussion with the Audience

The concluding discussion drew several relevant and timely questions from the audience, with many of them echoing the media's general discontent with Euro crisis management. One audience member questioned whether the austerity measures imposed in Greece were the main cause of stifling economic growth, or if in fact the lack of structural changes before the crisis was having this effect. Professor Hurrelmann responded that both factors were relevant, however restructuring the economy while imposing brutal austerity is an extremely difficult task to accomplish. He doubted the effectiveness of this approach, and stressed the importance of a long-term economic growth strategy for Greece. Another audience member asked for some insights regarding where Greece was going to cut 300 million Euros, as recently demanded by the Troika of the ECB, the European Commission, and the IMF. Because the presenters did not possess the details of the Greek budget, they responded generally indicating that this is not the last round of austerity measures facing Greece, with a significant cut to take place this Summer or early Fall. Professor Leblond added that politicians are faced with very difficult choices, given that they have to appease an angry electorate. This leads to a game of brinkmanship that is played between the Troika and the Euro zone members, resulting in decisions being made five minutes to the deadline. Professor Hurrelmann later addressed this point as well, adding that the inter-EU "bickering" denoted in the media is typical for EU meetings addressing the crisis. Another audience member pointed to the fact that Greece is more indebted now than it was at the beginning of the crisis, and asked how this represents a solution to the debt problem. Professor Leblond responded that if Greece was cut off by its lenders, its deficit would decrease from 14% to 0% overnight and it would only be able to spend the money it could raise, which would spell disaster for the Greek banking system, economy, and people. In order to effectively restructure the economy and address the debt problem, it is necessary to close the deficit gradually, thus temporarily increasing debt levels.

Some common misconceptions were also addressed during this discussion. In response to a question about the possibility of a Greek default based on the Icelandic situation, Professor Leblond clarified that Iceland did not actually default; its banks went bankrupt and had to be bailed out by the government. However, an EU Member State default is entirely possible. It is much more desirable though, to restructure debt over the long-term in an organized fashion. Another audience member expressed anger at the fact that the bankers who helped create the international banking crisis have not been reprimanded with jail time. Professor Leblond explained that the regulatory system in the US and EU allowed bankers to leverage as much as they wanted, thus these activities were not illegal.

The discussion produced a variety of additional interesting elements. Professor Leblond spoke about what the EU can learn from a similar crisis experienced by Japan two decades ago. He said the key is to ensure that the baking system is cleaned up right away (ie. getting rid of "zombie banks") and to use stimulus money in a growth-creating way by restructuring the economy. In addressing a question about Bundesbank orthodoxy, he explained that this is the last thing to be desired during a crisis and pointed out that without the unorthodox actions of the ECB, the banking system would have collapsed and defaults would have ensued. Professor Hurrelmann agreed that the ECB has been improvising very well in response to this crisis. He also addressed a question about the upcoming elections in France and their impact on the crisis, given the current Merkel-Sarkozy tandem. Professor Hurrelmann explained that although the current Socialist candidate, François Hollande, has not proposed any radical departures from the current crisis response, he does intend to renegotiate the recently agreed to Fiscal Compact. Ultimately, without the legitimizing support of French President Sarkozy, Germany's hegemonic position will become more apparent.

In his concluding comments, Professor Hurrelmann stated that the upcoming elections in France and Greece will have important implications for the development of this crisis. Professor Leblond closed the discussion on a positive note, predicting that the Euro will survive and noting that significant progress has been made to date. To sum up the tumultuous nature of the crisis response, he ended with, "sausages are great, but nobody wants to know how they're made".