



Europe's Sovereign Debt Crisis: The End Game

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of Turkey

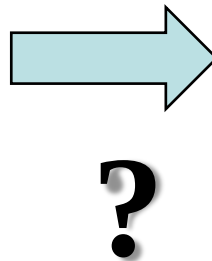
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Concerns about EMU

- Prior to Creation of EMU, commentary pointed to:
 - Shortcomings
 - Fault lines
 - Concerns
 - Deficiencies
 - Flaws
 - Potential fault lines
 - Hazard areas
 -
- Now, commentary points to:
 - Crisis
 - Unsustainability
 - Breakup
 - “Troika” (IMF, EC, ECB) forcing change...

Crisis, what crisis?

- Charlemagne (Economist, April 7, 2012): A euro divorce: “think the unthinkable”

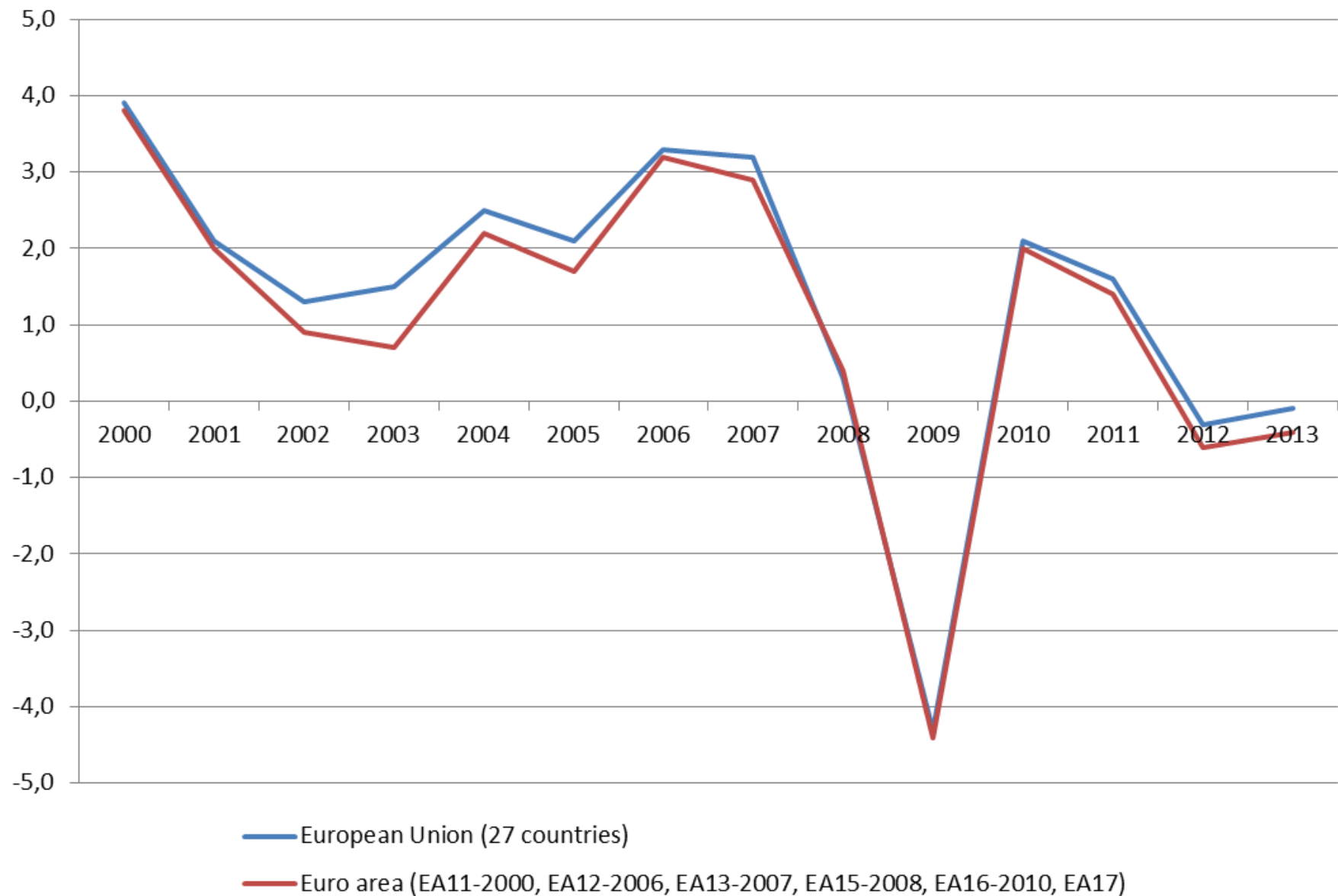


Could crisis derail a fifty-year vision for Europe?

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EU and Euro Area: Double Dip Recession



This Talk

- Developments to “save” EMU
- Evaluating progress to “save” EMU
- Will EMU survive in current form?
 - Is EMU valuable for Germany and “core”?
 - Is it worth it for Greece, Portugal and other GIIPS to stay in EMU?
- Recent research to guide policymakers

The Big Picture: Nobel Peace Prize 2012 Awarded to European Union



The EU has received the 2012 award for advancing the causes of peace, reconciliation, democracy and human rights in Europe.

*In its announcement on 12 October, the Norwegian Nobel Committee said its decision was based on the **stabilising role the EU has played in transforming most of Europe** from a continent of war to a continent of peace.*

EMU Part of Larger Integration Process...



EMU part of broader political and economic integration process...

Developments to Maintain EMU

1. Financial crisis management for banks / governments
2. Role of Lender of Last Resort of ECB
3. Financial regulation and supervision
4. Fiscal rules

1. Financial crisis management for banks / governments

- EU/ECB/IMF Financial assistance for Greece, Ireland, Portugal, Spain and– in progress– Cypress (& Slovenia?)
- New financial programs/institutions:
 - European Financial Stability Facility, May 2010 (EFSF), debt *guarantees* by Euro member states
 - Greek, Irish, Portuguese programs (& Spanish bank recap 2012)
 - European Financial Stabilization Mechanism, May 2010 (EFSM)

Financial crisis management (cont.)...

- European Stabilization Mechanism, October 2012 (ESM)
 - To become primary support mechanism in Euro Area
 - Reinforces economic surveillance, conditionality: avoid future crises
 - Debt issues supported by *paid in capital* from Euro states
 - Provide loans to a euro area Member States in financial difficulties;
 - Intervene in the debt primary and secondary markets;
 - May act on the basis of a precautionary program;
 - Provide loans to governments for the purpose of recapitalization of financial institutions (Cyprus loan Euro 9B approved w/conditions)

Financial crisis management (cont.)

- Alongside the EC institutions: EFSM, EFSF, ESM etc.
- Funding from IMF
- ECB purchases of sovereign debt on secondary markets
- Hence, “Troika”: EC, ECB, IMF

2. ECB Crisis Actions: lender of last resort

- October 2007: Extra liquidity, including USD liquidity
- August 2008: Extraordinary liquidity measures
- June 2009: Purchase program for covered bonds
- May 2010: Securities Markets Program (SMP)
- December 2011: Long Term Refinancing Operations (LTRO)
- August/September 2012: Outright Monetary Transactions (OMT) introduced, replacing SMP

2. (cont.) ECB

- OMT– a major and radical new approach
 - Buys bonds outright on secondary sovereign bond markets, 1-3 yr.
 - Mario Draghi, ECB president: necessary adjunct to monetary policy, because the *ECB's ability to set interest rates for the euro zone as a whole has broken down over fears that some countries may leave the single currency*
 - Draghi didn't say "lender of last resort", a role the ECB accepts for banks, not for governments. But de facto purpose is to support government bond market finance.
 - Conditional upon issuing country has agreed to a fiscal adjustment program with either EFSF or ESM (Portugal, Greece and Ireland) or a precautionary program for countries experiencing temporary shocks (Spain, Italy)
 - Unlimited purchase potential, no senior creditor status (as w/SMP)

3. Financial Regulation and Supervision

- EC proposed Single Supervisory Mechanism
- June 2012 EC proposal on recovery and resolution tools for banks in crisis, and the components necessary for an integrated "banking union"
 - A single recovery and resolution framework
 - The single rulebook in the form of Capital Requirements
 - Harmonized deposit protection schemes
- Recent (2012) progress reported by EC (April 2013) in European Financial Stability and Integration Report (EFSIR)
 - approval of new regulations on OTC markets, CDS markets, Credit Rating Agencies, short-selling of securities

A dramatic landscape photograph featuring a dark, stormy sky with heavy, dark grey clouds. The sky is filled with intricate cloud patterns, with some lighter patches where light breaks through. Below the sky, a line of trees with green foliage stretches across the horizon. In the foreground, a grassy field with some dry, yellowish patches is visible. The overall mood is dramatic and atmospheric.

Breakdown of SGP

4. New Fiscal Rules: Fixing SGP

- SGP with Excessive Deficits Procedure (EDP), July 1998
- SGP revision in 2005
 - Relaxed fiscal rules (more flexible?)
- “Six Pack” (December 2011)
 - Five Regulations and one Directive
 - Part of which is set of EU legislative measures to reform SGP

New Fiscal Rules (cont.)

- Fiscal Compact (in force: January 1, 2013)
 - International Treaty: "The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" (TSCG)
 - Balanced budget rule, Automatic Correction Mechanism
 - Requires enacting national laws to incorporating rules
 - Further conditionality, fines possible...
- "Two Pack" (Being negotiated, 2 regulations proposed)
 - Aims at further strengthening the surveillance mechanisms in the EA
- And more...

Observation 1: Common International Responses to Financial Crises

- Common financial crises, common response along financial, monetary, fiscal lines
- EMU area responses similar to other large MUs facing crises, especially on financial and monetary front
- Japan 1990s and now
 - Institutional change: independent BOJ, new financial authority, new laws
 - ZIRP
 - QE (much more aggressive now)
 - Inflation targets introduced designed to
 - Fiscal loosening, fiscal tightening, loosening...

Common International Response (cont.)

- USA from 2008
 - Emergency financial fund established (USD 750b)
 - ZIRP and QE (emergency measures)
 - Long term bond purchase programs, also buying MBS
 - Restructuring financial system (end of pure investment banks)
 - New financial regulations, regulatory structure (power to Fed, close OTS, regulate CDS)
 - fiscal austerity after initial stimulus
- Austerity paramount in Japan, USA, EU...

Observation 2: Centralization Hypothesis

- EMU more integrated financially, fiscally
- All moves towards centralization and federal (EU) power
- Slow and erratic– but towards centralization
- Financial crisis spurred and accelerated process
- Less national autonomy / sovereignty
- Restrictions on national actions and national sovereignty

Centralization Hypothesis (cont.)

- Centralization, yes...but working to make EMU more viable...less national sovereignty
- Moves addressing long-standing shortcomings in EMU (fiscal, financial, ECB)
- Inevitable (or at least helpful) if EMU is to survive...
- Similar to other monetary unions with strong federal structure but with federal-state power sharing (e.g. USA, Canada, Australia)

Are we there now?

- EC vision
- Country vision



The EC View: A Blueprint for a **deep and genuine** Economic and Monetary Union: Launching a European debate

- EC View: Initiative from **November 2012**
- “In a deep and genuine EMU, all major economic and fiscal policy choices by Member States would be **subject to deeper coordination, endorsement and surveillance** at the European level.”
- i.e. at the EC level, by the EC bureaucracy...

Language matters...

What does the Blueprint mean by a deep and genuine EMU?

*In a deep and genuine EMU, **all major economic and fiscal policy choices by Member States should be subject to deeper coordination, endorsement and surveillance at the European level.** Steps towards more responsibility and economic discipline should be combined with **more solidarity and financial support. Political integration, ensuring democratic accountability and legitimacy, is necessary every step of the way.** This transformation would take place gradually, over the short, medium and longer term, and would entail eventual Treaty changes.*

Proposals and Timeline

			A blueprint for a deep and genuine EMU Launching a European debate	Secondary law	Treaty change
ALL ALONG THE PROCESS	SHORT TERM	Within the next 18 months	1. Full implementation of European Semester and six-pack and quick agreement on and implementation of two-pack	✓	
			2. Banking Union : Financial regulation and supervision: quick agreement on proposals for a Single Rulebook and Single Supervisory Mechanism	✓	
			3. Banking Union : Single Resolution Mechanism	✓	
			4. Quick decision on the next Multi-annual Financial Framework	✓	
			5. Ex-ante coordination of major reforms and the creation of a Convergence and Competitiveness Instrument (CCI)	✓	
			6. Promoting investment in the Euro Area in line with the Stability and Growth Pact	✓	
			7. External representation of the Euro Area	✓	
	MEDIUM TERM	18 months to 5 years	1. Further reinforcement of budgetary and economic integration	✓	✓
			2. Proper fiscal capacity for the Euro Area building on the CCI	✓	✓
			3. Redemption fund		✓
			4. Eurobills		✓
	LONGER TERM	Beyond 5 years	1. Full Banking Union		✓
2. Full fiscal and economic union				✓	
			Political union: Commensurate progress on democratic legitimacy and accountability	✓	✓

But centralization is inevitable only if EMU survives...Why?

Original Fault Lines of EMU (partial list)

- Europe not an optimal currency area (Mundell)
 - Shocks asymmetric (different industrial structures, trading patterns)
 - Different levels of economic development / institutional development
 - Limited labor mobility, wage flexibility
- No single financial regulatory/supervisory authority
- No clear “lender of last resort” to stabilize financial system

Inevitable only if EMU survives... (cont.)

- No automatic fiscal stabilizers
 - Small central budget
 - Where did these concerns go wrong?
 - New issues: endogenous institutions
- Fiscal policy rules: too tight or too loose?
- Still no plans for large centralized budget for automatic fiscal transfers
 - Euro bonds?
 - Large budget along lines of “structural funds”?
 - German’s want treaty change for any banking union

Again: EMU was a political construction. Is there political will to continue?

- Much bluster in Germany, Finland and others about “bailing out” profligate countries
 - Understandable reluctance to effect fiscal transfers or issue “Euro bonds” with German guarantees
- Euro countries financial stabilization fund guarantees, fiscal compact partly effecting a fiscal transfer (in PV terms)
- But large gains to Germany, Finland, Netherlands...from participating in Euro Area are very large
 - Why would the Germany exchange rate be if had own currency?
 - Strong export sector
 - German self-interest to be in Euro

Gains to Periphery?

- Not as clear of the benefits to Greece, and lesser extent to Portugal and Spain

Short-Period Comets and Jupiter: Greece (GIIPS) and Germany in EMU?

Comets often have their *orbits strongly influenced by the gravity of giant planets* as a result of a close encounter. Jupiter is the source of the greatest perturbations, being more than twice as massive as all the other planets combined, in addition to being the swiftest of the giant planets. These perturbations *can deflect long-period comets into shorter orbital periods.*

If a comet is traveling fast enough, it may leave the Solar System. Comets are only known to be ejected by interacting with another object in the Solar System, such as Jupiter.

Comet



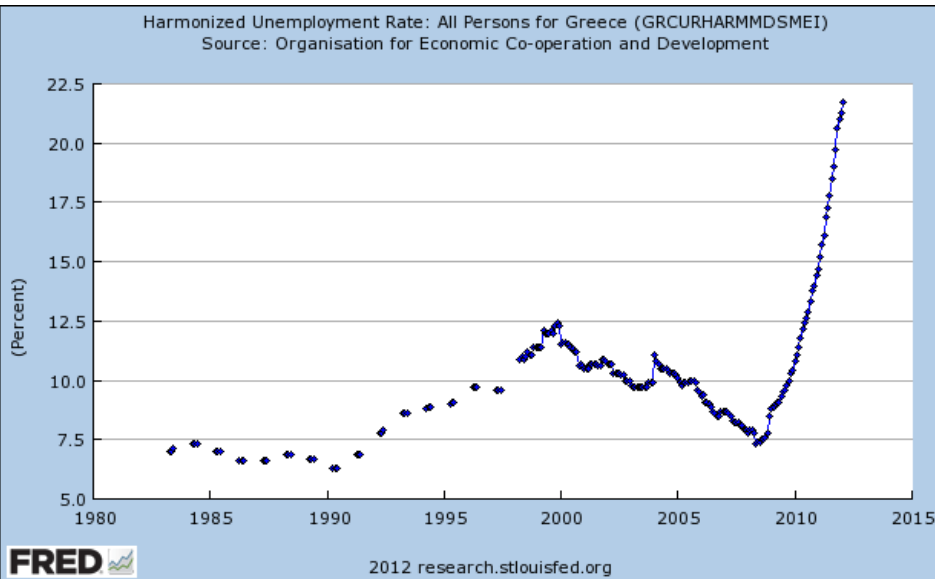
Hurtled out of Solar System or Crashing into the sun...



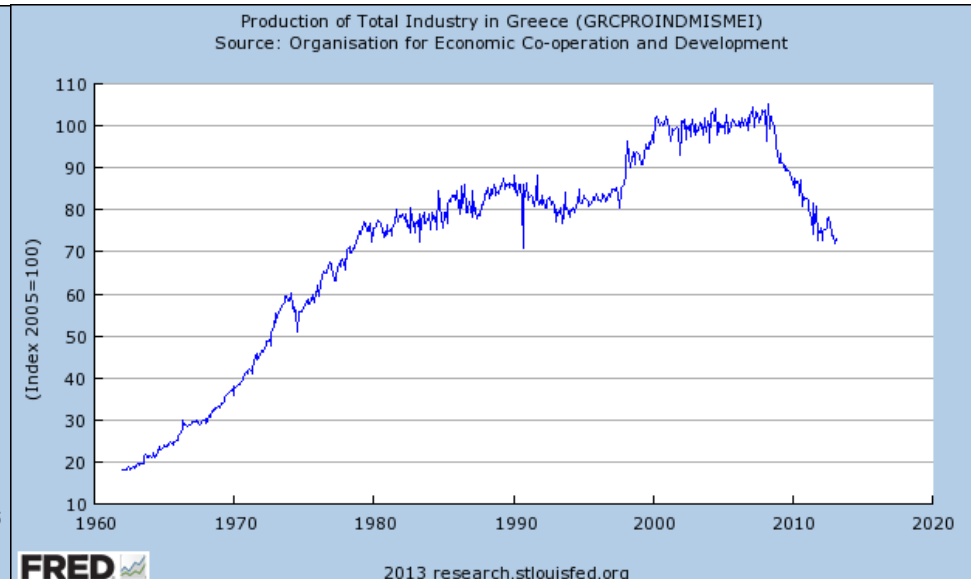
Comet Lovejoy diving through the sun's atmosphere on Dec. 15, 2011. Lovejoy's tail is visible as a faint diagonal smudge to the left of the sun. Contrast: Could a comet destroy the solar system? Threat of Greece to Euro Area?

The Greek Problem: Icarus flying too close to the (German) sun?

Unemployment



Production



- How long can they continue austerity?
- Does austerity work?
- What is the alternative?

But should Greece exit Euro before more damage is done? Is Divorce the Solution to a Troubled Marriage?



Greek Options: Classic Greek tragedy?

- Austerity and restructuring: current policy
 - “Internal devaluation” designed to bolster competitiveness
 - Austerity and default to restore govt solvency
 - Is it working?
 - One side misses Keynesian stimulus
 - One side misses budget constraint
 - Medium-term austerity, short-term stimulus
 - How do you get stimulus if no one buys bonds?
- More defaults?
 - Little/no private capital inflows (financial capital)...FDI flows remain; but recent interest by hedge funds in Greece again
- Restructure w/o long depression?

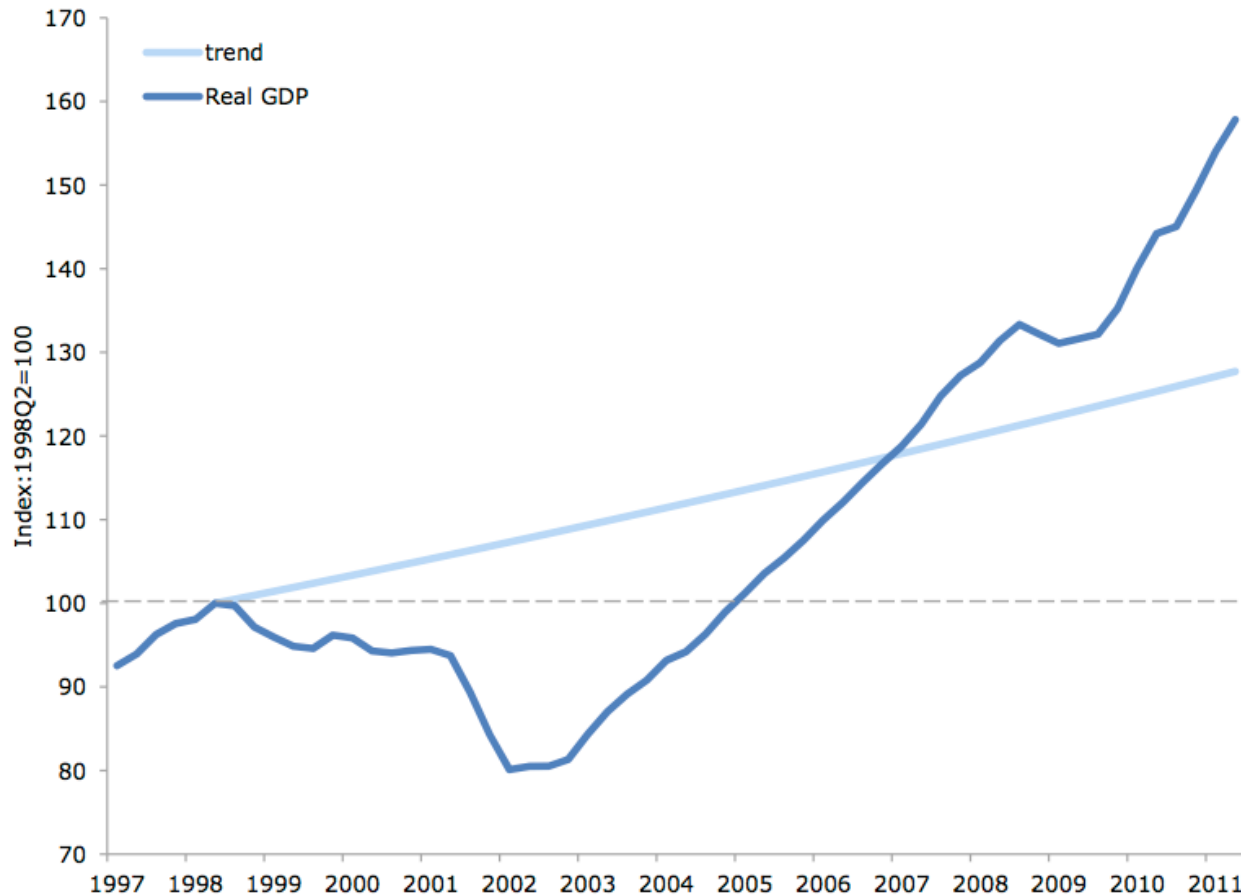
Greek Options (cont.)

- Option 2: Greece exits Euro
 - New currency, sharp devaluation
 - Creates contagion
 - Likely option unless Greek competitiveness and government/tax structure changes
- If Greece is to exit, do so quickly!
 - Why do internal devaluation if Euro exit inevitable?
- What would be the effects on output, employment, inflation, trade of Euro exit?
- International experiences; Argentina, Czech Republic/Slovak “Velvet Divorce”

How bad is default and exit from currency board? Argentina Case...could be worse!

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FIGURE 1
Real GDP: Actual and 20-Year Trend (Seasonally-Adjusted)



Source: INDEC 2011a, IMF 2011b and Authors' Calculations.

*December
2001-January
2002*

*Default and
Abandoned
Currency Peg,
sharp
devaluation*

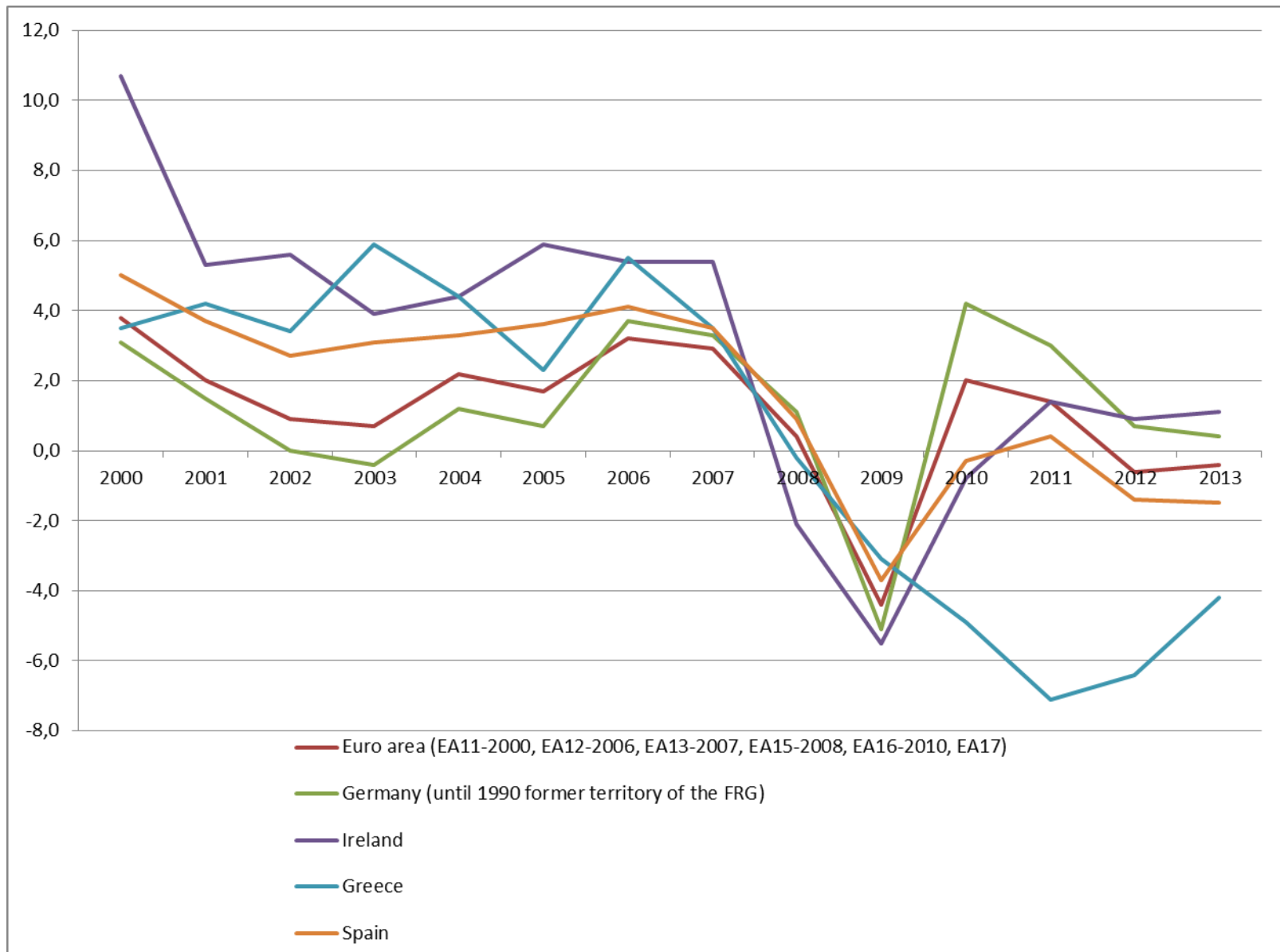
*Exclusion from
international
financial
markets*

Reluctant to use Argentina as model economy!

What about Turkey?

- Should it try to get a “Danish exception” from EMU if it joins EU?
- Let’s look at some fundamental issues, going beyond fiscal and sovereign debt
 - Competitiveness in EMU

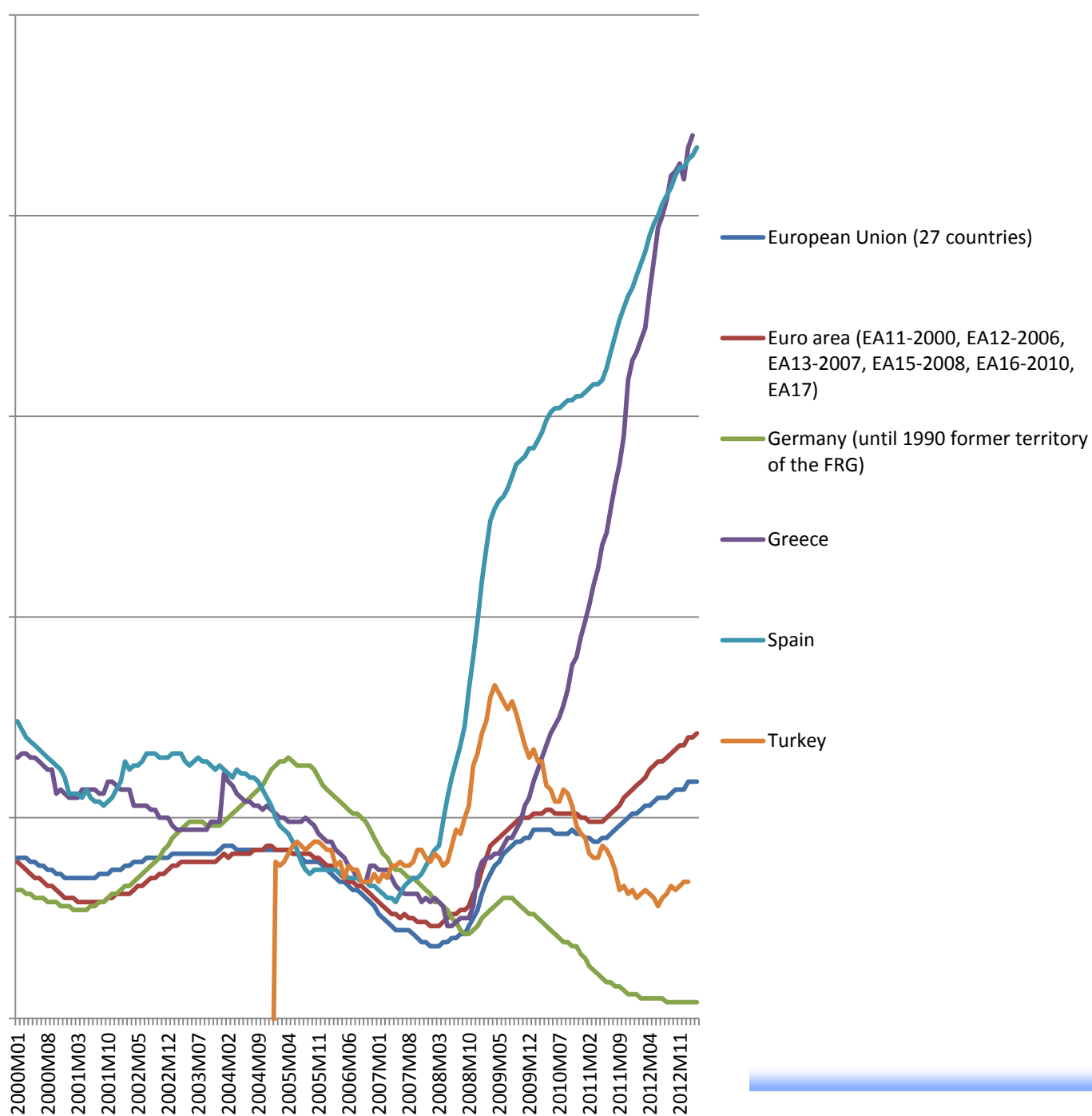
Two Speed Europe: Germany (Holland, Sweden, Finland...) and the others



Unemployment Rates

*Bipolar
Eurozone...*

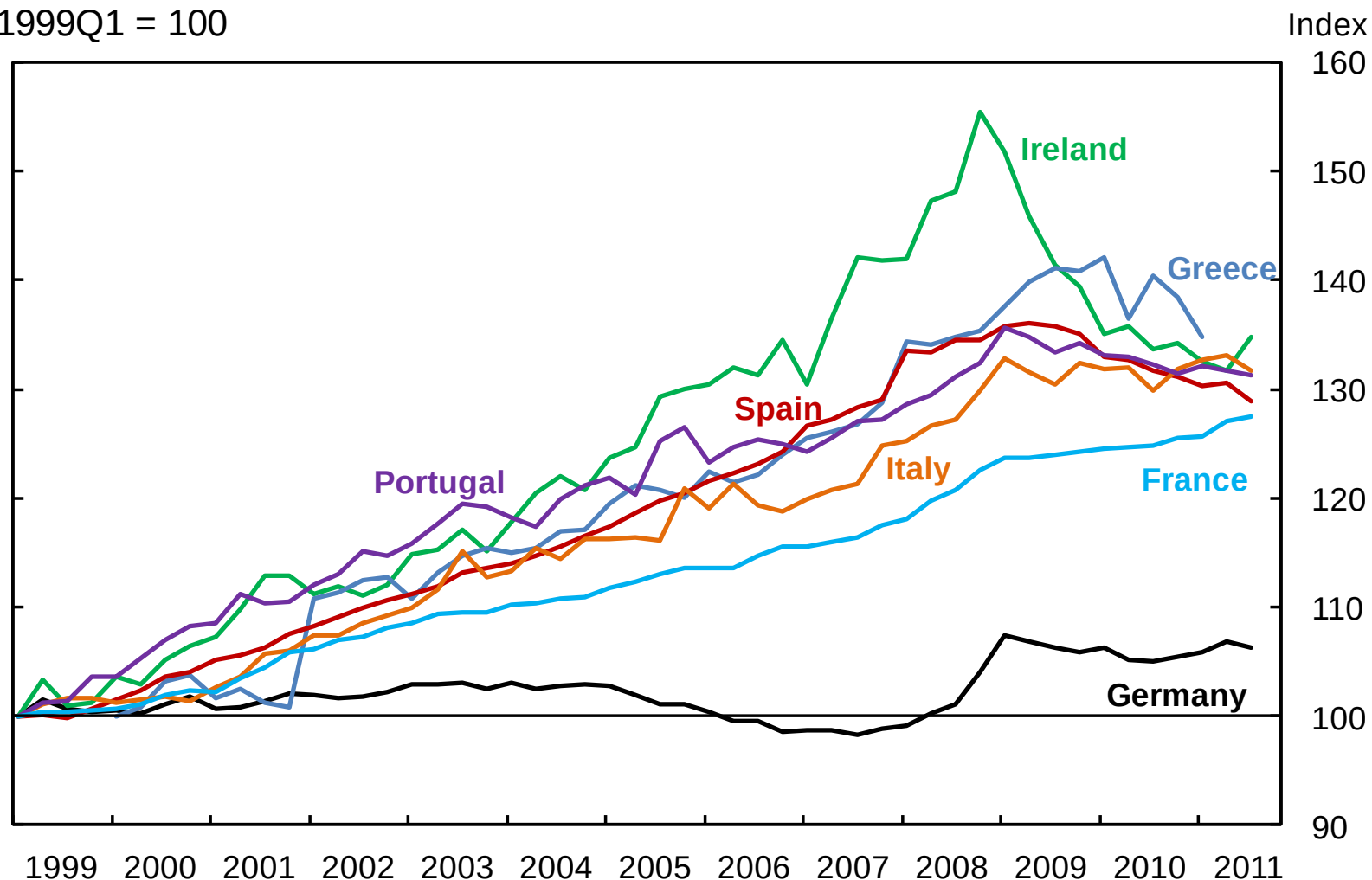
*Where does
Turkey Stand?*



Wide disparity between labor costs in Germany and other euro countries poses long-run challenge

Unit Labor Costs

1999Q1 = 100



Source: Eurostat

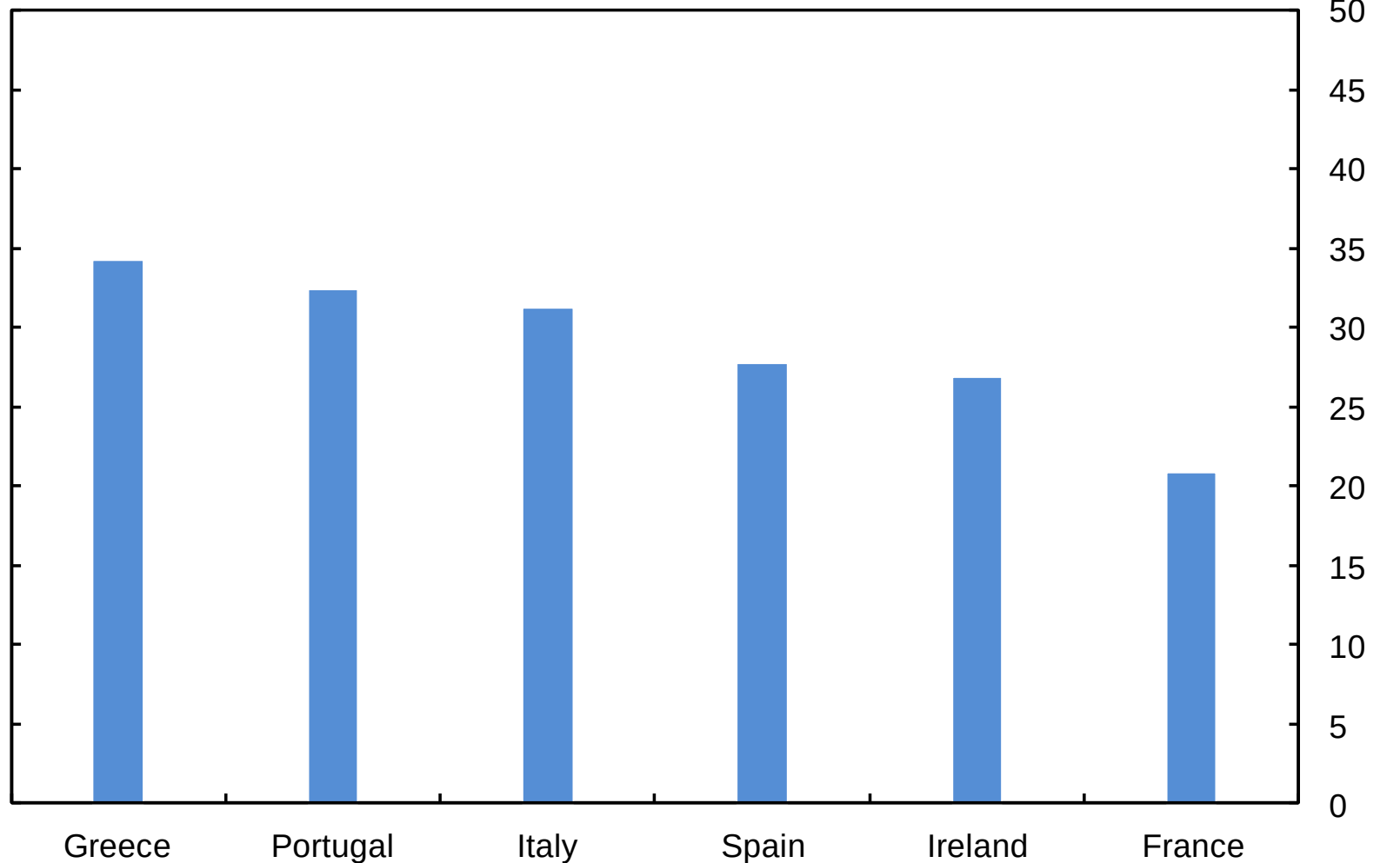
Note: Greece data starts in 2000Q1; it is indexed to 100 in 2000Q1

Peripheral labor costs rose faster than in Germany.

Change in Relative Labor Costs (1999-2011)

Cumulative percent change relative to Germany

Percent

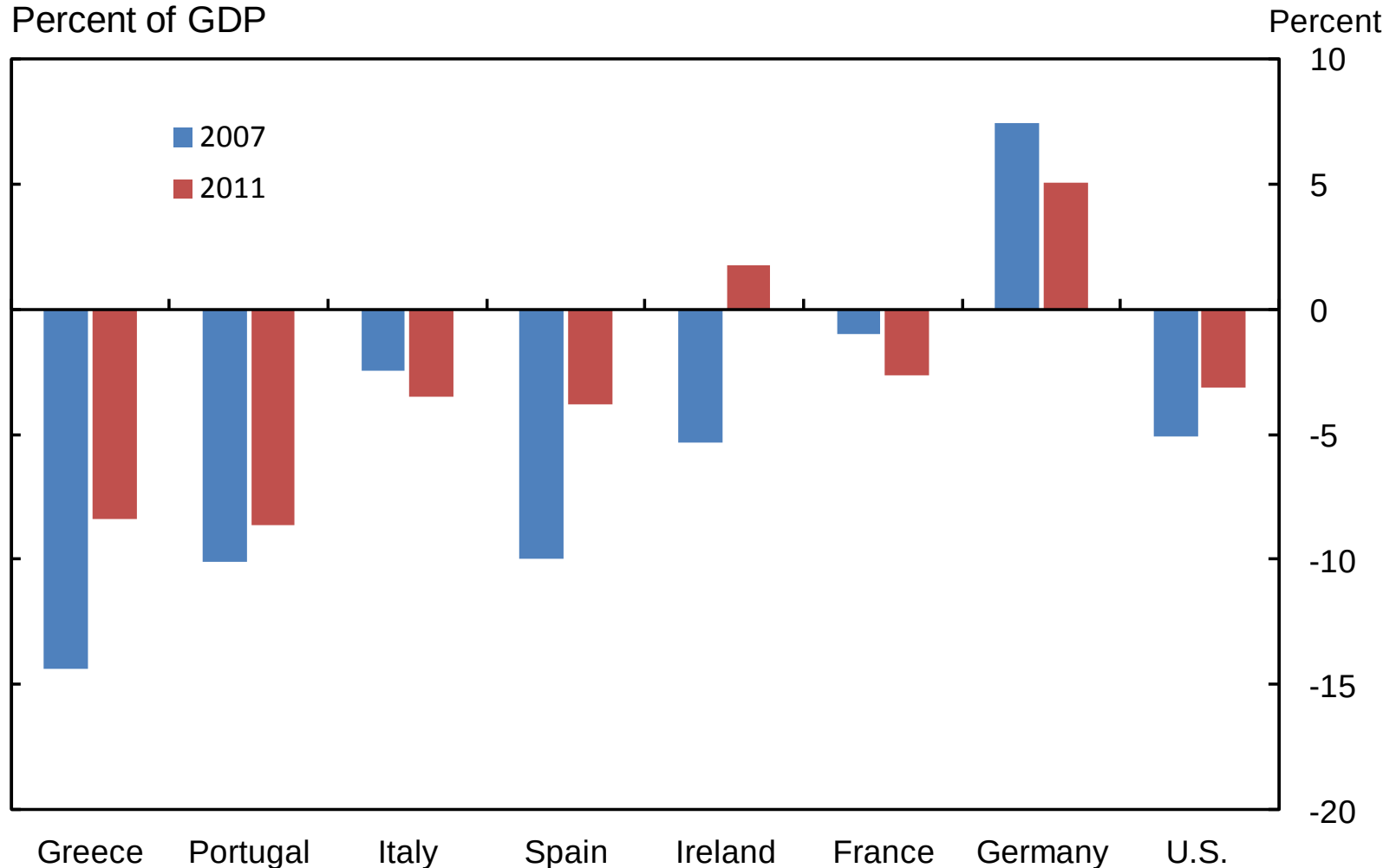


Source: OECD Economic Outlook 90. Note: 2011 figures are estimates

Peripherals running sizable current account deficits...and NO exchange rate adjustment

Current Account Balance

Percent of GDP



Source: IMF WEO; 2011 figures are estimates

*Recent Developments:
Greece, Portugal, Spain become more
competitive...
at huge “internal devaluation” cost*

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6



*The crisis forced the troubled eurozone economies to fire workers and cut salaries and this is boosting their competitiveness.

* Much of the **competitiveness gap** that partly caused the eurozone debt crisis is **disappearing, as unit labour costs fall rapidly in the periphery countries**, a study by the business research think tank The Conference Board shows. (1/31/13)



Would Turkey be different than EMU Periphery?

- Exchange rate substantial depreciation
 - 1.78 in January 2005
 - 2.34 in April 2013
 - 30% depreciation of lire; 4% annually
- Inflation in Turkey
 - Average CPI of 8% since 2005; PPP maintained by depreciation
- Once in EMU, need to follow “northern” inflation rates
 - 2% and no exchange rate depreciation
 - And productivity growth to keep pace with EMU center
- But sizable economic / political benefits of being in EU...but Turkey should try to negotiate a “Danish clause” from EMU...which Sweden also did indirectly

Perspectives on academic work relevant for EMU policy

- A. Underestimated vulnerability of EMU countries to capital flight/sudden stops
 - 1. Being in EMU doesn't offer "full protection" at this institutional stage
- B. Underestimated "real effects" of adjustment
 - 1. Importance of exchange rate regimes in facilitating adjustment
 - 2. Difficulty of "internal devaluation"
 - 3. Importance of financial crises
- C. Re-focus on capital flows
 - 1. Common currency allows continued imbalances, doesn't "force" adjustment
 - 2. Usually burst of capital inflows when joining EU/EMU...can create instability
 - 3. Can't use monetary policy, fiscal, or CAPITAL CONTROLS

Thank you!