The European Debt Crisis

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The Architecture of Fiscal Policy in the Euro Zone before the Crisis

- **EU Treaty**
- **No bailout clause (Art. 125):**
  - Prohibition of “debt monetization"
  - Need to avoid "excessive deficits"
  - Deficit and debt limit over GDP (3/60)
    - Correction procedure (Commission → ECOFIN)
• **Stability and Growth Pact (1997)**
  - **Preventive Arm**: quasi-balance or surplus in the medium term
  - **Corrective Arm**: Excessive Deficit Procedure (EDP)
    - Correction: 2 years (1 year after identification)
    - Exceptions:
      - small and temporary diversions
      - natural disasters or deep recession (> 2%)
      - Sanctions (+ deposit 0.2% → fine)
  - **The SGP in practise (until 1995):**
    - fiscal deterioration since 1999 in some countries
    - Nov. 2003: ECOFIN suspension of the Excessive Deficit Procedure against France and Germany
• **The Reform of the SGP (2005):** relaxed the rules
  - **“Preventive Arm”**
    - country-specific Medium-Term budgetary Objective (MTO).
    - MTOs: upper target limit structural deficits relative to GDP considered to ensure sustainability of the government accounts throughout the following 20 years (considering both future potential output, future cost of government debt, and future increases in age-related costs)
    - The structural deficit in the medium term may not exceed 1%
    - correcting deviations: 0.5% deficit / GDP per year in structural terms.
    - Exception: structural reforms, ex. pensions.
  - **“Corrective Arm”**
    - more exceptions:
      - persistent negative GDP growth below trend
      - Consideration of "all relevant factors" that affect the fiscal position in the medium term
      - Possible extension of time correction
Origins of the EU Debt Crisis

- The economic crisis 2008-2009
- Fiscal consequences of the crisis:
  - Automatic stabilizers
  - Discretionary countercyclical policy
    - increasing debt / GDP
    - interest rate differentials increase (spreads)
The chart presents the ratio of Debt/GDP for various countries in 2007 and 2013. Countries listed include Grecia, Irlanda, Portugal, Espanya, Italia, Belgica, Holanda, Austria, Eslovàquia, Finlândia, Eslovenia, França, Alemanya, Regne Unit, and EUA. The x-axis represents the countries, while the y-axis shows the ratio of Debt/GDP. Colored bars indicate the ratio for 2007 and 2013, with teal for Deute/PIB 2007 and yellow for Deute/PIB 2013.
Interest rate on long-term debt in the euro area
Public debt and interest rates before the debt crisis

Font: Manganelli and Wolswijk (EP, 2009)
Key facts in the debt crisis

- Precedents: rescue of Latvia, Hungary and Romania (14.6mm, EU & IMF)
- 2 May 2010: Greek bailout (EU & IMF, 80 +30 = 110mm)
- May-June: open tools for other countries
  - European Financial Stability Mechanism: CE, 60mm
  - European Financial Stability Facility: euro, 440mm
  - FMI: 50% of European contributions
  - BCE: Purchase debt securities ("Securities Markets Programme") + suspension collateral requirements
- Novembre 2010: Rescuing Ireland
  - 50mm (deficit) + 35mm (banking system)
  - EFSM (22.5mm), EFSF (17.7mm), FMI (22.5mm), …

March 2011: Pact for the Euro ("Six-pack")

http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

- Strengthening implementation SGP
- Tougher penalties for noncompliance recommendations SGPs with decision to "reverse qualified majority"
  - SGP by "excessive debt" (> 60%) if there is no set "satisfactory" (1/20 annual deviation)
  - expenditure growth ceiling (= GDP growth in the medium term)
  - common national accounting standards and predictions
- Procedure prevention and correction of "excessive macroeconomic imbalances" (credit, current account, unit labor costs ...)
  - Strengthening coordination ex ante ("European semester")
  - Creation of the "European Stability Mechanism" (ESM)

http://www.esm.europa.eu/
• May 2011: Portugal bailout (EU+FMI, 52+26=78mm)

• March 2012: second Greek bailout (130mm)
  • exchange "voluntary" private sector debt, 50% loss.

• March 2012: Treaty on Stability, Coordination and Governance ... ("Fiscal Compact")
  • Adoption of "budgetary stability law" at each state, with automatic correction mechanisms
  • *Maximum structural deficit: 0.5% (1% if debt <60%)*
  • *Adjustment 1/20 deviation debt / GDP*

• April 2012: “Budget Stability Act“
  • Art develops. 135 Constitution (Reform Set. 2011)
  • *Maximum structural deficit: 0%*
  • Debt / GDP up 60%
  • Gradualism 2020: 0.8% annual structural deficit reduction
• July 2012: Financial assistance to Spain to recapitalize the banking system (up to 100mm; cash: 41mm)
• September 2012: Announcement of the "Outright Monetary Transactions" ECB
• October 2012: the ESM comes into operation
• February 2013: adopted "two-pack"
  ◦ Evaluation and control drafts budget deficits and correction
    • "Common budgetary calendar" (30/4 medium term, 15/10 budget, ...), EC recommendations in case of deviations with respect SGP (or EDP)
    • create independent tax advice
    • semester budget execution information

Economic and budgetary monitoring "enhanced" to European countries with financial stability issues (eg, preventive care)
  • consultation / information to the "troika"
  • possible macroeconomic adjustment program

April 2013: Rescue Cyprus (ESM: 9mm, IMF: 1mm)
The European Stability Mechanism

- Capital: 700mm (80 paid-in+620 callable)
- Lending capacity: 500mm - permanent
- "Preferred creditor status": refers to the willingness of the Fund’s debtor member countries to give priority to repayment of their obligations to the Fund over other creditors, and the agreement or acquiescence of other creditors to this situation
- Instruments:
  - Macroeconomic adjustment program
  - Bank recapitalization program
  - Financial Programme of Preventive Assistance
  - Ease primary market support
  - Ease secondary market support