# Chapter 19

# Lessons from the euro debt crisis[1]

## 1. Introduction

In Europe, just as we were beginning to breathe a sigh of relief and believe that there is light at the end of the tunnel in the long euro debt crisis, we now have to address the unimaginable: a Member State leaving the EU. Some have already called Brexit the “Lehman Brothers of Europe”. It is still early days, but what is for sure is that Europe once again causes headaches for the rest of the world, be it the markets and/or the policy-makers.

Before turning to the main subject of my speech, let me say a few introductory remarks about the outcome of the UK referendum on 23 June 2016, which I will discuss at length. This topic makes headlines these days and it is what everyone is talking about at the moment. Here are a number of important questions on the British referendum, which I hope to answer in the course of my speech.

First and foremost, the seriousness of the situation. In other words, if indeed Brexit will be the worst-case episode in the euro saga, namely even

1 This is an edited and abridged version of a lecture delivered at the Columbia Business School in New York, organised by the School’s Chazen Institute, on 12 July 2016.

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worse than the euro debt crisis of 2012, and whether a perfect storm will unfold. If this is the case, what is at stake? And what will the reaction from the authorities be? Would more expansionary monetary policies be enough? Is the solution to the above problem more integration given that EU public opinion is becoming all the more eurosceptic? How will all this affect the EMU's incomplete architecture and the so-called democratic deficit in Europe? Some commentators claim that British politics are starting to imitate Greek politics; this may be so, I do not know. There are huge differences between the institutions of the two countries. What I do know is that my country, without questioning its euro area membership, should start resembling Britain in a number of areas, including the attraction of foreign direct investment (FDI), public sector accounting, transparency and financial management and reforms that produce tangible results in the functioning of labour and product markets.

My speech will be structured as follows. The next two sections will focus on a chronicle and the lessons to be drawn from the euro debt crisis over these past few years. Section 4 will take a look at the risks to sustainability of public debt, while Section 5 provides an overview of post-Brexit effects on the markets. Concluding, I will take a brief look at today's world order comprising three major poles: US, Europe and China, and I will raise the questions whether the US's predominant global role is at risk, if and when China's ambitions about becoming the world's superpower will materialise, and, finally, if there is a chance of reversing Europe's decline in the new world economic order.

## *2. A chronicle of the euro debt crisis*

First, allow me to give you a very brief chronicle of the debt crisis in the euro area, which originated in the government debt crisis in my country at the beginning of 2010. Although initially the Greek problem was a problem of credibility and a higher primary deficit (liquidity shortage), it soon evolved into a public debt solvency crisis which led to my country's exclusion from international markets, a request for financial support from our euro area partners and the International Monetary Fund (IMF), and the signing of a Memorandum of Understanding on 2 May 2010. As a result of its systemic nature (bond markets work as communicating vessels given that European banks used to hold large quantities of Greek gov-

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ernment bonds in their portfolios), the debt crisis in Greece soon became a self-fulfilling prophecy for the entire euro area.

Soon Ireland followed, but on quite different grounds. The first rescue package to a euro area member country as a result of a banking crisis was granted on 28 November 2010, when Dublin requested financial support from the European Union and the IMF in order to rescue its domestic banks.

In May 2011, Portugal became the third member of the euro area to be forced into signing an MoU and receive financial assistance due to the prohibitive cost of government borrowing on international markets.

In March 2012, the biggest debt restructuring in world economic history with the voluntary participation of the private sector (PSI) caused losses for Greek banks, necessitating their recapitalisation. The haircut in Greek government bonds was accompanied by a new loan agreement programme and the signing of the second Memorandum of Understanding by the government of Prime Minister Lucas Papademos, of which I was a member.

In the same month (June 2012), Spain made an official request for financial assistance from the EU. Markets were calmed down by Mario Draghi's statement that he would do "whatever it takes"[2] to preserve the euro and a couple of months later, the announcement of the Outright Monetary Transactions (OMT) programme for unlimited interventions in the secondary short-term bond market.

### *3. Lessons from the latest crisis in the euro area*

When the global financial crisis hit in 2008, the euro area did not have the safety valves and institutions to respond timely to the severe crisis ahead. The US proved to be a lot more knowledgeable in its response to the crisis, both the Fed and the government. Europe, on the other

2 Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London, 26 July 2012.

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hand, was slow to respond, even after the Greek debt crisis broke out in the first months of 2010. Instead of addressing the sovereign and banking crisis with expansionary fiscal and monetary policies (like the US), Europeans worried about moral hazard and opted for contractionary policies. In my view, there are three major lessons to be drawn from the crisis in the euro area, which originated in Greece in 2010.

*Lesson 1*

Since the introduction of the single currency, both EU officials and markets kept a false sense of safety, as they failed to recognise that the elimination of exchange rate risk would lead to systemic risk caused by chronic structural problems being incorporated as credit risk premium in a country's borrowing cost. It is true that member countries of the Economic and Monetary Union (EMU) lost the ability to print money at national level. As a result, euro-denominated debt of a country would, to a large extent, be equal to external debt expressed in quasi-foreign currency. In other words, markets now focus on the fiscal deficit and public debt to evaluate risks.

*Lesson 2*

The euro area crisis highlighted the vicious circle between banks and sovereigns. In order to break it, the EU reacted quickly and adopted emergency measures to establish a Banking Union among euro area member countries (open to other EU Member States which would want to opt in), in order to "create the right conditions for the financial sector to lend to the real economy, spurring economic recovery and job creation". The first pillar of the Banking Union is the Single Supervisory Mechanism, which is a new system of banking supervision for Europe comprising the ECB and national bank supervision authorities. The ECB directly supervises the 125 significant banks of the participating countries, which hold almost 82% of banking assets in the euro area. The second pillar is the Single Resolution Mechanism (SRM), which comprises the Single Resolution Board (SRB) and National Resolution Authorities of the participating Member States of the Banking Union (NRAs). The SRB has taken over the responsibility for deciding when a

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bank has failed and for overseeing its "resolution" and, entered into operation on 1 January 2016. The final pillar of the Banking Union for a pan-European deposit guarantee system has stumbled on resistance from certain Member States; the European Commission's proposal for the European Deposit Insurance Scheme (EDIS)[3] is under discussion and has yet to be approved by the Council.

However, the lesson that has clearly come out of the ongoing crisis is the incomplete architecture of the European Union and the need for further integration. It is imperative that the Banking Union structure is completed sooner than planned, so that the EU can be protected against, and become sort of immune to, future systemic crises. I'll come back to this issue later on. The question remains how quickly Europe will complete the EMU and move towards some form of debt mutualisation. Or indeed put in place the initiative for a Capital Markets Union to improve the financing of small- and medium-sized enterprises in the euro area by bolstering market-based finance. Let me simply point out that the European economic model remains to a large extent bank-centered, with more than 70% of corporate financing derived from bank loans, compared with around 20% in the US, which has a more market-based economy.

*Lesson 3*

The experience of the last 5 years with adjustment programmes in the europeriphery —and more particularly in Greece— has shown that there are limits to the effectiveness of austerity policies and internal devaluation in over-indebted countries that are members of a monetary union. Excessive austerity, the aggravation of the recession caused by drastic cuts in active demand and sort of "disarming" the automatic stabilisers in an economy, accompanied by the (unconfessed) truth that the growth effects of implementing structural changes and reforms take time (3-5 years must pass before any tangible results appear), have cre-

3 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM/2015/0586 final.

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ated a vicious circle of negative expectations, recession and new measures of austerity. Undeniably, less attention has been paid to the role of recession in adjustment programmes in the euro area. More generally, it appears that there is an issue of aggregate demand in the euro area, to which I will also come back.[4]

On the monetary frontier, since the onset of the 2008 global financial crisis, all four major central banks (the US Federal Reserve, the Bank of England, the Bank of Japan and the European Central Bank) applied unconventional monetary policies. Only the US Fed is preparing its exit strategy, namely the normalisation of monetary policy, while the ECB and the Bank of Japan continue to apply their non-standard policies. The Bank of England, in the aftermath of the Brexit vote, is widely expected to revert to a new round of QE and possibly even negative rates (its base rate now stands at 0.5%).

### *4. Risks to debt sustainability in the euro area*

Let me now focus on public debt sustainability in the euro area, since there is an interesting point to be made here. Despite the rise in debt-to-GDP ratios, debt servicing is much easier. Despite that, risks to sustainability are on the downside, which after the Brexit vote are now heightened indeed!

The global financial crisis has led to a rapid accumulation of government debt in most countries of the euro area. Indeed, the euro area government gross debt-to-GDP ratio is estimated to have risen by 28 percentage points from its pre-crisis level in 2007 to reach 93% in 2015. As far as individual euro area countries are concerned, for 2015, debt ratios in Greece, Italy, Spain and Portugal are estimated to have been very elevated, at around 186%, 133%, 101% and 129% of GDP, respectively. However, financing concerns are currently mitigated by low sovereign funding costs for almost all sovereign rating categories and solid demand for government bonds against the backdrop of the Eurosystem's ongoing public sector purchase programme (QE). Total debt service of euro area

4 See the author's two articles in the *Financial Times* (2012) and *Wall Street Journal* (2012) and the author's latest book "The Double Crisis of Sovereign Debt and Banks" [in Greek] (2014).

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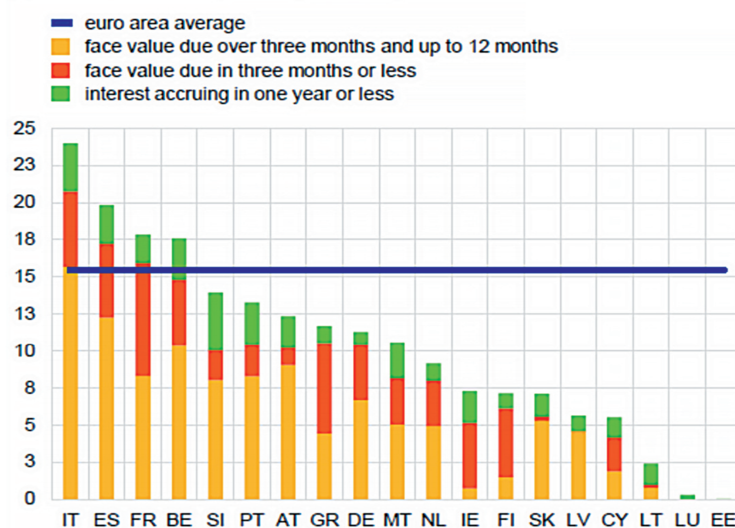
governments for the next 12 months is around 16% of GDP (around €1.6 trillion), a figure which comprises 13.9% of principal (face value) and 2.1% of interest, but is expected to decline further, as lower interest rates translate into reduced debt servicing costs.

Figure 1 Total government debt service in the euro area by country




Source: European Central Bank.

But, despite frontloaded and comprehensive fiscal consolidation in euro area countries, euro area's debt sustainability has to be closely monitored as concerns remain to the downside mainly due to the following risks in the short- and medium- to long-run.[5]

The low interest rate environment increases the disincentive to fiscal consolidation. Ultra-low interest rates flatter the debt service ratio, painting a misleading picture of debt sustainability. Fiscal reforms can be put off indefinitely, undermining fiscal discipline. For instance, negative

5 See European Central Bank, *Financial Stability Review*, May 2016.

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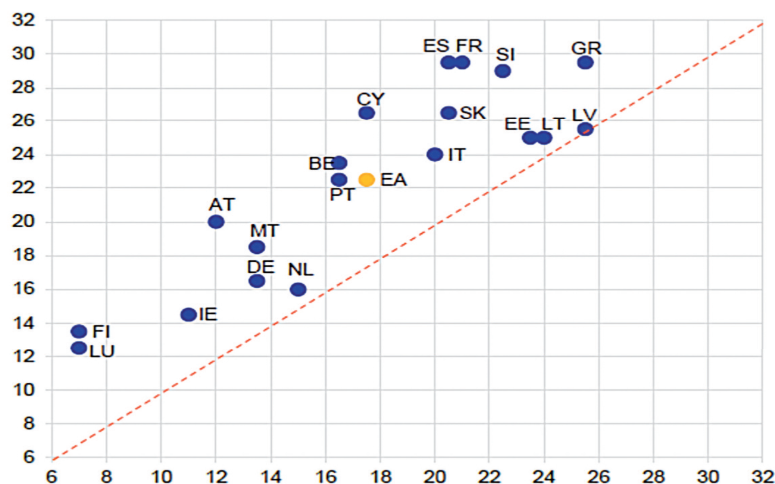
rates, if applied too long, may act as an anaesthetic to euro area governments, especially in the europeriphery. The fiscal space gained from lower debt service costs may slow enactment of the necessary fiscal and structural reforms.

The problem in the euro area is that inflation is persistently low, and so too is nominal demand (up by 1% over the last seven years, compared with a 3.7% rise before the 2008 global financial crisis). Clearly, the denominator effect is a risk to public debt sustainability.

Last but not least, political risks have been on the rise (see Figure 2), posing a challenge to fiscal and structural reform implementation. Heightening political risks (especially in Spain, Portugal, Greece, Italy and France) and increasing support for populist political parties, seen to be less reform-oriented given their eurosceptic credentials, have the potential to undermine the European direction of these countries, with potential destabilising effects also for the euro itself.

Figure 2 Political risks in the euro area




Sources: The PRS Group (International Country Risk Guide) and ECB calculations.

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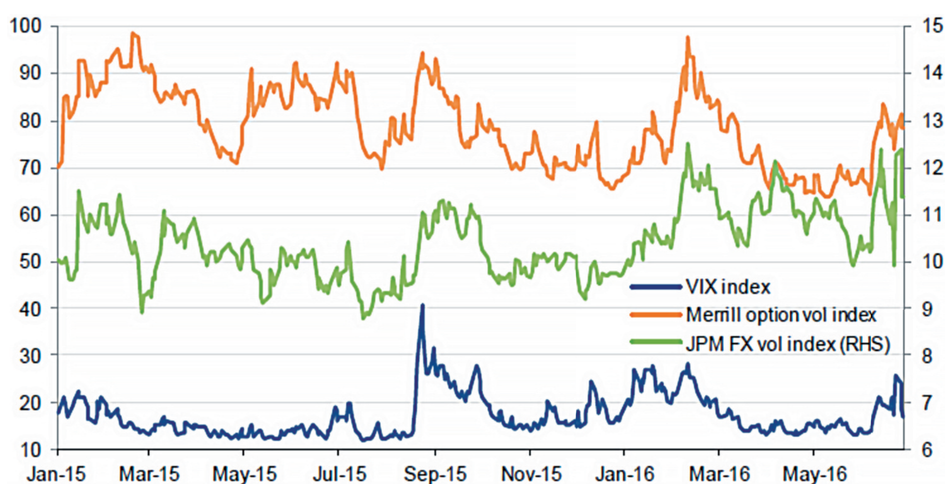
## *5. Post-Brexit effects on international markets*

Of course, in the aftermath of the British referendum the biggest political risk to the whole of Europe is Brexit, for reasons that I am going to explain below. First of all, I propose to take some time to analyse in more detail the Brexit short-term effects on global capital markets, in my capacity as Bank of Greece Deputy Governor in charge of the Bank's investment portfolio of several billions, as well as other impacts on Britain's future and on the UK's relationship with the rest of the EU.

The UK referendum's shock result created massive uncertainties with significant spill-overs across financial markets. The day after the referendum, the VIX index increased sharply by around 55%, as you can see in the Figure below.

Figure 3 Indicators of volatility after the Brexit vote outcome




Sources: Bank of Greece and Bloomberg.

As far as foreign exchange markets are concerned, the pound sterling fell sharply across the board, it plunged against the US dollar to a 30-year low of 1.3229, and against the euro to 0.848, its lowest level since October 2013 (see Figures 4 and 5).

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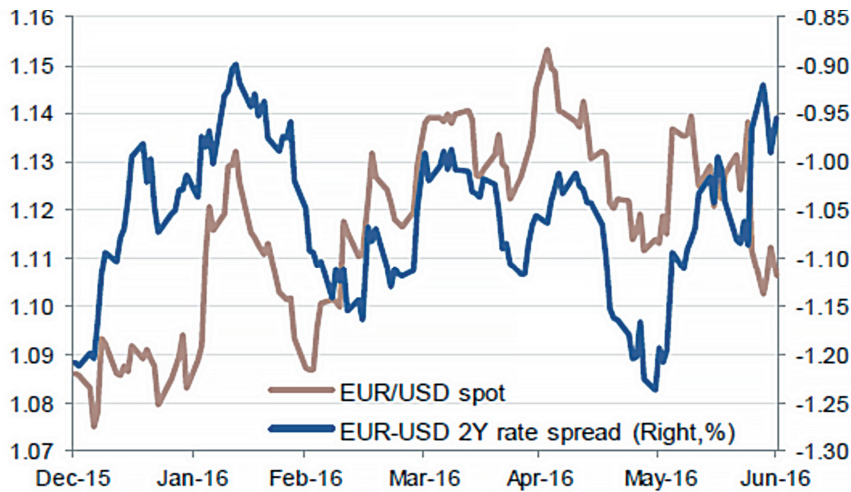
Figure 4 Exchange rate of the euro vis-à-vis the pound sterling (2000-2016)

Sources: Bank of Greece and Bloomberg.

Figure 5 Exchange rate of the euro vis-à-vis the US dollar and 2-year rate spread




Source: Bank of Greece.

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The bond market reactions show that euro area peripheral spreads have been particularly affected by the British electorate's decision.

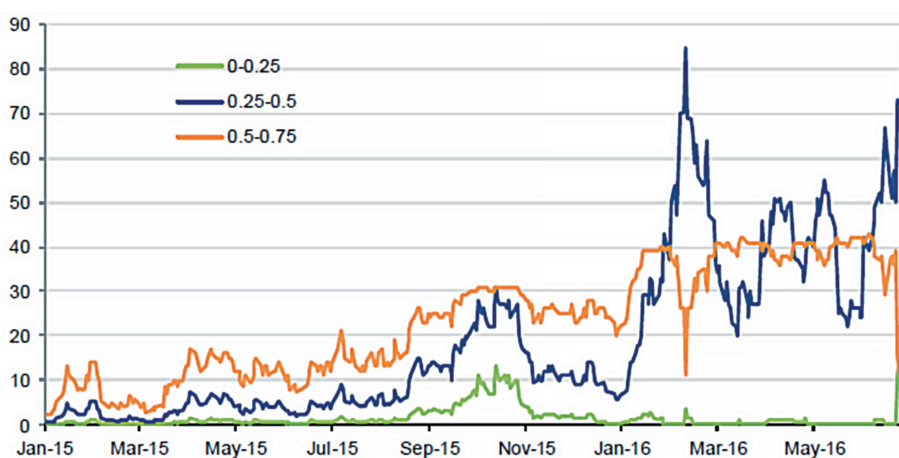
Stock markets recorded a broad-based selloff and bank stocks were down by about 6.8% on account of growing concerns over the potential macroeconomic, financial and political implications of Brexit.

All these market reactions point to a year that can be described as "Britain out – Bear in".

As far as central banks' future monetary policies are concerned, the Bank of England Governor, Mark Carney, has rolled up his sleeves and appeared almost every other day in public, signalling a willingness to cut interest rates and offering funds to banks, possibly cutting banks' capital requirements – reversing the decision that the Bank of England took in March to raise the countercyclical buffer for UK exposures and renewing credit easing.

Across the "little pond", the post-Brexit era might delay a normalisation in US monetary policy because of the rise in US dollar prices (see Figures 6 and 7).

Figure 6 Fed funds futures show an 85% probability of unchanged policy rates by year-end




Sources: Bank of Greece and Bloomberg.

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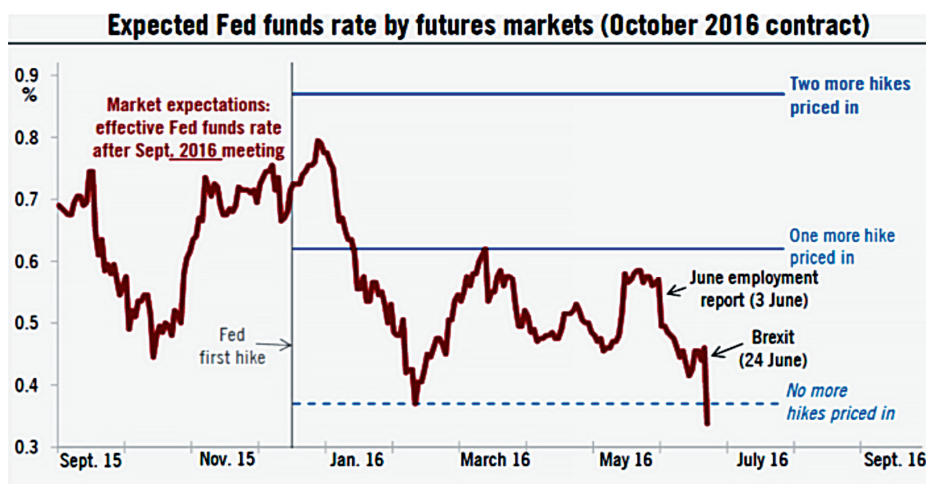
Figure 7 Market expectations for a Fed rate hike fall after the UK referendum




Sources: Pictet Wealth Management - Asset Allocation & Macro Research and Datastream.

Moving away from financial market effects, the question now is how Brexit will play out in the following months and years and how the relationship between Britain and the continent will evolve in the wake of the referendum. The United Kingdom is facing the following trilemma, i.e. having to strike a balance between, on the one hand, the promises that the political system has made to its voters and the need to respect their democratic will and, on the other hand, accepting the European Union's rules and particularly its acquis, including the four freedoms of movement of goods, services, capital and, most importantly, people – not only labour – and, thirdly, access to the Single Market. Let me stress here that the core European ideal of free movement of people is not restricted to workers, reflecting the sensitivity of Europe to migration.

My conviction is that we will see a compromise of conflicting principles by means of a "light" version of Brexit. Britain has long been a conservative nation and there is a well-anchored instinct to preserve stability, with deep roots down in history. So I believe that the UK will maintain its close economic ties with the rest of Europe and the post-Brexit arrangements are very likely to resemble more the *status quo ante* than

lead to a radical disentanglement from the continent. There are many options offered to the UK ahead of its negotiations on its terms of exit from the EU. These vary from the Norwegian model to the Swiss model.

No matter if we have a full-blown Brexit or a "light" version of Brexit, the political risk for the rest of the continent is a tug-of-war between populist parties, the political establishment and elites in referenda across Europe. This risk is particularly heightened for countries with a rising anti-European public sentiment such as Hungary, the Netherlands, Denmark or even France.

## *6. Global risks and the role of the US today*

In the final section of my speech, I will take a medium- to long-term global view beyond the European continent.

### *Global outlook and risks*

In addition to the risks associated with the above-mentioned divergence of monetary policies and risks stemming from a possible Brexit, global capital markets' uncertainty is heightened by two more factors: China and the price of oil.

In my opinion, there are three major risks facing China, stemming from: a) its lower growth prospects, b) significant capital outflows, and c) rising private debt. My view is that the biggest risk is the rebalancing of the economy which, however, will take years and markets will have to learn to live with this significant risk.

Regarding the low price of oil and in the context of weak global growth, lower inflation observed in the euro area, driven in part by lower oil prices, could de-anchor inflation expectations from the ECB's target. In US monetary policy, the pressure on oil prices and subsequent pass-through to lower inflation levels could impact the economy in such a way so as to delay the pace of normalisation of the US Federal Reserve's monetary policy.

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*The role of the US today*

The US has been the world's leading power since the mid-twentieth century and it will be so in the future, not least because it is a dynamic economy that creates incentives and is based on low taxation, the rule of law, less regulation, equal opportunities and meritocracy in terms of access to its labour market, etc.

But above all, if you ask my personal opinion, what makes the US so great and secures its leading global role in the future is *investment in talent*, the fact that it has been attracting talented individuals from all corners of the earth over decades, as this is manifested in its pioneering academic thought and high-end research in technology and sciences. In the last 30 years, US-based researchers have received the lion's share of Nobel Prizes in Physics, Chemistry and Medicine, and Economics; Columbia University alone has won an impressive number of more than 80 Nobel Prizes, and a dozen in Economics! Even today, the US still invests more than any other country in research and development and remains the largest provider of information, financial, and business services around the world. It is the creation of new ideas, turned quickly into new products and services in the US economy, which is the new engine of growth these days. In modern economies, it's all about creative ideas.

*China*

Moving on from the Atlantic to the Pacific, China is the world's number one trading power, accumulating the highest stock of foreign exchange reserves, and is the undisputed second major economic player in the globe today. A significant development is that as of October 2016, the Chinese yuan will join the dollar, the euro, the sterling pound and the yen as a foreign exchange reserve currency in the IMF's Special Drawing Rights (SDR) basket. The objective is for the Chinese yuan to become a leading world reserve currency, second to the US dollar, sidelining the euro in the next decade or so. Whatever the place of its currency in the world, China would still not replace the US as the world's economic superpower in my opinion, given its low level of technological sophistication and innovation, and the poor quality of its institutions. By way of indication, the quality of the legal system, transparency and accountability, a

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slim and efficient public sector, business ethics, etc. all matter for sustainable economic growth. Not least, in order to become a leading geostrategic player like the US, China needs to build up alliances and exert a certain influence in global affairs. But these things take time.

*Europe*

The European Union has failed to stimulate strong growth rates, as the rest of the world economy, which has grown faster, and is still lagging behind its global partners in terms of investment (investment gap). After a particularly turbulent decade, it is mired in a stubbornly slow recovery from a global financial crisis that was followed by a sovereign debt crisis in the euro periphery. Europe's international standing has been steadily declining over the last twenty years. Its economic power is further at risk, as it faces acute simultaneous challenges (*inter alia*, political fragility and a pronounced tendency towards national solutions, along with an ongoing debt crisis and the recent migrant crisis), which have threatened it with disintegration. The unknown variable of the British referendum's outcome adds another layer of complexity to Europe's future. As one of the largest economic entities in the world, the EU can be a major player on the global arena today, by continuing and intensifying its integration process. Against this background, the EU's efforts to complete a Banking Union and proceed with fiscal integration move in the right direction.

## 7. Concluding remarks

In closing, European integration started as a project of regional economic integration. It has always shown an ability to undergo modification –albeit with fits and starts– so as to adapt to new circumstances.

There is an old saying in Brussels that the European project only advances in times of crisis, and Europe's leaders are known to have a tried-and-tested method for coming up with policy fixes when forced to cope with emergency situations. I only hope that this time is not different. As they say: "Time will tell".