Draft July 20; rev. Aug. 29, 2015

**“Causes of Eurozone Crises”**

**Jeffrey Frankel, Professor, Harvard University**

Written for *Causes of Eurozone crises past and future,* a VoxEU eBook co-edited by Richard Baldwin and Francesco Giavazzi, part of the “Rebooting Europe” project.

After six years of crisis in the eurozone, it is hard to find anyone who is optimistic about the prospects. To make the monetary union work would seem to require that the member countries relinquish more national sovereignty than they originally agreed to. Meanwhile the crisis has made the publics in most of the member countries *less* inclined to give up sovereignty than before, even if their elites ask them to give up more.

American economists continue to be especially pessimistic about the prospects. They might be pardoned for thinking that many of their warnings have come true. [[1]](#footnote-1) Even Martin Feldstein’s warning that the project would eventually result in worse political relations among the members, rather than better relations as intended, has lately turned out to have been surprisingly on target. [[2]](#footnote-2)

But we pessimists should recall that the 13 American colonies were no more eager to give up their separate sovereignties as of 1783, at the end of the American Revolution, than European countries today. And yet by 1789, against all odds, the colonies had agreed to federate as a single nation under the United States constitution.[[3]](#footnote-3)

**Three fundamental sources of Eurozone crises**

The sources of Eurozone crises, past and future, can be divided into three areas:[[4]](#footnote-4)

1. asymmetric shocks, where the problem is loss of ability to respond to national economic conditions via independent monetary policy or devaluation;
2. fiscal policy, where the problem is the real and perceived moral hazard that the prospects for bailouts create for the incentive of member countries to exercise budget discipline; and
3. banking, where the problem, as with fiscal policy, is that responsibility for financial regulation was left at the national level while monetary policy was moved to the ECB.

Problem number 1 is a way of saying that the members of the Eurozone don’t meet the criteria for an optimum currency area (OCA). This was the main basis for the pessimism of most American economists ahead of time. The OCA criteria start with the need for “symmetry of shocks,” i.e., high cyclical correlation. It turned out that euro members did indeed suffer from asymmetric shocks. Economic conditions in a country like Ireland during the first decade of the euro warranted a tighter monetary policy than was set in Frankfurt, and conditions after 2008 warranted an easier monetary policy.

Problem number 2, the fiscal problem, was not part of the traditional OCA criteria. That the architects of the euro in 1991 did focused sharply on this issue surprised many economists at the time.[[5]](#footnote-5) The architects put fiscal and debt limits at the heart of the Maastricht criteria for entry (3% of GDP and 60 %, respectively), they adopted a “No Bailout Clause” (1991) and later they agreed the Stability and Growth Pact (1997) and its successors. They deserve credit for recognizing the moral hazard problem early, in that fiscal policy constraints had not previously been featured in the scholars’ lists of Optimum Currency Area criteria. On the other hand, the elites were forced to do it politically. Voters in Germany and some other Northern European creditor countries were opposed to the euro project on the grounds that “we know you elites will have us bailing out a profligate Mediterranean government before you’re done.”

Problem 3, banking supervision, was at best mentioned in passing in the 1990s. Almost no thought was given to the possibility of moving deposit insurance, supervision, or bank resolution to the ECB level. Fortunately the eurozone has taken some steps in the direction of banking union since Mario Draghi became ECB president.

**Seven Mistakes**

Arguably if the Eurozone had gotten through its first decade or two without a serious crisis, some of the structural fundamentals might have evolved favorably, as they did early in US history. A monetary union tends to raise the trade links and raise the symmetry of shocks among the members, so that it may meet the OCA criteria ex post even if it does not ex ante. But how can the Eurozone get through a decade or two without a crisis?

One can take as given that the member countries wanted to go ahead and form a monetary union at the end of the 1990s, and even take as given that they weren’t yet ready to give up sovereignty with respect to fiscal policy and banking regulation, and yet identify a variety of ways in which it could have been done better. Ivory tower observers are generally too quick to point out the mistakes made by political leaders, often failing to recognize the constraints they were under at the time. Nevertheless, one can identify at least seven mistakes.

1. The membership should not have been expanded so quickly. In particular, Greece was not in truth ready to be admitted as early as 2001. Given the absence of any provision for countries to leave the euro, it would have paid to take more time with the entry process, even if it meant putting off some countries forever.
2. Soon after the euro’s inauguration, it became very clear that the attempt to address problem 2 had failed: the fiscal criteria were violated repeatedly, by countries large and small. The SGP (Stability and Growth Pact) had no teeth and no credibility. In other words, the moral hazard problem, though correctly identified, had not been effectively addressed. Virtually all members had violated the ceilings well before the euro crisis began in late 2009.[[6]](#footnote-6) When they received letters from Brussels informing them that their budget deficits exceeded the ceilings and needed to be corrected, they would invariably respond with optimistic forecasts that strong growth would soon bring the deficits below the ceilings. Repeated attempts to strengthen the SGP failed, perhaps because they did not take into account this problem of over-optimistic forecasts.[[7]](#footnote-7)
3. When interest rate spreads of Greece and other periphery countries fell almost to zero after joining the euro (2002-07) despite substantial violations of the fiscal criteria, this was viewed as a good thing rather than a bad thing. But it is clear, at least in retrospect, that low spreads among euro countries were direct real-time evidence that the moral hazard problem had not been solved.

Why did Mediterranean country spreads relative to Germany all but disappear? Private investors should bear some blame for having pushed the throttle all the way to “risk on” during this period; but they would point to top ratings that the bonds received from the rating agencies. Rating agencies should bear some blame; but they would point to the readiness of the European Central Bank to accept the [periphery bonds](http://www.voxeu.org/article/could-eurobonds-be-answer-eurozone-crisis) as collateral. In effect, markets must have believed that any countries that got into debt trouble would be bailed out. When an American state gets too deeply into debt, its creditors demand higher interest rates.[[8]](#footnote-8)

1. The fourth mistake was the failure to [send Greece to the IMF](http://www.voxeu.org/article/greek-debt-crisis-ecb-s-three-big-mistakes) early in the crisis. In January 2010 the need for the IMF should have been clear. Rather than going into shock, leaders in Frankfurt and Brussels could have welcomed the Greek crisis as a useful opportunity to establish a precedent for the long-term life of the euro.

The idea that such a debt crisis would eventually arise somewhere in the Eurozone cannot have come as a surprise. After all, that is why had the architects written the Maastricht fiscal criteria, the No Bailout Clause, and the Stability and Growth Pact? When the rules failed and the crisis came, the leaders should have thanked their lucky stars that the first test case had arisen in a country that met two characteristics admirably. First, the Greek government had broken the rules so egregiously and so frequently that Europe’s leaders could, with a clear conscience, judge a firm stand to be merited. The alternative was to risk establishing the precedent that all governments are ultimately to be bailed out, with all the moral hazard headaches that precedent implies. [[9]](#footnote-9) Second, the Greek economy was small enough to make it feasible for Europe to come up with the funds necessary to insulate others, who were vulnerable to contagion but not as blameworthy, for example Ireland.

European leaders also should have thanked their stars that the IMF existed. Instead of acting as if such a crisis had never been seen before, they should have realised that imposing policy conditionality in rescue loan packages is precisely the IMF’s job. International politics is less likely to prevent the IMF from enforcing painful fiscal retrenchment and other difficult conditions than it is among regional neighbours or other political allies. Europe is no different in this respect than Latin America or Asia.

But the reaction of leaders in both Frankfurt and Brussels was that going to the IMF was unthinkable, that this was a problem to be settled within Europe. They chose to play for time instead, to treat insolvency as illiquidity. Their argument was that such steps would result in contagion to Ireland, Portugal, Spain and others. But they subsequently got the contagion that they feared anyway. The contagion only became harder to fight, when leaders’ statements had lost credibility and the spreads on these countries shot up to levels so high as to make the arithmetic of debt dynamics impossible. What started as a small “Greece fire” became harder to contain after it jumped the natural firebreak and spread to other parts of the forest.

1. The fifth mistake was the failure to write down more of the debt and to do it earlier, at a time when most of the debt was still held by private creditors. They could usefully have taken a “haircut,” which is harder for public sector creditors (particularly the IMF, ECB, ESFS and ESM). But again, leaders in both Frankfurt and Brussels insisted in 2010 and 2011 that writing down the debt was unthinkable.
2. The sixth mistake is the stubborn belief that fiscal austerity is not contractionary, even in the short run. Some even insisted that it can raise GDP and lower debt/GDP ratios. The mistake was made especially by many in Germany and other creditor countries. The International Monetary Fund was forced to go along with over-optimistic forecasts of its programs’ effects on growth, because its rules specified that it was not allowed to participate in the country programs unless it could forecast that they would lead to a return to debt sustainability in the form of declining ratios of debt to GDP. In the event the fiscal austerity – coming as it did at the wrong time – worsened the recessions in Greece and other periphery countries. As a result, debt/GDP ratios, far from coming down, rose at an accelerated rate. A simple Keynesian multiplier model would have given better predictions.[[10]](#footnote-10)

1. Needless to say, the Greeks made plenty of mistakes too. Let us pick up the story from when the Syriza government came to power in January 2015.

The new Greek Prime Minister, Alexis Tsipras, had the chance to play a role for his country analogous to the roles played by Korean President Kim Dae Jung in 1997 and Brazilian President Luiz Inácio Lula da Silva in 2002. Both of those presidential candidates had been long-time men of the left, with strong ties to labor, and were known to place little priority on fiscal responsibility or the virtues of markets. Both were elected at a time of economic crisis in their respective countries. Both confronted financial and international constraints in office that had not been especially salient in their minds when they were opposition politicians. Both were able to make the mental and political adjustment to the realities faced by debtor economies. As a result, both were able to lead their countries effectively.

They pursued needed reforms. Some of these were “conservative” reforms (or “neo-liberal”) that might not have been possible under more mainstream or conservative politicians.

But Kim and Lula were also able to implement other, “liberal,” reforms consistent with their lifetime commitment to reducing income inequality. Korea began to rein in the chaebols, the country’s big family-owned conglomerates. Brazil expanded the Bolsa Familia plan, a system of direct cash payments to households that successfully lifted millions out of poverty.

Mr. Tsipras and his Syriza party spent their first six months in office still mentally blinkered against financial and international realities. A career as a political party apparatchik is probably not the best training for being able to see things from the perspective of other points on the political spectrum, other segments of the economy, or other countries. This is true of a career in any political party in any country but especially one on the far left or far right.

The Greek Prime Minister seemed to think that calling the July 5 referendum on whether to accept terms that had been demanded previously by Germany and the other creditor countries would strengthen his bargaining position. If he were reading from a normal script, he would logically have been asking the Greek people to vote “yes” on the referendum. But he was asking them to vote “no”, of course, which they did in surprising numbers. As a result – and contrary to his apparent expectations -- the only people whose bargaining position was strengthened by this referendum were Germans who felt the time had come to let Greece drop out of the euro.

The Greek leadership eventually discovered that its euro partners, predictably, were not prepared to offer easier terms than they had been in June, and in fact asked for more extensive concessions as the price of a third bailout. Not until a week after the referendum did Mr. Tsipras finally begin to face up to reality. The only possible silver lining to this sorry history is that some of his supporters at home may – paradoxically – now be willing to swallow the bitter medicine that they had opposed in the referendum. Like Kim Dae Jung and Lula, he may be able to bring political support of some on the left who figure, “If my leader now says these unpalatable measures are necessary, then it must be true”. As they say, only Nixon can go to China.

None of this is to say that the financial and international realities are necessarily always reasonable. Sometimes global financial markets indulge in unreasonable booms in their eagerness to lend, followed by abrupt reversals. That describes the large capital inflows into Greece and other European periphery countries in the first ten years after the euro’s 1999 birth. It also describes the sudden stop in lending to Korea and other emerging market countries in the late 1990s.

Foreign creditor governments can be unreasonable as well. The misperceptions and errors on the part of leaders in Germany and other creditor countries have been as bad as the misperceptions and errors on the part of the less-experienced Greek leaders. The belief that [fiscal](http://www.project-syndicate.org/commentary/the-first-world-s-fiscal-follies) [austerity](http://www.project-syndicate.org/blog/procyclicalists-across-the-atlantic-too) raises income rather than lowering it, even in the short run, was one [mistaken](http://www.project-syndicate.org/commentary/the-case-against-expansionary-austerity-by-jeffrey-frankel) perception. As noted, the refusal to write down the debt in 2010 was a mistaken policy as well.

A stubborn clinging to wrong propositions on each side has reinforced the stubbornness on the other side. The Germans would have done better to understand and admit explicitly that fiscal austerity is contractionary in the short run. The Greeks would have done better to understand and admit explicitly that the preeminence of democracy does not mean that one country’s people can democratically vote for other countries to give them money.

In terms of game theory, the fact that the Greeks and Germans have different economic interests is not enough to explain the very poor outcome of negotiations to date. The difference in perceptions has been central. “Getting to yes” in a bargaining situation requires not just that the negotiators have a clear idea of their own top priorities, but also a good idea of what is the top priority of the other side. We may now be facing a “bad bargain” in which each side is called upon to give up its top priorities. On one side, Greece shouldn’t expect the ECB to be willing explicitly to write down the debt it holds. On the other side, the creditors shouldn’t expect Greece to run a substantial primary budget surplus.[[11]](#footnote-11) A “good bargain” would have the creditors stretch out lending terms even further so that Greece doesn’t have to pay over the next few years and would have the Greeks committing to structural reforms that would raise growth.

One hopes that the awful experience of the recent past has led both sides to clearer perceptions of economic realities and of top priorities. Such evolution is necessary if the two sides are to arrive at a good bargain rather than either a bad bargain or a failure of cooperation altogether. The non-cooperative equilibrium is that Greek banks fail and Greece effectively drops out of the euro. This may be even worse than a bad bargain, though I am not sure.

A recurrent theme of the Greek crisis ever since it erupted in late 2009 is that both the Greeks and the Euro creditor countries have been reluctant to consider that lessons from previous emerging market crises might apply to them. After all, Greece was not a developing country but rather a member of the euro. And one should not underestimate the opposition that reforms will continue to face among Greeks. But the Emerging Market crises do have important lessons for Europe. If Tsipras were able to shift gears in the way that Kim Dae Jung did in Korea and Lula did in Brazil, he would better serve his country.

References

Bayoumi, Tamim, Morris Goldstein and Geoffrey Woglom, 1995, “Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States,” *Journal of Money, Credit and Banking,* Vol. 27, No. 4, Part 1, Nov.: 1046-1059.

Beetsma, Roel, and Harald Uhlig, 1999, “An Analysis of the Stability and Growth Pact,” *Economic Journal* 109 (458): 546–71.

Blanchard, Olivier, and Daniel Leigh, 2013, “ Growth forecast errors and fiscal multipliers,” *American Economic Review*, 103(3), May: 117-120.

Buiter, Willem, Giancarlo Corsetti and Nouriel Roubini, 1993, “Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht,” *Economic Policy*, Vol.16,57-100.

Eichengreen, Barry, and Ugo Panizza, 2014, “A Surplus of Ambition: Can Europe Rely on Large Primary Surpluses to Solve Its Debt Problem?” CEPR Discussion Paper 10069; NBER WP 20136.

Ellis, Joseph, 2015, *The Quartet: Orchestrating the Second American Revolution, 1783-1789* (Alfred A. Knopf).

Feldstein, Martin, 1997, "EMU and International Conflict," *Foreign Affairs*, 76, no.6, 60-73.

--- 2005. "The Euro and the Stability Pact." *Journal of Policy Modeling* 27, no.4: 421-426.

Frankel, Jeffrey. 1993. “ ‘Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht;’ Comments on Buiter, Corsetti and Roubini,” *Economic Policy*, Vol.16: 92-97.

--- 2015,”The Euro Crisis: Where to From Here?” *Journal of Policy Modeling*, 37, issue 3, May/June.

Frankel, Jeffrey, and Jesse Schreger, 2013,"Over-optimistic Official Forecasts and Fiscal Rules in the Eurozone," *Review of World Economy* (*Weltwirtschaftliches Archiv*)149, no.2.

Frankel, Jeffrey, and Andrew Rose, 1998, "The Endogeneity of the Optimum Currency Area Criteria." *The Economic Journal* vol.108, no. 449: 1009-1025.

Jonung, Lars, and Eoin Drea. 2009. “The Euro: It Can’t Happen, It’s a Bad Idea, It Won’t Last. U.S. Economists on the EMU 1989-2002." *European Economy*. Economic Papers **395.** Dec. (Brussels).

Shambaugh, Jay. 2012. “The Euro’s Three Crises.” *Brookings Papers on Economic Activity*, no. 2, Spring.

1. Jonung and Drea (2009). [↑](#footnote-ref-1)
2. Feldstein (1997). [↑](#footnote-ref-2)
3. Ellis (2015). [↑](#footnote-ref-3)
4. Shambaugh (2012); Frankel (2015). [↑](#footnote-ref-4)
5. E.g., Buiter, Corsetti and Roubini (1993); Frankel (1993); Beetsma and Uhlig (1999). [↑](#footnote-ref-5)
6. E.g., Feldstein (2005). [↑](#footnote-ref-6)
7. Frankel and Schreger (2013). [↑](#footnote-ref-7)
8. Bayoumi, Goldstein and Woglom (1995). [↑](#footnote-ref-8)
9. In the case of the United States, the important precedent was the decision to let 8 states (plus Florida, then a territory) default on their debts in 1841-42 rather than bail them out. Partly as a result, nobody expects the federal government to bail out Illinois when it gets over-indebted today. [↑](#footnote-ref-9)
10. Blanchard and Leigh (2013). [↑](#footnote-ref-10)
11. Eichengreen and Panizza (2014) find from the historical record that the large primary surpluses envisioned by the Troika for the periphery countries over the next ten years are unlikely to be achievable. [↑](#footnote-ref-11)