The Eurozone in the GFC

Chapter 3

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In Kawai, M., Lamberte, M.B., and Park, Y.C. (eds.) *The Global Financial Crisis and Asia*. Oxford University Press, 2012

Quarterly GDP growth rate

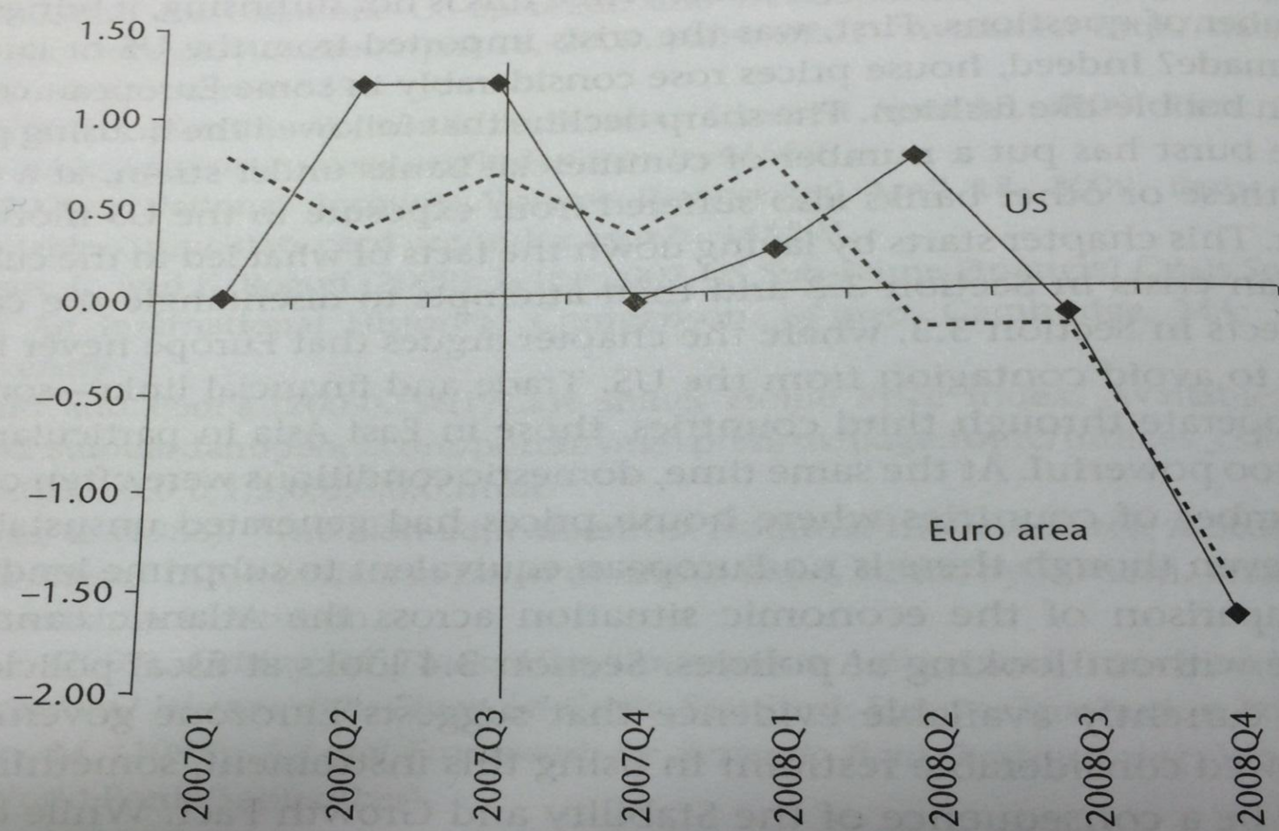

Figure 3.1 Quarterly real GDP growth rates
Source: International Financial Statistics, IMF.

Decoupling?

- The Eurozone's economy peaked in Q1 2008 before plunging into a severe recession.
- Has the decoupling theory proven wrong, judging from Figure 3.1?

Is the Eurozone immune from the financial crisis in the US?

The 2007 Financial crisis

The financial crisis started at the same time in Europe as in the US.

June 2007, Bear Stearns had liquidity problem in the US.

August 9, 2007, BNP-Paribas suspended redemption of funds because of the lack of liquidity.

Monetary policy response

ECB started to inject massive amounts of cash into the interbank market, followed a few days later by the Fed.

Both central banks started to lose control of interest rates in the interbank markets.

The spreads between the three months vs. overnight amounted to 10 basis points reflecting the maturity difference.

Interest rate spreads in dollars and euro

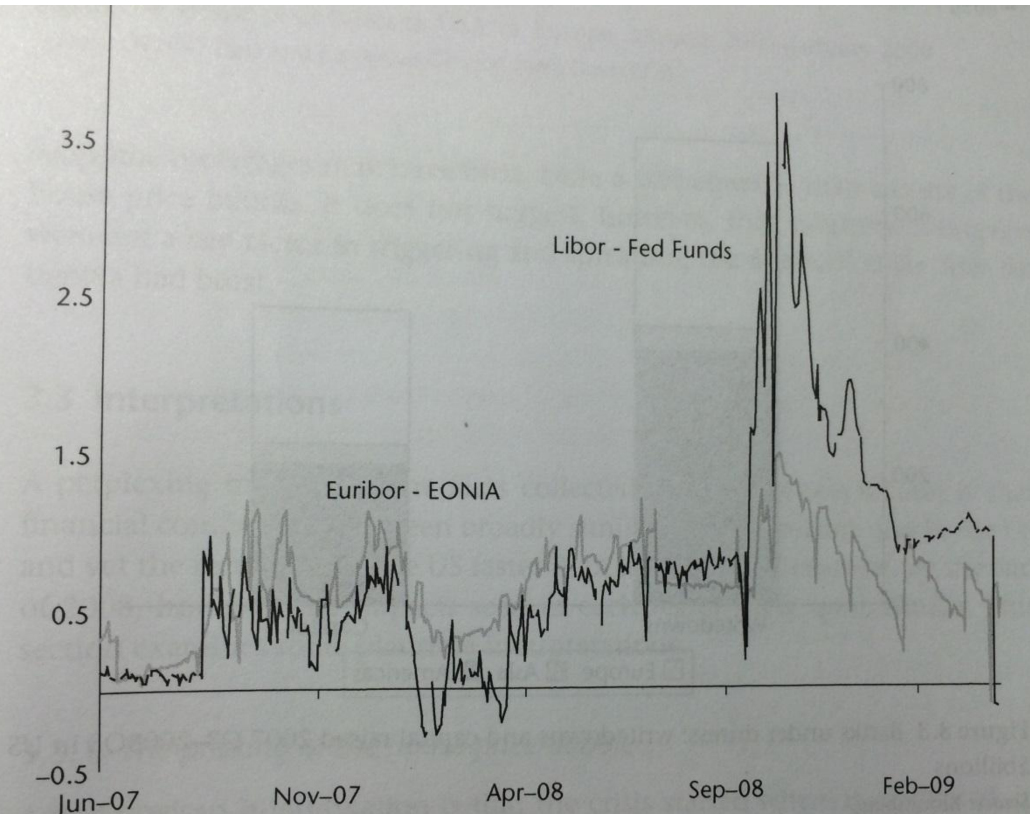

Figure 3.2 Interest rate spreads in dollars and euro

Sources: Euribor (http://www.euribor.org/), The British Bankers' Association (http://www.bba.org.uk), European Central Bank (ECB), and Fed Reserve Bank of New York.

Volatility

- Both spreads instantaneously rose and became volatile.
- Volatility reached new highs in September 2008 following the demise of Lehman Brothers.
- Financial markets were impacted in similar ways on both sides of Atlantic.

Bank under duress

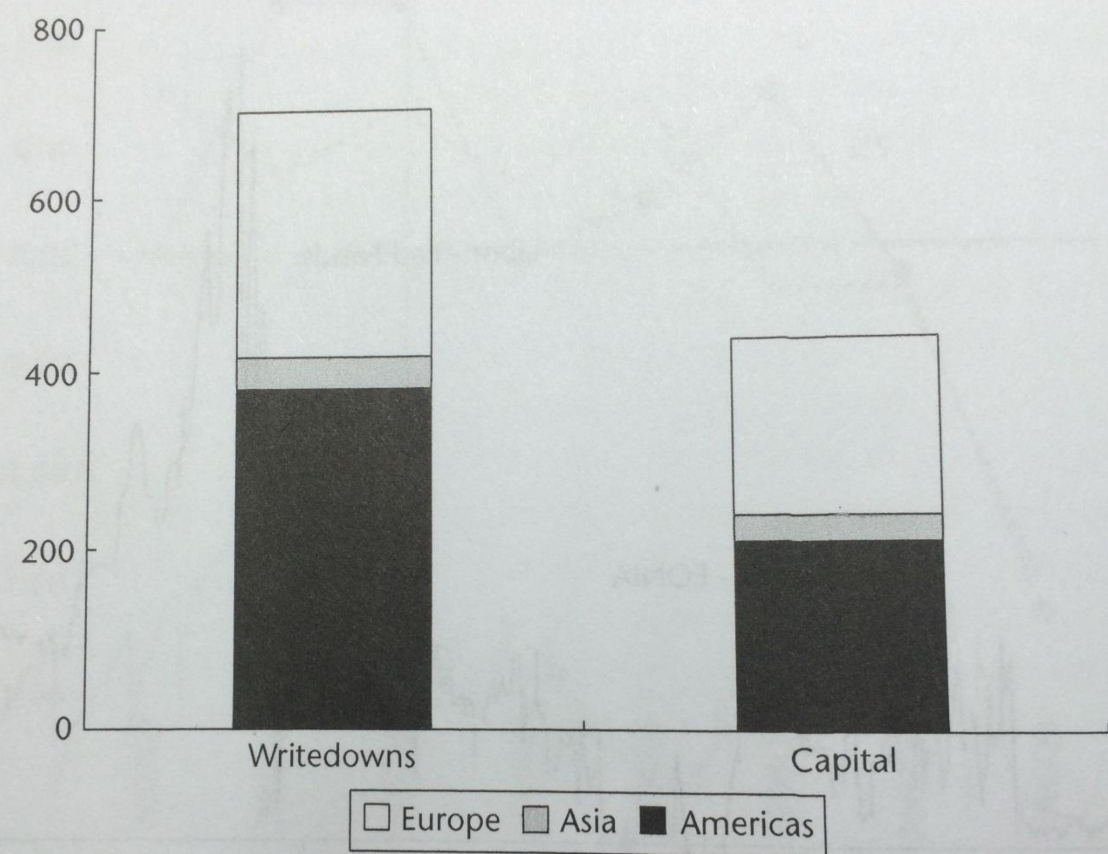

Figure 3.3 Banks under duress: writedowns and capital raised 2007 Q3–2008Q3 in US $billions

Source: Bloomberg.

Bank difficulties in comparison

- Writedowns and capital injections were forced on European and American banks, compared to Asian banks during 2007Q3-2008Q3
- Asian banks suffered less than those in the US and Eurozone.
- Europe and USA had nearly identical house price bubbles.

Almost identical bubble

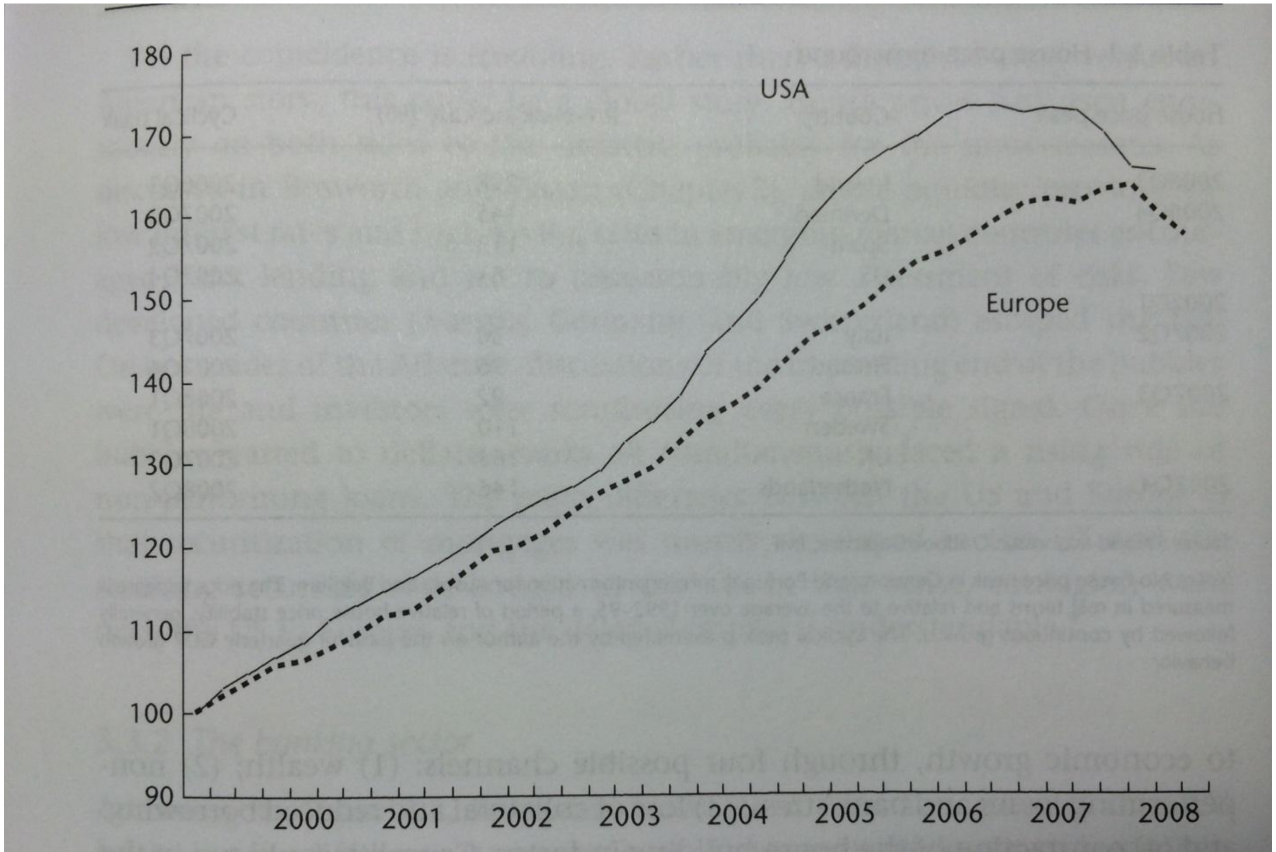

Figure 3.4 House price indexes: USA vs. Europe, January 2000–January 2009
Sources: OFHEO Data and European Central Bank Data (ECB).

- House prices peaked earlier in the US while the decline was nearly identical with Europe.
- Subprime mortgages may be a triggering and spreading factor of the financial crisis once the bubble had burst.
- Recall the Minsky moment.

Crisis in the US and Transmission to Europe

Table 3.1 House price turnaround

House price peak	Country	Pre-peak increase (%)	Cyclical peak
2006Q3	Ireland	298	2006Q3
2006Q4	Denmark	145	2007Q3
	Spain	113	2007Q2
	US	61	2007Q4
2007Q1			
2007Q2	Italy	30	2007Q3
	Finland	96	2007Q4
2007Q3	France	92	2008Q1
	Sweden	110	2008Q1
	UK	164	2007Q3
2007Q4	Netherlands	146	2008Q2

Source: World Economic Outlook Database, IMF.

Notes: No house price peak in Germany and Portugal; missing information for Austria and Belgium. The price increase is measured in real terms and relative to the average over 1992–95, a period of relative house price stability, generally followed by continuous growth. The cyclical peak is estimated by the author on the basis of quarterly GDP growth behavior.

Pricking the house price bubble: Causality does not run from the US to Europe

- Why did the recession hit the US faster than the Eurozone despite similar financial conditions?
- Europe had nurtured its own bubbles and they exploded randomly.
- Ireland (2006 Q3), Denmark (2007 Q3), and Spain (2007 Q2) house prices peaked earlier than the US (2007 Q4)

In the US, house prices affected Economic Growth

Causality run through four channels

- (1) Wealth
- (2) Non-performing losses and bank stress
- (3) Loss of collateral and reduced borrowing
- (4) Contraction of house-building industry

Causality could run in the opposite direction in Europe.

A global story

- Ample liquidity provided by low interest rates and high saving rates in emerging countries encouraged bank lending and led to unreasonably low assessment of risks.
- Once the bubbles started to deflate, banks faced a rising tide of NPLs.
- The main difference between the US and Europe is that securitization of mortgages was mostly developed and bought in the US.
- Contagion went from the US to Europe with delayed impact.

Public Support to the Banking Sector

- Write-offs and recapitalization depend on local regulations and enforcement.
- Government may buy toxic assets at favorable prices or provide guarantees for either assets or liabilities.
- Central banks may provide liquidity, which defer write-offs and recapitalization.

Public support to financial sector
(% GDP)

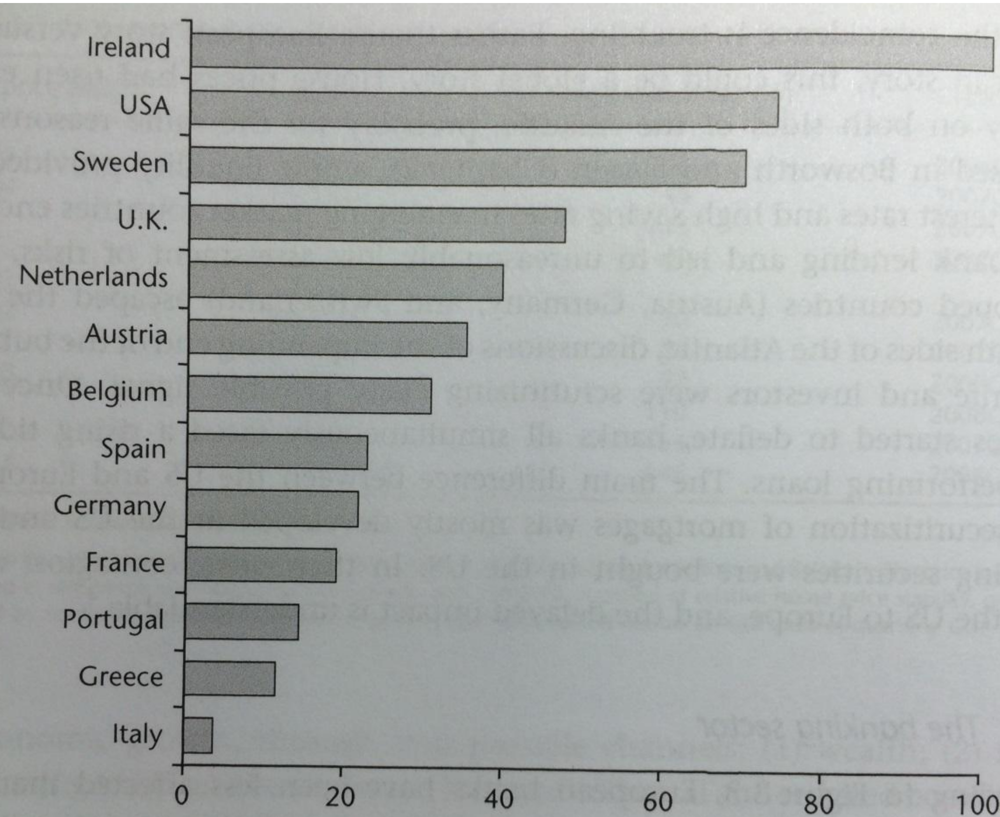

Figure 3.5 Public support to the financial sector (as of February 18, 2009, % of GDP)
Source: International Monetary Fund (2009).

Bank credit: Supply-side crunch or demand-side decline?

- Credit has considerably declined, due to deleveraging.
- But the demand for loans also declined as a result of economic downturn.
- The US banking system had been more affected by the crisis than the Eurozone countries.

Credit in the Eurozone

Source: International Monetary Fund (2009).

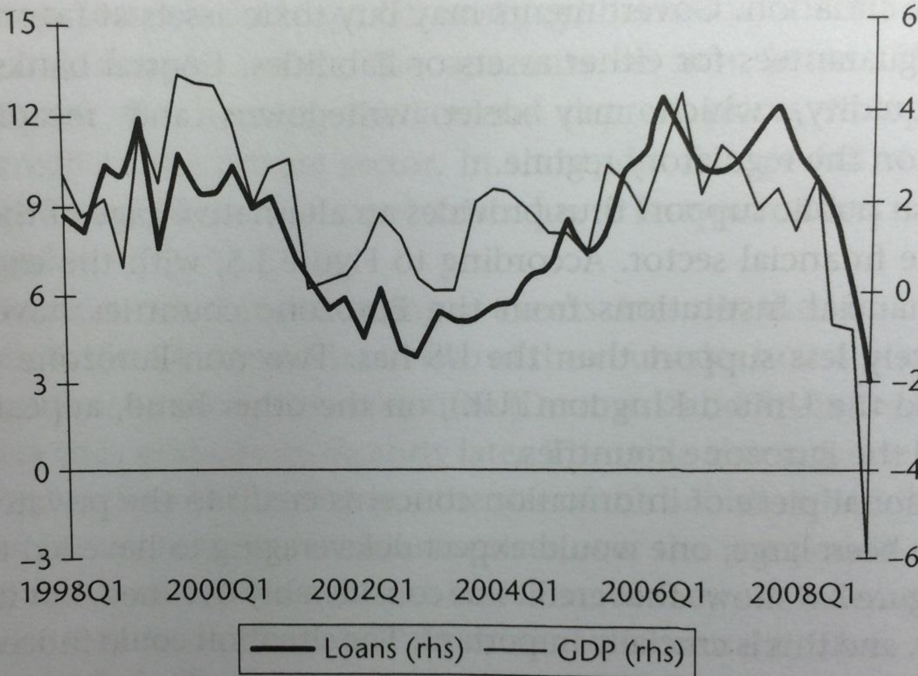

Figure 3.6 Credit in the Eurozone (% change)

Source: European Commission (2009), *Quarterly Report of the Euro Area* 8(1).

The role of welfare systems

- High unemployment benefits and universal health care and unfunded pensions ***could have*** prevented Europe from the US contagion.
- Actually, decoupling did not materialize.
- Fiscal stabilizers can offset less than 100 percent of shocks, so they cannot deliver decoupling—just reducing the impact.
- Welfare systems explains why the crisis occurred ***more slowly*** in the Eurozone than the US and UK.

Limited Exposure to Financial and Housing Markets

- European households hold fewer financial assets than do US households.
- Housing wealth has no impact on consumption: housing wealth equals the present value of rental costs.
- If the bubble is expected to be temporary, its present value is nil.

Wealth effect on consumption

- Rational home-owners should not have felt richer as the bubble grew and should not feel poorer after its collapse.
- The use of house as collateral weakens the link between wealth effect on consumption and the house price bubble.
- The influence on fluctuations of house prices on consumption may be much smaller than is often claimed.

Monetary Policy Responses

- It took 14 months for the ECB to start lowering its policy rate for the first time in October 2008.
- In contrast with the Fed which *promptly* lowered its policy rate and held it steadily at 2 percent until the Lehman Brothers collapse, at which point it drove the interest rate down to the zero bound.

Interest rates in the Eurozone and the US

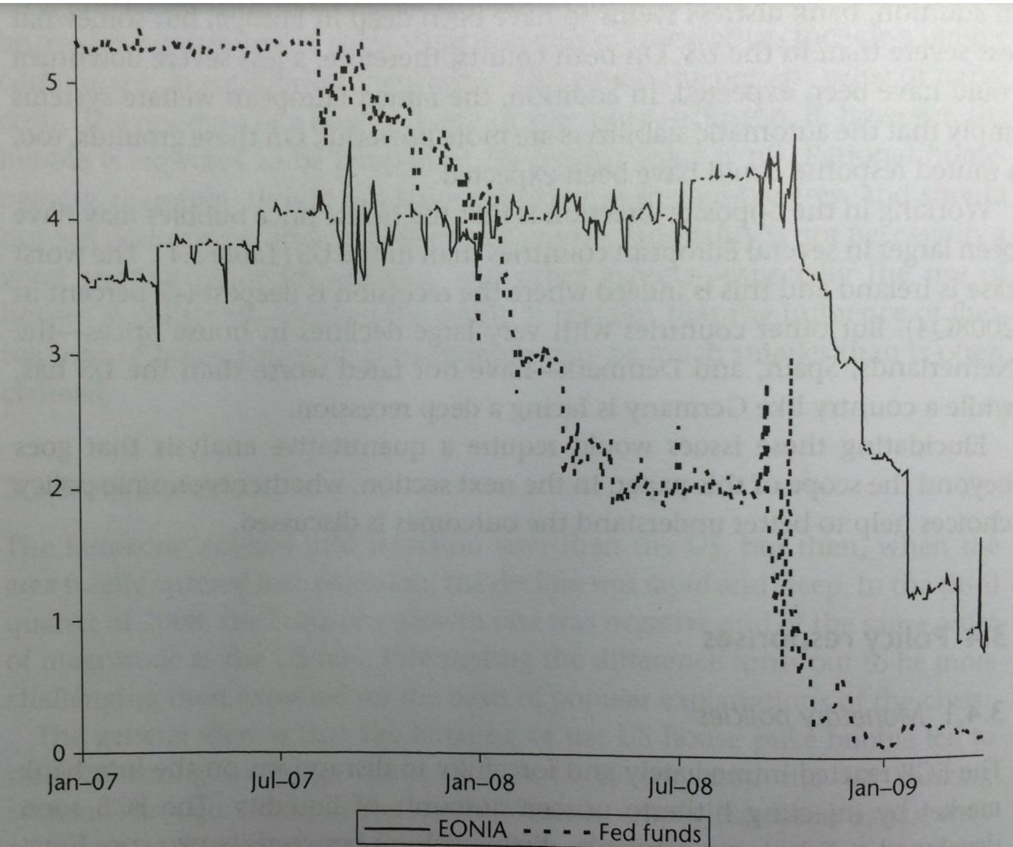

Figure 3.7 Interest rates in the Eurozone and the US (interbank rates)
Sources: European Central Bank (ECB) and Federal Reserve Bank of New York.

Price stability vs. growth and unemployment

- In contrast with the Fed, the ECB kept its policy rate at 4 percent and ***raised*** the rate by 25 basis points in July 2008, as the ECB was more concerned by inflation which had been steadily rising since 2006 because of oil, commodity, and food prices were skyrocketing.
- The ECB did not foresee that ongoing financial crisis would eventually provoke a recession.

Lag effects of monetary policy

- Monetary policy in the Eurozone did not address the crisis until it was well under way—monetary policy was late by almost a year.
- Monetary policy operates with lags of at least two quarters.
- The Fed has a dual mandate, while the ECB has inflation as the top priority.

Fiscal Policy Response

- Stabilizers only mitigate shocks but far too weak to offset them by a wide margin.
- Fiscal policy may have been automatically countercyclical, but there is a tendency for fiscal policy to be pro-cyclical in many European countries.
- Discretionary fiscal actions are more limited in Europe and nearly nonexistent in France and Italy.

Automatic stabilizers

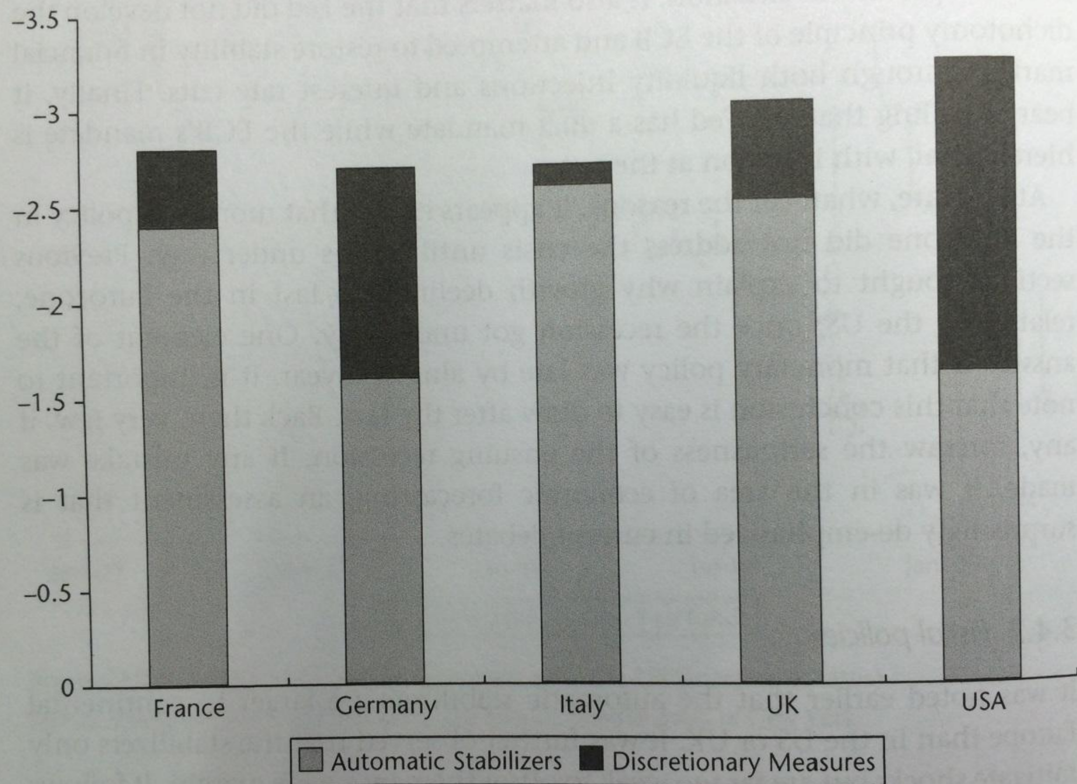

Figure 3.8 Changes in budget balances, October 2008

Source: International Monetary Fund (2009).

Fiscal policy has a little role to play

- Fiscal policy has not played much of a countercyclical role in the Eurozone.
- Resumption of growth will have to rely on private spending or exports.
- The mandatory 3 percent ceiling on public debts explains the limited use of fiscal policy.
- The Eurozone's Stability and Growth Pact explains why most Eurozone government have *little inclination* to use fiscal policy forcefully as US, Japan, and PRC.

The role of the euro

- The two oil shocks and the 1993 recession led to sharp speculative attacks on some currencies .
- The exchange rates of the original founding countries relative to the deutsche mark were shown in Figure 3.9.
- Sine the adoption of the euro, there has been no currency attack within the Eurozone.

Exchange rare vis-à-vis the deutsche mark

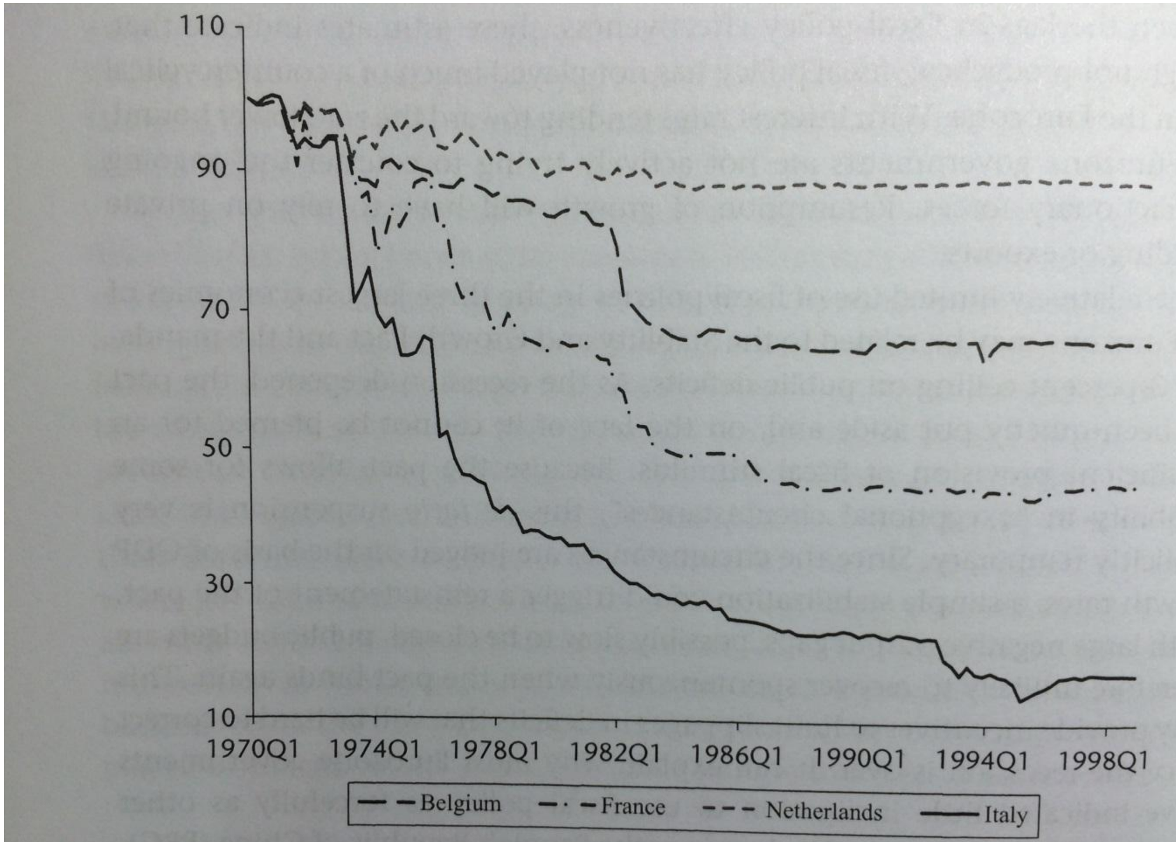

Figure 3.9 Exchange rates vis-à-vis the deutsche mark (Index: 1970Q1 = 100)

Source: International Financial Statistics, IMF.

For countries outside the Eurozone

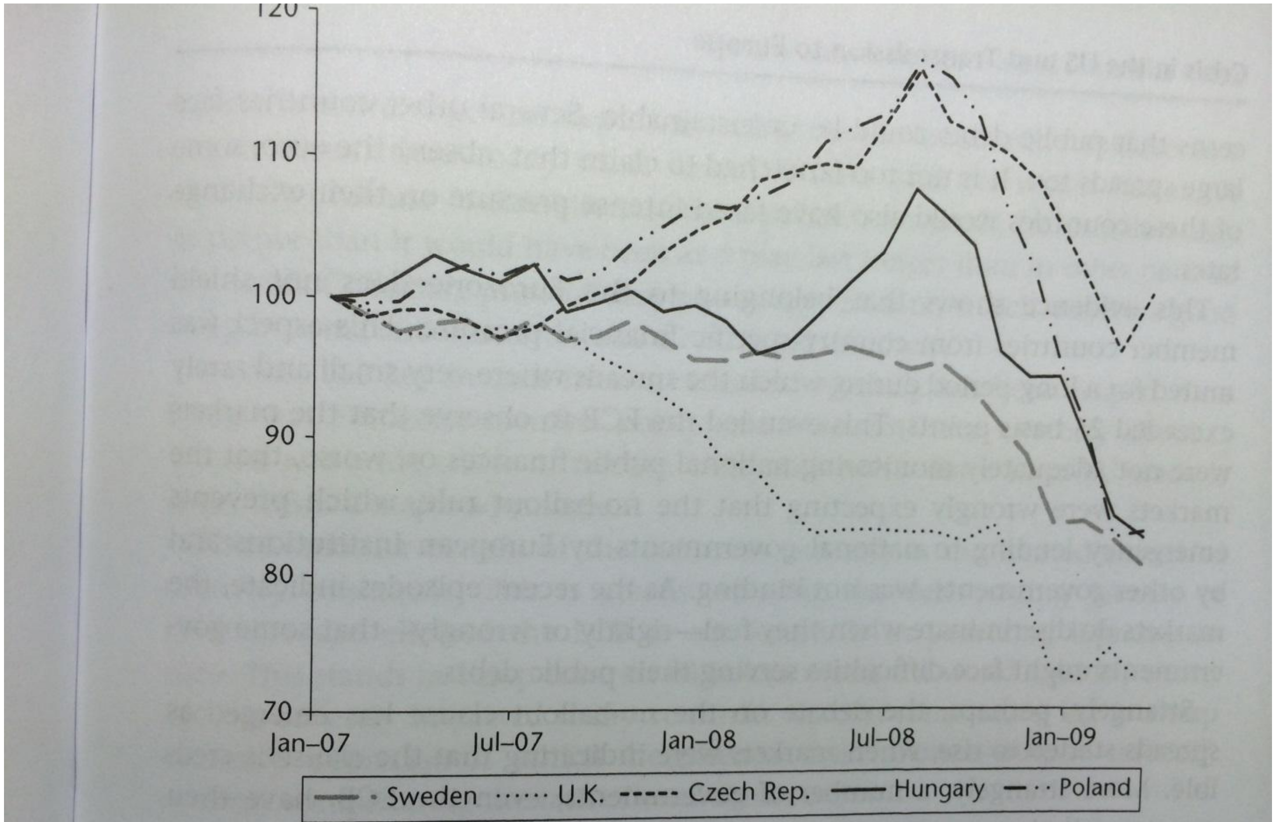

Figure 3.10 Exchange rates vis-à-vis the euro (Index: 2007m1 = 100)
Source: *Monthly Bulletin*, European Central Bank (ECB).

Financial support from outside

- Their exchange rates vis-a-vis the euro became unusually volatile once the financial crisis started.
- The free floating Swedish and British currencies have both undergone deep depreciation.
- Hungary and Poland obtained support from the ECB and the IMF’s flexible credit line.

Pressure within the Eurozone

- Using the German bund rate as a benchmark, the spreads of interest rates on national public bonds are shown in Figure 3.11.
- The largest spreads on Greek and Irish bonds reflect concerns about unsustainable public debts in both countries.
- Belonging to the Eurozone does not shield member countries from country-specific financial pressure.

Treasury bond spreads

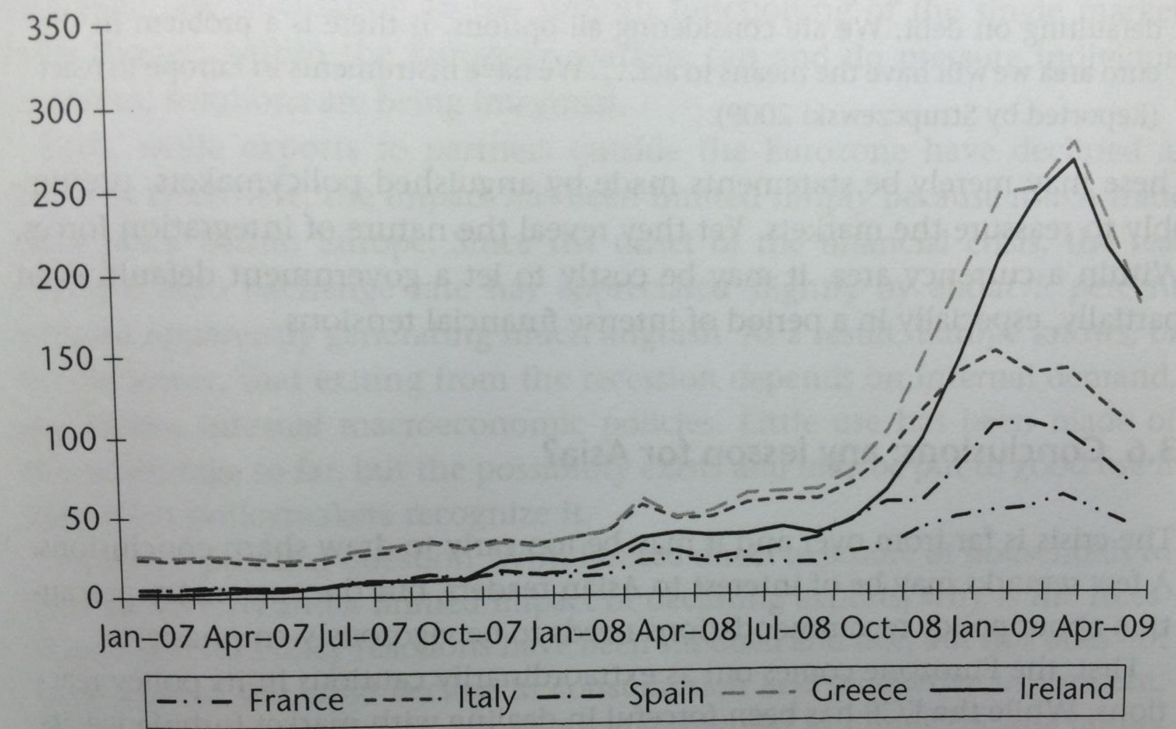

Figure 3.11 Treasury bond spreads (basis points)

Source: International Financial Statistics, IMF.

Moral hazard?

- Markets do discriminate that some governments might face difficulties serving their public debts.
- The Eurozone is prepared to help if one of its members is threatened with defaulting on debt.
- Within a currency area, it may be costly to let a government default, especially in a period of intense financial tensions.

Lessons for Asia

- Eurozone was extraordinarily cautious in its policy reactions, resulting in deeper and longer recession than other parts of the world.
- Eurozone countries benefit from a common currency, without worrying about shifting relative competitiveness as intra-EU trade is large.

Lessons for Asia

- Limited extent of currency mismatch, greatly assisting the deleveraging process of banks.
- Unlike Asia where the world liquidity shortage severely impacted many countries to depreciate currencies, the ECB acts forcefully in providing liquidity in euro without complicating the task of central banks.

Lessons for Asia

- European governments have shown a great deal of solidarity in providing support to countries that have not joined the euro, reducing the risks caused by exchange rate fluctuations to smooth the functioning of the single market.
- Although exports to outside the Eurozone declined, the impact was limited as much trade takes place within Europe.
- The existing recession depends on internal demand, and hence macroeconomic policies, which should have been put to good use.

A puzzling question

- With limited direct expose of households to financial events and limited impact of declining exports, why is the recession so severe in the Eurozone?
- Policy reactions have been subdued and late.
- Households and firms have become overly cautious, triggering a self-fulfilling prophecy.
- Recall Keynes' views on animal spirits.