<u>Seminar in European Economics</u>
Midterm Correction Topics – S2 24-25

The sovereign debt crisis in the euro area is a stark reminder that the participation in a monetary union brings benefits but also imposes commitments.

a. What characterizes an optimal currency area? Does the euro area fulfil those conditions?

- An optimal currency area must follow criteria such as:
  - 1) mobility of labour and capital as well as wages flexibility to allow for the smoothing of the cycle across different countries;
  - 2) business cycle synchronization, through an homogenous production structure, thus minimizing the impact of idiosyncratic shocks, since monetary policies do not target any specific country;
  - 3) fiscal federalism, allowing for the operation of automatic stabilizers across countries/regions;
  - 4) strong international trade flows;
  - 5) homogeneous preferences and solidarity across countries
- The Euro area does not fulfil several of these criteria.
  - Labour mobility is still constraint by language and cultural differences as well as different employment protection legislation across countries.
  - Member countries still depict significant productivity differentials worsened by heterogenous fiscal positions. This prompts macroeconomic imbalances to emerge, notably in terms of current account balances, which are hard to solve with a limited set of economic tools available.

b. What triggered and fueled the 2009-2010 sovereign debt crisis in the euro area?

- The 2008 global financial crisis exposed vulnerabilities in financial systems worldwide. While the immediate impact was mitigated by fiscal and monetary interventions, the resulting economic slowdown strained public finances in many euro area countries. Investors became increasingly risk-averse, reevaluating the creditworthiness of countries with high debt levels or weak economic fundamentals.
- Prior to 2010, several euro area countries, such as Greece, Portugal, and Spain, had run persistent current account deficits. These deficits indicated reliance on external financing to fund imports and consumption, making these economies dependent on foreign capital. When confidence in these countries' ability to meet their financial obligations waned, capital flows reversed.
- After 2010, sovereign debt levels in countries like Greece, Ireland, and Portugal became unsustainable, leading to fears of default. Rating agencies downgraded

these countries' credit ratings, making it costlier and riskier for them to borrow internationally.

- Eurozone countries share a common currency but lack centralized fiscal policies or mechanisms to address asymmetric shocks effectively. This meant that countries with weaker economies and less competitive exports faced greater difficulty recovering from crises. Unlike countries with their own currencies, euro area members could not devalue their currency to regain competitiveness, exacerbating their vulnerabilities.
- The crisis in one country (notably Greece) created fears of contagion across the euro area. This led to a generalized withdrawal of capital from other peripheral economies perceived to be at risk, such as Spain and Italy.

c. Could the crisis have been prevented? How was it solved?

- The crisis could have been prevented, as several fragilities existed:
    - Lack of Fiscal Discipline – Some countries (e.g., Greece, Italy, Portugal) accumulated excessive debt before the crisis, partly due to low interest rates after joining the euro. Stronger enforcement of the Stability and Growth Pact (SGP) could have prevented excessive deficits.
    - Banking and Financial System Weaknesses – Many European banks were heavily exposed to sovereign debt, creating a vicious cycle between weak governments and weak banks. Better financial supervision and early intervention could have reduced contagion risks.
    - Lack of Crisis Management Mechanisms – The euro area lacked institutions like a common fiscal authority or a lender of last resort to support struggling economies. Establishing mechanisms such as a European Monetary Fund earlier could have helped prevent panic.
    - Diverging Competitiveness – Some eurozone countries (e.g., Germany) maintained high productivity growth, while others (e.g., Greece, Spain) lost competitiveness. Structural reforms to improve labor markets and productivity in weaker economies could have reduced these imbalances.
- To solve the crisis:
    - Bailout Programs and Financial Assistance in the affected economies – Several euro area countries (Greece, Ireland, Portugal, Spain, and Cyprus) required financial assistance to prevent default. These bailouts came with strict conditions, including austerity measures and structural reforms.
    - European Central Bank (ECB) Interventions – "Whatever It Takes" Speech from ECB President Mario Draghi, which restored confidence and lowered bond yields; the Outright Monetary Transactions (OMT), which was a new ECB program allowing unlimited purchases of sovereign bonds from crisis-hit

countries in exchange for economic reforms – although never used, its mere existence helped ease market tensions –, and Quantitative Easing (QE), where the ECB launched a large-scale bond-buying program to inject liquidity into the eurozone, lower interest rates, and stimulate growth.

d. Is the euro area more prepared for such a crisis nowadays?

- Some key reforms were implemented, to make the euro area more prepared:
  - Fiscal Reforms and Stricter Budget Rules – To prevent excessive debt accumulation, the EU strengthened fiscal rules, with a strengthened Stability and Growth Pact (SGP), which enforced stricter limits on public deficits (3% of GDP) and debt (60% of GDP), which was done with the "two-pack" and "six-pack", and the Treaty on the stability, coordination and governance in the Economic and Monetary Union (TSCG).
  - European Stability Mechanism (ESM) (2012) – A permanent bailout fund created to provide financial assistance to eurozone countries in distress, replacing temporary mechanisms like the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM).
  - European Semester and Macroeconomic Imbalance Procedure – key mechanisms introduced after the eurozone crisis to improve economic governance, prevent future crises, and ensure stability in the European Union (EU), enlarging the surveillance beyond fiscal variables.
  - Banking Union – The crisis exposed weaknesses in Europe's financial system, where fragile banks held excessive sovereign debt. To prevent future crises, the EU created a Banking Union with 3 key pillars: Single Supervisory Mechanism, Single Resolution Mechanism and European Deposit Insurance Scheme. *(topic not yet addressed in classes, not mandatory)*
- However, some existing fragilities remain:
  - Lack of automatism in fiscal rules – Although the renewed fiscal framework has not yet been sufficiently tested, it does not seem to have a strong enforcement mechanism, thus maintaining initial fragilities.
  - Fiscal Rules have been suspended during the pandemic – The EU's Stability and Growth Pact (SGP) limits (3% deficit, 60% debt-to-GDP ratio) have not been enforced due to the need for large fiscal stimulus during the pandemic.
  - Banking Union Remains Incomplete – The European Deposit Insurance Scheme (EDIS) is still missing, meaning deposit protection varies across countries, potentially destabilizing weaker banking systems. *(topic not yet addressed in classes, not mandatory)*