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SEMINAR 11.
Economics in the EU

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Part IV

The crisis

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Outline Part IV

- **Eurozone crisis**
- Eurozone crisis versus Covid-19 crisis

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Stage one: the global financial crisis

Financial deregulation

- Great Depression (1929) → Strict regulation
- 1980s → Deregulation → Expansion of the financial sector → profits & risks
- Banks
    - Traditional role:

      deposits → loans

    - Active investors: They borrow globally (short term) to invest globally in long-term (mismatch).

- What is special about banks?
    - Most people and firms have deposited significant parts of their wealth in bank.
    - A bank failure, therefore, can have dramatic implication for the whole economy.

- Vicious cycle:

  Protection from risks

  More risk taken

    - Moral hazard: The major risk taken by banks were implicitly borne by the governments (and taxpayers), which encouraged banks to take even more risks.

Stage one: the global financial crisis

The roots of the financial crisis

The subprime mortgage loans

• Low (or not) income households cannot borrow because regulation and banking practice establish a minimum ratio between debt service and income.
 	
• Subprimes
    • Loans with an initial low interest rates → low debt service
    • When *i* was stepped up, a new, similar, loan would be granted to enable the debtor to pay back the previous loan.
    • Price of housing as a guarantee
    • NINJAs (No Income, No Job or Assets)
 	
• As housing prices kept rising, refinancing before step-up was easy.
 	
• Housing prices trend (figure).

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Stage one: the global financial crisis

The subprime mortgage loans (cont.)

- Mortgage companies
  - They borrowed money, granted loans and promptly sold the loans to banks.
  - They were passing the risks of non-repayment to the banks.

- Banks
  - Banks that accumulated the loans, in turn sold them to other banks, which sold them to yet other banks with a twist, called securitization.

- Securitization process
  - Lumping together a large number of individual mortgage loans into one big bundle (diversification).
  - The bank divides the bundle into formally independent “tranches”, which is then rank.
    - The top tranches received an AAA ranking and sold at a high price.

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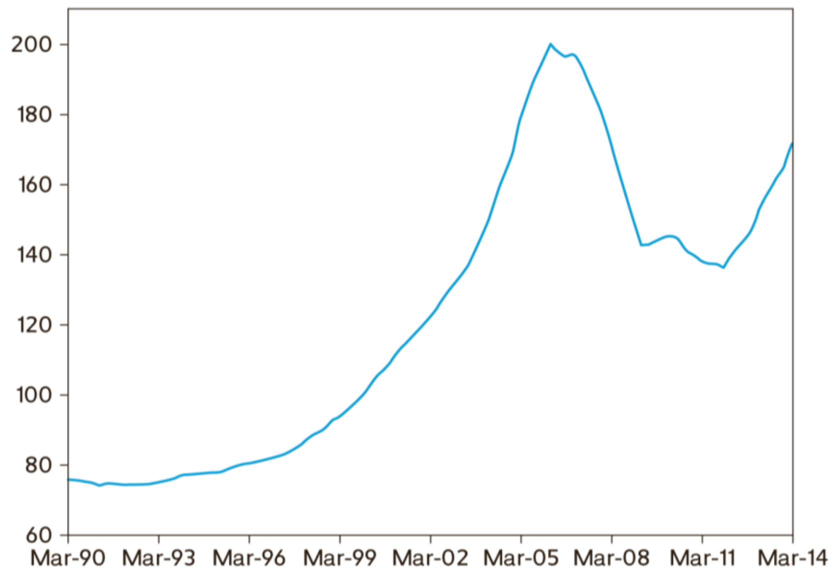
Stage one: the global financial crisis



Source: Bank for International Settlements

Figure: Housing prices In the USA
(Index: January 2000 = 100)

Discussion question

Should subprime lending have been subject to rigorous consumer protection and, if so, what would you propose?

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Stage one: the global financial crisis

Banks: meltdown and rescues

- April 2007 → New Century Financial Corporation (one of the largest US mortgage lenders) declare bankruptcy.
- Sept. 2007–Spring 2008 → Several major banks failed
    - Bank grew suspicious of one another and stopped their mutual lending (interbank market).
    - Central banks provide liquidity directly to their banks

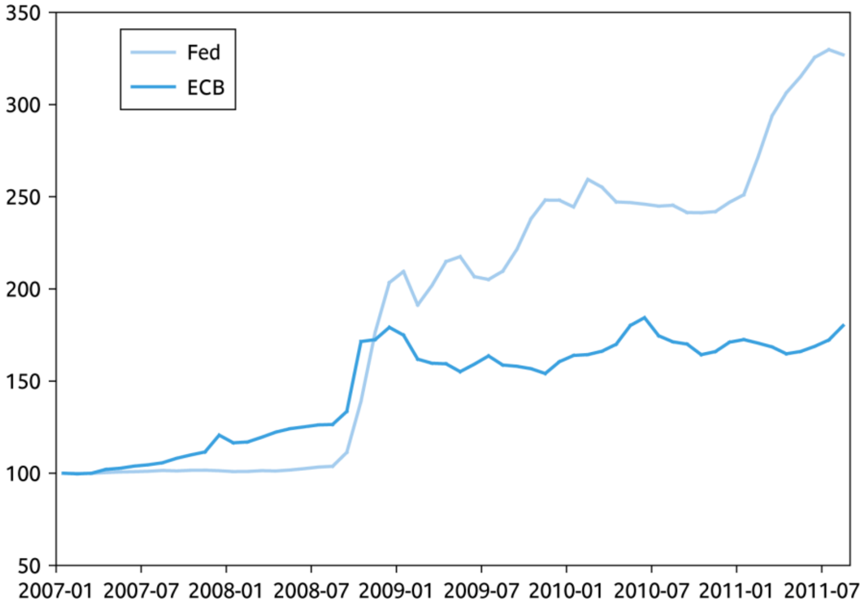

Figure: Assets of central banks
Index: January 2007 = 100

- Sept. 2008 → The failure of Lehman Brothers triggered the worst financial crisis since 1929. The US authorities refused to intervene (They took high and profitable risk.)

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Stage one: the global financial crisis

Avoiding a New Great Depression Banks: meltdown and rescues

- Policy makers (governments and central banks) followed the lessons learnt from the Great Depression
  - Rescue large financial institutions
  - Central banks
    - Liquidity
    - Expansionary monetary policies (↓interest rates)
  - Governments
    - Bail-out banks
    - Expansionary fiscal policies
- The London G20 Summit (2009) → Expansionary fiscal policies
  - AD = C+I+G+X-M
  - Impact on budget deficits → Next crisis: Eurozone debt crisis

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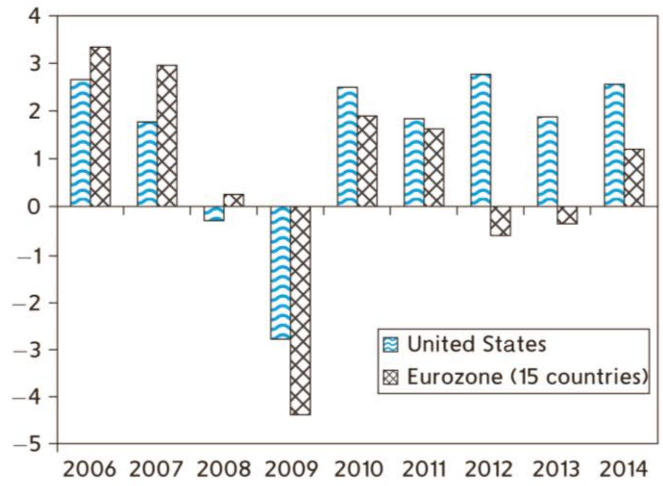
Stage two: the public debt crisis in the Eurozone

The legacy of the financial crisis: the Great Paradox

Figure: GDP growth, 2006–2012

- Negative growth + large budget deficit → ↑debt/GDP
  - Debts must be paid by taxes.
  - Taxes are levied on the incomes that make up GDP.



Notes: Forecasts for April 2014. The EU15 refers to the Eurozone excluding Cyprus, Estonia, Lithuania and Slovakia.
Source: Economic Outlook, OECD

- Paradox
  1) The financial crisis led governments to run considerable budget deficits to contain the recession.
  2) The deficits led financial markets to become worry about the sustainability of public finances. → Deep recession

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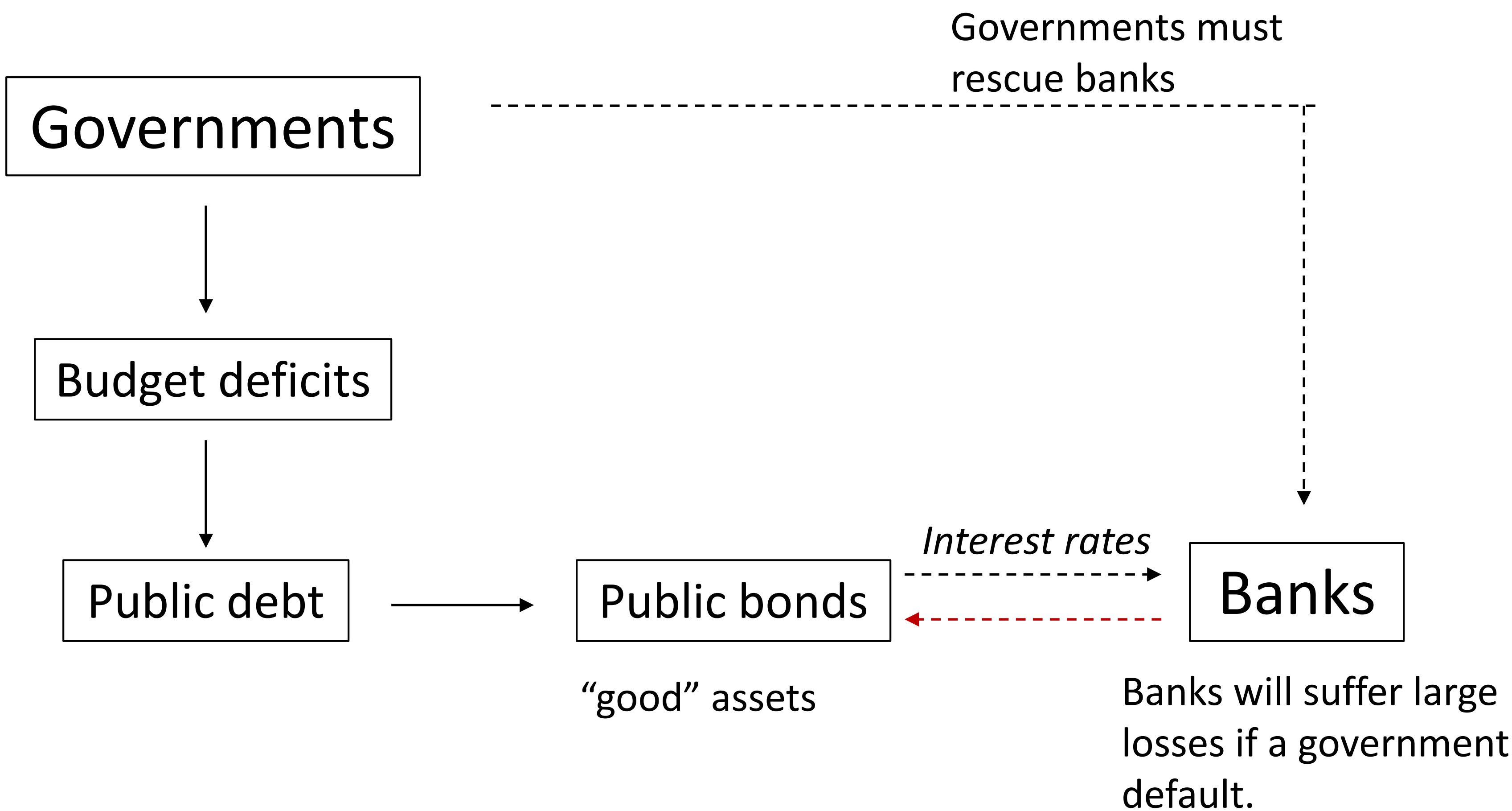
Stage two: the public debt crisis in the Eurozone

The legacy of the financial crisis: the Great Paradox

- Governments and banks are tied strongly together.



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Stage two: the public debt crisis in the Eurozone

Contagion inside the Eurozone

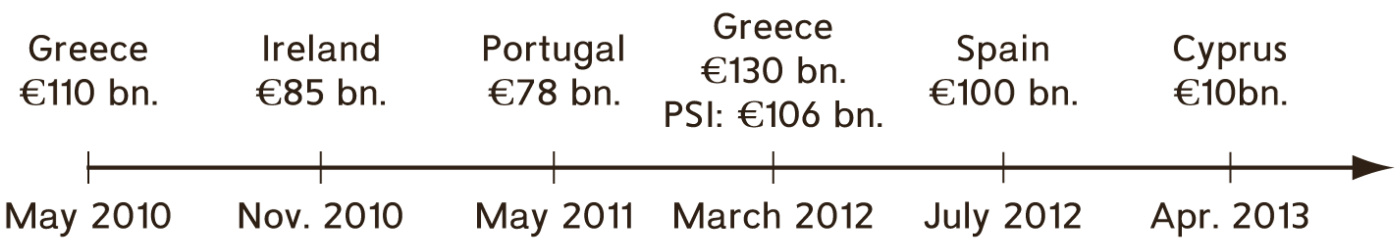

Figure: Time line of financial assistance

Spain

- By mid-2011, the markets were worrying that many Spanish banks were in need of a rescue.
- The Spanish government refused to apply for a Troika (IMF–EU–ECB) program.
- It needed money to recue some banks and did not want to borrow on the markets.
- European Stability Mechanism (ESM)

Survival of the euro

A number of people concluded that the Eurozone is doomed.

YES

- Failure to establish fiscal discipline.
- Countries with high debts need to grow fast to generate tax revenues. In general, defaulting countries undergo a sharp exchange rate depreciation.
    - But there is no room for depreciation in a monetary union.
- Gap between well-functioning North and badly wounded South.
    - Solidarity?
- Many international investors do not believe that the euro can survive. This believe can become a self-fulfilling process.
- Europe is not an optimum currency area. Right from the start it was an experiment doomed to fail.

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Survival of the euro

A number of people concluded that the Eurozone is doomed.

NO

- Breakup would have catastrophic implications.
- New currency would have to be printed and reintroduced.
  - It took three years introduce the euro…
- It may well be that some countries will have to default, but that dies not require exit from the Eurozone.
  - A country is protected by the Eurozone crisis.
- No legal procedure for a country to leave the Eurozone.
- The crisis has made it clear that the euro architecture needs to be improved, and solutions do exist.
- The deeper problem has been the political mishandling of the crisis.

Video: “Emerging stronger from the crisis” (06:14)

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Eurozone crisis

Situation in 2019…? (Before Covid-19)

- Interest rate
- Housing prices

Discussion question

Develop the case for (or against) a fiscal union.

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Outline Part IV

- Eurozone crisis
- **Eurozone crisis versus Covid-19 crisis**

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Eurozone crisis versus Covid-19 crisis

What are the differences between the economic crisis derived from the Covid-19 and the Great Recession?

In any economic crisis it is possible to distinguish three stages:

- The core of the problem
- The mechanism of propagation and magnification
- The answers to the crisis

Let’s compare the Eurozone crisis versus Covid-19 crisis.

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Eurozone crisis versus Covid-19 crisis

	Eurozone crisis	Covid-19
Core	Collapse of the financial system. Collapse of the construction sector.	Health problem a pandemic. Part of the economic activity has to stop.
Mechanisms of propagation and magnification	Companies directly affected by the crisis cannot produce and does not receive revenues. Then, some liquidity problems arise: companies cannot pay banks and other companies. Consequently, companies have to fire workers and unemployment increases. This generates pessimism about the future economic situation and reduces new investments.	
		There is an additional magnification problem. Huge interdependence among companies (national and international). If one company cannot produce due to the pandemic, this affects other companies from the same production line due to the scarcity to inputs or intermediate goods.
Answers *It is too early to compare both crisis.	Some countries like Spain applied expansionary fiscal policies (that is, more public spending). This increased the public debt/GDP ratio and generated a public debt crisis. In May 2010 the European Council decided to carry out rescue operations. Some countries (Greece, Ireland, Portugal, Spain, and Cyprus) received loans under conditions set.	It is very important to reduce uncertainty. To do that, governments have to communicate policy intentions conditional on pandemic dynamics. The European Council has agreed on a package of €750bn to help countries' economies recovery. Countries that receive the funds have to fulfill some conditions that will be monitored by the European Commission. See here and here.

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Covid-19

Discussion question

Comment the economic consequences of the Covid-19.

- economic sector
- gender
- self-employment
- entrepreneurship
- …

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Main references

- Baldwin, R and Wyplosz, Ch.: *The Economics of the European Integration*, McGraw Hill Education, 5th edition.