CHAPTER 2

Background: The Evolution of the Euro Area Crisis

13. The third and final stage of European Economic and Monetary Union (EMU) began on January 1, 1999 when a common currency, the euro, was adopted by 11 member states of the European Union (EU).[11] On January 1, 2001, Greece joined the euro area as its twelfth member. The EMU architecture, as specified by the Maastricht Treaty of 1992, included (i) an independent central bank, the European Central Bank (ECB), focused on price stability and (ii) a set of rules (fiscal deficit and public debt ceilings of 3 percent and 60 percent of GDP, respectively) designed to promote fiscal discipline in individual member states. The Stability and Growth Pact (SGP), adopted in 1997, introduced a "corrective arm" that specified the procedure to be followed by a country violating these limits (known as the Excessive Deficit Procedure, EDP) and a "preventive arm" requiring countries to maintain fiscal positions close to balance or in surplus over the medium term.[12] Banking supervision and deposit insurance remained national competencies.

14. Among its many consequences, the introduction of the euro caused sovereign bond yields to converge at a lower level, as country and exchange rate risks were perceived to have been virtually eliminated.[13] The convergence sharply lowered borrowing costs for countries in the European periphery and encouraged increases in borrowing from the euro area core. For the periphery countries, the result was generally to raise consumption and investment (especially in real estate) and economic growth. From 1999 to 2008, Ireland grew by more than 5 percent per year and Greece by 3.5 percent, compared with the euro area average of 2.1 percent (Figure 1). Portugal's average growth rate, at 1.6 percent, was less than the area average because for various reasons the country could not sustain the rapid growth experienced in 1999 and 2000. The counterpart of external borrowing was a widening of current account deficits. Greece's current account balance widened from 5.1 percent of GDP in 1999 to nearly 15 percent of GDP in 2008 (Figure 2). Portugal's current account deficit averaged nearly 10 percent of GDP in the first decade of the euro, remaining high even when growth stalled. Ireland was a special case, because only in 2007 did that country begin to run a sizable deficit, which reached 5.7 percent of GDP in 2008.

15. Academic experts have increasingly come to believe that the euro area crisis was precipitated by "sudden stops," whereby cross-border capital flows came to a halt in an environment of diminished risk appetite caused by the global financial crisis (Merler and Pisani-Ferry, 2012; see Baldwin and Giavazzi, 2015 and Baldwin and others, 2015 for a summary view of the literature). Weak public finances were clearly central to the crisis in Greece (Table 2), but according to the sudden-stop narrative "the key was foreign borrowing" (Baldwin and Giavazzi, 2015).[14] Even so, because the crisis countries were members of a currency union the crisis did not evolve as a conventional balance-of-payments or currency crisis. The Eurosystem (consisting of the ECB and national central banks) provided liquidity to crisis countries (and their banks) through facilities such as Long-Term Refinancing Operations (LTRO) and Emergency Liquidity Assistance (ELA), as

[11]The original members were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

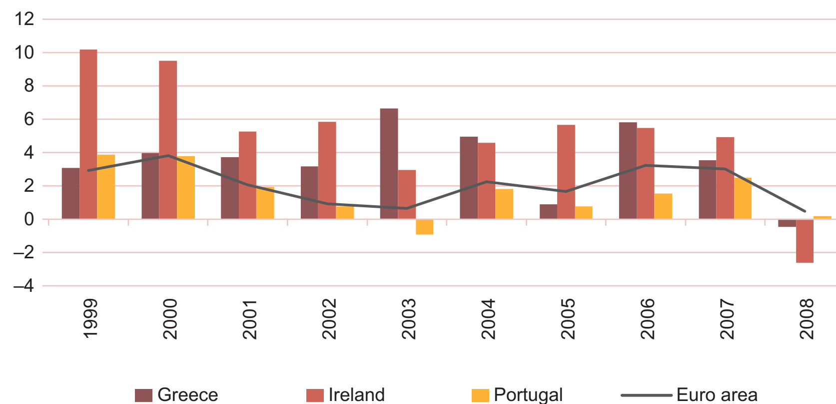
[12]The SGP framework was amended in 2005 to give more emphasis to cyclically adjusted deficits. This followed the Council's decision in November 2003 to suspend the EDP for France and Germany (Buti and Carnot, 2012).

[13]Three reasons have been offered to explain the convergence of bond yields. First, financial markets treated all sovereign debt as risk-free, encouraged in this belief by regulatory and collateral rules (Buti and Carnot, 2012). Second, despite the no-bailout clause, the markets expected "some sort of rescue for individual sovereigns in trouble" (Obstfeld, 2013). Third, euro participation was considered to be permanent. This perception changed in 2010–12 with the possibility of "Grexit"—Greece's exit from the euro—which introduced "redenomination risk."

[14]Regardless of the state of public finances, no country that had a current account surplus experienced a crisis. See Gros (2015).

Figure 1. Real GDP Growth, 1999–2008

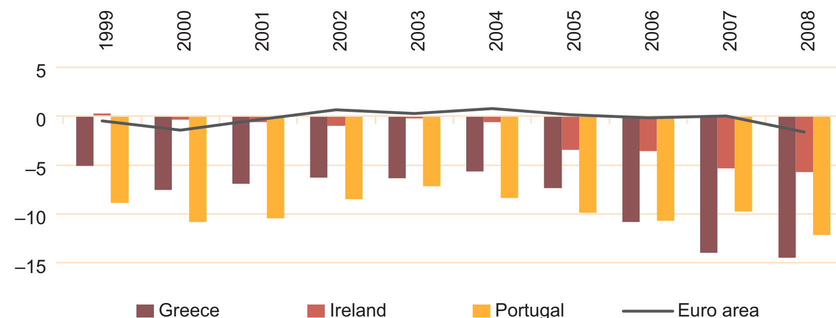
(In percent per year)



Source: IMF, *World Economic Outlook* database, October 2015.

Figure 2. External Current Account Balances, 1999–2008

(In percent of GDP)



Source: IMF, *World Economic Outlook* database, October 2015.

Table 2. Fiscal Developments, 2001–09

(In percent of actual or potential GDP)

	2001–05[1]	2006	2007	2008	2009
Greece					
Headline fiscal balance	–5.4	–6.1	–6.7	–9.9	–15.3
Structural fiscal balance[2]	–5.4	–8.4	–10.5	–13.9	–18.6
Gross government debt	98.1	102.9	102.8	108.8	126.2
Ireland					
Headline fiscal balance	0.8	2.8	0.23	–7.0	–13.8
Structural fiscal balance[2]	–2.3	–5.6	–9.9	–13.1	–11.0
Gross government debt	26.1	23.6	23.9	42.4	61.8
Portugal					
Headline fiscal balance	–5.0	–1.99	–3.0	–3.8	–9.8
Structural fiscal balance[2]	–5.8	–1.9	–3.8	–5.2	–8.6
Gross government debt	60.8	61.6	68.4	71.7	83.6

Source: IMF, *World Economic Outlook* database, October 2015.
[1] Averages for 2001–05; end-2005 for gross debt.
[2] IMF staff estimates.

well as through the area-wide settlement system known as TARGET2.[15]

16. The literature has highlighted two underlying causes of the crisis (Pisani-Ferry, 2011; Buti and Carnot, 2012). Some authors view the crisis as resulting from policy failures in individual countries, such as lack of fiscal discipline, failure to carry out structural reforms, and external borrowing that was not productively invested. Others see it as rooted in a flaw in the euro architecture—for example, monetary union unaccompanied by banking, fiscal, or political union—or a flaw in the operation of the union—for example, reluctance of member countries to transfer more powers to the union. Baldwin and Giavazzi (2015), summarizing what they call the consensus view, argue that the fallout from the sudden stop was amplified by the absence of a national central bank to provide a sovereign lender-of-last-resort support in its own currency; by the predominance of bank financing; by the vicious feedback between banks and sovereigns; and by the rigidity of labor and product markets in crisis countries.

17. A first sign of crisis within the euro area appeared in Ireland, when Bear Sterns was rescued by public funds in March 2008, thereby signaling to the market that governments would provide financial support to banks in difficulty (Mody and Sandri, 2012).[16] This is when sovereign spreads in Europe started to diverge noticeably. Following the collapse of Lehman Brothers in September 2008, pressure on the sovereign debt of periphery countries intensified. The size of Ireland's underlying banking and budgetary problems started to become more apparent after the property bubble burst and a deep recession began. From early 2009, IMF staff informally inquired about the Irish authorities' possible interest in a precautionary financial arrangement from the IMF.[17] It was against this background that in late October 2009 the newly elected Greek government of George Papandreou announced that the Greek deficit for the year was likely to be 12.8 percent of GDP rather than the 3.6 percent previously estimated (the actual figure would rise to 15.6 percent).[18]

18. Market reaction was subdued at first, and it was only from December 2009 that Greece's sovereign spreads saw a sustained rise as rating agencies successively downgraded Greek debt;[19] sovereign spreads for Ireland and Portugal rose in tandem, albeit much more slowly (Figure 3). The rise in sovereign spreads was gradual in the early months of 2010, while reacting to the actions or statements of European officials. Though Europe was facing an unexpected situation, a crisis management mechanism was deliberately absent in the euro area, in part to lessen moral hazard. Article 123 of the Treaty on the Functioning of the European Union (as last revised in 2007) prohibited the monetary financing of budgetary deficits, while Article 125 prohibited the EU or any member state from assuming the commitments of another state. This was interpreted by much of the official sector as a prohibition against an intergovernmental bailout.

19. The IMF was in close contact with Greek and other European authorities from the beginning, but it remained on the sidelines as initial options were debated. At the outset, there was resistance in Europe to having an IMF-supported program for Greece, as has been widely documented (Bastasin, 2012). The IMF at this stage provided technical assistance to Greece on tax administration and public financial management through the Fiscal Affairs Department (FAD), and financial sector advice to the Greek central bank through the Monetary and Capital Markets Department (MCM). Gradually, though, an alternative view began to prevail within Europe: that it would be desirable to draw on the IMF's program expertise and crisis management experience (Pisani-Ferry and Sapir, 2010).

20. On March 25, 2010, euro area leaders announced their readiness to contribute to coordinated bilateral loans as part of a package involving substantial IMF financing.[20] On April 11, the euro area member states issued a statement specifying the modality of support to Greece, namely bilateral loans centrally pooled by the EC with non-concessional interest rates as

[15]As a result, the size of official financing to these countries was mainly determined by budgetary, not balance of payments, financing needs (Pisani-Ferry, Sapir, and Wolff, 2013).

[16]Some even trace the start of the euro area crisis to the end of July 2007, when the German authorities bailed out IKB, a specialist lender based in Dusseldorf. This served as a signal that failing banks in the euro area would be rescued. "Germany Rescues Subprime Lender," *Financial Times*, August 2, 2007.

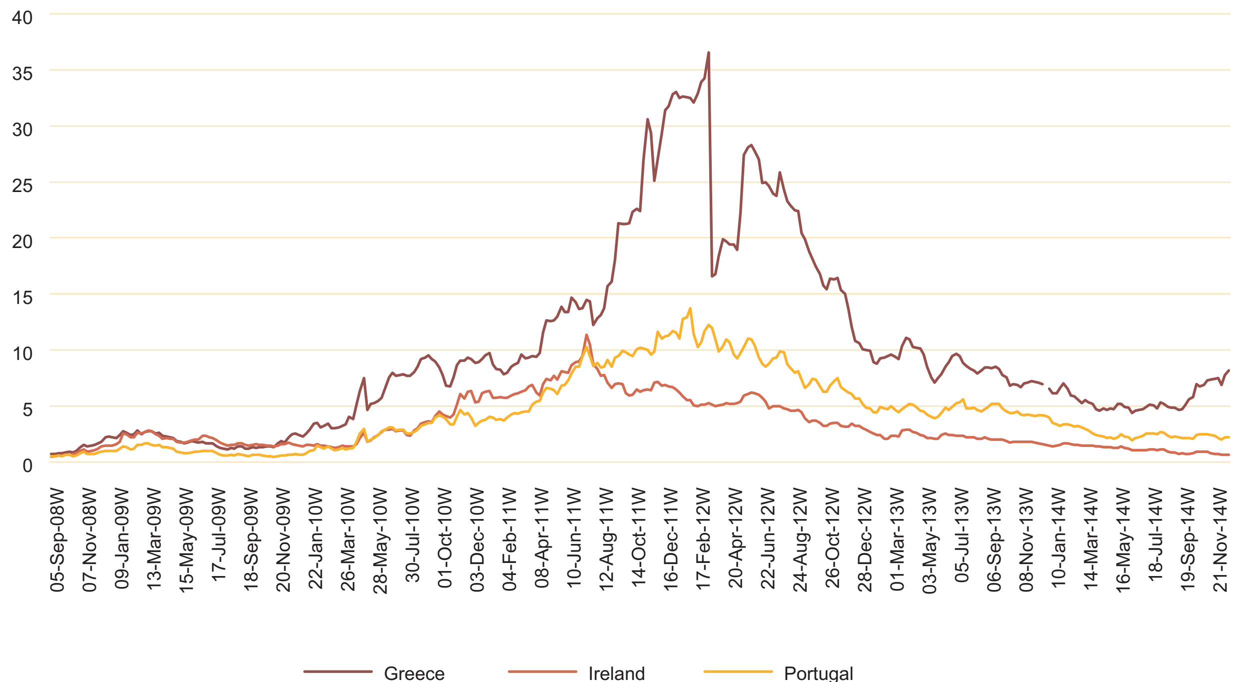
[17]The authorities were not receptive. Informal discussions on a program with Ireland started only in late September 2010.

[18]In 2010, the IMF found Greece in breach of members' reporting obligations under Article VIII, Section 5, of the Articles of Agreement (IMF, 2010e).

[19]Greece's rating was eventually downgraded to speculative-grade status in late April 2010. The ECB relaxed its collateral rules in several steps to keep Greek government debt eligible for refinancing operations.

[20]Statement by the Heads of State or Government of the Euro Area, March 25, 2010.

Figure 3. Ten-Year Government Bond Yields in Euro Area Crisis Countries, September 2008–December 2014
(In percentage points above comparable German bond yields)



Source: Haver Analytics.

"incentives for Greece to return to market financing."[21] The statement also noted that the EC, in liaison with the ECB and the IMF, would begin to prepare a joint program with the Greek authorities, starting on April 12. The same day, the IMF Managing Director expressed the IMF's readiness to "join the effort, including through a multi-year Stand-By Arrangement, to the extent needed and requested by the Greek authorities" (IMF, 2010b).

21. Greece formally requested EU-IMF financial assistance on April 23, 2010. On May 2, an IMF staff mission, in consultation with representatives from the EC and the ECB, reached agreement with the Greek authorities to support their adjustment program with a three-year SBA and with conditional financing of €80 billion, to be provided in the form of bilateral loans from 15 euro area partners (IMF, 2010c). The SBA for Greece, approved by the Executive Board on May 9, included financing in the amount of SDR 26.4 billion (approximately €30 billion). Market anxiety may have eased somewhat as European policymakers announced on May 10 the first of a series of measures to build firewalls against the impact of a future crisis on the euro area (Box 2).

22. Banking sector fragility played a greater role in the unfolding of crises in Ireland and Portugal than it did in Greece, as Irish and Portuguese banks heavily dependent on external financing came to rely increasingly on funding from the Eurosystem. With their spreads over German debt rising to above 6 percent, Ireland and Portugal turned to the IMF for financial support. In December 2010 and May 2011, respectively, they received assistance under the EFF in the amounts of SDR 19.466 billion (€22.5 billion) and SDR 23.742 billion (€26 billion). These financing packages were combined with additional financing of €45 billion (for Ireland) and €52 billion (for Portugal) from the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM), both of which were created subsequent to the Greek package to provide emergency financing to a country in financial difficulty.

[21] Statement on the Support by Euro Area Member States, Brussels, April 11, 2010.

Box 2. Building Euro Area Firewalls

European Financial Stability Facility (EFSF): a temporary €440 billion crisis response and assistance mechanism (to be phased out after three years) that was created by euro area member states on the basis of an Economic and Financial Affairs Council (ECOFIN) decision on May 9, 2010. The facility was established as a public limited liability company in Luxembourg on June 7, 2010. Its notional size was increased to €780 billion in June 2011, in order to increase the effective size to €440 billion while maintaining a triple A rating.

European Financial Stabilization Mechanism (EFSM): also created by the ECOFIN decision of May 9, 2010, this was a €60 billion European Union (EU) instrument whose creation derived from Article 122 of the Treaty on the Functioning of the European Union (regarding financial assistance to a member state that is in "difficulties or seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control"). The EFSM was modeled after the existing EU balance of payments assistance instrument.

Securities Markets Program (SMP): a Eurosystem program to purchase primarily sovereign bonds issued by euro area member governments in the secondary market. The program was announced by the Governing Council of the European Central Bank (ECB) on May 10, 2010, and was superseded by Outright Monetary Transactions (see below) in 2012.

European Stability Mechanism (ESM): a permanent €500 billion mechanism to supersede the EFSF and the EFSM. The ESM was created by an intergovernmental treaty that was signed on February 2, 2012 and entered into force on October 8, 2012. Set up as an international organization, its financing is provided to member countries in financial difficulty and is subject to strict policy conditionality. A euro area member requesting financial assistance from the ESM is expected to address, "whenever possible," a similar request to the IMF.

Banking union: an agreement was reached at the euro area summit of June 28–29, 2012 to initiate a process of centralizing at the euro level most of the banking regulatory authorities exercised at the national level. In its final form, banking union will consist of three pillars: a Single Supervisory Mechanism (SSM) that establishes the European Central Bank (ECB) as the central supervisor of euro area banks; a Single Resolution Mechanism (SRM) that establishes a new framework for bank crisis management and resolution, with a new agency, the Single Resolution Board; and a European Deposit Insurance Scheme (EDIS). The SSM has been in force since November 2014 and the SRM since January 2016. The EDIS is yet to be finalized.

Outright Monetary Transactions (OMT): an ECB program announced on August 2, 2012 by the ECB Governing Council to purchase a potentially unlimited amount of sovereign bonds issued by euro area member governments, superseding the SMP. The creation of OMT followed the announcement, at the end of July 2012, by the ECB President that the ECB would do "whatever it takes" to save the euro—an announcement that had an immediate calming effect on the markets. OMT would take place in the context of a request by a euro area member for financial assistance from the ESM (or EFSF). OMT have not been activated for any country.

23. The crisis in Ireland occurred after years of robust growth, which had masked the vulnerabilities of the country's financial sector and the fragility of its public finances dependent on property-related revenues.[22] In the wake of the global financial crisis, Irish banks faced severe liquidity pressures that prompted the Irish authorities to introduce a blanket state guarantee covering nearly all of their liabilities. From 2009 to 2010, the banks' insolvency began to emerge more clearly, while the collapse of the property sector and a severe recession turned the country's small fiscal surplus into a very large deficit. The ongoing Greek crisis and the announcement that the Irish banks would need yet more capital injections, among other things, led to major pressures on Irish bond spreads. With wholesale funding in decline, Irish banks turned to the ECB for liquidity support. These were the circumstances under which the Irish authorities, in November 2010, turned to their European partners and the IMF for emergency financial assistance.

24. The case of Portugal differed from those of Greece and Ireland. Even though Portugal's boom period had ended in 2000, the fiscal balance remained in deficit, and the private sector continued to borrow

[22]From the mid-1990s, Ireland had been among the fastest growing advanced countries. The country saw an unprecedented boom in living standards and attained full employment, while its budget position remained generally in surplus with a low debt-to-GDP ratio of about 25 percent. These "Celtic Tiger" years ended abruptly with the global financial crisis.

extensively from abroad, pushing the country's net international investment position to about –115 percent of GDP by the time the crisis broke. Financial markets' apparent indifference to Portugal's growing indebtedness changed,[23] when public finances deteriorated sharply in the aftermath of the global financial crisis.[24] In May 2010, when the SBA-supported program for Greece was approved, sovereign spreads of Portuguese versus German bonds stood at more than 200 basis points. In early 2011, Portugal's sovereign debt was approaching, if not exceeding, 100 percent of GDP.[25] As one credit rating agency after another downgraded Portugal's sovereign debt, the country faced an acute retrenchment of net capital flows, with a sovereign spread over German bonds of nearly 700 basis points. On April 8, 2011, the Portuguese authorities requested emergency financing from European partners and the IMF.

25. In July 2011, the IMF had a change in Managing Director when Christine Lagarde was selected to replace Dominique Strauss-Kahn, who had resigned in May. When the new Managing Director arrived at the IMF, Greece was negotiating with its private creditors for possible debt relief. In late July, euro area authorities agreed in principle to a debt reduction of 21 percent in net present value (as well as to lengthen the maturities of official loans to Greece and to lower lending rates),[26] but a sharp deterioration in Greece's economic situation made any debt relief envisaged under the agreement insufficient for restoring debt sustainability.

26. The next round of Greek debt relief negotiations began with full IMF participation, and led to a substantial reduction in the face value of Greek debt held by private (but not official) creditors. In March and April 2012, Greece exchanged bonds worth €199.2 billion in face value for a set of four instruments to achieve a net relief of about €100 billion in present value terms—equivalent to more than 50 percent of 2012 GDP under reasonable assumptions. In December 2012, Greece implemented a debt buyback that resulted in further relief equivalent to 6–11 percent of GDP, depending on the discount rate assumed (Zettelmeyer and others, 2013; see also Xafa, 2014).

27. From the summer of 2011, the crisis spread to Italy and Spain, the countries that experienced the largest capital outflows. When a Group of Twenty (G20) summit convened in Cannes on November 3–4, 2011, Italy seemed about to be cut off from market financing. European partners failed to persuade Italy to seek IMF assistance but welcomed the "measures presented by Italy in the Euro Summit [on October 26]" and its decision to "invite the IMF to carry out a public verification of its policy implementation on a quarterly basis."[27] Likewise, Spain accepted IMF assistance in a non-lending role in July 2012, when the Fund agreed to provide technical assistance in the context of European support (up to €100 billion) for the Spanish authorities' efforts to recapitalize the financial sector.[28] The IMF conducted quarterly monitoring missions to Spain from October 2012 onwards and prepared quarterly "progress" reports. In the event, decisive action, coupled with aggressive bond purchases by the ECB, allowed Italy to contain the crisis without the IMF's formal involvement in what was contemplated as "enhanced surveillance" (Box 3).[29] Likewise, Spain stabilized its situation through a combination of decisive action and European financial assistance.

28. The three IMF-supported programs evaluated were completed or canceled by the middle of 2014 (Table 1). Ireland completed the EFF-supported program on schedule in December 2013, regained market access, and saw its growth recover and unemployment fall sharply, with a declining debt-to-GDP ratio. Most of the amounts that Ireland owed to the IMF were repaid early. Portugal, after allowing its EFF-supported program to elapse in June 2014 without completing

[23]The sovereign spread of Portuguese 10-year bonds over German counterparts averaged about 20 basis points between 2000 and 2007. See Eichenbaum, Rebelo, and de Resende (2016).

[24]Not only did the government ease fiscal policy, but it also reclassified some state-owned enterprises and public-private partnerships as part of the general government in keeping with an agreement reached with the European authorities. These liabilities, amounting to about 10 percent of GDP in 2011, required additional financing by the government.

[25]According to the data available at the time, Portugal's government debt was 90.6 percent of GDP in April 2011. The revised data show that the actual amount was 111 percent of GDP. See Eichenbaum, Rebelo, and de Resende (2016).

[26]Statement by the Heads of State or Government of the Euro Area and EU Institutions, Council of the European Union, Brussels, July 21, 2011.

[27]Communiqué, G20 Leaders' Summit, Cannes, November 3–4, 2011.

[28]"Spain—Terms of Reference for Fund Staff Monitoring in the Context of European Financial Assistance for Bank Recapitalization," July 20, 2012.

[29]The IMF's public statements, except in one instance, did not use the term "enhanced surveillance," which is a procedure developed in 1985 whereby the IMF provides monitoring of a quantified economic program "generally formulated with the assistance of the staff" (IMF, 1993). Enhanced surveillance is a service provided at the request of a member under Article V, Section 2*(b)* of the IMF Articles of Agreement (IMF, 1994b).

Box 3. Proposed "Enhanced Surveillance" for Italy

Italy's economic situation became precarious in the summer of 2011 against the background of heightened political uncertainty and the evolving euro area crisis. In August, European central bankers highlighted the need for fiscal consolidation measures, for which the Italian government secured parliamentary approval in September. By mid-October, however, public outcry over some elements of the austerity package was becoming louder while European partners were calling the package "too little, too late" (Marshall, 2012). It was under these circumstances that, on the sidelines of a G20 meeting in Cannes in early November, European and non-European leaders urged Prime Minister Berlusconi to consider accepting an IMF-supported program of macroeconomic adjustment.

The IMF's "enhanced surveillance" role for Italy was a counterproposal from the Italian authorities, who were convinced that, given the size of the Italian economy, any official financing would be insufficient and might well be counterproductive. The idea was for the IMF to monitor Italy's implementation of detailed policy measures to be agreed with the European partners. On November 4, the IMF Managing Director noted that the IMF was to "come independently as third parties based on our expertise of such situations to verify" if Italy was "doing what it said it would do."

In the event, the IMF did not find a formal role to play in Italy. Negotiations with the Italian authorities over how the monitoring was to be conducted continued for some time. On February 23, 2012, an IMF spokesman stated that "this enhanced monitoring of the Italian economy is very much at the government's own initiative, and really it's up to the government to decide on the timing of that." Decisive action taken by the new government (which took office on November 16, 2011), coupled with aggressive bond purchases by the ECB, caused the spreads of Italian bonds to decline sharply. The Italian authorities no longer needed the credibility of the IMF as an independent assessor to restore market confidence.

Sources: Marshall (2012); Irwin (2013); and IEO interviews.

the final review, also regained market access, though its growth has not yet picked up and unemployment and the debt-to-GDP ratio remain high. In Greece, the SBA-supported program, after an impressive start, went off track following the third review amid mounting uncertainties about the future of the country in the euro area. The program was canceled in March 2012 to be succeeded by a new one. Compared to the initial program projection for 2012, Greek GDP was lower by more than 15 percent, and unemployment stood at over 25 percent. The country's debt-to-GDP ratio continued to rise despite the sovereign debt restructuring of 2012.