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The Eurozone in the Current Crisis

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Abstract

This paper contrasts the United States (US) and European situations during the crisis and examines how much of the crisis has been imported by Europe from the US. The paper argues that Europe never had a chance to avoid contagion from the US. It also documents the relatively limited reaction of both monetary and fiscal authorities. Muted fiscal policy actions may well be a consequence of the Stability and Growth Pact despite its having been de facto suspended. While the European Central Bank (ECB) intervened promptly and massively to attempt to maintain liquidity in the money market, it has been slow in dealing with the upcoming recession. The concluding remarks consider the differences that the monetary union has made and their relevance.

JEL Classification: E02, E42, E58, E61, F32, F33

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1. INTRODUCTION

Europe has tilted into recession a bit later than the United States (US) did, but the decline is of the same magnitude. While this is not surprising, it brings up a number of questions. First, was the crisis imported from the US or largely homemade? Indeed, house prices rose considerably in some European countries, in bubble-like fashion. The sharp decline that followed the housing price bubble burst has put a number of commercial banks under strain, at a time when these or other banks also suffered from exposure to the US mortgage market. This paper starts by laying down the facts of what led to the current European crisis in Section 2 and then attempts to disentangle the causes and effects in Section 3, in which the paper argues that Europe never had a chance to avoid contagion from the US. Trade and financial links—some of which operate through third countries, those in East Asia in particular—are simply too powerful. At the same time, domestic conditions were often critical in a number of countries where house prices had generated unsustainable booms, even though there is no European equivalent to subprime lending.

A comparison of the economic situation across the Atlantic cannot be complete without looking at policies. Section 4 looks at fiscal policies and provides currently available evidence that suggests eurozone governments have showed considerable restraint in using this instrument, something that may well be a consequence of the Stability and Growth Pact. While de facto suspended due to exceptional circumstances, the pact is bound to be reactivated when the situation improves. This may deter governments from undertaking active countercyclical policies. Section 5 examines monetary policy, showing that the European Central Bank (ECB) intervened promptly and massively to attempt to maintain liquidity in the money market. It is also argued that the ECB was more focused on (then high) inflation than on the (then largely unexpected) upcoming recession.

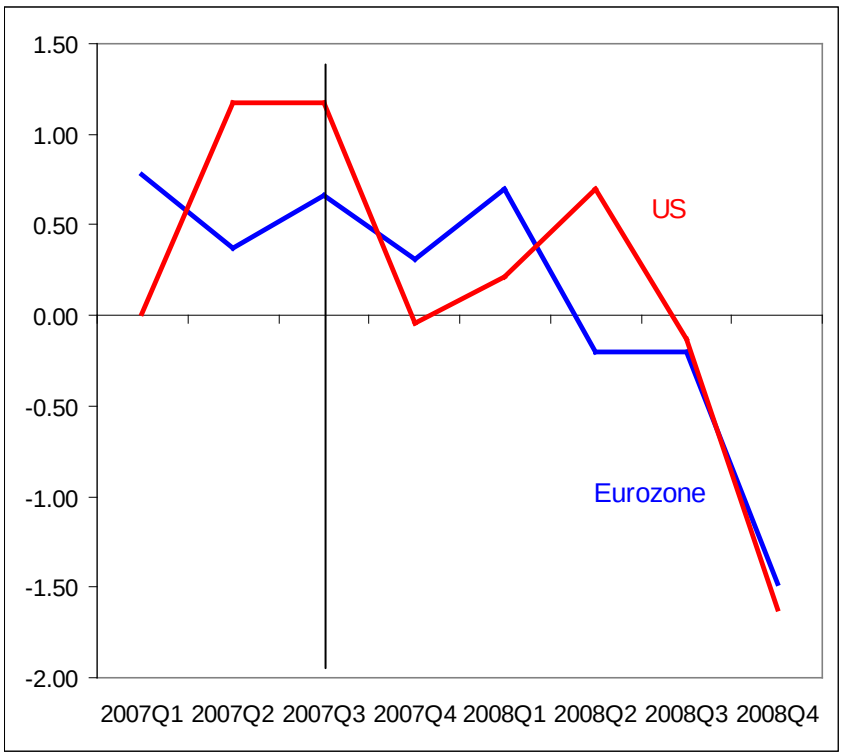
The last section offers some concluding remarks that may be interesting for East Asians. The quietness on the currency front—the *raison d'être* of the monetary union—is a remarkable achievement. It has not prevented markets from discriminating among countries, but this time through another channel: the markets for public bonds. Reasons why both the ECB and national governments have acted more prudently than most other developed countries are also discussed.

2. FACTS

With some delay, the eurozone has been hit by the financial crisis that erupted in August 2007. Figure 1 shows that the eurozone's economy peaked in the first quarter of 2008 and then quickly plunged into a severe recession.[1] The apparent immunity from the financial crisis led to a European version of the decoupling theory, which has proven as wrong in Europe as elsewhere around the world.

[1] The Centre for Economic Policy Research's Euro Area Business Cycle Dating Committees also dates the peak to the first quarter of 2008, more precisely January 2008, see http://www.cepr.org/data/Dating/.

Figure 1: Quarterly Real GDP Growth Rates

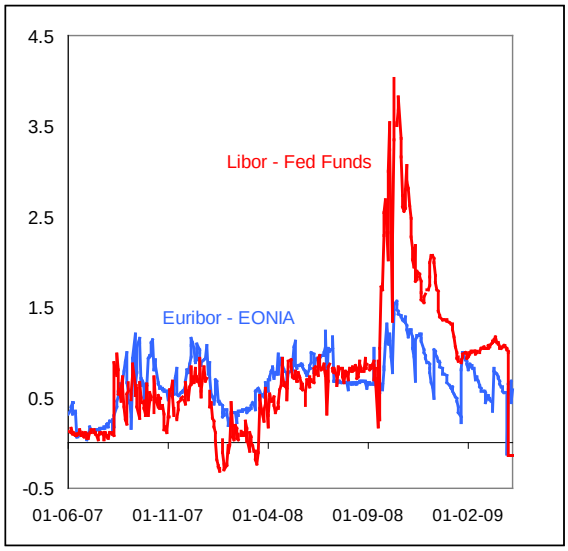


Source: International Financial Statistics, IMF.

In fact, the financial crisis started at the same time in Europe as in the US. The "official" starting date, 9 August 2007, corresponds to the announcement by BNP-Paribas that it was suspending redemption of three funds because of lack of liquidity in the market. This was, in fact, the second warning shot. In early June of that year, a similar move by Bear Stearns had gone almost unnoticed. That same day, the ECB started to inject massive amounts of cash into the interbank market, followed a few days later by the US Federal Reserve Board (hereafter, the Fed).

This is also the time when both central banks started to lose control of interest rates in the unsecured sections of the interbank markets. This is illustrated in Figure 2, which displays the spreads between the three-month Euro Interbank Offered Rate (Euribor) and the Euro OverNight Index Average (EONIA) rates, in the case of the eurozone, and between the three-month dollar London Interbank Offered Rate (Libor) and the Federal Funds rates in the US. In normal times, the spreads between the unsecured Euribor and Libor and the corresponding EONIA and Federal Funds rates essentially reflects the maturity difference—three months vs. overnight—and amounts to about 10 basis points. As Figure 2 shows, both spreads instantaneously rose and became quite volatile. Volatility reached new highs in September 2008, following the demise of Lehman Brothers Holdings, Inc. To a large degree, therefore, financial markets were impacted in broadly similar ways on both sides of the Atlantic. This is further confirmed by Figure 3, which reports the extent of duress suffered by banks in the form of writedowns and capital raised since the beginning of the crisis. For both measures, so far at least, Europe is found to have suffered less than the US but not by a large margin, as the difference with Asia illustrates.

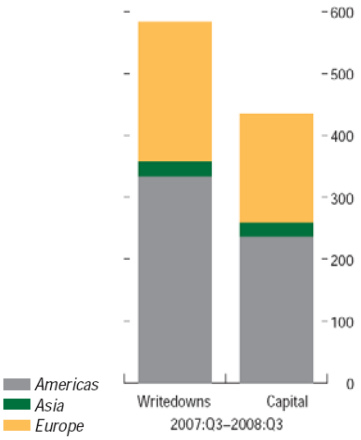
Figure 2: Interest Rate Spreads in Dollars and Euros



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

Figure 3: Banks Under Duress: Writedowns and Capital Raised

(US$ billions)

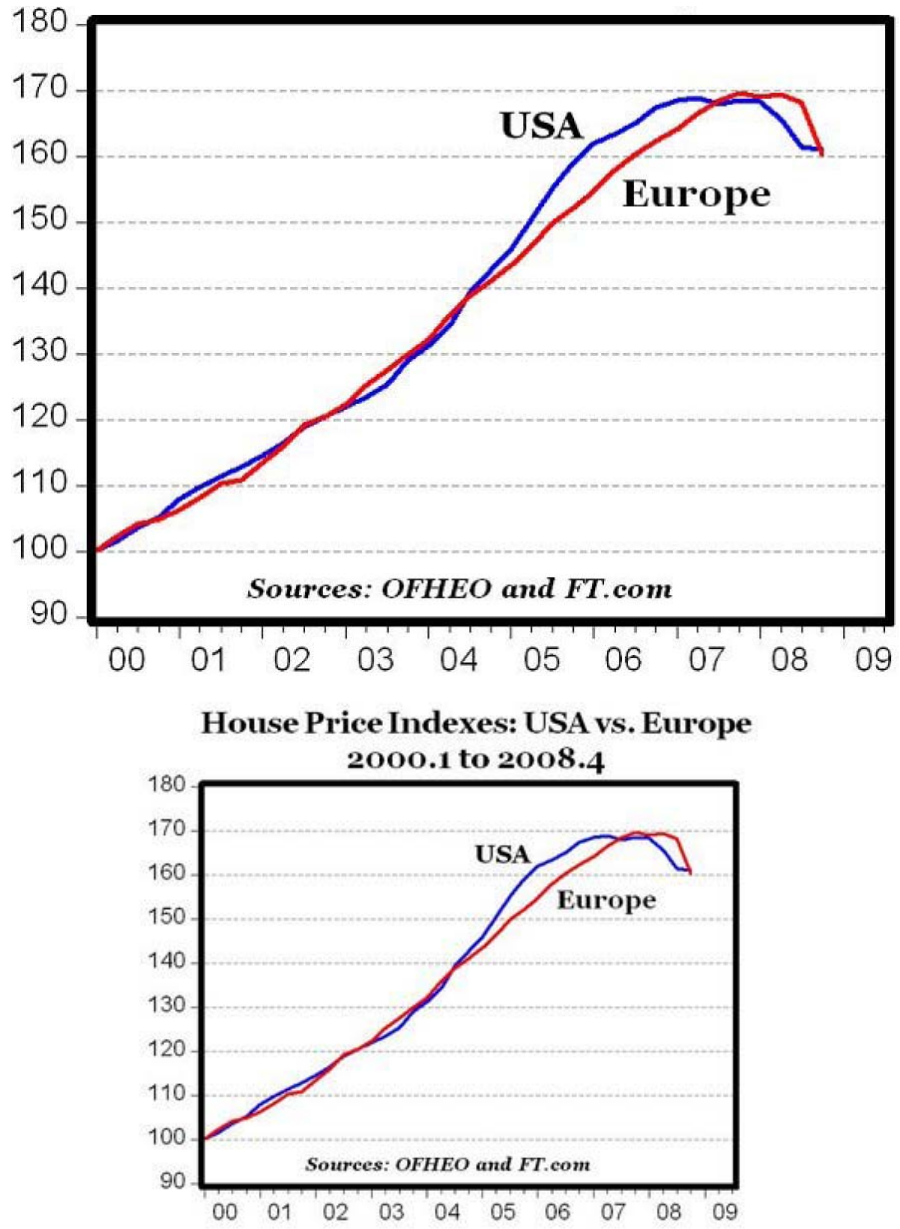


Source: International Monetary Fund (2008)

Much the same can be said about house prices. Although there are large differences from one eurozone member country to another, on average, Europe[2] was subject to a nearly identical bubble, as Figure 5 documents. The relative time profiles of house prices mirror those of gross domestic product (GDP): they peaked earlier in the US than in Europe and the decline is now nearly identical (Figure 1). This observation suggests that the much maligned subprime mortgages may have been more a consequence than a cause of the house price bubble. It does not suggest, however, that subprime mortgages were not a key factor in triggering and spreading the financial crisis once the bubble had burst.

[2] The data refer to the European Union, not just the eurozone.

Figure 4: House Price Indexes: USA vs. Europe, January 2000–April 2008



Source: Carpe Diem (http://mjperry.blogspot.com/2009/04/house-price-indexes-usa-vs-europe.html).

3. INTERPRETATIONS

A perplexing message of the facts collected in the previous section is that financial conditions have been broadly similar in the eurozone and in the US and yet the recession hit the US faster than it did in the eurozone. By the end of 2008, however, the impacts seen in each region were quite similar. This section examines some plausible interpretations.

3.1 The Pricking of the House Price Bubble

A first obvious interpretation is that the crisis started where it originated, in the US, where the housing market indeed peaked nearly a year beforehand, in 2006 (Figure 4). This view rests on causality running from housing prices to economic growth, through four possible channels: 1) wealth; 2) non-performing losses and bank stress; 3) loss of collateral and reduced borrowing; and 4) contraction of the house-building industry. Causality could run in

the opposite direction though probably not in the US, where housing prices peaked a year before the crisis; but, quite possibly in Europe, where the peak mostly occurred after the onset of the financial crisis.[3] The scenario would be one where large losses suffered on US mortgage-backed securities led banks to deleverage and sharply reduce the amounts of new loans. This would adversely impact the housing market and depress prices while generally restricting credit to the private sector. In short, did Europe fall victim to its own house price bubble or is Europe's crisis due to European bank exposure to US mortgages?

Looking in more detail at the timing of events does not shed much light on the question. Table 1 shows that in two of the countries house prices peaked before (Ireland) or at about the same time (Denmark and Spain) as in the US, but elsewhere they peaked significantly later. The table also suggests that there is no relation between the timing and the size of the bubble, when the latter is measured as the increase in real house prices over the last period of relative stability. Europe had nurtured its own bubbles and they exploded apparently randomly. In that sense, there is little evidence of causality from the US to Europe. If anything, timing would imply that Ireland is the source of the world crisis, a rather implausible assertion.

Table 1: House Price Turnaround

House price peak	Country	Pre-peak increase %)	Cyclical peak
2006Q3	Ireland	298	2006q3
2006Q4	US	61	2007q4
	Denmark	145	2007q3
	Spain	113	2007q2
2007Q1	-		
2007Q2	Finland	96	2007q4
	Italy	30	2007q3
2007Q3	France	92	2008q1
	Sweden	110	2008q1
	UK	164	2007q3
2007Q4	Netherlands	146	2008q2

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 1992–1995, 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.

Source: World Economic Outlook Database, International Monetary Fund.

Yet the coincidence is troubling. Rather than a European story versus an American story, this could be a global story. House prices had risen enormously on both sides of the Atlantic, probably for the same reasons. As discussed in Bosworth and Flaaen (2009), ample liquidity provided by low interest rates and high saving rates in emerging market countries encouraged bank lending and led to unreasonably low assessment of risks. Few developed countries (Austria, Germany, and Switzerland) escaped the fad. On both sides of the Atlantic, discussions of the impending end of the bubbles were rife and investors were scrutinizing every possible signal. Once the bubbles started to deflate, banks all simultaneously faced a rising tide of non-performing loans. The main difference between the US and Europe is that securitization of mortgages was mostly developed in the US and the

[3] For a recent empirical study on causality between credit and house prices, and extensive references, see Goodhart and Hofmann (2008).

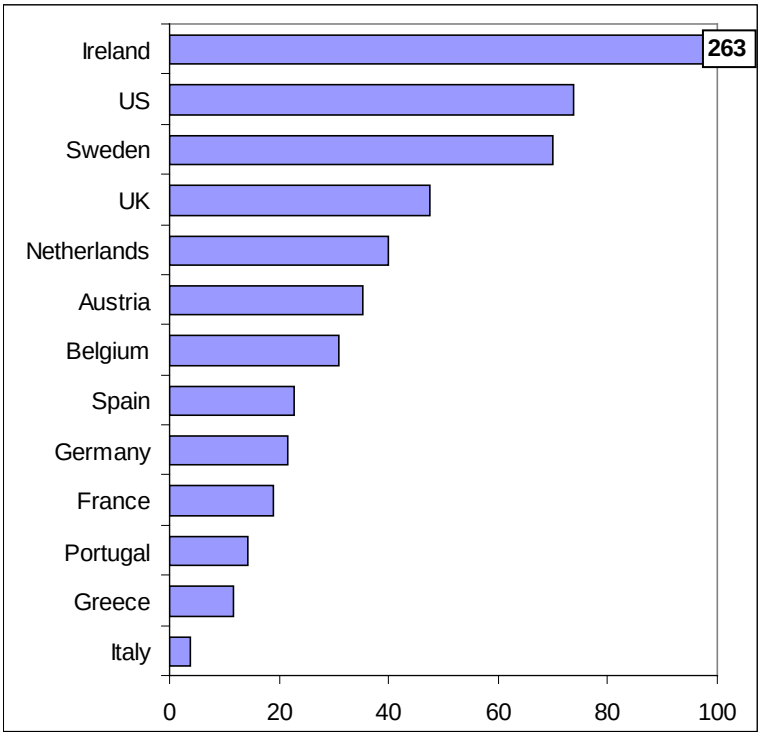
resulting securities were bought in the US. In that sense, contagion went from the US to Europe, and the delayed impact is understandable.[4]

3.2 The Banking Sector

According to Figure 3, European banks have been less affected than US banks, but the difference is not very large. However, writedowns and recapitalization are imperfect measures of the severity of the bank crisis. Writedowns depend upon local regulations and on their enforcement. Like recapitalization, they also depend on various measures that governments may take to alleviate the situation. Governments may buy toxic assets at favorable prices or provide guarantees for either assets or liabilities. Central banks may also provide liquidity, which may defer writedowns and recapitalization, depending on the regulatory regime.

Looking at public support thus provides an alternative gauge of the deterioration of the financial sector. According to Figure 5, with the exception of Ireland, financial institutions from the eurozone countries have received comparatively less support than the US has. Two non-eurozone countries, Sweden and the United Kingdom (UK), on the other hand, appear between the US and the eurozone countries.

Figure 5: Public Support to the Financial Sector (as of 18 February 2009, % of GDP)



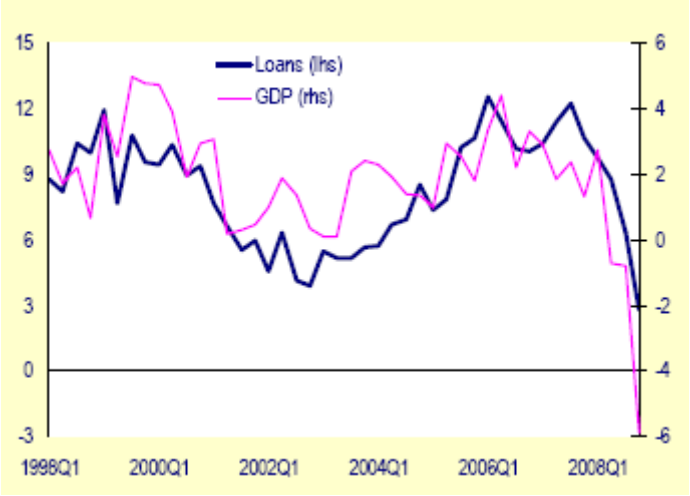
Source: International Monetary Fund (2009).

An additional piece of information concerns credit to the private sector. If losses have been large, one would expect deleveraging to have led to a credit crunch. Figure 6 shows that credit has considerably declined, but it does not tell us why, and this is crucially important. The situation could indeed reflect a supply-side crunch, but it could equally well correspond to a sharp decline in demand for loans as economic conditions worsen. One reason to doubt

4 It may be interesting to note that Spanish banks were forbidden by their central bank from buying asset-backed securities. Given the size of the Spanish bubble, however, Spanish banks and the Spanish economy ended up being hurt as much as—if not more than—other European countries.

the credit crunch interpretation is that the figure suggests that credit has declined less than could be expected on the basis of previous experience.

Figure 6: Credit in the Eurozone
(% change)



Source: European Commission (2009).

At this stage, it is impossible to determine with any precision the degree of deterioration of national financial systems. The available information could suggest that the US banking system has been more affected by the crisis than has been the case in the eurozone countries. Alternatively, it may be that the US authorities have taken more forceful action and have managed to at least compensate for the earlier damage created by the subprime mortgage crisis. This would explain the early decline in the US and the similarity of the overall effect by the beginning of 2009, but not the rebound observed in the US in 2008.

3.3 The Role of Welfare Systems

As in Asia, some market economists and officials have put forward the decoupling theory, in which case, Europe would not be subject to contagion from the US. Their arguments were based on empirical work that did not detect any increase in comovements of key economic variables in recent years, despite evidence that trade and financial integration was deepening (Doyle and Faust 2005). A further reason why decoupling would occur in the European case, it was argued, is the existence of a large welfare system. High unemployment benefits and progressive income taxation deliver large automatic stabilizers, while universal health care and unfunded pensions—not in all countries, see below—reassure households at a time when asset values fall precipitously.

However, in actuality, decoupling did not materialize. The belief that the automatic stabilizers would be enough to offset the shock has been shown to be incorrect or, at least, overblown. By definition, the stabilizers offset less than 100% of shocks, so they cannot deliver decoupling, but they can reduce the impact. In fact, estimates of the stabilizers indicate that the absorbing effects are a small fraction—at most 25%, and usually much less—of the original shock (Fatas and Mihov 2001).

While the decoupling theory has proven to be wrong, welfare system differences may go some way into explaining why the crisis may have taken hold more slowly in the eurozone than in the US or UK. On the other hand, these differences would predict that, overall, the impact of the crisis should be less profound in Europe. Although it is too early to draw any sharp conclusion, the evidence presented in Figure 1 does not provide support for this view.

3.4 Limited Exposure to Markets

European households hold fewer financial assets than do US households, especially because pensions are largely unfunded in a number of countries. With the exception of the Netherlands (149% of GDP in 2007), Ireland (94%), and Finland (78%), pension fund assets total less than 25% of GDP among eurozone countries, and often significantly less.5 This means that wealth destruction affected households mostly after house prices started to decline, which took place over a period of one year, as discussed in Section 3.1. This would help to explain the delayed onset of the recession in Europe but not its depth.

In fact the depth of the recession has come as a surprise, as evidenced by the unending revisions of forecasts since 2007, all downward. True, house price declines have been pronounced in Europe, but the expected magnitude of their impact remains unclear. Buiter (2008) argued that housing wealth has no impact on consumption, suggesting that unless house prices include a bubble component, in equilibrium housing wealth equals the present value of rental costs. The presence of a bubble does not alter the conclusion. If, however, the bubble is expected to be temporary, its present value is nil. Rational homeowners, therefore, should not have felt richer as the bubble grew and should not feel poorer now, after its collapse. Of course, rationality is not necessarily a good starting point for analysis, and other aspects—especially the use of houses as collateral—weaken the result. It remains that the influence of fluctuations of house prices on consumption may be much smaller than is often claimed.

3.5 Assessment

The eurozone entered into recession later than the US did, but then, when the area finally entered into recession, the decline was rapid and steep. At the time of writing, the eurozone growth rate is negative and of the same order of magnitude as the US rate. Interpreting the difference turns out to be more challenging than expected on the basis of popular explanations of the crisis.

The general view is that the bursting of the US house price bubble led to nonperforming mortgage loans, which badly impaired the US banking system. Through securitization, non-US banks, chiefly European banks, were also deeply affected. As bank lending fell, a vicious cycle started to unfold, going from reduced demand (consumption and investment) to falling house and asset prices and to further bank stress. Of course, via exports, the recession was propagated and possibly expanded internationally. Because the EU and US are reasonably closed economies, this last effect has been ignored in previous analyses, but it is well understood and therefore does not need much more attention at this stage.

While the decoupling hypothesis was clearly wrong from the beginning, a number of factors should have mitigated the impact of the financial crisis in Europe. It can be argued that the acquisition by European banks of securities backed by US mortgages spread the impact of the US house price bubble burst to Europe, thus aggravating the impact of Europe's own house price bubble. While correct, this observation ignores the fact that some countries, chiefly Germany and Austria, never had house price bubbles and yet are sharing in the recession. The export channel may be part of the explanation, but then it should be a mitigating factor for the other countries.

Another puzzling observation is that, with few exceptions, European households are much less exposed to stock market swings than are US households. In addition, bank distress seems to have been deep in Europe, but somewhat less severe than in the US. On both counts, therefore, a less severe downturn could have been expected. In addition, the famed

5 Source: Organisation for Economic Co-operation and Development Global Pension Statistics.

European welfare systems imply that the automatic stabilizers are more powerful. On these grounds, too, a muted response could have been expected.

Working in the opposite direction is that the house price bubbles may have been larger in several European countries than in the US (Table 1). The worst case is Ireland and this is indeed where the recession is deepest (-7% in 2008Q4). But other countries with very large declines in house prices—the Netherlands, Spain, and Denmark—have not fared worse than the US has, while a country like Germany is facing a deep recession.

Elucidating these issues would require a quantitative analysis that goes beyond the scope of this paper. In the next section, whether economic policy choices help to better understand the outcomes is discussed.

4. POLICY RESPONSES

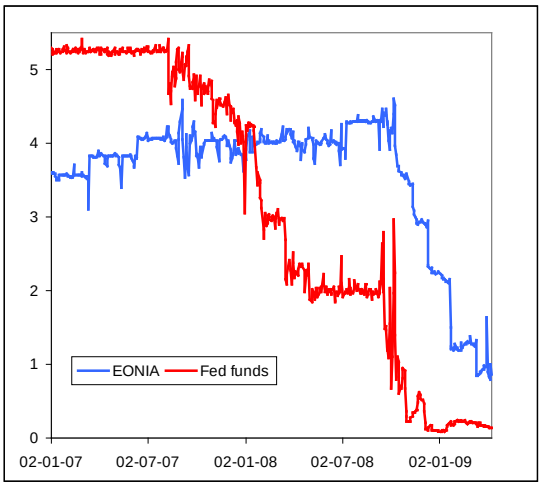
4.1 Monetary Policies

The ECB reacted immediately and forcefully to disruptions on the interbank market by injecting hitherto unseen amounts of liquidity. The ECB soon developed a dichotomy principle, distinguishing between its two core functions. In order to achieve orderly conditions on the financial markets, it would provide as much liquidity as needed. Liquidity provision, however, would not interfere with interest rate setting, which would remain driven by monetary policy objectives. Rejecting any link between quantity and price could seem strange. The ECB's reasoning was based on the distinction between unsecured interbank rates and the policy rate—the former largely exceeded the latter (Figure 2).[6] The ECB considered that it would pursue two intermediate objectives that were temporarily disjoint: set the policy rate (i.e., the refinancing rate, or "the refi") and as well as close the gap between the interbank rate and the policy rate The dichotomy had some logic to it, but only up to a point. Since the market rate is a key channel of monetary policy transmission, the ECB could not just set the policy rate on the basis of previous experience. It had to recognize that the market rate was at least as important for monetary policy as the refi.

This may help to explain why it took 14 months for the ECB to start lowering its policy rate, which it did for the first time in October 2008. The contrast with the Fed is striking. In September 2007, the Fed promptly lowered its policy rate, then held it steady at 2% until the Lehman Brothers Holdings collapse, at which point it drove the interest rate down to the zero lower bound (Figure 7).

[6] Figure 2 displays the spread between unsecured (Euribor three months) and secured (EONIA) market rates, not between Euribor and the policy instrument, the main refinancing rate.

Figure 7: Interest Rates in the Eurozone and the US (interbank rates)



Sources: ECB, Federal Reserve Bank of New York

In contrast the ECB kept its policy rate at 4%, reaching its high point in July 2007, until it raised the rate by 25 basis points in July 2008. As abundantly explained in its monthly press conferences, the ECB was more concerned by inflation, which had been steadily rising since 2006 in part because oil, commodity, and food prices were skyrocketing, than about growth and unemployment. Along with most other forecasters, the ECB did not foresee that the ongoing financial crisis would eventually provoke a recession. Indeed, the eurozone economy peaked in 2008Q1, when inflation was still rising (Figure 1).

The problem, of course, is that monetary policy operates with lags of at least two quarters and possibly significantly more. With hindsight, the ECB should have started to lower its policy interest rate by fall of 2007 at the latest, which is what the Fed did. Was the Fed more prescient? One important difference is that the financial crisis erupted in the US, so the risk to growth was more immediate there than in Europe. In fact, the situation promptly deteriorated in the US, which greatly simplified the usual tradeoff between growth and inflation that bedeviled the ECB. Another factor is that the US financial system was under intense pressure while, initially at least, only some European banks were in a precarious situation. It also matters that the Fed did not develop the dichotomy principle of the ECB and attempted to restore stability in financial markets through both liquidity injections and interest rate cuts. Finally, it bears recalling that the Fed has a dual mandate while the ECB's mandate is hierarchical, with inflation at the top.

At any rate, whatever the reasons, it appears ex post that monetary policy in the eurozone did not address the crisis until it was under way. Previous sections sought to explain why growth declined so fast in the eurozone, relative to the US, once the recession got under way. One element of the answer is that monetary policy was late by almost a year. It is important to note that this conclusion is easy to draw after the fact. Back then, very few, if any, foresaw the seriousness of the ensuing recession. If any mistake was made, it was in the area of economic forecasting, an assessment that is surprisingly de-emphasized in current debates.

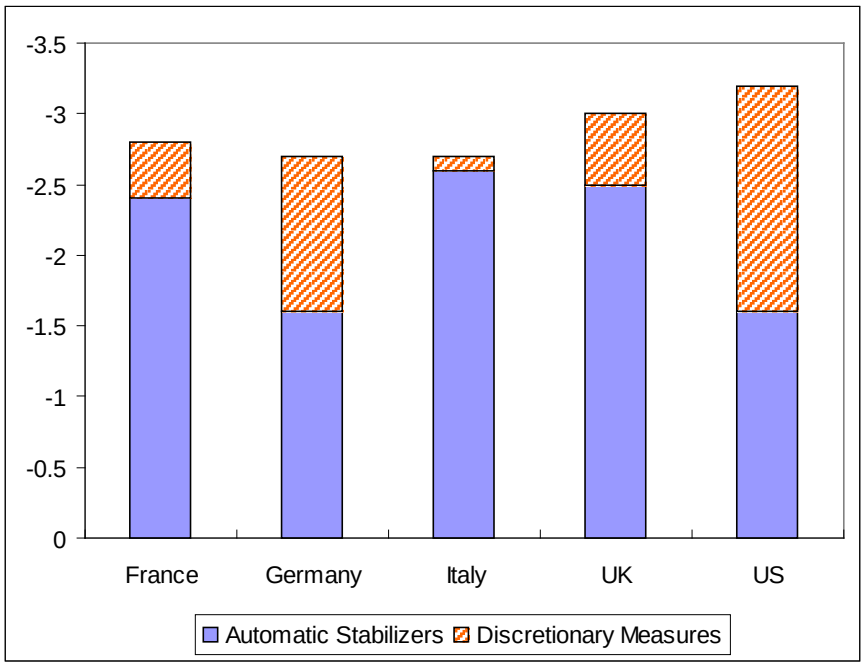
4.2 Fiscal Policies

It was noted earlier that the automatic stabilizers are larger in continental Europe than in the US or UK. It was further observed that the stabilizers only mitigate shocks but are far too weak to offset them by a wide margin. It follows that fiscal policies may have been automatically countercyclical but that does not mean that, overall, they have been used to thwart the recession. In examining this issue, note that a number of systematic studies (e.g.,

Galì and Perotti 2003; Wyplosz 2005; Fatas and Mihov 2009) have documented the tendency for fiscal policy to be procyclical in many European countries. What about this time?

To gauge the situation, the combination of the automatic stabilizers and of discretionary actions need to be examined. Preliminary evidence is presented in Figure 8 for a subset of countries (the four large European countries that belong to the Group of 20 and the US). The data are estimates compiled by the International Monetary Fund (IMF) on the basis of policy announcements for the whole period 2008–2010. They represent the change in budget balances as a percent of GDP, distinguishing discretionary actions and automatic stabilizers. The figure suggests that budget balances have deteriorated less in the three eurozone countries than in the UK and US. Not surprisingly, this is also where the automatic stabilizers are larger. As a corollary, discretionary actions are more limited in the eurozone countries, actually estimated to be nearly nonexistent in France and Italy. In addition, the time profile of the changes is backloaded for the three eurozone countries, a reflection of the important role played by the automatic stabilizers as the economic situation deteriorates.

Figure 8: Changes in Budget Balances, October 2008



Source: IMF (2009)

Given the lags in fiscal policy effectiveness, these estimates indicate that, though not procyclical, fiscal policy has not played much of a countercyclical role in the eurozone. With interest rates now at the zero lower bound, the eurozone governments are not actively trying to counter the ongoing contractionary forces. Resumption of growth will have to rely on private spending or exports.

The relatively limited use of fiscal policies in the three largest economies of the eurozone may be related to the Stability and Growth Pact and the mandatory 3% ceiling on public deficits. As the recession deepened, the pact has been quietly put aside and, on the face of it, cannot be blamed for an insufficient provision of fiscal stimulus. Because the pact allows for some flexibility in “exceptional circumstances,” this de facto suspension is very explicitly temporary. Since the circumstances are judged on the basis of GDP growth rates, a simple stabilization could trigger a reinstatement of the pact. With large negative output gaps, possibly slow to be closed, public budgets are therefore unlikely to recover spontaneously when the pact binds again. This may provide incentives to limit slippages in deficits that will be hard to correct once the recession is over. It can explain why most eurozone

governments have indicated little inclination to use fiscal policy as forcefully as other countries have such as the US, Japan, or People's Republic of China.

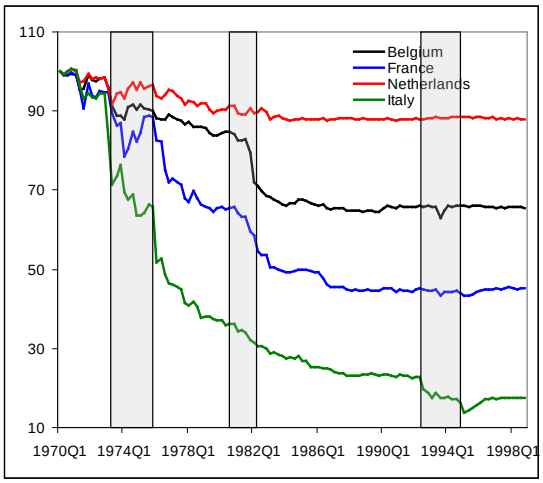
5. THE ROLE OF THE EURO

5.1 The Silent Proof of Success

Never before have European countries gone through troubled times without undergoing sharp speculative attacks on some currencies. This is illustrated in Figure 9, which shows the exchange rates of the original founding countries relative to the deutsche mark. The shaded areas identify the two oil shocks and the recessionary episode of 1993, arguably the major macroeconomic events that occurred between the end of the Bretton Woods system and the creation of the euro. Each of these events was accompanied by sharp tensions within Europe and, in most cases, a few currencies faced acute speculative attacks.[7] In many respects, the single currency was adopted to rule out a repeat of these attacks. Since the adoption of the euro, there has been no currency attack within the eurozone.

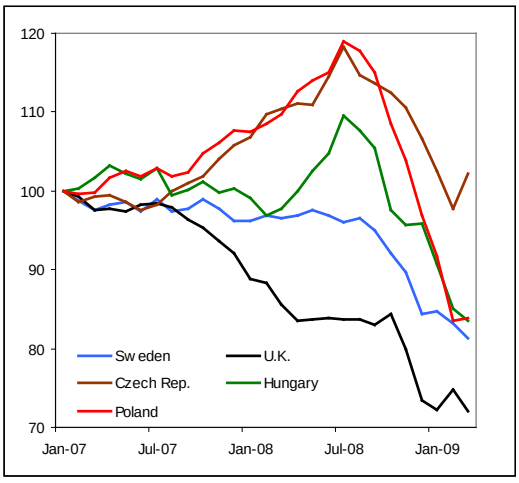
It is impossible to imagine what would have happened in the absence of the euro. One relevant observation is the behavior of the currencies of the countries that have not joined the eurozone. Figure 10 shows that their exchange rates vis à vis the euro became unusually volatile once the financial crisis started.[8] Hungary has obtained emergency assistance from the IMF, while Poland has claimed support under the IMF's new Flexible Credit Line facility. Both have also received emergency credit lines from the ECB. The EU Commission also created a €50 billion balance-of-payment assistance fund for Eastern and Central European member countries. The freely floating Swedish and British currencies have both undergone deep depreciation.

Figure 9: Exchange Rates vis-à-vis the deutsche mark (Index: 1970q1 = 100)



Source: International Financial Statistics, IMF

Figure 10: Exchange Rates vis-à-vis the Euro (Index: 2007m1 = 100)



Source: *Monthly Bulletin*, European Cenrtal Bank

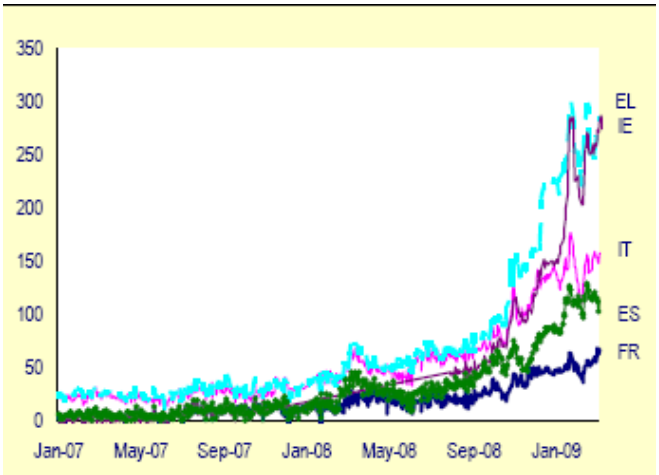
[7] In 1993, the Dutch, French, and Belgian currencies escaped mostly unharmed, but several other currencies (Irish, Spanish, and Portuguese) had to be devalued while Italy and the UK were forced out of the European Monetary System.

[8] Not shown are countries that peg to the euro, of which, Latvia, has obtained emergency funding from the IMF, as well as Romania, which is also under an IMF program.

5.2 Pressure within the Eurozone

Another indication that the single currency has most likely prevented several currency crises (or deep depreciations) is provided in Figure 11. The figure displays spreads of interest rates on national public bonds over the German bund rate. The largest spreads on Greek and Irish bonds reflect market concerns that public debts could be unsustainable. Several other countries face large spreads too. It is not too farfetched to claim that, absent the euro, some of these countries would also have faced intense pressure on their exchange rates.

Figure 9: Treasury Bond Spreads (basis points)



Source: European Commission (2009).

This evidence shows that belonging to the eurozone does not shield member countries from country-specific financial pressure. This aspect was muted for a long period during which the spreads where very small and rarely exceeded 25 basis points. This even led the ECB to observe that the markets were not adequately monitoring national public finances or, worse, that the markets were wrongly expecting that the no-bailout rule, which prevents emergency lending to national governments by European institutions and by other governments, was not binding. As the recent episodes indicate, the markets do discriminate when they feel—rightly or wrongly—that some governments might face difficulties serving their public debts.

Strangely, perhaps, the debate on the no-bailout clause has emerged as spreads started to rise; i.e., when markets were indicating that the clause is credible. More strangely, a number of governments, even the ECB, have then suggested that some arrangements could be imagined without violating the no-bailout clause. The EU Commission President, José Manuel Barroso, even stated:

> The euro zone is prepared to help if one of its members is threatened with defaulting on debt. We are considering all options. If there is a problem in the euro area we will have the means to act. […] We have instruments in Europe to react (Strupczewski 2009).

These may merely be statements made by anguished policymakers, presumably to reassure the markets. Yet they reveal the nature of integration forces. Within a currency area, it may be costly to let a government default, even partially, especially in a period of intense financial tensions.

6. CONCLUSIONS: ANY LESSON FOR ASIA?

The crisis is far from over and it may be too early to draw sharp conclusions. A few remarks may be of interest to Asian readers, but the customary precaution about policy recommendations needs to be vigorously emphasized.

First, the eurozone comes out as extraordinarily cautious in its policy reactions. While the ECB has been forceful in dealing with market turbulence, its macroeconomic reaction has erred on the prudent side, perhaps because of its price stability mandate. Even though it has gone all the way to the zero bound, its actions have been delayed relative to those of the Fed and other major central banks. Similarly, perhaps because of the Stability and Growth Pact, eurozone member governments have relied on the automatic stabilizers to a greater extent than many other countries have and the region has made relatively little use of discretionary fiscal policy. As a result, its recession may be deeper than it would have been and may last longer than in other parts of the world. Collective pressure may encourage restraint, which may be a good thing in some circumstances and a bad thing in others.

Second, the key benefit from a common currency has been reaped. One thing that eurozone member policymakers do not have to worry about is sudden and wide shifts in relative competitiveness. Since intra-EU trade is large, this is a major advantage.

Third, another benefit of the common currency is the limited extent of currency mismatch. This is greatly helping the deleveraging process of banks. It also allowed the ECB to act forcefully in providing liquidity in euros. This stands in sharp contrast with Asia where the world liquidity shortage has severely impacted many countries and, in some cases, led to sharp currency depreciation which heightened the inflation-output tradeoff, severely complicating the task of central banks.

Fourth, beyond the benefits of a common currency, European governments have shown a great deal of solidarity. Some of it has led directly to significant financial support to countries that have not joined the euro. The ECB thus recognizes the central role played by the euro and the risks posed by large exchange rate fluctuation to the smooth functioning of the single market. Even though within the eurozone markets can and do pressure individual countries, solutions are being imagined.

Fifth, while exports to partners outside the eurozone have declined as much as elsewhere, the impact has been limited simply because much trade takes place within Europe. Since the onset of the financial crisis, the real effective euro exchange rate has appreciated slightly by about 5% without apparently generating much anguish. As a result, Europe knows, or should know, that exiting from the recession depends on internal demand, and hence internal macroeconomic policies. Little use has been made of this advantage so far, but the possibility exists and may be put to good use if and when policymakers recognize it.

Finally, a puzzling question: With limited direct exposure of households to financial events and a limited impact of declining exports, why is the recession so severe? Policy reactions have been subdued and late, but this does not quite explain the rapid decline in consumption and productive investment. An intriguing possibility is that demand was reined in simply because households and firms became overly cautious, thus triggering a self-fulfilling prophecy. This has led a number of observers to recall Keynes' views on animal spirits.

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