Summary for non-specialists
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Country adjustment to a 'sudden stop': Does the euro make a difference?

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Soon after the creation of the Economic and Monetary Union (EMU) significant amounts of capital, largely intermediated by the banking system, started to flow from what are today called the core to the periphery of the euro area. Countries like Greece, Ireland, Spain, Portugal and, to a much lesser extent, Italy seemed to offer attractive investment opportunities relative to the economies of the core, which at the time, seemed much less dynamic. The elimination of the exchange rate risk appeared beneficial for both borrowers and lenders. These capital flows, and the associated current account imbalances, were then seen as part of a well-functioning monetary union and a by-product of the process of convergence towards higher output levels. The academic and political debate therefore simply disregarded the current account imbalances which arose over time.

With the eruption of the financial crisis in late 2007 and 2008 the large current account deficits of the periphery were no longer regarded as the side effect of a convergence process but rather as indicators of excess debt, construction bubbles and resource misallocation.

This led to a 'sudden stop' in the capital inflows periphery and such a sudden stop is very disruptive because it forces an almost immediate reversal in the current account unless the loss of private capital is made up by official sources. This happened in the euro area periphery via two different sources: Official loans to the government and via the monetary policy operations of the ECB. These official support operations allowed the countries in question to maintain current account deficits for longer than they would have otherwise been possible and the conditionality might have led to more structural reforms.

How could one judge the success of these so-called 'bail outs'? This study starts from the observation that large capital inflows and the associated external imbalances were not a phenomenon limited the euro area. The capital flows and external deficits even more extreme in some new EU member states which had all fixed their exchange rate to the euro, either as peg or in the form of a currency board. Indeed, Baltic States (Estonia, Latvia and Lithuania) and countries such as Bulgaria experienced huge capital inflows partially driven by the expectation that the catching-up potential among the BELL was much larger than for the GIIPS, given that the former were still much poorer (relative to the EU average). Accordingly, expected growth was larger in the EU periphery than in the euro-area periphery. These expectations were validated for quite some time as the capital inflows allowed the economy to expand. Whatever the reasons the average current account deficits were at close to 20 % of GDP almost twice as large for the BELL than for the euro area periphery.

The ‘sudden stop’ of lending was also not limited to EMU peripheral countries. After the outbreak of the global financial crisis, flows of private capital towards the BELL suddenly dried up. This 'sudden stop', forced these countries to undergo a profound adjustment process to correct their external position (in general by reducing private and public expenditure).

The analysis presented in this paper starts from the observation that two groups of European countries, neither of which could use the exchange rate as an adjustment instrument, experienced a sudden stop after the outbreak of the global financial crisis. The first group comprises the five euro area member states under financial stress (Greece, Ireland, Italy, Portugal and Spain = GIIPS) during the euro area debt crisis. The second group comprises four newer EU Member States in Central and Eastern Europe with fixed exchange rate to the euro (Bulgaria, Estonia, Latvia and Lithuania = BELL). These two groups do not constitute quite a natural experiment, but the differences between them can show whether the existence of the euro led to a better adjustment process.

The main finding is that the adjustment was quicker outside EMU than inside with two factors crucial. First, the shock absorbers provided by the financial ‘plumbing’ of the Eurosystem seem to have created an environment in which the pressure for a quick adjustment was much weaker. The financing channel available through the Eurosystem protected the banking systems of the countries in the euro area from the immediate effects of a sudden stop. This led to a slower correction of imbalances.

Second, a large degree of foreign ownership of banks proved to work as loss absorber in the BELL, while the legacy of the banking crisis in some of GIIPS is likely to weight for long time on still incomplete adjustment process.

Only one of the BELL countries, Latvia, was subject to adjustment programme, whereas all the GIIPS had, under various degrees of stringency, to undertake structural reforms. However, there is no evidence yet that the EMU membership and the associated pressure from the economic governance mechanisms will deliver reformed and more competitive economies.

All in all, it appears that the ‘softening’ of the budget and liquidity constraint within EMU has delayed both fiscal and external adjustment.

The paper also attempts at providing an assessment of the two adjustment trajectories in terms of macroeconomic costs. All the indicators used by us suggest that the cost of adjustment was larger in the GIIPS than in the BELL (but the differences are not very large). Moreover, the quicker adjustment of the BELL also meant that they accumulated less debt over their adjustment paths.

In terms of policy prescription going forward, we observe that the ‘short and sharp’ adjustment in the BELL countries has allowed them to escape the debilitating effects of a long drawn-out crisis. The quicker adjustment was ‘enforced’ by much higher domestic interest rates and a lower availability of domestic credit (coupled with a tight fiscal policy). Such tough macroeconomic conditions are considered as excessively costly when they arise, but they had the advantage of accumulating less debt accumulated and the macroeconomic performance tend to be better when measured over time.