The Sovereign Debt Crisis in Europe

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Greece prior to the crisis (2000-07)

- Greece was highly indebted when it adopted the euro in 2000
- Many factors should have helped Greece consolidate its finances
  - Strong growth, in absolute terms and relative to the rest of the eurozone
  - Very low real cost of borrowing
- But Greece ended the pre-crisis period where it started
  - European institutions did not provide fiscal discipline
  - Markets did not provide fiscal discipline
Greece after the crisis

Economic factors led to a sharp fiscal weakening

- Borrowing spread went through the roof
- Recession was one of the deepest in Europe
- Financial system required extraordinary support
- Economy faced further real appreciation
Why a sovereign debt crisis?

Necessary ingredients

- Triggering event: Global financial crisis
- Fiscal indiscipline in Greece and other troubled member countries
- Lack of clarity in Europe’s fiscal institutions
Fundamentals in Europe

Cyclically-adjusted primary balance (2006-08, %)

Government Debt (2008, % of GDP)

Real Exchange Rate vs Germany (2011, 1999=100)

GDP (2010, % change since 2007)
Three choices for Europe

1. No monetary union and no fiscal union
2. A monetary union, no fiscal union
   - Requires a clear mechanism for default
3. A monetary union, with a fiscal union
   - Requires significant institutional changes

- The choice does not necessarily dictate the short-run resolution of the debt crisis
Europe and existing fiscal unions

- Europe is different than existing fiscal unions
- Suggests the cost of transition to a strong fiscal union is nontrivial

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<th>Europe</th>
<th>Canada</th>
<th>U.S.A.</th>
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<tbody>
<tr>
<td>Member debt levels</td>
<td>large</td>
<td>small</td>
<td>small</td>
</tr>
<tr>
<td>Member level banking systems</td>
<td>yes</td>
<td>no</td>
<td>not really</td>
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<tr>
<td>Central fiscal authority</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
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