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Athanasios Orphanides, senior lecturer at MIT, discusses the forces that caused the Euro crisis, the measures that have been taken to correct it, and the future of the common currency.

MIT lecturer analyzes Euro area debt crisis, fiscal situation

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"Things actually look better for the Euro area today than they did a year ago—are they?" With this question, Athanasios Orphanides, a senior lecturer at the MIT Sloan School of Management, opened his lecture on the politics and economics of the Euro area crisis, in which he gave one explanation of what has happened to the Euro area because of the crisis and what he expects for the Euro area in the future.

At Boston College last Monday as a part of the International Economic Policy and Political Economy Seminar, Orphanides drew from his experience as governor of the Central Bank of Cyprus from 2007 to 2012 and a member of the Governing Council of the European Central Bank (ECB) from 2008 to 2012 to give his interpretation of the sovereign debt crisis in Euro area countries, as well as the circumstances surrounding the crisis.

Orphanides began by tracing the beginning of the crisis and explaining how it reached Europe from its origins in the U.S. after the collapse of Lehman Brothers in September 2008, when the crisis shifted from an American to a global crisis in 2009. While Orphanides said that monetary and fiscal interventions averted catastrophic outcomes, he also stressed that the Euro area did not see a recovery, but rather became the new center of the financial crisis.

Analyzing what the problem was really about, Orphanides listed five different possibilities as answers that different experts gave: fiscal, competitive, growth, banking, and governance. However, he dismissed the first four and suggested that the issue of economic and political governance was at the heart of the crisis.

"The Euro area is not in the top two [among the Euro area, the U.S., the UK, and Japan] in terms of running deficit or in terms of debt-to-GDP," Orphanides said, as he explained the fiscal situation in Europe. "Markets seem to be attacking specific governments within the Euro area. Since the crisis, we have seen the disintegration of the Euro area sovereign markets. Markets are telling us that they don't think this monetary union is functioning well. But again, this is not a fiscal issue overall."

Looking at three problem countries—Greece, Portugal, and Ireland—Orphanides then addressed the question of competitiveness. While there was some divergence in unit labor cross between France, Italy, Spain, and Greece and Germany in the 2000s, Orphanides cited the inconsistent market response to this divergence—Italy, Spain, and Greece were punished by the bond markets while France was not—as why this was an insufficient explanation.

Turning to growth, Orphanides talked about the increase in the unemployment rate in the Euro area. He talked briefly about the recessions in the member states and the general lack of growth in the Euro area, but quickly shifted focus to the issues of governance, which he saw as the biggest part of the crisis.

"I think we need to look deeper into the economic governance of the Euro area and try to understand what went wrong and what needs to be fixed," Orphanides said. "What was uncovered in the first phase of the global crisis was something that was known all along—that the Euro area was incomplete in its design. Among other things, it doesn't have a crisis management framework. This was understood at the time the Euro area was created in the '90s. At the time, this was a conscious decision."

With this deficiency, the Euro area faced a crisis that has become an existential threat, according to Orphanides. There are a number of member states that are currently under stress from the bond markets. He linked the stress that the governments faced in their sovereign debt issues with the banking problem, a problem with undercapitalized banks.

"Because of the global crisis and recession, significant gaps were revealed in the monitoring and enforcement of the rules [for member state's deficit and debt levels] and it was recognized something that was suspected all along—that many countries were not following the rules," Orphanides said. "Greece was the first offender in this. The Greek system data could not be trusted. At that point, in the first quarter of 2010, people started realizing that we had to complete the monetary union and figure out how to deal with crisis. The crisis management framework was not there and had to be designed on the spot."

Focusing on crisis management, Orphanides discussed the constraints faced by the Euro area in resolving the crisis. Primarily, these were political constraints stemming from the fact that there were restrictions on action by the ECB, the EU, and other member states embedded in the EU treaties. Furthermore, Orphanides spoke about the necessity of avoiding moral hazard going forward. He described two possible approaches, a cooperative one and a non-cooperative one, and how the member states eventually settled on the latter, after the former failed to work.

Looking at the current situation and the future of the Euro area, Orphanides offered few absolute answers.

"Words continue to suggest a strong desire for solution, while actions suggest a continued bias toward postponement," Orphanides said. "The European Central Bank ensures that the crisis can be averted for a little while longer. Can this muddle be sustained until the [European] leadership will make changes?" ■