



# **The EMS crisis of the 1990s: Parallels with the present crisis?**

by

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1990s: crisis starts after long period of stable exchange rates, when capital flows liberalised.

Crisis not anticipated by markets (exchange rates and interest rates calm until just before crisis breaks (like today)).

After 1993: de facto end of EMS, but crisis continues 1995.

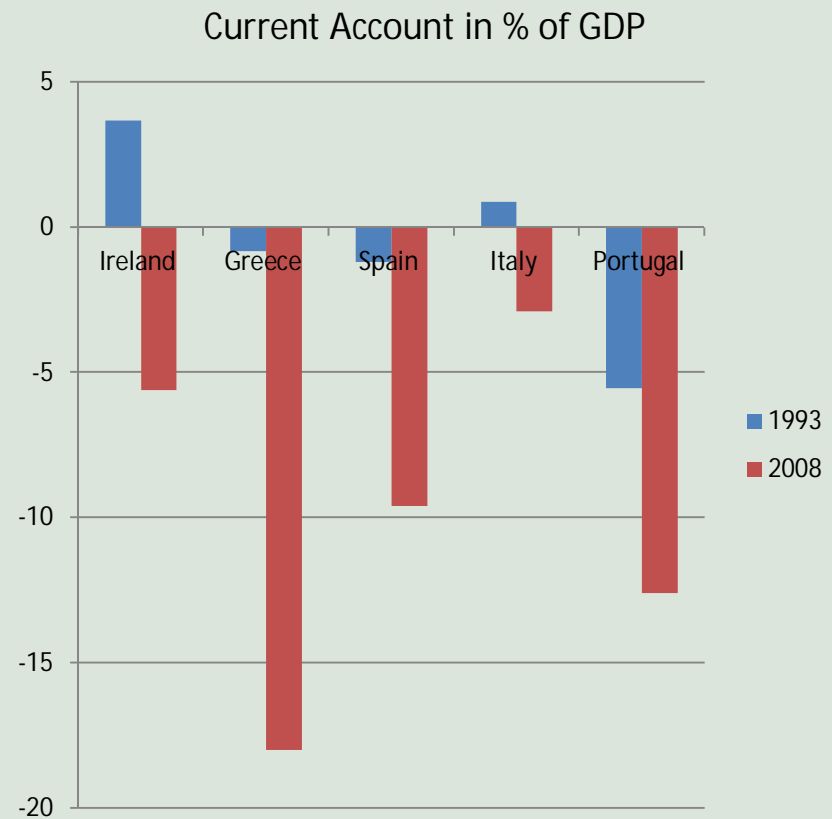
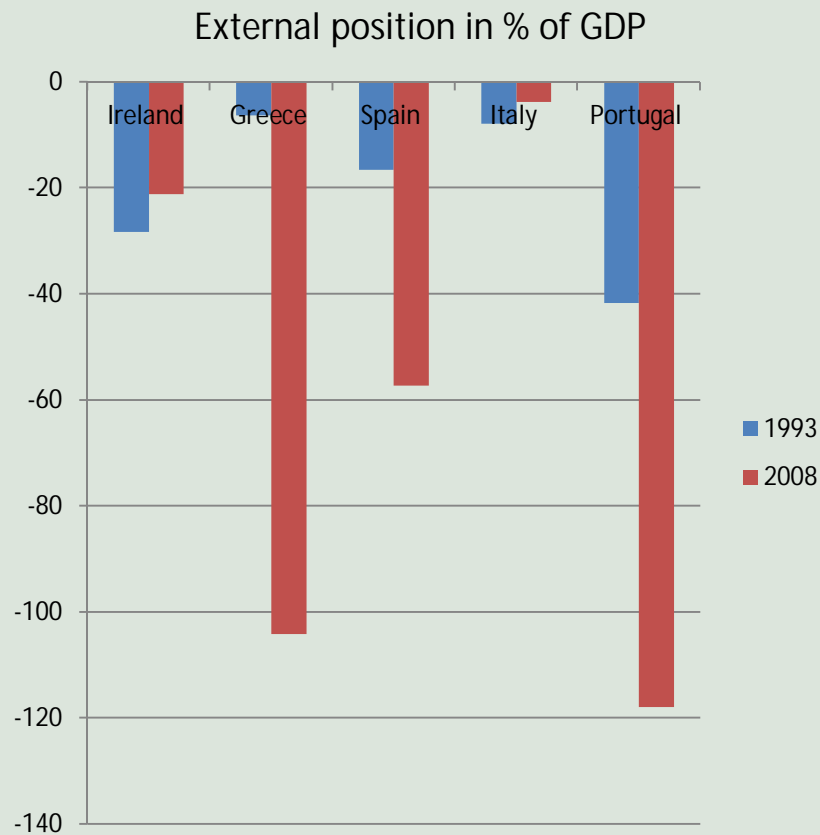
Dominant explanation: multiple equilibria!

Fundamental factors driving the crisis during the 1990s:

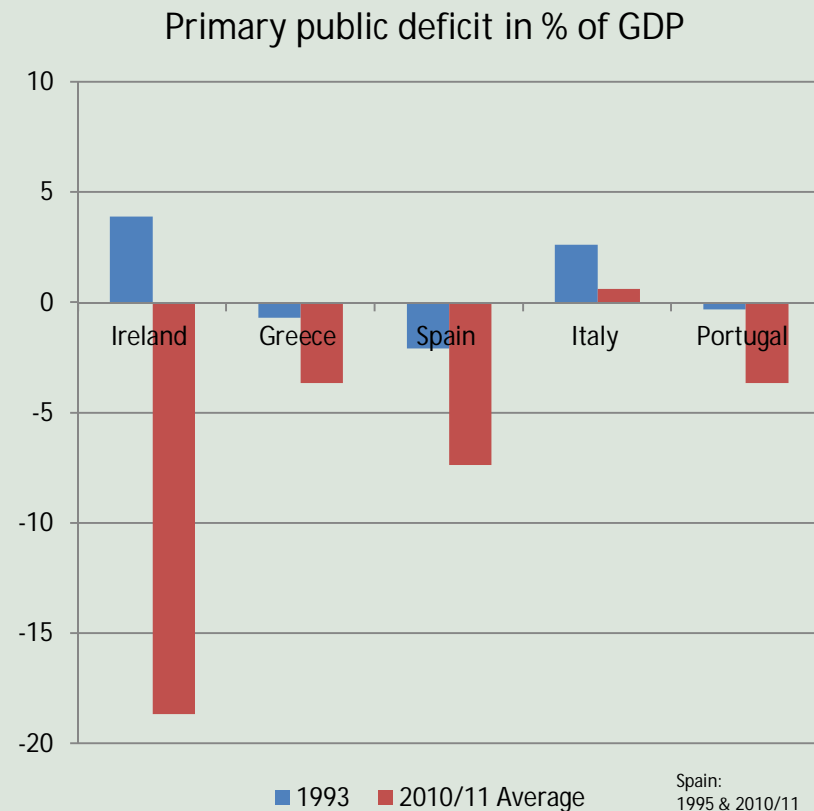
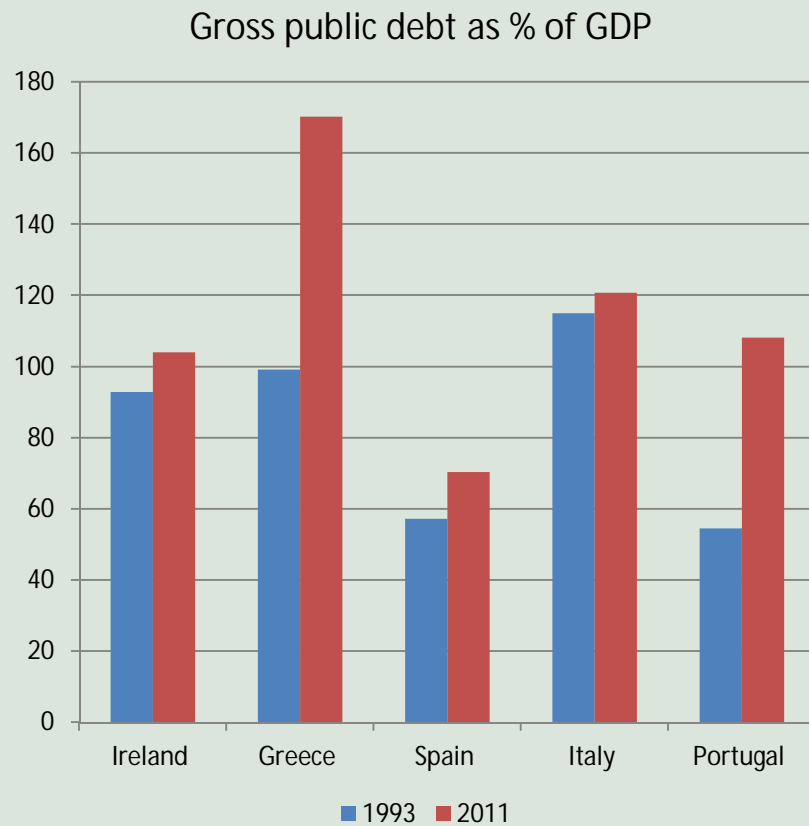
External: much larger disequilibria today.

Fiscal: difference smaller, but even here today looks worse.

# GIIPS today and then: External position and current account balance



# GIIPS, today and then: Gross public debt and primary deficit



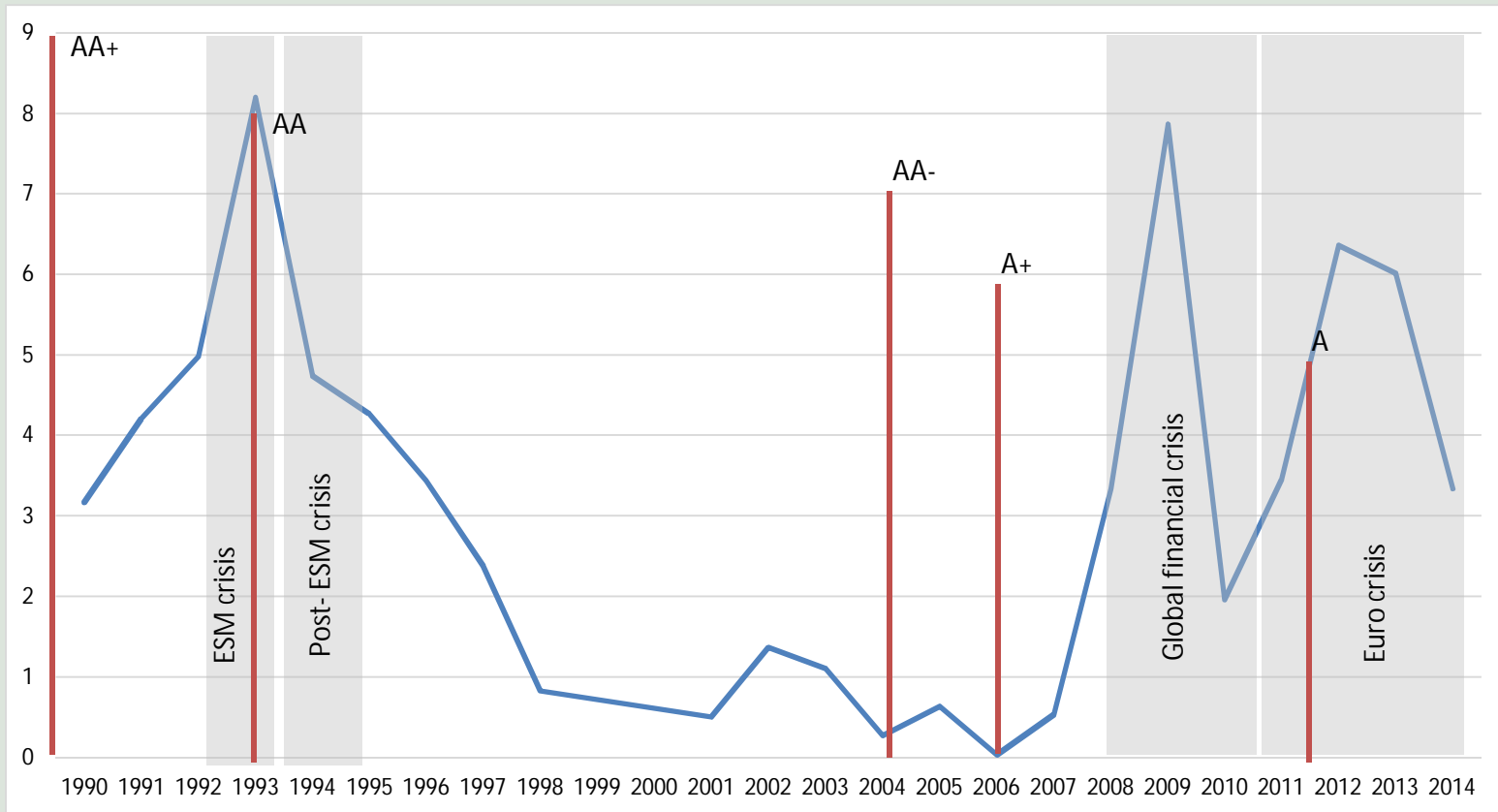
# Nature of crisis

- In 1990s exchange rates highly variable and interest rates high.
- Model: market believes country will inflate and sets high interest rate. If government does not inflate ex post real rate so high that fiscal burden unbearable => market can enforce high interest rate/high inflation equilibrium. (little difference: floating or fixed rate)  
Reality different!

# How to measure market pressure?

- Snow ball effect = interest rate minus growth rate of nominal GDP.
- During 1990s snowball effect driven by high interest rates, today by low GDP growth rates.
- Spikes in both cases at similar values and then declines as market realizes that the 'bad' equilibrium will not materialise.

# Italy: Snow-ball factor (interest rate minus growth of GDP) 1990-2014 and S&P ratings history





Today dual equilibrium view again dominant (behind OMT): if markets set high interest rates countries under stress will default because the interest burden will be too high.

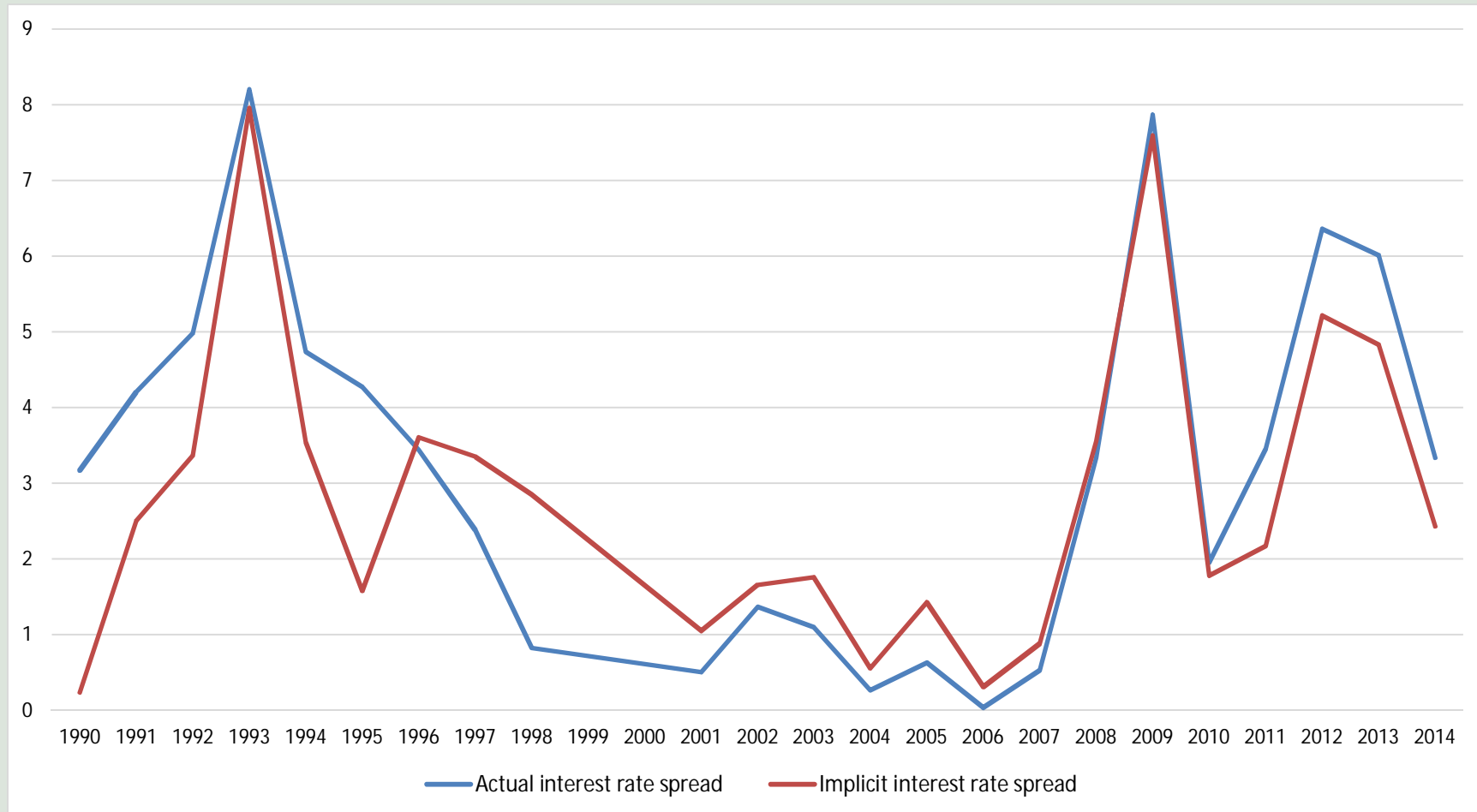
Reality:

Long average maturity attenuates impact of spikes in interest rates on debt burden.

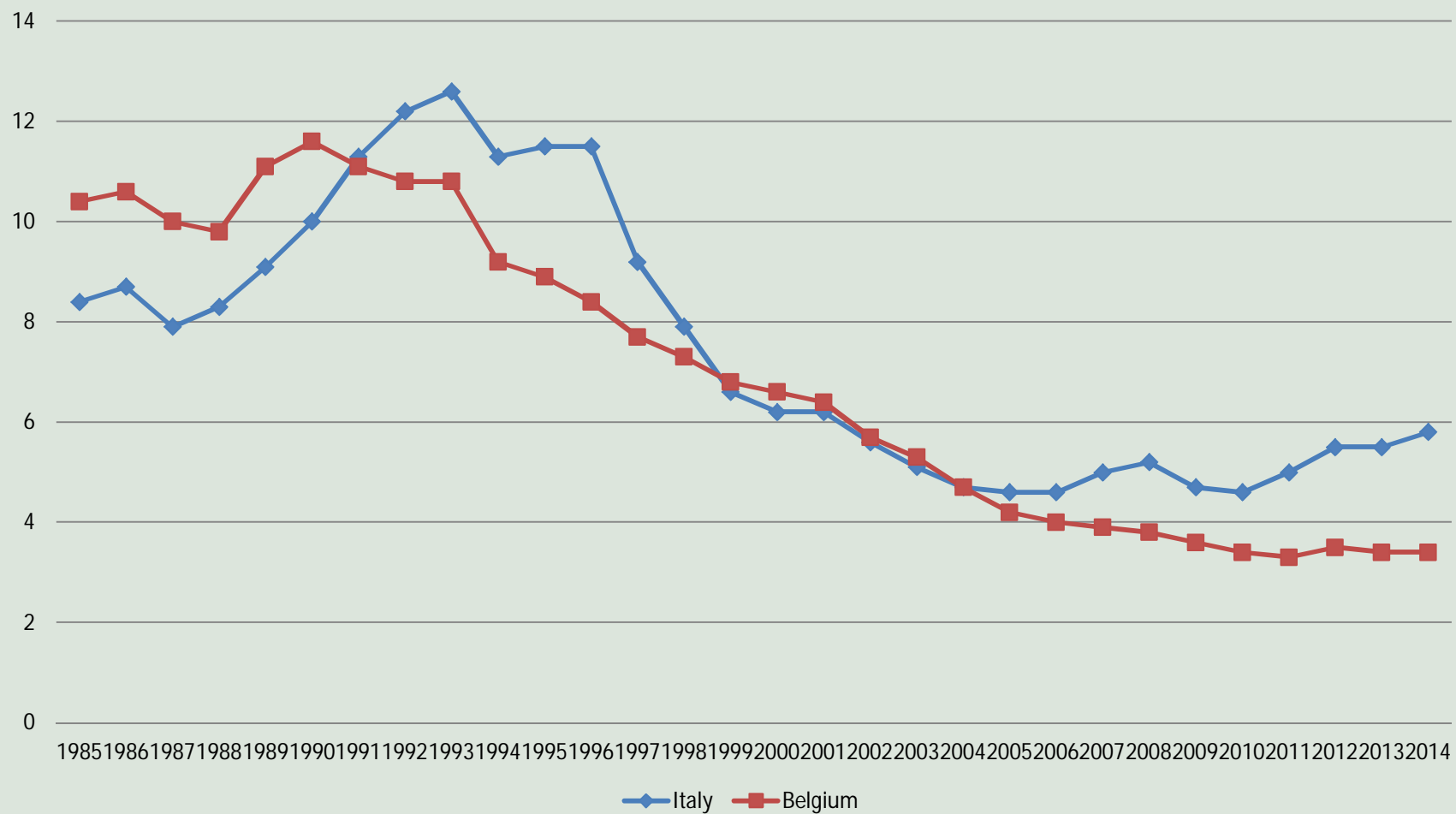
Movements in snow ball effect today driven more by GDP growth the risk premia.

Interest burden high, but not uniquely so.

# Italy: Actual vs. implicit interest rate spread



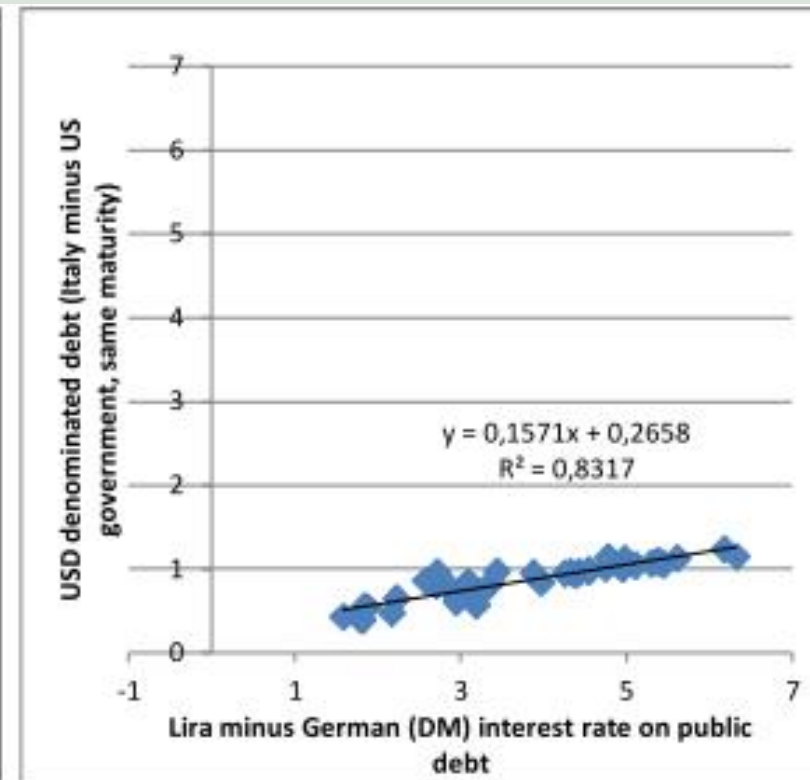
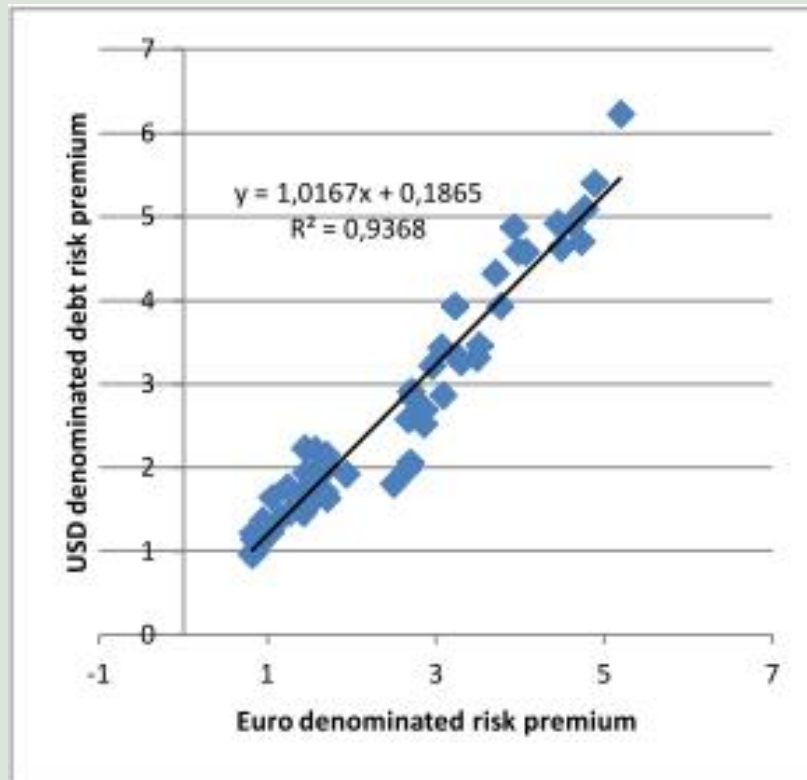
## Interest payments on public debt as % of GDP



# Nature of crisis different

- IN 1990s mainly about inflation, little concern about default
- Measure by 'spread' on foreign currency (USD) debt.
- In 1990 correlated with risk, but small transition (about 1/6).
- Euro crisis different: 1:1 transmission, correlation between USD and euro risk spread.

# 'Foreign currency' and 'domestic currency' risk premia compared



First conclusion:

Neither floating rates, or EMU constitute a panacea.

Highly indebted countries have nowhere to hide.

=> Payoff from fiscal consolidation can be very high, whatever the exchange rate regime.

Second conclusion:

Difference inflation versus default risk. The latter is more pernicious (for reasons poorly understood).

=> Payoff from fiscal consolidation even higher under euro.

# Public debt/GDP ratio: Italy vs Belgium, 1998-2013

