Europe and the Global Crisis

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Prologue: The Global Financial Crisis

- Problems in a small speculative segment of American credit market (subprime)
- Amplified by financial innovation and securitization: Toxic assets and uncertainty
- Near-collapse of financial markets (2007-2008)
- Bold intervention of central banks (monetary policy mark I)
- From financial crisis to global recession via credit crunch (flight to safety/liquidity)
- Monetary policy mark II ineffective (liquidity trap)
- Keynesian sequence. The witness passes to fiscal policy: Stimulus plans (spring 2009)
- Great recession avoided (not severe slump, though)
- Green sprouts of recovery: FI's balance sheets slowly improve, confidence starts to return.
- And then…

The Papandreou government takes office on October 6, 2009

The Crisis: From Global to European

- 2009, bifurcation between EMU and rest of the world
- The EMU specific issue: Sovereign debt
- Two narratives:
  - The Fiscal Profligacy Story (a.k.a. The Berlin View)
  - The Structural Imbalances Story
- The way out of the crisis depends on the choice of narrative

A Few Elements of History of Thought: Neoclassical Theory

- The Two Main Results of the Theory:
  - Existence - General equilibrium (Walras)
    - It does always exist a vector of relative prices that equates demand and supply
  - Fundamental Welfare Theorems (Pareto)
    - A perfectly competitive equilibrium is efficient.
- Conditions for Welfare Theorems to hold:
  1. Perfect competition
  2. Perfect (symmetric) information
  3. Complete markets
  4. (Price flexibility)

A Few Elements of History of Thought: Neoclassical Theory

- Main Policy Conclusions
  - Markets are perfectly capable of determining the “best” equilibrium
  - Provided markets are flexible, the optimal equilibrium is reached through market forces
  - Demand follows supply (Say’s Law)
- Thus, the basic message is that *there is no role for policy*
- Corollary:
  - Money is used for transactions. It is just a ‘veil’, and determines absolute prices (quantity theory). Dichotomy and neutrality

The Berlin View

- The intellectual reference is the market efficiency hypothesis
- No role for fiscal or monetary policy in boosting growth: Importance of fiscal discipline
- Exports rather than domestic demand should be the basis for growth
- Club-Med countries had out-of-control public finances
- As a consequence, blame, and adjustment is only on countries in difficulty. Fiscal Consolidation!
- Structural reforms allow competitiveness to be restored

The Berlin View

- The institutional consequences of the Berlin view
  - EMU fiscal coordination happens from the bottom, through strict fiscal discipline (the « fiscal compact » as a fiscal union)
  - Monetary policy should limit itself to price stability. No role for OMT's, insurance, and so on. The best for growth is a stable inflation environment
- Notice that the Berlin View is nothing else than the Washington (Brussels) consensus, and is already embedded in the Maastricht treaty.
  - Stability and Growth Pact limits fiscal policy to automatic stabilization
  - The ECB mandate, contrary e.g. to the Fed, is limited to the inflation objective

The Structural Imbalances Story

- The EMU is a non-optimal currency area
- Convergence of interest rates (wrong perception of markets) led to capital flows from core to periphery
- Capital used for consumption: private (Spain, Ireland) or public (Greece, Portugal maybe Italy)
- Corresponding high debt, in a foreign currency (the euro)
- Global imbalances, and need for rebalancing through
  - Symmetric adjustment (deflation in periphery and inflation in core)
  - Co-ordinated, not synchronized fiscal policies (global demand support)
- Role of ECB in debt management (LOLR – Monetization-Insurance)

Making Sense of the two Narratives

- There is (still) no way to disentangle one narrative from the other
- There is a sort of « observational equivalence »
- The best we can do for the moment is to look at some stylized facts and check whether they are or not coherent with the two narratives
- We can check:
  - Fiscal Profligacy
  - External imbalances (excess savings/consumption)

Some National Accounting

- Expenditure

$$Y \equiv C + I + G + CA$$

- Budget Constraint

$$Y \equiv W + \Pi + R \equiv C + S_p + T$$

- Subtract one from the other

$$S_p + (T - G) = S_p + S_g = CA + I$$

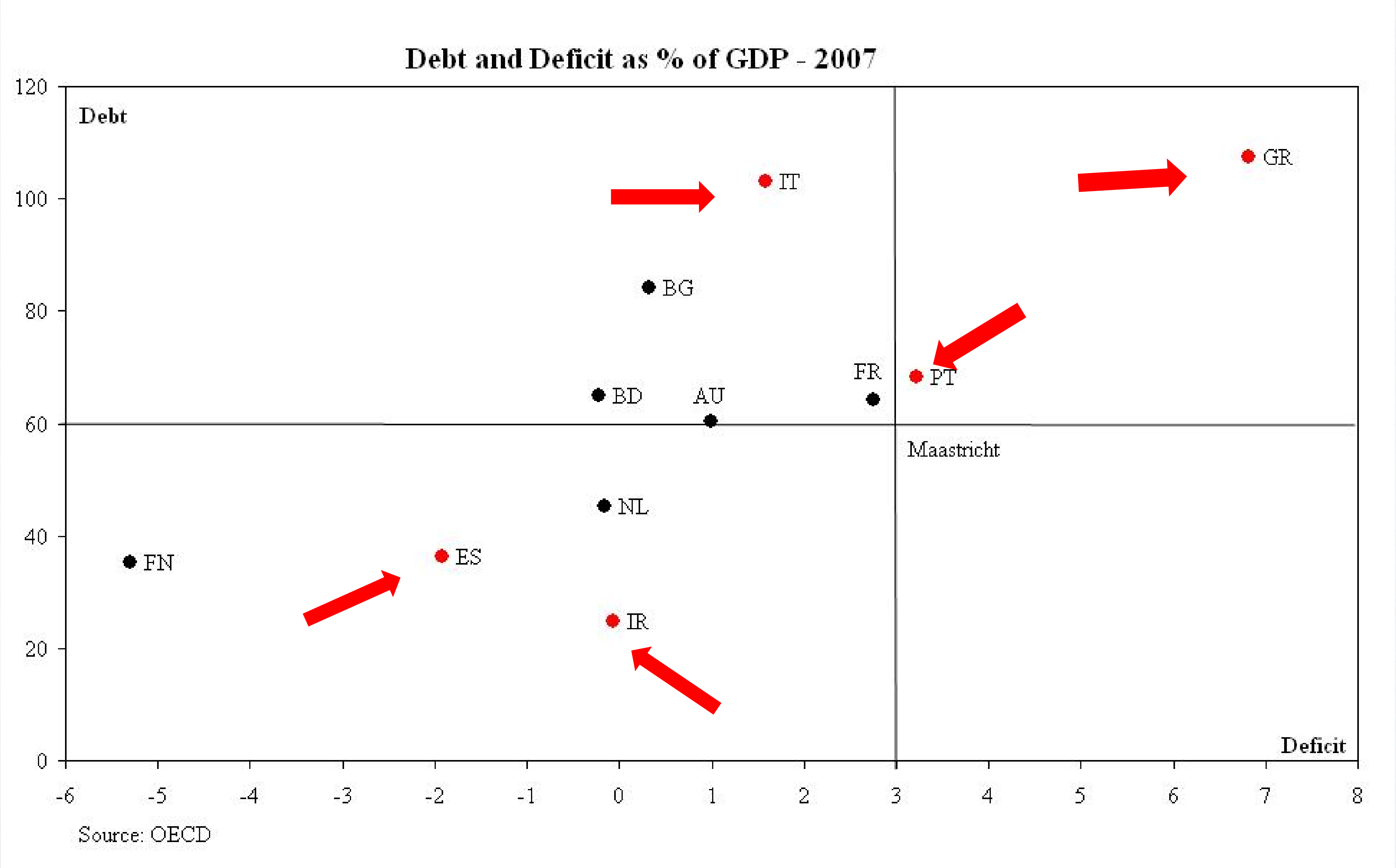
Berlin View:

$$(G - T) \uparrow \Rightarrow \text{CA} \downarrow \text{or } I \downarrow \quad \text{(but what about } S \uparrow \text{?)}$$

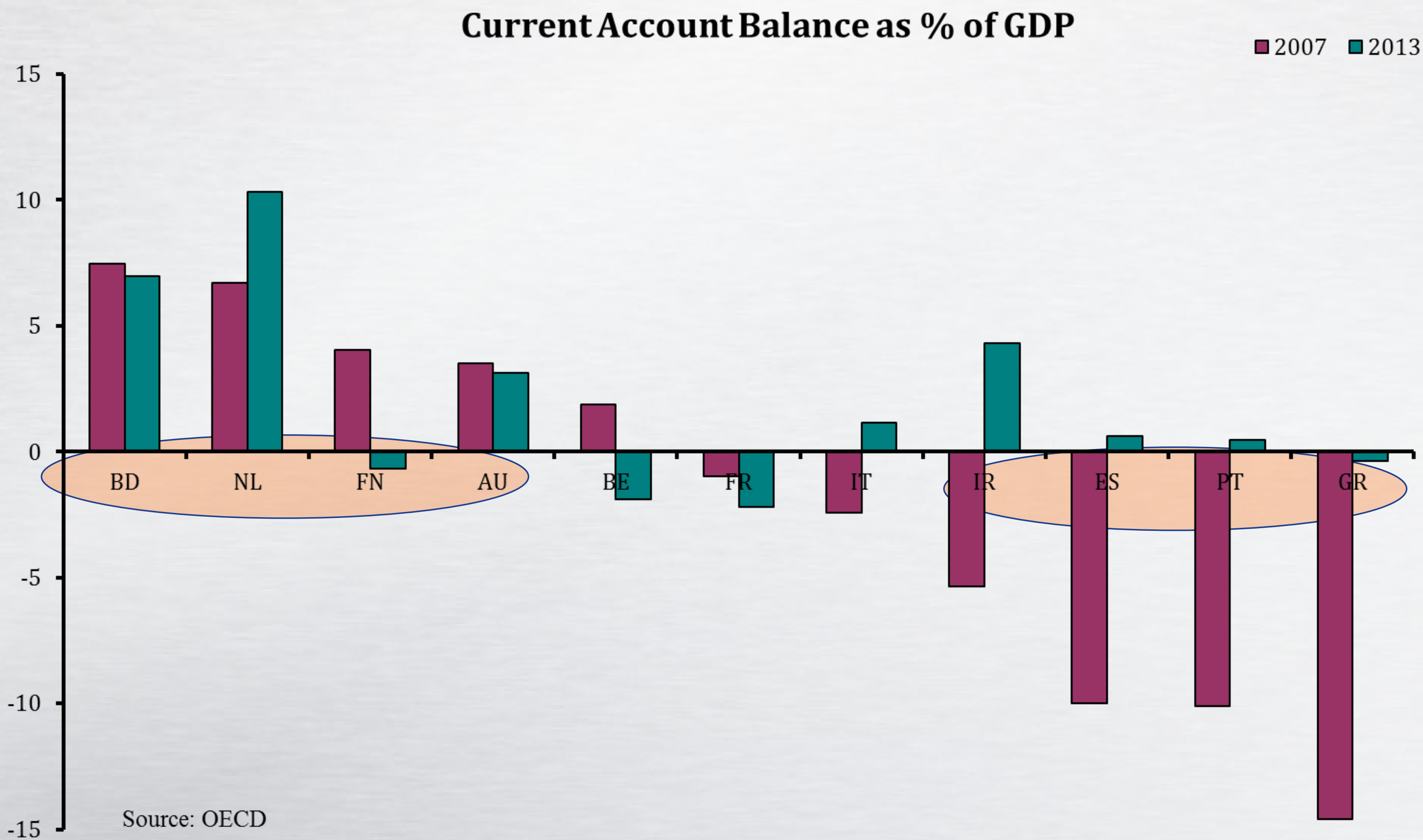
Structural Imbalances:

$$(S - I) \uparrow (\downarrow) \text{ or } (T - G) \uparrow (\downarrow) \Rightarrow CA \uparrow (\downarrow)$$

- No clear public finances pattern for the PIIGS



- But a pattern in external imbalances



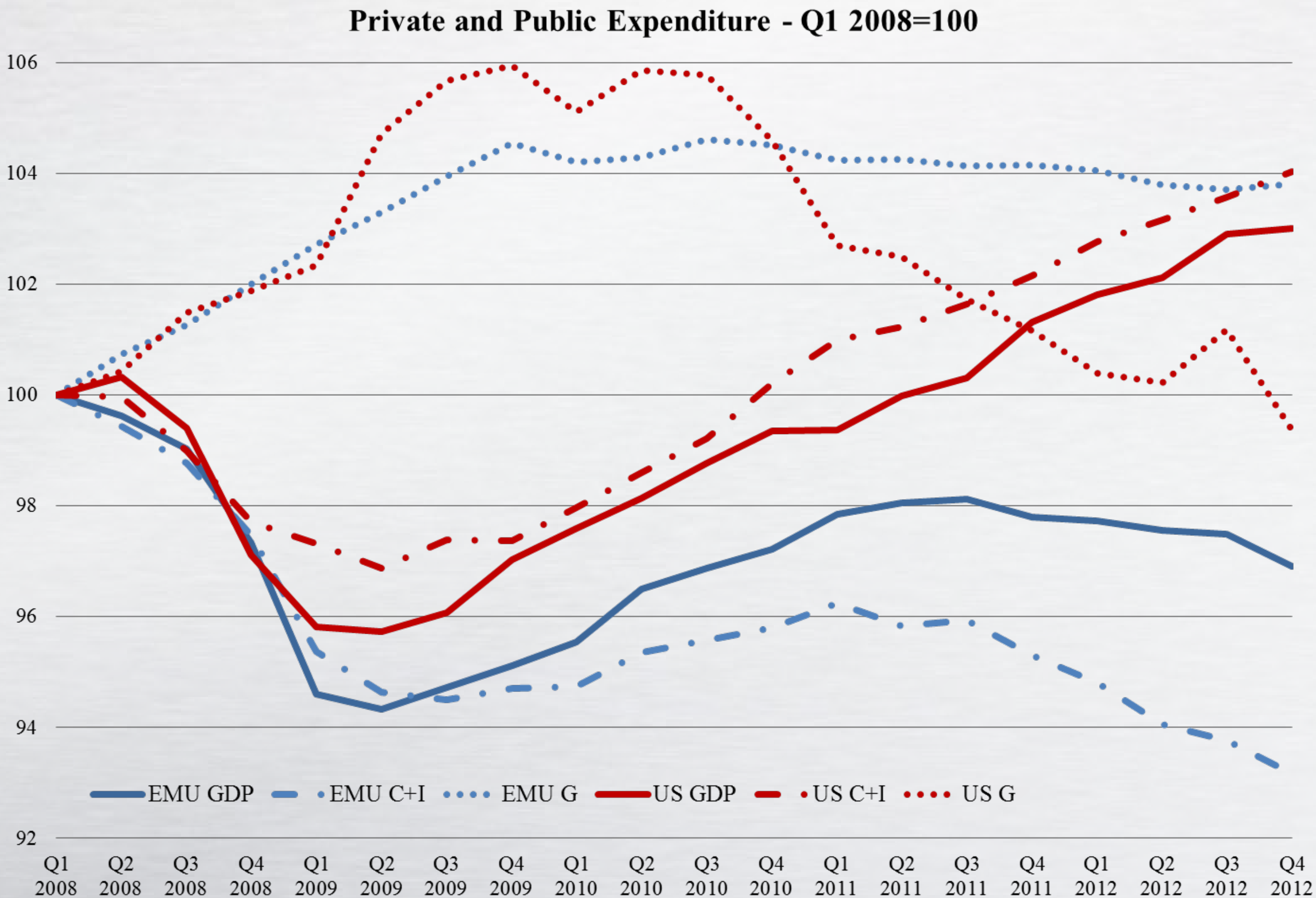
Lessons from the Crisis

- Suggestive evidence does not support the Berlin View
- If anything, it points to structural imbalances
- Yet, the Berlin View won the policy debate
  - Adjustment is only carried on in the peripheral countries
  - Austerity is generalized to core countries
  - The entry into force of the fiscal compact tightens the rules aimed at preventing discretionary fiscal policy

The Fiscal Compact

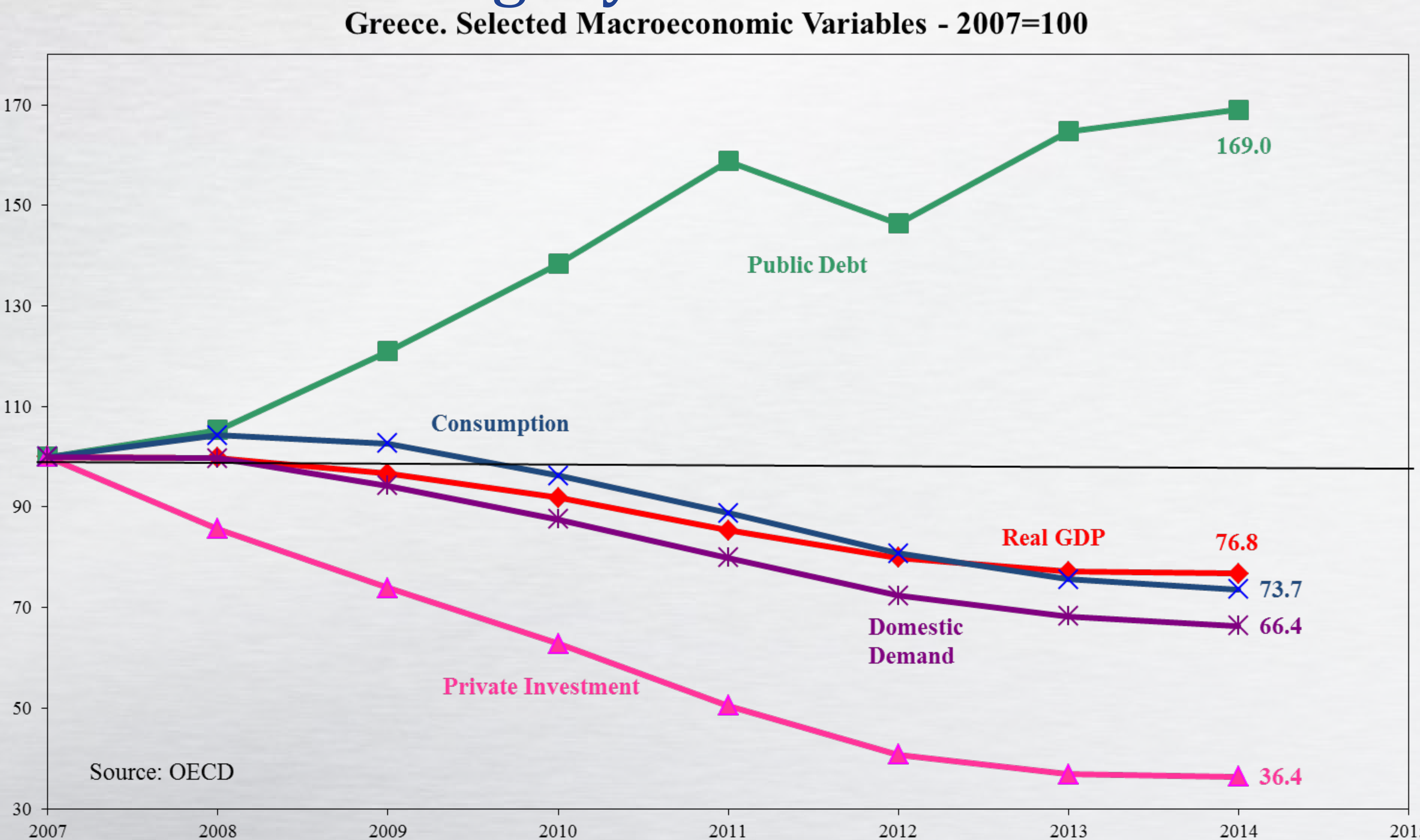
- Evolution/tightening of the Stability and Growth Pact of 1997: Budget balance, peer review, and sanctions
- Intergouvernemental pact (25 signataires) introduced at the constitutional level in Member countries' legislation. Effective january first, 2013
- Provisions :
  - Structural budget balance. Deficit net of cyclical components needs not to be in excess of 0.5% of GDP. Once again, be aware of the consequences on the debt ratio!
  - Sanctions are automatic (remember the clash of 2003)
  - Return to a 60% debt ratio in twenty years
- What differences with the balanced budget rules of US States?

Austerity, or Pro-Cyclical Fiscal Policy



Source: Eurostat
Seasonally adjusted quarterly data

The Greek Tragedy



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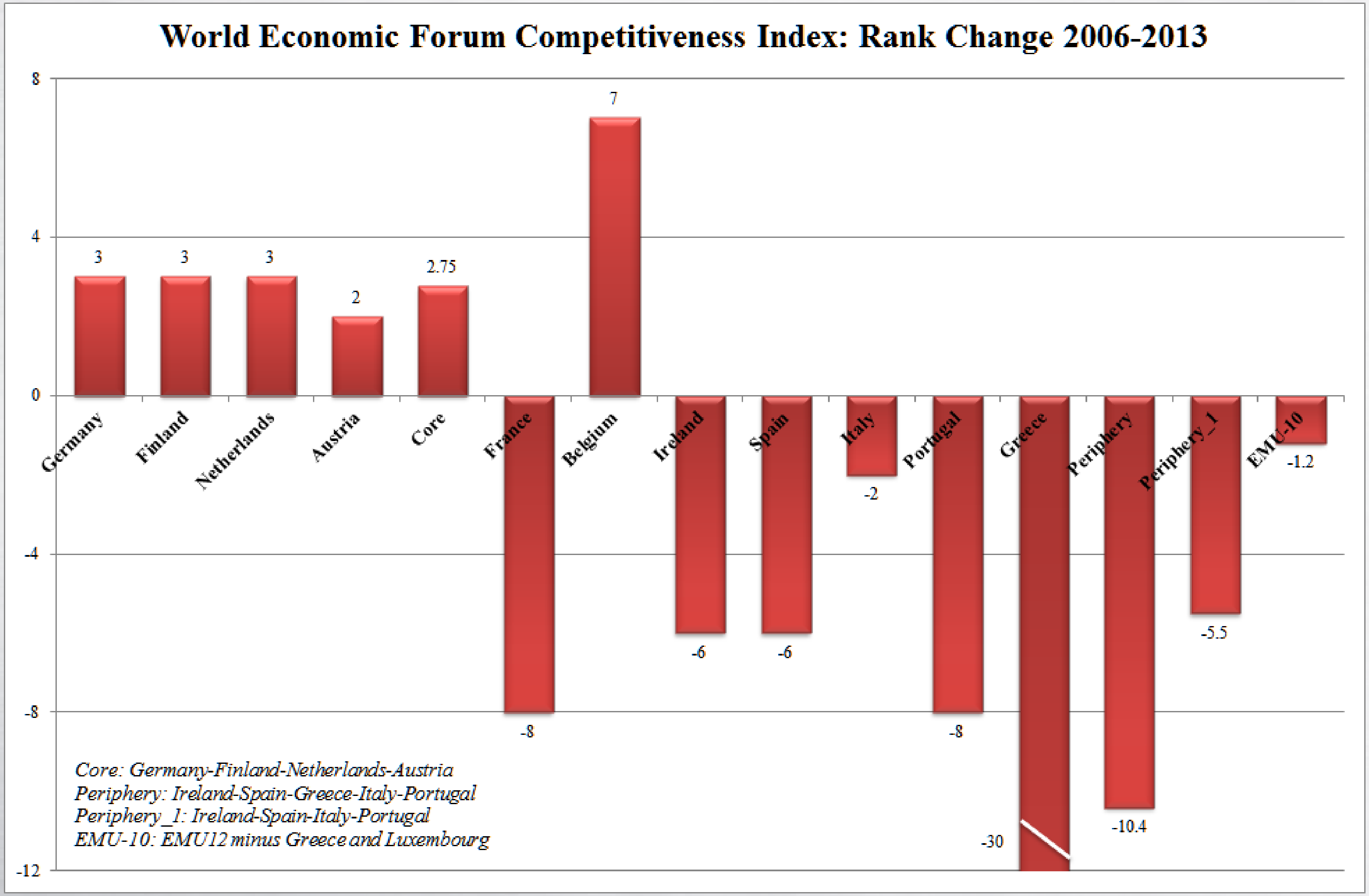
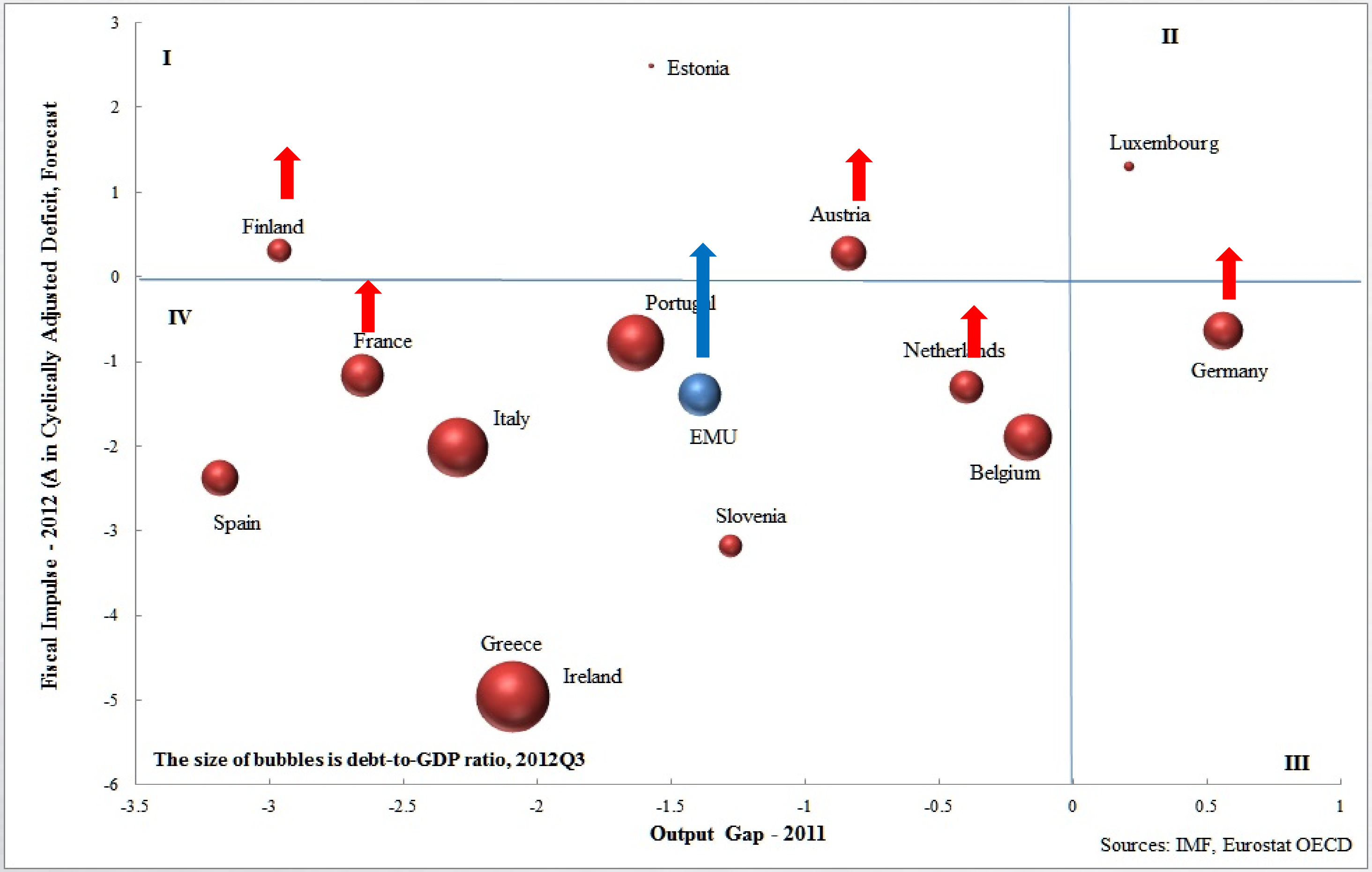
Short Term Pain for Long Term… Pain

- More competitive thanks to Austerity?



What is the Way Out?

- First and Foremost, *reverse the aggregate stance*
- Symmetric adjustment: Fiscal expansion in surplus countries



And What About Structural Reforms?

- It is undeniable that EMU countries (especially in the periphery) have structural problems and rigidities
- The main issue with structural reforms is sequencing (See Dani Rodrik, Project Syndicate, June 12, 2013)
- Also:
  - Competitiveness goes beyond price competitiveness
  - Excessive emphasis on labour market is suspicious (political capture by the 1%?)

Is Europe Stuck?

- Germany and the core will most likely not change course of action
- Austerity is discredited, but alive and kicking
- Any further ECB action will only have an impact at the margin. It is an illusion that last week we had a new « whatever it takes moment »
- Structural reforms are not the solution
- So, we are doomed?
- Maybe not…

What to do, Waiting for ~~Godot?~~ Germany?

- In this Keynesian crisis the obvious solution would be an aggregate fiscal expansion.
- It will not happen
- For peripheral countries fiscal policy is not an option. Alone, they cannot reverse austerity, only slow it down
- The only solution is to restart their private demand (look at data on private consumption!)

How to Restart Private Demand

- Three decades of increasing income and wealth inequality led to chronic aggregate demand deficiency, and speculative bubbles. In some countries credit boosted expenditure, but the crisis proved it to be non viable
- Peripheral countries should implement *now* a revenue-neutral fiscal reshuffling:
  - Increase tax on the rich and very rich (beware of evasion and tax base!)
  - Reduce taxes on poor households and tax wedge on firms
- Ideally, this should be coordinated at the European level

For the Long Run: What Structural Reforms?

- The Berlin View advocates standard supply-side structural reforms
- The crisis proved that structural imbalances impact demand
- Binary solution: either fully fledged federal budget (to compensate for constraints at the country level), or breakup of the euro. We are in the middle of the ford
- Need to think of how to preserve the European social model in today's world. Relying less on export-led growth may be part of the solution

A Few More Remarks

- The Berlin view calls for adjustment in peripheral countries but:
  - How to generalize the German model (export to Mars?)
  - Small country syndrome (export-led growth):
    - Lack of economic independence (Look at these days with EM!!)
    - Should we give up the ambition to be a major geopolitical power?
- The global imbalances view calls for a transfer mechanism in the long run, and for coordinated fiscal expansion in the short
  - Scarce feasibility both for the long and the short run