Europe and the Global Crisis

Francesco Saraceno
OFCE-Research Center in Economics of Sciences Po
Luiss School of European Political Economy
Jakarta School of Government and Public Policy

Brussels – June 11, 2015
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
- 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
Optimal Currency Areas (OCAs)

• The theory dates back to Mundell (1961)
• When is it optimal to abandon sovereign currency and join a monetary union?
• Optimality depends on:
  ▪ Symmetry of macroeconomic shocks within the union
  ▪ Flexibility in the labour markets – ability to adjust to shocks
  ▪ Integration in terms of trade to generate benefits of using single currency
  ▪ Existence of transfer mechanisms
Is the EMU an Optimal Currency Area?

- Trade Integration: OK
- Symmetry: Mixed
- Flexibility: No
- Fiscal transfers: No

Final Verdict:

Not an Optimal Currency Area!
Can the EMU Become an OCA?

- « Endogeneity » of Optimal Currency Areas (Frenkel and Rose, 1998):
- Forming a currency union can be ex post convenient, because the increase in trade increases symmetry and flexibility.
- Empirical literature on endogeneity is inconclusive: Is it currency unions or custom unions that increase trade and symmetry?
- The case of the UK is an example.
- The crisis proves that divergence, not convergence, happened
The Structural Imbalances Narrative

• 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)
• No clear public finances pattern for the PIIGS
But a pattern can be spotted in external imbalances

Current Account Balance as % of GDP

Source: OECD Economic Outlook

http://fsaraceno.wordpress.com - @fsaraceno
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

Private and Public Expenditure - Q1 2008=100

Source: Eurostat
Seasonally adjusted quarterly data
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%?)
The Greek Tragedy

Greece. Selected Macroeconomic Variables - 2007=100

Source: OECD
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
- More gradual austerity in the periphery (after all this is what Greece is asking for)
Public Investment is Key

• Since the summer there is awareness that investment is the problem
• Debate on Germany’s poor investment performance and crumbling infrastructures (DIW Report)
• Yet, very little actual content (Juncker plan is too small)
• October 2014 IMF World Economic Outlook: Public investment today is a free lunch
• Three issues:
  ▪ A serious investment plan in Germany
  ▪ Breaking the pact? (French strategy)
  ▪ Change the rules: A new golden rule (See Dervis Saraceno, Brookings blog September 3rd 2014)
A Governance Failure

SuperMario to the Rescue!!!
Whatever it Takes: SuperMario to the Rescue

• The turning point of the crisis is the September 6, 2012 announcement of Mario Draghi.

• “Outright Monetary Transactions” (OMT) program. The ECB engages to buy unlimited amounts of government bonds (on secondary markets) if
  - Eurozone stability is in danger
  - The country in trouble engages in the conditionality of the Fiscal Compact

• In spite of the conflict with the Bundesbank, and the excessive conditionality, the change is for real
  - Markets calm down almost overnight
  - Insurance did work well. No country asked for the OMT so far

• Fundamental change. The eurozone has an embryo of Lender of Last Resort, like all the other major economies
Luckily we Have SuperMario... Or not?

• Mario Draghi is a reluctant main character of the EMU play

• Jackson Hole Speech: Draghinomics’ three arrows
  ▪ Continued monetary accommodation
  ▪ Structural Reforms
  ▪ Expansionary Fiscal Policy

• The emphasis on Fiscal Policy is a revolution for a proponent of the Berlin View.

• Or maybe not
  ▪ Fiscal policy can be expansionary only within the limits of current norms
  ▪ This means for 2015 0.4% of GDP. A fifth of the Juncker Plan.
  ▪ Peripheral countries have no margin

• Draghinomics is not really a revolution. Compare Japan with the EMU!
What Future for the EMU and for Europe?

- 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