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

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

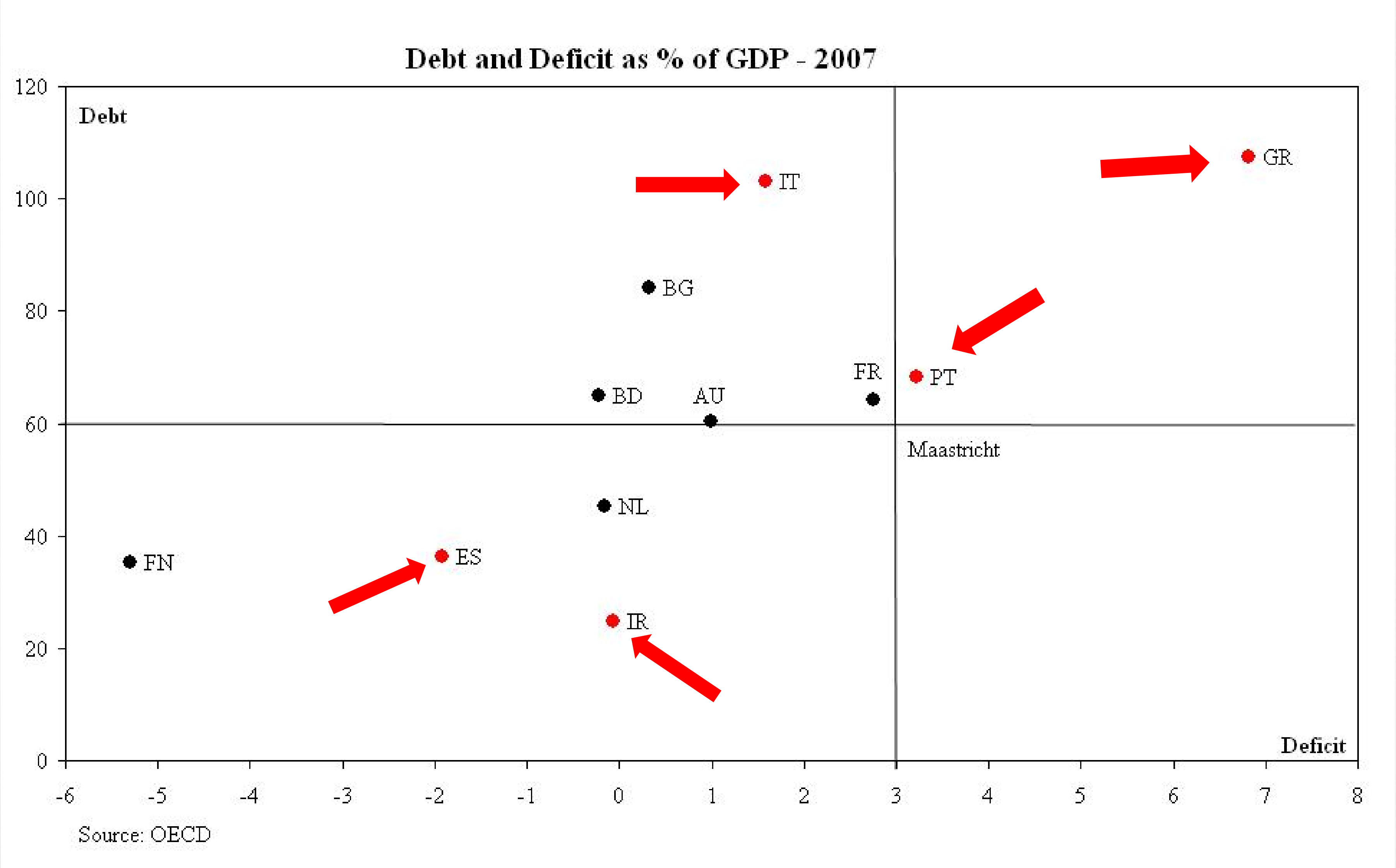
The Structural Imbalances Narrative

- 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)

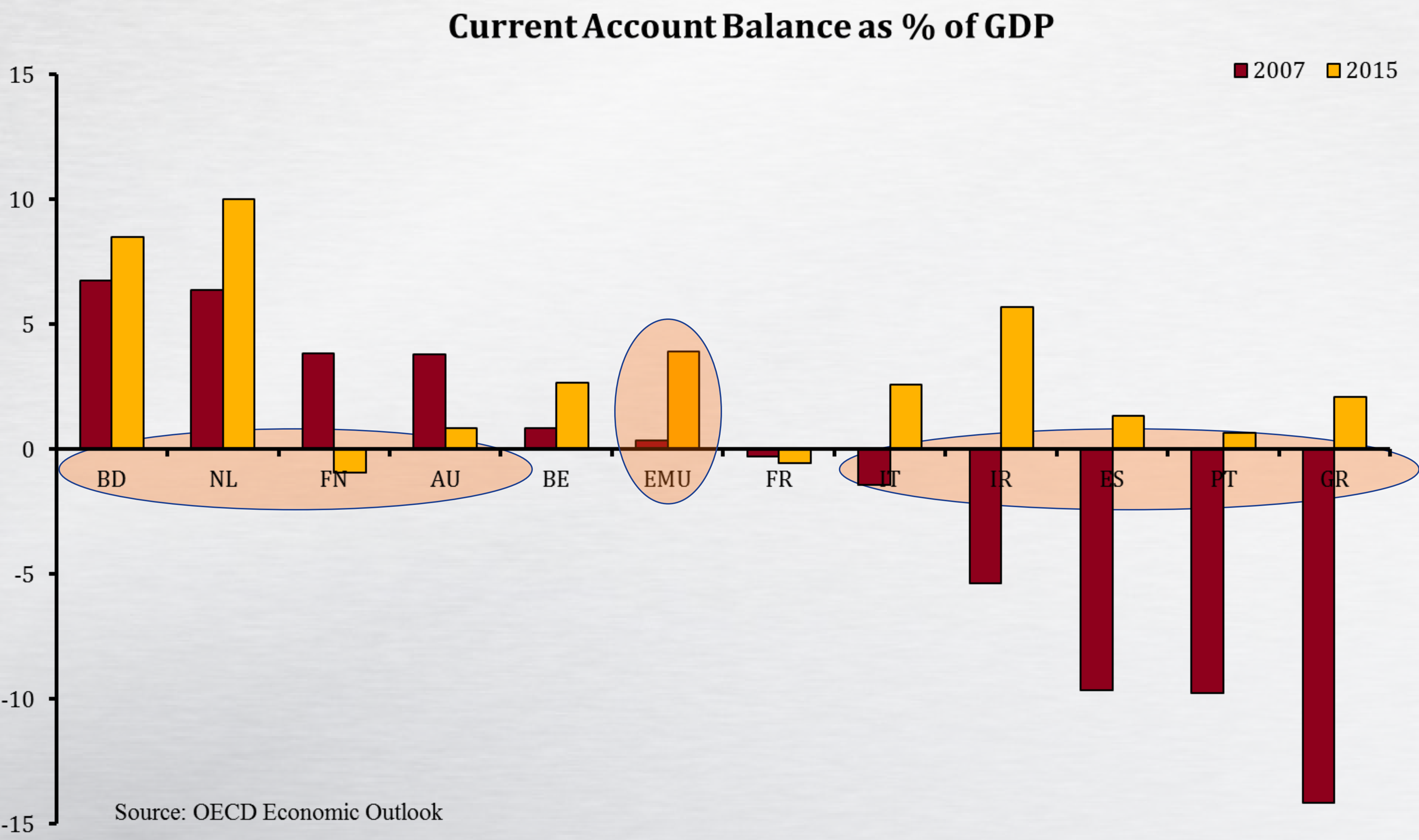
Making Sense of the two Narratives

- 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



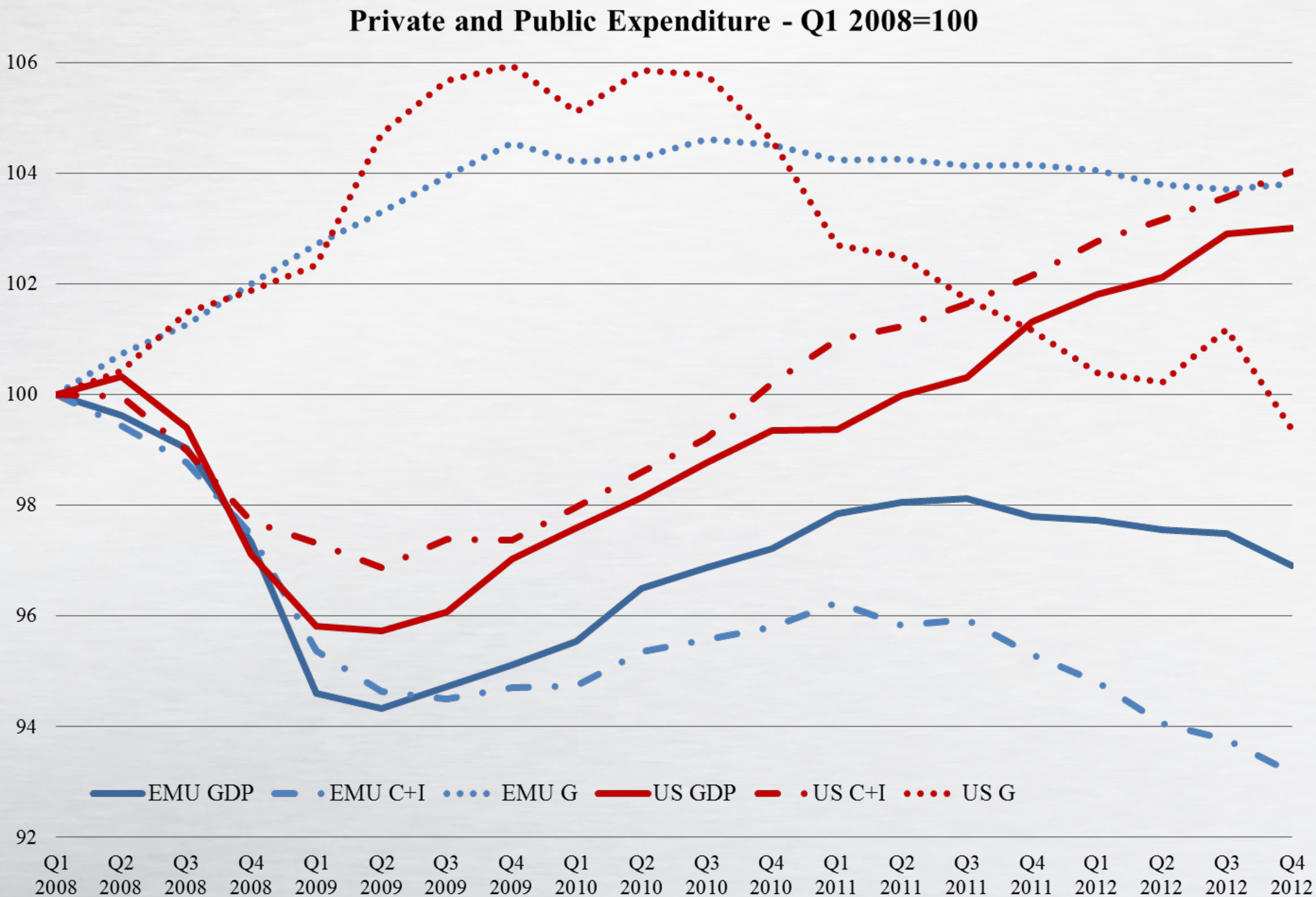
Lessons from the Crisis

- 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

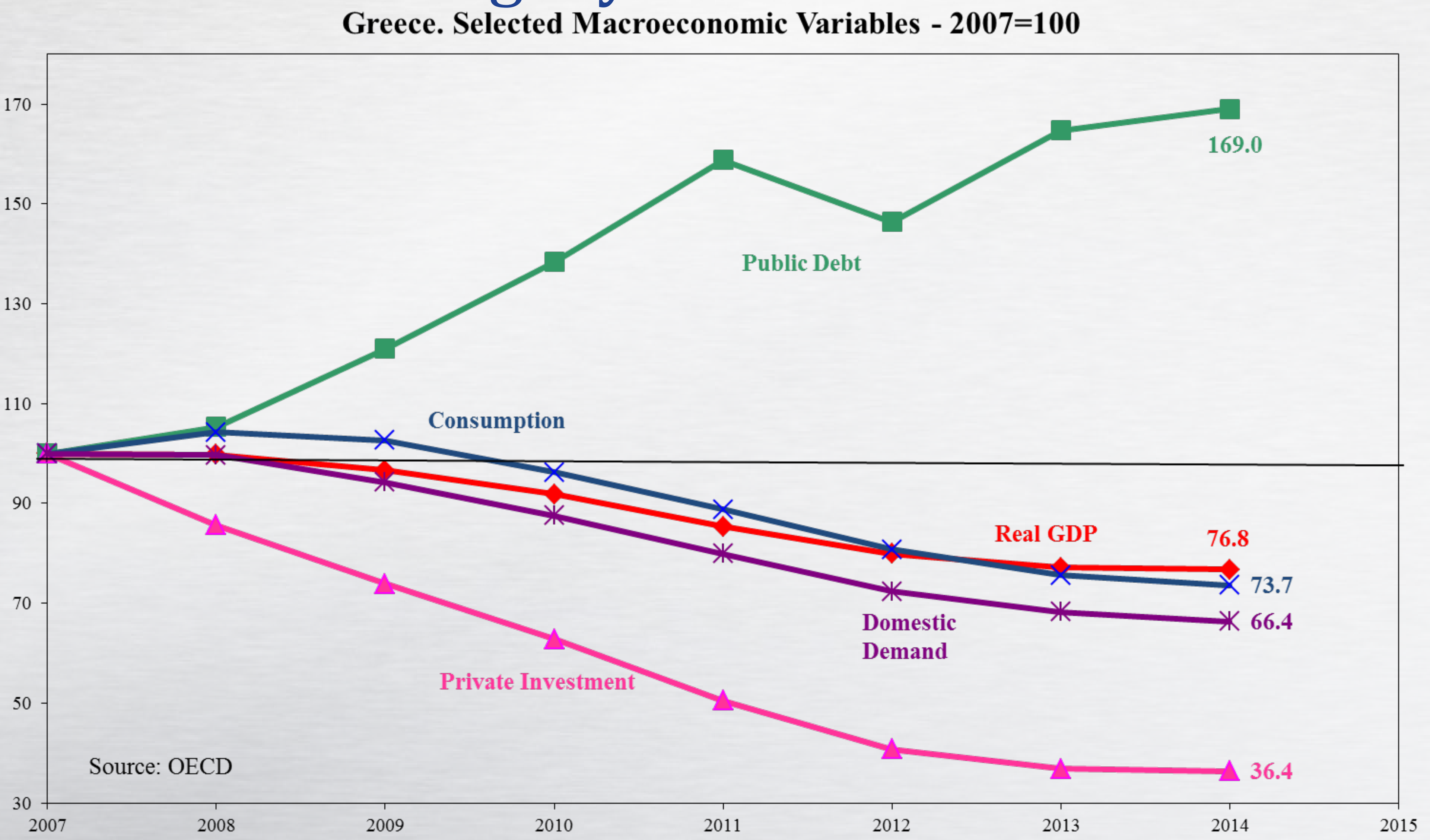


Source: Eurostat
Seasonally adjusted quarterly data

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%?)

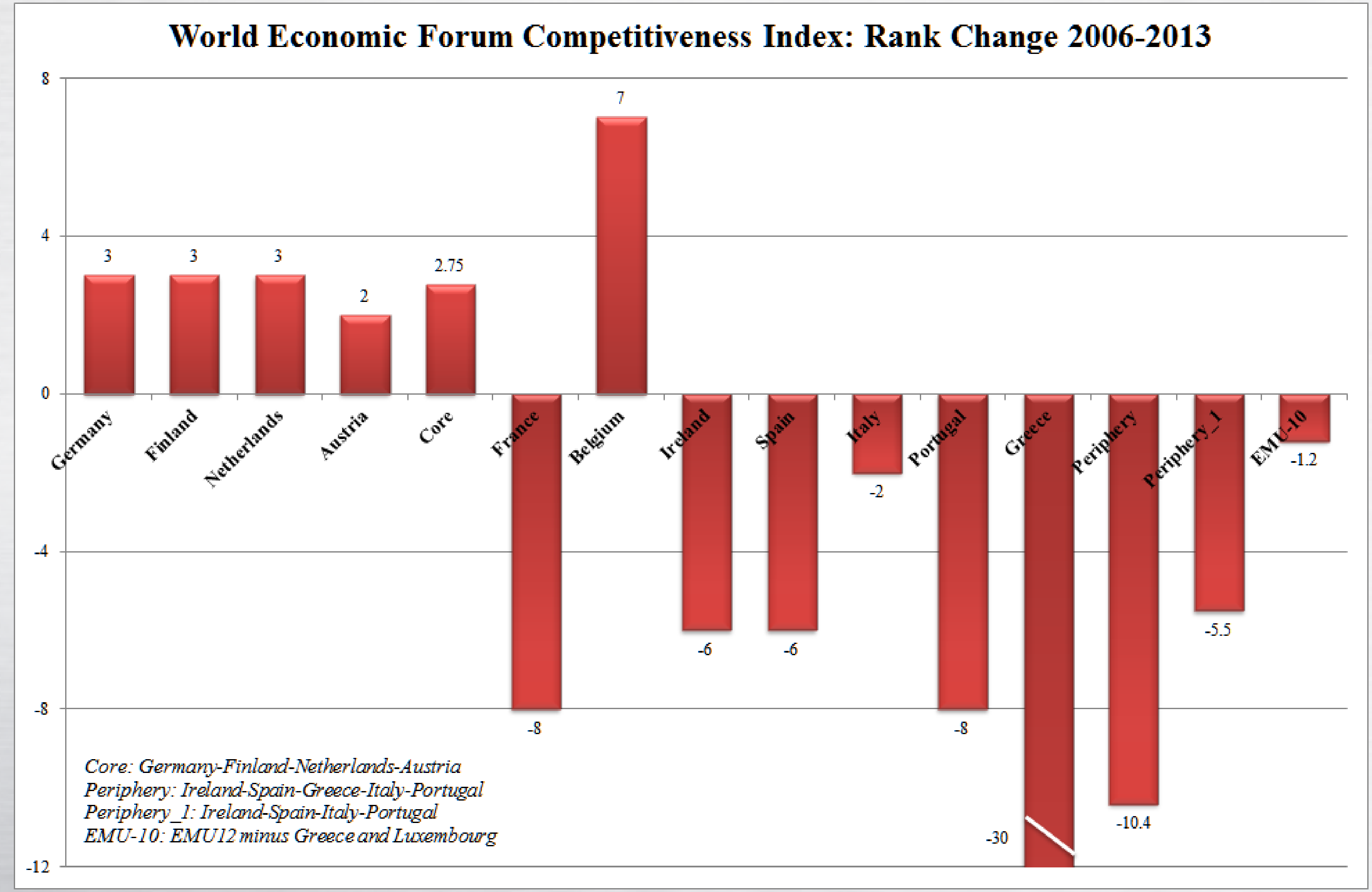
The Greek Tragedy



http://fsaraceno.wordpress.com

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