The euro crisis and beyond

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Where are we now?

1. Euro saved ‘crisis over’
2. But …. Underlying problems (especially debt overhang in periphery) not solved.
3. Adjustment via exports, progressively easier as global economy ‘normalizes’, but dependent on state of global financial markets.
4. What role for the new rules for economic governance?

Where are we now?

Euro crisis was mainly balance of payments (only countries with current account deficit in trouble).

Greece exception, not general problems.

Inverse of Anna Karenina principle:

During acute phase all victims look similar.

Now differentiation prevails.

Discriminating factor is export growth (not fiscal deficit).

Where are we now?
I. Where there is hope

Ireland had classic real estate boom and bust. Adjustment almost done (domestic prices/wages down, export up, banking system on the mend).

Spain: similar, but adjustment in real estate less brutal, hence longer. Exports stabilize labour market.

Portugal had structural problems (low growth even before crisis), but export growth indicates economy is adjusting.

In these three cases fiscal problems incidental.

Where are we now?
II. Where there is little hope

Italy, not no boom, but still a bust. Structural problems obvious (low growth even before crisis). Little sign that things have improved as export have stalled.

Greece: key problem is that exports are stagnating,

Indicating that the economy is not adjusting.

Both IT and GR have serious governance problems (indicators of corruption, etc).

Not surprising that fiscal problems so difficult?

The cost of a financial crisis
Is the euro crisis special?

Cost of crisis for government: high interest rate premium makes debt service more costly => potential for self-full filling attacks?

Today (euro crisis) 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.

In past (1990s): high interest rates driven by expectations of devaluation/inflation.

Which is worse? Spain versus Sweden 1990s?

Italy versus Belgium als during 1990s?

The cost of a financial crisis
Is the euro crisis special?

Loss of output similar 1990s as today, risk premia also similar in 1990s:

=> euro crisis not special + euro not responsible for Europe’s problems!

Where are we now?
Can surplus Europe take up the slack?

Periphery (formerly deficit area) euro account for 30 % of euro area GDP, core is more important.

Core, especially current account surplus countries also not very dynamic.

Germany only part of it. Other Northern European surplus (CH, NL, DK, SW and N) have together as large a surplus as DE.

They should be locomotive, but …….

Example of new rule: Excessive Imbalances Procecure:

The German surplus in context

German surplus = deficit elsewhere in euro area?

No longer (past: correlation of current accounts between Germany and periphery was -1, now close to +0.9).

National policy makers have national mandates. => Cannot ask them go act against (perceived) national interests.

Germany not alone

- All countries North of the Alps have a surplus.
- The others (CH, NL, DK, SW, NO) have a larger surplus (220 bn euro) than Germany (190 bn).
- Sum of current account surpluses since 1995: 1 500 bn euro for Germany, 2 500 for Germanic Europe (larger than accumulated reserves of China!)

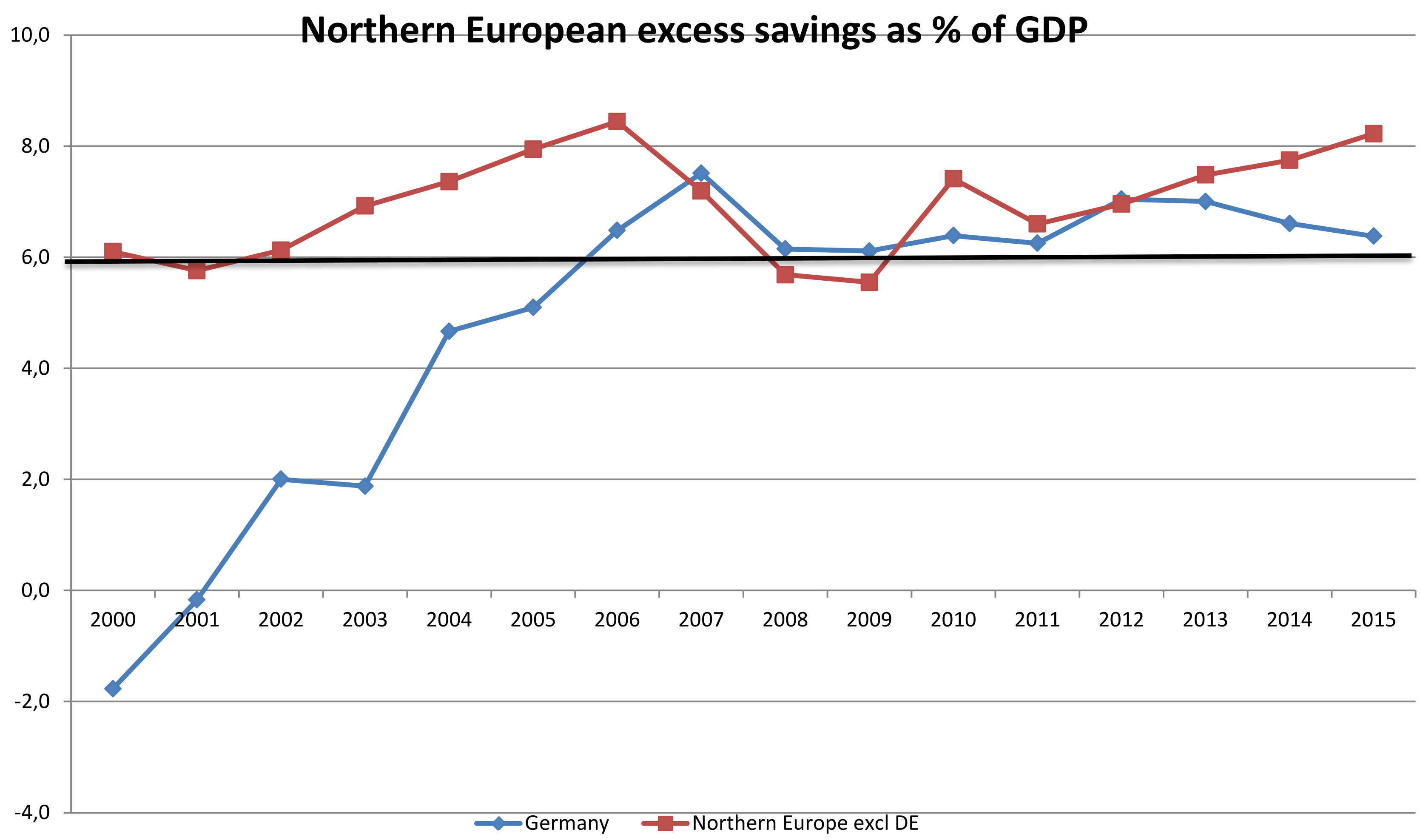
Germany not alone

Diverse situations of other surplus countries:

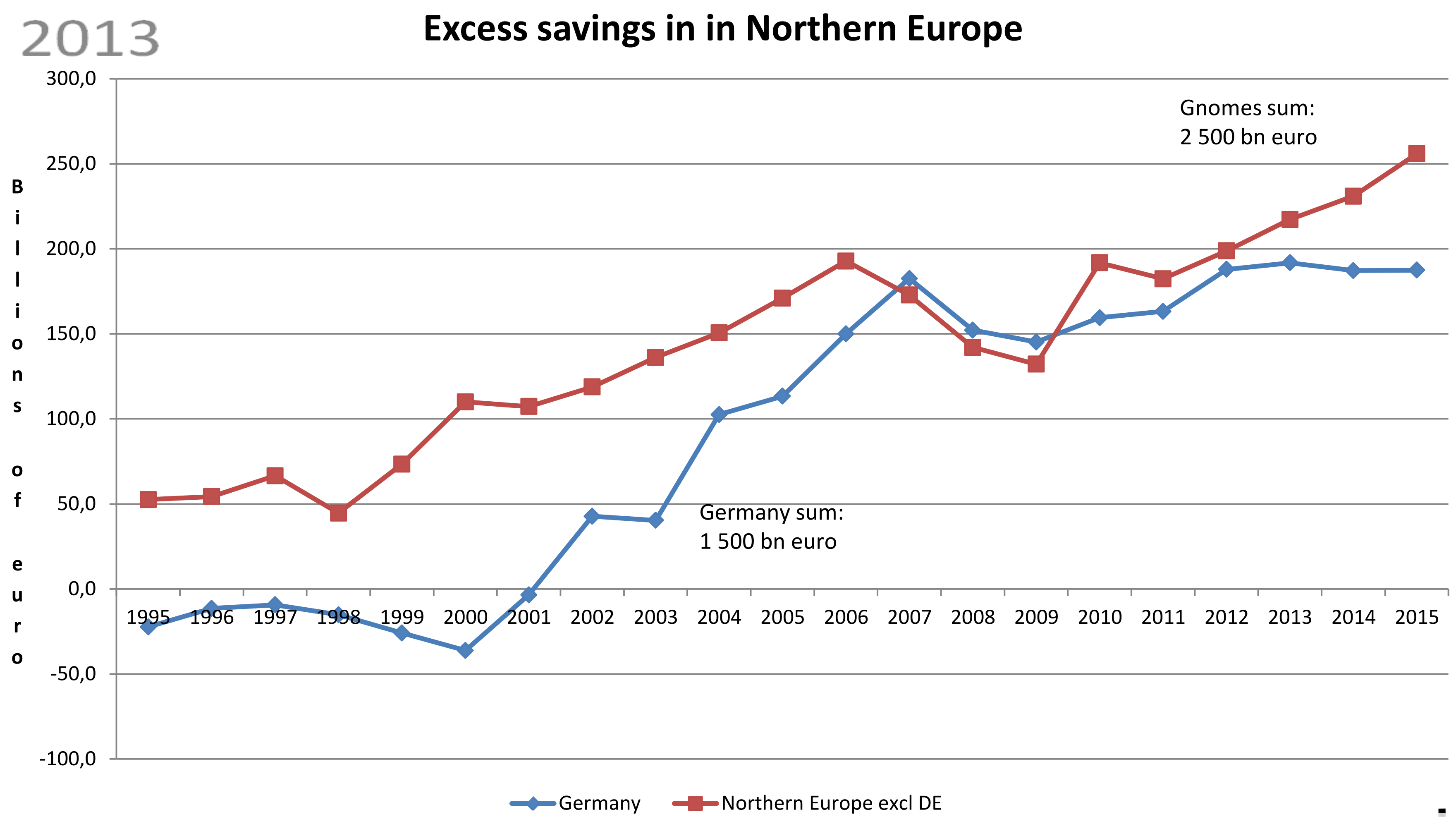
- CH now unilaterally one side peg,
- DK old tight peg,
- SW floating,
- NO floating (but with SWF).

All of them wage dumping, all insufficient fiscal deficits?

Surpluses in Northern Europe: DE versus the rest



DE versus the rest II



Who gains if Germany imports more?

- Imports from other European surplus countries ca. 4 times larger than imports from EA periphery.
- Higher German imports benefit mainly other surplus countries in Europe plus Eastern Europe and China.
- Germany small part of global economy. EA can grow out of problems by exporting more to the rest of the world.

How about Austria?

- Comfortable postion:
- Moderate current account surplus (not much different from euro area average today).
- Neither part of excessive savers, nor vulnerable.

Crisis over, but problems remain

- Two key issues:
- Asymmetric adjustment
- Legacy assets/Banking Union

Little chance that acute crisis returns as long as periphery runs current account surpluses.

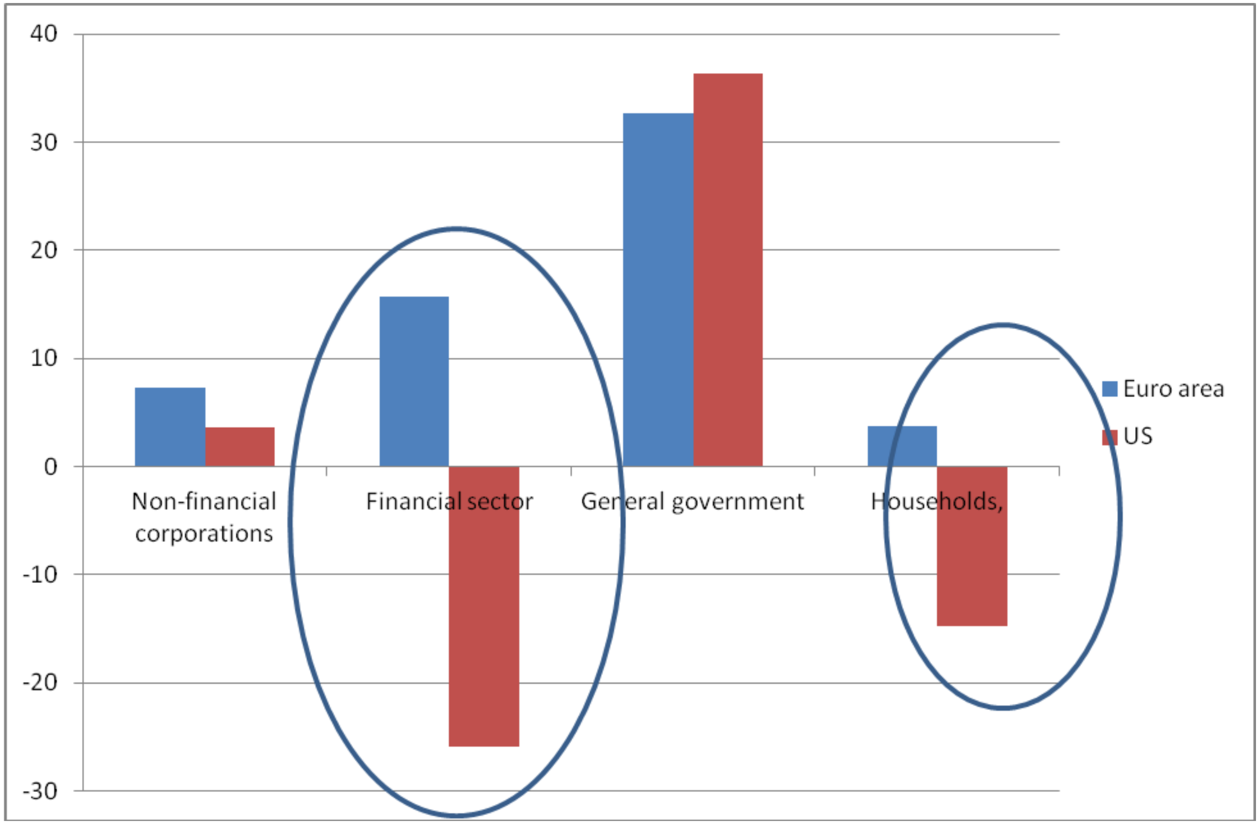
The ‘real’ problem

- Intra area adjustment mechanism does not work (is asymmetric): debtor countries must retrench, but creditors do not expand demand .
- Philips curves too flat and interest channels too weak – at least in short run (no housing boom yet in Germany).
- (Notice that pre 2007 the interest rate channel seemed to work. Country specific problem (DE plus NL) or structural problem?

Legacy problems: Debt and leverage

- Debt = claims fixed in nominal amount have an important function in the financial system.
- But what happens if too much of these claims are accumulated, outstripping the capacity for debt service (=debt overhang)?
- System becomes brittle and stifles growth.
- Aggregate debt service capacity = GDP.
- Excessive debt/GDP ratio negative for growth.

Comparison of changes in leverage



Europe's most likely future: Stability in Stagnation

- Stability (of euro) seems assured as periphery turns into current account surplus.
- But stability breeds complacency:
- External surpluses allow governments to protect national champions and thus prevent financial system from shrinking.
- Continuing debt overhang limits growth below a potential that is anyway declining due to population decline.

Stable stagnation difficult to overcome

- Stability is considered success.
- Decline in living standards gradual, becomes ‘new normal’.
- => EA becomes ‘small open economy’, external safety valve increasingly important, but euro survives.

ECB to the rescue?

(More) unconventional measures? QE?

Aim of QE: drive down <u>long term</u> rates (short term rates already close to zero).

Impact of lower long term rates:

Creditors lose income (Germany) => spend less?

Debtors gain => do not spend more to deleverage?

Unintended effects of QE?

QE leads to higher asset prices, especially housing.

In Germany majority rents => higher house prices and rents lower disposable income!

Higher house values locked up in financial institutions.

Not possible to extract home equity for owner occupied housing.

QE: the euro area is different

In US (perhaps only in US) QE could work:

US large net debtor in own currency (7 trillion of debt).

QE means higher income for US of about 0.5 of GDP.

Euro area approximately balanced externally with large stock imbalances inside.

Easy to extract equity in home, not in Europe.

QE useful in Europe?

- Possibly negative impact on consumption,
- very uncertain impact on investment,
- but maybe on exports via exchange rate.
- QE is certain to make the fundamental problem of relatively weak German demand (and excessive current account surpluses) even more acute.

New economic governance rules

- Lots of detailed rules. Essence:
- Ex ante coordination (European Semester)
- Ex post: fiscal and financial stability:
- New Stability Pact and Fiscal Compact
- Excessive Imbalances procedure.

Application of new rules I European Semester and CSR

- Country specific recommendation?
- Ignored by Creditor countries (Germany services).
- Redundant in many cases debtor countries (Italy: reform public administration for 15 years).
- In really important cases ignored (Italy: Renzi now).

Application of new rules II
Excessive Imbalances Procedure

- Aim: prevent another Spain/Ireland.
- Symmetric: creditor/deficit countries?
- Special case now: Germany?
- (Intellectual difficulty: Holland has larger surplus.)

Until now:
Dialogue des sourds

US Treasury, European Commission:

"Germany, please import more!"

German press and German government:

"Why should we export less?"

From now on:
Dialogue des malins

European Commission (excessive imbalances procedure):

"Germany, your surplus is a problem!"

German government:

"We agree we should import more!"

But how?

European policy dialogue:

- Germany:
- “we wholeheartedly agree that our surplus is a problem for the euro zone. Please tell what we should do to increase domestic demand.”
- Commission: “Hm? Increase infrastructure spending by 1 % of GDP.”
- Germany: “Deficit spending?”
- Commission: “of course not!”
- Germany: “…then there will be no impact on domestic demand.”

European policy dialogue II

Germany: (trying to be helpful):

should we increase minimum wages?

Commission: this might help, but we did not dare to say so.

Germany: (again trying to be helpful): should we reverse pension reforms (Rente mit 63)?

Commission: again might help (puts more money in pockets of elderly, but we did not dare to say so.

=> No action taken, no fines.

Application of new rules III: Renewed Stability Pact

- In principle tighter! now, emphasis on debt.
- Italy will be test case.
- But Brussels (and Berlin) have little power as long as markets calm.
- Italy: “we need a temporary exemption from the rules to pay for structural reforms” …. Just one last time…….
- Politically impossible to impose fines!

Application of new rules

- Created when Brussels and Berlin had maximum power (periphery needed German money).
- De facto perceived as ‘dictatorship of creditors’, not applied to Germany.
- Impossible to enforce when markets ‘sleep’ (current account surpluses of periphery).
- => German power ebbs very quickly.

Nothing changed?

- Important change is BU!
- ECB as supervisor plus common rescue fund.
- Consider Ireland/Spain under new regime?
- Consider HAA under new regime?
- For HAA today look at Denmark, not Lehman!)

BU more important than FU

- BU absorbs shocks
- BU allows Union to be tough with ‘sinners’.
- If banking system stable can just say ‘No’ to next Greece.
- BU necessary to make ‘no bail out’ credible!