Eurozone crisis and its implications for global growth prospects

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Outline

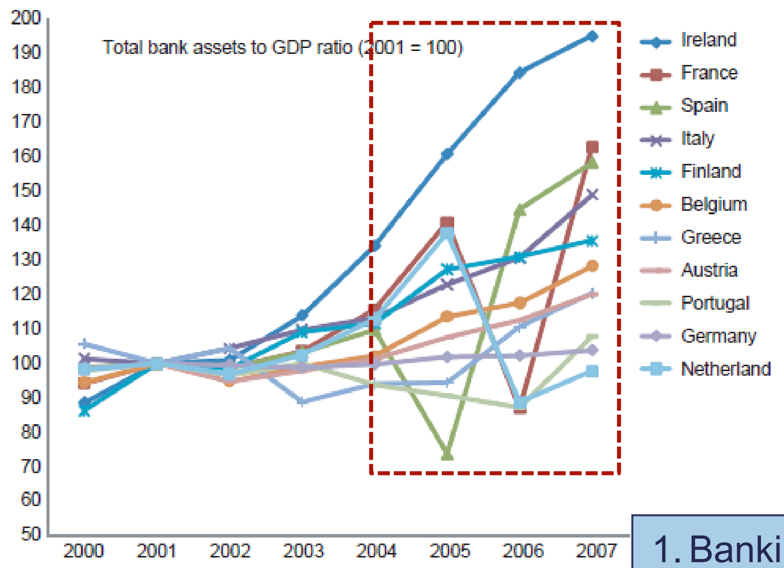
- Eurozone crisis
  - Run-up to the crisis:
    - Building-up imbalances
    - Similarities with the global financial crisis
- Eurozone is not an optimum currency area
  - Built-in self-fulfilling elements
- Resolving the crisis
  - Short run: Macro stabilization
  - Long run: Completing the monetary union
- Implications for global growth prospects

Building-up imbalances

The build-up of European imbalances

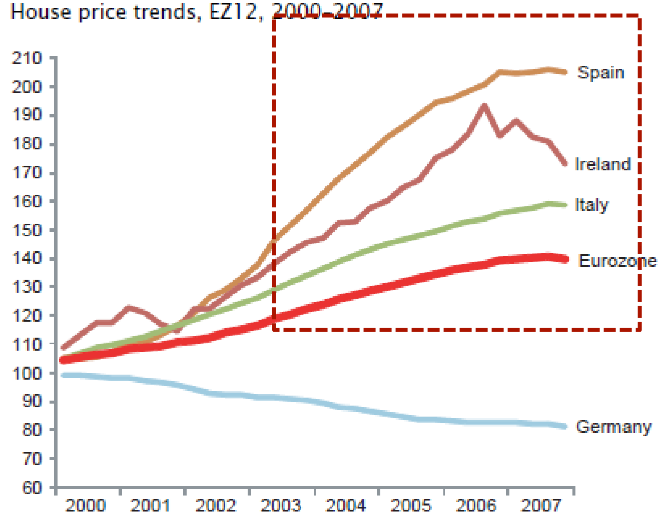
(Four figures from Baldwin & Gros, 2010)

Figure 1. Growth in bank-asset-to-GDP ratios, EZ12, 2000–2007



Source: European Banking Federation and Eurostat.

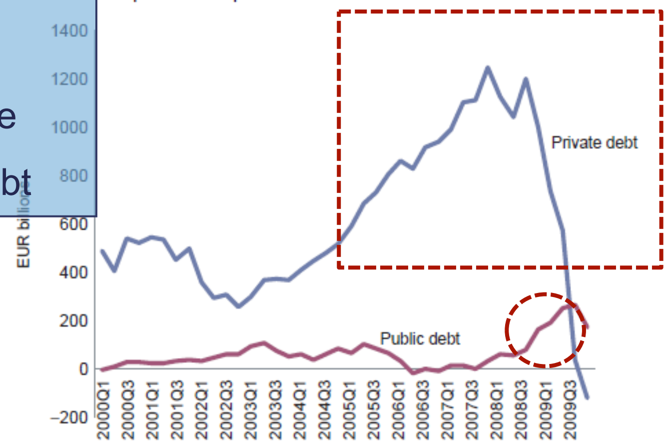
Figure 2. House price trends, EZ12, 2000–2007



Source: OECD online database.

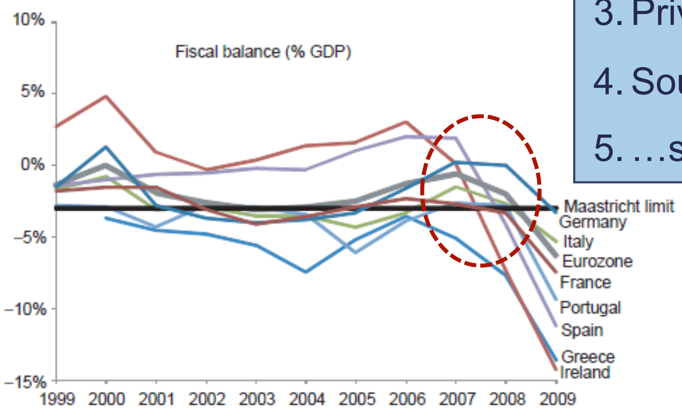
1. Banking bubble
2. Housing bubble
3. Private debt surge
4. Sound public finance
5. …surge in public debt

Figure 3. Eurozone private and public debt



Source: ECB (moving average of first difference over four quarters).

Figure 4. Deterioration of government deficits



Source: Eurostat. General government deficit (−) and surplus (+).

Causes for US financial crisis: Global Saving Glut

- Ben Bernanke (2005), "The Global Saving Glut and the U.S. Current Account Deficit"

- offered a novel explanation for the rapid rise of the U.S. trade deficit in the early 21st century:

  - the causes lay not in America but in Asia.

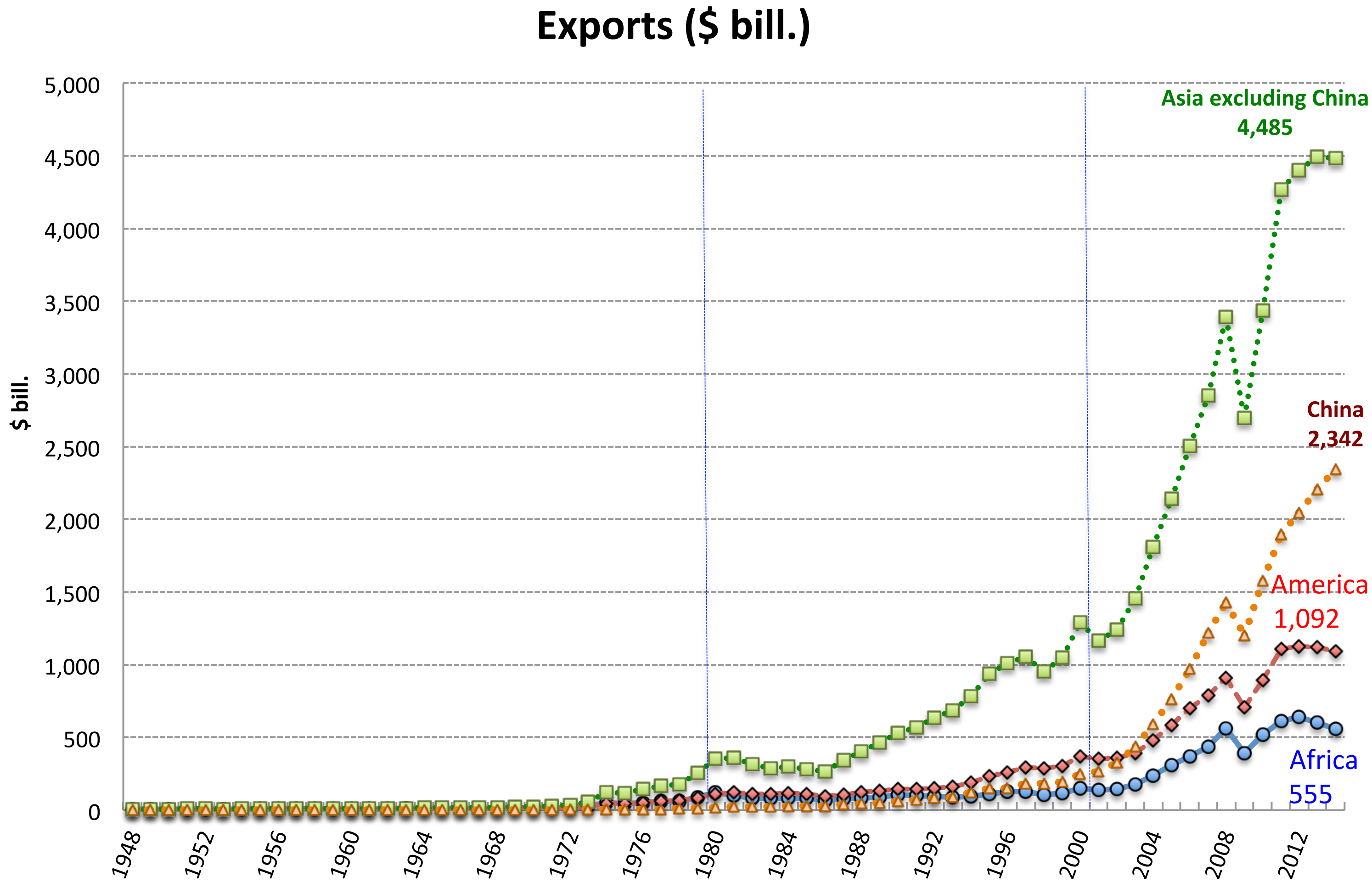
Global Picture after 1990

- In the mid-1990s, the emerging economies of Asia had been major importers of capital, borrowing abroad to finance their development.
- But after the Asian financial crisis of 1997-98 …
  - … these countries began protecting themselves by piling up huge war chests of foreign assets, in effect exporting capital to the rest of the world
  - Most of the Asian cheap money went to the United States
  - … facing the wide-open, loosely regulated financial systems characterized the US shadow banking system
  - … and creating the housing and financial bubbles

A more complete picture

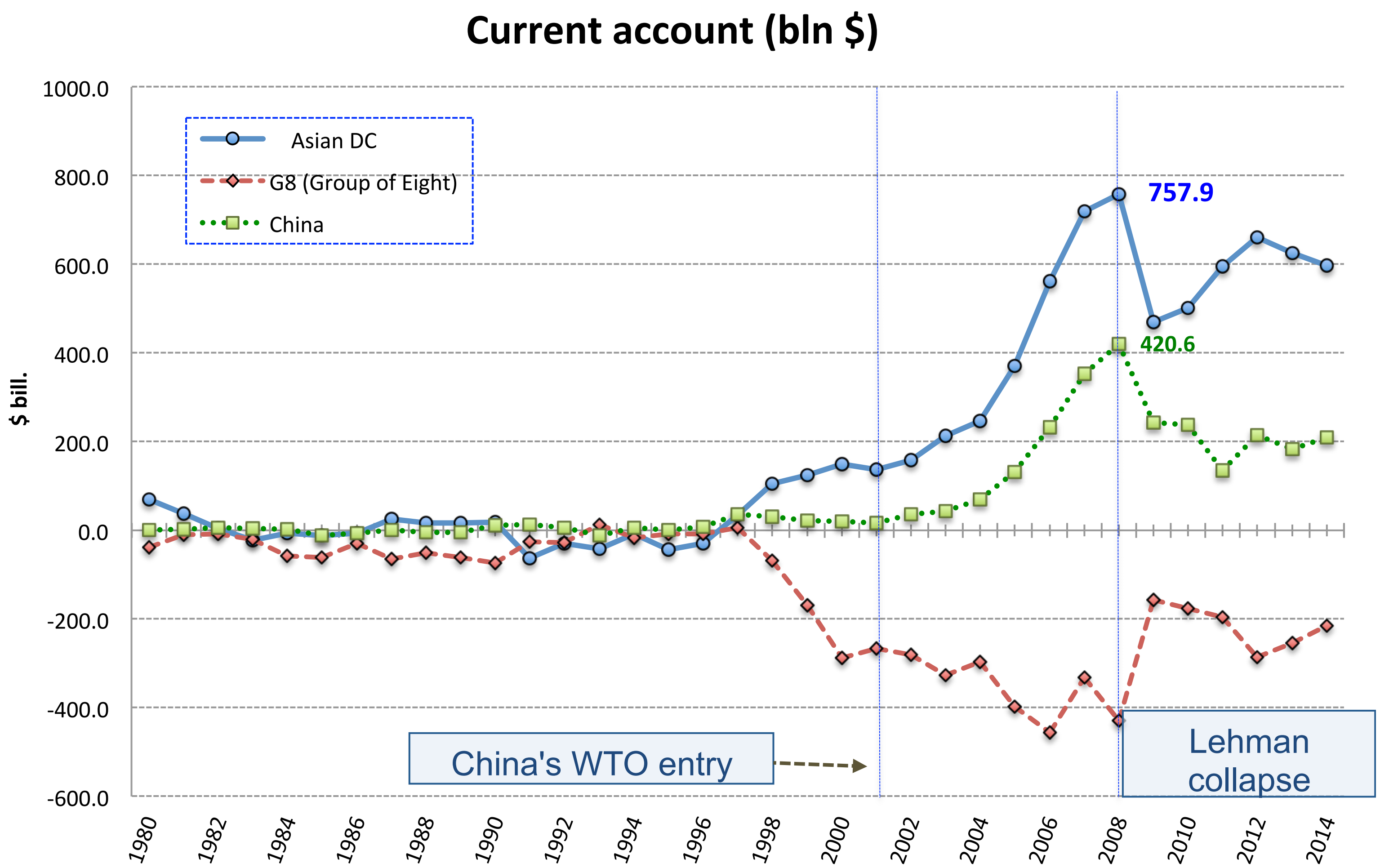
- Bernanke's picture takes into account only the "*war chests of foreign assets*" of Asian countries due to the 1997-1998 crisis,
- This picture, however, falls short of recognizing the effect of globalization:
  - i.e. relocation of production from the West to Asia,
  - resulting in fast export-led growth and building-up of export surpluses in Asia,
  - as well as emergence of China and the effects of its entry into WTO in 2001 on exports surge
  - and subsequent surge in export of capital from Asia to West

Broader issue: Export boom in Asian countries



- after 1970: export boom started in Asia, revival after 1985 (from 300 b$ to 4.5 t$
- China export boom only after 2000 (from 200 b$ to 2.3 t$)

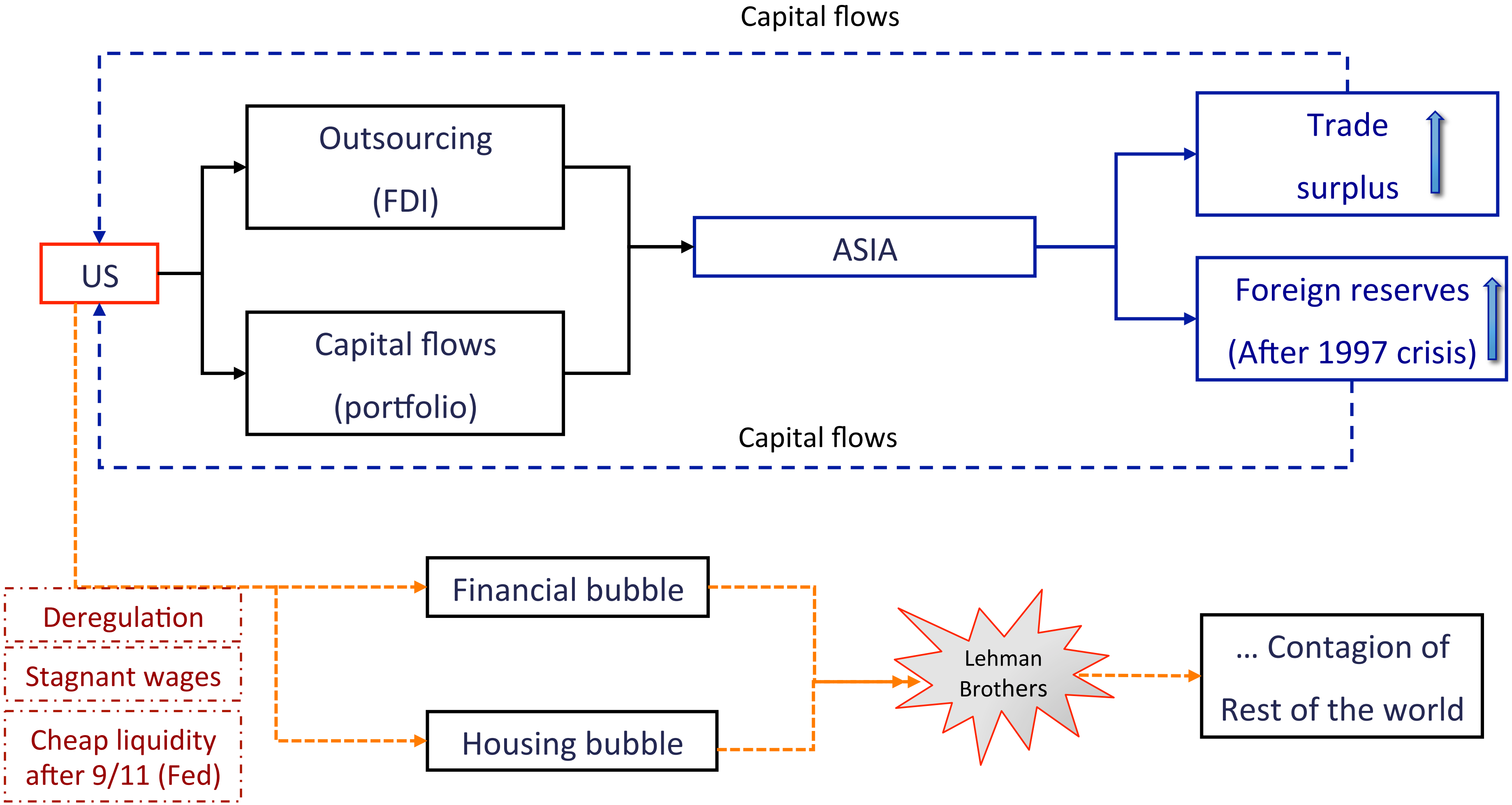
Buiding-up of current account surpluses (=capital exports) in Asian countries



- **Surging current account surpluses in Asia after 2001**
- **Matched by large CA deficits in G8 countries (esp. US)**

Global imbalances and crises

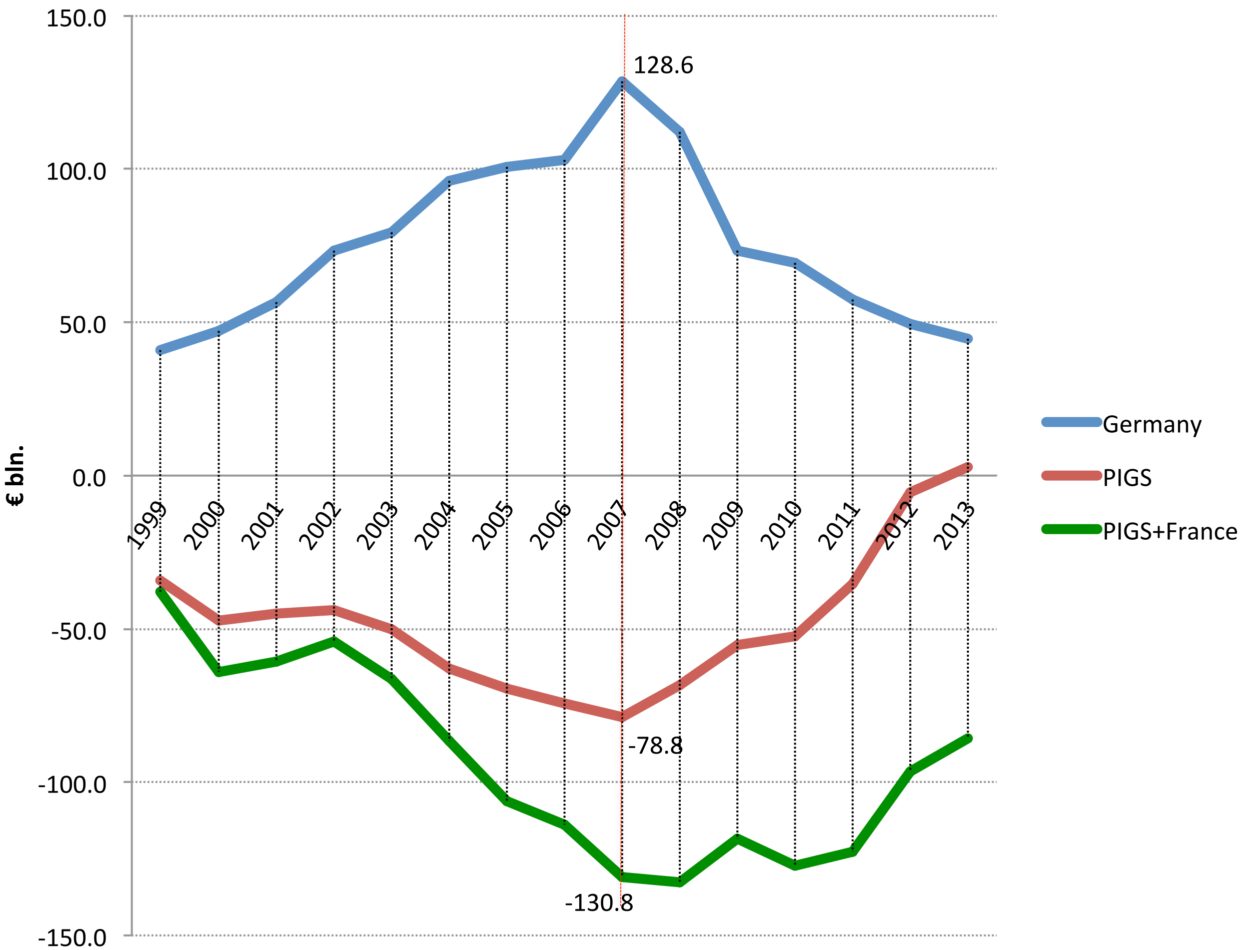
A more complete picture



Causes for Eurozone crisis

- Similar disease as in the case US - Asia
- Germany ran huge trade surpluses in trade with PIGS …
- …capital flows running in the opposite direction (financial sector, real estate)
- Consequences:
  - Debt overhang by private sector in PIIGS,
  - Governments stepping in with massive bank bail-outs
  - i.e. excessive private debt → resulting in sovereign crises

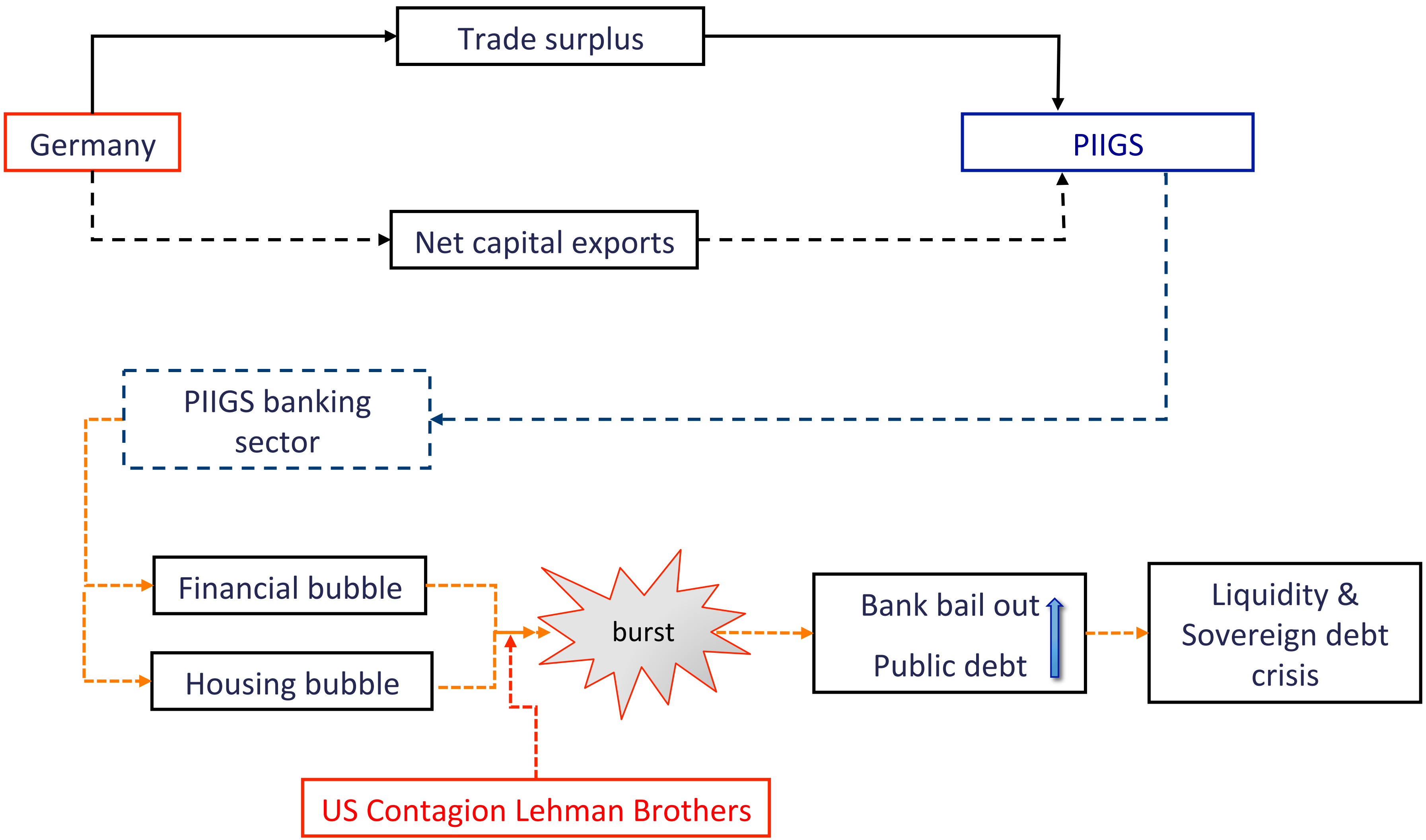
The vehicle of the problem
Trade balance (DE vs PIGS)



German trade surplus is …

a mirror picture of PIGS trade deficit

Eurozone: Mechanism of the crisis



Eurozone: Badly-designed MU

- Not optimal currency union
- No fiscal & transfer union
- Solidarity? What solidarity?
- *No-bailout clause* by the ECB
- But constraints on fiscal policies (SGP)
- Built-in Self-fulfilling elements

Fragility of *Eurozone*

- Eurozone countries are more prone to experience a sovereign debt crisis than countries not part of a MU
- Resulting from the essential feature of a MU:
  - Members of a MU <u>issue debt in a currency over which they have no control</u>
  - Hence, governments cannot give a guarantee that the cash will always be available to pay out bondholders at maturity.

- No problem for '*stand-alone*' countries
  - Can always call upon the central bank to provide the liquidity
  - Central bank as a '*<u>Lender of last resort</u>*'

Fragility

- Absence of a guarantee creates fragility
- Member countries are susceptible to movements of distrust:
  - When investors fear some payment difficulty, e.g. triggered by a recession, they sell the government bonds
- This has two effects:
  - It raises the interest rate,
  - and leads to a liquidity outflow (as the investors look for safer places)

Built-in defects of MUs

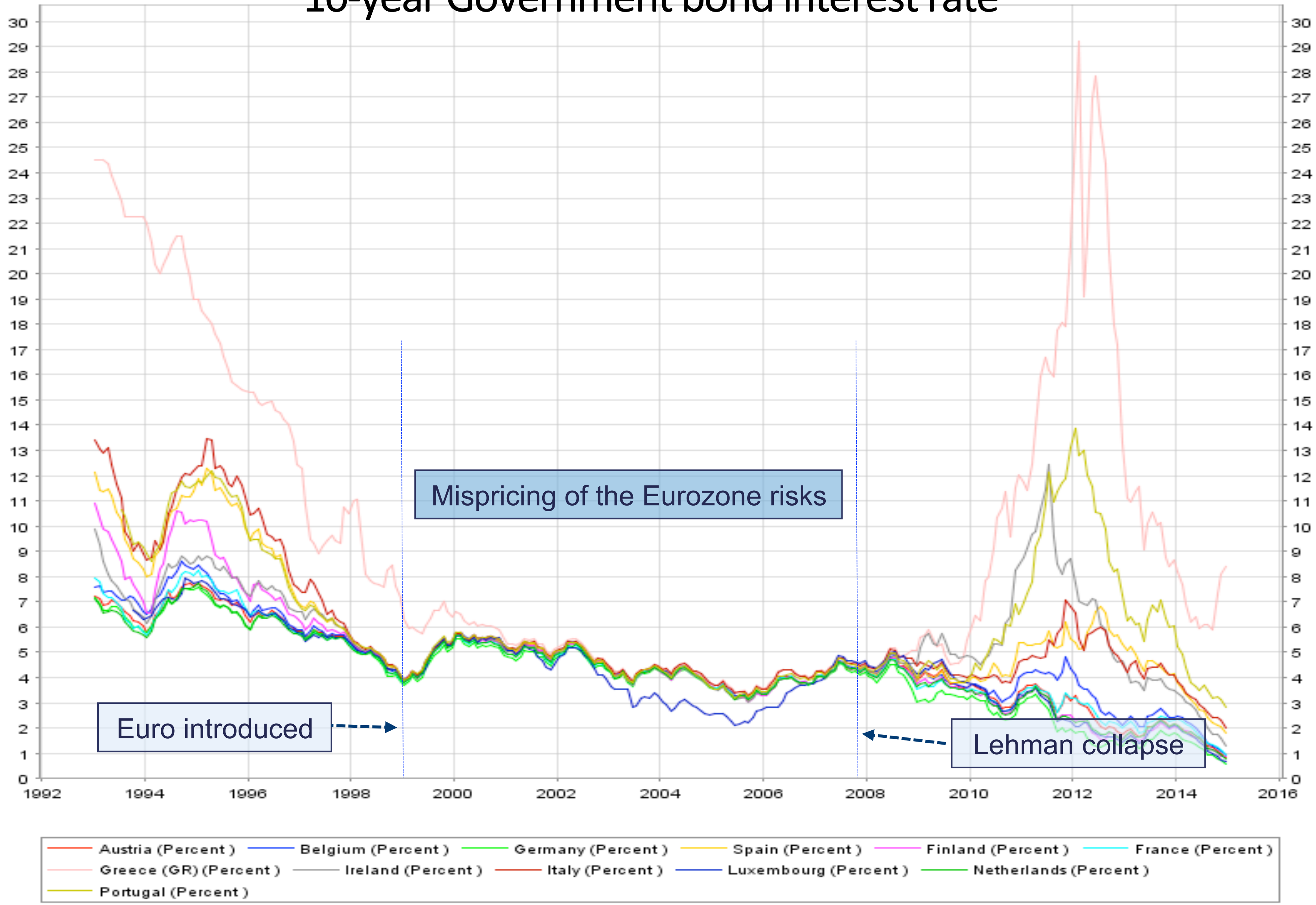
- In good times, investors' trust will be built upon the "MU effect",
  - notwithstanding the fundamentals of a particular member country
- When, however, market sentiments turn against a country
  - large movements in the spreads occur over short periods
  - whereby the latter appear to be dissociated from the fundamentals

Built-in defects (2)

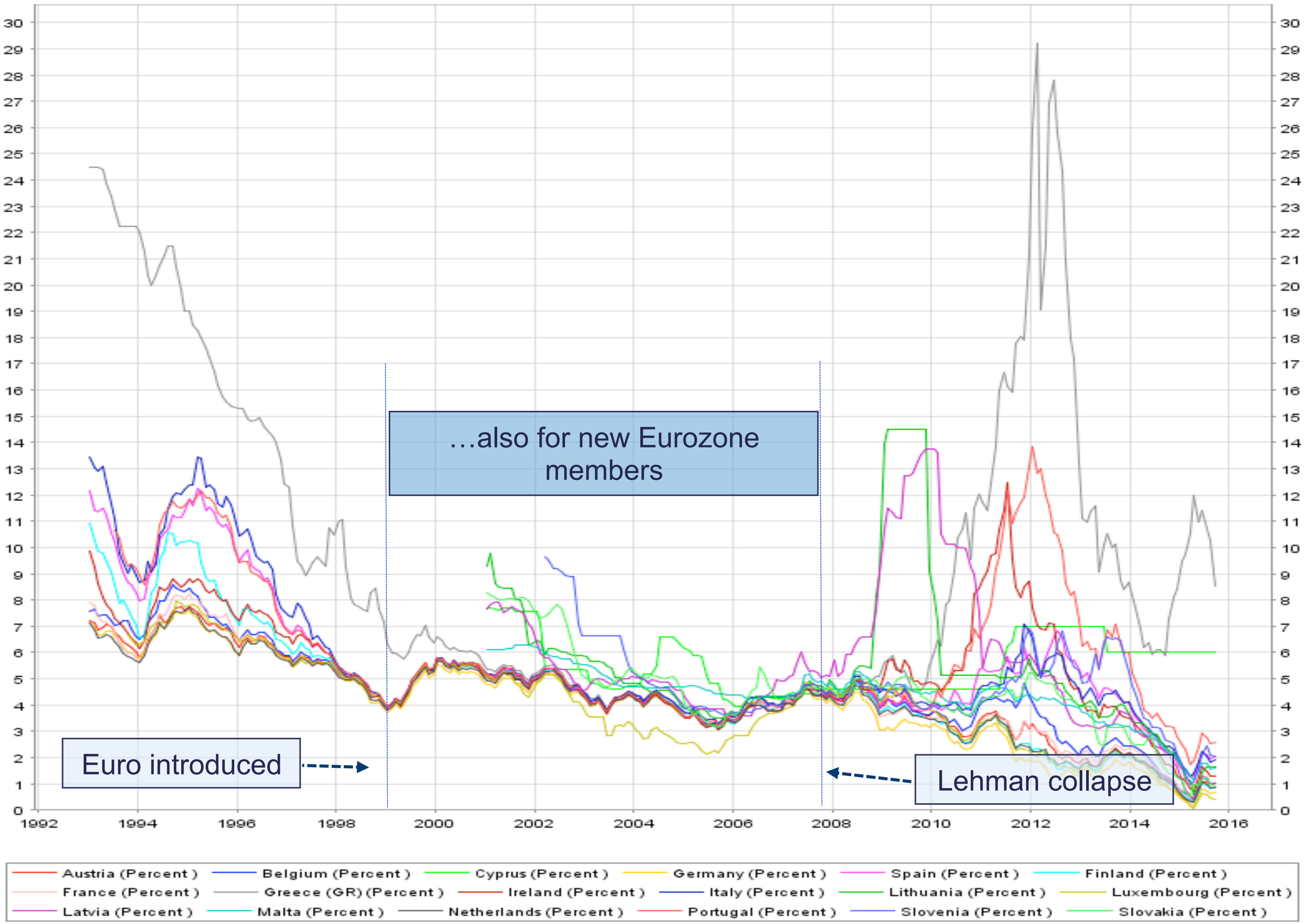
- Financial markets systematically misprice the MU country risks
  - in good times, markets under-estimate the risks of MU countries,
  - while during the crisis investors over-estimate the risks
- This, in turn:
  - promotes building-up of bubbles, and
  - worsens the recovery prospects

Mispricing risks

10-year Government bond interest rate



Mispricing risks …



Resolving the crisis

Part 1: Short run: Macro stabilization
Part 2: Long run: Fiscal consolidation & Transfer union

Part 1

Short run: Macro stabilization

Simple IS – LM framework

Did we learn from history ?

- ZDA: Yes
  - Fed: Bernanke (scholar of Great Depression & Japan)
    - Liquidity, QE
  - Government:
    - Bank bailout, Oct 2008 ($ 700 bln)
    - Stimulus, Feb 2009 ($ 831 bln)

- EU: No
  - EC: No common stimulus (only an agreement on "permitted" stimulus, € 200 + 30 bln)
  - ECB: No-bailout clause

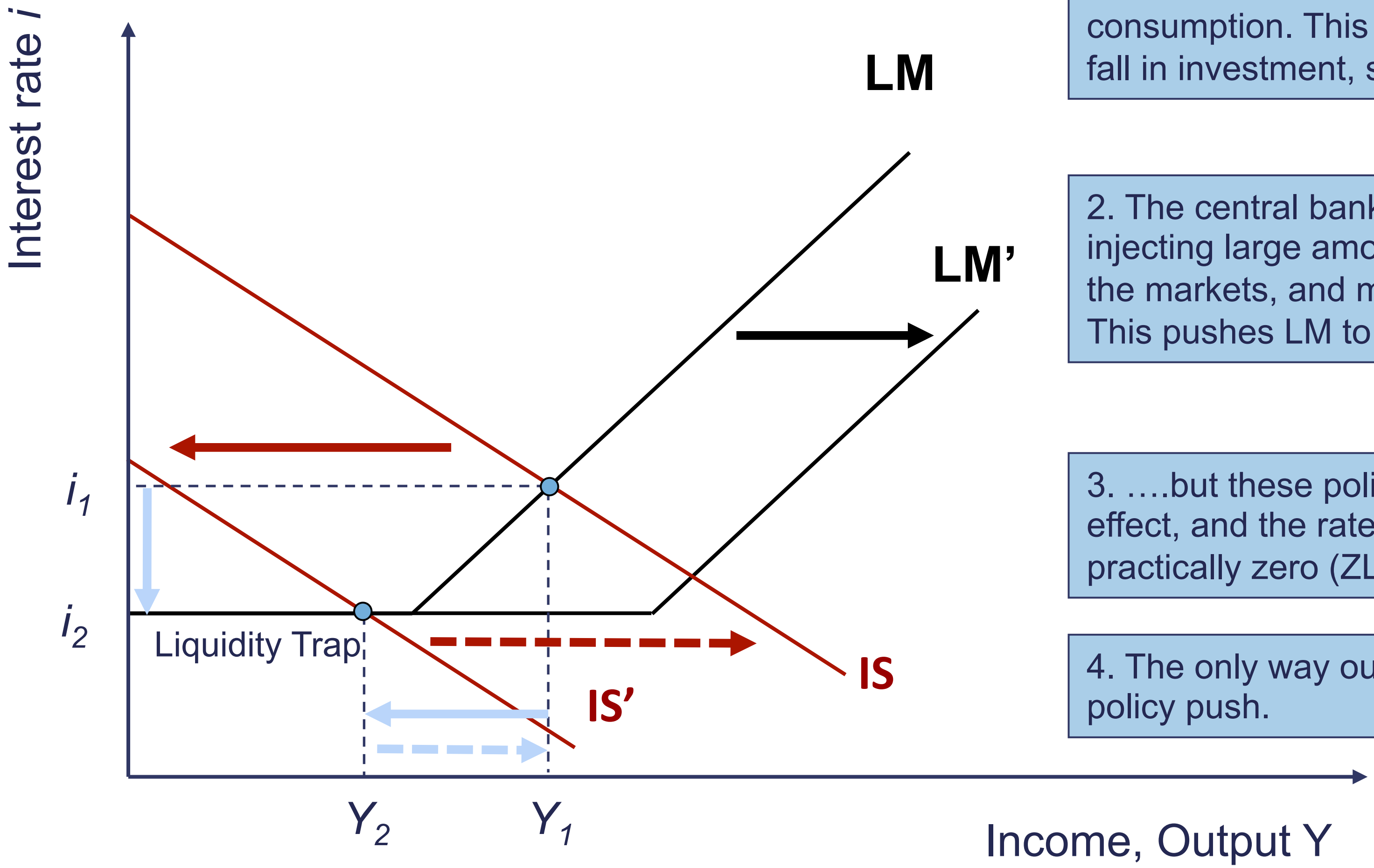
Short run: Macro stabilization

- Key: Stabilizing the depressed economies and restoring economic growth
  - Using macroeconomic policies,
  - Expansionary fiscal and monetary policies

- IS-LM model:
  - A good analytical tool for assessing macro policies
  - Finding optimal policy mix affecting:
    - Aggregate demand, output and employment

Macroeconomic stabilization and policies

How to get out of the current liquidity trap



1. The financial crisis has frozen credit markets as well as depressed consumption. This has caused a large fall in investment, shifting IS to the left

2. The central bank have responded by injecting large amounts of liquidity in the markets, and making credit easily This pushes LM to the right.

3. ….but these policies have had no effect, and the rate of interest is practically zero (ZLB !)

4. The only way out is a large fiscal policy push.

Part 2

Long run: Fiscal consolidation & Transfer union

Europe's non-solution: the 'bazooka' turned on itself (Auerbach, 2011)

Only a more active ECB can solve the euro crisis (De Grauwe, 2011).

Toward a Fiscal Union for the Euro Area, (Allard, C. et al (IMF, 2013)

Foregone years

- During the euro-crisis, many years were wasted on internal power struggle Berlin vs. Rest of EU on proper handling of the crisis:
  - sharp fiscal consolidation vs. stimulus,
  - no role for ECB allowed (due to "*No bail-out clause*")
  - no EU bonds until the fiscal union is established
- …at the cost of skyrocketing spreads of PIGS and pushing towards sovereign liquidity & solvency crisis

- …until Mario Draghi set the stage (2012)
  - "*whatever it takes*" to save the Euro

ECB

- September 2012, after ECB announced the program of (conditional) buying up the bonds of weak countries,
  - spreads dropped to sensible levels
  - the issue of EZ survival is off the table

- In September 2014, Mario Draghi announced
  - Quantitative easing (a limited version of it)
- … and called for policy coordination:
  - more expansive fiscal policies (where permitted),
  - structural reforms

Next steps

- Towards a Banking union (Stress test in 2014)
  - European Resolution Fund (ERF)

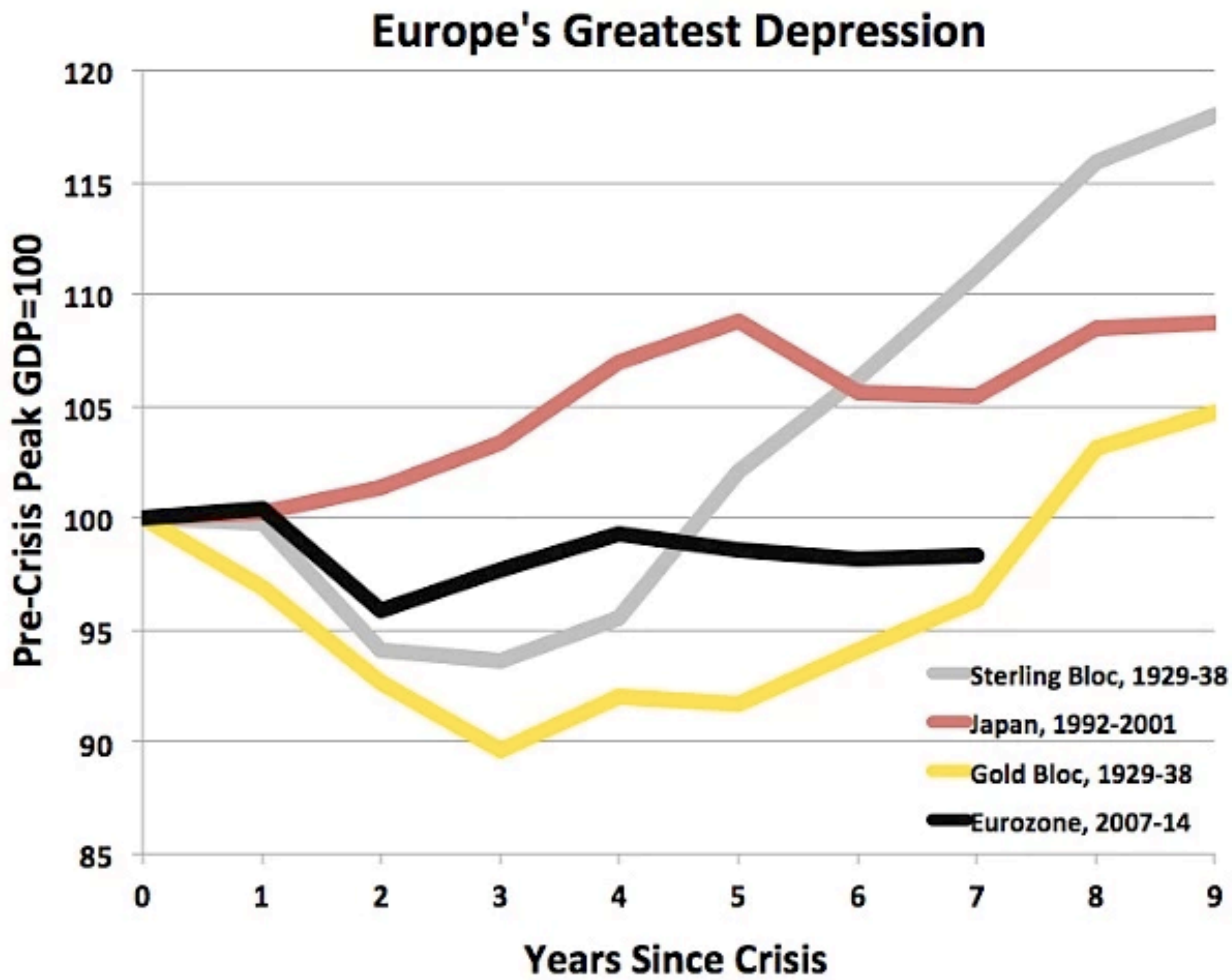
- Towards a Fiscal & Transfer Union (Long-run)
  - Fiscal consolidation (after growth is restored)
  - A permanent crisis resolution mechanism
    - a ‘rainy day fund’
  - (Some) centralized transfers
  - Euro bonds
- … But politically impossible

Big question

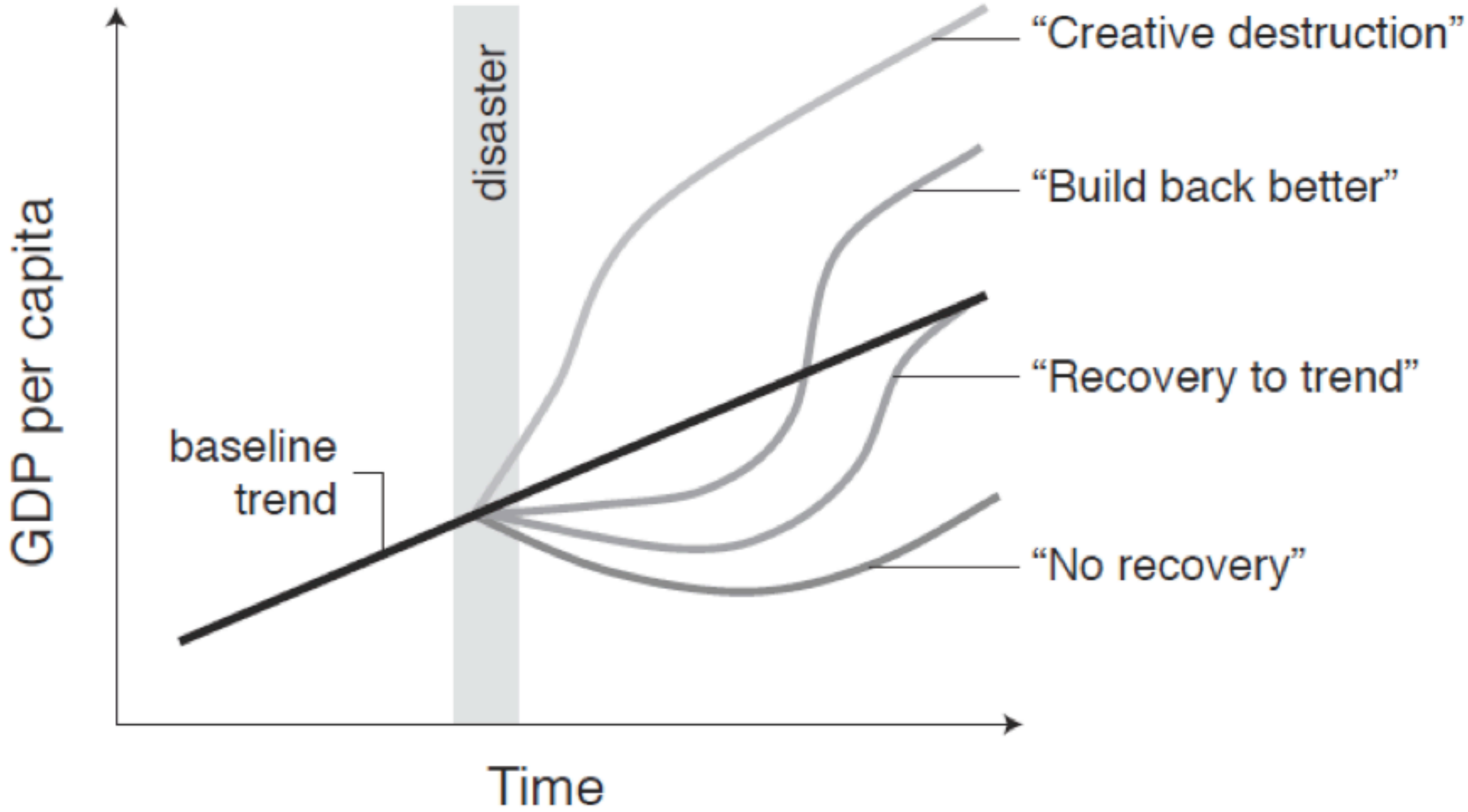
- Will Euro survive ?
  - Good question, thank you!
  - A similar solution as to "[How to save a bad marriage]" (Martin Wolf, FT)

Implications for global growth prospects

Comparison to the Great Depression



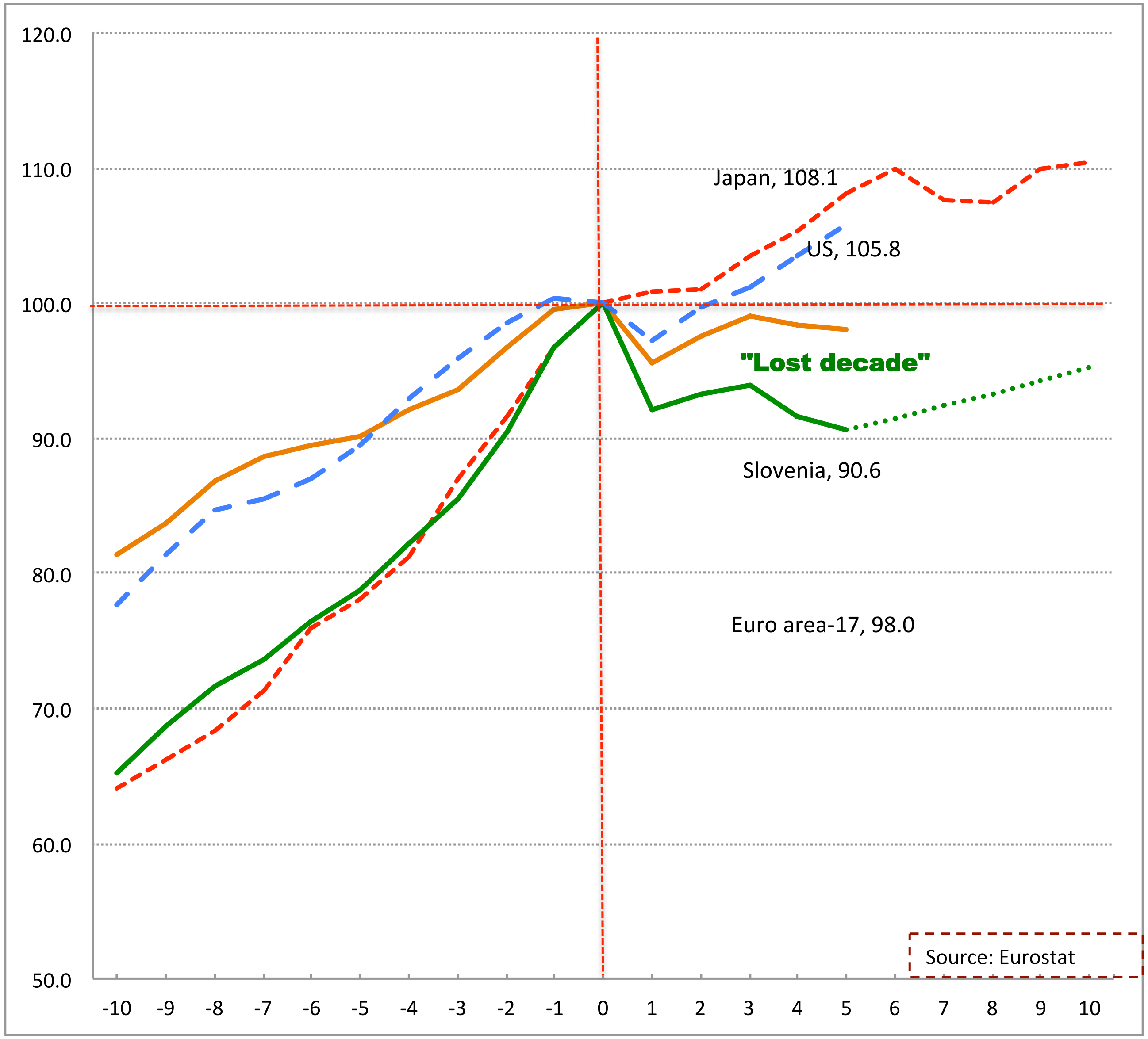
Which way forward ?



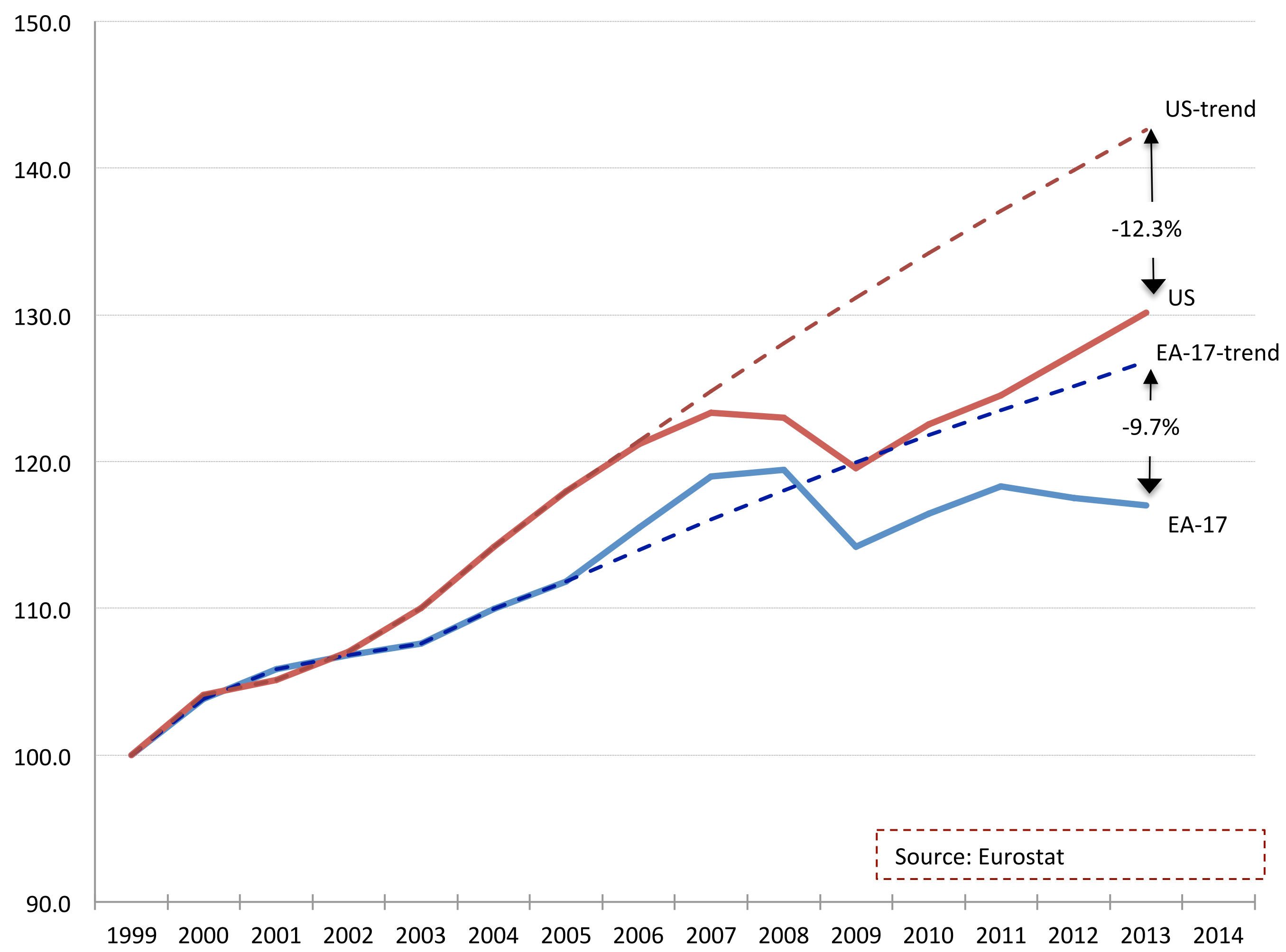
Vir: Hsiang & Jina,, The Causal Effect of Environmental Catastrophe on Long-Run Economic Growth, July 2014

“Lost decade” ?

(GDP, start of crisis=100)



Secular stagnation ahead ?



The risk of a global slowdown

- The risks of both a return to recession in the West and of a global growth slowdown
- No room left for easing: Interest rates are expected to remain very low almost permanently
- Risk of deflation
  - a sign of a depressed demand
  - but monetary policymakers lack the tools to respond
- Not too much, but too little lending (L. Summers)
  - ... for productive investment

The way out?

- Putting back the capital controls?
- Reversing globalisation?
- Globally coordinated fiscal stimulus?
  - fiscal expansion until demand accelerates to the point where interest rates can be raised
- Rethinking the conventional monetary-fiscal policy nexus:
  - QE directed to fund public investment
  - “QE for the people”: transfers / tax cuts

But…

- … will it be enough?

- Not sure
  - So far we are not even close to the consensus among academics

Thank you for your attention !