Discussion of "The eurozone crisis. Phoenix miracle or lost decade?"

by B. Eichengreen, N. Jung, S. Moch, A. Mody
Discussion by A. Philippopoulos

May 21, 2013
What the paper does

- It studies the current eurozone crisis.
What the paper does

- It studies the current eurozone crisis.
- In particular, it compares this crisis to:

  1. the Latin American crisis in the early 1980s and the East Asian crisis in the late 1990s
  2. the US (another monetary union).

Useful lessons to draw from past experience.

Another thoughtful paper by BE!
What the paper does

- It studies the current eurozone crisis.
- In particular, it compares this crisis to:
  - the Latin American crisis in the early 1980s and the East Asian crisis in the late 1990s.
What the paper does

- It studies the current eurozone crisis.
- In particular, it compares this crisis to:
  1. the Latin American crisis in the early 1980s and the East Asian crisis in the late 1990s
  2. as well as to the US (another monetary union).
What the paper does

- It studies the current eurozone crisis.
- In particular, it compares this crisis to:
  1. the Latin American crisis in the early 1980s and the East Asian crisis in the late 1990s
  2. as well as to the US (another monetary union).
- Useful lessons to draw from past experience.
What the paper does

- It studies the current eurozone crisis.
- In particular, it compares this crisis to:
  1. the Latin American crisis in the early 1980s and the East Asian crisis in the late 1990s
  2. as well as to the US (another monetary union).
- Useful lessons to draw from past experience.
- Another thoughtful paper by BE!
What is special in Europe/GIIPS?

- Before the crisis (what the authors focus on):

Although heterogeneity, Europe already faced a public debt problem.
Property and demand bubble in the 2000s.
Before the crisis (what the authors focus on):

- Although heterogeneity, Europe already faced a public debt problem.
Before the crisis (what the authors focus on):

1. Although heterogeneity, Europe already faced a public debt problem.
2. Property and demand bubble in the 2000s.
What is special in Europe/GIIPS?

- After the crisis (what the authors focus on):
  
  1. Relatively large procyclical austerity.
  2. Relatively big fall in private demand, especially investment.
  3. Bail out (EFSF, ESM, ECB) so current account deficits continue.
  4. Lack of exchange rate devaluation.
  5. Banking problem (need for banking union).
  6. Relatively successful public debt restructure (e.g. Greece). But more debt needs to be written off.
After the crisis (what the authors focus on):

1. Relatively large fiscal austerity.
What is special in Europe/GIIPS?

- After the crisis (what the authors focus on):
  1. Relatively large fiscal austerity.
  2. Relatively big fall in private demand, especially investment.
What is special in Europe/GIIPS?

- After the crisis (what the authors focus on):
  1. Relatively large fiscal austerity.
  2. Relatively big fall in private demand, especially investment.
  3. Bail out (EFSF, ESM, ECB) so current account deficits continue.
What is special in Europe/GIIPS?

After the crisis (what the authors focus on):

1. Relatively large fiscal austerity.
2. Relatively big fall in private demand, especially investment.
3. Bail out (EFSF, ESM, ECB) so current account deficits continue.
4. Lack of exchange rate devaluation.
What is special in Europe/GIIPS?

After the crisis (what the authors focus on):

1. Relatively large fiscal austerity.
2. Relatively big fall in private demand, especially investment.
3. Bail out (EFSF, ESM, ECB) so current account deficits continue.
4. Lack of exchange rate devaluation.
5. Banking problem (need for banking union).

Discussion of "The eurozone crisis. Phoenix miracle or lost decade?"

May 21, 2013
What is special in Europe/GIIPS?

After the crisis (what the authors focus on):

1. Relatively large fiscal austerity.
2. Relatively big fall in private demand, especially investment.
3. Bail out (EFSF, ESM, ECB) so current account deficits continue.
4. Lack of exchange rate devaluation.
5. Banking problem (need for banking union).
6. Relatively successful public debt restructure (e.g. Greece). But more debt needs to be written off.
This crisis is complex. Better to re-organize the rich issues discussed in terms of causes-imbalances-reactions.
My discussion

- This crisis is complex. Better to re-organize the rich issues discussed in terms of causes-imbalances-reactions.
- Try to evaluate some debated policy reactions by using a DSGE model.
Causes of the European crisis (mid 1990s to 2008)

- Fall in interest rates in the mid 1990s and credit bubbles.
Causes of the European crisis (mid 1990s to 2008)

- Fall in interest rates in the mid 1990s and credit bubbles.
- Rise in (private and public) demand. Real estate bubble.
Causes of the European crisis (mid 1990s to 2008)

- Fall in interest rates in the mid 1990s and credit bubbles.
- Rise in (private and public) demand. Real estate bubble.
- Rise in prices and loss in competitiveness.

Current account deficits (due to high demand and loss in competitiveness).
Made worse by procyclical fiscal policies (e.g. Greece).
See e.g. EEAG Report, 2013, CESifo.
Causes of the European crisis (mid 1990s to 2008)

- Fall in interest rates in the mid 1990s and credit bubbles.
- Rise in (private and public) demand. Real estate bubble.
- Rise in prices and loss in competitiveness.
- Current account deficits (due to high demand and loss in competitiveness).
Causes of the European crisis (mid 1990s to 2008)

- Fall in interest rates in the mid 1990s and credit bubbles.
- Rise in (private and public) demand. Real estate bubble.
- Rise in prices and loss in competitiveness.
- Current account deficits (due to high demand and loss in competitiveness).
- Made worse by procyclical fiscal policies (e.g. Greece).
Causes of the European crisis (mid 1990s to 2008)

- Fall in interest rates in the mid 1990s and credit bubbles.
- Rise in (private and public) demand. Real estate bubble.
- Rise in prices and loss in competitiveness.
- Current account deficits (due to high demand and loss in competitiveness).
- Made worse by procyclical fiscal policies (e.g. Greece).
- See e.g. EEAG Report, 2013, CESifo.
3 (plus 1) interrelated crises/imbalances since 2008

1. Sovereign debt crisis (public debt to GDP)
3 (plus 1) interrelated crises/imbalances since 2008

1. Sovereign debt crisis (public debt to GDP)
2. Balance-of-payments crisis (foreign liabilities to GDP)

Things are a bit better these days (thanks to ECB measures in summer/autumn 2012) but remain very fragile. "Recovery remains disappointing."
3 (plus 1) interrelated crises/imbalances since 2008

1. Sovereign debt crisis (public debt to GDP)
2. Balance-of-payments crisis (foreign liabilities to GDP)
3. Banking crises (not serviceable public and private debt)
3 (plus 1) interrelated crises/imbalances since 2008

1. Sovereign debt crisis (public debt to GDP)
2. Balance-of-payments crisis (foreign liabilities to GDP)
3. Banking crises (not serviceable public and private debt)

Things are a bit better these days (thanks to ECB measures in summer/autumn 2012) but remain very fragile. "Recovery remains disappointing."

See e.g. EEAG Report, 2013, CESifo.
3 (plus 1) interrelated crises/imbalances since 2008

1. Sovereign debt crisis (public debt to GDP)
2. Balance-of-payments crisis (foreign liabilities to GDP)
3. Banking crises (not serviceable public and private debt)
5. Things are a bit better these days (thanks to ECB measures in summer/autumn 2012) but remain very fragile. "Recovery remains disappointing".
3 (plus 1) interrelated crises/imbalances since 2008

1. Sovereign debt crisis (public debt to GDP)
2. Balance-of-payments crisis (foreign liabilities to GDP)
3. Banking crises (not serviceable public and private debt)
5. Things are a bit better these days (thanks to ECB measures in summer/autumn 2012) but remain very fragile. "Recovery remains disappointing".
6. See e.g. EEAG Report, 2013, CESifo.
Reaction to the sovereign debt crisis
Reactions to the sovereign debt crisis

The growing concern of financial markets about the sustainability of public and foreign debt (see sovereign premia) has forced GIIPS to consolidate.

But has austerity weakened demand and made things worse?

(ECB as lender of last resort or “more monetary support”?

(Fiscal union and eurobonds (like the US)?

See e.g. de Grauwe (2011).
Reaction to the sovereign debt crisis

1 The growing concern of financial markets about the sustainability of public and foreign debt (see sovereign premia) has forced GIIPS to consolidate.

2 But has austerity weakened demand and made things worse?

See e.g. de Grauwe (2011).
Reaction to the sovereign debt crisis

1. The growing concern of financial markets about the sustainability of public and foreign debt (see sovereign premia) has forced GIIPS to consolidate.
2. But has austerity weakened demand and made things worse?
3. (more) Debt restructure/haircut.
Policy reactions to the first two types of crises

- Reaction to the sovereign debt crisis
  1. The growing concern of financial markets about the sustainability of public and foreign debt (see sovereign premia) has forced GIIPS to consolidate.
  2. But has austerity weakened demand and made things worse?
  3. (more) Debt restructure/haircut.
  4. (!?) ECB as lender of last resort or "more monetary support".

See e.g. de Grauwe (2011).
Policy reactions to the first two types of crises

- Reaction to the sovereign debt crisis

  1. The growing concern of financial markets about the sustainability of public and foreign debt (see sovereign premia) has forced GIIPS to consolidate.
  2. But has austerity weakened demand and made things worse?
  3. (more) Debt restructure/haircut.
  4. (!?) ECB as lender of last resort or "more monetary support".
  5. (!?) Fiscal union and eurobonds (like the US).

See e.g. de Grauwe (2011).
Policy reactions to the first two types of crises

- Reaction to the sovereign debt crisis
  1. The growing concern of financial markets about the sustainability of public and foreign debt (see sovereign premia) has forced GIIPS to consolidate.
  2. But has austerity weakened demand and made things worse?
  3. (more) Debt restructure/haircut.
  4. (?!) ECB as lender of last resort or "more monetary support".
  5. (?!) Fiscal union and eurobonds (like the US).
  6. See e.g. de Grauwe (2011).
Policy reactions to the first two types of crises (cont)

- Reaction to the balance-of-payments crisis

  - Need for real devaluation around 30-35%. But how?
  - Internal devaluation via falling prices in GIIPS (exports).
  - Internal devaluation via rising prices in Germany.
  - Exit and devaluation.
  - Support of exit and devaluation by Germany.
Reaction to the balance-of-payments crisis

1. Need for real devaluation around 30-35%. But how?
Policy reactions to the first two types of crises (cont)

Reaction to the balance-of-payments crisis

1. Need for real devaluation around 30-35%. But how?
2. Internal devaluation via falling prices in GIIPS (exports).
Reaction to the balance-of-payments crisis

1. Need for real devaluation around 30-35%. But how?
2. Internal devaluation via falling prices in GIIPS (exports).
3. (?) Internal devaluation via rising prices in Germany.
Policy reactions to the first two types of crises (cont)

Reaction to the balance-of-payments crisis

1. Need for real devaluation around 30-35%. But how?
2. Internal devaluation via falling prices in GIIPS (exports).
3. (?) Internal devaluation via rising prices in Germany.
4. (?) Exit and devaluation.
Policy reactions to the first two types of crises (cont)

- Reaction to the balance-of-payments crisis
  1. Need for real devaluation around 30-35%. But how?
  2. Internal devaluation via falling prices in GIIPS (exports).
  3. (?) Internal devaluation via rising prices in Germany.
  4. (?) Exit and devaluation.
  5. (?) Support of exit and devaluation by Germany.
Try to evaluate 2 much debated policy reactions

- Use a - deliberately - standard NK DSGE model (Philippopoulos, Varthalitis and Vassilatos, 2013, CESifo WP, no. 4199) calibrated to Italy 2001-2010.

Depart from the status quo and study the effects of two reforms:
1. Debt consolidation or "austerity".
2. (The ...ction of) Monetary independence or "exit and devaluation".

Discussion of "The eurozone crisis. Phoenix miracle or lost decade?" May 21, 2013 10 / 16
Try to evaluate 2 much debated policy reactions

- Use a - deliberately - standard NK DSGE model (Philippopoulos, Varthalitis and Vassilatos, 2013, CESifo WP, no. 4199) calibrated to Italy 2001-2010.
- Quantitatively evaluate policy reactions by comparing the status quo (calibrated long run solution) to transition to a reformed economy.
Try to evaluate 2 much debated policy reactions

- Use a - deliberately - standard NK DSGE model (Philippopoulos, Varthalitis and Vassilatos, 2013, CESifo WP, no. 4199) calibrated to Italy 2001-2010.
- Quantitatively evaluate policy reactions by comparing the status quo (calibrated long run solution) to transition to a reformed economy.
- Depart from the status quo and study the effects of two reforms:
Try to evaluate 2 much debated policy reactions

- Use a - deliberately - standard NK DSGE model (Philippopoulos, Varthalitis and Vassilatos, 2013, CESifo WP, no. 4199) calibrated to Italy 2001-2010.

- Quantitatively evaluate policy reactions by comparing the status quo (calibrated long run solution) to transition to a reformed economy.

- Depart from the status quo and study the effects of two reforms:
  - Debt consolidation or "austerity".
  - (The …ection of) Monetary independence or "exit and devaluation".

by B. Eichengreen, N. Jung, S. Moch, A. Mo
Discussion of "The eurozone crisis. Phoenix miracle or lost decade?" May 21, 2013 10 / 16
Try to evaluate 2 much debated policy reactions

- Use a - deliberately - standard NK DSGE model (Philippopoulos, Varthalitis and Vassilatos, 2013, CESifo WP, no. 4199) calibrated to Italy 2001-2010.
- Quantitatively evaluate policy reactions by comparing the status quo (calibrated long run solution) to transition to a reformed economy.
- Depart from the status quo and study the effects of two reforms:
  1. Debt consolidation or "austerity".
  2. (The fiction of) Monetary independence or "exit and devaluation".
The model in words

- Calvo-type nominal fixities.
The model in words

- Calvo-type nominal fixities.
- Imperfect competition.
The model in words

- Calvo-type nominal fixities.
- Imperfect competition.
- Sovereign premia (when public debt is above 90%).
The model in words

- Calvo-type nominal fixities.
- Imperfect competition.
- Sovereign premia (when public debt is above 90%).
- No monetary policy independence (no room for Taylor rule).
The model in words

- Calvo-type nominal fixities.
- Imperfect competition.
- Sovereign premia (when public debt is above 90%).
- No monetary policy independence (no room for Taylor rule).
- Fiscal (tax-spending) instruments are allowed to react to debt and output gaps.
The model in words

- Calvo-type nominal fixities.
- Imperfect competition.
- Sovereign premia (when public debt is above 90%).
- No monetary policy independence (no room for Taylor rule).
- Fiscal (tax-spending) instruments are allowed to react to debt and output gaps.
Is debt consolidation productive?

Table 1: Welfare at various time horizons with and without debt consolidation

<table>
<thead>
<tr>
<th></th>
<th>4 periods</th>
<th>10 periods</th>
<th>50 periods</th>
<th>$E_0 V_0$</th>
<th>$u$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$s_t^g$</td>
<td>1.8109</td>
<td>4.6165</td>
<td>16.9614</td>
<td>22.5858</td>
<td>0.7323</td>
</tr>
<tr>
<td></td>
<td>(2.5098)</td>
<td>(5.5889)</td>
<td>(14.5509)</td>
<td>(16.2654)</td>
<td>(0.6466)</td>
</tr>
<tr>
<td>$\tau_t^c$</td>
<td>1.8852</td>
<td>4.7383</td>
<td>16.5754</td>
<td>22.5458</td>
<td>0.7329</td>
</tr>
<tr>
<td></td>
<td>(2.5098)</td>
<td>(5.5886)</td>
<td>(14.5520)</td>
<td>(16.2670)</td>
<td>(0.6466)</td>
</tr>
<tr>
<td>$\tau_t^k$</td>
<td>2.0275</td>
<td>5.0488</td>
<td>17.1352</td>
<td>22.9910</td>
<td>0.7721</td>
</tr>
<tr>
<td></td>
<td>(2.5096)</td>
<td>(5.5887)</td>
<td>(14.5516)</td>
<td>(16.2671)</td>
<td>(0.6466)</td>
</tr>
<tr>
<td>$\tau_t^n$</td>
<td>2.0288</td>
<td>5.1277</td>
<td>17.2199</td>
<td>23.1767</td>
<td>0.7597</td>
</tr>
<tr>
<td></td>
<td>(2.5096)</td>
<td>(5.5894)</td>
<td>(14.5537)</td>
<td>(16.2696)</td>
<td>(0.6466)</td>
</tr>
</tbody>
</table>

Note: results without debt consolidation in parentheses.
Is (the fiction of) monetary independence productive?

Table 2: With monetary policy independence (under debt consolid.)

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Optimal monetary reaction</th>
<th>Optimal fiscal reaction</th>
<th>Long-run period utility</th>
<th>Expected life-time utility</th>
</tr>
</thead>
<tbody>
<tr>
<td>$R_t \quad s_t^g$</td>
<td>$\phi_\pi = 3$</td>
<td>$\gamma^g_i = 0.16$</td>
<td>$0.7323$</td>
<td>$22.7285$</td>
</tr>
<tr>
<td></td>
<td>$\phi_y = 0.0001$</td>
<td>$\gamma^g_y = 0$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$R_t \quad \tau_t^c$</td>
<td>$\phi_\pi = 3$</td>
<td>$\gamma^c_i = 0.2$</td>
<td>$0.7329$</td>
<td>$22.7426$</td>
</tr>
<tr>
<td></td>
<td>$\phi_y = 0$</td>
<td>$\gamma^c_y = 0.02$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$R_t \quad \tau_t^k$</td>
<td>$\phi_\pi = 2.16$</td>
<td>$\gamma^k_i = 0.2$</td>
<td>$0.7721$</td>
<td>$23.3778$</td>
</tr>
<tr>
<td></td>
<td>$\phi_y = 0$</td>
<td>$\gamma^k_y = 0$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$R_t \quad \tau_t^n$</td>
<td>$\phi_\pi = 2.21$</td>
<td>$\gamma^n_i = 0.2$</td>
<td>$0.7597$</td>
<td>$23.4542$</td>
</tr>
<tr>
<td></td>
<td>$\phi_y = 0$</td>
<td>$\gamma^n_y = 0.0005$</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 3: With and without monetary policy independence (under debt consolid.)

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Long-run period utility $u$</th>
<th>Expected life-time utility $E_0 V_0$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$R_t \ s_t^g$</td>
<td>0.7323</td>
<td>22.7285</td>
</tr>
<tr>
<td></td>
<td>(0.7323)</td>
<td>(22.5858)</td>
</tr>
<tr>
<td>$R_t \ c_t$</td>
<td>0.7329</td>
<td>22.7426</td>
</tr>
<tr>
<td></td>
<td>(0.7329)</td>
<td>(22.5458)</td>
</tr>
<tr>
<td>$R_t \ k_t$</td>
<td>0.7721</td>
<td>23.3778</td>
</tr>
<tr>
<td></td>
<td>(0.7721)</td>
<td>(22.9910)</td>
</tr>
<tr>
<td>$R_t \ n_t$</td>
<td>0.7597</td>
<td>23.4542</td>
</tr>
<tr>
<td></td>
<td>(0.7597)</td>
<td>(23.1767)</td>
</tr>
</tbody>
</table>

Note: results without monetary independence in parentheses.
But, as the authors also point out, we should be cautious.

- Are results robust to market failures?
But, as the authors also point out, we should be cautious.

- Are results robust to market failures?
  - Nominal wage fixity (e.g. Dellas and Tavlas, 2005).

- Are results robust to policy failures?
  - Lack of commitment (e.g. Clerk, Dellas and Loisel, 2009).

- Are results robust to institutional failures?
  - “Right” measures can be counter-productive when poor institutions (polarization).
But, as the authors also point out, we should be cautious.

Are results robust to market failures?

1. Nominal wage fixity (e.g. Dellas and Tavlas, 2005).
2. Real wage rigidity and union behavior (e.g. Gali, 2010).
But, as the authors also point out, we should be cautious.

- Are results robust to market failures?
  1. Nominal wage fixity (e.g. Della and Tavlas, 2005).
  2. Real wage rigidity and union behavior (e.g. Gali, 2010).

- Are results robust to policy failures?
But, as the authors also point out, we should be cautious.

- Are results robust to market failures?
  - 1. Nominal wage fixity (e.g. Dellas and Tavlas, 2005).
  - 2. Real wage rigidity and union behavior (e.g. Gali, 2010).

- Are results robust to policy failures?
  - 4. Lack of commitment (e.g. Clerk, Dellas and Loisel, 2009).
But, as the authors also point out, we should be cautious.

- Are results robust to market failures?
  1. Nominal wage fixity (e.g. Della and Tavlas, 2005).
  2. Real wage rigidity and union behavior (e.g. Gali, 2010).

- Are results robust to policy failures?
  1. Lack of commitment (e.g. Clerk, Della and Loisel, 2009).

- Are results robust to institutional failures?
But, as the authors also point out, we should be cautious.

- Are results robust to market failures?
  1. Nominal wage fixity (e.g. Dellas and Tavlas, 2005).
  2. Real wage rigidity and union behavior (e.g. Gali, 2010).

- Are results robust to policy failures?
  1. Lack of commitment (e.g. Clerk, Dellas and Loisel, 2009).

- Are results robust to institutional failures?
  1. "Right" measures can be counter-productive when poor institutions (polarization).
Thank You