The Eurozone Crisis: Phoenix Miracle or Lost Decade?

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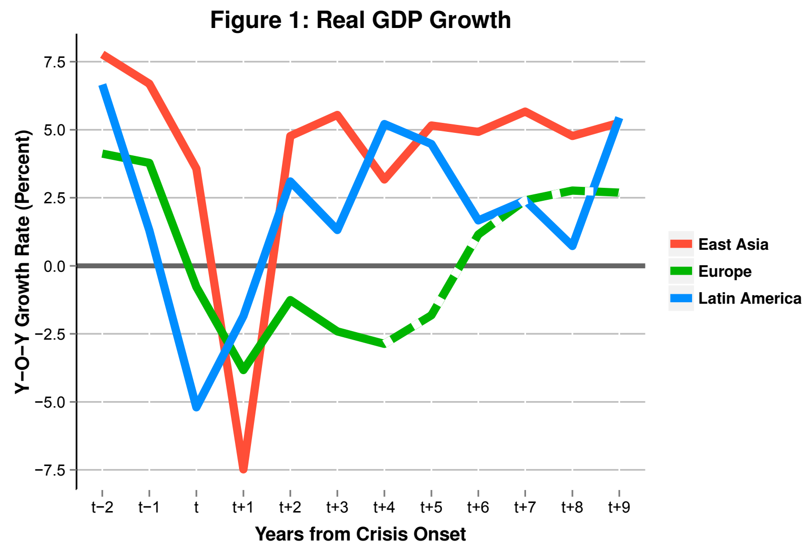
May 23, 2013

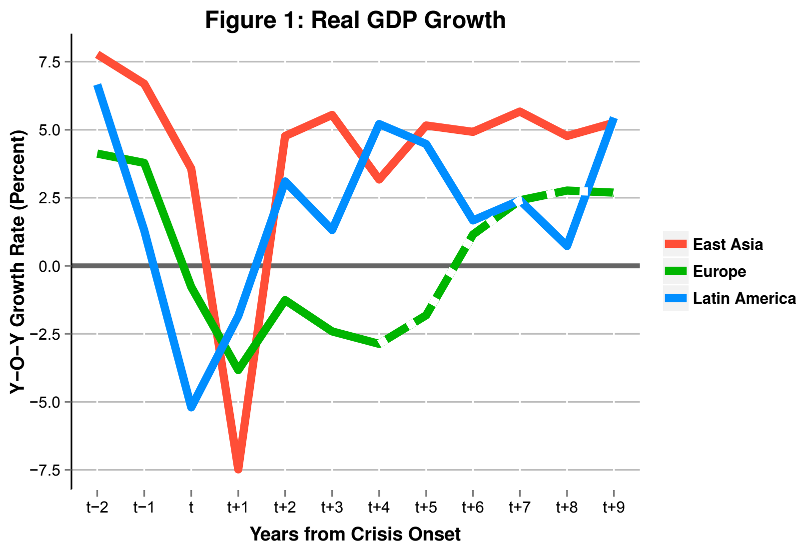
In this paper we compare 3 crises

- The parallels between them are self evident.
- But also the differences:
- The Asian crisis was V-shaped; the Latin American crisis was L-shaped.
- Increasingly the fear (and the reality) is that Europe will resemble Asia.
- That's the picture suggested by outcomes and forecasts to date.
  - In Latin American it took 9 years to return to sustainable growth.
  - The good news is that Europe is already halfway to its lost decade.



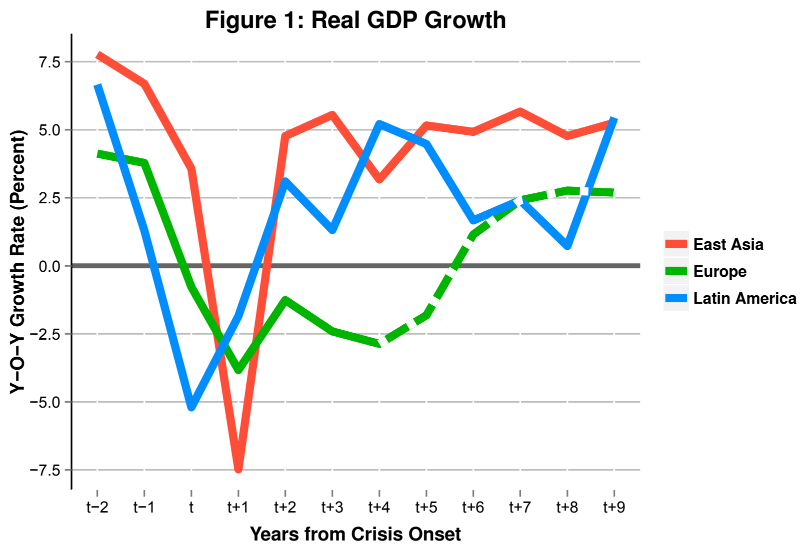
Additional differences: debt

- While much Latin debt was held by foreigners, much Eurozone debt is held internally.
- This makes restructuring easier economically (by amending the ESM Treaty to address holdouts, for example) but also more difficult politically.
- In Greece, it took "only" four years to move to meaningful debt restructuring.
- But there has been a reluctance to extend restructuring to official creditors.
- And there has been a reluctance to generalize the policy.
- Although we can now ask whether Cyprus will open a new chapter.



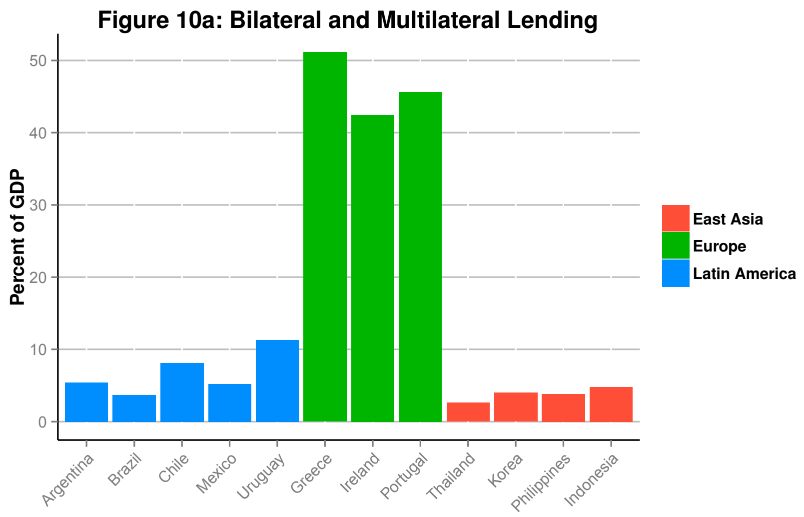
Additional differences: exchange rates

- Latin American had help from exchange rate depreciation, which facilitated adjustment through exports.
- Eurozone members, in contrast, lack an exchange rate to adjust.
- Of course, the Latins also suffered from adverse balance sheet effects of currency depreciation (given prevalence of foreign currency debt).
- And the Eurozone in principle possesses an exchange rate that could be depreciated against, inter alia, the dollar, although the ECB remains reluctant to go there.



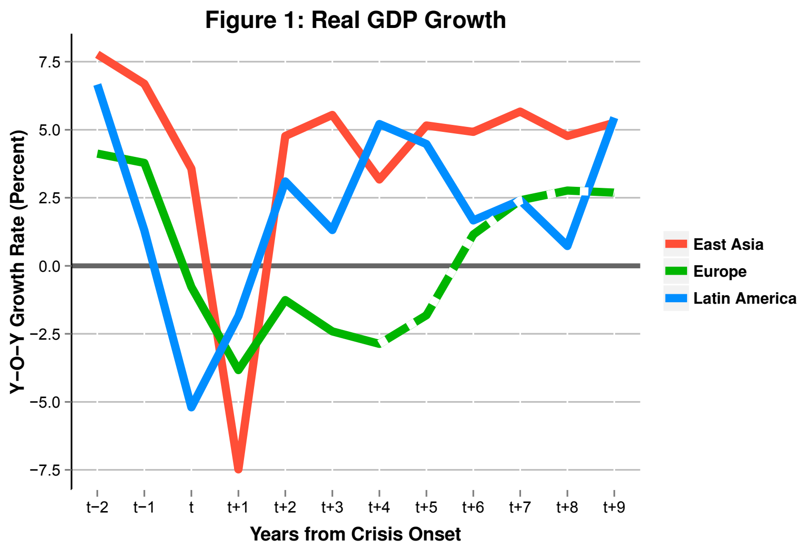
Additional differences: politics

- Eurozone countries are members of a regional economic and monetary bloc.
- This confers obligations, but also opportunities.
- This creates scope for external assistance (which has, in the event, been more extensive than in Latin America or Asia).
- There is scope for banking union, fiscal union and political union (opening up avenues for resolving the crisis not available elsewhere).
- Though there has been a reluctance to capitalize on those opportunities to date.



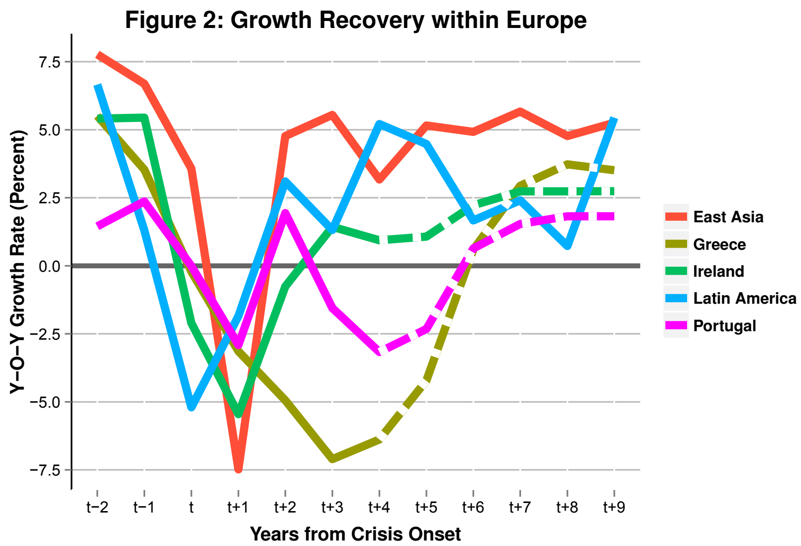
The other obvious comparison is with the United States

- A large literature considers this.
- Theory of optimum currency areas considers:
  - Labor mobility, fiscal federalism, asymmetric regional shocks.
- But neglects banking union (reflecting circumstances of 1960s-1990s).
- This turns out to have been a fatal omission/mistake.
  - Perhaps understandable under the circumstances, but no less regrettable now.



How we do our ocular analysis

- We center individual country observations on crisis years (as in Table 1).
- We take simple averages of the country cases enumerated.
- Some controversial decisions required about who to include and exclude (see paper).
- There is also some controversy over the realism of IMF WEO forecasts (denoted by dotted lines).



Austerity

- Most controversial aspect of crisis response in Europe, to put it mildly.
- Figure 3a shows that deficits were substantial in the now-crisis countries even before the crisis (reflecting mainly behavior in Greece and Portugal) – though there were also exceptions (Spain and Ireland).
- Asian countries, the figure reminds us, didn't have overt fiscal problems prior to their crisis.
- Latin Americans had long history of budget deficits and borrowing, though there were signs of improvement in the run-up to the crisis.

Figure 3a: Fiscal Balance

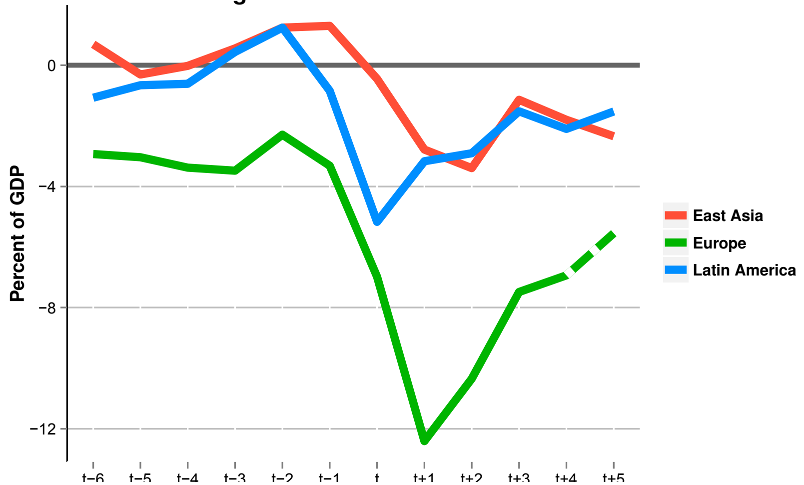
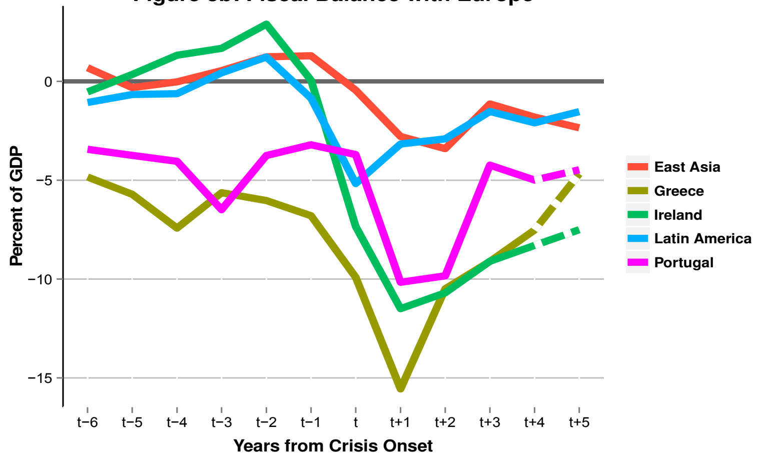


Figure 3b: Fiscal Balance with Europe



- Of course, what makes Europe different is high debts (immediately to right).
- This in turn prompted unusually large fiscal adjustments (compared to Asia and Latin America, at right below).

Figure 4b: Public Sector Debt

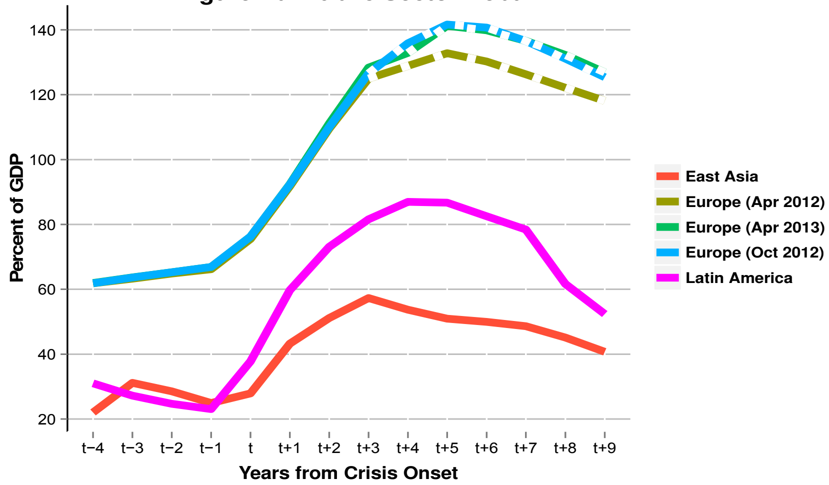
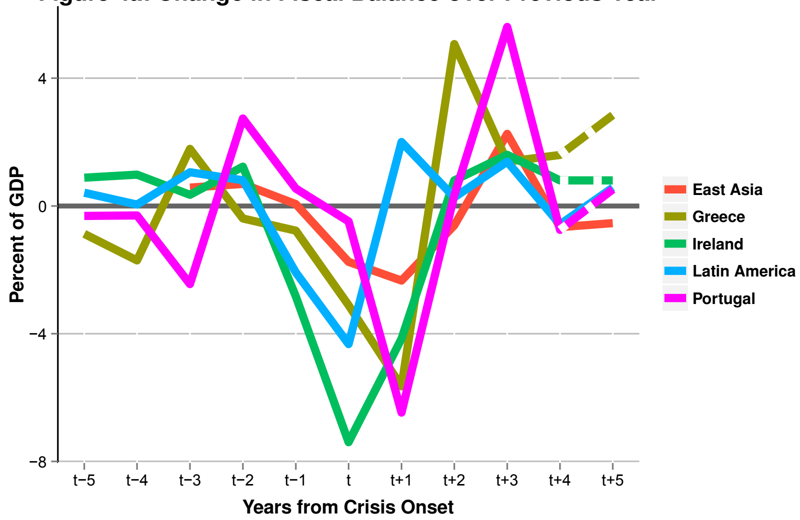
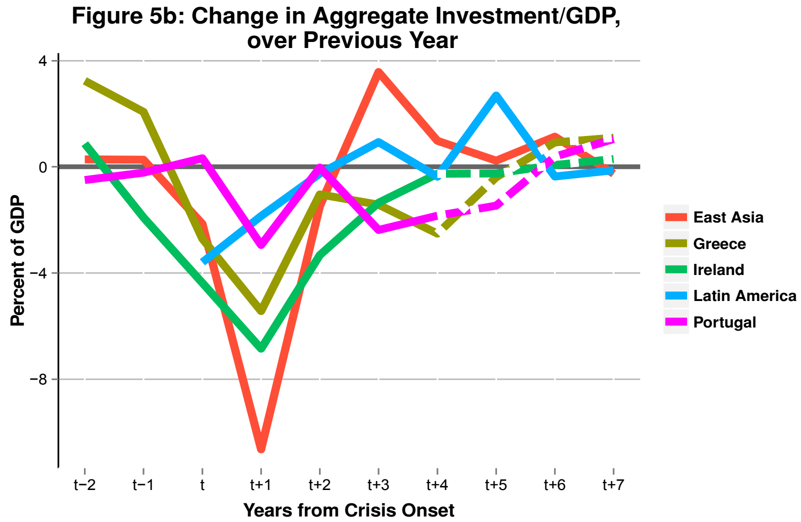


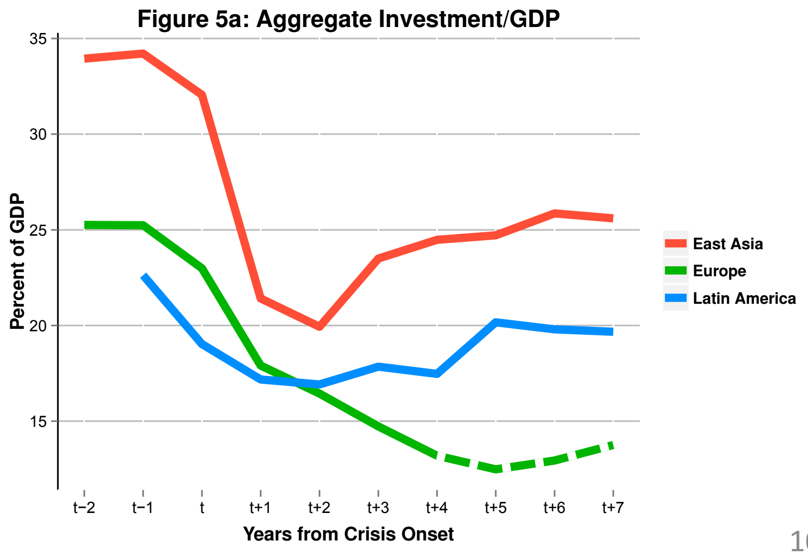
Figure 4a: Change in Fiscal Balance over Previous Year



Investment slumped in all three cases

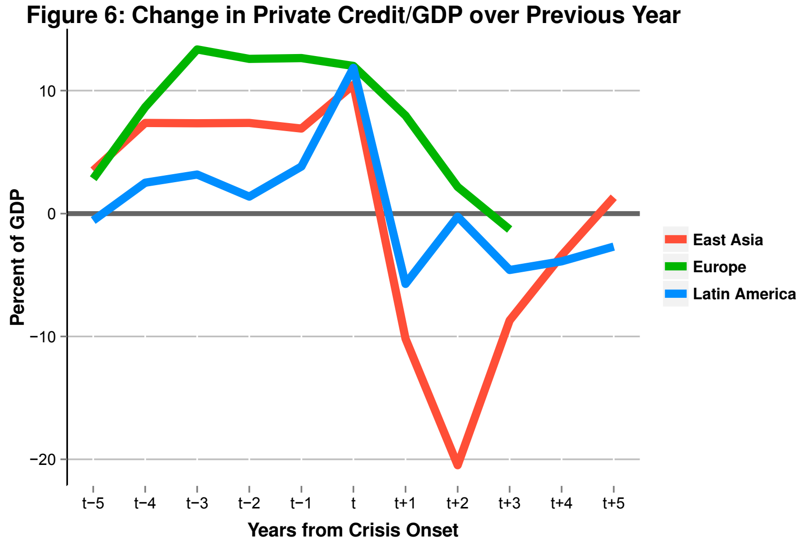
- The sharpest fall was in the Asian crisis (top panel).
- Arguably reflecting the extent to which investment had been boosted to unsustainable levels (and low-quality investments had been pursued).
- But in Asia investment growth went positive again within two years of the crisis.
- Even in Latin America, some recovery of investment is evident within three years.
- No such recovery is apparent (or, for that matter, on the horizon) in Europe.
- WEO forecasts suggest that investment growth in the crisis countries may turned positive in year t+7!





Problems of financing investment are part of the story

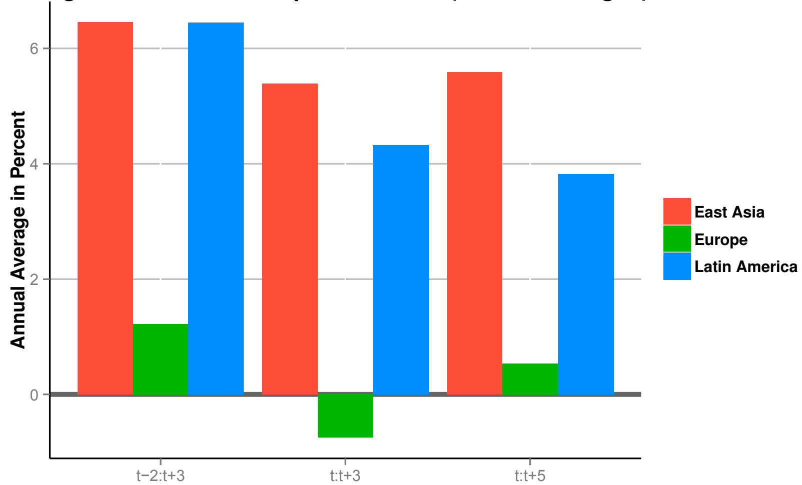
- Part of the explanation for the investment slump is the collapse in private credit growth.
- East Asia, with its banking crisis, had an even more dramatic collapse.
- But also recovery in credit growth, reflecting quick measures to clean up banking system (contrast Korea with Europe).

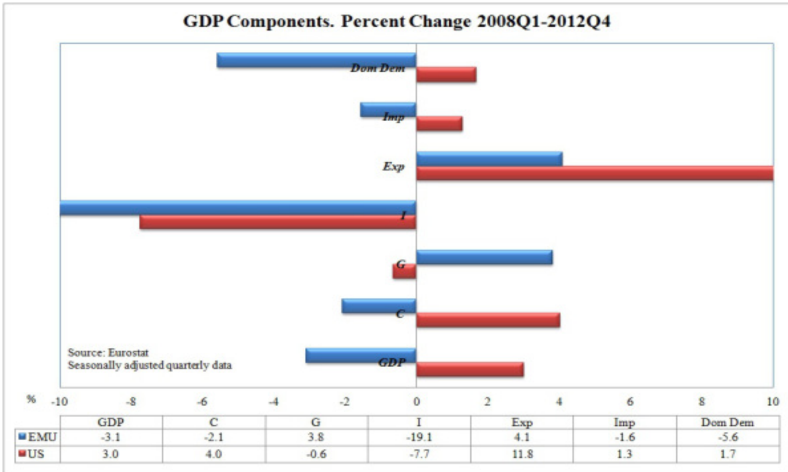


Exports

- Exports are a bright spot for Europe.
  - Everything is relative….
- Indeed, the only things keeping the eurozone alive are net exports and government spending (!).
- But a comparative perspective with Latin America and Asia suggests that Europe should be doing better.

Figure 7: Growth of Export Volumes (annual averages)

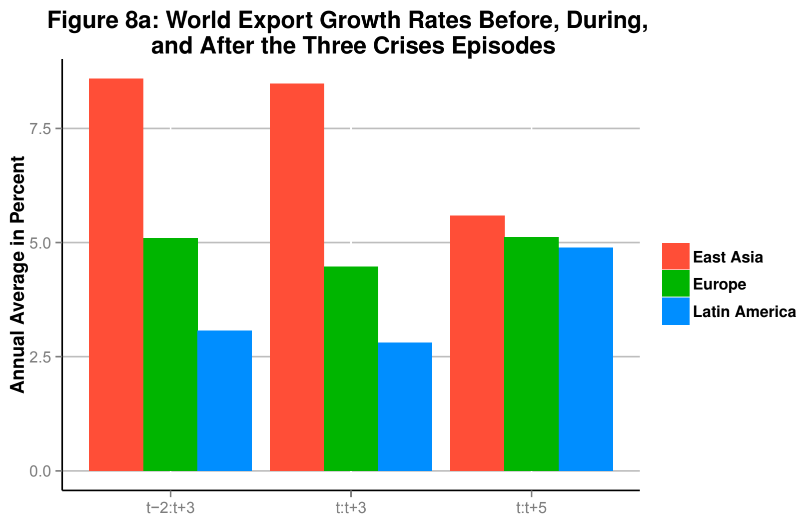


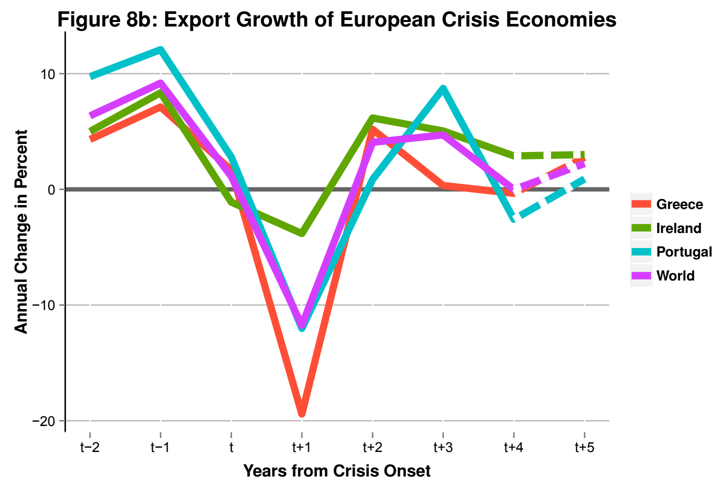


	GDP	C	G	I	Exp	Imp	Dom Dem
EMU	-3.1	-2.1	3.8	-19.1	4.1	-1.6	-5.6
US	3.0	4.0	-0.6	-7.7	11.8	1.3	1.7

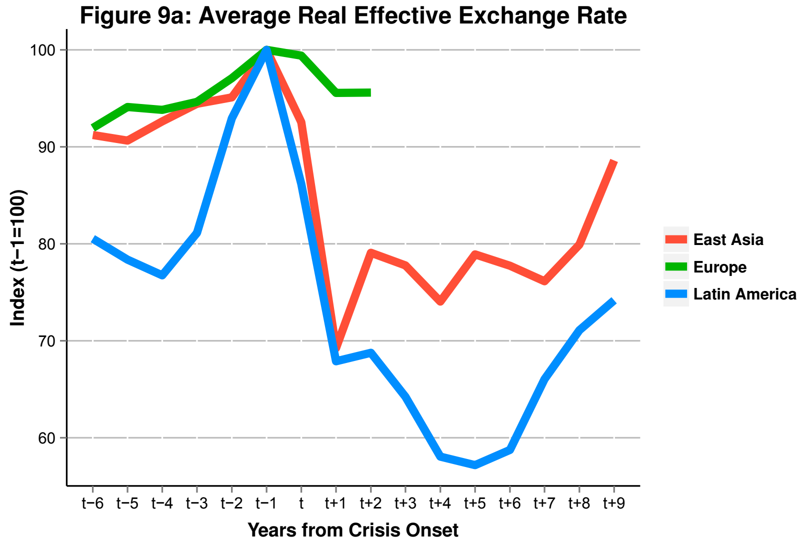
Exports

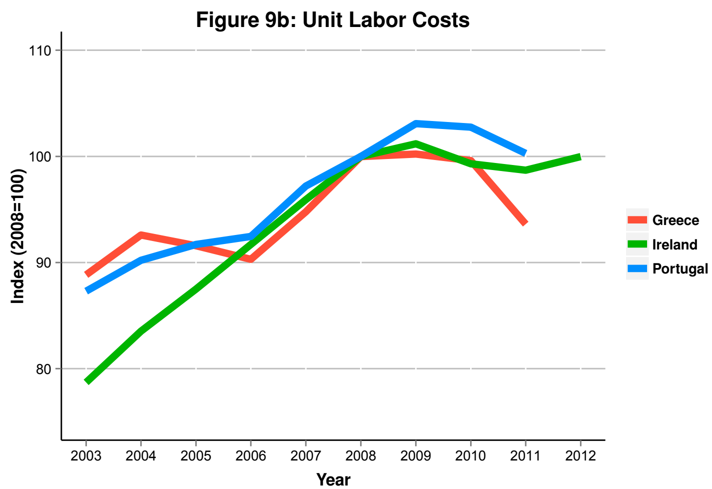
- Asia, of course, was a fast-growing catch-up economy.
- (But why not Greece?)
- Asia also had a more favorable external environment.
- We see from the bottom panel that world exports slumped right at the time of the crisis (2008-9).
- Note however that the external environment facing Latin America in the 1980s was not all that much more favorable.





- At least as important as an explanation for the export response was real exchange rate adjustment.
- Much more dramatic in both Asia and Latin America. It helps to have a nominal exchange rate under thee circumstances, or so it would appear.
- We are now beginning to see some unit labor cost adjustment in Greece and to a lesser extent Portugal and Ireland. But the response is limp by the standards of our two previous crises.
- Moreover, we have the fear in Europe that some of the apparent adjustment is an illusion insofar as it reflects compositional effects.
  - O'Rourke and Taylor (2013) report that the unit labor cost adjustment in Ireland essentially goes away once one takes this compositional effect into account.





European solidarity

- Has resulted in much more official assistance than in previous crises (even if it doesn't always feel like it).
- Also much more than AGH received in 1930-1.
- Result is that the crisis countries of Europe have been able to continue running current account deficits and been forced to compress spending by less (until now).

Figure 10a: Bilateral and Multilateral Lending

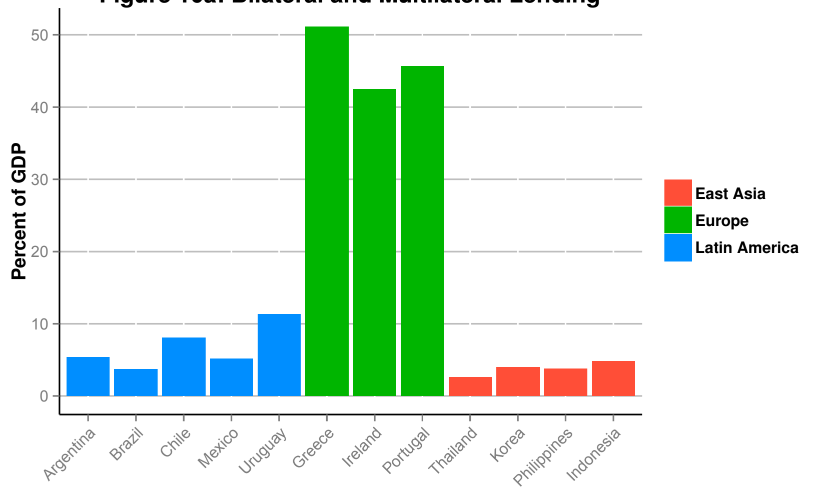
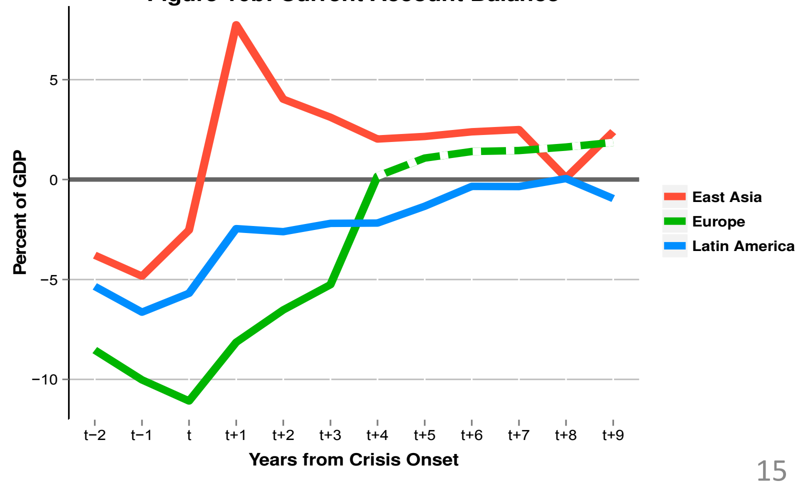
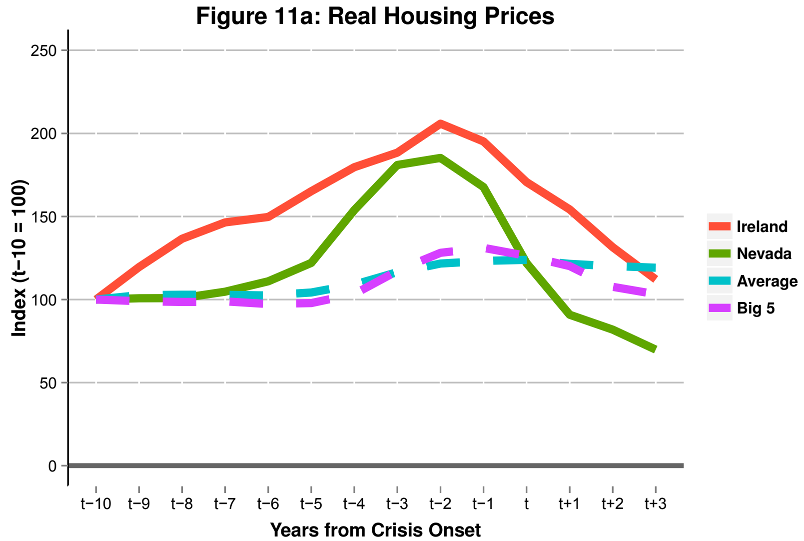


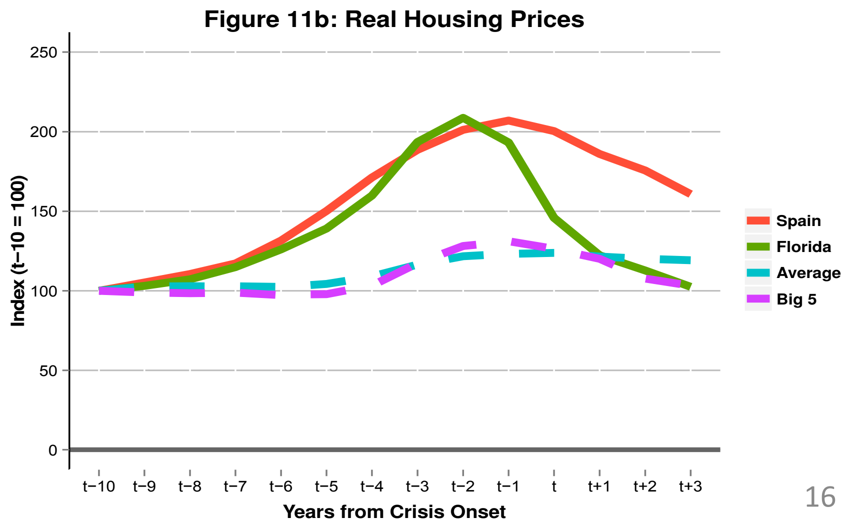
Figure 10b: Current Account Balance



Finally we consider the property boom and bust side of things

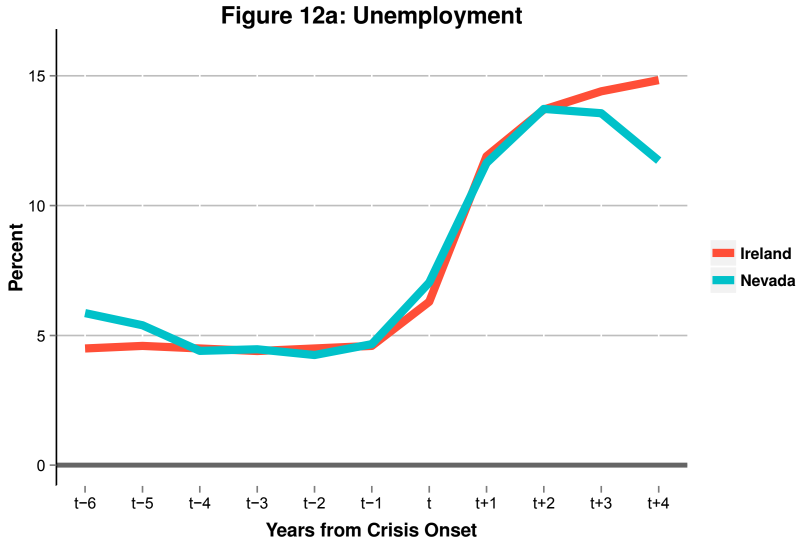
- Where here the relevant comparisons are Ireland and Spain vs. Nevada and Florida.
- Economies of similar size. Remarkably similar property run-ups.
- Much bigger ups and downs than in other financial crises (also shown at right).
- The main difference evident in the figure is that there has been relatively little downward price adjustment in Spain following the bust (as yet – suggesting more banking and financial problems to come).

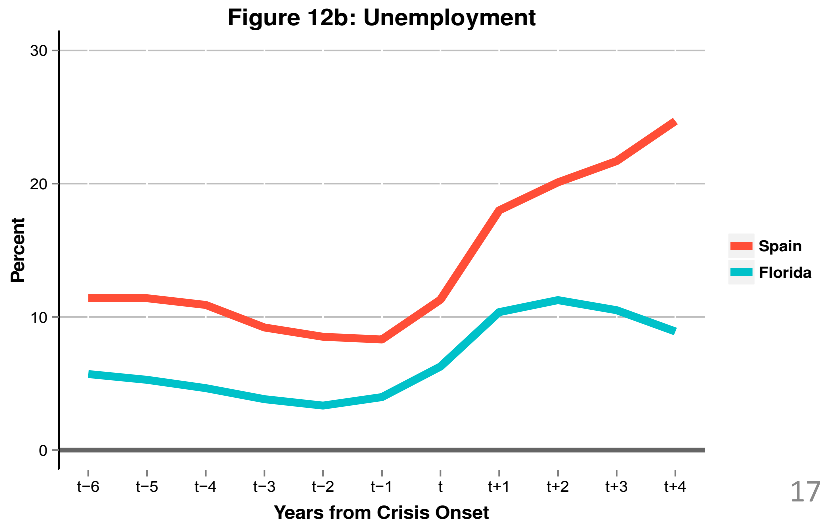




Similar consequences for unemployment

- Especially in the Irish-Nevada comparison. (Spanish unemployment is different.)
- But we see a decided divergence after 3 years, indicating less adjustment in the European case.
- This appears to reflect mainly migration as opposed to bank recapitalization/stimulus. Florida only returned to positive growth as measured by real per capita GDP in 2012, four full years into the crisis, while Nevada barely squeaked out positive real per capita GDP growth in 2011.





We see here more evidence of US labor market flexibility

- This difference is already evident before the crisis. There appears to be less of a real wage run-up/loss of competitiveness in the Sand States, presumably reflecting inward migration during the boom.
- There is then the need for less internal devaluation afterward, since inward mobility gives way to outmigration.

Figure 13a: Real Hourly Wages

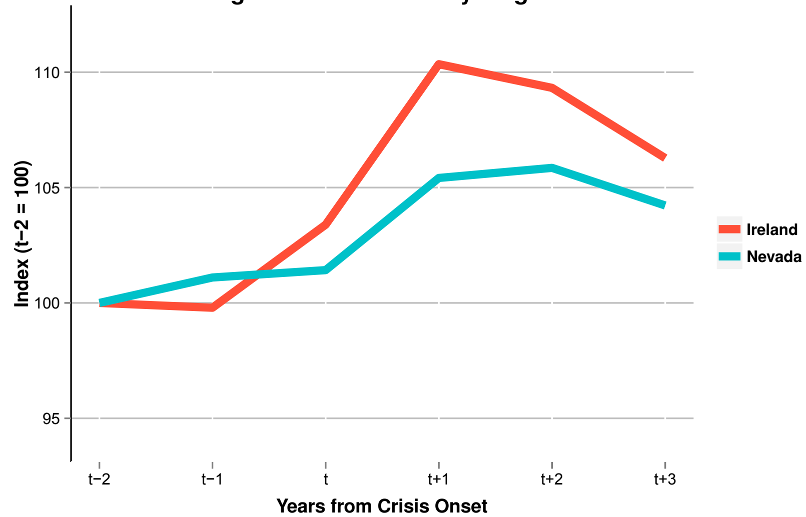
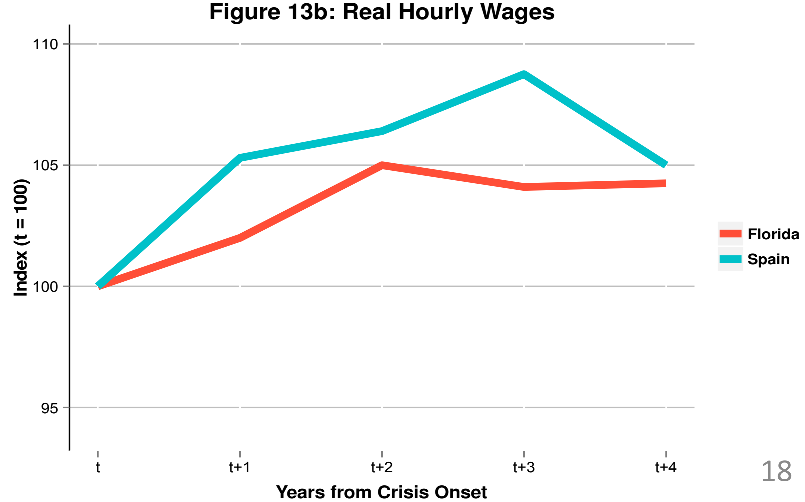
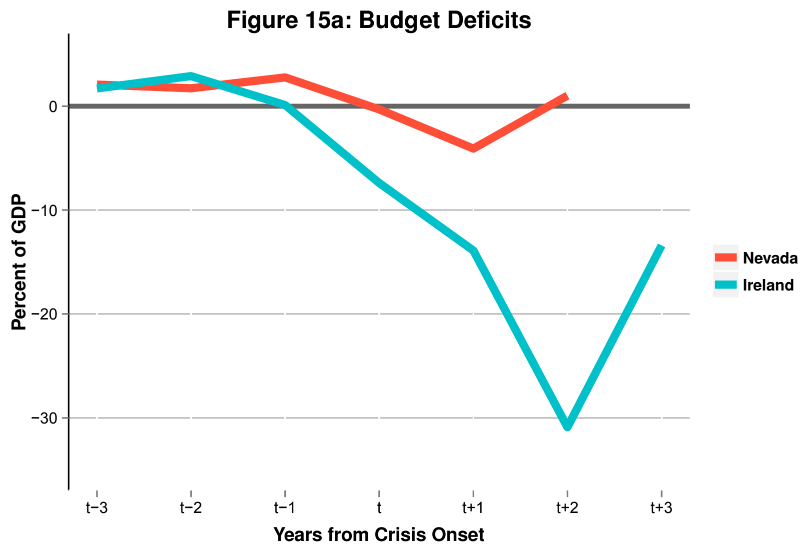
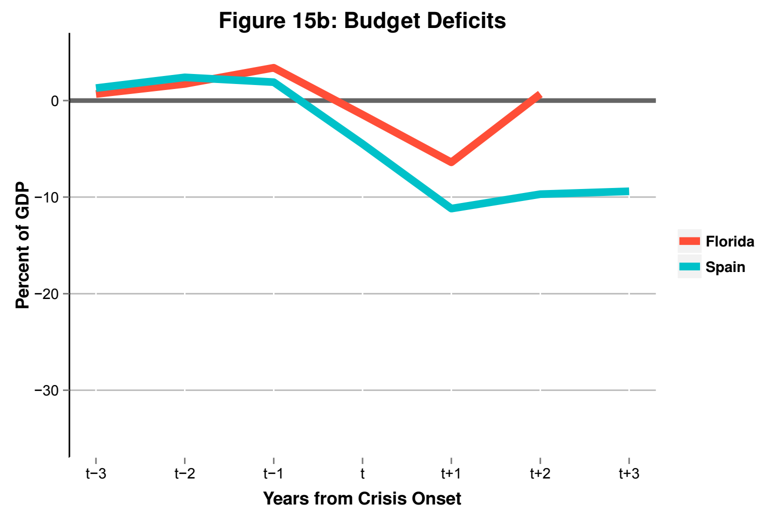


Figure 13b: Real Hourly Wages



- Finally, it is self-evident that neither Nevada nor Florida have debt and deficit problems comparable to those of troubled European sovereigns.
- Mobility of tax base encourages tax competition.
- Balanced budget statutes and amendments limit the accumulation of debts.
- There still is some ability to use the budget countercyclically (to accumulate rainy day funds in good times and run them down in bad times).
- The less positive way of putting it is that the degree of automatic stabilization through US state budgets is less.





- That is made up for through interstate transfers, of course.
- These accounted in Nevada's case to approximately 15 per cent of state GDP in each of the first 3 years of the crisis.
- This includes stimulus funds paid directly to the states plus Medicaid assistance and other assistance.
- Considerably larger than in Europe.
- Finally there are transfers through the FDIC, which helped to resolve the state's bad banks. These transfers, born by shareholders and customers of banks nationwide (which paid the fees that allowed the FDIC to absorb losses), turned out to be relatively small (3 per cent of Nevada GDP by our calculations) but significant nonetheless. To this we might want to add losses taken by Freddie Mac and Fannie Mae through charge-offs and foreclosures.

Assessment

- The comparison suggests that Europe's recovery remains disappointing.
- Our ten-word explanation focuses on "Austerity, difficulty of adjustment, chronic banking problems and debt overhang."
- Europe entered its crisis with heavy public debts compared to both Latin America and East Asia.
- This constrained or at least was perceived as constraining the choice set.
- The negative effects of austerity have been compounded by the difficulty of adjustment.
- Export growth has not made up for domestic demand compression.

- In addition, there has been the absence of monetary policy adjustments to help offset the effects of fiscal consolidation.
- The importance of this second dimension is underscored by the fact that not only is export performance weaker in Europe but that the same is true of private consumption, public consumption and investment alike.
- The long investment slump is particularly alarming – more so insofar as European regulators have exercised forbearance and bank credit held up relatively well in the initial phases of the crisis.
- But slowness in recapitalizing banks means that domestic credit now continues to decline, dragging down investment with it (or at least hindering the investment recovery).
- This failure to move faster and more forcefully to resolve problem banks and inject additional capital is, in our view, a critical aspect of Europe’s crisis.
- There are important first-mover/free-rider problems here. Thus we continue to think that banking union is key (if not formal banking union in the short run at least more effective peer pressure to address festering banking problems).

- Finally there is the reluctance to contemplate debt restructuring.
- Both East Asia and Latin America moved in this direction (East Asian countries quickly because debts were heavily private and could be restructured through domestic bankruptcy procedures, Latin America ultimately with the help of the Brady Plan).
- The worry in both cases was that restructuring would damage bank balance sheets.
- Here the fact that much Eurozone debt has migrated onto official balance sheets is both a good thing (economically) and a bad thing (politically).
- We are confidently that de facto restructuring is coming , whether through principal write-downs (more efficient) or conversion of official obligations into zero coupon, infinitely lived, effectively zero return debts (more expedient politically).
- The lesson we draw from Greece's crisis is that restructuring is viable and that it is likely to take place more widely (in Portugal, Spain, Cyprus, possibly Italy).
- And there is nothing wrong with that.

- If an accurate diagnosis of Europe’s problem is “austerity, difficulty of adjustment, chronic banking problems, and debt overhang,” then the corresponding solution is:
  - (i) back-load the austerity
  - (ii) provide more monetary support for adjustment
  - (iii) clean up the banking system, and
  - (iv) restructure the debt.
- This isn’t rocket science.

- Thank you.