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European Monetary and Fiscal Policy: Transatlantic Perspectives

SAIS/CTR & The Cournot Center For Economic Studies

The 2010 European Debt Crisis Response and Longer-Term Implications

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Outline

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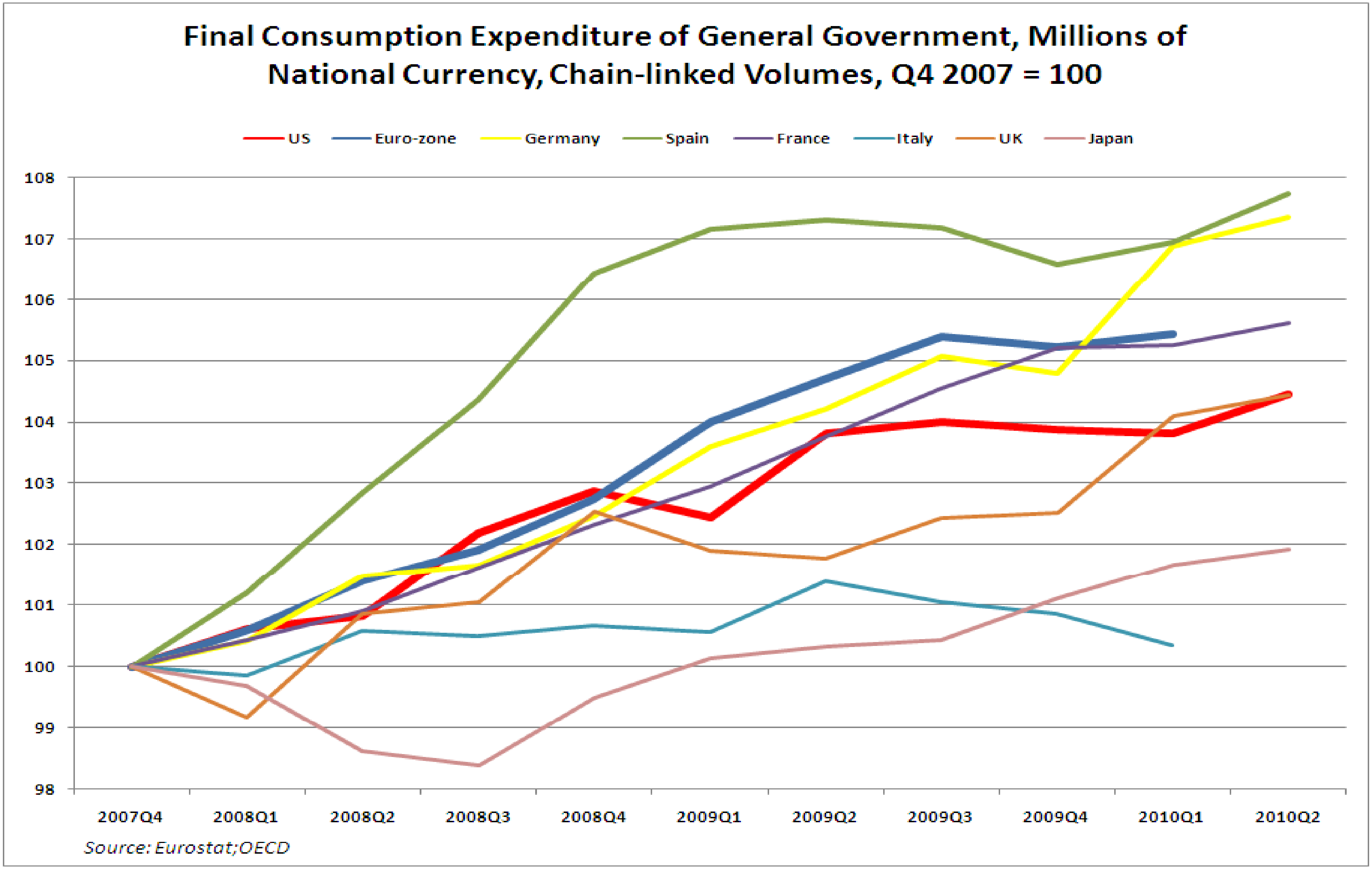
1) Two Trans-Atlantic Comparisons

2) The European Crisis Diagnosis and Response

3) Longer-Term Implications

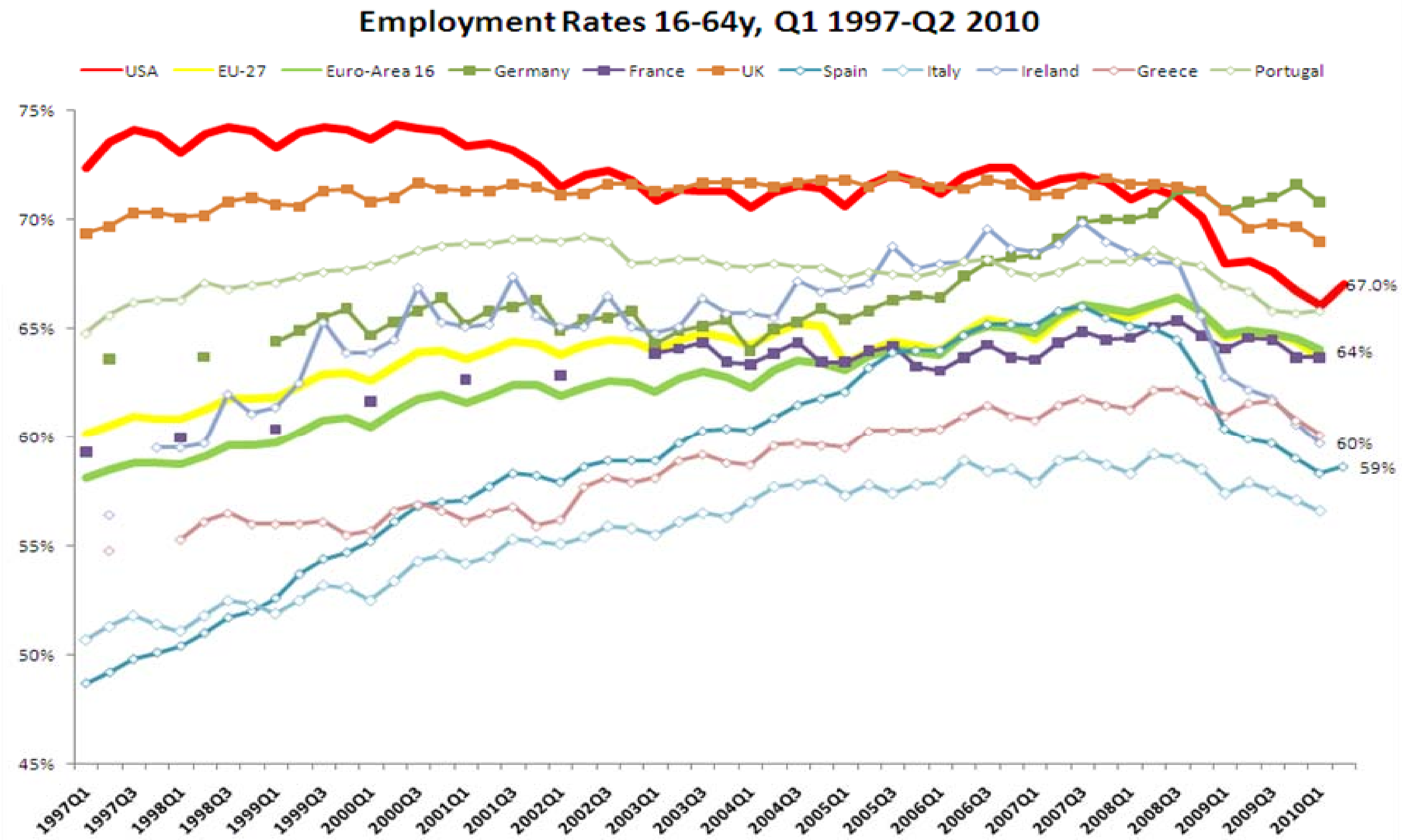
Trans-Atlantic Comparisons:

Actual Fiscal Stimulus During the Crisis



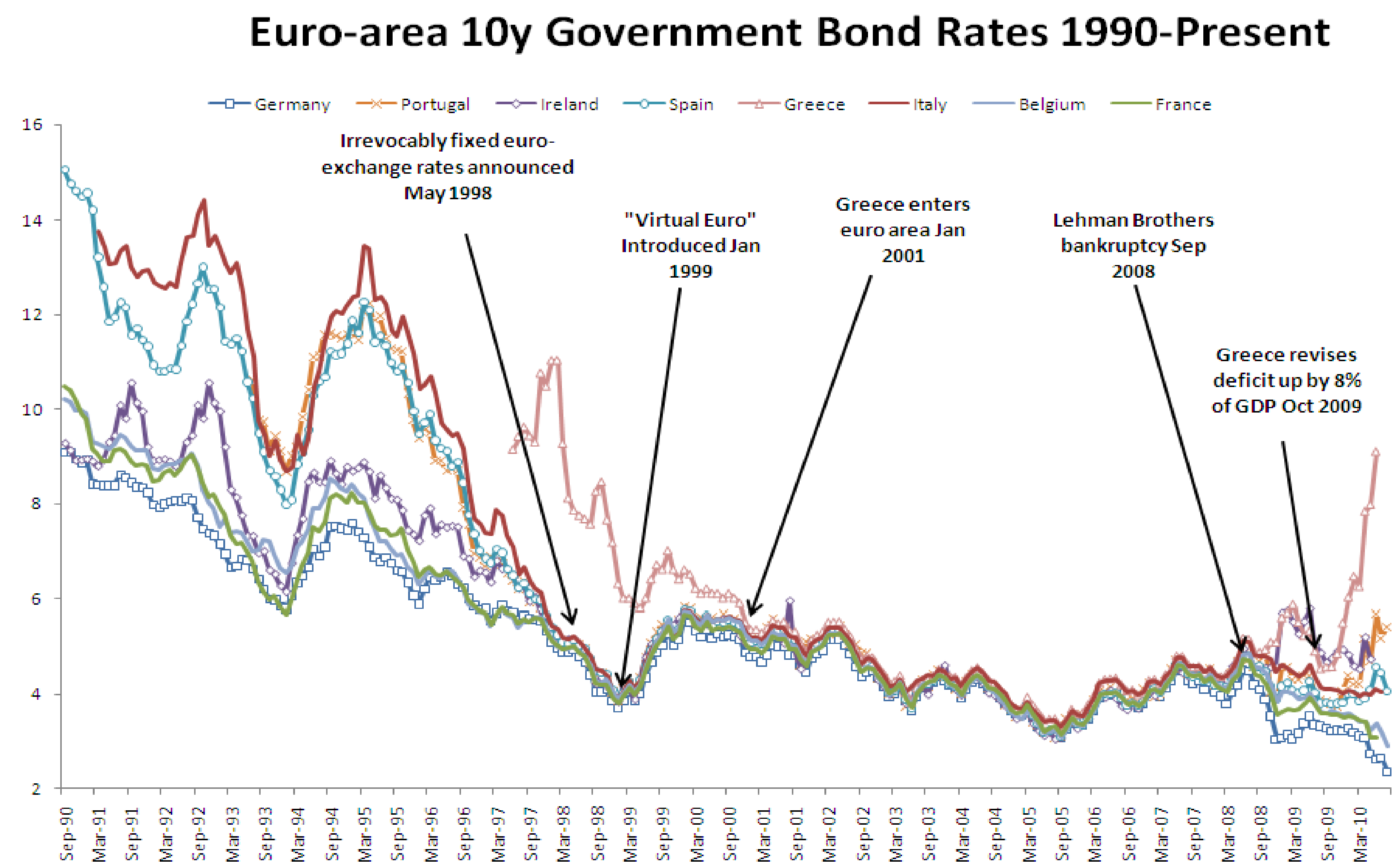
Trans-Atlantic Comparisons:

The Broader Employment Picture



Note: Seasonally Unadjusted Household Survey Data. *Source: BLS; Eurostat*

The European Crisis Diagnosis



Note: Belgium 6y or longer maturities. *Source: Datastream*

The European Crisis Diagnosis

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Design Flaws, BoP or Fiscal Crisis?

No agreement exists regarding the cause of the European debt crisis;

1) <u>Design Flaws (Milton Friedman):</u> The inevitable result of a flawed construction of a monetary union not being reasonably close to an OCA, i.e. without labor mobility or a central transfer mechanism/fiscal union?

2) <u>Balance of Payment</u>: The inevitable result of a loss foreign financing for excessively large current account deficits, arising from competitiveness divergences, i.e. peripheral inflation and German wage compression?

3) <u>Fiscal</u>: The inevitable result of unsustainable fiscal policies/growth strategies, which markets ignored for ten years and then suddenly post-Lehman woke up to when the real estate/construction growth model collapsed?

In my opinion, it was mostly 3), although 2) played an unhelpful role

The European Crisis Management Process

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Amateurish and Easy To Point Fingers, BUT:

1) No institutional experience in Brussels/national capitals in communicating in "real time" with financial markets (first 2am moment for the EU)

2) Very hard to coordinate 27 countries in multilayered regional group + a genuinely independent ECB + European Commission

3) Numerous EU policy U-Turns All "In The Right Direction"

   i. Starting at "small number (~€10-15bn) with no IMF involvement" (February)
   ii. Ending at "BIG number (€750bn) with 100% IMF conditionality" (May)
   iii. ECB from absent (as in Eastern Europe) to pan-European lender-of-last-resort
   iv. Years late, some improvements in bank transparency with stress tests

4) TARP was initially rejected by U.S. House and was widely criticized at the time, but proved beneficial

Europe's "Grand Bargain" of Early May 2010

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1) ***ECB Agrees To***;
   I. "At Will" purchase government/private bonds in secondary market
   II. "At Will" accept any government (and guaranteed) bonds as collateral (April)
   III. Guarantee the liquidity of any euro-zone credit market as a "lender of last resort" through its balance sheet
   IV. Despite (mostly) sterilized interventions, ECB has expanded its own mandate significantly beyond "Bundesbank Legacy" ("real QE" remain impossible!)

2) ***EU (Euro-zone) Member States Agree To***;
   I. Provide funding for EFSM/EFSF (e.g. *crisis-only euro-bonds*)
   II. Implement dramatic and politically painful austerity measures
      i. For Southern left-wing governments, a "Nixon goes to China" moment
   III. Agree to a longer-term "fiscal straight-jacket" revision of the SGP
   IV. Accelerate pro-growth structural reforms in labor markets and social systems

<u>**In Sum: The "cyclically adjusted rigidities in Europe" proved much smaller than feared pre-crisis**</u>

Who Pays for "Europe's Response"?

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- In extremis, Germany and France pays just over 40% of the total cost
- The political challenge of approving "bailouts" of a scale surpassing TARP to "other countries" should not be underestimated
- Precedent for bailouts introduces large-scale political and economic moral hazard into the EU
- Unsurprising that longer-term "institutional response" focuses on limiting moral hazard

Maximum Potential European Liabilities, €bn

	Total	Germany	France
EFSF (120% share)	440	147	111
EFSM (EU Budget Share)	60 (+35)	19	15
Greece Program	80	22	17
ECB SMP (Sep 24th 2010)	61.7	17	12
Total	581.7	205	155
Scaled to U.S. GDP Levels		*872*	*826*
Addendum			
Via IMF; Greece Program	30	2	2
Via IMF; Anticipated Future Participation	250	15	12

Source: ECB; EU Council; Commission; IMF

The Euro-zone "New Normal"

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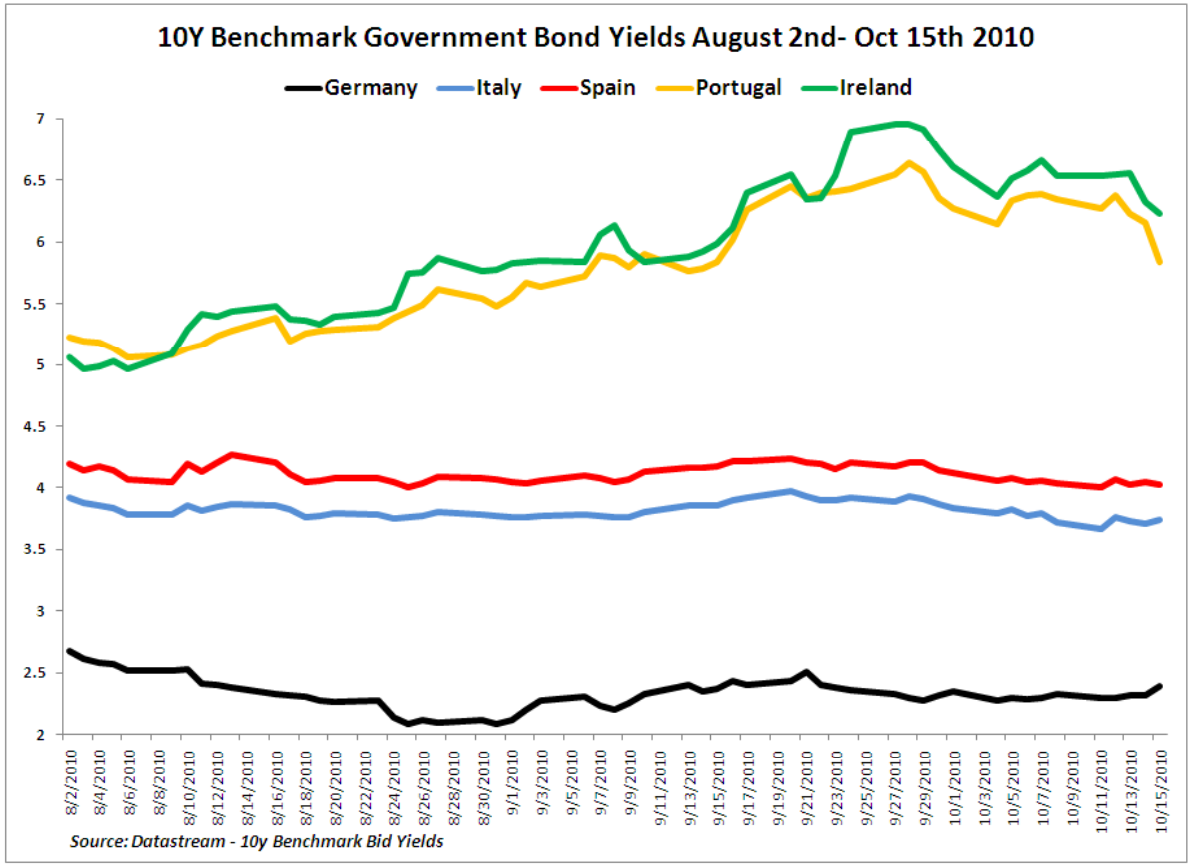
- Portugal and Ireland now in the "market crosshair"

- Deficient policies met promptly by "default premia"

- The problematic periphery right now consists of only small countries (might change again in the future)

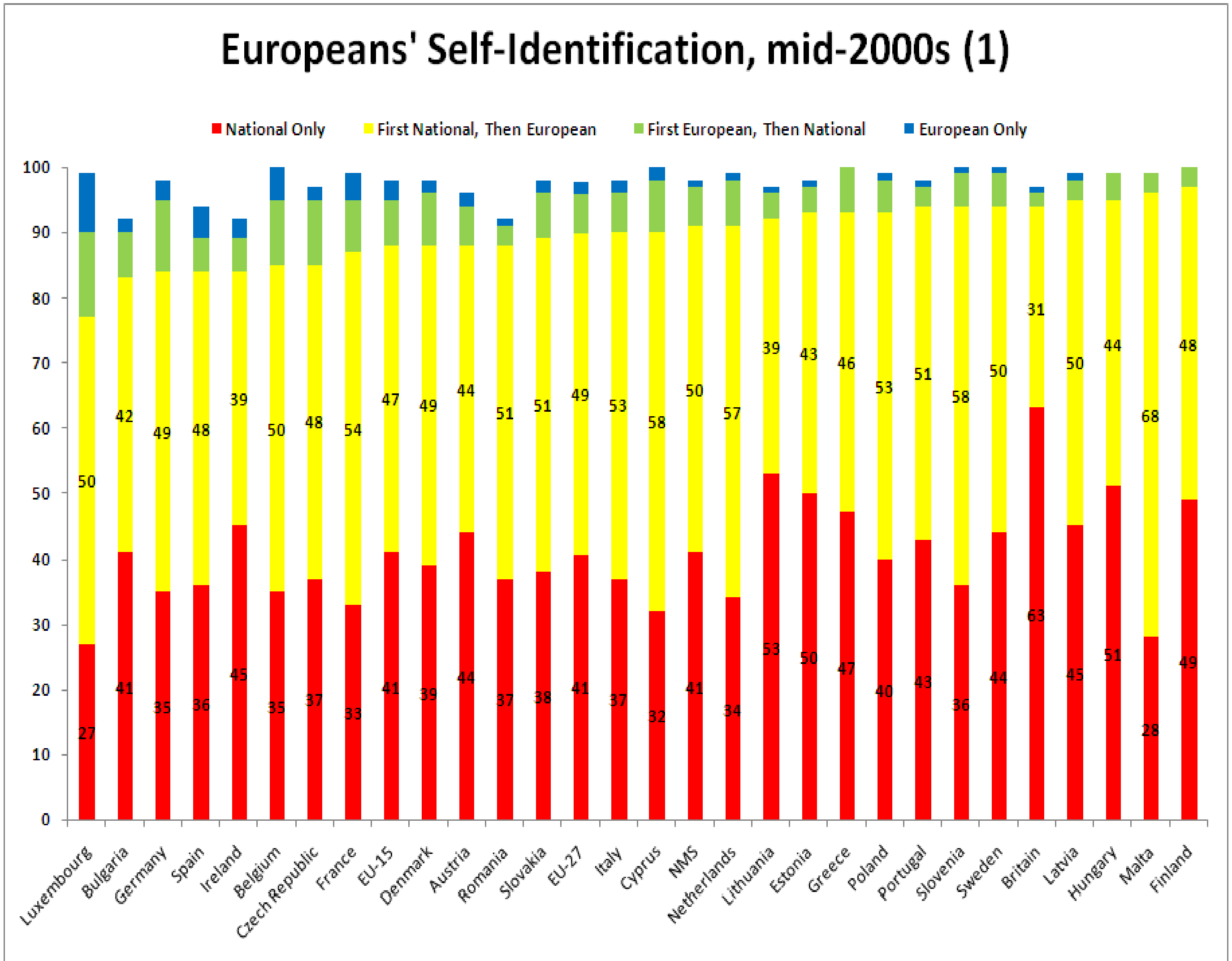
- Small states likely to be bailed out using ~€100bn in ESFM like Hungary (€6.5bn), Latvia (€3.1bn) and Romania (€5bn)

- Unlike the EFSF, §122.2 in TEU does not expire in 2013



Some Political Considerations Regarding The Longer-Term Response

- Prohibitively high political barriers in the “age of referenda” to “fiscal union” (or a higher EU budget)
- Populism a result of “economic consensus” on austerity/structural reforms (center-left abandons “Looney Left welfare policies”)
- Populist parties combine right-wing anti-immigration rhetoric with “Looney Left welfare policies” (threat to mainstream center-left)



1) Answer to Question "In the near future, do you see yourself as....?". "Don't Know" answers excluded. *Source: Eurobarometer 64.2*

Longer-Term Implications

1) **A Greek default now less risky and hence more likely (End-2011)**
   I. "Extension of the EU/IMF Program" = political spin for "Default"
   II. More public money to Greece not politically possible without "bailing in" private creditors
   III. Haircuts will be the price for any extension – ECB's new collateral haircuts (enforced from Jan 1 2011) likely the lower threshold

2) **Why Europe's fiscal austerity will be more credible this time**
   I. Multiple European sovereigns have their backs against the wall
   II. Huge and rapidly applied default premia back within euro-zone = bond markets will enforce fiscal sustainability in real time
   III. Unlike the US, weak euro-zone sovereigns have no chance to grow out of current debt levels (e.g. market scrutiny won't disappear)
   IV. The "demonstration effect" of Greece's demise will cause the domestic political costs of fiscally irresponsible policies to rise dramatically in Europe
   V. Fiscal austerity electoral platforms has triumphed in all EU national elections since May 2010 (Latvians reelected their government after a 20% drop in GDP/capita!!!)

The Longer-Term Political and Economic Implications of the Crisis and the Response

4) **As the "Euro Asset Safehaven" Germany has been vastly politically strengthened by the crisis within the EU**
   I. Germany has reaped the benefits of a decade of tough structural reforms
   II. Peripheral countries can no longer escalate conflicts with Germany
   III. Without serious fiscal reforms France will lose "resemblance of parity" to a Germany with a balanced budget and strong AAA (e.g. be like Italy in the EU)

5) **"Moral Hazard" in the EU to be controlled at multiple levels**
   I. IMF-like conditionality on all bailouts (Ex post)
   II. A more credible SGP focused on quasi-automatic sanctions (Ex ante)
   III. <u>Possibly</u> a euro-zone "Orderly Debt Restructuring Mechanism" (ODRM), e.g. a euro-zone SDRM (Ex ante – governments/Ex post – private creditors)
   IV. "Voluntary ODRM" = bail-in of private creditors + increase bond spreads and German political power in exchange for a permanent EFSF (no Treaty change)

6) **The real long-term political challenge is the "end of automatic economic convergence" for the periphery in the EU**
   I. Potential new members of the euro-zone won't rush to join prematurely
   II. ECB monetary policy will remain quite accommodating for some time to avoid pushing peripherals over the edge