# THE EURO CRISIS. POLITICAL AND ECONOMIC PERSPECTIVES

## Sessions 8-9: The Management of the Crisis and Beyond

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# Outline

The policy debate in 2011

The Austerity Debate

The politics of the Euro Crisis

# Section 1

## The policy debate in 2011

# Diagnosis and solutions for market tensions in 2011

- Diagnosis:
  1. Lack of fiscal discipline among Euro members $\Rightarrow$ need to send a clear market signal
  2. Lack of competitiveness in deficit countries $\Rightarrow$ need to make market more flexible
  3. Lack of banks funding to finance real projects $\Rightarrow$ need to provide liquidity
- Solutions:
  1. Fiscal compact: old and new fiscal rules $\Rightarrow$ ways to make them credible.
  2. Structural reforms to make market more flexible
  3. ECB lending operations to banks
- No more discussion of LLR. Each side does its job to reassure the markets

# The fiscal compact

1. TSCG or Financial Stability Treaty becomes the new stricter version of the Stability and Growth Pact
2. The two-packs introduces ex-ante oversight of national budget by the European Commission (near veto)
3. The six-pack makes the **Excessive Deficit Procedure and ex post sanctions operational**
4. The six-pack introduces reverse qualified majority voting (RQMV) implying the need to reach a 4/5 majority to deter sanctions (avoid the French-German alliance in 2003)

- Introduces budget policy coordination within the European Semester
- Limits the margins of action of Euro member fiscal policies

# Lending operations to banks

- LTRO: provides at fixed rate with unlimited amounts of funding for up to 3 years: in total one trillion lent in 3 months.
- Banks buy peripheral sovereign bonds
- Market tensions ease on sovereign and bank bonds

# Beyond the fiscal management: temptative coordination

1. Macroeconomic Imabalances Procedures by the European Commission
2. Banking Union: centralized oversight of the EZ financial system (ECB becomes the single-supervisor, EBA responsible for financial regulation at the eurozone level, single resolution fund and single deposit insurance)
3. The Juncker Plan: 240 billion euros within the European Fund for Strategic Investments (EFSI)
4. Project of a Capital Market Union

# EU and US compared after 2008

- US gave priority to private deleveraging
  $\Rightarrow$ QE to support consumption
  $\Rightarrow$ Despite budget rules at the state and local government level, budget consolidation is more precautionary in the US (1% per year).
- In Europe, no QE before March 2015, no try to prop up the economy.
- But counteract credit contraction due to impairments in the banking system
- Fiscal consolidation is the priority in Europe: on average 1.5% per year, Greece 4%, Portugal and Spain more than 2%).

# Justification in Europe

- Foreign versus domestic government bond holdings
- Adverse demographic perspectives and less fiscal room
- Southern countries have had lousy macroeconomic management: stricter fiscal rules appear as a moral imperative
- Without nominal devaluation at hand, real adjustment can only occur through deflation.
- Budget contraction helps to push wages down
- Structural reforms on the labor market are an additional way to do so

Section 2

# The Austerity Debate

# A Harsh Debate

- Pros: postponing austerity causes debt defaults and bank runs, another round of financial collapses. $\Rightarrow$ Crumbling of the European monetary union
- Cons: Austerity is (almost) always a bad idea. Even European countries experiencing serious difficulties in financial markets should have continued to stimulate their economies with high levels of government spending. $\Rightarrow$ Austerity is self-defeating because the recessions it induced, or extended, **only increases government debt as a ratio of GDP** (Blanchard and Leigh ,2014).
- **What is the size of fiscal multipliers?** $\Rightarrow$ lack of consensus

# What is the effect of fiscal policy?

- Fiscal multiplier = 3 when fiscal consolidation is motivated by reducing an inherited deficit (Romer and Romer, 2010)
- Alesina, Favero and Giavazzi (2015) find that fiscal consolidation based on spending cuts are less costly than those based on tax increases AND spending cuts are even found to be associated with increases in output growth
- Iyanatul Islam and Anis Chowdhury criticize Alesina et al (2015) in "Revisiting the evidence on expansionary fiscal austerity"
- Alesina, Favero and Giavazzi (2019) "Austerity: When It Works and When it Doesn't' confirm low multipliers with spending cuts and claim only few expansionary consolidation episodes.

# Main findings of Alesina et al (2015)

- They examine the effect of austerity on output growth
- Distinction between spending cuts and tax increase
- Distinction between normal and crisis times
- Evidence that tax-based adjustment generate bigger output losses than expenditure-based ones
- Fiscal multiplier for tax-based adjustment $= 2$ while they are almost null with spending cuts.
- Little evidence that recent fiscal adjustment have larger negative output effects than past ones. It implies that past data give valuable information and no evidence that fiscal multipliers are larger during a crisis.

# Revisiting the evidence on expansionary fiscal austerity

- Alesina et al. (2015) run counter Keynes' conclusion that the best time to implement a fiscal austerity program is during a boom rather than a slump
- Iyanatul Islam and Anis Chowdhury formulate two main criticisms:
  1. Expansionary fiscal consolidation is found only in a minority of cases
  2. Factual errors and omitted variables

# From **several** to **many** cases

1. 21 cases (from a total of 107) of successful fiscal adjustment (that is, debt-to-GDP ratios decline by more than 4.5% of GDP)
2. 26 cases (from a total of 107) of âexpansionary fiscal adjustmentsâ.
3. 10 (out of 19) countries experience âsuccessful fiscal adjustmentsâ, while nine (out of 19) experience âexpansionary fiscal adjustmentsâ

Alesina et al. (2015) conclude that they find several episodes while influential media talk about "in **many** cases"

# Factual errors and omitted variables

- Factual error about Australia
- Correlation is different from causality
- Omitted variables: complementary factors at work (1) the influence of the global and regional business cycle, (2) monetary policy, (3) exchange rate policy and (4) structural reforms

# Alesina, Favero, Giavazzi (2019)

1. Are all austerity plans the same? Do they have the same effects on output, various components of aggregate demand, and the debt/GDP ratio?
2. Was the austerity round of 2010-2014 especially costly; that is, were the fiscal multipliers larger than "?
3. What is the role of accompanying policies to fiscal adjustments? What about the zero lower bound?
4. What is the role of the timing of fiscal adjustments, namely relative to the phase of the business cycle?

# Results: output response to plans

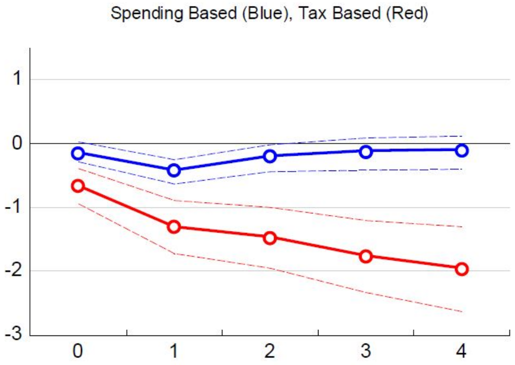
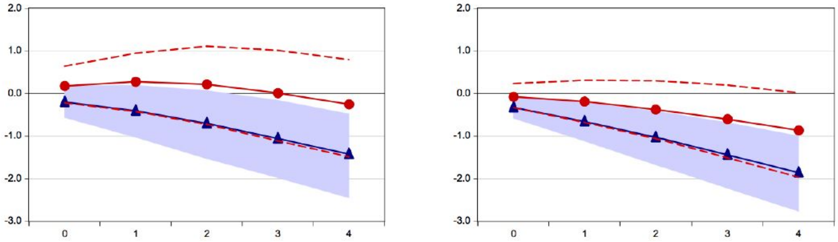



Figure: Response to an overall 1 percent fiscal consolidation: EB (blue) - TB (red)

# Results: public debt dynamics

Low interest rates environment




High debt country (left) – Low debt country (right)

# Results: consumption and investment

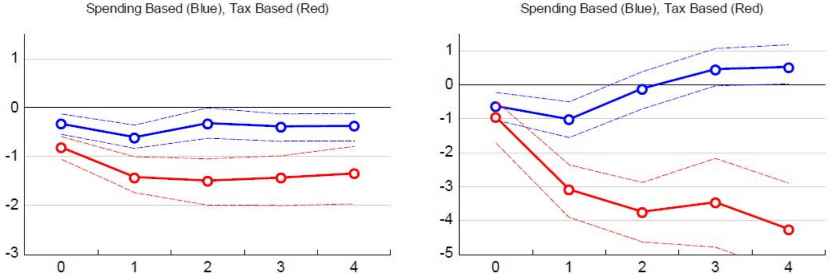



Figure: Response of consumption (left) and investment (right) to TB and EB plans

# Results: business confidence

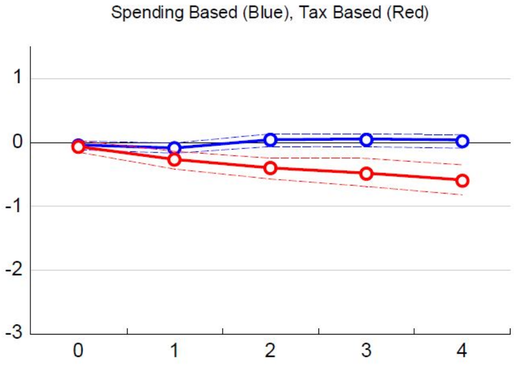


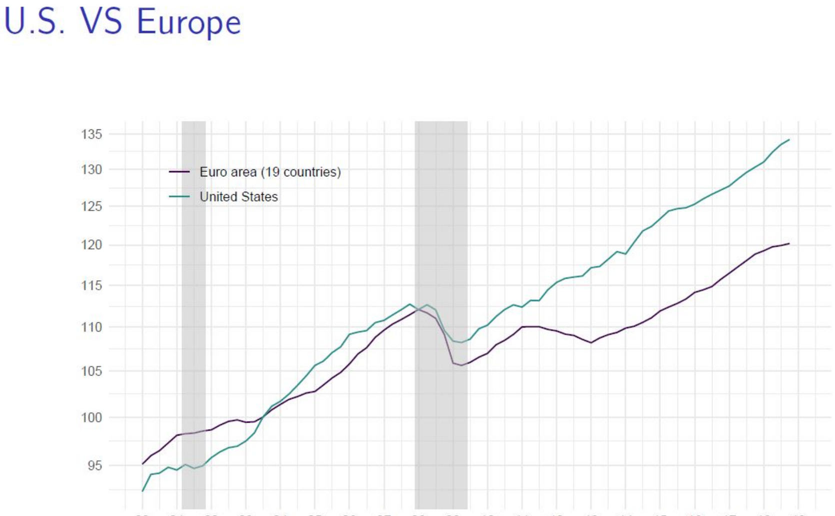

Figure: Response of business confidence to TB and EB plans

# Results

- Tax-based austerity is much more painful than expenditure-based austerity.
- Government Spending: sometimes "expansionary austerity", sometimes "recessionary austerity."
- Results now converge more to that of the rest of the literature, which has recently been surveyed in Ramey (2019): **around 3** for tax multipliers, **less than 1** for government spending multipliers.
- **Austerity is recessionary**, expecially tax-based austerity.
- Two interesting additional results:
  - Long-term Effects of Tax-Based austerity on GDP.
  - Investment Falls.

# Alternative view: watch the pervasive effects

- The main theoretical premise of the book is that that Keynesian policies are only about the short-run
- However growing evidence that demand shock such as financial crises can have permanent effects



# Alternative view: the paradox of Thrift

- Idea of austerity is to stimulate more investment (public debt competes with the private sector), through an increase in public saving $S_g$:
$$I = S_p + S_g$$
- Paradox of thrift: efforts to save more implies less aggregate saving, therefore **less investment**. This is because $Y$ falls so much that $S_p$ falls more than $S_g$ increases. (also: automatic stabilizers) Against the "Treasury View".
- But then, why are we doing this?

# Alternative views

- Tax-based multiplier is 3, implying that tax-based austerity actually reduces tax receipts $\Rightarrow$ public saving decreases AND private savings too
- An important conclusion is that austerity IS recessionary and that tax-based austerity is the *kiss of death*
- All the spending-cut austerity result relies on the idea that government spending is useless and does not crowd out private consumption. Is that true?
- What are the redistributive impact of spending-cut austerity?
- The potential free lunch of gvnt debt should not be left to the populists (cf Trump...) $\Rightarrow$ see Thiemo Fetzer (2019) showing that austerity caused Brexit.

# More questions than answers

1. Why has Austerity been so pervasive?
2. Why has the political process dragged so much?
3. Why has the euro-area not broken up yet?
4. Why EMU has no fiscal authority?
5. Are the EU institutions legitimate?

# Austerity conclusion have been influential

- Cited in the official communique of the EU finance minister's meeting
- Former President of the European Central Bank (ECB) Jean Claude-Trichet: "It is an error to think that fiscal austerity is a threat to growth and job creation. At present, a major problem is the lack of confidence on the part of households, firms, savers and investors who feel that fiscal policies are not sound and sustainable"
- Influenced the UK Treasury
- Collective opposition to countercyclical fiscal policy
- Monetary policy preferred because easier

Section 3

# The politics of the Euro Crisis

# The political perspective

- Why has the political process dragged so much?
- Why has the euro-area not broken up yet?

1. Peter Hall (2012) emphasizes different political economies conditions in the euro area
2. Jones et al. (2015) analyzes the factors of the coordination failures
3. Frieden and Walter (2017) emphasize the distributional effects of the crisis resolution

# Varieties of capitalism

- Rashomon Effect : Euro was a resounding success until it was a total failure
- Clashing narratives: fiscal profligacy versus lack of solidarity
- Peter Hall (2012) argues that the organization of political economies conditions in Europe differ too much to produce consistent economic policies

# Structural strains within EMU

- Northern European countries based on export-led growth gave them competition advantages in a monetary union.
  - Fixed internal exchange rate made their products competitive within EMU (cheaper)
  - ECB monetary policy counteracted excessive wage demand
  - Industrial relations helped wage coordination
- Southern European economies based on demand-led growth model
  - Euro reduce transaction costs and ECB monetary policy put some restraint on wages.
  - But relatively expansionary fiscal policy fueled labor cost increases $\Rightarrow$ real appreciation with no capacity to devalue

# Asymmetric policies

EMU institutional arrangement made it happen :

- Decrease in borrowing costs for Southern countries
- Export-led strategy generate surpluses that northern banks help to sustain.
- Common monetary policy has not addressed inflation in southern economies

⇒ For Peter Hall, it was not a matter of asymmetric shocks but of asymmetric policies

- But economic strategy depends on economic structures: export-led growth strategies were not feasible in Southern institutions.
- Similarity between Euro and US crises: not enough attention was paid to BoP imbalances and the drivers, i.e. cross-border loans

⇒ Responsability on both lenders and borrowers

# The Response to the crisis

1. Concerted European response to the bonds crisis with loans from Northern to Southern governments
2. But too slow and too tepid: EFSF, ESM, fiscal compact
3. Costs of adjustment imposed disproportionally to the South
    - Drastic austerity in the South : Greece reduced budget by 11% of GDP, Ireland by 6%
    - Aid from the North were loans used to service the debt to the North.

- The ECB played an important role in keeping banks afloat with different market purchase programs. As a result lots of Southern debt is held by ECB.

# How efficient?

- Interestingly the paper was published before the "whatever it takes" $\rightarrow$ Hall judges that the EU has missed an opportunity to restore confidence on financial markets
- Economic growth has not been restored because of uneven distribution of costs. Too much austerity in the South and not enough transfers from the North.
- Since it is a public debt crisis, the recovery shall depend on debt restructuring but no clear prospect

# Explaining the Response of the Crisis

1. Intractability of the problem $\rightarrow$ doom loop
2. Deficiencies in European institutions
   - ECB was legally prohibited to play the LLR$\rightarrow$ Europe was not equipped to restore confidence
3. Divergent diagnoses of the problem
   - In 2010 it was a GIIPS crisis not a European banking crisis $\rightarrow$ the costs were mostly borne in the South
4. Boundaries of European solidarity $\rightarrow$ the euro was introduced with the principle of no transfers.

$\Rightarrow$ Giant coordination game about who should bear the cost $\Rightarrow$ Conflicts among members and between ECB and members of the Union $\Rightarrow$ Bad coordination delayed the confidence restoring on bonds market, a fact that increased the costs

# Beyond coordination issues

- Longstanding difference in economic doctrines:
  - Balanced budget view of Friedrich school versus demand-led growth Keynesian view
  - Ordo-liberal view that governments should steer the society gently and operate as factor stability while dynamism lies in private sector. Versus activist governments
- Social solidarity stopped at national borders
  - Lack of sense of European identity
  - But also political story-telling: see Chancellor Angela Merkelâs remark in March 2011 that "member states face many years of work to atone for past sins" $\rightarrow$ solidarity fatigue after the German reunification

# Failing forward (Jones, Kelemen, Meunier (2015)

- The single currency was incomplete:
  - Centralized monetary authority but lack of fiscal coordination and adjustment mechanism
  - Cross-border trade in finance but national regulation and national back-stop
- Its incompleteness contributed to the eruption of the crisis: massive capital outflows after the US financial turmoil
- Existential threat to the project
- The policy-response could have been to cut the loss and unwind the union
- Instead the decision was made to fill the gaps

# Pervasive Incompleteness and integration deepening down the road

- Sequence of reforms contributed to fill several gaps: bailout funds, fiscal surveillance, banking union
- But no comprehensive reforms
- Two puzzles:
  1. Why did EU leaders adopt piecemeal, incomplete reforms that only contained the crisis?
  2. Why have the piecemeal reforms moved the EU toward deeper integration rather than dismantling?
- The EU appears to "fail forward": respond to the failure of incremental reforms by taking new incremental reforms to expand in the integration $\rightarrow$ Why do the opponents to deeper interaction recognize the pattern and still accept the piecemeal reforms that will eventually deep the integration forward?

# Two political theories about European integration

- They reflect the tension between the role of supranational institutions and the power of national governments (some flavours of Jefferson vs Hamilton in the US)
  1. Intergovernmentalism: national governments are in charge, and that supranational institutions are tools of the national states (Moravcsik, 1993, 1998).
     - National governments have built European institutions in order to pursue the economic interests of their domestic constituencies
     - Euro reflects the interests of powerful national producers.
  2. Functionalism: economic integration as a path towards political integration
     - Although this integration starts in economic areas, integration in one area may well lead to further integration in many other areas, not only economic but also political
     - Mostly pushed by elites and interest groups that transcend national boundaries.

# The Intergovernmental narrative

- Important steps in the deepening of the European Integration result from the lower common denominator bargaining among powerful member states.
- EU response to the crisis result from intergovernmental bargaining driven by national economic preferences
- So the piecemeal nature is due to one or few members who see more comprehensive reforms not aligned with their self-interests.

# The Neo-functionalist narrative

- Initial steps toward integration generate functional spillover in other fields which produce incentives to strengthen cooperation on these fields too.
- National governments are not the only actors (EU officials, pan-European economic interests, NGO) and their preferences are influenced and progressively transformed
- So by pushing for monetary integration, the EMU produced pressure to extend integration in fiscal and banking fields.
- Governments shift more and more their preferences towards supranational levels

# Fusion of the two theories of Integration

- Liberal intergovernmentalism and nefunctionalism are connected and produce the "failing forward"
- Policies in the long run result from spillover and supranational activism.
- But negotiations between member states determine outcomes in the short term
  - Eurozone governance institutions result from political compromises of multiple governments with heterogeneous preferences and unwilling to delegate to EU
  - Governments are unwilling to let the euro fail but many comprehensive reforms are not domestically popular $\rightarrow$ intertemporal bargains
  - Governments refuse to agree to domestically unpopular reforms until they are convinced by further eruptions of the crisis that it is absolutely necessary to do so to save the euro

# Distributive conflicts among and within countries (Frieden and Walter, 2017)

- Gaps in the original design and implementation of EMU were widely understood (see Jonung  Drea 2010).
- It was also well understood that the ECB would have trouble designing one monetary policy for heterogeneous countries, and that the absence of fiscal policy coordination would cause problems.
- But attempts to address these issues collided $\rightarrow$ domestic and international political constraints

$\Rightarrow$ Which countries will bear the principal costs ? How the adjustment burden will be distributed?

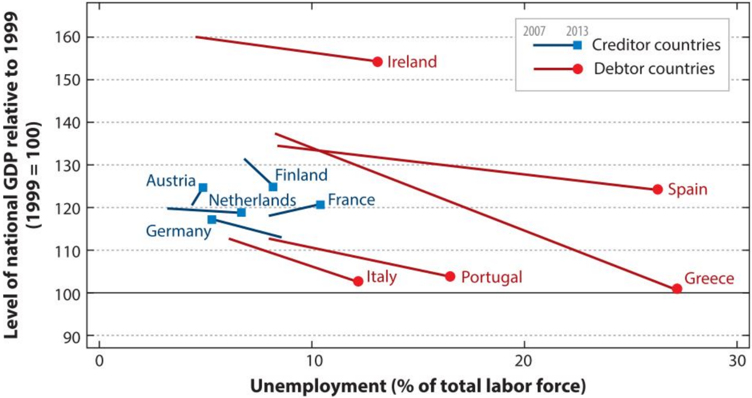
# Adjustment options

1. External adjustment: a change of the nominal exchange rate
2. Internal adjustment: change of the relative prices through domestic macro and structural policies
   - In deficit countries, associated with increased unemployment, lower wages, asset price deflation, and recession.
   - In surplus countries, increase relative prices through loose fiscal policy or through reforms that stimulate domestic demand and increase inflation.

# Choices Made

- Europeans have opted for a debt repayment by and internal adjustment in debtor states, coupled with temporary financing and expansionary monetary policy.
- Large bailout programs have been set up, but crisis countries have implemented austerity and reforms in return, and no meaningful debt relief has been granted.
- Unequal distribution of cost among the countries of the Eurozone and within.
- Why did debtor countries accept? This has resulted in deep recessions and record levels of unemployment

# Unequal distribution effects



# Why did debtor countries accept?

1. Powerful threat: financial exclusion
2. Deep trade and financial integration $\rightarrow$ loss at the micro level
3. Influence of creditor countries on IMF which recommended debt restructuring
4. Creditors have framed the narrative of the crisis

# Politics within countries

- Support for the euro : between keeping the euro and ending austerity at the same time Europeans have shown a strong preference for the euro (Dinas et al. 2016).

Only populist parties have anti-euro platforms

# Politics within debtor states

- Who will bear the brunt of the costs of the crisis? consumers, taxpayers, investors, government employees, pensioners, the unemployed, the export sector, the nontradable sector etc
  - Youth unemploy-ment tripled in Ireland between 2007 and 2012
  - Half of economically active people under age 25 in Greece and Spain were without work
- Party systems affected in Ireland Portugal, Italy, Spain, and Greece.

# Politics in Creditor States

- Should financial institutions absorb the losses from the loans they made? Or should taxpayers shore up the domestic financial systems or provide funding to help the debtor countries?
- No default!! (see Greece)

1. Fear of a Euro-zone wide crisis
2. Banks bailouts very unpopular in creditor countries $\rightarrow$ support domestic banks in creditor states via a bailout of debtor States
3. $\rightarrow$ Tax payer money
4. However almost no debate on distributive costs. The narrative has been on solidarity and European integration

# Conclusion