The euro crisis: Where to from here?

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For session *When Will the Euro Crisis End?*
organized by Dominick Salvatore,
AEA Annual Meetings, Boston, January 3, 2015
First, looking back: A selective chronology

- 1961: Robert Mundell introduces OCA criteria:
  - symmetry of shocks (cyclical synchronization) & labor mobility
- 1963: Ronald Mckinnon adds trade intensity to the list of OCA criteria.
- 1991: Maastricht Treaty emphasizes fiscal criteria for members of the coming monetary union (not OCA),
  - reinforced by the No Bailout Clause & later by the SGP,
  - to assure German taxpayers that they would never have to bail out a profligate Mediterranean country.
- Eichengreen (1993), Feldstein (1997), & other (American) economists question EMU, especially on the grounds that European countries do not satisfy the OCA criteria.
Looking back: A selective chronology, continued

• 1999: EMU goes into effect.

• By 2007, structural failures should have been clear:
  – The OCA failure: countries like Ireland couldn’t have the higher interest rates & currencies that they needed.
  – The fiscal failure: everyone violated the SGP fiscal/debt criteria, most egregiously Greece.
    • And yet sovereign spreads fell almost to zero.
    • This should have sounded the moral hazard alarm.

  – Symptom of both: inflated Unit Labor Costs in the periphery
    • => large current account deficits.
The Greek budget deficit in truth never came below the 3% of GDP ceiling. Nor did the debt/GDP ratio (≈100%) ever decline in the direction of the 60% limit.

Source: Ameco: General Government (S13), Expenditure (ESA95), ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, data extracted on 11 January 2011; own calculations.

Periphery-countries’ interest rates converged to Germany’s after they joined the euro => investors perceived no default risk.

Given the high debts, the ECB must have been seen as standing behind them.
The Competitiveness Problem (1999-2013)

During the euro’s first decade, wages & ULCs rose faster in the periphery than in Germany.

From: Rémi Bourgeot, Fondation Robert Schuman. Source: Ameco, EC.
Big current account deficits in periphery countries up to 2008 were seen as benign reflections of optimizing capital flows, instead of as warning signals.
Mistakes made after the crisis hit in 2010

- Initial ostrich-head approach to Greece
- Excessive fiscal austerity
- Insufficiently loose monetary policy
The EU leaders should have reacted to the Greek debt crisis as Washington reacted to the southern states’ crisis in 1841.

- When the crisis erupted in Athens, Frankfurt & Brussels should have seen it as a golden opportunity.
- They already knew their attempted fiscal constraints had failed.
  – So even the leaders must have known that sometime during the euro’s life it would be challenged by debt troubles among one or more members.
  – It was important to get the first case right, to set the correct precedent.

The EU should have reacted to the Greek crisis as US reacted in 1841.

• Greece was the ideal test case, for two reasons:
  – 1) Unlike Ireland or Spain, it was egregiously at fault,
    • a natural place to draw a line,
    • its creditors the natural ones to suffer losses.
  – 2) Unlike Italy, it was small enough that other governments
    and systemically important banks could have been protected
    from the consequences of a default,
    • at a fraction of the cost of the EFSF, ESM, etc.

• In early 2010 the EC & ECB should have urged Greece
  to go to the IMF and, if necessary, to restructure its debts,
  – rather than calling this course “unthinkable.”
  – The odds of containing the fire would have been better than later.

As one could have predicted, fiscal contraction is contractionary.
As a result of austerity, debt/GDP ratios continued to rise sharply. Declining GDP outweighed progress on reduction of budget deficits.
Interest rates on periphery bonds came back down after Mario Draghi took office in Nov. 2011.

“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”

-- July 2012


Source: Jeffrey Anderson and Jessica Stallings, IIF, Feb. 13, 2014,
Paths forward in the 3 areas of crisis

• (I) The **banking** problem:
  – Moves toward banking union are encouraging.
  – *But* it would require commonizing all three: ex ante supervision, deposit insurance & resolution of failed banks.

• (II) The **asymmetry** problem:
  – The periphery has been “toughing out” internal devaluations.
  – But these economies remain very weak

• (III) The **fiscal** problem:
  – Germany is right about moral hazard (in LR), but wrong about “expansionary fiscal austerity” (in SR).
The periphery countries had by 2013 managed to reverse much of the run-up in costs (except Italy).

But periphery economies remain weak
Unemployment in the periphery remains high

Unit Labor Costs have come down slowly... ...at the cost of still-high unemployment.

Carlos De Sousa & Guntram Wolff, 1 Oct., 2012, Breugel
Adjustment in the periphery is that much harder when eurozone-wide inflation < 1%.
The way forward: Three ideas

- **(1) Monetary policy:** How can the ECB pursue QE?
  - FX: Buy $ Treasury bonds in place of € bonds.

- **Fiscal policy:**
  - What reforms can avoid a future repeat
    - if budget deficits or debt write-downs are allowed now?
  - **(2) Ex ante:** address optimism-bias in official forecasts
    - by giving responsibility to independent forecasts.
  - **(3) Ex post:** eliminate moral hazard
    - By a version of the blue-bond / red-bond proposal.
Two ideas to help restore LR credibility to fiscal rules
\textit{(after eliminating legacy debt overhang)}

• Problem:
No version of the SGP or Fiscal Compact has come up with a way to prevent national authorities from making overly optimistic budget forecasts ex ante and then, when exceeding the caps ex post, saying it was beyond their control. “Who gets put in jail?”
1.1 Addressing the ex ante fiscal problem

- Fiscal rules are in fashion. Do they help?
- Most fiscal rules fail.
- Officials in most advanced countries make overly optimistic forecasts of growth and budgets. ¹/
  - The over-optimism bias is worse for countries with rules:
  - In euroland,
    - when the budget exceeded 3% of GDP, the authorities adjusted their forecasts, not their policies. ²/
- Solution: delegate the authority to forecast GDP and budgets to independent expert councils or agencies. ³/

E.g., even though true Greek budget deficits in most years were far in excess of the supposed limit (3% of GDP), the official budget forecasts were always rosy.

Until, in 2009, the bottom fell out of the budget.

Source: Frankel & Schreger (2011)
In the euro countries, subject to SGP rules, the optimism bias was reflected in the practice of never forecasting next year’s budget deficit > 3% of GDP.

Frankel & Schreger (2013)
I.2 Addressing the ex post fiscal problem

• Eurobonds might play a useful role:
  The world’s reserve holders crave an alternative to US T bills.
  – But most existing Eurobond proposals imply a “transfer union,”
    which Northern European taxpayers cannot be asked to support.

• The Eurobond version that might work goes under the name of
  “blue bonds,” proposed by two economists at Bruegel. 1/

• Only debt issued by national authorities below the 60% criteria
  would receive eurozone backing & effectively become Eurobonds.
  – These are the “blue bonds” that investors would view as safe.
  – If a country issued debt > 60% threshold, the resulting “red bonds”
    would lose eurozone backing; the issuer would be fully liable.

Addressing the ex post problem, continued

• As I see it, private markets would judge whether a country was crossing the 60% threshold, even before the final statistics were available, \(^2\) — and therefore whether a new default risk required an interest rate premium.

• The sovereign risk premium would operate --
  — much as it does among American states,
  — and as it did in Italy, Greece and the others before they joined the euro.

• The point is that the mechanism would be truly automatic.
  — Perhaps in borderline cases the judgment whether a country had truly exceeded the limit would ultimately have to be made by a court.
  — But private investors would act from moment to moment.
  — Market interest rates would provide the missing automatic discipline.

• Thus compliance would not rely on Brussels bureaucrats,
  — whose discretionary letters have proven toothless
    • no matter how many exclamation points are put at the end.

\(^2\) Frankel, 2012, “Could Eurobonds Be the Answer to the Euro Crisis?” *VoxEU*, June 2012.
Writings by Jeffrey Frankel


• “Pro-cyclicalists Across the Atlantic Too,” *Project Syndicate blog*, July 30, 2012.
• "Could Eurobonds Help Solve the Euro Crisis?" *VoxEU*, June 2012.
• “The ECB’s Three Big Mistakes,” *VoxEU*, May 16, 2011.
• "Let Greece Go to the IMF," Jeff Frankel’s blog, Feb.11, 2010.
Appendices

(1) Econometric findings regarding bias among EU countries in particular.

- Euro countries, subject to the SGP,
  - show even more optimism bias than others
  - in growth forecasts, significant at 1 and 2-year horizons
  - particularly when GDP is currently high.
- Forecasts of budget balance among euro countries also show extra bias when GDP is currently high.
Table 5(c): Frankel (2011)
GDP growth rate forecast error, full dataset

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<th>Variables</th>
<th>1 year ahead</th>
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<td>0.379*</td>
<td>0.780**</td>
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<td>0.192</td>
<td>0.221</td>
<td>–1.067*</td>
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<td>(0.199)</td>
<td>(0.352)</td>
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<td>(0.215)</td>
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<td>SGP*GDPgap</td>
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<td>0.148**</td>
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<td>(0.068)</td>
<td>(0.141)</td>
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<td>Constant</td>
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***p<0.01, **p<0.05, *p<0.1. (Robust standard errors in parentheses.) Random effects.
SGP ≡ dummy for countries subject to the SGP.
GDP gap ≡ GDP as deviation from trend.
All variables are lagged so that they line up with the year in which the forecast was made.
Graphs to be deleted because they have been superseded by updates
The Competitiveness Problem

During the euro’s first decade, wages & ULCs rose faster in the periphery than in Germany.
Huge current account deficits in periphery countries up to 2007 were seen as benign reflections of optimizing capital flows, instead of as warning signals.

Figure 5: Current Account/GDP (%)

Figure 6: European current account imbalances
As a result of austerity, debt/GDP ratios continued to rise sharply. Declining GDP outweighed progress on reduction of budget deficits.
Unit Labor Costs Updated (1999-2014)

Real Unit Labor Costs (1999=100)

Source: Ameco, EC; own calculations

updated 1/7/2015