

The Euro Crisis, Portugal, and Europe's Future

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Questions

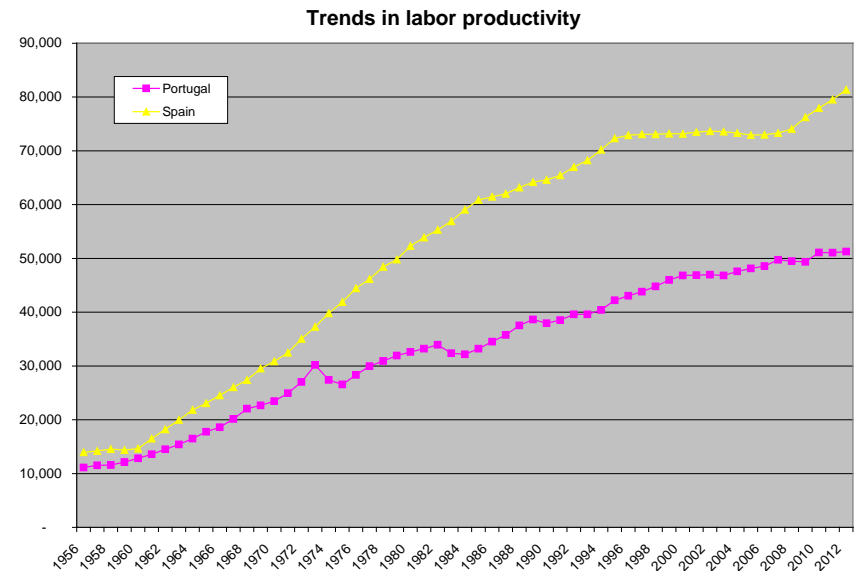
- What is this a crisis of?
- Is the crisis over?
- What kind of response is needed?

Two narratives

- “It’s their fault”
 - Countries of the periphery “misbehaved”
 - Excessive borrowing (public or private)
 - Rigid labor and product markets
 - Low productivity growth (esp. in Portugal)
- “It’s our collective fault”
 - The euro zone is an incomplete economic union, whose structural faults got exposed when hit by external financial shock
 - Lack of banking and fiscal union
 - Imbalance between single currency and multiple sovereigns/fiscs
 - Absence of common legal order and bankruptcy regime

There are elements of truth in both...

- Portugal and other countries of the periphery ran up large external deficits despite poor productivity performance
 - And hence likely inability to repay accumulated debts
- On the other hand, for every imprudent borrower, there must be one imprudent lender
 - Financial crises are not morality tales
- And if in a true economic union, external imbalances are resolved very differently



Implications of EU's incomplete union: a comparison with the U.S. (1)

- What is Florida's current account deficit?
- We don't know
 - because we don't care
- Florida is not a relevant economic unit, as long as
 - the state of Florida has no legal powers to interfere in cross-state payments
 - banking and bankruptcy laws are federal, as is deposit insurance
 - the Federal Reserve stands ready to act as a lender of last resort to any FL bank
 - Washington, DC sends out the welfare and unemployment checks
 - FL interests are represented in Washington directly and can push for remedies to local/regional problems
 - FL residents can easily move and seek jobs elsewhere in the U.S.
 - ... and therefore there is no expectation that Washington, DC will bail the state government out

Implications of EU's incomplete union: a comparison with the U.S. (2)

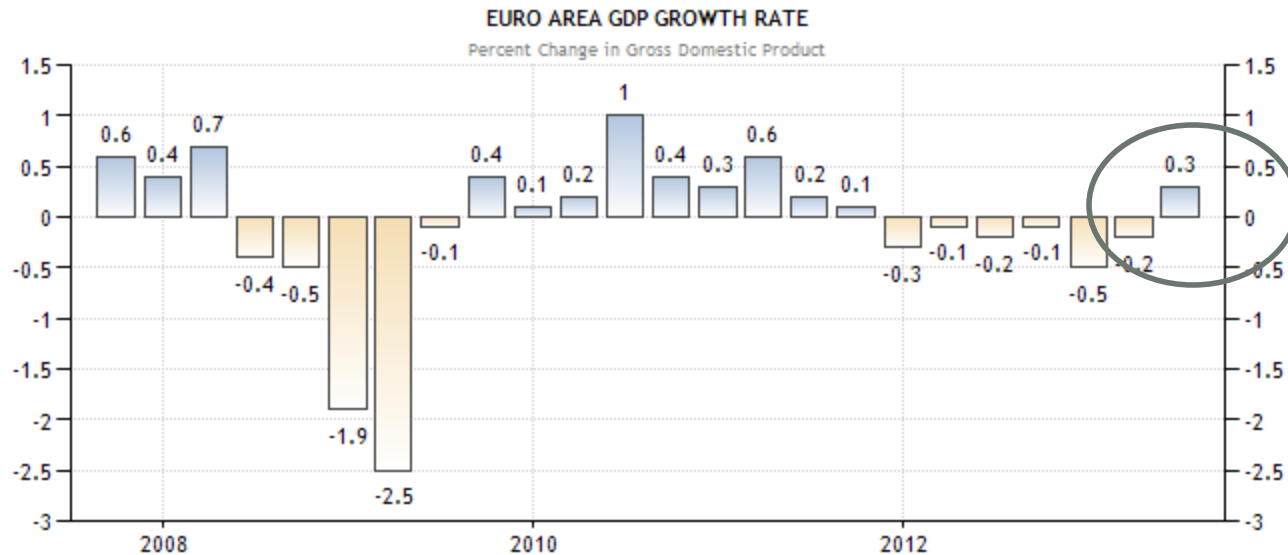
- Because the state of FL has no “sovereign powers,” it is effectively just like any other borrower
- The quid pro quo in the U.S.:
 - FL residents are (and *feel* like they are) part of the political community and governance structure in Washington
 - In return, FL has given up its sovereignty and has accepted the reach of federal laws and regulations
- None of these things is true in Euro zone
- Consequently, a crisis within the Euro zone is more costly both in economic and political terms
 - ad hoc arrangements to extend credit and arrange workouts, rather than automaticity
 - contagion and self-fulfilling panics
 - deeper economic recession
 - mutual resentment on all sides which threaten survival of Eurozone

So what is the crisis a crisis of?

- As long as the euro is an economic and (nascent) political union, creditor nations must approach the crisis not as a morality play, but as as a problem of mismanaged interdependence
- This means a lot of the responsibility for solving it rests on them
- I will return to remedies at end of talk

Where are we in the crisis?

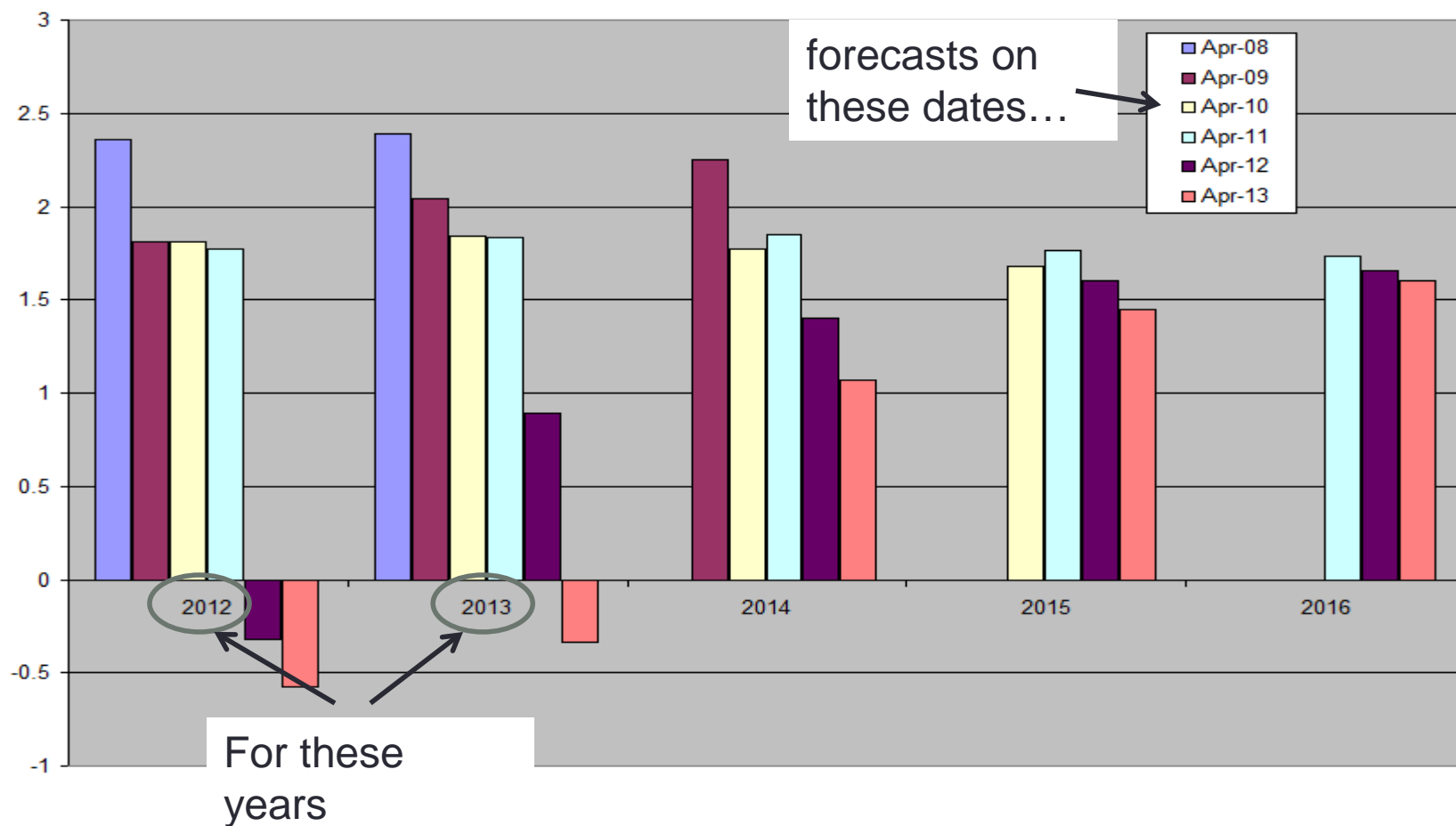
- Some good news in financial markets and one quarter of positive GDP growth



SOURCE: WWW.TRADINGECONOMICS.COM | EUROSTAT

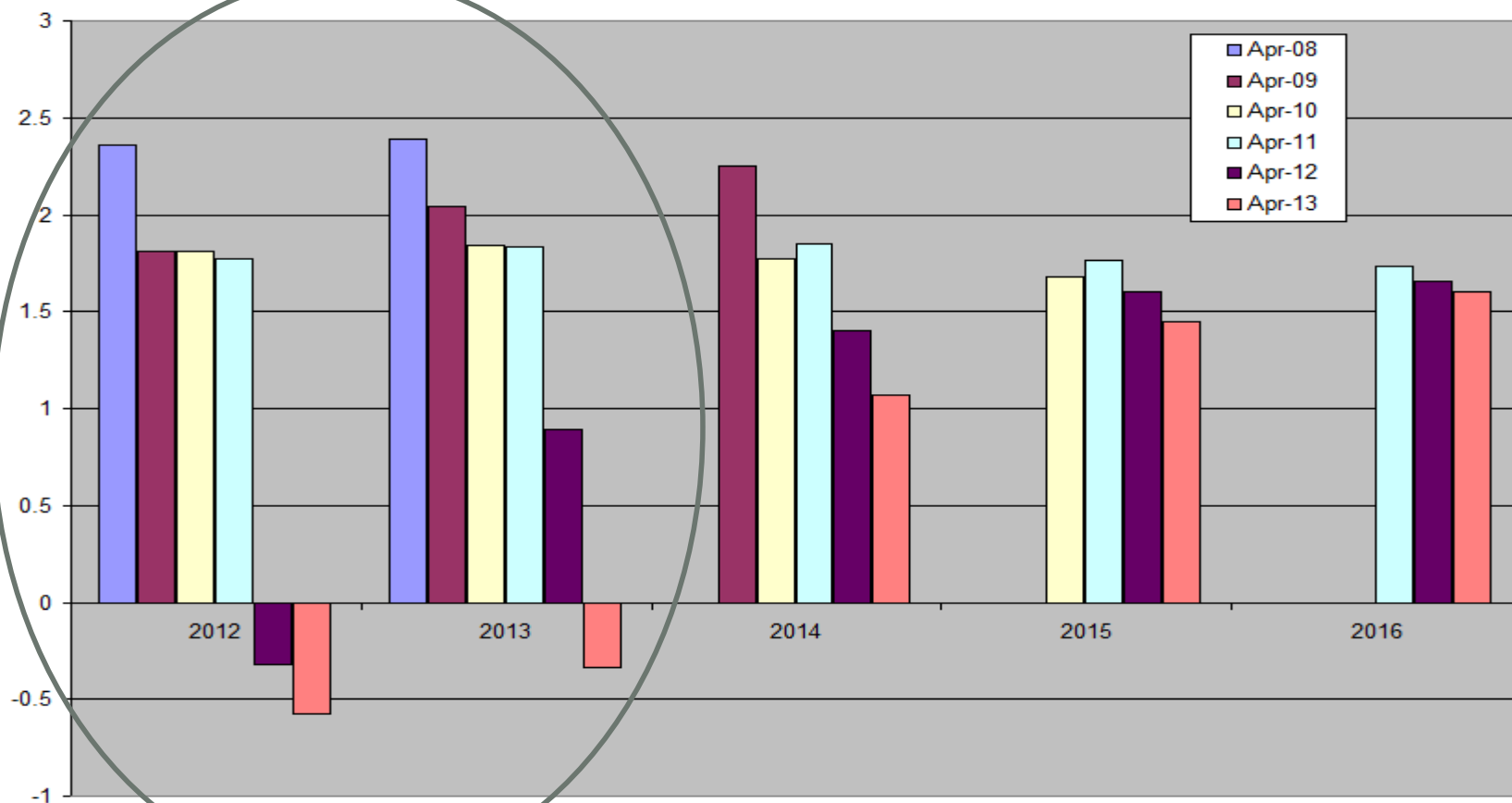
Beware optimistic official projections

IMF growth projections and outcomes for euro area



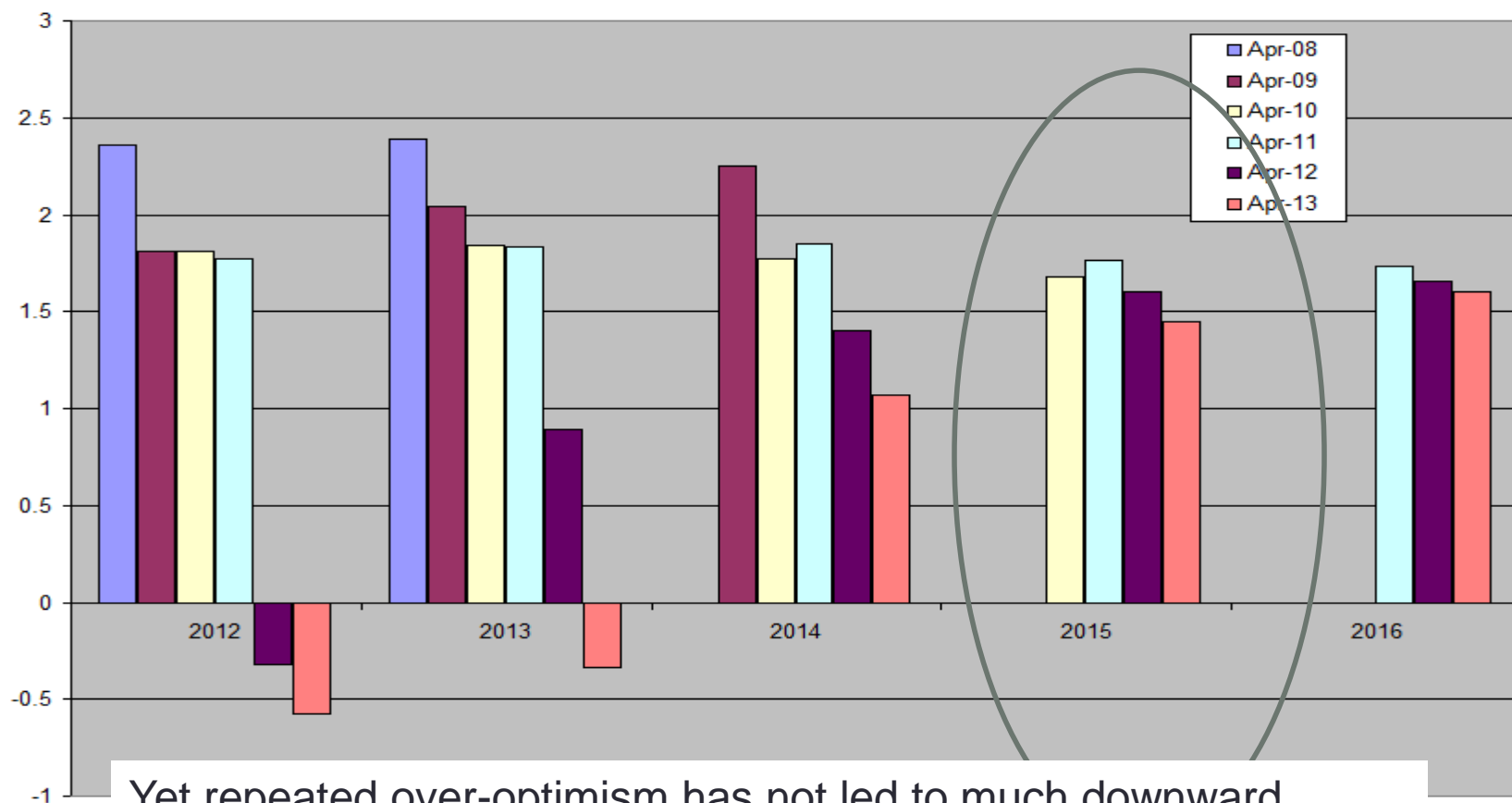
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Beware optimistic official projections

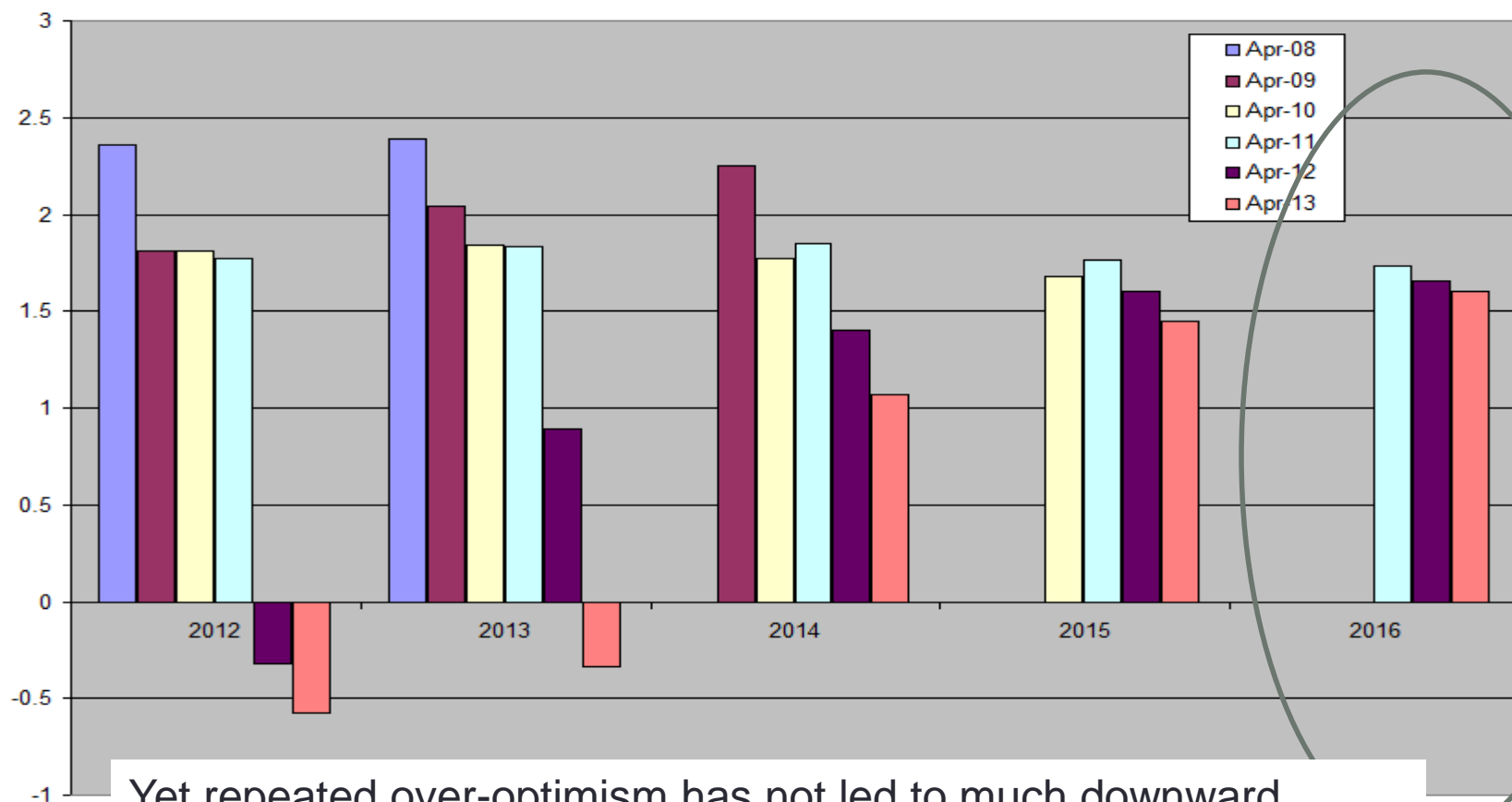
IMF growth projections and outcomes for euro area



Yet repeated over-optimism has not led to much downward revision on forecasts for years out...

Beware optimistic official projections

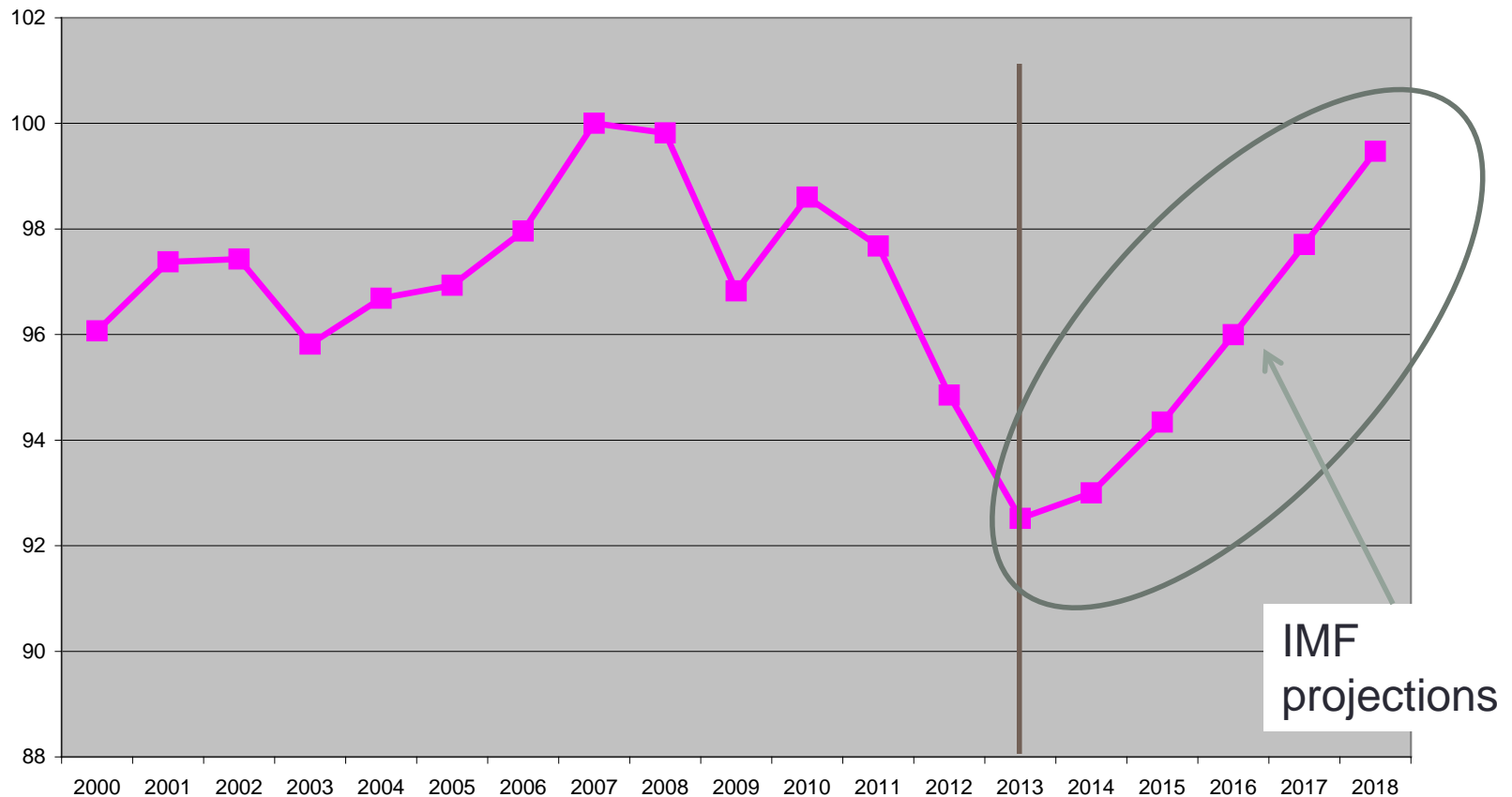
IMF growth projections and outcomes for euro area



Yet repeated over-optimism has not led to much downward revision on forecasts for years out...

And even under these assumptions, Portugal's bounce back will take more than 5 years...

Portuguese GDP per capita, 200-2013, and 2014-2018 (projected)
(2007 peak = 100)

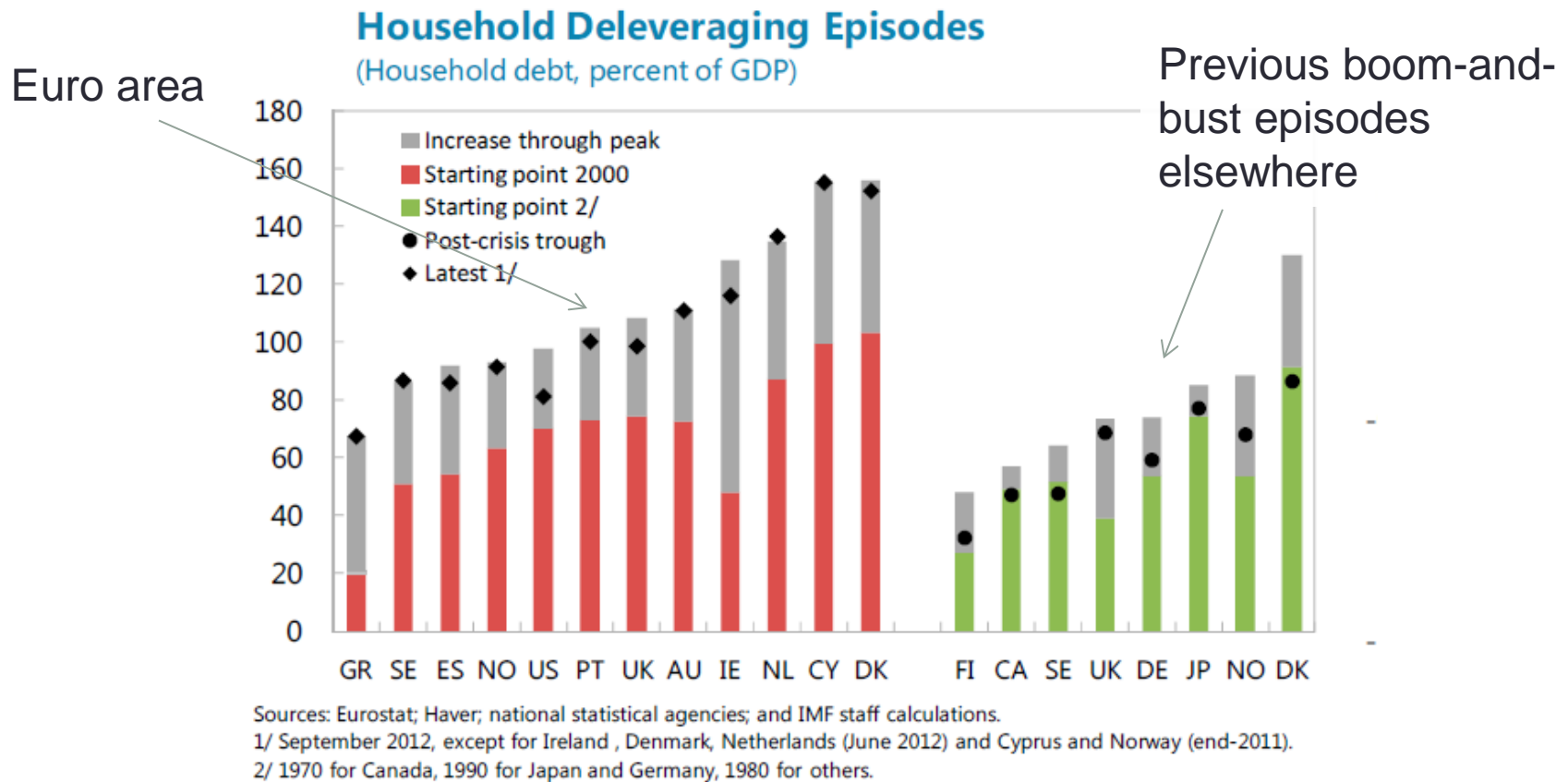


Economic fundamentals behind crisis have not been addressed

- Economies of the periphery are stuck with two key problems:
 - high debt
 - low competitiveness
- These are stock and a flow problems, respectively
 - The debt problem is a stock problem: unsustainably high and rising levels of debt, relative to GDP (a joint bank-sovereign problem)
 - Low competitiveness is a flow problem: produces low growth and a lousy trade-off between internal and external balance
 - either high unemployment or high external deficits

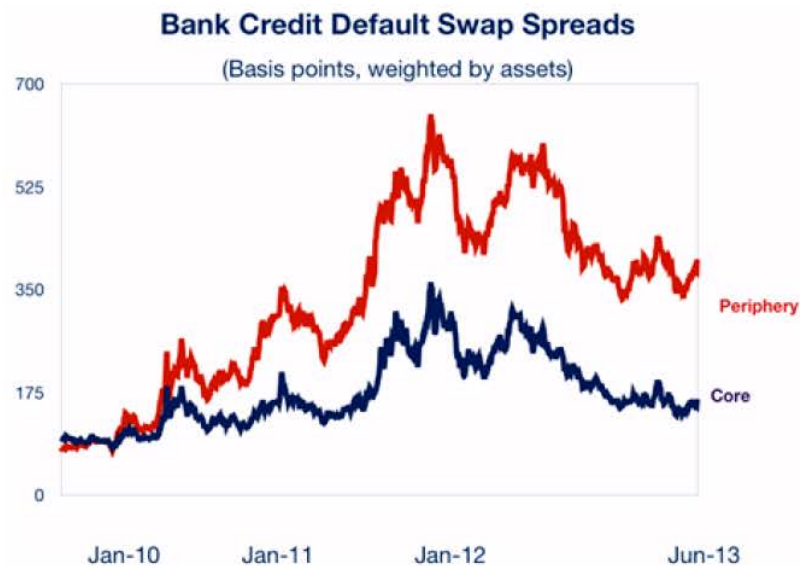
Has financial fragility been repaired?

Debt overhang continues and deleveraging has barely started

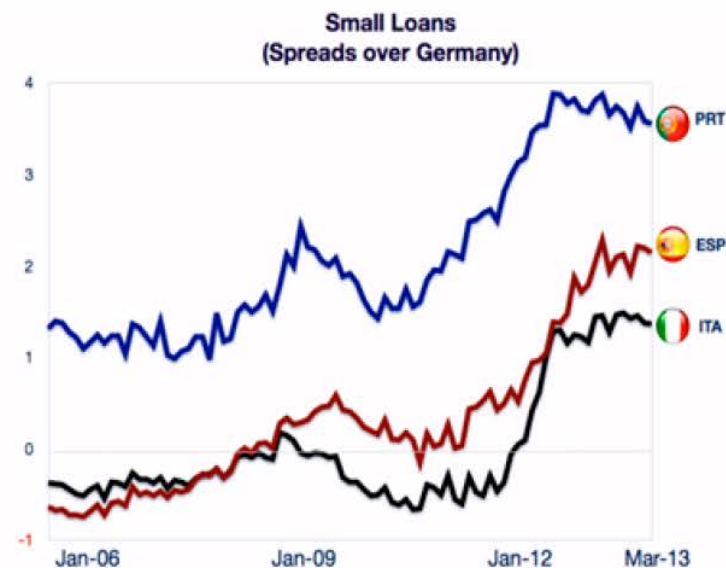


Euro area government debt has kept on increasing too...

Financial fragility continues in periphery



Periphery: Greece, Ireland, Italy, Portugal, and Spain. Core: Austria, France, Germany, the Netherlands, and Belgium

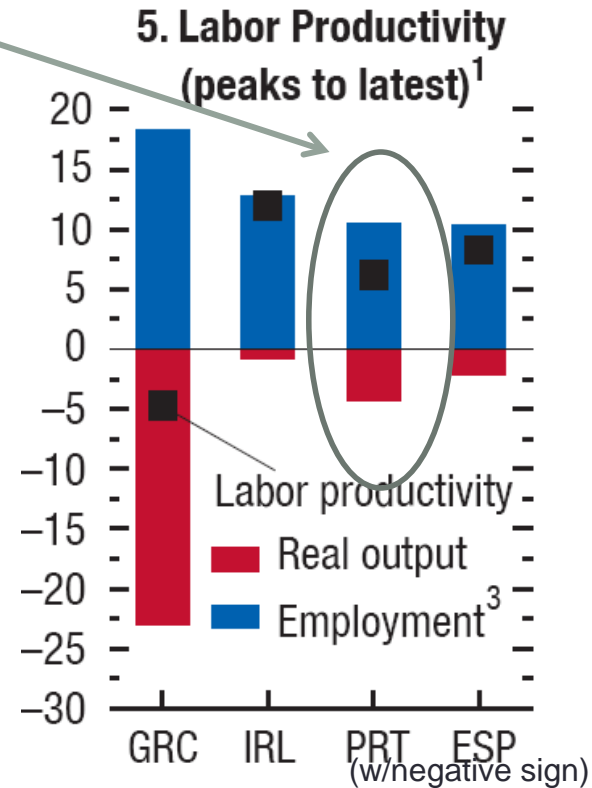
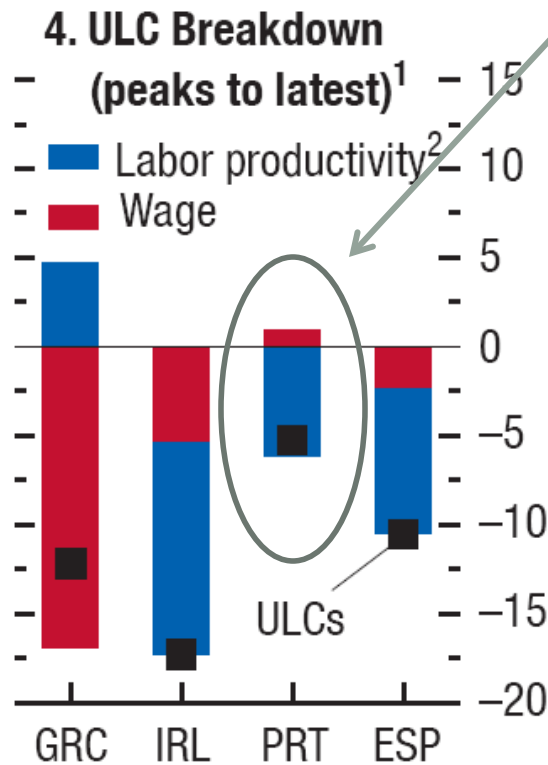


Has financial fragility been repaired?

- No!
- Debt overhang continues and financial markets remain segmented

Has competitiveness been restored?

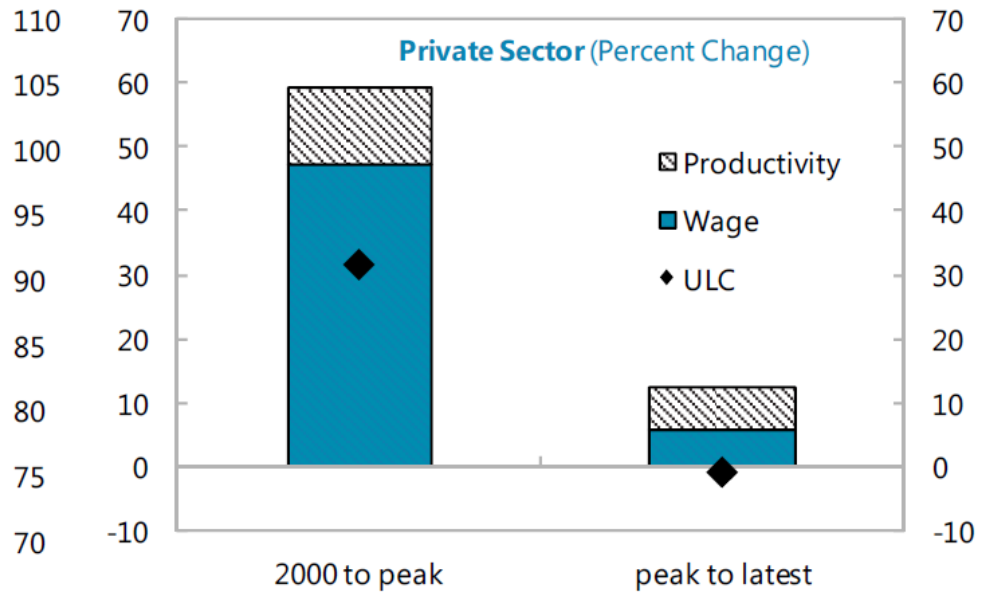
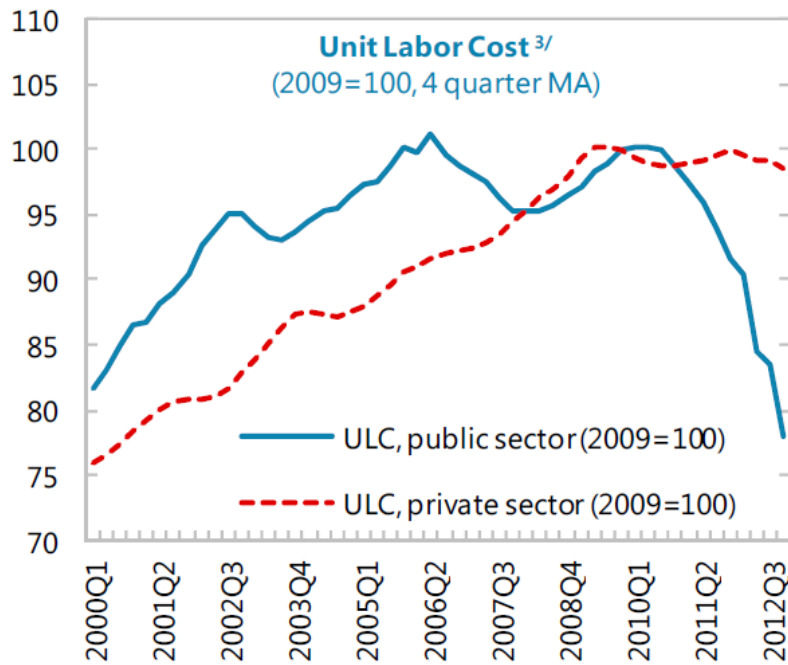
The improvement in competitiveness is limited, is largely due to labor shedding...



Source: IMF, WEO April 2013

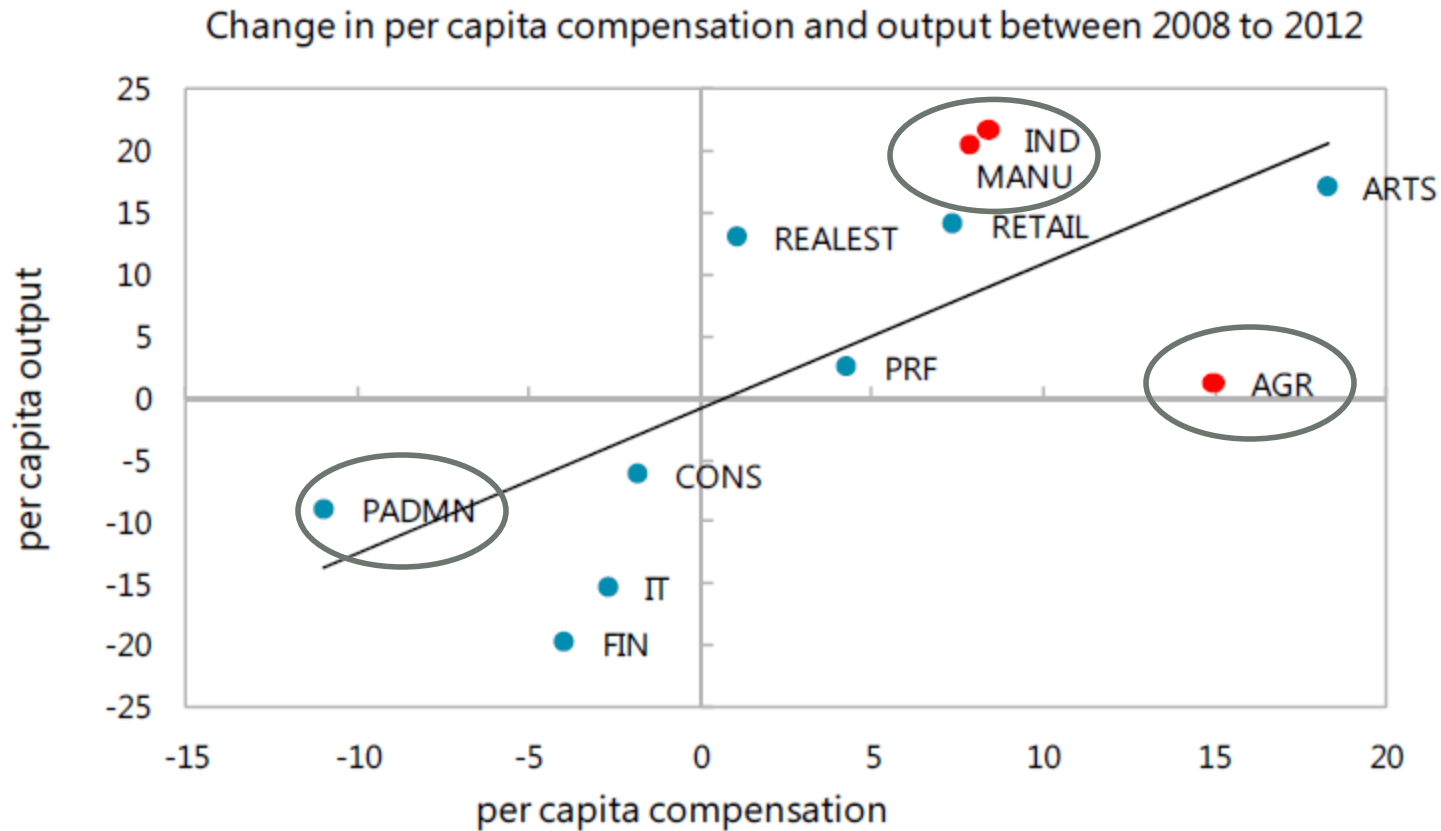
In IRL, PRT, and ESP, bulk of the decline in ULC is due to collapse in employment

... and is not happening in the private sector



Source: IMF

Labor compensation in tradable industries are rising!



Has competitiveness been restored?

- No!
- Improvement in ULC overwhelmingly due to public sector wages and employment cuts that exceed output loss.
- IMF: southern countries (incl. Portugal) have made up only about $\frac{1}{4}$ of the loss in competitiveness since 2000

Can structural reforms really spur growth?

- Theory: supply-side reforms boost can productivity, output, and employment
 - labor-mkt flexibility; deregulating professions; privatization
- How structural reform increases productivity in practice:
 - (a) shedding labor in low-productivity sectors
 - (b) expanding employment/output in productive sectors
 - need both to get economy-wide productivity gains
- Under low aggregate demand, first of these tends to increase unemployment, while second mechanism operates very weakly
 - making it easier to fire labor has little effect on hiring when firms have excess capacity and cannot sell their output
 - even IMF is now making this point...

Can structural reforms really spur growth?

- IMF on why structural reforms are not producing intended results:
 - “... with domestic demand in a depressed state and given the high credit cost faced by Portuguese companies, these macroeconomic tensions may first have to recede for structural reforms to yield the hoped-for results...”

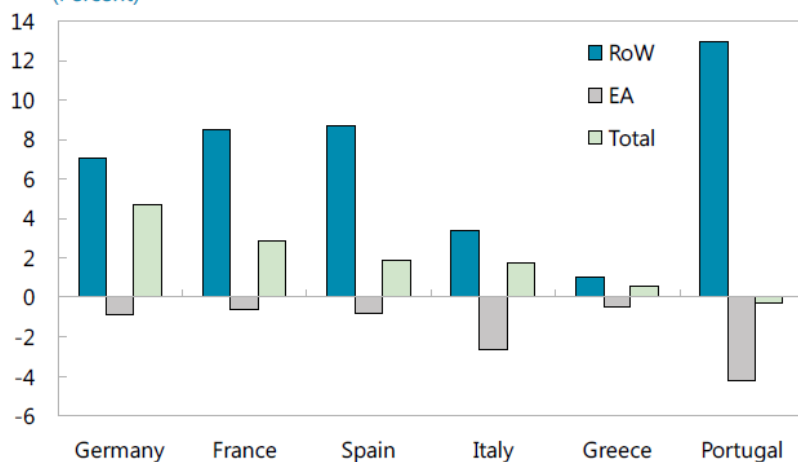
Caught in a vicious cycle

- Fiscal austerity works for external balance
- But aggravates unemployment
- While structural reform does/will do little to compensate
 - and possibly increase unemployment
- Net effect is decline in GDP, which makes debt/GDP worse too
- Calling for still more fiscal austerity...

How poor euro zone performance is hurting Portugal especially

Export Demand Growth, 2008-2012

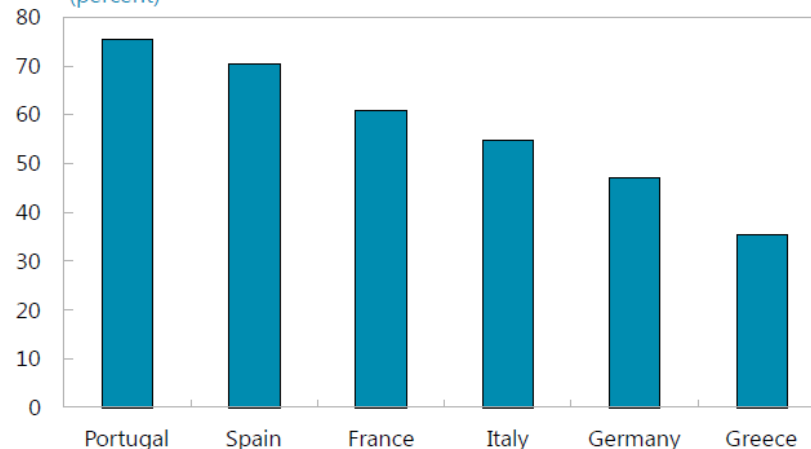
(Percent)



Sources: IMF, World Economic Outlook database; IMF, Directions of Trade Statistics database; and IMF staff calculations.

Share of Euro Area in Total Exports

(Exports of goods)
(percent)



Source: IMF, Directions of Trade Statistics database.

Portugal has experienced virtually no growth in its export markets, unlike other periphery countries, because its exports are so heavily concentrated on the euro area.

So is the crisis really over?

- Not really
- The current policy assignment
 - Fiscal austerity => reduce debt
 - Structural reform => spur growthisn't really working...

What's needed: economics (1)

- Debt write-downs
 - Rogoff: “Any realistic strategy for dealing with the eurozone crisis must involve massive write-downs (forgiveness) of peripheral countries’ debt.”
 - Not easy for Germans (and French) to accept that “hundreds of billions of euros go up in smoke”
 - But this is money that is already lost “and the game of pretending otherwise cannot continue indefinitely”
 - The Latin American debt crisis and the Brady Plan example
 - Didn't trigger growth but permitted it

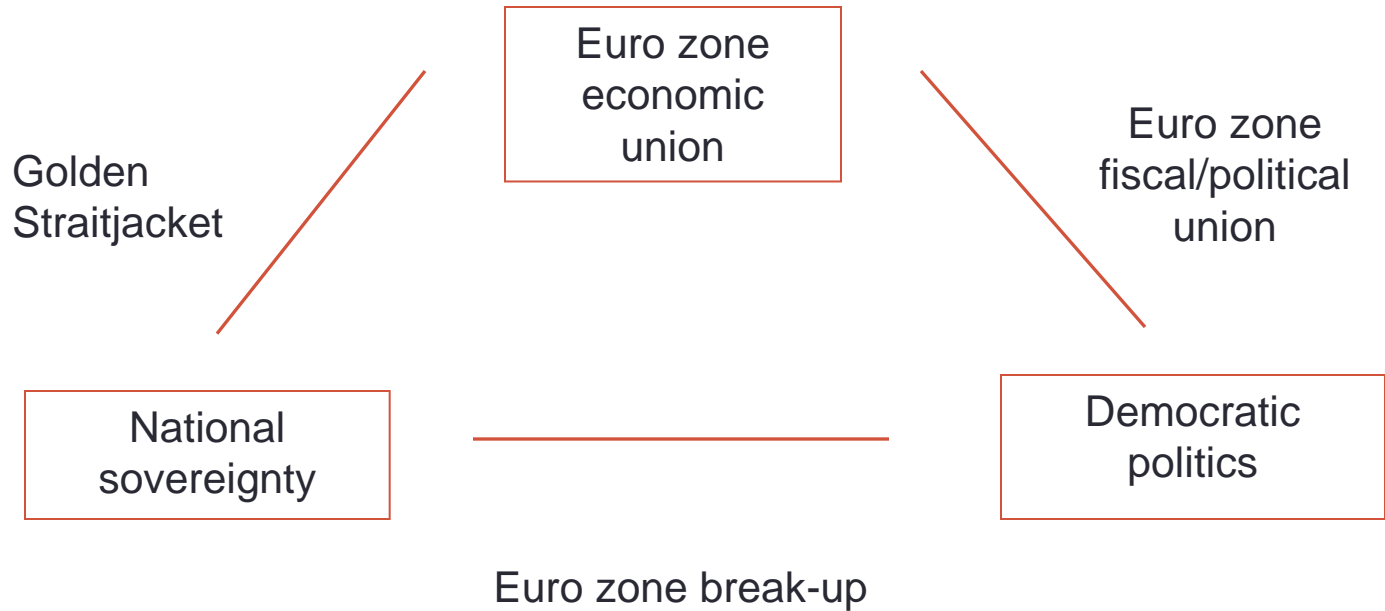
What's needed: economics (2)

- Policies directly targeted at expenditure rebalancing/switching
 - greater spending in creditor nations, esp. Germany
 - to boost euro area-wide demand
 - policies that aim to reduce non-tradables prices
 - to enable depreciation of real exchange rate and boost in competitiveness
 - incomes policies/social pacts would help (cf. IMF)
 - to reduce private sector wages
 - though probably politically too late
 - higher ECB inflation target
 - to allow room for real exchange rate changes via nominal changes

What's needed: politics

- A different narrative about the nature of the crisis
 - Germany must approach this as a problem of interdependence in an economic and (nascent) political union, not as a morality play
 - Germany must accept higher inflation + explicit plus bank losses
- Likely to happen?
 - “If there is violence in the streets of Madrid or political chaos in Italy, it is a huge problem for Germany” – top aide to Merkel.
 - “The window that opens after the German election is extraordinarily important” – Timothy Garton Ash
- Critical role of France
 - France big enough that if it put its weight fully before the alternative package, Germany would be isolated
 - But France remains too keen to separate itself from countries of the periphery, so no great incentive to form coalition with them

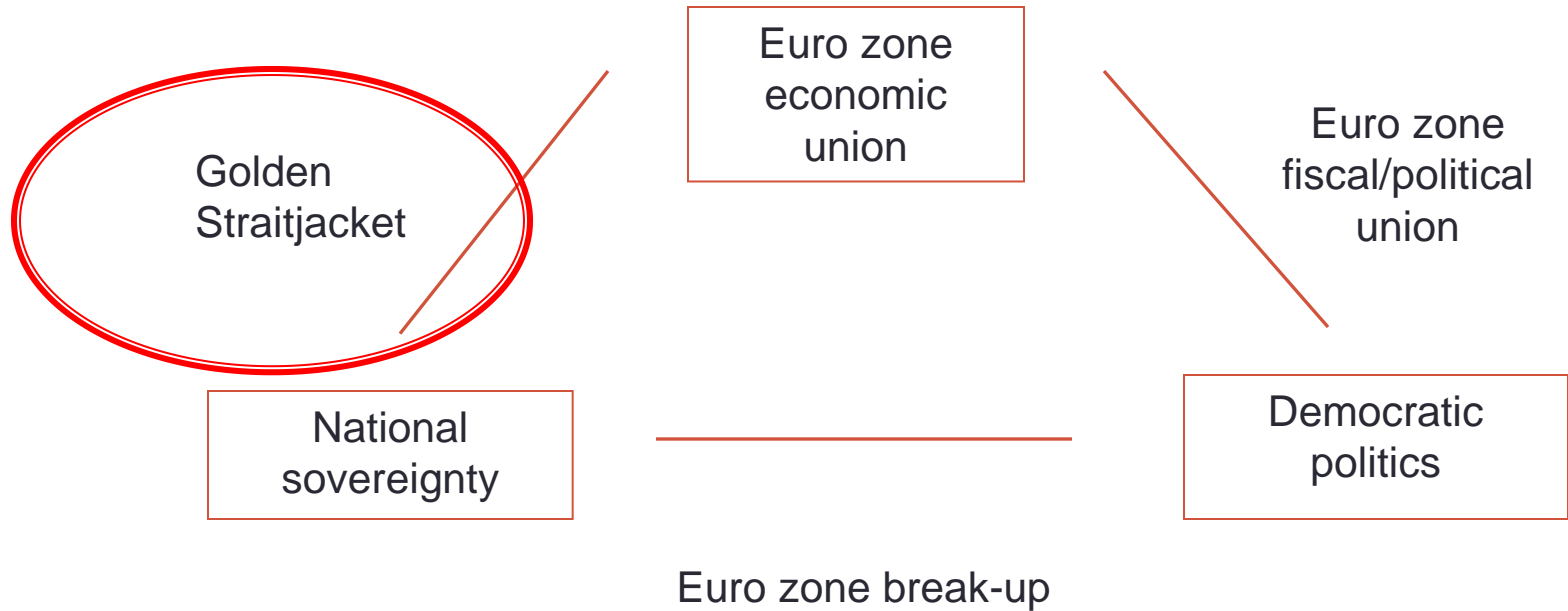
What's needed: the long run



Pick two, any two

The political trilemma of the world economy:
euro zone version

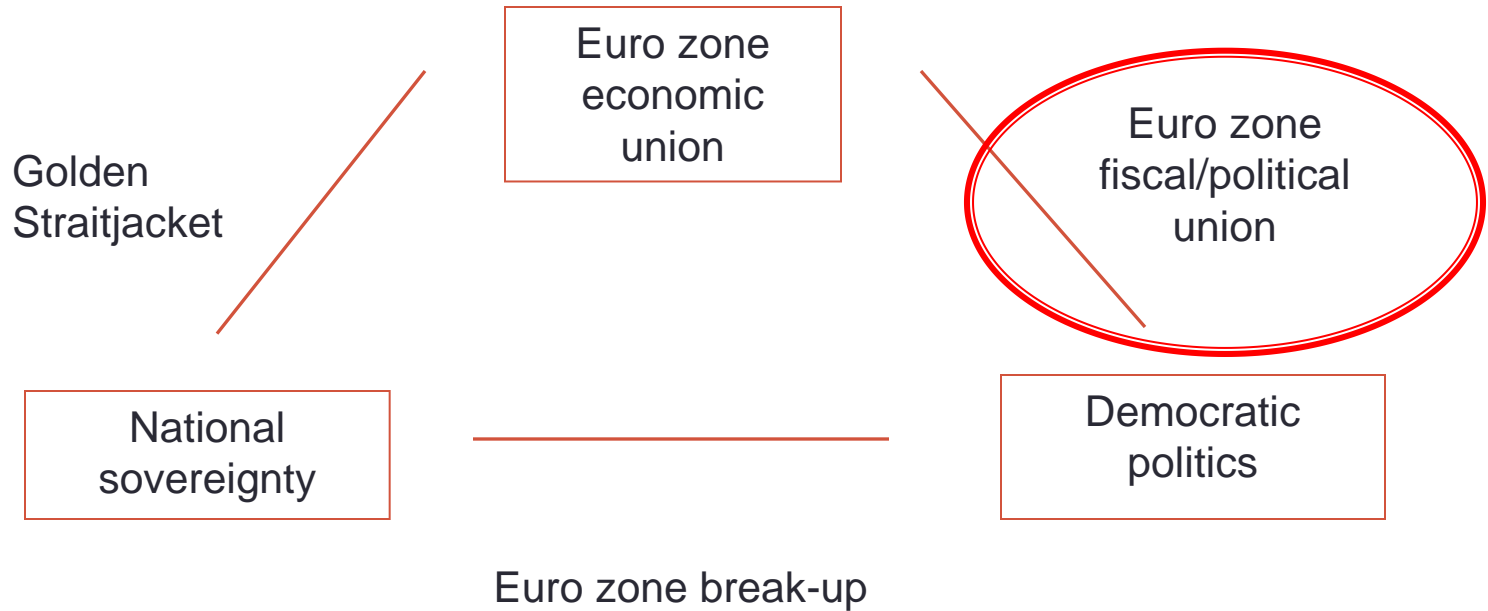
What's needed: the long run



Pick two, any two

where countries of the periphery are today

What's needed: the long run



Pick two, any two

the preferred outcome

Conclusions: the short- and long-run of the EU

- Ultimately, a workable economic union requires reduction in structural heterogeneity (in institutional arrangements, e.g. labor markets)
 - restrictions on national sovereignty and diversity
- So some version of the German argument is right – for the long-run:
 - countries need to look more like each other if they want to inhabit the same house
 - of course, what that house ought to look like (German-style or not) is a political decision that is preferably made by all in democratic fashion.
- But euro zone faces a short-term problem that is much more Keynesian in nature
 - and for which the longer term structural remedies are at best ineffective, at worst harmful
- Too much focus on the structural problems, at the expense of Keynesian remedies, will make the long-run unachievable and hence irrelevant

Conclusions: the short- and long-run of the EU

- Democracy requires that the extent of the market be matched by the reach of political institutions
 - to provide regulation, accountability, and legitimacy
- So if true economic union remains goal, a vision of political union is a must
- But if political union is viewed as infeasible (or undesirable), economic union will not work, and we must begin thinking of a strategic retreat from it