Is There a Way Out Of The Euro Crisis?

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The conundrum

• Economies of the periphery are stuck with:
  • high debt; and
  • low competitiveness

• This is both a stock and a flow problem
  • 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
The current policy assignment

- Fiscal austerity => reduce debt
- Structural reform => spur growth

... isn’t working!
External adjustment has come at the cost of a severe worsening of the internal imbalance.

Generating sustainable fiscal and external balances comes at the expense of unacceptable levels of employment.
And much of the improvement in competitiveness that has taken place is illusory.

In IRL, PRT, and ESP, bulk of the decline in ULC is due to collapse in employment.
Can structural reforms really spur growth?

- Theory: supply-side reforms boost can productivity, output, and employment
  - while improving external balance
  - labor-mkt flexibility; deregulating professions; privatization
- But not very effective under present conditions of depressed demand
- 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
Latin American experience with structural reforms

Productivity decomposition in Latin America across different periods (annual growth rates)
The 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…
Addressing the stock problem directly: 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

• But can debt write-downs also help with the flow problem?
Can debt write-downs also trigger growth?

• Theory: debt hangover impedes credit flows and exacerbates policy uncertainty
  • Questions:
    • is growth constrained by lack of credit or lack of demand?
    • how much of policy uncertainty is due to debt hangover per se, as opposed to other policy conundrums

• Evidence: debt reduction an enabler rather than a trigger of growth:
  • Cf. Brady Plan in Latin America
    • In most cases, debt reduction took place after growth had begun to kick in
    • High growth comes years later, more the result of commodity prices than debt reduction per se
How much did the Brady Plan help in Latin America?

Vertical bars indicate official dates of the debt reduction agreements.
What’s needed: economics

- Debt write-downs, plus:
- Policies directly targeted at expenditure rebalancing/switching
  - greater spending in creditor nations, esp. Germany
    - to boost EZ-wide demand
  - policies that aim to reduce NT prices
    - to enable RER depreciation
  - incomes policies would help
    - to reduce private sector wages
    - though probably politically too late
  - higher inflation target
    - to allow room for RER 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 Southern countries, so no great incentive to form coalition with them
Concluding notes: the short and long of it

• Ultimately, a workable economic union requires reduction in structural heterogeneity (in institutional arrangements, e.g. labor markets)

• 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 up for grabs.

• But eurozone 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