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Comment on "The Eurozone Crisis: Phoenix Miracle or Lost Decade?"

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ABSTRACT

This comment discusses the paper "The Eurozone crisis: Phoenix miracle or lost decade?" by Barry Eichengreen, Naeun Jung, Stephen Moch, and Ashoka Mody, which was presented at the Bank of Greece Conference in May 2013.

1. Introduction

The European Union, and the euro area in particular, have been experiencing a deep crisis since the global shock in 2008. The paper by Barry Eichengreen, Nauen Jung, Stephen Moch and Ashoka Mody offers a thoughtful evaluation of this crisis by comparing it to the Latin American crisis in the 1980s and the East Asian crisis in the 1990s. It also makes a comparison to the US economy which is another federal economy. These comparisons are useful in the sense that past experience can provide significant guidance to European policymakers in developing a strategy to overcome the current crisis.

After a careful study of the characteristics of the three crises (the Latin American, the East Asian and the current euro zone), the authors conclude that policymakers in the euro-area peripheral countries (Greece, Cyprus, Italy, Ireland, Portugal and Spain, from now on GCIIPS) should re-evaluate fiscal consolidation, provide more monetary support, clean up the banking system and restructure their debt.

My discussion will focus on four points. First, I will start by organizing the plethora of issues associated with the European crisis into causes, imbalances and policy reactions. I do so because, as the authors themselves point out, this is a complex crisis so it is not easy in their paper to understand what causes what. Causation is important if we want to make policy suggestions. Second, I will argue that there are worse and deeper problems that are usually ignored. Here I will focus on institutional quality and its crucial role. Third, I will evaluate two particularly debated macroeconomic policy reforms nowadays: fiscal consolidation and exiting the euro. Fourth, I will argue that the supply side is relatively neglected. This is not right because the European crisis is not a crisis of inadequate demand. Addressing the supply side problems is instrumental to viable growth in output and employment and hence to exit from the debt crisis.

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2. Organizing the issues studied: causes, imbalances and reactions

Following most policy reports (see e.g. EEAG Report, CESifo, 2013), it is useful to distinguish among causes, imbalances and reactions to the European crisis. Regarding causes, problems started in 2000 in the form of excessive public and private borrowing triggered by the fall in nominal and real interest rates. This credit bubble was further fueled by bubbles in the housing market and pro-cyclical fiscal policies. All this also led to higher demand and rising prices, which resulted in large current account deficits (around 10% of GDP in 2000s) and accumulation of foreign liabilities (around 100% of GDP) in most GCIIPS financed mainly by borrowing from banks in the center countries like Germany. Thus, when the global financial crisis erupted in 2008, most of GCIIPS were already in trouble. Regarding imbalances, it is now widely believed (see EEAG Report, CESifo, 2013) that GCIIPS are in the grip of three closely interrelated crises: a balance-of-payments crisis, a sovereign debt crisis and a banking crisis. The combination of these has led to sharp increases in perceived solvency risks. Regarding reactions to the crisis, all countries have undergone adjustments, albeit to different degrees. To date, most of the attention has been paid to the last two imbalances (see, for instance, fiscal consolidation and support of the banking sector), while relatively little progress has been made to resolve the balance-of-payments problem. This is not surprising; this problem has to do with competitiveness and an improvement in competitiveness requires structural or supply side measures which are more unpleasant than demand side monetary and fiscal injections.

3. Further imbalances and heterogeneity across countries

The above described debt crisis is a typical example of short-termism or myopic behavior. Borrowers have over-borrowed and over-spent by not internalizing the costs in the future. And lenders have under-estimated the risks. However, all this should not come as a surprise. Several authors have repeatedly warned us that the European model has not been sustainable since the 1970s (see e.g. Alesina and Giavazzi, 2006). Thus, there are deeper explanations of what is happening to Europe nowadays. Here, I will focus on institutional quality.[1]

By institutions, we typically mean rules, laws, regulations and policies that affect incentives and, in particular, the incentive to invest in technology, physical capital and human capital. As such, institutions are endogenous meaning that they are a social choice. I focus on institutions for several reasons all of which are directly related to the current European crisis. For instance, there is empirical evidence that institutions have a profound effect not only on growth and employment but also on a plethora of other phenomena like savings, entrepreneurship, innovation and foreign investment (see e.g. Algan and Cahuc, 2010, for a rich review). The quality of institutions can also explain why in some countries foreign aid (like EU structural funds and CAP programs) is growth-enhancing, while in some other countries leads to rent seeking and so proves to be counterproductive (see e.g. Economides et al., 2008).

Among the various indices of institutional quality available, it is widely believed that the most characteristic one is the index measuring the degree of protection of property rights (see e.g. Acemoglu, 2009). Then, the data[2] show that Greece, Italy and Spain are countries with very weak property rights. It is interesting that Greece, Portugal and Spain have been experiencing a clear deterioration since 2002. Greece, the country most in trouble these days, scores the lowest property rights index both in terms of the mean and standard deviation. This is bad for trust and, in turn, for all economic variables mentioned above. This is a deeper crisis than the debt crisis.

Here, it is worth making a clarification. Although poor incentives and low-quality institutions are a uniform problem across GCIIPS, there are also important differences. For instance, in terms of the property rights index, Ireland and Cyprus do much better than Greece, Italy and Spain, with Portugal somewhere in between. Similarly, public sector efficiency (measured as an output-to-input ratio) seems to differ a lot across EU countries. Thus, there are many types of heterogeneity. Heterogeneity implies that, even if the shock is uniform across countries (the burst of the global bubble in 2008), its effect is different across countries due to different propagation mechanisms. This implies in turn that different policies are required. For instance, arguments for fiscal austerity (see below) become stronger if the public sector is inefficient or provides the ground for rent seeking activities (see e.g. Angelopoulos et al., 2009).

4. Two much debated macroeconomic policy reforms

Many reforms have been suggested ranging from disintegration of the euro zone to full fiscal and banking union. Here, I will focus on two reforms also discussed by the authors: debt consolidation and devaluation.

Before I move on, I would like to make a methodology remark. Most of the policy questions raised (for instance, "is debt consolidation good?") are quantitative. They thus require quantitative answers. What is needed is a quantitative assessment of the implications of policy reforms. This requires the use of DSGE models. These models, calibrated or estimated, can be

[1] Alesina and Giavazzi (2006) provide a rich description of the mistakes made in Europe since the 1970s. They pay particular attention to incentives and institutions.

[2] In Papageorgiou et al. (2013), we have constructed a measure of the quality of institutions that protect property rights for 19 EU countries using the World Bank's "Worldwide Governance Indicators" dataset, which is widely used in empirical studies and covers the period 2002–2010. The institutional quality index is the sum of the following three indicators: "*rule of law*", "*regulatory quality*" and "*political stability and absence of violence/terrorism*". These indicators are closely related to issues concerning the protection of property rights. Results are available upon request from the authors.