FES Seminar 2
Krise in der Euro-Zone am Beispiel der Austeritätspolitik – Scheitern des ökonomischen Mainstreams

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WHY WOULD YOU THINK THAT AUSTERITY IS THE RIGHT POLICY?
Two Diagnoses seem to be Necessary

“It is an **undisputable fact** that **excessive state spending** has led to **unsustainable levels of debt** and deficits that now threaten our economic welfare. Piling on more debt now will stunt rather than stimulate growth in the long run.”

W, Schaeuble Financial Times, May 2011

“The Problem is that Greece has lived beyond its means for a long time and no one wants to given them any more money without Guarantees.”

W. Schaeuble, Deutschland Rundfunk, February 2015.
LET'S EXAMINE BOTH OF THESE CLAIMS
Does the Euro Area Government Debt Profile Suggest Overspending?
Does Overall Government Spending Show This?
Greece as the Model of Overspending? Debt Profile
Greece as the Model of Overspending?
Government Spending
Germany as the Model for this same pathology?
Germany as a Model of Overspending?

Government Spending
So what’s actually going on?

• Amplitude is similar if baselines and timing are different
• General debt profiles are flat going into the crisis, even in Greece (2010 deficit as exception)
• Germany can pay for overspending – Greece Can’t – but what if growth in debt is not a function of current spending (denominator problem)?
The more intense austerity programs coincide with increasing government debt ratios.

The underlying mechanism is well known since the days of Irvin Fisher (Fisher(1936)).
Figure 3: Cumulative GDP Growth and Austerity during 2009-12

The estimated equation suggests that on average for every one percent increase in austerity output declines by 1.4%.

The stronger is the austerity program the deeper is the decline in GDP.
Mainstream Theory Problem One: Austerity Increases Debts

- Mainstream Theory hinged on expansionary Austerity (Sweden, Denmark, Ireland, Canada in the 1980s)

- IMF turn against austerity 2011 (battle of the boxes 2012) uses strict neoclassical models to get 1-1.4/7 negative multipliers

- EC response is “if people had not been pricing in Euro break up the yields would not have spiked and the multipliers would have been positive.”

- So Why were the Markets Pricing this in?
Mainstream Theory Problem Two: The Financial Sector Doesn’t Exist

• Keynesian and Neoclassical Theories discount finance (pass through versus information system plus ‘sums to zero.’)

• Both miss leverage and it’s effects on market clearing (panic and liquidity effects)

• “One man’s debt is another man’s income” – at least until the debtor can’t pay (Krugman and Egertsson 2011 – credit constraints and debt spiral)

• NB: Both miss ‘moral hazard trades’ and TBTF extortions
Welcome to the Greatest Moral Hazard Trade in Human History?
That trade gave us Euro bank Balance Sheets filled with periphery debts-gone-bad

Foreign banks combined consolidated claims on Greece, Ireland, Italy, Portugal, Spain (% GDP 2011)
BIS March 2011
...which is the real reason we bailed out the periphery

Periphery lending were indirect bank bailouts to core banks for prior over-lending to periphery...

But that’s not all...

- Greece: €274.5 billion
- Ireland: €85 billion (plus €47 billion in Promisory notes)
- Portugal: €74 Billion
- Cyprus: €10 Billion
- Total: €490.5
How Much was Actually Bailed-in to Eurozone Banks 2009-14?

• “Total state support approved for the EU financial sector totals more than E5 trillion, equivalent to 40 percent of [eurozone] GDP.”

• Of capital injected into banks to keep them afloat, “only about 10 percent of the original capital injected has been repaid.”

• “Otherwise insolvent banks have been recapitalized and the monetary policies of the ECB and national central banks have allowed themselves at low cost.”

• Oliver Wyman, “The Shape of Things to Come: What Recent History Tells US About the Future of European Banking.” Oliver Wyman Consulting Group, August 2013: 14
Which today means a whole bunch of NPLs going on...

### NPL by country 2008-2013

<table>
<thead>
<tr>
<th>Country</th>
<th>In billions EUR</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
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<td>111</td>
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<td>133</td>
<td>133</td>
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<td><strong>Sub-total</strong></td>
<td><strong>404</strong></td>
<td><strong>680</strong></td>
<td><strong>795</strong></td>
<td><strong>846</strong></td>
<td><strong>895</strong></td>
<td><strong>899</strong></td>
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<td>Greece</td>
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<tr>
<td><strong>Total Europe</strong></td>
<td><strong>511</strong></td>
<td><strong>880</strong></td>
<td><strong>1,022</strong></td>
<td><strong>1,096</strong></td>
<td><strong>1,201</strong></td>
<td><strong>1,220</strong></td>
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Source: Publicly available information, PwC information, analysis and estimates.
Mainstream Theory Problem Three: Institutions Matter

- Germany and the ‘Not Switzerland’ Problem
- Export Led Growth relies on other people’s spending and consumption suppression
- Varieties of Capitalism are real in their consequences
Mainstream Theory Problem Four:  
Tight Fiscal and Loose Money – No reward for Austerity

- Italy – Debts and 10 Year Yields
- France - Debts and Ten Year Yields
Policy Mixes post 2009

- 2009-10 – Expansionary – strong recovery
- 2010 – Contractionary – recovery falters, spreads widen
- 2011a – Contractionary – rates raised - recovery falters, spreads widen
- 2011b – Banks run out of funding – LTRO (disguised QE) – tight fiscal loose money
- 2011 – present – same stance
Problems

1) Tight Fiscal Offsets Loose Money

“If confidence in public finances is assured, the next stage – and this is where we are now – is to exploit the available fiscal space, so that fiscal policy can work with rather than against monetary policy in supporting aggregate demand.”


2) If QE stabilizes debt profiles via Monetization, why do you need the tight fiscal at all?

3) Why keep Squeezing Greece when the policy mix is the problem?
Mainstream Theory Problem Five: From Austerity to Structural Reform

• Structural Reforms as the New Mecca via ‘enhancing competitiveness’ (tax and labor market changes key)

• Problems:
  • Competitiveness is a relative term
  • Can’t all run a surplus (even if MiB tries to make that happen)
  • Misreading the German Experience (Dustmann 2014 JEL)
  • More than Contractionary in the Short Run (Eggertsson 2015 JME) – if you damage the demand side enough you can permanently shift long run supply curves
This is seen most clearly in the fall in investment and in the fall in inflationary expectations in the EU.
There is a risk that the euro area is shifting from the targeted equilibrium to the deflationary equilibrium in which Japan became mired. The ECB has acted remarkably slowly to address this risk...

Why did We get it so Wrong?

• Inflation Obsessions?
• Overly Rational Homogeneous agents?
• Willing Blindness regarding Finance?
• Generational Change in Economics?
• The Death of Fiscal Policy and the Rise of Independent Central Banks?
• Turning Economics into Morality? (Saving Good - Spending Bad)
The Actual 1970s UK Philips curve
The one for 1992-2009