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

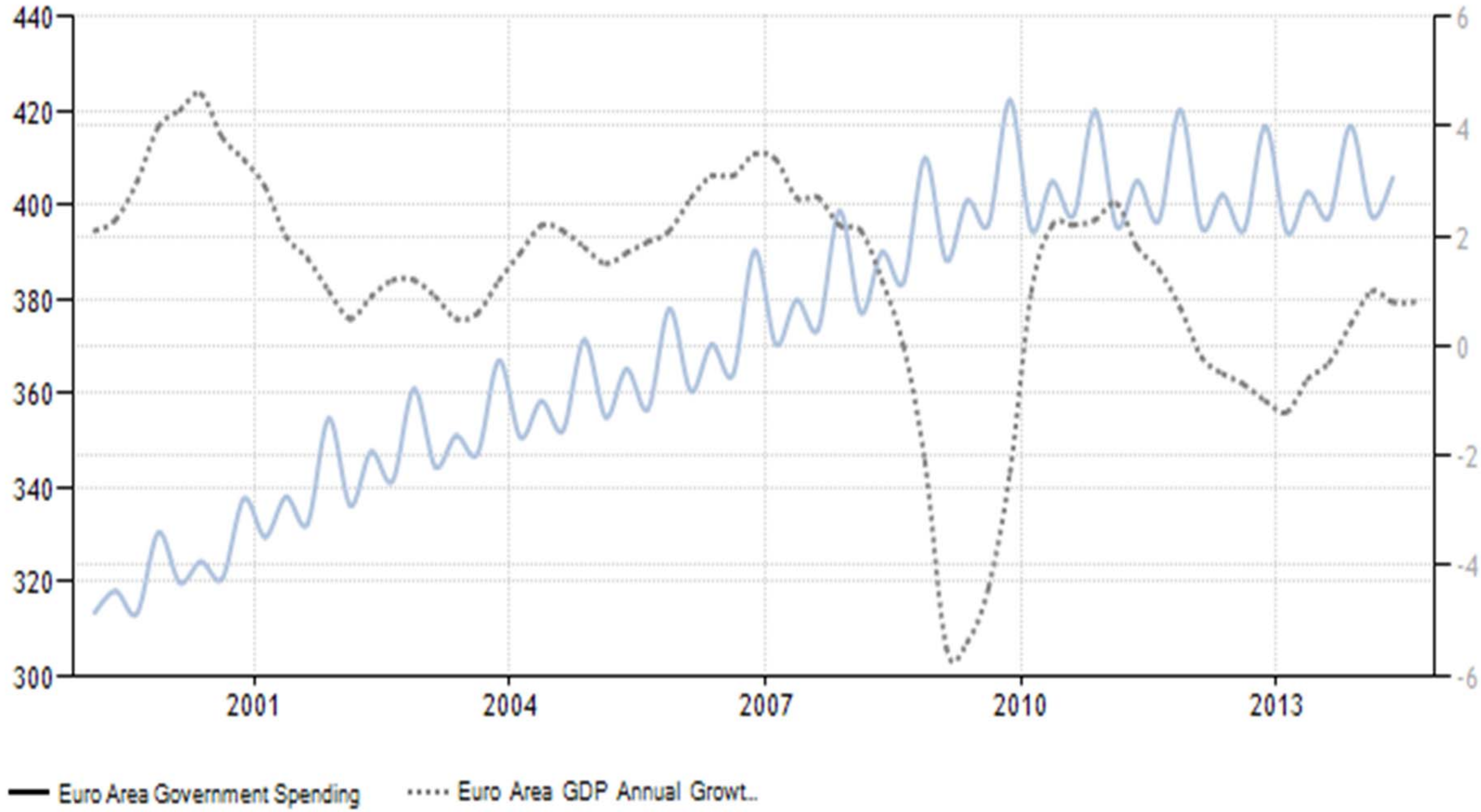
"The Problem is that Greece has lived beyond its means for a long time and no one wants to given them any more money without Guarantees."

W. Schaueble, Deutschland Rundfunk, February 2015.

LETS EXAMINE BOTH OF THESE CLAIMS

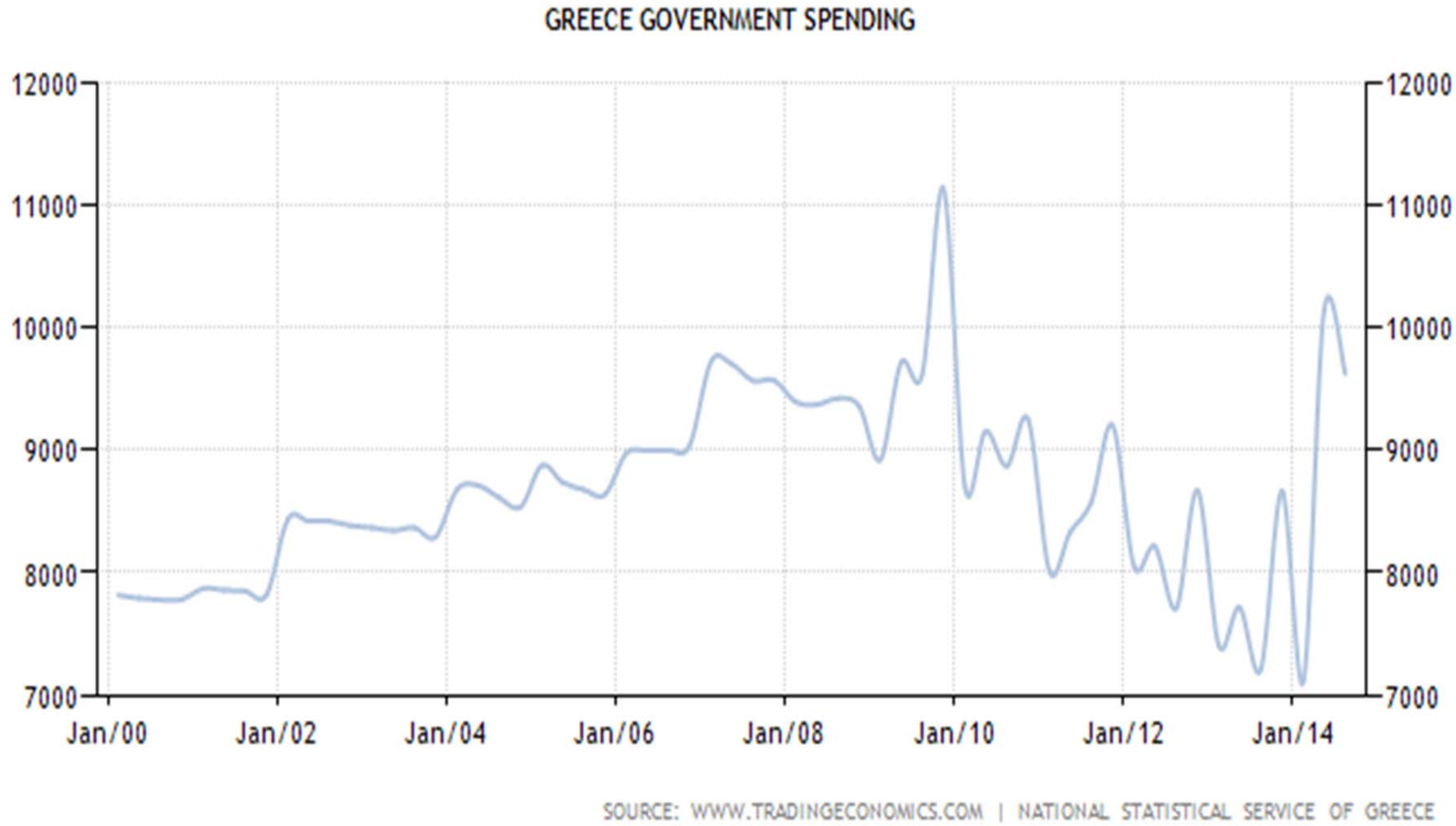
Does the Euro Area Government Debt Profile Suggest Overspending?

Does Overall Government Spending Show This?



Greece as the Model of Overspending? Debt Profile

Greece as the Model of Overspending? Government Spending

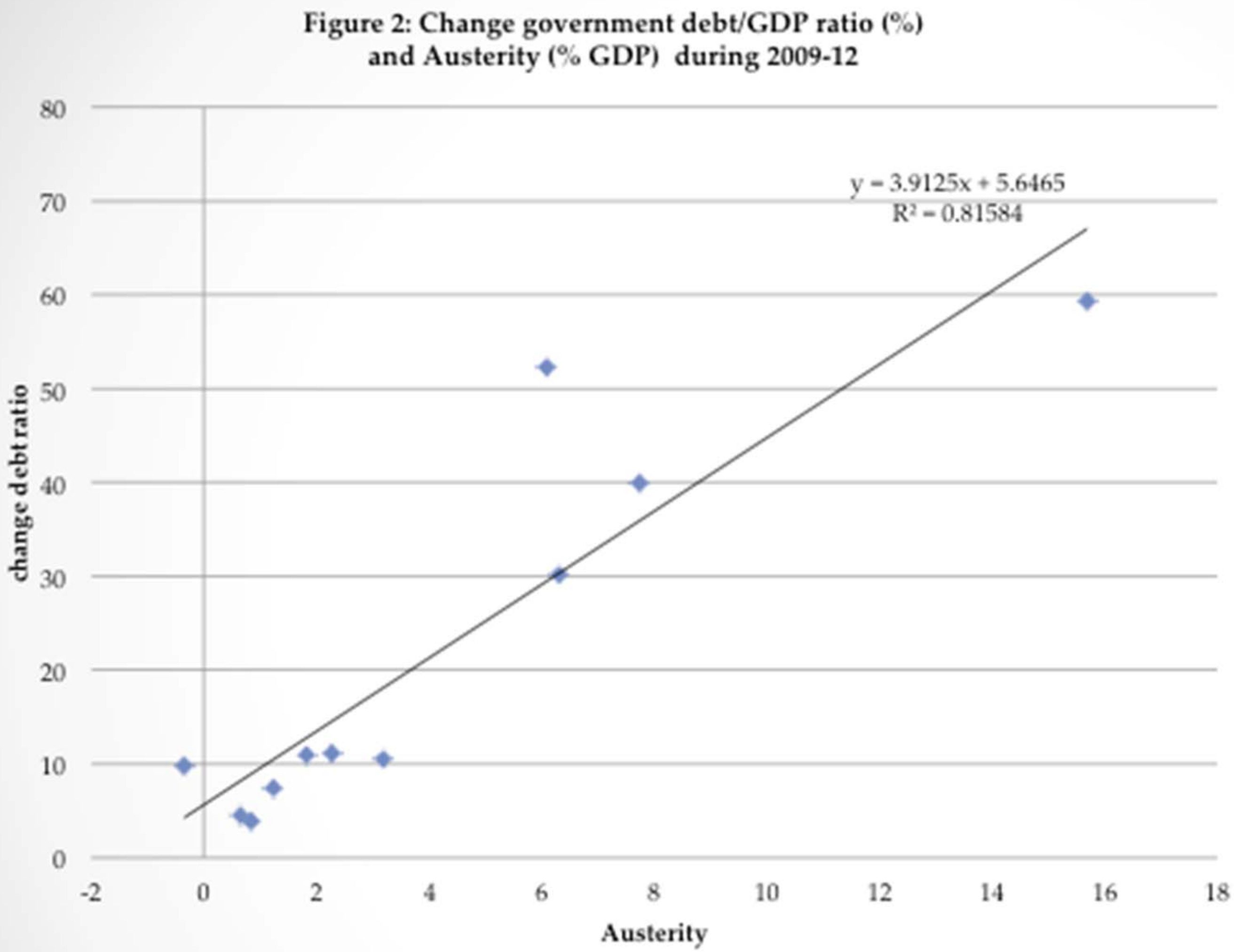


Germany as the Model for this same pathology?

Germany as a Model of Overspending? Government Spending

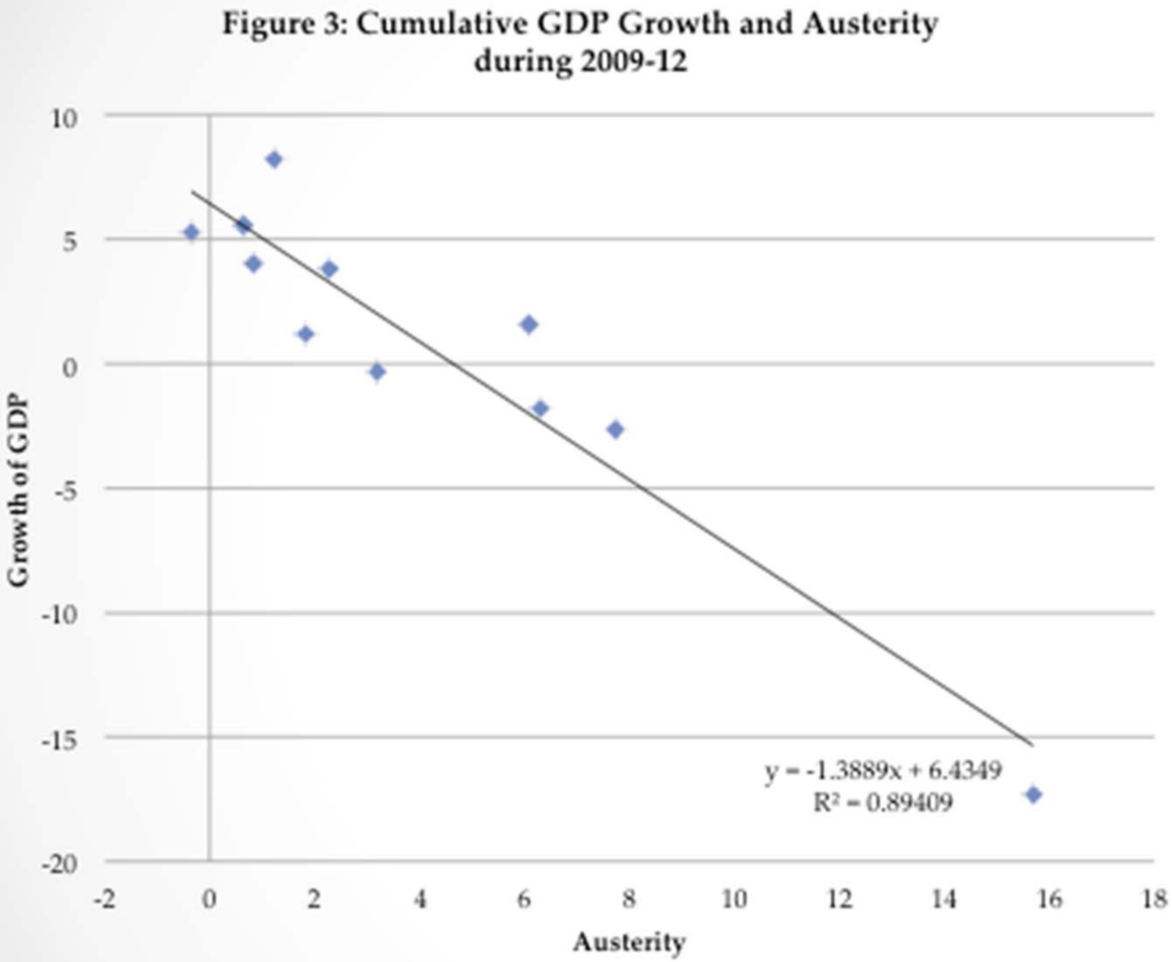
So what's actually going on?

- 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)).



the stronger is the austerity program the deeper is the decline in GDP.

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

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

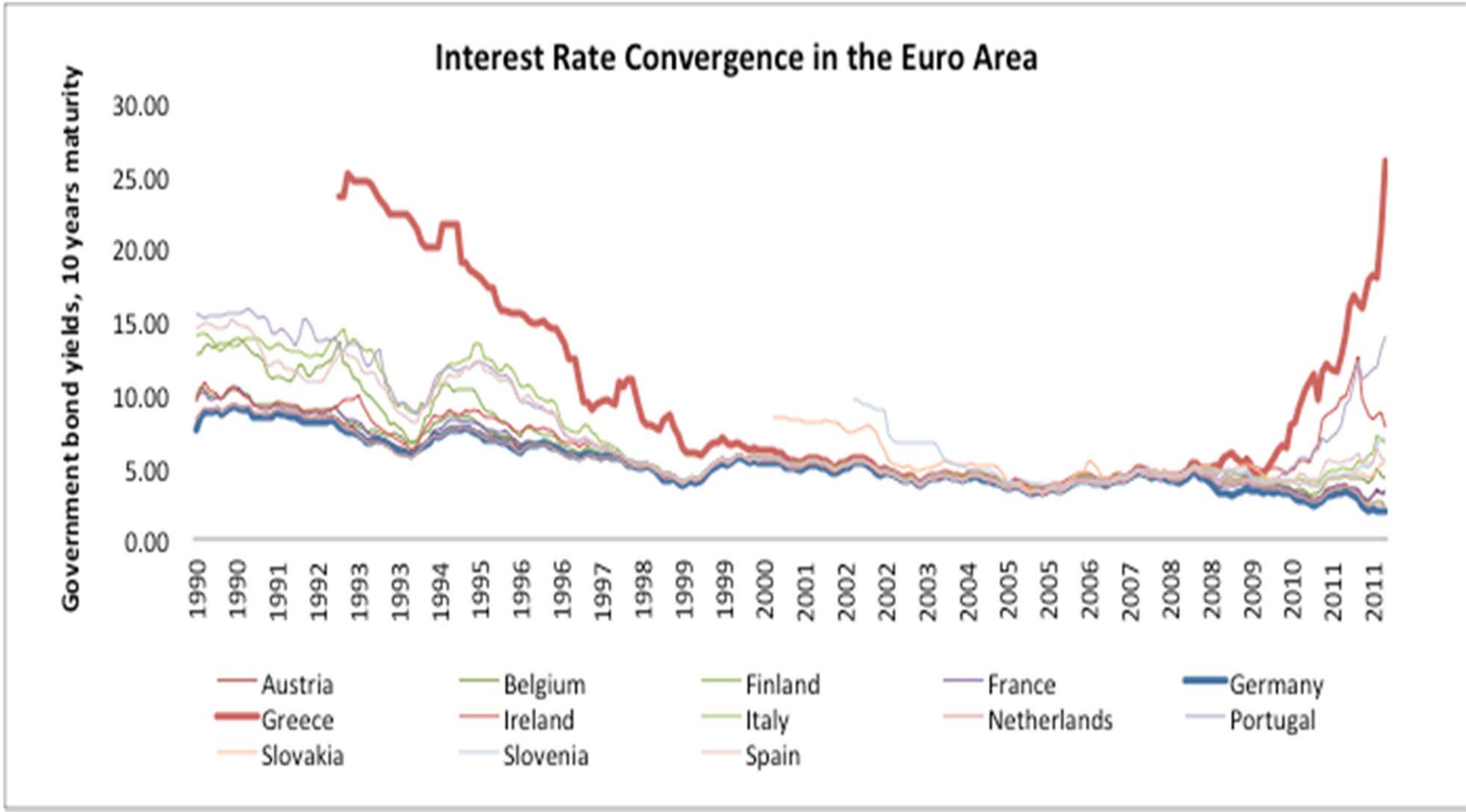
- EC response is "if people had not been pricing in Euro break up the yields would not have spiked and the multipliers would have been positive."

- *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

…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 E47 billion in Promisory notes)
- Portugal: €74 Billion
- Cyprus: €10 Billion

- **Total: €490.5**

How Much was Actually Bailied-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."

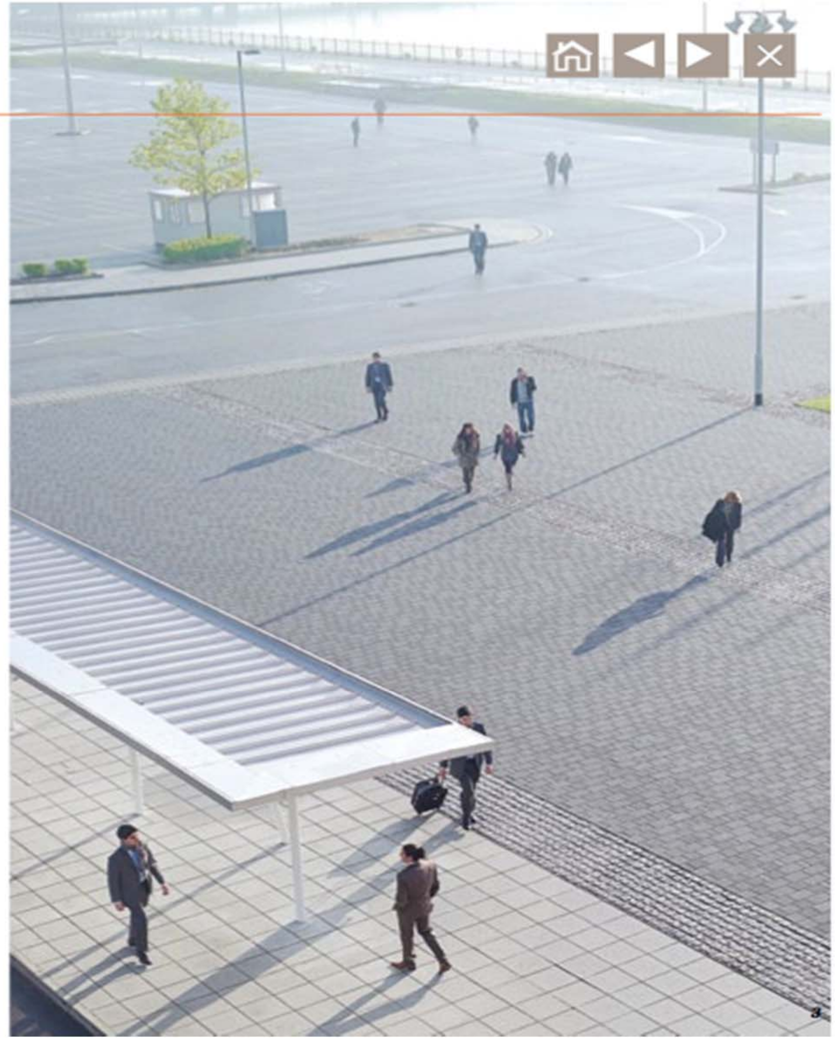
- *Oliver Wyman, "The Shape of Things to Come: What Recent History Tells US About the Future of European Banking." Oliver Wyman Consulting Group, August 2013: 14*

Which today means a whole bunch of NPLs going on…

NPL by country 2008-2013

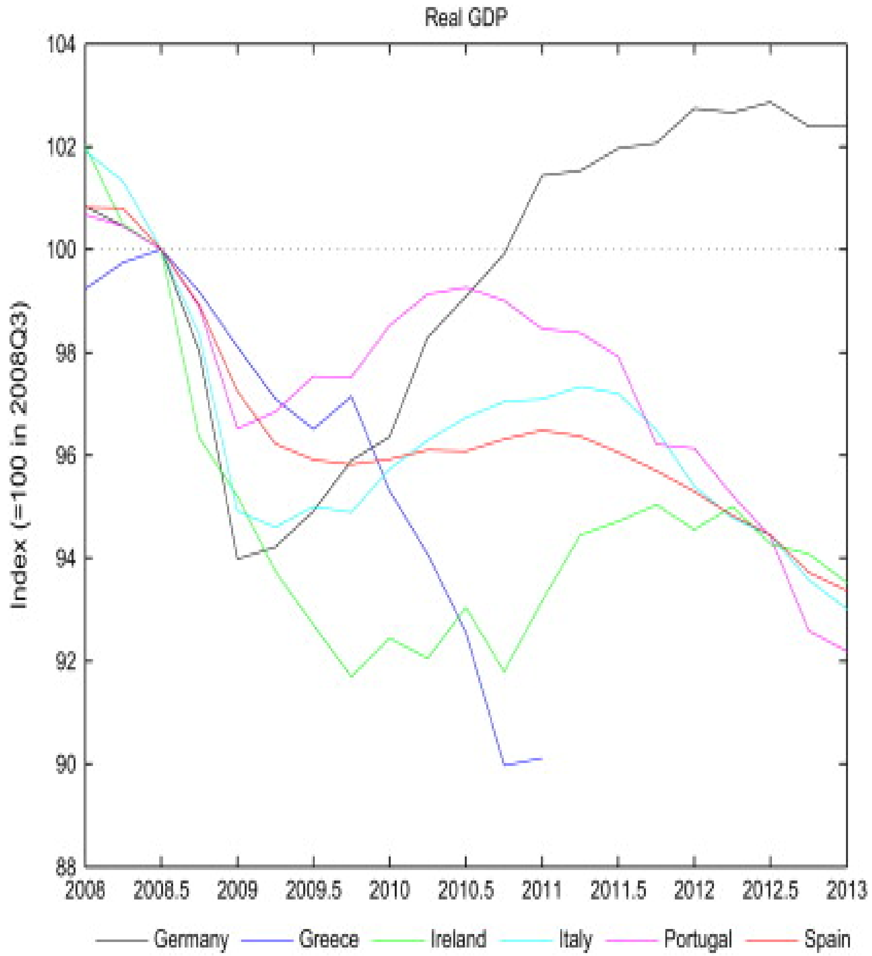
In billions EUR	2008	2009	2010	2011	2012	2013
Spain	66	97	111	136	167	197
Italy	42	59	78	107	125	157
Germany	142	204	192	179	179	157
United Kingdom	88	155	172	172	164	136
Ireland	15	88	109	119	135	130
France	51	77	133	133	125	122
Sub-total	*404*	*680*	*795*	*846*	*895*	*899*
Greece	12	19	27	40	56	77
Netherlands	32	58	52	52	57	55
Russia	n/a	27	32	34	39	39
Cyprus	n/a	4	6	9	18	19
Austria	9	12	17	18	21	19
Portugal	5	8	10	12	17	19
Poland	9	12	15	15	17	17
Ukraine	11	11	11	12	16	14
Denmark	8	13	16	17	15	14
Turkey	7	11	11	9	11	11
Romania	1	3	5	6	11	10
Hungary	2	3	5	7	8	8
Sweden	5	8	8	7	6	5
Czech Republic	2	4	5	5	6	5
Norway	2	4	4	4	5	5
Slovakia	1	2	2	2	2	2
Finland	1	1	1	1	1	2
Total Europe	***511***	***880***	***1,022***	***1,096***	***1,201***	***1,220***

Source: Publicly available information, PwC information, analysis and estimates'



Mainstream Theory Problem Three: Institutions Matter

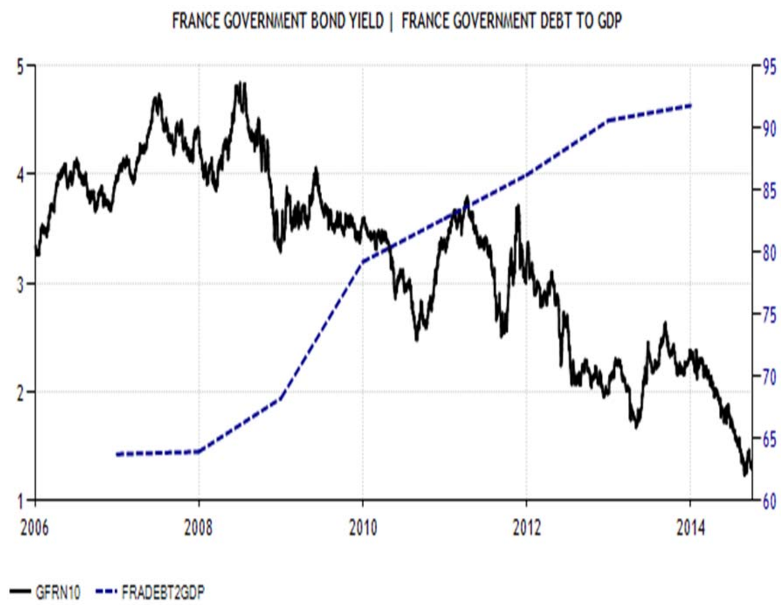
- Germany and the ‘Not Switzerland’ Problem
- Export Led Growth relies on other people’s spending and consumption suppression
- Varieties of Capitalism are real in their consequences



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.”

Mario Draghi, The Brookings Institute, Washington DC, USA, 9th October 2014.

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

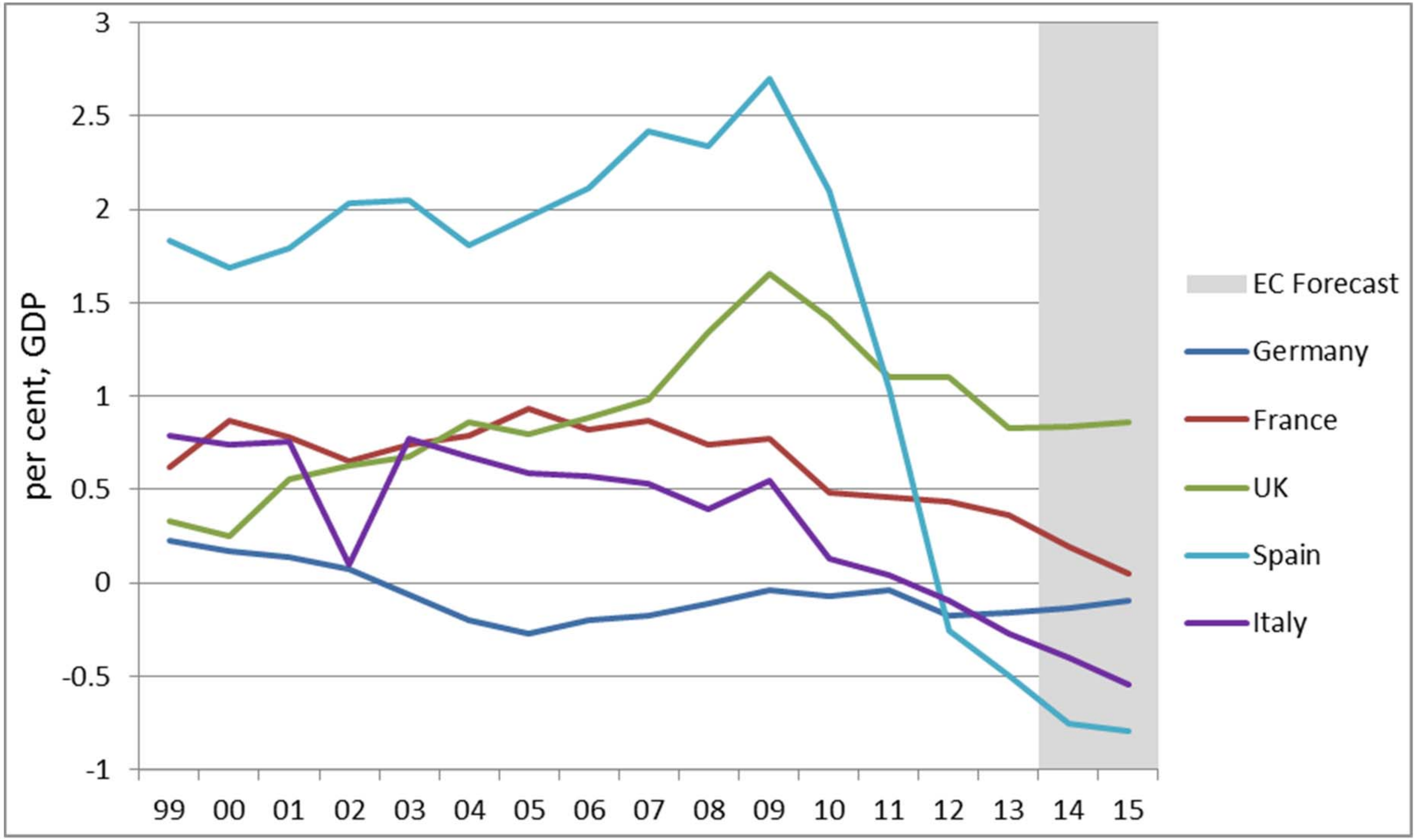
3) Why keep Squeezing Greece when the policy mix is the problem?

Mainstream Theory Problem Five: From Austerity to Structural Reform

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

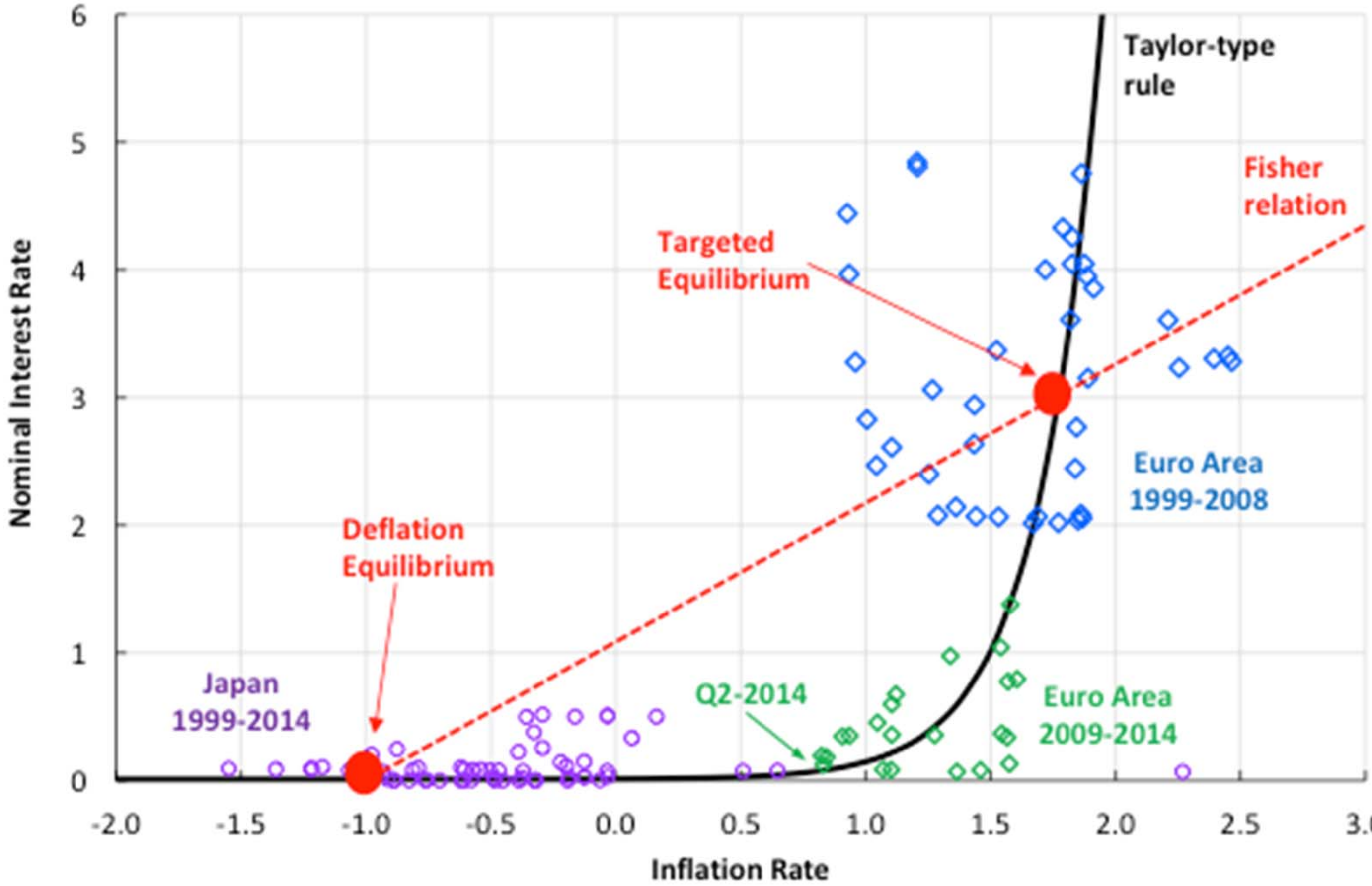
- **Problems:**
- Competitiveness is a relative term
- Can’t all run a surplus (even if MiB tries to make that happen)
- Misreading the German Experience (Dustmann 2014 JEL)
- More than Contractionary in the Short Run (Eggertsson 2015 JME) – if you damage the demand side enough you can permanently shift 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…

Interest rates, inflation, and multiple equilibria

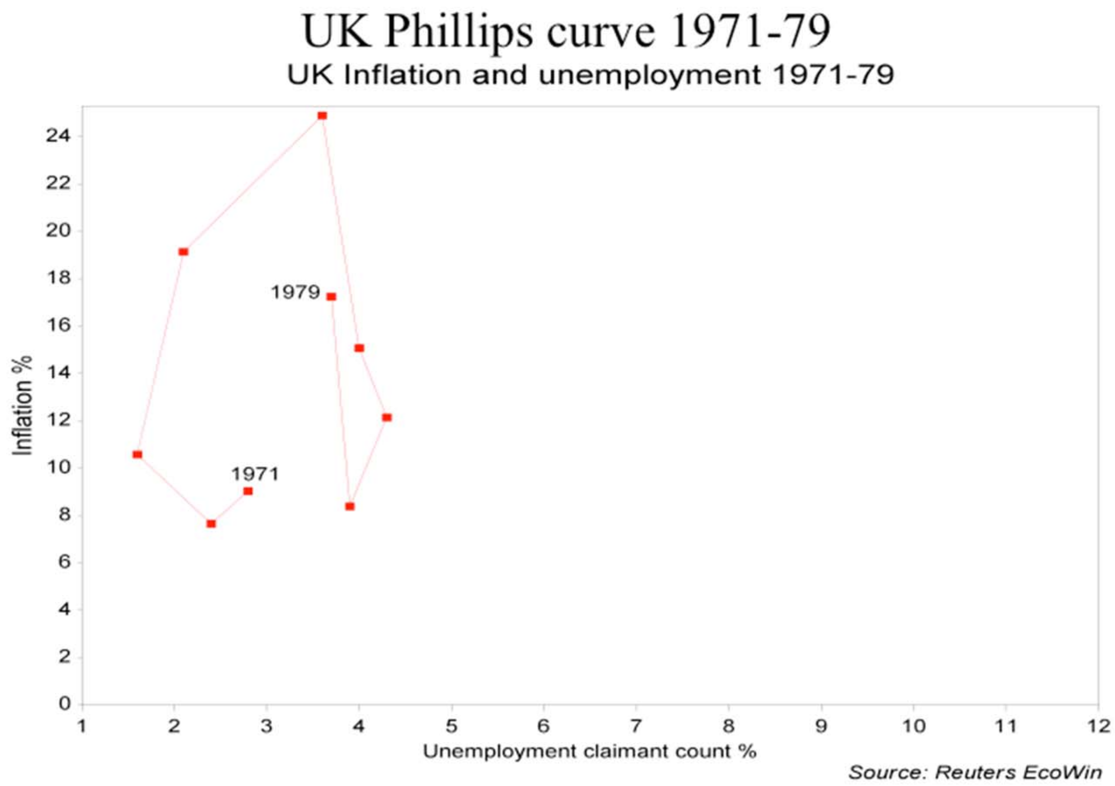


Source: Antolin-Diaz (2014), "Deflation Risk and the ECB's communication Strategy", Fulcrum Research Paper

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