PROSPECTS FOR EUROPE AND THE WORLD

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EUROPE ENTERS A DOUBLE DIP RECESSION

- After slow growth in 2010 and 2011, growth in 2012 is expected to be negative
  - 1.8% for 2010, about 1.5% for 2011, and predictions of -1.0% for 2012.
- For some countries, like Portugal and Greece, even 2011 was marked by negative growth
  - Greece was -5.2% in 2011, predicted to be -7.4% in 2012
  - Portugal -1.4% in 2011, predicted to be -4.1% in 2012
- Negative growth is a predictable—and predicted—consequence of flawed economic policy framework and institutions

FLAWED POLICY FRAMEWORK AND INSTITUTIONS

- A central bank that focuses on inflation, paying little attention to unemployment, financial stability, or the flow of credit

- A currency area that is far from optimal, without the institutional arrangements that can make it work

- Austerity fiscal policies, motivated by deficit fetishism—even in countries with more fiscal space

AT RISK….

- High and persistent levels of unemployment
- Large-scale business failures
- A recession—or at least a very weak economy—stretching out for a decade or more

Or worse…

- The break up of the euro
- Political turmoil, at least in several of the European countries
- A global recession

A BRIEF HISTORICAL PERSPECTIVE

- Great Depression was a time of enormous structural change—movement from agriculture to industry, as a result of large increases in productivity

- Markets didn't manage transition well
  - With the result that there was massive unemployment, high levels of inequality
  - Finance didn't understand transition, made large loans to agricultural sector, which went bad
  - Bubble helped offset weaknesses in agriculture—for a while

- Gold standard inhibited adjustment
  - Countries that left gold standard did better
  - Though part of their gain was at expense of others (beggar-thy-neighbor policies through competitive devaluation)

A BRIEF HISTORICAL PERSPECTIVE

- Central banks in some countries exacerbated problem
  - Contractionary monetary policy
  - Didn’t realize critical role of financial sector failure

- Ambiguous fiscal policy
  - Under Hoover, austerity converted stock market crash into Great Depression
  - New Deal was too small, barely enough to offset contractionary policies of state and local levels
  - New Deal was reversed in 1937

RECOVERY

- Based on large war time spending
- But helped to restructure the economy
  - Moving people from rural to urban
  - Retraining people for industrial jobs
  - G.I. Bill providing further education
  - Heavy investments in infrastructure
  - Heavy investments in technology

SOME ANALOGIES

- Today, the problem is a shift from manufacturing to service sector economy
  - Exacerbated by shifting global comparative advantage
  - And again associated with high levels of inequality

- Consequences (including growing inequality, labor market polarization) masked by bubbles
  - Only temporary palliative
  - Left a legacy of debt, overhang of excess capacity in real estate

LEARNING THE LESSON?

- Central banks—not wanting to be accused of not learning the lesson of the Great Depression—poured liquidity into the system
  - Saved the banks, but didn't save the economy
    - Banks haven't restored lending
    - Equipment and software investment (at least among large firms) largely restored
    - Real estate investment won't be restored
  - *Policymakers made a fundamental mistake: they thought that fixing the financial system would restore the economy to health*

IT'S NOW EVIDENT

- The economic problems are deeper
  - Flawed monetary policies can help create a crisis, but may not be able to get us out of the problems

- The banking system has not really been fixed
  - Problems of excessive leverage still persist
  - Problems of excessive risk taking, non-transparency still persist
  - Anti-competitive practices and predatory lending still persists (at least in US)
  - Lending to SME's still subdued

BACK TO THE ANALOGY

- Stimulus worked—but was not as well designed as it could have been, not as big or long-lasting as it should have been

- Euro introduces, within Europe, a kind of rigidity analogous to the gold standard—makes adjustments more difficult
  - Iceland, with deepest crisis, is now doing much better than other crisis countries in Europe, US
  - Europe hurt by America's "beggar-thy-neighbor" policies, as quantitative easing works to lower exchange rate, and ECB doesn't respond

AUSTERITY

- Has almost never worked to restore the economy

- And doesn't even help fiscal position as much as hoped because of weakened economy—lower tax revenues, increased expenditure
  - A couple of instances of countries with flexible exchange rates, where trading partners are having a boom
  - But Europe is entering a recession, so exports can't fill in for drop in domestic spending

- Problems are especially severe with credit constraints imposed by weak banking system

FOR COUNTRIES LIKE THE US, THERE IS AN EASY ALTERNATIVE

- Spending money on high-return public investments (technology, infrastructure, education) *improves* balance sheet

- Returns far higher than cost of funds

- Would be foolish not to undertake investment

- Debt/GDP lower even in the medium term

FOR OTHER COUNTRIES FACING BORROWING CONSTRAINTS, ARE THERE CHOICES?

Yes:

- Raising taxes and spending the proceeds
  - Balanced budget multiplier
  - Especially large if tax structure can encourage investment (lowering taxes on firms that invest or create jobs in country, raising it on other firms)

- Restructuring taxes and expenditure policies
  - More progressivity
  - Increased spending on high multiplier activities
  - Especially those that “crowd in” private investment

EUROPE NEEDS TO REALIZE THAT AUSTERITY IS NOT THE ANSWER

- Framework focusing on austerity simply worsens the problem
- Highly indebted countries will only be able to deal with debts with growth, and growth won't occur with austerity, without further assistance
- July 21 agreement *seemed* to recognize this, but no growth assistance was forthcoming
- More recent agreement seems to return to single minded focus on austerity

- *At most* austerity might prevent next crisis; doesn't solve this one
- But Ireland and Spain had surpluses and low debt/GDP before crisis—so commitment to balanced budgets wouldn't even have prevented their problem

MOVING THE GOAL POSTS:

- Now Europe says that current account deficits are the problem
- But there is no way of telling what are good current account deficits (country has created such a good business environment that capital is flooding in) or bad
- And no policy framework—given commitment to single market principle—to deal with them

BEYOND AUSTERITY?

- Many Programs have heavy emphasis on structural reforms
  - But structural reforms take time
  - And mostly are supply side measures
  - Problem today is lack of demand
  - Some so-called structural reforms may weaken economy by weakening demand
    - Labor market flexibility (code word for lowering wages)
    - US—allegedly most flexible labor market—has not performed well; much worse than Germany and other European countries with better systems of social protection
    - Increasing consensus that growth in inequality in US contributed to crisis
      - Led to weaker demand
      - Fed tried to offset by creating a bubble, through low interest rates and lax regulation

BEYOND AUSTERITY?

- Many programs have emphasized privatizations
  - Deep recession not best time to sell assets
  - Nor are fire sales the best way to sell assets
  - Government’s fiscal position (long term) can even be worsened
    - Ambiguous evidence on improved performance post-privatization

BEYOND AUSTERITY?

- Countries like Greece, Ireland, and Portugal will only be able to go beyond austerity with assistance from Europe
  - European Investment Bank
  - Solidarity Fund for Stabilization
  - Eurobonds
  - Assistance with bank recapitalization
  - New Lending Facilities

IS THE EURO VIABLE?

- Was originally a political project
  - The EU 17 were never an “optimal currency area”
  - But the politics were not strong enough to create the institutions that could make it work
  - Hope was that they would evolve over time, and strengthen European solidarity
  - Didn’t happen
  - Hope was that after the Greek crisis came to fore, the necessary steps would be taken
  - Didn’t happen
  - Rather than bringing solidarity, has brought new divisions

THE PROBLEM

- The Euro took away two key mechanisms for adjustment (interest rate and exchange rate) and put nothing in its place
  - So long as there was rapid growth, everything was OK
  - Inevitable that different countries would be buffeted by different shocks
  - And different countries would face different long term rates of growth of productivity

“INTERNAL DEVALUATION” IS NO SUBSTITUTE

- Deflation hard to coordinate
- And causes hardship, with unindexed debt contracts—borrowers can’t pay back what is owed
- Leading to financial stress and instability
- If internal devaluation was an easy substitute, gold standard would not have imposed any constraint on adjustment

THE ECB—UP TO THE TASK?

- The wrong mandate—focusing only on inflation
- The wrong “client”—focusing on the banks (the lenders), not the borrowers and on Europe
- The wrong mindset—”market fundamentalism,” the kind of thinking that helped create the crisis in the first place

AN EXAMPLE

- Opposition to debt restructuring
- But Greece’s debt could only be managed with a deep restructuring
- But then it said, it had to be “voluntary,” couldn’t set off a “credit event”
- Presumably because of worries about the consequences of holdings of credit default swaps

- But if credit default swaps were a problem, it should have regulated them more tightly—its failure to regulate banks adequately seems to be imposing impediment to Europe's recovery
- If CDS's were doing what they're supposed to do, they are insurance—if banks had bought insurance, one would want the insurance to pay off—would strengthen banks
  - Suggests that banks may have been gambling

- Whether a restructuring is a credit event is determined by a secret American committee of interest parties
  - Europe shouldn’t delegate responsibility for what is or is not acceptable to such a body
  - Evidence that at least some members of the Committee have in fact been acting in a self-interested way

WILL CURRENT PROPOSALS SUFFICE?

- Europe has taken a number of steps to reassure the market—but will they work?

- Probably not, but some big question marks
  - As effects of austerity take hold, there will be widespread disappointment—deficits will improve less than hoped
  - Markets will realize that the amount of funds currently provided are not sufficient
  - And probably can’t be leveraged to make them seem as if they are (“voodoo finance” won’t work)
  - If there are serious problems in ratification of measures, confidence in European solidarity will be further eroded

IS THERE LIFE AFTER DEBT?

- Argentina has shown that there can be very rapid growth after a large debt restructuring
  - Though the process itself was very painful
  - And it did an impressive job of managing the economy post-restructuring

- Consistent with economic theory
  - Funds used to service the debt now used to stimulate the economy
    - But it's essential that there be a primary surplus—either lack of access to funds may cause further cutbacks
  - With growth and lower debt, the government is far more creditworthy than it was before

BUT DEBT RESTRUCTURING MAY NOT BE ENOUGH

- Devaluation was an important part of Argentine's success
- Consequences/complexities of countries within Europe leaving the Euro even greater
- Among economists, increasing talk of what is best way to "restructure" the euro

SOME OF THE LARGE UNCERTAINTIES

- Will Germany realize that it will be among the big losers if the euro falls apart?
  - Both from changes in exchange rate and credit losses?

- Will Germany be willing to support stronger solidarity measures—eurobonds and a large European solidarity fund, larger than the current EFSF?

SOME OF THE LARGE UNCERTAINTIES

- Will the market turn more strongly against European sovereign bonds, and if so, when?

- Will the ECB be willing to buy European sovereign bonds, in essentially unlimited quantities, if the market turns against European sovereign bonds?
  - Eurozone can't function without the ECB acting as a lender of last resort to the banks of all eurozone members

- For how long will the citizens of the high unemployment countries accept austerity—without any prospect of things getting better in the future?

CONCLUDING COMMENTS

- Need to remember: human, physical, natural resources *after* the crisis are the same as they were before the crisis
- If markets worked well, resources would be fully used, with or without a large government debt/deficit
- But markets often don't work well, and they haven't worked well
- Government policies are supposed to step in then, to ensure full employment
- But in Europe and America, government policies have been making matters worse…

- … and are likely to continue to do so
- There are alternative policies that hold out the promise of economic recovery
- But both politics in Europe and America (for different reasons) make it unlikely that these policies will be adopted
- The consequence: a high risk of economic hardship and turmoil for years to come
- With political consequences that are hard to fully foresee