Getting the Story Right

HOW YOU SHOULD CHOOSE BETWEEN DIFFERENT INTERPRETATIONS OF THE EUROPEAN CRISIS (AND WHY YOU SHOULD CARE)

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The European crisis is over-determined

There are at least four explanations for Europe’s recent crisis
- The euro was a mistake
- Governments wasted money and borrowed excessively
- Households lived beyond their means
- Market participants (banks, investors) got startled and lost confidence

These explanations are complementary and not competitive
- They can all be true at the same time
- They are (often) reinforcing
- The presences of one factor can repair the absence of another
Over-determination is a problem

It distorts data collection
- Stop at confirmatory data
- Ignore differences between cases
- Exclude cases

It obscures causal mechanisms
- Imbues symptoms with causal significance
- Complicates tests for necessity, sufficiency, and sequencing
- Result is a loss of leverage and therefore also control
The European response is under-powered

Solutions compete even if interpretations do not
  ◦ Political attention (cherry-picking)
  ◦ Burden sharing (winners and losers)
  ◦ Economic outcomes (reinforcing, negating)
  ◦ Timing (inside and outside lags)

Muddling through is risky
  ◦ Mistakes happen (Cyprus)
  ◦ Key actors run out of room for manoeuvre (ECB)
  ◦ Structural damage accumulates (lost generation)
How do we assign priority?

Three-fold test
- Necessity – does the condition exist in every case of crisis?
- Sufficiency – does the condition exist in any case of non-crisis?
- Sequencing – does the condition come before or after the crisis?

Confirmation strategy
- Standard causal pattern – does the causality look familiar?
- Fair causal comparison – can the argument explain more variation?
- Leverage – does the argument point to a policy response?
Necessity

Were there countries outside the euro that got into trouble? [Iceland, UK, Hungary, Latvia]

Were there countries that got into trouble without excessive government borrowing? [Ireland, Spain, Portugal]

Were there countries that got into trouble without excessive household leverage? [Greece, Italy]

Were there countries that got into trouble without a sudden loss of confidence from market participants? [tautology – see sequencing]
Sufficiency

Were there countries in the euro area that escaped attention? [Luxembourg, Malta]

Were there countries that managed high public debt? [Belgium]

Were there countries that got away with high household leverage? [Denmark, Netherlands]

Were their countries that lost market confidence without falling into crisis? [Belgium; Vienna Initiatives 1 and 2]
Household Debt (percent GDI, OECD)
Sequencing – focus on capital flight

Does a rise in the current account deficit precede a flight of capital? [Ireland]

Does a rise in government borrowing precede a flight of capital? [Greece]

Does a rise in household borrowing precede a flight of capital? [Italy]

Does a flight of capital undercut competitiveness, government finances, and household balances?
Current account and capital flight (Ireland)
Fiscal balance and capital flight (Greece)

Greek-German 10-year sovereign yield spread
Household leverage and capital flight (Italy)
‘Sudden Stop’ as standard causal pattern

Basic mechanism familiar to students of balance of payments crises
- Capital market liberalization
- Gradual increase in cross-border capital flows
- Accumulation of cross-border asset positions
- Shock to confidence
- Liquidation and flight

Few requirements (Occam’s Razor)
- No specific exchange rate regime
- No specific banking structure
- No necessary government or household balances
‘Sudden Stop’ versus ‘Competitiveness’

Some of these countries were both flexible and competitive: Ireland

Others were inflexible and yet oddly successful in world markets: Italy

Still others were more successful than you might suspect: Greece

Meanwhile, there were countries that had worse competitiveness problems prior to the crisis in terms of world market shares and manufacturing employment.
World market shares

**World Export Market Shares (AXGT)**

Year: 1991 to 2007

- Germany
- PCS
- USNDS

Percent
Manufacturing employment

Employment in Manufacturing (NETM)

Thousands


Germany  PCS  USNDS
‘Sudden Stop’ versus ‘Government Finances’

The question is solidarity as much as sustainability: Greece

There is also a consideration of who holds the debt: Italy

Finally, there is the question of whether you can reassure market participants: Belgium
Solidarity and sustainability

Greek-German Interest Rate Differential

- First Greek Restatement
- Second Greek Restatement
- December European Council
- February European Council
- Van Rompuy Calls for Special Council
- March European Council
‘Sudden Stop’ versus ‘Household Leverage’

Here I have some trouble – particularly with Ireland, Spain and Portugal

The question is whether household borrowing is cause or effect?

Really this is two questions:
- Is it easier to make a country borrow or to make it lend?
- Do countries that borrow have an adverse selection problem when lending?
Prioritizing ‘Sudden Stops’

Positive Agenda
- Outright Monetary Transactions (OMT)
- Banking union
- Comprehensive assessment
- Mutualized sovereign debt obligations (common risk-free asset)

Negative Agenda
- Renationalization of finance
- More conservative fiscal policy
- Tighter restrictions on household balances
- [NB: Competitive labour and product reforms may be useful for other reasons but are largely irrelevant in this context.]
The ECB’s policy dilemma

Conflict between the ECB, the Council of Ministers, and the Member States
- Inside lags for ECB action are so much shorter
- Outside lags for everyone are politically too long

Empirical evidence is indecisive
- What you see depends upon where you sit – both institutionally and geographically
- Confirmatory evidence is all around us (and my story is not all that convincing north of the Alps)

The ECB is overextended (politically) and under-committed (economically) as a result
- Problem of managing expectations – TLTROs are a good example
- Problem of rebuilding mechanisms – ABS and the debate over quantitative easing (QE)
Many thanks for your attention.