

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

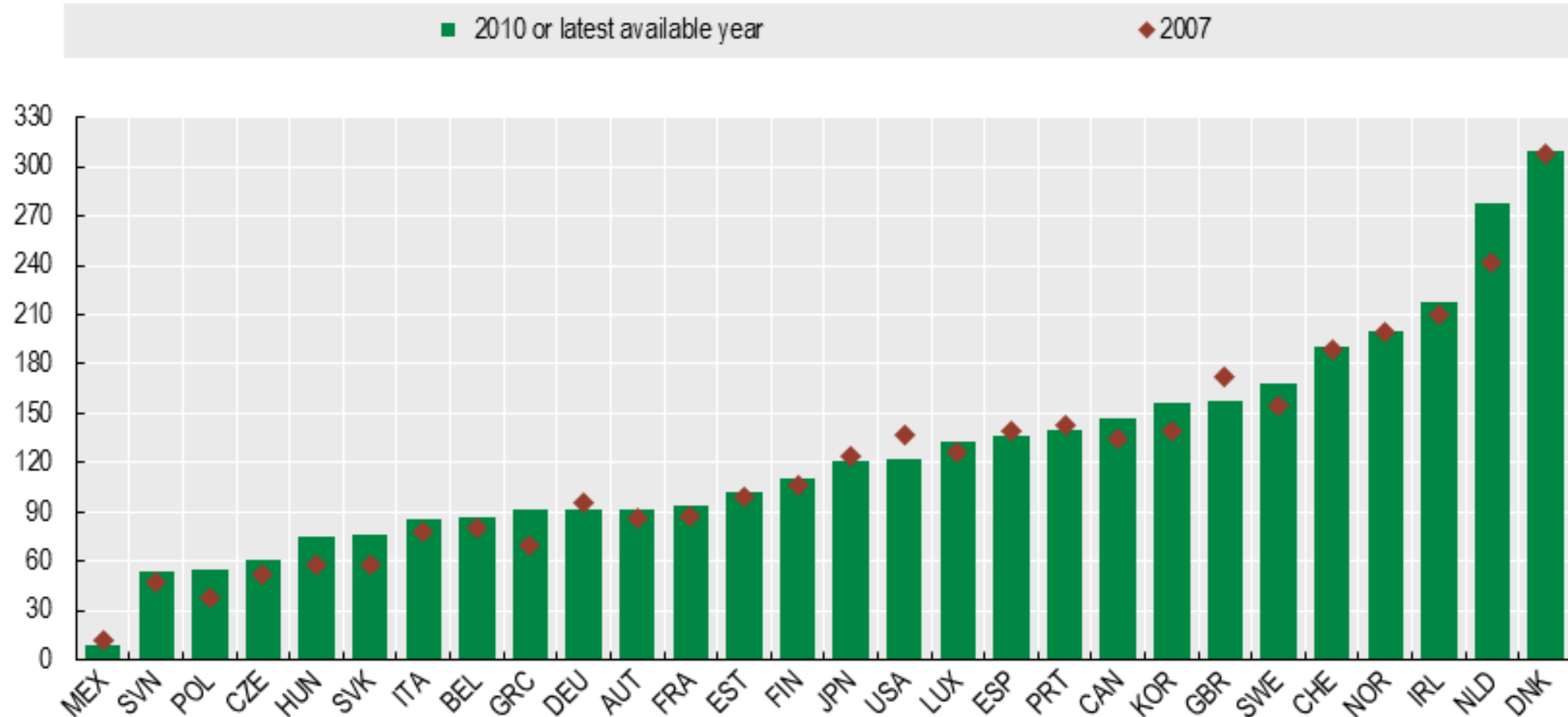
Were there countries in the euro area that escaped attention? [Luxembourg, Malta]

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

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

Were there 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

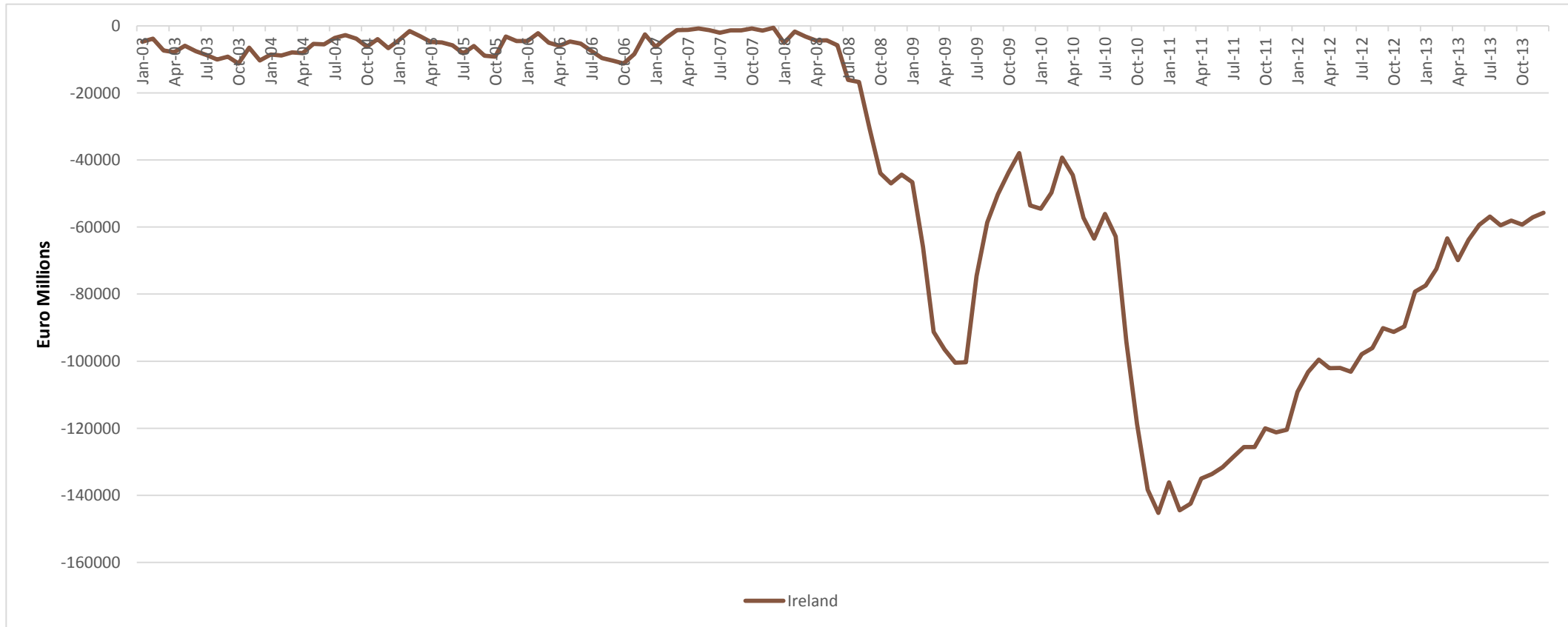
Does a rise in the current account deficit precede a flight of capital? [Ireland]

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?

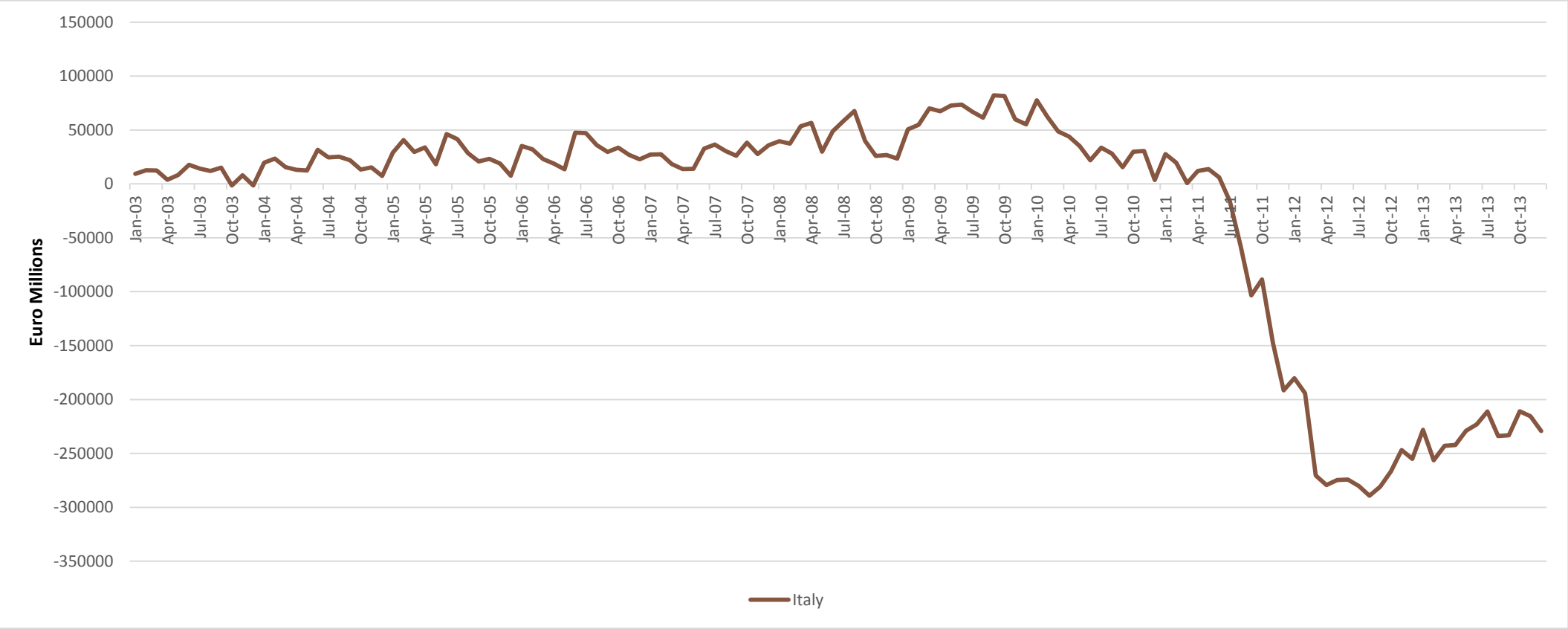
Current account and capital flight (Ireland)



Fiscal balance and capital flight (Greece)



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'

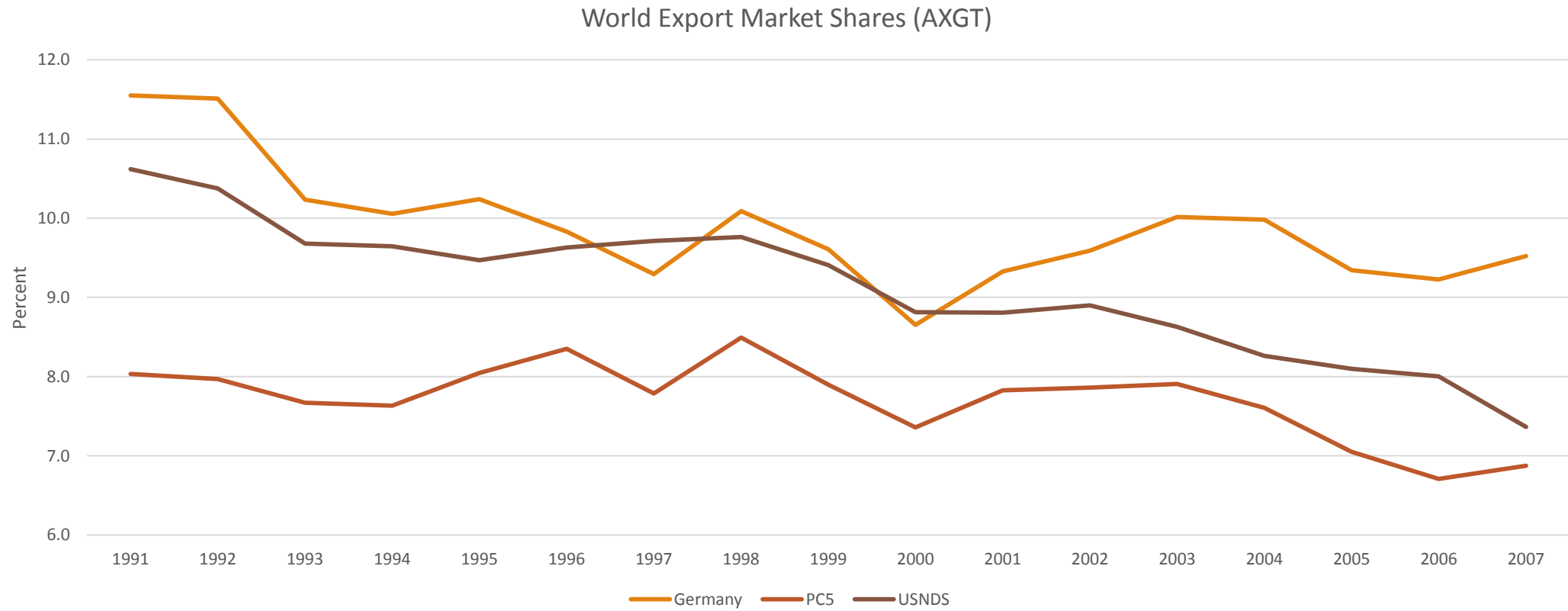
Some of these countries were both flexible and competitive: Ireland

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

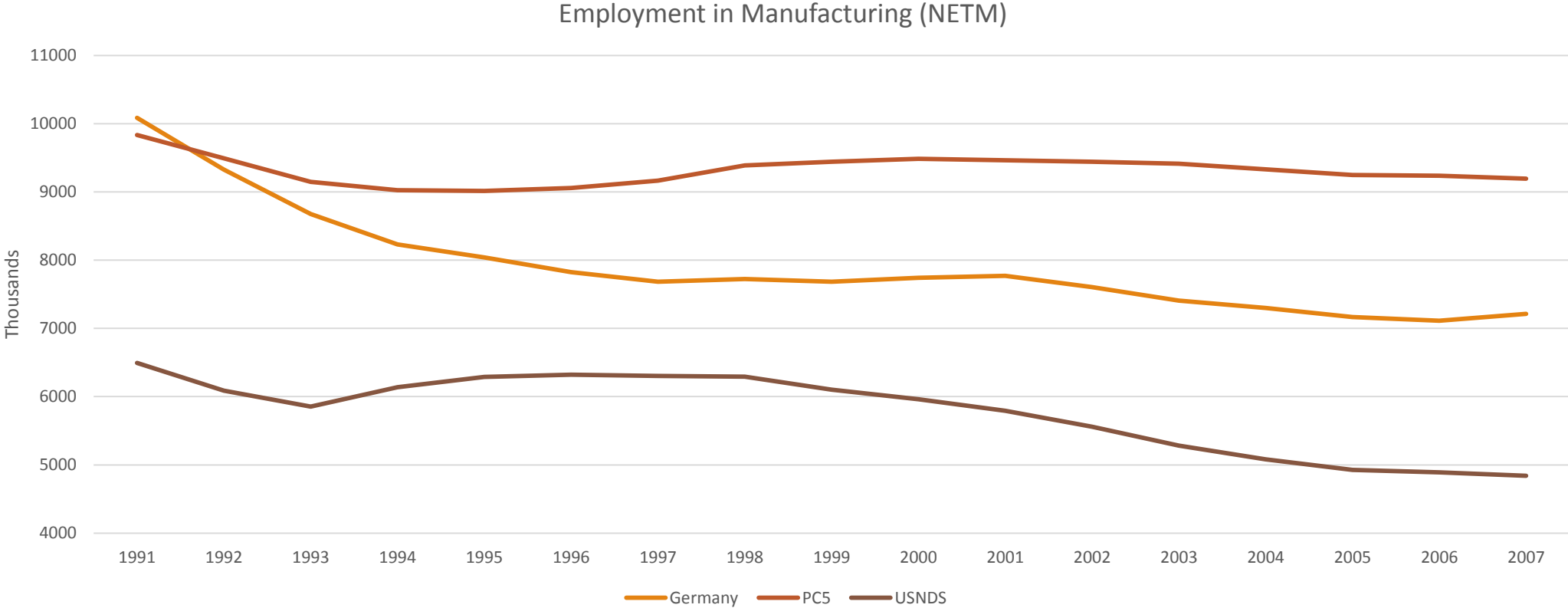
Still others were more successful than you might suspect: Greece

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



Manufacturing employment



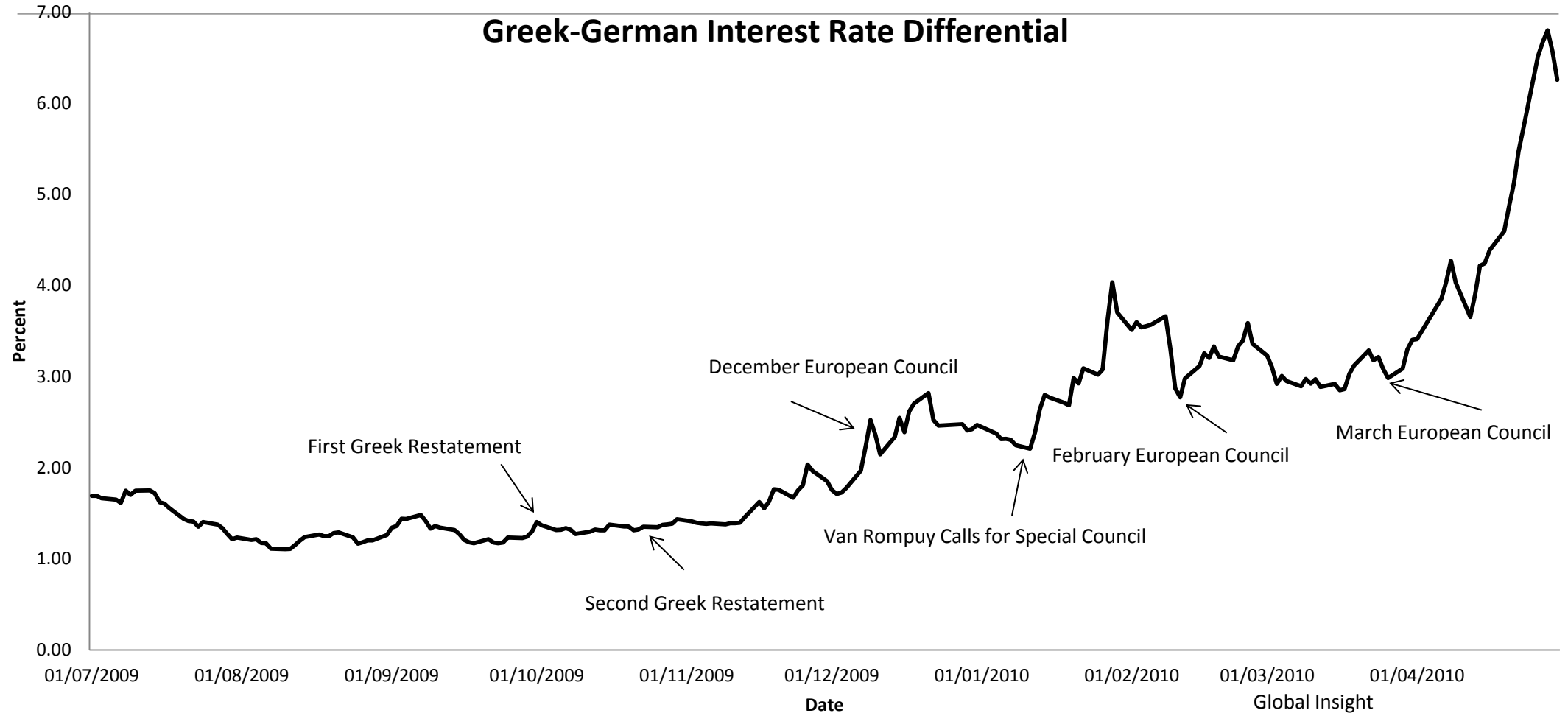
'Sudden Stop' versus 'Government Finances'

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



'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.
