

**NYU International Business Association**

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# **What's Going On in the Euro Zone?**

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**NYU  STERN**

# Economics at NYU

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- Free advice (and worth what you paid for it!)  
[http://pages.stern.nyu.edu/~dbackus/undergrad\\_advice.htm](http://pages.stern.nyu.edu/~dbackus/undergrad_advice.htm)
- Econ courses for students with courage (ECON UB 233/234)  
<https://sites.google.com/site/macrosternfall2012/home>  
<https://sites.google.com/site/nyusternmacrofoundations/>
- NYU Stern econ blog  
<http://nyusterneconomics.wordpress.com/>
- Buy The Economist (my faculty id is 4724)  
<https://www.economistsubscriptions.com/academic/>
- These slides (soon!): link near the bottom of  
[http://pages.stern.nyu.edu/~dbackus/index\\_research.htm](http://pages.stern.nyu.edu/~dbackus/index_research.htm)

# The Euro Zone

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- What is the EZ?
- What's going on there?

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## *Classic crisis triggers*

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# Crisis triggers

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- The classic crisis triggers
  - Sovereign debt (“debt crisis”)
  - Financial system weakness (“financial crisis”)
  - Fixed exchange rates (“exchange rate crisis”)
- What about Europe?

# Europe

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- Our challenge: find a coherent story for a huge mess
- My take
  - Sovereign debt problems in Greece, Portugal, Spain, Italy...
  - Banking problems in Ireland, Spain, ...
  - “Enabled” by Euro Zone

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# *The European Union*

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# Europe and the Euro Zone

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- European Union emerged from wreckage of WW II
  - Closer economic ties to connect countries, maintain peace
- Short history
  - Paris Treaty (1951): coal and steel community
  - Treaty of Rome (1957): more extensive free trade zone
  - Continued integration and expansion to the present
- The Euro Zone
  - Maastricht Treaty (1993) established ground rules, ECB
  - Euro launched Jan 1 1999 with 11 countries, now has 17



# The Euro Zone is different

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| <b>Common?</b>      | <b>US</b> | <b>EU</b> |
|---------------------|-----------|-----------|
| Currency            | Yes       | Yes       |
| Deposit insurance   | Yes       | No        |
| Bank regulation     | Yes       | No        |
| Fiscal policy       | Yes       | No        |
| Political authority | Yes       | No        |
| Language            | Yes       | No        |
| Olympic team        | Yes       | No        |
| Army                | Yes       | No        |

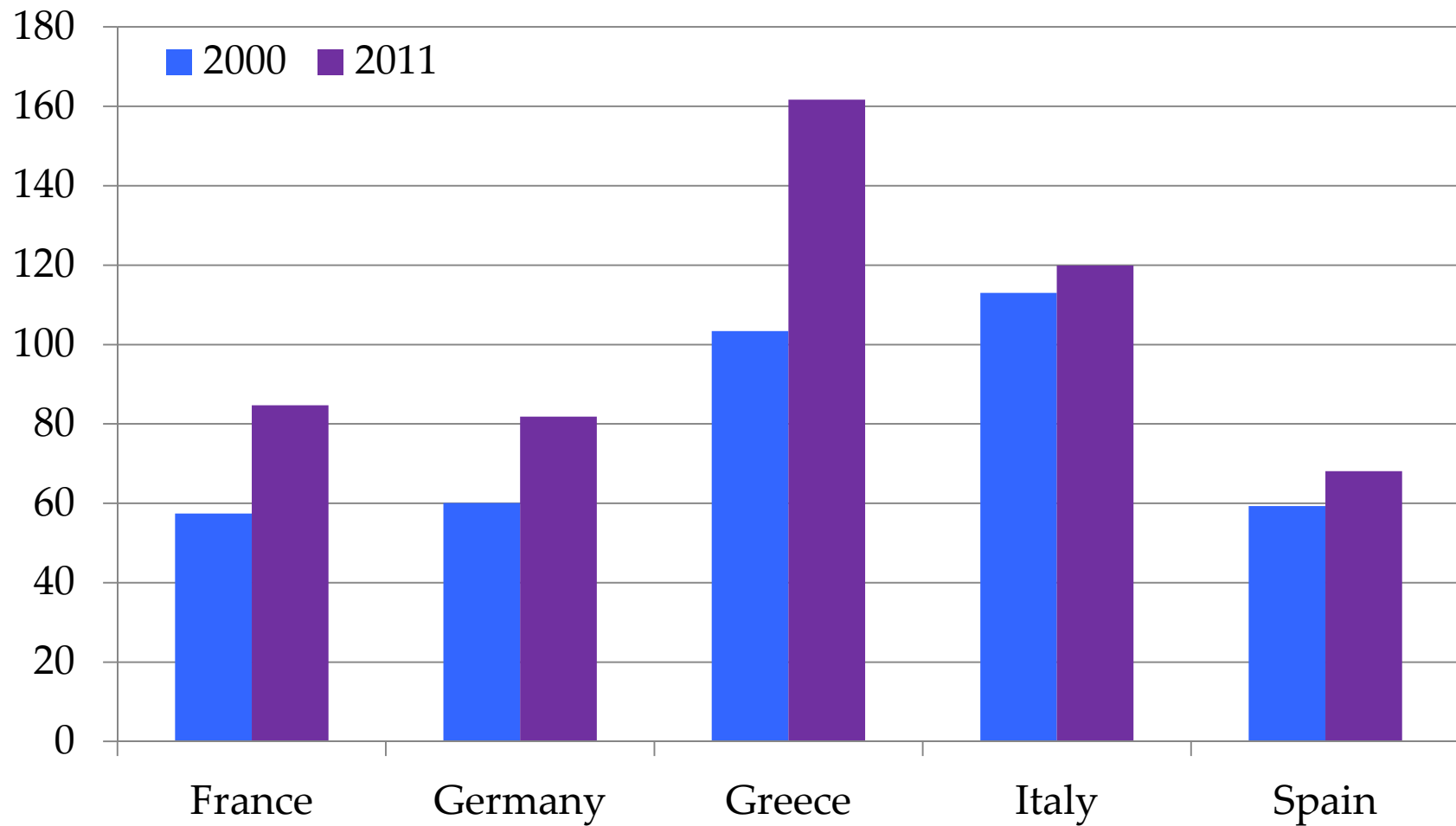
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# *Overview*

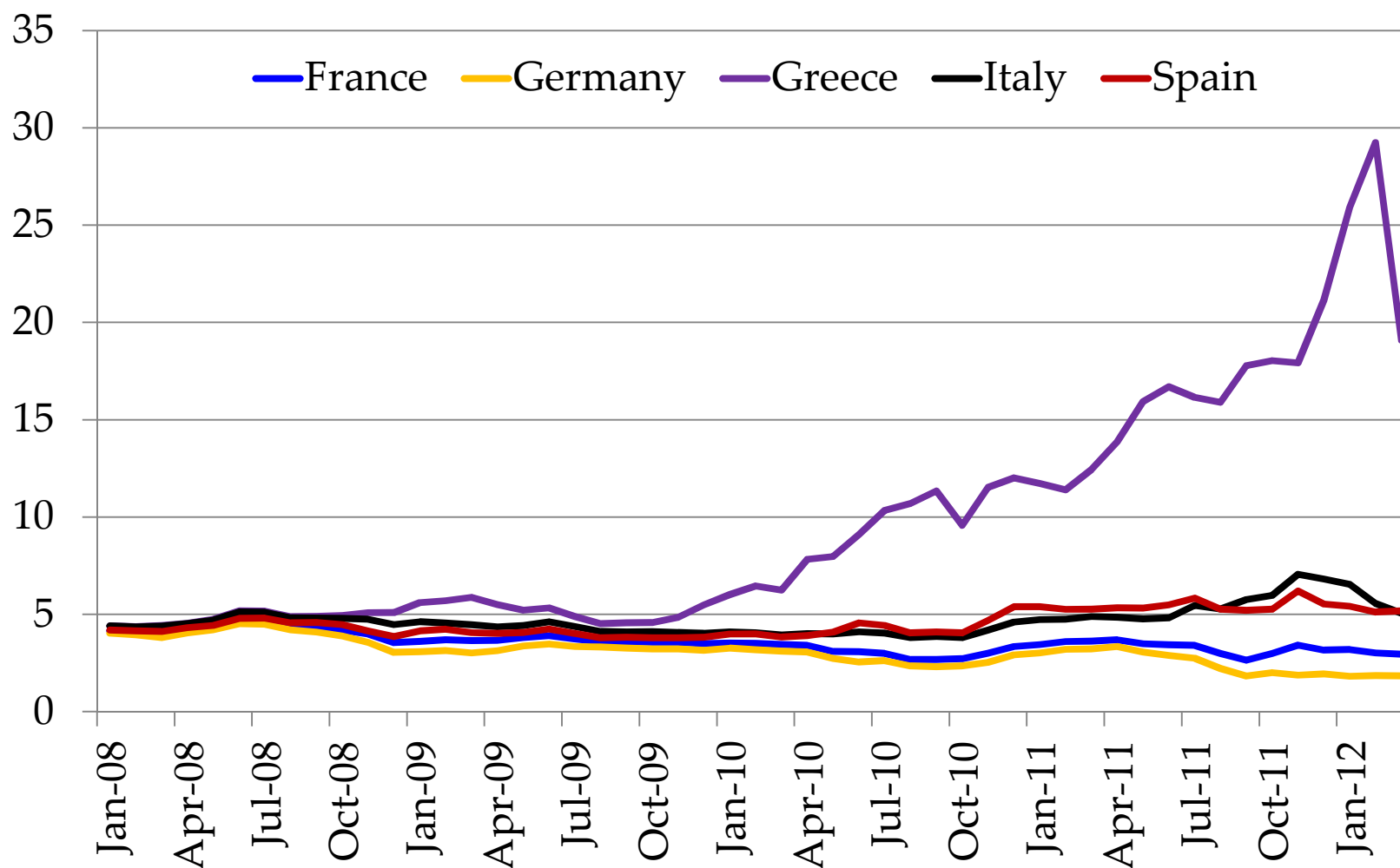
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# Government debt (% of GDP)

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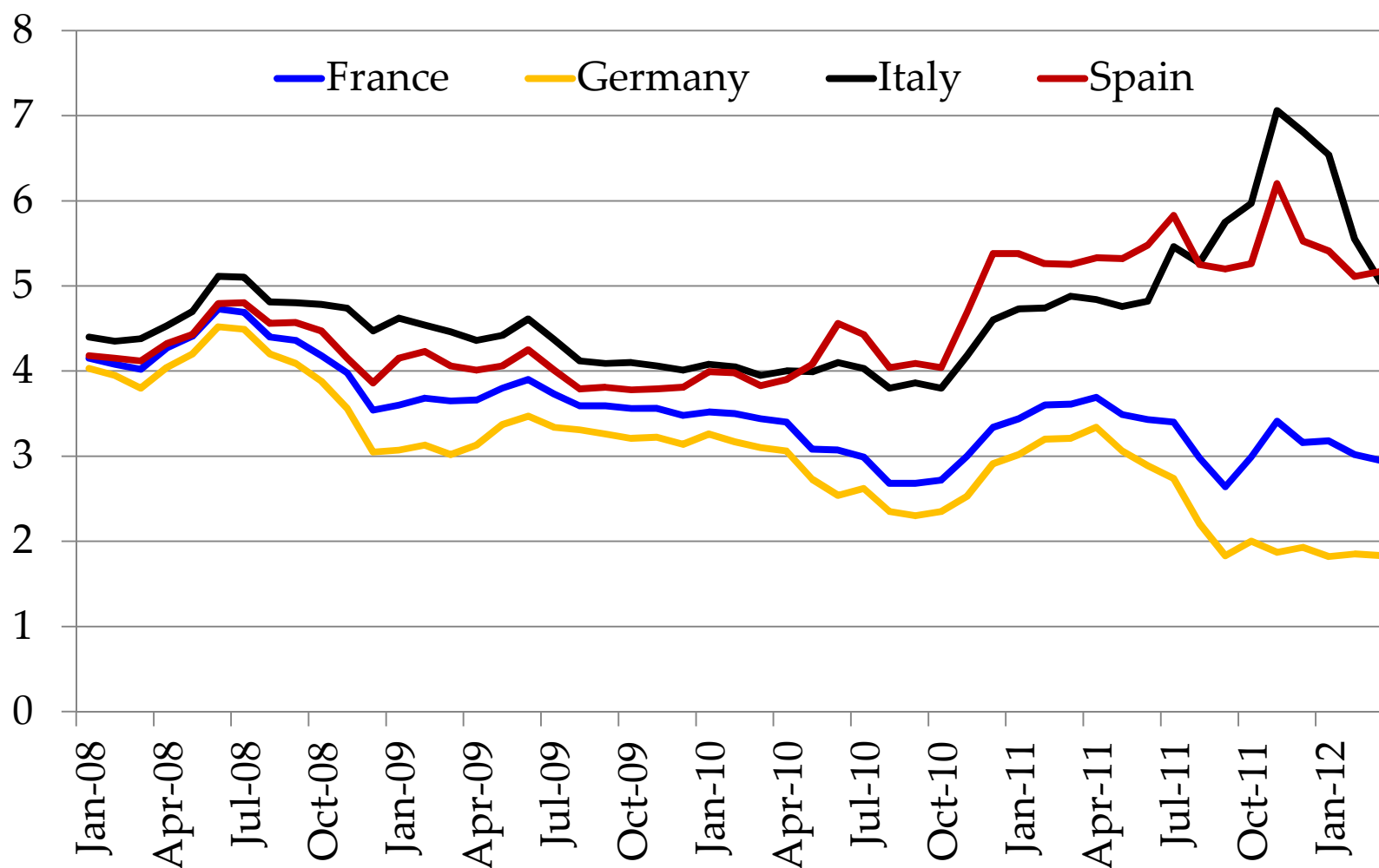


# Long-term government interest rates



Source: ECB, statistical data warehouse.

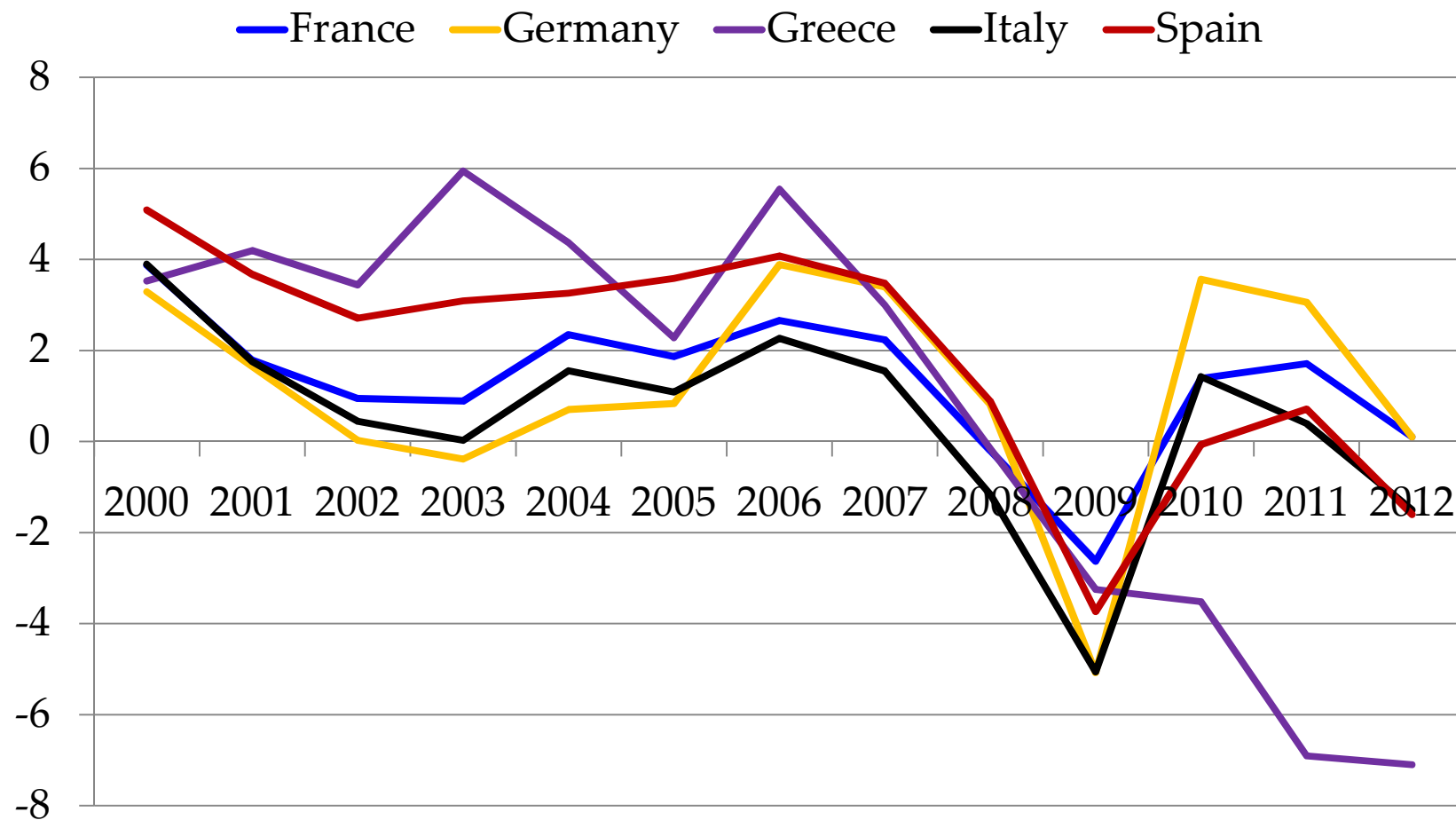
# Long-term government interest rates



Source: ECB, statistical data warehouse.

# GDP growth

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Source: ECB, statistical data warehouse.

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# *Case studies*

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# Greece

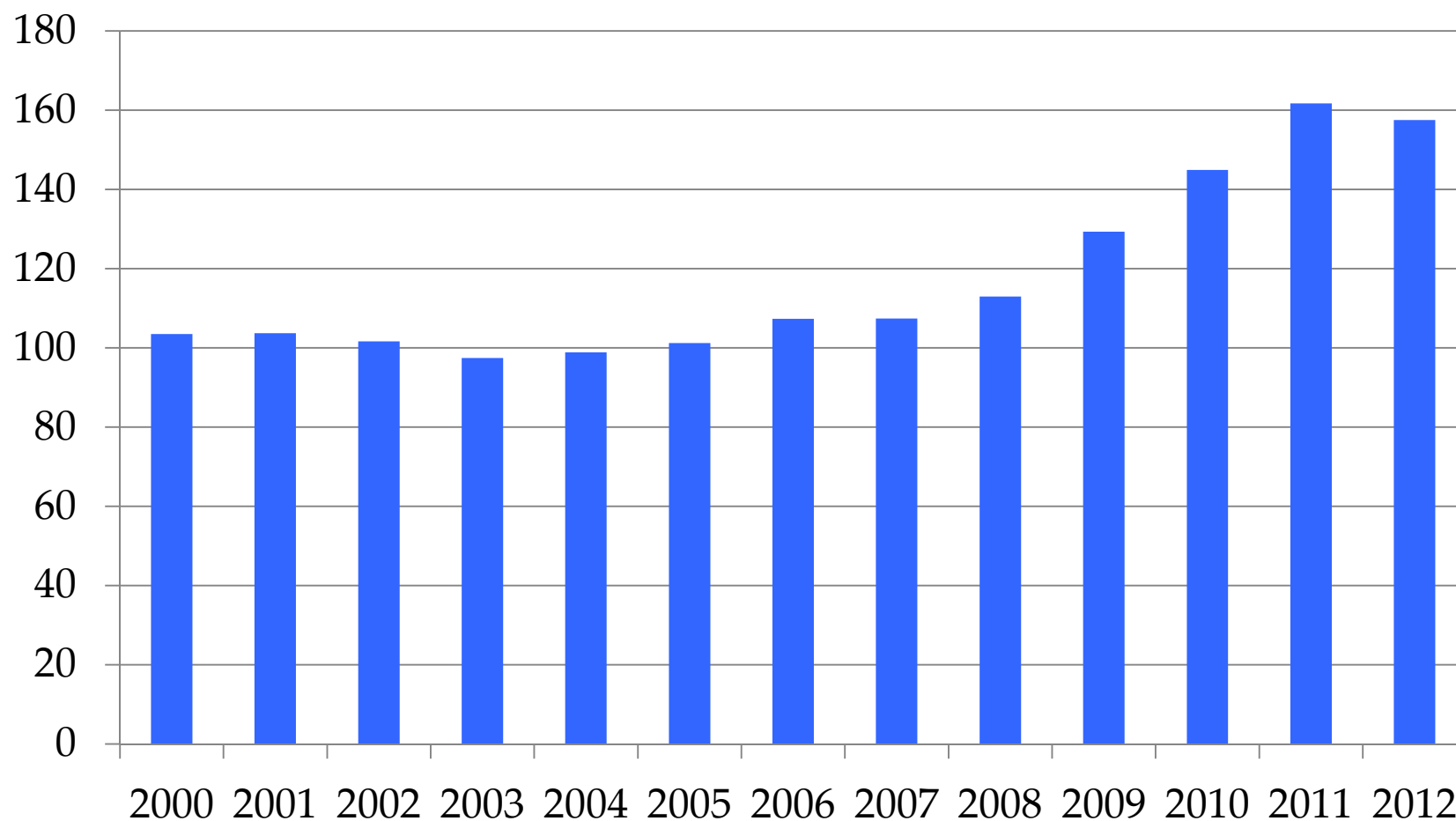
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- What's happening in Greece?

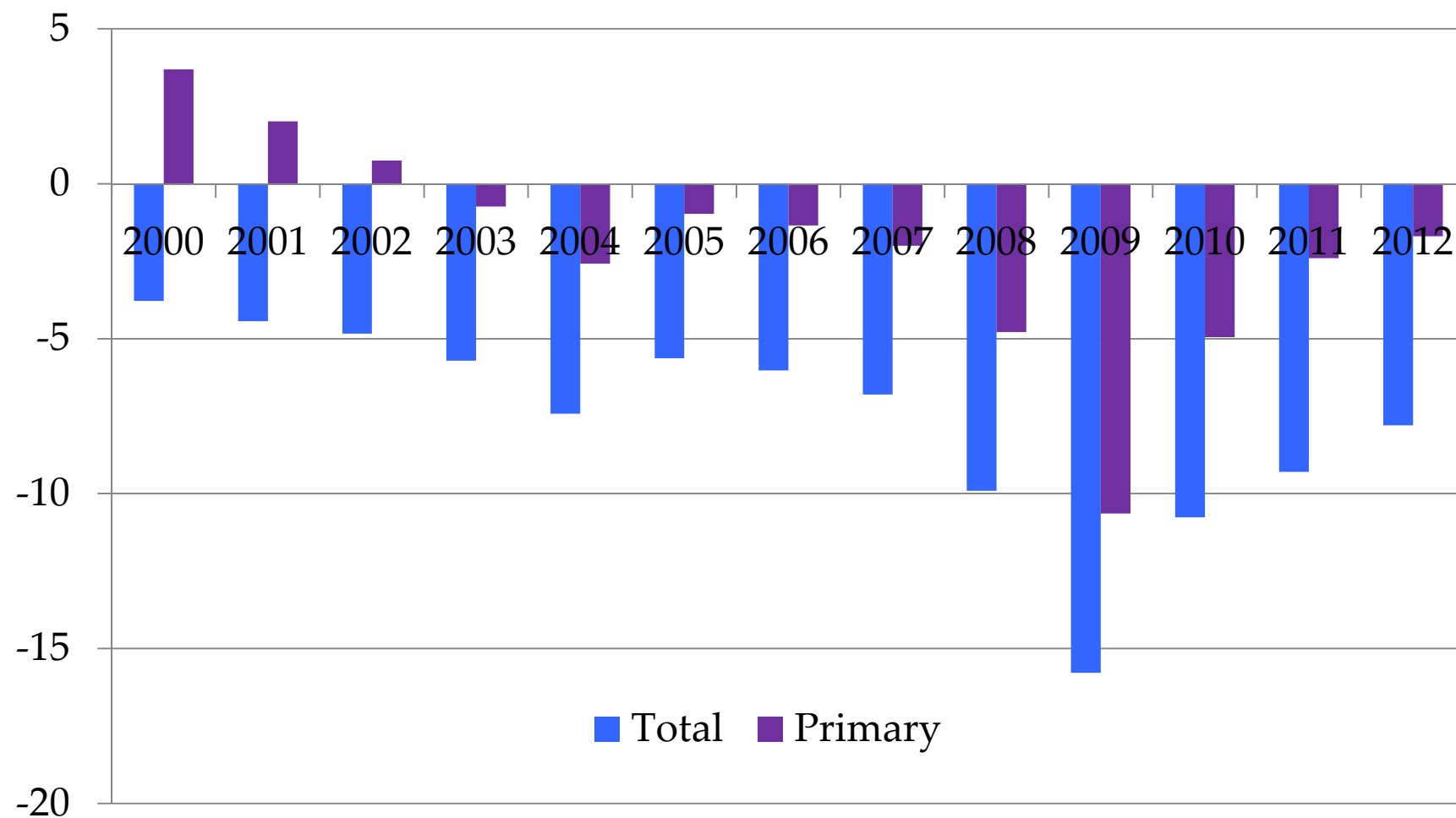


# Greece: government debt (% of GDP)

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# Greece: government surpluses (% of GDP)



# Greece

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- What's happening in Greece?
  - Large government debt, suspect financial statements
  - Continuing deficits (high spending, poor tax collection)
  - Sharp rise in rates makes debt unsupportable
- Questions
  - Why were they able to sell debt at such low rates?
  - Why continued deficits in 2009-2012?
  - Are endless negotiations worse than “cold turkey”?
  - Would devaluation have helped?

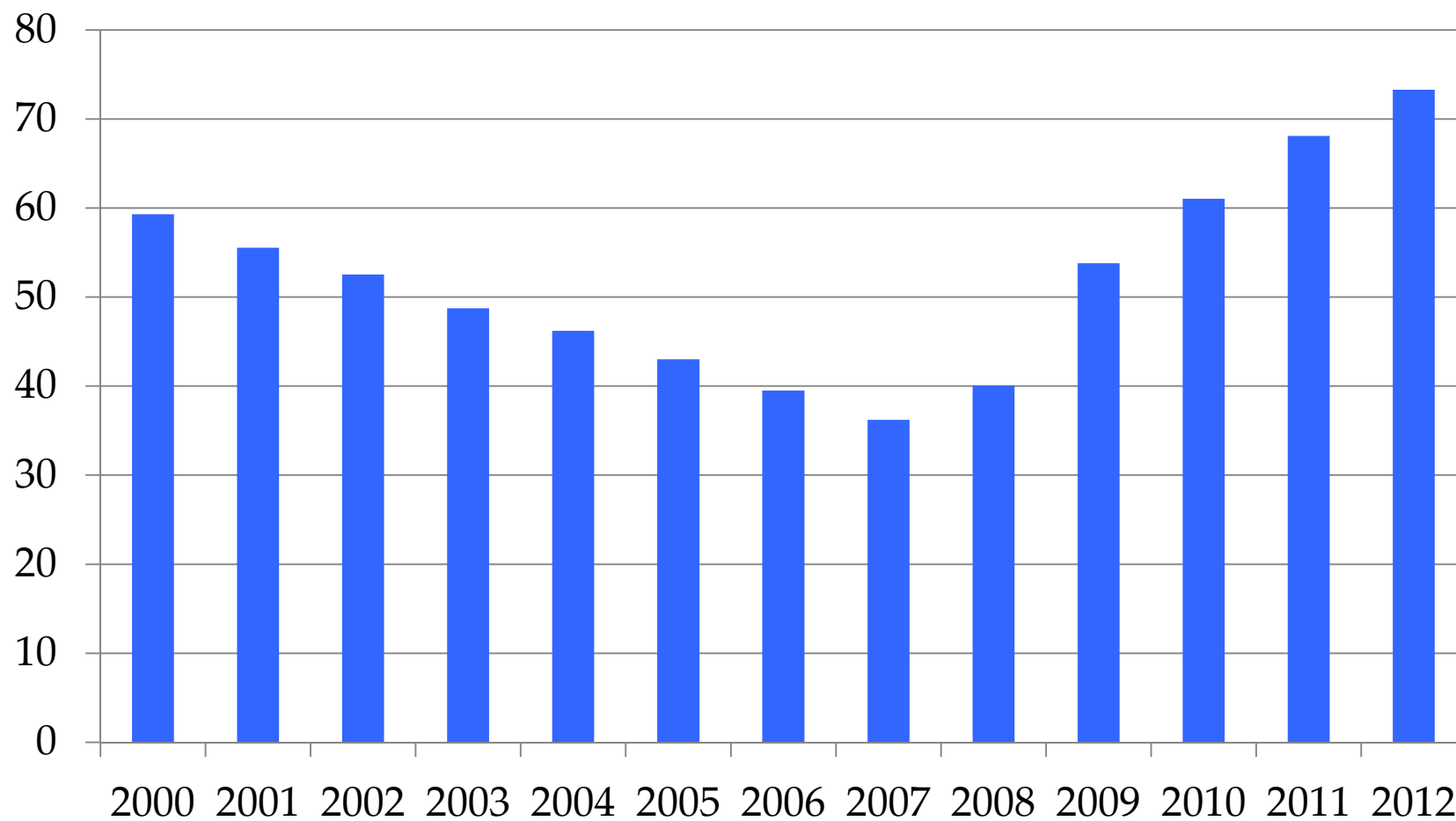
# Spain

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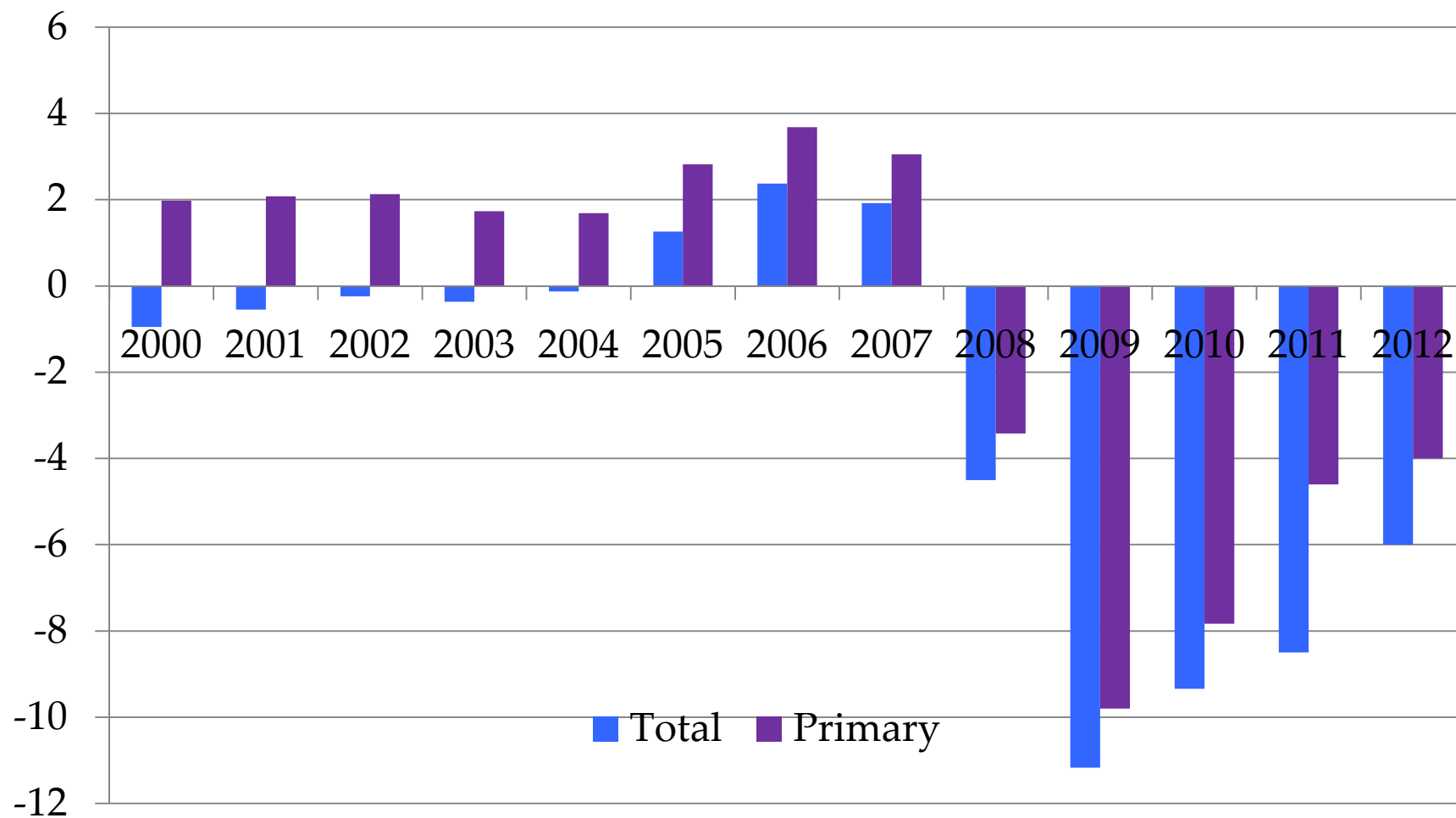
- What's happening in Spain?

# Spain: government debt (% of GDP)

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# Spain: government surpluses (% of GDP)



# Spain

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- What's happening in Spain?
  - Modest debt and deficits prior to crisis
  - Global downturn hit revenue hard, led to large deficits
  - Larger housing boom and bust than most
  - Problems with regional governments and “cajas” feeding back on sovereign debt
- Questions
  - Can government recapitalize financial system without bankrupting itself?
  - Will regional tensions make agreement impossible?

# Italy

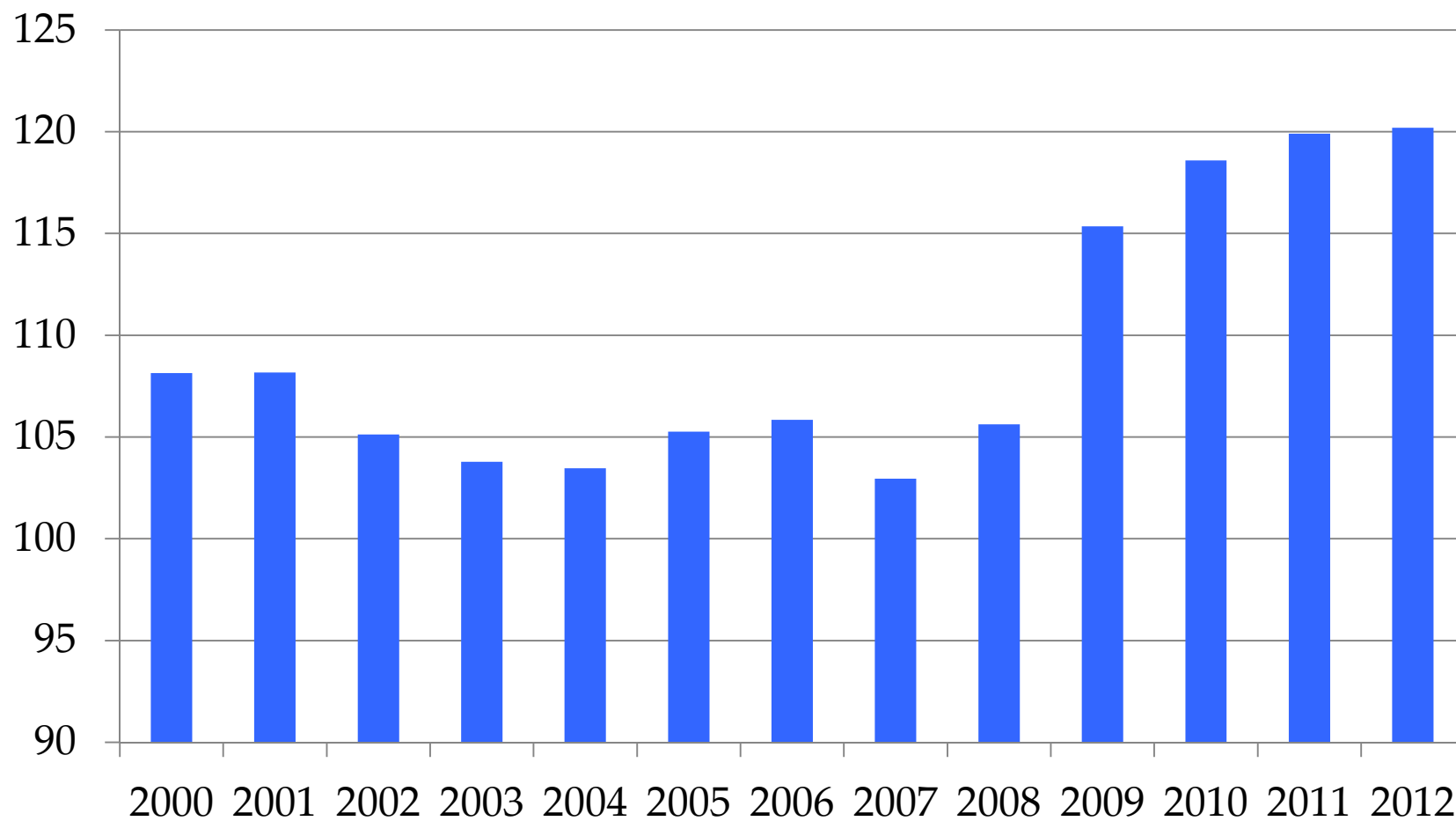
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- What's happening in Italy?



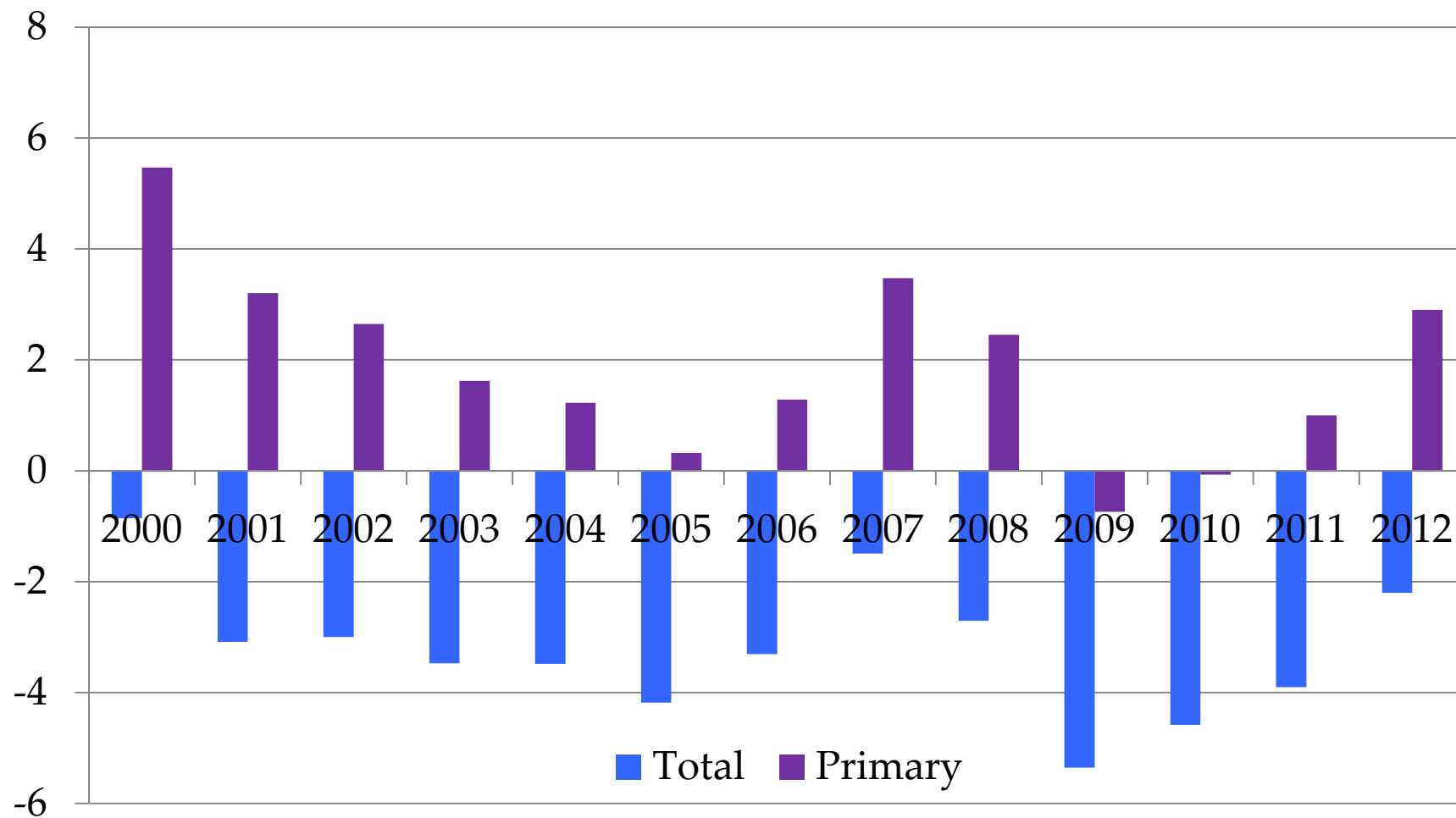
# Italy: government debt (% of GDP)

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# Italy: government surpluses (% of GDP)

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# Italy

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- What's happening in Italy?
  - Large debt prior to crisis, but deficits modest and primary balance is in surplus
  - Problem is growth:  $B/Y$  stuck high because  $Y$  is stalled
  - Rigid labor markets, other economic frictions, hurting growth
  - Widely regarded as best case among troubled countries
- Questions
  - What will it take to restart economic growth?

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*The Euro Zone as “enabler”*

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# Problem #1

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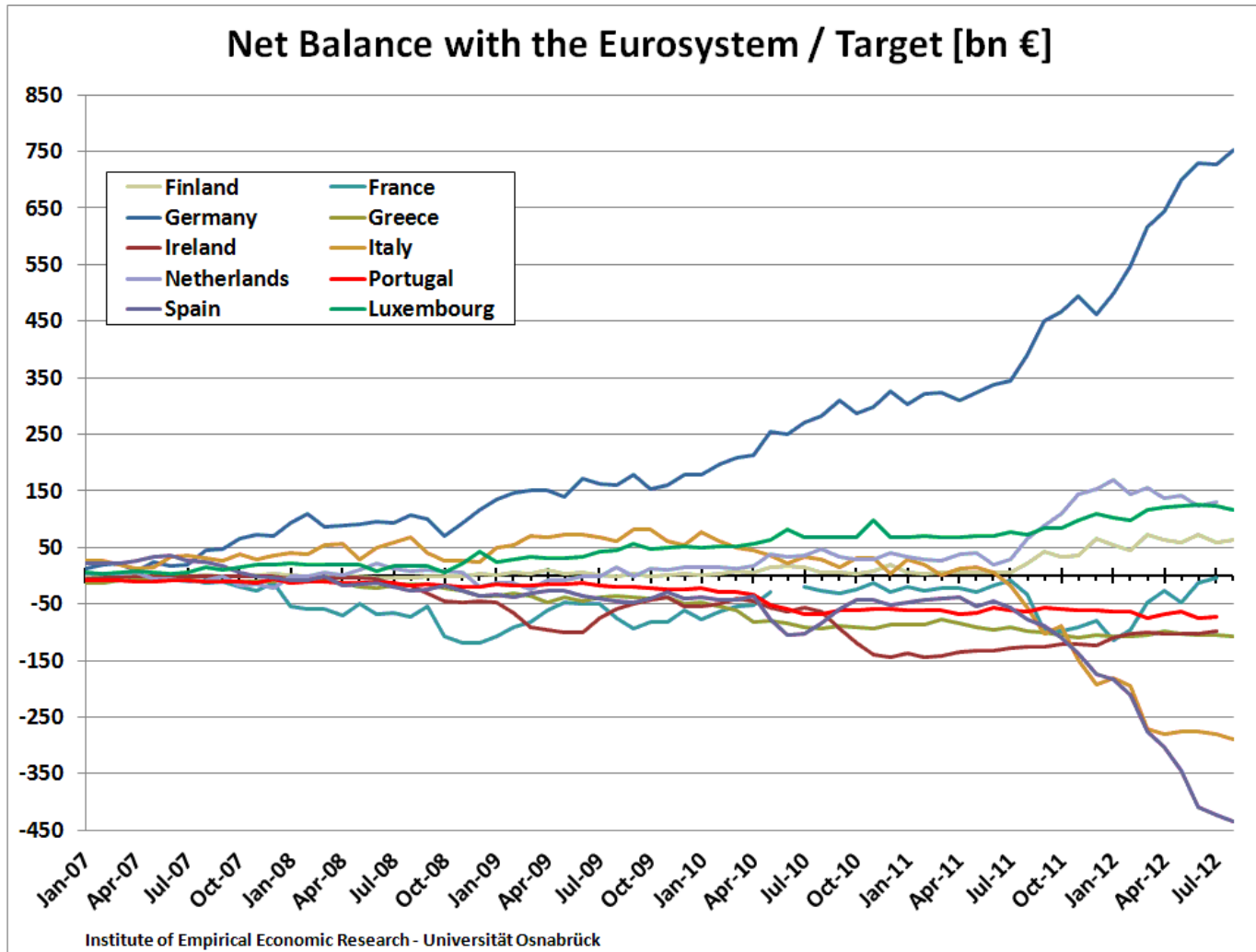
- **Lack of fiscal discipline**
- Fiscal criteria in Maastricht Treat abandoned early on
- Not credible anyway?
- Would a US-like system have worked better?

# Problem #2

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- Leaks in the payments system
- “IMF without conditionality”

# Target2 balances



# Problem #3

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- **National bank regulation and deposit insurance**
- A recipe for cross-border bank runs



# Problem #4

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- Regulators gave all member debt zero risk weight
- Greek debt less risky than British debt!
- Obvious play: buy Greek debt, use as collateral for ECB loan

# Problem #5

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- **No exit strategy**
- Gives weak countries excessive leverage
- Why give Greece a gun?
- Is Ecuador a better model?

# Problem #6

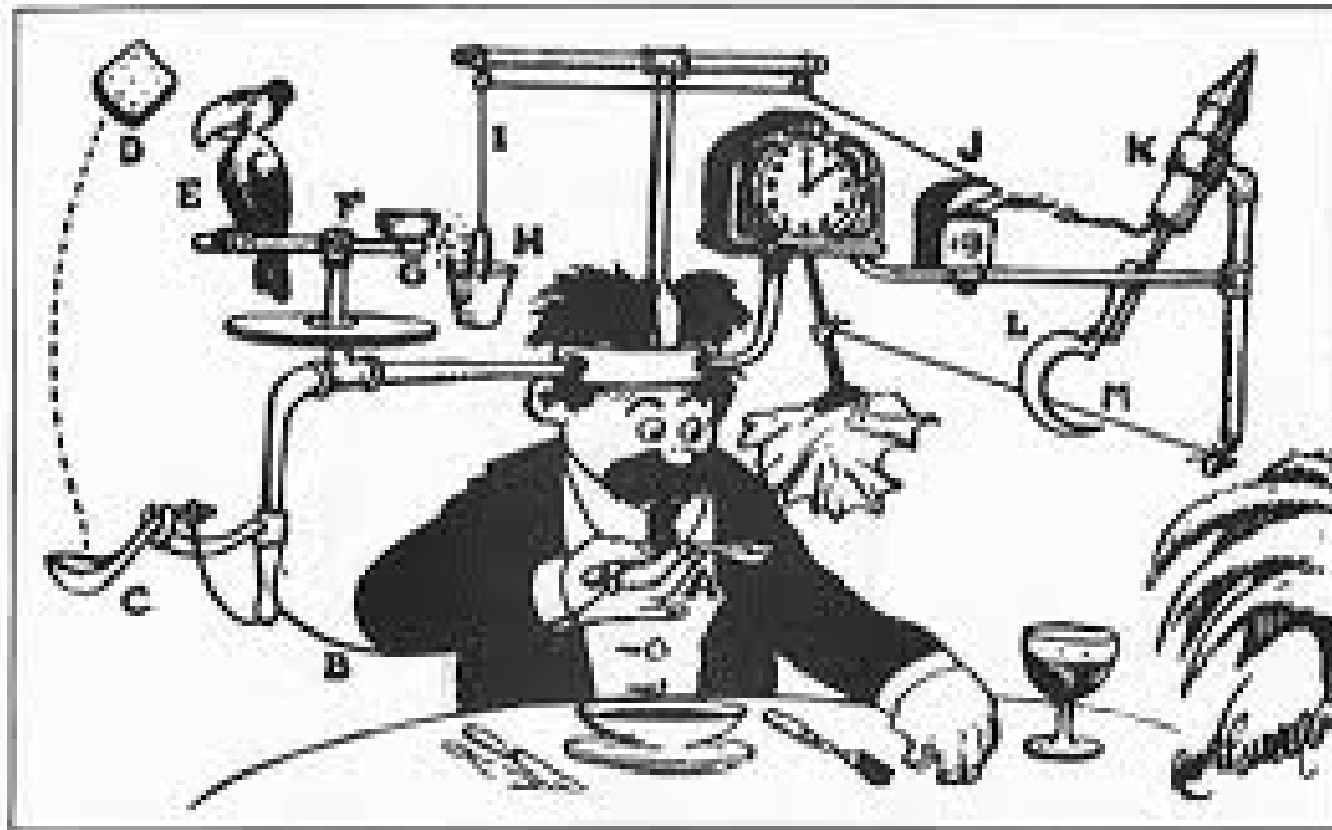
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- **Cumbersome political process for fiscal coordination**
- Remember: political authority not centralized
- Why do we care what Finland thinks?
- The OMT/EFSF/EMS Rube Goldberg machine is on its way

# Rube Goldberg machine

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Self-Operating Napkin



# Problem #7

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- **Europeans associate themselves with countries, not Europe**
- The United States: plural or singular?

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*Where now?*

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# Problems – and progress

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- Problems
  - Common currency hard to do right
  - Governance slow and cumbersome, esp fiscal actions
  - Clear cost in terms of performance (Mexico v. Greece)
- Still: remarkable progress along many fronts
  - Fiscal discipline catching on in most places
  - OMT/EFSF/EMS shows coordination isn't impossible
  - Common bank regulation under discussion
  - Odds of success? What would success look like?

# Open questions

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- Will mismatch between common currency and national political authority emerge in other ways?
- Do members want integration or sovereignty?



# Lessons for others

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- Common currency has great symbolic value
- But hard to do right
- Also a huge distraction from bigger issues
- Like productivity

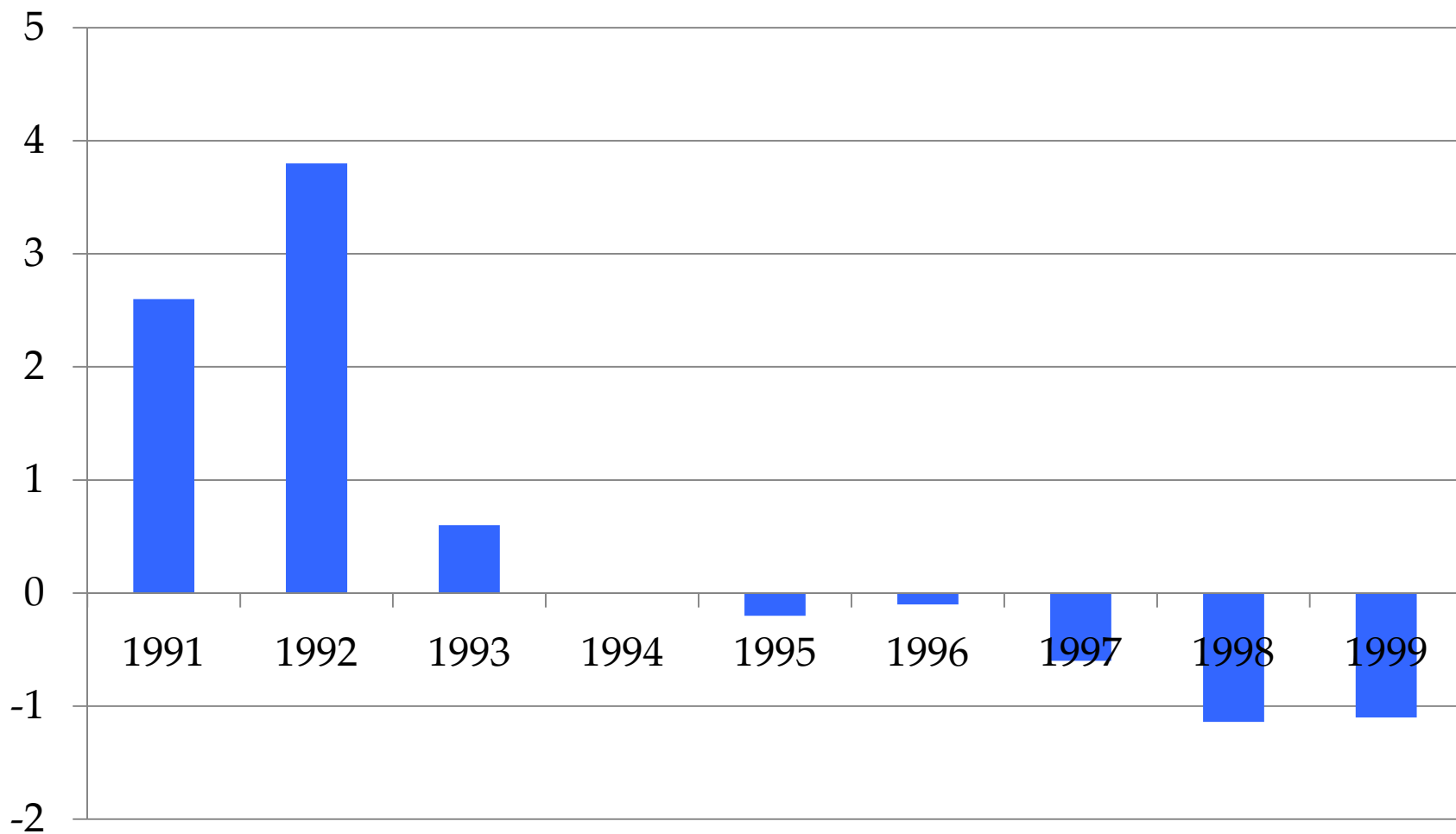
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*Extra slides*

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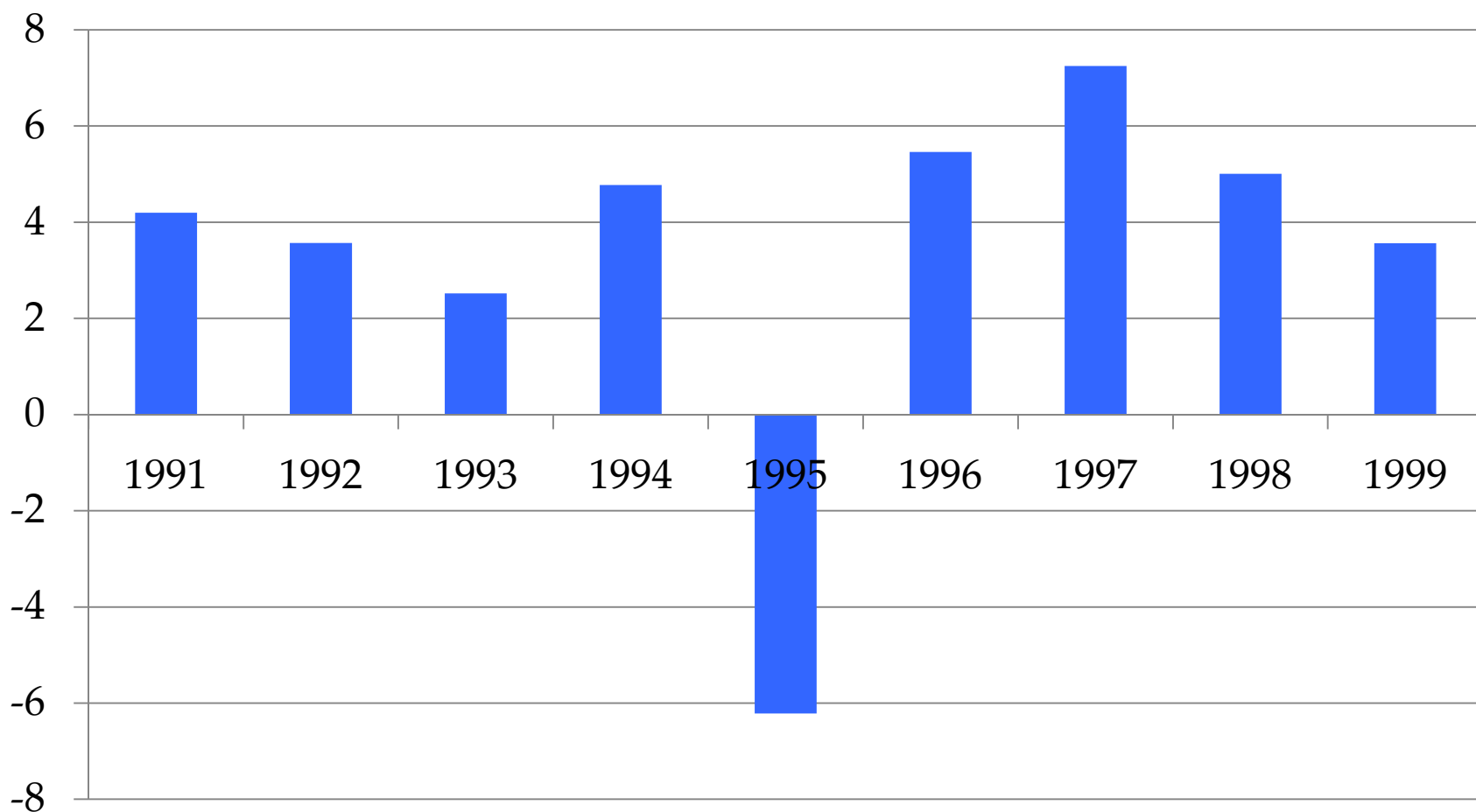
# Mexico: budget balance (% of GDP)

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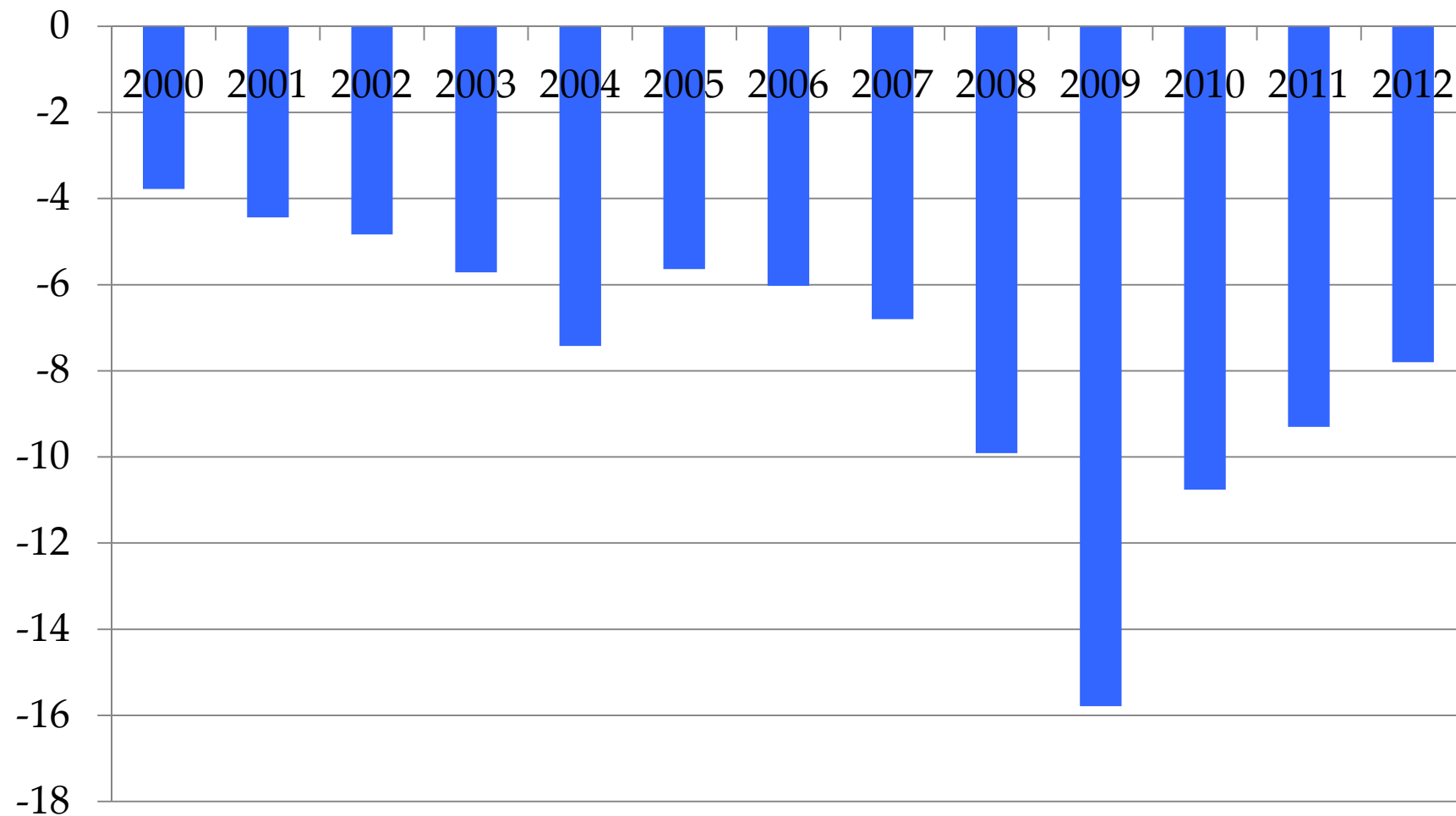
# Mexico: GDP growth (%)

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# Greece: budget balance (% of GDP)

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# Greece: GDP growth (%)

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