

NYU Stern Political Economy Exchange

Lunch Talk, April 8, 2013

**Economics and Politics
Collide in Europe**

David Backus, New York University

dbackus@stern.nyu.edu

NYU  STERN

Economics at NYU

- Free advice (and worth what you paid for it)
http://pages.stern.nyu.edu/~dbackus/undergrad_advice.htm
- Econ course for students with courage (ECON UB 233)
<https://sites.google.com/site/nyusternmacrofoundations/>
- Other courses
 - Competitive analysis, Cabral (Fall)
 - Global macroeconomics, Cooley (Fall)
 - Advanced topics in macroeconomics, Veldkamp (Spring)
- NYU Stern econ blog
<http://nyusterneconomics.wordpress.com/>
- These slides (soon!): link near the bottom of
http://pages.stern.nyu.edu/~dbackus/index_research.htm

The US and the EU

- Analogous?
- How are they similar? Different?

The EZ and the US

Common?	US	EU
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

Classic crisis triggers

Crisis triggers

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

Europe

- 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, Cyprus, ...
 - “Enabled” by Euro Zone

The European Union

Europe and the Euro Zone

- 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 as “enabler”

Problem #1

- **Lack of fiscal discipline**
- Fiscal criteria in Maastricht Treat abandoned early on
- How would this work in the US?
- Would a US-like system have worked better?

Problem #2

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

Problem #3

- **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 #4

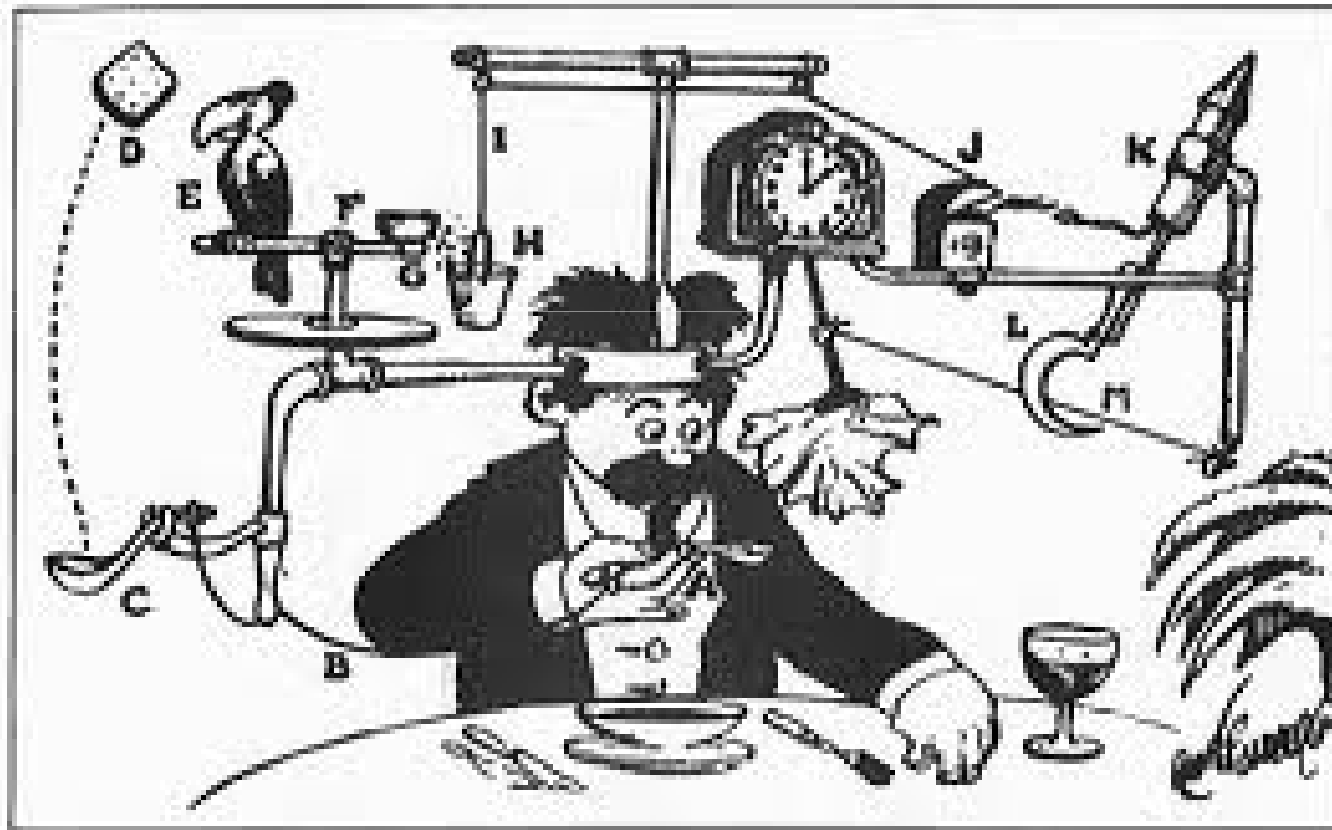
- **No exit strategy**
- Gives weak countries excessive leverage
- Why give Greece a gun?
- Is Ecuador a better model?

Problem #5

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

Rube Goldberg machine

Self-Operating Napkin



Problem #6

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

The EZ and the US

Common?	US	EU
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

Who's swimming naked?

Vacations

- European vacations:
 - Europe's Court of Justice has ruled that if you get sick while on vacation, you're entitled to make up for it with another vacation. The logic is that sick leave and vacation time are separate entitlements.

Austerity

- Austerity in Portugal:
 - The Portuguese government is out of money: no one will buy its bonds, so it has no choice but to balance spending and tax revenue. By necessity, and by agreement with the EU and IMF, at least part of this balancing must come from spending cuts. One such cut was the temporary elimination of a one-month bonus traditionally paid to public sector workers semi-annually. In July, Portugal's "Constitutional Court ruled that because the measure only applies to the public sector, it infringes basic principles of equity" (quoted from the [BBC](#)). In other words: it's discrimination against government workers.

Reform

- Reform in Italy:
 - The problem in Italy is growth: the economy hasn't grown in over a decade. The classical solution is reform: for example, liberalize labor markets to make hiring more attractive to firms. The previous government was unable to enact reforms, so an election was held February 24-25 to establish a new government. As yet, no government has been formed. One party leader, with 25% of the seats in parliament, said "you'd have to be crazy" to want to lead the next government.

Case studies

Greece

- What's happening in Greece?

Pick a country

- What's going on there?
- Why?

Greece

- 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

- What's happening in Spain?

Spain

- 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

- What's happening in Italy?

Italy

- 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?

Where now?

Problems – and progress

- 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

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

Lessons for others

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