Global Financial Systems
Chapter 21
Concerns

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To accompany
Global Financial Systems: Stability and Risk
http://www.globalfinancialsystems.org/
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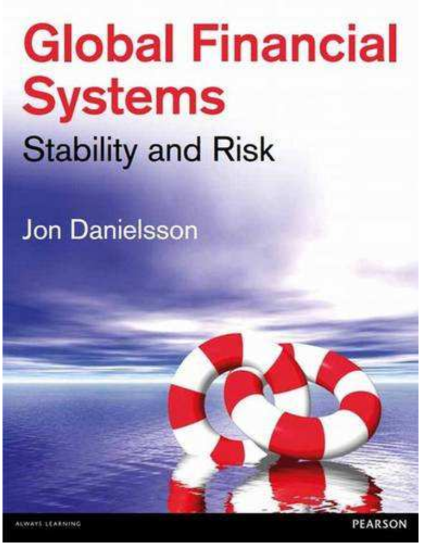
Book and slides



- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page `www.globalfinancialsystems.org`

Data

- The data in this chapter comes from the ECB, Eurostat and WDI (World Bank development indicators)
- Bruegel database of sovereign bond holdings developed in Merler and Pisani-Ferry (2012)", updated 2017
- There is no consistent way to measure government debt
- And there are multiple ways one can represent the size of the economy
- Even GDP has more than one form, e.g.
    1. nominal in local currency
    2. nominal in euro or USD
    3. real, in local currency or euro or USD
    4. per capita or not
    5. real PPP (purchasing power) adjusted

GDP measurements

- GDP is measured in *nominal* units of a *national currency*
  - US GDP is $19 trillion in 2016
- The problem is that one cannot do time or country comparisons
- We can translate to constant units (e.g. USD) and adjust for inflation (GDP deflator)
- And maybe adjust for population
- But still left with purchasing power, especially for non-tradables
  - a haircut can cost ¢50 in one country and $50 in another
- So adjust for purchasing power parity (PPP)

The many forms of sovereign debt

- Different institutions (Eurostat vs. OECD vs. WB vs. ...) will give quite different estimates of debt (e.g. 85% or 98% of GDP)
- And then what to measure
  - Central government
  - General government?
  - Include regions?
  - Include government entities?
  - Accounting conventions
- There is a paper on why the differences
- Use both Eurostat and WB below

Background to the European Union, EU

Why the EU

- The motivation for European integration was political, not economic
- But economics (like common market and currency) tools to achieve integration
- Two areas of concern (within the confines of the financial system considerations)
  1. The common currency
  2. Common market in banking services

Successful monetary unions

- Single nation state
- Free movement of people
- Economic rules and regulations mostly harmonized
- Economic development in sync
- Transfer union
- *Or* junior member much much smaller (Luxembourg, Panama, ...)
- Successful
  - German, US, Italian, Indian, ...
- Unsuccessful
  - Scandinavian, Latin, ...

Transfer union

Definition (Transfer union)

an arrangement whereby a number of countries come together in some organization, where the stronger members of the group directly and significantly subsidize the weaker members on a long–term continuous basis, where the member countries have strong political connections between them.

Defined by size

Very few numbers available

- Foreign aid
- Net EU transfers 0.3% of GDP, up to 4% for some countries
- In Spain, 2.2% of GDP, up to 16% for some regions
- Transfer unions defined by size

UK transfers

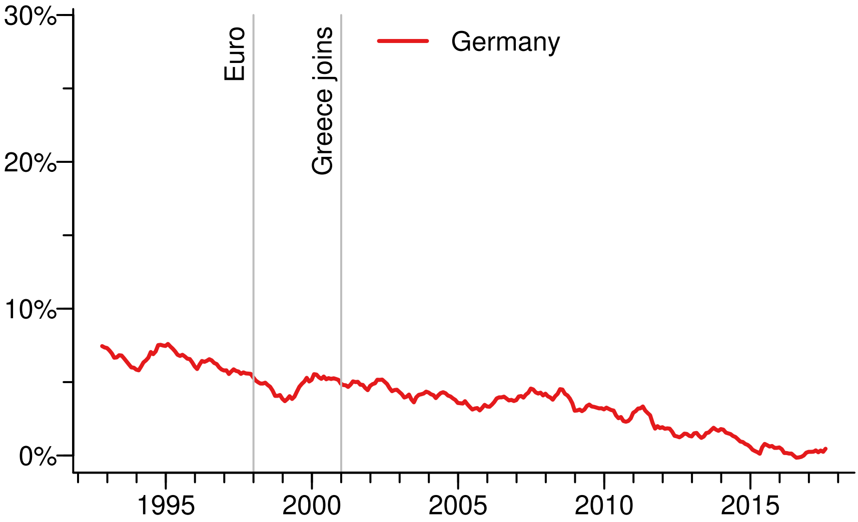
Source: IFS/Scottish government

Region	amount per person
Scotland	+£2,210
Wales	+£4,300
Northern Ireland	+£5,000
North of England	+£2,700
Midlands of England	+£2,000
South of England	*-£2,000*

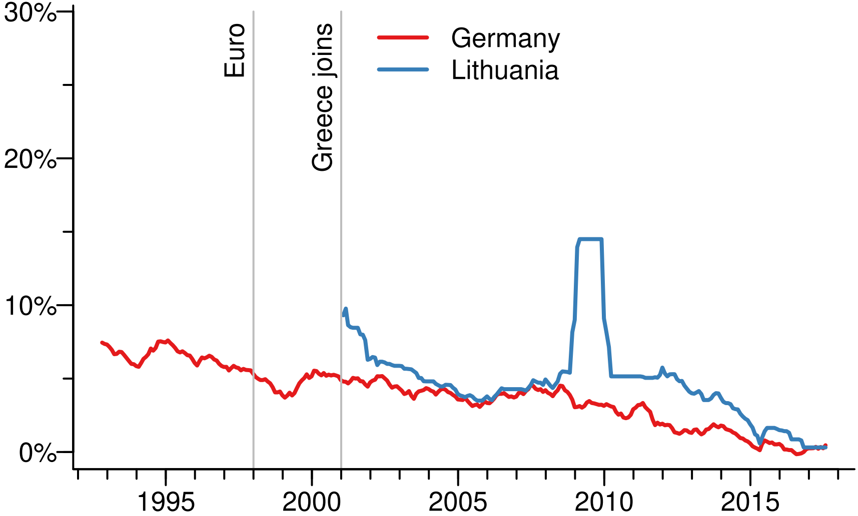
Role of the euro

- Several EU, but not euro zone members, have suffered serious crises and received bailouts
  - Hungary, Latvia, Romania
- No impact on anybody else
- Tiny Cyprus had a huge impact

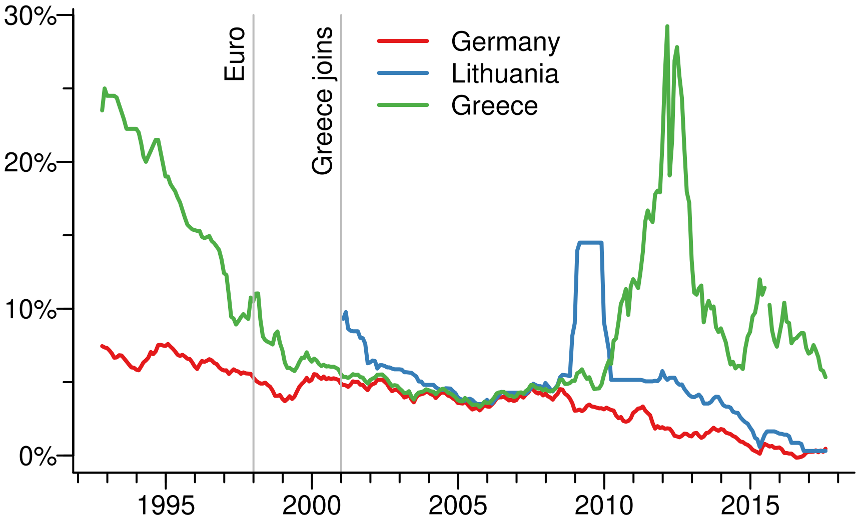
Selected European long–term bond rates



Selected European long–term bond rates



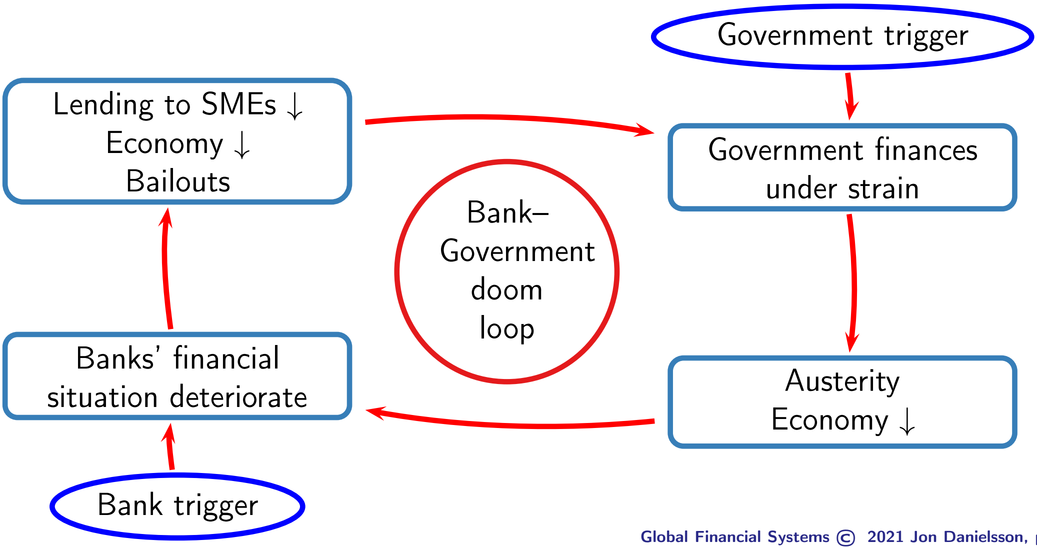
Selected European long–term bond rates



Sovereign debt crisis

- A country may seem to have sustainable debt levels when things are good, but can quickly get into a crisis
- The start was the Greek crisis which then spread to other countries
- Some countries came into the crisis with very high debt levels (e.g. Greece)
- Others had little debt which quickly exploded, like Ireland and Spain

Bank–Government doom loop



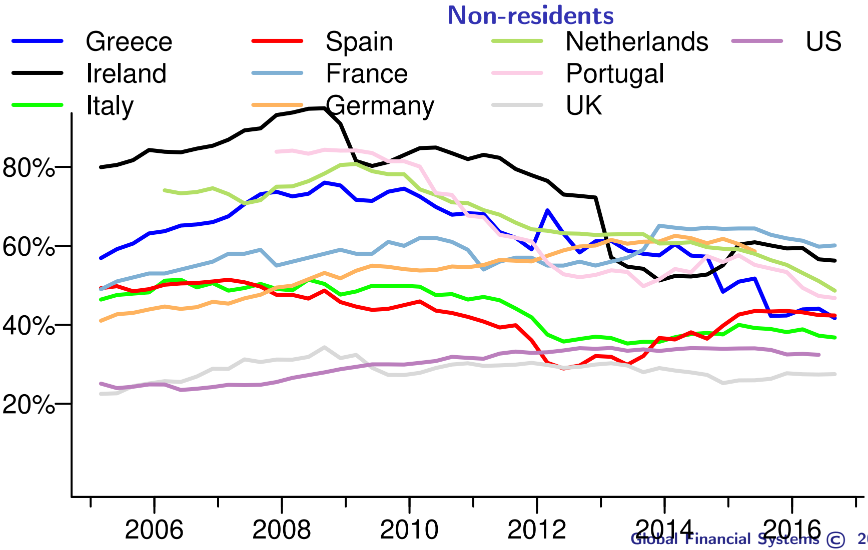
Own government debt as percentage of bank assets

- Banks have been pushed to buy government bonds by ECB

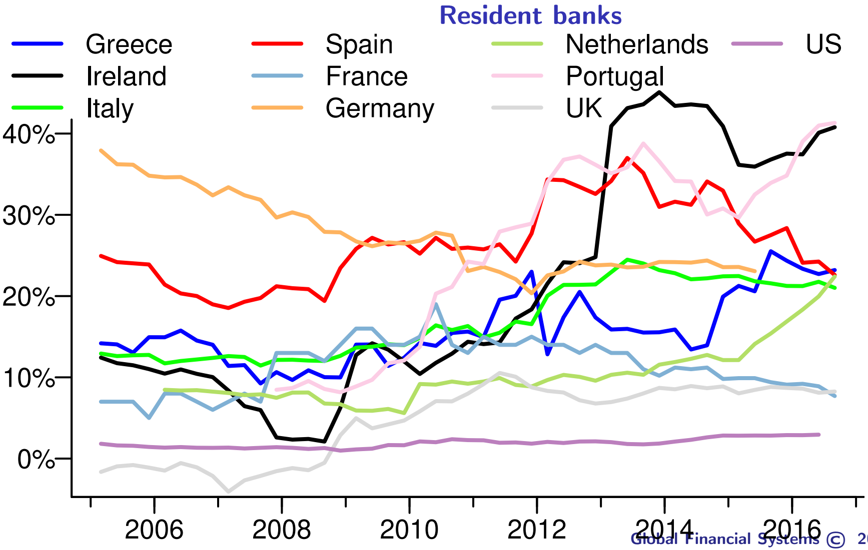
	Italy	Portugal	Spain	Germany	Eurozone
January 2012	6.8	4.6	6.3	3.5	4.6
February 2014	10.2	7.4	9.5	4.6	5.8

- But now that the ECB is able to directly buy government bonds this is changing

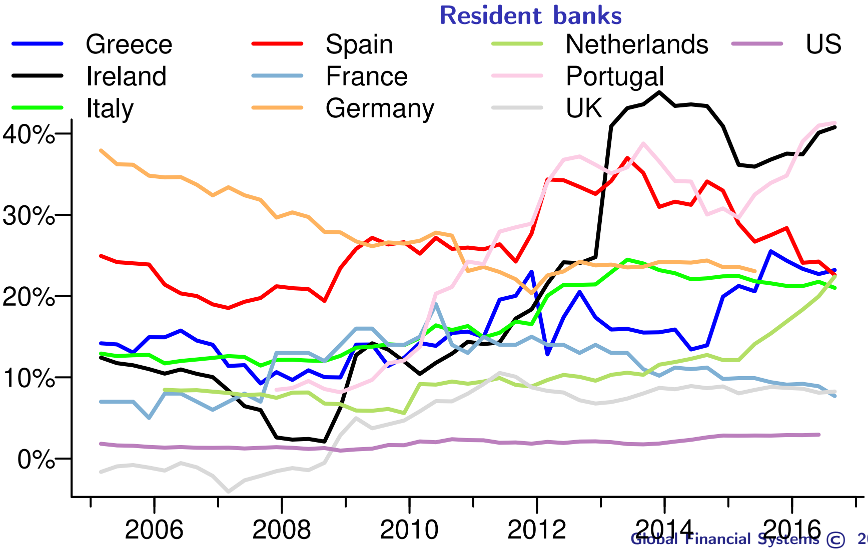
Holdings of sovereign bonds



Holdings of sovereign bonds



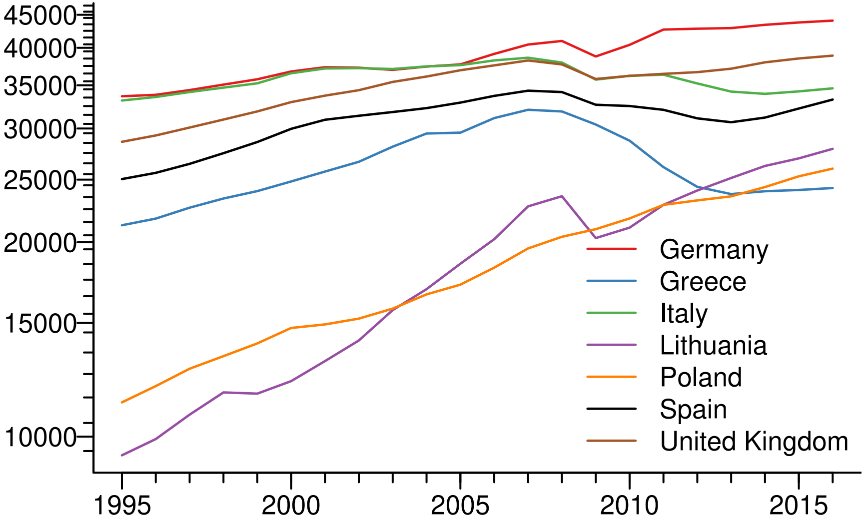
Holdings of sovereign bonds



Importance of growth

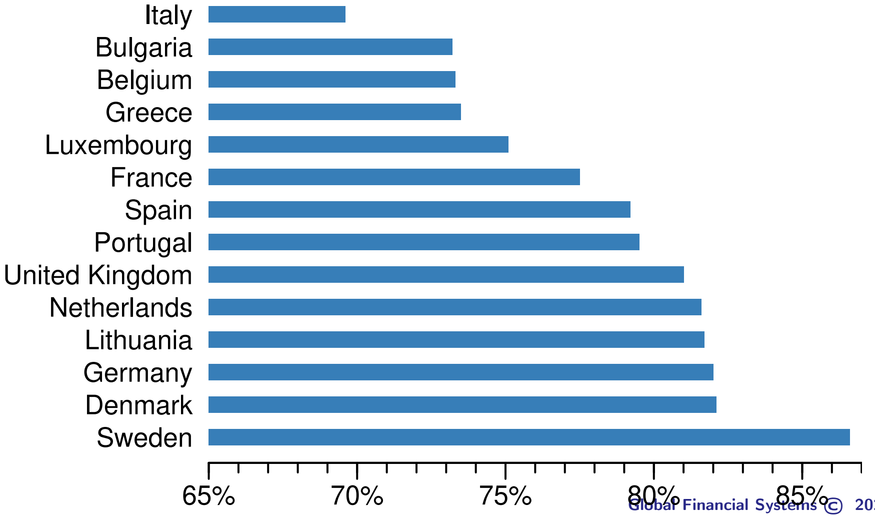
- If all countries in Europe enjoyed similar economic growth, a crisis would be less likely
- Problem is divergence in economic fortunes
- Some European countries increasingly uncompetitive
- If growth is negative and the growth prospects are poor, a country can enter a vicious cycle
- Meanwhile it is shunned by foreign investors
- This affects other countries in the Union
- *Large — and even small if over a long period of time — differences in growth patterns can therefore create instabilities*

GDP (PPP per capita in constant USD)

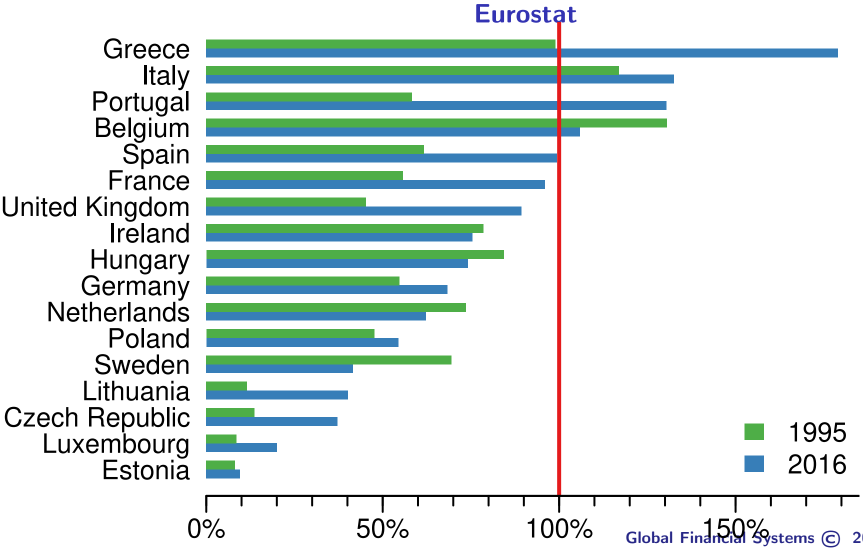


Active population % of total

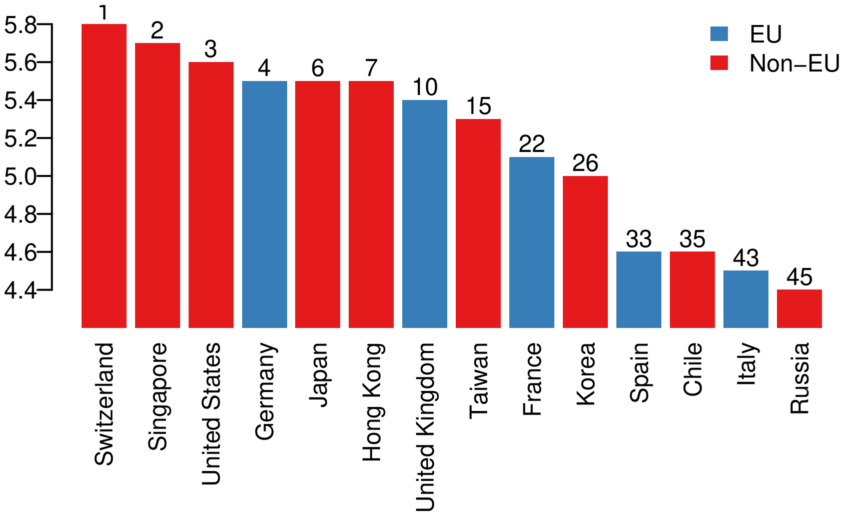
In employment, 20-64 year olds, excludes students



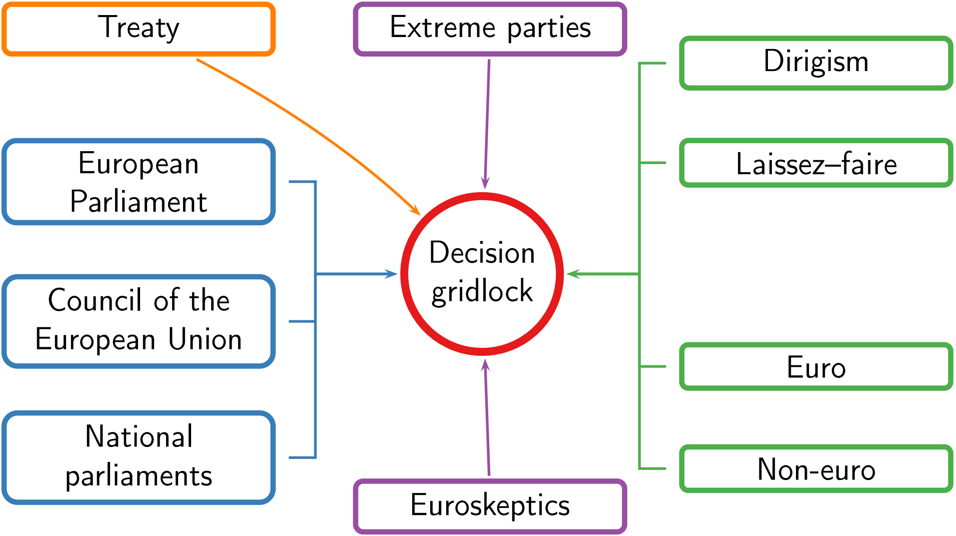
Debt/GDP


Eurostat
Greece
Italy
Portugal
Belgium
Spain
France
United Kingdom
Ireland
Hungary
Germany
Netherlands
Poland
Sweden
Lithuania
Czech Republic
Luxembourg
Estonia
1995
2016
0%
50%
100%
150%

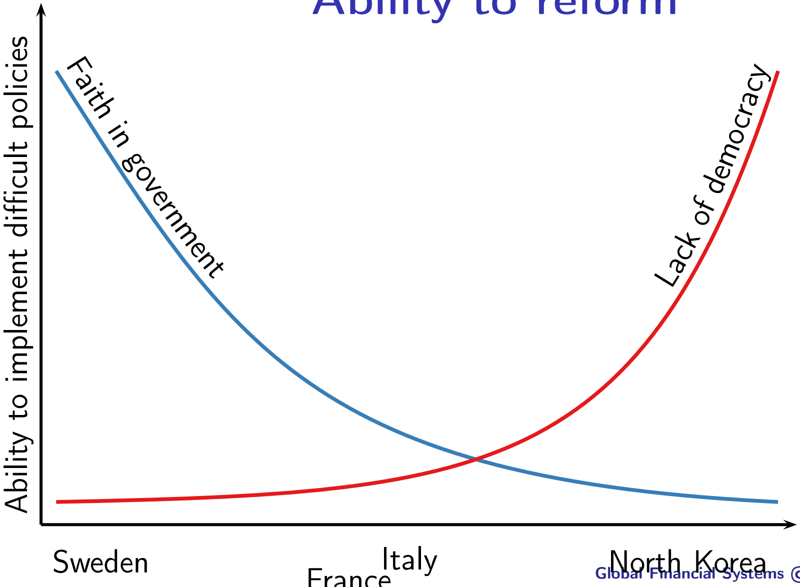
Global Competitiveness Index (WEF)



Politics


Treaty
Extreme parties
Dirigism
European Parliament
Laissez–faire
Decision gridlock
Council of the European Union
Euro
National parliaments
Non-euro
Euroskeptics

Ability to reform



Fiscal & transfer union

United States of Europe?

- Very unlikely in short and medium-term
- Common taxes and intra–state re-distribution (much more than now)
- Centralization of key-decision making
- Eurobonds
- The successful countries may end up sending money to the poorest indefinitely
- The unsuccessful forced to reform
- Key obstacle: political

Breaking up

- Very unlikely in short and medium-term
- Reversion to national currencies
- Even split of the European Union
- Separation of non-crisis and crisis countries
- More efficient & tailored solutions to problems in crisis countries possible
- Potentially new common market & currency by smaller set of countries
- Favored by euroskeptic parties but politically very unlikely

Muddling through

- Most likely
- Prevailing approach taken by EU authorities
- Circumvent most difficult questions and deal with small decisions towards European integration
- They have been quite good at dealing with the crises since 2007
- But Greece and Cyprus are tiny
- And Spain did not really need help
- How will it cope with Italy and even France?

Structural reforms and the austerity debate

What to take from crises and economic difficulties

- After country is in a crisis the immediate reaction is usually
  1. this is the first time it ever happened in the world
  2. it is all the *fault of the foreigners* (US/Germany/New York/London/Bankers/HFs/IMF/*)
- Some countries eventually learn — other don't
  - see chapter 6, Asian crisis (Korea vs. Thailand/Malaysia/Indonesia)

Historical European reforms

- Luxembourg ditched its industry and mining in 1973 for finance
- Netherlands, Denmark, Sweden reformed in late 1970s/1980s
- The UK with Thatcher in early 1980s
- Germany with Hartz I-IV in early 2000s

Preparing for the new globalization

- Labor market flexibility
- Sustainable government financing
- Education system that prepares for future technical demands and uncertainty
- Legal system that is impartial and efficient
- Business environment that is open to innovation
- Prevent monopolies and oligopolies
- Tax system that is fair, also taxes foreign tech companies, and does not prevent innovation
- Some countries do others don't

Austerity

- Some European countries had to make painful decisions
- In response to the 2007/8 crisis and the European crisis
- Crisis are a great opportunity to implement painful and useful reforms

"Don't let a good crisis go to waste"

- What to do about falling government revenues and increasing demands on government services
  a. borrow ones way out
  b. or
  c. austerity
- Much depends on whether the crisis is rational or irrational

Criticisms of austerity

- Government spending has *multiplier effect* > 1
- Austerity measures too stringent, hindering growth
- Cutting government expenditure during a recession aggravates downturn, is counterproductive
- Falling GDP counteracts efforts to reduce the debt/GDP ratio through debt reduction
- Lower living standards, with no improvement of debt sustainability
- Backed up by evidence from the Great Depression
- Ideally, the exchange rate should be adjusted
- Think of Greece

Proponents of austerity

- Government spending multiplier is <1 — crowding out
- Stimulus might just lead to increased savings if seen as temporary
- Increase in government debt might simply encourage lenders to demand higher interest rates, which in turn would drag down growth
- Think of Lithuania

Political instability

- Austerity leads to widespread, identifiable costs such as falling wages and unemployment
- Voters are less confident than the technocrats that this pain will lead to gains for them (and not just the wealthy)
- Austerity causes protests and encourages extreme political parties
- Makes it difficult to accept austerity
- Feelings of lack of democracy
- Many governments changed consequently

Role of the currency

- If a country has its own currency it can just devalue
  - that may prevent reforms
- UK in 2009, Greece, Italy, Portugal, etc. historically
- When in a common currency impossible
- So internal devaluation (next slide)?

Internal devaluation

- Lowering factor costs (e.g. wages)
- Germany did this successfully in the early 2000's (Hartz plan)
- So have the Baltic countries and Ireland
- Even Spain has had some success
- But this is inefficient

Structural reforms

- Some European countries have became increasingly uncompetitive
  - Italy, Greece, Portugal, etc.
- Some countries have been able to use the crisis to reform
  - Lithuania, Latvia, Spain,
- Some have been forced to
  - Greece
- Others not. Why? (next slide)
  - Italy, France, Belgium, etc.
- And yet others are in continuous reform
  - Sweden, Denmark, etc.

Obstacles to structural reforms

- Liberalization of services and utility sectors
- Some are more heavily regulated and less productive
- *The labour market* is often singled out as being especially in need of reform that are strongly resisted by vested interests
    - Insider–outsider labor market, and unions protecting the insiders
- Reforms are often painful in the short–run — beneficial in the long–run
- Removing obstacles for firing employees can lead to further unemployment in the short-run
- Reforms require a broad political agreement, can be difficult to achieve