

# The economic crisis in Europe – causes, effects, policies, alternatives

Presentation to European Forum Cyprus seminar  
Two tests for Cyprus – world financial crisis and identity,  
Nicosia, 12-14 June 2009

Causes – not just a financial crisis

Current situation

Green shoots?

EU policy response

Critique – what needs to be done

# Causes – complex interaction of fundamental developments

## Global current account imbalances

Excessive consumption (and overvalued USD) in US, excessive savings in China, Japan, Germany

## Internationalisation of production without internationalisation of regulation and oversight

## State withdrawal, liberalisation, de-regulation

Notably but not only in finance

## Distributional changes

Falling labour share and/or increasing inequality of wage incomes

## ‘Financialisation’ of the economy

Securitisation, rising debt levels

## Low interest rates

## Causes – ‘traditional’ sources of downturn plus external shock

Sharp rise in commodity prices

Sharp appreciation of the euro

Lagged effect of past interest-rate rises

Imbalances and (housing) booms in some EU countries

Then shock from US (housing bubble!) hit Europe:

US consumer retrenchment

Fed rate cuts led to more appreciation of euro

Toxic assets held by EU banks

Emerging markets and world trade hit

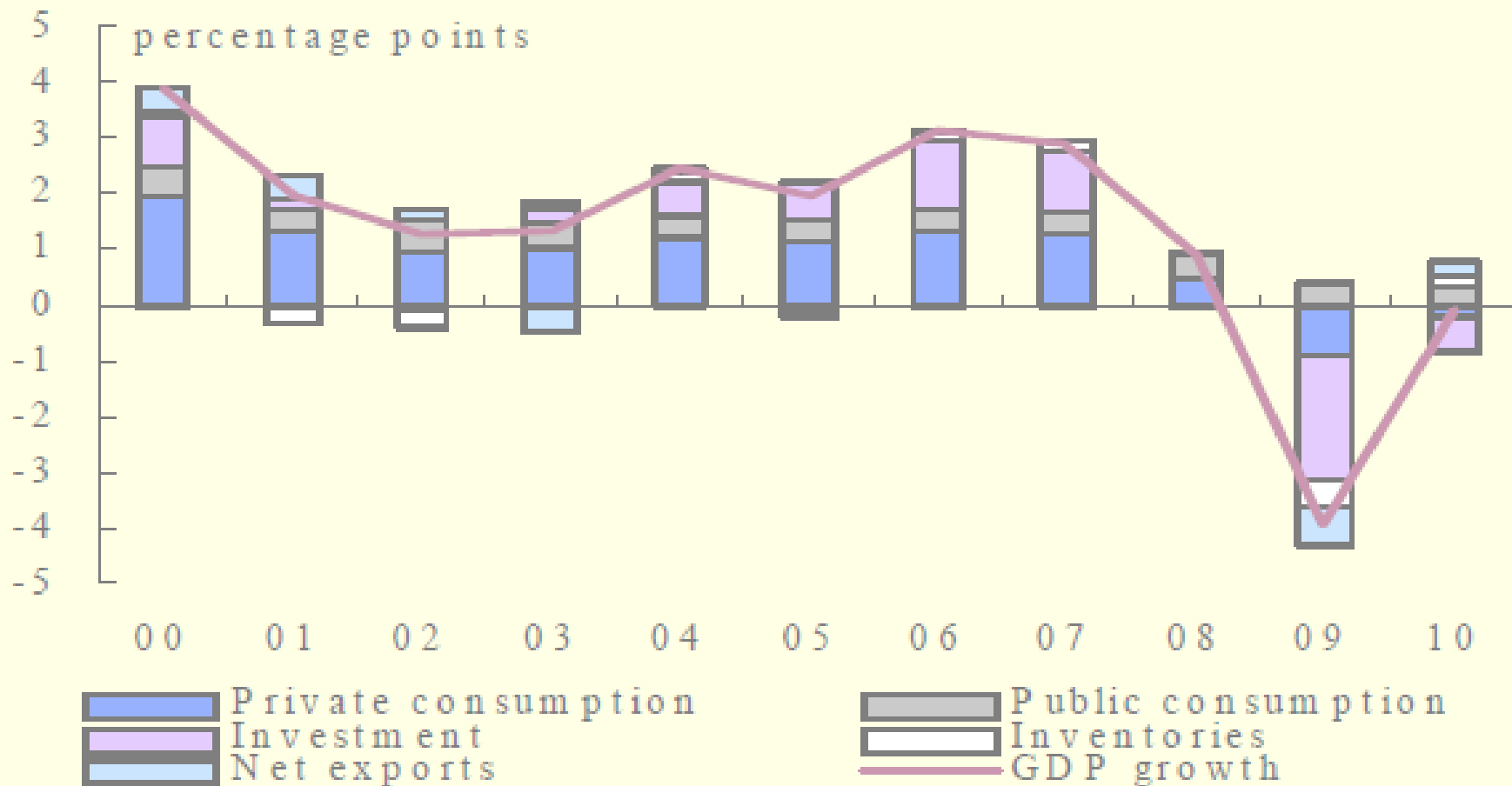
# Grim prospects for EU (worse than US)

Note: following charts from European Commission Spring Forecast

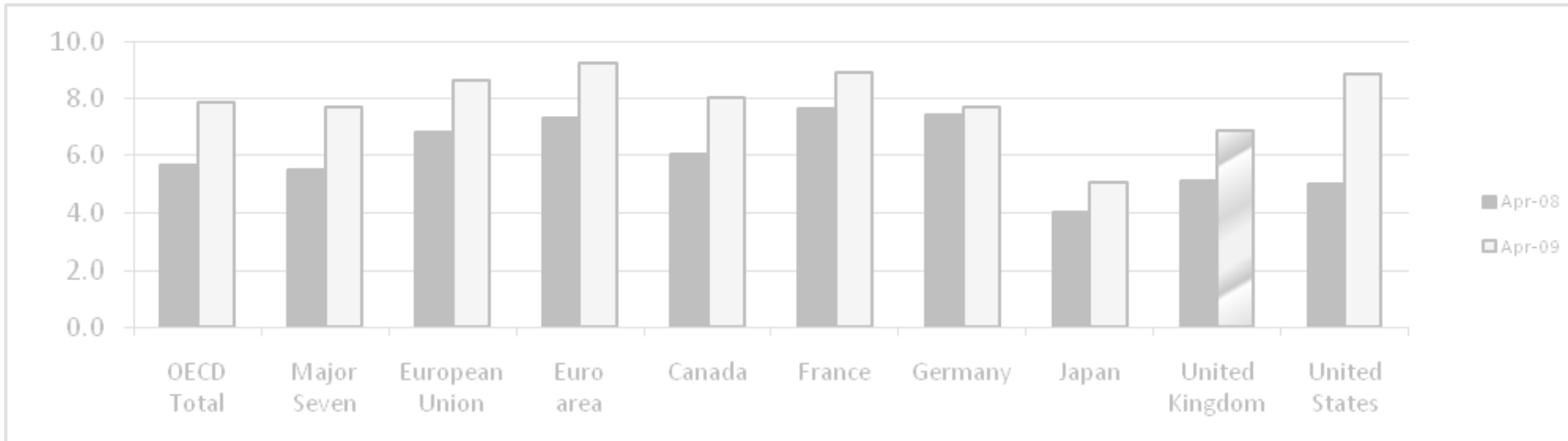
	2007	2008		2009		2010	
(percentage change on preceding year)		Spring	Jan-09	Spring	Jan-09	Spring	Jan-09
World GDP growth	5.1	3.1	3.3	-1.4	1/2	1.9	2/4
GDP growth in:							
- the US	2.0	1.1	1.2	-2.9	-1.6	0.9	1.7
- Japan	2.4	-0.7	-0.1	-5.3	-2.4	0.1	-0.2
- China	13.0	9.0	9.7	6.1	6/4	7.8	8
- EU	2.9	0.9	1.0	-4.0	-1.8	-0.1	0.5

# Massive output drop – but no unsustainable boom

## Contributions to real GDP growth, EU

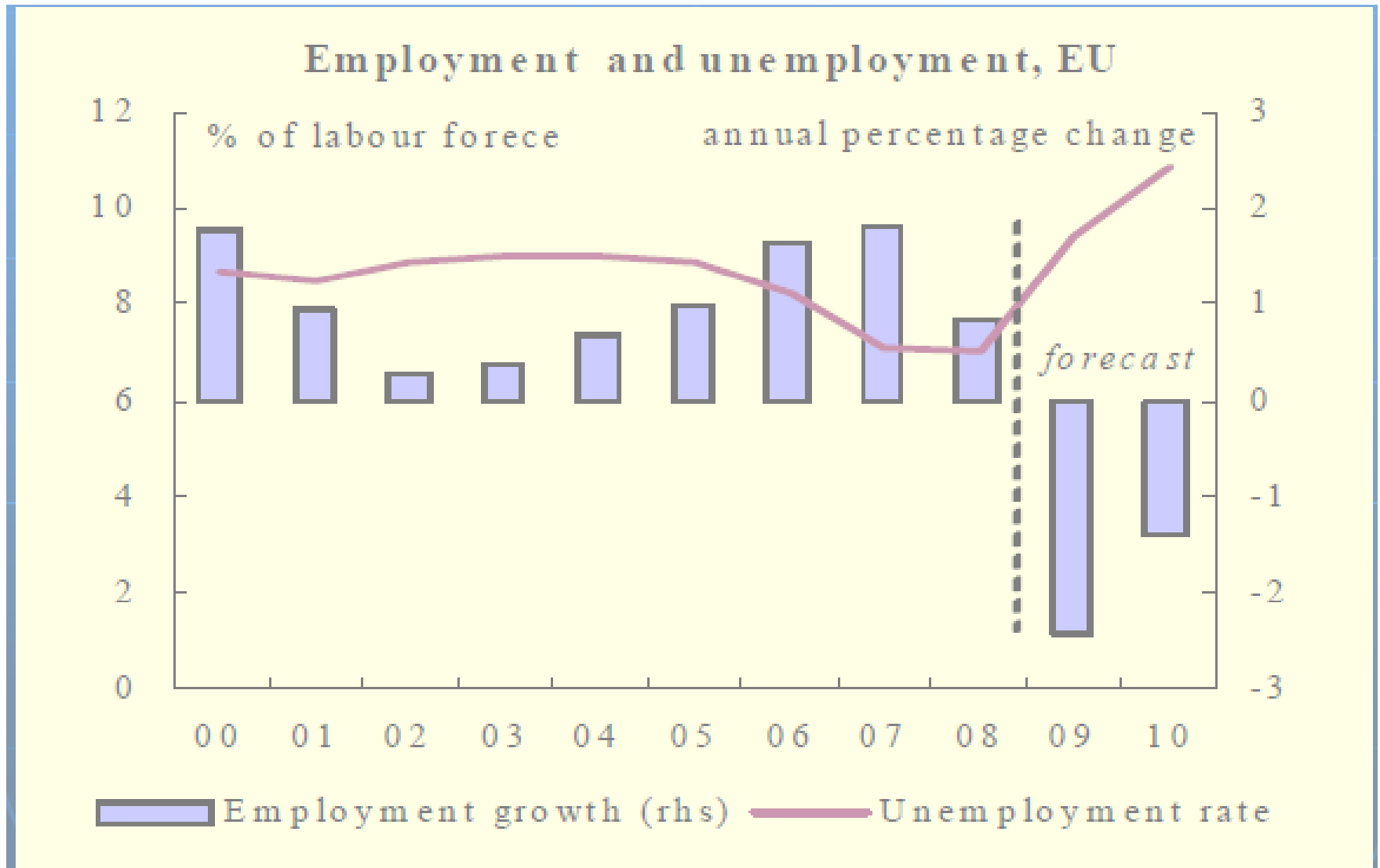


# Latest unemployment figures (OECD 8 June 09)



- small rise in Germany: temporary success, but much worse to come
- US now equal to euro area.

# Severe lagged impact on (un)employment



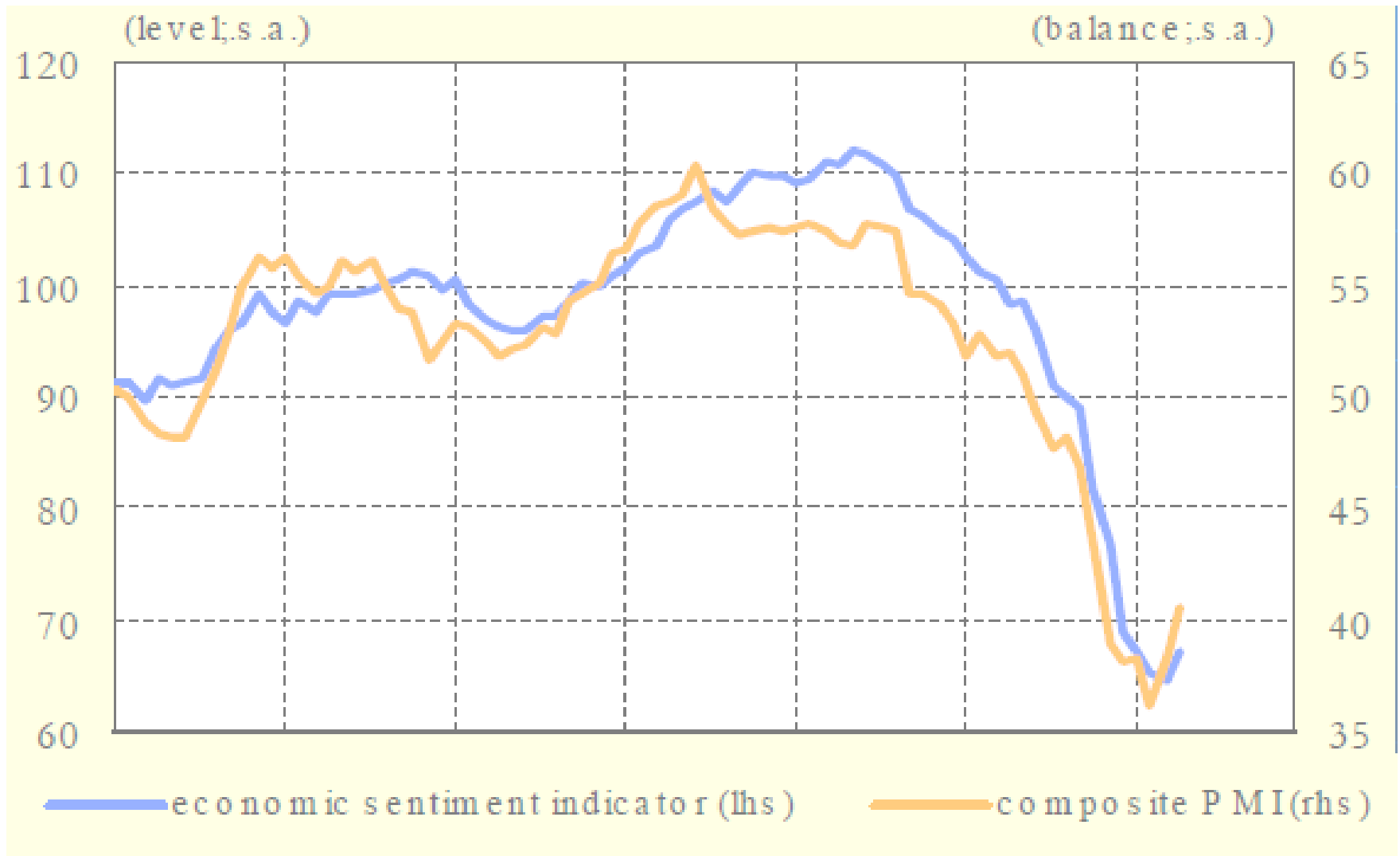


# Severe lagged impact on fiscal position

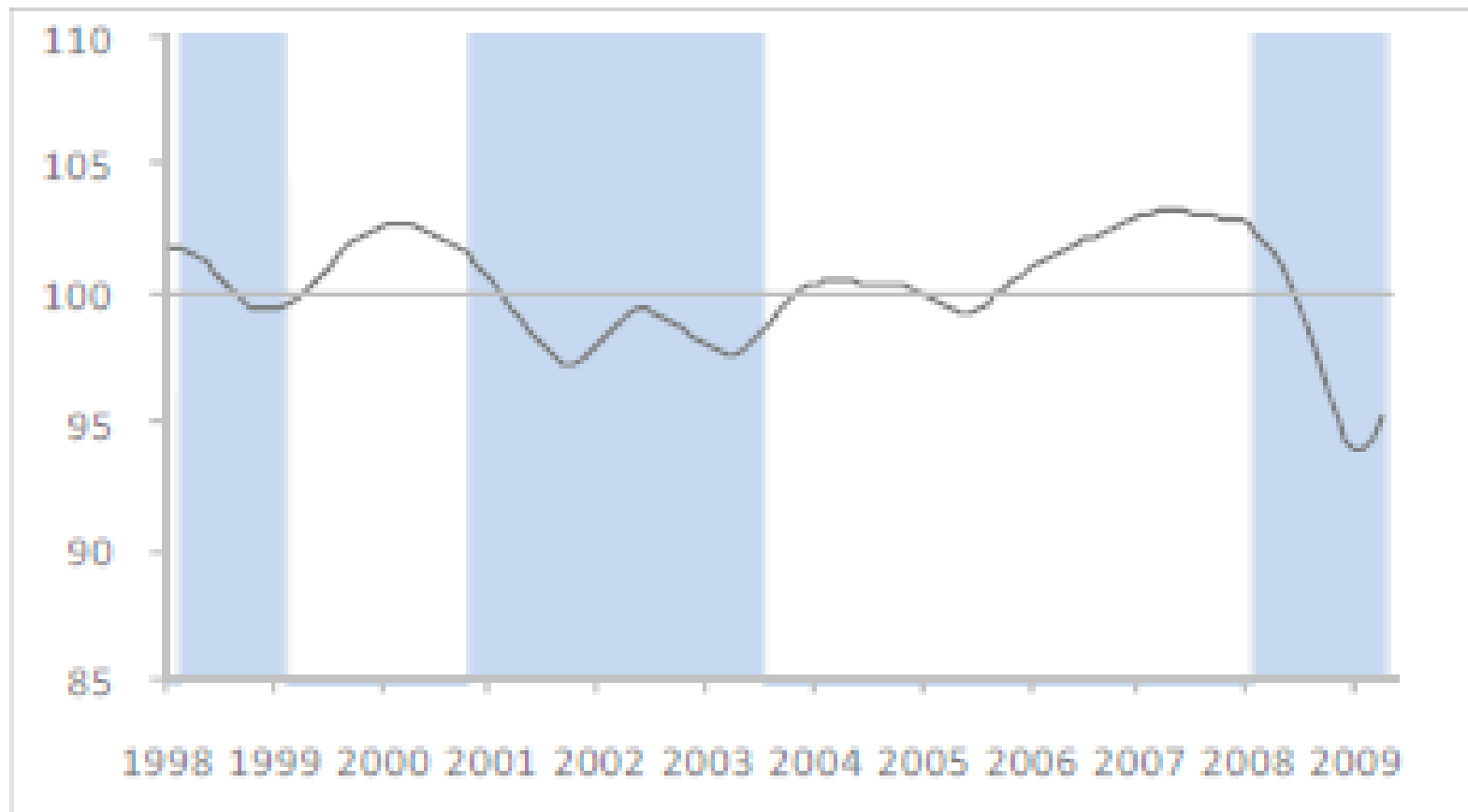
(% of GDP, general gov't)	euro area				EU27			
	2007	2008	2009	2010	2007	2008	2009	2010
Government balance	-0.6	-1.9	-5.3	-6.5	-0.8	-2.3	-6.0	-7.3
Interest expenditure	2.9	3.0	3.0	3.2	2.7	2.7	2.8	3.0
Primary balance	2.3	1.1	-2.3	-3.3	1.9	0.4	-3.2	-4.3
Structural balance (1)	-1.8	-2.8	-3.9	-4.7	-2.0	-3.1	-4.6	-5.5
Gross debt	66.0	69.3	77.7	83.8	58.7	61.5	72.6	79.4

(1) = The structural budget balance is the cyclically-adjusted budget balance net of one-off and other temporary measures, estimated by Commission services

# Bottoming out? – sentiment indicators



## Bottoming out? – OECD leading indicator euro area

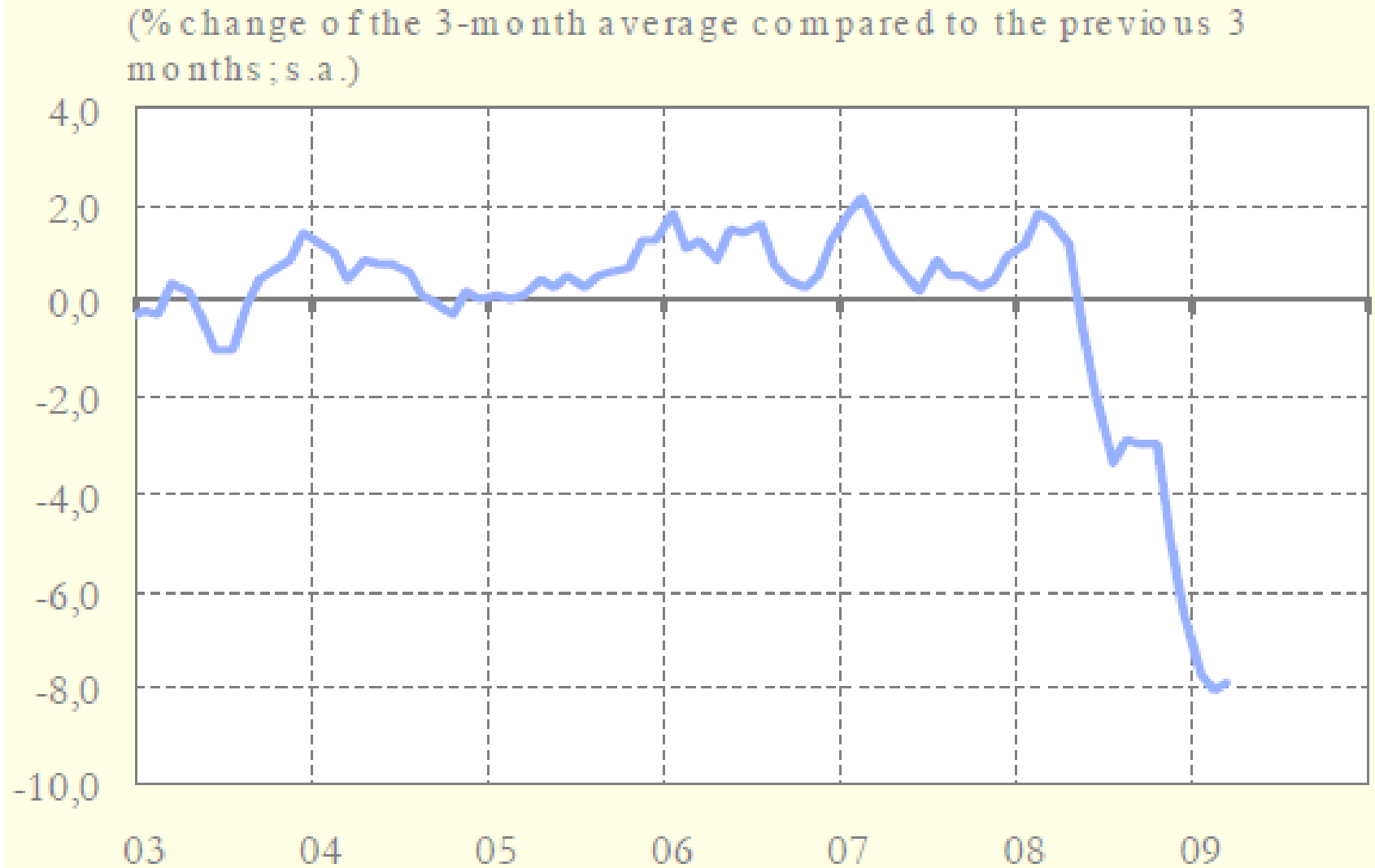


CLI stable Jan, Feb, rose Mar, Apr. (shaded areas = downswings in activity)

# Bottoming out? – share prices



# Bottoming out? - industrial production



# Green shoots but major downside risks

Green shoots thanks to massive government intervention  
Keynesian policies work!

Renewed rise in commodity prices

Unexploded bombs in the financial sector (especially in Europe!)

IMF: 2/3 EU toxic assets not accounted for

Collapse of the US-dollar

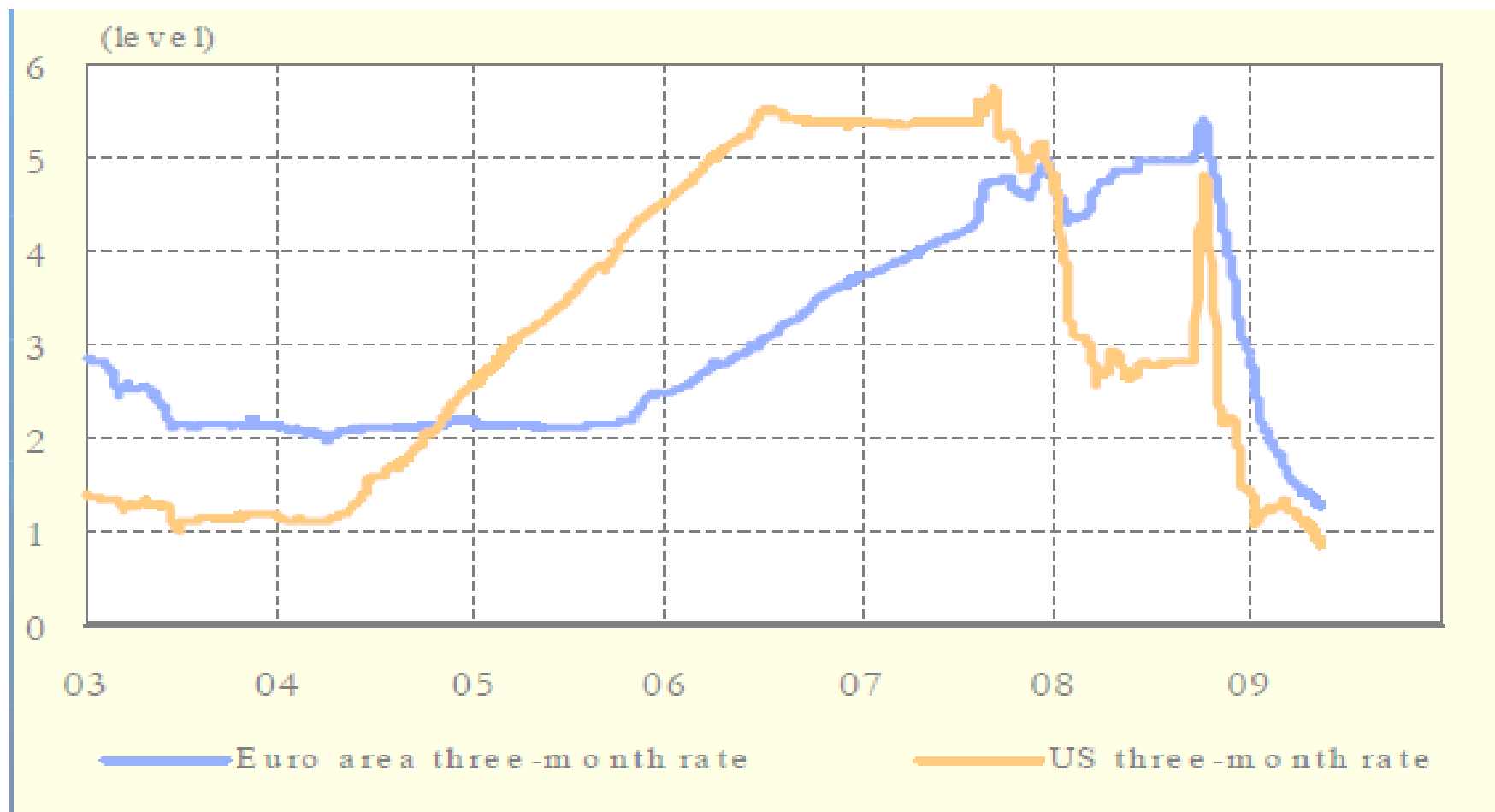
Currency crises in eastern Europe

Premature exit strategies

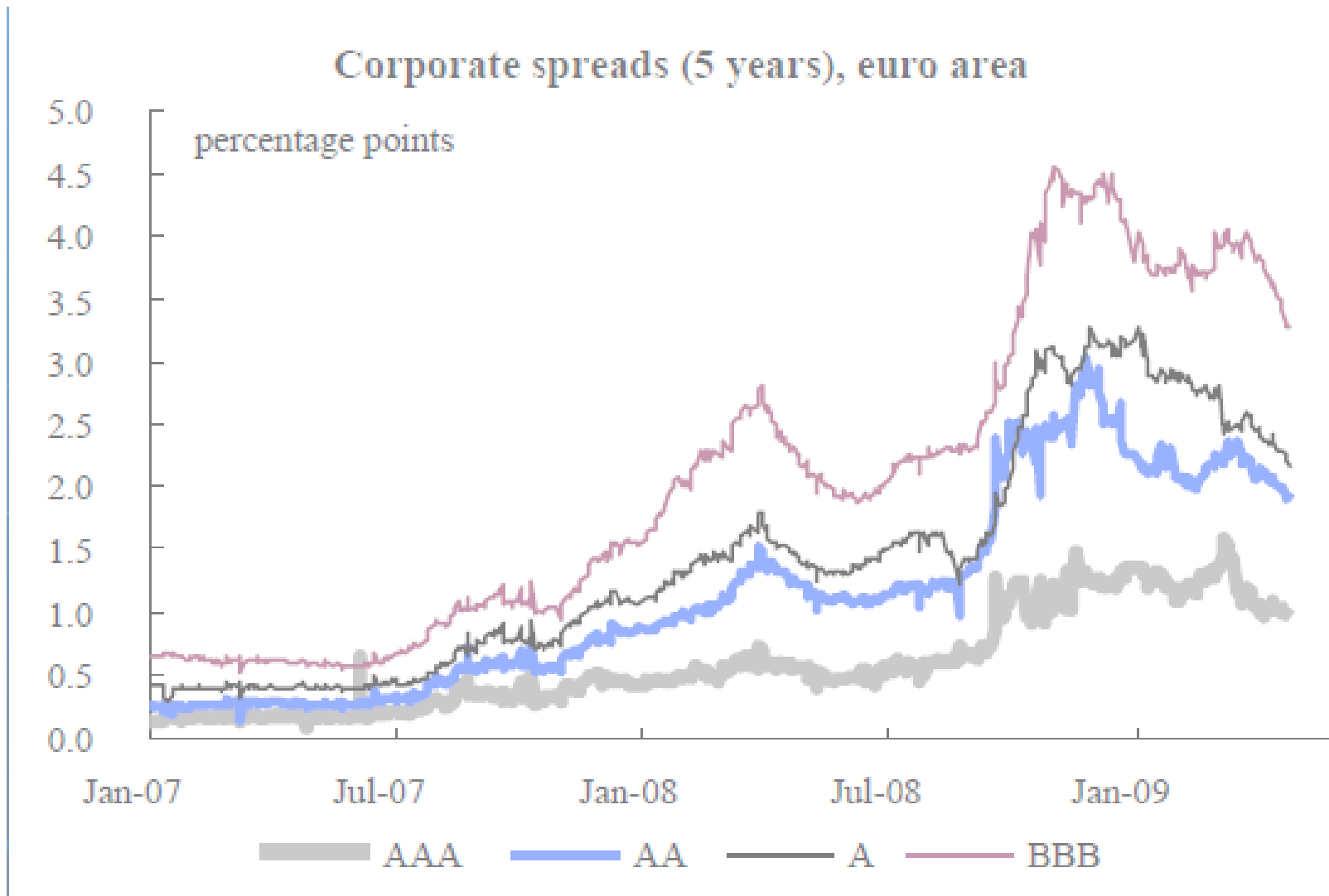
# Policy response in Europe – too little too late

ECB 325 bp cut (but after increase in July 2008)

No significant quantitative easing (cf. US, UK)



# Cut in interest rates limited impact on firms borrowing costs





# Policy response in Europe – too little too late

	Simple average	Weighted average
Total fiscal package 09/10	<b>1.70</b>	<b>1.79</b>
in 2009	<b>0.99</b>	<b>1.02</b>
in 2010	<b>0.61</b>	<b>0.59</b>
revenue side	<b>52%</b>	<b>52%</b>
expenditure side	<b>48%</b>	<b>48%</b>

# Policy response in Europe – too little too late

	AT	BE	DK	FI	FR	DE	H U	IT	LU	NL	NO	PT	ES	SE	UK
Overall size of fiscal package	2.4	0.9	2.2	1.5	1	2.64	0	0.2		1			4.6	2.4	1.5
in 2009	1	0.4	1.2	1	0.7	1.2	0	0.2	1.7	0.4	0.7	1.2	2.3	1.2	1.4
in 2010	1.4	0.4	1	0.5	0.3	1.5	0	0.1		0.5				1.1	-0.1
expenditure side	30	60	60	20	64	46			50	80	84	75	80	34	10

# Assessment of fiscal packages

The fiscal packages in the EU are too small they offer a 'quantum of solace' to Europe and fail to address global imbalances. Current self-satisfaction by policymakers completely inappropriate.

The distribution across countries varies considerably. On the positive side, to some extent this is justified economically and widespread free-riding seems to have been avoided (success for EU). However, the supposed 'fiscal room for manoeuvre' seems to be a binding constraint on more cyclically appropriate policies. Particularly problematic in eastern Europe (IMF). Failure of European fiscal solidarity.

Mixed picture in terms of content of the packages. Considerable focus on public investment, but concerns about distribution, lack of attention to labour market crisis and missed opportunity on green issues.

## Critique – recession in Europe needlessly deep and long

Overall European macroeconomic policy is behind the curve and too timid

Policy coordination was partially effective (protectionism free-riding) but inadequate

Lack of European solidarity (especially vis-a-vis eastern Europe)

Social and distributional issues not adequately addressed

Missed opportunity for longer-term reforms (especially climate change)

Misplaced concerns about inflation and fiscal deficits/debt risk leading to premature exit strategies (cf. Japan)

## Policy alternatives – save the economy and address distributional crisis

Make support for financial sector more conditional

Expand fiscal packages

Ease constraints on fiscally challenged countries to enable them to run expansionary policies and prevent downward spirals

EU investment program especially in ‘green’ growth

Equitable exit strategy (higher top rate of income tax, financial transactions tax): announce now, do later

Reform of financial sector regulation – strengthen EU level

Guidelines for management remuneration schemes

Medium term: Support for collective wage bargaining institutions, strengthen economic policy coordination, debate on fiscal and monetary architecture, rehabilitate public investment, more European coherence to industrial policy and restructuring, strengthen worker participation, etc. etc.