Comments and Discussion

COMMENT BY

RICARDO REIS The editors of this volume gave Jay Shambaugh a daunting task. The *Brookings Papers* has already published many articles—including two in this issue alone—on various aspects of the Great Recession in the United States, but Shambaugh's assignment was to produce, in a single paper, an account of everything that has happened in Europe over the last 3 years. Yet the European crisis is, both in its depth and in its consequences, more complex and, dare I say, more important for world affairs than the recent U.S. recession and its aftermath. It has led to faster increases in unemployment in some regions of Europe than in any U.S. state, and it has had impacts beyond the economic domain, enmeshing Europe's institutions and politics as well as its economies. Moreover, it is likely to lead to a very different Europe 5 years from now, whether as a more integrated union of states or as a more fragmented one, perhaps even without a common currency.

Rising to the challenge, Shambaugh provides a very readable summary of the euro crisis. Those in search of a bird's-eye view of the main features of the crisis and its policy debates will find it here. Necessarily, because so much ground is covered, the paper does not nail down any particular cause as the real driving force behind the crisis. Likewise, so many policy choices are discussed that none is definitely ruled out. But ruling out policy options, at least, was *not* part of his task, so he should not be criticized for that. I hope that over the next decade, researchers will use this paper as a starting point for taking one by one the many features of the crisis and exploring in depth what role it played.

As a discussant, it is my duty to alert the reader to some of the perils of such a comprehensive approach. I will do so in four ways. First, I will quarrel with Shambaugh's contention that any policy solution must address all three of the euro's crises. Second, I will raise some doubts about whether there is a competitiveness problem behind the euro crisis. Having laid out some criticisms, I will then discuss some alternatives. In the third section, I will put forward an account of the crisis in which the movements in countries' current accounts and competitiveness are a consequence, not a cause, of the crisis. In the fourth section, I will propose a simpler policy solution. Both my story for the crisis and my solution may look incomplete relative to Shambaugh's broad survey, but they are consistent with most of the facts.

SHOCKS VERSUS PROPAGATION OF SHOCKS Imagine an academic economist just like Shambaugh, contemplating the crisis from an office thousands of miles away. But instead of picturing this scholar in Boston or Berkeley, imagine him (or her) sitting in Barcelona or Berlin and looking in amazement at the statistics on the U.S. economy since 2008. He would see that real GDP in the last quarter of 2011 was just 0.8 percent higher than in the last quarter of 2007, which included the last business cycle peak. He would conclude that the United States is suffering from a long recession, if not an output crisis. He would then observe that the civilian unemployment rate in that last quarter of 2011, at 8.5 percent, was not just well above the 5.0 percent recorded at the end of 2007, but also higher than at any time between 1983 and 2007. A labor market crisis would be the obvious diagnosis. Looking next at the federal balance sheet, he would see a dramatic debt crisis, with the public holding about $10.5 trillion in government debt at the end of 2011, more than twice the approximately $5.1 trillion held at the end of 2007. Finally, he would look at the balance of the current account and note that since 1982, the United States has run a deficit in every year but one, and that the deficit for 2011 was a staggering $466 billion. Taking Shambaugh's comprehensive approach, the conclusion would be that the U.S. Great Recession is really four crises: in output, in labor markets, in sovereign debt, and in borrowing from abroad.

In this paper, Shambaugh's governing principle for evaluating policies is that any proposed policy that addresses only one or some of a set of simultaneous crises, while making any of the others worse, should be discarded. Looking at the above numbers for the United States with such a principle in mind, our European academic would immediately discard deficit spending as a worthwhile policy. Raising the U.S. public deficit would surely make the federal debt crisis worse, and it would likely increase the deficit on the current account as well. Our imaginary academic would be puzzled as to why there has been such a fervent debate about U.S. government spending in the past 2 years.

I hope this hypothetical exercise serves as a caveat to those readers who follow the U.S. economy closely but the euro crisis less so, alerting them to the dangers of a comprehensive approach. This way of looking at a crisis leads to a multiplication of possible subcrises that fails to distinguish between the original shock and how that shock propagated to other parts of the economy. It is common for a recession to lead to a fall in production and an increase in unemployment, but also to an increase in public debt through the automatic fiscal stabilizers, and to a current account deficit as the country borrows from abroad to smooth out the shocks. In a big recession, all of these responses will be more extreme. Nonetheless, there is still only *one* crisis, the recession itself.

Moreover, stabilization policy should not be confused with first-best economic policy. There may be many problems with the U.S. economy today, and they will surely take many different policies to address. Focusing on one of these problems, and thinking of policies to address it, is still a valid way to proceed, while also taking note of their effects on other sectors. Looking at the problem as a whole, policymakers will find that a combination of different policies is needed, but also that each of those policies, adopted to address one problem, may tend to make some other problems worse. And that is fine. In the U.S. case, it is perfectly valid to think of deficit spending as a way out of the recession, even though it increases the public debt, and even though other measures, such as entitlement reform, are needed to ensure the long-run solvency of the government. Because a menu of policies is needed, it would be unwise to reject any of the items on the menu because it alone does not solve the whole problem.

Shambaugh is right that fiscal austerity in Greece or Portugal will likely deepen the contraction in economic activity there. Yet in these two countries, where government spending has expanded continuously and rapidly as a percent of GDP over the last 20 years, where an aging population and a generous welfare state raise serious concerns about government solvency, and where private lenders are unwilling to extend 10-year loans to the government at rates below 10 percent, it is hard to see how some fiscal consolidation could be avoided. Fiscal austerity will not by itself end the crisis, but a moderate amount of it is probably part of the menu of optimal policies.

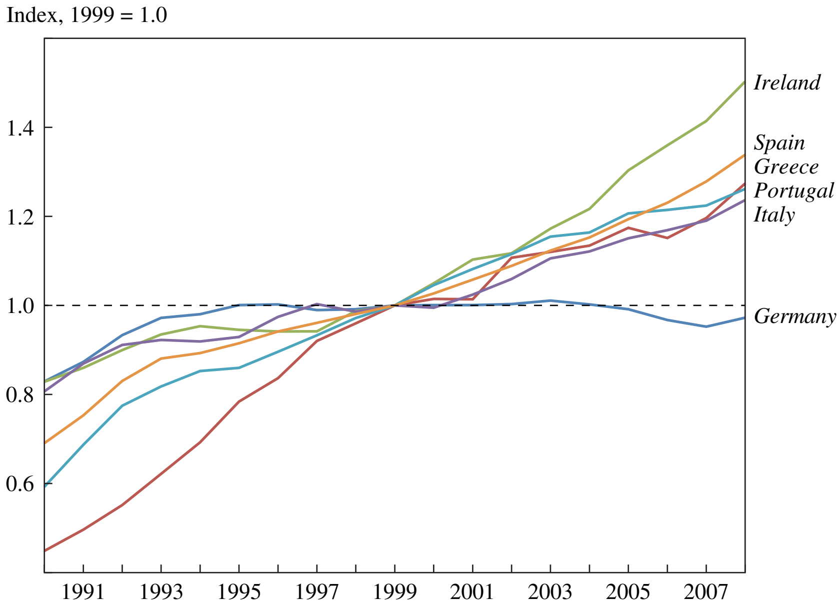
THE COMPETITIVENESS CRISIS The interaction between the sovereign debt crisis and the banking crisis has been part of the debate over the euro area's problems. Markus Brunnermeier and others (2011, p. 27) label this interaction the "diabolical loop," whereby concerns about the solvency of sovereigns fuel concerns about the solvency of banks, given their large holdings of government bonds, and these in turn confirm the concerns about the sovereigns, given the likelihood that they will have to bail out their banking systems. Runs on the banks and on the sovereign debt market can then happen quite quickly, and indeed this explains the rapid run-up in yields in Greece, then Ireland, then Portugal, and now Spain.

Shambaugh adds a competitiveness crisis to the mix and develops an interesting web of interaction between it and the other two elements. This is a very useful contribution to the debate, and the three-way interaction among sovereign debt, banks' balance sheets, and competitiveness should be further explored in future research. At the same time, however, I am skeptical about the role of competitiveness in the crisis, for two reasons. First, the justification commonly given to these competitiveness problems is the widening of the gap in unit labor costs between Germany and the crisis countries between 1999 and 2008. In those 9 years, unit labor costs fell by almost 3 percent in Germany, while increasing by almost 34 percent in Spain. A competitiveness crisis it seems indeed.

However, if one extends the comparison back in time for 10 more years (as in my figure 1), one sees that the faster relative increase in real unit labor costs in the crisis countries is there all along. It is hard to see any distinct break at the start of the century. Why, then, did this gap, which is at least two decades old, lead to a deep crisis only after 2008? Obviously, gaps in competitiveness between regions are an endemic and worrisome feature of the European Union. But it is less obvious that these gaps caused or even played a significant role in the crisis of the last few years.

Second, from the perspective of policy, a focus on competitiveness in Europe has its dangers. A driving force in the integration of Europe's periphery countries into the union has been the so-called structural and cohesion funds. These are investments funded at the EU level with the goal of developing infrastructure in the periphery countries or of raising their competitiveness in other ways. An important part of the discussion around the 1992 Maastricht Treaty, leading to the creation of the euro, was to stop the periphery countries from using periodic currency devaluations to mask competitiveness problems. Finally, the ambitious Lisbon agenda of 2000 set competitiveness as the European Union's main target over the next 20 years. It is only a slight exaggeration to say that competitiveness has been the main concern of European policymakers for the past 30 years. Thus, to suggest that lack of competitiveness is one of the main culprits of the current crisis gives the comforting, but dangerous and likely wrong, impression that European policymakers should do what they have been doing all along, just more of it and faster.

Figure 1. Unit Labor Costs in Selected European Countries, 1990–2008

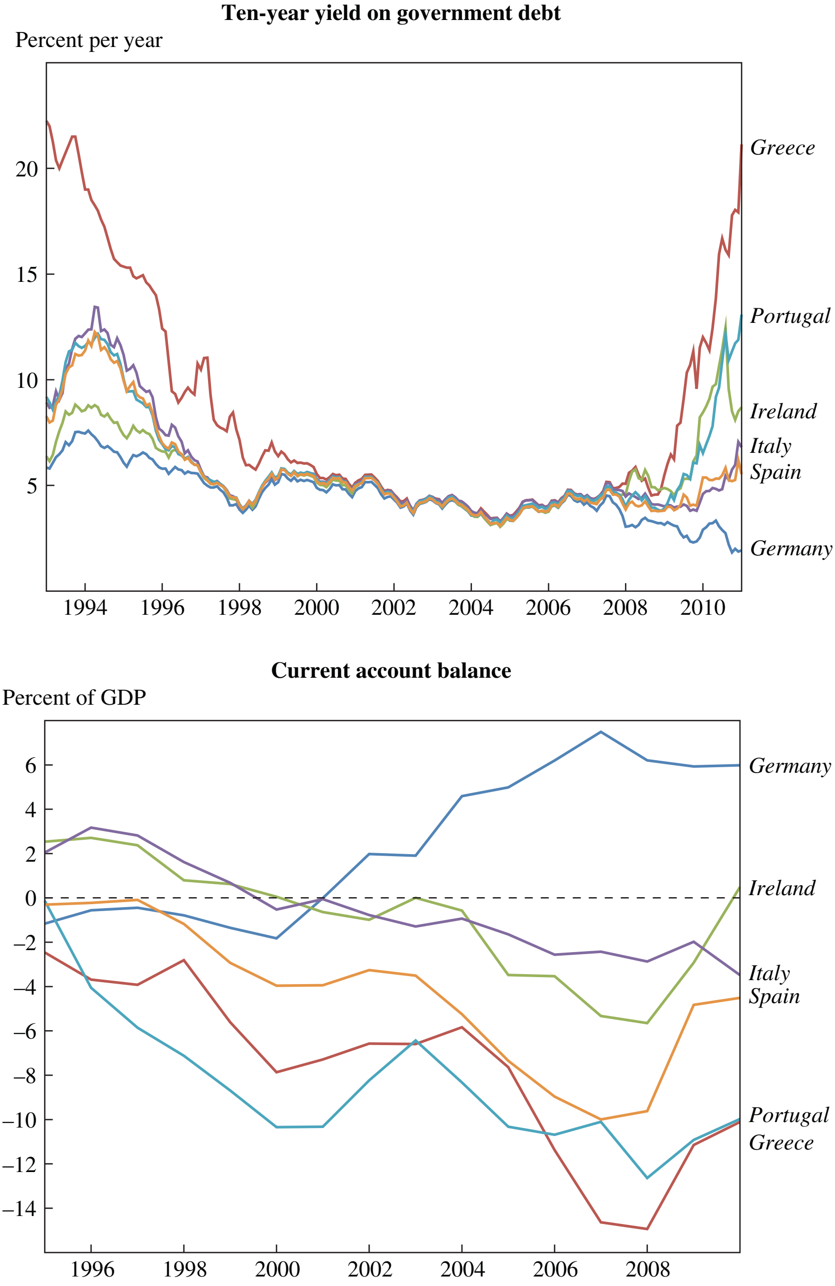


Source: Organisation for Economic Co-operation and Development.

COMPETITIVENESS AS CONSEQUENCE, NOT CAUSE As a contrast to Shambaugh's comprehensive approach, let me offer a simple description of the crisis that is nonetheless powerful at accounting for the facts. This alternative story sees the crisis as an example of a "sudden stop" of lending as described in the work of Guillermo Calvo (1998, p. 36), and is partly shared with Lane (2012). The two parts of my figure 2 provide the main ingredients of this story.

The introduction of the euro removed exchange rate risk for Northern Europeans wanting to diversify their savings by investing part of those savings in the south of Europe. Perhaps there was some overoptimism, but whether the resulting boom in lending was justified or unjustified, interest rates across European countries all eventually came within less than 20 basis points of each other. Capital flowed steadily from north to south until in 2008 a world financial crisis led to a worldwide increase in risk premiums. Greece, Ireland, Portugal, and Spain, the recipients of these large inflows of capital in the years before, were now hit with a sudden stop. The institutional constraints and limited policy responses of the European

Figure 2. Interest Rates on Government Debt, 1993–2011, and Current Account Balances, 1995–2010, in Selected European Countries



Sources: European Central Bank and Organisation for Economic Co-operation and Development.

authorities in handling the crisis further fueled the perception of risk in the periphery and justified the rapid outflows of private capital ex post. The diabolical loop between banks and sovereigns then took over, leading to runs on these countries' sovereign debt and financial systems, and eventually to the need for public assistance from the International Monetary Fund and the European Commission.

In this account, the widening current account deficits in the periphery countries before 2008 are a reflection, not of lack of competitiveness, but of the direction of capital flows. It is hard to see any sudden changes in competitiveness in the crisis countries after 2008, but the sharp reversal in their current account deficits matches well the reversal of capital flows characteristic of a sudden stop. As for the real appreciation in the periphery before 2008, a capital flows–based story can again provide an explanation that does not involve competitiveness. As capital flowed to the periphery, it found its way to the nontradables sector (construction in Ireland and Spain comes to mind), pushing up prices and wages in that sector, and thus raising aggregate unit labor costs, as figure 1 showed. That this has implications for competitiveness is a consequence of the capital flows, not a cause of the crisis.

A FOCUSED POLICY ALTERNATIVE If, as I have argued, at the center of the euro crisis is not the problem of competitiveness, but rather the diabolical loop between banks and sovereign debt and the sudden stop in capital flows across regions, then a policy solution tailored to these problems emerges. To escape its crisis, Europe needs a Europe-wide safe asset. If banks held such an asset, the diabolical loop would be broken. If, in addition, there were a Europe-wide risky counterpart to this asset, then capital fleeing to safety, and capital in search of higher yield, would flow in opposite directions between these two assets, and not across geographical regions.

In joint work with a few colleagues (Brunnermeier and others forthcoming), I have shown how such an asset could be created without the need for joint and several liability of each European state for the other states' debts. Briefly, a European debt agency would buy a bundle of sovereign debt of each country in the euro area, allocated using some sort of fixed weights such as average GDP over the past 5 years. The flow of payments from this bundle would be used to create two securities: a European safe bond, which would be paid first, and a European junior bond, paid with the remainder. The debt agency would hold a modest amount of capital, and the safe bond would be a covered bond, so that if the payments from the bundle of sovereign bonds were not enough to pay off the safe bonds, the capital of the debt agency would answer for the shortfall.

The diversification arising from this bundling of different countries' debt, the senior claim to payment from the bundle, and the buffer provided by the capital of the debt agency would, all three together, ensure that these safe bonds would be extremely safe. Banks would hold them to satisfy their need for safe assets, and because they would not be tied to any particular sovereign, the diabolical loop would be broken. Moreover, as periods of euphoria and flight to safety alternate in their usual fashion, they would trigger shifts of funds between the safe and the junior bond, without bringing about the collateral damage of current account deficits and sudden stops.

This policy proposal would not solve all the many problems of the European economies, nor would it automatically make those economies more productive, more efficient, or more competitive. But by breaking the diabolical loop and preventing sudden stops, it would go to the heart of what has driven the crisis of the last 2 years. It would greatly attenuate the recession, and it would stop the runs on sovereign debt and the sharp rise in yields in the periphery countries. The competitiveness problem, the reform of European institutions, and other structural reforms could then be dealt with at greater leisure, allowing them to be more carefully thought through.

REFERENCES FOR THE REIS COMMENT

Brunnermeier, Markus, Luis Garicano, Philip R. Lane, Marco Pagano, Ricardo Reis, Tano Santos, Stijn Van Nieuwerburgh, and Dimitri Vayanos. 2011. "European Safe Bonds (ESBies)." euro-nomics.com/wp-content/uploads/2011/09/ESBiesWEBsept262011.pdf.

———. Forthcoming. *European Safe Bonds.* In preparation. Euro-nomics.

Calvo, Guillermo. 1998. "Capital Flows and Capital-Market Crises: The Simple Economics of Sudden Stops." *Journal of Applied Economics* 1, no. 1: 35–54.

Lane, Philip. 2012. "The European Sovereign Debt Crisis." Trinity College, Dublin.

COMMENT BY

HÉLÈNE REY[1] In this paper Jay Shambaugh presents a clear and insightful overview of the euro crisis. He analyzes the lethal interplay among the fragility of the banking system, sovereign risk, and the lack of economic growth in euro-area economies. Obviously some perverse dynamics are

1. I thank Richard Portes for very helpful discussions.