Comments to "Boom-bust cycles and imbalances in Europe. Lessons for shaping a more stable monetary union"

by Enrique Alberola, Luis Molina and Pedro del Río

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XXIV Symposium Moneda y Crédito, Madrid, November 4, 2011

Main results of the paper

- **Pre-crisis period:** European institutions provided a solid protection against economic instability and shaped the incentives, expectations and actions of agents, eroding discipline at all levels.

- **Whit the crisis** markets changed dramatically their valuation of large imbalances

- **The econometric analysis** of the fundamentals of the risk premium corroborates the change of market perceptions

  1. Prior to the crisis only the **global turmoil indicator**, the level of GDP per capita and the rate of growth of GDP were statistically significant

  2. During the crisis only the **current account** and the forecasted increase of **public debt** are significant

  3. The "**halo effect**" disappeared after the crisis and markets are now penalizing the previous deterioration of fundamentals.

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Imbalances and the convergence hypothesis

- Before the crisis (excessive) current account imbalances were understood as the result of convergence hypothesis among EMU and EU.

- Consistent with economic theory (Barro, Mankiw and Sala-i-Martin, 1995): Δ LTV

Current account balance and GDP per capita 2002-2008

Source: BBVA Research based on Eurostat

ccb = 6.76 lnY - 68.3
R^2 = 0,60

Y-axis: Current account balance (% GDP)
X-axis: GDP per capita (logs)
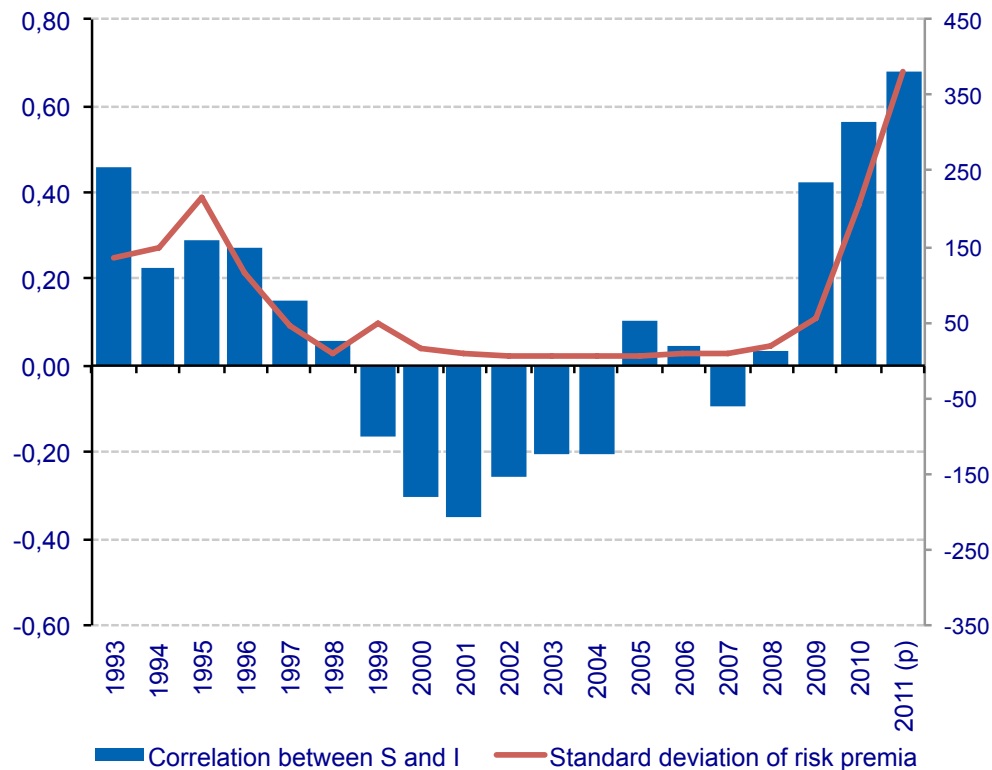
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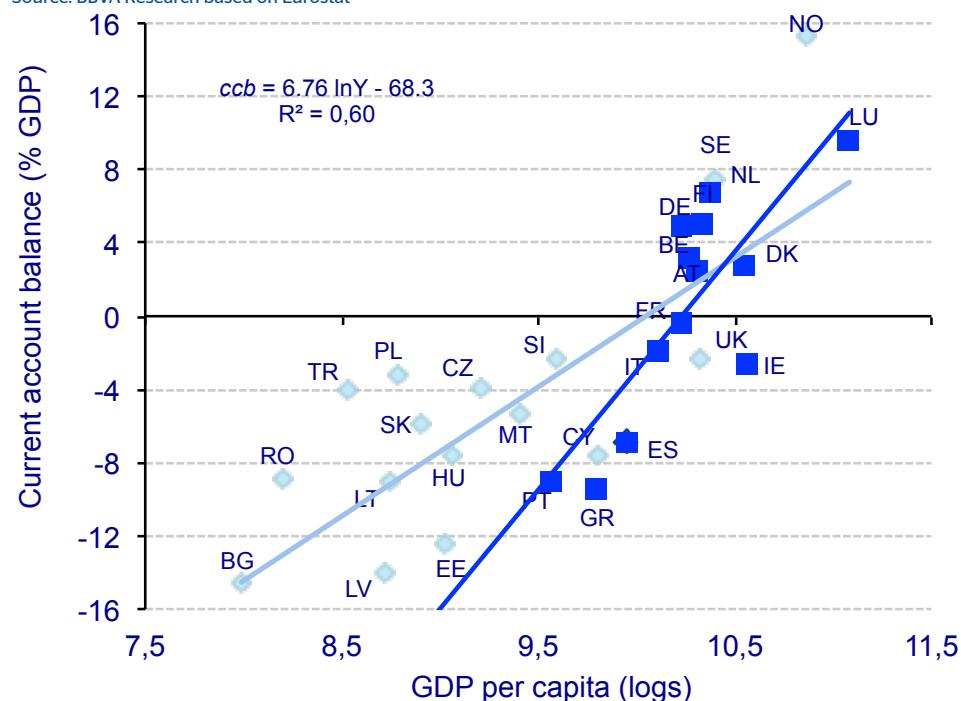
Imbalances and the convergence hypothesis

- From the mid 1900s to 2008 the Feldstein-Horioka puzzle vanished (Blanchard and Giavazzi, 2002), as well as the dispersion of risk premia (correlation equal to 0.8)

Correlation between investment and saving rates and standard deviation of risk premia
Source: BBVA Research based on Eurostat

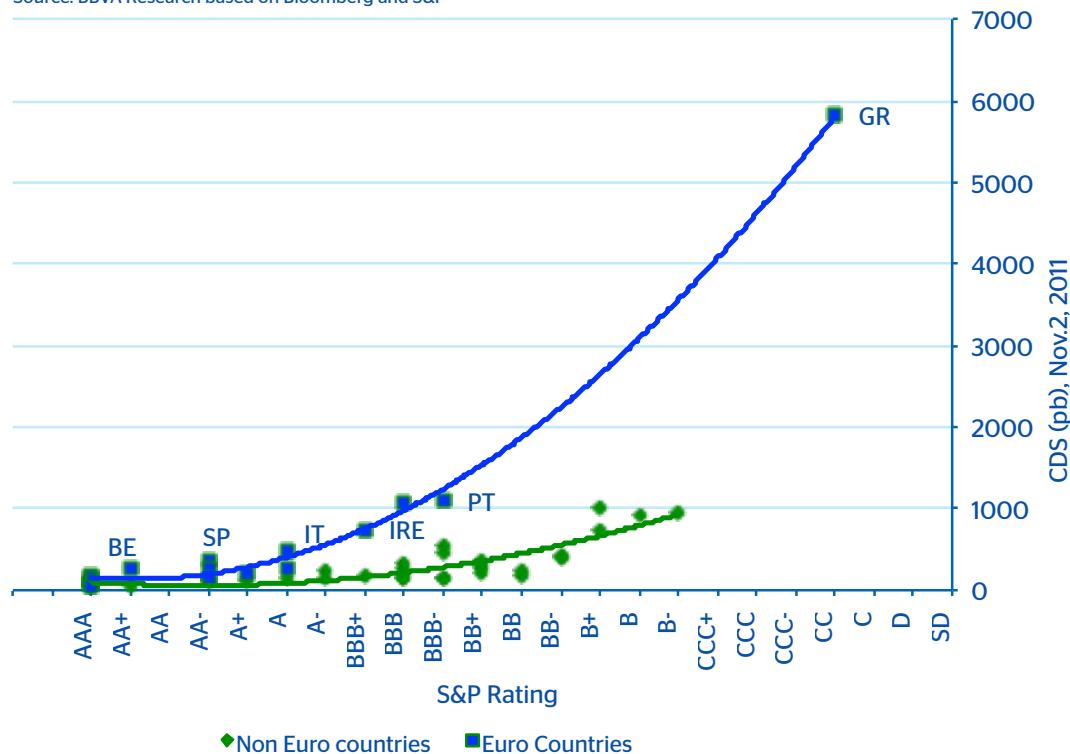Correlation between S and I — Standard deviation of risk premia

The crisis: the "halo effect" became negative

- With the current sovereign debt crisis euro area countries face higher risk premia than non euro countries with the same rating (Sanz, 2011)

Rating and risk premia
Source: BBVA Research based on Bloomberg and S&P
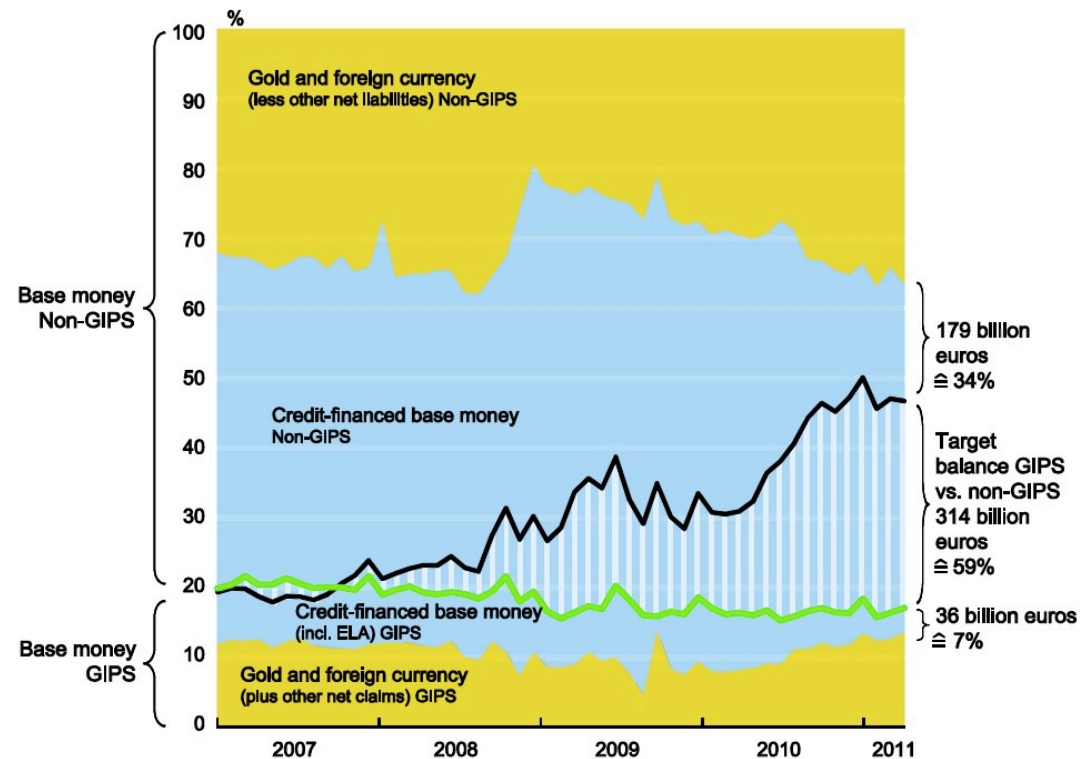
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The crisis: distribution of monetary base

- Since financial markets are closed for some countries, they have increased their dependence on ECB liquidity.

Distribution of ECB's monetary base
Source: Sinn and Wollmershäuser (2011)

EMU after the crisis

The need for institutional and structural reform to achieve economic convergence

- **The new economic governance (SGP, Euro+ Pact) at the European level may prevent future crisis but cannot ensure economic convergence.**

- **EMU countries follow different growth models**: coordinated market economies (Germany and other northern European countries) and the mixed market economies' of southern Europe (Greece, Portugal, Italy and Spain).

- **To ensure economic convergence the institutions of mixed market economies should converge to the ones in coordinated market economies**.

Varieties of Capitalism and Comparative Advantage (Hall and Soskice, 2001)		
Liberal Market Economies (USA, UK)	**Coordinated Market Economies (Germany, Northern Europe)**	**Mixed market economies (Southern Europe)**

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EMU after the crisis

The need for **institutional and structural reform to achieve economic convergence**

- **Convergence hypothesis before the crisis:** monetary and economic integration would be sufficient for economic convergence → growth → capital flows and reduced risk premiums
- **With this crisis, the markets have concluded that this hypothesis was not correct:** there are significant differences between European countries in their structural capacities, in fiscal policies and in institutions

Need for structural reform in developed countries
Source: IMF and BBVA Research

| Medium Term	Liberal Market Economies			Coordinated Market Economies									Mixed market Economies				Avge.
	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE	
Labour market	1	1	1	2	3	2	2	2	1	1	2	1	3	3	3	3	1.9
Corporate regulations	1	1	1	2	2	1	3	2	2	1	1	2	3	2	2	3	1.8
Network regulations	1	1	3	1	2	1	1	1	2	1	1	2	1	2	2	3	1.6
Retail	1	1	1	1	2	1	3	3	2	2	1	1	2	2	2	3	1.8
Professional services	1	1	1	3	2	1	2	2	1	1	1	1	2	3	2	3	1.7
Long term																	
Institutions and contracts	1	2	2	1	2	1	2	1	1	1	2	2	2	3	3	3	1.8
Human capital	2	2	1	2	2	1	1	2	1	1	1	1	3	3	3	3	1.8
Infrastructure	1	1	3	1	1	1	2	2	2	1	1	1	1	3	2	3	1.6
Innovation	1	1	2	1	1	1	2	2	1	1	1	1	3	2	3	3	1.6
Average	1.1	1.3	1.7	1.6	1.9	1.1	1.9	1.9	1.6	1.1	1.2	1.3	2.2	2.6	2.4	3.0	1.7

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EMU after the crisis

The need for **institutional and structural reform to achieve economic convergence**

- **Contrary to previous expansion years, during the crisis risk premium has been correlated with structural capacity** (Cardoso and Doménech, 2010)
- **This correlation will remain after the crisis** (although with a much lower slope).

Structural capacity and country risk
Source: Cardoso and Doménech (2010)
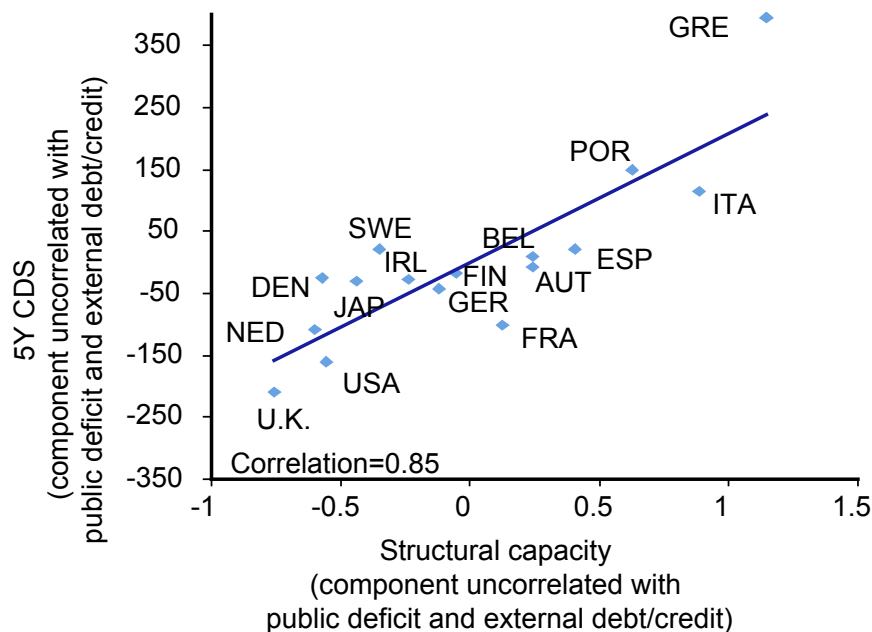
Conclusions

Expectations and markets valuations are procyclical

More cautious approach to potential imbalances is needed in the future, analysing the effects under risk scenarios

Imbalances are usually correlated across sectors, agents and markets. A general and comprehensive analysis, rather than a partial one, is needed.

Not only surveillance but also convergence of economic institutions

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