A tale of two crises: the euro area crisis and how it compares with Asia in the 1990s

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Why Europe will bounce back in 2013
by Ruchir Sharma

“Watching the crisis in Europe I cannot help but recall the drama that unfolded in Asia in 1997 and 1998”.

In: Financial Times, 18 December 2012
1. Pre-crisis facts
2. Deflagration in Europe
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5. How does Asia compare to Europe?
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Pre-crisis facts

- Public sector liabilities
- Private sector liabilities
- Nature of private debt and sectoral concentration
- Trade and stabilization
• Diversified fiscal behaviour (domestic fiscal frameworks and enforcement of Stability Pact?) and underlying (fiscal) weaknesses masked by asset price booms
Chart 1 Notified vs. actual deficits

Greece (a)          Spain (b)

Source: Bruegel calculations based on EU Commission.
Underlying weaknesses

Graph: Fiscal performance in the euro zone, 1999-2013

- Ireland - revenues vs. expenditures
- Spain - revenues vs. expenditures
- Greece - revenues vs. expenditures
- Germany - revenues vs. expenditures
• Accumulation of large private-sector liabilities in the euro area periphery supported by access to cheap credit (ie convergence in LT interests)

• Low borrowing costs in euro area periphery driven by financial markets’ (over)-enthusiasm for the Euro and ECB’s collateral policy not distinguishing across government bonds (see Buiter and Siebert 2007)
## Private sector liabilities

### Debt ratios of non-financial corporations, households and general government sector in selected countries (% of GDP)

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<td>239.8</td>
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Sources: ECB, Bank of Japan, Office for National Statistics, Bureau of Economic Analysis and OECD.

Note: The data for single euro area countries are confidential before the publication by Eurostat in September 2010.
Convergence in LT interests

DE  IE  EL  ES  FR  IT  PT  Log. (IT)
• Elimination of exchange rates favours liquid investments but negligible impact on illiquid
• Rapid financial integration with cross-border holdings of short-term capital (Treasury Bills and bank deposits) but no FDI (↑sudden reversals)
• Capital inflows are used for investment in non-tradable sector (real estate) on the back of single market, financial deregulation and standard booms dynamics
Financial openness: sovereign

**GREECE**
- Resident banks
- Non-residents

**IRELAND**
- Resident banks
- Non-residents

**ITALY**
- Resident banks
- Non-residents

**SPAIN**
- Resident banks
- Non-residents
Foreign direct investment intensity is measured as the average of inward and outward FDI flows divided by GDP. The index measures the intensity of investment integration in one specific area.
• EMU does not deliver intra-industry trade and hence business cycle synchronization with the result that the ECB’s monetary policy has pro-cyclical effects (ie Walters critique)
Intra-industry trade is the value of total trade remaining after subtraction of the absolute value of net exports or imports of an industry and expressed as a percentage of each industry's combined exports and imports.
Deflagration in Europe

- The financial crisis of 2009 resulting in government rescue of some banks and the recessive impact of tighter credit constraints exposed underlying weaknesses
- The Greek fiscal crisis in 2010 adds to the perception that there are significant fiscal vulnerabilities in the euro area
- There is widespread perception that all private sector liabilities can turn into public liabilities
- Sudden stops force public and private deleveraging in the South of Europe
Figure 1: Fiscal costs of banking crises over 2008-2011 (% of GDP)

Source: Own elaboration based on Laeven and Valencia (2012); ECB (2010).
Halt to convergence in LT interests
Asia before financial deregulation

• Asia previously pursued an export-led growth strategy with undervalued exchange rates, artificially compressed consumption, capital controls to break link between value of exchange rate and monetary policy, and financial regulation regime favouring investment in traded sector

• For example, under the BW system, Japanese government would use domestic savings to support manufacturing through Postal Savings Systems and force commercial banks to do same
Asia after financial deregulation

- Asia pursues an export-led growth strategy with undervalued exchange rates, artificially compressed consumption, but capital controls are lifted, which creates link between value of exchange rate and monetary policy, and financial deregulation channels investment through to non-traded sector, leading to real estate booms.
How does Asia compare to Europe?

- Real estate boom-bust cycles
- Sudden stops...but...
- Faster recovery in Asia than in Europe today, i) Asia smaller portion of world GDP, ii) devaluation option, iii) specialization in dotcom strong www, iv) change in growth model in Asia with switch to strengthening of domestic demand
Conclusive remarks

- Solutions for Europe much more complicated than for any other regional group due to fiscal constraints, issuance of debt in a ‘foreign currency’, and modest market-based risk sharing.
- Stabilization may thus be provided by markets (i.e. credit and equity markets) with banking union but also improved business environments (i.e. transparency and rule of law).
- Or alternatively by a euro area capacity, whose design is but a challenge in itself.