

Financial Crisis and Economic Adjustment: The Recent EU experience

John FitzGerald
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Adjusting to the Crisis

- Best indicator of growing problems was the BOP
 - Spain and Ireland had government surpluses but both had large and rising BOP deficits
- Once crisis hit both BOP and Government must adjust
- Look at some past large adjustments

Previous Crises



		Balance of payments		Exports	Imports	GDP	Effective
		as % of GDP					Exchange rate
Country	Years	Initial	Change	Change	Change	%	%
Austria	1980-85	-4.5	3.4	3.4	0.1	7.4	5.3
Finland	1989-93	-5.0	3.5	8.4	2.0	-9.5	-24.8
UK	1989-94	-4.9	3.9	2.8	-0.4	6.1	-8.8
Belgium	1980-85	-3.9	4.3	13.4	9.3	4.8	-15.1
Denmark	1986-90	-5.5	5.9	4.1	-1.8	2.3	8.2
Portugal	1982-86	-14.5	13.0	6.6	-7.5	4.9	-44.5
Ireland	1981-87	-13.3	13.1	9.3	-9.2	15.2	-0.3

Previous Crises

- No clear pattern
 - Mostly through higher exports
 - In most but not all cases changes in exchange rate
 - Finland only country with financial crisis
- External environment important
 - Allows adjustment with growth
- Takes 4 to 6 years for quite large adjustments
- Current circumstances different
 - The external environment is universally bleak

Adjustment to date



		Balance of payments		Exports		Imports	GDP	Exchange rate
		as % of GDP						Effective
Country	Years	Initial	Change	Initial	Change	Change	%	%
Portugal	08-10	-12.6	2.8	32	-1.5	-4.4	-1.2	-1.4
Greece	08-10	-16.3	4.6	23	-2.5	-6.9	-6.4	-0.5
Ireland	07-10	-5.5	4.8	80	22.4	12.5	-11.8	1.2
Spain	07-10	-10	5.5	27	-0.6	-5.2	-3.0	0.7
Hungary	08-10	-6.9	8.6	82	4.8	-2.0	-5.6	-8.7
Romania	07-10	-13.6	9.5	29	6.5	-2.0	-1.5	-20.1
Lithuania	07-09	-15.1	17.7	54	0.5	-11.4	-12.2	3.7
Estonia	07-09	-17.2	21.7	68	-2.9	-19.6	-18.3	3.6
Bulgaria	07-10	-25.2	24.3	59	-1.7	-19.5	0.5	1.7
Latvia	07-09	-22.3	30.9	42	1.5	-17.0	-21.4	3.2

Adjustment to date

- Generally not completed
- Size of export sector matters
- Mainly through cut in import share of GDP
 - Ireland Hungary & Romania exceptions
- Accompanied by big falls in output
 - The channel for reducing imports
 - In turn – significantly driven by fiscal policy
- Limited changes in effective exchange rate
 - Hungary and Romania exceptions

Adjustment to date



		GDP				
		Growth	Investment share of GDP			Unemployment rate
Country	Years	%	Start	End	change	change
Portugal	08-10	-1.2	22.5	19.0	-3.5	3.3
Greece	08-10	-6.4	19.1	14.7	-4.4	0.1
Ireland	07-10	-11.8	26.4	11.3	-15.1	9.1
Spain	07-10	-3.0	30.7	22.5	-8.2	11.8
Hungary	08-10	-5.6	20.6	17.7	-2.9	3.4
Romania	07-10	-1.5	30.2	22.7	-7.5	0.9
Lithuania	07-09	-12.2	28.3	17.1	-11.2	9.4
Estonia	07-09	-18.3	34.4	21.6	-12.9	9.1
Bulgaria	07-10	0.5	28.7	23.5	-5.2	3.3
Latvia	07-09	-21.4	33.7	21.5	-12.2	11.1

Adjustment to date

- Some countries with BOP problems had very large investment shares of GDP
 - Reflected building booms
- In these countries the adjustment in the BOP occurred through a building bust
 - Ireland, Spain and Baltics
- Consequence: very large rise in unemployment
 - Adjustment costs concentrated on unemployed
- In other countries reduction in imports and hence the BOP through cuts in consumption
 - Very painful for wider population – adjustment not complete
- Policy instrument used – Fiscal Tightening

Adjustment to date



	Government Borrowing		Investment	Current a/c	GDP	
	as % of GDP				Growth	
Country	Years	Change	End	Change	Change	%
Finland	1989-93	-14.8	-9.3	-12.1	3.5	-9.5
Ireland	2007-10	-11.6	-11.5	-15.1	4.8	-11.8
Spain	2007-10	-11.2	-9.2	-8.2	5.5	-3.0
Lithuania	2007-09	-8.5	-9.5	-11.2	17.7	-12.2
Latvia	2007-09	-6.5	-6.8	-12.2	30.9	-21.4
Hungary	2008-10	-5.8	-5.3	-2.9	8.6	-5.6
Portugal	2008-10	-5.6	-9.2	-3.5	2.8	-1.2
Bulgaria	2007-10	-4.4	-3.2	-5.2	24.3	0.5
Estonia	2007-09	-4.3	-1.8	-12.9	21.7	-18.3
Romania	2007-10	-3.8	-6.4	-7.5	9.5	-1.5
Greece	2008-10	-0.6	-10.4	-4.4	4.6	-6.4



Adjustment to date

- Ranked by deterioration in government balance
 - Include Finland in early 1990s as illustration
- A big deterioration in government correlated with:
 - Collapse of investment bubble
 - Big fall in GDP
- However, there are exceptions – Estonia
- Not a close relationship between
 - Current account and government borrowing

Financial Crisis and the Adjustment



- Bust national banks:
 - Ireland and Spain
- Bust foreign Banks
 - Estonia and Latvia
- Consequences:
 - Renationalisation of banking
 - Ireland, Austria, Italy, UK
 - Country specific cost of capital
 - Consequences for growth in EU

A Return to Growth

- Solvency depends on both:
 - Ending borrowing by government and by nation
 - A return to growth
- Different experience on twin deficits
 - Ireland has addressed the BOP but not yet borrowing
 - Portugal and Spain have smaller government borrowing but continuing BOP deficits
 - Implications of progress on one but not both?
- Return to growth: after adjustment?
 - Obstacles? Financial disintegration

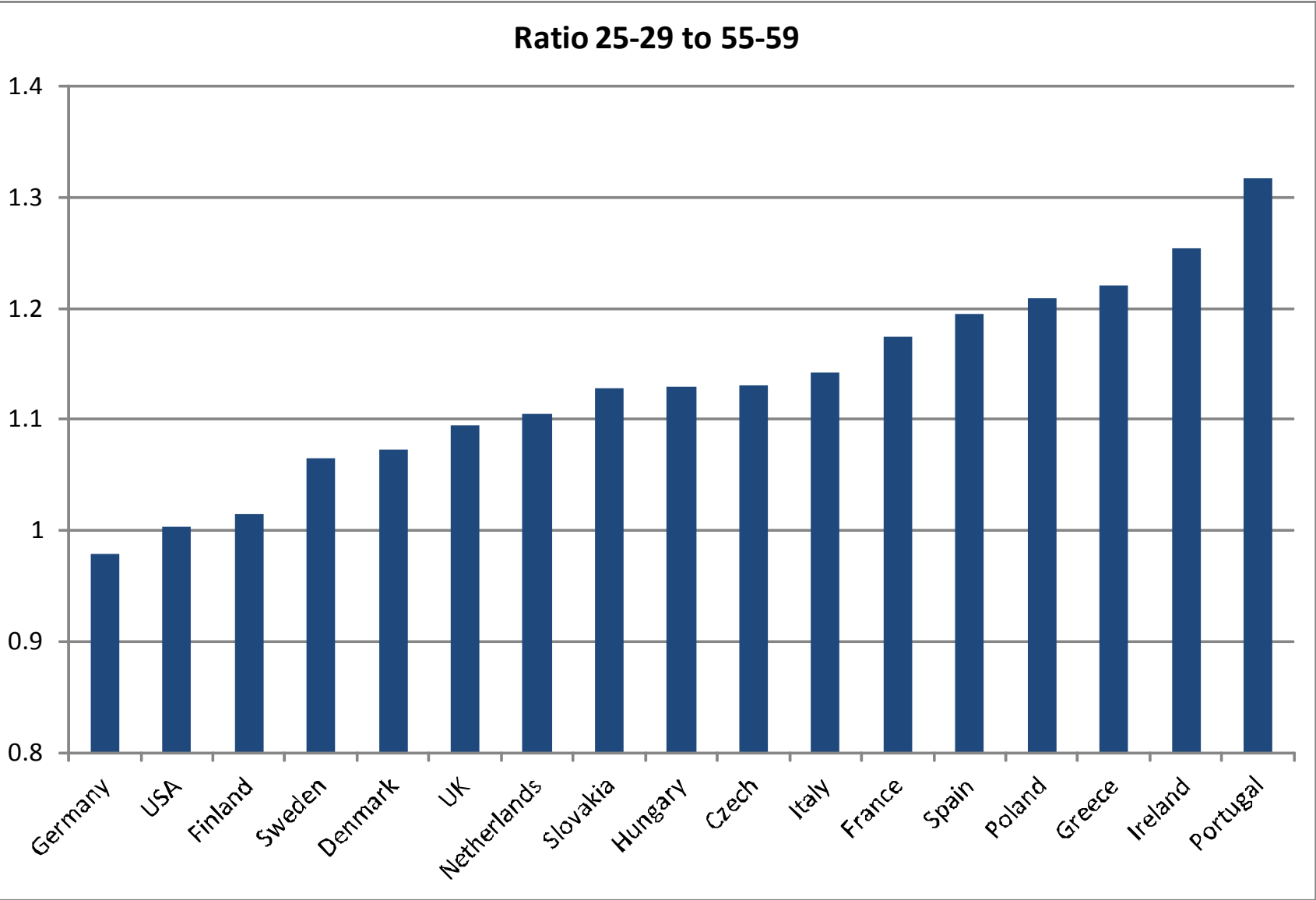
A Return to Growth

- Return EU economy to growth
- Complete necessary adjustment of domestic imbalances
- European or national banks?
- Improving competitiveness
 - Example: costs of energy infrastructure
- Addressing labour market problems

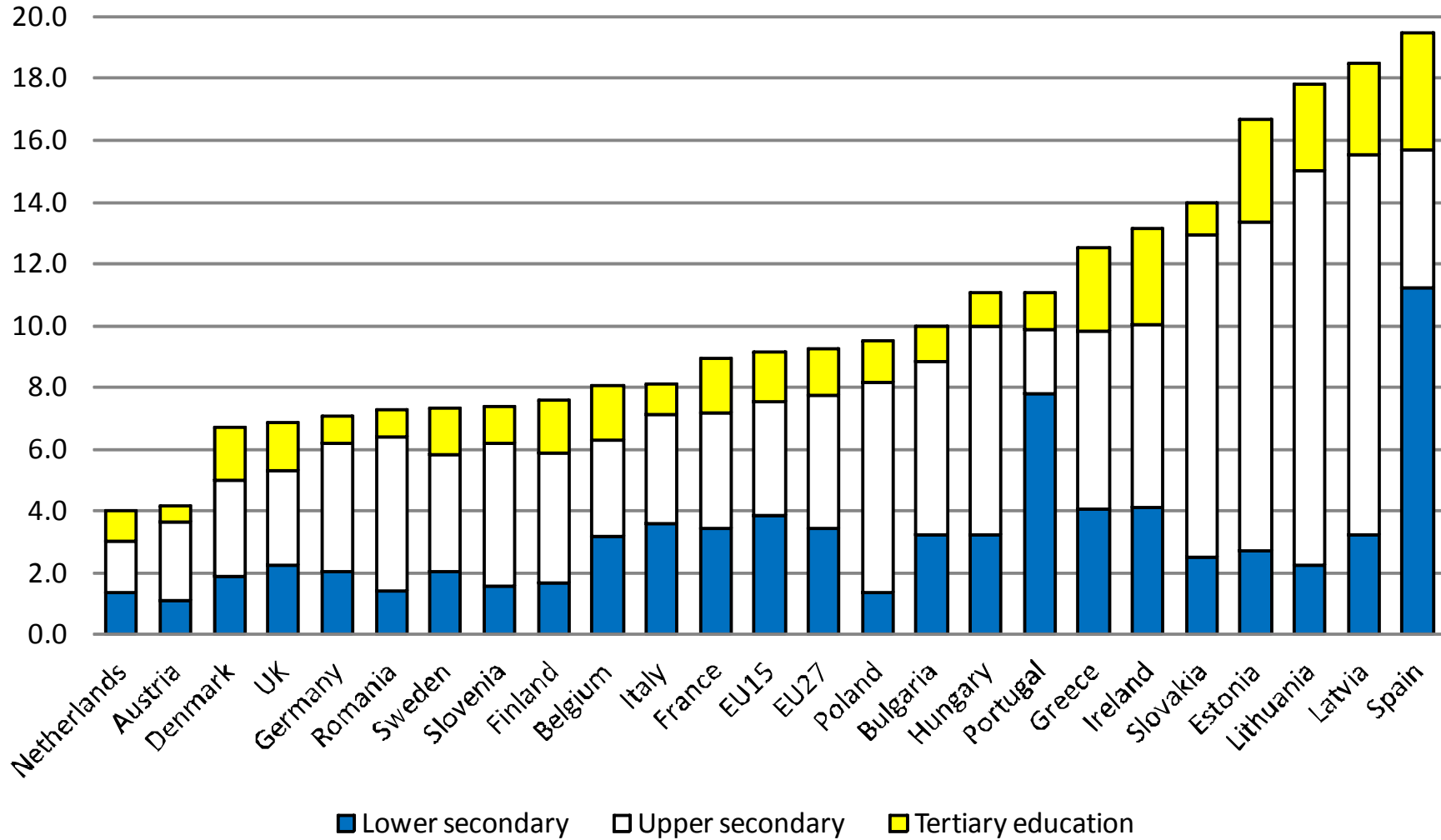
The Labour Market

- Legacy of high unemployment
 - Return to full employment – raise potential output
- Long-term implications of human capital
 - Still significant positive effects for some countries
- The Labour market - Addressing underperformance
- Elasticity of substitution of skilled for unskilled
 - If elasticity low, need to grow demand for aggregate labour or reduce supply of unskilled

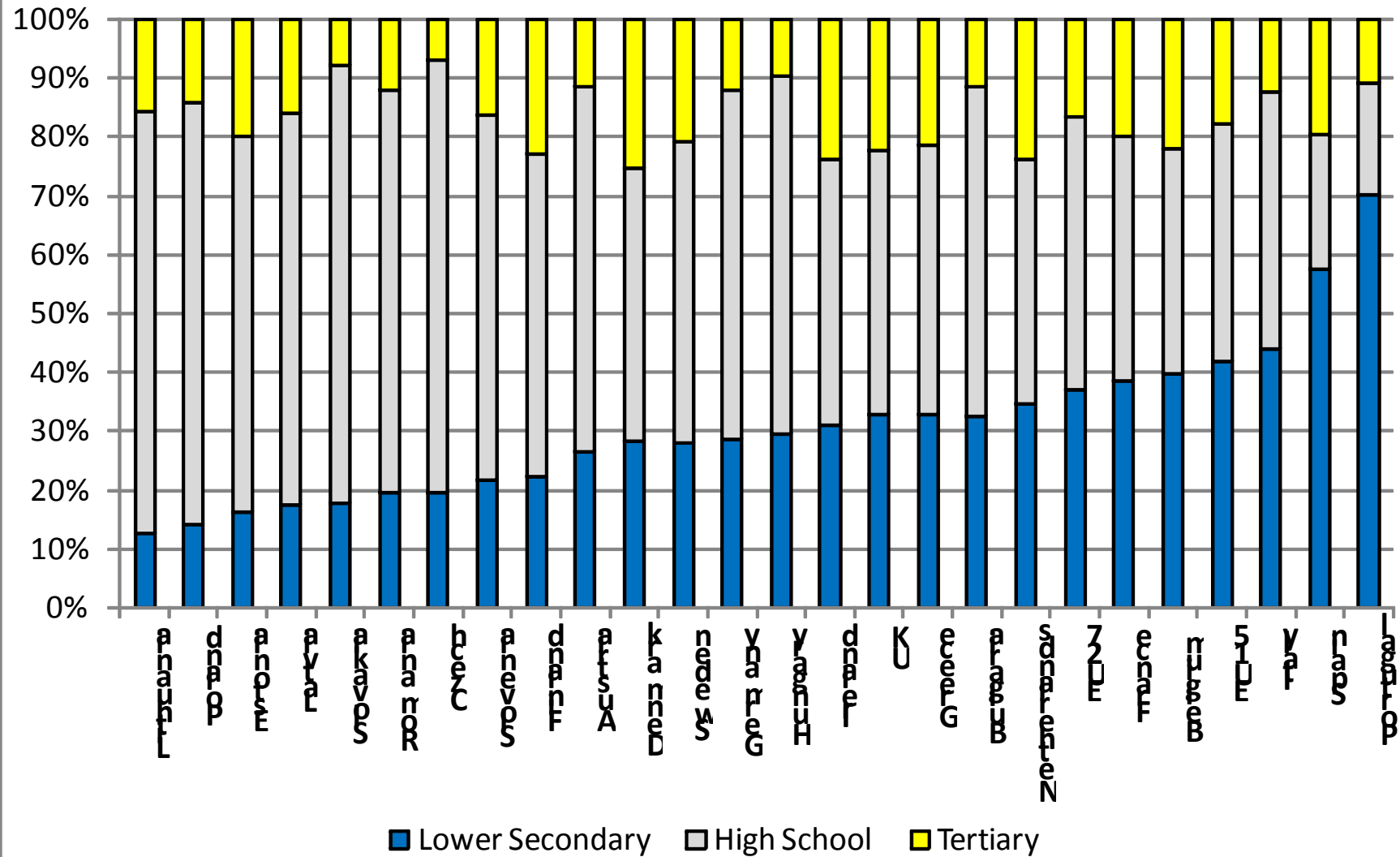
Investment in Human Capital, 2010



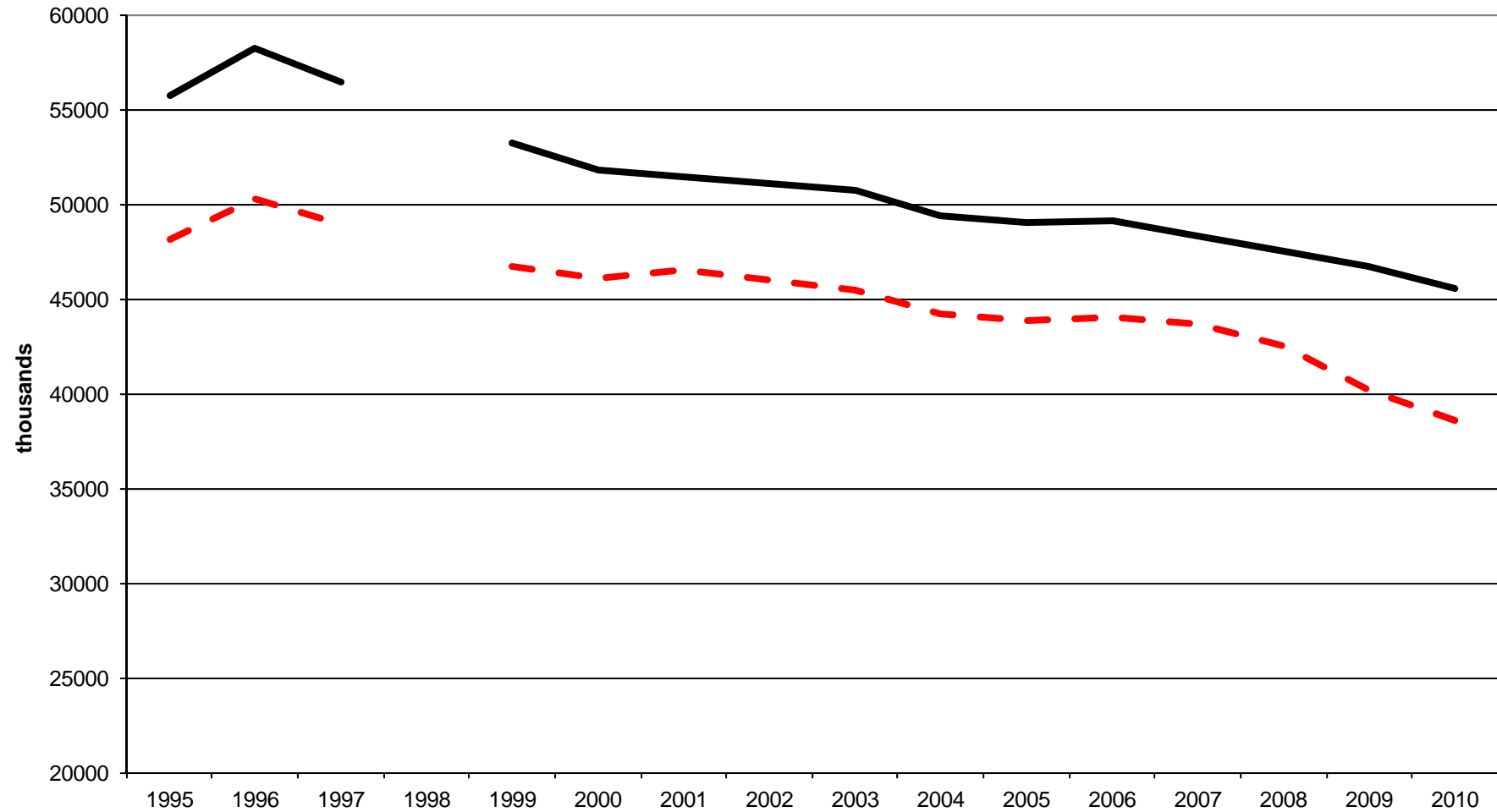
Unemployment rate by level of education, 2010



Unemployment by level of education, 2010

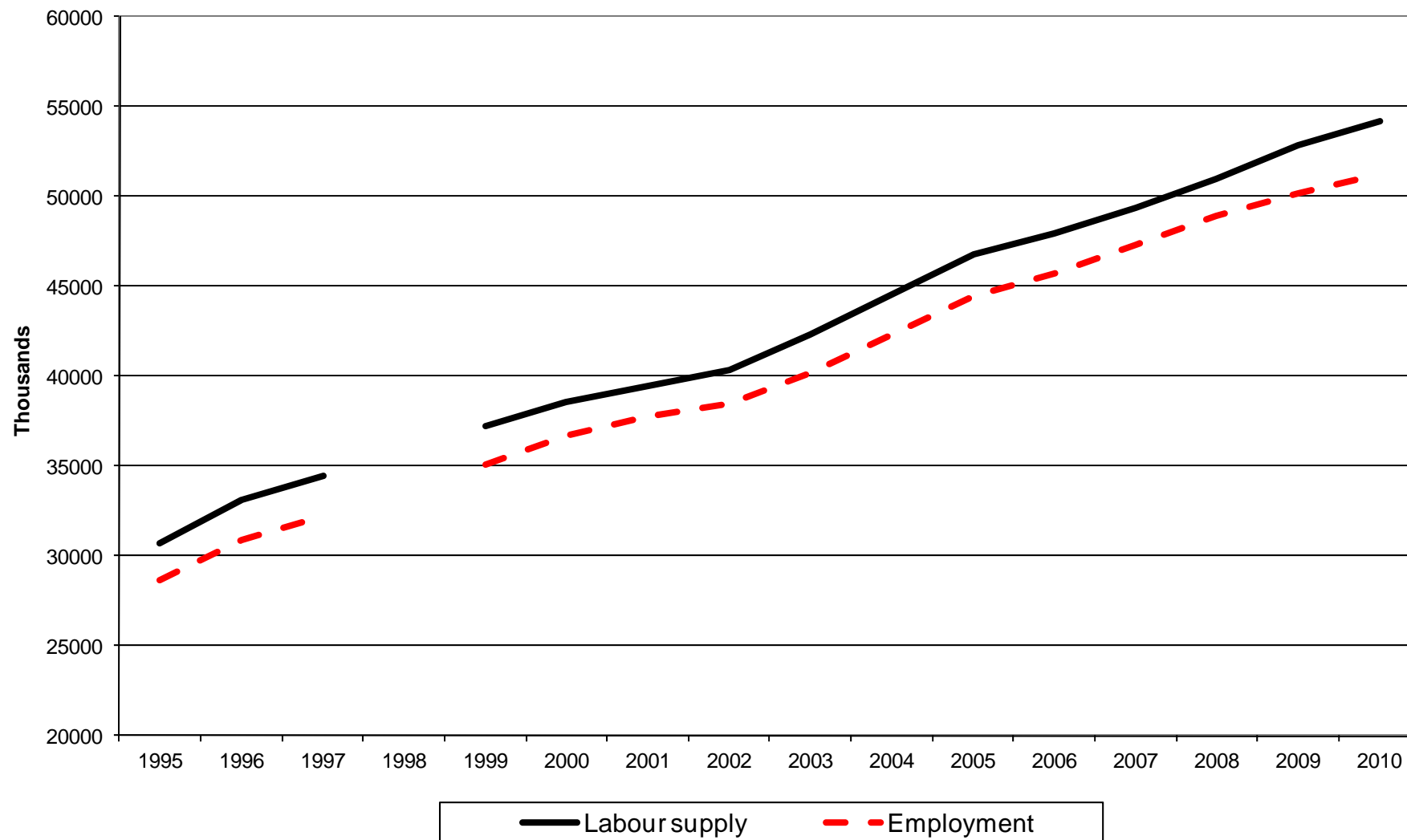


EU 15, Labour Market, Lower Secondary Education



— Labour supply - - - Employment

EU15, Tertiary Education



The EU Banking System

- A single market or 27 national markets?
- Regulation



Conclusions

- Ending the economic crisis in the EU
- Problem of domestic imbalances
 - Must growth await completion of adjustment?
- Growing the tradable sector in some countries
- There is upside potential due to human capital in some of the countries with big problems
 - Could result in higher growth after adjustment
- Costs of nationalised banking systems