Discussion of
“The Shifts and the Shocks”
by Martin Wolf

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A great book

- Classic Martin!
- Global financial crisis.
- Euro area crisis.
- Causes—lessons—solutions.
The financial crisis

- Balance of payments imbalances.
- Flawed regulatory framework.
- A failure of mainstream economics.
- Minsky instability—hybris.
A failure of mainstream economics?

“For the dominant school of neoclassical economics, depressions are a result of some external (or, as economists say, ‘exogenous’) shock, not of forces generated within the system. The opposite and, in my view, vastly more plausible possibility is that the crisis happened partly because the economic models of the mainstream rendered that outcome ostensibly so unlikely in theory that they ended up making it far more likely in practice. The insouciance encouraged by the rational-expectations and efficient-market hypotheses made regulators and investors careless. As Minsky argued, stability destabilizes.”
The euro area crisis

“The euro has been a disaster. No other word will do.”

- Balance of payments imbalances.
- Flawed construction.
- Crisis mismanagement.
- Hybris.
"Faith in unfettered financial markets and the benefits of everrising private debt was not the only dangerous form of economic hubris on offer. Another was the creation of the euro. Indeed, in a column written in 1991, as the negotiation of the Maastricht Treaty was completed, I had already judged this risky venture in words used by the ancient Greeks of the path taken by a tragic play: hubris (arrogance); ate (folly); nemesis (retribution)."
The cost of the crisis: GDP per person

Index 2007 = 100


United States  Euro Area (12)

October 2010 IMF WEO
Worse than the Japanese “lost decade”?

October 2010 IMF WEO
Some questions?

- Was the euro area crisis unavoidable?
- Was its severity due to economic mismanagement?
- What was the role of politics?
- What was the role of the ECB?
- Are we out of the woods yet?
“What we have, in fact, is a crisis of the ability of the European Union’s political bodies to act. This glaring weakness of action is a much greater threat to the future of Europe than the excessive debt levels of individual euro area countries.”

Helmut Schmidt, October 19, 2011
A charitable interpretation of the politics

“In a financial crisis, creditors rule. In the Eurozone crisis, the creditor that mattered was Germany, because it was much the largest. The aims of any plausible German government, and certainly of one headed by Angela Merkel, the country’s popular, cautious and self-disciplined chancellor, have been relatively simple to understand: these are to preserve the Eurozone, but on Germany’s terms.”
A less charitable interpretation

- Every crisis generates losses.
  - Economic cost
  - Political cost

- Key question: Who pays?

- Proper crisis management minimizes the economic cost.

- What happens when some governments exploit the framework and focus on shifting crisis losses to others?

- The result: A considerably higher total cost for Europe as a whole and massive destruction in some member states.
From an economic perspective, the euro area crisis was avoidable.

Instead, short-sighted political considerations dominated.

Specific policy decisions during the crisis caused the massive destruction.

The fundamental failure of mainstream economics is the failure to properly address the role of political motives in policy decisions that drive economic outcomes.
Who done it? A stroll in Deauville
Implications of Deauville and other blunders

- Introduction of credit risk in euro area sovereign debt markets (PSI concept).
- Ring-fencing of banking operations and fragmentation of financial markets.
- Adverse feedback loop between sovereigns and banks.
- Overall higher crisis losses.
- But the distribution of losses beneficial to some.
Winners and losers: GDP per person

Index 2007 = 100


United States  Germany  Euro Area ex. Germany
A nightmare for the ECB

- The political economy of the crisis has put the ECB in an impossible position.

- The ECB has “saved the euro” e.g. SMP, OMT.

- Doing “whatever it takes” when tensions are high fends off immediate collapse. But does it solve the problem?

- Governments can agree on actions that could stabilize the euro area only when tensions are high.
  - SMP led to non-implementation of earlier decisions.
  - OMT led to abandonment of complete banking union.
“In March 2000, European leaders committed the EU to become, by 2010, ‘the most dynamic and competitive knowledge-based economy in the world’. If nothing else, this demonstrated a sense of humour. Needless to say, the EU will fail to achieve this objective.”

“It is time for the old continent to become an adult, with a mature voice in the world’s councils. That voice is desperately needed. Can Europe rise to the challenge of supplying it? I doubt it. Who, given the record, would not? But I also hope.”

(Martin Wolf, “Europe must grow up.” FT, 9 November 2004)