

Some Lessons for Asia from the Euro Crisis

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Perhaps the most obvious lesson from the Euro crisis is that one should not count on endogenous optimal currency area considerations to lead to substantial increases in cooperation on economic policy issues among members of the area, nor in substantial increases in the flexibility of domestic economies. The euro was widely expected to promote convergence among the euro members. On balance, however, it promoted divergence.

1. The Limitations of Endogenous OCA Theory

The creation of the euro did lead many countries to take actions to increase the flexibility of their economies and reduce their fiscal deficits but a substantial proportion of these improvements occurred in the run up to entry. This suggests that conditions for entry had a much more powerful effect than the endogenous responses once entry had been accomplished. As a consequence proposals to reverse the traditional sequencing of integration and put monetary before trade integration are quite dangerous. They might make sense if the endogenous forces generated by currency union were quite powerful

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but the euro experience suggests that they are likely to be too weak to make such a strategy successful. [See Willett, Wihlborg, and Zhang (2009)]

Nor do looser exchange rate commitments necessarily automatically increase monetary policy discipline and coordination sufficiently to avoid crises generated by inconsistencies between monetary and exchange rate policies. This is demonstrated by the earlier crises in the European Monetary System in 1992 and 1993. [See the analysis and references in Willett and Wihlborg (2011)] There are definitely instances where exchange rate commitments have helped countries follow more disciplined macroeconomic policies. The turnaround of the Mitterand government in France from over expansionary to highly prudent macroeconomic policies is an important example. The stability of the EMS regime of pegged exchange rates in the late 1980s might appear to be a more general case of successful exchange rate led coordination of monetary policies.

The original design of the exchange rate mechanism of the EMS was to have sufficient exchange rate flexibility through wider bands and more frequent parity adjustments to avoid the one-way speculative option problems of the narrow band adjustable pegs of the Bretton Woods system. And this was the way the ERM operated in practice in its early years. By the mid 1980s, however, the degree of exchange rate flexibility practiced had declined sharply and in the later 1980s the regime became one of unadjustable pegged rates. The absence of the currency crises suggested that a high degree of monetary coordination had been achieved. This was largely illusionary, however. While the pegged rates helped Italy reduce its inflation substantially, this improvement was far from sufficient to keep its real exchange rate from continuing to

appreciate leading to crises and subsequent devaluation in 1992. For a number of countries increased monetary coordination had been substantial, but this increase in cooperation was far from sufficient to cope with the major fiscal shock generated by Germany's reunification. Hence the crisis of 1993.

It was the strongest country, Germany, in which the responses to disciplinary effects of the euro were strongest and in the periphery where they were weakest. Wages and prices diverged by considerably more than could be explained by differences in productivity growth. Thus the real exchange rates of many of the periphery countries rose substantially against France and Germany. The resulting losses in competitiveness for these countries were reflected in substantial current account deficits. However rather than exerting strong disciplinary pressures on the deficit countries, these current account deficits were financed by large inflows of private capital, much of it coming from the surplus euro countries. This was another facet of the failure of the financial markets to provide strong disciplinary pressures.

2. Crises Come in Many Varieties

A major lesson of both the recent and the earlier European crises is that serious disequilibria can come from many sources and consequently regional monetary arrangements need to be designed to be robust to a variety of types of shocks. [See Wihlborg, Willett, and Zhang (2011)]

In designing the euro zone institutions' almost exclusive concern was placed on limiting crises generated by financial sectors. And the official position of the Germany

government appears to remain that the failure of these safeguards was the predominant cause of the crisis.

This position can be reasonably argued for Greece, although its loss of competitiveness was also a major problem. Fiscal laxity was certainly not a problem with Ireland before the crisis, however. Indeed its frequent surpluses were the envy of much of the euro zone. Its problem, like the United States, was primarily a real estate bubble financed by heavy borrowing. Ireland's huge fiscal deficit today comes largely from the government's support of the financial sector and the recession. Portugal and Spain fall between the Greek and Irish cases. Each had a variety of problems with the most striking for Spain being its huge real estate bubble. For Portugal the greatest problem was its structural rigidities that led to the lowest growth rate in the euro zone and a substantial loss of competitiveness through wage increases that far exceeded the growth of productivity. The result was a huge current account deficit.

Fears of contagion, especially in the wake of the Lehman Brothers bankruptcy have led to actions which have converted large private sector problems of too big or interconnected to fail for financial institutions has been multiplied by government responses to the global financial crisis. While analysis of potential ways to deal with this problem go beyond the scope of this paper, the euro zone's responses to date are widely seen outside of official circles as good examples of how not to deal with these problems. Clearly these are important issues for Asian governments. The United States and other advanced economies generally failed to pay attention to the lessons about financial sector problems that were illustrated by the Asian crisis of 1997-98. It is to be sincerely hoped

that Asia will do a better job of learning from the crisis experiences in Europe and the United States.

3. Strong Fiscal Coordination Is Necessary For Successful Monetary Union

Another lesson is that Europe's bold experiment with pursuing monetary integration without an extremely strong degree of fiscal coordination is quite dangerous. The euro countries sought to deal with the potential fiscal problems through the Growth and Stability Pact, which limited the size of countries' fiscal deficits. Some criticized these limitations for constraining the ability of countries to adopt national stabilization policies in the face of their loss of monetary autonomy. However the bigger problems proved to be the substantial degree of ineffectiveness of the agreement once it was violated by France and Germany. This illustrates the limited effectiveness of international agreements when they run into serious conflicts with the interests of major powers. Had France and Germany remained in compliance there would have been at least some possibility that sufficient pressure would have been placed on Greece to have limited substantially the buildup of their fiscal problems. Note that given the highly inaccurate budget figures produced by the Greek government, such pressure would have required a strong central institution to expose such practices. Nor were the major countries immune to using accounting tricks to hide the true sizes of their deficits.

4. The Limits of Financial Market Discipline

While official discipline through political pressure failed so did discipline from the financial markets until the crisis had erupted. Ideal behavior of the financial markets would have started to give early warning signals through rising risk premia and higher prices on credit default swaps. Instead the markets fell prey to euro euphoria, pricing in very small differences in the risk of sovereign debt across the euro countries. Other examples of the failure of financial markets to give early warning signals of emerging disequilibria are given by the large capital inflows into Asia before the 1997-98 crisis and into Argentina before its crisis.

Such surges and sudden stops of financial flows present major problems for the management of open economies. We now have clear evidence that large financial inflows can result from over-optimism rather than always reflecting rational analysis of improved economic conditions. Thus rather than being seen only as a validation of one's policies they may also signal increased danger of sudden stops. This is especially so when the inflows are accompanied by substantial and persistent current account deficits.

5. Dealing With Capital Flow Surges and Sudden Stops

These deviations of the behavior of financial flows from our models of farsighted and well informed rational expectations present a case in principle for the use of capital controls, although there are well known costs to such policies and limits to their effectiveness. In many instances improved prudential regulation and supervision is a better strategy.

There is also a fairly strong case for sterilized intervention to limit the short run exchange rate and/or monetary effects of such inflows. Many Asian and other emerging market countries have been pursuing this approach. Some critics have seen such interventions as reflecting mercantilist currency wars and if such actions are taken to an extreme such disreputations could be deserved, but recent experience and research clearly demonstrates that as a country's international financial liabilities increase, so do its optimal levels of reserve holdings. Of course one cannot clearly identify what inflows will be temporary versus long term, nor can we precisely calculate optimal reserve levels, but there is a strong presumption that it is prudent to increase international reserves by some non-trivial fractions of financial inflows under a country's reserves are already far above optimal.

Sterilized intervention is a way to implement this strategy. While some agree that capital mobility has grown too high for sterilized intervention to be effective, there is considerable evidence that Asian countries have been able to sterilize substantial portions of capital inflows when they so choose. [See, for example, Ouyang, Rajan, and Willett (2008)] The danger of using such strategies to avoid adjusting to more fundamental forces suggests that there are strong regional and international interests in monitoring such policies to limit their excessive use and avoid the costs that individual countries' actions may place on others. Analysis of such issues is underway at the IMF and should also be high on the agenda of efforts at monetary and financial cooperation within Asia.

6. Caution in Financial Liberalization

One false lesson that some have drawn from the financial crises in Europe and the United States is that emerging Asia should abandon or at least drastically slow its progress toward financial liberalization. Such reactions are understandable, but they misread the primary causes of the crisis. Financial deregulation in the advanced economies was only a minor cause of the crisis. Much more important was the failure of regulators and other government officials to use the powers that they had to restrain the excessive risk taking of the financial sector.

The correct lesson from these disasters is not that governments should retain a dominant role in the allocating of credit, but that the belief of Alan Greenspan and others that self-interest would lead major financial institutions to police themselves was wishful thinking. Indeed rather than promoting financial discipline in many instances heavy competition induced many financial institutions to take excessive risks in order to keep up profits and market share.

Likewise discredited is the view that the innovations in financial engineering and risk management had made financial systems much safer. These innovations have provided some real benefits in terms of making it easier to diversify and to hedge some risks, but they also generated an exaggerated view of the level of safety of many financial products and of highly leveraged positions of financial institutions. Both the institutions themselves and their regulators succumbed to this highly over optimistic view.

One important lesson is that while the need for supervision of many facets of the financial sector is substantially just providing laws for regulation and supervision is far

from sufficient. Market failures were compounded by regulatory failures. This is not the place to go into detail about the lessons of the crisis for regulatory strategies but it is clear that a continuation of business as usual is far from sufficient. There is a strong need for more economic like thinking that focuses on incentive structures to counter the excessive legal focus of many regulators.

While Basel III looks to make some improvements it still retains too much of the old mind set that permitted financial institutions to greatly understate the riskiness of their positions and thus economize on the levels of capital required to support these positions. It seems clear that emerging Asia has a strong interest in engaging actively in the international discuss of financial regulatory reform and introducing fresh thinking to counter the biases of traditional regulatory mindsets.

7. Concluding Comments

Sadly the lessons from the Euro experience are primarily negative. Rather than providing a road map for how to increase regional cooperation over time, it provides more of a check list of problems that must be faced and policy strategies to be avoided.

Perhaps the most common underlying theme of this history is of the dangers generated by the political incentives to adopt policies which provide quick benefits at the expense of longer term costs and the converse tendency of failing to adopt fundamental solutions to serious problems when they have large up front costs and options are available to postpone the day of reckoning at much lower initial costs. These are examples of the basic time inconsistency problem in policy making. In t he recent crisis in Europe this has

shown up as a consistent tendency of European officials to deal with the crises in Greece, Ireland, and Portugal as if they were just liquidity problems rather than fundamental solvency problems that are unlikely to be cured without semi permanent transfers or sovereign debt restructuring. Such behavior is likely to greatly increase the ultimate costs of the crisis to both the crisis countries and to the rest of the euro zone.

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