ADJUSTMENT PROGRAMS IN EURO COUNTRIES: WHY IRELAND SUCCEEDED WHILE GREECE FAILED

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Dublin Economic Policy Conference, October 17th, 2015

Outline

- The GIPSC adjustment programs:
  - Sudden-stop and external desquilibrium in the Eurozone due to over-indebtdeness
  - Different crisis: IR and SP real estate bublles and banking crisis; GR public debt crisis; PT over-leveraging in all sectors
  - Benefit-cost analysis: Ireland has the best, Greece the worst, Portugal and Spain intermediate success
  - No exit from adj. prog. before solution of Euro crisis (ECB unlimited interventions, September 2012)
- Record levels of official financial flows to help the crisis countries (Greece: 803 Billion Euros, Portugal 226, Ireland 237 and Spain 145) totalling 1.4 Trillion Euros!

Outline (2)

- Common characteristics of adjustment programs:
  - Fiscal adjustment to trigger an internal devaluation and reduce domestic demand (Structural deficit cut by 17 pp of GDP by Greece and around 8 pp by other countries)
    - Relied mainly in cuts in wages and pensions (10%) and freezing public employment (Greece cut by 30%)
    - Increases in VAT and income taxes (10% revenue increase)
  - Strong reductions in Bank´s transformation ratios: IR, PT and SP reached targets (away from public´s eye)
  - Some structural reforms in labor and product markets
- Impacts of adjustment programs:
  - Very low (even reversed)fiscal and credit multipliers for Ireland
  - Low fiscal and credit multipliers for SP
  - High credit and low fiscal multipliers for PT
  - Fiscal and monetary multipliers high (but predictable) for Greece
- Normal adjustment programs for IR, PT and SP. Great Depression for Greece not conform to most macro models. Why? Our main explanation: mismanagement of expectations (exogenous factor) and its impact on the credit mechanism

Outline (3)

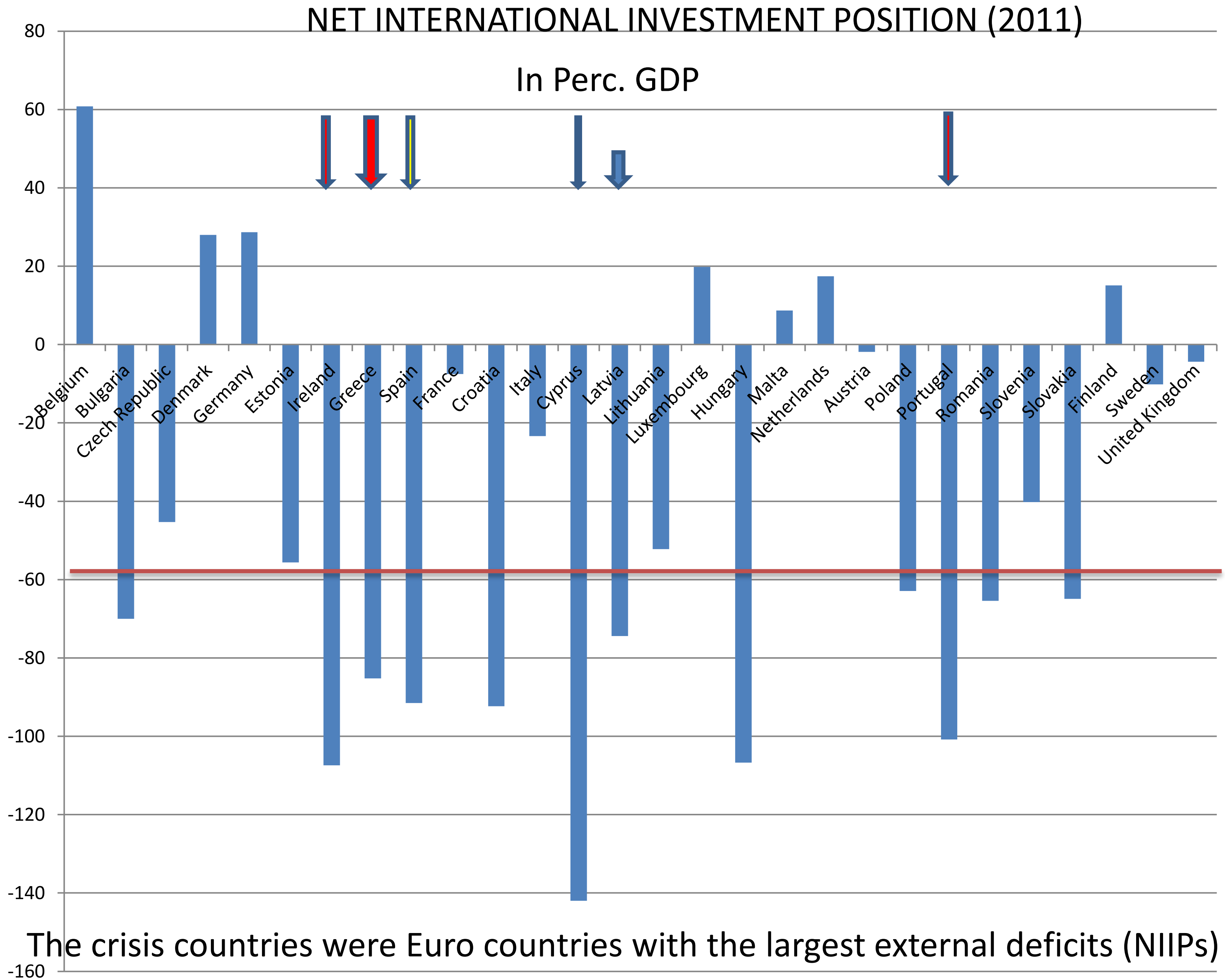
- Criticism of adjustment programs
  - Situations at start got too serious (German economists)
  - Too much austerity? (Stiglitz, Krugman)
- Costs of the crisis
  - Among the highest of financial crisis
  - Despite the good macro recovery, Ireland had one of the highest long-term GDP cost (because it is a high-growth country), largest bank rescue cost and the largest increase in Public Debt close to other crisis countries
- Lessons to be learned
  - Procastrination at all levels (snowballing effect was a major cause of the high levels of aid required)
  - Role of expectations: Greek and German policymakers miscalculations: insisting on Grexit!
  - Policy mix: too few supply-side measures
  - Assymetry of fiscal policies between core and periphery
- What lies ahead?
  - The great deleveraging: all economies still far from desirable (e.g. pre-crisis) levels
  - Is the Euro problem fixed? Still problems with banking union. Are fiscal rules now enforceable?
  - Quantitative easing
  - Re-energizing growth and solving the unemployment problem

ON IRELAND

- Ireland remains one of the most open and flexible economies of the EU, with one of the highest levels of GDP per capita. However, the Celtic Tiger suffered a huge credit/property boom in the first decade of the 21st C.
- We will show that Ireland had the most successful adjustment program among Euro crisis countries, but had one of the costliest bank rescues in history. It has now one of the highest GDP growth rates in the EU. It stabilized the banking sector, but substantial work needs to be done to build an efficient and competitive financial system, and pursue in the long and ardous process of deleveraging.

What is an adjustment program?

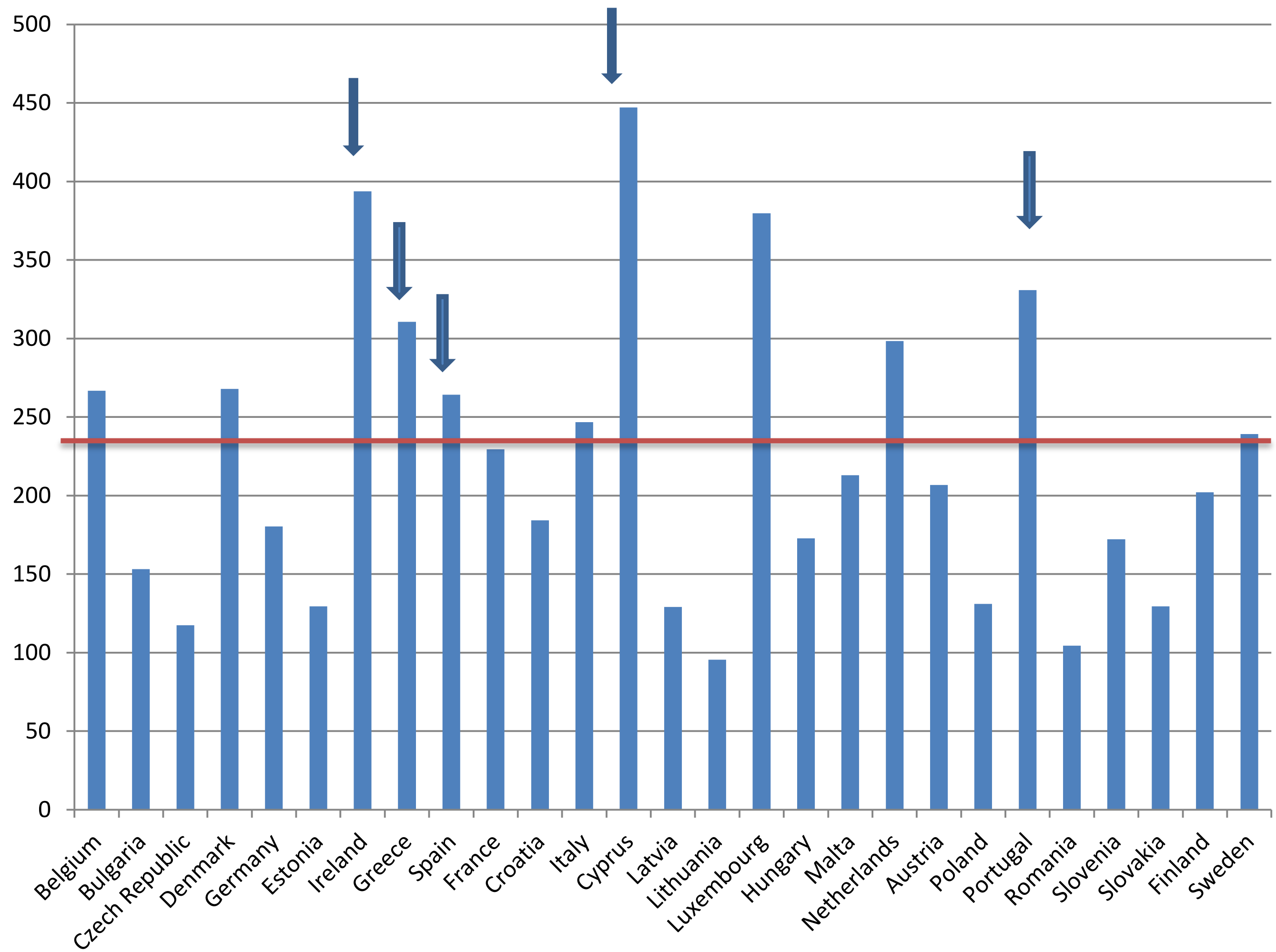
- "Set of policies and measures to restore market access and put the economy on a debt sustainable path for Banks and State"
- Why GIPSC lost market access? Why sudden stop of financial flows to the GIPSC? Double treaths:
  - Break-up of the Eurozone with GIPS being forced out of the Euro (systemic Euro problem)
  - Unsustainable external debt levels of banks and States of GIPSC (country specific)



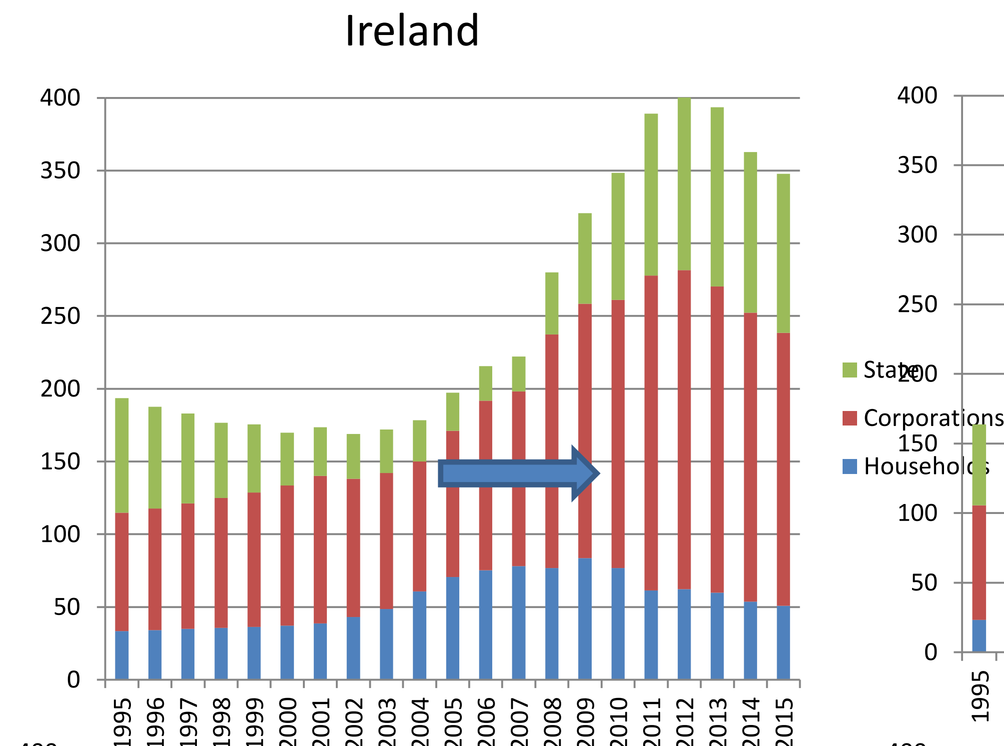
The crisis countries were Euro countries with the largest external deficits (NIIPs)

Source: Eurostat

Gross Public and Private Debt over GDP (2013)



All crisis countries had Total Debt over GDP above 240% of GDP.
But not all countries with that level of Debt had a crisis: cases of NT,DN, ...
DN and NT special case because mortgage bonds are bought by pension funds
SS capitalization system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State
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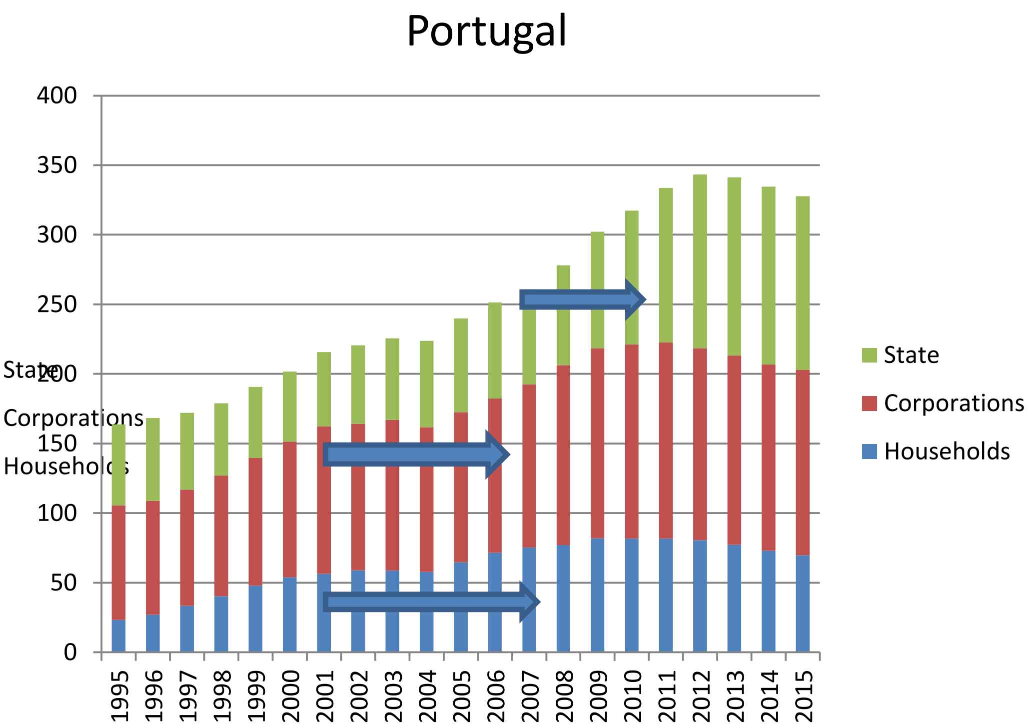
Households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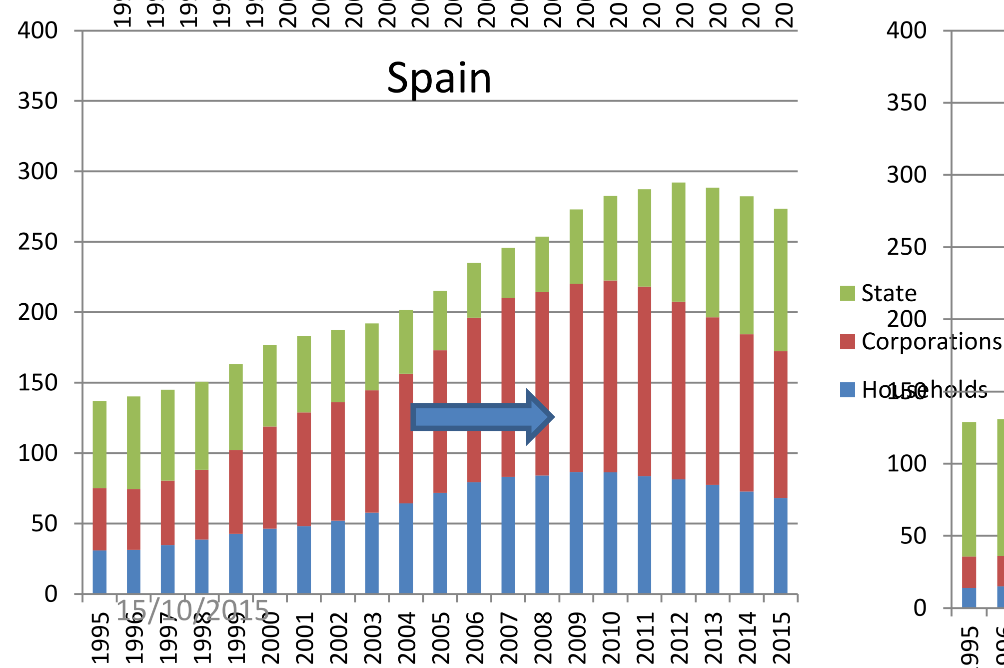
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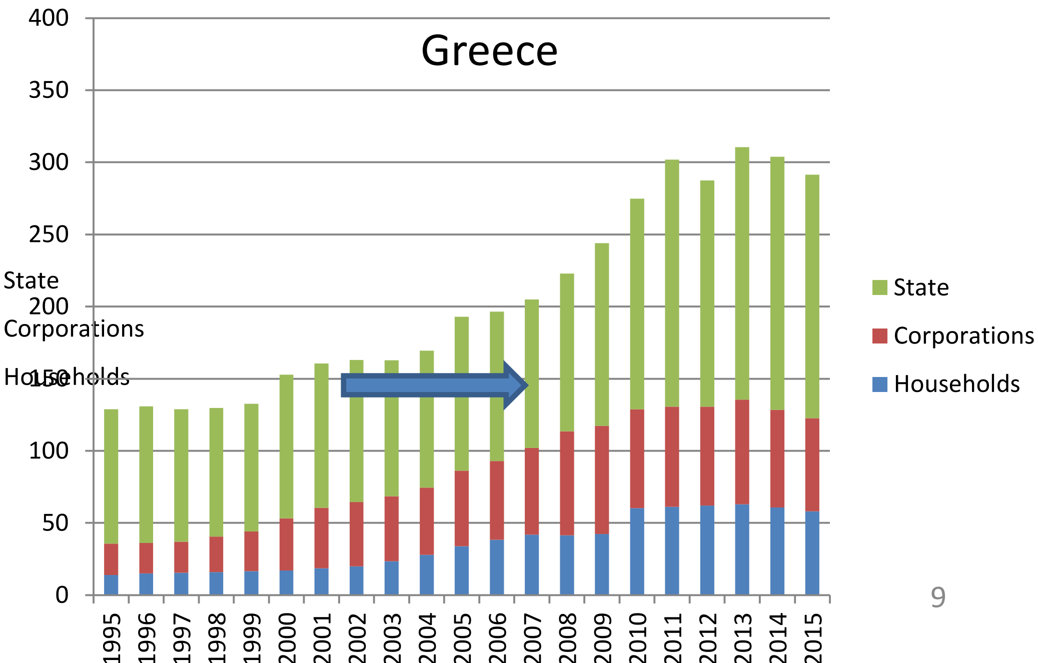
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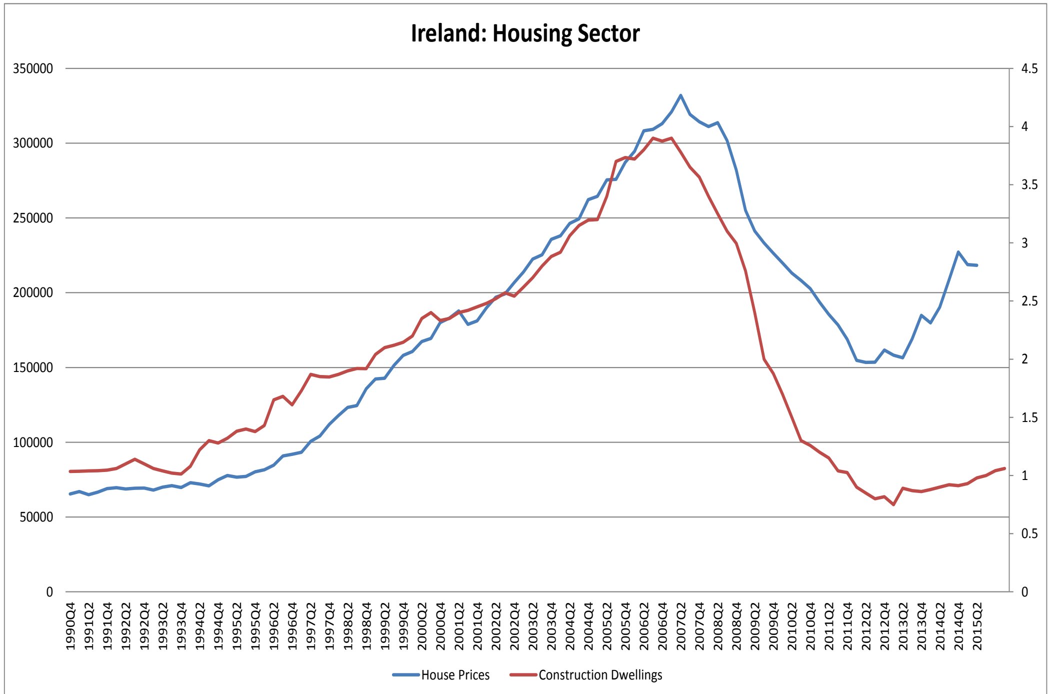
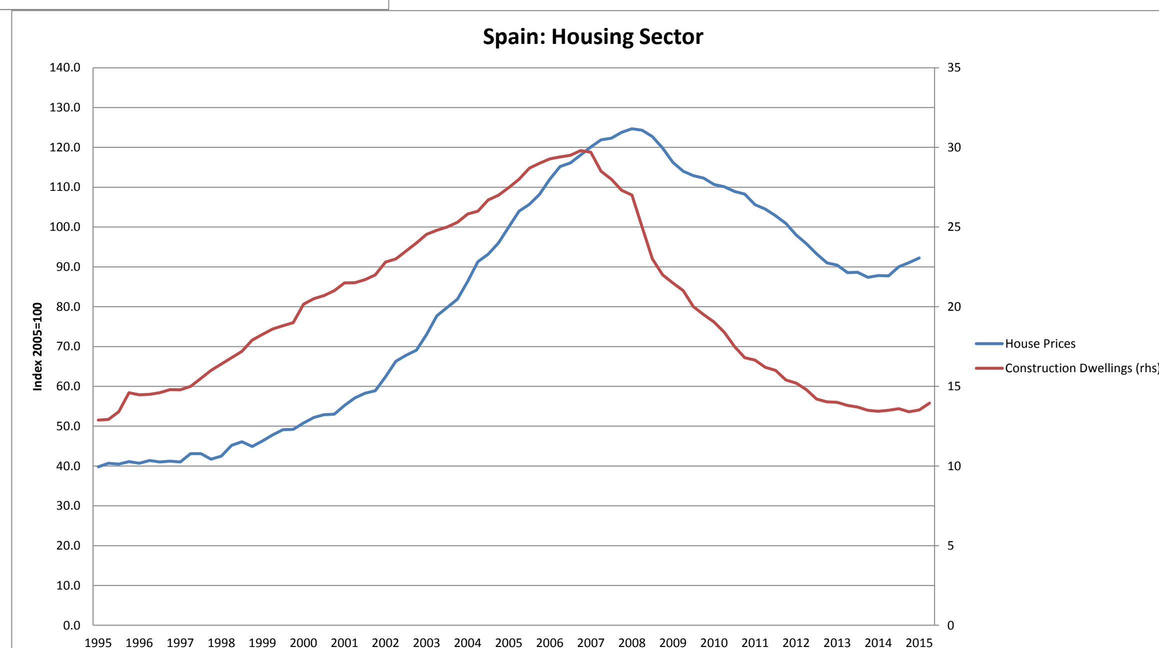


The property shock was more severe
In Ireland than in Spain

The boom in house prices:
Ireland: 60%
Spain: 40%



What is a successful adjustment program?

- A program that restores market access and puts the economy on a debt sustainable path at a minimum cost, in terms of GDP and unemployment, in the minimum span of time
- How to measure? It depends on
  - Initial conditions: a larger disequilibria at the start means more austerity is required
  - Final conditions: what was the restoration of equilibria achieved at the end
  - The adjustment path: what alternatives were hypothetically available and feasible?
    - It depends on the context: was the Eurozone and global economy growing?
    - A simple measure is the Benefit (adjustment achieved in terms of budget deficit or external accounts) by Cost (GDP loss, or unemployment increase)
- What benchmarks?
  - Alternative simulations (require a DGEM, but model dependent)
  - Historical for the same country or cross-section of countries (we do only this, sample of crisis countries, Alesina& Giavazzi do a VAR of fiscal policy)

Dating the adjustment programs

Country	Start dates	Exit dates
Greece	May, 2010	Expected at end of 2014, delayed
Ireland	Dec., 2010	Dec., 2013
Portugal	May, 2011	May, 2014
Spain	July, 2012	January, 2014

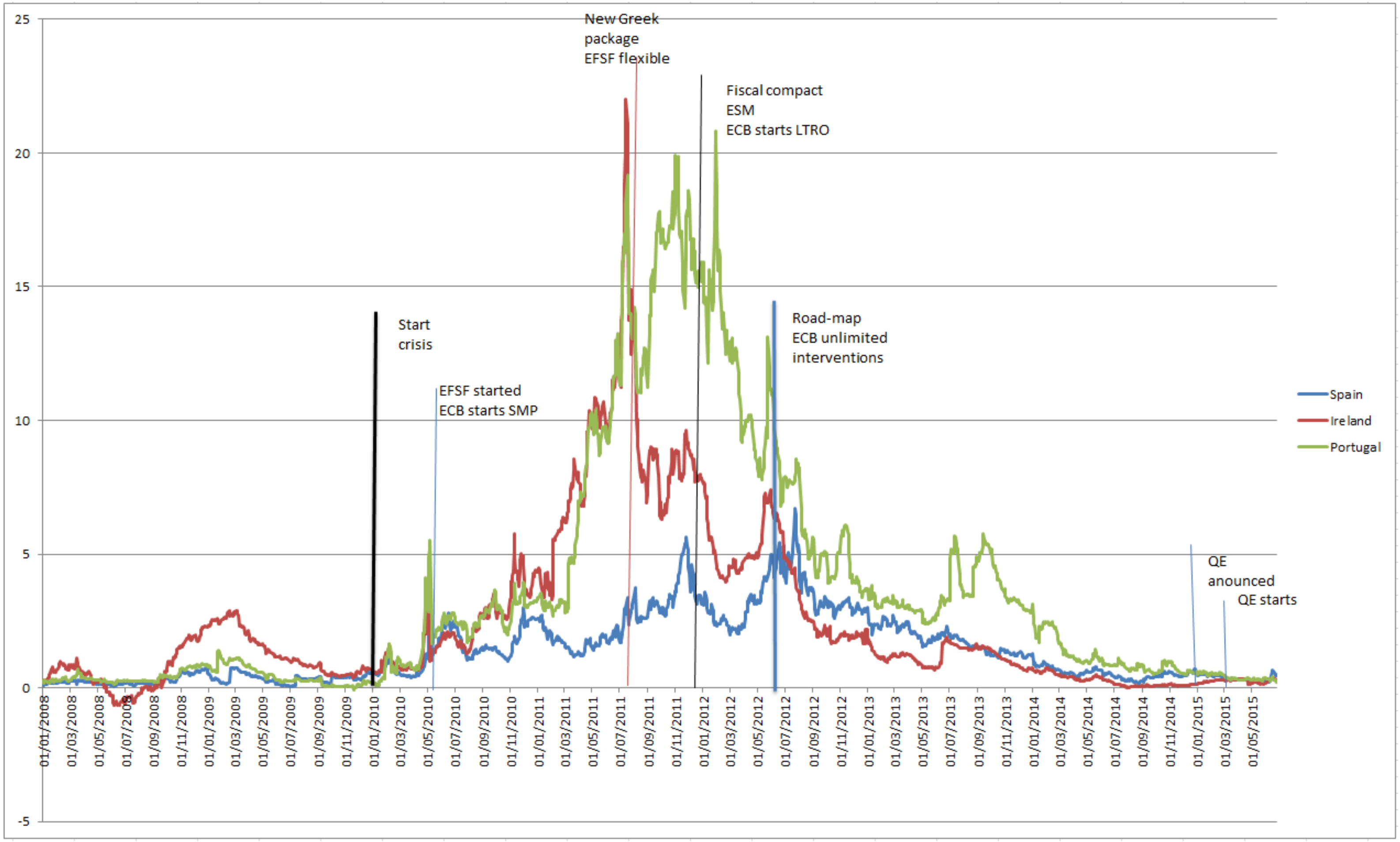
Duration:

Ireland: 36 months
Spain: 17 months
Portugal: 36 months
Greece: more than 90 months

Common factors: Phases of Euro crisis

Context

No Exit before core Eurozone System was fixed



Spreads of 2-Y sovereign bonds v.a.v Germany. Source: Bloomberg

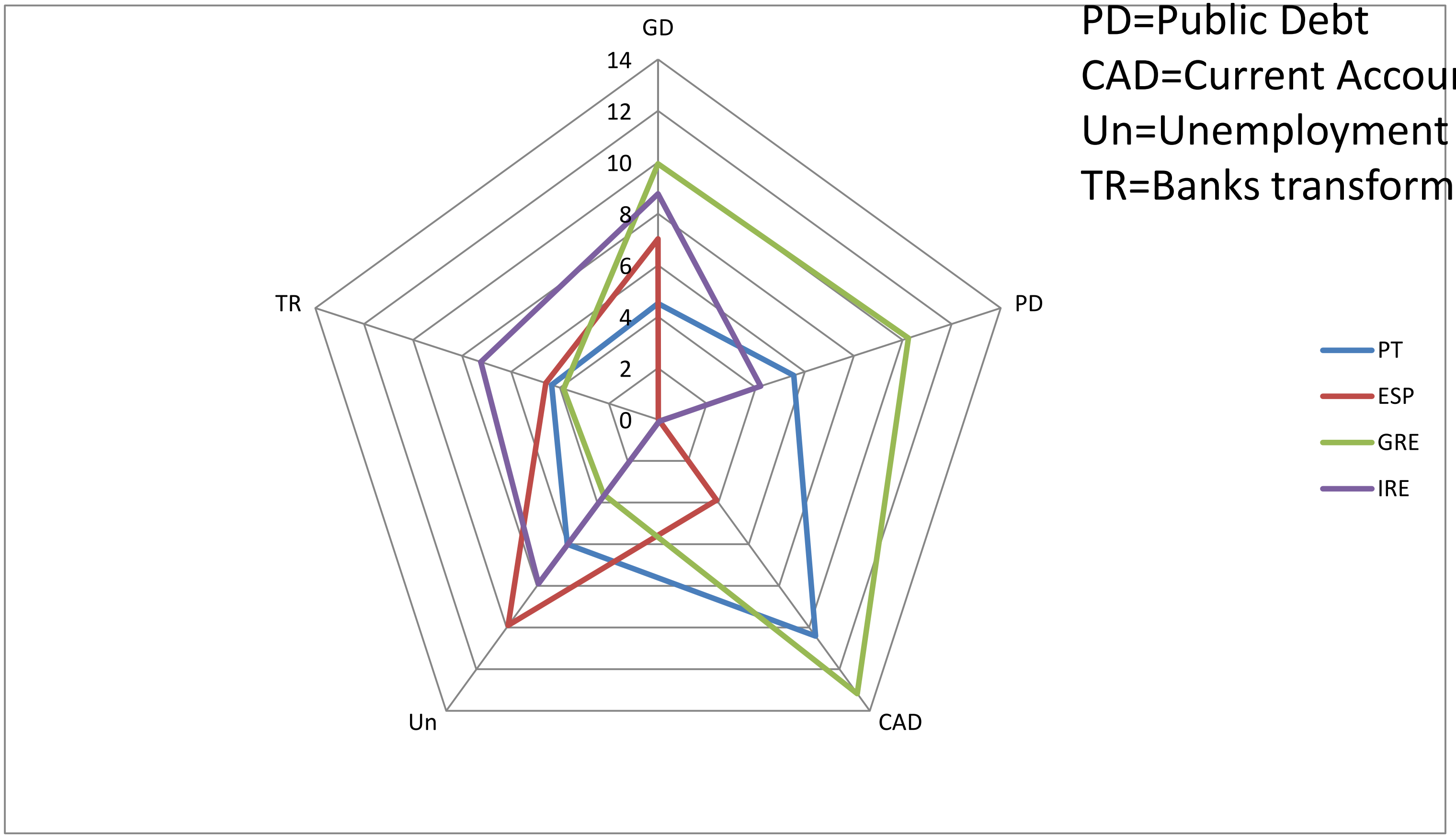
Plus: contagion

Realized correlations and covariances for Sovereign Bonds (in basis points)

Countries		Correlations		Covariances	
i	j	5Y	10Y	5Y	10Y
DE	GR	-0.022	0.033	-9.36	3.96
DE	IR	0.049	0.098	0.85	1.50
DE	IT	-0.286	-0.306	-20.59	-19.13
DE	PT	0.088	0.081	10.83	4.80
DE	SP	-0.186	-0.240	-13.74	-15.62
GR	IR	0.135	0.096	414.48	104.14
GR	IT	0.081	0.052	81.77	44.99
GR	PT	0.079	0.118	12.70	226.92
GR	SP	0.086	0.065	16.00	40.03
IR	IT	0.053	0.077	23.19	18.52
IR	PT	0.123	0.117	74.96	29.33
IR	SP	0.072	0.125	31.80	26.16
IT	PT	0.065	0.069	29.36	16.93
IT	SP	0.653	0.727	139.21	86.05
PT	SP	0.113	0.085	62.27	10.82

Macroeconomic disequilibria by country: before the crisis

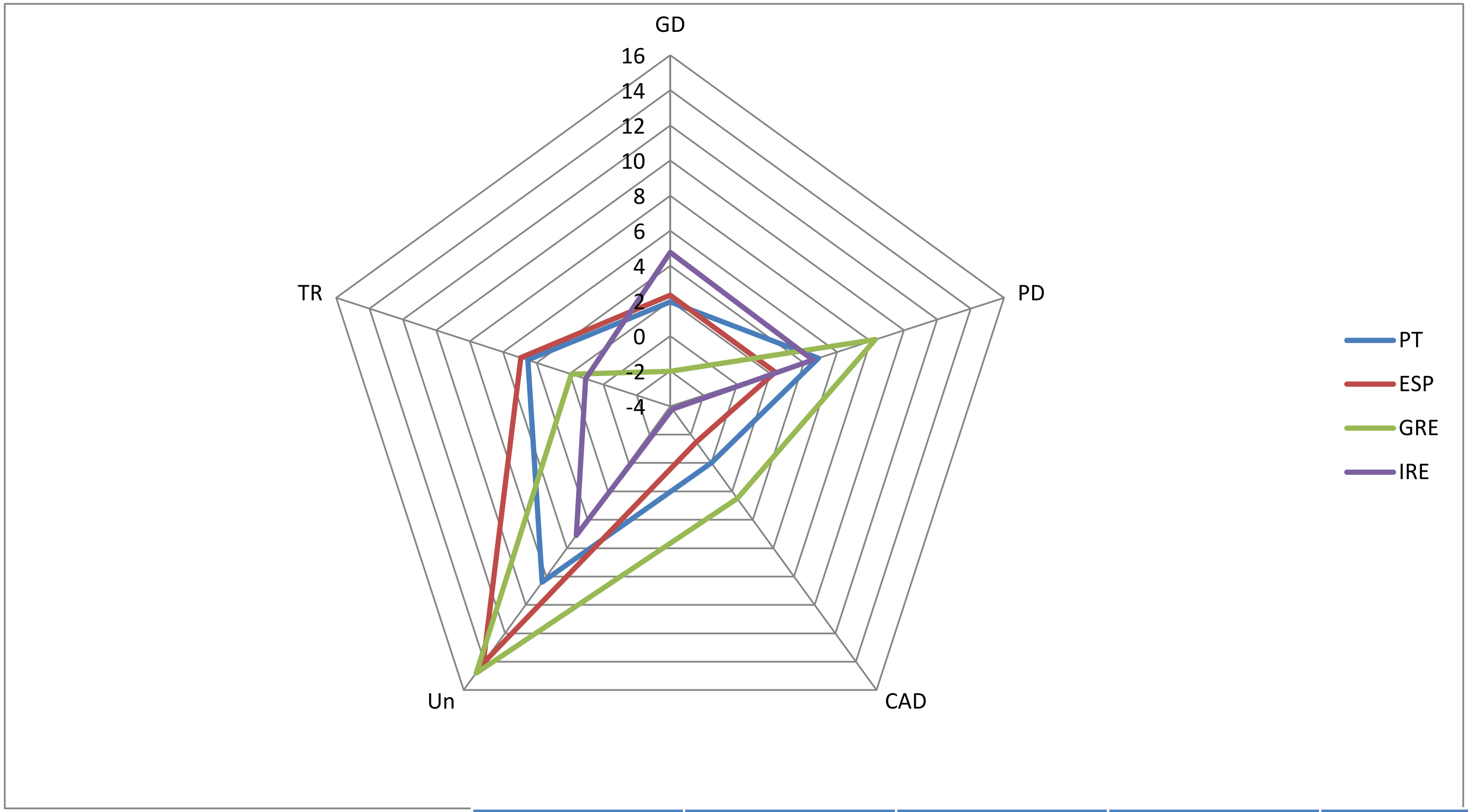
GD=Government Deficit
PD=Public Debt
CAD=Current Account Deficit
Un=Unemployment
TR=Banks transformation ratio



Areas by country:

Country	Portugal	Spain	Greece	Ireland
Aggregate	85.6	41.9	149.0	47.5

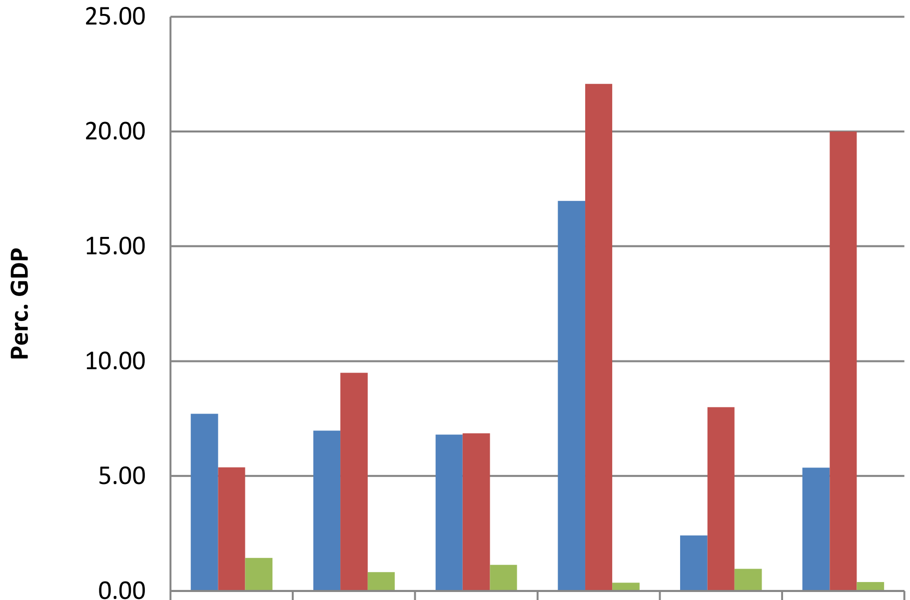
Macroeconomic disequilibria by country: after the crisis



Areas by country:

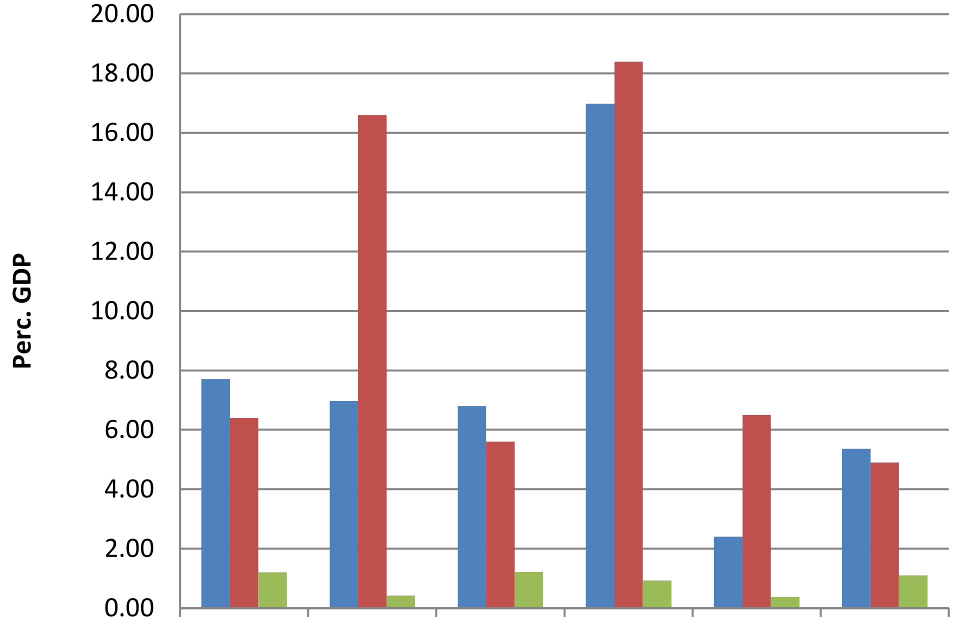
Country	Portugal	Spain	Greece	Ireland
Aggregate	23.8	25.4	34.7	-4.7
Differential	61.9	16.5	114.3	52.3

Benefit-cost ratio 2



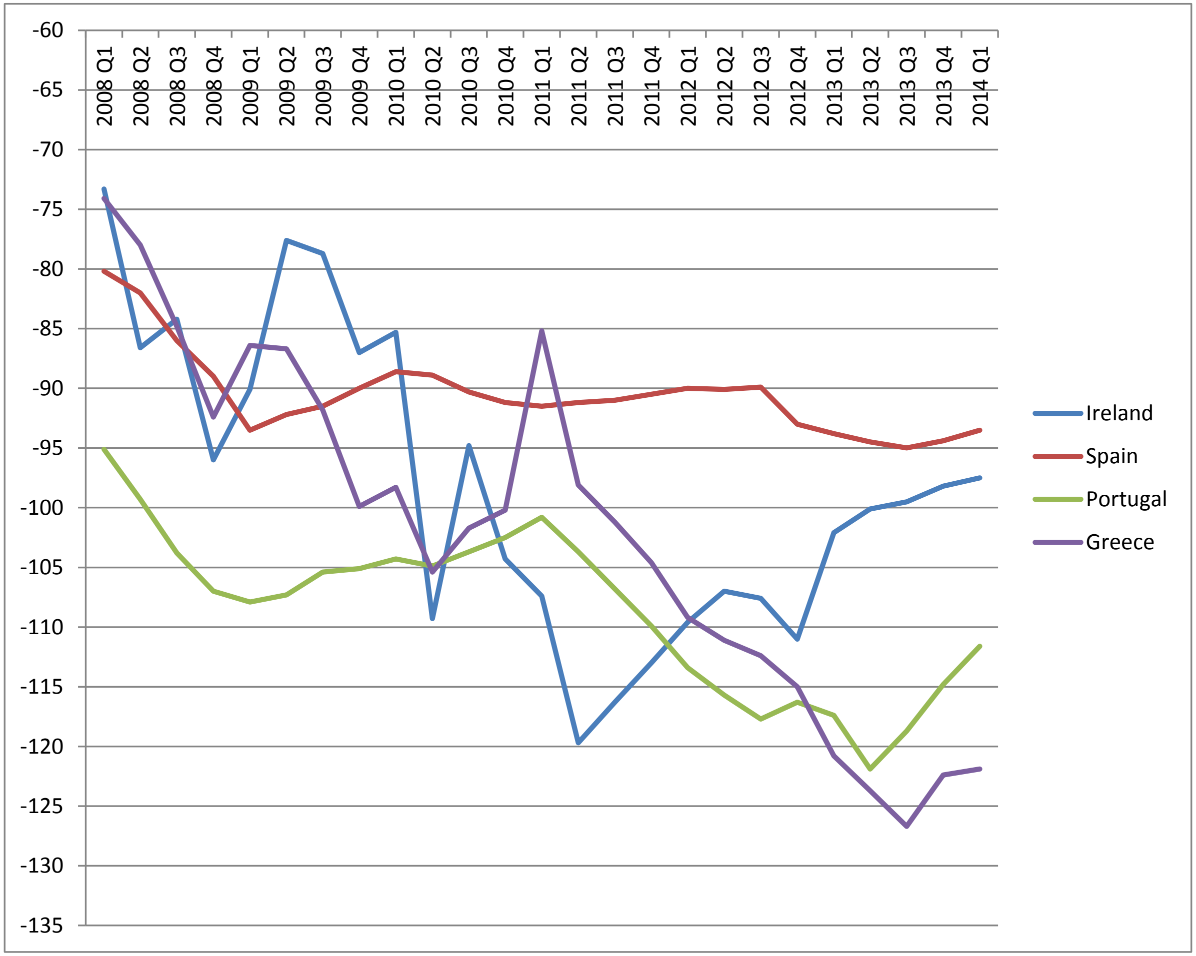
	Ireland	Spain	Portugal	Greece	Italy	Latvia
Deficit Red	7.71	6.97	6.80	16.98	2.41	5.36
Loss GDP	5.38	9.50	6.85	22.07	8.00	20.00
Ratio	1.43	0.81	1.13	0.35	0.96	0.39

Benefit-cost ratio 1



	Ireland	Spain	Portugal	Greece	Italy	Latvia
Deficit Red	7.71	6.97	6.80	16.98	2.41	5.36
Inc Un	6.40	16.60	5.60	18.40	6.50	4.90
Ratio	1.20	0.42	1.21	0.92	0.37	1.09

Net International Investment Position



Ireland reversed the IIP after 2011 Q2. Spain had stabilized its IIP since 2009. Portugal started to reverse it in 2013 Q2. Greece still the most serious case

What is the role of external aid in the adjustment programs?

- Avoid a sudden adjustment of the desequilibria and ease out the process to restore equilibria in a more gradual way (solidarity principle)
- Accelerate the process of market access (problem of credibility)
- Funds given with <u>conditionality</u> attached to facilitate/require the government to take austerity measures and avoid moral hazard problem

FINANCIAL ASSISTANCE TO EURO CRISIS COUNTRIES							
Un.: Billions of Euros							
	Greece-I	Greece-II	Greece-III	Greece-Total	Ireland	Portugal	Spain
	2010-2012	2011-2014	2015-2018	2010-2014	2011-2013	2011-2014	2012-2014
IMF	30.0	19.8	16.0	65.8	22.5	26.0	
Euro-area bilateral members	80.0			80.0			
Non-Euro bilateral members					4.8		
UK					3.8		
Sweden					0.6		
Denmark					0.4		
European Financial Stability Facility (June 2010)					17.7	26.0	
European Stability Mechanism (Oct 2012)		144.7	50.0	194.7	22.5	26.0	41.4
Total	110.0	164.5	66.0	340.5	72.3	78.0	41.4
Percent Of 2010 GDP	48.6	72.7	29.2	150.5	43.8	43.4	3.8
Projected Public Debt in 2013	374.0	374.0	374.0	374.0	211.0	190.0	
Percent of Public Debt	29.4	44.0	17.6	91.0	32.0	41.0	
Transfer of profits from Eurosystem			7.7				
Debt Relief							
Private Sector Contribution		37.0		37.0			
Debt buy-back		12.6		12.6			
Proposed official debt relief			60.0				
(Estimate of total contribution) (2011-2019)		106.0	60.0	166.0			

Total Assistance to Greece

In Billions Euros	**2010**	**2011**	**2012**	**2013**	**2014**	**2015-2018**	**Total**
Budget Assistance							
Program I	60.8	49.2					110.0
Program II			80.0	23.0	30.6		133.6
Program III						65.0	65.0
Structural Fund Transfers	3.7	4.8	4.7	5.4	4.0	12.0	34.5
Official assistance for bank recap			44.2			20.0	64.2
PSI (debt relief)			6.0	14.0	14.5	16.0	101.0
Official Debt Relief				90.0			90.0
ECB support of banks	92.0						92.0
Target 2 balances to banks	87.0	86.9	84.9	76.4	63.9	51.6	75.1
SMP support			38.0	38.0	38.0	38.0	38.0
Total	243.5	140.8	257.8	246.8	151.0	202.6	803.4

Total aid to Ireland

Total Assistance to Ireland							
In Billiosn Euros							
	2010	2011	2012	2013	2014		Total
Budget Assistance							
Program		12.3					12.3
Structural Fund Transfers	0.9	0.5	0.8	0.4	0.3		2.7
Official assistance for bank recap	46.3	17.8					64.1
ECB support of banks	75.8						75.8
Target 2 balances to banks	49.8	49.8	49.8	49.8	49.8		49.8
SMP support			32.0	32.0	32.0		32.0
Total	172.8	80.4	82.6	82.2	82.1		236.7
memo: Exposure of foreign banks							-250
Bonds held by foreigners							-23

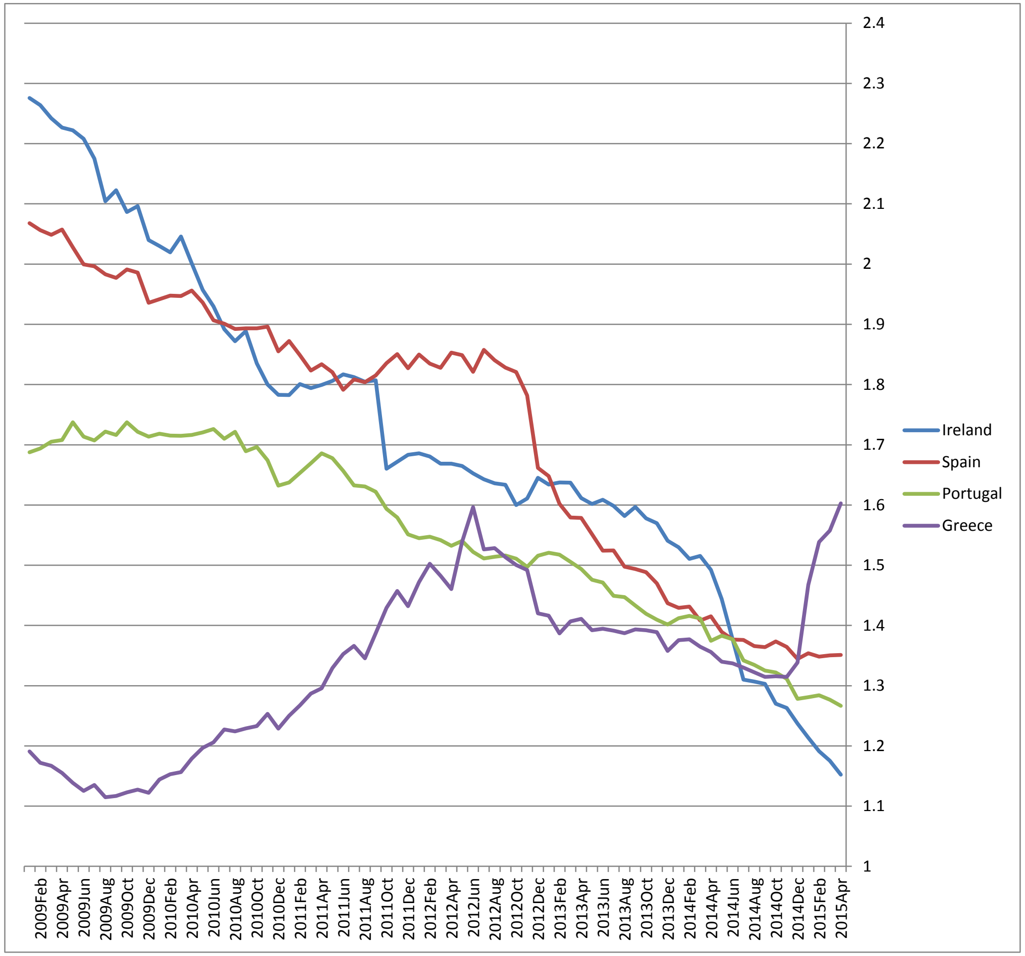
Characteristics of the adjustment programs

- Fiscal austerity: From 2009 to 2014, Greece cut the structural deficit by 17 pp of GDP, Ireland 7.7, Spain 7 and Portugal 6.8.
  - Tax increases v. Expenditure cuts: expenditure cuts represented 60-70% of fiscal adjustment, except for Spain (50%)
  - Deep cuts by Greece in gov consumption (cut of 30% in employees and 8% wages) and social transfers (20%)
  - Portugal and Ireland cut gov consumption (mainly salaries) by 14 and 9%, Spain by 7%
  - Revenues increased by 10-15% in PT,IR,SP, decreased in Greece due to recession (but discretionary measures were similar to other countries: 4% of GDP)
- Banks´ retrenchment and cuts in transformation ratios to reduce foreign and ECB financing
  - Target for the transformation ratio of 120% at end 2013: achieved exc. Greece
- Structural policies
  - Labour market flexibility (reduction firing costs for PT, SP)
  - Product market liberalization (reduction in infrastructure costs)

Effective Budget Measures

			2009-2015	
	2009	2015	Change in percent	Change in volume
Ireland				
Total Expenditures	47.59	36.85	-10.75	-11.50
Current expenditures	40.22	35.01	-5.21	-0.49
Gov Consumption	20.09	15.97	-4.13	-9.17
Social transfers	14.71	12.23	-2.47	-4.92
Interest payments	2.03	3.84	1.81	116.34
Total revenues	33.07	33.44	0.38	15.60
Tax burden	27.75	28.52	0.77	17.47
Spain				
Total Expenditures	45.77	43.07	-2.70	-5.07
Current expenditures	39.37	40.44	1.07	3.62
Gov Consumption	20.48	18.90	-1.58	-6.90
Social transfers	14.37	15.95	1.58	11.94
Interest payments	1.70	3.38	1.68	100.74
Total revenues	34.80	38.03	3.23	10.24
Tax burden	29.92	33.18	3.27	11.89
Portugal				
Total Expenditures	50.22	47.70	-2.52	-2.86
Current expenditures	45.35	44.96	-0.39	1.40
Gov Consumption	21.43	18.06	-3.37	-13.80
Social transfers	16.40	17.43	1.04	8.76
Interest payments	2.97	4.96	1.98	70.39
Total revenues	39.61	43.40	3.79	12.08
Tax burden	29.91	34.01	4.09	16.27
Greece				
Total Expenditures	53.97	45.93	-8.04	-32.99
Current expenditures	47.29	41.81	-5.48	-30.38
Gov Consumption	22.75	18.15	-4.60	-37.17
Social transfers	17.57	17.90	0.33	-19.79
Interest payments	5.02	4.15	-0.87	-34.86
Total revenues	37.36	43.73	6.37	-7.84
Tax burden	30.32	34.83	4.51	-9.53
Euro-18				
Total Expenditures	51.20	49.10	-2.10	6.60
Current expenditures	46.20	45.42	-0.78	9.30
Gov Consumption	22.30	20.90	-1.40	4.21
Social transfers	17.30	17.50	0.20	12.44
Interest payments	2.75	2.66	-0.09	7.33
Total revenues	42.70	46.28	3.58	20.49
Tax burden	37.10	40.36	3.26	20.92

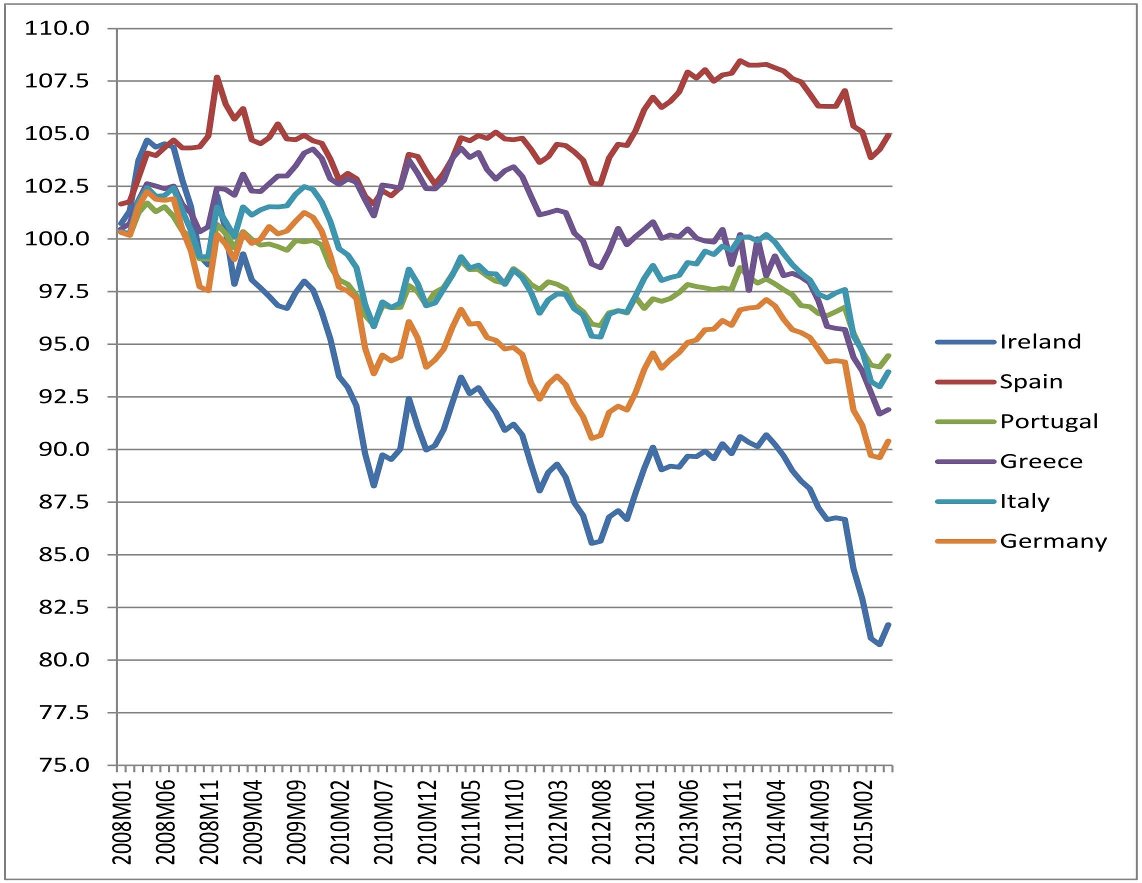
Bank´s Transformation ratios



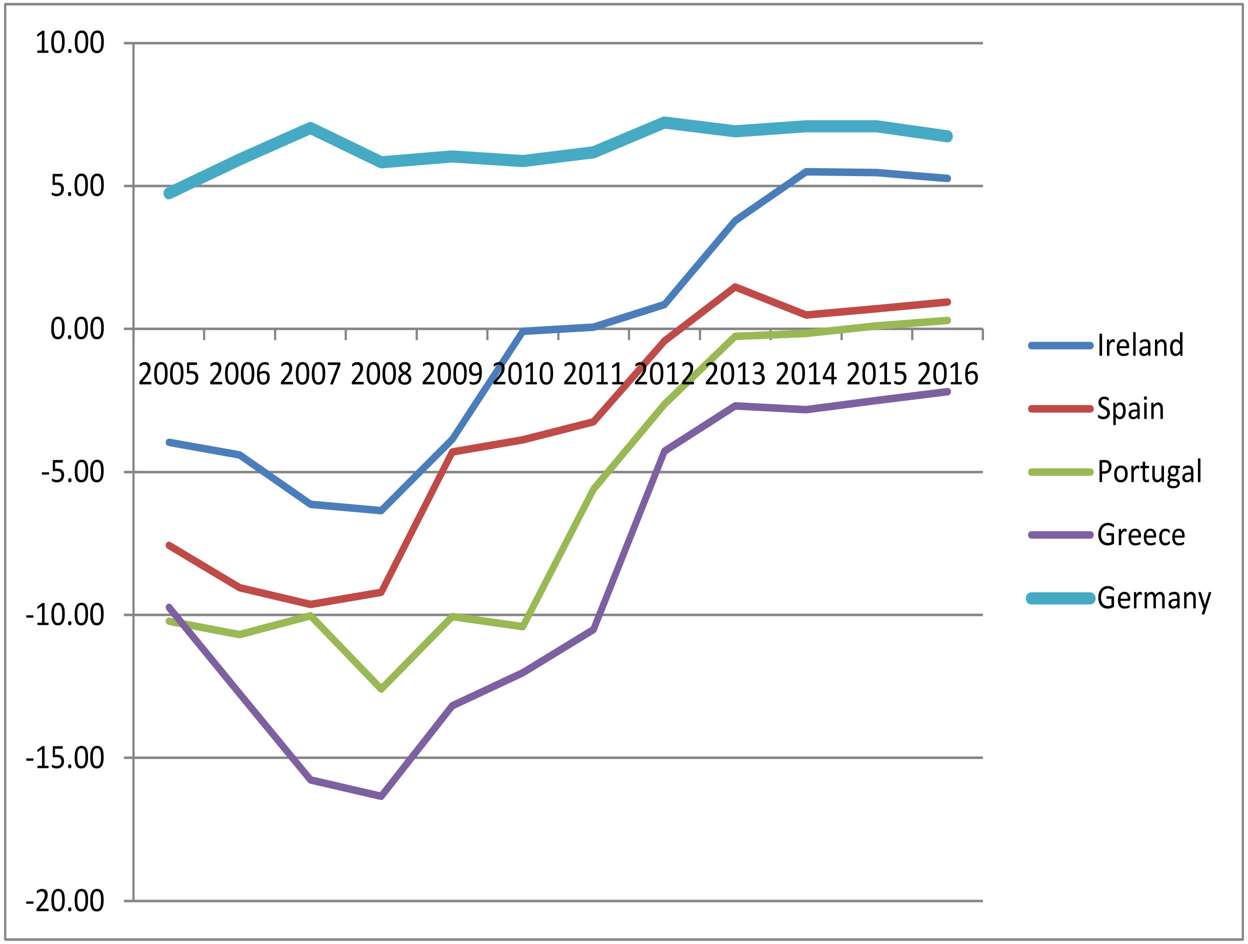
Impacts of adjustment programs

- The intermediate obejctives of the a.p. were: (i) to increase the competitiveness, and (ii) cut domestic demand to reduce external deficit, and (iii) start process of deleveraging
- Cut in credit to the economy led to a large cut in domestic demand
- The GIPS had a strong improvement in the current account (10 to 14 pp of GDP), partly due to improvement in competitiveness and partly due to cuts in domestic demand
- GDP decreases: normal for IR, SP and PT, Great Depression for GR. But large reduction in potential GDP.
- Labor market adjustment. Level of flexibility:
  - Unemployment at record levels
  - Emigration: large outflows mainly of qualified and young professionals
- IR had an impact similar to other adjustment programs in the past (1987-2000) with GDP and exports recovering fast.
- Also SP and PT impacts were similar to programs in the 70s and 80s
- GR is the odd case

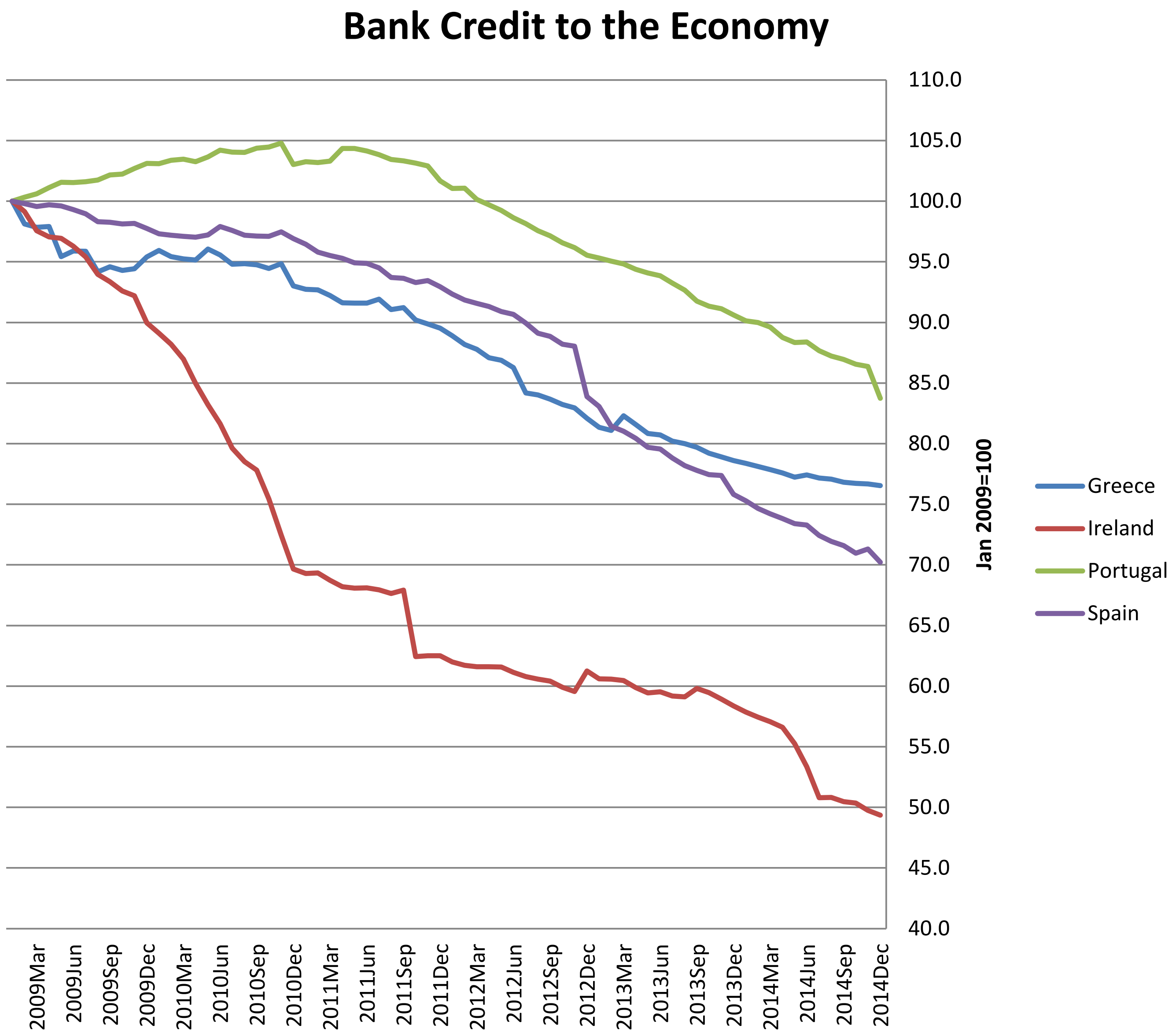
Real Effective Exchange Rates



Source: Bruegel



Current Account Surplus (Deficit): Percent of GDP


Bank Credit to the Economy
110.0
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100.0
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90.0
85.0
80.0
75.0
70.0
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60.0
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Jan 2009=100
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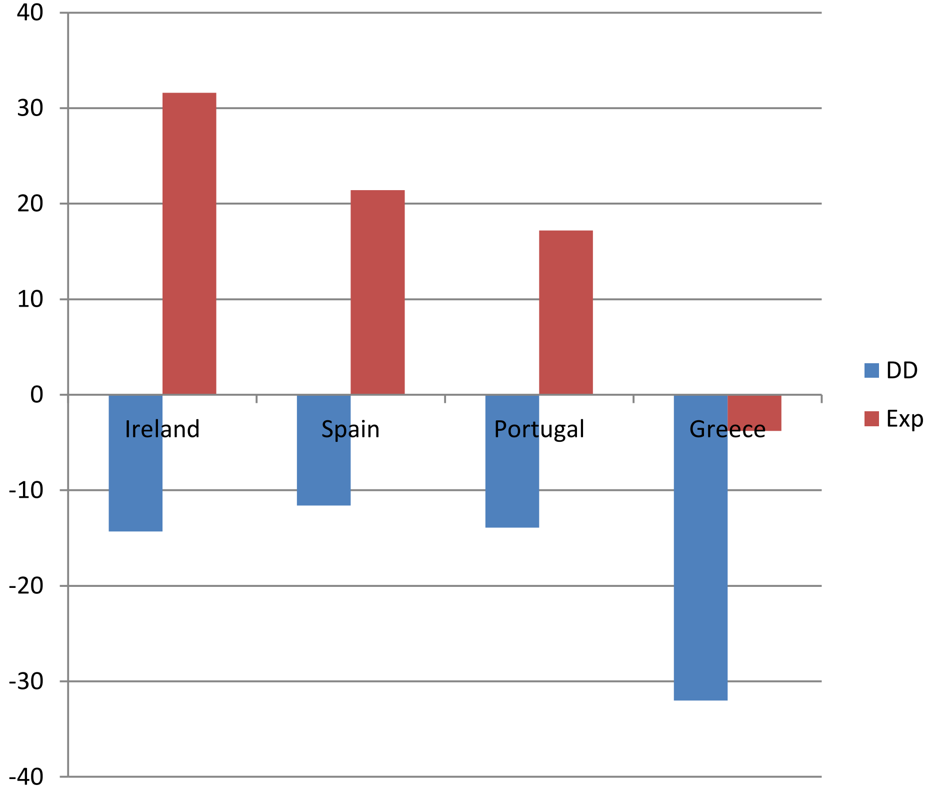
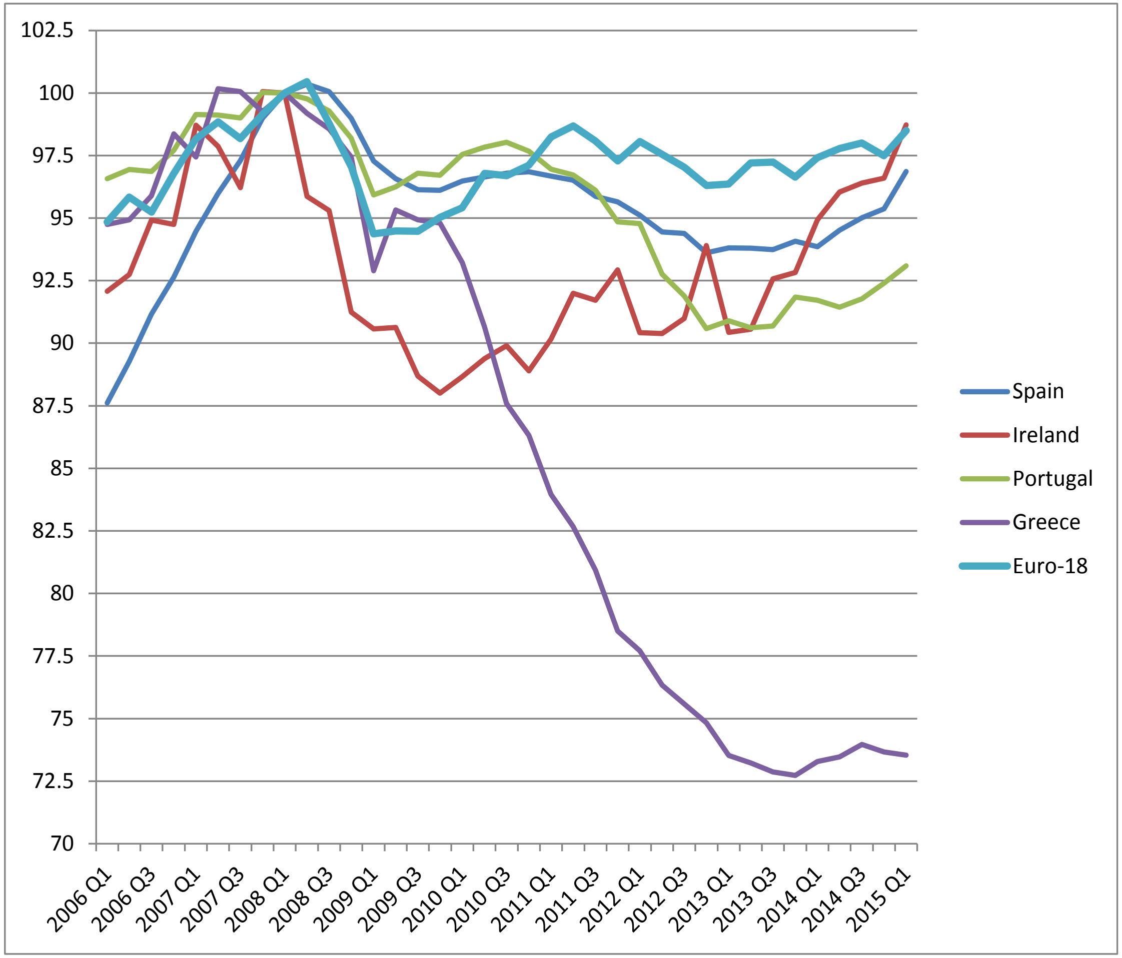
IMPACT OF DISCRETIONARY FISCAL MEASURES FOR BUDGET CONSOLIDATION								
In Perc. GDP					(2010-2014)			
	Ireland	Impact	Greece	Impact	Portugal	Impact	Spain	Impact
Revenues	3.1	-0.9	4.0	-1.1	4.3	-1.3	3.9	-0.8
Income taxes	1.4	-0.7	0.6	-0.3	1.3	-0.7	1.2	-0.6
Consumption taxes	0.8	-0.2	2.1	-0.8	2.3	-0.7	1.5	-0.2
Expenditures	5.9	-4.2	6.6	-5.7	9.1	-6.9	3.9	-2.0
Total	8.9	**-5.1**	10.6	**-6.9**	13.4	**-8.2**	7.8	**-2.8**

Increase in Exports and Cut in Domestic Demand, in perc. (2008-2014)



Quarterly GDP



Criticism of the austerity programs

- Criticism of the initial conditions: why crisis countries (GIPSC) accumulated so high desequilibria – lack of warning signs and self-correcting mechanisms (Sin and other German economists)?
- Criticism of the austerity programs: why the costs were so high – particular case of Greece where GDP loss reached a level similar to Great Depression (Krugman, Sachs, Stiglitz)?
- Multipliers are comparable among the 4 countries, given characteristics, except Greece
- Comparable with other past episodes (Alesina&Giavazzi)
- Comparison with other countries (problems of context and economic/political structure)

Conclusions: (i) the currency union did not change drastically multipliers,
(ii) It increased somewhat fiscal multipliers (as in fixed exchange rate environments)

The impact of the adjustment programs on GDP growth
Was within the confidence interval of previous programs

Table 6: Fiscal Adjustments and GDP growth in Southern Europe

	IR		IT		SP		PT	
	Actual	Projected	Actual	Projected	Actual	Projected	Actual	Projected
2010	-1.5	-1.04	1.17	0.01	-0.51	0.28	1.87	-1.97
		(-4.38, 2.37)		(-1.25, 1.15)		(-0.73, 1.3)		(-4.43, -0.28)
2011	1.71	1.20	0.14	-0.84	-0.06	0.49	-1.1	-1.6
		(-2.07, 4.68)		(-2.07, 0.34)		(-0.51, 1.52)		(-4.01, 0.12)
2012	-0.06	1.40	-2.9	-2.53	-1.74	0.04	-3.35	-2.23
		(-1.97, 4.77)		(-3.79, -1.38)		(-0.96, 1.06)		(-4.67, -0.53)
2013	-0.29	3.06	-2.41	-2.19	-1.44	-0.14	-1.45	2.05
		(-0.3, 6.45)		(-3.45, -1.04)		(-1.13, 0.89)		(-0.38, 3.75)

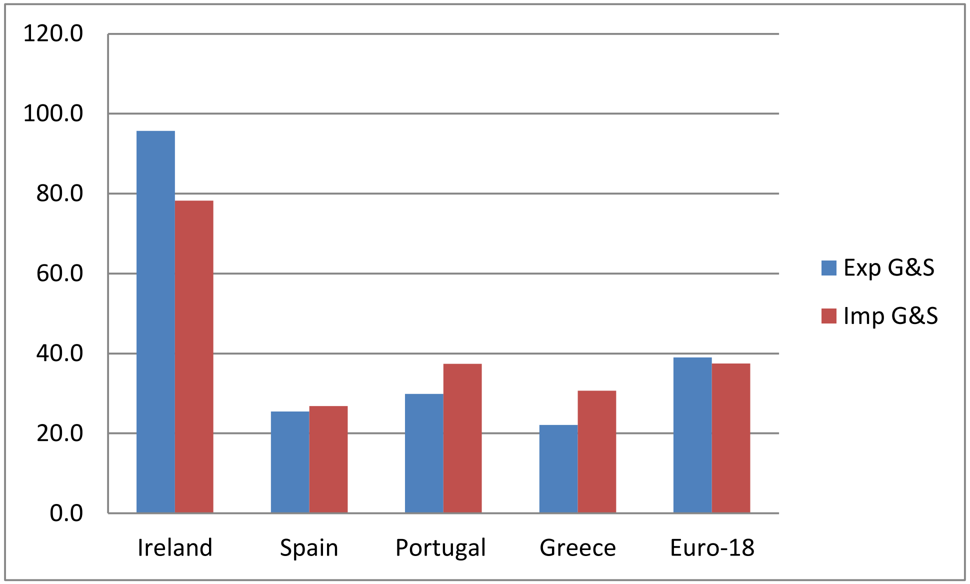
In brackets, 95% confidence bounds for projected GDP growth.

Except for the case of Greece

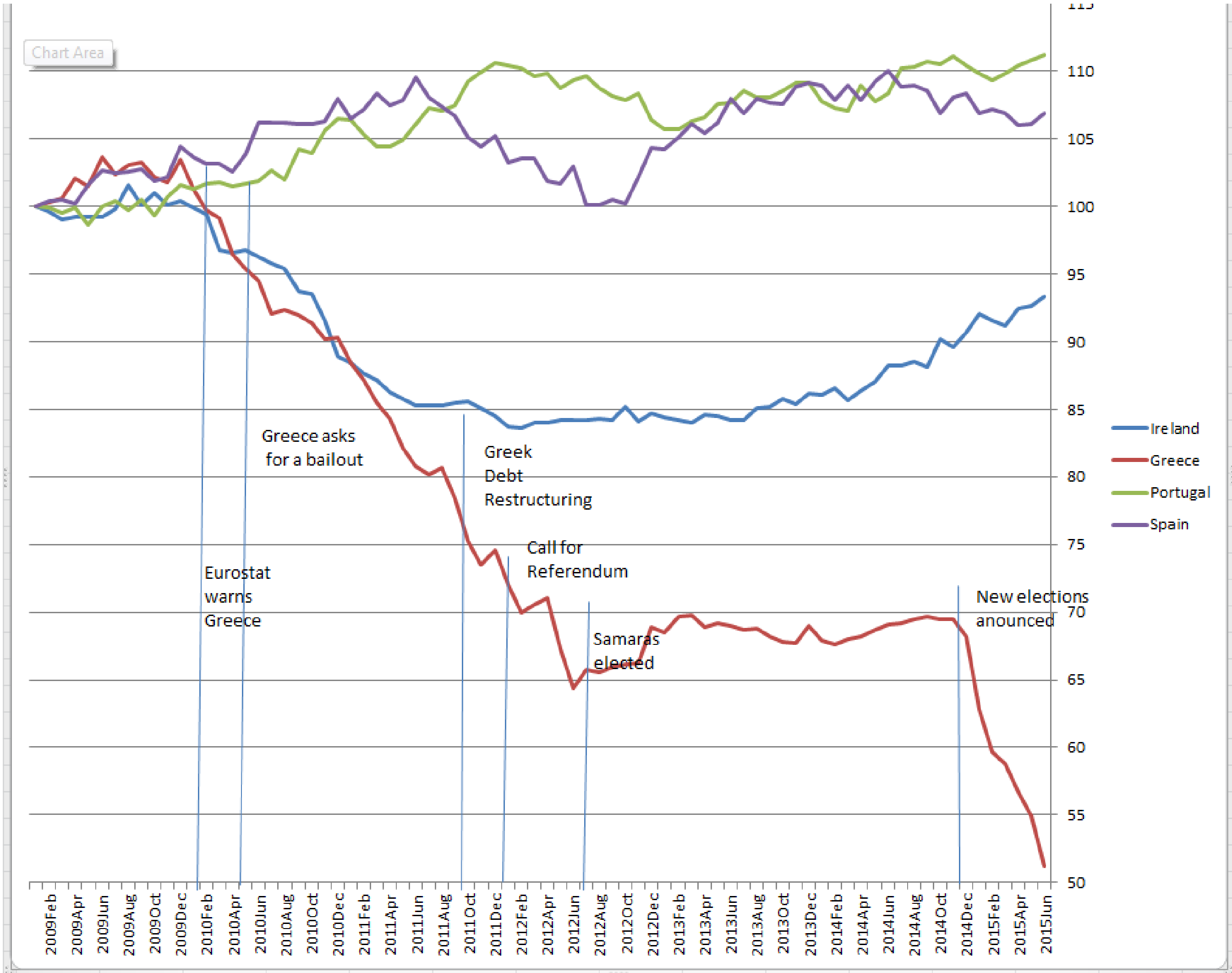
Why Ireland best, Greece worst and Portugal and Spain intermediate?

- Political and institutional factors
  - Cohesiveness of Political Parties and capacity to control vested interests
  - Ownership of program
  - Government technical competence and capacity of public administration to implement measures
- Economic structure
  - Openness of the economy (weight of tradables and interconnection in the global economy)
  - Capacity of enterprises to increase exports of goods and services
  - Capacity of banking to manage deteriorating portfolios and state financial services to manage public debt and restore confidence
- Prompt and decisive action (the weakest point for all)
  - Prompt intervention (like in any critical situation)
  - Expectations management

Openness of the Economy



The Greek Crise in a Nutshell



Greece: Deposits of Households and Non-financial Corporations

But, the costs of the crisis were very high

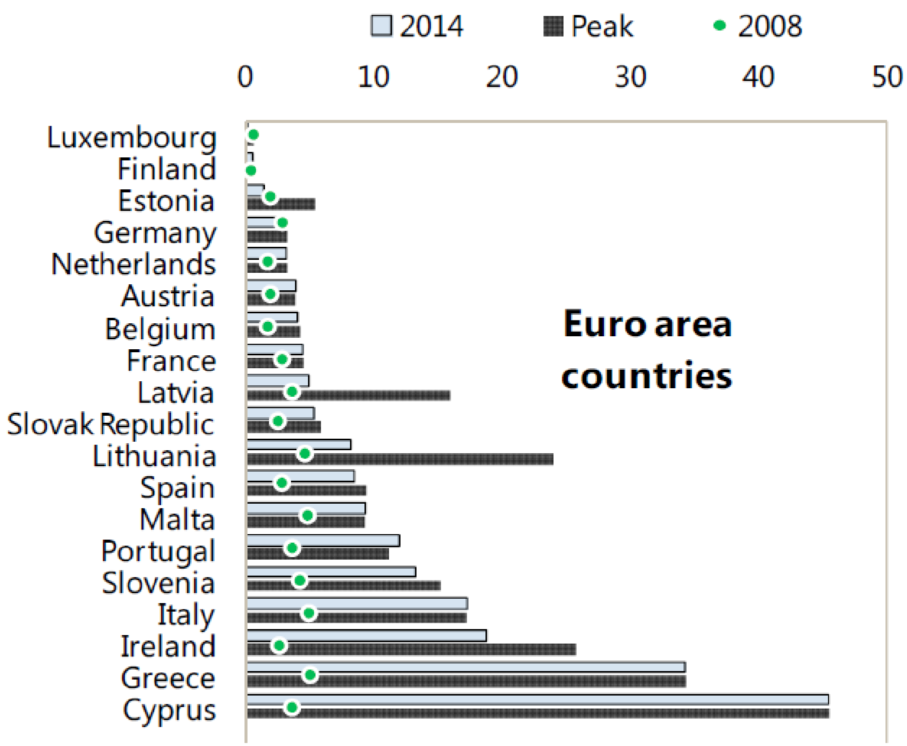
- The output loss, in terms of the trend growth were among the highest recorded in other financial crisis (e.g. Greece 164%, Ireland 110% of GDP, cumulated)
- Ireland recorded one of the largest bank rescue costs (60% of GDP) and the largest increase in Public Debt of the crisis countries alt. similar
  - Despite the best macro recovery
  - Price of bad regulation and procastrination in bank resolution

	Ireland	Spain	Portugal	Greece	Italy	Latvia	Indonesia	Argentina	Iceland	Thailand	Chile	Korea
							1997	1980	2008	1997	1981	1997
Output loss (2008-2013)	110.0	74.0	53.0	164.0	36.0	106.0	72	43	66	109	67	12
Long-term damage on output (2015)	34.0	22.0	14.0	36.0	12.0							
Increase in Public Debt (2007-2014)	66.8	61.8	53.4	59.5	31.5	38.0			72	88		
Costs of bank rescues/recap (2010-2014)	60.0	9.0	10.0	28.0	0.0		57	55	44	44	43	31
ECB Support of banks (2009-2014 av.)	75.8	9.6	27.4	39.8	8.7							
Target balances (2009-2014 av.)	49.8	6.5	29.3	49.9	1.1							

Costs of Crisis (In percent of GDP)

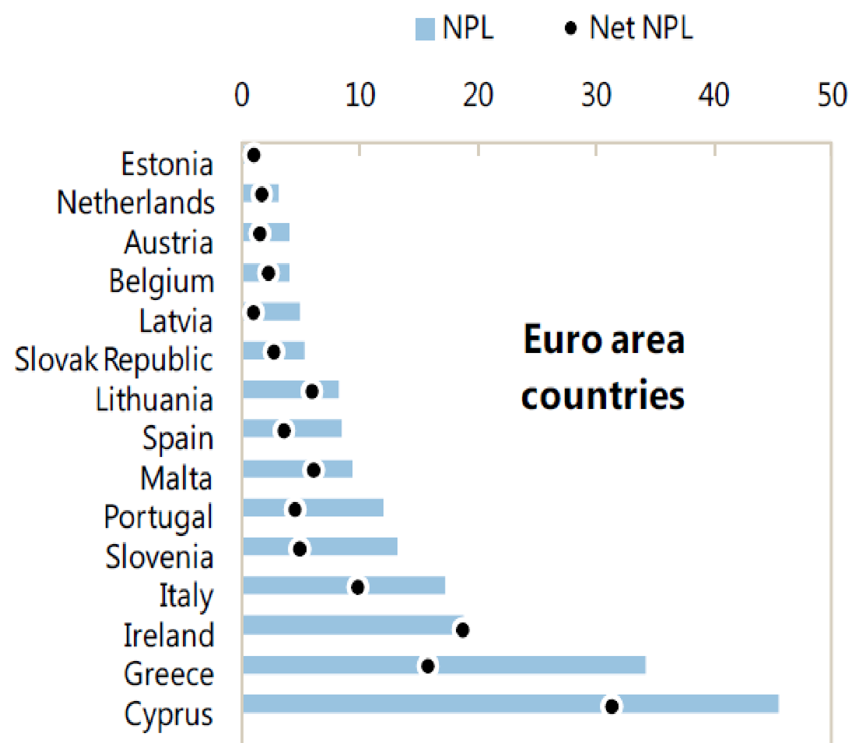
Gross NPLs, 2008–14

(in percent of total loans)



Gross and Net NPLs, 2014

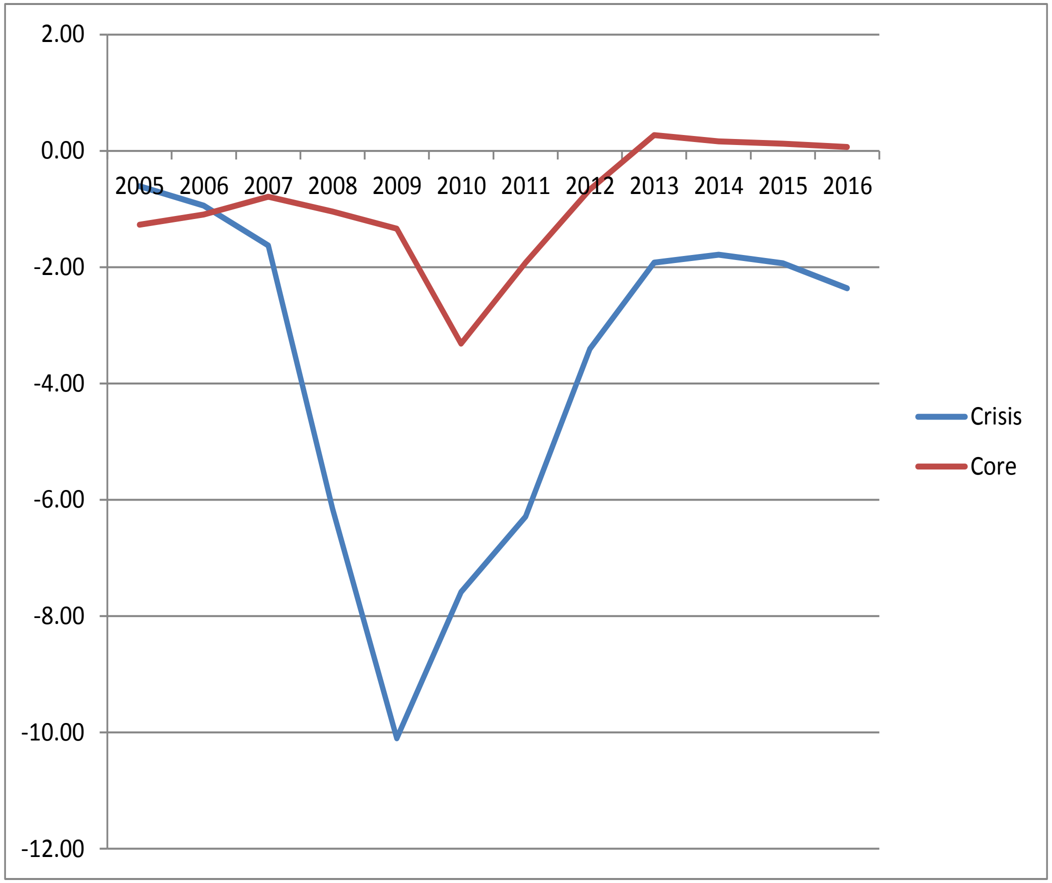
(in percent of total loans)



What lessons to be learned?

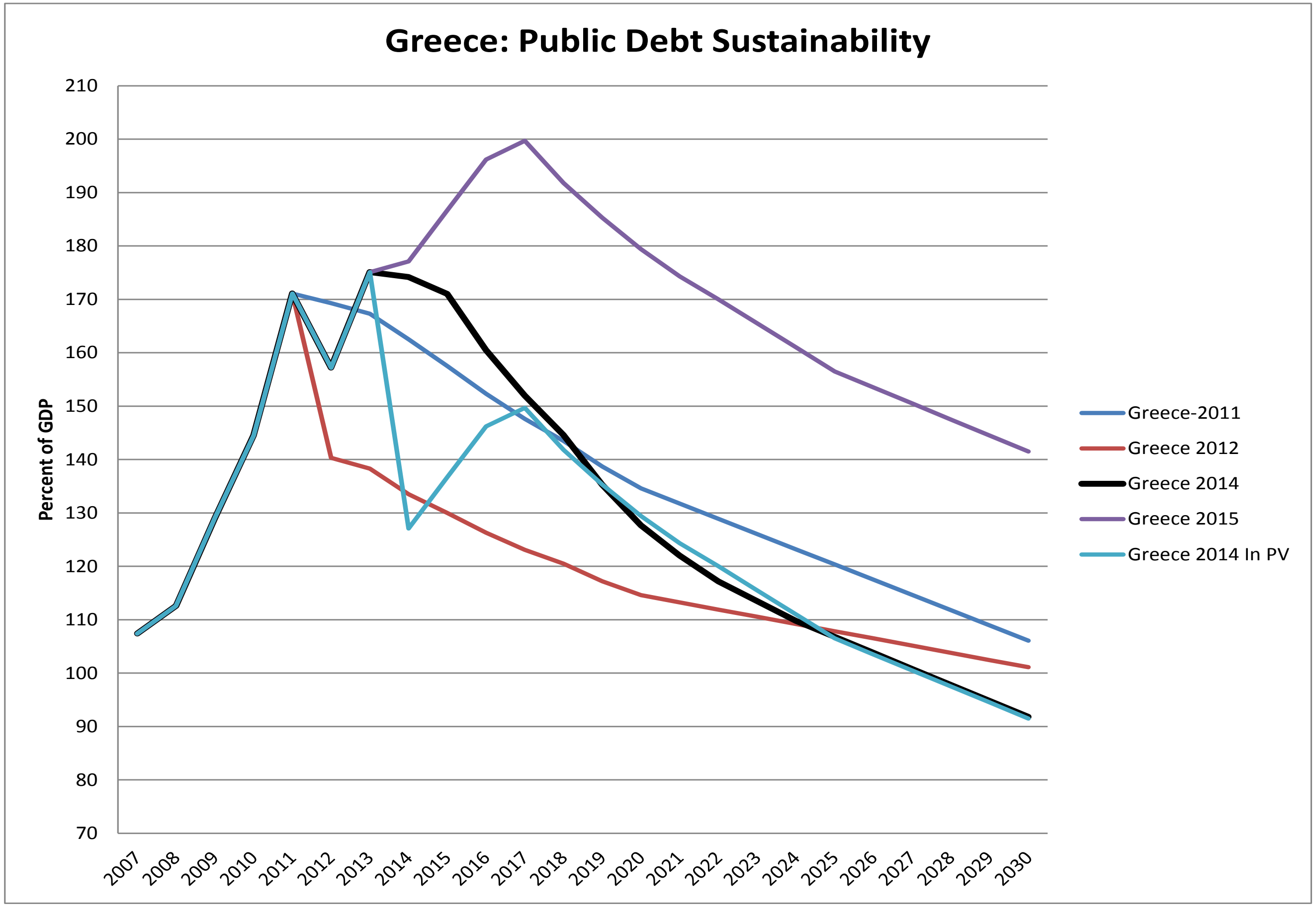
- Be clear on what are the rules of the game within the Eurozone
- Immediate and resolute intervention crucial: delay and denial compounds problem [all countries]
- Context: lack of growth in Eurozone - core countries also implemented contractionary policies
- Programs need to be more tailor-maid: e.g. More open economy has different fiscal multipliers than closed
- Emphasize more supply side: right policy mix (e.g. use fiscal devaluation)
- Be careful on how to manage expectations
- Fixing Euro systemic problems is a sine-qua-non to solving country member problems
- Country political and institutional problems should be taken more seriously (e.g. Syriza)

Structural Budget Deficits over GDP



One of the main reasons of large GDP cost: pro-cyclical Fiscal policy of core countries

Is Public Debt in Greece sustainable?
IMF say No; But if we use PV is Yes



What lies ahead?

- What will be the impact of the ECB and QE on asset prices and economic expectations?
- Problem of deleveraging
- Need to intensify resolution of banking NPLs (IMF paper)
- Need to solve banking structural problems: competition and efficiency
- Problems with resolution systems in banking crisis (flaws of new Directive and prolongation of systemic crisis)
- How to improve bank regulation and governance?
- Need for a better fiscal coordination of the Eurozone
- What role for structural policies?