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The Global Economy and the European Sovereign Debt Crisis
OMFIF Golden Series Lecture
London
July 10, 2012

Introduction

Recent readings on the global economic outlook have been tepid. Europe taken as a whole is in a recessionary state, and the uncertain effects of the ongoing sovereign debt crisis continue to weigh on the medium-term outlook. Global investors are dividing Europe once again into member states, a sort of market-based disintegration of the continent. The U.S. is growing, but at a sluggish pace. Recent data from China suggest a slower pace of growth than might have been expected earlier this year. Commodity prices have fallen to lower levels during recent months in part in response to the slowing global economy. Inflation readings have generally been lower. This constellation of data is causing considerable unease in global financial markets and in policymaking circles. Much of the unease can be traced to the increasing realization that the European sovereign debt crisis may be more traumatizing and more intractable than previously understood.

In this talk, I will begin with the policy situation in the U.S., and I will argue that among many factors affecting the U.S. in the medium term, the ongoing European crisis is the most pressing one from the U.S. point of view. Accordingly, I will then turn to discuss some aspects of the present European debate on the crisis, including the notion of exit from the eurozone and the possibility of a grand bargain outcome with increased political and fiscal cooperation within Europe. I will also discuss increased economic growth as a helpful tonic for the crisis. I will stress that while growth is certainly desirable, increased government spending today followed by higher future taxes is not likely to produce more rapid growth. I will conclude that the most likely way forward continues to be a long period of debt paydown and sluggish growth, both in Europe and the U.S., and that the most pressing policy issue is to accept this path and prevent any additional problems from developing as we press ahead.

My remarks here today are my own and do not necessarily reflect those of others on the Federal Open Market Committee.

The U.S. Situation

The U.S. economy remains on a modest growth path. The housing bubble and the ensuing financial crisis probably did some lasting damage to the economy, suggesting that the output gap in the U.S. is not as large as commonly believed and that the growth rate of potential output is modest. This helps explain why U.S. growth continues to be sluggish, why U.S. inflation has remained close to target instead of dropping precipitously and why U.S. unemployment has fallen over the last year—from a level of 9.1 percent in June 2011 to 8.2 percent in June 2012. This pace of improvement in unemployment has not occurred since the middle of the 1990s. The most recent labor market data for the U.S. were somewhat weaker than expected, with the unemployment rate remaining at 8.2 percent and the total private sector payroll jobs added coming in at 84,000. However, the hours figures were somewhat more encouraging, and unemployment claims remain below the threshold value of 400,000. Accordingly, this report, by itself, is not sufficient to change my forecast of modestly improving economic growth during the second half of 2012 along with a slow and intermittent decline in unemployment.

U.S. monetary policy has been aggressively easy for more than four years, and all the policy actions remain in effect today. The Committee lowered the policy rate substantially in the beginning of 2008. Later that year, the policy rate was lowered to near-zero, where it remains to this day. In addition, the Committee embarked on balance sheet policy, buying mortgaged-backed securities beginning in 2009 and buying Treasuries through the QE2 program beginning in the last months of 2010. The Fed's balance sheet remains exceptionally large today due to these outright purchases. The Committee took additional actions in 2011, offering forward guidance on the length of time the policy rate is currently anticipated to remain near-zero and introducing a new Operation Twist program aimed at lowering Treasury yields at longer maturities.

The Twist program was extended at the June 2012 meeting, in part as a reaction to incoming data suggesting a slower pace of growth in the U.S. and globally. Some estimates have suggested that the Twist extension is akin to a 25-50 basis point reduction in the policy rate in normal times. Given the lags in the effects of monetary policy, it will now take some time to see the impact of this action and to see whether or not the economy can meet the current set of expectations on performance during the remainder of 2012.

The U.S. economy is also being held back by significant uncertainties both within the U.S. and globally. Uncertainty is inhibiting both household and investor behavior. The U.S. fiscal

situation is similar to that of some countries in Europe and requires dramatic and sustained attention. The political compromise in the U.S. has been to delay action until after the November election, but markets tend to pull the uncertainty forward. Housing activity in the U.S. remains well below the levels experienced during the bubble period and seems likely to improve only slowly over the coming years. The U.S. healthcare system is about to engage in a major transformation, the effects of which are opaque. But even more pressing is the situation in Europe. The crisis is contributing to recession, adding a dragging factor on U.S. and Asian performance. There is a financial sector dimension which periodically threatens to expand into a more generalized financial crisis. It has been difficult for many in the U.S. to envision how the situation will develop going forward.

The Incentives for Exit

Debt problems take a long time to work out. We know from individual household situations that many with excessive debt enter into multiyear programs that force a routine level of debt paydown and force saving while curtailing consumption. Households can and do sell assets if they have them, and might search for extra income if opportunities are available. Like countries, they can be cut off from credit markets, and rebuilding reputations can take time. There simply are no real shortcuts in this process. The general advice for households has been to use credit wisely, borrowing only to make key personal investments that have a clear probability of paying off or to smooth consumption. When the discussion turns to macroeconomics, these principles are sometimes forgotten in a blizzard of analysis, but I think they basically apply.

One of the principal issues facing policymakers inside Europe (and worrying those outside) is exit from the Economic and Monetary Union (EMU). Exit is often portrayed as a crisis-producing event, as it would suggest the use of alternative and presumably much weaker currencies to pay back external debt. In this sense, it would be a way to partially default, as is always the case with surprise inflation and devaluation. Markets are reacting by pricing in some probability that such an event could occur, even though the official line is that it cannot.

The EMU was formed from a subset of EU countries, and so some countries famously remain outside the EMU—the leading example being the U.K. Since not all countries joined, it would seem that the experiment might have allowed exit from the EMU, but it did not. In addition, there are European nations that are euroized (using the euro) even though they are not part of

the EMU. These arrangements give me pause concerning the meaning of exit from the EMU—clearly some countries never joined and others have joined in a *de facto* sense.

The EMU can be viewed as a club, and members enjoy benefits that do not accrue to nonmembers. The value of being a member was originally to get German credibility on monetary policy. Countries choosing not to join calculated that they could run an equally effective monetary policy to the Germans and so decided not to join. The value of club membership was highest for countries with the least amount of credibility on monetary policy. The initial success of the EMU was stunning, driving yields on all EMU member debt essentially to German levels. This created a great environment for investment and stability within the EMU.

The logic of exit suggests that if the club is valuable, member countries will not want to leave, just as they desired to get in initially. Survey evidence seems to indicate that these incentives to stay in the club remain strong today. Still, the common refrain that no country can ever be allowed to leave the EMU is altering the incentives for nations to take the actions necessary to maintain membership. This is one of the main penalties that in principle should be enforcing the equilibrium behavior among the members of the club. Russell Cooper of the European University Institute and Penn State University has recently written extensively on this topic.[1]

The incentive effects for club membership are critical in another way. For countries that are already members, taking on country credit risk through mutualization is also damaging their incentives to remain in the club. They enjoy the benefits of membership, but the calculus could change if they see too many disadvantages from the policies undertaken to keep the union together. Countries can, in principle, remain on the outside and also do well, as Sweden has demonstrated.

In short, my view is that the incentive effects for a member country to remain in the EMU must be considered very carefully going forward. Policies should be designed with an eye toward these incentives, and can no longer assume that the political processes will back the EMU in all circumstances.

[1] See Russell Cooper, 2012, "Exit from a Monetary Union through Euroization: Discipline without Chaos," NBER Working Paper No. 17908.

Grand Bargains

From the beginning of the sovereign debt crisis, analysts, policymakers and financial market participants have craved a simple and sharp solution to the problem. My earlier remarks suggested that debt problems are unlikely to have quick solutions and, therefore, that we should expect a long and slow resolution process peppered with bouts of increased financial stress. Still, there is one possibility for a grand bargain that makes some sense and that has been increasingly discussed in policy circles. This is the notion that Europe has reached a "Hamilton moment."

Thomas Sargent, in his Nobel prize lecture, discussed some of the parallels between the U.S. colonies at the time of the ratification of the U.S. constitution and the current situation in Europe.[2] Alexander Hamilton was a proponent of a more powerful national government for the member states, then bound together by the Articles of Confederation. The states had considerable debts. In a famous compromise, the new and stronger national government assumed the states' debts under certain conditions. Could something similar happen in today's Europe? Certainly there are many calling for greater fiscal and political union.

A common refrain in U.S. policy circles is that while some EMU countries have considerable debt problems, Europe as a whole has sufficient resources to contain the situation. The debt-GDP ratio for the EMU as a whole is 87 percent, not that different from and arguably better than the U.S., depending on how U.S. obligations are counted. A stronger "national" government for Europe could hold and service that level of debt. Member states could transfer today's debts to the European level, likely in exchange for balanced-budget amendments or similar binding restrictions on future borrowing and a ceding of greater power to the European-wide government. Powers of the European Parliament, in particular taxing authority, might be increased.

Put starkly as a grand bargain like this, what Sargent termed a "political revolution," such a deal seems remote at the current juncture. But the basic building blocks of a deal are in place, as they were in Hamilton's time. Much of the current maneuvering in Europe has elements of this type of bargain: In particular, the discussion of a fiscal compact and ideas concerning debt mutualization. This makes me put some probability on a sunnier outcome for the situation. On the downside, however, I do not have the sense as an outsider to Europe that there is sufficient

[2] Thomas Sargent, 2012, "U.S. then, Europe now," manuscript, New York University. Delivered as the Nobel Lecture, Dec. 8, 2011.

political support for a ceding of sovereign authority to the European level. This is making me keep my baseline case as one of a slow paydown of debt in an environment of slow growth.

Growth and Fiscal Stabilization Policy

It is often noted that more rapid economic growth would help solve a lot of problems—and I have to agree. My reading of the literature concerning economic growth is that growth depends on innovation, improvements in technology, human capital and other long-run factors. It is not really a matter of government spending in the abstract or of monetary policy. I am worried that a growth agenda interpreted as a government spending agenda instead of a focus on the factors actually driving economic growth will not succeed and may make problems worse.

I have been disappointed in the debate concerning fiscal stabilization policy in the U.S. over the past several years, and I have written about it extensively in recent months.[3] We have a leading theory of how fiscal stabilization policy could work in some circumstances, a theory that respects what is known and has been learned concerning fiscal stabilization policy over the last several decades.[4] My sense is that there is a mismatch between what the theory suggests might be reasonable policy in the current environment and what is generally proposed in policy discussions. Critically, the theory suggests that the stance and efficacy of monetary policy is a key feature in determining the success of a fiscal expansion, a topic addressed only in the rarest of macroeconomic quarters. Perhaps the broadest point is to say that according to the leading theory, a certain type of fiscal expansion can substitute for a missing monetary policy (missing because of the zero lower bound), and is not a complement to monetary policy. The policy discussion almost always treats the two as complements, perhaps in the spirit of "throwing everything at the problem."

One very concrete version of this would proceed as follows. If you think, as I do, that monetary policy can be effective even with the policy rate at the zero lower bound, then one should not talk about fiscal supplements to that policy because, according to the theory, that would not make sense. Further, if monetary policy is appropriately calibrated given the current macroeconomic situation, as I believe it is in the U.S., then we have the countercyclical policy we need in place. For those who think, on the other hand, that monetary policy is not effective

[3] See James Bullard, 2012, "Death of a Theory," Federal Reserve Bank of St. Louis *Review*, *94*(2): 83-101.
[4] See Michael Woodford, 2011, "Simple Analytics of the Government Expenditure Multiplier," *American Economic Journal: Macroeconomics*, *3*(1): 1-35.

once the zero lower bound is encountered, the focus should be exclusively on fiscal stabilization policy, and supplements from monetary policy would be a distraction. However, the basic fiscal intervention required is a tax-financed increase in expenditure, not a deficit-financed one. Even this will have the intended effects only if implemented in a relatively precise way.

In short, while more rapid economic growth is very much a desirable outcome, I am doubtful it can be achieved through traditional fiscal expansion. In the medium term, it may be possible to undertake structural reforms both in the U.S. and in Europe and improve growth prospects, something I would very much favor, but that should not be expected to improve the crisis situation in the very near term.

Summary

The global economy is facing a slowdown combined with an ongoing sovereign debt crisis in Europe. I have argued that among the many cross-currents and uncertainties facing the U.S. economy, the most important one is the continued uncertainty emanating from the European situation.

I have also presented some comments on aspects of the crisis. In my view, the notion of the incentives of nations to leave the EMU has received too little attention up to now, perhaps on a judgment that the debt situations could be managed without raising such a possibility. In the current environment, these incentives have to be calculated and taken seriously. While I have some sympathy for the idea that Europe may be facing its own "Hamilton moment" and, thus, that the outlines of a grand bargain solution to the sovereign debt crisis may be faintly visible, as of now I continue to put low probability on such an outcome. I have also stressed that I am very supportive of efforts to increase the pace of economic growth both in Europe and the U.S., but that I do not think growth prospects can be meaningfully improved through traditional fiscal expansion. Instead, I think structural reforms which improve medium-term growth prospects are more likely to be successful.

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