



CENTRE FOR
EUROPEAN
POLICY
STUDIES

Thinking

CEPS

ahead for Europe since 1983

Analysis of the US approach: What the EU can learn from US policies and politics

Daniel Gros

Vienna, October 21, 2010

Outline:

- Transatlantic structural differences and similarities
 - Housing
 - Credit
 - Market vs. bank-centric system
- Europe internal heterogeneity
- Post-crisis differences

Structural factors: Crisis and Recovery

- Key driving factors of crisis similar both sides of Atlantic
- Obstacles also?
- Recurrent theme: house price boom leads to consumption boom and expansion of financial sector
- Intra: Euro area divergences: But not necessarily to construction boom!

What kind of crises?

From real estate bust to financial bust:

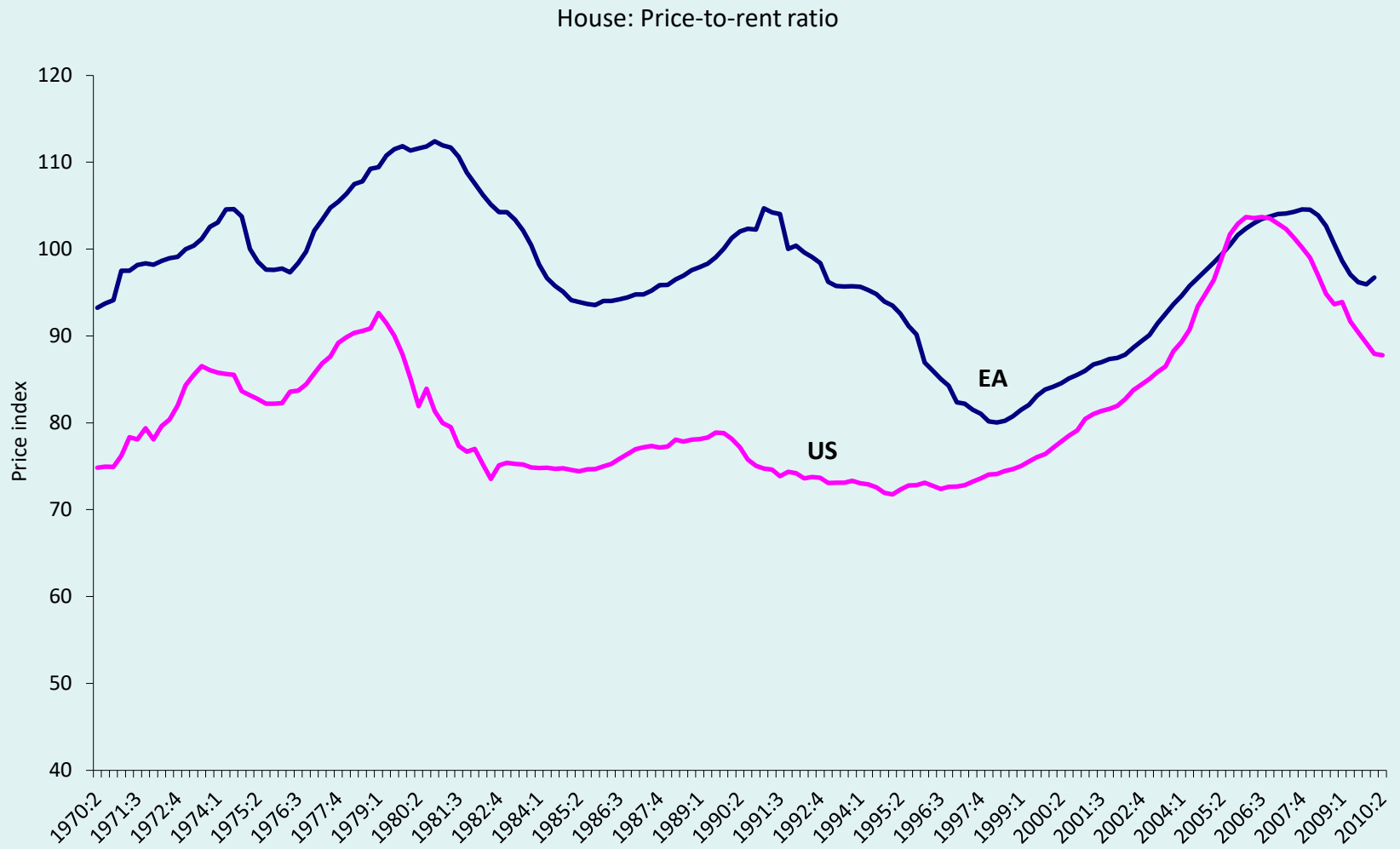
- Sub-prime only tip of iceberg.
- Real problem is combination of two factors:
 1. Global real estate boom
 2. Explosion of financial activity, a credit boom with most of the risk superficially outside banking system (via securitization, credit default insurance, etc.).

An 'Anglo-Saxon' crises?

- Real estate boom not only US, but global (with two exceptions, DE and J).
- Securitization on industrial scale: mainly an Anglo-Saxon phenomenon plus Spain
- But expansion of financial sector comparable in Europe.

=> Crisis not made in USA!

Not just a US Housing Boom



Transatlantic Difference (I)

- In US most mortgages are 'no recourse': the borrower can just send the keys to the bank.
- In Europe borrower remains liable for remainder should value of house be lower than mortgage: no 'jingle mail'.
- => in US cost of house price bust is borne by financial system, not households.

Not just a US Credit boom: No problem with Corporate Leverage?

Debt-to-GDP ratios	Economy-wide		Non-financial corporate sector	
	EA	US	EA	US
1999	3.51	2.66	0.67	0.46
2007	4.54	3.47	0.92	0.49
2008	4.73	3.46	0.97	0.49
Change 1999-2007	1.03	0.81	0.25	0.03

Not just a US Credit boom: Transatlantic Difference (?)

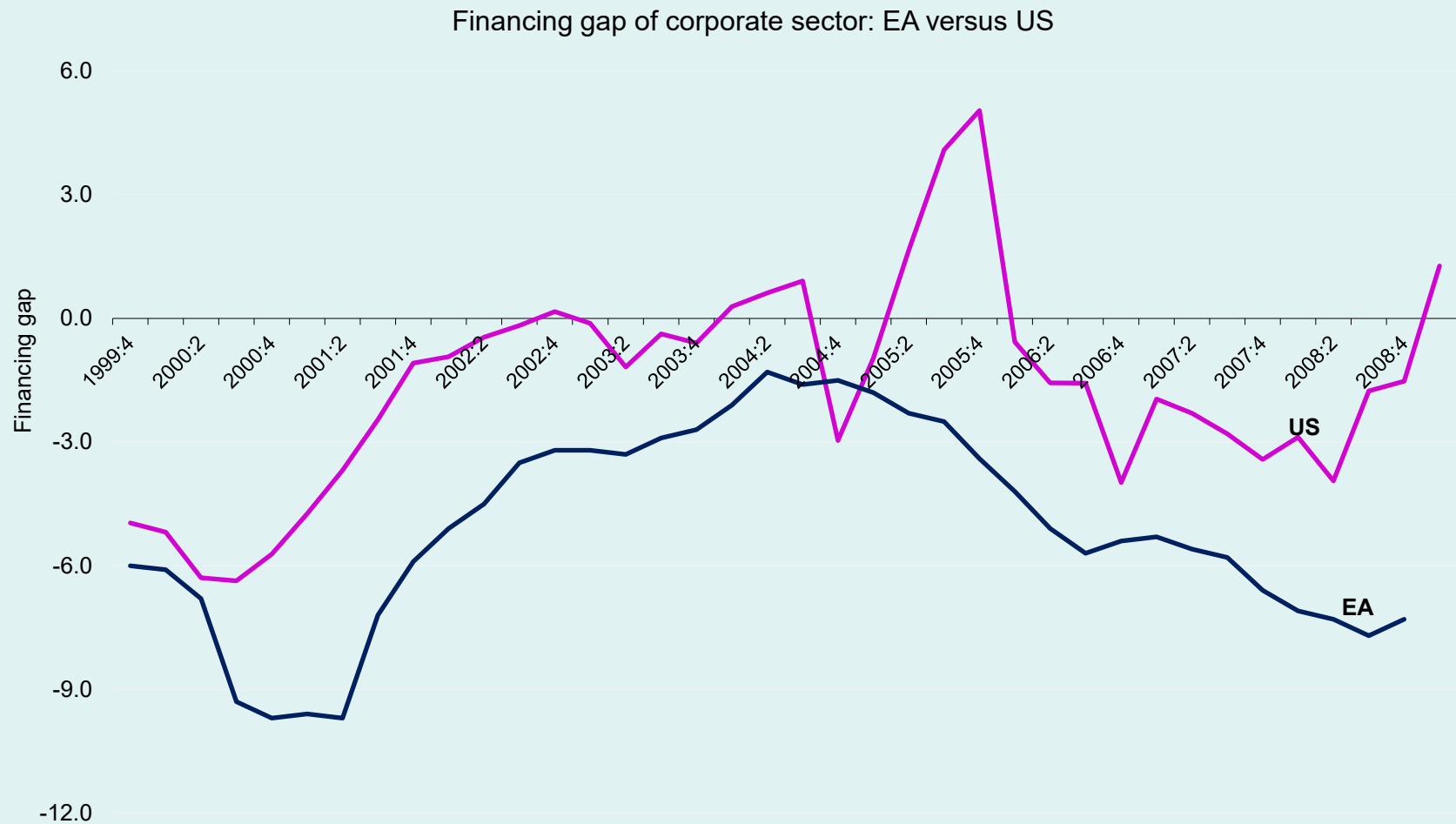
Debt-to-GDP ratio	Financial sector		Households & small business	
	EA	US	EA	US
1999	1.61	0.79	0.48	0.88
2007	2.32	1.17	0.61	1.28
2008	2.42	1.17	0.61	1.24
Change 1999-2007	0.71	0.38	0.13	0.4

Transatlantic difference (II)

Deleveraging problem in Europe as least as severe as in US. But ...

- more quickly apparent in US due to securitization (market based system).
- In EU banks allowed to hide problems and no area wide institution to deal with consequences.

Transatlantic differences (III): Financing need higher in EA than US



Source: ECB and Federal Reserve Board

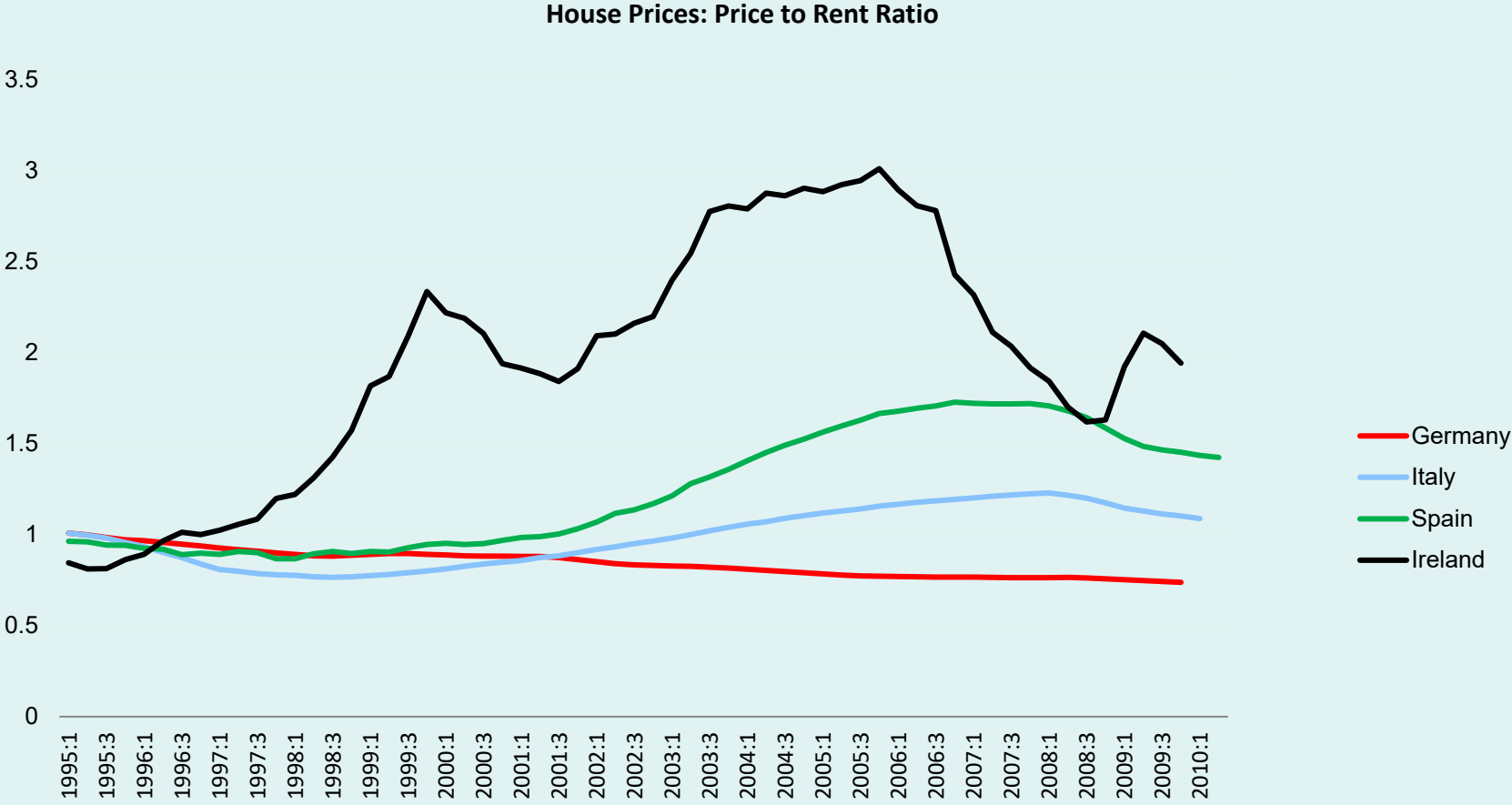
Note: financing gap=internal cash flow minus cap expenditure as % of value added

Divergences within EA more salient than transatlantic similarities?

Large and sustained differences in prices and activity (construction):

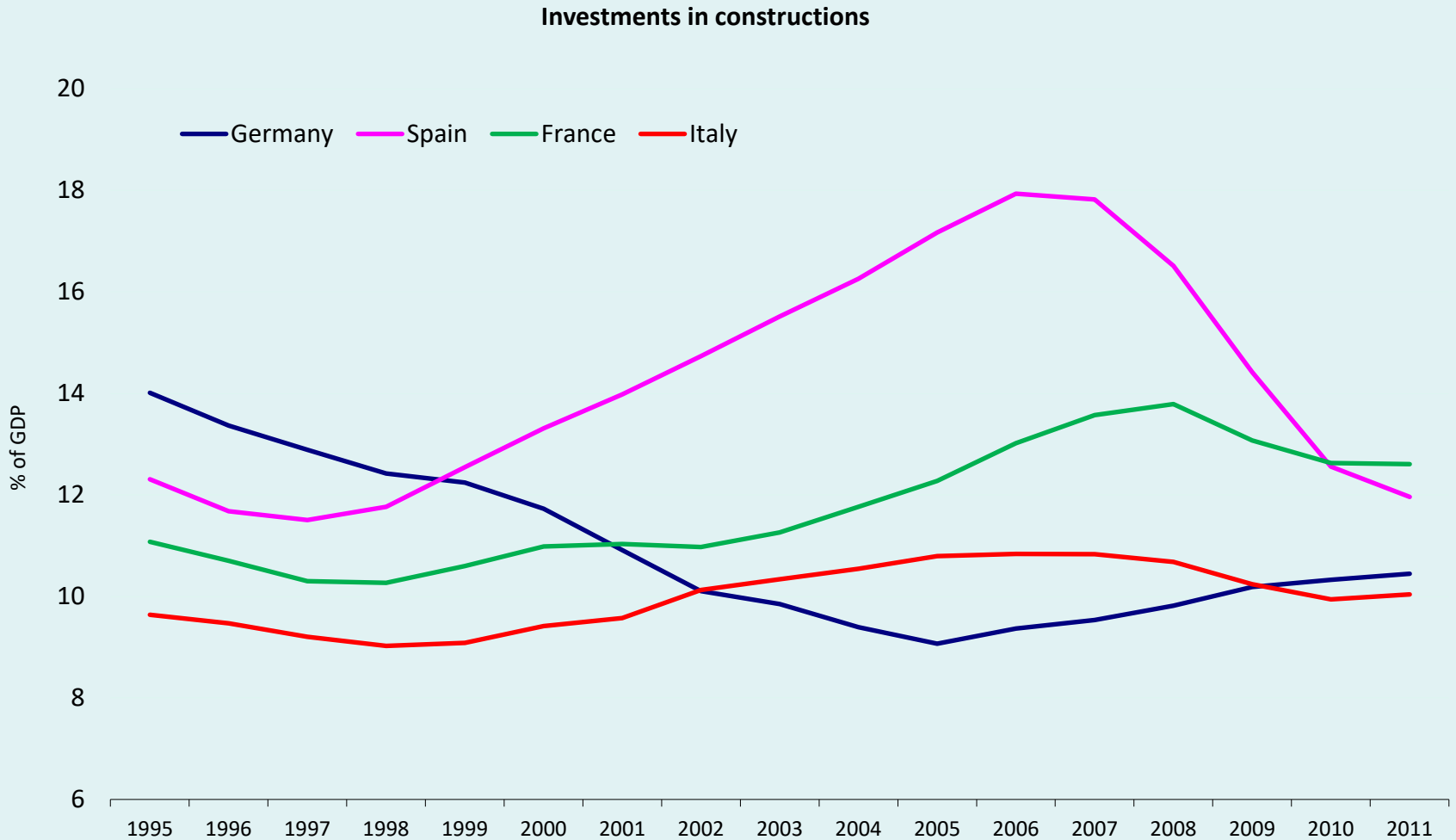
- Prices up like in the US almost everywhere, except in Germany.
- Why not in DE? Unification boom (and bust after 1995): key asymmetry in starting condition!
- Housing cycles can (have) lasted over a decade.

Divergences within EA (I)



Source: OECD. House price to rent ratio
Note: Index divided by the average 1990-1999

Divergences within the EA (II): Construction booms (and busts)

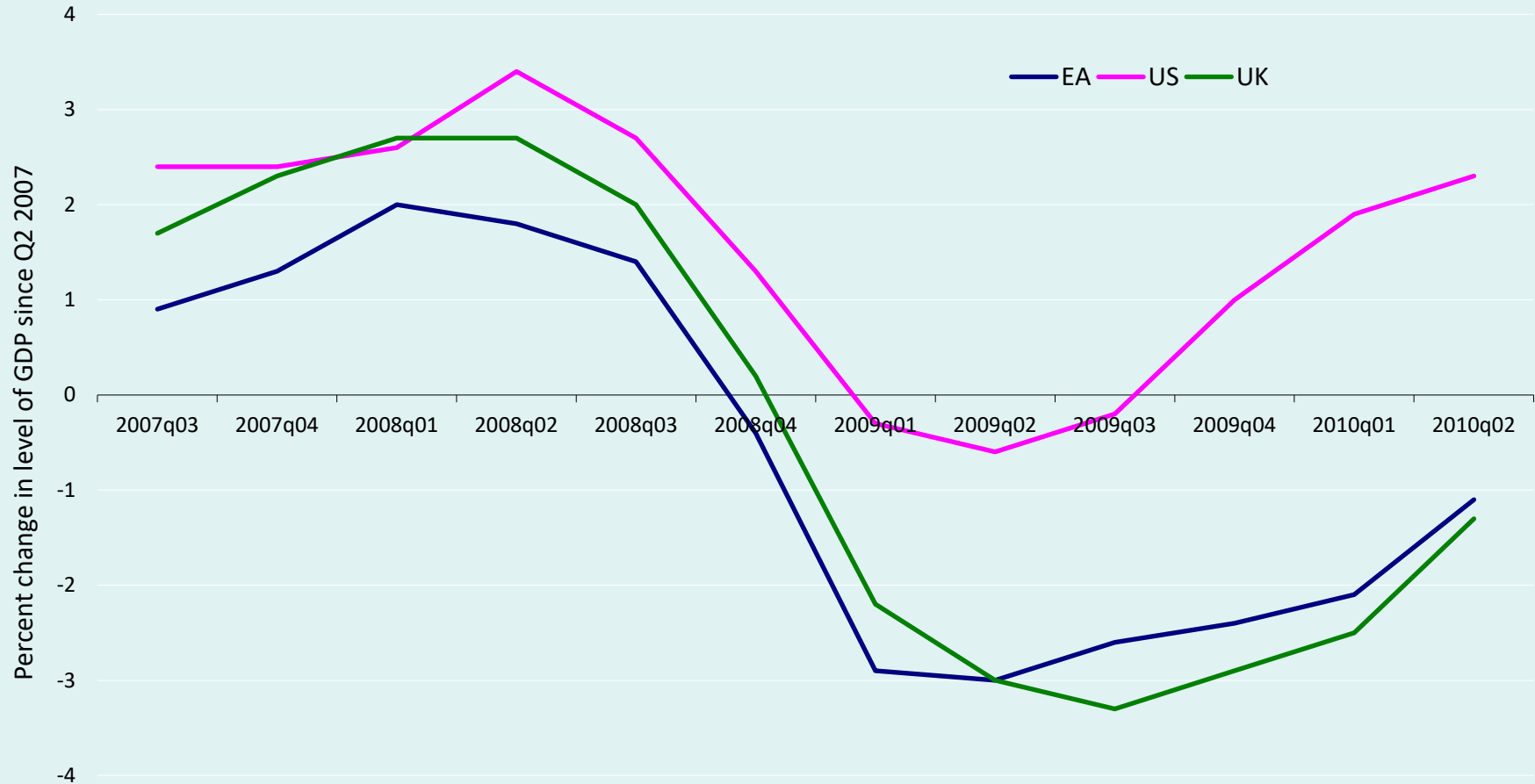


Consequences of National Housing Boom(s): Lasting Divergence

- National housing booms lead to strong domestic demand and hence long cycles of divergence.
- National housing cycles can (have) lasted over a decade (Germany, Japan).
 - Busts also?

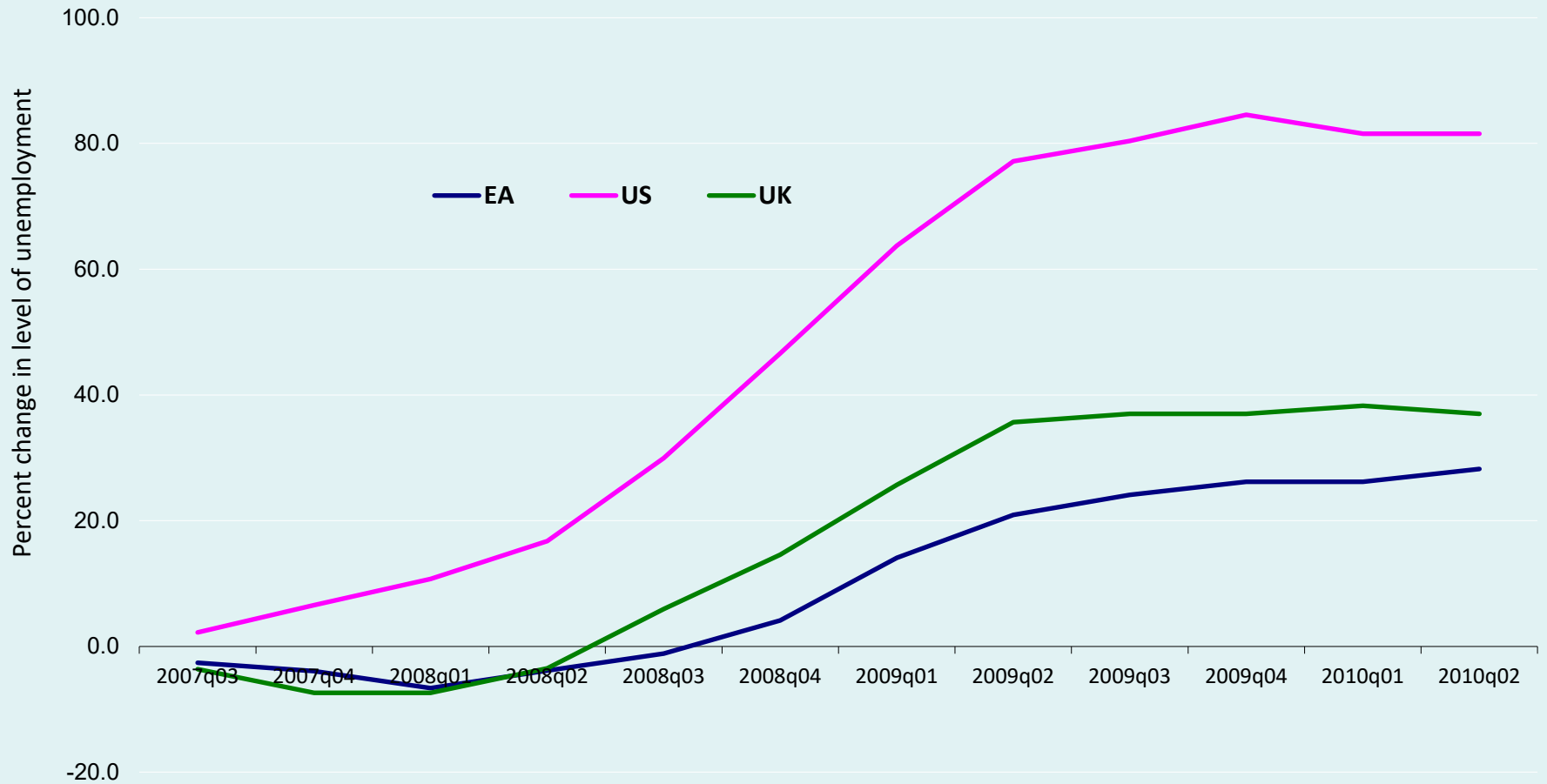
Post-crisis Transatlantic difference (I): growth

Cumulated growth since outbreak of crisis



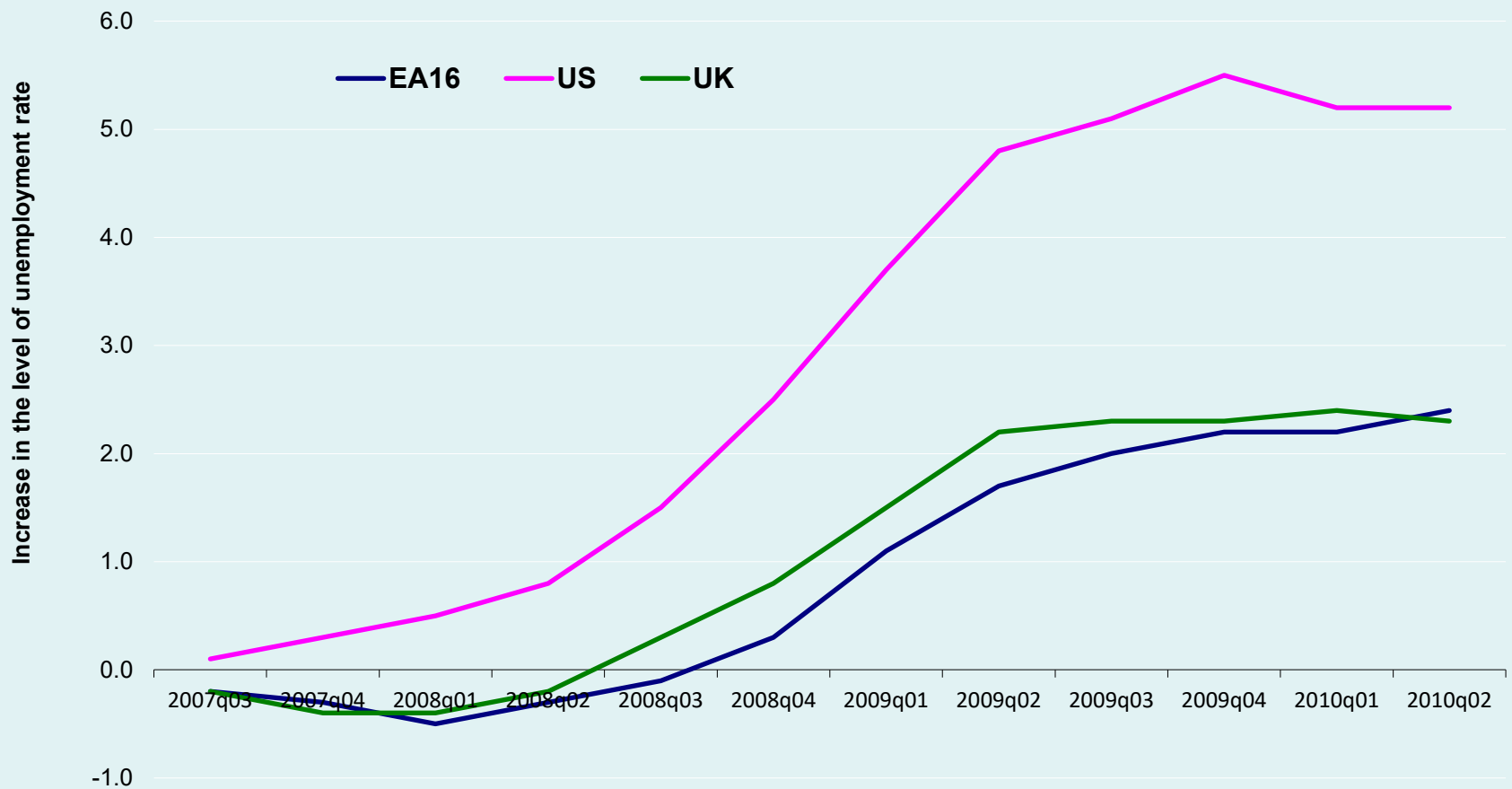
Post-crisis transatlantic difference (II): unemployment

Cumulated % changes in the unemployment rate since outbreak of crisis



Post-crisis transatlantic difference (II): unemployment (II)

Cumulated changes in the level of unemployment since outbreak of crisis 2007q2



Concluding Remarks I

- Within a monetary union national real estate markets can (they do not have to!) go on different trajectories.
- Divergences difficult to explain except for DEU
- What to do?
 - Intervene when prices/construction activity get out of hand.
 - Limit loan-to-value ratios for mortgages.
 - Auction off building permits.
 - Dynamic provisioning for banks (Spain!).

Concluding remarks II: Outlook

- Without financial crisis: smooth adjustment with trends of first ten years in reverse (construction sector contracts in Spain, inflation higher in DE with slow reversal in current account (im)balances).
- Financial crisis accelerates this process.
- Can politics accept the inevitable?

Concluding remarks III: Outlook

- Immediate impact of crisis similar everywhere. But this masks fundamental long term differences:
 - Germany affected by external demand, domestic demand largely stable.
 - Spain/Ireland, EU periphery opposite
 - France: in between

Conclusions: Europe will suffer more

- EA Financial sector highly leveraged
- EA Corporate sector more dependent on external financing than in US
- US large losses on credit but partially born by European investors
- EA banks delay loss recognition with agony of credit supply

Thank you