CENTRE FOR EUROPEAN POLICY STUDIES

Thinking ahead for Europe since 1983

Crisis and Recovery
A transatlantic comparison of the key structural factors

by

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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:

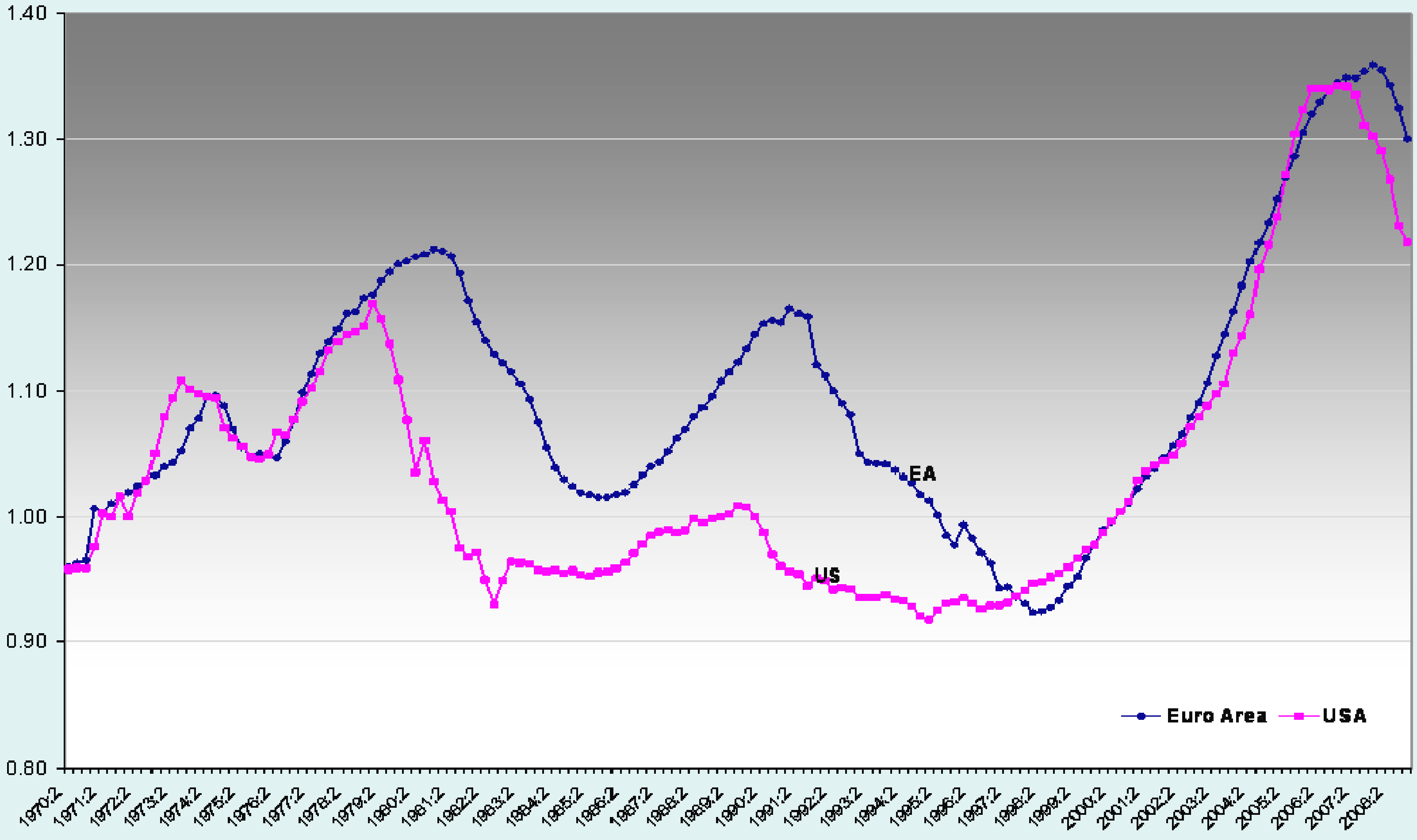
- Sub-prime only tip of iceberg.
- Real problem is combination of two factors:
  1. Global real estate boom
  2. Explosion of financial activity, a credit boom with most of the risk superficially outside banking system (via securitization, credit default insurance, etc.).

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



Source: OECD

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 (?)

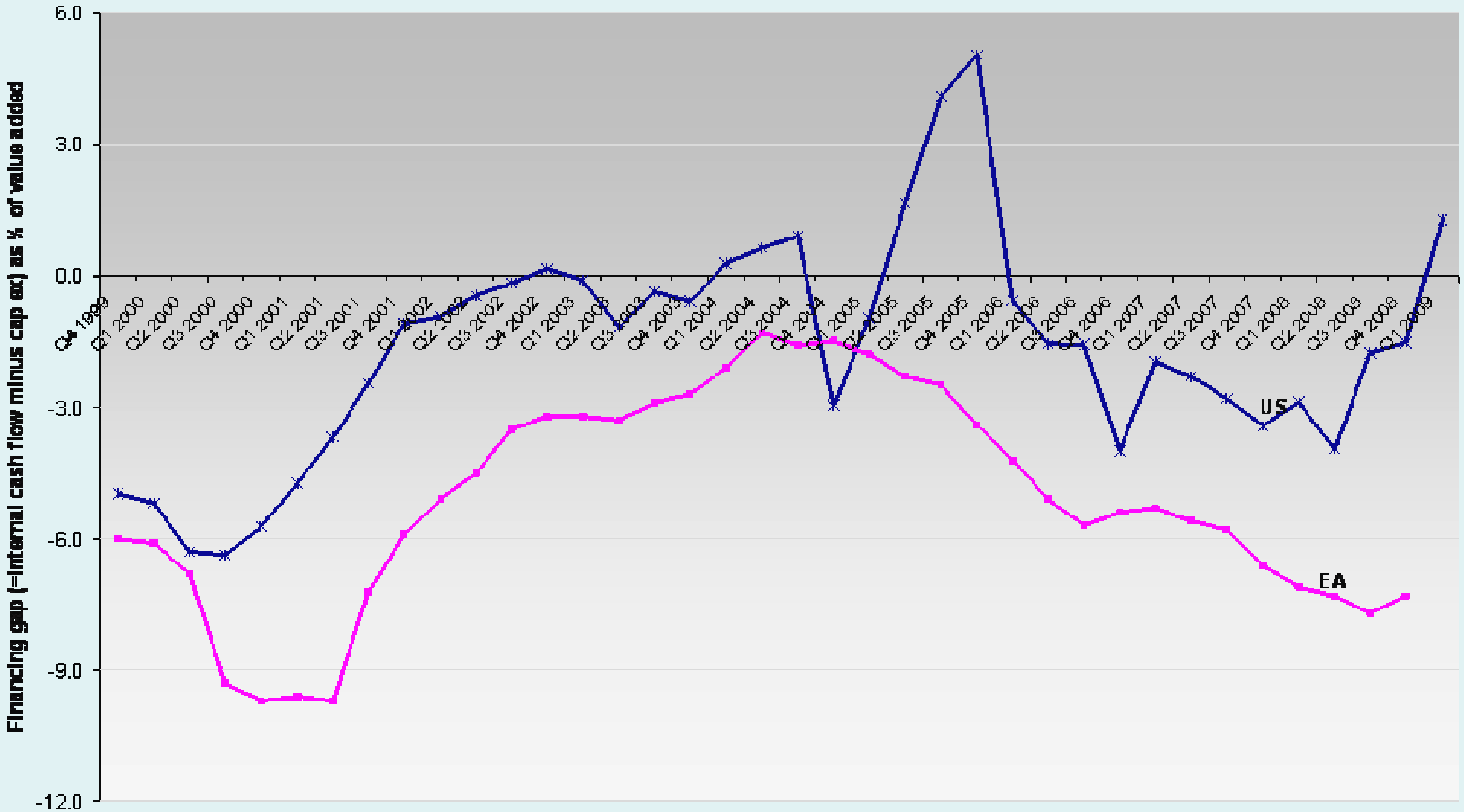
Debt-to-GDP ratio	Financial sector		Households & small business	
	EA	**US**	**EA**	**US**
1999	1.61	0.79	0.48	0.88
2007	2.32	1.17	0.61	1.28
2008	2.42	1.17	0.61	1.24
Change 1999-2007	**0.71**	**0.38**	**0.13**	**0.4**

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)
Enterprises less capitalized in EA



Source: ECB and Federal Reserve Board

Conclusions:
Europe will suffer more (?)

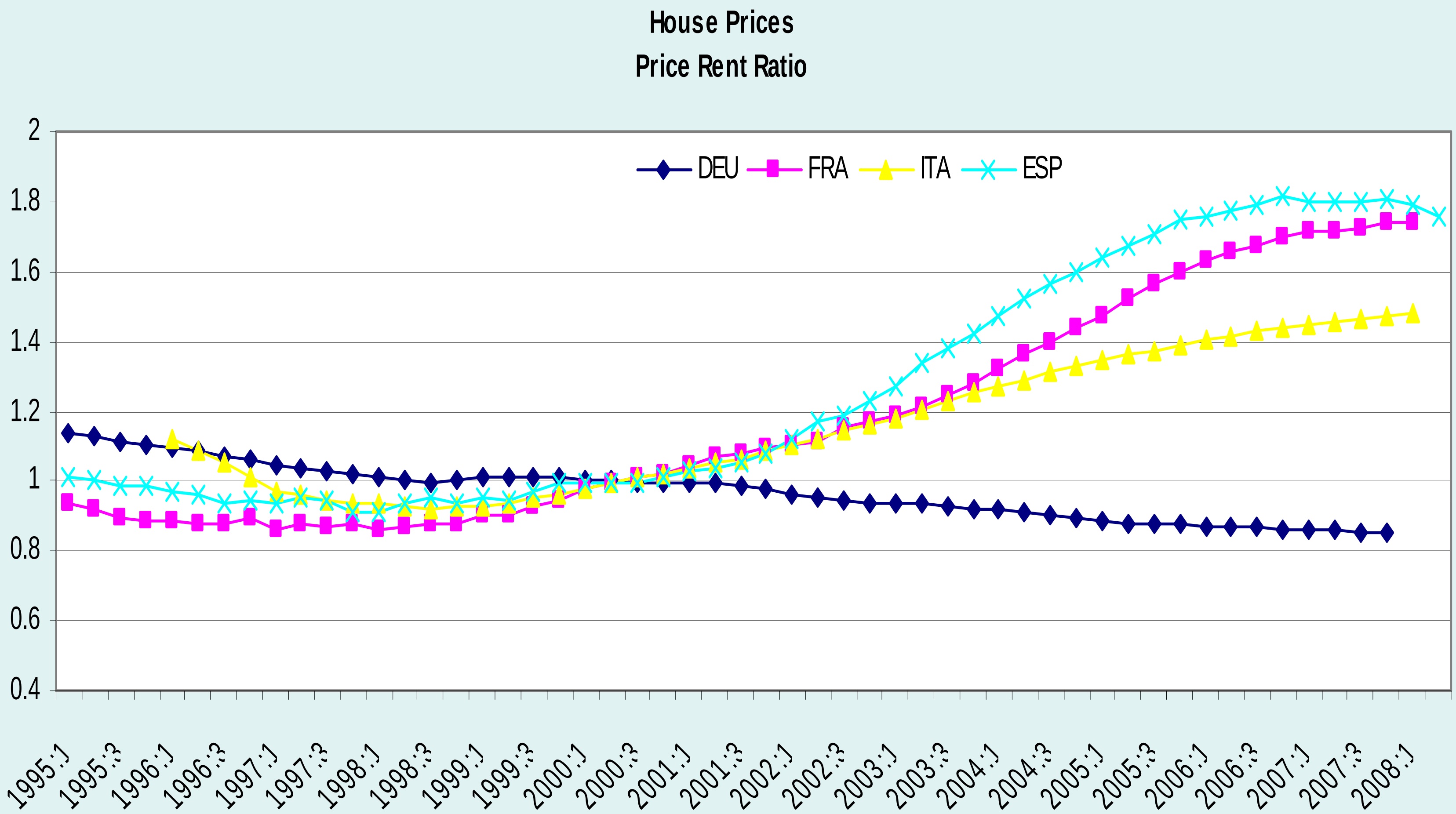
- EA Financial sector highly leveraged
- EA Corporate sector more dependent on external financing than in US
- US large losses on credit but partially born by European investors
- EA banks delay loss recognition => prolonged credit?

Divergences within EA more salient than transatlantic similarities?

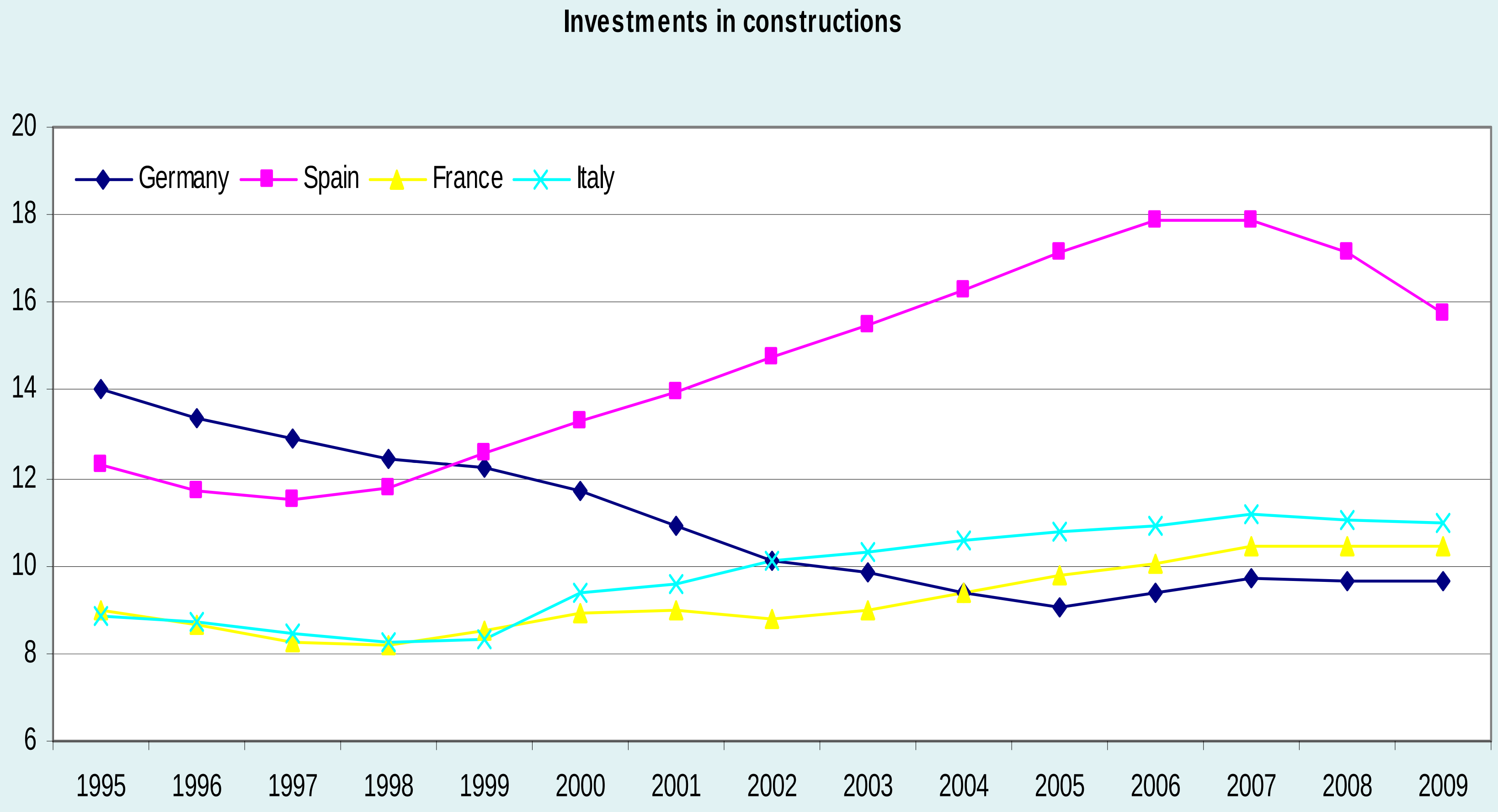
Large and sustained differences in prices and activity (construction):

- 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)



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?

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

Thank you

Legacy of Housing Booms: Housing Overhang(s) in EA?

As % of GDP	DE	Spain	FR	Ireland	Italy
Construction	-19.1	30.2	-4	51.8	-5.5
Dwellings	-6.5	24.6	-8.6	44.3	-0.9

What Determines Diverging National Cycles?

- Conventional view: Walters critique: high inflation means lower real interest rates which fuel domestic demand and hence drive up inflation => positive feedback loop.
- =>Small difference in starting point magnified.
- Also applies to housing booms?

What Determines National Housing Boom-Bust in a Monetary Union?

Reality does not confirm Walters critique:

- France vs. Germany (same inflation but divergent house prices).
- Spain vs. Germany consistent, but not Spain vs. France (similar house prices but different inflation).
- Spain vs. Italy (similar real interest rates but no construction boom in Italy).

Divergences within Europe (I)

Differential w.r.t. Germany Average 99-2007	**HCPI Inflation**	**Mortgage Rates**	**Real House Prices (Growth rate)**
France	**0.2**	**-0.5**	**10.3**
Spain	**1.6**	**-1.1**	**10.4**
Italy	**0.7**	**-0.2**	**5.84**

Divergences within Europe (II)

Differential w.r.t. Germany Average 99-2007	**CPI Inflation**	**Mortgage Rates**	**Real House Price (growth rate)**
Ireland	**1.8**	**-0.8**	**10.5**
Greece	**1.6**	**0.8**	**7.7**
Portugal	**1.4**	**-0.3**	**2.3**

Legacy of Housing+Credit Booms

Housing booms national, but financial (banking) system integrated at EA level:

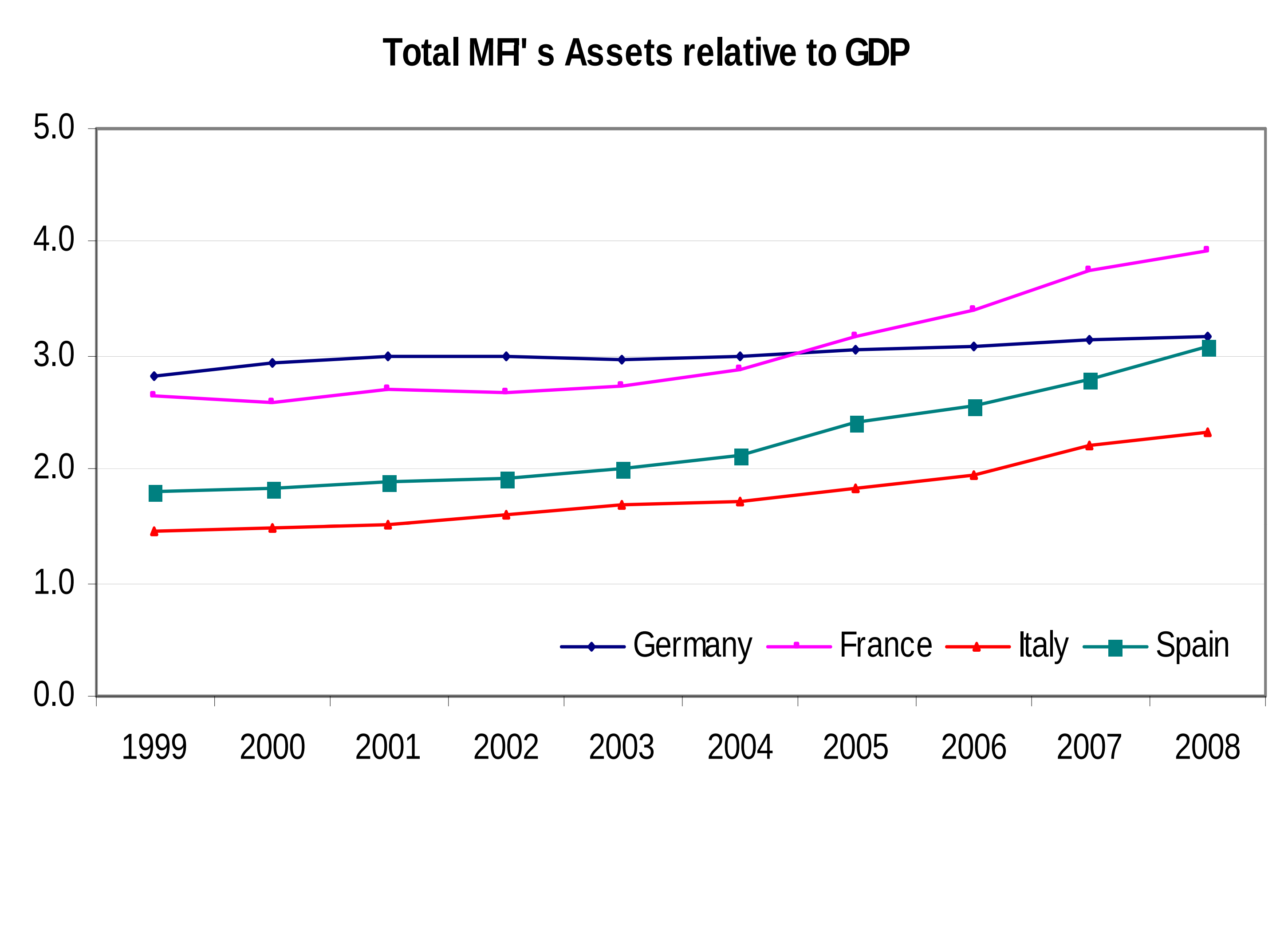
National housing bust(s) lead to system wide banking weakness.

But systemic financial sector weakness has different national consequences.

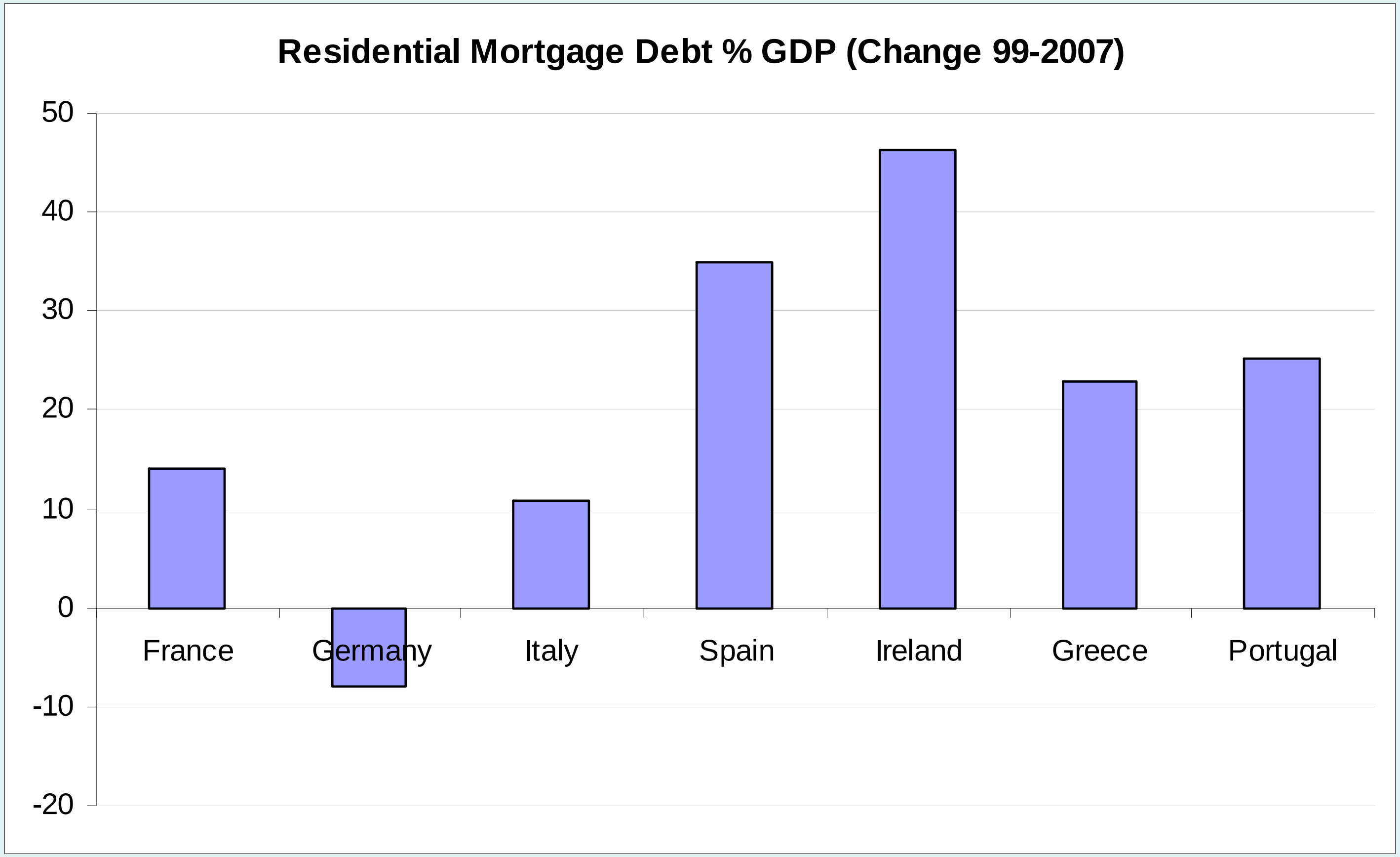
EA not Homogeneous in terms of Growth of Leverage

- Expansion of banking sector correlates well with house prices.
- DE: highest starting level but little increase.
- Italy: lowest starting level but big increase.
- Spain: biggest increase, overtakes German level.

Differences within EA (I)



Differences within EA (II)



Transatlantic Difference (?): Households Leverage

Households Liabilities/GDP	EUR	US
1999	0.54	0.73
2008 (Q3)	0.68	1.02
Change	0.15	0.29

No problem with Corporate Leverage?

Business Corporate Liabilities/GDP	EUR	US
1999	2.47	0.91
2008 (Q3)	2.47	0.90
Change	0.0	0.01

Not just a US Credit boom! (1)

Financial Sector Liabilities (Debt)/GDP	EUR	US
1999	1.89	0.79
2008 (Q3)	2.54	1.17
Change	0.65	0.38

Not just a US Credit boom! (2)

Total Liabilities (Debt)/GDP	EUR	US
1999	4.89	2.14
2008 (Q3)	5.69	2.94
Change	0.80	0.80