Insights into Differences in Response of the USA and the EURO Area to the Recent Crisis

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Abstract

The recent financial crisis followed by recession has strongly hit the economies of the USA and euro area. However, their fiscal policy tools available differ significantly, hence also the response of fiscal authorities of both monetary unions to the crisis. On the other hand, in the field of monetary policy, rather similar tools have been used, although with different timing and results so far. The aim of the paper is to underline the main differences and common features of the institutional response to the crisis in the USA and euro area, to compare the developments of selected macroeconomic indicators in the period 2007 – 2015 and formulate conclusions for both monetary unions. The first part of the paper deals with the response of the US Federal Reserve System (Fed) and the European Central Bank (ECB) to the recent crisis. In the second part, the focus is on different possibilities of fiscal policy response in both monetary unions – the USA as a fiscal union and the euro area as a monetary union without a fiscal union. In the third part, developments of selected macroeconomic indicators since the start of the crisis are analysed, namely economic growth, unemployment rate and general government gross debt. The key outcomes are summarized in conclusion.

Keywords: Euro area, USA, economic crisis, monetary policy, fiscal policy

Introduction

The reaction of responsible institutions to the recent financial crisis is unparalleled in US post-war history and sixteen years of the euro area's existence, both in terms of the need to act against all of its diverse forms (mortgage, credit, banking, debt crisis, crisis of demand, etc.) as well as in terms of the scope and the intensity of adopted monetary and fiscal measures.

When looking for reasons of different macroeconomic developments in the USA and euro area since the start of the crisis, a number of structural differences need to be taken into account. They include the existence of a functional fiscal union in the USA in contrast to the euro area, level of labour market flexibility as well as the status of the USD as the main reserve currency. In this paper, the focus will be particularly on parameters of policies conducted by central banks (Fed, ECB) and responsible fiscal authorities. The aim of the paper is to underline the main differences and common features of the institutional response to the crisis in the USA and euro area, to compare the developments of selected macroeconomic indicators in the period 2007 – 2015 and formulate conclusions for both monetary unions.

Response of monetary authorities

In the light of the debt crisis and the need for fiscal consolidation in advanced economies, monetary policy has become the main instrument for the support of aggregate demand and the re-start of business cycle expansion. Cukierman (2016) introduced several reasons for the differences in monetary policy instruments used in both monetary unions and their various effects. The first is a relatively greater caution and conservatism of the ECB compared with the Fed, as evidenced by the different intensity of quantitative easing (QE) policy implemented by these two institutions. In the period 2008-2012 the balance sheets of the two central banks have developed similarly. However, since the second half of 2012 further monetary expansion has been carried on only by the Fed, while the assets of the ECB have begun declining sharply. Reversal occurred only after launching the QE programme in 2015.[14]

The second difference is that the share of banks on total lending is greater in the euro area than in the USA, due to more developed capital markets in the USA compared with continental Europe. This is also why the structure of monetary operations varied between the ECB and Fed. While the former provided necessary liquidity to banks through REPO transactions, the operations of the latter were primarily carried through direct purchases of securities. Monetary base and money supply in the euro area were more sensitive to short-term fluctuations in demand for liquidity by banks, while in

[14] The ECB launched the QE programme in March 2015, with asset purchase plan of 60 billion euros a month, at least until September 2016 and in any case until the ECB sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. In December 2015, the ECB extended the asset purchase programme until the end of March 2017 and in March 2016 the monthly amount of purchases was increased to 80 billion euros, which means more than 1700 billion euros for the whole period. For comparison, during implementation of the QE programme in the USA (November 2008 – November 2014), the Fed pumped into the economy more money than the ECB. Total assets of all Federal Reserve Banks increased from 2074 billion to 4486 billion USD during this period.

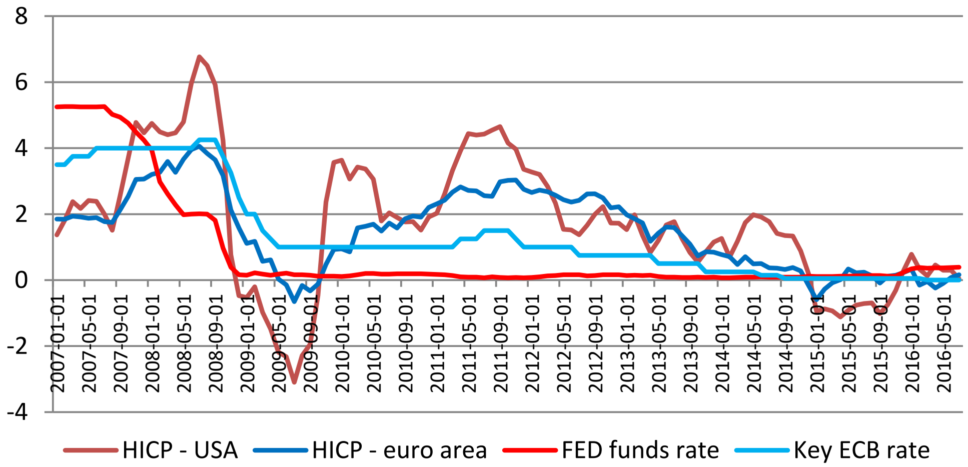
the USA monetary base was essentially influenced by decisions and policies conducted by the central bank. Hence, Fed's policy could be more efficient in terms of achieving defined objectives (full employment, price stability), which was also reflected in higher growth of asset prices.

At the first glance, it is obvious that the USA have achieved better results in parameters of GDP growth, inflation and unemployment, but as more detailed analysis shows, the results of implemented macroeconomic policies are not so straightforward. In the euro area, the current development does not suggest that extremely expansionary monetary policy (with a minimum space for further loosening available) could be successful without increased efforts of the Member States governments. The character of the ECB's monetary policy intensifies risks for future developments, whether it is risk of creating price bubbles or dependence on the QE policy, timing of finishing the programme and its consequences.

An interesting phenomenon of the recent crisis is the fact that virtually all advanced economies were negatively affected by increased deflationary pressures. The trend of decreasing inflation could be seen in the USA already since the eighties of the last century. However, since 2012 the US inflation is below its historical average (Figure 1), despite unprecedented monetary expansion. In 2015 even deflation was recorded, which occurred only shortly after the recession in 2009. This could indicate that the Fed's policy may not be so effective and the US economy could be closer to the recession than it might seem. The euro area was also confronted with the problem of deflation in 2009, although to a lesser extent than the USA, and the ECB is fighting this negative phenomenon again since the end of 2014.

Figure 1

US Fed funds rates and ECB's key interest rates, inflation rates in the USA and euro area (%)



Source: ECB (2016), Eurostat (2016), FRED (2016).

Already for a long time, deflation is a relevant problem in the Japanese economy. Although in the USA and euro area deflation is present for a relatively short period, it can pose a serious risk. The US and euro area authorities are well aware of this and therefore they have implemented unprecedented monetary expansion, leaving interest rates at historically low levels near zero or even at the zero level (USA for the eight consecutive year, euro area for the last three years) (Figure 1).

Response of fiscal authorities

Regardless of the economic development, expenditures of the US federal budget amounted around 19% of GDP for most of the 1985-2007 period. However, the scope and intensity of the Great Recession required unprecedented government intervention (banks bailouts, social transfers), increasing the share of federal budget expenditures up to 24.4 % of GDP in 2009 (White House, 2016).

An important parameter of the debt crisis, which highlights the nature of fiscal union in the USA, is the increase in transfer payments from the federal level down to the national and local governments. At the state and local governments' level, requirement for balanced budgets (in the light of falling tax revenues and rising expenditures) was compensated by an increase in transfer aid from the federal level. In term of the debt crisis' negative impact on the budgets of the euro area Member States, there are obvious positive effects from the existence of fiscal union in the USA. In contrast to the euro area, the USA could afford record growth of spending at the federal level, enabling effective compensation for the negative impact the debt crisis had on the aggregate demand.

Integral part of this process was postponement of enforcement or direct increases of limits for the amount of federal debt. Such action has taken place eleven times since 2007. Historically nothing exceptional, since after the end of World War II this happened more than ninety times. In the USA, the process of determining the debt limit is separated from the creation of the federal budget and therefore the limit does not restrict the government´s ability to operate with budget deficits or under new commitments (White House, 2016). Increased deficits and higher debt limits are natural consequence of weaker economic activity and the loss of tax revenues as well as of the growth of expenditures due to financial crisis' negative consequences.

Expansionary fiscal policy at the federal level has played an important role when offsetting the effects that crisis and subsequent recession imposed on the budgets of individual states and local governments. Federal government response to the crisis has been relatively straightforward, compensating at least partially for the loss in the private demand (2009-2013) which occurred during the deleveraging of households and businesses. Hence, the growth of public debt created counterweight to a record-high private debt and the process of deleveraging.

On the other hand, restrictive fiscal policies implemented in the euro area, in particular from 2011 to 2013, had rather negative impact on economic growth and labour market developments. Fiscal austerity worsened recession mostly in Greece and other periphery countries, hence, debt-to-GDP ratios increased faster.

In contrast to the USA, the euro area is not a fiscal union, which represents a disadvantage from the view of both economic theory and economic reality. The recent crisis, with its consequences for the euro area, has revealed the necessity to face this shortage. Mechanisms of solidarity in the euro area are not at the level of the American federal fiscal system at all. The US system contributes to stabilization of regions hit by asymmetric shocks. The centralised budget of the whole European Union is low – approximately 1 % of GDP (versus almost 20 % GDP in the USA), which means about 2 % of public expenditure in the EU Member States (versus more than 50 % of total public expenditure in the USA) – and in case of asymmetric shocks in individual countries, it does not work as an automatic stabilizer. Although the euro area (more precisely the whole EU) has a kind of solidarity mechanism available - the Structural Funds and the Cohesion Fund (aimed to promote economic convergence and reduce disparities among the Member States), these cannot be considered as sufficient compensation, due to their lower volume and medium- or long-term effects, which means that they do not work anticyclically (Iša, 2002).

According to D'Apice (2016), yearly cross-border flows within the USA amounted to 1.5 % of GDP between 1980 and 2005 on average, compared to 0.25 % in the EU for 2007 to 2013. For each euro paid by an average net contributor (EU Member State), approximately 75 cents return through the EU budget, and 25 cents cross a border. Although the US federal budget is less redistributive in normal times (around 90 cents per dollar returning to the contributing state), in the wake of the global crisis net cross-border fiscal flows increased strongly, financed by federal borrowing. Moreover, the main net beneficiaries of the EU cohesion policy funds are not yet members of the euro area, which implies that cross-border flows within the euro area are even closer to zero.

The euro area tries to solve the absence of fiscal union. According to the so-called *Five Presidents' Report*[15] *Completing Europe's Economic and Monetary Union* (Juncker, Tusk, Dijsselbloem, Draghi and Schultz, 2015), a

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[15] President of the European Commission in cooperation with the President of the European Council, President of the Eurogroup (eurozone Finance Ministers), President of the ECB and the President of the European Parliament.

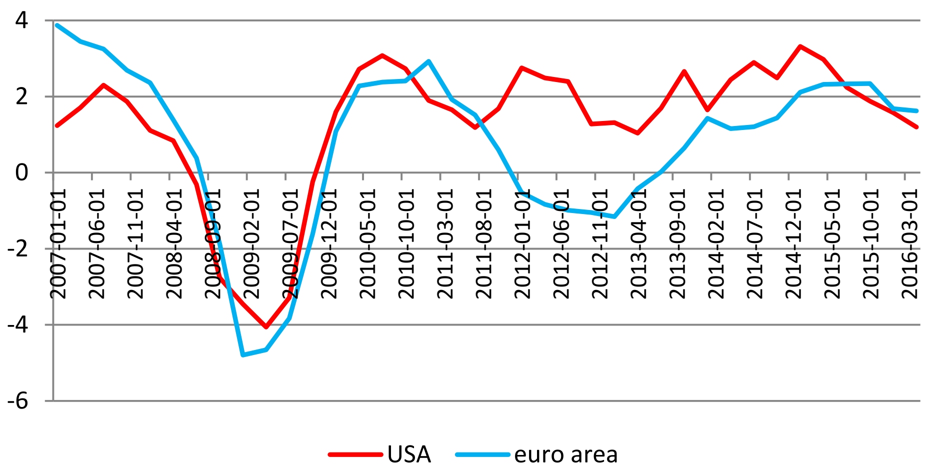
stabilizing function of the euro area should be formed to improve the cushioning of asymmetric shocks in future. The European unemployment benefit scheme is among the most considered solutions. It could take many forms; the main types are reinsurance and genuine schemes (for more detail, see Gros, 2016).

Development of selected macroeconomic indicators

At the beginning of 2009, the US economy has experienced significant decline in real GDP growth exceeding 4 % at the annual level (Figure 2). Responsible authorities were obliged to respond and revive the expansion of economic cycle as soon as possible. The US economy was able to start the expansion relatively quickly, especially when compared with other advanced economies. The quarterly growth rates of real GDP in the USA averaged 2 % since the end of the recession until the first quarter of 2016 (FRED, 2016).

Figure 2

Year-to-year changes in real GDP in the USA and euro area (%)



Source: FRED (2016).

In this regard it can be concluded that measures taken by responsible US authorities were effective. But after looking at the evolution of GDP in more detail manner, some doubts about the policy achievements have to be expressed. It is, for example, very unusual to experience quarter-to-quarter fall in real GDP during the expansion of business cycle (in first quarters of 2011 and 2015). That certainly does not suggest sufficiently robust expansion when compared with episodes of business cycles in the past.[16]

[16] Last time something like this happened during the fifties of the last century.

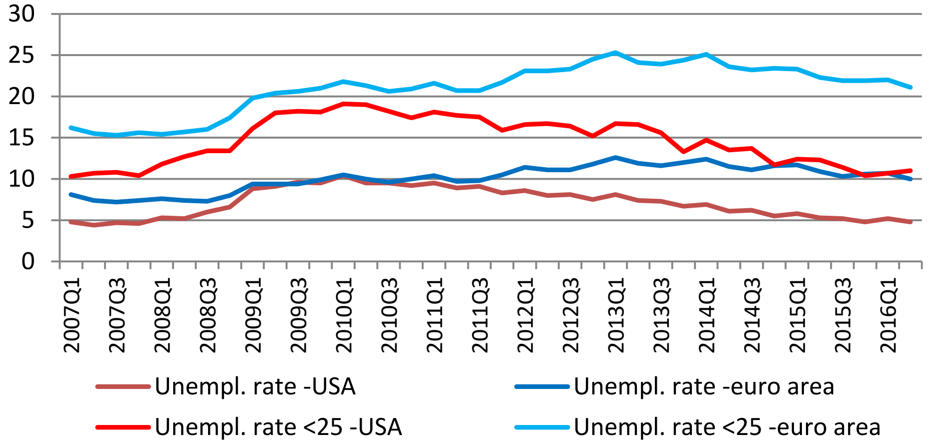
The euro area experienced similarly deep recession in 2009 as the USA; however, the economy of the European monetary union did not recover as quickly as the US economy. In 2012, after two years of economic growth, the euro area lost dynamics and recorded the second recession in this millennium, although a more modest one compared with the one in 2009. The reasons behind such development include weak investments and private consumption, due to increased uncertainty, continued fiscal consolidation, weaker foreign demand as well as growing unemployment. These two recessions can be considered as one crisis period with two bottoms – the first caused by the global financial crisis and the second (less deep) one as a result of the European debt crisis.

One reason for such a slow recovery might be pro-cyclical fiscal tightening. That is why the effectiveness of the EU's fiscal framework[17] has been questioned recently, whether it is in achieving fiscal stabilization or public debt sustainability. In addition, the existing EU's fiscal rules have not been properly applied so far.

USA seems to be more successful also in terms of labour market developments. The unemployment rate reached more than 10 % in October 2009, the second highest level since the end of the World War II. Due to the higher economic growth as well as more flexible labour market, when compared with the euro area, the US economy was able to get unemployment back to the levels close to its natural level relatively quickly (below 5% in 2016) (Figure 3).

Figure 3

Unemployment rate and youth unemployment rate in the USA and euro area (%)



Source: Eurostat (2016).

[17] The Stability and Growth Pact, the Fiscal Compact, the so called Six-Pack and Two-Pack.

On the contrary, unemployment rate in the euro area continued to grow after exceeding 10 % in the end of 2010, reaching even 12.6 % at the beginning of 2013. Currently, unemployment rate is again at the level of about 10 %, with one half representing long-term unemployment. However, the differences among the individual Member States are rather big – on the one hand, Germany and the Czech Republic recorded in the second quarter of 2016 the lowest unemployment rate (about 4 %), and Greece, on the other hand, the highest one (23 %).

Similar trends can be seen in the developments of unemployment rates in the active population under 25 years. While since 2010 this indicator has fallen from more than 19 % to the current level of about 11 % in the USA, the euro area recorded maximum of 25 % at the beginning of 2013, followed by stagnation or decrease to currently recorded 21 % unemployed in the active population of young people (Figure 3).

At first sight, labour market development and job creation may indicate effectiveness of the Fed´s actions. However, on closer look it turns out that the current revitalization of labour market was the longest one, only comparable with the recovery right after the World War II. It suggests that the US economy is no longer able to generate new jobs in such a fast pace as before. Besides, most of the newly created jobs are low-paid positions in the service sector. This fact combined with rising number of part-time work contracts diminished opportunities for higher earnings, hence leading to higher working poverty and income polarization.

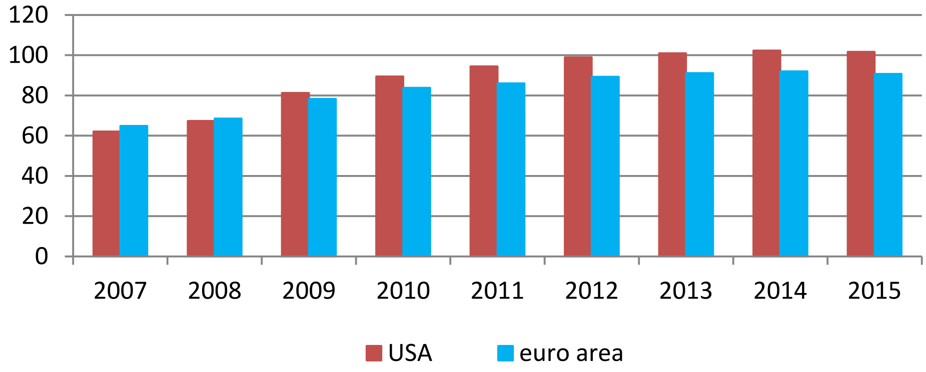
The euro area registers double unemployment rate (total as well as in the young population) compared with the USA, although also in Europe the use of part-time jobs increased. Given the growing share of part-time employed, the overall amount of hours worked did not still exceed the level reached in 2008 in the euro area. Structural unemployment remains one of the key problems in the European labour market, in particular within the group of low-skilled people.

Both monetary unions the euro area and the USA face risks related to indebtedness of the public as well as private sector. Given rather significant differences in the field of fiscal policy, attention is further paid to government debts.

Prior to the recent crisis, the growth of the public debt did not pose any significant threat to the US economy and was kept under control. In 2007 it amounted to about the same level as ten years before. Its rapid growth to record levels, even from historical perspective, begun with the financial crisis and subsequent recession after 2008. Public debt has risen from 62 % of GDP in 2007 to more than 100 % of GDP in 2015 (FRED, 2016) (Figure 4). It is a result of weaker economic activity and the loss of tax revenues as well as the growth of expenditures to overcome negative effects of the financial crisis.

Figure 4

Government debt in the USA and euro area (% of GDP)



Source: Eurostat (2016), FRED (2016).

Government debt of the euro area as a percentage of GDP has also increased since 2007 and already in 2009 it exceeded the 1999 level (71 % of GDP). In 2015 it slightly decreased for the first time since the beginning of the recent crisis, namely to 90.7 % of GDP. This decrease has been possible due to a slightly faster economic growth and extremely low interest rates. However, it needs to be underlined that in absolute terms the volume of debt further increased in 2015. Out of nineteen euro area Member States, five registered the government debt above 100 % of GDP (Greece, Italy, Portugal, Cyprus, and Belgium) and further nine countries above 60 % of GDP defined in the Stability and Growth Pact.

Conclusion

Recent macroeconomic performance of the two monetary unions resulted also from different reaction of responsible institutions to the financial crisis and the Great Recession, whether it was in the field of fiscal or monetary policy. In spite of these differences, the USA and the euro area face a number of similar risks including deflation, timing of the QE programme or the rise of public debt.

Programme of QE realized by the Fed has lasted for six years to bring results in terms of macroeconomic indicators. Therefore, it is reasonable to expect that a similar programme in the euro area realized by the ECB should have comparable length and intensity to be effective. In terms of fiscal policy, the US fiscal union provided needed spending at the federal level which enabled financial compensation for negative effects the debt crisis imposed on budgets of individual states, nevertheless leading to increase of the public debt at the federal level. On the other hand, it would be essential for the euro area to establish a new efficient institutional framework for stabilisation of asymmetric shocks in order to eliminate shortages resulting from the absence of a fiscal union.

When comparing economic developments in the USA and in the euro area after the Great Recession in terms of macroeconomic indicators as GDP growth, the rate of unemployment or inflation, it can be concluded that the USA outperformed the euro area in general. However, a closer look at structural indicators reveals weaker economic expansion as well as lower ability of the US economy to create new jobs with similar pace as during the previous expansions. On the other hand, there are still only weak signs of recovery in the euro area manifested in economic performance and in the labour market development. Since the beginning of the crisis the government debt to GDP ratio has increased to historically record levels in both monetary unions. In the absence of fiscal consolidation and in the light of future budget expenditure challenges (e.g. population ageing), sustainability of public finances could be endangered.

Note

The paper was elaborated with the support of grant VEGA No. 2/0070/15 and grant VEGA No. 2/0109/16.

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