ABSTRACT

- Europe is struggling very hard from crisis to recovery since the 2007 crisis. But it seems that the recovery in Europe is neither robust nor sufficiently strong. Various researches propose the possibility of a lost decade in Europe like Japan`s experience.
- I will analyze the similar conditions and factors in Europe and Japan, focusing on banking issues and structural problems. The monetary, financial and political reforms integrated in the whole region system wait for reviewing, regulating and rebuilding. The reforms of EU will be tough and the process of reforms even reversal is remarkable.

CONTENTS

1. Introduction

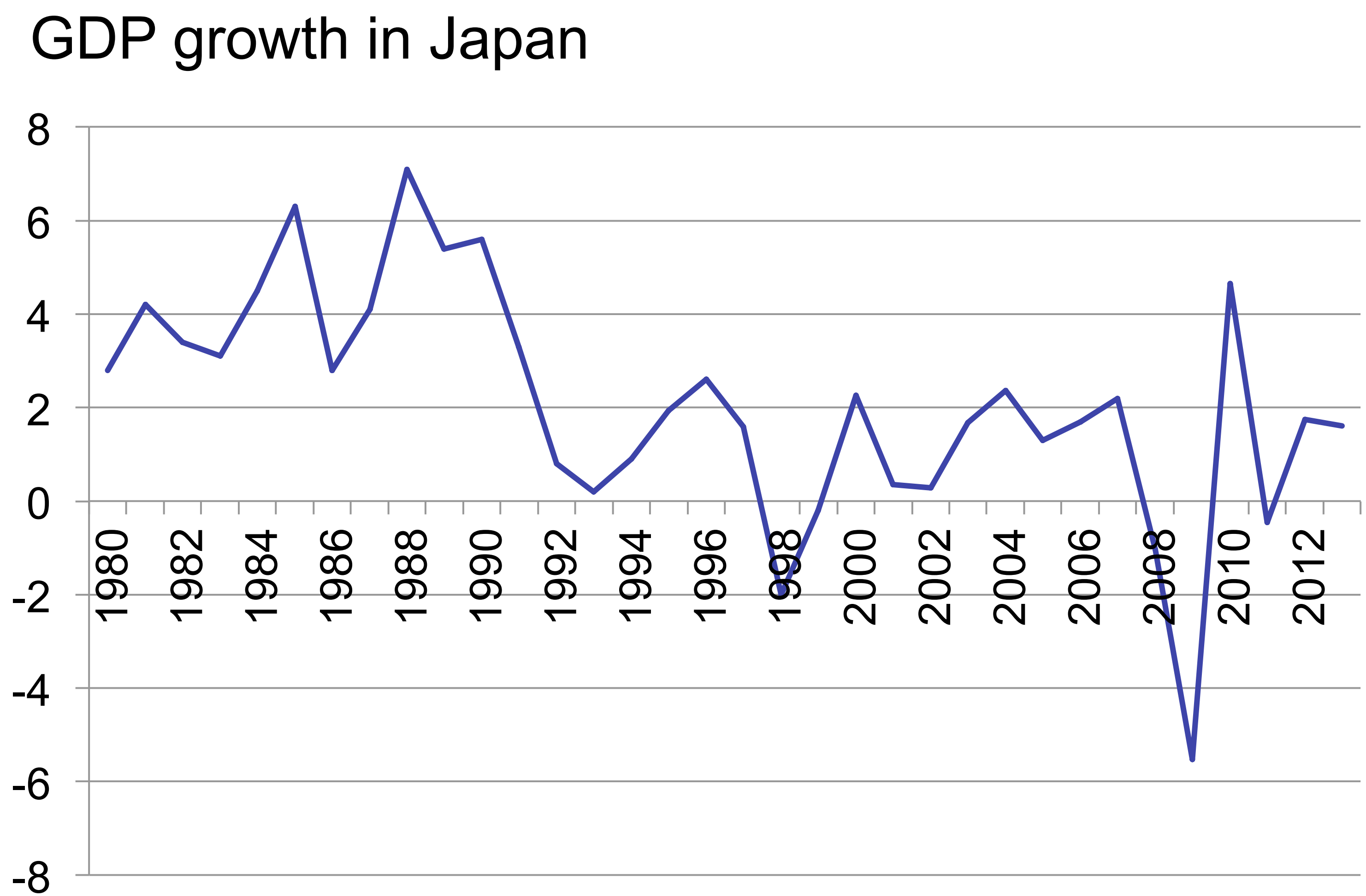
- The recovery in Europe is neither robust nor sufficiently strong. Many researchers hold the view that the Euro area will follow Japan`s path to long economic stagnation (Takeo Hoshi and Anil Kashyap, 2013; Christoph Schaltegger, 2013; Koo Richard, 2011, etc.).
- Hoshi and Kashyap show that there are two aspects of post crisis economic policy of Japan and Euro area: <u>the delay in bank recapitalization and the lack of structural reforms.</u> These two policy shortcomings are key factors of stagnant post-crisis growth.
- Euro area will probably face a lost decade like Japan`s experience. And the situations are more complex in Europe.

CONTENTS

2. What can we learn: similarities with Japan

- 2.1 The overview of Japan`s post crisis
  - Many factors are considered as causes of the Japan`s post crisis. Two key policy mistakes are closely related to the lost decade.
    - ✓ the failure to recapitalize the banks
    - ✓ the failure to address structural growth problems

2. What can we learn: similarities with Japan



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2. What can we learn: similarities with Japan

- 2.1 The overview of Japan`s post crisis
  - The first critical mistake was the failure to clean up bank balance sheets and recapitalize the banks.
  - Some research suggests that the system of relationship banking caused the prolonged fragility of the Japanese banking sector (Masaharu and Horiuchi, 2000, 2003).

2. What can we learn: similarities with Japan

2.1 The overview of Japan`s post crisis

- The second critical mistake was the failure to recognize the need for structural reforms to sustain growth. Many government statements and policies were focused on very short-term issues and many fiscal policy choices were aimed at near-term stimulus.
- The various political parties to try to protect their favored constituents form fully facing all the associated risks of a stagnant economy was probably the most important reason why the structural reforms did not proceed rapidly in Japan.

2. What can we learn: similarities with Japan

- 2.2 Banking Issues in Europe
  - Before 2010, the process of banking recapitalization is very slow in Europe. And governments seem to dissemble the severity of the problem, which is similar to the situation in Post crisis Japan.
  - In both cases, the banks remained undercapitalized well after the acute phase of crises. These conditions occurred in part because of the authorities` reluctance to admit the size of the problem and because of policies that allowed the banks to avoid sanctions.

2. What can we learn: similarities with Japan

2.2 Banking Issues in Europe

- Europe banking issues are a bit different from Japan`s in the sovereign-bank nexus. Domestic banks become the main creditor to national governments in Europe, making the reforms more difficult. We should sanitize both bank balance sheets and public finances and to break the link between the banks and sovereigns.

2. What can we learn: similarities with Japan

- 2.2 Banking Issues in Europe
  - The banking recovery is well underway recently. In October 2014, ECB published the aggregate report on the comprehensive assessment.
  - The ECB`s Comprehensive Assessment of bank sheets is proceeding well. And banks falling below the required capital ratio will be expected to remedy the shortfall speedily. The key step right now is the implementation of banks. We will wait and see how well the exercise will be.

2. What can we learn: similarities with Japan

- 2.3 Structural Problems in Europe
  - Carton, Héricourt and Tripier (2014) show that there is currently a moderate to high risk of production capacities in the Euro Area being permanently impaired. The risk relates mostly to the prolonged period of stalled investment and persistent unemployment, with its detrimental effect on human capital. In addition, paying off past debt will be painful to both the public and private sectors, in particular in the context of a low inflation environment.

2. What can we learn: similarities with Japan

- 2.3 Structural Problems in Europe
  - The lessons we can learn from Japan`s experience are to realize and practice structural reforms as soon as possible. But like the situations in Japan, the politics is a significant factor of structural reforms. European countries also face the politics obstacle of further reforms. The crisis and recession weakened the political leaders in Europe, which makes the long-term structural reforms questionable.

2. What can we learn: similarities with Japan

- 2.4 The difference and difficulty of Europe
  - Europe shares many similarities with Japan`s experience. The key lessons we can learn are bank capitalization and structural reforms. Some countries seem to follow the Japan`s lead to a lost decade.
  - Case study approach cannot be overextended. Europe and Japan do share some similarities but there are some differences making the recovery and reforms in Europe much more difficult.

2. What can we learn: similarities with Japan

- 2.4 The difference and difficulty of Europe
  - The first obvious difference between Europe and Japan is that Europe has more than one crisis.
    - ✓ There are three crises in Europe: the banking crisis, the sovereign debt crisis and the macroeconomic crisis, which makes the recovery and reforms very complicated.
  - The second remarkable difference is that the cross-country political dynamic makes negotiations and policies much more complicated in Europe.

2. What can we learn: similarities with Japan

- 2.4 The difference and difficulty of Europe
  - A very typical case of this difficulty is that some countries are always breaking rules and criteria to maximize their own interests. Few countries obey the Convergence Criteria in EU and some countries almost never fulfill certain conditions. And there is scarcely any French-German Compromise on Policy Convergence, let alone other countries.

CONTENTS

3. Where are we going: policy choices

- 3.1 New framework
  - The financial crisis in 2007 and 2008 revealed serious weaknesses in the structure and exercise of supervision of national institutions and the financial system as a whole. The monetary, financial and political reforms integrated in the whole region system wait for reviewing, regulating and rebuilding. A more cohesive financial supervision system, a more effective and flexible fiscal system and a more coordinated politics are needed in Europe.

3. Where are we going: policy choices

- 3.1 New framework
  - 3.1.1 System of financial supervision
    - ✓ First of all, the crisis showed us the weaknesses of the financial supervision. Supervisory systems based on national models proved inadequate in the integrated and interrelated European financial markets. Further reforms are on the way to rebuilding and reregulating the system. And the critical element in the design of the institutional framework for financial supervision is the appropriate level of (de)centralization because of the financial trilemma.
    - ✓ The IMF Staff Report for the 2014 Article IV Consultation of Euro Area Policies give us three aspects of this issue: Single Supervisory Mechanism (SSM), Single Resolution Mechanism and Fund (SRM/SRF) and Backstop.

3. Where are we going: policy choices

- 3.1 New framework
  - 3.1.2 Fiscal system
    - ✓ Europe has made substantial progress with fiscal consolidation over the past few years. In the euro area, the average budget deficit has halved compared with the peak level during the crisis. This has created some room for slowing the pace of consolidation. And many countries are fed up with the austerity policies with low growth rates, gloomy market confidence, and sociopolitical instability. The changes of Fiscal policy are inevitable in Europe.
    - ✓ But the choice of the fiscal policy is really difficult and there are no consensuses on the theory and practice. The reason for this uncertainty is that fiscal policy itself is very complex comparing to the monetary policy. Fiscal policy has many instruments and goals and instruments to achieve goals sometimes conflict with each other.

Growth in a Time of Debt

- Reinhart, Carmen M., and Kenneth S. Rogoff. 2010. *American Economic Review*, 100(2): 573-78.
- Politicians, commentators, and activists widely cited the paper in political debates over the effectiveness of austerity in fiscal policy for debt-burdened economies.
- The paper argues that when "gross external debt reaches 60 percent of GDP", a country's annual growth declined by two percent, and "for levels of external debt in excess of 90 percent" GDP growth was "roughly cut in half.“
- Appearing in the aftermath of the financial crisis of 2007–2008, it provided support for pro-austerity policies. In 2013, academic critics demonstrated that the paper used flawed methodology, and that the underlying data did not support the authors' conclusions. Consequently, its critics hold that this paper led to unjustified adoption of austerity policies for countries with various levels of public debt.

Two Tales of Adjustment: East Asian Lessons for European Growth

- Chari, Anusha, and Peter Blair Henry. *IMF Economic Review* (2015).
- Hit by the Global Financial Crisis in 2008, Europe fell into recession and Euro Zone governments implemented expansionary fiscal policy to counteract the shock. In 2010, they changed tack and pursued fiscal consolidation.
- East Asia was also hit by a financial crisis (1997-1998), but unlike their European counterparts, they consistently pursued expansionary to neutral fiscal policy until their economies recovered. Prior to the crisis of 2008, the average annual growth rate of the East Asian crisis countries exceeded that of the European Periphery by 4.21 percentage points. After the European pivot to fiscal consolidation, this difference widened to 7.13 percentage points.

Two Tales of Adjustment: East Asian Lessons for European Growth

- The 2.92 percentage-point increase in the difference in difference is statistically significant. Panel regressions that control for country-fixed effects, changes in exchange rates, and differences in debt-to-GDP ratios confirm that Europe pivot from stimulus to austerity had a negative and statistically significant impact on European growth.
- The difference in fiscal stance helps explain the difference in the post-crisis paths of output and employment in the two regions.

Two Tales of Adjustment: East Asian Lessons for European Growth

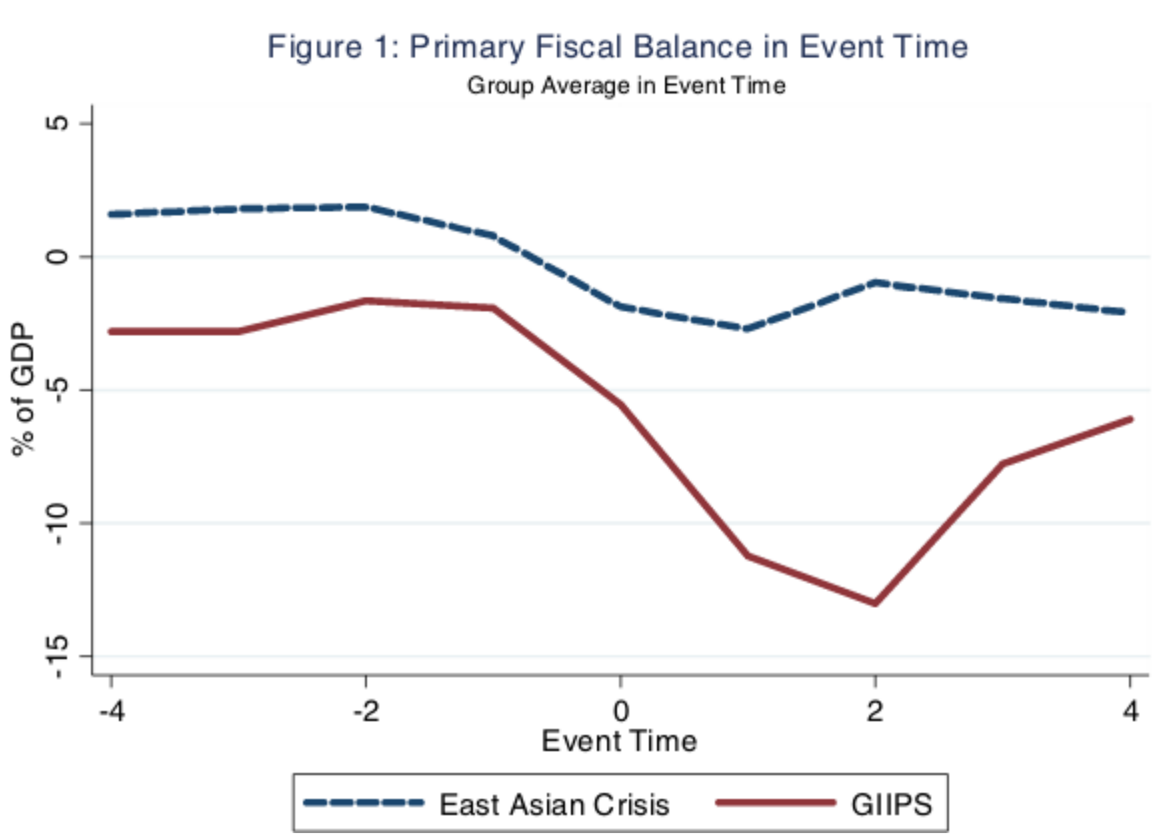

Figure 1. Policymakers in Asia and Europe adopted very different approaches to fiscal policy following their financial crises.

Two Tales of Adjustment: East Asian Lessons for European Growth

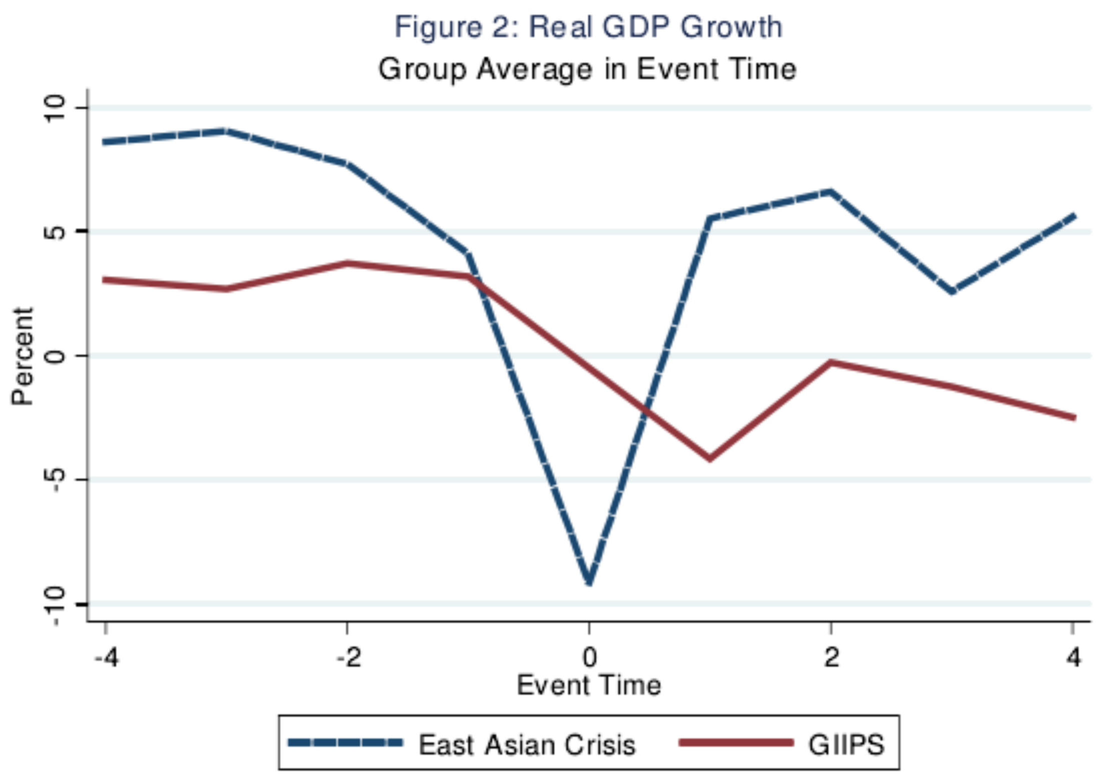

Figure 2. Growth in Asia following the Asian Financial Crisis rebounds more quickly than growth in the European Periphery countries following the 2008 Financial Crisis.

3. Where are we going: policy choices

- 3.1 New framework
  - 3.1.2 Fiscal system
    - ✓ The enforcement of Stability and Growth Pact was a failure and Eurozone countries almost never meet the Convergence Criteria including even Germany and France. The heterogeneous of countries make the process almost impossible to achieve.
    - ✓ While the SGP as a coordinating device at the European level is debatable, since it imposes coordination from the bottom, limiting the space for future fiscal policies that could in principle be beneficial in the short as well as in the long run. The debate on whether to strengthen governance only in the direction of a more rigidly disciplined fiscal policy and the macroeconomic results are still unresolved.

3. Where are we going: policy choices

- 3.1 New framework
  - 3.1.3 Governance and politics
    - ✓ There is trilemma of politics in Europe similar to the financial trilemma. Dani Rodrik (2000) first raised the concept of political trilemma: trade-offs among integrated national economies, nation state and mass politics. Any reform of the international economic system must face up to this trilemma. If we want more globalization, we must either give up some democracy or some national sovereignty.

3. Where are we going: policy choices

- 3.1 New framework
  - 3.1.3 Governance and politics
    - ✓ We can see the imbalance and trilemma happen all the time in Europe, not only in indebted countries but also in creditor countries, and not only in periphery countries but also in core countries. Every step to convergence would be really difficult although some progress has been made. So the reforms are more than economic reforms.
    - ✓ No final verdict of the structural and framework reforms is possible at this time, since the proposals and recommendations issued by the various bodies have to go through the political process. As Semmler and Young (2010) say, the challenge for the multilevel governance system of finance is to find a way to regulate without refragmentation both at the European and the global level. And the future of Europe largely depends on the political attitudes of different countries.

3. Where are we going: policy choices

- 3.2 Structural reforms
  - Structural reforms are the most efficient way to increase potential growth in the long run and solve the severe unemployment problem in Europe. Structural reforms can play an important role in reviving investment, employment, and productivity, as well as resolving intra-euro area imbalances.
  - Lessons of Japan`s lost decade highlight the importance of structural reforms in Europe. The term a “lost decade” in Japan not only means the poor economic outcomes, but also the failure of structural reforms. That is to say, what was “lost” was not only current growth, but the opportunity to fix its underlying problems and lay the foundations for future growth.

3. Where are we going: policy choices

3.2 Structural reforms

- Europe is on the way of practicing structural reforms. The Europe 2020 growth strategy pursues smart growth, sustainable growth and inclusive growth. But few changes have actually happened.
  - ✓ The structural reforms are diverse and mutually supportive. Action can be taken to improve participation in the labour market, to make tax structures supportive of private investment and to make sure that fiscal consolidation plans do not sacrifice socially profitable public investment.
- To figure out the mechanism of innovations is the key factor to revive economies. The structural reforms await further exploration along with great rewards..

CONTENTS

4. Conclusions

- Compared with Japan`s experience, the Europe is faced with similar banking and structural issues. But the situation in Europe is much more complex than that of Japan. Many reforms are on the way but the re-regulation and rebuild process is far from completed.
- Monetary, fiscal and structural policies are complementary tools to promote a faster and more widely shared recovery in Europe but few consensuses have been made in the practice of specific reforms. A new framework should be built, coordinating various systems and countries in EU.

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