Book Review:

Lacina, L., Rozmahel, P., Rusek, A. (eds.),

Eurozone and Its Neighbors: The Third Year of Crisis

Bucovice: Martin Striz Publishing, 2012

The "Great recession" of 2008/09 relentlessly revealed the weak points of the institutional and economic setting in the European Economic and Monetary Union (EMU) and posed an existential threat to the European integration process for the first time in history. Not surprisingly this provoked a huge literature on problems of the Eurozone and its possible solutions, whereby results and suggestions are all but homogenous so far, given the multi-faceted nature of the crisis (sovereign debt crisis, banking crisis, recession from austerity measures). The book edited by *Lacina, Rozmahel* and *Rusek* is of course not able to unify this now multi-voiced reasoning. However, it contributes valuably to the literature, in providing a fresh view onto the topic from the perspective of the New Member States.

The editors gathered 17 authors from universities and research institutes in the Czech Republic, Poland, Austria and the US to think about the problems mentioned. The resulting contributions are broad in range what concerns topics as well as quality, and it certainly was not an easy task to consolidate them to a well structured book following a clear internal logic. The editors succeeded by clustering the papers in three parts and an Epilogue, which tries to build on the results by discussing possible scenarios for the future of the Eurozone.

The first part discusses the Eurozone problems in general and hints at possible solutions, featuring papers on the possibility of stagflation in the Area (*Smrcka*), on the effects of a debt relief ("haircut") in EMU's "core" and "periphery" countries (*Blueschke - Neck*), and on the idea of introducing a parallel currency alongside the Euro in the latter to mitigate the effects of adjustment and restore competitiveness in countries most affected by the sovereign debt crisis (*Rusak*; *Koráb – Buresová*). From a methodological standpoint the paper of *Blueschke – Neck* stands out here. They present a dynamic game model of an asymmetric EMU with "core" and "periphery" (defined by initial public debt levels) that takes the interactions between the governments of these country groups and a common central bank into account. Calibrating the model to economic indicators of the present 17 Euro Area, the authors provide numerical solutions for a ("no policy") simulation of the demand shock of the "great recession", a scenario including the reactions of policy makers according to their preferences, and a simulation including a "hair cut" in the periphery. Thereby all these simulations were run for different strategy choices of the policy makers (noncooperative Nash feedback solution vs. cooperative Pareto solution). The results show that for major target variables (including debt levels) a scenario with policy reactions by far outperforms a "no policy" scenario (providing support for an active policy stance in crisis), that a cooperative solution is preferable to a non-cooperative equilibrium (providing an argument for a

coordinated fiscal policy in EMU), and that a debt relief ("haircut") for the periphery is disadvantageous for both EMU country groups, due to anticipating reactions in the periphery and a higher risk premium after the haircut. The last result is especially interesting, given that a (longer-run) positive relationship between a default and subsequent borrowing conditions so far was suggested by theory[1], but did not show up unambiguously in 30 years of empirical research[2]. However, recent results[3] building on restructuring details show that the size of a "haircut" matters in this respect, and Blueschke – Neck build on these results to calibrate the respective exogenous variable in their model.

Part Two of the book provides evidence on the impact of the financial and economic crisis on Non - Euro Area EU countries – a part especially useful given the usually narrow focus of the actual governance debate on the Euro Area proper. We find papers on the effects of the crisis on the liquidity position of Slovak commercial banks (*Vodová*), on the relationship between economic performance and government spending in the Czech Republic (*Szarowská*), as well as two comparative studies on the very heterogeneous experiences of (comparable) Non – Euro Area EU countries in the "great recession" (*Koronowski*; *Sitz*). Here *Koronowski* compares the development of Estonia and Hungary as countries with major differences in monetary (currency board vs. floating exchange rate) and fiscal policy (fiscal discipline vs. large deficits before the crisis), pointing to the importance of the exchange rate as a balance of payment adjustment mechanism. His conclusion that "good fiscal stance is good but it cannot substitute for flexible exchange rates in the case of external shocks" may be exaggerated. Nonetheless, the high volatility of the FDI-driven Estonian development path may actually demonstrate the danger of "boom and bust cycles" in small countries with a pegged exchange rate (but no common currency). *Sitz* in a broader analysis of neighboring countries in the Eastern part of the EU (but with a special emphasis von Poland and the Baltic Countries) confirms the influence of the exchange rate regime on the economic impact of the "great recession". In addition he highlights the diverse reactions of economic policy and (not the least) vastly different degrees of international indebtedness and encumbrance in foreign currency as essential factors of performance in times of crisis.

Part Three of the book is – somewhat unsatisfactory - entitled "miscellaneous", but essentially deals with instrumental issues in crisis. Here *Vavrina – Janová* perform a nice empirical test of the validity of different corporate bankruptcy prediction models (step-wise discriminant analysis vs. Data Envelopment Analysis methods) based on a sample of Czech agricultural enterprises in the "great recession", while *Wieliczko* demonstrates that the EU's Common Agricultural Policy do not succeed in establishing a level playing field (i.e. a single market),

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[1]) see e.g. Eaton, J., Gersovitz, M., "Debt with Potential Repudiation: Theoretical and Empirical Analysis", Review of Economic Studies, 48(2), 1981, 289-309.

2) e.g. Bulow, J., Rogoff, K.S., "Sovereign Debt: Is to Forgive to Forget?", American Economic Review, 79(1), 1989, 43-50; and for a recent survey Panizza, U., Sturzenegger, F., Zettelmeyer, J., "The Economics and Law of Sovereign Debt and Default", Journal of Economic Literature, 47(3), 2009, 651-698.

[3]) Cruces, J.J., Trebesch, C., „Sovereign Defaults: The Price of Haircuts", CESifo Working Paper, 3604, Munich, 2011.

given wide differences in CAP design and implementation in EU member states. From a more theoretical perspective, *Otáhal – Rybácek* employing a rent-seeking model with endogenous rents argue that tight and centralized financial regulations may increase the risk of inflation, and *Wawrosz's* interesting paper asks for a reappraisal of the now dominant "New Consensus in Macroeconomics" (NCM) and its economic policy implications (especially inflation targeting) in the light of recent economic incidents. Indeed, the crisis casted a dazzling light on essential shortcomings of this now dominant theoretical approach (e.g. the sticking on a long-term equilibrium, the inobservance of the role of disequilibrium prices, the postulate of fiscal policy ineffectiveness), and central assumptions like forward looking agents without liquidity restrictions and with perfect information and on a perfect capital market may sound more like a bitter joke in view of recent experiences. The Author's opinion is rather mild in this respect. Although Wawrosz does not deny that the policy of cheap money in the first half of the 2000s as well as the non-consideration of asset price inflation (both to a certain extend descending from NCM reasoning) contributed to the recent crisis, he concludes that "the NCM models showed their validity in times of economic growth" and that "expansions of the NCM models for cases of crisis.." were needed. Indeed, a feasible economic theory should be valid in good as well as bad times, and one may wonder if this can be guaranteed by some "expansions" in the case of the NCM, given some of its (core) assumptions.

Summing up, the book presents a lot of interesting and in part very useful papers on a central topic in recent economics. This makes it a contribution worth reading. Having said this, two suggestions remain. From a methodological kind of view more caution in using historical narratives and analogues would have been desirable in some places. Is it really possible to draw conclusions for the risk of stagflation in the Euro Area from developments in the Western Roman Empire 200 AD? Is it really useful to draw upon a narrative of "wild cat banking" in the US in 1817-1863 (a period with uncontrolled state banking and no National Bank Act) when thinking about the relationship between regulation and inflation after crisis? And is it really feasible to underpin the idea of a parallel currency for EA "peripheral" countries by the experience of "dollarization" in e.g. South American countries, given that the $ appeared as a parallel currency here due to weak national currencies not able to fulfill their function as a store of value (the exact opposite of the situation in the EU periphery)? The reviewer is not really convinced here.

With regard to contents a contribution summarizing the recent measures at the EA level to fix the macroeconomic problems would have been a valuable feature of the book. Remarkable proceedings were achieved here in 2012, but they are hardly reflected in the book. This may be seen as a shortcoming, as these proceedings may ease the unpleasant situation of having "no alternatives" to a) a full fiscal union (politically not feasible), b) a strong internal devaluation in indebted EA countries (economically extremely costly), or c) a break-up of the Euro Area (dangerous for stability) – a dilemma, which runs like a common thread through the macro parts of the book. After all an European Stability Mechanism (ESM) safety net now provides access to finance in cases of acute market-financing difficulty, a

very sizable provisioning of liquidity by the European Central Bank helped to prevent a major banking crisis, and the agreement to form a banking union is without doubt a step to break the vicious circle connecting banks and sovereigns[4]. Last but not least the commitment of the ECB to unlimited support of the government bond markets was a "game changer" in the Eurozone crisis, as it pacified bond markets and led to a strong decline in the spreads of the Eurozone countries. Obviously, the surging spreads from 2010 to mid 2012 when the ECB announced its outright monetary transactions programme (OMT) were driven not least by collective movements of fear and panic, and the ECB's commitment to a role as lender-of-last was able to counter these market sentiments – without firing a single shot so far. However, as pointed out by *DeGrauwe – Ji*[5] recently, this stunning market reaction also shows that financial markets provided wrong signals since the start of the debt crisis – not the least also to the European authorities, which translated the market panic into excessive austerity programs (with the effect of extensive economic and social tensions in the countries concerned).

Of course the recent success of the ECB in stabilizing financial markets didn't resolve the troubles in the Eurozone sustainably, but it bought time to do the right things now – less driven by hasty reactions to market sentiments but by rational decision-making. Of course it will be necessary to get the fundamentals in the problem countries right and to tackle the huge imbalances in competitiveness within the Euro Area. However, there's not only depreciation to restore competitiveness. Maybe a look at the evolutions of EU regions within their respective national states can be of value here[6]. Albeit being in an undisputed "monetary union" (the respective national state) there are a lot of examples of less developed regions catching up or even leapfrogging. However, to the knowledge of the reviewer there is not one example where this success materialized by merely "saving out" of backwardness. Rather catching-up usually involved consistent measures of structural reforms, smart specialization and investments in the determinants of competitiveness (esp. qualification, innovation). Therefore, questions about (e.g.) how such policies can be pushed forcefully by European institutions and which measures are needed to restore competitiveness in the respective countries may be central to guarantee long run stability and cohesion in the Eurozone. However, this may be the leitmotif for a further valuable book.

Peter Mayerhofer,
Austrian Institute of Economic Research

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[4]) see on this and further necessities e.g. Pisani-Ferry, J., Vihriälä, E., Wolff, G., "Options for a Euro-Area Fiscal Capacity", Bruegel Policy Contribution, 2013/01, Brussels.

[5]) DeGrauwe, P., Ji Y., "More evidence that financial markets imposed excessive austerity in the eurozone", CEPS commentary, 2013, Brussels.

[6]) see Aiginger, K., Huber, P., Firgo, M., "Policy options for the development of peripheral regions and countries on Europe", European Policy Brief, 2, European Commission Socio-economic Sciences and Humanities Research, 2012.