Lessons of the eurozone crisis

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Lessons of the eurozone crisis

- 19 years ago, I described the project for monetary union as an example of the core principle of Greek tragedy: “hubris (pride), ate (folly), nemesis (destruction).
- It is essentially a gold standard type of system. But the loss of the exchange rate and monetary policy safety valves robs national governments – the focus of politics – of freedom of manoeuvre.
- Creditors are forced to rescue debtors and debtors forced to obey creditors, against both their wills
- Thus, the euro has become a machine for exacerbating tensions among members of the eurozone, rather than reducing them.
- I always believed a currency union needs a political union in today’s world. We do not live in the 19th century any more.
- Will the eurozone survive until 2020 in its present form? I wonder.

Lessons of the eurozone crisis

- I will ask five questions:
  - How did the eurozone get where it is?
  - What is the challenge of adjustment?
  - How has the eurozone tackled its crisis?
  - How might the eurozone fix its problems?
  - What are German interests?
  - Conclusion

1. How did the eurozone get here?

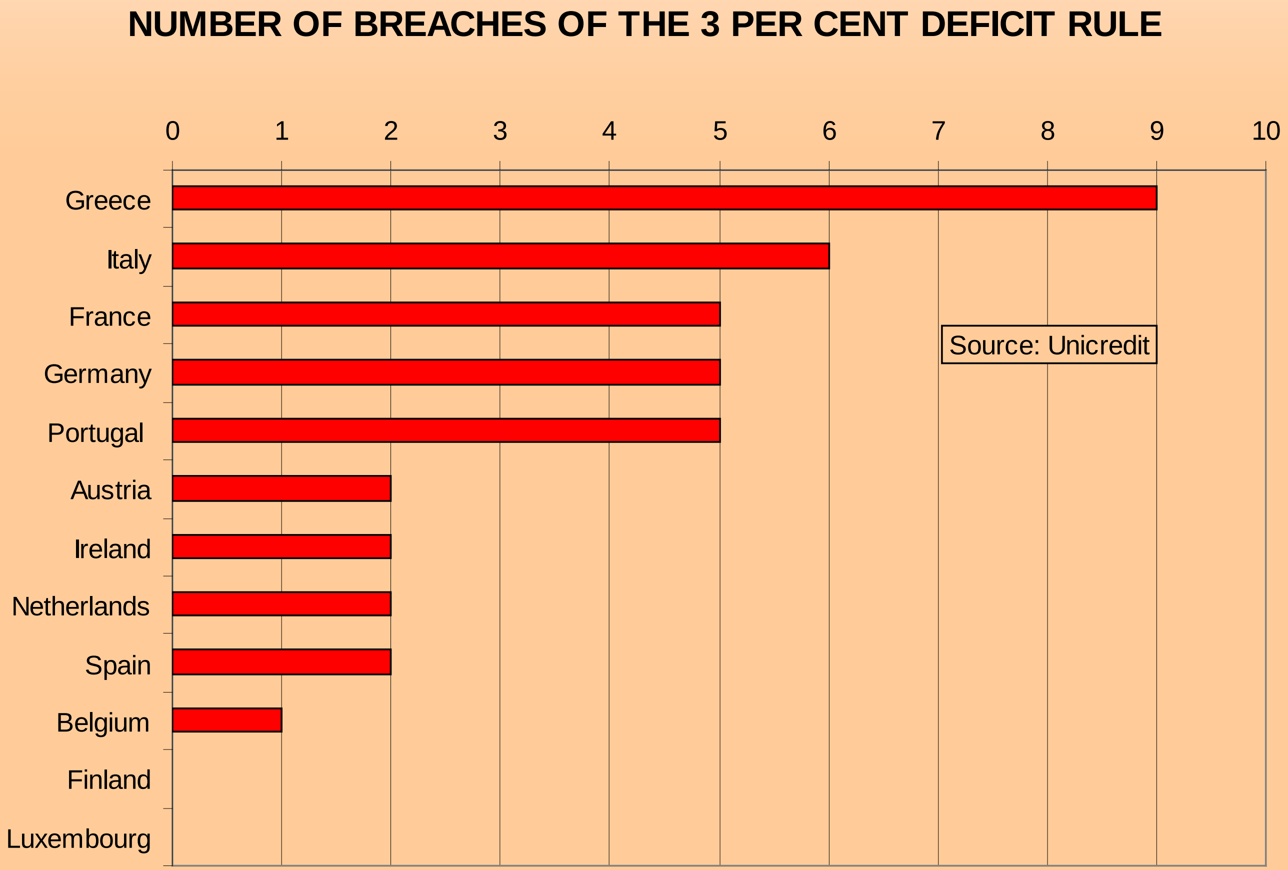
- Bad diagnosis gives bad medicine: the crisis is NOT solely or even mainly due to fiscal indiscipline.
- There was reasonable growth and contained fiscal deficits prior to the crisis, in countries now in trouble, with the big exception of Greece.
- But this masked macroeconomic divergences:
  - Huge private surpluses in Germany, the Netherlands and Austria; and
  - huge private deficits in Spain, Ireland, Portugal and Greece

1. How did the eurozone get here?

- What drove cumulative divergences? Partly excessive confidence
  - The ability to borrow at lower rates than ever before;
  - The failure of markets to impose penalties, because they ignored what was going on in both private and public sectors;
  - The tendency, inside a currency union, for bubble-affected countries to have relatively low real interest rates (short and even long term) and, vice versa, for the countries with weak domestic demand and low inflation.
  - Then, when the private bubbles burst, fiscal deficits exploded and anxiety about sovereign debt grew.
- This caused self-fulfilling illiquidity and solvency crises

1. How did the eurozone get here?

THE GOOD, THE BAD AND THE UGLY

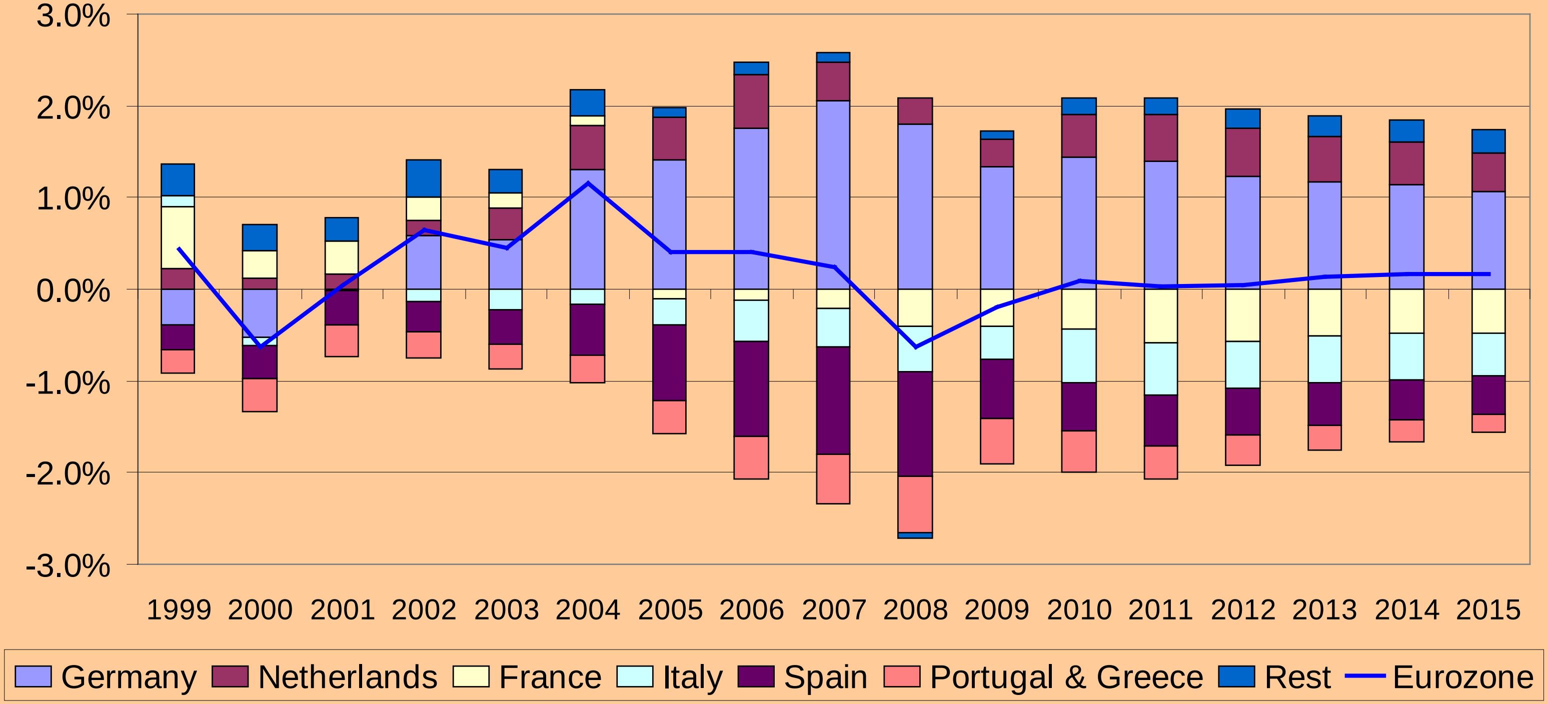


1. How did the eurozone get here?

THE GOOD, THE BAD AND THE UGLY

CURRENT ACCOUNT IMBALANCES IN THE EUROZONE
(per cent of Eurozone GDP)

Source: IMF, World Economic Outlook database, April 2011



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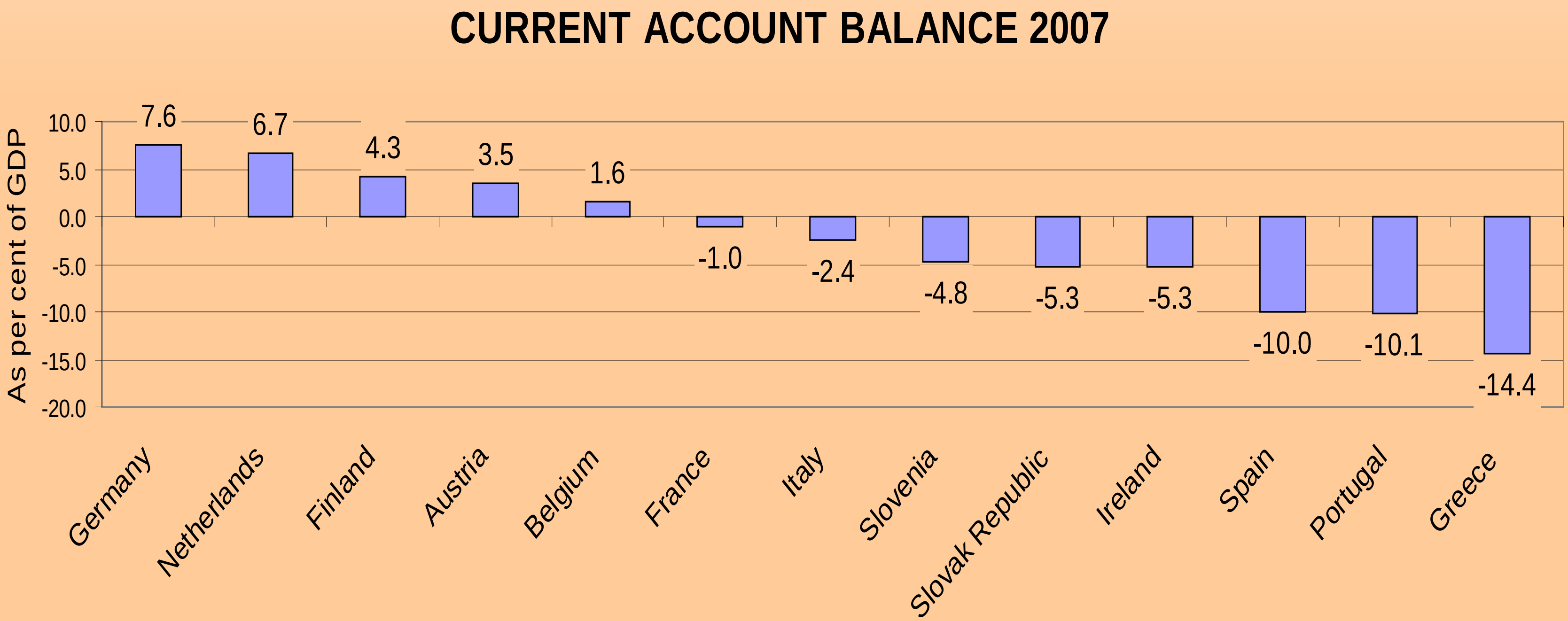
IT'S THE CURRENT ACCOUNT, STUPID



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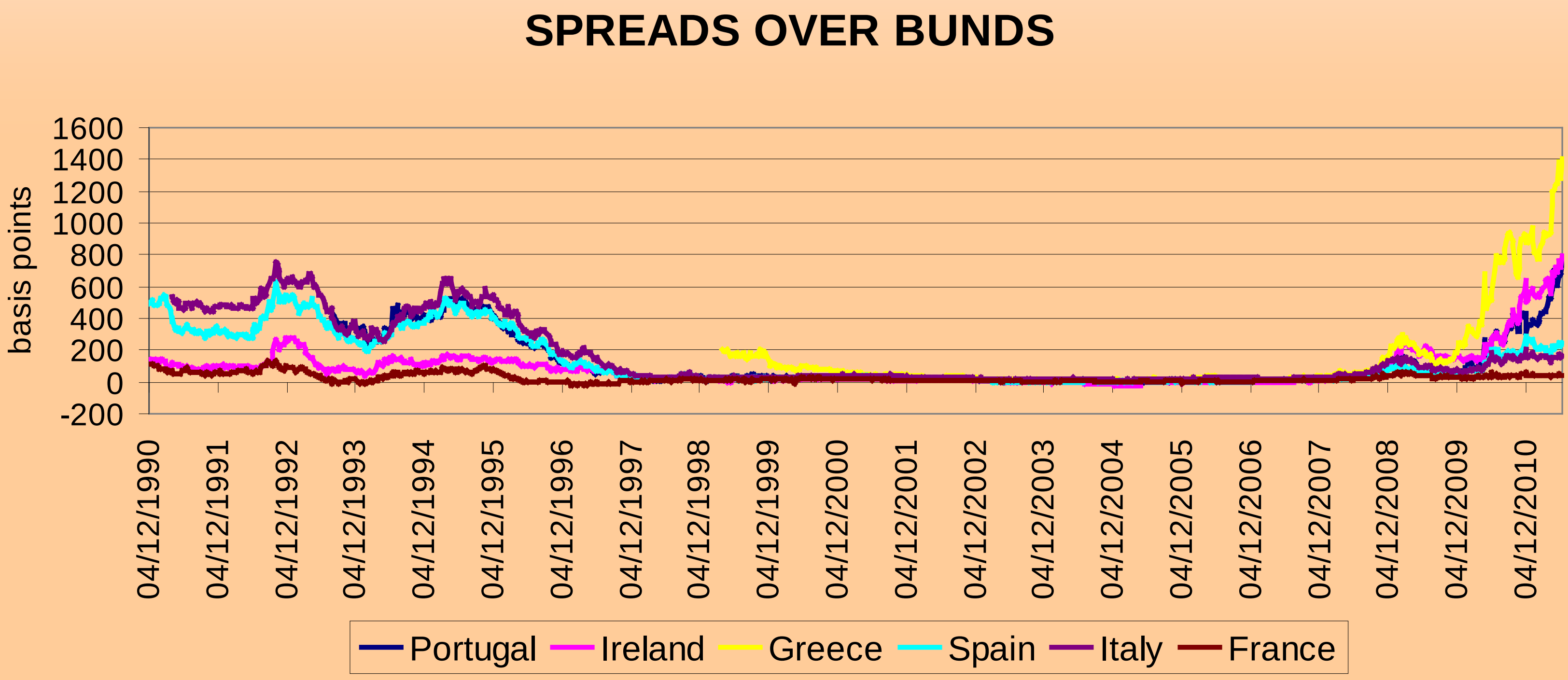
FROM COMPLACENCY TO PANIC



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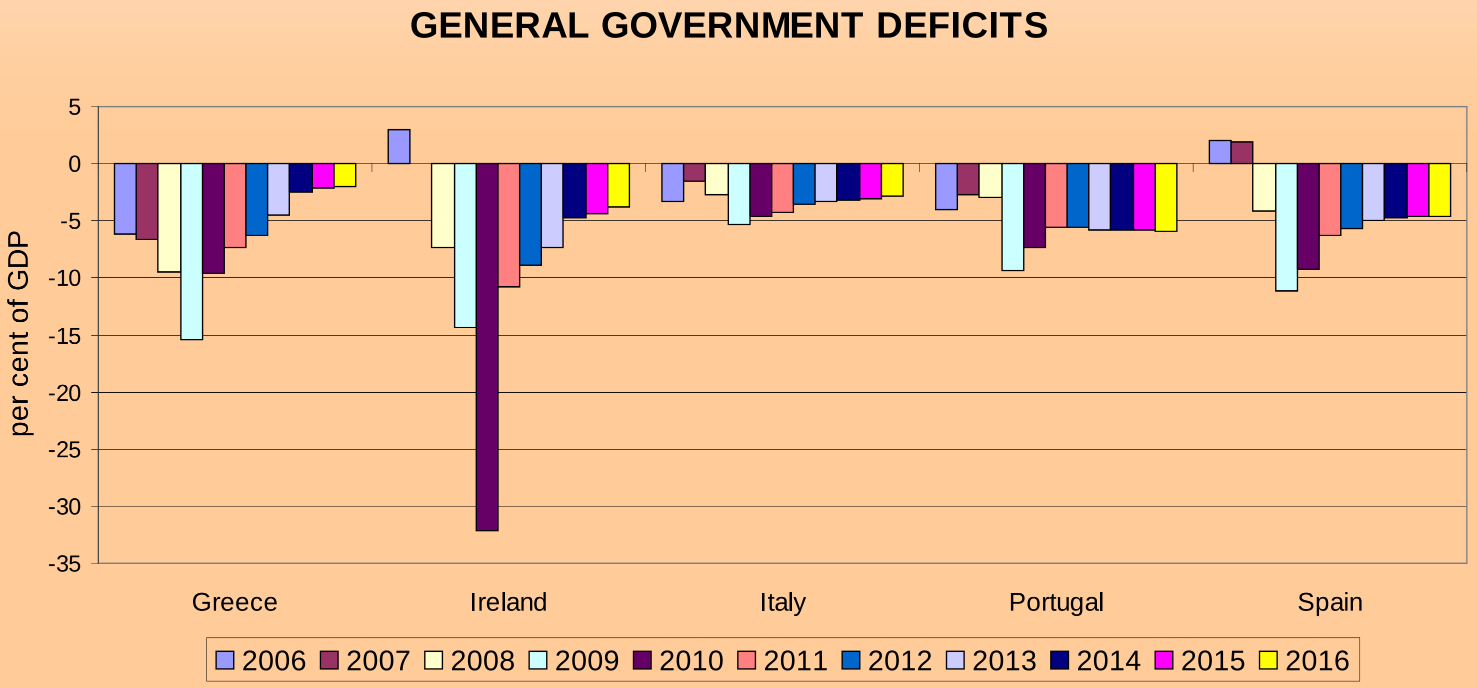
ROAD TO THE FISCAL DEFICITS



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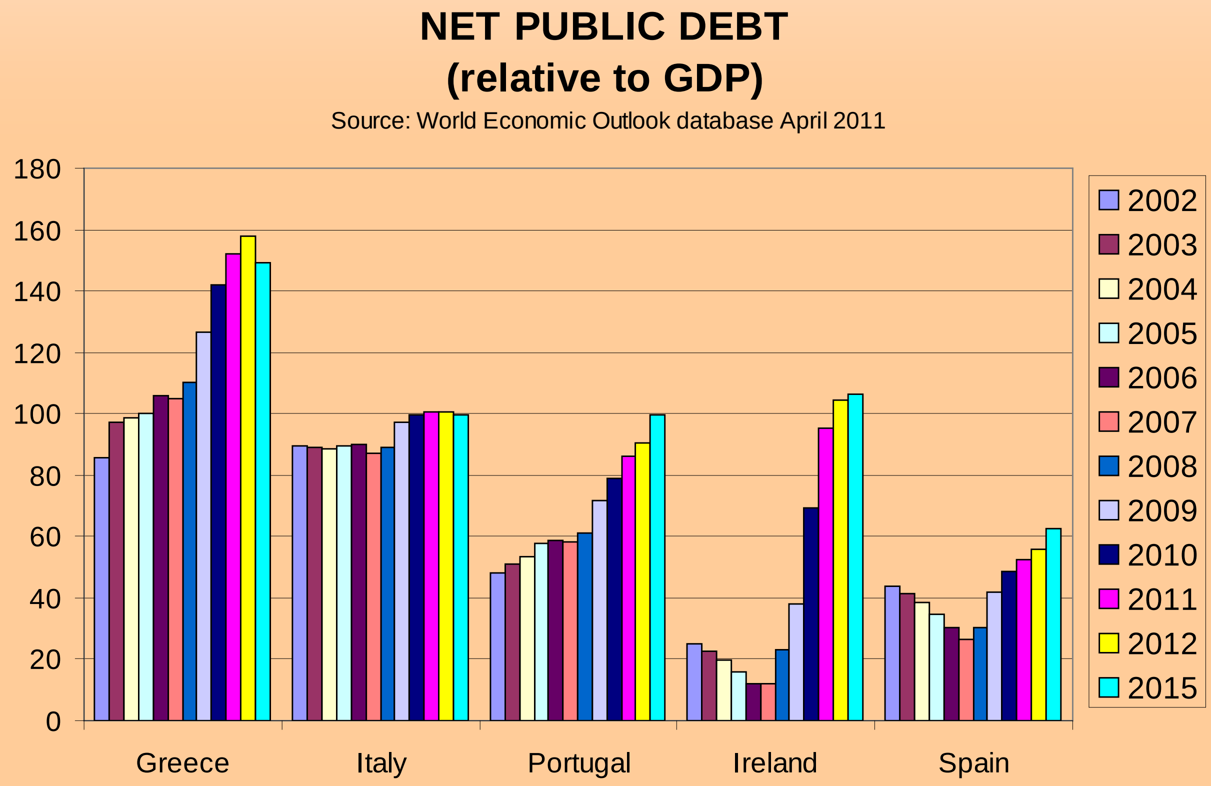


2. What is the challenge of adjustment?

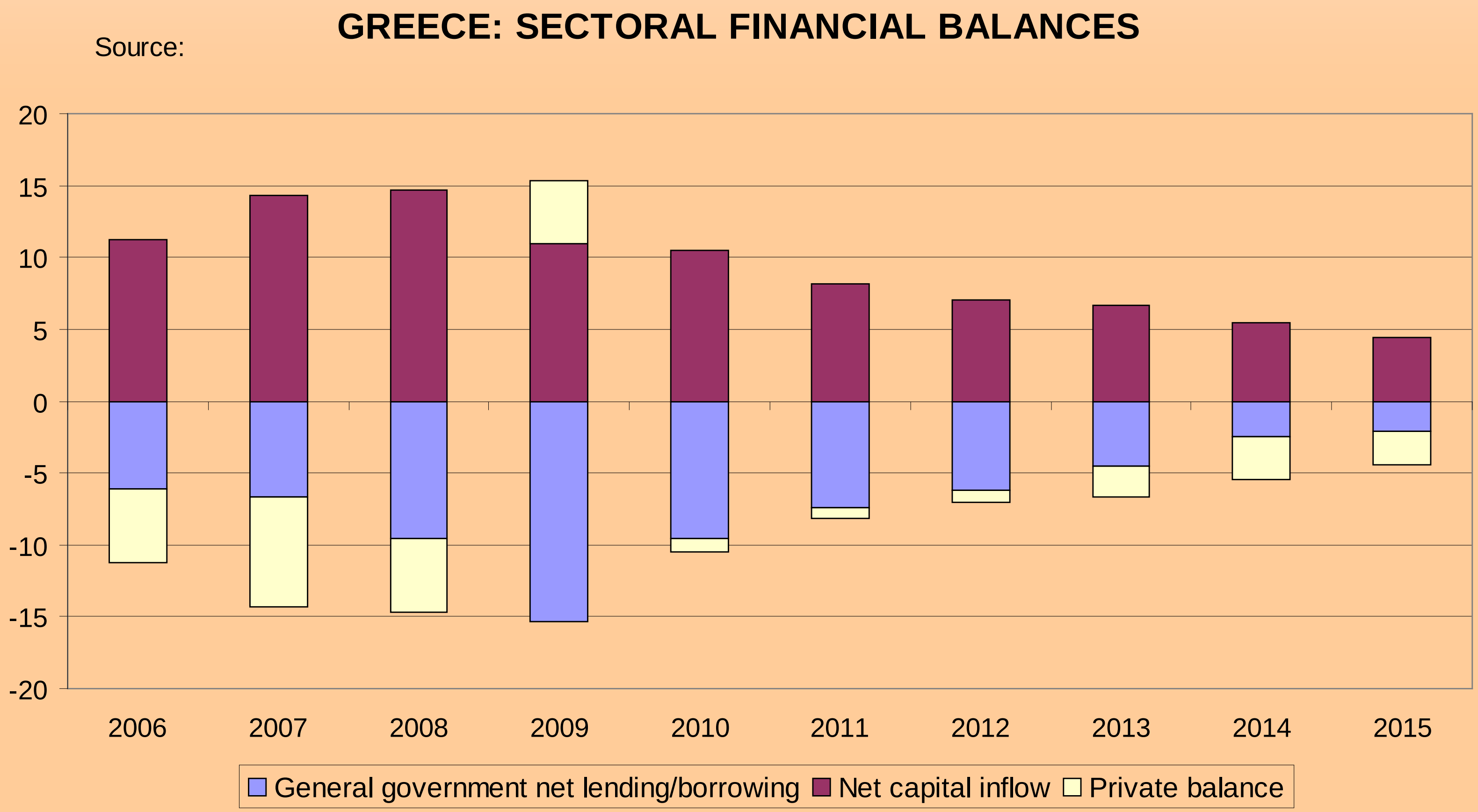
- The crisis of 2008 brought a “sudden stop” to capital flows across frontiers
- Debt-fuelled private spending shrank
- Governments went massively into fiscal deficit
- Financial systems imploded
- A simple choice suddenly emerged: finance the no longer creditworthy countries or write off loans made to them

2. What is the challenge of adjustment?

- Yet financing is a short-run choice
- In the long run, the pre-crisis transfer of resources needs to be reversed, unless one thinks the external capital flow can restart
- This requires either the surplus countries to go into deficit or the eurozone as a whole to go into external surplus
- Without one of these changes, deficit economies cannot adjust
- They might just shrink and die, instead

2. What is the challenge of adjustment?

THE PRIVATE SECTOR MATTERS, TOO



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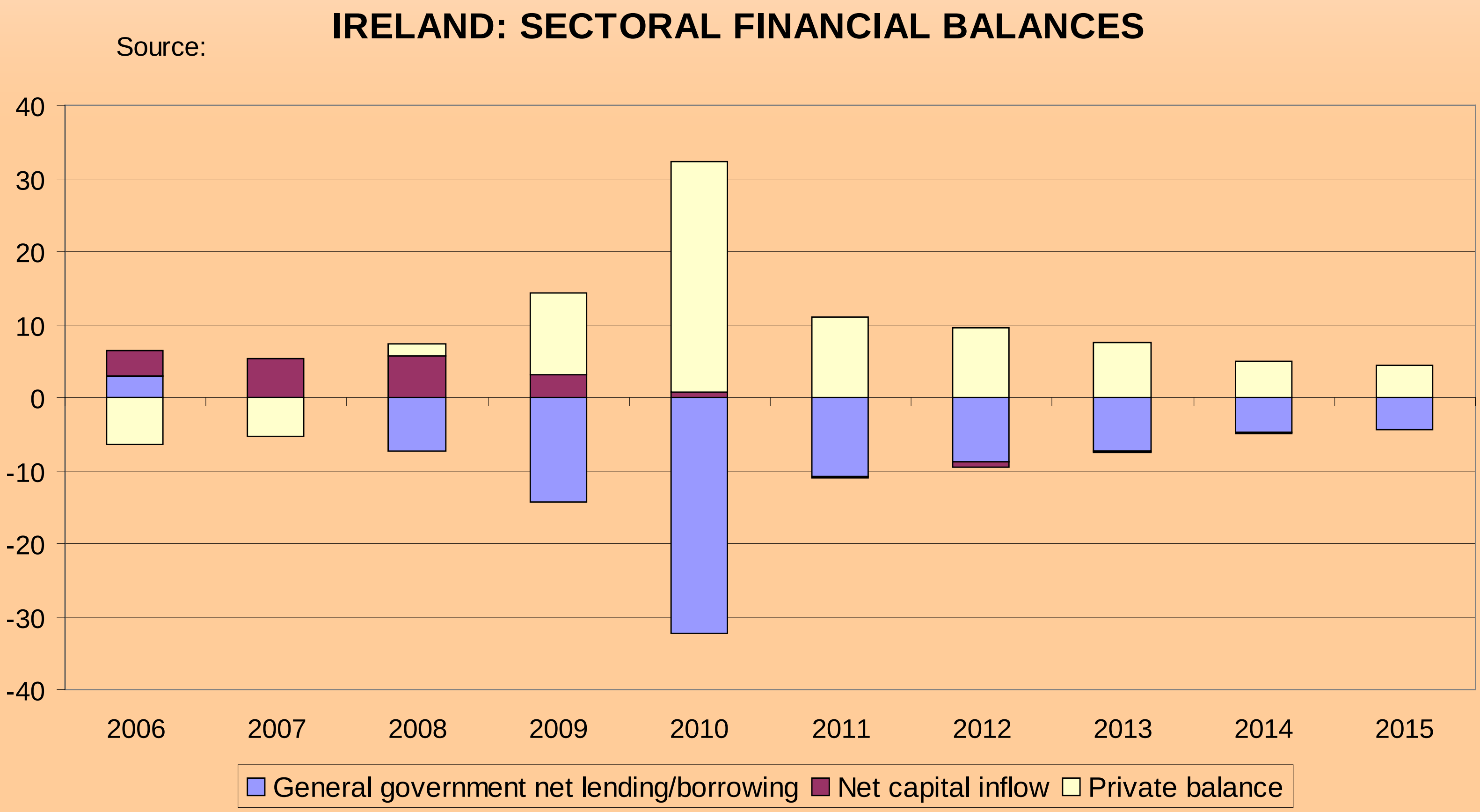

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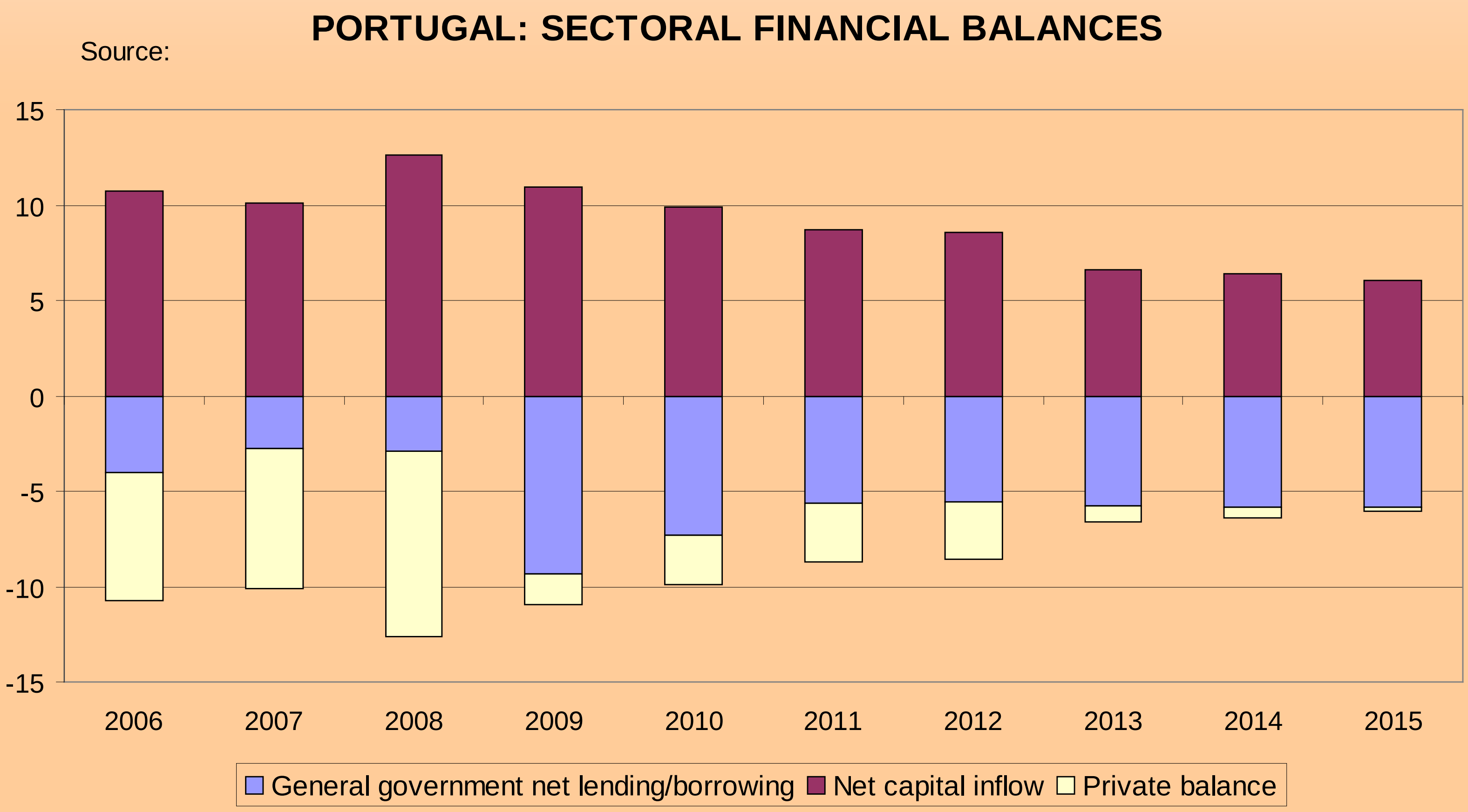

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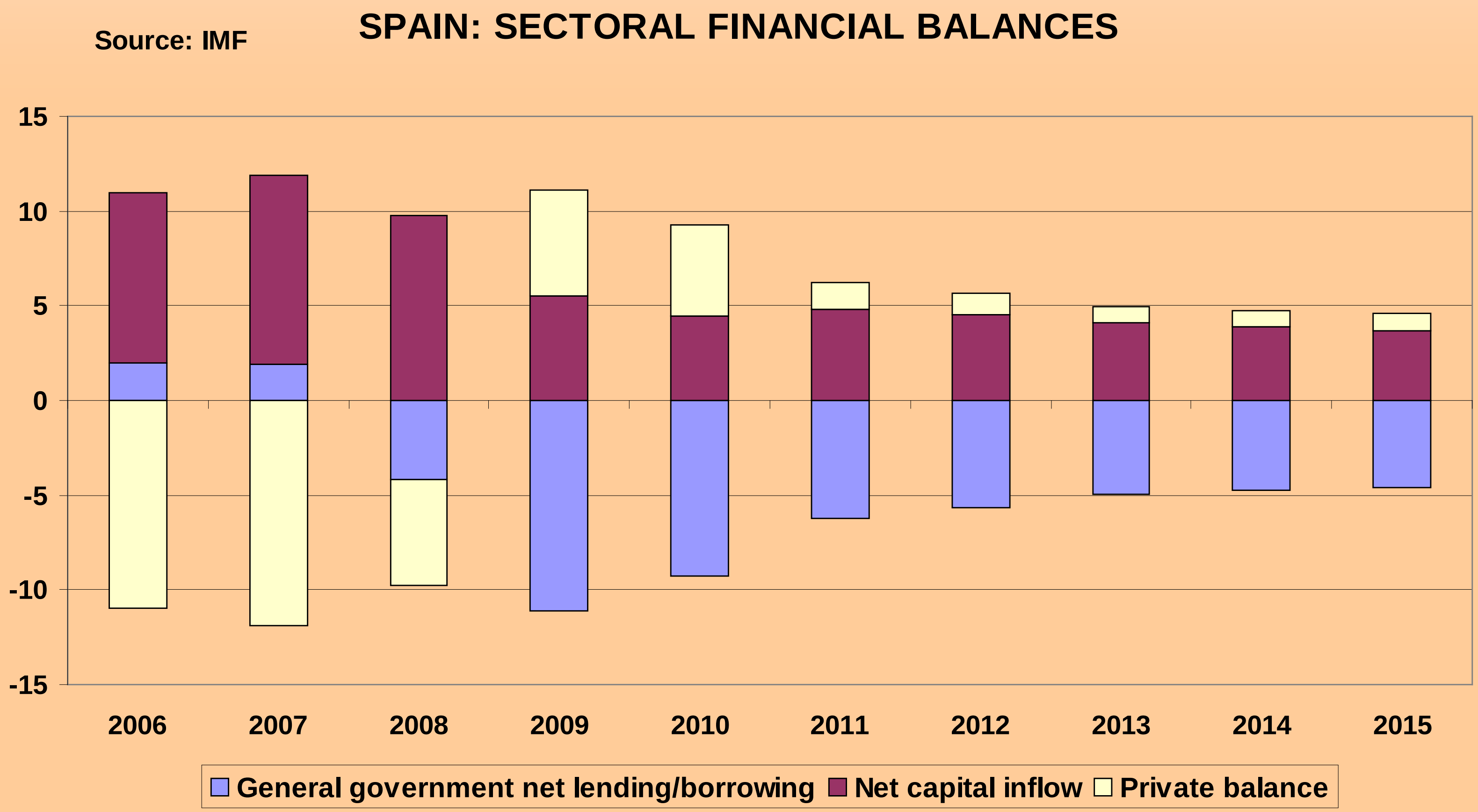

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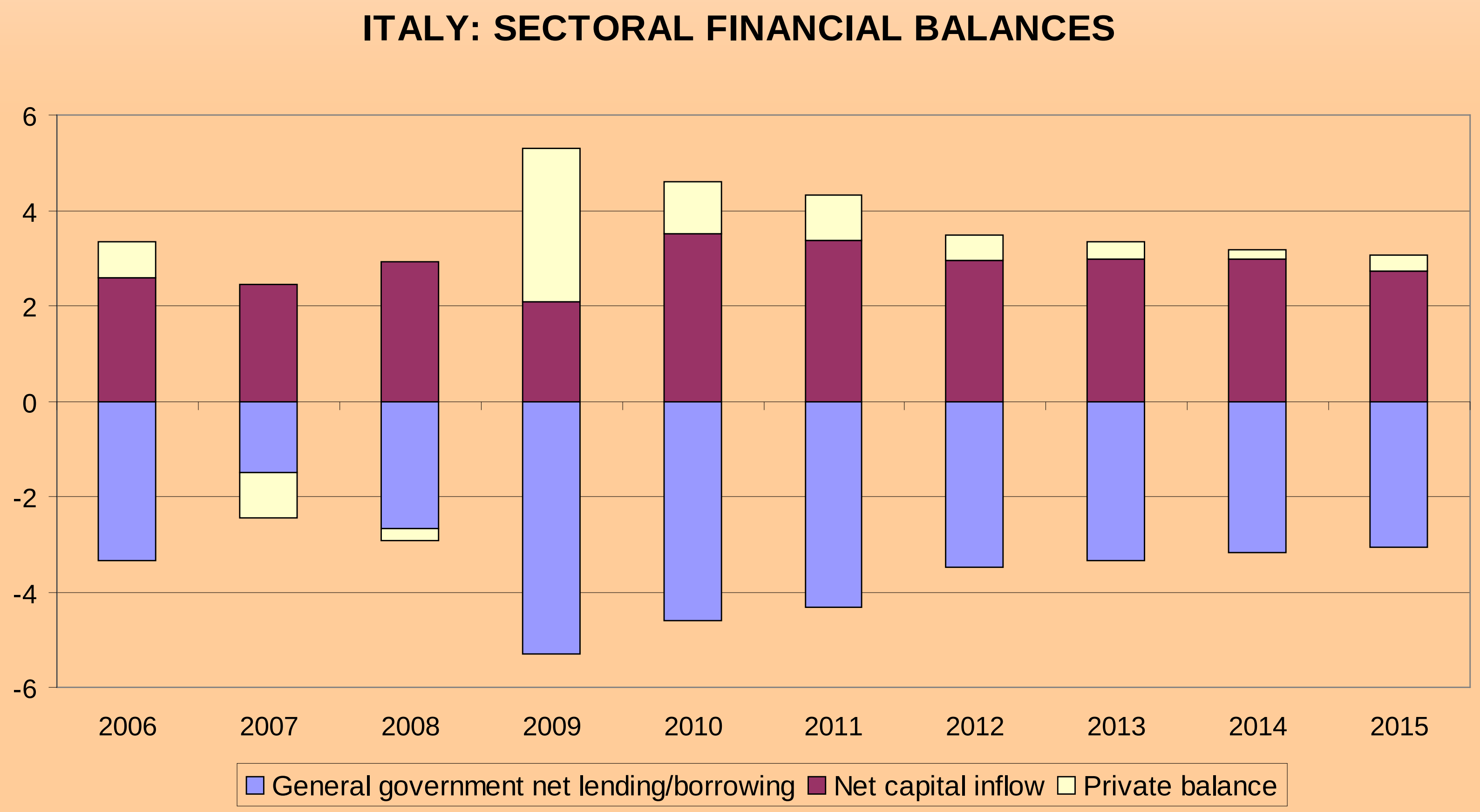

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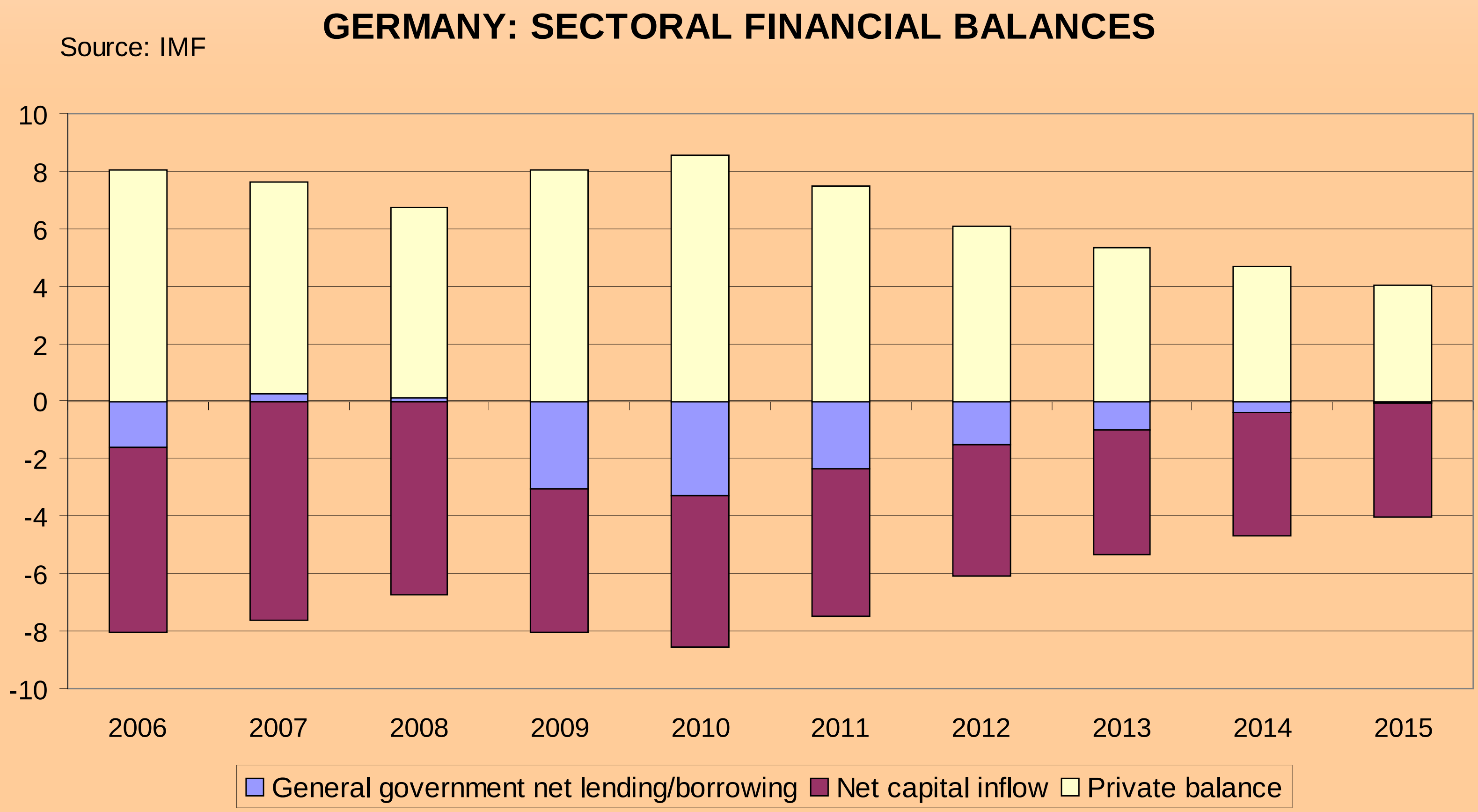
WHY IS FOREIGN LENDING GOOD?



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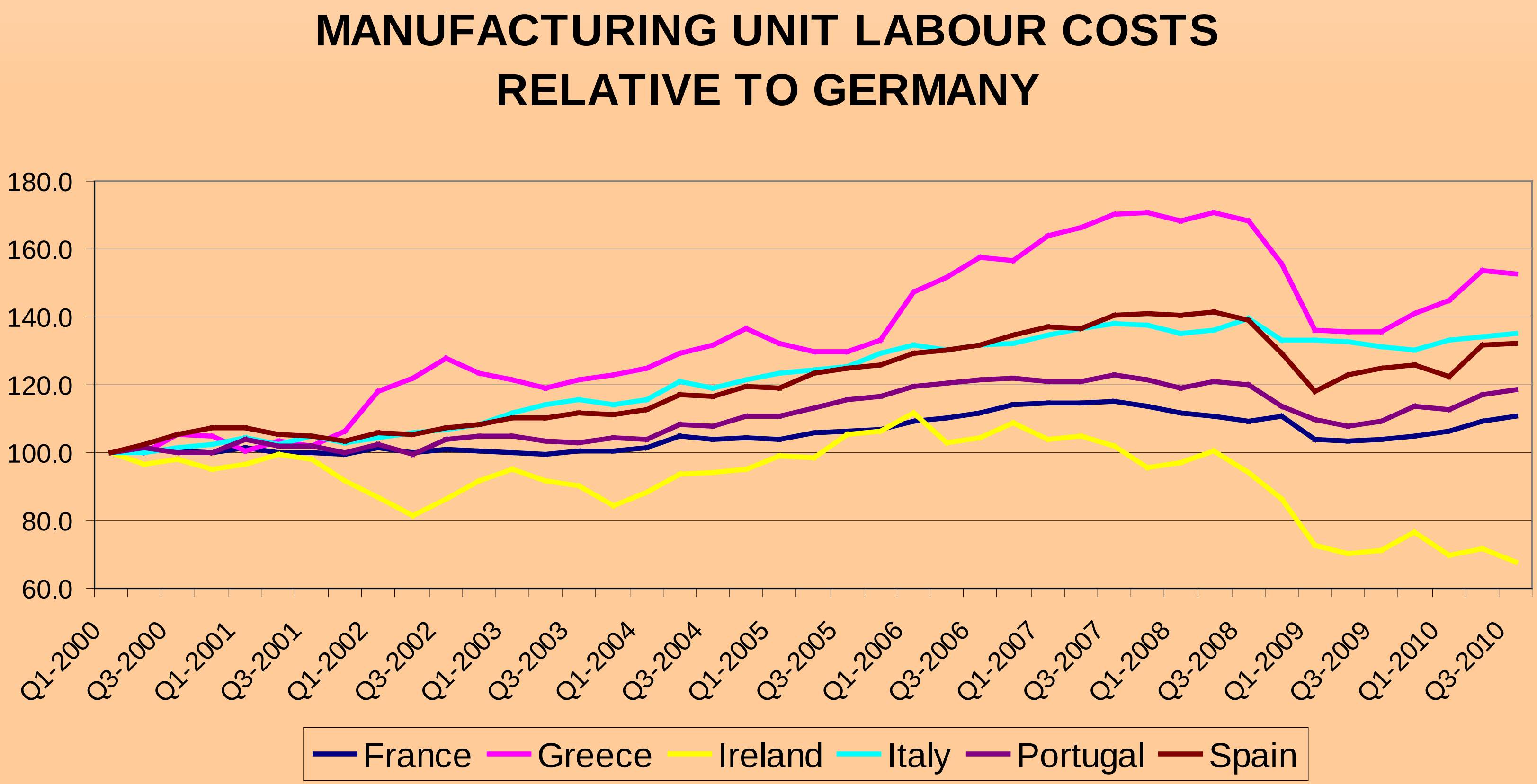
LOST COMPETITIVENESS IN THE PERIPHERY



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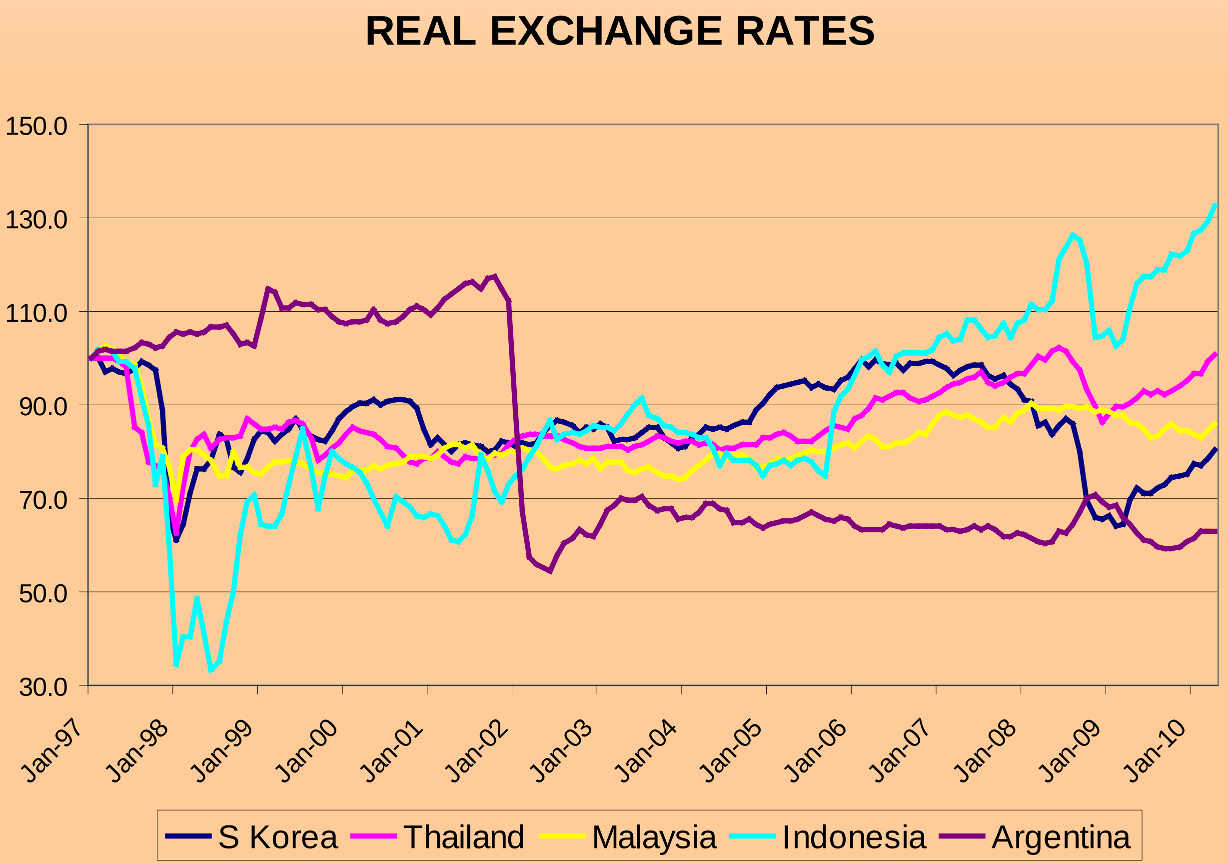
HOW TO SOLVE DEBT CRISES: DEVALUATIONS



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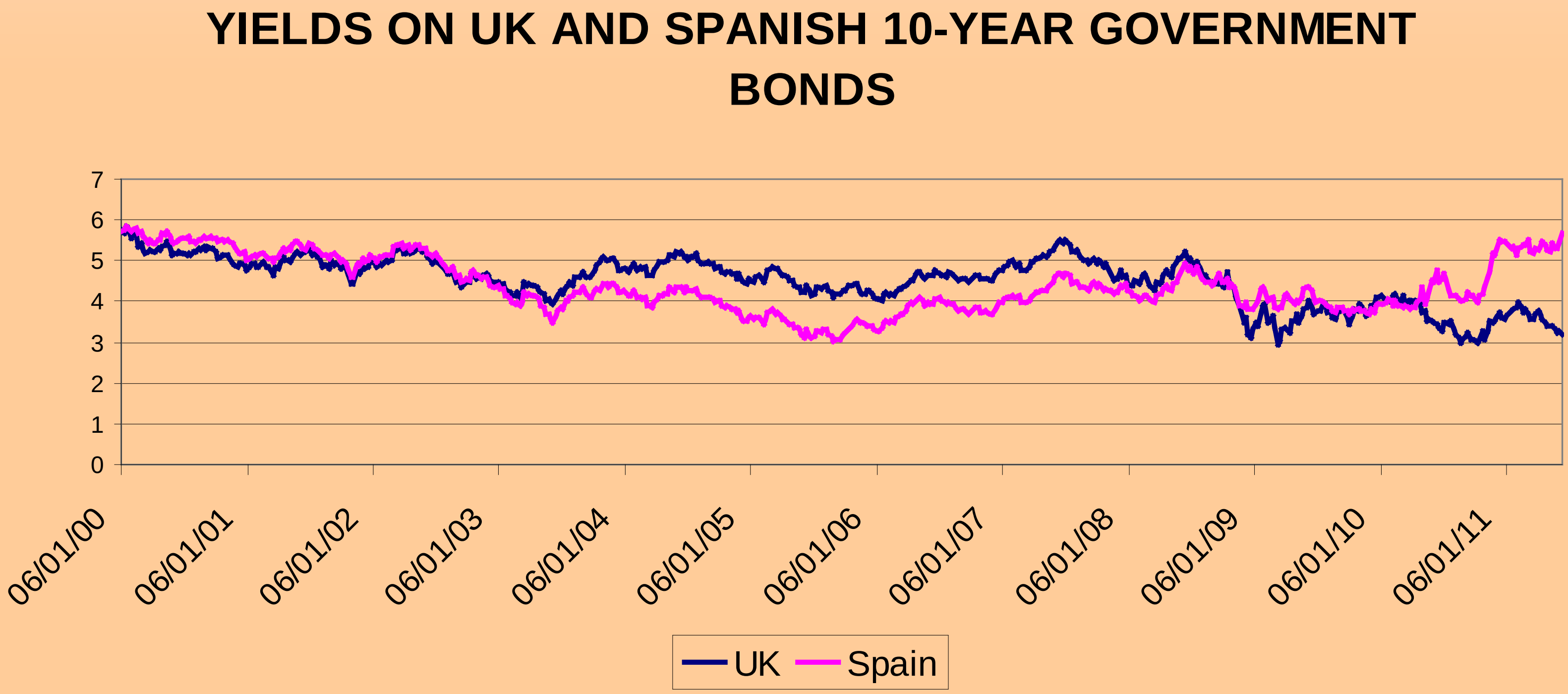
THE COSTS OF BEING IN THE EURO: SPAIN



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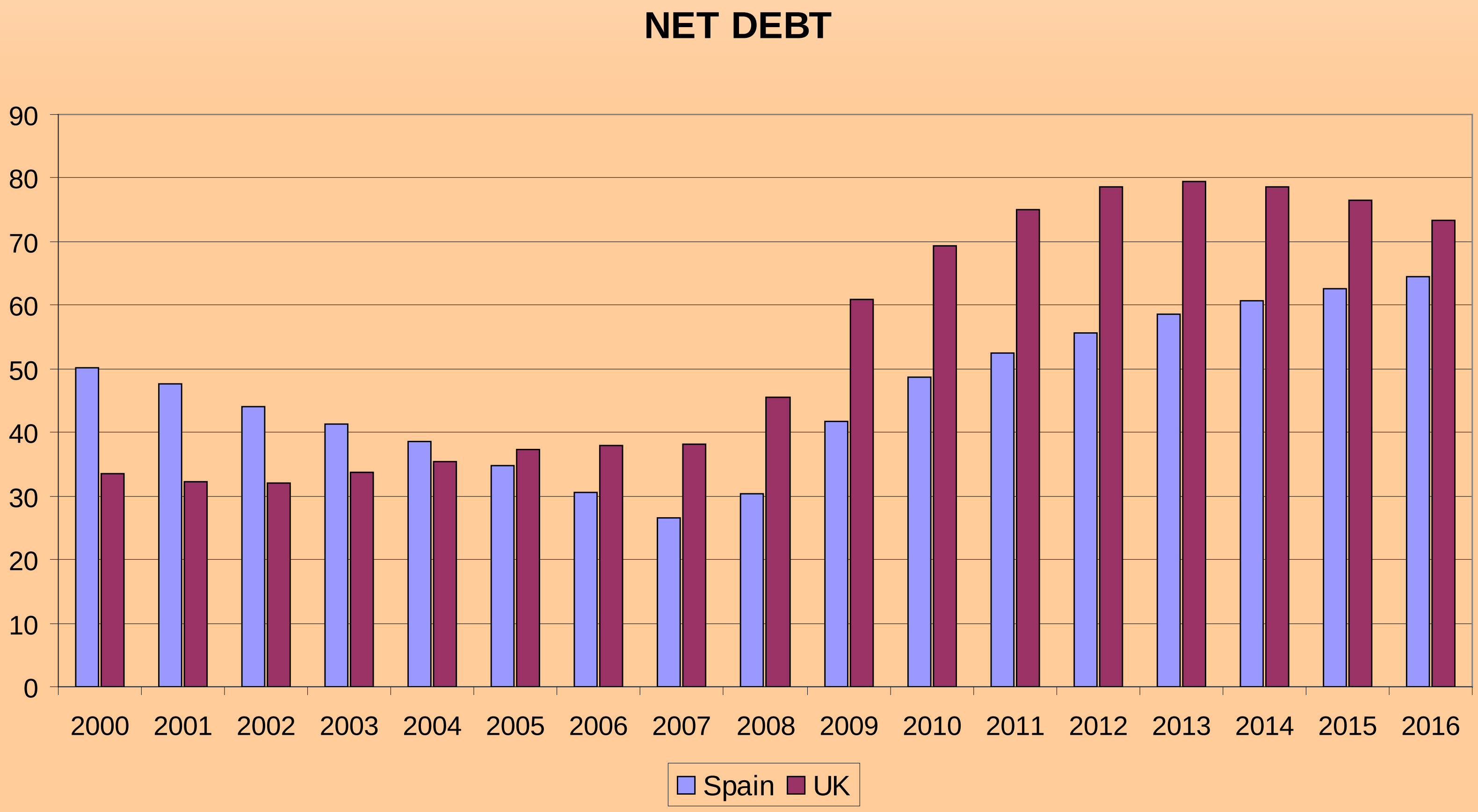


3. How did the eurozone deal with the crisis?

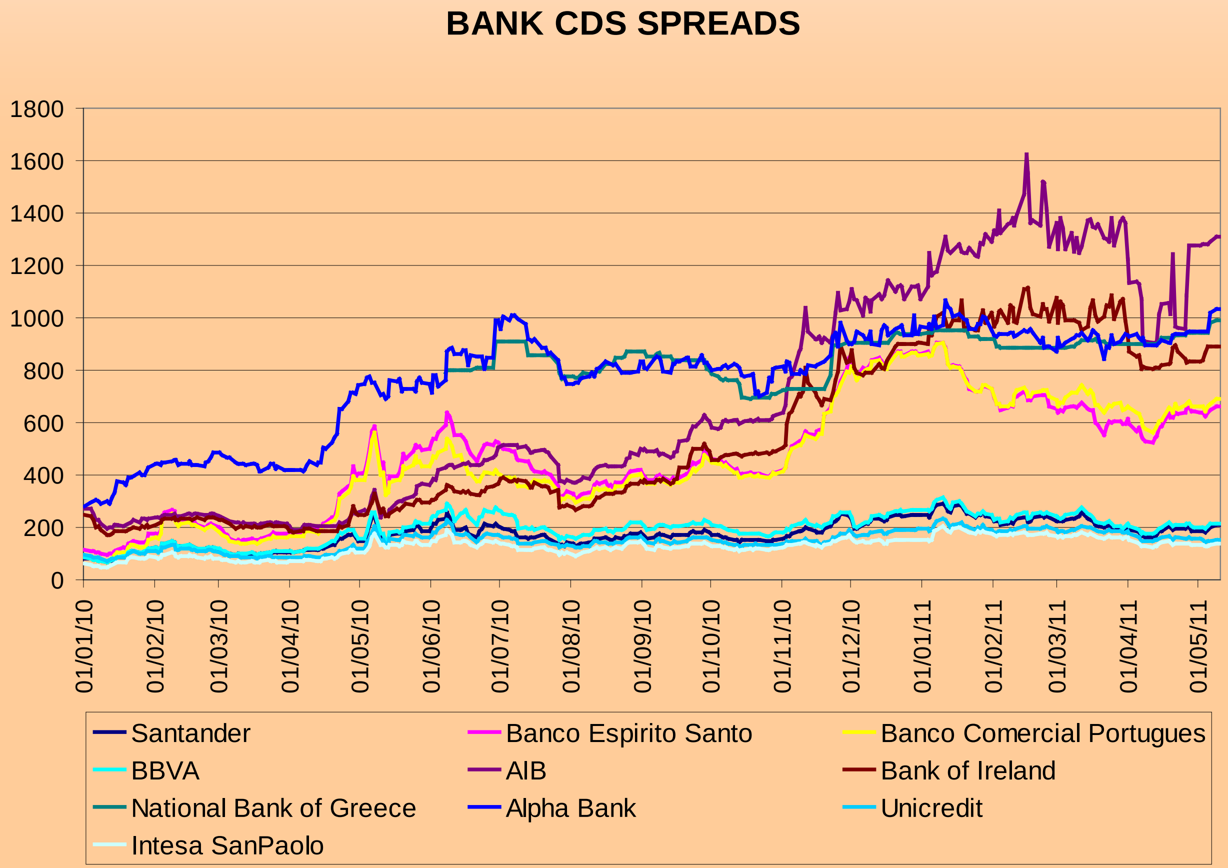
- The Greek admission of cheating triggered panic
- Among the worries was over the impact of defaults on eurozone banks;
- In an interconnected financial system, the crisis of one is the crisis of all
- The danger of flight
- Is a euro really a euro everywhere?

3. How did the eurozone deal with the crisis?

BANKS' EXPOSURE TO PUBLIC DEBT, END-2009 (per cent of Tier 1 capital)					
	Italy	Greece	Ireland	Portugal	Spain
Germany	48.0%	12.0%	8.0%	7.0%	21.0%
France	26.0%	6.0%			
Italy	**157.0%**				
Greece		**226.0%**			
Ireland			**26.0%**		
Portugal	6.0%	9.0%		**69.0%**	
Spain					**113.0%**
Belgium	76.0%	14.0%		9.0%	11.0%
Netherlands	14.0%				
Cyprus		109.0%	10.0%		

3. How did the eurozone deal with the crisis?

THE DESTRUCTION OF THE BANKS



3. How did the eurozone deal with the crisis?

- So a bail out of Greece and then Ireland and Portugal and a new financing facility (European Financial Stability Fund) were hastily arranged.
- But these actions have not regained market confidence:
  - The eurozone has not addressed the insolvencies, but insists that there can be no restructuring of existing debt
  - Yet Germany does want restructuring of new debt after 2012. This makes it impossible to borrow from private markets, since lenders: ask who is going to refinance those loans?
- Thus they are on the road to taking all of the debt of Greece, Ireland and Portugal onto public sector balance sheets.
- Will even Spain and Italy be safe?

4. How far can the eurozone fix the problems?

- We need to distinguish two classes of challenge:
  - Getting the right diagnosis; and
  - Solving the inherent economic and political problems of a multi-country currency union.
- Mistaken diagnosis:
  - The main problem is not fiscal policy:
    - The main culprits on fiscal rules were not the countries now in difficulty, except Greece;
    - No, structural payments imbalances and financial bubbles caused the biggest damage.

4. How far can the eurozone fix the problems?

- Mistaken solutions:
  - A toughened growth and stability pact will not only be highly pro-cyclical, but will not be applied consistently across countries, and can only arouse wild resentment and anger.
- Correct diagnosis:
  - The eurozone is caught between being a 19th century gold standard and a modern federal state.
  - It lacks the automatic market-based adjustment mechanisms and willingness to accept default and financial collapses of the former.
  - It lacks the automatic fiscal transfers, federal support for financial systems and internal migration of the latter.

4. How far can the eurozone fix the problems?

- Tasks that must be tackled:
  - Illiquidity: need to support countries in temporary difficulties;
  - Insolvency: need to be able to write debt down without causing huge crises;
  - Financial fragility: need to create robust financial system – either via a common treasury or via location of all banks in solvent countries; and
  - Adjustment: need to be able to move wages easily.
- It will either become a eurozone of the like-minded or it will need to be more of a political union

5. What are Germany’s interests?

- Germany is the principal creditor country, the biggest economy with the most creditworthy government
- So it has the power to decide what will happen
- But Germany seems to be a reluctant hegemon
- What are its national interests?
  - Pro support: interests of exporters and political interest in stability in Europe
  - Contra support: risks to domestic stability and a possible need for fiscal transfers

5. What are Germany’s interests?

- I think the pros have it:
  - Risks to stability are small, at least so far
  - The transfers have already occurred. This is probably the only way to get the money back!
  - The construction of a stable European neighbourhood may be reversed if the eurozone unwinds
- So Germany is probably right to create the new mechanisms of transitional support

6. Conclusion

- Eurozone now has a choice of which way to go or whether to break up
- One possibility would be further moves to a fiscal union, with banks underpinned by a common treasury and substantial fiscal transfers to weak regions. But this would surely require a single political process.
- Another possibility would be a move to full economic flexibility, with debt restructuring and national financial meltdowns.
- A problem is that the starting point is so dreadful.
- It is hard to imagine any restructuring that does not trigger a panic across the eurozone
- In short, I wouldn’t start from here.