# Crisis of the eurozone and globalisation

Good afternoon ladies and gentlemen. Thank you very much for inviting me here today. Unfortunately for me, it is only a day trip

As a Briton, it is often rather awkward talking about the eurozone crisis. I'm in favour of the euro and campaigned for UK membership of it.

I can't see that ever happening now. Even if my countrymen wanted to join, we don't meet the criteria and won't do for many years

But everyone in Europe has a strong interest in the euro realising its potential, even if Juergen Stark, as he told us last week, believes that 'Anglo-Saxons', are somehow conspiring to bring down the single currency.

I will start by outlining how I think we got to this point and why the strategy to deal with the crisis is not working. I agree with much of Yannos Papantoniou's report

I'll then go on to say why I think he is right to link the eurozone crisis with the challenges facing the global economy.

## The eurozone at launch – don't read out

When the euro was launched, even its supporters conceded that it did not meet the conditions of a so-called optimum currency area (OCA) – that is, a region where the benefits of sharing a currency outweigh the costs.

In particular, the euro lacked traditional shock absorbers to compensate for the loss of the exchange rate as an instrument of economic adjustment.

Three such "shock absorbers" should be mentioned:

**One: Market integration was too low**.

a. Factors of production did not move as freely between Germany and France as say between New Jersey and Delaware. Thus:
    i. Lower levels of labour mobility.
    ii. Intra-EU merchandise trade was much lower than intra-US trade
    iii. Services markets were very fragmented – basically a patchwork quilt of national markets
    iv. And there were political obstacles to cross-border MA

A far as possible a single currency requires a single economy. Without such integration, differences in productivity and inflation risk becoming entrenched. This increases the risk of sharing a single currency. Interests are too high for some, too low for others, creating imbalances.

**Two: National product and labour markets were too inflexible**.

b. There was not enough competition in product markets.
c. And national labour markets were much more rigid than in successful currency unions such as the US.

In the absence of exchange rate adjustment, everything else has to be very flexible.

**<u>Three:</u> There was no federal budget to transfer funds to struggling regions**.

Even in in the US, which largely meets the criteria for an OCA, there is a federal budget.

For these reasons, many observers expressed scepticism about the euro's long-term viability when it was launched.

The European answer was three-fold:

1. They attempted to minimise the differences, arguing, for example, that private-sector imbalances would be no more problematic in the eurozone than in US.
2. EZ not yet OCA, but it would become more like one in time.
    a. That is, the introduction of euro would drive the changes needed for it to succeed.
3. Fiscal transfers would not be necessary, because budgetary rules would obviate need for them.
    a. And if crisis happened, the political commitment to euro would spark moves towards greater fiscal union.

**<u>Were European assumptions borne out by events?</u>**

EU politicians certainly talked a good game. In 2000, they launched the Lisbon agenda. As we all know, the objective was to become "the most competitive, knowledge-based economy in the world" by 2010.

Lisbon was a wide-ranging programme of microeconomic reform aimed at raising productivity and labour utilisation across the EU. Policy-wise, its dominant themes were liberalisation, competition and innovation.

Which all sounds fine. But what did the Lisbon agenda achieve? Conventional wisdom says that the agenda has failed. This is probably fair, but it does need qualifying.

Euro-pessimism can be pushed too far. Economic reforms <u>have</u> been pushed through over the past decade, and these <u>have</u> improved supply-side performance.

(i) Sectors like telecoms, rail transport and energy have been liberalised.
(ii) The share of Europeans completing secondary and tertiary education is up.
(iii) The EU as a whole has actually created more jobs than the US over the past decade.

So why the generally downbeat assessment? Broadly speaking, three reasons:

(i) Despite progress, few countries met the targets they set themselves.
(ii) Reforms were slowest in countries where they were needed the most.
(iii) National reform paths may have been same even if Lisbon and euro hadn't existed: For example:
    a. There was no more policy convergence within EU than within OECD.
    b. No evidence that members of euro were more assiduous reformers than non-members – if anything the reverse was the case:
        i. The worst performers were inside euro.
        ii. The euro appears to have had a soporific effect on its members– widely seen as shield, rather than corset.
        iii. Strikingly, there is lower support for single market inside euro than outside euro.

So the first assumption of Europeans – that euro would galvanise supply-side reforms – turned out to be too optimistic. Why?

(i) <u>Charitable interpretation?</u> governments knew what to do but not how to get re-elected. The Jean-Claude Juncker argument.
(ii) <u>Uncharitable interpretation?</u> politicians did not know what they were doing.
    a. Indeed, anecdotal evidence that they misunderstood consequences of MU.
        i. They continued to obstruct free movement across borders.
        ii. Frequently launched rhetorical tirades against economic liberalisation.

Let me now turn to the **eurozone crisis.**

When I read the German newspapers, the dominant account of the crisis seems to go something like this: the eurozone is in crisis because some countries were virtuous and others were not. Some played by the rules, others didn't.

The evidence advanced in support of this claim includes:

(i) Greece's mismanagement of its public finances.
(ii) The failure of Southern Europeans to push through supply-side reforms.
(iii) And as a result of this failure, a dramatic loss of competitiveness in the periphery.

The lesson of the crisis is that all eurozone economies should copy Germany by reforming their economies, consolidating their public finances and learning to live "within" their means.

I think this dominant German narrative is mistaken for a number of reasons:

**One: It overstates the importance of fiscal mismanagement**.
    a. Greece <u>was</u> villain, but Ireland and Spain were not.
    b. Before the crisis, Germany closer to Greece than were Ireland or Spain.

**Two: Supply-side reforms alone are not enough**.
    c. Ireland had flexible economy but still became hugely leveraged.

d. Italy, with inflexible and largely unreformed economy, did not. Though it should be noted that Italy could well find itself in trouble.

**Three: Perhaps most importantly, the dominant narrative in Germany neglects link between virtue in the core and vice in the periphery**.

e. German export-led growth reliant on indebtedness in the periphery.
f. Germany was able to live within its means only because others did not.

**Indeed, much of the explanation for eurozone crisis is to be found largely on demand side**:

(i) Demand grew faster than output in the periphery.
(ii) Demand grew slower than output in much of the core.
(iii) Demand in the periphery funded by savings in the core.
(iv) Much of the capital exported by core was wasted in periphery.
  a. In the case of Greece, through the public sector.
  b. In Ireland and Spain, the agent of misallocation was the private sector, the banks which fuelled investment in construction.
(v) Capital that was misallocated in periphery weakened banks.
(vi) Banking crisis mutated into a sovereign debt crisis.
  a. Private-sector liabilities ended up on state balance sheets.
(vii) Banking systems in the core highly is exposed to debt crisis in periphery.

## <u>How have policy-makers responded?</u>

Ever since the crisis broke out, European leaders have struggled to reconcile two mutually incompatible objectives:

(i) The need to restore confidence in the eurozone's indebted periphery.
(ii) And hostility among creditor countries in the core to turning EZ into transfer union.

The perception in Germany is that the country is now 'writing cheques' to bail out debtors in the periphery.

But I'm not sure that the **new system of eurozone governance** agreed by EU leaders warrants this conclusion. Agreement reached by EU leaders at their summit in March has been widely described as a 'grand bargain' between its thrifty core and its indebted periphery. There are two elements to the deal:

(i) Germany and other core countries agree to the creation of a permanent and enlarged financial assistance facility – the **European Stability Mechanism**.
  a. The ESM will dispense loans, not grants. This is not a bail-out mechanism
  b. It will earn a spread on the liquidity assistance it provides.
  c. Its loans will need to be approved by <u>all</u> member-states.

d. And be dispensed on basis of strict IMF-style conditionality.
e. These loans will enjoy preferred creditor status (junior only to IMF loans).

(ii) In return, all eurozone countries agreed to submit to new rules and procedures to ensure they reform their economies and consolidate their public finances. There will be:

a. A strengthened **Stability and Growth Pact**.
    i. More focus on public debt.
    ii. Sanctions that will bite earlier and harder.
b. A new exercise called **'European semesters'**
    i. Countries will present their budgets to the EU before these are adopted nationally.
    ii. Countries will have to tell peers what economic reforms they intend to introduce over coming year.
c. There will be increased **surveillance of macroeconomic imbalances**.
    i. The focus will be on countries running trade deficits, those running huge trade surpluses will not be deemed to have a problem.
    ii. There will be emphasis on ensuring that wages do not grow faster than productivity, but no action where the reverse is the case. productivity.

**Will the reform of eurozone governance work?**

The reforms being carried out to eurozone governance therefore point to the emergence of a more German Europe – that is, a Europe in which German assumptions about policy are hardwired into other member-states.

I do not mean by this that national economic models will disappear, or that Greece will be transformed into Germany. But German influence on economic policy will be much stronger than before.

This raises two key questions: ***Will this restore economic confidence in euro?*** and **Will the reforms we've seen so far restore political confidence in the euro?**

**Let's look at economic confidence first.** The grand bargain is highly unlikely to restore the most troubled countries to debt sustainability:

(i) Some countries (Greece, Ireland and Portugal) are in debt traps – ie the more they cut spending, the more their economies contract and the worse their fiscal positions become.

It's not enough to simply state, as Juergen Stark did last week, that the countries in question simply need to abide by their 'agreements', and market confidence

will be restored. The degree of fiscal tightening we're seeing here and elsewhere in the eurozone is unprecedented. The problem is that debts are rising as the ability to pay is falling.

(ii) Financial support under the ESM will not really help – it's a bit like a borrower taking on credit card debt to service a mortgage he can no longer cover with his income. Basically, piling more debt on top of already unsustainable levels of debt.

EU policy-makers, in particular those at the ECB, protest that they are against 'debt re-restructuring' or 'reprofiling' etc because they want to avoid 'another Lehman Brothers'. – that is, a catastrophic loss of confidence in financial markets resulting in a pan-European banking crisis and contagion to eurozone countries such as Spain and Italy.

Trichet, unsurprisingly, does not want to become the next Hank Paulson.

The ECB is right to worry about the consequences of a debt restructuring. But its own position looks just as problematic: the eurozone faces a solvency crisis – it cannot simultaneously resist a bail out (properly defined; ie transfers) and a restructuring of debt.

Its view that Greece (and others) can be restored to debt sustainability without any form of relief is wishful thinking.

The eurozone needs to devise a framework that shares the burden of adjustment.

Official loans need to be dispensed at less onerous interest rates; holders of peripheral sovereign bonds need to take 'haircuts'. Maturity extensions will not be enough, there will have to be write-offs.

The big question facing eurozone is whether such debt write-offs can be managed without: -

(i) spreading contagion to other countries, or
(ii) sparking a banking crisis in countries like Germany where banks have large exposures to peripheral debt and are thinly capitalised.
(iii) Weakening the ECB

For countries in the core, a default/restructuring in periphery would therefore raise important questions about their banks:

(i) Which banks should taxpayers recapitalise?
(ii) Which banks should the state try and wind up.
(iii) How to recapitalise the ECB

These are obviously big, challenging questions. The ECB is understandable concerned. But the alternative is hardly less risky. After all, we are seeing contagion as it is.

***<u>What about the second question: restoring political confidence in the euro?</u>***

The eurozone financial crisis is intimately related to a broader European political crisis.

EU leaders have been struggling to come up with solutions because of domestic political constraints at home.

(i) **<u>In the creditor countries</u>**. Mood summarised by German word: *Wutbürgertum*.

a. Widespread anger stemming from belief that lazy Southern Europeans and feckless Celts are being bailed out.
    i. In some countries, the rise in support for populist parties directly connected to this feeling (eg Young Finns).
    ii. No rise support for populists in Germany, but sharp fall since 2008 in share of Germans who think euro will be a success.

(ii) **<u>In the debtor countries</u>**. Mood is just as sullen.

a. Governments face an uphill task to persuade increasingly sceptical electorates of the case for austerity and structural reforms.
b. All peripheral economies are contracting. Ireland, which has seen its economy contract by 15%, is in a 1930s style depression.
c. There is no sense in any of these countries that they are being 'bailed out' by countries in the core.
d. Indeed, there is a growing feeling that they are being placed on an economic torture rack to bail out savers and banks in core.

The political backdrop, in other words, is extremely difficult – and risks becoming poisonous. Three lines of tension:

**First:** **Between governments and their electorates**.
Merkel has not been spared, despite a strong economic recovery.

**Second:** **Between creditor countries and debtor countries**.
<u>Creditors</u>: We played by the rules, others didn't.
<u>Debtors</u>: Others oblivious to our pain and their medicine isn't working.

**Three:** **Between eurozone member-states and the EU**.
We're seeing rising euroscepticism – for example in Germany:

**I'll round off by saying a few words about the Eurozone and the G20**

I think Yannos is absolutely right to connect the discussion of the eurozone to the G20.

In many ways, the problems we see in the eurozone are a microcosm of the challenges the world faces at global level.

The underlying problem – excessive private sector capital flows and a failure to agree what is driving them – is the same.

I agree there is a need to address financial regulatory issues. There is clearly a strong case for greater EU-level oversight of the financial services industry.

We have to prevent unchecked leverage and financial innovations that ratchet-up risk rather than reduce it.

But the underlying problem is excess savings in some countries, inadequate savings in others.

Or, put another way, excessively weak demand in some countries, which is only sustainable if it is offset by excessively strong demand elsewhere.

Neither is sustainable, whatever the creditor countries claim.

Indeed, it is pretty lamentable for creditors to decry indebtedness elsewhere. For every creditor, there must be a debtor. We cannot all generate excess savings.

Be it the Germans or the Chinese, they seem to be saying that they should be able to accumulate ever greater international assets without being exposed to any exchange rate of sovereign debt risk.

This is clearly highly problematic.

(i) We cannot all do a Germany unless the eurozone runs a steadily larger trade surplus with the rest of the world.

(ii) And at the global level trade balances sum to zero.

The Chinese yuan-dollar peg and Economic and Monetary Union – which has enabled Germany to engineer an artificially low exchange rate – are major obstacles to the necessary rebalancing of the eurozone and global economies.

This is hardly surprising as they were the chief mechanisms by which the surplus countries pursued the export-led policies that were the driving force of the imbalances that so contributed to the crisis.

There are two necessary preconditions for a healthy long-term global recovery:

(i) Stronger domestic demand growth in the surplus, excess-saver countries in order allow the deficit countries to deleverage without undue reliance on government deficits.

(ii) At both eurozone and G20 levels, countries' economic strategies must be consistent with balanced economic growth elsewhere.

Unless the imbalances are addressed, the world will stumble along, only supported as long as the US is willing or able to run up huge deficits and debts.