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The Euro Area After the Crisis

The list of challenges confronting Europeans is long and intractable. Will the euro area exist, with all its present members and several more, ten years from now? If it does still exist, how radically will it have changed? Will the fast-growing European economies of the past decade or two recover? Or will countries that have been relatively sluggish now outperform them? What sort of financial system should Europe seek? What structural reforms are necessary? How should Europe address its multifaceted challenge of demographic change? Can the new members in Central and Eastern Europe (CEE) continue to converge on the incomes of richer older members? The challenges ahead for Europe are, then, many, various and large. Moreover, the rapid rise of China and India, each of which has more than twice the population of the entire European Union, is shifting the balance of the world economy at a rapid rate. The periphery is on its way to becoming the centre, while the centre is, in all probability, on a long journey back towards being the periphery. So which of these issues do I intend to address today? The answer is given in the prospectus for the conference, which refers to "the long-term impact of the crisis on the process of European integration". The euro area, many will agree, needs radical reform. The question is how to carry out those reforms. In the process, I hope also to consider some aspects of another question: how to promote more rapid growth.

It was not logically impossible for the euro area to work well as constructed. But it was contingently unlikely. The attempt was made to impose the 19th century gold standard mechanisms, in a somewhat updated guise, on heterogeneous democracies with generous welfare states, rigid labour markets and government-insured financial systems. That has not worked, because nobody is prepared to accept the implications, which include, above all, labour market flexibility, sovereign default and, perhaps most important, waves of bank failures. If the euro area is to survive, with its current membership, it will need to become a very different union. There are some big choices to be made. The time has come to make them.

I am not surprised by the difficulty. It was as an English-speaking sceptic that I wrote some 20 years ago that the project for a monetary union was an

example of the core principle of Greek tragedy: hubris (pride); ate (folly); nemesis (destruction). The loss of the exchange rate and monetary policy safety valves in moments of crisis would rob national governments – the focus of politics now and in the future – of their freedom of manoeuvre. But in an integrated currency area, the practical consequences of defaults for confidence in the financial system would be too severe to contemplate. Creditors would feel forced to rescue debtors and debtors would be forced to obey creditors. In the process, the euro area would become a machine for exacerbating political frictions among member nations, not reducing them. These worries have surely been vindicated by events. With

this background, I would like to address three questions. First, why did this crisis happen? Second, is the crisis being addressed in a sensible way? Third, what reforms are needed to secure the system in the long run and how do they bear on the needs of long-term growth?

Why Did the Crisis Happen?

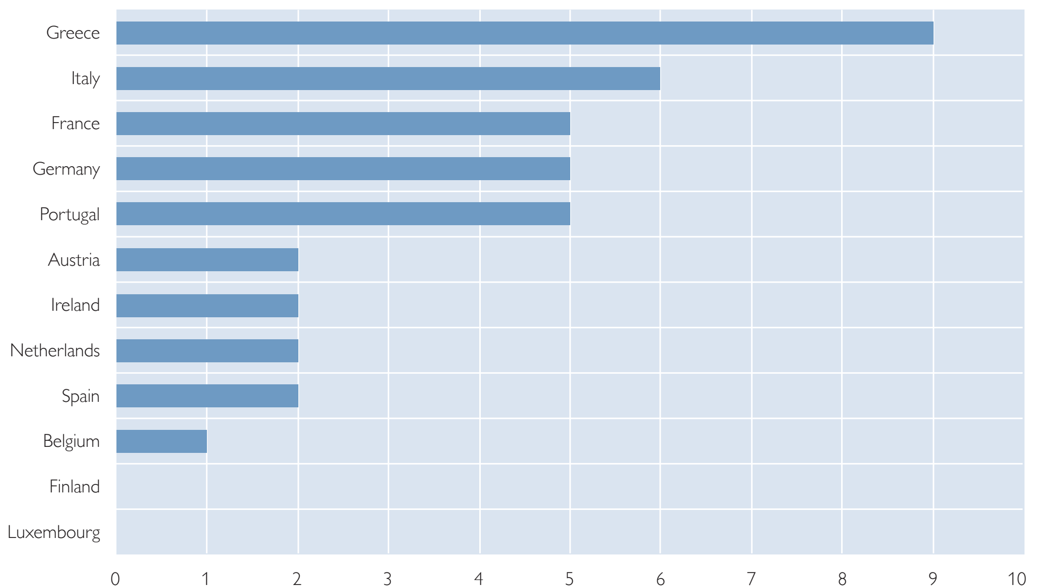
Bad diagnosis gives bad medicine. The crisis is not solely due to fiscal indiscipline, with the admittedly important exception of Greece whose fiscal indiscipline was egregious. But among the other Member States, fiscal policy does not demarcate countries that have avoided crises from those that have not. Thus, in the years leading up to the crisis, Greece exceeded Maastricht treaty limits nine times, Italy six times, France, Germany and Portugal five times, Austria, Ireland, Netherlands and Spain four times, Belgium once and Finland and Luxembourg never (chart 1).

In 2007, immediately before the crisis, Ireland and Spain both had budget surpluses and their net public debt was 12% and 27% of gross domestic product, respectively. It is simply wrong, then, to argue that the difference between the crisis-hit countries and those that have been crisis-free is their fiscal policies. More precisely, bad fiscal policy is a sufficient, but not a necessary, condition for a crisis. So long as bank debt is treated as if it were off-balance sheet public debt, a banking crisis will necessarily cause a fiscal crisis. Moreover, so long as banks are the principal financial intermediaries, large current account imbalances are also almost certain to generate banking crises, since they entail private sector financial deficits in deficit countries that are financed by rising bank credit, relative to incomes (chart 2).

In short, large current account deficits generate banking crises that then ultimately generate fiscal crises. This, in case anybody has missed the point, is

Chart 1

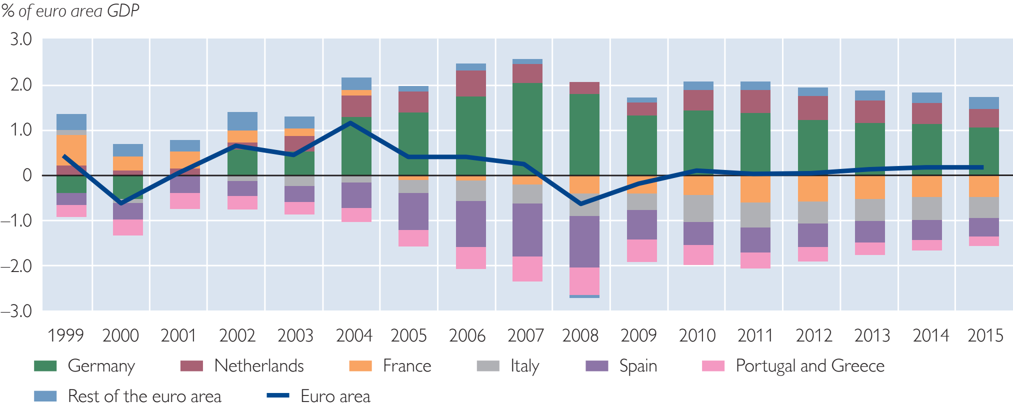
Number of Breaches of the 3%-Deficit-Rule



Source: Unicredit.

Chart 2

Current Account Imbalances in the Euro Area



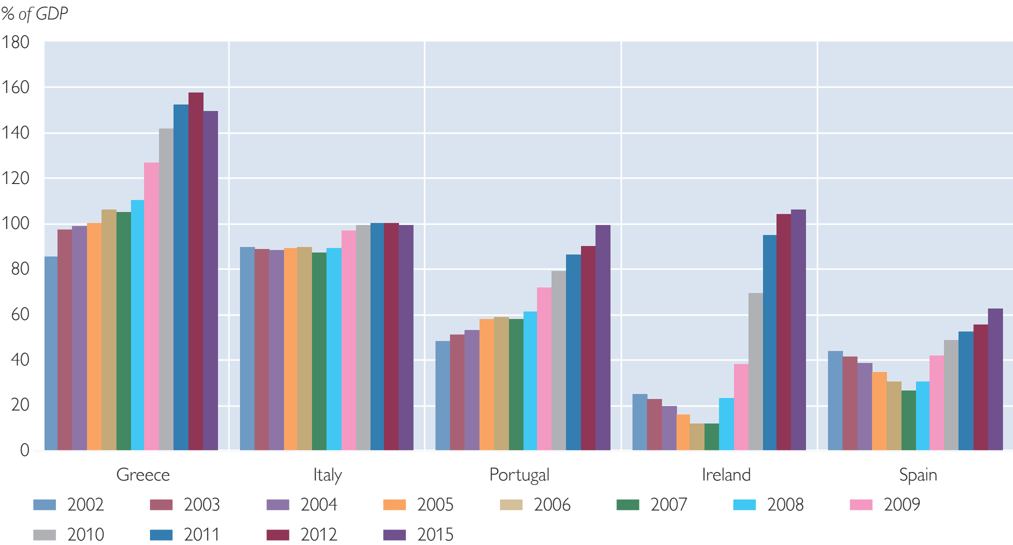
Source: IMF, World Economic Outlook database, April 2011.

precisely what has happened in Ireland and Spain (charts 3 and 4).

So what did drive the crisis? The answer is huge accumulations of debt in either the private or the public sectors. The notion, central to the design of the euro area, that the private sector's finances would be inherently stable turned out to be totally false, just as it did outside the euro area, in, for example, the USA and UK, to name but two. More precisely, the macroeconomic balance of the euro area was based on huge private sector surpluses in some countries, particularly Germany and huge private or public financial deficits in others. In effect, this is how the economy of the entire euro area balanced, given the monetary policy objectives of the European Central Bank. Meanwhile, vast flows of capital flowed from surplus countries into the private and public liabilities of deficit countries via lightly capitalised banking systems.

Chart 3

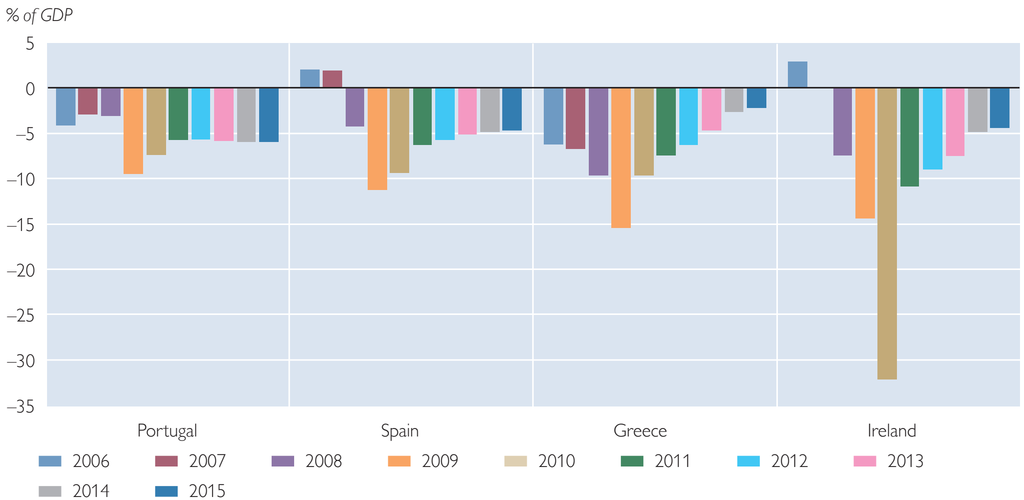
Net Public Debt Relative to GDP



Source: World Economic Outlook database, April 2011.

Chart 4

General Government Deficits



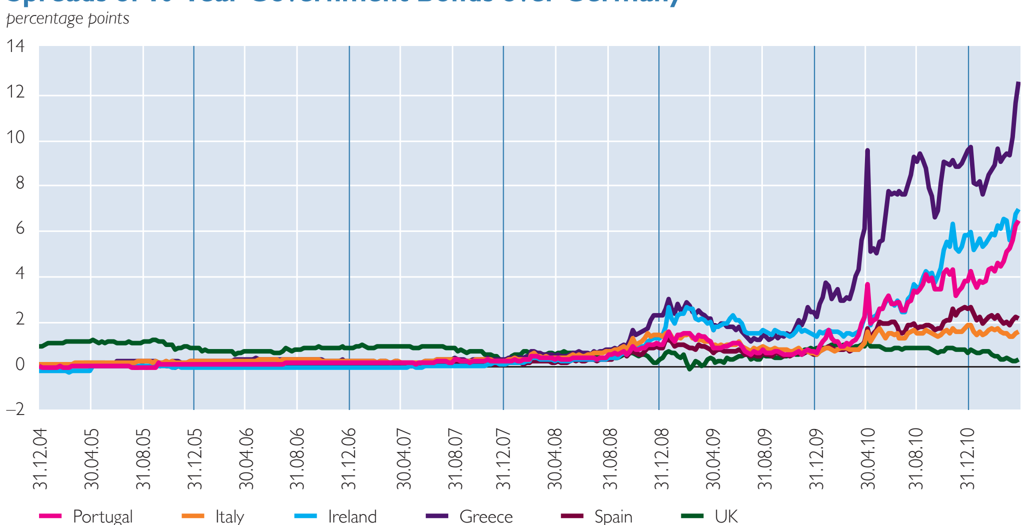
Source: IMF WEO database, April 2011.

This crisis, then, was created by the intersection between macroeconomic imbalances, defective financial intermediation and bad spending decisions, driven by profligate public or profligate private sectors. In the end, it has made very little difference, if any, whether the private or the public sectors were primarily at fault, not least because public debt is held by private financial institutions and insolvent private financial institutions are uniformly rescued by the public sector. It is essential, in fact, to forget the idea that, in current circumstances, the private and public sectors are distinct. They are not.

An obvious question is why these cumulative macroecononomic diver-

Chart 5

Spreads of 10-Year Government Bonds over Germany



Source: Thomson Datastream.

gences occurred and whether, in particular, this should be viewed as a temporary or a structural difficulty. One reason was that a number of countries found themselves able to borrow on much more favourable terms than ever before (chart 5).

This seems to have led to a "rush of blood to the head". That is a one-off event. A second reason was the failure of markets to differentiate among borrowing countries. Again, that will not be the case again, for at least some time. A third reason, however, is inherent in a currency union: booming economies tend to have high inflation and so relatively low real interest rates and vice versa. So divergences tend to cumulate. Then, when divergences become extreme and the bubbles finally burst, markets find themselves overextended. The result is internally driven regional boom and bust cycles. One consequence of the cumulative divergences of the pre-crisis years should, however, be stressed. Not only did an enormous quantity of bad debt accumulate, but so, too, did huge divergences in competitiveness (chart 6).

These must now be reversed. This is particularly important for countries with very large current account deficits, despite very weak economies: Greece, Portugal and Spain are the obvious examples. But that legacy makes the post-crisis adjustment far more difficult, since it implies both weak growth and very low inflation for lengthy periods, both of which tend to worsen the debt overhang. In these respects, the predicament of the countries in trouble is far worse than that of, say, Germany during its long period of "competitive disinflation".

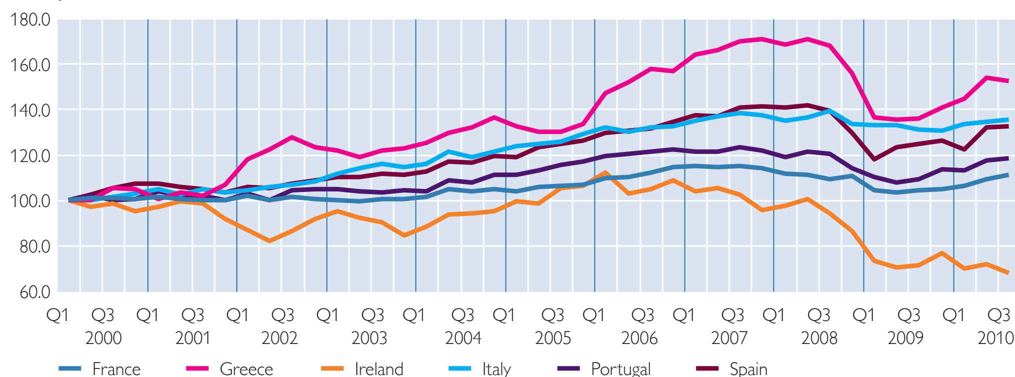
How Did the Euro Area Deal with the Crisis?

When it became evident that Greece had lied about its true fiscal position, a panic emerged in the markets. It was quickly agreed that a default would be massively destabilising for the euro area as a whole, because of direct and indirect linkages created via the financial system. In an interconnected currency union, the crisis of one country, however small, is potentially the crisis of all. This, in short, is a system simply riddled with externalities. So bail outs were arranged for Greece, Ireland and now Portugal and the European Financial Stability Fund was created. But we can now see that these efforts have not

Chart 6

Manufacturing Unit Labour Costs Relative to Germany

Index Q1 2000=100



Source: OECD.

restored confidence in the private sector, which clearly still fears insolvencies. This difficulty has, no doubt, been exacerbated by the evident conflicts among Member States over whether sovereign debt restructuring should be considered under any circumstances, with Germany saying "yea" and most others saying "nay". Further difficulty is created by the failure to separate bank debt from sovereign debt, which makes the potential (or actual) debt burden of sovereigns so much worse, with Ireland being far and away the most important case of this concern. In any case, with a decision not to restructure debt now, but to consider restructuring from 2013, on new debt, private sector flows tend to dry up for any country in difficulty: creditors can see quite easily that it will be extremely hard to sell debt to creditors who fear being "bailed in" after that date. That means that it may be impossible to refinance any debt they purchase now. That, in turn, makes it next to impossible to finance troubled countries in the market. As Paul de Grauwe, of Leuven University, has noted, there is a zone of indebtedness where there exists a risk of multiple equilibria. It is extremely easy to fall into a bad equilibrium without the right sort of support. Yet providing such support in a multi-country currency union is evidently very hard, since it looks like a blank cheque to the suppliers of the money.

In effect, the choice becomes either debt restructuring quite soon or official funding for the indefinite future. Both alternatives are horrible. The former choice risks a financial, cum sovereign debt crisis, of considerable magnitude. The latter means raising large amounts of money, to finance troubled countries, indefinitely. (Indefinitely, though, is not the same as forever.) It is possible – even likely – that almost all of the debt of countries in trouble will end up on the balance sheets of other Member States and the International Monetary Fund. Moreover, while it is conceivable that the countries in trouble will ultimately be restored to fiscal health, it is far from certain. The political and economic challenges for Greece, Ireland and Portugal are, in different ways, all enormous. It is quite possible that the members who finance them will lose some of their money. That will be hard to explain! Moreover, given the close links between the banking sectors and the governments (table 1), a sovereign default more or less necessitates a banking crisis, as well.

Table 1

Bank's Exposure to Public Debt End-2009

	Italy	Greece	Ireland	Portugal	Spain
	% of tier1 capital				
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		

Source: Nomura and BIS.

This will involve the European Central Bank or at least the system in politically embarrassing losses and the profound dilemma of what it is supposed to do, after such a crisis, to restore the banking system to some sort of health: is it a genuine central bank or is it the European Monetary Fund?

Lessons of the Crisis

I do not want to comment more on how to deal with the current crisis, except to note the many difficulties. It is not true, for example, that cutting fiscal deficits sharply will necessarily improve the situation of vulnerable countries if the result

is to weaken the balance sheets of the private sector and so the fragility of the state-insured banking system. This has to be a concern in, say, Ireland or Spain. But let us consider, in turn, some of the long-term lessons for reform of the euro area. Again, I am not going to look at the specific plans now under way, but the fundamental principles.

First, get the diagnosis right. It is not just a fiscal policy problem. Tighter application of the Maastricht treaty fiscal rules would not have prevented the crises, except, most obviously, in the case of Greece. An essential role was played by the internal imbalances and associated flows of funds, via the banking system, into financing asset bubbles. Thus, private sector imbalances can be as dangerous to stability as public sector imbalances. Effective supervision and regulation of the financial system is essential. So, too, in my opinion, is the possibility of serious discussion of macroeconomic imbalances. Surplus countries need to understand that they have to finance countries in deficit, one way or the other. Otherwise, their surpluses will prove unsustainable. Thus a toughened growth and stability pact will not solve the underlying problem.

Second, fix the problem caused by the symbiosis between banking and the state. The banking sector needs to be able to survive sovereign debt restructuring and sovereign creditworthiness needs to be able to survive bank failures. One of the arguments for Eurobonds up to, say, 60% of GDP is that it would provide banking systems with unimpeachable assets, so protecting themselves against the failure of their own governments. Also crucial is the development of a euro area-wide banking system and that would be far better able to cope with problems in any one country. Moreover, the banking sector as a whole needs to be far better able to cope with shocks. Much higher capitalisation is, in my view, a crucial element of such a strengthening. It would also be very helpful if more of the flow of capital

went outside the banking system and particularly in the form of equity. Financial sector reform is, in short, an essential element in making the euro area system as a whole more robust.

Third, be able to offer substantial liquidity on affordable terms to governments in temporary difficulties. The toughness comes in the conditions imposed not in the interest rates that need to be paid. This is the only way to deal with the evident problem that members of the euro area are more like emerging countries borrowing in their own currencies than countries able to borrow in their own. Along with Eurobonds, this should eliminate the risk of severe sovereign debt crises. But, in the last resort, it will be necessary sometimes to accept debt restructurings. It is crucial, if that is to happen that the reforms of the banking system, to separate it more fully from the state, have also taken place.

Fourth, introduce systems of automatic wage flexibility. In the absence of exchange rate adjustments, the principal adjustment must come via wages. While

big wage falls create severe risks of debt deflation, the alternative is even worse. So it must be possible to adjust wages swiftly when competitiveness is impaired. Whether that is possible in European welfare states is, however, an open question. But many years of painful wage deflation is immensely costly. This sort of process has to be accelerated.

Conclusion

The survival of the euro area with its current membership is very far from certain. It requires movement in three directions simultaneously: towards greater solidarity, greater flexibility and greater discipline over both private and public sector finance. The members are bound together more fully than many may have realised when the project began. But that is now evident. A crisis in one creates problems for all. The question is whether it is politically possible to draw the necessary conclusions.