Event Transcript

# Why the Eurozone Crisis is Not Over

Martin Wolf, *Financial Times*

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*Unedited transcript*

Marcus Noland: And it is my great pleasure to welcome you here to this event featuring Martin Wolf that we are hosting together this afternoon with the National Economist Club (NEC). Let me just say a couple words of welcome, then I'll hand things over to Robert Graboyes from the NEC.

As a speaker, I am always particularly gratified by return invitations because it indicates that I must not have screwed things up too badly the first time around.

Well, Martin Wolf spoke here only a few months ago at the book release event for Arvind Subramanian's book and before that was one of our Whitman Lecturers a number of years ago. So clearly, we have great confidence in Mr. Wolf and I am sure that you will enjoy this afternoon's program. So please, Robert.

Robert Graboyes: Hi folks. I'll be very quick about it. Just a couple of things. I'm Bob Graboyes. I'm president of NEC. I wanted to thank first of all Martin Wolf for the very generous allotment of his time for doing this. I want to thank Fred Bergsten and Peterson for allowing us to do this wonderful partnership. I think it's probably the biggest NEC event since I've been in Washington. And just the last thing I'll say before turning it over is we have an astonishingly fine lineup of speakers the next couple weeks: Dale Jorgenson, Jeff Miron, Doug Halsey, Jared Bernstein, a bunch of others. We'd love to have you as members and we'd love to have you attend. And with that, let me just turn it over to Jules Lichtenstein, our programming VP, who will introduce. And I'll also mention Brian Roberts, who is somewhere in Africa and couldn't be here.

Jules Lichtenstein: Thank you Bob. Good afternoon. I'm Jules Lichtenstein. I'm an economist at the Small Business Administration, Office of Advocacy, and co-Vice President for programs at NEC, along with my colleague Brian Roberts who can't be here today.

I have the distinct honor and pleasure of introducing our distinguished speaker for today's luncheon talk, Martin Wolf. Martin is Chief Economics Commentator at the Financial Times of London. He was awarded the CBE, the Commander of the British Empire in 2000, for services to financial journalism. Mr. Wolf is an associate member of the governing body of Bluefield College Oxford and is an honorary fellow of Corpus Christi College Oxford University and the Oxford Institute for Economic Policy in Oxonia. He is also an honorary professor at the University of Nottingham.

He has been a forum fellow at the annual meeting of the World Economic Forum in Davos since 1999 and a member of its international media council since 2006. He received an honorary Doctor of Letters from Nottingham University in July 2006 and an honorary doctorate of science and economics of London University from the London School of Economics in December 2006. He is a member of the UK government's independent commission on banking in 2010-2011 and Martin's most recent publications are Why Globalization Works and Fixing Global Finance.

Please join me in a warm welcome for our speaker. Thank you.

Martin Wolf: Okay. This is an astonishingly large audience. I must say that I would've thought that most of you could do something better than be depressed about the fate of Europe.

As I entered I met a friend of mine, I won't say who, and we had a discussion about where we are in this crisis. And I said over the last four or five years, we see to be running a relay race across the Atlantic to decide who can screw up most. I think the U.S. was definitely ahead in the first year or two but Europe has certainly far surpassed it. But I'm confident that towards the end of this year, the U.S. may catch up again. We will see. I hope not actually, but we will see.

I also have to say I'm always very amused when I'm introduced explicitly in the United States as a Commander of the British Empire. As I'd like to note, it shows that whatever else, the British haven't lost their sense of humor. We will still be awarding the commander of the British Empire when people have long since forgotten that there ever was a British Empire.

I'm going to try and cover a fair amount of ground quite quickly so we can have a discussion about the issues. It's inevitably going to be very superficial. There are a lot of counties involved, a lot of economics, a lot of politics, and it's a very, very much an overview of where we are and why the crisis is ongoing and what might need to happen to resolve it and how long it's likely to take. The most important point of that is a long time. This is a crisis that will take a long time to fix.

Let me start, if I may. This isn't sort of—I think entirely vainglory—with sort of saying where I came from on this. This is a quotation from a column I wrote in a debate I had with a colleague of mine who was a delightful man and a mad Europhile on whether the monetary union was a good idea. And it's 21 years ago, so it's a long time ago, and I wrote then that I was concerned that the effort to bind states together in the Currency union obviously may lead to a huge increase in frictions among them, and if so, the event would meet the classical definition of tragedy, hubris, arrogance, arti, folly, nemesis, destruction. And I think—I do think—that those worries that when life got really hard we would find that the currency union split Europeans from one another rather than brought them closer together, made the creditor nations despise the debtors for their irresponsibility and the debtor nations despise the creditor nations for their harshness, is exactly where we are.

I'm going to go through seven questions. You don't have to remember all these but it will give you a framework for what I'm going to say and I should say that a full version of this talk, not just the slides, will be posted so you can pick it up. I'm just going to—after this show you the charts.

So, first of all, I'm going to talk, say why I thought all along that the Euro was an immensely risky project. But, and it's very important in this context, I also think that now that it's being created, breaking it up is a very dangerous idea. It's not completely infeasible and in some ways it's even got a little bit easier for reasons I'll come to. But it's a very, very difficult and dangerous idea.

So that leads me to the third question is—well, if you don't want it to break up, what is the Euro's own need to do? What are the core challenges that have to be addressed if that outcome is not going to be a disaster? And that leads me to the fourth and major point that it has been an argument of mine throughout as anyone will have read my columns will know, that it's extremely difficult to fix a crisis like this if you don't have a correct and agreed understanding of what the problem is. And the problem in the Eurozone is there is neither an agreed understanding nor to the extent that there is an understanding of the most powerful country in my view, is the correct understanding. The combination of an incorrect understanding, which is the dominant view, along with disagreement is a huge part of the difficulty of solving the crisis. That will then lead me to my analysis of why we are where we are, which is the major part of what I'm going to do, and then I'm going to talk about what needs to be done at once, and then what needs to be done in the longer term.

My reasons for skepticism … I assume the creation of the Euro and the creators of the Euro assumed first that the balance of payments would not matter inside a currency union. I believed all along that that was a serious mistake and the balance of payments issues would reemerge but they would of course reemerge as credit issues. And that's exactly what has happened. And in many ways, they are more difficult to resolve than a balance of payments issue, which can at least allow adjustment through the exchange rate.

The second difficulty was that it was perfectly obvious that the Euro was going to tie together fundamentally different economies with fundamentally different sources of competitiveness and therefore there would be situations—one would not know what they were—when they would find themselves in very different economic situations. And some of that would be exogenous and some of it would be endogenous, and I'll come to that in a moment.

The Euro obviously eliminated the pressure valve that most countries, many countries, had used in the past, namely the exchange rate adjustment, and therefore inevitably and necessarily, puts adjustment pressure on nominal wages. And this it did in some of the most rigid labor markets on earth. And finally, the Euro as structured offered next to no insurance arrangements, essentially no insurance arrangements for countries should they get into difficulty. The assumption was either they would not get into difficulty or that automatic market disciplines would work to force them to change and that in any case they should be able to have some access to capital markets. Government should be able to have some access to capital markets in the event of adjustment difficulty. And those assumptions were crucial, and in my view, when you put them next together, it was obvious that they were likely to make for very big crisis if and when—if a crisis started.

So that's why I was very concerned about creation of this system. Nonetheless, in my view, there is tremendous danger in trying to reverse the process that created the Euro. The way I put that is pretty obvious and banal. It's really difficult to unmake an omelet. And they have created a monetary and financial omelet.

Obviously, many people have talked about partial breakups, one or two countries leaving. But of course, inevitably once that happens, it ceases to be an irreversible system. Currency risk therefore is back inside the system. Currency risk will re-emerge of course in the form of credit risk and it can become quite unmanageable—indeed it's what's happened—so partial breakup is very difficult. Comprehensive breakup, which might follow from partial—might happen on its own, will be an enormous shock to the European and global financial and economic systems, and even more important to my mind, to the political credibility of the entire post- war European order. They've staked this entire project on this monetary union now and the collapse would be, I think, an enormous political threat. It's almost impossible to imagine it happening without irreversible changes in attitudes of countries, important countries in Europe, to one another. So the costs are enormous.

Just to make a little footnote on this, on the economic side, obviously one of the consequences of the crisis, without a doubt, has been the renationalization of finance within Europe. As a result, a very large part—I'm going to come to this later—a very large part of finance is now being carried out by the European Central Bank, which is operated as the one genuinely European institution. That, in some sense, makes breaking up easier. It doesn't make it easy. It's still a nightmare. But it makes it easy. It really means when there's a breakup, the Germans end up with an enormous credit balance, which will never be repaid. And the balance is getting bigger and bigger, and the Germans are very well aware of this. It's one of the big risks in the system now. But the basic point is that the whole idea was to make the project irreversible by making the cost of exit enormous and those costs are not illusory. They are real. There are very large costs associated with breakups.

So then the question that's led me to my third question, assuming that it wasn't a bright idea in the sense that it was going to create—it was likely to create at some point a severe crisis, and lots of the protagonists thought that might happen. That would be the trigger for further reform so that's where we are now. And the second point is once you get to that crisis really trying to reverse it is a tremendous mess.

So then—that's the third question—is what does the Eurozone need to do to solve these problems? We already know that, as many people thought—many economists thought—that as designed in the way that I laid out very, very simply, the project has failed in the simple sense that when the crisis hit, it has been necessary to create a very large number of new institutional arrangements. Funds which would have the capacity of offering insurance to countries in stress in the European financial stability from the new European stability mechanism, of course the extraordinary role of the European Central Bank as a founder of the new fiscal compact, the whole array of new arrangements to oversee internal imbalances are a reflection of the fact that the project as designed failed. What they are doing, in my view, the way I've described it, as it's like rebuilding an aircraft while it's crashing. This is a very tricky task and I would have to say, in all, they've done more than I would have expected. Under pressure, they've done more than I would've expected.

But the big question, which I'll leave to you towards the end, is whether the feasible political set, namely, the set of arrangements that they can agree with to handle the problems that have emerged, intersects with the feasible economic set. That's essentially the point. Is there a set of politically acceptable arrangements for everybody, which are compatible with a workable economic arrangement? By a workable economic arrangement, I mean one that allows member countries to feel on the whole and in the long run, it's an arrangement that is to their economic benefit. That's the fundamental question on which I think the answer is not obvious.

That then leads me to my fourth question or issue, why is a correct understanding essential? It seems to me obvious that if you are to fix this airplane while it's crashing, you have to agree on what went wrong because otherwise you don't know what to repair. There has to be some essential agreement. The agreement has to be correct and it has to be at least largely agreed. Now of course, Germany is overwhelmingly the dominant country, the largest and most credit-worthy country, and its views count for as much as everybody else put together, if not more. But they can't decide it all on their own. They have to gain consent. This can't be run, in my view, as an empire. And for that reason, there has to be some agreement because if there isn't, the political processes in other countries are going to generate leaders who simply won't go along with it. And that is what I think we're beginning to see.

Now, I believe that the official view at least, being offered by the German government, noted by all the German economists, they're not by all parts of the German government at all times is seriously incorrect because it regards the crisis as essentially a fiscal crisis. And in my view, following on what I said, it's essentially a balance of payments come financial crisis, which has fiscal, profound fiscal ramifications. And if we view it as a fiscal crisis alone—and I'll come back to the end—I think we are on a path to calamity.

So that then leads me to my fifth section, which will be much of what I have to say, which is well what actually drove this crisis? Now if I leave aside for the moment the fact that in some sense the project as a whole bid, namely breaking a single currency among very different, very different states which continued to have predominant sovereignty, overwhelming sovereignty in all areas of policy other than monetary, including financial policy which they controlled and the states controlled. Fiscal policy was controlled by the states. Labor market policy was controlled by the states. Pretty well everything we considered the normal attributes of statehood continued to be controlled by the member states. The federation really operated on the basis of monetary integration and very weak fiscal rules and nothing really else. Obviously, this is not what we would think of in any way as a federal union, even in its weakest form.

So that's obvious, okay? But beyond that, essentially the trigger for this crisis was the result of enormous divergences that accumulated in the years of excess, driven by and helped by euphoria about the project and equally and matched in euphoria in financial markets more broadly, of which the Euros zone was one, but far from the only victim. I'll come to that in a moment. In fact, it turned out to matter far less whether private or public sectors were being financed than how big the external financial flow[inaudible 00:20:44] turned out to be. And when the crisis occurred, what happened essentially were a series, a rolling wave of what Latin American economists would call sudden stops. "In Private Finance Across the Eurozone" is an excellent paper, which I've referred to in my columns by—coauthored by Jean Pisani-Ferry for Bruegel, which illustrates that phenomenon beautifully.

So let me just with that go through a few bits of data, which support my proposition. I think the best indicator of whether a country has accumulated a profound—obviously I can't go through every chart. I could give you a hundred charts but I'm actually limiting it, you will be happy to know. So I'm limiting to a few that I think are relevant.

So how big a problem was the debt problem, the fiscal problem, as a result of past malfeasance in the countries that have got into difficulty? So I tend to think net public debt is a better indicator than gross but they're basically very close so it doesn't really matter. Well, we can all agree that Finland is fine—net asset, 73% of GDP, that's great. We would all like to be Finland in this situation. Let's look at the rest of them.

We have five countries that got into really serious difficulty. The first two, as we read from the left, are Ireland and Spain. Ireland's net public debt in 2007 was 11% of GDP, which we would agree was a pretty good fiscal position. Spain's fiscal debt in 2007 was 27% of GDP and both of them are either a quarter or a half of the German and French level.

We then move to Portugal, which is very close to France and Germany. So if it's a fiscal crisis, France and Germany should be in the same state as Portugal—actually, maybe France will be. I will come to that in a moment. And then we've got the two outliers, Italy and Greece, which genuinely did have very large net debt, and in the case of Greece as well, huge fiscal deficits. Italy had very small fiscal deficits. These debts were the result of the spending and deficits of the 80's and early 90s'. They're a very long legacy. But it's pretty clear that if you wanted to use the accumulated fiscal errors as an indicator of the likelihood to get into crisis, you would've been completely use it would have been useless—completely and totally useless.

So what I will do now is just to follow that up and look at these five countries, which have gotten to the most obvious difficulty and show what happened after the crisis. And you will see that in the Greek case—by the way, this of course includes the benefit of the haircuts because this is the most recent IMF data, so it would've been much worst otherwise—but you can see even in the Greek case, a very large part of the debt accumulation was after the crisis—Italy, much more controlled, relatively small. But Greece, it was clearly after the crisis. Portugal's debt has exploded after the crisis. It's the consequence of the crisis. And in Spain and Ireland, this is dramatically so. In the case of Spain, net public debt is forecast to increase from a roughly 27% of GDP to close to 80% of GDP in seven years. And in the case of Ireland, I've never seen anything like this—but there may be people in the audience more expert than I am—but in the case of Ireland, net debt went from 11% of GDP to 105% of GDP in a very short period of time. About a third of that was due to the direct bailout of the banks and the rest was due--which was a colossal policy error and by everybody, by the way because it was imposed upon them in significant measure but they did ask for it—and the rest of it was just the recession.

So these countries do all have fiscal problems now. There's no doubt. But it's not where they started in the case of Portugal, Spain, and Ireland. And even in the case of Greece, it's clear that the problem was enormously exacerbated by the crisis.

A much better indicator of whether a country was going to be in the crisis, hit by the crisis, was its prior net capital inflows and I've constructed this chart which follows perfectly the pattern of the IMF's famous global imbalances chart, but it's just for the Eurozone, and it's put in the major groups of country. Ireland is so small, deficit wasn't that huge. It doesn't really figure here. But essentially what you see here is that the Eurozone as a whole has been imbalanced—that's the blue line—pretty well for the last—it's basically an external balance but the external balance has disguised in colossal emergencies of internal imbalances or net capital flows if you like. With Germany and the Netherlands—Germany and then the Netherlands—emerging as enormous capital exporters and Spain, Italy to a smaller degree but still Spain, Italy, Greece and Portugal, and lately France emerging as very large net capital importers and of course it will not have escaped your attention that every country that was a large net capital importer without exception is now in crisis.

That's the crucial thing. And this reveals the same point essentially in terms of the averages of what happened between'97 and 2007—so the decay up to the crisis—essentially we have a number of capital surplus countries—Finland, Netherlands, Belgium, Germany. Germany was actually getting bigger and bigger. This is an average. France and Italy was going to be—and then we have a number of very, very large, huge capital importing countries particularly Ireland, Spain, Greece and Portugal. Estonia also fell into that category, also fell into crisis, but it falls into a different category. I don't have the time to discuss it. But it's clear that the countries in crisis have in common, very clearly, that they were either large or enormous net capital importers.

In the case of Portugal and Greece, we're talking about countries that ran current account deficits that averaged between 8 and 11% of GDP over ten years. And of course, they accumulated an enormous, enormous net foreign liability positions, which I don't have the time to show you. But what also happened as part of this process of capital flowing into the peripheral countries on this enormous scale was very large changes in competitiveness.

To illustrate this—there are many different ways of looking this—I've used unit labor cost in manufacturing, since these are tradeables, and I've used Germany as the benchmark. Now there's some reason to argue that Germany was somewhat overvalued initially, so I don't want to suggest that all this is a deterioration, but if you look at Greece, the unit labor cost relative to Germany rose by 80%. It is not surprising they have a problem. It is not. And there is no deflation on earth that can reverse that, in my view.

In the case of Italy and Spain, it's between 30% and 40% which is pretty disturbing, particularly in the case of Italy I think. Portugal is smaller but Portugal was seriously uncompetitive to start with. The only country of the bunch that looks reasonably attractive from this point of view is Ireland, which is the only country in the Eurozone that has genuinely managed debt and internal devaluation. It's the only country to manage internal devaluation, which you can see at the bottom. Others have really serious competitiveness problems, which they obviously have to reverse.

Now, what happened? There was a huge inflow of capital, private capital, into these countries. The public sector was not involved in any way. These charts I've taken from my column on this subject, which are themselves based from the Bruegel charts, which I think are wonderful. What they show is the cumulated private inflows for Greece, Portugal, Spain and Italy—that's the dark red. Above them in yellow is essentially—putting it very crudely—the net inflows from the European Central Bank operating as a lender of last resort. And the pink above that is official programs—the IMF, the EFSF, bilaterals, all that stuff. And you will see that in the case of Greece and Portugal, from 2008 the private inflows went negative. The private sectors have just been taking money out in a big way. That started in Spain and Italy much more recently. You can begin to see it happening much more recently in a subsequent wave of sudden shocks and with the weight there being taken up, overwhelmingly in all these cases, by the European Central Bank operating as a lender of last resort. And we have to say very, very clearly that without the willingness of the ECB to operate in this way, the system would've completely collapsed. All the banks would've gone and the governments would've gone.

So I give the ECB and Jean-Claude Trichet and Mario Draghi—particularly with his brilliant LTRO operation—a great deal of credit for taking this enormous exposure on their balance sheet, which of course as you all know if you've looked at this issue of the target balances, has meant giving huge net claims to Germany. I think they are now running at about 700 billion Euros—I'll have an exact figure later—and will just keep on accumulating because they are essentially funding the system in this way. It's much more important than the official programs.

Now of course, this is associated with and crucially, a tremendous capital market price reversal. The disaster for these countries was that up to 2008, all credit risk among sovereigns—and that affected of course all the credits within countries since the country still mattered those recipients of capital in my view for the reasons I've tried to say—all credit risks disappeared. They were all treated as the same and that was what encouraged these enormous inflows of capital funding, either the government in some cases or very often the private sector, who where country risk was assumed—country risk itself was assumed to be zero.

Then of course—in fact, there was even a period interestingly in 2006 when there was a negative spread with Ireland. Ireland was trading with a lower interest rate than Germany. But that was a very brief peculiarity.

We then got a very rapid explosion of credit spreads. You can see the Greek one. You can see the Portugal one, and the Ireland one, which has come back a bit. That's the one real successor gain. They moved within a year essentially, from a position in which there was no problem in funding themselves to a situation which rollover was completely unmanageable. Their debt became completely liquid and these countries were driven into the arms of the ECB and official lenders.

More recently, and much more seriously, the same phenomenon has affected Italy and Spain. You can see that really started late in 2009. You can see on this chart, they peaked spreads of between four and five percentage points, so Italy's debt was then trading at about—with a yield of 7%, which in the case of Italy is absolutely unsustainable as a long run rate, since we're talking about a country who's normal GDP in a good time is going to grow 3% and for the next few years is going to decline.
So a 7% nominal yield is just not a sustainable yield.

You will see that the LTRO, when introduced at the end of last year, reduced spreads by a couple of percentage points and you will see that this is now beginning to reverse. The impact of putting in a trillion Euros to fund the banking sector was not enough to bring those spreads to manageable levels and that is giving both of these countries a very serious long run, rollover problem.

Belgium is better at the moment than that. It's got in many ways quite a strong position, but of course it has this huge debt hangover problem.

Now, the final point I would like to make about where we are and how these things fit together, is of course an absolutely fundamental attribute of this system as it evolved when crisis hit. People started saying, "We don't want to lend to Spain and that because we doubt the Spanish sovereign and therefore we doubt the institutions that are closely connected to the Spanish sovereign. Now one of the in—Spain actually is better. I'll come to Italy in a moment. And the institutions that are most closely connected to a sovereign in the Eurozone system are their banks and they are funded now increasingly by the ECB and they hold a lot of sovereign paper. And even if they don't hold a lot of sovereign paper, the sovereign backstop has historically been deemed important.

One of the results of that is an extraordinarily close correlation between the deemed riskiness of banks and the riskiness of the sovereign associated with those banks and since the sovereign is deemed highly risky, that generates a fundamental structural riskiness in the banking system.

In Spain interestingly because the big domestic banks are so international and deemed historically run, well run, the spreads are actually below the sovereigns, but they are still very highly correlated.

In Italy the spreads are so close that you can hardly separate them. Essentially lending to the major Italian banks is now deemed—it goes along with lending to the Italian sovereign. This nexus between the banks and the sovereigns has become a decisive element in the crisis.

Now what—when in this post crisis period has then happened with the funds cut off with real interest rates soaring, with fiscal positions under stress, a lot of pressure to cut fiscal deficits—what's happened to GDP and unemployment and trade and I think that's the last part of this—what are the causes of where we are—that I'm going to go through and you can see that all the countries were very badly hit by the crisis.

Interestingly, Greece initially not—it just kept going. But today Greece and Ireland are basically running about 10% below the starting point. There's no sign of recovery. I don't have the latest data from Greece, but it's continuing on down. We had a very weak recovery for Italy and Spain, and they're now both way below the starting point and now declining again. I'll come to that in a moment. The same is true for Portugal. Therefore these countries are all now essentially in structural slumps.

The question is only how deep this will get and how prolonged? I think it will be deep and for many, many years. I've just put in contras Germany, which also had a deep recession, has of course made a very strong and vigorous recovery, which roughly matches interestingly the U.S. recovery.

More important probably than the GDP figures, is what's happened to unemployment. So here from the latest wheel, I compare the unemployment rates in 2007 with those for 2012 for Spain, Greece, Ireland, Portugal. I won't go further and you can see it's a horror story.

Now of course everybody knows Spanish unemployment statistics are a bit strange, but whatever their measuring, it's increased 3 times. In the case of Greece, it's gone up 2 ½ times. In the case of Ireland, it's gone up more than 3 times. In Portugal it's doubled. We are talking about countries in which the average unemployment rates are now between 15 and 25% and youth unemployment is anywhere between 30 and 50%. In my view, in a modern welfare state this is not going to turn out compatible with political stability.

There is some good news on the trade front, particularly and strikingly for Spain. This is these exports of goods and service—the light blue line. Spain has managed a very impressive export surge. Italy has done actually quite well, though it's still way below the starting level, but Spain actually has managed to get its exports above the starting level before the crisis and so has Ireland.

So there's important little windows of light. I'll come to the implications of that later. So that, very briefly, is where I think—how I think we got into this crisis. Of course, when I go through this story, there are some important similarities with other countries, particularly the U.S. and U.K, but the scale of the current account deficits run in those cases—noted in the U.K., even in the U.S—was significantly smaller. Second of course, there is exchange rate flexibility and third, there's a central bank that is willing to act as a credible provider of liquidity to the sovereign and these attributes are missing in the Eurozone case.

So what do they have to do now and I'll come to that in the last part of what I want to say. They have to finance in the short run and they have to adjust in the long run. Essentially that's an absolutely classic IMF type problem. You've got a huge financial crisis in a country. It's totally liquid. The sovereign is a liquid. The private sector is a liquid. There's a lot of losses, clearly. There's no doubt about that, and a lot of debt will have to be written off. And to get out of this, ultimately, the country has to adjust and essentially that means in this case, the country has to adjust to a situation where it's reasonably prosperous and has much, much smaller current account deficits than it started with and that means a new economy.

Put very crudely, in the case of Greece, it clearly means a new economy. In the case of Portugal it means a new economy. In the case of Spain, it means a bit of a new economy. In the case of Italy and Ireland, I think rather less so.

So, the question is how to make this possible. Obviously, if you had a fully-fledged transfer union of a federal nature, financing would be solved automatically, but if you were completely automatic, adjustment might be postponed forever. I think that would be very, very undesirable. So I actually go with Germany in the view that a fully-fledged complete transfer union, which provided unlimited finance to countries now in difficulty, will be a very undesirable outcome. It risks creating a Southern European metzajournal. The whole of southern Europe becomes a metzajournal. It's not going to happen, but that will be in the desirable.

But in an incomplete union with very limited transfers, the financing may be inadequate and the adjustment so severe that the political system crumbles under the weight and it's getting the balance between those two that is the heart of the policy challenge they now confront.

In practice, the EC governments and IMF have very partially solved the financing problem, but not without leaving a massive rollover problem in the short or medium term for these governments. They continue to face interest rates, which in my view are not sustainable given the length of time it will take them to adjust their fiscal accounts and their external accounts, which are of course very closely related.

The real adjustment itself, to creating economies which are viable and competitive, can sustain reasonably high employment without huge current account deficits will take many years and it's going to create a lot of problems along the way—high unemployment, debt deflation—a crucial part of the problem because to get competitive, prices have to fall in these countries and that will mean that the real indebtedness will get worse, so the debt problems get bigger. They're going to have to be more write-downs, and that will lead certainly to more defaults in private and public sectors. And this is very different from the German adjustment, which is often pointed to in the period up 2007, which of course occurred during a boom and particularly an inflationary boom in the countries outside.

I know I've got about five more minutes, so let me go through where I think we need to go and I'll come to this in a moment.

So what needs to be done? Well in the short run, and by the short run I mean the next five years or so, could be 10 years. The short run is quite long. The short run is quite long, very important. Getting out of this crisis will take 5-10 years if they can do it. Basically, there's going to have to be financing on a scale and generosity sufficient to allow the real adjustments required to occur and in the absence of devaluations, the real adjustments are going to take 5-10 years minimum. There's no other way that these adjustments can occur except on that sort of time horizon in my view. There will have to be recapitalization of banks on a scale sufficient to manage plausible losses and by definition the recapitalization cannot come from the sovereigns in the case of the countries that are in difficulty because as I pointed to you, that screen convergence of risk spreads, the cost of funding for the sovereigns is essentially the same as the cost of funding for the banks. There is no risk-free rate in these countries and the fact the Eurozone system makes the banks national responsibilities—I'll come to that in a moment—is a giant problem.

There has to be adjustment by both surplus and deficit countries in the context of quite dynamic aggregate demand in the Eurozone as a whole and a significant relative price rising of core countries by a divergent inflation.

As I like to say when I'm in Germany and the Netherlands, "We'll know the system is working when inflation in your country is 4 or 5%." And that is not a joke. Just think what it means to have a 2% average inflation. If these countries are to improve their competitiveness at a reasonable rate, their inflation is going to have to be somewhere in the zero to negative range and the core countries will have to have much higher inflation.

Apart from fiscal adjustment finally, that matches the plausible pace of adjustment of external and private sector accounts. And that leads me to sort of the last charts. This is what [inaudible 00:44:57] has shown for 2012, successively starting with January of last year and ending with March of this year, as it's consent, and you will see that over that time two big things have happened. First, people have realized that Spain and Italy are going to have very deep recessions and they've got deeper with each successive month and they've also concluded that the Eurozone as a whole will be in recession and of course that means that the context within which these countries are adjusting is about as bad as it can be. It's just about as bad as it can be and unfortunately, this is expected to continue into 2013—and I suspect this is too optimistic—I expect these countries to continue to be in recession next year.

But anyway, they're not expected to grow at all and again, in the context of a very weak Eurozone growth, now forecasts a .8% next year.  The [inaudible 45:57.7] chart—these two go together—is to show the nature of the adjustment problem that is required if they are to eliminate the fiscal deficits as the German mandated fiscal compact or as the fiscal compact suggests they must. And this is another way of looking at where we are on the crisis and it sort of leaves us, I think, with a very clear macro view.

Basically, what I've done is take from the IMF stator by a bit of manipulation, the implied private sector financial balances. That's to say the surpluses and deficits. Up to 2007, in essence, are very simply the German level and Dutch private sector ran huge surpluses and colossal deficits were being run in Spain, Greece, Portugal, Ireland, Slovenia, and so forth, exactly as you'd expect because they were net borrowers. It was the private sector that was the biggest borrower.

This is what that looks like now. Essentially all the private sectors are either imbalanced or running huge surpluses. If the fiscal deficits disappear, either those private sector balances must go towards zero or the current account deficits must become surpluses. This is a matter of pure logic and the only way those two things can happen quickly is through depressions. There is no other way and that's why the challenge of adjustment is so difficult and long term.

Let me just sort of bring it together, what needs to be done finally in the longer term. Those are the adjustment challenges ahead and why the crisis is certainly not over. In the longer term, if it is going to survive, the Eurozone needs to become a minimal federal union. It will include the Eurozine—what I call hideously the Euro-zonization of the banking system. The banking system must be backed up and guaranteed by Eurozone-wide fiscal authority. That's what you discovered in the U.S. it seems to me in the '30s and it's irrelevant now. It must include an adequate safety net for countries in trouble, being sure that they can fund themselves on tolerable terms, which is not where they are now during the process of adjustment. And it means therefore, inevitably much greater flexibility in hitting the medium to longer-term fiscal targets than is now being allowed.

This means a profound transformation in both the institutions and the method of operation of the Eurozone acidize today and the fundamental questions are the Eurozone members willing, given the fear and terror of breakup to make those necessary reforms? They've done much more than I expected. They've done less than is necessary and I, at the moment, give the chances of success with this tremendous task about 50/50.

Thank you very much.

Marcus Noland: Am I on now? So in case you needed any proof about why Martin Wolf is the Chief Economics Commentator for the Financial Times, I think the last 30 minutes has proven his case. That is absolutely the most lucid description and analysis of a crisis that I have heard. I'm joined by Ed Kean of the Observatory Group and the National Economists Club and Ed, why don't you start us off with the question-answers, and then we'll open it up to the audience.

Ed Kean: So Martin, I was very intrigued by the point you made in your talk about the potential or the need for Germany and the Netherlands to accept higher inflation rates. I'm wondering, particularly in the case of Germany, if you could talk about the extent to which you think the German political leadership, as well as the notoriously inflation-adverse German population will be willing to accept such an outcome?

Martin Wolf: I think it's one of the most interesting questions. There's actually a little wrinkle in that. One question is whether they can prevent it and I'll come to that. I had a conversation about four years ago with a very distinguished German official—who has since left the European Central Banks Board and who's name I will not mention--at which I said, "Given where you are"—this was four years ago—"Given where you are now and what has happened in the last decade, it is obvious that we're going to have a period when this will, must be to some degree, unwound and that will mean given the target for inflation that you have in Germany"—and in the ECB which is less than 2% or close to 2%; it's never been entirely clear what the target is—they have clarified it a bit. Let's say it's 2%, "that you will have to accept for a long period an inflation rate in Germany which is higher than that target." And his response was "That is absolutely unacceptable." And then I said, "Then in that case, this is not a currency union." And so there is clearly a lot of resistance among some people to this notion.

However, it is important to note that I did this figure and you may well know it, but if actually looked at the actual average inflation rate, achieved under the [inaudible 52:05.3], in its many decades of overseeing German inflation, it actually averaged 3%. So there wouldn't be anything terribly catastrophic if it were at that sort of level or even, I think, a bit higher.

So there's a political sensitivity issue, yes, and of course it has become greater now, but a somehow higher inflation rate than 2% would not be at all extraordinary in German postwar experience. The view on whether it can be avoided is this—this is sort of the view that my friends Hans Van Sinn has been arguing now—that Germany is on the verge of having a really big credit boom and the reason, I hope this is correct, the reason for this is that the German banks are of course absolutely stuffed with cash in every possible way. I won't go into their reserve positions, which are unbelievable, but just deposits, and they really don't want to lend to anybody outside Germany because they worked out that all the people they lend to outside Germany, including Americans, British, Spanish, Irish, they're all crooks.

So—and by God are they right—and so they want to lend at home and there is, therefore, a tremendous effort he tells me by German banks to persuade German people to borrow in one way or another and it is going to be a very interesting question to see whether that resistance will be overcome. In addition to that, of course, German industry is doing very well. It's very profitable. The German Trade Unions have noticed this. They've had a very long period, a very long period of essentially zero real wage growth. They've accepted that as the price of making Germany competitive and they want some of this. So if you are optimistic, though I suspect that might not be how it feels to a German policymaker, we're going to see over the next 10 years a massive, wonderful credit plus real wage boom in Germany and it will solve the problem. Well, it won't solve the problem, but it will be an important component. That plus a weak Euro, which the European Central Bank will do it's best to deliver. Unfortunately their competing with the Fed, which is doing it's best to deliver the same thing and it's not clear to me that the European Central Bank is necessarily more determined than the Fed to weaken it's currency.

Marcus Noland: We have a microphone in the middle of the room and we have a floating microphone up here, so if there're questions. Yes sir?

Audience: Thank you.[Inaudible 00:54:42] from the University of Toronto. Thank you very much Martin. I think it really is very stimulating and mostly convincing, but it has been said that the best of the argument that I'm most convinced by is the one that I heard last. In any event, I have one important question to ask you—what I think is important—it ties to what you just said about German society. You didn't mention explicitly, although you hinted at it, that the Euro is a child of the European Union which itself was originally motivated mainly not the economic benefits thereof, but finding a way to overcome the centuries of struggles and wars.

That has so far not been brought up as an issue very much or as an argument for doing all we can and it matters a great deal. Now it may not matter on the technicalities of what is the economic mechanism of adjustment it has to go through. I would agree fully that it means for these countries, basically no other way than a big depression, and by the way there's a tiny example of Latvia, which is outside but because of a fix has similar problems to a Greece or something, which showed that economically it's not that difficult and it doesn't take that long.

But the connection with the original motivation, is there a time at which things will become so difficult politically, and so important economically, to make the EU survive by making the Euro survive, that this argument will begin to be made—let's say on the German street—that look if we give up the Euro, we have to worry about giving up the EU and it's not only economic benefits that it has provided us.

Martin Wolf: But that wasn't what I was referring to when I said that the cost to break that up are profoundly political and that it would put in question the achievements. Nobody knows what would happen if it were to dissolve. Legally it's impossible. Anybody who did this would be breaking the treaties. Now Sweden is in violation of the treaties at the moment, so nobody seems to worry about this too much, but it would be rather different if it were a core country, so the political risk associated with this are enormous. If I were to view this as an economic—purely economic structure, purely; there were no [inaudible 57:20.6]—I would say that its breakup is certain. So the 50/50 is because it's not. It's a political project. It's a political project and the political project is a very, very profound one. It doesn't need to be said secretly. Many Germans say, and many people in other countries say, that maintaining the Euro is a matter of maintaining Europe. Actually, Nicolas Sarkozy said that among many others and Hollande I think will feel exactly the same way.

I wrote a column recently which said that the political will to make this work should not be underestimated and for that reason, I think there is a very significant chance that it can be made to work, but it's going to be—what I wanted to stress—is that this is going to be a long process and there will be lots of crises along the way. And the difficulty with that is that in every one of these meetings, we associate it with a crisis. I think they've had—somebody told me they have 17 or 18 summits in the last two years, something like that, to handle this. There's always the risk that in any one of these at 4:00 in the morning, an utterly exhausted leader says, "Enough! I can't bear this anymore! Out!" And that's how catastrophes start. Look at your history.

Marcus Noland: We have a relatively little amount of time and I see that we already have a veritable murderer's row lined up here, so please make your questions concise. Why don't we take three questions as a group and you can respond. Bernie Lee.

Bernie Lee: Bernie Lee, a banking consultant here in Washington. As I look at the Euro, I've long thought that it really is fundamentally the same as a classical gold standard and when we take a look at what the history of the gold standards are, they ultimately all fail. Why should we think that this, today's gold standard, the Euro, is going to come to any different fate than the classical gold standards of the past?

Marcus Noland: Okay.

Audience: I'm [inaudible 00:59:29] Investment and Petersen Institute. Martin, until you started putting the charts up there, I thought you were talking about the U.K. and not the Euro IM because you were basically talking about an economy with imbalances, fiscal deficits, a financial sector that got in trouble. Then, what experience has shown is that the advantage of having your own central bank and your own currency helps you do nothing because the performance of the U.K. since 2009 has been essentially as bad as in Spain, or on the average of the Euro IM. So what are we learning from that experience? Aren't we learning that when you have a structural problem and there is very little the monetary and currency policies can do, and so you just have to wait and solve the problem. And second, what's the future of the U.K. given that it seems to be tied to the Euro IM and given this structure that you have given us on the Euro is about to break up. What is the U.K. going to do about that when that time comes? Thank you.

Nicolas Veron: Nicholas Veron at the Institute here and at Bruegel in Brussels. My question is also about the U.K., but it's a slightly different question. You said that we would have to see a Euro-zonization of the banking system, if I remember the vocabulary well. And the question is how this squares with the single market and how has the U.K. will manage its relationship with the unified banking union in the Eurozone, if, of course, assuming this happens? How do you see the Euro banking policy going forward under that particular assumption? Thank you.

Marcus Noland: Why don't we …

Martin Wolf: Okay, I wasn't asked to speak about the U.K., I'm very happy to give a lecture of the same length on the state of the U.K. economy and you can read my column tomorrow morning. It is a gold standard with one important exception and it is so important that it shouldn't be ignored, which is that it has a central bank. It's a shared central bank. There is a profound reciprocal commitment inherent in that central bank. If it had been a classical gold standard, it would have looked a bit like the early 30's and I would guess that it would have gone.

But in fact, that turned out to be an enormous flow of free—not free, actually relatively expensive—but manageably cheap credit, some of it very cheap, from the central bank or within the central bank and that allowed it to survive and gives it time to adjust. And I think that institution, which is the one genuine Europe zone institution, is unbelievably important and it's only relatively recently that people outside a few specialists have begun to understand how important it is.

Well I would say—I'm sorry to say this—but the difference between having a government able to borrow at 7% or 6% and one able to borrow at 2% is really quite important in terms of your freedom of maneuver, so I wouldn't want to change with Spain, and I suspect you wouldn't mind having the 2% rates. In other words, the difference is that the U.K. has relevant sovereignty and that gives it a great deal of room for maneuver which doesn't depend on the say so of other states. That matters to me. It may not matter to you. It's why I wanted us to stay out. To put it very, very crudely, and I hope this will not be taken in any way invidiously, but the idea that—let's suppose we'd been in and let us suppose we were in a situation in which the German Chancellor told the British Prime Minister how to run his fiscal affairs, how long do you think this would have gone on for? Not very long. So these differences are crucial if you care about sovereignty at all. But I would also point out that partly because of being able to cushion this in different ways and run a huge deficit very easily and tighten it relatively slowly, our unemployment rate is only 8%. That's quite a big difference.

The final question by Nicholas Veron is a really important question. When in '97 I wrote a column—I wrote three columns actually in which—two columns, in which I said, "Look this is going to happen and if it's going to succeed, if it's going to succeed, then Britain will find itself in the position which is either in the Eurozone or it's out of the EU and I remain of that view. Subsequently I came to the view if that's the choice I'd rather be out of the EU. That's my personal choice. I believe it's the choice of Britain. It may be a catastrophe for Britain. I have no idea. It may be the end of Britain as a functioning entity. We may break up into four bits. Anything can happen. It's completely unpredictable. But if that's my choice, I'd rather be outside it. That's just my choice. But it is clear that if the Eurozone successfully moves towards being a stronger federal entity with a stronger political center, which I do think is a necessary condition for successfully managing the crisis, then the relationship with the U.K. may break. The alternative may be that it works so wonderfully, that it is so successfully integrated and not on the basis of domination by one country—let's be very clear about that—but as a genuine political unity, that in the future the four component parts of the U.K. will decide that they will join as the four component parts and that will be a different history. That's a choice that could very well arise. It seems to me clear that the relationship of the U.K. with the rest of the EU will be fundamentally transformed now, whatever happens, whether it breaks or whether it resolves the crisis because the status quo in the Eurozone is not sustainable and therefore the status quo in our relationship with the EU is not going to be sustainable.

At the moment I think the best policy for the U.K. is to wait and see—very classical—don't exercise your options when they're still options. See what happens. Try to manage our own affairs much better than we have. I agree completely with the question on that and then some years from now this might be a very different set of issues for the British government. The good rule of British politics is don't make a decision before you have to.

Marcus Noland: Please.

Audience: Martin is it—as someone who comes from Holland, I was intrigued—

Marcus Noland: Could you please identify yourself?

Antoine van Agtmael: Oh sure, Antoine van Agtmael, Ashmore EMM. Coming from Holland, I was intrigued by how often you mentioned Holland next to Germany, for very logical and good reasons. But I was also surprised by how little you mentioned Switzerland, Sweden, Denmark, Finland—about Finland once—Norway, who are competitive economies that are functioning, that are neighbors with important trading relations. What do you see as their role because they must have a role?

Martin Wolf: Well the reason I didn't mention them is that I have far too many countries already and there were far too many things to discuss and they're not member of the Eurozone, though Denmark is almost so we could have included Denmark because it has had a fixed relationship for so long. I think your answer, the answer I would give, is that the experience of these countries shows, as I argued back in the early 90's when I argued for our not joining, that a well-managed countries with functioning economic systems and functioning political systems, which are small and have adjustable exchange rates, can do rather well without joining the Euro because there was a huge argument at that stage that anybody that was outside it would lose such enormous efficiency benefits at various times that they would become a backwater and that was very much an argument in the U.K.

I think we can safely say, looking at the experience of these countries, that those fears were wrong and that would justify my view that it was not necessarily the best possible thing to create the Euro, but I think these countries, so long as the Eurozone functions and therefore the Europe functions it's economic system, all seem to me to be in great shape. I didn't go into the Latvian case, by the way, which you mentioned. I shouldn't do this, but I'll mention a story to you, which will amuse you and is relevant.

Last September, I went to Italy to talk to a very senior official. In this case I won't indicate who it was, but had an important role and it was clear that he was then thinking about exit. That was quite a shock to me and he said to me, "These people, they think we are Latvia. We are not Latvia." Okay?

Marcus Noland: We are approaching the witching hour, so let me abuse my privilege of being the co-host here to ask the final question.

Martin Wolf: Oh dear.

Marcus Noland: You ended your presentation with a description of a short run that is 5-10 years long that involves profound downturns and you mentioned in passing youth unemployment in some of these countries are 25-50%. What do you think the likelihood is of the rise of serious mass politically radical movements in these countries? And if that were to occur, given the sort of multi-national aspect of this whole program, what would be the effect on the governance of the European union?

Martin Wolf: I think it's probably the biggest question, and since I'm not a political scientist, I'm going to largely duck it, but I'll make two points or three points. First, I've tended to be moderately optimistic about this for two reasons. One, European countries are very old. The youth unemployment is very high, but there aren't many youth and though parents care about them, you don't start a revolution with 60-year-olds is my theory. They're conservative and though their benefits maybe cut, they're still not going to overturn governments and it's not 1848 in other words. Demographically we're not 1848. And secondly, a very large part of the elites, politically, economic and social, in all European countries, are deeply and totally invested in the European project and they sustain that through the political parties, the business interests, and so forth.

These are incredibly powerful conservative forces. Beyond that I would stress that, and that's my second major point, that all major European countries have had experiences, which are still living memories, though fading, of total political catastrophe brought about by extremism. In some cases this was war. In some cases of course it was civil war. In some cases it was both and people aren't that stupid. They know this.

Finally, we are seeing signs, of course, of extreme parties emerging. Look at the vote for Marine Le Pen in the Presidential Election. Look at what's happening in the Netherlands—I'm sorry come back to the Netherlands—which has been very remarkable in populous parties. But they have come nowhere near getting the sort of vote shares that is needed to get close to power and I think if they did, all the other parties would unite against them. All the other parties would unite against them and so you would never have the situation famous in '33 when essentially the German conservatives allowed Hitler in, though he'd actually only won a third of the votes.

So I am moderately optimistic and that's why my modern optimism got through, that political stability can be sustained despite these very, very depressing circumstances and in addition, by the way, a lot of the brightest and most able young people—and this is a tragedy; it's actually real—you can read it in the papers now, that a lot of the brightest mentality younger people would simply leave and go elsewhere. That threatens these countries with long-term implosion, but it doesn't lead to political instability.

My concern in the end, if it survives, is more that quite a number of countries might actually effectively not turn out to function in the future, but I think the fear of voter instabilities is not that great. And I would just make the final comment. The most important country by far, of course, is Germany and I think this is very important in the optimistic view that it will be fixed. Fringe parties have done consistently very, very badly in Germany through all the ups and downs since the war, for God knows understandable reasons and the Sinter's parties, the Christian Democrats, the Free Democrats on a good day, the SBD and the Greens are all overwhelmingly pro-European. In fact, if you had a grand coalition, which I had sort of suspected Anglo-American Chancellor to go for, they could pass through Euro bonds tomorrow.

So the political will, the core of the political systems in Europe, must not be underestimated and the danger from extreme forces must not be exaggerated. I may turn out to be, I've ventured into political—hugely over-optimistic, but I am reasonably optimistic that the center will hold in Europe, even in these very stressful times. In fact, I'm going to end up with a barb. I'm more optimistic in this regard about Europe than America.

Marcus Noland: Ah. Ed, I was about to say that I managed to extract something optimistic out of Martin, but that last comment at the end, I may have to retract that. Would you like to make any final comments?

Ed Kean: No, I think we can wrap this up. Thank you all for coming.

Marcus Noland: Well thank you very much on behalf of the Petersen Institute and the National Economists Club. Thank you most of all to our guest, Martin Wolf.

Martin Wolf: The full presentation with all the notes and everything will be up somewhere at Petersen if anybody's interested and the pretty pictures.

Marcus Noland: Thank you Martin. Meeting adjourned.