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Why is the euro zone crisis not over?

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Peterson Institute, Washington DC

Why is the eurozone crisis not over?

“The effort to bind states together may lead, instead, to a huge increase in frictions among them. If so, the event would meet the classical definition of tragedy: hubris (arrogance); ate (folly); nemesis (destruction).”

Martin Wolf, FT, December 1991.

Why is the eurozone crisis not over?

- I am going to address seven questions:
 1. Why was creating the euro a bad idea?
 2. Why is breaking the euro zone up a bad idea?
 3. What does the euro-zone need to achieve?
 4. Why is a correct understanding a precondition for success?
 5. What are the causes of the crisis?
 6. What needs to be done now?
 7. What needs to be done in the longer term?

1. Why was creating the euro a bad idea?

- My reasons for skepticism:
 - The euro assumed that the balance of payments would not matter, but it would re-emerge as a credit constraint;
 - The euro tied together fundamentally different economies;
 - The euro eliminated the exchange-rate pressure valve;
 - The euro put adjustment pressure on nominal wages; and
 - The euro offered next to no insurance arrangements.
- In short, the euro was likely to exacerbate tensions, not ease them, and weaken European unity rather than strengthen it.

2. Why is breaking the euro zone up a bad idea?

- Unfortunately, it is impossible to unmake an omelet.
- Partial break-up undermines the idea of irreversibility and may be impossible to contain.
- A comprehensive break-up would be a big shock to:
 - The European and perhaps even global, financial and economic systems; and to
 - The political credibility of the post-war European order.
- The idea was to make the euro project irreversible, by imposing huge costs on exit. The costs are real.

3. What does the euro-zone need to achieve?

- We already know that the project as designed has failed.
- We know this because of the arrangements that have been created during the crisis, particularly new support arrangements and now the fiscal compact.
- I think of this as rebuilding an aircraft while it is crashing. The process is not yet finished.
- The big question is whether the feasible political set intersects with the feasible economic set.

4. Why is a correct understanding essential?

- If the euro zone is to succeed, it has to start with a correct and agreed understanding of what has gone wrong
- Unfortunately, it does not have such an understanding:
 - The German official view is incorrect; and
 - It is also not agreed
- This is not a fiscal crisis. It is, fundamentally, a balance-of-payments *cum* financial crisis.
- Viewing it as a fiscal crisis is a path to calamity.

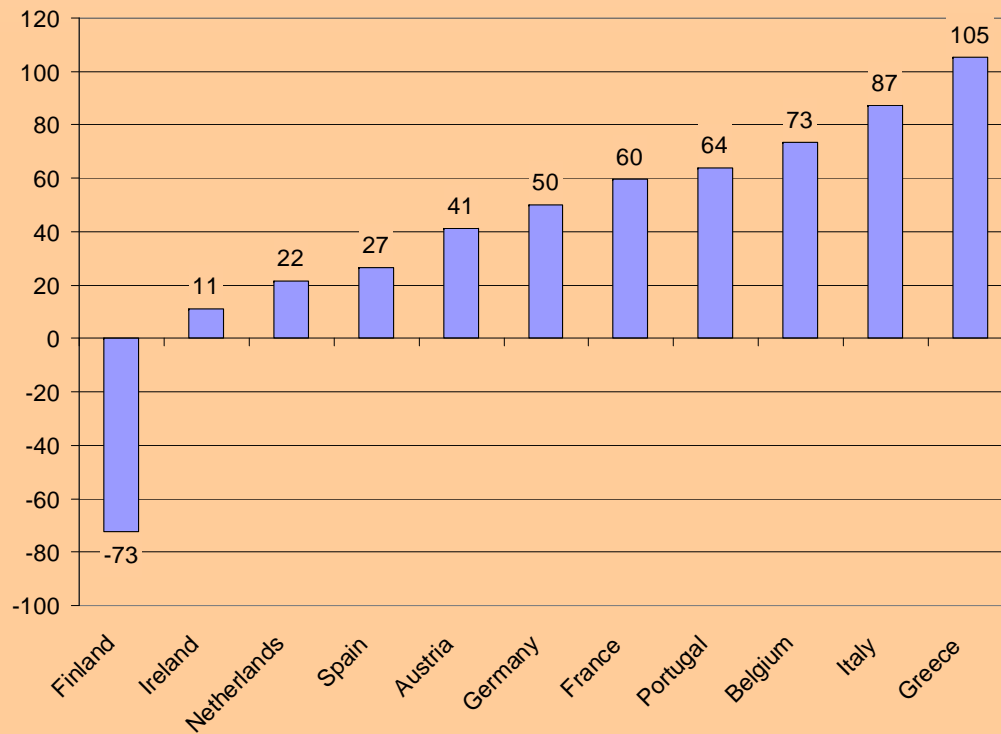
5. What are the causes of the crisis?

- The crisis is directly the result of divergences accumulated in the years of excess
- What made everything seem so good was in fact laying the ground for an acute crisis
- It mattered less whether private or public sectors were financed than how big external finance turned out to be
- When the flows of finance stopped, there were huge crises

5. What are the causes of the crisis?

NOT THE ROAD TO THE EUROZONE CRISES

NET PUBLIC DEBT 2007
(relative to GDP)

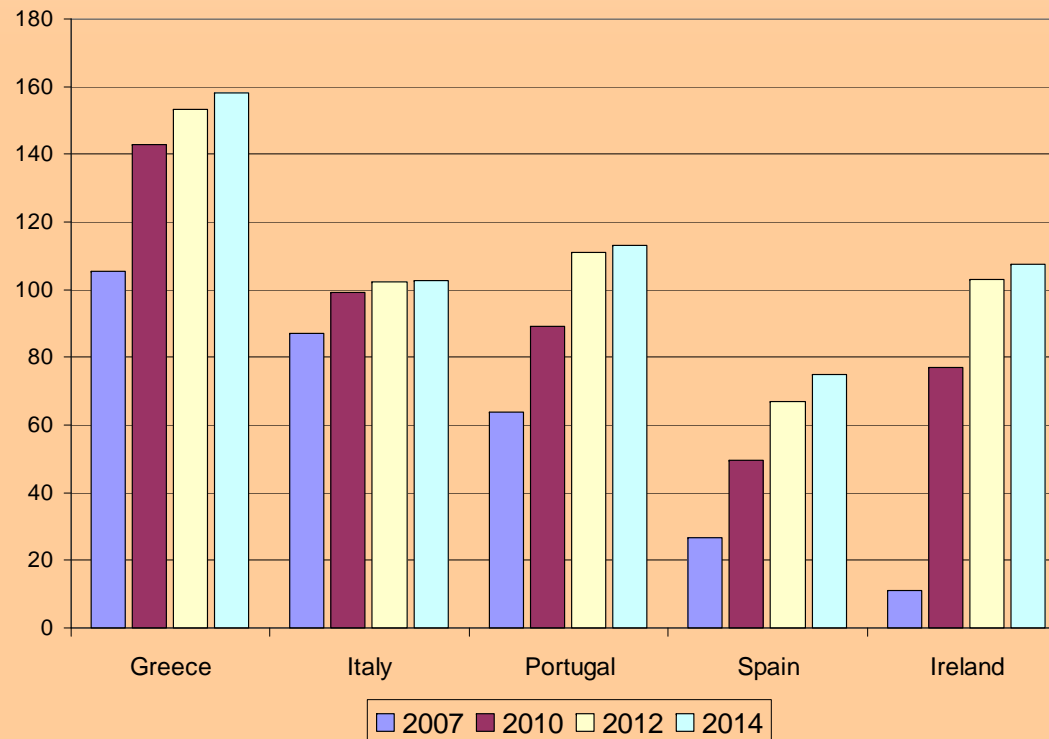


5. What are the causes of the crisis?

NOT THE ROAD TO THE EUROZONE CRISIS

NET PUBLIC DEBT (over GDP)

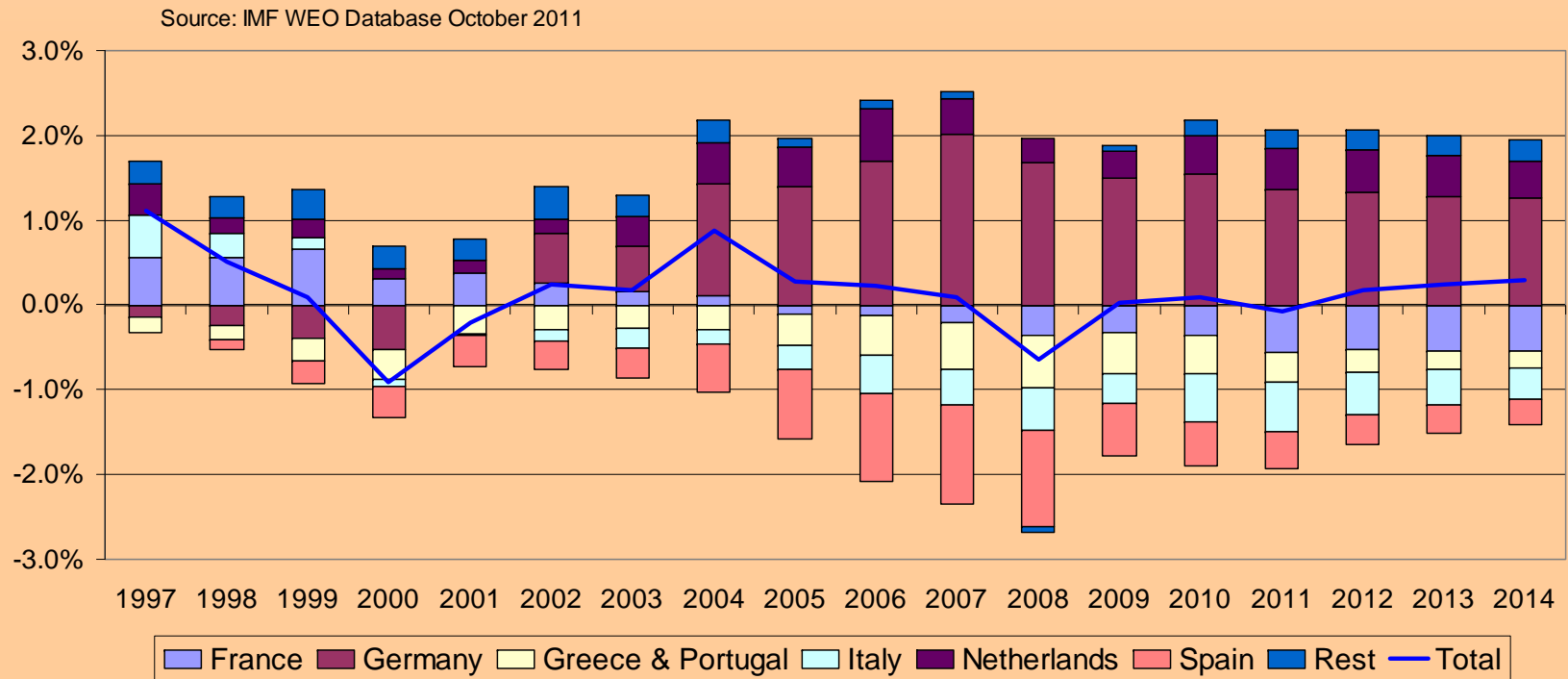
Source: IMF WEO database April 2012



5. What are the causes of the crisis?

THE ROAD TO THE EUROZONE CRISES

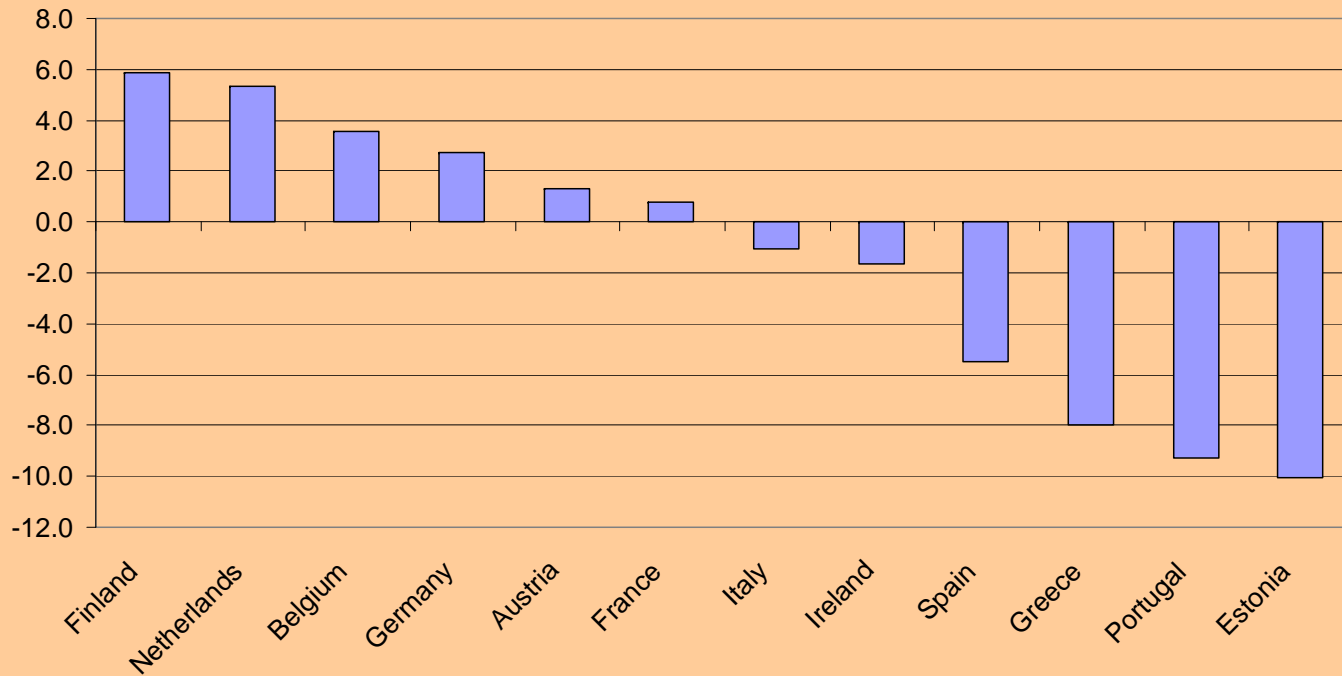
CURRENT ACCOUNT IMBALANCES IN THE EUROZONE (as a share of eurozone GDP)



5. What are the causes of the crisis?

THE ROAD TO THE EUROZONE CRISES

CURRENT ACCOUNT BALANCES
(1997-2007 averages, per cent of GDP)

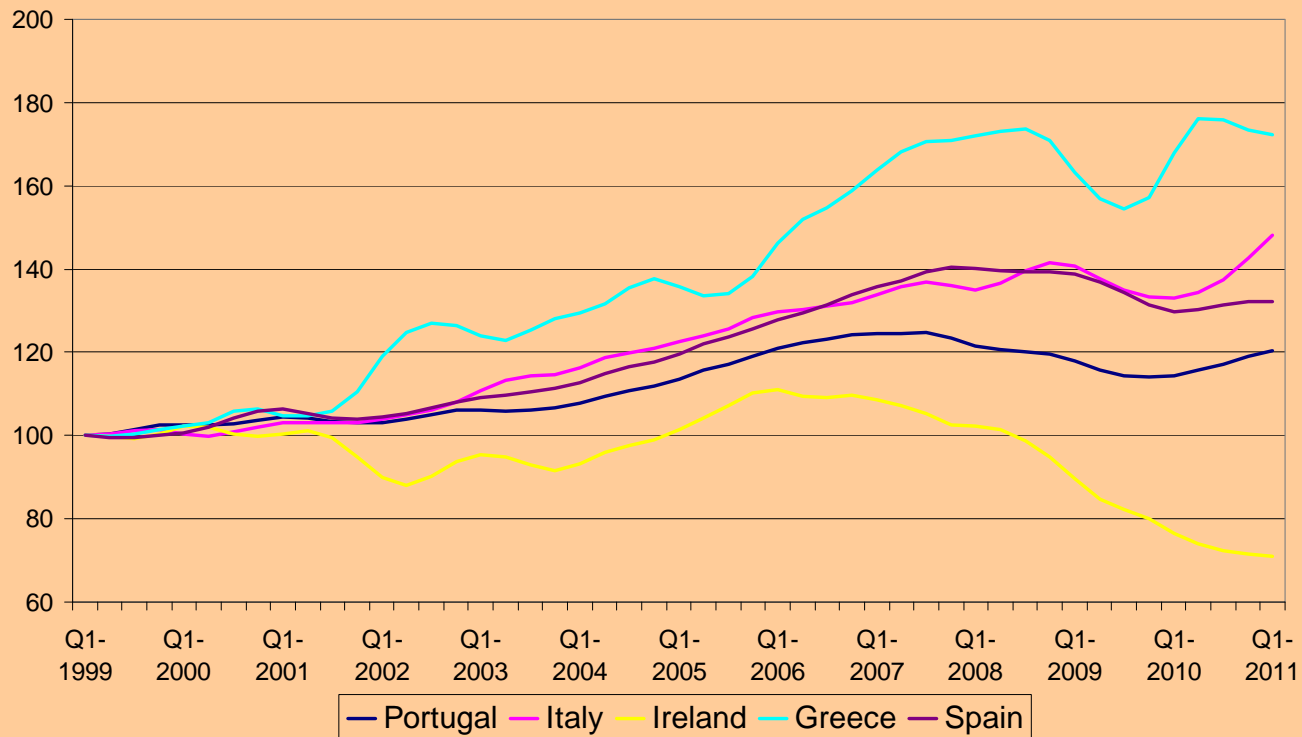


5. What are the causes of the crisis?

LOST COMPETITIVENESS

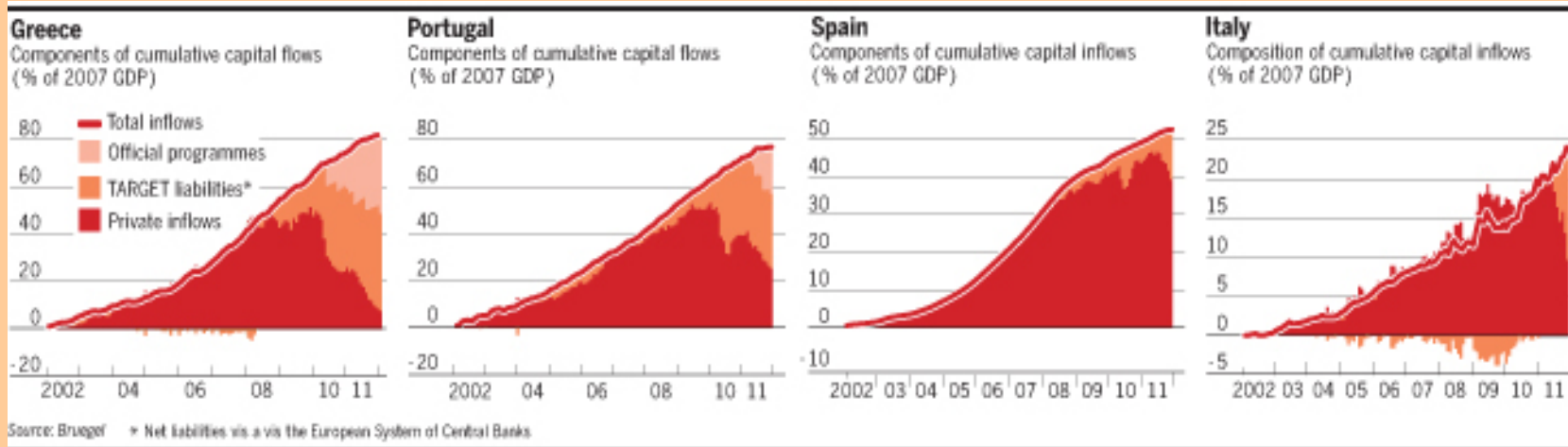
UNIT LABOUR COSTS IN MANUFACTURING RELATIVE TO GERMANY

Source: OECD



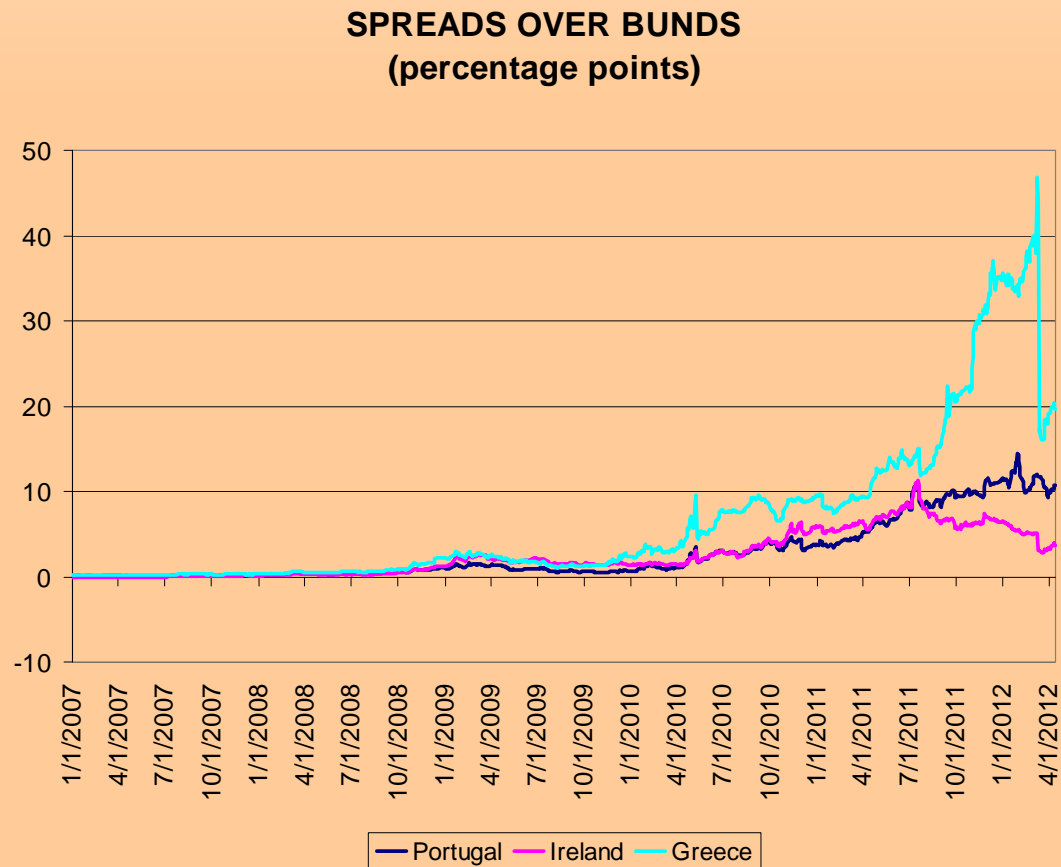
5. What are the causes of the crisis?

HOW THE MONEY CAME IN AND OUT



5. What are the causes of the crisis?

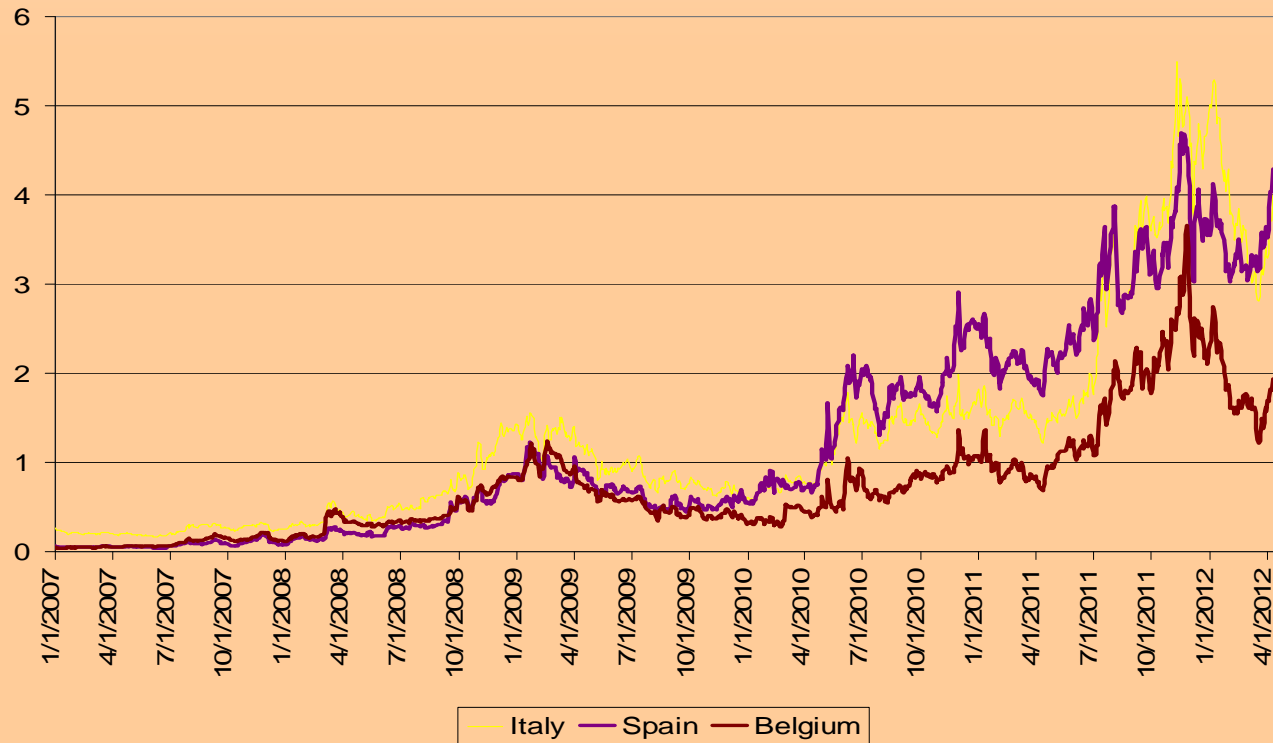
ROAD TO THE EUROZONE FISCAL CRISES



5. What are the causes of the crisis?

THE ECB'S INTERVENTION BLIP

SPREADS OVER BUNDS
(percentage points)



5. What are the causes of the crisis?

THE LINK BETWEEN BANKS AND SOVEREIGNS

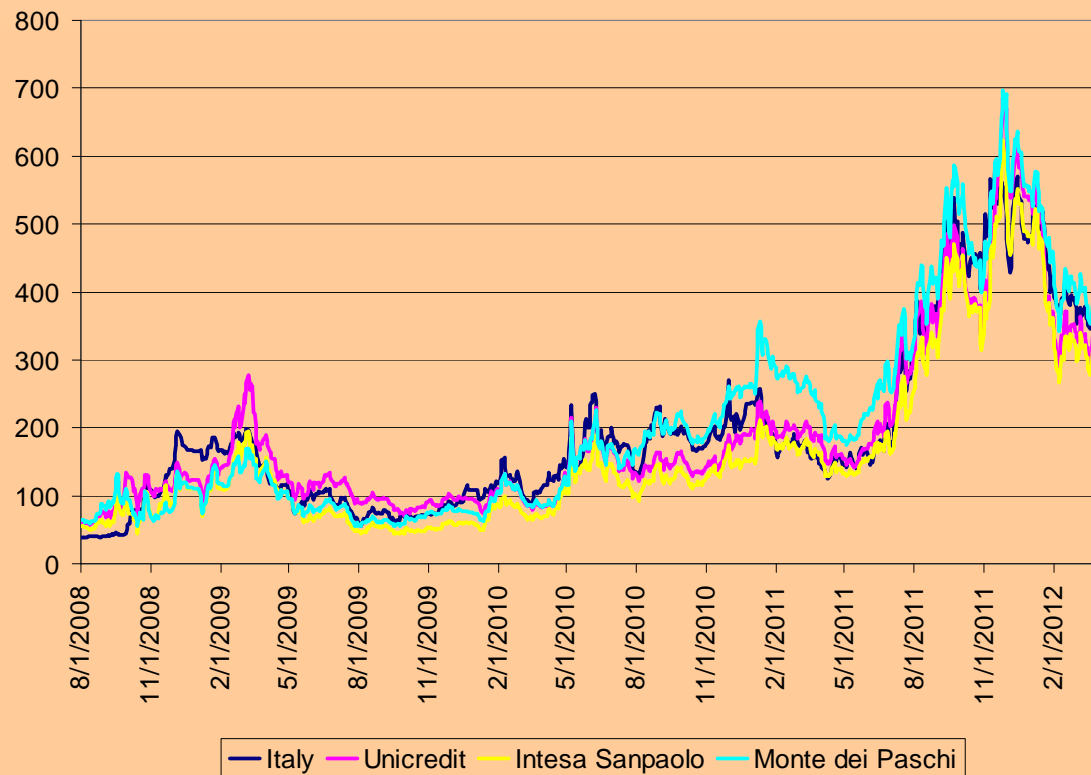
CREDIT DEFAULT SWAP SPREADS



5. What are the causes of the crisis?

THE LINK BETWEEN BANKS AND SOVEREIGNS

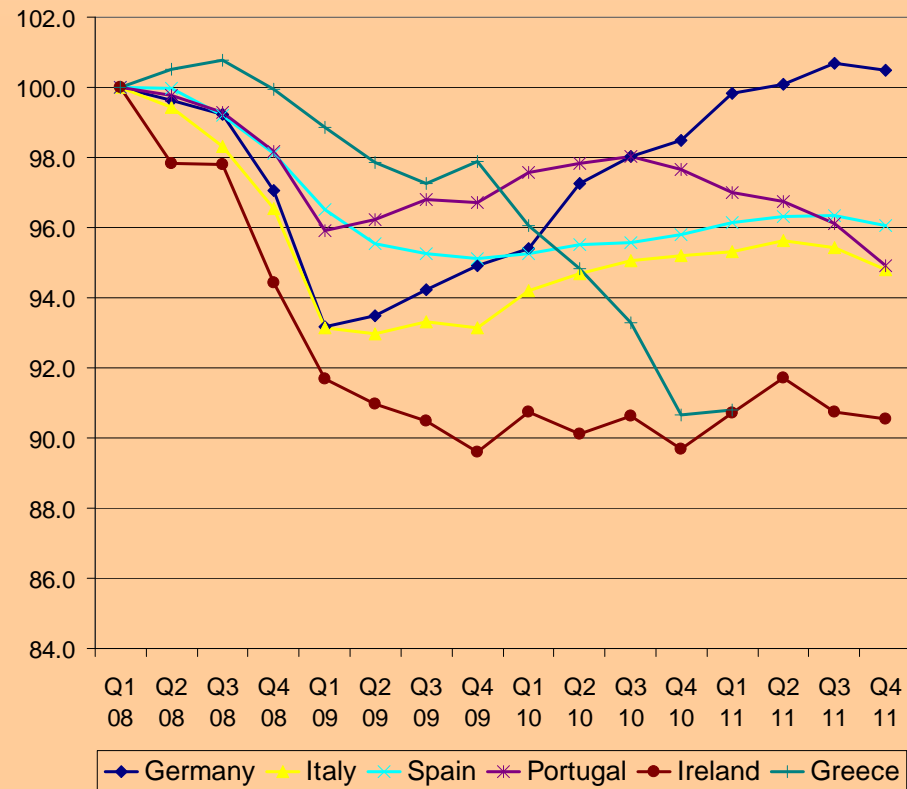
CREDIT DEFAULT SWAP SPREADS



5. What are the causes of the crisis?

THE PATH TO STAGNATION

REAL GDP IN THE EUROZONE



5. What are the causes of the crisis?

THE PATH TO STAGNATION

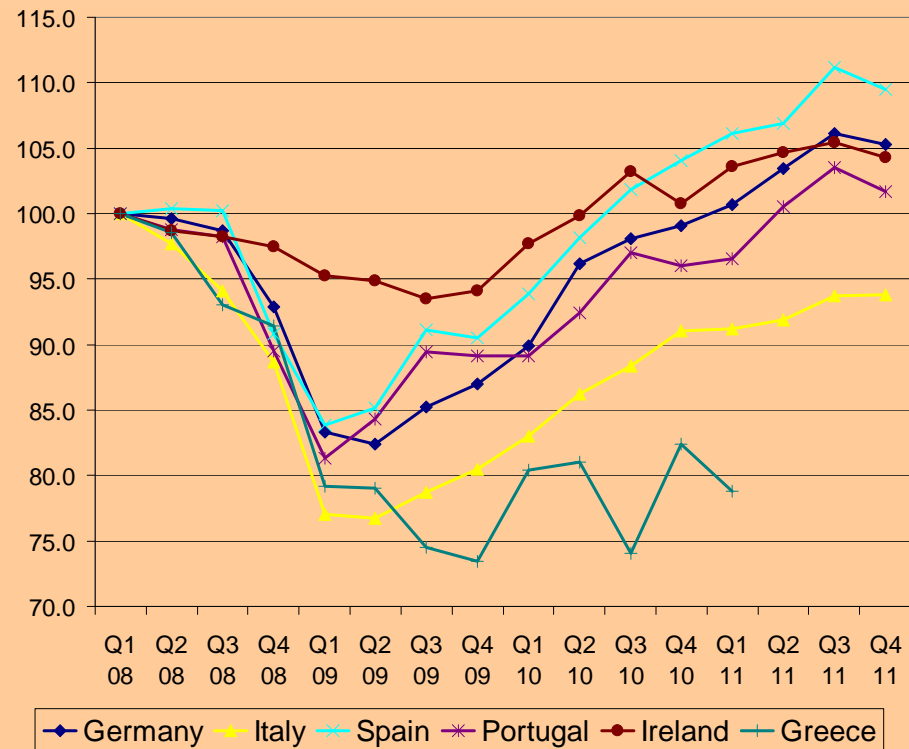
UNEMPLOYMENT RATES



5. What are the causes of the crisis?

SOME SIGNS OF LIFE IN EXPORTS

EXPORTS OF GOODS AND SERVICES SINCE THE CRISIS (in constant prices)



5. What are the causes of the crisis?

- Much of this is shared with other crisis-hit countries (e.g. US or UK)
- The difference are two:
 - No exchange rate flexibility; and
 - No true central bank.
- Challenge: financing in the short run and adjustment in the longer run.
- With a transfer union, financing would be solved automatically, but adjustment would be postponed forever. That would be bad.

5. What are the causes of the crisis?

- In an incomplete union, the financing may be unavailable, but adjustment is enforced.
- But this risks defaults and then break-up.
- The ECB, governments and IMF have partially solved the financing problem.
- The adjustment will take many years and create huge problems – high unemployment; debt deflation; and defaults in private and public sectors.
- This is not the same as the German adjustment, which occurred during a boom

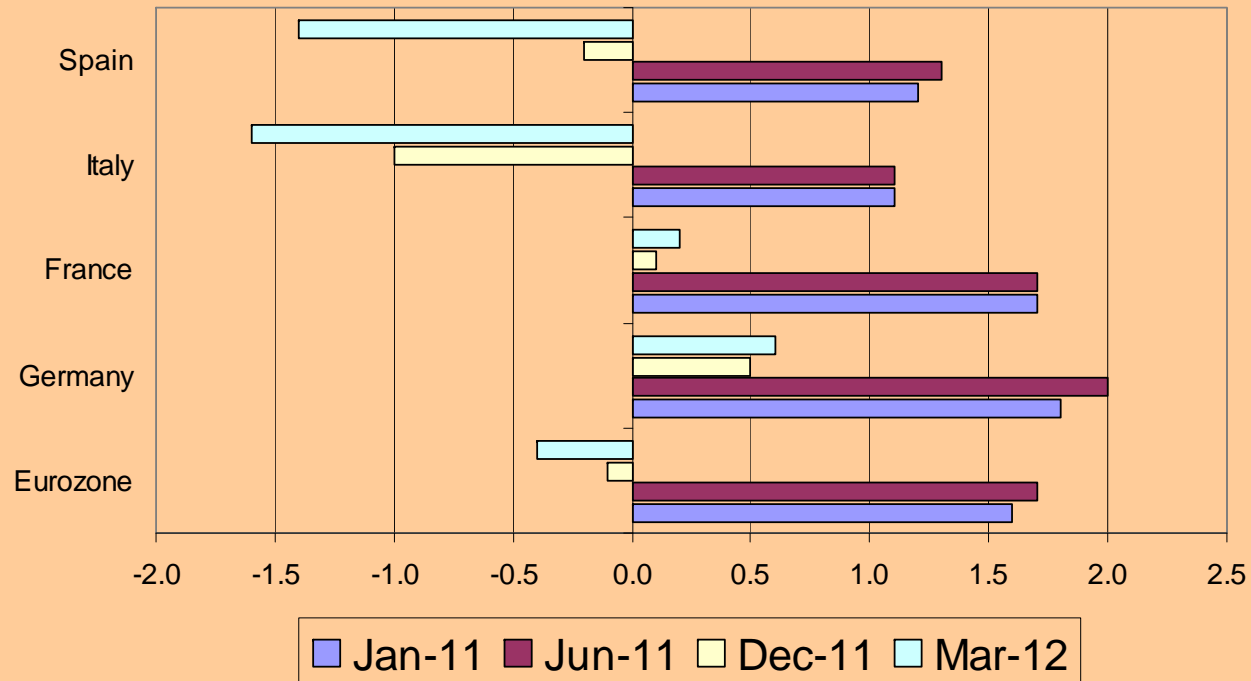
6. What needs to be done now?

- The solution is:
 - Short-term financing on a scale and time-period sufficient to allow real adjustment to occur, in the absence of devaluation
 - at least five years;
 - Bank re-capitalisation on a scale sufficient to manage plausible losses; and
 - Adjustment by both surplus and deficit countries, in the context of dynamic aggregate demand and a significant relative rise in prices in core countries, via divergent inflation
 - A path for fiscal adjustment that matches the plausible pace of adjustment of external and private sector accounts

6. What needs to be done now?

GROWTH PROSPECTS DWINDLE FOR 2012

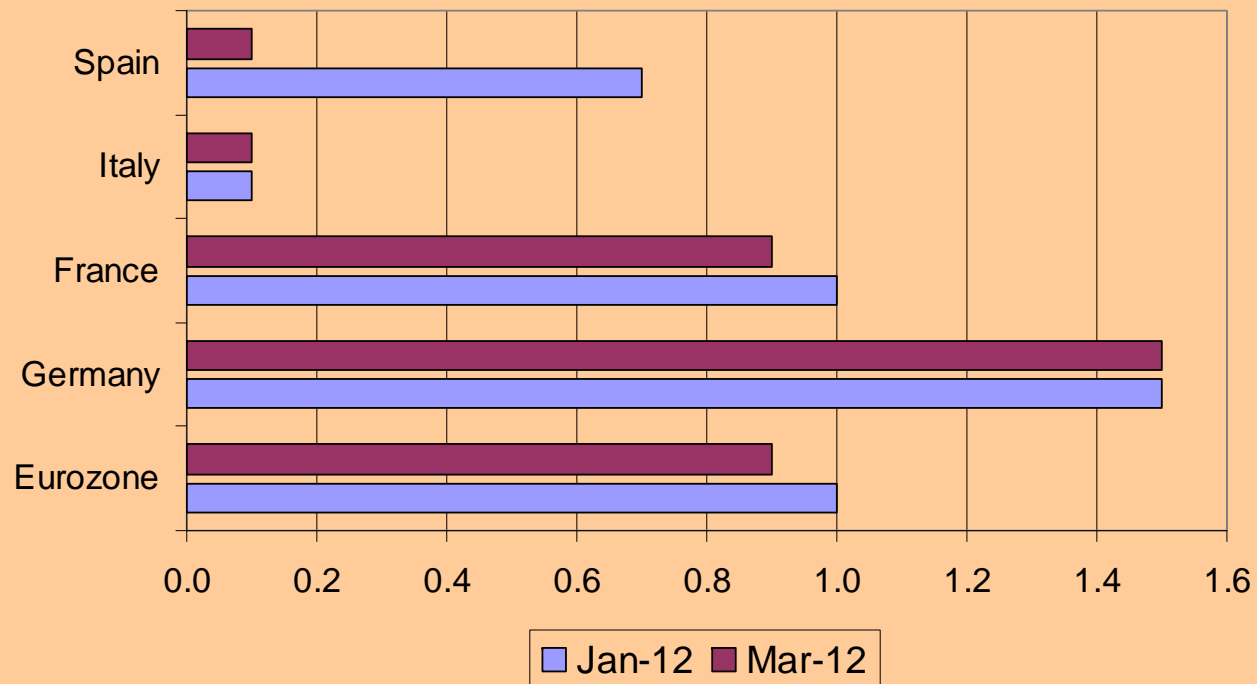
SUCCESSIVE CONSENSUS FORECASTS FOR GROWTH IN 2012



6. What needs to be done now?

GROWTH PROSPECTS DWINDLE FOR 2013

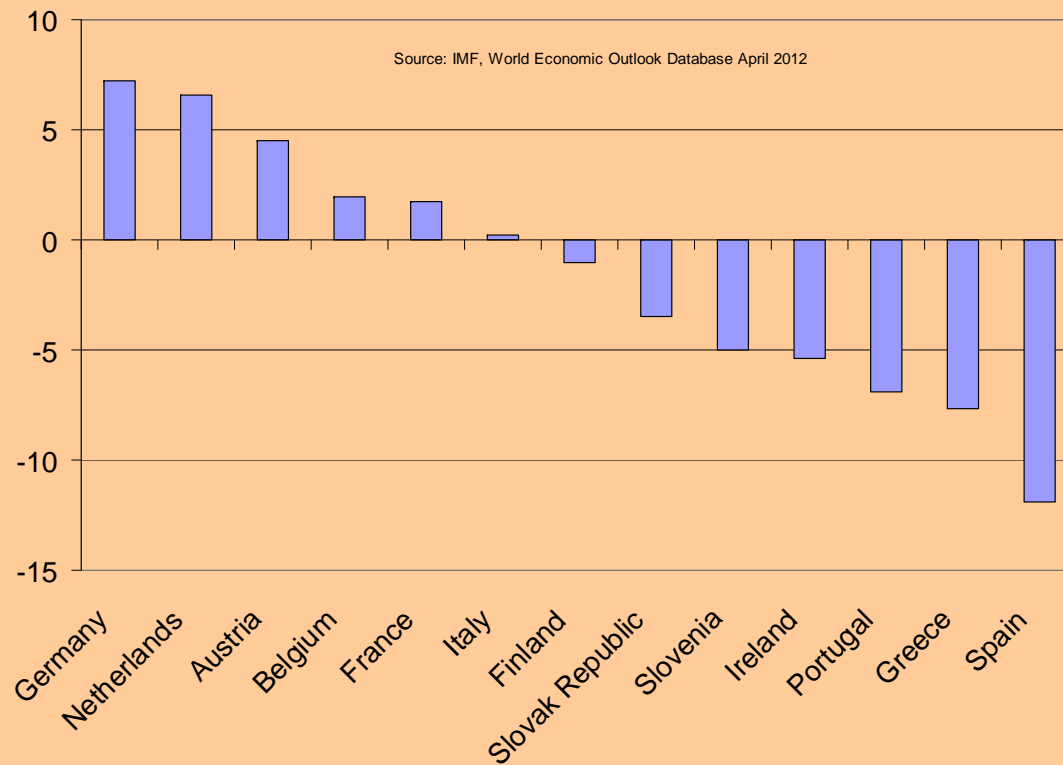
CONSENSUS FORECASTS FOR GROWTH IN 2013



6. What needs to be done now?

THE PRIVATE SECTOR PRE-CRISIS DIVERGENCE

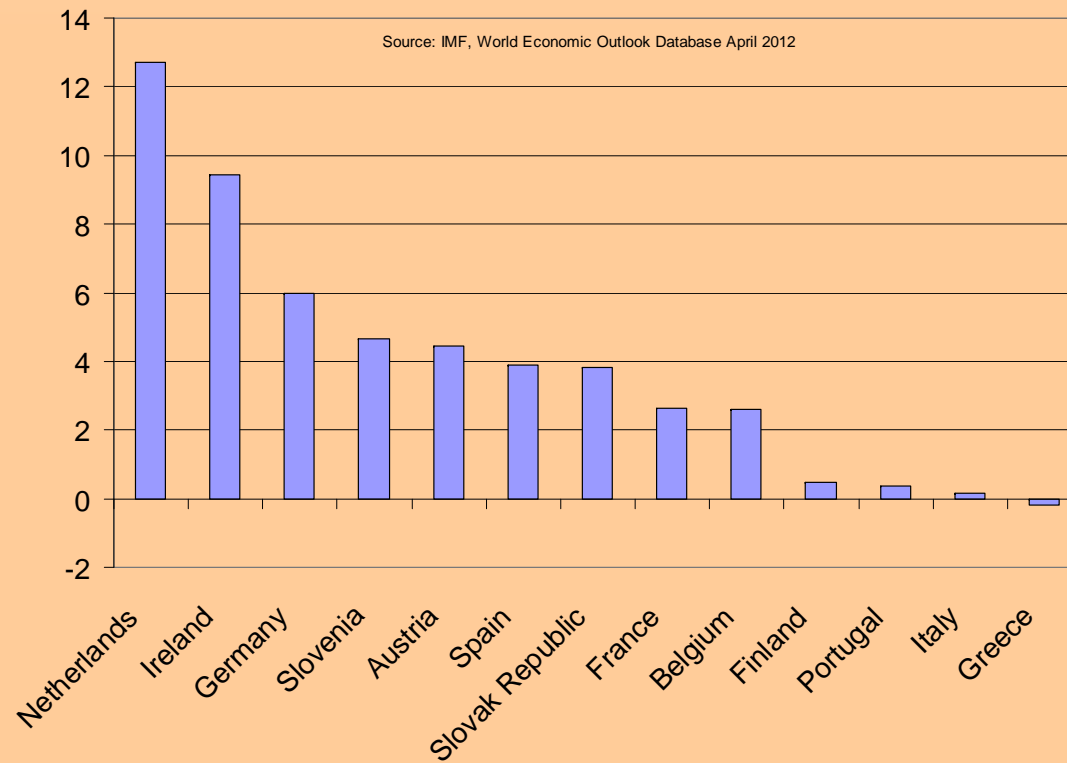
PRIVATE SECTOR FINANCIAL BALANCES 2007



6. What needs to be done now?

THE PRIVATE SECTOR PRE-CRISIS CONVERGENCE

PRIVATE SECTOR FINANCIAL BALANCES 2012



7. What needs to be done in the longer term?

- In the long term, the euro zone needs a minimum federal union
- This should not include permanent cross-border fiscal transfers
- It should include:
 - "eurozonisation" of the banking system;
 - An adequate safety net for countries in trouble (many times bigger than the European Stability Mechanism) and a mechanism for containing interest rates on sovereign bonds for countries that are adjusting.
 - And so a more supportive central bank; and
 - The fiscal compact should be scrapped, in its present form.
- Such a "eurozonisation" of the banking system would be possible without a budgetary backup if (and only if) banks could be resolved without budgetary support.

7. What needs to be done in the longer term?

- It is clear that willingness to reform was substantial, once it became obvious that the original design had failed
- But the willingness to reform has also been insufficient
- The obstacles to adequate reform are of three kinds:
 - economic (it is hard to make this work);
 - ideological (difference in economic viewpoints are large); and
 - political (countries and peoples do not like one another very much and do not identify with one another very much and the misery is unexpected)
- Will the euro zone survive another decade?
- I give it 50:50.